

Contact

Real Estate Finance

John J. Kriz

Mbody'sEconomy.com

Mark Zandi

Mbody'sEconomy.com

John Lonski

Residential RMBS

Marjan Riggi

Financial Guarantors & Mortgage Insurers

Arlene Isaacs-Lowe CFA CPA

Finance & Securities

Blaine Frantz

US Banking

Michael Mascarenhas

Real Estate Finance

Brian Harris CPA

Real Estate Finance

Philip Kibel CPA

Residential MBS

Warren Kornfeld

Sub-Prime Mortgages: An Integrated Look into Credit Issues Today and What to Expect

The following is an edited transcript of a teleconference held on Friday, 9 March 2007.

Welcome to Moody's teleconference on the current state of the sub-prime mortgage business, how it is affecting participants, and what to watch for next. This cross-team and cross-discipline group is bringing together diverse talents to tackle this credit issue, and is emblematic of the analytical approach Moody's takes in all of our ratings and research. We're pleased to have you join us today, especially such a large number of our investor clients.

We commence with brief overviews from the participants. We will then turn to your questions. The Moody's analysts will focus on headline-level comments, but we would welcome more detailed questions from you during the Q&A period.



Key Take-Aways From John Kriz

- You must differentiate among firms and RMBS deals. Not all are alike.
- The US housing downturn, which is around two years old, has perhaps another year to run and it's not helping the economy.
- Liquidity is vital for financial services firms; and liquidity sources, reliability and management sophistication can vary markedly among institutions and asset types. Liquidity, liquidity, liquidity.
- Many current sub-prime mortgage problems are classic end-of-the-cycle problems such as risk stacking and eased underwriting to maintain volumes by boosting so-called affordability to more would-be homeowners. We have been to this movie before in this cyclical real estate market. It usually doesn't turn out well for the heroine.
- The 2006 sub-prime vintage is the most worrisome, and most of that vintage was hybrid product. There are growing worries with seconds, ARMs, high-LTV and no/low doc product. Piggyback sub-prime product with low doc is the worst. Rising EPDs do not augur well as weak loans tend to show their weakness early. 2007 will be a tough year and this could well extend into 2008.
- The key factors that will drive sub-prime credit quality are 1) rates, 2) house prices, 3) credit availability and 4) unemployment. Remember that rates also affect house prices as well as the capacity of strapped borrowers to refinance and to carry their mortgages. Recently originated ARM or hybrid product resets a few years after origination, and those dates with destiny are approaching. A combined rate and house price whammy -- a double whammy -- would be particularly stressful. And let's not forget the effects of a recession, especially on people of more modest means. Over the past few years, many households have maintained their lifestyles with three salaries: Mom, Dad and the house -- and the house is now off the table.
- The challenge of sub-prime is not just one of asset quality: it's also of a drop in originations that undermines revenues and the company's business model. The most vulnerable are the monoline sub-prime firms, not only due to credit risk concentrations, but also due to business model vulnerabilities. The experience of sub-prime monolines in the last cycle is not encouraging. Remember, if you're riding a unicycle and the wheel comes off, you have a problem.
- Despite these challenges, we do not see downgrades of mortgage finance, general finance, mortgage insurance, financial guarantor, securities or banking and thrift firms stemming from sub-prime challenges. Why is this? The principal reason is that these firms are almost all highly diverse firms that have other resources that can be brought to bear, and sub-prime tends to be a minor part of their overall business mix. Nevertheless, profit pains will be felt.
- For RMBS, the ratings of the overwhelming majority of bonds will be stable. We have been boosting enhancement levels for some time. However, securitization performance might deteriorate in 2007. Also greater servicer risk is an issue.
- An open question is whether the Alt-A and A-, and even the prime, mortgage sub-segments will follow sub-prime down the delinquency and loss slope, and to what degree. At this juncture, we do not see this happening to a particularly worrisome degree, but those are vital factors to watch for as 2007 unfolds and, in a negative scenario, they could affect our ratings.
- Finally, the possibility of contagion into other sectors such as commercial mortgages, whether warranted or not, needs to be recognized. More broadly, one wonders whether sub-prime is the bell that's ringing out the era of the incredible shrinking credit spread and of easy liquidity.

Mark Zandi on US Housing

I'll make three points.

First, the housing correction, which began nearly two years ago, has another year to run. I expect sales to hit bottom in the second quarter. Construction, which is measured by construction put in place, will hit the bottom in the fourth quarter, and in terms of median existing house prices, I think the bottom will be this time next year.

The market has to work through three different problems before it hits bottom: 1) affordability must be restored, 2) new housing inventories need to be substantially reduced, and 3) short-term investors who infected the market in the boom must be wrung out of that market. This outlook depends on several key assumptions, the most important being that the job market outside of housing remains sturdy judging by today's employment numbers, and that monetary policy and long-term interest rates remain largely unchanged.

Second, the housing outlook has turned more negative in recent weeks due to the stunning erosion in mortgage credit quality. The surge in credit problems primarily among sub-prime loans, but to a lesser degree in Alt-A, IO and option ARMs, will have a measurable negative impact on the housing market. These loans accounted for approximately one-third of mortgage origination volume in 2006.

The negative fallout will occur in at least two ways. First, tighter underwriting standards will make it much more difficult for sub-prime borrowers to get a loan, weighing on housing demand. Some 2.25 million homebuyers received a sub-prime loan in 2006. If the sub-prime market is cut by just one-fourth in 2007 due to tighter standards, then some 500,000 in home sales will be lost. There were some 7.6 million new and existing home sales in 2006.

The second fallout on housing will be via foreclosures, which will rise sharply in 2007 as sub-prime borrowers facing payment resets are unable to refinance due to the tighter underwriting. An estimated 400,000 sub-prime loans went into foreclosure in 2006. This could very well double in 2007, adding an additional nearly 400,000 unsold homes to a market that is already choking on high inventories.

Third, the risks to the housing outlook are turning more negative. With the housing correction expected to continue for another year and for declines in activity and prices expected to be more severe, there is a growing threat that the housing downturn is infecting the broader economy, which of course would then reverberate back on the housing market.

The most important link between housing and the broader economy is through the housing wealth effect and consumer spending. To date, consumer spending has seemingly not been affected by housing sector's problems. This may be due in part, however, to the plunge in oil and gasoline prices at the end of 2006, which provided a substantial windfall to consumers. Energy prices are no longer falling; indeed they are now moving higher. When combined with even weaker house prices and a now-fragile stock market, consumers may turn more circumspect in their spending. The job market outside of housing would almost certainly be hurt in such a scenario, with serious ramifications for the entire US economy -- including housing.

Another link between housing and the broader US economy runs through the global financial system. There is a very low, but measurable, risk that global investors become unnerved by the impact of eroding mortgage quality on the mortgage securities market. Global investors own an estimated \$1.6 trillion in mortgage securities, accounting for almost 15% of all their US financial holdings. Any disruption to the process of intermediation through global capital markets would have a quick and substantial economic impact.

Despite the risks, odds are high that housing, the broader US economy, and the financial system will remain resilient in the face of the substantial erosion in mortgage quality. However, a significant bump or two in the coming year also seem likely.

John Lonski on the Securities Market and Housing Credit

A reduction in the available supply of sub-prime mortgage credit implies fewer home sales and lower home prices than otherwise, but it does not rule out a recovery in home sales and a stabilization of home prices. Why? Mortgage credit remains readily available at reasonable costs for creditworthy households. Home sales are not being impeded by a broad-based credit crunch.

Excessive inventories of unsold new homes suggest that residential construction will be slow to recover. However, these excessive inventories offer little reliable insight regarding how quickly home sales might stabilize. A much-diminished supply of sub-prime mortgage credit and fewer speculative buyers of housing implies that home sales may not return to 2005's record high until 2011, at the earliest. Moreover, the annual rate of growth for home prices should lag core CPI inflation into 2012.

Fortunately, the best near-term indicator of home sales supports the possibility of a springtime stabilization of housing. For now, comparatively low borrowing costs and adequate employment growth support expectations of an impending bottom for home sales, with sales of existing homes likely stabilizing before new home sales do.

The near-term outlook for home sales finds support in the improving trend of mortgage applications from potential homebuyers where the year-to-year decline of this statistic has narrowed from August 2006's -22% to February 2007's relatively narrow -2.3%.

Homebuyer mortgage applications are an excellent near-term predictor of home sales. The correlation coefficient between homebuyer mortgage applications of this quarter and home sales for the following quarter is an extraordinarily high -- almost perfect -- 0.99.

Mortgage applications from homebuyers dipped sequentially in February 2007, but they did so in nine of the ten previous February's, some of which overlapped the recent boom in home sales. If homebuyer mortgage applications extend their rise of the two weeks ended March 3, then the US equity market probably overreacted to the unfinished difficulties of the sub-prime mortgage market.

There has been a recent surge in applications for mortgage refinancings, February's index for mortgage refis was both the highest since September 2005 and was up by 24% annually. All of this suggests that more homeowners may be reducing their mortgage repayment risk via refis.

Our big worry regards the possibility of extended home price deflation. This looms large in the worst case scenario. Home sales will benefit all the more quickly as uncertainties regarding the stability of home sales subside. Virulent, runaway, home price deflation would be damaging for both the housing and the overall US economy. If expectations of home price deflation take hold, both the sales and prices of residential real estate will suffer.

Home buying might well be postponed until uncertainties surrounding the sustainability of home prices are resolved. Because of this lingering risk of home price deflation, we believe Fed policy will remain on hold indefinitely. Fed policymakers may become more tolerant of price inflation in order to lessen the risk of expectations of home price deflation. As shown by the inverted yield curve, relatively low Treasury bond yields imply that inflation expectations are well contained, and that the Fed has more than enough leeway to cut rates if this coming home selling season disappoints.

Nevertheless, the avoidance of both a 10-year Treasury yield above 4.75% and a hiking of fed funds is critical if home sales are to bottom convincingly.

For now, the problems of sub-prime mortgages have yet to substantially widen corporate credit risk premia. We start by noting that the economic and financial backdrop of the current housing recession compares quite favorably with the housing and economic recession of 1990 – 1991. The high yield bond default rate is much lower today. Yield spreads are generally well below their long-term averages, and aggregate measures of corporate financial health are far superior to what held when housing last tanked.

We further add that the latest widening of corporate risk premia, in response to lower stock prices and difficulties with sub-prime mortgages, is much less than what occurred in conjunction with the October 1987 stock price crash, Russia's default of August 1998, and 2005's downwardly revised outlooks for Ford and GM. We would take from this the view that the comparative resilience of corporate credit risk premia to the recent plunge of equity prices weighs against the nearness of a credit crunch owing to sub-prime mortgage foreclosures.

What about consumer spending and the difficulties with housing? For starters, it's worth mentioning that surveys of consumer confidence offer no indication that lower home prices are significantly diminishing the spending patterns of US consumers. Consumer confidence today is much higher than it was at the time of the last housing recession of the early 1990s. Moreover, home sales, as well as the funds supplied by sub-prime mortgage credit, are not among the primary drivers of US consumer spending.

The current housing recession has yet to slow consumer spending beyond the sales of building materials, and furniture and appliance store sales. Motor vehicle sales have been sub-par both before and during the current housing slump.

In summary, home sales may be forming a bottom, but for now the moving three-month average of total home sales bottomed as of November 2006. Second, a possibly controlled decline of home prices that is not deeper than currently expected may not be especially damaging to home sales and consumer spending. Third, as long as the housing slump is perceived as threatening the overall economy, benchmark interest rates will be lower than otherwise. Finally, the contagion effect of sub-prime mortgage repayment problems for credit in general should remain limited.

Marjan Riggi on Sub-Prime RMBS

My topic is the rating implications of the current residential mortgage market on sub-prime RMBS securitization.

First I will give an overview of the state of the sub-prime mortgage market. For several years, securitizations of sub-prime mortgages, or home equity asset-backed securities have represented the largest consumer in ABS sector. The current state of this market is characterized by the following main themes: 1) considerably higher serious delinquencies in the 2006 vintage versus what we saw in 2002 through 2005, 2) rising early payment defaults, and 3) a changing lender landscape as originators either exit the market or become consolidated into other entities.

While these events signal deterioration in market conditions, they are not entirely surprising. The slowdown in house price appreciation coupled with higher mortgage rates and a greater frequency of low or no down payment loans have resulted in weaker sub-prime loan performance.

Given the broader availability of mortgage products which made it easier for borrowers to obtain loans, such as limited income documentation or low or no equity financing, sub-prime loans have become riskier. This is particularly an issue in areas where negative or static house price appreciation has left few options for borrowers with financial difficulty. In certain cases, such borrowers are simply vacating their homes as many have made no or very little down payment.

Moody's has frequently communicated to the market about the steady increase in risk layering in sub-prime pools over the past few years as a number of collateral and origination trends continued to deteriorate. I will next summarize these trends, then address how Moody's rated deals throughout this period.

While FICO credit scores have risen by about 10 to 15 points since 2003, we have seen almost every other loan level credit attribute in the sub-prime mortgage market become weaker. Borrower leverage has increased, and although loan-to-value ratios have remained stable at around 80%, CLTV ratios, which measure the combined impact of first and second lien loans, have risen by about 8 points. This indicates that more borrowers were opting for second liens to finance part or all of their down payment. Borrowers who are more leveraged and have little or no equity in their homes have higher default probabilities on their first lien mortgages.

Borrowers have also stretched on payment capacity. Products such as interest-only and longer tenor loans, which result in more affordable monthly payments, made up nearly 50% of the loans backing securitizations in 2006. Longer tenor and interest-only loans are riskier because they do not amortize as quickly as conventional thirty-year term loans. Interest-only loans are also subject to large payment shocks because their principal balance starts to amortize only after a defined interest-only period.

In addition, we saw a compounding of risk in recent securitizations as some weak loan characteristics were often combined with other risky features, such as higher borrower debt-to-income ratios and higher levels of limited-income documentation, especially from wage-earners, where the ability of borrowers to pay is no longer substantiated by true levels of income. Also, many first-time home buyers who may not have as clear an understanding of the true costs of owning a home entered the market in recent years; this has added yet another layer of risk to securitized transactions.

Because of these factors, the collateral characteristics of sub-prime mortgages were declining overall.

Now I'll discuss how these matters have affected deal performance and ratings to-date.

Having noted weaknesses in collateral early on, Moody's anticipated that performance would deteriorate once the housing market cooled off. The poor performance is, so far, concentrated in the 2006 vintage, where serious delinquencies as a percentage of original balance have reached 7%. These loans are performing worse than the loans originated between 2002 and 2005, but are performing similarly to what we saw for the 2000 and 2001 vintages at this stage of seasoning. While the performance of these earlier vintages stabilized after a few years because of the strong housing market and low mortgage rates, the 2006 vintage is subject to different economic conditions.

Moody's loss expectations on securitized transactions are forward-looking, and thus reflected the increased layering of risk in sub-prime pools, as well as our changing market outlook. On average, our loss expectation on securitized pools increased by about 30% over the past three years. Reflecting this increase, the amount of protection on Moody's-rated bonds also increased. Therefore, given the higher amount of credit enhancement for more recent vintages, the overwhelming majority of our outstanding ratings --including those from the 2005 and 2006 vintages-- have been relatively stable.

Looking forward, housing prices, the availability of credit, and other economic factors such as interest rates and the level of unemployment, are significant variables in how the sub-prime market will perform. We expect further correction in housing prices well into 2007. Sub-prime borrowers are still vulnerable to lower house price appreciation or depreciation, which, together with lower availability of credit, narrows their options for refinancing.

Mortgage servicers will play a major role in pool performance. They will need to be more active because fewer seriously delinquent borrowers will be able to refinance if they experience payment increases or financial stress. We anticipate creative payment plans, forbearance options and loan modifications to become more prevalent.

If pool performance of the 2006 vintage continues to decline, the impact on ratings would vary by rating category. The higher the rating of a bond, the higher the level of protection against collateral losses. So, if overall loan losses are somewhat higher than expected, Ba-rated tranches are more vulnerable to downgrade pressure than investment-grade tranches, and may even incur losses. Baa-rated bonds could also come under downgrade pressure, but loan performance would have to decline materially for those bonds to incur losses. Most of the home equity bonds rated by Moody's in 2006 have ratings of single-A and higher, i.e., they represent approximately 95% by volume of the Moody's-rated tranches in 2006. These bonds are the least susceptible to rating pressure at present. Rated bonds from earlier vintages, due to tighter loan underwriting and the intervening years of home price appreciation, are less susceptible to stress if real estate market movements remain moderate.

As to 2007 deals, we expect collateral performance to be better than for the 2006 vintage. A number of issuers began tightening their underwriting guidelines in mid-to-late 2006 in an effort to combat performance pressures. They applied more stringent standards to problematic areas such as first-time homebuyers, stated documentation loans and simultaneous second liens with high combined LTVs. If these standards remain in place, it should help the performance of 2007 and future vintages.

As my colleagues will discuss in more detail, the weaker recent credit performance in the sub-prime mortgage market has adversely affected the profitability and viability of many sub-prime lenders. We are seeing lenders go out of business or consolidate with other entities. The financial instability of some lenders may create risk for their securitized transactions because of the impact on servicing and also because those lenders may no longer be able to honor their representations and warranties to securitization trusts.

Arlene Isaacs-Lowe on Financial Guarantor & Mortgage Insurers

The mortgage insurers and financial guarantors are highly rated entities that provide credit enhancements to the capital markets. The ratings of these companies are concentrated in the double-A and triple-A range, respectively. Our rating outlook for both industries is stable. At this time, we do not anticipate that the difficulties in the sub-prime mortgage market will result in rating downgrades for either mortgage insurers or financial guarantors.

These industries are in the business of understanding and pricing credit risk. Their exposures to sub-prime mortgages are relatively contained, and benefit from the terms and structure of the credit enhancement they provide. Furthermore, more recently these industries have taken a backseat to other providers of credit enhancement in the sub-prime space.

One of the attributes that supports the high ratings of the companies in these industries is their embedded revenue streams, which should allow firms to be disciplined during more difficult market cycles. The metrics we use to assess this characteristic is described in more detail in our recently released rating methodologies.

Moody's does, however, continue to be cautious regarding the potential spillover effects that have been outlined to the wider mortgage market, which could be more detrimental. Let me provide a little more color on our views of the implications of recent trends in the sub-prime mortgage market on these industries. I'll do it from two perspectives: 1) the impact on operating results and capital adequacy, and 2) the impact on business models which we believe to be more benign for these sectors than for others that either originate, invest in, or service sub-prime mortgages.

Mortgage insurers increased their exposure to sub-prime first lien mortgages in the last few years in the traditional conforming mortgage market as the GSEs expanded their affordability housing criteria, and they've also done so in the structured market as they have increasingly sought to provide credit enhancements for RMBS transactions. However, with increased competition from hedge funds and senior sub-investors, aggressive pricing and narrow credit spreads, mortgage insurers' participation in the sub-prime mortgage market did decline during 2006.

Today, sub-prime mortgages account for roughly between 10% and 2% of the total risk in force for the firms in the MI industry. Seasonally adjusted delinquency and severity experience for the sub-prime portion of the insured portfolio has been deteriorating, while loss trends for other mortgage products have been more stable. The situation seems to be more pronounced for those sub-prime mortgages that were insured as part of structured transactions.

Of note, the ratio of reserves against sub-prime risk-in-force has been between four to seven times that of prime mortgages. In addition, those mortgage insurers with larger sub-prime exposures have taken steps to actively manage those risks, either by laying some of that exposure off via capital market transactions, or by being in a second loss position on a pool of mortgages. Mortgage insurers also have the ability to rescind and arbitrate claims in the event of fraud or misrepresentations, which can enhance liquidity management in stress scenarios.

From a revenue perspective, the anticipated reduction in sub-prime and other non-prime mortgage originations should be somewhat offset by higher persistency rates and greater penetration as a result of the recently approved tax deductibility of mortgage insurance and by a more cautious view on second lien mortgages, which has served to dampen the demand for MI in more recent years. Premiums for sub-prime mortgages are significantly higher, but even so, a key profitability issue for mortgage insurers is whether they have accurately assessed and priced for the risk of the mortgages that have been insured.

We remain cautious regarding the potential spillover effect on the US economy and credit markets more broadly and, in specific, the implications for other types of non-prime mortgages, such as Alt-A and A-product. As I said, to date, the delinquency and severity experience for other non-prime mortgages in the insured portfolios has been stable for the most part, but the potential of rate shocks still exists for some of the hybrid ARM products that became popular in the last few years. With high volumes of mortgage risk insured in 2005, some with two- and three-year rate resets with housing price appreciation not providing the take out, and with the likelihood of more constrained mortgage markets for refinance, delinquency and ultimately claims could increase in these product segments as well.

Turning to the financial guarantors, guarantors have a more diversified insured portfolio across all asset classes, with sub-prime mortgage exposure typically ranging less than 1% to 5% of the total par insured. There has been more detail provided on the individual companies on some of their web sites, and to the extent that you'd like additional details, please follow up with the individual analysts who cover the specific companies.

An important consideration for financial guarantors is that they typically insure the more risk-remote layers of structured transactions attaching at the investment-grade tranche. Financial guarantors insured or wrote credit default swaps against sub-prime first and second lien securitization, but during 2005 and 2006, also affected by the increased competition, the narrow credit spreads and the multiplicative effects of risk layering, the financial guarantors substantially reduced the volume of sub-prime RMBS par written or attached at very high levels in the capital structure -- typically at the triple-A and double-A levels.

Given the high attachments and the increase in enhancement levels that have been referenced, Moody's does not anticipate the financial guarantors to experience meaningful increases in losses from sub-prime RMBS transactions. However, should ratings at these levels be downgraded, their capital adequacy may be marginally impacted. The guarantors will also need to manage their exposure to weak servicers, and the potential for the resulting adverse impact of portfolio credit trends and loss mitigation alternatives.

The question is: Will the current market dislocation be an opportunity for these credit enhancement providers? The recent accelerated deterioration in the sub-prime mortgage segment has resulted in widening spreads, particularly at the lower and non-rated tranches. The current reduction in liquidity in the fixed income markets for sub-prime mortgages, a renewed focus on credit risk and a resulting spread widening should all help to validate the value of these types of credit enhancement providers. There is already anecdotal evidence of enhanced pricing power for mortgage insurers and financial guarantors; this should ultimately enhance the terms of the insurance they provide, and increase their premiums and penetration rates. We expect that the sub-prime mortgage market will survive, but it will be more cautiously underwritten.

Blaine Frantz on Finance Companies and Securities Firms

My comments will focus on the Moody's-rated, branch-based consumer finance sector which, as a result of consolidation, is comprised of just two companies: Aa-3 rated HSBC Finance, and A1 rated American General Finance or, AGFC.

At this juncture, we don't anticipate that the current stress in the sub-prime mortgage market will result in any change of their current ratings or outlooks. The outlook for AFGC is stable, while the rating outlook for HSBC Finance remains positive. I'll elaborate on this a little later.

Despite the current challenges within a sub-prime mortgage space, Moody's believe that a greater weighting of real estate secured assets within a traditional finance company's portfolio is preferable to unsecured exposure due to the protection provided by ample collateral, which results in the product's comparatively low loss rate versus unsecured loans, and should benefit risk-adjusted yields over the course of the credit cycle.

In addition to principal protection, mortgages also benefit from improved behavioral tendencies of the borrowers, who have a greater incentive to protect their residence than they do to worry about paying their credit cards or other loans.

However, these statements are only true to the extent that underwriting discipline is maintained and the borrower has skin in the game – in specific equity in the property.

As recent trends and sub-prime mortgages have shown, mortgages are not riskless assets, and caution is warranted given the intense competitive conditions in the US mortgage markets and increased leverage carried by today's consumers. Lenders must resist pressures to compromise on loan structure and borrower quality in order to grow volume and earnings. This is especially true for portfolio lenders such as HSBC Finance and AGFC. Maintaining underwriting discipline, using appropriate risk-based pricing and having highly granular market intelligence are important tools for protecting the balance sheet.

Market discussion is focused on the role that esoteric mortgages have played in the current problems facing sub-prime borrowers and lenders. To their credit, neither HSBC Finance nor AGFC has been a big holder of interest-only loans or hybrids, but as HSBC Finance has demonstrated, esoteric mortgages are not the only way a lender can get into trouble. In Moody's opinion, the asset quality erosion at HSBC Finance reflects not only the growing stress in the sub-prime mortgage space, but also the need for prudence in underwriting controls and growth.

As Moody's has cautioned in our research, rapid growth in a finance company's wholesale mortgage portfolio has the potential to erode asset quality depending upon underwriting standards including, to name a few, decisions regarding LTV, lien positions and document requirements. Portfolio seasoning will also affect credit metrics -- particularly when receivable growth decelerates.

HSBC Finance hit the breaks on growth in 3Q06, when managed receivables in its wholesale mortgage book grew by \$11.1 billion year-over-year, or almost 30%, to \$49 billion. In contrast, AGFC's wholesale mortgage portfolio actually shrank year-over-year.

In HSBC Finance's case, all of the factors that I've mentioned contributed to the asset quality erosion of the company's wholesale-oriented mortgage services business. Much of this weakness can be traced to management's decision to increase originations of second lien product in the second half of 2005 and first half of 2006. Growth in low documentation and stated income loans exacerbated the problem. These loans grew some 60% year-over-year to \$12 billion, or 24.6% of the mortgage services portfolio.

At the end of 2006, approximately \$10 billion, or 21%, of mortgage services real estate secured loans, were second liens, with almost 90% of the seconds being originated in 2005 and 2006. There is also a very significant 55% of the wholesale mortgage portfolio that is adjustable rate that will eventually be exposed to payment shock.

Most problematic are second liens sitting behind another lender's adjustable-rate first lien that is about to reset. HSBC Finance began to address this growing stress in its wholesale mortgage portfolio around mid-2006 by raising income requirements and credit score cutoffs. The company also eliminated stated-income seconds, introduced a foreclosure avoidance program and beefed up its collection staff.

In contrast to HSBC, AGFC has not, and we expect will not, experience the same degree of asset quality erosion within its wholesale-originated mortgage portfolio, which AGFC refers to as "centralized real estate." AGFC's centralized real estate portfolio tends to be high quality, almost entirely first lien, with average FICOs north of 700 and LTVs in the low 80% range. AGFC does not hold or originate any option ARMs or negative-amortization loans. AGFC also kept a very tight rein on wholesale-originated receivables growth in 2006. Though delinquencies have risen slightly in this portfolio, they remain very low at under 1%, and loss rates are currently de minimus.

Looking into 2007, rising loss provisions at both companies will add marginal pressure on profitability as credit performance returns to a more realistic long-term run rate. Moody's expects that delinquency levels and core loss rates of consumer finance companies will continue to normalize upward in 2007 from their near historic lows as the industry has seen the best days of the most recent credit cycle. Nevertheless, economic and employment conditions remain largely favorable and supportive of asset quality with modest loan growth, which should result in an acceptable, though subdued, operating profitability.

Despite the current challenges facing the sub-prime mortgage sector, Moody's continues to hold a positive outlook on HSBC Finance's ratings, with the current outlook based upon our assessment of the growing degree of integration between the HSBC group and the finance company, and the implications of this integration on the likelihood of the group extending capital and other support if required.

In Moody's view, the involvement of HSBC's senior-most management in addressing problems at the finance company indicates that the parent company takes the issues very seriously and will move aggressively to minimize the likelihood of similar issues arising at the finance company in the future.

Notwithstanding the challenges facing the mortgage services business, HSBC Finance's overall asset quality remains acceptable and within expectations, with adequate reserve and earnings coverage to cover likely credit erosion and maintain acceptable profitability over the coming year. The branch-based business continues to perform acceptably well across various products, including mortgages.

Though AFGC's asset quality did weaken in recent quarters across all asset types, its rating outlook remains stable. AFGC's overall asset quality metrics are comparatively strong and well within cycle expectations. The company continues to perform well.

Ownership by strong parent companies remains a positive rating factor for both of these consumer finance companies. Though HSBC Finance and AFGC lack direct parental guarantees, they nonetheless receive a degree of implicit support, and benefit from the financial strength of their parents. A change, either explicit or implicit, in the parent-subsidiary relationship that weakens implied support could have negative ratings implications. By the same token, a more definitive strategic relationship or explicit guarantee from a stronger parent could lend additional support to the finance company's ratings.

Michael Mascarenhas on US Banks and Thrifts

Overall, the exposure to sub-prime mortgage lending at US banks and thrifts is moderate and is concentrated in just a few names. This contained exposure is a positive in light of recent trends that have been unfolding in the sub-prime mortgage market.

We do not see sub-prime mortgage lending as a widespread rating issue for US banks and thrifts. Fremont General Corporation is a name that has been in the news for its sub-prime mortgage lending, which constituted a major line of business for the company. We do not expect other banks and thrifts to be affected to anywhere near the degree that Fremont has been affected.

Since the majority of sub-prime mortgages are financed by investors in the securitization market, the business model for banks that operate in this segment of the mortgage market is one of origination and sales to the capital markets, sometimes retaining a subordinated claim or residual interest in the same. Often the residual interests held on the balance sheet are further reduced through securitization of the subordinated claim in what are referred to as NIM transactions. However, some banks and thrifts do retain portfolios of sub-prime mortgages on their balance sheet.

The impact of the deterioration in the sub-prime mortgage market and in sub-prime mortgage asset quality on US banks and thrifts manifests itself in the following ways: first, gain on sale income is negatively affected by higher write downs of a bank's warehouse portfolio, and second, banks need to make provisions when they take back loans that defaults soon after they have been sold. In the past, Wall Street serviced these loans instead of putting them back to the originating banks. That practice has now ceased and virtually all such defaulted loans are being put back to the originators. Third, the residual interest that banks retained in securitizations have to be written down. Last, provisions for losses in the portfolio of sub-prime mortgages that are held on balance sheets need to be increased.

In addition to Fremont, the other US banking institutions engaged heavily in sub-prime mortgage lending are HSBC, Citigroup, Wells Fargo, Washington Mutual and National City prior to its sale of First Franklin to Merrill Lynch in the fourth quarter of 2006.

Sub-prime has been a major line of business for Fremont and in fact, the company ranked as the fifth largest originator of sub-prime mortgages in the USA. Earlier this week, Fremont disclosed that it is subject to a cease and desist order from the FDIC; and in compliance with this order, the company is attempting to divest itself of its sub-prime mortgage business.

In the meantime, unless a waiver is obtained, Fremont has been prohibited from accessing the brokered CD market, whether for new or for rollover of existing CDs. These deposits make up approximately 16% of the bank's deposits, and fund approximately 12% of its assets.

This reduced flexibility in Fremont's funding could increase liquidity challenges at both the bank, Fremont Investment and Loan, and at the holding company, Fremont General Corporation. Moody's downgraded Fremont in response to this reduced financial flexibility as it attempts to sell its sub-prime mortgage business and meet other requirements of its regulatory order.

Following the downgrade, Fremont Investment and Loan's deposits are rated B1. Fremont's senior unsecured debt is rated B3, and the ratings are on review for possible downgrade. Fremont filed a quarterly report for the quarter ended December 2006, but has yet to file its 2006 10-K, or discuss its 2006 earnings in a conference call.

From call reports, it is evident that Fremont incurred a net loss of about \$30 million in the fourth quarter of 2006. In mid-2006, the bank tightened its underwriting standards in response to the increased put back of mortgages from Wall Street. As a consequence, earnings suffered because of increased provisions that had to be taken. The bank has also been writing down its residual interest in prior securitizations.

HSBC's sub-prime mortgage exposure is housed in HSBC Finance, the consumer finance arm of the bank's organization in the USA, whereas the mortgage portfolio in HSBC Bank US NA is comprised of loans that are mostly prime or near prime.

Citigroup's sub-prime mortgage exposure is housed largely in its CitiFinance subsidiary. Blaine Frantz has already discussed HSBC's sub-prime mortgage exposure that is housed in HSBC Finance. In the case of Citigroup, this business line is a part of its retail distribution segment that accounts for less than 10% of the company's earnings. Our conclusion for both HSBC and Citigroup then is that sub-prime mortgage lending in the USA is a relatively modest business in relation to their overall franchises, and the downturn in the sub-prime mortgage market and in asset quality have little impact on their earnings.

Wells Fargo is reported to be among the top sub-prime mortgage originators in the country, but it does not disclose specific statistics on this business segment. Some of the origination volume relates to Wells' co-origination arrangement under which it does not retain credit or sell liability. Furthermore, much of Wells' sub-prime exposure is to finance customers who tend to have multi-product relationships with the institution. This helps limit asset quality downside. As such, we do not see sub-prime mortgage lending as an issue for Wells Fargo.

Washington Mutual is the ninth-largest sub-prime mortgage originator. WAMU's sub-prime problems were a major contributor to the sizable loss incurred by its mortgage operations in the fourth quarter of 2006. The downturn showed itself in a notable decline in gain on sale and a write down on its residuals. We assume that the net residual level is small.

WAMU also chooses to fund a portfolio of sub-prime mortgages, which it refers to as specialty mortgage finance loans. The average amount of these loans on the balance sheet is just over WAMU's tangible equity in size. The NPA level for the portfolio is 6% of outstandings, which is below the national average. The charge-off rate in the fourth quarter of 2006 annualized is a low 1%, but increased provisions were not a negative factor in the fourth quarter results in its mortgage operations. Not all of WAMU's problems were due to sub-prime mortgages. The business line incurred a sizable net MSR hedge loss in the fourth quarter.

WAMU has cut back on its sub-prime mortgage exposure and increased its reserves. We believe these actions are manageable in the context of WAMU's overall mortgage business. WAMU's retail and credit card operations have given it timely diversity, but the mortgage business has performed poorly.

National City sold its sub-prime mortgage operations to Merrill Lynch in the fourth quarter of 2006. The after-tax gain boosted its earnings. Nevertheless, it did retain a sub-prime mortgage portfolio and a warehouse portfolio which required write-downs and provisions, hurting results. The portfolio is in a two-year+ run-off. The portfolio is about 70% of tangible equity. We expect National City's sub-prime mortgage portfolio may require further provisioning that will weigh on the company's performance. However, we see the situation as manageable because of its limited size, the portfolio is in run off, reserves levels were increased in the fourth quarter of 2006 when the company booked a gain and a good portion of the mortgages have some credit risk insurance linked to it.

Brian Harris on Mortgage Companies

First, the rated universe of mortgage finance participants is eclectic, and includes A3 rated H&R Block, the parent of Option One, the monoline sub-prime firm; A3 rated Countrywide and Baa3 rated Residential Capital, companies with diverse product portfolios; Aaa rated Fannie Mae and Freddie Mac, which invest in conforming mortgage product including some sub-prime securities; as well as Baa3 rated PHH and Ba2 rated Thornburg Mortgage, which focus on the prime mortgage market. The point here is that not all mortgage finance companies are alike and it's important to differentiate among them.

Sub-prime mortgage performance has significantly deteriorated for participating mortgage firms, especially the recent vintages. This deterioration is largely attributed to looser underwriting standards as the housing boom progressed, coupled with stagnating – if not declining -- house prices, as well as the inherently higher risk profile of the sub-prime space. Some smaller, mono-line sub-prime firms have generated attention recently, with significant stock price drops, accounting issues, and/or higher delinquencies. Moody's had not been asked to rate these firms, although we did maintain a B1 rating on New Century until March 2005, at which time the REIT paid off its rated debt and the rating was thus withdrawn.

Moody's believes any likely credit losses associated with sub-prime are manageable for our rated mortgage company universe, though profitability will assuredly be pinched. The impact of the emerging sub-prime downturn could have a disproportionate effect on monoline companies, as well as those firms that focus on lower loan quality. Such difficulties could create opportunities for large more diverse firms.

In addition, it is important to look beyond credit losses when gauging the effects of a sub-prime downturn. Investors should also consider the effects on origination volumes and business flows, as well as their ability to obtain pipeline and other funding. Based on these expectations, the most likely rating actions would be outlook changes to negative, if that.

In rating the mortgage industry, Moody's attempts to assign a rating that incorporates the inherent volatility associated with the sector, especially subsectors such as sub-prime, through a complete cycle. An important aspect of the rating process is Moody's assessment of the diversity and franchise of a company's business platform, the strength and stability of the company's earnings, as well as the company's liquidity. The wide range of ratings from mortgage companies can be largely attributed to these factors.

Moody's Real Estate Finance team views the mortgage industry as cyclical and volatile and, as a result, believes monoline mortgage firms are unlikely to be rated higher than Baa. Along the same lines, Moody's believe the credit challenges for firms focused on riskier mortgage sub-segments such as sub-prime are even more acute. The experience of mono-line sub-prime firms in the last cycle demonstrates this.

Liquidity, as noted, is a particularly important analytical issue for the mortgage space, especially for the sub-prime space, with that product having more limited financing options than, say, the conforming market. We note that the proximate cause of failure for financial firms is often, if not, usually illiquidity -- and liquidity conditions can shift very rapidly. Thus, we focus more on terms and conditions of financing such as diversity and reliability of sources, term structure, average maturity of debt, and the vulnerability to shifting advance ratios rather than on mere cost.

What's next? In addition to sub-prime credit performance and funding, the next act in this play is: What will happen to other mortgage types such as Alt-A, A- and Prime? Will they follow in a sad step behind sub-prime? Material difficulties in these sub-segments would indicate a more severe housing correction, which could result in diverse and significant rating actions. We do not see this happening.

How will issuers fare? Countrywide's A3 rating, which is currently on review for upgrade, reflects the company's successful leadership position in the mortgage market, the diversification of its business as well as improved liquidity from Countrywide Bank. A material decline in asset quality likely due to significantly higher losses associated with alternative loans could change our outlook for the company.

Moody's stable outlook on H&R Block's A3 rating reflects its diversified business services platform as well as the cash generating capacity of the tax preparation business. Material changes to the company's capital structure or significant delays in the sale of Option One could lead to negative rating actions, though we view these events as unlikely.

Residential Capital's Baa3 rating reflects the company's leadership and diversification of its business lines across mortgage finance, as well as its international presence. Operating losses, likely due to asset quality issues including sub-prime or material declines in origination, which might impact the company's leadership position, may also have ratings implications.

Questions & Answers

Question: What do we have on the extent of piggyback mortgages? If you combine the first and second liens on these sub-primes and Alt-A's, do we know what the true loan to value ratios are? Do we know what the actual monthly payment to income ratios are?

Answer: In the past two years, we've been getting the second lien information when analyzing a first lien loan where the borrower is simultaneously receiving a second lien loan. I would say we receive such information on 99% of the securitization transactions that we rate. So for those loans, we have the combined LTV ratio, including both the first and second liens which allows us to better estimate the default probability on the first lien loan. Obviously the default probability of the first lien loan with a second lien is higher than a first lien loan without a second.

Question: Do you know on average what percentage of originations have had piggybacks?

Answer: I think that in sub-prime securitization deals, the CLTV ratios as a percentage of the pools are around 7% to 8% above the actual LTV. I would say that piggybacks are around 30%, I can't say for certain about originations in general, but I can tell you what we see in the securitization pools, the originations probably would reflect the same. Most of this data is published in our year-end securitization reviews.

Question: I have a question about stabilization in home sales. I assume that new home sales are included in that. How much, given the level of excess inventory out there, which is something I don't think we've ever seen to this degree, is really coming from just price cutting by the builders attempting to flush out excess inventory?

Answer: I think home sales, new and existing, will stabilize in Q3, but that is based on the assumption that we see significant price discounting both by existing home lenders and by homebuilders. I think homebuilders have to be aggressive, and in fact are, and will remain so, to work off that inventory; and it is sizable.

Just to give you context, there are 550,000 unsold new homes out there right now as far as the census can guesstimate it. Equilibrium in the market is probably closer to 300,000 to 350,000 units. So, we have at least 200,000 to 250,000 units that have to be worked off, and that will require very aggressive pricing. Or if they aren't aggressive, then I'm going to be wrong about sales and they're going to continue to fall for longer than Q2.

One other point, one thing you can watch to gauge whether sales are weakening is the purchase application index from the Mortgage Banker's Association, a weekly index. In fact, historically it's been a pretty good leading indicator of sales. You do need to be careful with that indicator in the next couple of months because that measures applications and not approvals. So if lenders are tightening, they could be getting applications and not approving those applications. So, it bears close watching, and it has to be followed with some care, but I would use that as a gauge as to whether expectations of sales and the bottoming of sales is coming to fruition.

Question: My question refers to servicers and financial institutions with large servicing portfolios and the workings of their business models. In specific, how do increases in delinquencies and foreclosures affect earnings? Do they lead to greater fees or to greater expenses? And generally, what risks do servicers face with increases in delinquencies and foreclosures?

Answer: A couple of issues with servicing: there tend to be a number of fees associated with dealing with delinquencies and other problems that occur, and these fees actually tend to be relatively lucrative. And so, in most cases, the fee component can be substantial, and offset other costs from heightened levels of servicing. This has been the case most of the time, and we would expect that to be the most likely scenario here. To the extent the originator is also the servicer, there may be some puts or EPD issues, but then it's a different conversation. But just from a pure servicing perspective, that tends to be the case.

From a servicing standpoint for RMBS, we have servicer quality ratings on virtually the entire universe of securitization servicers. Servicing, just from a performance standpoint, is a key item in regards to ultimately how securitizations perform. The challenges that servicers are going to face include (remember the last several years were a very benign market in terms of seriously delinquent loans) being under pressure in regards to staffing -- finding people who are able to service seriously delinquent accounts well. There will be significant focus on loss mitigation strategies including an increase in loan modifications. It will be a challenging environment for servicers, and good servicers will make a solid impact in regards to RMBS performance.

Continuing on that theme, with stress in the marketplace, you have an opportunity to separate the sheep from the goats, so to speak, and the stronger servicers will be able, most likely, to gain market share from the weaker servicers that will have scalability challenges, G&A challenges, personnel and other challenges that will cost them. That will take a while to sort itself out, but we would expect that to happen. And so, I would look for more favorable outcomes for the stronger servicer platforms, with further encouragement being given to consolidation among servicers in all types of single-family mortgage product.

Question: On Residential Capital (ResCap), you made mention of the fact that operating losses or material declines in origination would have ratings implications. Could you talk a little bit about your benchmarks in terms of what would constitute a material drop in origination volumes? In listening to some other companies, it sounds like, at least in the sub-prime arena, that could be 20% to 30% down in volume. What are your thoughts on that?

Answer: One thing that we're evaluating as it relates to ResCap is what's the effect on their overall mortgage originations, even though the sub-prime component is larger than for all of the banks and even for Countrywide. Sub-prime is not ResCap's only engine for volume. The question for us is not so much how much origination volume comes down, but what the ultimate impact will be on its performance not just for 4Q06, but going forward; and if there's any impact on its liquidity. If they were to drop out of the top 10 originator group, that would be something we'd have to think hard about.

Question: Do you have a benchmark in terms of what you're looking for from guidance in terms of sub-prime being down? Do you have a sense of what would be negative for you? If they said sub-prime is down 20% to 30% and prime was flat, how do you feel about that?

Answer: Our view would be looking at the portfolio of origination they have, which includes non-US activity, prime, Alt-A, sub-prime and various other pieces. On the whole, if they were to move below the top 10 originator status, that would be the benchmark, as opposed to necessarily a component. And so, if the component moves them down, that's the issue, but we're looking at a multi-line mortgage business, and it's the health of the overall mix that we focus on, and we would draw the line at top 10 versus non-top 10.

Question: What about the notion that originators' gains on sales would be pressured, at least some, on the sub-prime side? How do you factor that in as regards to operating losses?

Answer: That goes back again to diversification. For a diversified company like RESCAP, we would expect to see their other business lines pick up some of the slack caused by the drop in the sub-prime volume. They have a very good international platform that's growing, so we would expect that sector to grow. Their sub-prime originations still remains an important business for them. They also have diversification from their BCG group, which remains pretty profitable. So, the question is how much do the sub-prime losses and their exposure there bring their overall business down? We do expect it to have a significant impact. The question is how big is that impact relative to their overall business and relative to their competitors.

Question: The market continues to talk about the transaction true up, which according to rumors may be up to a billion dollars. There's a potential for GM to pick up potentially some of that. How are you thinking about that potential payment as it relates to the ratings? Are you not as focused on that right now or are you more focused on going forward with the overall operating performance of the business? I'm just trying to get a sense of that.

Answer: We don't comment on rumors regarding whether GM is contributing capital or not, but our focus would be on the business going forward in regards to their performance. We will also focus on the size of the write down, whether the write down relates to something that they have their hands around and whether they can control it going forward. Why did the write down happen is also important. Does the write down reflect a change in underwriting standards and how does it affect their business model going forward? That's really where a large write down would impact the rating. The fourth quarter is a tricky quarter for (RESCAP) because the sale of GMAC by GM, occurred within the quarter. So there are several factors involved there that may be non-cash charge offs that are not related to the real performance and operations of (RESCAP).

Question: I have a question regarding Countrywide. Do you have concerns with the pay option ARM portfolio? About 50% of their loans held for investment are pay option ARMs. Is there a high reset risk, or are there some other structural features of their underwriting of the product that get you comfortable with the risk here?

Answer: Countrywide tends to be very conservative with their capital management, and with their underwriting. Our underlying assumption and understanding is that they underwrite to the highest reset value, but we still monitor as it could become a concern. Going forward, we will continue to monitor the earnings impact of any asset quality issues not only on its sub-prime portfolio, but its other than sub-prime portfolio, as well as the impact of any resets on its hybrid products.

Question: Performance to date on option ARMs has been pretty good. If you look at the 2006 vintage versus earlier years you do have higher delinquencies, though you're coming off of some extraordinarily low years. The product in general has higher FICOs. It has lower LTVs. They did not have nearly the risk layering that you had with sub-prime products. Is it notched in terms of products that have been offered to sub-prime borrowers?

Answer: With the average original LTV for Option ARM loans being in the mid 70's even if the loan reaches its negative amortization cap of 10% or 15% the overall LTV would be somewhere in the low to mid 80s.

Question: You could argue that delinquencies have been pretty low because a lot of these loans haven't even hit their reset points yet, but it sounds like the low LTVs give them a bit of a cushion?

Answer: Yes, that and the higher FICOs. Option ARM borrowers tend to be better borrowers in the whole anyway.

Question: Is it possible to provide any visibility into FPD (first payment default) and EPD (early payment default) rates currently being experienced? And, if so, is it possible to further break that down for wholesale originations in the near-prime space?

Answer: We have it originator by originator, and the number is changing. In the sub-prime sector, we have seen numbers as high as 6% or 7%. Those numbers though are definitely decreasing across the board, as originators are tightening guidelines---the tightening began somewhere in mid-2006, and it takes a bit of time to work its way through.

For sub-prime at this point, I think pretty much across the board, we're seeing early or first payment defaults at around 3%. In the Alt-A space, the numbers are significantly lower. Have we seen an increase? Yes, we've seen an increase. In the past, servicers would try to service such loans as well as they could and most of the EPD loans would eventually re-perform. But in today's market given the lower chances for a loan re-performing and for good recoveries the vast majority of these loans are being put back to originators.

Obviously, one of the big issues with FPD/EPDs today is the ability of originators to repurchase such loans. Another question is whether the rise in EPDs is just a bump up in performance followed by flattening, or a sign of ultimate performance deteriorating.

Question: To go back to ResCap, could you characterize generally your analysis of their liquidity, simply because it's been such a hot topic for other smaller, specialized companies?

Answer: Sure. So far, what we've seen with ResCap is they've been able to maintain good liquidity. They have committed lines and revolvers where they still have full availability in those revolvers. We've seen them perform on one of the key issues that we had in the rating as they were becoming an independent company from GMAC and the whole Cerberus acquisition. How well could they be issuers in the market, and be independent issuers? That has gone very well. We do expect some liquidity -- not constraints -- but slowdown as it relates to them being able to securitize their subprime portfolio at prices that they used to enjoy. But from a cash position, internal cash positions, committed lines and other backup facilities that they have, we still feel pretty comfortable with their liquidity.

Question: Given the fact that housing price appreciation is an important determinant of cumulative losses in this sub-prime mortgage space, it's my understanding after several conversations and meetings with Moody's that you're integrating a new HPA assumption into the (M3) model for new issuance. How are you handling your new HPA assumptions in the old securitizations in, say, 2005 and 2006?

Answer: The HPA is one of the main variables in our M3 model which together with interest rates and unemployment data gets updated every quarter-so our loss coverage numbers take updated HPA into account. Our model simulates 1,250 economic scenarios, and therefore, it takes into account 1,250 HPA outcomes. The expected loss number calculated by the model is an average of all those 1,250 HPA outcomes, which include negative HPA scenarios.

Question: I understand you're integrating Mark Zandi's moodyseconomy.com piece of all the relevant MSA's in the country. If you were to integrate those HPA assumptions in the sub-prime arena where the majority of sub-prime loans exist, it would dramatically change the cumulative loss assumptions for the 2005 and 2006 securitizations. So it seems like there's a void between new issuance and what you're doing from a ratings perspective in 2005 and 2006. I'm just trying to understand how that void can exist with you changing HPA assumptions now and not going back and looking at what that assumption would do to those securitizations.

Answer: It is still early to tell, but at this point, the performance of 2005 tracking the 2002 vintage. 2005 performance is worse than what we saw in '03 and '04 which is expected, but it's performing actually better than 2000 and 2001 at this stage of seasoning. The 2006 vintage at this early stage is trending along the lines of the 2000 and 2001 vintage.

From a monitoring standpoint, we take a lot of different variables into account: losses, delinquency buckets, excess spread and structure; we then overlay other volatilities in the market, such as HPA changes. We are constantly factoring in what's going on in the market and what our expectations are-- that's built into the new transactions as well as the old ones.

For existing transactions, it's a combination of making sure that our ratings remain correct. As you know, we are leaders in regards to our monitoring effort. And we try not to make drastic changes in ratings when it's too early. But the message is that we do incorporate our expectations with regard to market dynamics at any point in time for new transactions as well as old transactions.

Question: There's a lot of talk from the servicing side today of loan modifications being made from the (servicer) side that will - let's say these loans are hitting - their teaser rates expiring and they're going to the fully indexed rate. A lot of (servicers) are talking today about just basically extending or modifying the loans to basically eliminate excess spread that it - as it exist and try to not let these people default. You know, in my opinion, that would really make the Aaa (tranches) a little riskier to the benefit of the (sub-tranches). How do you feel about, massive loan modifications at this point in time?

Answer: Modifications that are used properly are obviously a very good tool. The servicers are empowered to do whatever they can to keep losses as low as possible, reducing defaults and reducing severity. If you have someone who has been in that property for two years and has more or less paid their monthly payment, has a willingness, has an ability and is able to pay an eight percent coupon but is not able to pay an 11 percent coupon, you don't want to go through a foreclosure process and lose 40 percent. You want to keep that borrower in their home-you are losing, three percent per annum but you hope that at some point in time, the borrower will have a refi opportunity to get out of that particular loan. Even if it takes three years from that reset, that's a nine percent severity versus a 40 percent severity.

Question: Right, but in an environment where there's housing price depreciation, if you're delaying something that might be inevitable, it's actually to the detriment of the triple-A.

Answer: Absolutely, the one thing you don't want to do is to defer the inevitable--there has been a lot of focus on this in terms of both servicer quality ratings and the ratings on the transactions. You don't want to go through more than two or three years of losing three percent in coupon where instead of a 40 percent severity, you may have a 50 or 60 percent severity.

Ultimately, the servicer needs to make a judgment call as to whether a mortgage is salvageable or not, and that varies depending on market conditions. So, if you have a decent borrower who has some, perhaps, health problems and seems to be getting back on his or her feet but missed a couple of payments and needs some time to make it up, you may conclude that this mortgage is going to fix itself, let's bear with the borrower, particularly if you have positive housing price movement. If the borrower is just not making it and you don't think he or she is going to make it, and it seems like you will have to carry that person indefinitely, it's not good to prolong it. These are judgment calls you have to make on a case by case basis. There's significant benefit as far as lower severity as well as frequency to modify the loan if the loan is salvageable.

Question: 2007 and 2008 seem like they're going to be big years for sub-prime refi. What's your opinion about the trend outlook here, and what options do sub-prime borrowers have if they cannot refi?

Answer: Yes, this refi issue is a risk that we've known about, and it's a significant risk today, especially because the underwriting guidelines have been tightened by many lenders. But that's also something that we've taken into account in our sub-prime securitizations. As we've noted, we have seen more hybrid loans in the pools with more risk layering. Recognizing this early on, we have increased credit enhancement on those loans, and we're also taking into account the teaser rates on these loans. We were aware that once they reach their reset dates there will, in some cases, be considerable payment shock on some loans, and have increased credit enhancements.

Question: What's your opinion about the percent of these borrowers who will be able to successfully refi and how will that impact the level of severity?

Answer: The short answer is we don't know at this point.

Some of the issues to think about, though, are not just rate issues and housing price appreciation issues, but also what's happening on the originator side. To the extent that some of the major originators are no longer with us or are, perhaps, shadows of their former selves, the ability of the marketplace to address that refi volume -- even if the financial capacity of the borrower is still in fairly decent shape -- could be effected, too. You have to look at the manufacturing side of the equation, not just the financial health of the borrower or housing price appreciation. Many of the answers to these questions are linked, and so you may find if one variable goes bad, the other variables will go bad, too. But it's not clear at this point, and you express a legitimate worry. A lot of finance is predicated upon someone willing to take a borrower out. If that's not the case, then you essentially have to match the maturity of the loan with operating cash flow or earning with savings, and that's a different conversation. It's an issue we're looking at carefully for the originators, and the GSEs are looking at this, too.

Question: What effect will sub-prime mortgage stress have on the sub-prime auto sector?

Answer: We're starting to see some stress in sub-prime auto. It's nowhere near the degree that we've seen in sub-prime mortgages. Certainly the credit cycle has turned. We're seeing pressure in virtually every asset class. But at this point in time, there is erosion, but nothing anywhere nearly as significant versus what we're seeing sub-prime mortgages. Again, the overall environment remains reasonably healthy from the perspective of the US economy and from the perspective of employment, so at this point, we're not seeing the same sort of repercussions rippling through sub-prime auto, but it is there to a small degree.

Question: What about securities firms?

Answer: With respect to securities firms, we believe the current challenges facing sub-prime mortgages will likely have only a modest earnings impact, with no ratings repercussions anticipated, for the big five securities firms. To date the damage has been, and is expected to remain, relatively minimal. The decline in mortgage-related earnings has been in several areas, including a fall off in origination volumes, mark-to-markets of retained interests, and reduced secondary trading activity, particularly in lower rated ABS tranches. At this point, the weakness does appear to be concentrated in the sub-prime mortgage business with minimal spillover to their Alt-A or prime businesses. The first firms that could be most affected or potentially affected are firms such as Lehman Brothers and Bear Stearns. These firms continue to risk manage their exposures quite well, utilizing derivatives and other hedges to mitigate the risk of residuals that are staying a little longer on the balance sheet than what these firms would like. But, nevertheless they are getting the job done. We've seen tighter underwriting criteria beginning in early 2006 from these companies, not with respect just to receivables but also to the warehouse lines that they issue to mortgage banks. Counterparty exposures are monitored very closely with decreased advance rates, which perversely may be exacerbating some of the problems that we're seeing at some of the smaller mortgage banks as well. So net/net, we think this could be a slight earnings issue, but nowhere near the disaster that one might infer from what the CDS spreads have done in the recent week or so.

Regarding RMBS, as just pointed out one of the questions was, the impact on modifications on the Aaa levels. A related, frequently asked question is rating stability and what's going to happen in future? At this point, from a single A level standpoint, we would have to have a significant continued deterioration in loan performance for those bonds to be under ratings pressure. Obviously lower rated bonds like the Ba rated or speculative grade bonds are more vulnerable. In terms of Aaa rated bonds, we would have to have quite a meltdown before the vast majority of Aaa bonds are at risk of ratings transition or loss.

Conclusion

We would like to thank the 600+ Moody's clients who have called in to this teleconference. It has been a privilege to serve you. We are here to provide straight talk and prompt answers. Please let us know how we're doing.

Related Research

Issuer Comment:

[New Century TRS Holdings Inc., March 2007](#)

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Author

Senior Production Associate

Wing Chan

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