Focus on
Residential Mortgage Backed
Securities

FALCON BRIDGE Capital

July 30, 2012

In this issue

Government Intervention Programs and Settlements – Update

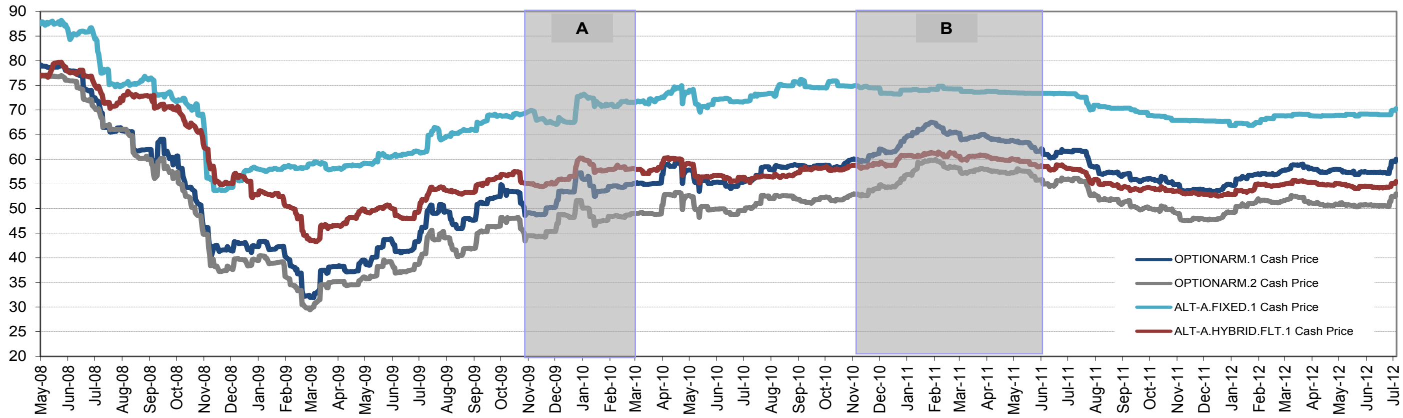
Over the past 2-3 years the government has taken steps to support housing recovery by promoting homeownership (tax credits offered to new homebuyers), supporting and providing relief to existing homeowners (keeping interest rates low), as well as attempting to limit the inflow of distressed properties onto the market (Foreclosure moratoria, modification programs) and facilitating access to mortgage credit (refinance programs). The implications of the various government initiatives and settlements, created with the intention to strengthen the housing market, often times has created inconsistent results across different Non-Agency RMBS product types and affect bond valuations differently depending on their position in the capital structure.

In this issue, we briefly describe various government intervention and settlement programs and focus on evaluating new legislative policies, examining their possible outcomes, and analyzing their impact on the performance of Non-Agency RMBS securities.

A QE1 (Nov '09 - Mar '10) resulted in a relatively significant drop in rates that was intended to increase credit availability to homebuyers and aid existing homeowners (especially those with adjustable rate mortgages) by keeping their payments affordable. At the same time, the economic stimulus bill (Mar '09) offered billions in spending and tax cuts in an attempt to encourage economic growth. Additionally, earlier implemented Troubled Asset Relief Program ("TARP") helped stabilize financial institutions and brought some liquidity back to the market. One of its initiatives, Public-Private Investment Program ("PPIP") provided non-recourse leverage, as well as increased price transparency. All these efforts resulted in a positive response to mortgage backed securities.

B First Time Homebuyer Credit, along with QE2 (Nov '10 - Jun '11) also resulted in tighter spreads across securitized products. The impact of these programs wasn't as pronounced this time around because of other market developments. For instance, Foreclosure moratoriums that were created to sort out title or other legal foreclosure concerns resulted in liquidation delays and increased severities creating uncertainty around key RMBS pricing assumptions. Also, Maiden Lane II sales by the New York Fed played a meaningful part in the softening of Non-Agency RMBS prices.

The chart below shows the timing of certain government actions implemented in recent years, as well as corresponding price movements in various Option Arm and Alt-A securities.



Source: JPMorgan, Falcon Bridge Capital

State Attorneys General Settlement ("AG Settlement")

General Overview

A **$25bn** settlement with Ally Financial Inc. ($310mm), Bank of America Corp. ($11.8bn), Citigroup Inc. ($2.2bn), JPMorgan Chase ($5.3bn) and Wells Fargo Bank ($5.4bn) comprising of:

1. $1.5bn in cash payments to borrowers who were foreclosed upon between 2008 and December 31, 2011. (Up to $2,000 per borrower).
2. $2.75bn to the states and $750mm to the federal government to fund legal aid (consumer and foreclosure protection efforts).
3. $10bn in credits for principal forgiveness on underwater delinquent borrowers.
4. $3bn for refinance of current borrowers (Servicer-owned first lien mortgage loans only).
5. $7bn in credits for various foreclosure initiatives including but not limited to: short sales, anti-blight measures, principal forbearance for the unemployed.
6. Improvement in loss mitigation processes - (a) dual tracking of FC and modification is prohibited (b) single point of contact for borrowers.

California is to receive a significant portion of the settlement - $18bn:

1. $12bn in principal reductions
2. $3.5bn to forgive unpaid debts on foreclosures
3. $1.1bn on foreclosure prevention programs
4. $849mm for refinance of current borrowers
5. $279mm in cash to foreclosed borrowers
6. $430mm in costs, fees and penalty payments

Additional considerations:

- GSE loans are excluded from the settlement.
- Banks earn $1.00 credit for $1.00 write-down of principal on loans in their portfolio and $0.45 credit on loans held by investors.

Implications

1. Impact on Non-Agency RMBS is highly dependent on how Servicers allocate their modification efforts (portfolio vs. serviced loans) and PSA restrictions. Many market participants expect Servicers to focus on portfolio loans due to continued concern of litigation from bondholders.
2. Increase in principal forgiveness rates could result in higher near-term losses (over the next 2-3 years), reduced interest income and improved loan characteristics and performance of the remaining pool. Mezzanine and subordinate bonds will be affected the most as the increase in realized losses will result in faster write-off of these bonds, negatively impacting their performance and valuations.
3. Possible extension of the liquidation timelines in the near-term while the Servicers set up/ modify their processes.
4. Higher near-term losses but possibly lower severities in the future as the processes become more efficient.
5. Negative impact on Subprime Front Pay and OA Super Senior bonds due to extended duration if it's not outweighed by lower severities over time.
6. Increased short-sale activity will result in shorter liquidation timelines and possibly lower loss severities.
7. The settlement potentially creates conflicts of interest and may result in:
    a. Disproportionate amount of modifications in securitized product, allowing Servicers to satisfy credit requirements with investor funds.
    b. Larger principal forgiveness on first lien loans where seconds are held in bank portfolios (thus improving the position of the second lien).
8. Prime, Alt-A, and OA deals are expected to be significantly affected (due to the reasons above) given a large portion of the settlement is allocated to California, where the majority of these properties are located.

Intervention Programs and Settlements

Expanded Home Affordable Modification Program ("HAMP")

General Overview

Expanded HAMP eligibility:

1. Application deadline was extended to the end of 2013.
2. Relaxed debt-to-income requirements.
3. Investors with rental properties can take advantage of the program.

Increased incentives for modifications:

1. Treasury is expected to pay from 18 to 63 cents on the dollar of principal forgiveness to investors (triple the original amount - up from between 6 cents and 21 cents), depending on the degree of change in LTV of the individual loans.
2. Principal reduction incentives are being offered for loans insured or owned by the GSEs.

Implications

1. The expanded HAMP may result in increased up-front principal forgiveness coupled with lower severities due to the incentive pay to investors. The bulk of the modifications is expected to happen in the latter part of 2012, gradually decreasing through December 2013.
2. Similar to the AG Settlement, OA Senior Mezzanine bonds would be adversely affected due to faster writedowns (although to a lesser extent, given the increased incentive payments). Also, Subprime Front Pay may be negatively impacted as they may face increased extension risk or the timing to the cross-over may be shortened.
3. OA Super Senior and Alt-A bonds should benefit due to possibly lower future severities. Also, certain Subprime LCF (those with cross-over) may benefit due to the principal window opening sooner.

FHA Refinance Program ("Obama Refinance Program")

General Overview

Expanded refinance program (non-GSE) offers borrowers that meet the following criteria to refinance:

1. Current on their mortgage for the past 6 months (no more than 30 day delinquency in the past 12 months).
2. Current FICO score of at least 580.
3. Existing loan balance is no larger than the current FHA conforming loan limits in their area.
4. Single family, owner-occupied principal residence, and loan-to-value limits which may require lenders interested in refinancing deeply underwater loans (e.g. greater than 140 LTV) to write down a portion of the balance of these loans before they qualify.

The estimated **$5-$10bn** cost of the Plan would be paid for by a fee on the largest financial institutions.

Implications

1. Most Non-Agency RMBS would benefit from the refinance program as it would increase prepayment speeds in the loan pools or losses experienced would be less than losses from liquidation.
2. It's unlikely the FHA refinance plan gets Congressional approval due to the current political uncertainty.
3. In conjunction with HAMP, some borrowers could be candidates for refinancing.

Intervention Programs and Settlements

Bank of America Settlement (“Countrywide Servicer Settlement”)

General Overview

1. An **$8.5bn** cash settlement for rep and warranty breaches with Bank of New York and a group of 22 institutional investors. Settlement payout is to be divided between 530 Countrywide-issued (only) trusts as subsequent recoveries (or principal payments for bonds entitled to receive principal).
2. Bank of America has agreed to move the servicing of high-risk loans for troubled borrowers to qualified sub-servicing firms (at Bank of America’s expense), clarify loss mitigation standards, improve servicing processes, benchmark Bank of America’s servicing performance to industry norms, and pay agreed upon fees to the Covered Trusts if these servicing standards are not met on loans it continues to service. The additional servicing obligations are expected to cost approximately $400mm.

Implications

1. Bonds that benefit the most from higher prepayments are OA Senior Mezz or Mezz (if they receive settlement prior to being written down) and Subprime Front Pays due to increased cash flow.
2. Countrywide-issued OA Super Senior bonds are also positively affected, but would gain even more if the settlement payout occurs once Senior Mezz bonds are being written down (or already written-off), thus receiving a larger portion of the cash payment.

Federal Reserve Board White Paper, entitled “The U.S. Housing Market: Current Conditions and Policy Considerations”

General Overview

1. Recommends programs that would facilitate converting REO properties to rental units:
    a. Bulk sale transactions to Investors with debt financing.
2. Expanding refinancing to homeowners with high LTVs whose mortgage is not guaranteed by the GSEs.

Implications

1. Selling properties to Investors in bulk sales with some form of debt financing could reduce the inventory of foreclosed properties in distressed communities.
2. It would expedite eventual liquidations at possibly lower severities.
3. Refinancing Non-HARP eligible borrowers under a new program would be extremely accretive to OA and Alt-A valuations.

Intervention Programs and Settlements

Expanded HARP 2.0 - GSE Loans ONLY

General Overview

Expansion of Refinancing to previously ineligible borrowers:

1. Extension of HARP refinancing till December 2013.
2. Program is limited to loans originated on or prior to May 2009; Proposed extension to loans originated on or prior to May 2010
3. No LTV Limit.

Implications

No direct implications to Non-Agency bond valuations, however;

1. Increased refinancing could have a positive impact to the housing market in general as reduced monthly payments could boost consumer spending.
2. Possibly avoid delinquency and defaults of borrowers who would have strategically defaulted.

Rescap Settlement ("Rescap - Direct and Indirect Subsidiary - Settlement")

General Overview

1. \$8.7bn cash settlement for rep and warranty breaches with a group of 17 institutional investors.
2. Settlement payout to be distributed pro-rata to other senior unsecured creditors once bankruptcy is approved by court.
3. Assuming 25% recovery on senior unsecured claims or \$2.2bn allocated to the trust.
4. Specifics to the distribution of proceeds to various bonds/trusts are still in the works.

Implications

1. Estimated payouts to Non-Agency RMBS investors worth ~1-4 pts for jumbo and Alt-A deals and ~4-8 pts for subprime, second-lien, and OA deals (JPM).
2. Subprime second and third-pays, as well as Alt-A and OA senior and junior mezz bonds, will benefit most from the settlement recoveries (JPM).

Intervention Programs and Settlements

California Homeowners' Bill of Rights

General Overview

1. The law goes into effect on January 1, 2013. The intent of the Homeowner Bill of Right is to ensure the transparency of the foreclosure process and to prevent any abusive tactics.
2. The Homeowner Bill of Rights incorporates and extends the reforms that were part of the AG Settlement:
   a. Dual-track foreclosures are prohibited (borrowers pursuing modifications cannot be foreclosed on).
   b. Assignment of a single point of contact is required.
   c. Civil penalties on fraudulently signed mortgage documents will be imposed.
3. Homeowners may require Servicers to document their right to foreclose.

Implications

1. Liquidation timelines may extend even more as Servicers and Lenders are ensuring their compliance with the new law. This may result in increased severities in the short-term (negatively affecting all product types). On the positive side, once the new and efficient processes are in place, losses over the longer time horizon may decrease (especially if the home prices stabilize or even increase).
2. The initial (currently observed) slowdown in the foreclosure process will cause a drop in the available supply of distressed properties that may artificially increase home prices during that time.

Homeownership Protection Program - San Bernardino County

General Overview

1. The County of San Bernardino and the cities of Fontana and Ontario created a Joint Powers Authority and initiated the use of eminent domain law in an attempt to aid underwater borrowers within their jurisdiction.
2. The plan is to seize and restructure non-delinquent mortgages (excluding Fannie Mae and Freddie Mac loans) with the intent of helping owners keep their homes. The trusts would be required to sell the loans at court-determined fair-market values to the local governments.

Implications

1. The proposal affects only a small portion of the Non-Agency RMBS. The implications may be felt across the entire sector however, if the investors feel that the ability of municipalities to exercise the call option on loans in RMBS is going to spread to other counties.
2. The premise of the initiative is to restructure the loans so the borrowers are able to refinance into other government-sponsored mortgages. This will most likely result in unnecessary and high realized losses on best performing, current loans and may negatively impact all product types (especially Alt-A and Option ARM as they have the highest proportion of non-delinquent, underwater loans) and specifically securities lower in the capital structure.

Rebuilding American Homeownership ("RAH") Trust

General Overview

A proposal from Oregon Senator Jeff Merkley released on July 25, 2012 offers three mortgage refinance options for underwater borrowers who are current on their existing mortgage and would satisfy standard underwriting criteria:

1. 15-year mortgage at 4%.
2. 30-year mortgage at 5%.
3. Two-part mortgage, consisting of a first mortgage for 95% of a home's current value and a soft second mortgage on the balance. The soft second mortgage does not accrue interest or require payments for five years.

Mortgages with a LTV exceeding 140% would need to be written down to 140% LTV to qualify for the program.

The proposed funding sources include:

1. Securitization.
2. Mortgage insurance.
3. "Risk transfer fee" imposed on parties currently holding the loans.
4. Unused money from other federal foreclosure prevention programs.
5. State funds from the Hardest Hit Program.
6. Funds awarded through the AG Settlement.

Implications

The plan is in its initial stages and one of the various government plans proposed in order to help underwater borrowers to refinance. Refinancing underwater borrowers would be extremely accretive to OA and Alt-A valuations.

Conclusion

Ongoing government intervention through any existing or new legislation, programs or settlements will continue to greatly influence pricing and collateral performance of Non-Agency RMBS. In the long-term they are expected to reduce the excess supply of distressed properties and contribute to the emergence of a healthy housing market. However, in the meantime, they may create performance uncertainty and temporary mispricing.

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.

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