

Challenges along the Sub-prime Credit Dimension

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Agenda

- Loan modifications
- Laws and regulations
- Performance uncertainty
- Definitions

Loan Modifications (1)

- Over-emphasized by policymakers
- In good times, more than 1/3 of mods fail within one year
- Should be used only when economically advantageous to lender/investors
- Should be used only when there is high confidence of no re-default within 2 years
- Should not be used to keep borrower in a home that he cannot afford

Loan Modifications (2)

- Despite the best of intentions, many loan mods will fail
- ABS deal restrictions on mods (e.g. 5%)
- ABS deal trigger issues
- Conflicts between ABS classes



Laws and Regulations

- Taxpayer-funded bailouts ✘
- Foreclosure moratorium ✘
- Mandatory, one-size fits all loan mods ✘
- Tougher predatory lending laws ✓
- Assignee Liability ✘
- Federal preemption of predatory lending ✘
- Restrict or kill stated income loans ✓
- Restrict or kill \$0 downpayment loans ?

Performance Uncertainty (1)

- Resets for 2006 vintage in 2008 and 2009
- HPA outlook – wide range of views
- Models running outside range of their development samples
- Emotional and psychological factors

Performance Uncertainty (2)

Notable U.S. Real Estate Price Declines (mostly in the late 1980s or early 1990s)			
City	Decline	Duration (years)	Recovery (years)
Boston	-11.7%	4	9
New York	-8.4%	6	10
Los Angeles	-21.5%	6	10
San Francisco	-11.6%	4	7
Houston	-24.5%	5	15
Honolulu	-16.0%	5	9

Old Definitions: Sub-prime

- **Usually either**
 - Delinquent in past 12 months
 - FICO below 620
- **Common features**
 - high DTI
 - low or no reserves
 - no escrows
 - no MI if LTV over 80
 - hybrid ARM 2/28 or 3/27

Old Definitions: Alt-A

- **Borrower has clean credit**
- **But ... one or more of**
 - LTV > 80% w/o MI
 - temporary resident alien
 - non-owner occupied property
 - high DTI
 - high LTV w/ other factors (e.g. cashout)
 - less than full documentation

Old Definitions: Prime

- **Conforming in all respects to standard Fannie/Freddie program criteria**
- **Typical features**
 - Clean payment record: 0x30x12
 - LTV \leq 80% or with MI
 - DTI \leq 28% inside, 36% outside
 - Full documentation
 - Reserves and escrows
 - Owner occupied

New Definitions

- A quality spectrum
 - Prime: top ~70%
 - Alt-A: next: ~15%
 - Sub-prime: bottom ~15%
- New non-traditional products complicate classification
 - Option ARMs
 - Interest-only
 - Hybrid ARMs
 - Piggy-back seconds
 - Stated income to W-2 borrowers
 - Risk layering !!!

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