NOMURA

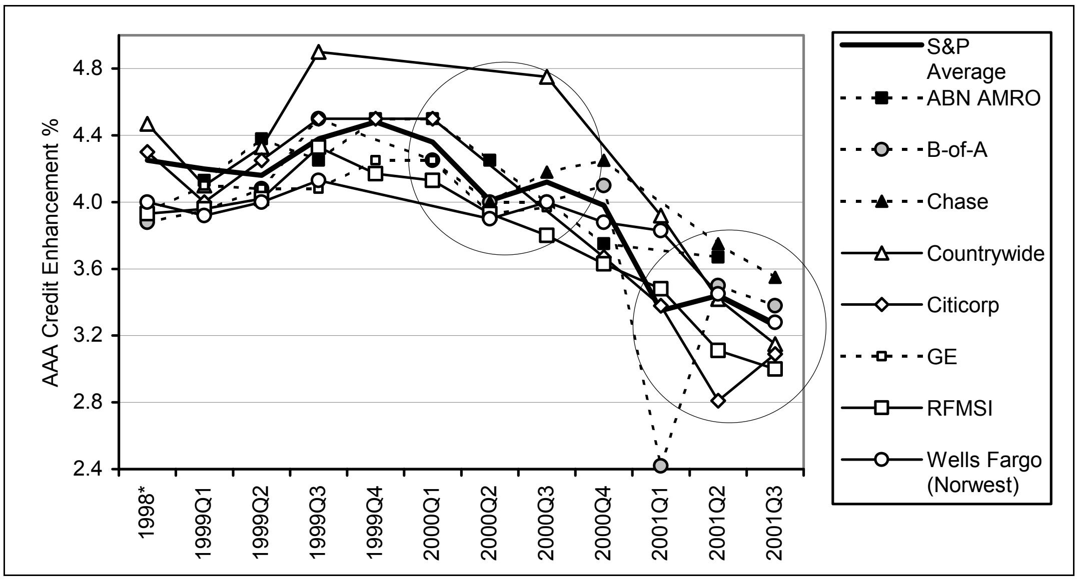
Jumbo MBS Credit Enhancement: More of the Same, or Less?[1]

5 December 2001

With two more quarters of available data, the trend of declining credit enhancement levels for jumbo mortgage securitizations is continuing. We believe that the reductions in credit enhancement levels are difficult to justify based on the reportedly improving credit characteristics of the underlying mortgage loans.

As reported by Standard & Poor's, the average credit enhancement level for triple-A-rated classes of deals backed by 30-year, fixed rate jumbo mortgage loans (FRM30s) dropped from 3.98% in the fourth quarter of 2000 to 3.26% in the third quarter of 2001. The trend in the average was punctuated by a very steep decline in the first quarter of 2001, but the trend for most individual issuers has been smoother, as shown on Chart 1:

Chart 1: Quarterly Average AAA Credit Enhancement Levels for Jumbo FRM30 Deals



*full year 1998
Source: Standard & Poor's

The decline in triple-A credit support levels appears to have been based primarily on lower reported loan-to-value ratios (LTVs) and, secondarily on higher FICO scores. Chart 2 and Table 1 show how the reported LTVs for FRM30 deals from a number of the major MBS issuers declined in recent quarters. Similarly, Chart 3 and Table 2 show how the corresponding FICO scores rose.

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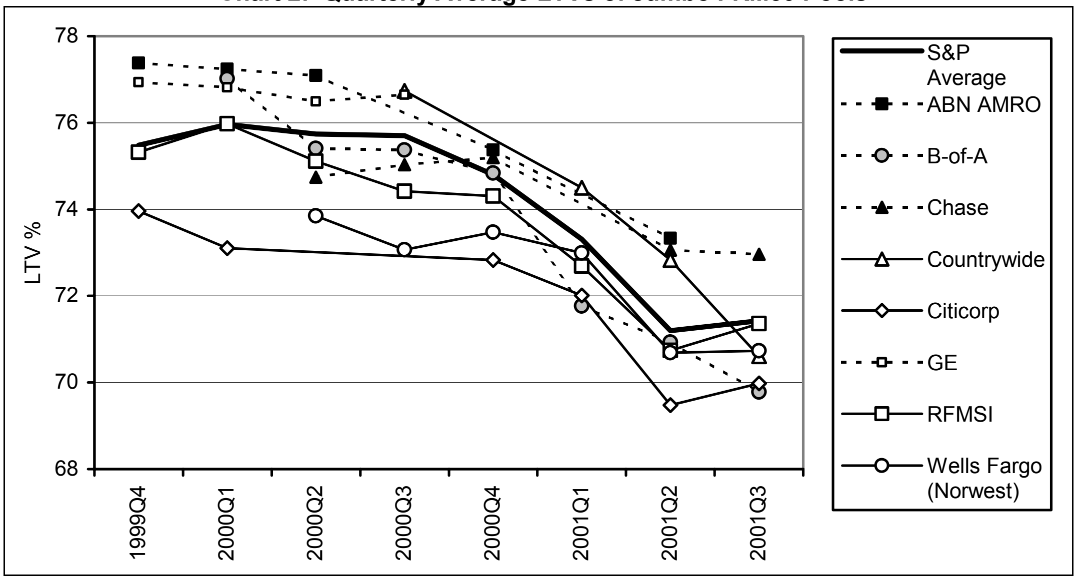
[1] This market letter updates our report of 12 June 2001 titled *Jumbo MBS: Where's the Credit Enhancement?*

Chart 2: Quarterly Average LTVs of Jumbo FRM30 Pools



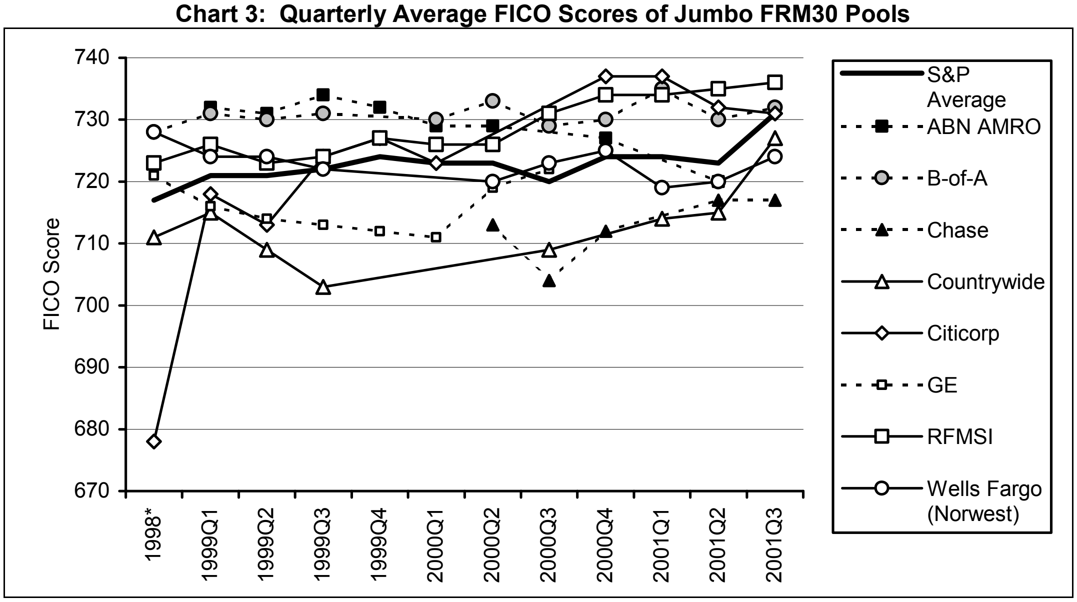
Source: Standard & Poor's

Table 1: Quarterly Average LTVs of Jumbo FRM30 Pools

	1999Q4	2000Q1	2000Q2	2000Q3	2000Q4	2001Q1	2001Q2	2001Q3
S&P Average	75.48	75.96	75.74	75.70	74.80	73.31	71.20	71.43
ABN AMRO	77.38	77.24	77.09		75.37		73.33	
B-of-A		77.02	75.41	75.37	74.84	71.77	70.93	69.78
Chase			74.74	75.03	75.19		73.06	72.96
Countrywide				76.74		74.50	72.83	70.61
Citicorp	73.96	73.10			72.83	72.01	69.48	69.98
GE	76.94	76.82	76.49	76.65				
RFMSI	75.32	75.98	75.11	74.42	74.31	72.69	70.74	71.36
Wells Fargo (Norwest)			73.85	73.07	73.47	72.99	70.69	70.73

Source: Standard & Poor's

Chart 3: Quarterly Average FICO Scores of Jumbo FRM30 Pools



*full year 1998
Source: Standard & Poor's

Table 2: Quarterly Average FICO Scores of Jumbo FRM30 Pools

	1998*	1999Q1	1999Q2	1999Q3	1999Q4	2000Q1	2000Q2	2000Q3	2000Q4	2001Q1	2001Q2	2001Q3
S&P Average	717	721	721	722	724	723	723	720	724	724	723	731
ABN AMRO		732	731	734	732	729	729		727		720	
B-of-A	728	731	730	731		730	733	729	730	735	730	732
Chase							713	704	712		717	717
Countrywide	711	715	709	703				709		714	715	727
Citicorp	678	718	713	724	727	723			737	737	732	731
GE	721	716	714	713	712	711	719	722				
RFMSI	723	726	723	724	727	726	726	731	734	734	735	736
Wells Fargo (Norwest)	728	724	724	722			720	723	725	719	720	724

*full year 1998
Source: Standard & Poor's

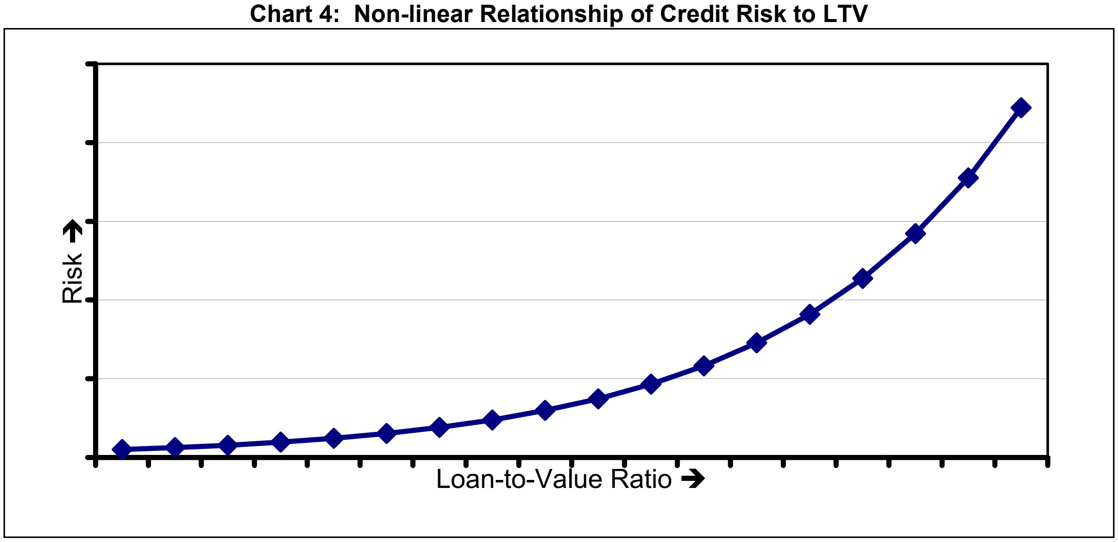
As shown on Chart 2, the decline in reported LTVs was in the ballpark of 3 percentage points for most issuers and about 5 percentage points for B-of-A. However, the decline started from the already moderate level of about 75% LTV. So, does the drop of 3 percentage points of LTV support reducing credit enhancement by roughly 70 basis points, or nearly one-sixth of the total amount? We think not.

Clearly, lower LTVs imply lower risk in the underlying mortgage loans. On the other hand, the reported lower LTVs are associated with a period of continued rapid home price appreciation. This argues for taking the reported numbers with a grain of salt. Only time will tell whether the rapid trend of appreciation during the first half of 2001 will be sustainable or whether it was the peak of a cycle.[2]

Moreover, the proportion of refinance loans has exceeded 50%, on average, in recent quarters. This means that the main basis for determining the value used in calculating LTVs is appraisals, rather than arms-length transactions. Appraising real estate is hardly an exact science. The high proportion of refinance loans therefore warrants yet another grain of salt.

Lastly, the relationship between LTV and the credit risk of a mortgage loan is not linear. In the range of 75% LTV, modest changes in LTV produce smaller changes in risk than they would at higher LTV ranges. At high LTV levels, risk changes more abruptly with shifts in LTV. At lower LTV levels, changes in LTV translate into smaller changes in risk. In other words, the relationship of risk to LTV is convex. Chart 4 illustrates the relationship:

Chart 4: Non-linear Relationship of Credit Risk to LTV



[2] See HPI <Index> <Go> on Bloomberg to see U.S. housing price indices compiled by OFHEO.

The same kind of relationship holds true for FICO scores. Risk increases at faster and faster rates as FICO scores decline. Risk becomes smaller at slower and slower rates as FICO scores rise. Indeed, in certain respects, FICO scores are even designed around the notion of an exponential function. See Chart 5.

The very small change in FICO scores recorded over the past year is not sufficient to contribute significantly to the decline in credit enhancement levels.

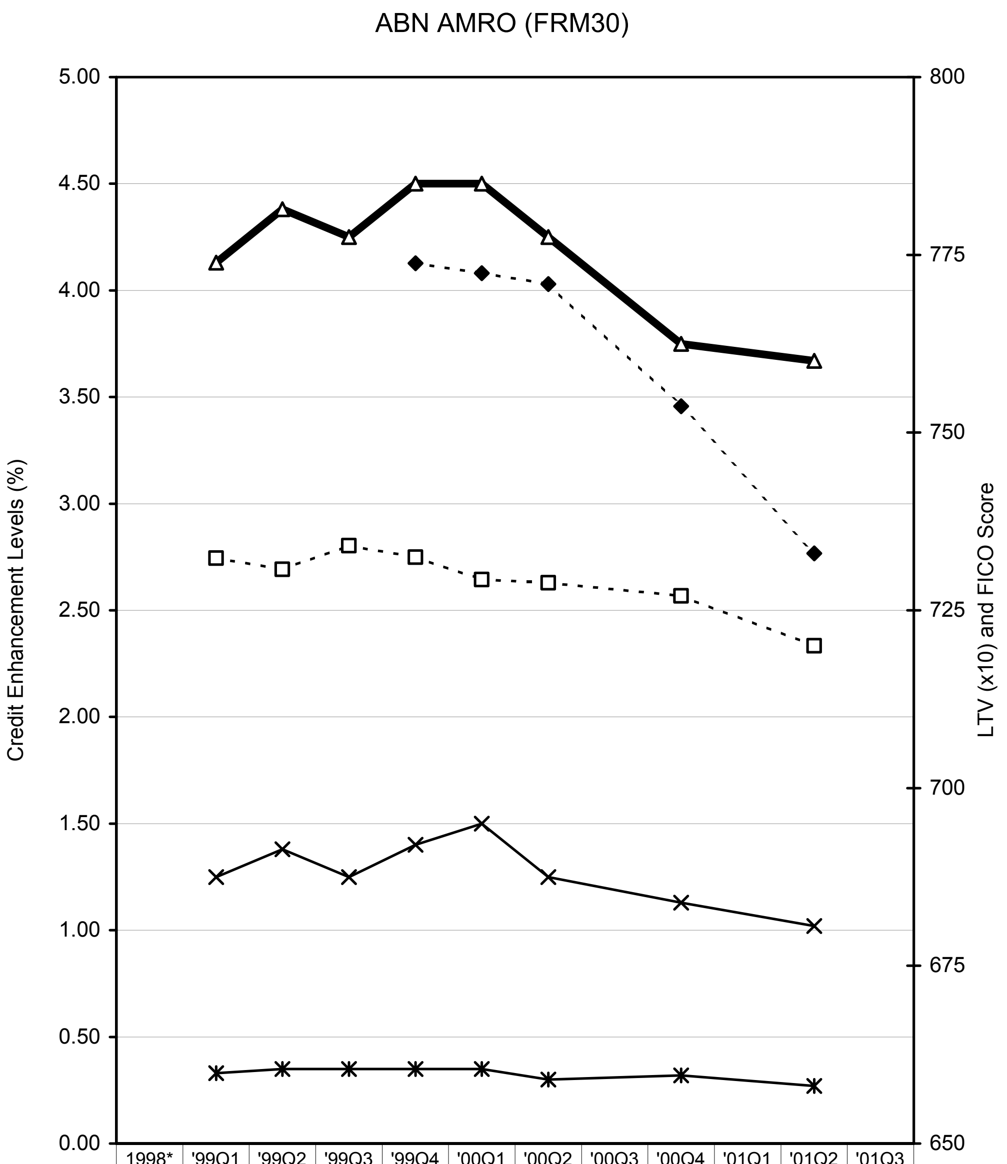
Chart 5: Non-linear Relationship of Credit Risk to FICO Score

In short, we believe that the continuing decline in credit enhancement levels is making newly issued MBS riskier than older MBS. Accordingly, we believe that it is now more important that ever to differentiate among MBS issuers. Issuers with strong origination practices and excellent track records – such as Wells Fargo and Cendant – should continue to produce consistently good deals. Their deals will be less likely to draw heavily on their credit enhancements. For other issuers – those with weaker origination practices or lackluster track records – the likelihood of producing a disappointing deal seems much greater.

The overriding theme is quality. Until market pricing firmly differentiates deals from different issuers, investors should exercise their right to be choosy and steer their investment decisions toward deals from the top-quality issuers. Remember, S&P's credit enhancement model does not take into account the identity of the issuer; the model is based entirely on the reported characteristics of the loans. Investors have a chance to "beat" the model by considering a factor that the model ignores.

I. Appendix

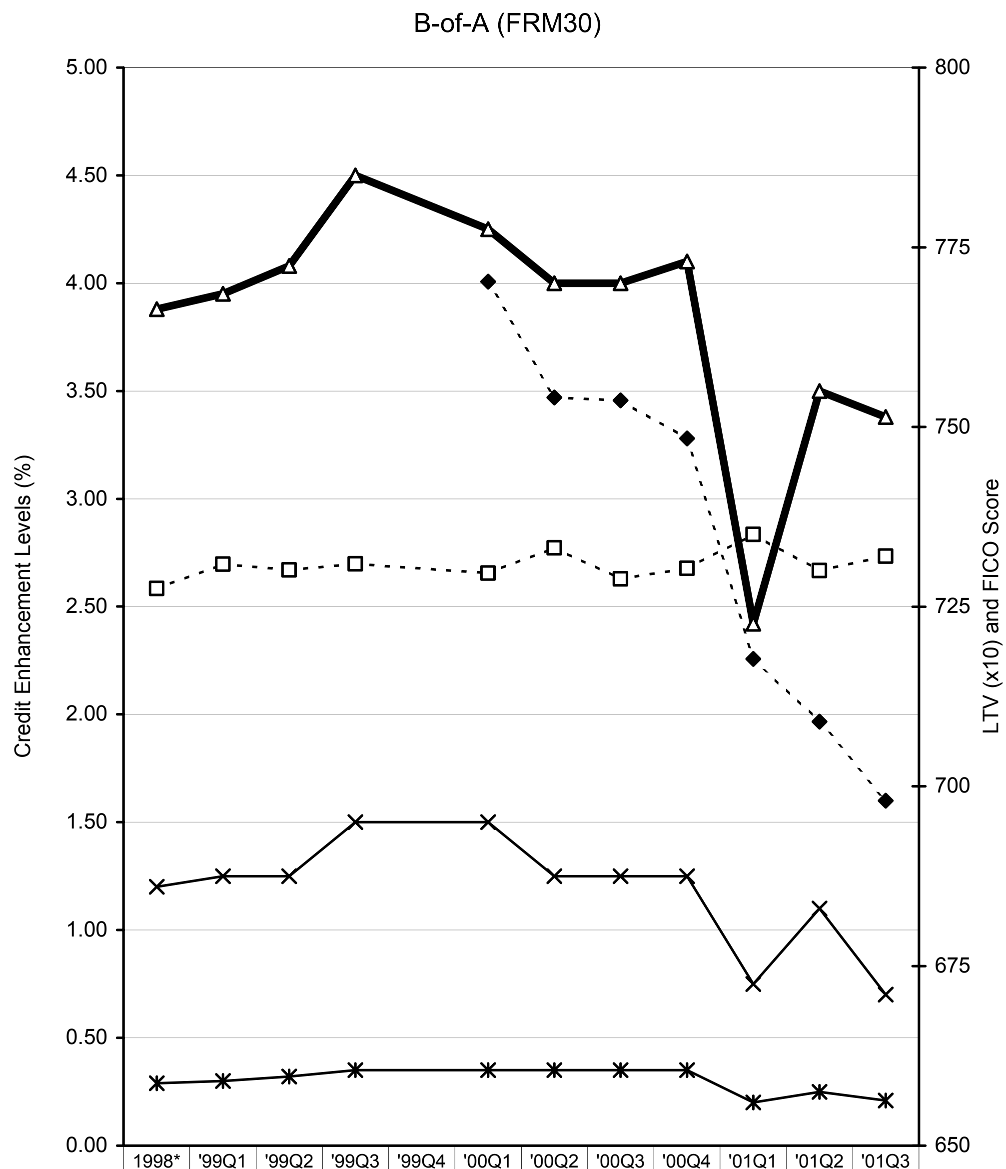
The following charts update the ones that we published in July. The charts illustrate the close relationship among credit enhancement levels, LTVs, and FICO scores, as reported by S&P. By fine-tuning the relative scaling of the left and right axes, the relationship is clearly apparent. However, in our opinion, the changes in LTV and FICO do not necessarily warrant the corresponding changes in enhancement level.



	1998*	'99Q1	'99Q2	'99Q3	'99Q4	'00Q1	'00Q2	'00Q3	'00Q4	'01Q1	'01Q2	'01Q3
AAA		4.13	4.38	4.25	4.50	4.50	4.25		3.75		3.67	
BBB		1.25	1.38	1.25	1.40	1.50	1.25		1.13		1.02	
B		0.33	0.35	0.35	0.35	0.35	0.30		0.32		0.27	
LTVx10					774	772	771		754		733	
FICO		732	731	734	732	729	729		727		720	

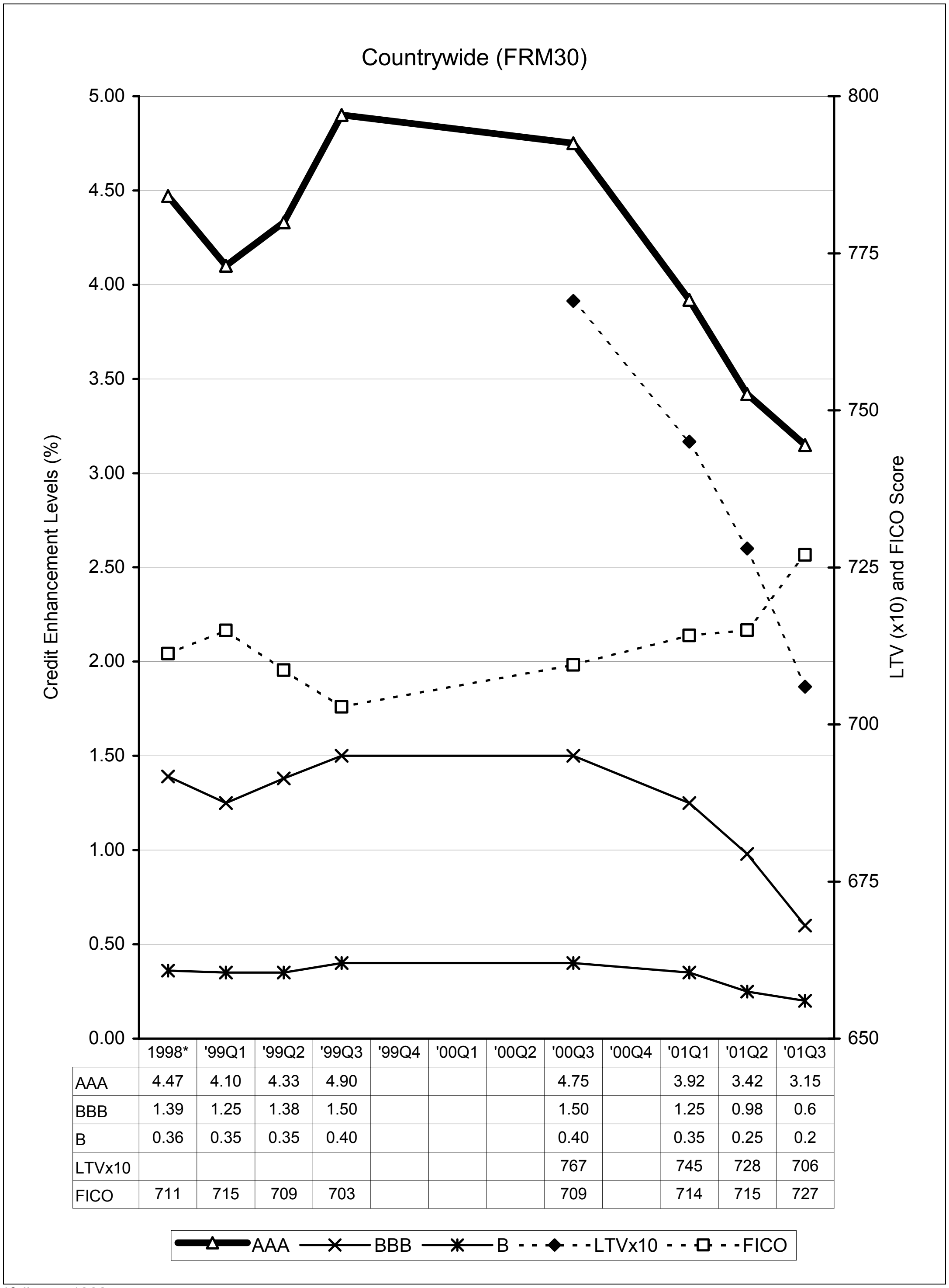
AAA — BBB — B — LTVx10 — FICO

*full year 1998
Source: Standard & Poor's



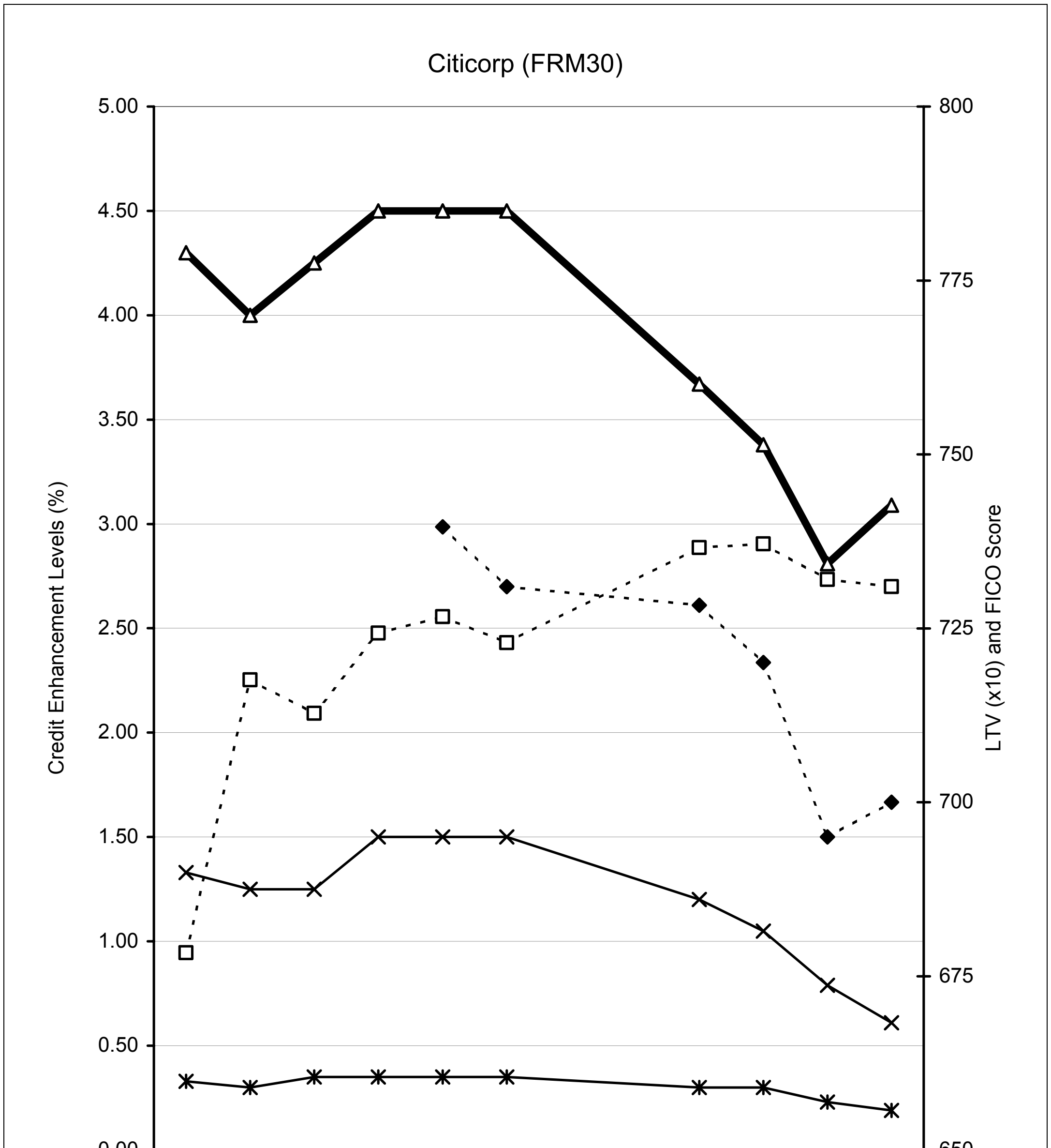
	1998*	'99Q1	'99Q2	'99Q3	'99Q4	'00Q1	'00Q2	'00Q3	'00Q4	'01Q1	'01Q2	'01Q3
AAA	3.88	3.95	4.08	4.50		4.25	4.00	4.00	4.10	2.42	3.5	3.38
BBB	1.20	1.25	1.25	1.50		1.50	1.25	1.25	1.25	0.75	1.1	0.7
B	0.29	0.30	0.32	0.35		0.35	0.35	0.35	0.35	0.20	0.25	0.21
LTVx10						770	754	754	748	718	709	698
FICO	728	731	730	731		730	733	729	730	735	730	732

*full year 1998
Source: Standard & Poor's



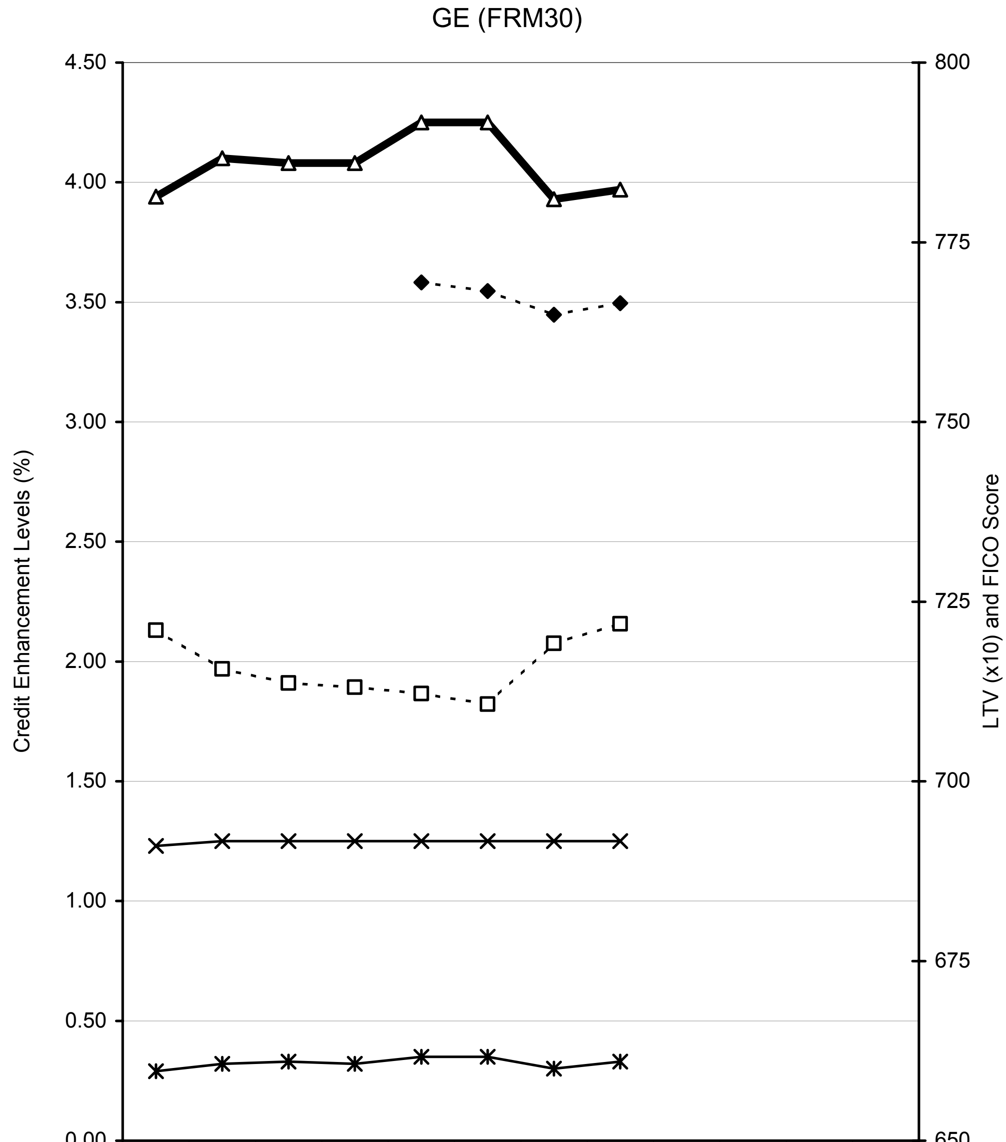
	1998*	'99Q1	'99Q2	'99Q3	'99Q4	'00Q1	'00Q2	'00Q3	'00Q4	'01Q1	'01Q2	'01Q3
AAA	4.47	4.10	4.33	4.90				4.75		3.92	3.42	3.15
BBB	1.39	1.25	1.38	1.50				1.50		1.25	0.98	0.6
B	0.36	0.35	0.35	0.40				0.40		0.35	0.25	0.2
LTVx10								767		745	728	706
FICO	711	715	709	703				709		714	715	727

*full year 1998
Source: Standard & Poor's



	1998*	'99Q1	'99Q2	'99Q3	'99Q4	'00Q1	'00Q2	'00Q3	'00Q4	'01Q1	'01Q2	'01Q3
AAA	4.30	4.00	4.25	4.50	4.50	4.50			3.67	3.38	2.81	3.09
BBB	1.33	1.25	1.25	1.50	1.50	1.50			1.20	1.05	0.79	0.61
B	0.33	0.30	0.35	0.35	0.35	0.35			0.30	0.30	0.23	0.19
LTVx10					740	731			728	720	695	700
FICO	678	718	713	724	727	723			737	737	732	731

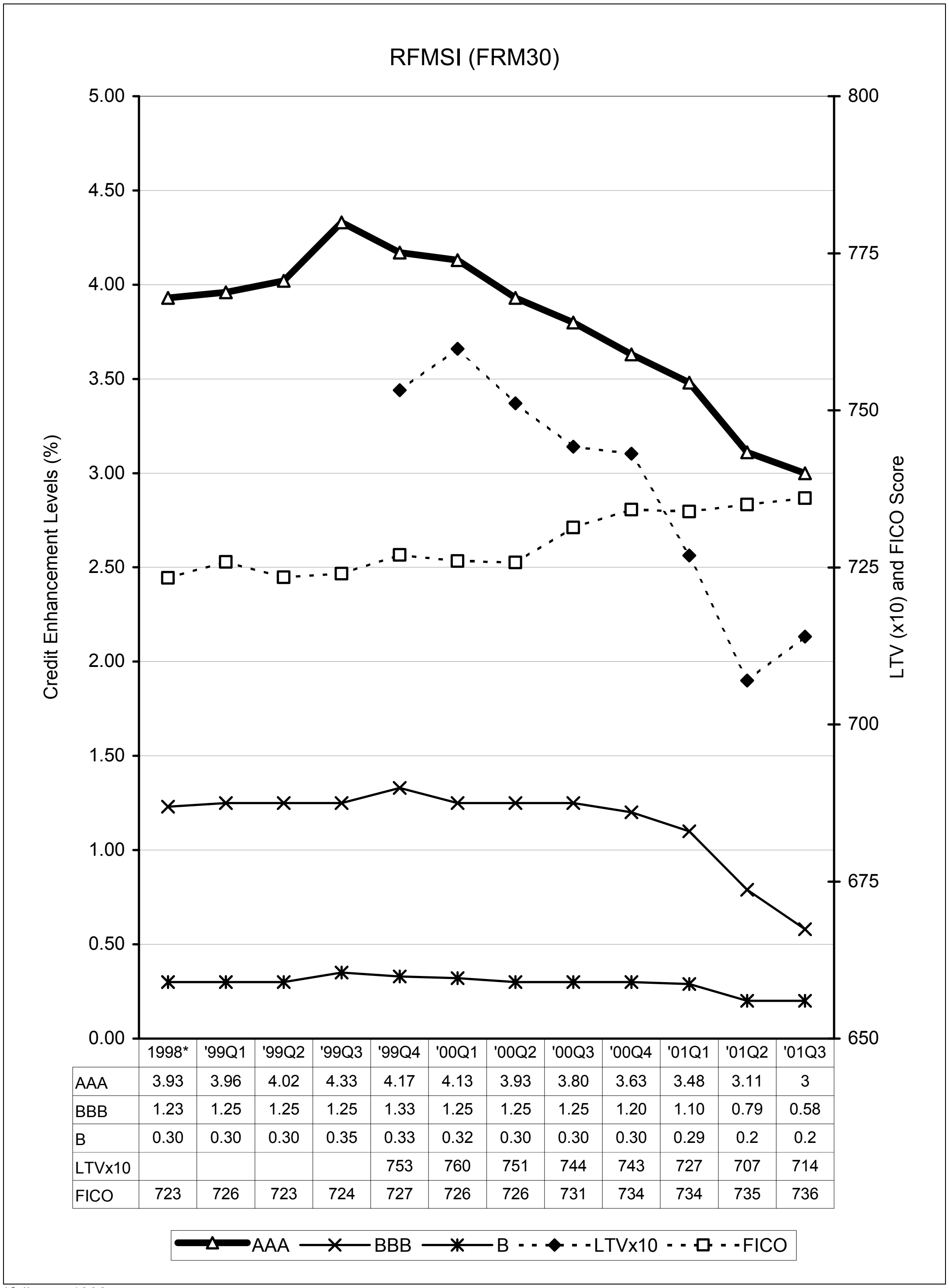
*full year 1998
Source: Standard & Poor's



	1998*	'99Q1	'99Q2	'99Q3	'99Q4	'00Q1	'00Q2	'00Q3	'00Q4	'01Q1	'01Q1	'01Q1
AAA	3.94	4.10	4.08	4.08	4.25	4.25	3.93	3.97				
BBB	1.23	1.25	1.25	1.25	1.25	1.25	1.25	1.25				
B	0.29	0.32	0.33	0.32	0.35	0.35	0.30	0.33				
LTVx10					769	768	765	767				
FICO	721	716	714	713	712	711	719	722				

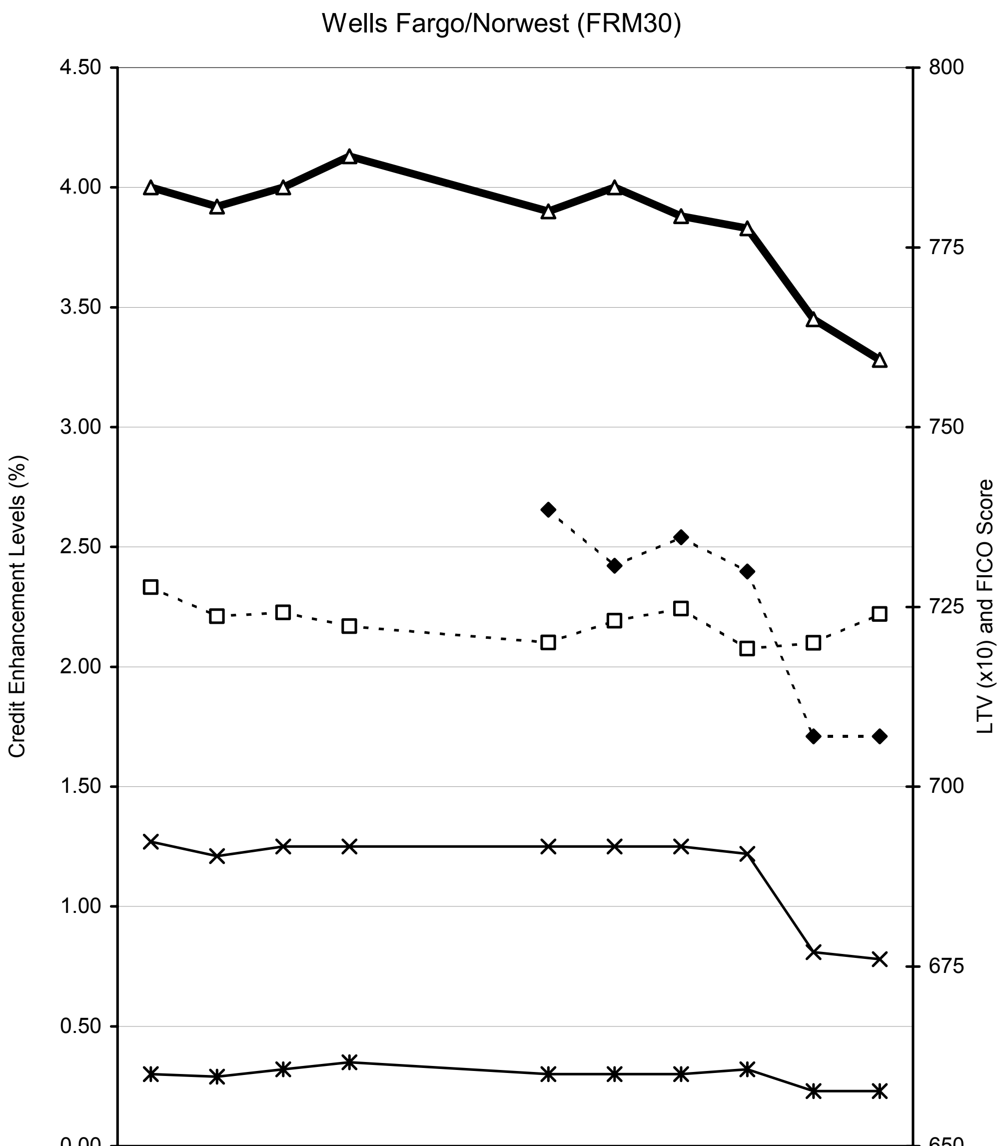
AAA — BBB — B - - LTVx10 - - FICO

*full year 1998
Source: Standard & Poor's



	1998*	'99Q1	'99Q2	'99Q3	'99Q4	'00Q1	'00Q2	'00Q3	'00Q4	'01Q1	'01Q2	'01Q3
AAA	3.93	3.96	4.02	4.33	4.17	4.13	3.93	3.80	3.63	3.48	3.11	3
BBB	1.23	1.25	1.25	1.25	1.33	1.25	1.25	1.25	1.20	1.10	0.79	0.58
B	0.30	0.30	0.30	0.35	0.33	0.32	0.30	0.30	0.30	0.29	0.2	0.2
LTVx10					753	760	751	744	743	727	707	714
FICO	723	726	723	724	727	726	726	731	734	734	735	736

*full year 1998
Source: Standard & Poor's



	1998*	'99Q1	'99Q2	'99Q3	'99Q4	'00Q1	'00Q2	'00Q3	'00Q4	'01Q1	'01Q2	'01Q3
AAA	4.00	3.92	4.00	4.13			3.90	4.00	3.88	3.83	3.45	3.28
BBB	1.27	1.21	1.25	1.25			1.25	1.25	1.25	1.22	0.81	0.78
B	0.30	0.29	0.32	0.35			0.30	0.30	0.30	0.32	0.23	0.23
LTVx10							739	731	735	730	707	707
FICO	728	724	724	722			720	723	725	719	720	724

*full year 1998
Source: Standard & Poor's

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