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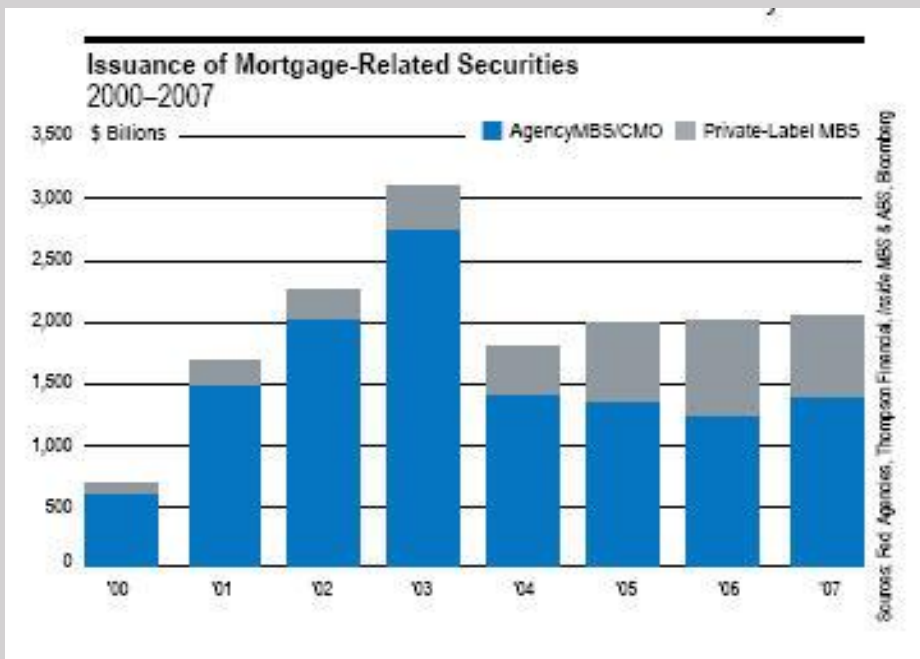
## Restoring Investor Confidence in the Private Label Market

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- Introduction
- Current State of Private Label Market
- Multi-dimensional Framework for Restoring Investor Confidence
- Seven Frictions of Securitization
- In the mean-time...
- Panel Questions

- “Every consumer in America depends on securitization and benefits from it...any American with a home, a car, or a child in college - that is to say, millions of Americans - depend on it...it is very likely that had they [loans] not been securitized, many of these loans could never have been extended in the first place.”
  - Christopher Cox, Chairman SEC (American Securitization Forum, 2006)
- Securitization: A structured finance activity of pooling interests in identifiable cash-flows from illiquid assets and transfer them investors in the form of securities
  - Securitization provides a mechanism to raise capital while transferring risk
  - Senior-sub-OC structure provides maximum flexibility and mechanism to handle sophisticated investment needs.
- In the U.S., about 80% of all financing occurs via securitization; outside the U.S., this number is about 20%
- MBS issuance in 2007 just over \$2 Trillion
  - Agency pass-through \$1.15 Trillion; Agency CMO \$222 Billion
  - Private-label RMBS \$440 Billion

# Current State



Source: Quarterly Research Vol. 3-2, Feb 2008, SIFMA

## Share of Mortgage Market by Major Type of Financial Institution, 1955-2007

Year	Savings Institutions	Commercial Banks	Life Insurance Companies	Government-Sponsored Entities	Individuals and Others
1955	37.6%	16.6%	22.6%	4.1%	20.1%
1970	43.9%	15.6%	15.7%	8.0%	16.7%
1980	41.2%	18.0%	8.9%	17.5%	14.2%
1990	21.1%	22.3%	7.0%	33.1%	16.5%
2000	10.6%	24.4%	3.5%	41.7%	19.7%
2005	9.4%	24.3%	2.3%	34.8%	29.0%
2006	8.0%	25.2%	2.2%	33.7%	30.8%
2007*	8.0%	24.5%	2.2%	34.6%	30.7%

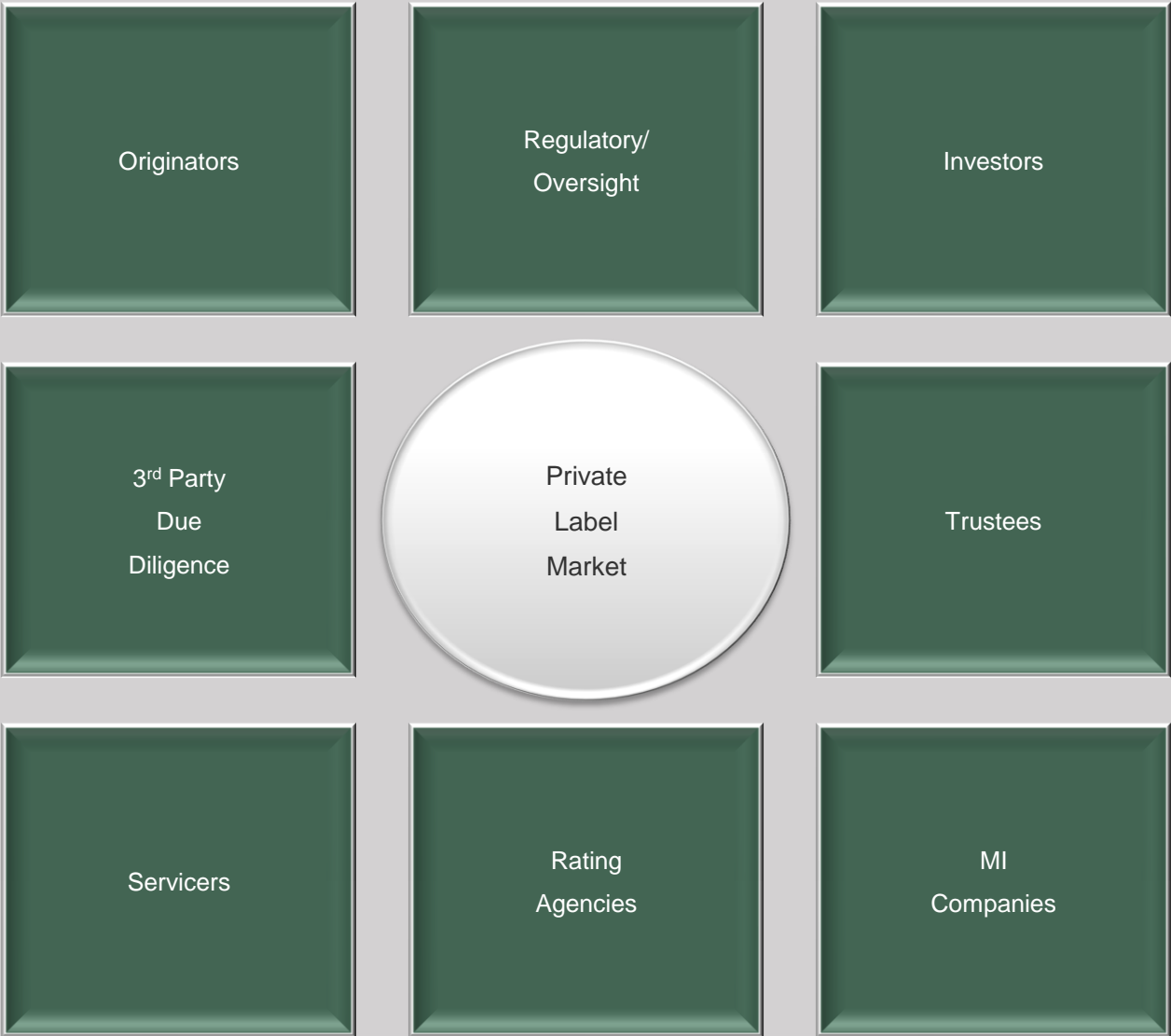
\* As of the third quarter.

Source: Executive Office of the President, *Economic Report of the President*, February 2008, pp. 314-315, Table B-76, at [www.gpoaccess.gov/eop/2008/2008\\_erp.pdf](http://www.gpoaccess.gov/eop/2008/2008_erp.pdf) (April 10, 2008).

Source: The Subprime Mortgage Market Collapse: A Primer on the Causes and Possible Solutions

- Ronald D. Utt

- GSE share down by 7.1% & private-label up by 11% between 2000 and 2007
- Higher agency issuance in 2007 due to weakening private label market



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- Back to the Basics: The importance of good underwriting
  - The Five-C's of Credit (Character, Capacity, Capital, Collateral and Conditions)
    - Correlation between past credit history & future debt obligations
    - Employment history and skill-sets to ascertain present & future capacity
    - Personal financial statement (income, expenses, assets and liabilities) - focus on liquidity & leverage.
    - Quality and marketability of the collateral
    - Market, Industry and Economic context – application of simulations & stress in forward-looking scenarios
  - Emphasis on specific underwriting parameters like Income, Appraisal, Credit, LTV, DTI, Occupancy and so on
    - Verification
    - Documentation Review
    - Red-flag identification (e.g., occupancy status versus commuting distance to work...)
  - Stronger issuer reps and warrants covering parameters such as income, employment, occupancy, EPD, MI, Fraud and so on

- Investor-centric Due Diligence
  - Traditional Model: Due Diligence on 5-10% of loans and running pool level extrapolations
  - New Paradigm:
    - 3<sup>rd</sup> Party Due Diligence Providers; arm's length transactions
    - In-depth coverage of credit, collateral, compliance and legal issues
    - Move toward 100% coverage: Start with covering 100% loans eventually move to 100% coverage on loans (Example: Automated due-diligence software)
    - Special Emphasis on Exception Loans and Compensating Factors
    - Reporting: Due Diligence report with full audit-trail to rating agencies, investors...
    - Reps and Warrants from Due Diligence Provider
      - Will force consolidation in this market; few large players with strong underwriting and sophisticated technology solutions

- Focus on Delinquency/Default Management for reducing losses
  - Early Mitigation Techniques (Dual track Collections & Loss Mitigation)
  - Risk-based Loan Scoring Models
  - Occupancy Status; Call and Mail Campaigns; Door Knocks;
  - Workout options based on Borrower financials, property valuation, market outlook and Net Present Value (NPV) analysis
  - Work with 3<sup>rd</sup> parties for Short-sale deals
  - Loan Modifications as a feasible workout option
  - Close monitoring of re-performing loans
  - Dual Tracking Loss Mitigation & Foreclosure (91+ days)
- Delegated Authority and Approval Process
  - Loan Mods – Loan Term, Capitalization, Schedule & Amortization
  - Automation of process for faster approvals
- Surveillance: Regular ongoing surveillance of loans and pools
  - Data Transparency: Ability to share data (loan and pool level) and Loss Models/projections with MI Companies, Rating Agencies and Investors
  - Web-based portals/technology platforms for easy data integration

# Rating Agencies

- Enhancement to Rating criteria
  - Originator/Issuer Assessment
  - Stronger Reps and Warrants
    - Fraud, Misrepresentation, Data quality, EPD...
    - Loan Information (e.g., Property Valuation, Borrower income, Employment & Occupancy)
  - Emphasis on 3<sup>rd</sup> party due diligence
  - Forensic Analysis of all loans in EPD, Loss Mitigation and FC/BK
  - Higher transparency; monthly loan-level data reporting to monitor ongoing performance

- New Underwriting criteria
- Better pricing of risk
  - High-risk segments (>95% LTV, Stated/Reduced Documentation...)
- Increased Loss Mitigation effort
  - Counseling Staff
  - Onsite staff at Servicer locations (for faster approvals)
  - Proactive use of Short Sales as a Loss Mitigation Workout option
  - Identify borrowers who qualify for Loan Modifications
  - Delegated Authority based on Servicer rating
  - Work with state-funded outreach programs & Non-profit Organizations for credit counseling

## Short Sale Example

Original Value	\$475,000
Borrower Down Payment	\$25,000
MI Coverage MI absorption	25% of \$450,000 \$112,500
Estimated loss at early Short Sale	\$80,000
Decline in value	17.78%
Estimated Value at time of Foreclosure	\$300,000 (i.e., \$150,000 loss)
Decline in Value	33.33%
MI Savings from Short Sale	\$112,000 - \$80,000 = \$32,000

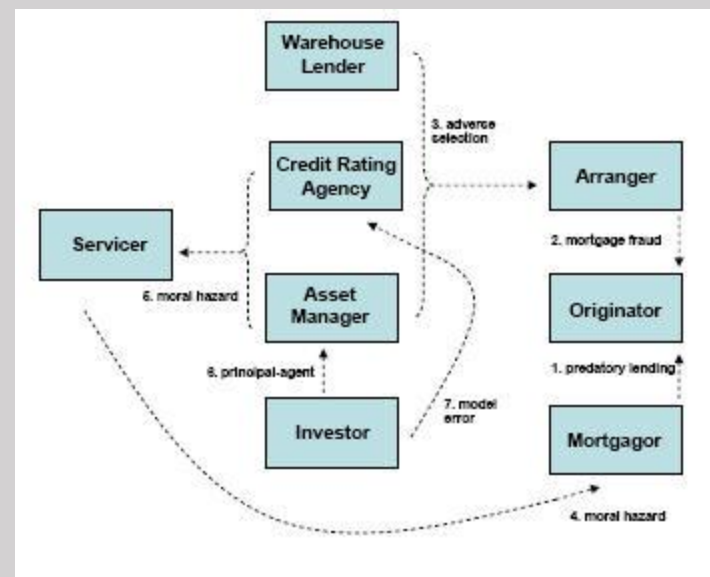
- Current State
  - Rapid growth and increasing complexity in the Collateralized Debt Obligation (CDO) business
  - Range of assets include high-yield bonds, asset and mortgage backed securities and synthetics
  - More investors with more complex fiduciary, client service and asset administration needs
- Need for more analytics and full transparency in liquidity, price volatility, prepayment & default probabilities
  - Web based systems for clients (investors) to access
  - Timely and accurate tracking and reporting (real-time or near real-time)
  - Bond agreement to performance compliance
- Technology Investment – cash-flow, bond payment, tax reporting & portfolio management investor portals
- Financial Strength; Staying Power

- Fundamental Investment Strategies to manage risk
  - All investments carry risk; follow investment strategies that align with level of risk tolerance
  - Diversification: Investment grade vs. high-yield; corporate issues vs. U.S. Treasury; private label MBS vs. GSE Pass-through certificates
  - Laddering: Purchase bonds with varying maturities (longer-term securities are subject to higher price volatility); reduces interest-rate risk
    - Return should be higher than portfolio of only short-term securities
    - Risk should be lower than portfolio of only long-term securities
  - Barbell: Purchasing securities with maturities at the two ends of the spectrum – maturity in 6 months to a year and 20 to 30 years
  - Bond swaps
    - Number of objectives (change maturity, credit, income...)
- Increased delegation of authority to Trustees & Servicers (through PSA)
  - Loss Mitigation Strategies – specifically Short Sales and Loan Mods
  - Incentive alignment (deal based incentives for resolution)

# Regulatory/Oversight

- Regulatory/Oversight
  - Fraud Prevention
  - Sound underwriting and effective disclosures
    - Sub-prime qualification standards with risk-layering cautions
    - Disclosures on loan-term and fees
    - Prohibit abusive, unfair and predatory lending
- Fed's Proposals
  - Proposal #1: Fix Underwriting
    - Mandatory 10% down payment
  - Proposal #2: Fix Broker Abuse
    - Upfront Mortgage Broker (UMB); currently voluntary
  - Proposal #3: Fix Servicing Abuse
    - Prevent pyramiding late fees
    - Mandate comprehensive monthly statements detailing all charges & fees
- Other
  - Transfer of prior servicing record when servicing rights are sold

- Friction #1: Mortgagor vs. Originator: Predatory Lending
  - Prohibiting predatory lending practices
- Friction #2: Originator vs. Arranger: Information asymmetry
  - Due-diligence; Reps & Warrants; Repurchase Agreements
- Friction #3: Arranger vs. 3<sup>rd</sup> Parties: Adverse Selection
  - Additional due-diligence and Credit Rating
- Friction #4: Servicer vs. Mortgagor: Moral Hazard
  - Regularly maintain escrow for Taxes and Insurance
  - Corporate Advances during delinquencies
- Friction #5: Servicer vs. 3<sup>rd</sup> Parties: Moral Hazard
  - Servicer Ratings (estimated  $\pm 10\%$  level of losses due to servicer quality)
  - Having a master servicer monitor performance against PSA
- Friction #6: Asset manager vs. Investor: Principal-Agent
  - Evaluation of manager performance
- Friction #7: Investors vs. Rating Agencies: Model Error
  - Publication of rating criteria and disclosure of rating changes



Source:  
Federal Reserve Bank of New York  
“Understanding the Securitization of Sub  
Prime Mortgage Credit”  
- Adam Ashcraft & Til Schuermann

- Good liquidity risk management
  - Matching cash inflows & outflows; assets & liabilities
  - Look at different sources of funds
    - Equity
      - Public issue of stock; Private Equity/Leveraged Buyout to recapitalize
    - Debt
      - Collateralized (e.g., Warehouse line)
      - Non-Collateralized (e.g., bank notes and corporate bonds)
    - Asset Sale/Transfer
      - Sale of Trading and Marketable Securities
      - Whole Loan Sales (investors, REIT, Mortgage Funds...)
      - Repo agreements for short-term liquidity
- Use of Residential Mortgage Covered Bonds (RMCB)
  - Good source of liquidity until investor confidence in Private Label is restored
  - Lower risk-return for investors; default recourse – originator and cover pool
  - Opportunity to season loans for year or two before securitizing

# Panel Questions

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Area of Focus	Submitted By	Panelist(s)
Introduction and Current State of Private Label Market	Daniel	Daniel
Underwriting Changes (regulatory compliance and lessons learnt)	Ted	Michael, Ted
Delegated Authority to Bond Trustee to direct Servicer & Revision of PSA to give clarity on Loss Mitigation strategies	Ted	Ted
Collateral Evaluation Techniques to minimize over valuation	Ted	Michael
Regulatory changes that will help/hinder private label market	Richard	Richard
Impact of Fannie/Freddie temporary \$730,000 loan purchase limit	Daniel	Richard
Changes in Servicing Practices	Richard	Ted, Sanjay
Multi-dimensional framework for restoring confidence	Sanjay	Sanjay
Fitch's perspective	Daniel	Roelof
S&P's perspective	Daniel	Michael
Transparency in the Rating process	Daniel	Michael & Roelof
What can lenders do in the mean time?	Sanjay	Sanjay
Future State of Private Label Market	Ted/Richard	Ted
Q&A and Conclusion	Sanjay	Daniel