

Market Intellect

from Standard & Poor's

Market, Credit and Risk Strategies

Putting A Dollar Value On Legacy RMBS Losses

Observations

Legacy assets remain an ongoing concern for U.S. banks, with losses that could still reach high into the hundreds of billions of dollars. To get a sense of just how deep those losses could be, the Market, Credit & Risk Strategies (MCRS) group reviewed the total amount of private-label (not issued by Fannie Mae or Freddie Mac) residential mortgage-backed securities (RMBS) outstanding, as well as their current performance record. As part of our analysis, we also measured the progress of the payments of underlying mortgages that will lead to the wind down of these structures, which many argue are responsible for the current stresses in the financial markets.

Key Findings

- With more than \$4 trillion in mortgages securitized since 2004, the legacy assets remaining on the balance sheets of banks continue to unwind themselves through repayments and defaults with a total remaining balance of \$2 trillion.
- Prime, Alt-A, and subprime structured RMBS transactions totaled \$3.7 trillion in issuance since 2004 and through repayments and defaults, the outstanding balance remains at \$1.7 trillion.
- The MCRS group expects total additional losses from the legacy assets to reach \$260 billion: \$165 billion from subprime, \$90 billion from Alt-A, and \$5 billion from prime RMBS. In a worst-case economic scenario, we would expect \$375 billion in total losses: \$235 billion from subprime, \$132 billion from Alt-A, and \$10 billion from prime.
- Given that the securitized structures assumed a certain loss percentage before equity tranches began to suffer losses, even relatively low nonperforming balances in prime mortgage structures would be damaging to equity-tranche investors.
- A total of \$250 billion in loans is in bankruptcy, foreclosure, or REO, though banks will recover a percentage of these balance through the sale of properties, but these properties will keep home prices depressed.

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Selected Research Analysis And Output

Table 1 looks at the total balances of the major groups (subprime, Alt-A, and prime) for RMBS structures as of March 2009. All structure types outside of the three primary categories and including second home loans and home equity line of credits are categorized as "other." In the following table, the nonperforming category comprises loans that are delinquent, in bankruptcy, foreclosure, or REO.

Table 1

Total RMBS Issuance Since 2004 (Mil. US\$)						
Balance	Alt-A, Subprime, And Prime	Prime	Subprime	Alt-A	Other	
Original	3,693,663	805,670	1,602,201	1,285,792	570,892	
Total Current	1,707,787	405,748	557,171	744,868	330,399	
Performing	1,197,362	376,279	306,747	514,336	226,764	
Nonperforming	511,201	29,760	250,728	230,713	33,281	
Count	4,323	1084	1584	1,655	1690	

Since 2004, a total of \$4.3 trillion in new mortgages were issued. Roughly \$3.7 trillion in mortgages were securitized in the three main categories. Subprime and Alt-A loans accounted for the bulk of the securitized market with \$1.6 trillion and \$1.3 trillion in issuance, respectively. There were fewer prime securitized mortgage transactions because Fannie Mae and Freddie Mac were the largest players in the prime space and would have purchased individual loans from the banks. There is currently a total of \$1.7 trillion in outstanding collateral, which includes performing and nonperforming loans.

Table 2 below highlights the current stresses in each of the three main RMBS categories. Homeowners with prime mortgages keep making payments at much higher rates than either subprime or Alt-A owners. At the other end of the spectrum, the subprime loans are split almost evenly between performing and nonperforming loans. For all three categories, the amount of nonperforming loans is rising well above levels of delinquencies and defaults expected at origination for the respective asset type.

Table 2

Performing Vs. Nonperforming Balance Amounts (%)				
	Alt-A, Subprime, Prime	Prime	Subprime	Alt-A
Performing	70.1	92.7	55.1	69.1
Nonperforming	29.9	7.3	45.0	31.0

The current and expected stresses can be better understood by breaking down the nonperforming loans into the delinquent category and those loans still held by banks. The subprime loans, which started the housing market slide, continue to show the highest delinquency levels for the three major groups. Subprime also has the largest amount of the total outstanding collateral balance held by banks, at over 25%. We believe these loans will keep continued downward pressure on housing prices. The already-defaulted and delinquent loans heading towards default will keep a steady supply of homes coming to market and thus keep pressure on prices to the downside.

Table 3

Nonperforming Loan Breakdown Of Total Pool					
Balance	Alt-A, Subprime, And Prime	Prime	Subprime	Alt-A	
Bankrupt	23,603	1,091	12,929	9,583	
Foreclosure	168,783	7,822	84,527	76,434	
REO	77,235	2,248	43,526	31,461	

Table 3

Nonperforming Loan Breakdown Of Total Pool (cont.)				
Nonperforming categories as percentage of current balance				
Bankrupt, Foreclosure, REO	15.8	2.8	25.3	15.8
Delinquent only	14.1	4.6	19.7	15.2

Current Payment Trends

We reviewed the balance trends in the securitized structures using data from the last six months. Despite having the largest issuance over the past four years, subprime has the lowest performing balance and its nonperforming balances keep rising, as well as the amount of loans in the bankrupt, foreclosed, or REO category. With interest rates near record low levels, homeowners have the ability to refinance their loans into much lower payments. Limiting that ability, however, is the falling—or even negative—amount of home equity and many consumers' inadequate credit profile. If subprime loans were made to those who cannot access the current credit market, the subprime performance trend will not improve.

The stress in the current economy is even being seen in the prime loan category, whose performing balance fell to 93% from 96% of the outstanding pool over the past six months from September 2008 to March 2009. The nonperforming prime balance nearly doubled over the same six month period. Comparing the remaining balances of the prime and the Alt-A pools indicates the discrepancy seen in the credit market and the level to which borrowers extended themselves. The rate of payment for prime structures shows that many prime borrowers are taking advantage of the favorable rates. A further breakdown of the prime performance is in table 8.

The outstanding loans are affected by the current rate environment in which borrowers can refinance into new loans, assuming adequate home equity and access to credit to obtain a new loan. However, these loans are more likely to face pressure from increasing unemployment numbers and continued decline in home prices meaning more homeowners will be heading towards the nonperforming category as the housing market crisis ends.

Table 4

Performance Trend By Asset Class				
	Remaining	Performing	Nonperforming	Bankrupt, Foreclosure, And REO
Alt-A				
Mar-09	57.9	69.1	31.0	15.8
Dec-09	59.8	71.3	26.6	13.2
Sep-09	61.6	78.6	21.4	11.7
Subprime				
Mar-09	34.8	55.1	45.0	25.3
Dec-09	36.7	57.9	42.3	24.5
Sep-09	39.1	61.6	38.5	24.1
Prime Jumbo				
Mar-09	50.4	92.7	7.3	2.8
Dec-09	52.3	92.7	5.5	1.9
Sep-09	54.2	96.0	4.0	1.6
Combined				
Mar-09	46.2	70.1	29.9	15.8
Dec-09	48.2	71.9	26.8	14.2
Sep-09	50.2	77.0	23.1	13.5

In table 4, the bankrupt, foreclosure, and REO category represents the amount of the current balance that are classified into these categories. They are also reflected in the nonperforming category.

Breakdown By Collateral Type And Year

Though home prices peaked in 2006, mortgage securitizations continued through 2007 and even into early 2008. Table 5 breaks each structure into its total issuance for the year and its resulting performance. The bankrupt, foreclosure, and REO column represents that amount of the nonperforming loans in the three categories of default.

Table 5

Asset Class By Year And Current Performance (Mil. \$US)							
Asset Type	Year	Deal Count	Original	Total Current	Performing	Nonperforming	Bankrupt, Foreclosure, And REO
Alt-A	2004	241	154,970	41,339	35,681	4,667	2,450
Alt-A	2005	433	367,999	175,189	142,733	32,479	17,743
Alt-A	2006	496	426,235	312,801	231,302	81,554	45,559
Alt-A	2007	360	281,262	249,905	199,722	50,754	27,018
Alt-A	2008	5	1,819	1,501	1,370	132	35
	Year	Deal Count	Original	Total Current	Performing	Nonperforming	Bankrupt, Foreclosure, And REO
Subprime	2004	324	340,062	51,207	38,653	12,645	7,448
Subprime	2005	408	453,249	137,590	83,746	53,770	34,993
Subprime	2006	428	437,636	253,307	141,268	112,626	72,824
Subprime	2007	213	199,543	164,633	106,361	58,317	33,982
Subprime	2008	3	2,027	1,888	1,396	493	196
	Year	Deal Count	Original	Total Current	Performing	Nonperforming	Bankrupt, Foreclosure, And REO
Prime Jumbo	2004	274	193,459	75,658	72,994	2,704	1,054
Prime Jumbo	2005	212	182,337	119,346	114,182	5,168	2,207
Prime Jumbo	2006	132	107,182	80,038	75,818	4,222	1,751
Prime Jumbo	2007	140	111,716	97,736	93,406	4,361	1,600
Prime Jumbo	2008	5	3,942	3,461	3,365	96	21

Excluding 2008 when there were an insufficient number of deals to analyze trends, the earlier seasoned deals (2004-2007) possessed the best performance, regardless of asset type. The prime deals show consistency with more than 95% of the current balance being classified as performing. The year with the worst performing collateral for Alt-A and subprime was 2006, which corresponds to the peak in home prices and arguably the time with the weakest underwriting standards. Currently 45% of the pool balance is classified as nonperforming, which serves to indicate just how many people who did not deserve credit were able to obtain it.

Only 15% of the subprime loans from 2004 and 30% from 2005 are still outstanding though we are not able to gain full clarity on how much of these would appear in a later structure due to refinancing. The end of a loan via sale one could argue would be more likely to default than those that refinanced at a later date and may still have some equity in their homes and thus a lower likelihood of default.

With home prices declining in 2007, the issue of that vintage's current performance of Alt-A and subprime deals arises. Rates in 2006 and 2007 were in the 6% to 7% range for 30-year fixed mortgages. This allowed 2007 borrowers to purchase more home as prices began to fall, though this vintage hasn't gone through its full stresses given its seasoning. Further declines in performance for the subprime and Alt-A deals can be expected because much of the original balance

remains outstanding.

Table 6

Alt-A Performance By Year							
Asset Type	Year	Deal Count	Percent Of Original Balance Remaining (%)	Performing (%)	Nonperforming (%)	Bankrupt, Foreclosure, And REO (%)	
Alt-A	2004	241	26.7	86.3	11.3	5.9	
Alt-A	2005	433	47.6	81.5	18.5	10.1	
Alt-A	2006	496	73.4	73.9	26.1	14.6	
Alt-A	2007	360	88.9	79.9	20.3	10.8	
Alt-A	2008	5	82.5	91.2	8.8	2.3	

Table 7

Subprime Performance By Year							
Asset Type	Year	Deal Count	Percent Of Original Balance Remaining (%)	Performing (%)	Nonperforming (%)	Bankrupt, Foreclosure, And REO (%)	
Subprime	2004	324	15.1	75.5	24.7	14.5	
Subprime	2005	408	30.4	60.9	39.1	25.4	
Subprime	2006	428	57.9	55.8	44.5	28.7	
Subprime	2007	213	82.5	64.6	35.4	20.6	
Subprime	2008	3	93.2	73.9	26.1	10.4	

Table 8

Prime Performance By Year							
Asset Type	Year	Deal Count	Percent Of Original Balance Remaining	Performing	Nonperforming	Bankrupt, Foreclosure, And REO	
Prime Jumbo	2004	274	39.1	96.5	3.6	1.4	
Prime Jumbo	2005	212	65.5	95.7	4.3	1.8	
Prime Jumbo	2006	132	74.7	94.7	5.3	2.2	
Prime Jumbo	2007	140	87.5	95.6	4.5	1.6	
Prime Jumbo	2008	5	87.8	97.2	2.8	0.6	

In the current environment, with continued declining home prices, there is still a large amount of mortgages outstanding that remain a concern to investors.

Concluding Thoughts

Even with the economy showing no signs of a letup in the monthly unemployment numbers, home prices in many areas still decreasing and credit remaining tight, there are some offsetting positive factors. These factors include the massive federal stimulus bill as well as numerous programs to aide borrowers' refinancing to retain their homes. What does this all mean for the remaining \$1.7 trillion in securitized mortgages? It depends on the asset class.

Standard & Poor's economic outlook calls for unemployment to rise to 9% by the end of 2009 and to 9.9% by the end of 2010. Standard and Poor's GDP growth forecasts currently stand at -3% for 2009 and 1.4% for 2010. Using this economic scenario and acknowledging existing trends from the servicers, we generated expected loss numbers for RMBS structures using a projected default rate based on current pool performance (aggregating each asset class and vintage.) We then applied a loss severity to the expected default balance and the current Standard & Poor's economic forecast represents the base-case scenario. Under this scenario, the MCERS group expects total losses from the legacy assets to reach

\$260 billion: \$165 billion from subprime; \$90 billion from Alt-A; and \$5 billion from prime. In a worst-case scenario, in which unemployment rates rise even higher than 9.9% and GDP for 2010 remains negative, we could instead expect \$375 billion in total legacy asset losses: \$233 billion from subprime; \$132 billion from Alt-A; and \$10 billion from prime.

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