

U.S. Structured Finance Newsletter

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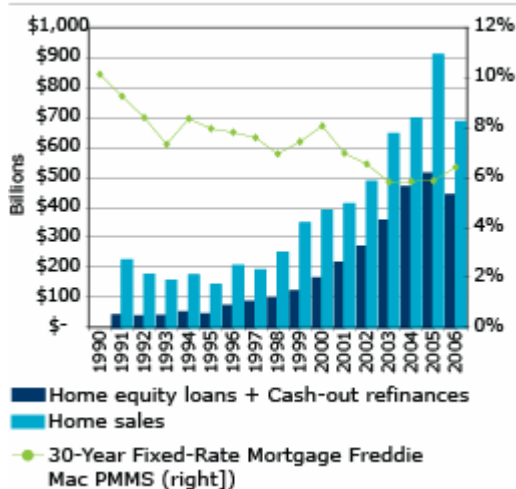
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WHERE ARE WE GOING NEXT?

The interest rate on a prime 30-year fixed-rate mortgage (as measured by Freddie Mac's Primary Mortgage Market Survey) fell from more than 18% at the end of 1981 to less than 6% in 2003. As the rates declined, Freddie Mac and Fannie Mae worked strenuously to extend mortgage credit to lower-income borrowers and private lenders were expanding the range of their mortgage offerings. As a result, borrowers took the opportunity to refinance into mortgages at a lower coupon, a shorter amortization term or both.

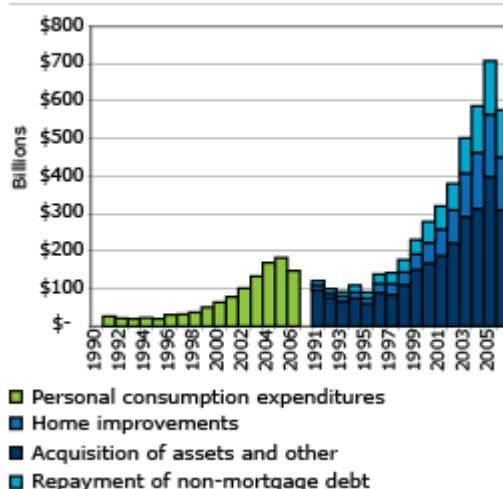
Mortgage credit continued to flow easily from private lenders until 2007. Many measures demonstrate this: the balance sheets of individual mortgage lenders, national mortgage origination volumes and the volume of issuance of residential mortgage-backed securities (RMBS). Analysis conducted by Greenspan and Kennedy¹ delves into how mortgagors used the equity they obtained from their homes. "Free cash is generated by home equity extraction"; broadly defined, this includes funds from the sale of homes, home equity loans (closed-end and lines of credit) and cash-out refinancings, net of closing costs and repayment of mortgage debt. The largest portion of free cash is used to buy another home.² About one-third of home equity cash and cash-out refinancings are used for home improvements and another third of home equity cash and more than one-quarter of cash-out refinancings are used to pay down other (non-mortgage) debt. Relatively little is used directly to fund personal consumption: 10% or less of sale proceeds, about one-quarter of home equity loans and less than 20% of cash-out refinancings.

Equity Extracted from Homes



Source: Federal Reserve Board and Freddie Mac.

Uses of Equity Extracted from Homes



Source: Federal Reserve Board.

Overall, 80% of the cash extracted from homes is reinvested in assets (to purchase a subsequent home and/or other assets), used to improve a borrower's financial condition by paying down other debt and used to make home improvements, according to the Greenspan and Kennedy analysis. During 2007 and into 2008, mortgage lenders have tightened credit standards to the point that borrowing to buy a home has become very difficult and borrowing against the equity in one's home has become next to impossible, even if you are a prime borrower. As lenders continue to shut off mortgage credit while waiting for financial markets to right themselves, with or without government assistance, they are depriving many mortgagors of their single most important means of bettering their financial condition. As a result, all eyes are on Congress as we await the outcome of the proposed rescue plan, which will hopefully restore confidence in the U.S. economy, renew the ability of the consumer to obtain credit and revitalize the secondary markets.

For questions or comments, please contact Susan Kulakowski at skulakowski@dbrs.com.

1. "Sources and Uses of Equity Extracted from Homes," by Alan Greenspan and James Kennedy, published in March 2007 by the Federal Reserve. Available at www.federalreserve.gov/pubs/feds/2007/200720/200720pap.pdf.

2. The data to support this inference is very limited but seems reasonable given that a home seller still needs someplace to live after the sale of a home and, despite the current turmoil in residential housing markets, a home remains an individual's largest, most stable long-term investment.