# Credit Burnout

FALCON BRIDGE Capital

## Delinquency Profile

**June 20, 2014**

Strong home price performance over the past 18 months, improving economic conditions, better employment situation, and loan seasoning have led to positive changes in collateral characteristics and behavior of the remaining borrowers in Non-Agency RMBS pools.

In this article, we focus on high level trends in roll rates, as well as their impact on eventual liquidations. As value investors, we strive to identify improving developments in the underlying collateral of analyzed securities in order to invest in "cheap" bonds and generate portfolio returns.

The level of seriously delinquent loans has dropped meaningfully across all product types. As shown in Figure 1, 60+ day delinquencies are almost 45% lower relative to peak levels observed in the first quarter of 2010. More recently, over the past 12 months, the percentage of borrowers who are two payments behind has fallen to 34% in Subprime, 21% in Alt-A, and 30% in Option Arm collateral, reflecting a 9%, 11% and 16% drop, respectively.

The improvement in delinquency profile of the remaining pools can be attributed to:

1. Credit burnout, as the bulk of problem mortgages have already left the pool through liquidation (Short-sale, Foreclosure sale or REO sale).
2. Better economic and housing environment that resulted in fewer new delinquencies, exhibited by improving Current to 30 day delinquent roll rates (Figure 2). The percentage of borrowers becoming delinquent has dropped by 20% in Subprime, 22% in Alt-A, and 25% in Option Arm collateral during the last 12 months. On average, this percentage has declined by almost 75% relative to the peak levels.
3. Increased cure rates (Figure 3) that represent a continued Servicer focus on loan modifications and highlight the borrowers' willingness and ability to withstand the most severe housing recession in their lifetimes. Over the last 12 months, the cure rates increased by almost 10% (7% in Subprime, 14% in Alt-A, and 11% in Option Arm), and surged by almost 1.4 times relative to the trough in December of 2008.

*Figure 1: 60+Dq by Product Type*

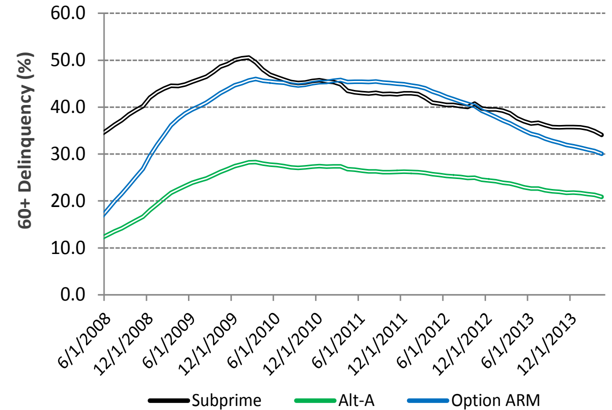



*Figure 2: Current to 30 Roll Rates*

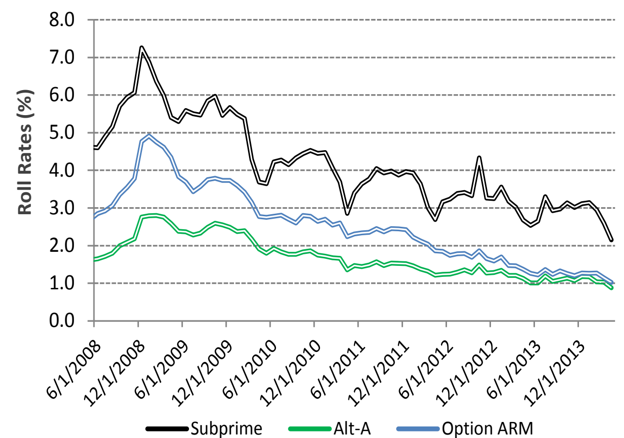
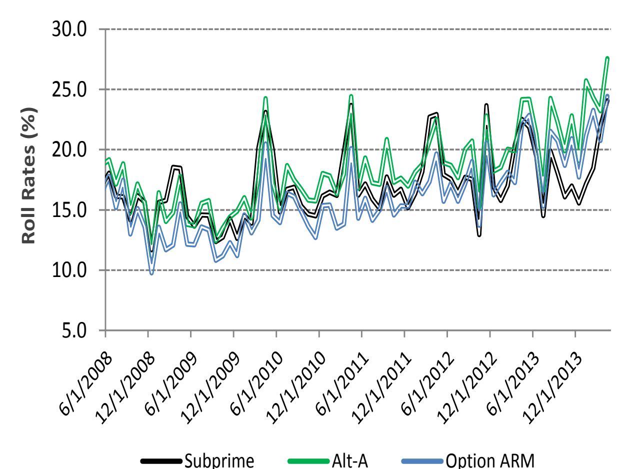
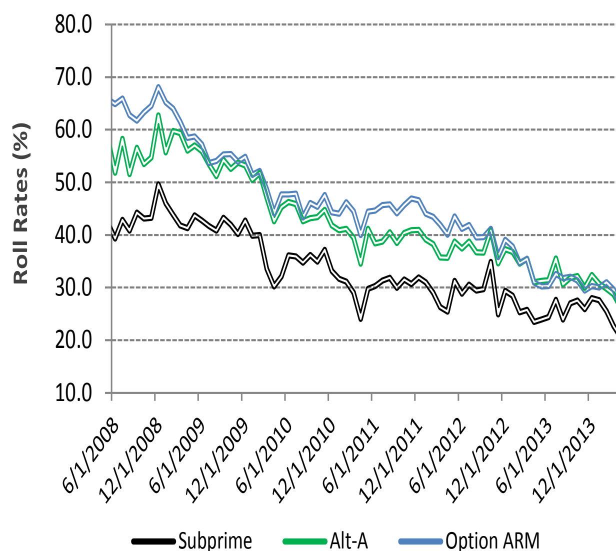



*Figure 3: Cure Rates*



4. A steady decline in 30 day delinquent to 60 day delinquent roll rates (Figure 4), further indicating a positive shift in borrower behavior to cure their delinquency. Over the last 12 months, this roll has declined by approximately 14% (12% in Subprime, 16% in Alt-A, and 15% in Option Arm), and decreased by almost 60% relative to the peak in December of 2008.

*Figure 4: 30 to 60 Roll Rates*




## Conclusion:

Current market pricing allows us to utilize conservative default and loss assumptions. Our base case presumes that all delinquent loans and a substantial portion of currently performing mortgages will default. These assumptions account for the recent improvement in borrower behavior, but ignore the possibility of further progress in roll rates. In our opinion, this represents an attractive buying opportunity, especially in collateral well positioned for continued improvement in housing. We favor loan pools with higher percentage of borrowers demonstrating consistent payment history i.e. current with their payments for more than 24 months, larger balances representing homes in more affluent areas, and lower judicial state exposure since some of these areas continue to experience lackluster home price performance and high level of pending distressed inventory. The segment described above represents between 20% and 30% of the $900b Non-Agency universe. We believe these assets will outperform other securities in the sector and provide stronger collateral and price performance in the years ahead.

In an effort to provide our readers with a thorough market and collateral analysis, we will discuss the aforementioned delinquency trends at a much more granular level in an upcoming Part II of the “Credit Burnout” article next week.

## 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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