

Special Report

Subprime Worries? Financial Guarantors Exposure to Weaker RMBS Originator/Servicers

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■ Introduction

For the past decade, financial guarantors have maintained a large and increasing exposure to residential mortgage-backed securities (RMBS), including securitizations backed by nonprime/subprime mortgage assets. As a result of noticeable deterioration in the subprime mortgage market in the past few quarters, Fitch Ratings has begun to receive an increased level of inquiries related to investor concerns over the nature of these exposures and the potential ramifications that they can present to the financial guaranty industry. For the purpose of this special report, Fitch has focused its analysis on those securitizations issued by less stable originator/servicers.

As part of Fitch's analysis of portfolio risk management for financial guarantors, the agency actively monitors exposure to the RMBS sector. One aspect of this analysis is to examine the nature of financial guarantors' exposures to securitizations of specific mortgage originator/servicers. This report focuses on securitization exposures related to certain less stable mortgage originator/servicers, as Fitch believes that many of these exposures are more susceptible to financial pressures at the originator/servicers, and may be more negatively affected by adverse conditions in the residential mortgage market. Recent trouble at companies such as ResMae Mortgage Corp., Ownit Mortgage Solutions Inc., Mortgage Lenders Network USA Inc., New Century Financial Corp. (New Century), and Fremont General Corporation are examples of problems in the sector.

Positively, our early conclusions are that financial guarantors as a group appear relatively well-positioned to withstand stresses placed on securitizations in the event of financial strains at the less stable RMBS originator/servicers. That said, Fitch will not rule out individual instances of problems involving one or more securitizations from these companies. However, these problems are likely to be isolated and small in relation to each financial guarantor's capital base and level of earnings.

■ Background

Financial stress at mortgage originator/servicers can adversely affect their securitizations in a number of ways. Initially, in tightening market conditions a mortgage originator may loosen origination standards in order to maintain volume needed to cover its fixed expense base. Financial pressures may lead to staff layoffs and increased staff turnover, which can adversely affect origination and servicing quality. In more severe situations, a mortgage originator may become unwilling or unable to repurchase loans that are in violation of securitization representations and warranties, leaving problem loans in

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Financial Guarantor Exposure to Less Stable Originator/Servicers

(\$ Mil., Net Par Exposure)

Lowest Attachment Point	Ameriquest	Accredited	Impac	New Century	Option One	Terwin/SLS	Other*	Total
'AAA'	6,381.6	36.5	1,748.9	853.0	974.1	1,689.1	820.3	12,503.4
'AA'	1,982.8	—	2,053.4	—	50.7	520.8	14.7	4,622.3
'A'	739.6	416.9	2,550.2	84.4	38.8	432.1	42.5	4,304.5
'BBB'	387.3	486.9	—	499.3	290.1	58.6	310.0	2,032.2
<'BBB'	7.7	—	—	9.1	54.6	—	—	71.4
Total	9,499.0	940.3	6,352.4	1,445.7	1,408.4	2,700.6	1,187.4	23,533.9

*Other includes exposures to Delta Financial Corp., Fremont General Corp., Nationstar Mortgage LLC (f/k/a Centex Home Equity Corp.), NovaStar Financial Inc.

Ameriquest – Ameriquest Mortgage Company. Accredited – Accredited Home Lenders, Inc. Impac – Impac Funding Corp. New Century – New Century Financial Corp. Option One – Option One Mortgage Corp. Terwin/SLS – Terwin Holdings LLC.

Source: Financial Guarantors Data Feeds from year-end 2005 through Sept. 30, 2006.

the securitization collateral pools. In extreme cases, financial problems can lead to a transfer of servicing — which may cause cash flow disruptions that can lead to spikes in loan delinquency and potentially foreclosures.

The subprime mortgage sector in particular is sensitive to these issues, as the quality of both origination and servicing can have an amplified impact upon loan collateral performance. Delinquencies in this subsector are relatively harder to cure, as borrowers have less financial flexibility and resources to bring delinquent loans current.

■ **Industry Exposure**

In the table above, Fitch provides a breakdown of financial guarantors' aggregate insured exposure by rating category to various less stable RMBS originator/servicers that are either unrated by Fitch or whose financial profile would suggest an issuer default rating in the speculative grade categories. Although Option One Mortgage Corporation is a subsidiary of an investment-grade rated parent, it is included in the figures above because it is widely reported to be for sale. Exposure generally includes securitizations sponsored by these companies, and also securitizations via third-party shelves that are either serviced by these companies or consist of loans primarily originated by them.

Fitch notes that some of the data reported in the tables in this report are somewhat dated, although Fitch believes the general trends with respect to exposure to less stable RMBS originator/servicers has not changed much in 2006. Fitch believes this is positive, in view of reported weakness in 2006 subprime originations.

As seen in the table, financial guarantors' insured net par exposure to securitizations related to listed companies totaled almost \$24 billion. While this aggregate figure appears substantial in nominal terms, Fitch is comforted from the fact that most of the exposure is to the most highly rated classes within the individual securitizations. Specifically, more than 70% of the aggregate exposure is rated in the 'AAA' or 'AA' categories.

This is an important point of emphasis in Fitch's view because the highly rated senior classes of RMBS securitizations are structured to have substantial credit enhancement available to absorb stress case losses from a securitization's collateral pool. As a result, deterioration in the performance of collateral, whether from weakened origination practices, servicing breaches, or other causes, can be expected to first affect the most subordinate classes of a securitization, which absorb the initial impact and provide a cushion that insulates the more senior classes from losses. The relative seniority of the industry's exposure within the securitization structures is a key factor in evaluating the extent of the industry's actual risk.

In addition to having the benefit of credit enhancement provided by subordinate classes, 'AAA' rated exposure in this sector is generally expected to pay down relatively quickly compared to lower rated classes, as loan prepayments are frequently directed first toward the senior-most classes. The lower average life usually results in shorter exposure to the potential impact of deterioration in collateral performance.

That said, Fitch also recognizes that a portion of the financial guarantors' 'AAA' rated exposure is to "last cash flow" classes, which are structured to be the last

‘AAA’ class to sequentially be paid down among senior classes. Depending upon the securitization structure, it is likely that a portion of this “last cash flow” exposure would remain outstanding while loan prepayments are allocated to subordinate tranches. As a result of this “last cash flow” feature, Fitch’s financial guaranty capital model, Matrix, typically assigns more capital to these transactions relative to similarly rated tranches that amortize sooner.

The concentration of financial guarantors’ exposure in the higher rated classes in part reflects market dynamics, as the strong impact of competition from senior/subordinate securitization structures has diminished returns available at lower attachment points in the subprime and alternative-A (Alt-A) subsectors. At the same time, Fitch believes concentrations to higher-rated classes reflect a sound underwriting discipline within the industry which has recognized the inherent risk that financially less stable originator/servicers may face during an industry downcycle. The financial guarantors, especially the large established ones, had firsthand experience with an earlier wave of contraction in the subprime mortgage industry at the end of the 1990s that created pressures on subprime mortgage securitizations at that time. Due to the lessons learned from the last downturn, the financial guarantors have generally found it more suitable from a risk/return perspective to assume exposure of these securitizations at higher rating levels.

In the table on page 2, aggregate exposure in the ‘BBB’ category includes several securitizations that attach at that rating level and insure the entire capital structure above, but also includes a number of net interest margin (NIM) securitizations. In the case of Ameriquest Mortgage Company (Ameriquest), a majority of the net par exposure in the ‘BBB’ category represents NIMs. A NIM is a further securitization of excess spread from a subprime

RMBS transaction, and is designed to pay down relatively quickly, usually in 18–36 months. As a result, NIM balances are expected to pay off faster than what is generally the case for similarly rated classes of a subprime RMBS senior/subordinate securitization. However, NIMs that underperform and pay down more slowly than expected may have a significantly increased risk of loss, and thus require careful monitoring. Aggregate exposure listed in the table above also includes a small amount of exposure to mezzanine classes or layers. These represent a partial layer of a securitization capital structure that absorbs collateral losses prior to more senior layers in the structure. Mezzanine layers may incur relatively higher loss severity compared with an equivalently rated exposure to a full securitization capital structure. As a result, Fitch’s analysis pays particular attention to these transactions from a risk and capital perspective.

In the table on page 2, the largest exposure is to securitizations related to Ameriquest, at \$9.5 billion. However, more than 85% of this exposure has underlying ratings of at least ‘AA–’. Exposure to securitizations of Impac Funding Corporation (Impac) is also relatively large in nominal terms — but none of the exposure is currently rated below the ‘A’ category. Impac is primarily an originator of Alt-A mortgage loans, rather than subprime loans. Also, the securitizations are subserviced by either GMAC Mortgage Corporation or Countrywide Home Loans Servicing LP, with Impac retaining only a role as master servicer. The outsourcing of primary servicing functions to financially stronger companies mitigates some of the servicer risk associated with securitizations sponsored by financially less stable originators.

■ Company Exposure

The table below provides a breakdown by financial guarantor and rating of the aggregate net par

Company Exposure to Less Stable Originator/Servicers

(\$ Mil., Net Par Exposure)

Lowest Attachment Point	MBIA	Ambac	FSA	FGIC	SCA	AGL	CIFG	RAA	Total
‘AAA’	458.5	2,557.4	4,430.8	1,597.1	561.0	2,184.3	634.0	80.2	12,503.4
‘AA’	22.8	2,088.1	74.9	1,998.3	356.8	33.2	33.0	15.3	4,622.3
‘A’	19.3	294.4	24.8	3,452.4	216.7	207.0	68.2	21.8	4,304.5
‘BBB’	260.2	486.8	386.6	637.4	—	158.7	—	102.6	2,032.2
<‘BBB’	1.3	55.7	—	—	—	12.6	—	1.8	71.4
Total	762.0	5,482.4	4,917.1	7,685.1	1,134.5	2,595.8	735.2	221.7	23,533.9

MBIA – MBIA Insurance Corp. as of Dec. 31, 2005. Ambac – Ambac Assurance Corp. as of Sept. 30, 2006. FSA – Financial Security Assurance Inc. as of Mar. 31, 2006. FGIC – Financial Guaranty Insurance Company as of Mar. 31, 2006. SCA – Consolidated XLCA and XLFA as of Sept. 30, 2006. AGL – Consolidated Assured Guaranty Corp. and Assured Guaranty Re Ltd. as of Sept. 30, 2006. CIFG – CIFG Guaranty as of Sept. 30, 2006. RAA – Radian Asset Assurance Inc. as of Mar. 31, 2006.

exposure shown on the table on page 2. As the table indicates, FGIC and Ambac have the largest aggregate reported exposures to the originator/servicers focused on in this report. However, almost all of the exposure to Impac's securitizations referred to above has been wrapped either by Ambac or FGIC, and this accounts for a significant portion of their aggregate exposures in this table.

FSA and FGIC have relatively large exposures to Ameriquest-related securitizations, and together account for about 60% of the \$9.5 billion aggregate net par shown in the table on page 2. However less than 10% of their exposure is rated lower than 'AA-'.

Although FSA's exposure to the originator/servicers focused on in this report is nominally significant, it is very heavily weighted toward the 'AAA' rating category, and the limited amount of 'BBB' exposure primarily consists of a number of NIM transactions. MBIA's exposure is small in nominal terms, and especially on a relative basis compared to the size of its insured portfolio. AGL's exposure is largely 'AAA' rated, but also includes some lower rated exposure to mezzanine tranches of 2003 vintage securitizations. Aggregate net par for Radian Asset Assurance also includes some lower rated mezzanine exposure to 2003 vintage transactions. Reported exposure for Radian Asset Assurance does not include deal-specific coverage provided by its mortgage insurance company affiliate.

Lastly, Fitch suggests it is important to put the aggregate numbers shown above into perspective. The exposure of the financial guarantors to securitizations related to companies in the table

represents only a small portion of the financial guarantors' overall domestic RMBS exposure. The financial guarantors have much more significant exposure to a relative handful of financially stronger high volume originator/servicers—especially the operating entities of Countrywide Financial Corporation (Countrywide) and Residential Capital Corp. For example, from the most recent data received by Fitch, the combined servicing exposure of the financial guarantors to Countrywide alone approximates \$45 billion. (This includes servicing of all types of RMBS securitizations, and much of the securitization collateral is loans to prime borrowers). Exposures to securitizations of these financially stronger companies frequently attach at the 'BBB' rating category.

■ Conclusion

As seen from the data listed above, the financial guarantors as a group appear relatively well-positioned to withstand stresses placed on securitizations in the event of financial strains at the less stable RMBS originator/servicers. That said, Fitch will not rule out individual instances of problems, such as with a NIM transaction or a mezzanine exposure, involving one or more securitizations from the originator/servicers listed above. However, these exposures are likely to be isolated and small in relation to each financial guarantor's capital base and level of earnings.

Fitch will continue to monitor developments in the RMBS sector for implications upon the insured portfolios of the financial guarantors. In future special reports, Fitch will provide a more comprehensive list of subprime RMBS exposure in the financial guaranty industry.

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