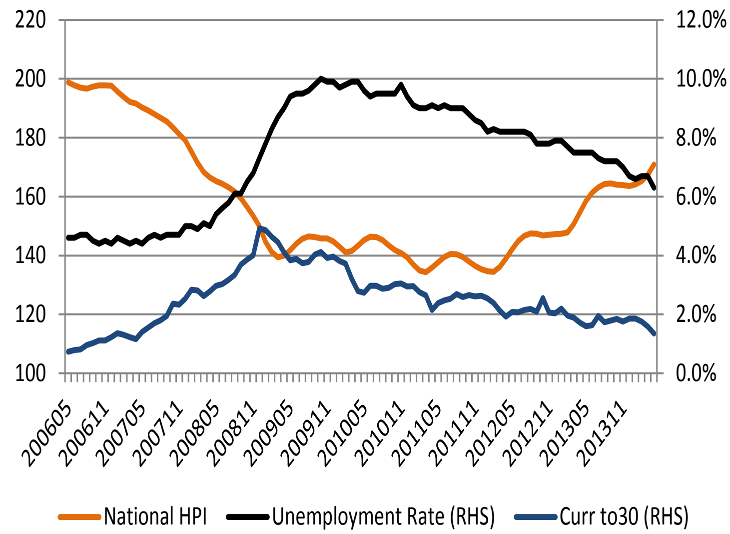
Credit Burnout

Delinquency Profile - Part II

July 3, 2014

Two weeks ago, we focused our discussion of credit burnout on the level of overall delinquencies and recent developments in certain roll rates. We concluded that strong home price performance, low interest rates, progress in the employment situation and positive selection among borrowers remaining in mortgage pools have greatly contributed to improvements in delinquency patterns that will eventually result in lower overall liquidations. This week, our discussion of the subject continues as we further dissect delinquency trends we believe are pivotal to the future RMBS performance.

Figure 1a: Current to 30 rolls



As discussed in Part I of the article and shown in Figure 1a, the rate of mortgages rolling from current payment status to 30 days past due (Current to 30) has improved dramatically, and in tandem with unemployment and home prices. This positive trend also holds true on a granular level. The rate of early-stage delinquencies has been steadily decreasing across all product types, LTV cohorts and for both, performing and re-performing loans (figures 1b and 1c). As economic indicators continue to show trends of recovery, the developments in the collateral performance should remain positive.

Figure 1b: Current to 30 Roll Rates

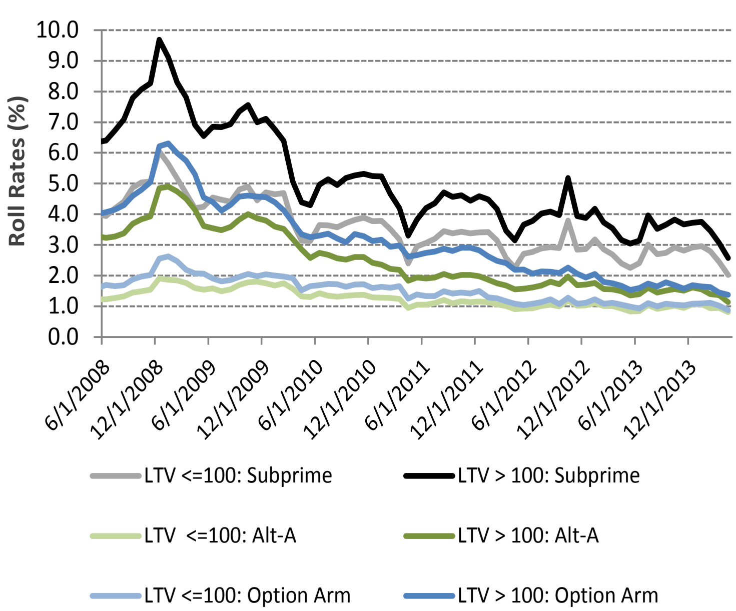
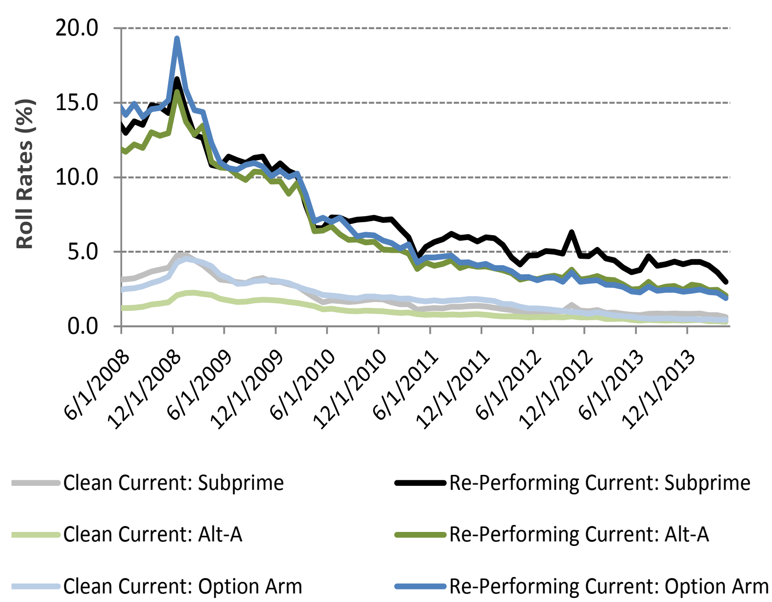


Figure 1c: Current to 30 Roll Rates



- Starting in 2008, Servicers and policymakers focused their attention on loan modifications as an alternative to foreclosures to minimize loan losses and to help borrowers stay in their homes. Over the years, modification activity increased substantially (as discussed in Part I of the article) resulting in a large portion of modified borrowers comprising the remaining mortgage pools. It is important therefore, to take a look at their post-modification performance. In tandem with other roll rates , modified loans show signs of improvement across all product types (as exhibited by Current to 30 day delinquent rolls in figures 1d, 1e, and 1f). Modified Current (loans that received some form of modification from the Servicer in the past and have been current since) to 30 day delinquent roll rates have dropped approximately 90% from peak and are lower relative to rolls exhibited by current borrowers who missed their mortgage payments in the past, but did not receive loan modification ("Dirty Current"). This trend is not as apparent in Subprime loans. The bulk of modifications in this specific product type occurred early on during the housing crisis, when the adjustments to original mortgage terms weren't very aggressive, and focused mainly on lowering the interest rate. The data indicates that the re-default rates on these types of modifications tend to be higher relative to those that aimed at payment reduction.

Figure 1d: Subprime: Current to 30 Roll

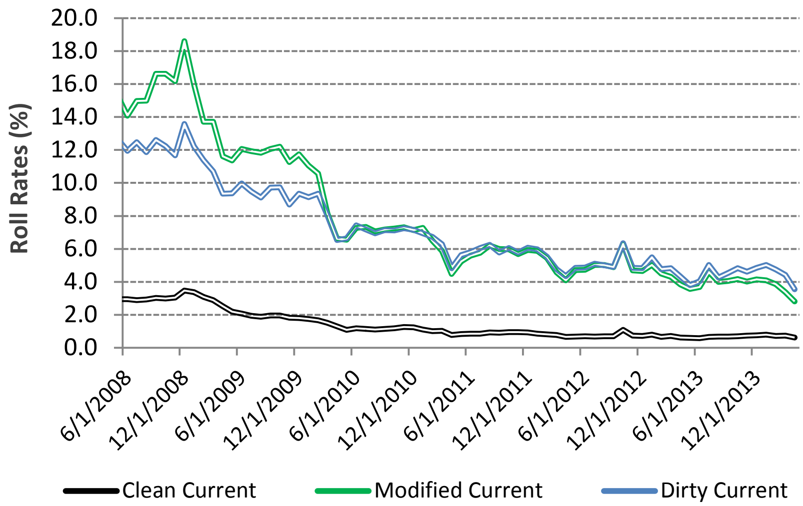


Figure 1e: Alt-A: Current to 30 Roll

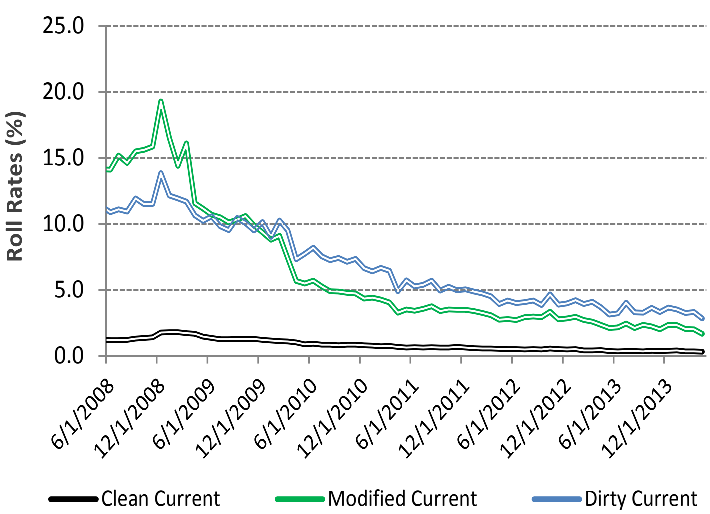
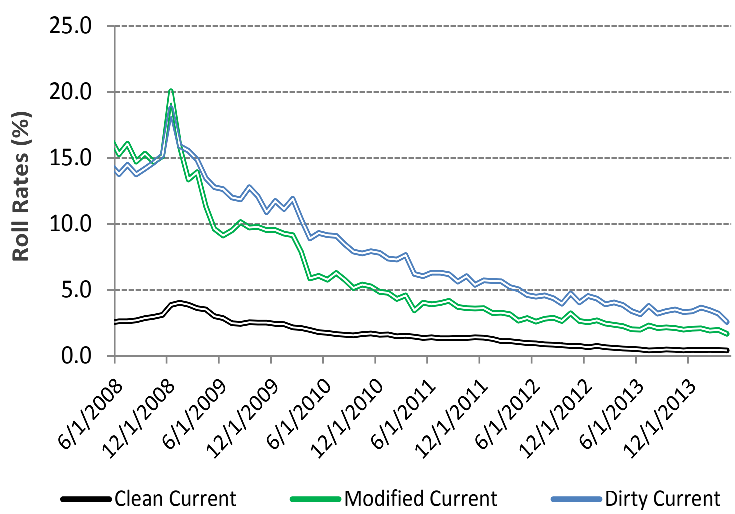


Figure 1f: Option Arm: Current to 30 Roll



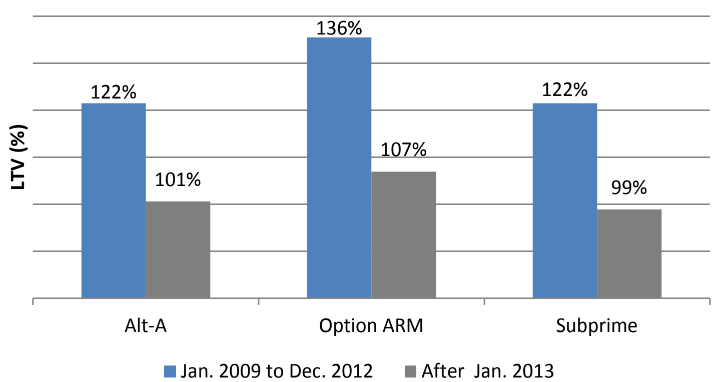
- The makeup of borrowers missing two simultaneous payments is also improving. As illustrated by Figure 2, the share of new borrowers entering serious delinquency has dropped drastically. This is a direct result of lower Current to 30 roll rates, as well as improved 30 to 60 dq transition rates.

Figure 2: % of loans that became 60 days delinquent for the first time during the specified time period.

Product Type	Jan. 2009 to Dec. 2012	After Jan. 2013
Alt-A	66.91%	32.73%
Option Arm	69.54%	28.49%
Subprime	37.43%	13.95%

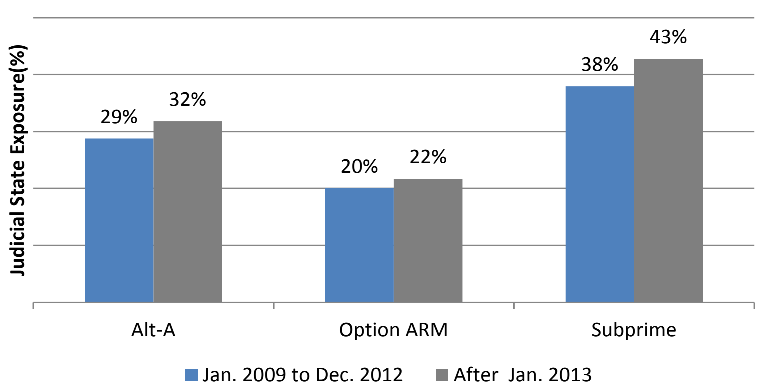
- Borrowers entering severe delinquency (60 day delinquency bucket) have very little or no equity in their homes (Figure 3). Stable or positive home price appreciation is therefore crucial for continued improvement in this specific roll. As borrowers pay down their credit in a recovering housing environment, the propensity to default will decrease even further. Assuming everything else remains constant, lower LTVs on delinquent loans should also result in lower loss severities upon liquidation. It's important to note however, that the level of realized losses is a function of multitude factors, including liquidation timelines and loan balances. For this reason, Subprime severities will continue to trend higher relative to other product types despite lower LTVs on the loans awaiting liquidation.

Figure 3: LTV% of loans becoming 60 days dq.



- Figure 4 shows a slight shift in geographical distribution of 60 day delinquent loans. Loans that became seriously delinquent since January 2013 have a higher exposure to judicial states. In general, judicial areas have experienced weaker home price performance and suffer from the elevated levels of the shadow inventory. As a result, severities on properties located here tend to experience higher loss severities. Increasing proportion of delinquent loans in judicial areas may adversely affect overall severities.

Figure 4: Judicial State % of loans entering 60dq.



Conclusion

Mortgage collateral performance continues to improve amid recovery in the economic conditions and home prices. Roll rates peaked in the summer of 2009 and have since exhibited significant progress by moving towards normalized levels. The continuation of this trend will result in lower than expected liquidations and losses, as well as provide support for bond prices. Additionally, modified loans continue to show significant progress, the trend we are monitoring very closely, as it may provide attractive buying opportunities

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.

For questions or additional information, please contact:

Aga Linsky
alinsky@falconbridgecapital.com
(925) 979-4291

Danny Zhou, CFA
dzhou@falconbridgecapital.com
(925) 979-4290