Subprime Loss Severities

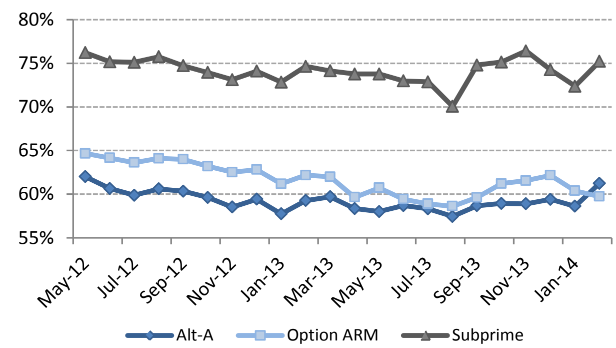
Update

May 02, 2014

In an article posted July 5, 2012 (“Subprime Loss Severities - Will They Continue to Underperform?”), we discussed factors affecting loss severities[1] and noted that certain collateral characteristics specific to Subprime mortgages (lower loan balances and longer liquidation timelines, etc.) may negate positive effects of improving housing market on their performance. We revisit the analysis, review actual results and evaluate the current housing environment in order to estimate future loss severities across product types.

As depicted in Figure 1, almost two years after the release of the original article, Subprime loss severities have not improved. In fact, at 75% they are now roughly at the same level as they were in May 2012 and are on average 14 points higher than those realized in other product types.

Figure 1. Loss Severities by Product Type



Over the same time period, liquidation timelines continued to extend, further increasing Servicer advances of scheduled P & I, maintenance, tax and legal costs, as well as possibly allowing more time for property deterioration. Additionally, growing liquidation timelines offset the benefit of the strong home price performance experienced over the past two years. The average liquidation time for Subprime loans rose almost 30%, from 31 to 41 months since May 2012 (Figure 2). As seen in the graph, Subprime mortgages are not alone in this trend. All product types have experienced sharp increases in liquidation timelines as Servicers faced regulatory changes, spent more time on loan modifications and loan pools experienced adverse selection (better properties were liquidated sooner, many through the short-sale process). It is important to note however, that the expanding timelines have a much more detrimental impact on Subprime collateral given its lower property valuation, as accumulating costs constitute a much higher percentage of the eventual liquidation proceeds (Figure 3a-3b).

Figure 2. Liquidation Timelines (Months)

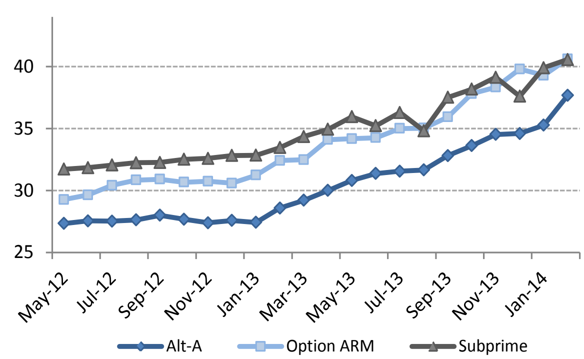
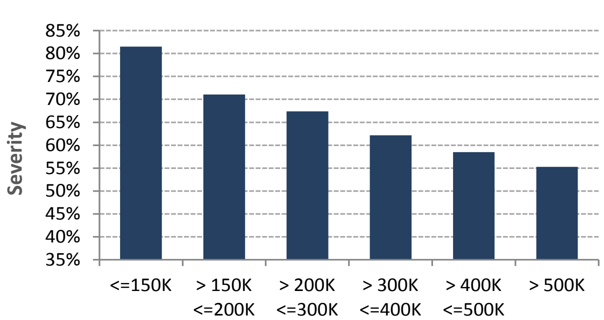
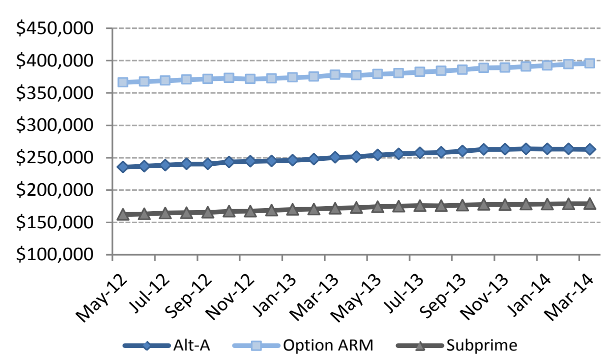


*Figure 3a. Loss Severity by Liquidated Balance**



*Include liquidation data from Jan2013 to Feb2014

Figure 3b. Average Liquidated Balance



[1] Loss severity is calculated by dividing total loss amount by unpaid loan balance at the time of liquidation. Loss severity of 70% means that 30% of the loan balance at liquidation was distributed to the trust.

Looking ahead, Subprime loans are less likely to experience substantial improvements in this area because of their geographical distribution (Figure 4). Roughly 45% are located in judicial states, notorious for longer liquidation timelines (Figure 5), as they require lengthy judicial processes. The elevated judicial exposure leaves Subprime collateral vulnerable to the backlog of the shadow inventory and home prices that are increasing at a slower pace relative to non-judicial locations (Figure 6). Additionally, the proportion of delinquent loans in judicial states is expected to rise going forward since loans located in non-judicial states liquidate faster, leaving the pools of Subprime mortgages adversely selected.

Figure 4. Judicial State Exposure

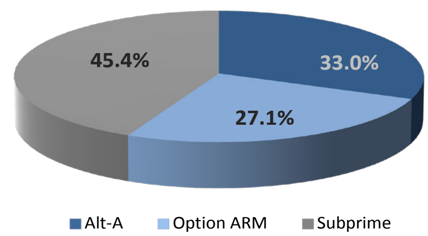


Figure 5. Liquidation Timelines (months) Judicial vs. Non-judicial states

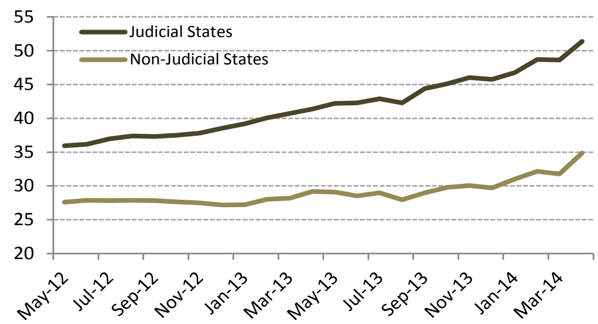


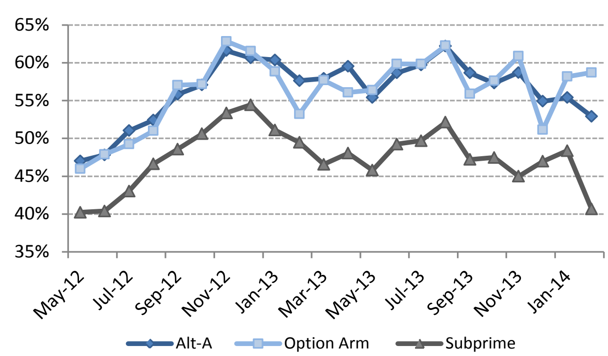
Figure 6. Home Price Changes

State	Change 1-Month	Change 12-Month	Change from Peak*	Change from Trough
Top 5 Non-Judicial States				
California	1.0%	19.8%	-19.8%	39.7%
Arizona	0.9%	12.5%	-30.5%	40.5%
Nevada	0.6%	18.5%	-39.9%	45.1%
Virginia	0.5%	5.4%	-16.7%	18.3%
Michigan	-0.6%	13.5%	-26.2%	34.8%
Top 5 Judicial States				
Florida	0.5%	12.3%	-36.4%	27.1%
Illinois	-0.2%	10.0%	-26.4%	10.9%
New York	2.4%	10.6%	-1.3%	17.3%
New Jersey	0.2%	7.3%	-23.3%	8.8%
Ohio	-0.9%	6.1%	-15.8%	8.4%

*Peak is defined as the highest HPI level before 2008

Figure 7 illustrates the fact that Subprime mortgages continue to experience the lowest percentage of non-REO liquidations, including short-sales (40% vs. the average of 55% for Alt-A and Option Arm). Most of these properties are located in less desirable neighborhoods that continue to face challenges. Additionally, many Subprime markets have been saturated with institutional investors targeting distressed and lower priced homes as rental investments. As discussed in one of our previous articles "Home Price Appreciation - Influenced by Investors, Oct 18th 2013", we believe that high investor demand may be short-lived and prove to be detrimental to these fragile neighborhoods.

Figure 7. Non-REO Sales by Product Type



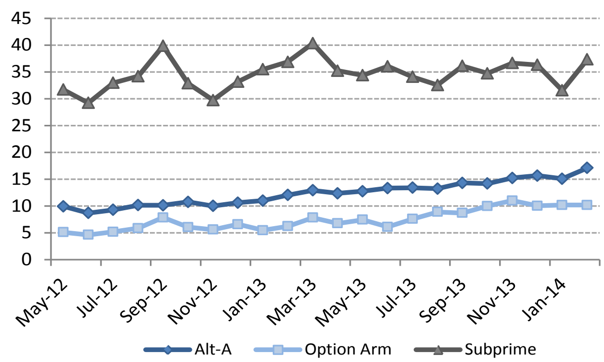
Modification activity continues to dominate this product type. In the first quarter of 2014, approximately 73% of all modifications occurred in Subprime collateral (Figure 8). Not only does this point to higher realized losses in the short-term (principal forgiveness amount is treated as an immediate loss to the trust), but also increases uncertainty about the future of these loans as modified Subprime borrowers consistently underperform other product types. According to our estimates, roughly 33% of modified Subprime borrowers become delinquent again. This share is considerably lower at 24% in Alt-A and 21% in Option Arm collateral.

Figure 8. Subprime Modification

Period	Subprime Share of all Modification
2012 Q1	74%
2012 Q2	77%
2012 Q3	73%
2012 Q4	66%
2013 Q1	69%
2013 Q2	70%
2013 Q3	61%
2013 Q4	71%
2014 Q1	73%

Lastly, over 65% of Subprime deals include 2nd lien loans known for their extremely high severities. The majority get charged off at or above 100% severity once they become 90-day delinquent. As a result and as illustrated in the graph (Figure 9), roughly 38% of all Subprime liquidations have experienced loss severities greater than 100%.

Figure 9: % of Liquidations with Severity >100%



Falcon Bridge Capital projects Subprime deals will continue to suffer from high loss severities for the next three to five years. Detrimental impact of longer liquidation timelines on lower valued properties, less desirable location of Subprime collateral, uneven economic recovery, and a larger pool of modified borrowers will contribute to continued underperformance. Over the longer time horizon, with continued modest home price appreciation, and as the inventory of distressed properties becomes more manageable, we expect loss severities to decline. We estimate that Subprime collateral will be the last to reap the benefits of the housing recovery, behind Prime, Option Arm and Alt-A collateral.

Market prices of Subprime bonds have rallied indiscriminately over the past few years based on techinicals. The underlying fundamentals of Subprime collateral do not support this price appreciation and should be noted by investors.

Disclosures

The underlying data is provided by CoreLogic (subscription-based data repository). Our access to CoreLogic data includes home price indices and approximately 95% of all U.S. Option ARM, Subprime, and Alt-A securitized product. Algorithms and analysis to access the information and any interpretation are proprietary to Falcon Bridge Capital, LLC.

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