Focus on
Residential Mortgage Backed
Securities

FALCON BRIDGE Capital

May 17, 2012

In this issue

Recast risk is almost behind us, but the reset risk still remains

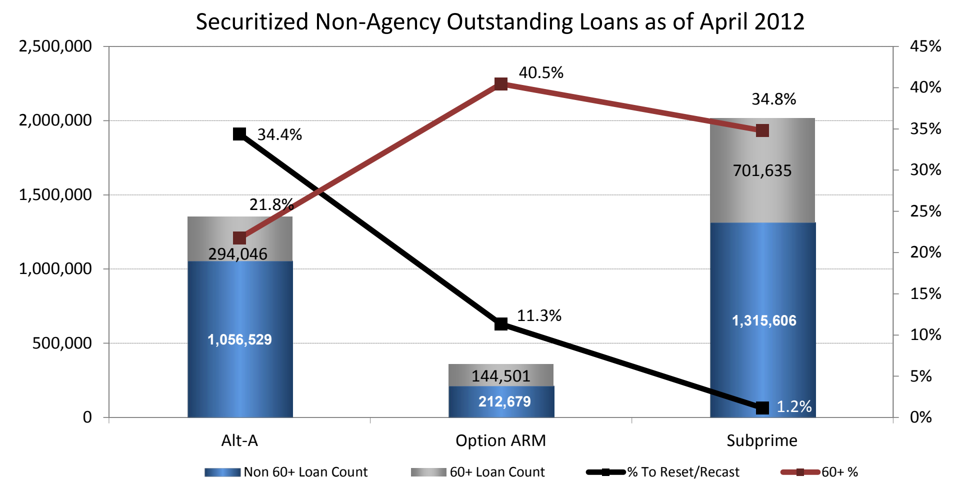
During the years of the housing bubble, exotic mortgage products were created to meet market demand and to increase affordability by offering Interest Only (Alt-A and Subprime) and Negative Amortization loans (Option ARM). These products usually offer attractive low payments in the initial years and eventually reset* (IO loans) or recast** (Option ARM loans), often resulting in a payment shock.

Early in the housing crisis, **Subprime** loans started defaulting due to home price decline and looming reset risk. Consequently, servicers attempted to prevent defaults by lowering rates on loans pending reset. The remaining number of subprime loans yet to reset for the first time is only 1.2% of the 2 million Subprime loans outstanding.

In **Option ARM** space, recast risk was discussed extensively throughout the last few years. Only 11.3% of the outstanding loans are yet to recast. Given that more than half of the loans that will recast are already delinquent or modified, the remaining recast risk is negligible.

In **Alt-A** space, 34.4% of the outstanding loans will reset in the next few years. Given the current low interest rate environment, it may not pose an immediate risk. However, if rates were to increase as implied by the forward curve, the payment shock could be substantial, which may lead to higher defaults or more modification activity.

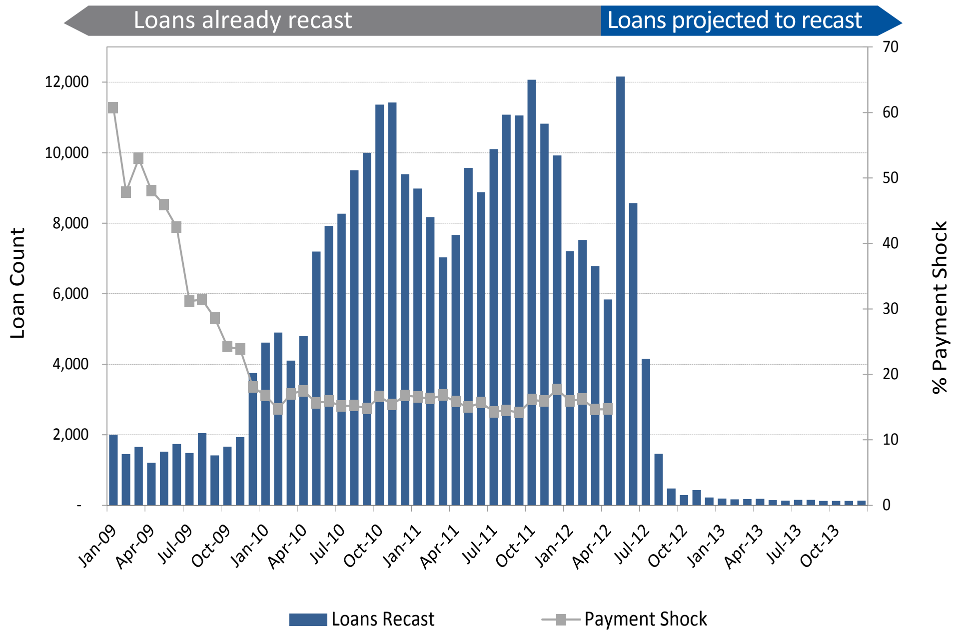
Recast risk for Option ARM loans is mostly behind us, but the reset risk still remains for all floating rate loans. The Federal Reserve may be forced to keep rates at historical low level beyond 2014 to prevent borrowers from defaulting due to possible payment shock.



* Reset: Borrowers make interest-only payments during the initial years (usually from two to ten years). After the initial interest-only period, the loans reset and begin to amortize, resulting in substantial payment increases because a) the principal component is being amortized over the remaining months b) the prevailing rates may be higher. Additionally, these loans are subject to subsequent resets and may result in payment increases as rates continue to rise. This article focuses mainly on risks associated with the initial reset when borrowers switch from interest only to fully-amortizing payments.

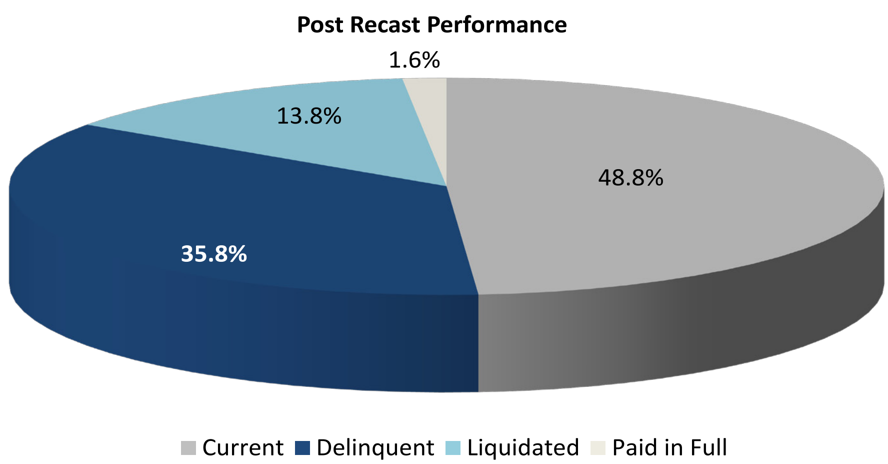
** Recast: Option ARM borrowers have the option to make minimum payments for the first few years, often not sufficient to cover interest, which increases the loan balance (negative amortization). When the option expires, the borrowers start to pay fully-amortizing payments based on the prevailing rate plus margin.

Loan Recast: Option ARM



Close to 90% of the Option ARM loans have already recasted.

Of the loans yet to recast, 52.3% are already delinquent and another 8.3% are current but modified.



Total current loans: 48.8%

Clean current loans*: 27.7%

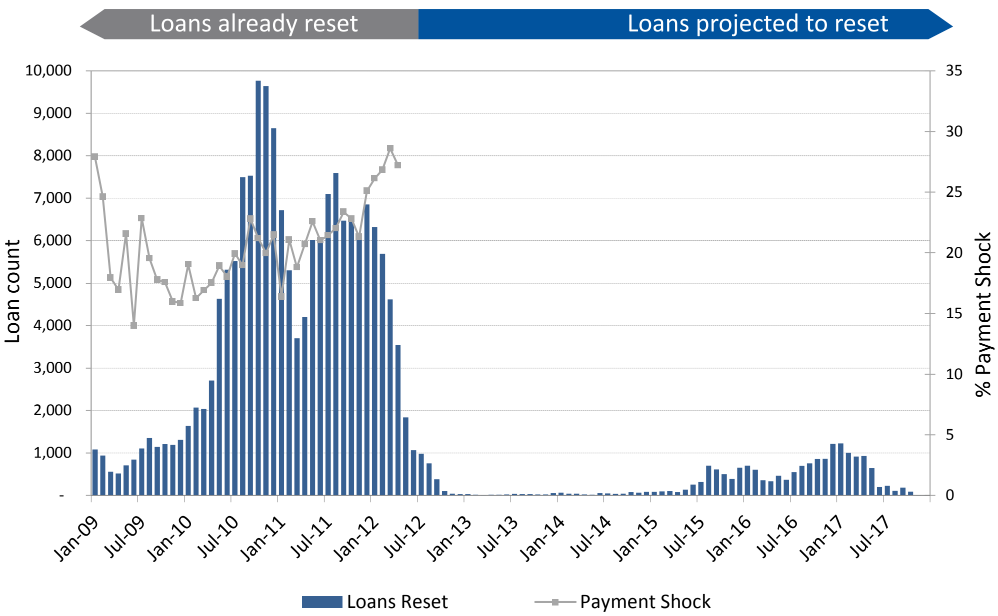
Total loans modified: 8.7%

Conclusion

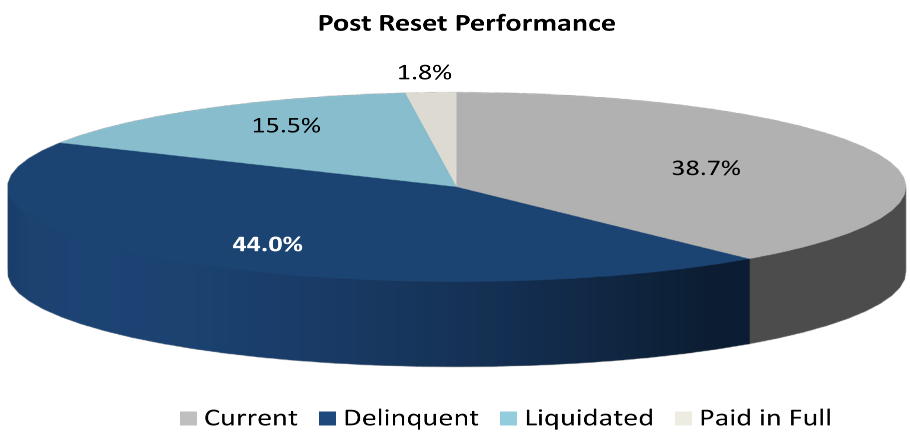
Recast risk for Option ARM loans is minimal since the remaining number of loans yet to recast is small and most will do so before the end of 2012. In addition, over half of these loans are already delinquent or modified.

* Never missed a payment

Loan Reset: Subprime



Over 98% of the Subprime loans have already passed the initial reset. These borrowers experienced average payment shock of 15% to 30%. As a result, approximately 41.8% of all Subprime loans that passed the initial reset have been modified.



Total current loans:

38.7%

Clean current loans*:

8.1%

Total loans modified:

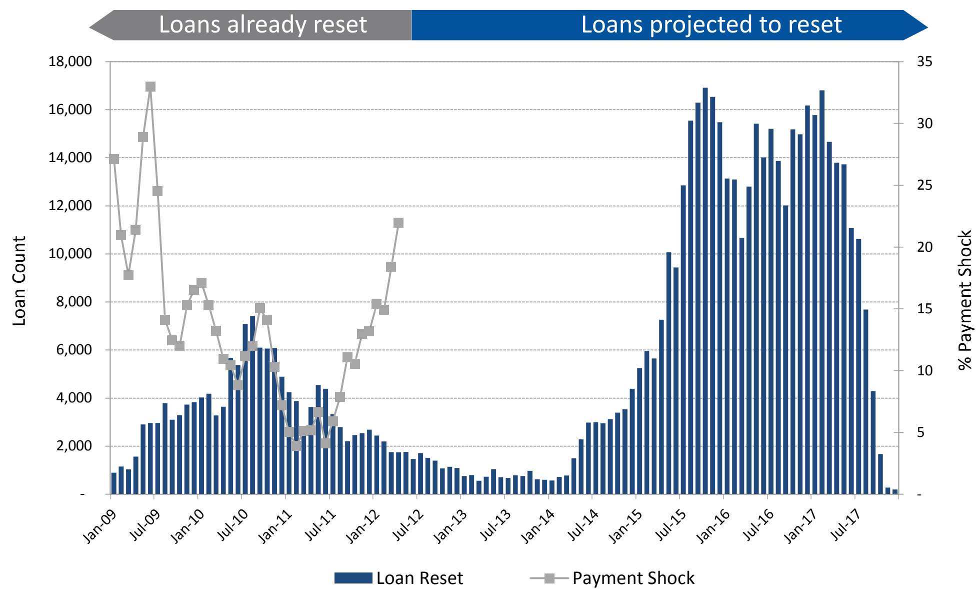
41.8%

Conclusion

Initial reset risk for Subprime loans is negligible due to small number of loans remaining to reset.

* Never missed a payment

Loan Reset: Alt-A

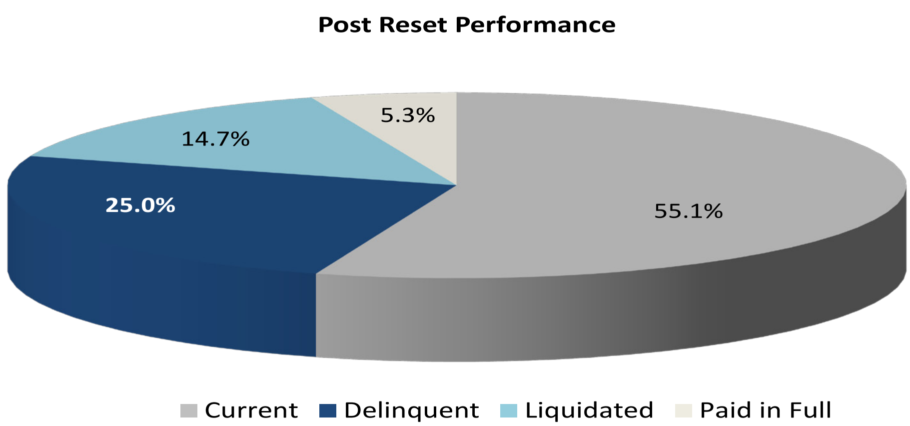


Since 2009, over 140,000 loans have passed the initial reset. These are mostly 5-year Interest Only loans.

Majority of loans that are yet to reset (initial) from 2015 to 2017 are 10-year Interest Only loans.

Of the loans yet to reset for the first time over the next few years, 27.2% are already delinquent and another 12.2% are current but modified.

The number of loans (current and non-modified) at risk of initial reset is over 280,000.



Total current loans: 55.1%

Clean current loans*: 31.3%

Total loans modified: 13.7%

Conclusion

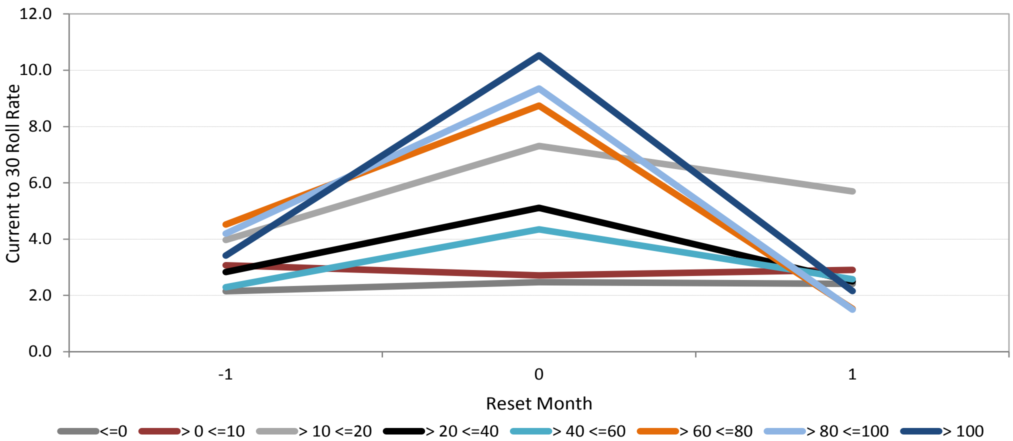
Approximately 280,000 loans are yet to reset for the first time and most will do so from 2015 to 2017.

* Never missed a payment

Post Reset Performance and Projected Payment Shock: Alt-A

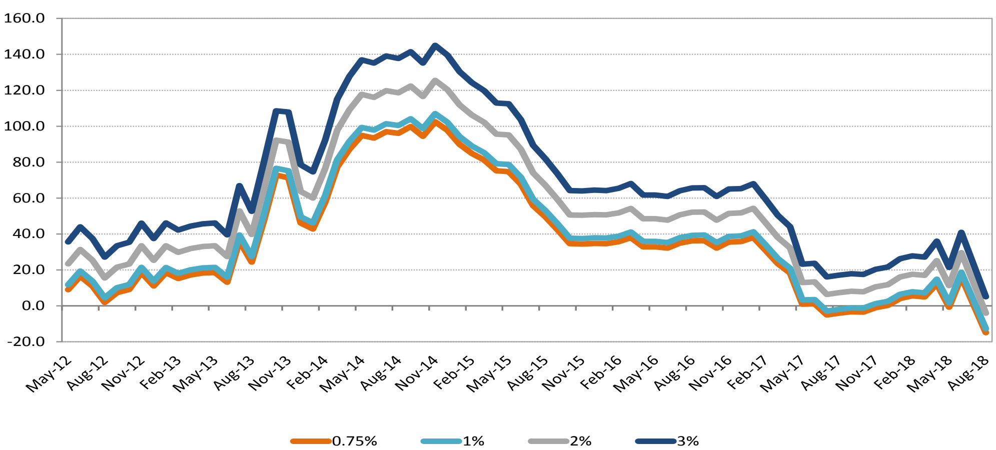
Post Reset Performance by Payment Shock *

(Loans reset during Jan. 2011 thru Feb. 2012)



* The analysis is done on non-modified loans.

Projected Payment Shock at Various Rate Assumptions *



The current monthly payment is about $1,400 on average.

* The analysis is done on current and non-modified Alt-A loans.

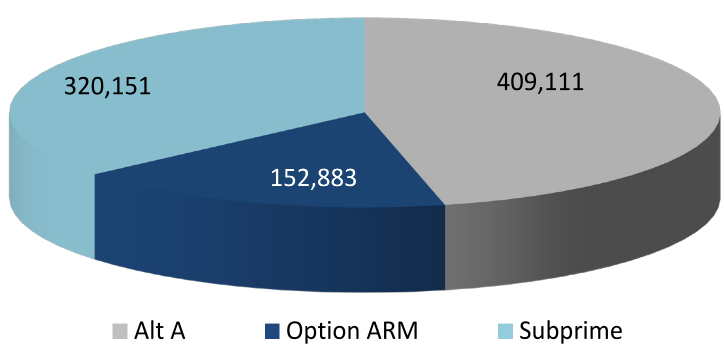
Current to 30-day delinquent roll rate increased at reset for loans with payment increase of more than 10%. For instance, for the loans with a payment shock between 60% and 80% (orange line), current to 30-day delinquent roll rate increased from 4.5% to more than 8.7%.

Most loans are indexed off 6M LIBOR, which is around 0.75% as of April 2012. Even if rates stay at current levels, the payment shock can be as high as 60% when borrowers switch from interest only to fully amortizing payment.

The forward curve indicates that 6M LIBOR may rise to 1.2%, 1.8%, and 2.3% in 2015, 2016, and 2017, respectively. Based on the past performance at various payment shock levels, the current to 30-day delinquent roll rate can increase significantly from 2% to over 10% as indicated in the first graph.

Non-Modified Current Floating Rate Loans

Loan Count as of April 2012



* All floating rate loans can experience payment shock when rates increase at periodic reset.

Conclusion

Besides the initial reset/recast risk, close to 900,000 floating rate loans in non-agency space (excluding Prime) are subject to periodic reset risk. Additionally, over 432,000 of them are underwater as of April 2012 . The payment shock may not be as high as that from initial reset/recast, but it can still be as high as 20%, even with periodic payment cap in place.

Federal Reserve may be forced to keep rates low beyond 2014 to prevent these borrowers from defaulting.

Servicers may ramp up the modification effort to help borrowers stay in their homes.

Disclosures

The underlying loan data is provided by CoreLogic (subscription-based data repository) for a specific subset of loans. Our access to CoreLogic data includes approximately 95% of all U.S. Option ARM, Subprime, and Alt-A securitized product. Unless specified, Prime, Jumbo, or Agency Backed loans are not includes in the graphs and charts.

Algorithms and analysis to access the information and any interpretation are proprietary to Falcon Bridge Capital, LLC.

For questions or additional information, please contact:

Sunil Chowdry
schowdry@falconbridgcapital.com
(925) 979-4280

Danny Zhou
dzhou@falconbridgecapital.com
(925) 979-4290

• BY ACCEPTING A COPY OF THIS CONFIDENTIAL PRESENTATION, THE RECIPIENT AGREES THAT NEITHER IT NOR ANY OF ITS EMPLOYEES OR ADVISORS SHALL USE THE INFORMATION FOR ANY PURPOSE OTHER THAN EVALUATING THE SPECIFIC TRANSACTION DESCRIBED HEREIN OR DIVULGE TO ANY OTHER PARTY SUCH INFORMATION. THIS CONFIDENTIAL PRESENTATION SHALL NOT BE PHOTOCOPIED, REPRODUCED OR DISTRIBUTED TO OTHERS WITHOUT THE PRIOR WRITTEN CONSENT OF THE PRINCIPALS.

• NOTWITHSTANDING ANYTHING TO THE CONTRARY CONTAINED HEREIN, THE RECIPIENT (AND EACH EMPLOYEE, REPRESENTATIVE, OR OTHER AGENT OF THE RECIPIENT) MAY DISCLOSE TO ANY AND ALL PERSONS, WITHOUT LIMITATION OF ANY KIND, THE TAX TREATMENT AND TAX STRUCTURE OF THE TRANSACTIONS DESCRIBED HEREIN) AND ALL MATERIALS OF ANY KIND THAT ARE PROVIDED TO THE PROSPECTIVE INVESTOR RELATING TO SUCH TAX TREATMENT AND TAX STRUCTURE (AS SUCH TERMS ARE DEFINED IN TREASURY REGULATION SECTION 1.6011-4). THIS AUTHORIZATION OF TAX DISCLOSURE IS RETROACTIVELY EFFECTIVE TO THE COMMENCEMENT OF DISCUSSIONS WITH PROSPECTIVE INVESTORS REGARDING THE TRANSACTIONS CONTEMPLATED HEREIN.

• THE FINANCIAL PROJECTIONS INCLUDED HEREIN HAVE BEEN PREPARED ON THE BASIS OF ASSUMPTIONS STATED THEREIN. FUTURE OPERATING RESULTS ARE IMPOSSIBLE TO PREDICT AND NO REPRESENTATION OF ANY KIND IS MADE RESPECTING THE FUTURE ACCURACY OR COMPLETENESS OF THESE FORECASTS.

• THIS DOCUMENT AND THE RELATED ORAL PRESENTATION IS NOT AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY SECURITIES.

• THE INFORMATION INCLUDED HEREIN IS PRELIMINARY, AND WILL BE SUPERSEDED BY A DEFINITIVE PRIVATE PLACEMENT MEMORANDUM.

• WE WILL NOT ACCEPT ANY OFFER BY YOU TO PURCHASE SECURITIES AND YOU WILL NOT HAVE ANY CONTRACTUAL COMMITMENT TO PURCHASE SECURITIES UNTIL AFTER YOU HAVE RECEIVED THE DEFINITIVE PRIVATE PLACEMENT MEMORANDUM.

• DISCUSSIONS OF FEDERAL TAX ISSUES IN THIS PRESENTATION ARE NOT INTENDED TO BE RELIED UPON BY INDIVIDUAL INVESTORS. EACH INVESTOR SHOULD SEEK ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.

• THERE CAN BE NO ASSURANCE THAT PROJECTED RETURNS WILL BE ACHIEVED OR THAT THE FUND WILL BE ABLE TO IMPLEMENT ITS INVESTMENT STRATEGY OR ACHIEVE ITS INVESTMENT OBJECTIVES.

• GROSS IRRs DO NOT REFLECT MANAGEMENT FEES, CARRIED INTEREST, TAXES, TRANSACTION COSTS AND OTHER EXPENSES TO BE BORNE BY INVESTORS IN THE FUNDS, WHICH WILL REDUCE RETURNS.