



The President's Plan for Sub-Prime

by James Lukens, PhD, CFA and Karen Watters, CFA

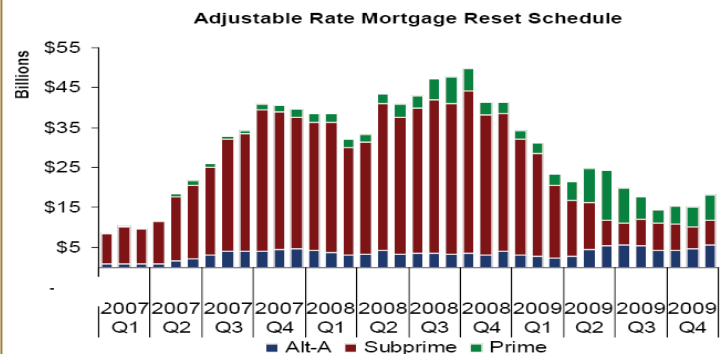
I. The Problem

Delinquencies, foreclosures, and losses on sub-prime mortgages have exceeded even the worst-case scenarios developed by Wall Street risk analysts. New evidence of their estimation problems arrives almost daily in the form of headlines announcing yet another round of write-downs by major investment banks, two of whom have already sacrificed their CEOs on the altar of sub-prime. The causes of this crisis are many but can be reduced largely to human acquisitiveness, of which evidence abounds. Borrowers bought properties at prices they couldn't afford or refinanced and took most of the equity out of their homes, confident that it would be replenished by perpetually rising real estate values. Lenders, encouraged by the Fed's own easy credit terms, were happy to oblige: they offered mortgages at usurious spreads over their own borrowing costs, with little or no money down, to unqualified borrowers unlikely to repay. Then, in packaging these loans for sale to yield-hungry investors, the securitizers and credit rating agencies collected huge fees for their work but failed to over-collateralize against the inevitability of delinquencies and defaults, which are naturally exacerbated by a slowing economy, job losses, and flattening or falling home values. Apparently, no one cared to calculate the leverage created in the process, or even to consider that these bad things often happen together, and usually fuel and feed off one another. In any case, the rating agencies conferred AAA ratings on more than three-quarters of all securites created by packaging sub-prime mortgages.

Now the chickens have come home to roost. Of all sub-prime mortgages originated in the last three years, about 80% have been adjustable rate mortgages (ARMs) that carry "teaser" rates of 7.5% to 8% for the initial two or three years, after which they reset to rates another 2% to 3% higher. Over the next year and a

half, approximately \$20 to \$30 billion of these sub-prime ARM's will reset every month, and the mortgage payments required of already-stretched borrowers will increase by an average of 25%. As suggested by the bar graph below, an already bad problem is about to get worse.

Subprime ARM Resets are Imminent
 - \$30-35 BN of Subprime Loans Will Reset Each Month for the Next Year



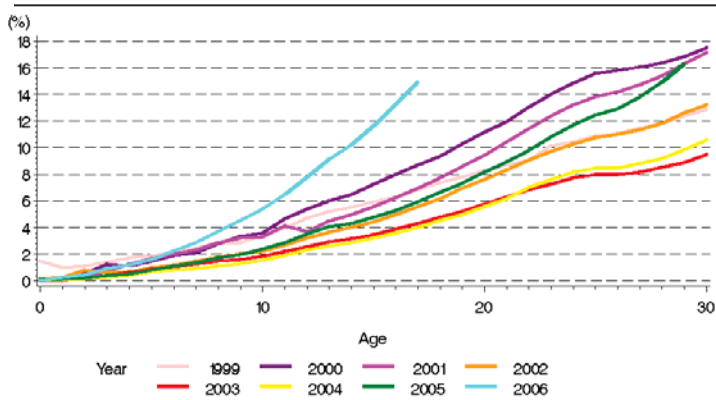
Source: Goldman Sachs 11/27/07

II. Basics of the Plan

In attempt to stem the red tide of foreclosures caused by ARM's resets, US Treasury Secretary Henry Paulson has proposed a plan that would freeze interest rates on ARM's originated during the two-and-a-half-year period ending July 2007. Rates would be frozen at initial "teaser" levels for a period of five years from the first scheduled reset. The Secretary's reason for focusing on mortgages issued during this time should be apparent from the trajectories of the green and blue lines in the graph that follows. 2006 was the year when lending standards were lowest and the vintage that now, understandably, exhibits the highest delinquency rate.

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60D+ Delinquency by Vintage—Subprime



Source: Loan Performance, UBS 12/8/07

The Paulson Plan separates sub-prime ARM borrowers into three distinct groups, only the middle of which, so-called Segment 2 borrowers, are eligible to have their monthly payments frozen at pre-reset or “teaser” levels. Homeowners on either side of this middle group, so-called Segment 1 and Segment 3 borrowers, are ineligible for such modification. Segment 1 consists of homeowners who, because they’ve made their monthly payments to date and still have some equity value in their homes (LTVs below 97%), are assumed to be able to refinance on their own – through FHA, FHA Secure, or some other traditional mortgage program. On the other side, and also ineligible, are Segment 3 borrowers, those who have been at least 60 days delinquent even before their payments increase. Basically, the Plan assumes that Segment 1 borrowers don’t need much help, and that Segment 3 borrowers may be beyond helping.

In-between and eligible for fast-track modification are Segment 2 borrowers, whom the plan is intended to benefit. These are homeowners who are barely able to make their monthly payments at current “teaser” rates, unlikely to continue to make payments at higher reset rates, and unable to secure alternative refinancing on their own. Eligible Segment 2 borrowers are more fully defined by the following seven criteria:

- Mortgage originated between January 1, 2005 and July 31, 2007
- Initial rate reset occurs between January 1, 2008 and July 31, 2010

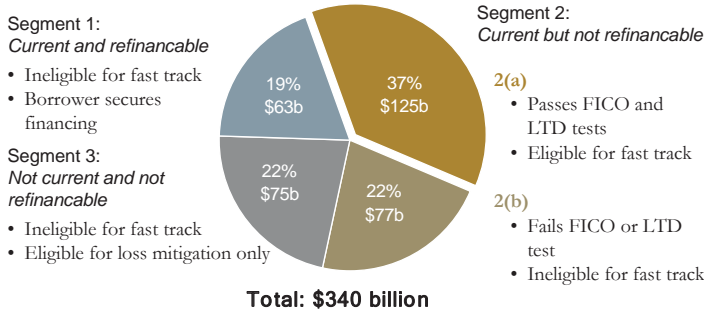
- Reset increases monthly payment by at least 10%
- Current loan-to-value ratio (LTV) is greater than 97%
- Borrower occupies property as primary residence
- Borrower’s FICO score is less than 660 (and less than 10% higher than at origination)
- Mortgage is included in a securitized pool.

The President’s Plan is intended to provide a framework for modifying a large number of at-risk loans in as efficient a manner as possible, and in a relatively short period of time. By basing eligibility rules on simple and generally available criteria, the government hopes to relieve mortgage servicers of the burden of contacting borrowers, negotiating restructurings, or re-underwriting individual loans. These activities would prove difficult and expensive, given the large number of homeowners needing to be contacted, and given the tendency of people facing foreclosure to avoid answering either the phone or the front door. A second purpose of the Plan, no doubt, is to provide some legal “cover” for mortgage servicers, whose first obligation is neither to borrowers nor to the US government, but to the holders of the mortgage-backed securities that contain these troubled loans.

Exactly how many homeowners will benefit is a matter of some debate. In announcing its Plan, the Treasury Department suggested that modification will help some 1.2 million of the 1.8 million sub-prime borrowers facing ARM rate resets. This figure, however, approximates the total number of borrowers comprising *both* Segments 1 and 2 – when Segment 1 borrowers have been given telephone numbers and left mostly to fend for themselves. But even the targeted Segment 2 group is likely to be smaller than advertised, largely because of the requirement that LTVs have reached at least 97%. Even in 2006, the heyday of loose lending, the average LTV remained in the neighborhood of 83 to 84%. To push these loans into Segment 2 eligibility would require a decline in home prices of nearly 15% – more than in any major US market to date. Continued housing market declines could expand the eligibility pool, of course, but a reasonable expectation is that only about 100,000 to 300,000 homeowners will have their mortgages modified under the President’s Plan.

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Sub-prime ARMs originated between January '05 and July '07



III. Practical Obstacles and Risks

Simple and sound in design, the Plan could encounter a few difficulties in implementation. First, while most eligibility criteria are readily available, LTVs are only estimates based on local appraisals that grew notoriously unreliable during the lending boom. (Busy appraiser to borrower: “What do you *want* the house to be worth?”) Second, FICO scores, a measure of borrowers’ creditworthiness, are updated only infrequently and sometimes with a lag to the financial events that affect actual creditworthiness. Also, the requirement that borrowers have low FICO scores could encourage people to “game” their way to these lower scores; and the requirement itself raises the distinct possibility that mortgage modifications will be granted to those homeowners least likely to repay. Third, many of today’s troubled mortgages – about 40% of all loans originated in 2006, for instance – are so-called “low-doc” or “no-doc” loans, meaning that the original lenders never verified the borrower’s employment or income level. The term “ninja loans” was coined later to describe mortgages given to people with “no income, no job, and no assets.” The Plan does not remedy this lack of documentation and, in fact, only carries it forward by allowing blanket modifications based on publicly available data, and by relieving servicers of the need to contact homeowners directly to secure missing documents. An original “ninja” borrower who hasn’t found a job, or doesn’t have adequate income, could have his loan modified under the Plan only to default a few months later.

Finally, the Pooling and Servicing Agreements (PSAs) that govern servicers in mortgage securitizations could create legal problems in either the short or the long term. Many PSAs limit the percentage of loans that can be modified inside a given securitized pool. While the US Treasury has suggested that servicers should abide by such

PSA restrictions, servicers adhering too strictly to their PSAs will almost certainly prevent a full implementation of the Plan. On the other hand, servicers taking too liberal an interpretation of PSA restrictions, in order to implement the Plan more fully, could find themselves facing lawsuits later. At the end of the day, the PSA is a legal contract that obligates servicers to act in the best interests of bondholders by maximizing recovery value on each loan in the portfolio. To the extent that servicers see the plan as somehow setting aside these contracts, they expose themselves to the risk of later litigation from bondholders. A few critics have suggested that a full implementation of the Plan could even weaken the contractual underpinnings of our capital markets and worsen the credit crisis that the Plan is intended to relieve. No one will buy a mortgage-backed bond, they argue, if its terms can be changed arbitrarily in the middle of the game.

IV. Unintended Consequences

Legal and long-term implications aside, the President’s Plan may have direct and unintended effects on the behavior of both homeowners and the institutions that either lend them money or securitize their loans for sale to investors. As noted, the requirement that borrowers have low (and non-improving) FICO scores virtually assures that loan modifications will be granted to people least likely or able to repay. In much the same way, the requirement that LTVs be greater than 97% means that modifications will be granted only to borrowers who have less than 3% equity in their homes *at the current level of home prices*. Among all mortgages originated in 2006, nearly 67% of borrowers actually took cash out of their homes – this *after* real estate values had peaked and begun to decline. If housing prices continue to fall, as most experts predict, these people will find themselves with considerable negative equity in their homes. Borrowers already “upside-down,” and expecting to become more so, may begin to regard monthly payments as throwing good money after bad. Foreclosure can seem a perfectly rational option to people for whom home ownership looks less like the route to riches than the road to debtors’ prison. These people may simply decide to live rent-free for a few months, hand over the keys to their local banks, and walk away.

A larger question is whether protecting borrowers and lenders from the consequences of their actions only encourages more

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of the same risk-taking behavior. The so-called “moral hazard” objection applies here not only to individuals, who could overreach in real estate again later, but also financial institutions, which have long seemed able to declare “do-overs,” restructure, and return to business as usual. The investment banks remain among the largest investors in sub-prime mortgages – less directly in inventories perhaps than indirectly through SIVs, capital notes, CDOs, and other structured products. The government evinced its interest in helping out the big banks back in September, when both the Secretary of the Treasury and the Chairman of the Fed proposed that the largest of them join together to create a rescue “superfund” that would purchase depressed mortgage-related assets today and then sell them off slowly at higher prices later. While the banks may never actually create their superfund, this same interest in *guaranteeing* liquidity and higher security prices may also have figured into the President's Plan for sub-prime. The last of its seven key eligibility requirements, after all, is that a mortgage be included in a securitized pool.

V. Investment Implications

While some have dismissed the President's Plan as a transparent attempt to win votes, there can be little doubt that it will also help a segment of sub-prime borrowers hold onto their homes for longer than they would otherwise, some perhaps permanently. At a minimum, the Plan will result in more mortgage modifications on the margin, and it will cause these modifications to occur sooner rather than later. Accelerated modifications, in turn, will serve to slow, and perhaps even to reduce, the inevitable increase in foreclosure sales that threaten to swell home inventories, damage the housing market further, and send the economy into recession. Any economic benefits, however, will likely be limited by the relatively small number of homeowners currently eligible for modification under the Plan.

Unlike the S&L bailout of the late 1980s, the President's Plan uses no federal or taxpayer monies to address the sub-prime problem. In the end, it is investors in mortgage-backed securities who bear most of the risks and costs associated with rate freezes on ARMs included in sub-prime securitizations. Wall Street's own serial write-downs suggest the difficulty of estimating cumulative losses on sub-prime (and other) securities, even prior to implementation of the Plan. Since the Plan's announcement, however, some of these same firms have calculated that its implementation would reduce the cumulative losses on sub-prime by somewhere between 1.5% and 2%. Although perhaps twice imprecise, these numbers are larger than zero, and we find few reasons to dispute them.

Clearer is the fact that investor losses will vary across the capital structure. The holder of AAA securities will likely receive additional assurance that he will not incur principal write-downs. The impact on BBB and BB investors, however, remains less clear – since the decreasing frequency of default due to modification will likely be offset by the decrease in coupon income resulting from these same modifications. In sum, while the President's Plan may improve broad market sentiment, it is unlikely to have any significant impact on sub-prime MBS performance – again largely because of the relatively small number of mortgages qualifying for modification under the Plan.

Things could change, however. Continued steep declines in housing prices could push more homeowners into meeting the 97% LTV requirement; more mortgages would be modified under the Plan; and its benefits to a struggling housing market and economy would increase accordingly. In this way, the Plan may serve as something of a low-cost insurance policy against catastrophic loss. If the worst comes to pass, we may be glad for any protection it provides.



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One Boston Place, Suite 2900 · Boston, Massachusetts 02108-4408

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