Focus on Residential Mortgage Backed Securities

FALCONBRIDGE Capital

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Reset Risk in Non-agency RMBS

In our May 2012 issue, we discussed the recast/reset risk of various Non-agency RMBS products. We concluded that 1) the risk for Option ARM (OA) loans was almost behind us because most OA loans should have either reached their negative amortization maximum or passed the 5-year recast time limit, 2) the majority of subprime loans have passed their interest only (IO) periods, and 3) Alt-A product continues to be at risk. IO periods for many Alt-A borrowers are scheduled to end in the next 2-3 years which may result in a substantial payment shock as loans begin to fully amortize for the remaining term.

In this issue, we examine the performance of IO loans originated between 2004 and 2007 (mostly 5/1 IO) to understand post-reset delinquency and prepayment trends. Evidenced by the performance graphs below, two general trends should prevail for the remaining IO loans:

1. The higher the payment shock, the more likely the borrowers are to become delinquent (Figure 1).
2. The lower the LTV, the less likely the borrowers are to default. In fact, borrowers with low LTV loans have a higher propensity to prepay, given they now have the ability to either refinance the existing mortgages or sell their homes. Three-month moving average roll rates shown in Figure 2 and Figure 3 illustrate this point.

Figure 1: Current to Delinquent Roll Rate by Payment Shock %

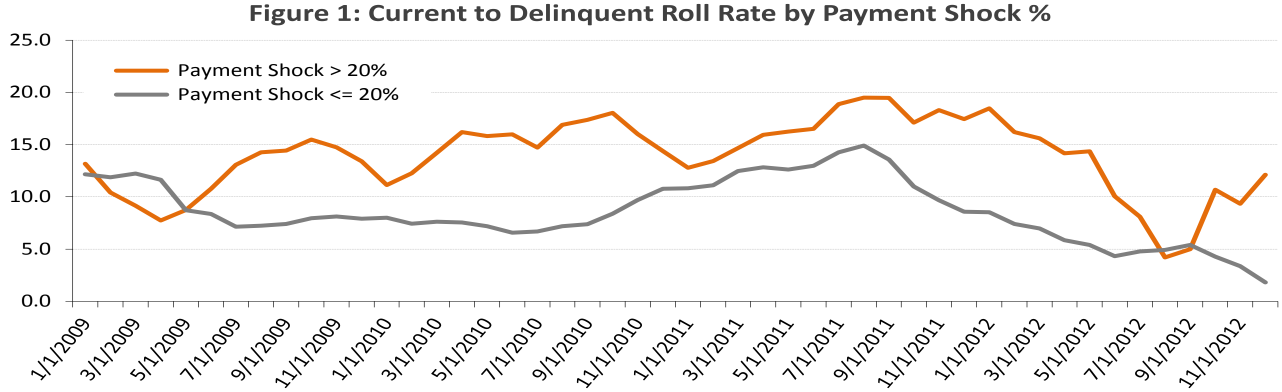


Figure 2: Current to Delinquent Roll Rate by LTV

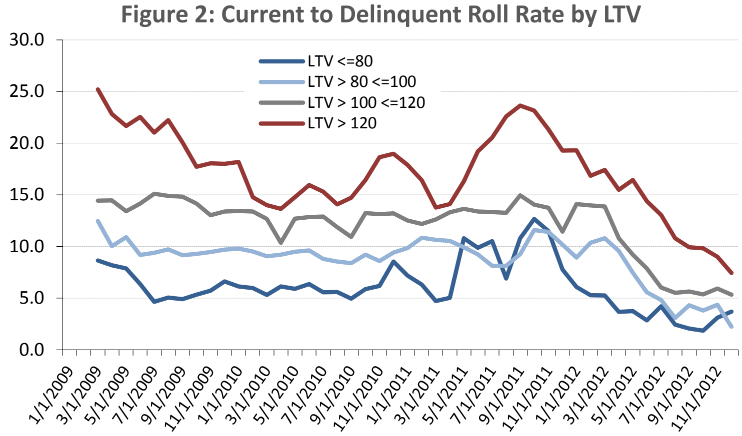
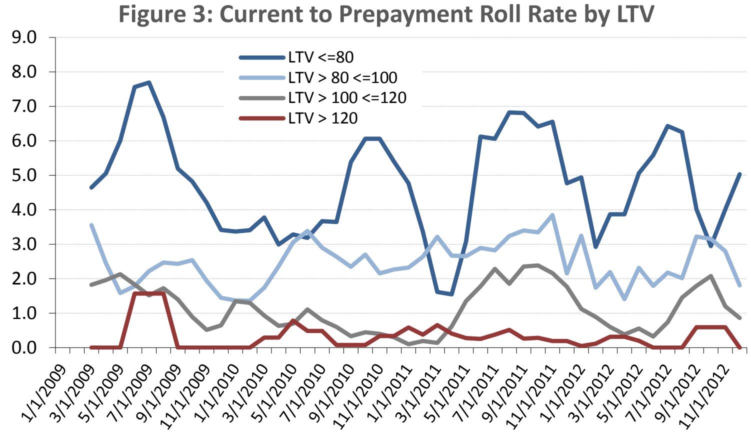
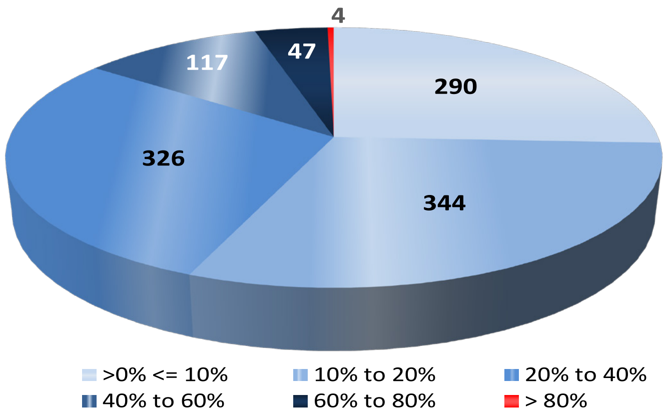


Figure 3: Current to Prepayment Roll Rate by LTV



Alt-A: Risks and Opportunities

Figure 4: % of Loans at Risk within Alt-A Deals



In Alt-A space, roughly 66% of deals (1,128 out of 1,713 deals) have some exposure to loans that are at risk of a payment shock. Of the 1,128 deals, 838 deals have more than 10% of the loans at risk. Figure 4 shows the number of deals within specific payment shock buckets.

Figure 5: Payment Shock Distribution at Recast

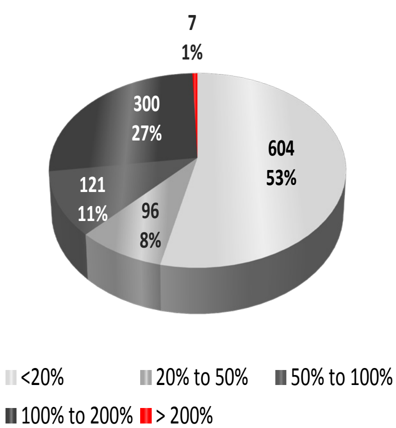
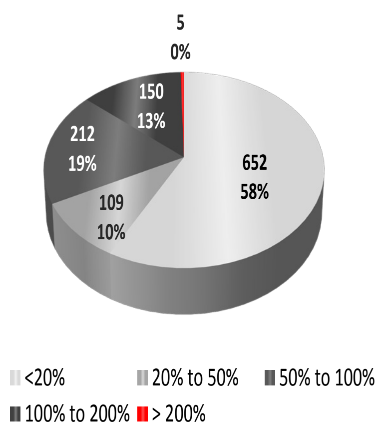
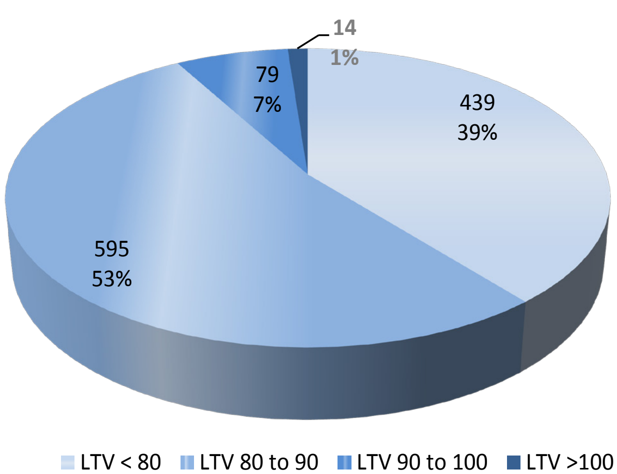


Figure 6: Payment Shock Distribution * Assuming Refi at 4%



Roughly half of the loans will face a payment shock exceeding 20% of their current monthly payment (figure 5). Even if all of them were able to refinance into a 4% 30-year mortgage, almost half of these borrowers would still face the payment shock of over 20% (figure 6). We believe this subset of loans would most likely need to be modified in order to avoid increased delinquencies at reset.

Figure 7: LTV Distribution



On the other hand, 39% of these loans have less than 80% LTV and 98.8% of these borrowers have equity in their homes. As shown on page 1, many low LTV loans have been able to prepay even at the height of the housing crisis. With moderate HPA, most loans should have less than 100% LTV and more borrowers could become eligible to refinance or sell their homes. Whether borrowers will sell is highly dependent on whether they can uproot their family and on the prevailing rent in the neighborhood, assuming they want to stay in the area.

Alt-A: Risks and Opportunities (Cont.)

To emphasize the importance of deal selection, we compare two deals serviced by Chase: Homebanc 2005-3 and Homebanc 2005-5.

On the surface, the collateral profiles are similar. The IO period for the majority of the loans in both deals is scheduled to end next year and other performance statistics are not significantly different (table 1). Correspondingly, general loan characteristics of mortgages facing the reset are also alike (table 2), thus making it appear as if the post-rest performance for these two deals should be similar.

Table 1: Characteristics of All Outstanding Loans

	HOMEBANC 2005-3	HOMEBANC 2005-5
Loan Count	1,567	1,764
Average Balance	195,173	208,507
60+ Delinquent	10.3%	14.9%
Clean Current	49.0%	46.3%
Current for 12 months	31.4%	30.9%

* Clean current: borrowers never missed a payment.

Table 2: Characteristics of Loans at Risk

	HOMEBANC 2005-3	HOMEBANC 2005-5
Loans at Risk	85.9%	80.0%
Avg Pmt Shock	151.9%	145.3%
Clean Current	58.4%	60.5%
Current for 12 months	34.3%	34.0%

However, the LTV stratification (table 3) shows Homebanc 2005-5 has a much higher exposure to underwater loans (36.4% vs. 16.5%). Based on the 5/1 post-reset performance experience shown on page 1, these higher LTV borrowers are more likely to become delinquent and they have very little chance of refinancing. On the other hand, Homebanc 2005-3 has 13.7% more < 80% LTV loans (42.6% vs. 28.9%), thus raising the possibility of higher prepayment in this deal. In summary, we should expect more prepayments in Homebanc 2005-3 and more delinquencies and modifications in Homebanc 2005-5. However, if home price appreciation continues at current pace, the prepayment on both deals could be much higher than expected.

Table 3: LTV Distribution of Loans at Risk

	HOMEBANC 2005-3	HOMEBANC 2005-5
LTV <80	42.6%	28.9%
LTV 80 to 90	23.9%	16.7%
LTV 90 to 100	16.9%	18.0%
LTV >100	16.5%	36.4%

Conclusion

Within the legacy Non-Agency RMBS, there are 192k current and non-modified loans making interest only payments at this time. As their IO period ends over the next 2-3 years and the payment amount increases, their performance is likely to be affected, most certainly impacting the returns to bond investors. Depending on the collateral make-up of individual deals, this may represent risks or opportunities going forward. We believe that borrowers with good payment history and considerable amount of equity in their homes will most likely be able to take advantage of the refinance options and prepay their mortgages. This subset of borrowers is likely to increase in size given recent developments in mortgage credit announced earlier this week (FNMA to guarantee 97% LTV loans and FHFA offering more clarity on their Representation and Warranty Framework in order to increase credit availability). Still, many may need help in the form of aggressive loan modifications that include rate reduction, term extension and principal forgiveness. Others may become delinquent and be forced to sell their homes. Because of these very different outcomes and their vastly dissimilar effect on investor returns, it is imperative to conduct detailed loan level analysis during the deal selection process.

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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