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Securitization & Real Estate Update 5/18/07

Sub-prime Mortgage Loan Servicing and Loss Mitigation

18 May 2007

On Wednesday evening (5/16/07), the American Securitization Forum hosted a sunset seminar titled "Subprime Mortgage Loss Mitigation Strategies – What's Working." The event was very well attended and the speakers offered important and insightful remarks. The speakers focused on the following main areas:

- the reasons for poor sub-prime mortgage credit performance,
- the outlook for home prices,
- the legal standards for using loss mitigation strategies,
- specific loss mitigation techniques, including loan modifications, and
- investor concerns relating to loan modifications

The first speaker reviewed the path of home prices and lending standards over the past decade. He noted that rising home prices and looser underwriting standards combined to form a dangerous feedback loop. The cycle broke when home prices peaked in mid-2006. The 2006 vintage of sub-prime mortgage loans includes many loans with risky features, such as "silent seconds" or "stated income."[1] A particularly risky combination is high loan-to-value (LTV) ratio and stated income.

The first speaker also addressed the issue of affordability. For the country as a whole, housing affordability remains reasonable. However, some areas that experienced very fast home price appreciation have become unaffordable for many potential homebuyers. Home prices have declined about 3% from their mid-2006 peak. Further declines are possible, though the ultimate magnitude and duration of the slump are impossible to predict. However, one notable home price slump had prices decline by about 8% over a period of three to four years, after which it took another four years

[1] The term "silent second" generally refers to a second-lien loan taken simultaneously with the first-lien loan on a property. Borrowers use silent seconds to get lower interest rates on their first-lien loans by keeping the loan-to-value (LTV) ratios at or below 80%.

The term "stated income" refers to a loan in which the lender does not obtain written verification (documentation) of the borrower's income. Instead, the lender relies simply on the borrower's unverified representation. In a fully-documented loan, the lender would obtain either the borrower's pay stubs or tax returns to document the level of his income.

Contact:
Mark Adelson
(212) 667-2337
madelson@us.nomura.com

Nomura Securities International, Inc.
Two World Financial Center
New York, NY 10281-1198

www.nomura.com/research/s16

Bloomberg: NFIR <GO>

for prices to recover to their pre-slump level.[2] The 2006 sub-prime mortgage vintage is very large and includes loans to many borrowers who bought at the top of the market. The first speaker estimated that losses on the vintage may be in the range of 8% to 10%, but there is substantial uncertainty because of the unpredictable affect of increased use of loss mitigation techniques and the possible impact of government policies.

The second speaker, an executive from a highly rated mortgage servicer, focused on loss mitigation tools. He described his company's proactive strategy of contacting hybrid ARM borrowers before their loans reach their initial interest rate adjustment dates (reset dates). By reaching out to borrowers before their loans reset, the servicer can evaluate whether each borrower will be able to afford the monthly payment after his loan resets. If a borrower cannot afford the full payment amount, then the servicer considers various alternatives. If the borrower has equity in the home, the servicer would encourage the borrower to sell the home. If the borrower does not have equity in the home and does not want to stay in the home, then the servicer would consider a short sale. If the borrower does not have equity in the home and wants to stay in the home, then the servicer would consider alternatives for modifying the loan based on what the borrower can afford to pay. One type of possible modification is to delay the loan's reset date. Other modification strategies include the following:

- temporarily or permanently reduce the interest rate on the loan,
- extend the maturity of the loan,
- make a payment plan for arrearages,
- capitalize arrearages,
- forgive arrearages, and
- forgive a portion of principal.

The second speaker noted that modifying loans for distressed borrowers is a labor-intensive process because the servicer must carefully evaluate each borrower's capacity to pay. The full cost of processing a loan modification can be in the range of $500 to $600. It is often necessary to visit the subject property and to interact with the borrower face-to-face.

The servicer tries to get as much as it can from each borrower. The company achieves impressive results on its loan modifications. Only about 35% of the modified loans re-default within a year. One of the reasons is that the servicer's parent company holds the first-loss credit exposure on all the loans that it services. Accordingly, its has an unambiguous economic incentive to use loss mitigation tools – including loan modifications – to minimize the losses on the loans that it services. The issue of servicing expenses is just one component in the calculation of minimizing losses.

The third speaker focused on legal aspects of loss mitigation strategies. He emphasized that securitization transactions permit servicers to make loan modifications when a loan is in default or

[2] Some regional real estate price declines have been severe and required longer periods for recovery:

Notable U.S. Real Estate Price Declines
(mostly in the late 1980s or early 1990s)

City	Peak to Trough Decline	Duration of Declining Prices (years)	Time to Climb Back to Original Peak (years)
Boston	11.7%	4	9
New York	8.4%	6	10
Los Angeles	21.5%	6	10
San Francisco	11.6%	4	7
Houston	24.5%	5	15
Honolulu	16.0%	5	9

Source OFHEO

when default is reasonably foreseeable. The REMIC provisions of the tax code permit reductions in the interest rate on loans, forgiveness of principal, and extensions of loan maturities. The governing document for a typical securitization (a Pooling and Servicing Agreement or P&S) requires the servicer of a deal to service the underlying mortgage loans in "customary" fashion, which can vary over time as the general practices of the industry evolve. In addition, a typical P&S specifies that any loan modifications must be "in the best interests of investors." However several open issues remain. What does "best interest of investors" really mean? Investors in the aggregate? Each class? A specific class? Moreover, it is also unclear what it means to maximize the recovery on a defaulted assets. Should the determination be based on net present value or gross cash flow? What assumption should be used about frequency and timing of re-defaults on modified loans?

The fourth panelist focused on investor issues. He noted that there may be conflicts between different classes of investors with respect to loan modifications. In addition, loan modifications can make it harder for investors to analyze securities. Investors need to understand what policies the servicer of a deal has with regard to loan modifications. Servicers vary in how they report on modified loans. Reporting is important because investors need to understand how loan modifications affect their modeling assumptions for defaults and prepayments (CDRs and CPRs). To perform a correct analysis, an investor also must estimate the re-default rate on modified loans. As loan modifications become more frequent, servicers may ask for higher fees on outstanding deals. This could be a further point of conflict among different classes of investors.

One issue that the panelists did not tackle is whether a typical mortgage servicing company will be able to achieve a reasonable rate of success with loan modifications. The servicing company represented on the panel is widely regarded as one of the best. Even so, it has experienced a one-year re-default rate of 35% during good times. It seems reasonable to expect that a company of merely average abilities and operating during stressful times would experience a somewhat higher rate of re-defaults. Also, unlike the company represented on the panel, a typical servicer does not have the incentive of first-loss credit exposure on the loans (*i.e.*, no "skin in the game") and gets paid the same fee regardless of the effort and expense of servicing a loan. The $64,000 question is whether the higher re-default rate would be just a little higher than 35% (*e.g.* 40%) or much, much higher (*e.g.*, 65%). Only time will tell.

Another area that the panelists did not fully explore is conflicts between different classes of investors. This area may become very important once servicers actually start to use loan modifications frequently. One issue is that modifications favor the interests of subordinate and residual classes by delaying the recognition of losses and the writedown of those classes. A second issue is the treatment of modified loans under performance covenants (trigger tests) that allow the release of principal to subordinate and residual classes. If modified loans are treated as "current," a substantial amount of cash flow may be released to subordinate and residual classes while the risk to the senior classes rises. We think that the better approach is to treat modified loans as delinquent for purposes of trigger tests. We also think that this is the area that is most likely to spawn litigation, both between investors and servicers and among competing classes of investors.

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NEW YORK	TOKYO	LONDON
Nomura Securities International	Nomura Securities Company	Nomura International PLC
2 World Financial Center, Building B	2-2-2, Otemachi, Chiyoda-Ku	Nomura House
New York, NY 10281	Tokyo, Japan 100-8130	1 St Martin's-le-grand
(212) 667-9300	81 3 3211 1811	London EC1A 4NP
		44 207 521 2000

David P. Jacob 212.667.2255 International Head of Research

Nomura U.S. Fixed Income Research

David Resler	212.667.2415	Head of U.S. Economic Research
Mark Adelson	212.667.2337	Securitization/ABS Research
Weimin Jin	212.667.9679	Quantitative Research
James Manzi	212.667.2231	CMBS Research/Strategy
Xiang Long	212.667.9652	Quantitative Analyst
Edward Santevecchi	212.667.1314	Analyst
Diana Berezina	212.667.9054	Analyst