The Current Capital Market

The current market environment remains difficult as uncertainty abounds in regard to government intervention, regulation, micro asset class risk and general macro economic issues. Liquidity (lack thereof) should only be discussed in the context of the current environment, recognizing the continued effects of the on-going deleveraging of the global financial system.

This uncertainty and dearth of liquidity has once again had an adverse effect on ABS bond prices. Specifically, consumer ABS spreads related to credit cards, auto loans and student loans have widened significantly of late as sellers that need to raise cash continue to exert downward pressure on prices. A prior uptick in RMBS prices in anticipation of TARP asset purchases has stalled and actually reversed itself as TARP continues on a program of bank and financial institution recapitalization.

Subprime Principal Reduction Loan Modifications

The recent headline splash in RMBS has focused on principal reduction loan modifications. Mortgage lenders such as JPChase and BofA have announced their intentions to modify loans rather than move delinquent borrowers into foreclosure. Additional mortgage lenders are expected to follow in their steps.

Prior to the recent principal reduction announcements regarding modifications, lenders/servicers focused on interest rate reduction modifications. However, rate modifications have had no noticeable impact on stemming foreclosures. From a RMBS noteholder standpoint, interest rate modifications mainly hurt the lower end of the capital structure (the I/O Mezz tranches). A rate reduction modification reduced the weighted average interest rate of the collateral pool and as a result less excess spread is available post-rate modification. Servicers report rate modifications on their remittance reports and reduced collateral pool WACs are modeled and the impact in prices calculated. Accordingly, the I/O mezz prices adjusted lower as a result.

Now, in order to slow, perhaps even possibly prevent additional foreclosures (i.e., establish a floor on housing prices), the new approach by lenders is loan (really principal reduction) modifications. However, there are significant legal hurdles to implementing such principal reduction loan modifications;

1. certain pooling & service agreements (PSAs) set a cap on loan modifications (typically limited to 5% of the securitization)
2. other PSAs require that any principal reduction loan modification is a loan that must be repurchased out of the pool.
3. legal challenges to these principal reduction loan modifications are fully expected and certain law firms are already rounding up the bondholders in the deals.

Principal reduction loan modifications mean that losses will be accelerated in the collateral pool. The impact on bondholders up and down the capital structure is as follows:

I/O mezz bondholders— may not fair too well. An acceleration of losses may wipe out the mezz tranches in their entirety.

Last Cash Flow (LCF) AAA bondholder— may fair better. If future losses are accelerated to today, it would actually help the LCF AAA tranches to the detriment of the current pay AAAs (i.e., the 1st, 2nd & 3rd pay AAA tranches). Potential loss acceleration increases the likelihood that the entire AAA stack shifts to a pro-rata allocation of principal payments rather than a sequential pay (as a result of the fact that the 1st/2nd/3rd tranches would not de-lever as much). Remember, if losses reach the AAA stack, they are allocated pro-rata. Since LCF tranches currently trade at much lower dollar prices than current pays, the LCF tranches may have a better price appreciation profile if loan modifications take off in a big way.

1st/2nd/3rd pay AAA bondholders— may be mixed. Depends on the transaction, vintage and current voluntary prepayment profile. Tiering is becoming even more pronounced from deal to deal. If losses are accelerated in size, then tranche duration will extend and their prices will drop accordingly.

As the cash flow profile changes and prices adjust accordingly, it allows for a better price entry point into first pay tranches albeit with a slightly longer duration profile as a result.

The impact discussed above focuses entirely on subprime residential mortgage securitizations. The Alt-A sector is less clear due to the moral hazard that can result from providing principal reduction loan modifications to higher FICO obligors and specifically to some obligors over others. If certain Alt-A borrowers receive loan modifications, then perhaps every Alt-A borrower with negative equity in their home may want a principal reduction modification and this could mushroom into a much larger problem.

It is our current view that implementing principal reduction loan modifications is easier said than done. We believe that if a compelling economic analysis shows that bondholders (both senior and subordinate holders—especially subordinate) are better off with loss acceleration versus the ultimate loss profile of running delinquencies through the foreclosure continuum, then perhaps loan modifications will occur on a grander scale. If not, then bondholders will fight to legally protect their rights under the securitization documents and will certainly be proactive against arbitrary loss acceleration.

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We continue to calibrate our loss models and severity curves to compensate for the potential impact of principal and interest reduction loan modifications on the capital structure of the RMBS securitizations.

Conclusion

The good news below the radar from all of this illiquidity and uncertainty is that investors have an assortment of compelling asset classes in which to capture yield. Our investment thesis is to focus on assets which offer attractive risk adjusted returns on an un-levered basis.

The key is specific credit selection, active credit management and surveillance, and creating fund structures which address the inherent nature of the underlying assets and the risk tolerance of the investor.

The thesis in the un-constrained, un-levered ABS fund is to invest high in the capital structure, selecting assets which exhibit relatively short duration.

In addition, there are compelling risk adjusted opportunities for investors willing to look at exposures to longer duration assets, for instance leveraged loans, top of the capital structure CLOs, as well as Commercial Mortgages.

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