

October 1998

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SUBPRIME HOME EQUITY

Industry Outlook

The Party's Over

Summary Opinion

Although there are many finance companies, banks, and thrifts involved in the home equity lending business, for purposes of this report, we define the subprime home equity industry as the group of finance companies active in this sector of the financial services industry for which we have debt ratings and which specialize primarily in home equity lending to consumers with below average credit records. These companies are often called subprime home equity, or mortgage lenders.

At this point in the credit cycle, independent subprime home equity lenders face greater challenges than ever before. Independent companies can survive in this industry only if they have the capital and liquidity to withstand an economic environment characterized by limited funding opportunities, a rapid rate of mortgage refinancing, and the potential for increasing loan defaults. As a product, home equity lending will not disappear. The traditional finance companies and banks will continue to be involved in this market.

The following bullet points summarize our opinion:

- Intense competition has reduced yields to the point where returns are inadequate relative to the risks of the product.
- Asset backed securities (ABS) spreads widened considerably during August 1998, further reducing profitability as well as liquidity.
- Asset quality has deteriorated as underwriting standards have been stretched in order to increase volume.
- Loan losses are being suppressed, at least temporarily, by refinancing opportunities available to distressed borrowers and by the restructuring of delinquent loans.
- Unexpected surges in prepayment rates have resulted in significant writedowns of interest-only and residual interests and may result in additional writedowns going forward.
- Subprime home equity lenders have very limited access to equity and unsecured debt markets and may now be facing limitations in their access to warehouse lines.
- The home equity lenders covered in this report have a continuing need for short-term funding to offset their negative cash flows from operations. Their funding dependence, in the face of extreme investor uneasiness with this sector, has resulted in an environment where survivability is an open question.
- The higher margins available to banks and thrifts, which may utilize federally insured deposits to fund subprime home equity portfolios, may lead to equity investments by these institutions in subprime mortgage lenders. However, the increasing regulatory scrutiny of the subprime home equity activities of depository institutions may somewhat dull the appetite for acquisitions.
- Home equity lenders with efficient distribution systems and servicing platforms, or a brand image, may be attractive takeover targets for larger financial institutions.

All of the above trends illustrate the stresses facing the current business model of subprime home equity lending. The viability of this model is now in doubt.

Although our ratings for companies in this sector reflect the concerns summarized above, we must be mindful of the severe deterioration in their bond and equity prices which has occurred over the past several weeks. Access to capital as well as the specter of further prepayment shocks will be considered carefully going forward.

It is noteworthy that several companies have announced plans to be acquired, or at least to find an equity "partner." The companies that fall into this category, as of this publication, are as follows:

Aames Financial Corporation
 FIRSTPLUS Financial Group, Inc.
 Southern Pacific Funding Corporation
 United Companies Financial Corporation

Since the beginning of this year we have seen the acquisition of The Money Store and a \$38 million private equity investment in Aames. We have also witnessed debt defaults by Cityscape, Mego Mortgage, and Southern Pacific Funding Corporation. The dual trends of consolidation and severe financial distress are likely to continue.

One additional, critical challenge has recently arisen. Due to declining collateral values and/or covenant violations, subprime home equity lenders may see material reductions in their lines of credit. In the case of Southern Pacific Funding Corp., for example, this situation led to a bankruptcy filing on October 1, 1998. In at least the short term, the survival of individual companies is severely stressed. It is likely that there will be additional defaults of unsecured debt in this sector.

Moody's ratings and outlooks for companies in this industry are as follows:

	Sr. Debt Rating	Sub. Debt Rating	Outlook
Aames Financial Corporation*	B3	Caa2	Negative
Advanta Corporation	B2	B3	Stable
ContiFinancial Corporation	Ba3	(P)B2	Stable
Delta Financial Corporation	B3	—	Negative
HomeGold Financial, Inc. (formerly Emergent)	Caa2	—	Negative
FIRSTPLUS Financial Group, Inc.	—	Caa1	Negative
Mego Mortgage Corporation	—	Ca	Stable
The Money Store, Inc.	A1	A2	Stable
Southern Pacific Funding Corporation	Caa3	Ca	Negative
United Companies Financial Corporation	B3	Caa2	Negative

* Ratings are on review for possible downgrade.

(FIRSTPLUS is included with home equity lenders because its basic product, the Hi-LTV mortgage, has many of the characteristics of subprime home equity loans. This product is normally a second mortgage, which, when added to the first mortgage on a property, results in a combined loan-to-value ("LTV") ratio which generally exceeds 100%. The unifying characteristic between subprime mortgages and Hi-LTV (or "125") mortgages is the poor credit quality of the borrower and his need to consolidate debts.)

THE INDUSTRY HAS GROWN RAPIDLY

Although home equity lending is not a new business, over the past several years the finance industry sector known variously as "subprime mortgage lending," "B/C mortgage lending," or simply "home equity lending," has seen explosive growth.

The following table shows the largest B&C home equity lenders and also shows the growth in their volume:

Origination Volume of 15 Largest B&C Home Equity Lenders (\$ in billions)

	6 Months to 6/30/98	6 Months to 6/30/97
Associates First Capital	\$4.5	\$3.4
ContiMortgage	3.8	2.4
IMC	3.6	2.2
The Money Store	3.4	2.4
Household	2.9	1.2
FIRSTPLUS	2.8	1.9
GMAC/RFC	2.3	1.0
Advanta	2.3	1.6
Green Tree	2.3	1.5
Commercial Credit	2.1	1.6
Beneficial	1.9	1.5
United Companies	1.8	1.3
WMC	1.8	.6
AMRESO	1.8	1.9
EquiCredit	1.8	1.3
Total	\$39.1	\$25.8

Source: Inside B&C Lending

The companies in this sector compete fiercely for opportunities to lend to homeowners who have had difficulty in obtaining housing credit from more traditional sources. Daytime television and the average consumer's mailbox are saturated with advertisements, often featuring a well known sports figure hyping the benefits of a home equity loan. The majority of these loans are made to people who are over-burdened with credit card debt. In most cases, a home equity debt consolidation loan can reduce their monthly payments and provide some cash for home improvements or other expenses.

The compound annual growth rates (CAGR) of the servicing portfolios of company's covered in this report demonstrate this rapid pace of growth:

Home Equity Portfolio Growth Rates (\$MM)

	12/31/97	12/31/94	CAGR (%)
Aames (a)	\$ 4,031	\$ 609	98.9
Advanta	5,309	1,346	58.0
ContiFinancial (b)	10,136	2,192	66.6
Delta	1,840	359	72.4
HomeGold	989	157	84.5
FIRSTPLUS (c)	4,658	53	345.1
Mego Mortgage (d)	628	8	327.8
The Money Store	11,430	3,726	45.3
Southern Pacific	2,477	69	230.3
United Companies	5,892	2,032	42.6

(a) At 3/31/98 and 6/30/95

(b) At 3/31/98 and 3/31/95

(c) At 9/30/97 and 9/30/94

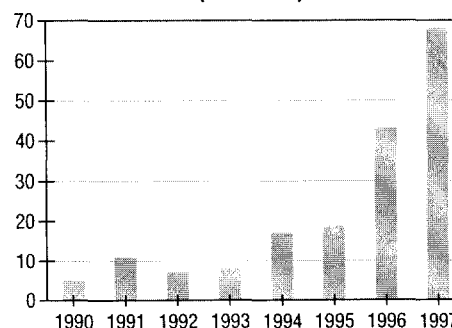
(d) At 8/31/97 and 8/31/94

The rapid growth of this industry is also apparent from the amount of home equity securitizations over the past several years:

GROWTH HAS BEEN FUELED BY SECURITIZATION AND GAIN ON SALE ACCOUNTING

The ability of these companies to grow rapidly has depended on securitization, as a funding source, and to a large extent on gain on sale accounting, which allowed them to build an earnings track record and attract equity and debt investors. Securitization allows companies to raise substantial funding without having to have a strong degree of corporate credit quality. B&C mortgage companies raised substantial amounts of unsecured term debt and equity from 1995 through 1997.

Home Equity/B&C Mortgage ABS Volume (\$ billions)



Investors became interested in this sector due to the sparkling earnings track records and historically low loan losses of companies in this industry. Earnings, however, are generated almost entirely from securitization gains. Before Financial Accounting Standard 125 (FAS 125) became effective, on January 1, 1997, companies had the option of accounting for securitizations as sales or as financings. Most home equity lenders chose to account for these transactions as sales, thereby recording significant gains on sale. Since FAS 125 has been enacted, all securitizers are required to calculate and record gain on sale from securitizations. Without the use of gain accounting, most home equity lenders would have reported net losses for the last several years. Their ability to attract capital has been predicated on gain on sale accounting.

This accounting method also provides a strong incentive for companies to grow origination volume. Since securitization gains are directly proportional to the volume of loans securitized, the primary source of earnings growth is increased loan origination and securitization volume. With numerous companies all seeking to aggressively increase volume, the returns in this business have declined and will continue to decrease until there is substantial capacity removed from the industry.

GAIN ON SALE ACCOUNTING MASKS TRUE LENDING PROFITABILITY

Gauging profitability for the B/C home equity industry presents many challenges. The primary issue is the extent to which earnings are impacted by gain on sale accounting. Over the past several years, this industry has shown impressive profitability, if one accepts the view that securitization gains represent current income as opposed to unearned future income.

It has been Moody's position that gain on sale accounting records a stream of future unearned income in the quarter of securitization, with the result being an overstatement of earnings, when viewed on an economic basis¹. We, therefore, feel that gain on sale does not provide an adequate measure of the true profitability of this industry.

The following chart depicts reported profitability, based on the ratio of return on average assets ("ROA"), of companies in this industry, and the contribution of gain accounting to pre-tax earnings.

1997* Earnings Performance				
	ROA (%)	Pre-Tax Earnings (\$ MM)	Gain on Sale (\$ MM)	Ratio of Gains to Pre-Tax Earnings (%)
Aames Financial Corporation	5.22	55.0	144.7	263.1
ContiFinancial Corporation	6.17	225.0	311.6	138.5
Delta Financial Corporation	9.72	51.2	86.3	168.6
HomeGold Financial, Inc.	3.51	7.6	38.7	509.2
FIRSTPLUS Financial Group, Inc.	8.97	224.5	288.2	128.4
Mego Mortgage Corporation	14.40	23.8	48.6	204.2
Money Store, Inc. (The)	3.33	227.7	574.6	252.3
Southern Pacific Funding Corporation	11.57	92.0	148.4	161.3
United Companies Financial Corporation	6.59	125.9	265.1	210.6

*Results are for the year ended December 31, 1997, except for Aames, which is annualized for 9 months to March 31, 1998; ContiFinancial, which is for the year ended March 31, 1998; FIRSTPLUS, which is for the year ended September 30, 1997; and Mego Mortgage, which is for the year ended August 31, 1997.

Without gain on sale accounting, these companies would look a lot less profitable.

LENDING PROFITABILITY - THE BASIC MODEL

In all sectors of the finance business, loan economics is quite straight forward. The finance company lends at a certain rate and obtains funding at a lower rate. The difference is the net interest margin. On an overall portfolio basis this margin is then reduced by losses, operating expenses, and income taxes, to arrive at a return on assets (ROA). Anyone lending money should want to know whether or not the ROA, determined in this manner, is sufficient relative to the risk of the loan portfolio.

1. See, for example, "Securitization and its Effects on the Credit Strength of Financial Services Companies", Moody's Special Comment, November 1996.

The following table, which illustrates this profitability model, provides a fair reflection of the actual returns in this business:

Loan rate	10.50%
Premium – yield equiv.	(1.50)
Yield	9.00
Funding cost	(6.50)
Net interest margin	2.50
Servicing cost	(.30)
Losses	(.75)
Pre-tax ROA	1.45
After-tax ROA	.87%

In this example, a loan with a 10.50% coupon rate was acquired at a premium of 4.5 points (price of 104.5). Since the duration of this particular loan is three years, this 4.5 point premium translates into a yield equivalent of 1.5 points, so that this loan has a 9% yield. From this yield, deductions are made for funding costs, servicing costs, and loan losses. The resulting 145 basis points (bp.) represents a pre-tax return on assets. After applying a corporate tax rate of 40%, we arrive at an ROA of 87 bp.

This, obviously, is not the same ROA as home equity lenders are allowed to report under GAAP accounting, as shown above for several companies in the industry. There are two primary reasons why reported profitability differs from what would be calculated using the above profitability model. First, when the comparison is made between current period income and assets that were securitized in the same period, we would be comparing all of the income expected to be earned over the life of the asset to the asset balance. This is quite different from comparing income earned in a period with the balance of assets that generated that income. Secondly, in a traditional ROA calculation, net income from gain on sale accounting is not compared to the assets that generated the gains, since these assets have been securitized and are therefore off the balance sheet.

PROFITABILITY IS INSUFFICIENT RELATIVE TO THE RISKS OF THE BUSINESS

In general, an ROA of 87 basis points for a high-risk lending industry is insufficient. The U.S. economy is at a point in the credit cycle where unemployment is low and real estate prices are rising. From an asset quality perspective, these are good times for home equity lenders. These lenders should be building equity capital through solid earnings so that, should the economy slow down significantly, higher credit losses can easily be absorbed. Instead, home equity lender's capital positions are weak and are not being built up by strong earnings.

ROA levels for diversified finance companies, many of whom also lend in the B&C home equity market, are considerably higher than the 87 basis points shown above. The profitability of these companies, all of whom have long earnings track records, provides a yardstick for acceptable returns.

	1997 ROA (%)	Sr. Debt Rating
American General Finance Corp.	1.45	A2
Aristar, Inc.	1.88	A3
Associates Corp. of North America	1.94	Aa3*
Avco Financial Services, Inc.	2.31	A2**
Commercial Credit Company	2.14	Aa3
General Electric Capital Corp.	1.27	Aaa
Household Finance Corporation	2.36	A2
Norwest Financial, Inc.	3.15	Aa3

*On review for possible downgrade
 **On review for possible upgrade

A brief list of the reasons why larger, diversified finance companies are more profitable than are subprime home equity lenders is as follows:

- The diversified finance companies, in general, have larger operations which they run more efficiently.
- The diversified, due to their market presence, get paid more for the risks they take. They are in a position to be more selective in approving loans and can charge higher rates through their branch operations.
- The diversified have lower funding costs.

PROFITABILITY IS ALSO VOLATILE

Average profitability reflected in an ROA of 87bp. is weak. But, it is also quite variable. The actual performance of any company in the industry can vary greatly from this average. Also, the variables that result in this ROA (loan yields, funding costs, losses, etc., etc.) will change going forward.

The widening out of spreads in the ABS market over the past several weeks has substantially reduced the profitability of this industry. Although higher spreads reflect disarray in credit markets in general, they also reflect concerns for asset quality, prepayment risk and the financial health of the industry. Spreads may tighten going forward, however, other costs may increase.

For example, servicing expenses of 30 basis points reflects a reasonably predictable level of collections activity. This is the single most variable operating expense related to loans in the portfolio. If delinquencies rise, collection activity, and therefore, collection expense must also rise. Servicing expenses will vary directly with the credit quality of the portfolio.

Additionally, in the above example, loan losses were estimated at 75 basis points annually. This is actually a higher level than what most lenders have experienced over the past few years, and is also a higher level than what most companies are using for a loss estimate in interest-only security valuation. But, there may be many reasons why this turns out to be an understated amount. If, for example, the economy slows down resulting in increasing unemployment, loan losses will rise. (The section on asset quality will provide further discussion.) At the least, loan losses can be highly variable and past experience may not be very helpful in predicting future losses.

One of the drawbacks of gain accounting for ABS issuers is the requirement that retained interests shown on the balance sheet be re-valued once there is any material change in the assumptions used to create its value in the first place. For example, a company may have estimated its gain on sale from a securitization based on the assumption that the underlying mortgages would prepay at a certain rate. Subsequent to the closing of the ABS, the loans may have prepaid at a much faster rate than anticipated. This experience would result in the issuer reassessing its gain calculation assumptions. An increase to the estimated rate of prepayments would result in a writedown of the value of retained interests (often termed "interest-only" securities).

By mid-1997, intense competition and lower interest rates resulted in higher prepayment experience than what many companies anticipated, resulting in writedowns. One of the first companies to announce a writedown was Aames Financial Corporation. Aames, whose fiscal year ends on June 30, determined, after having its fiscal year 1997 financial statements audited, that a writedown would be needed. Aames was quickly followed by other companies including Cityscape, Green Tree Financial², Mego Mortgage, and United Companies Financial. The stock prices for these companies, as well as for any company which relies heavily on gain accounting as part of its earnings, declined dramatically in December 1997, and January 1998. Companies which issued debt during 1997, found both the debt and equity markets far less receptive during the first half of 1998.

At this point, the whole concept of recording income for the life of a loan during a single quarter, which is then subject to adjustment in subsequent quarters, is viewed with a good deal of suspicion by investors. Adding to this uneasiness are concerns about operating cash flow and asset quality for home equity lenders. Because of the cool reception home equity lenders now face from investors, many companies are unable to raise long term debt or equity at reasonable prices at this time.

Our outlook is for profitability to continue to be constrained until there is a major reduction in industry capacity.

2. Green Tree announced a writedown due to prepayments in its manufactured housing loan portfolio, which were driven by similar competitive pressures to what home equity lenders have experienced.

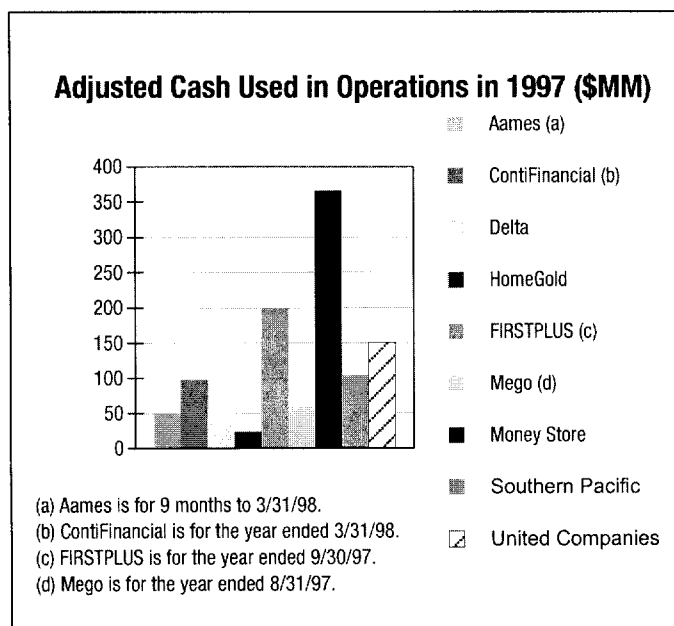
OPERATING CASH FLOW IS WEAK

The operating cash flows of subprime mortgage lenders contrast sharply with their reported profits. Weak cash flow reflects both the high cost of rapid growth, and, in several cases, rising collateral requirements in securitizations due to poor pool performance.

Most home equity lenders which fund their portfolios with securitization include changes in loans held for sale in the operating section of their cash flow statements. Since these companies are growing rapidly, their portfolios of loans held for sale are also growing, thereby "using" cash flow during each quarter. By contrast, "balance sheet lenders," a category that we define to include most of the diversified consumer finance companies³, generally do not designate their balance sheet portfolios as "held for sale." Therefore, changes in balance sheet loans are included in the investing section of the cash flow statement. These changes, which include purchases and sales of loans as well as principal collections, can be very large uses of cash. This is one reason why operating cash flows, as defined by Generally Accepted Accounting Principals (GAAP), are often large outflows for home equity lenders.

Because Moody's views home equity securitizations, in general, as financing transactions, and not sales, we restate financial statements so as to re-account for securitizations by home equity lenders. For the statement of cash flows this involves removing the effects of changes in loans held for sale from the operating section of the cash flow statement. The resulting measure of cash from operations is called "Adjusted Cash from Operations." This is a negative number for most sub-prime home equity lenders, indicating that cash was *used* in operations, as opposed to being generated from operations.

The following chart shows the amounts used during 1997 for companies in this industry:



Despite removing the effects of changes in loans held for sale, many home equity lenders still have negative cash flow. In some cases this is due to cash flows for excess spread being held by securitization trusts in order to build up collateralization (often termed "over-collateralization" or "OC"). Negative operating cash flow may also reflect rapid portfolio growth resulting in current expenses for origination activities which will not be offset by excess spread until future periods. There is a third, less favorable explanation which may have an impact on operating cash flow: the loan portfolio may not generate sufficient excess spread to cover expenses.

Access to capital markets is essential for subprime finance companies. Recognizing their vulnerability, many companies have plans to become "cash

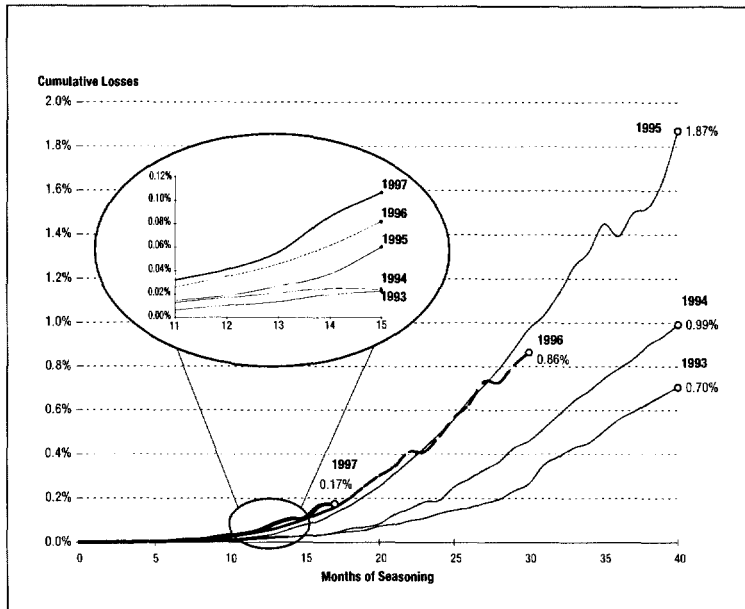
neutral." Indeed, this has become the holy grail of subprime finance companies. For many, achieving this goal will be difficult, to say the least. Companies will have to reduce operating expenses while securitized portfolios generate sufficient excess spread to meet their cash needs.

Regardless of the underlying reasons for negative operating cash flow, rapidly growing home equity lenders require a steady stream of external funding in order to maintain their growth. Over the past twelve months, their ability to raise this funding has been hampered by gain on sale accounting, just as it was buttressed in prior years.

3. Examples are Household Finance, Commercial Credit, The Associates, and Norwest Financial.

Although the transition has been a long time in coming, more investors are now looking at these companies from a cash flow perspective – which, we think, is the right thing to do.

WE EXPECT ASSET QUALITY TO DETERIORATE



Underwriting standards have declined over the past few years as companies compete to maintain increasing loan volume. This trend is evident in the vintage year deterioration for subprime home equity losses, which is shown in the chart⁴ at left.

Each line represents the accumulated loss experience for subprime home equity loan securitizations during the indicated year. The horizontal axis shows months since origination.

There are two reasons, however, why asset quality indicators of B&C mortgage lenders may not reflect the true extent of credit losses. First, delinquent loans are often restructured, so that they

will be reported as performing under the new terms. Second, subprime home equity lenders often buy delinquent loans out of trusts which are then either sold at a loss or are restructured and sold in the next securitization.

MANAGING ASSET QUALITY

Consumer finance companies have some discretion in the timing and the amount of credit loss recognition. In the Home Equity sector, a credit loss is normally taken when a property which secures a delinquent loan is foreclosed on and sold. An obvious way to avoid a loss is not to foreclose. If the finance company continues to hold the loan on its books, even though it is a non-performing asset, no loss is recorded. For lenders which are in no financial distress, the best course of action is to recognize the loss. However, when a lending institution, whether a home equity lender or not, is in a precarious position, losses can, and will, be hidden.

Non-performing loans would be disclosed by the company, both in financial statements, and for securitization reporting, as a delinquent loan. However, companies can also manage their delinquency numbers by choosing to re-negotiate the terms of the loan contract so that the loan can be counted as a performing loan based on the new, more lenient contract terms. These terms might include a longer period under which to repay the loan, or a lower interest rate, which would decrease the monthly payment. However, it is important to note that not all finance companies will count a loan which is only "performing" with respect to revised contract terms, as current. Also, keep in mind that strategies to reduce losses and delinquencies are not the exclusive arena of home equity lenders. All consumer lenders employ collection strategies designed to minimize ultimate losses. Problems arise, however, when these strategies are pushed too far, as is often the case with financially distressed companies.

We believe that loan losses will rise as the economy slows down. Also, as we expect loan volume growth to slow in this industry, refinancing opportunities for delinquent borrowers will decline, further exacerbating loan losses.

4. This chart was prepared by Moody's Mortgage Finance Group.

One final caveat on asset quality:

Home prices rise during periods of inflation and when the economy grows at a brisk pace. Any decline in home prices would further increase loan losses for the subprime home equity industry.

LEVERAGE AND CAPITAL ADEQUACY

In reviewing the capital adequacy of companies which rely heavily on securitization as a funding source, Moody's will restate financial statements, removing the effects of gain on sale accounting, when it is clear that only insignificant credit risk has been transferred through the securitization. The resulting ratios of debt to equity (the effective leverage ratio) are generally quite high for home equity lenders, indicating low capital adequacy⁵.

Shown below are the effective leverage ratios of companies which are major B/C home equity lenders and have relied heavily on gain on sale accounting as a source of earnings:

Leverage at Home Equity Finance Companies

As of 12/31/97	Effective Leverage (Total Equity)	Debt to Total Equity
Aames Financial Corporation	24.6	1.4
ContiFinancial Corporation (a)	24.0	3.0
Delta Financial Corporation	43.6	1.4
HomeGold Financial, Inc.	306.6	9.3
FIRSTPLUS Financial Group, Inc.	32.0	4.6
Mego Mortgage Corporation (b)	nm	4.9
The Money Store, Inc.	123.7	2.9
Southern Pacific Funding Corporation	141.0	2.8
United Companies Financial Corporation	32.5	1.5

(a) As of 3/31/98

(b) As of 2/28/98

"nm" means not meaningful

Capital adequacy can also be measured by reviewing the company's balance sheet, without adjustment for gain on sale accounting. The extent to which intangible assets such as goodwill and investments in retained interests in securitizations, are supported by debt funding should be an area for careful analysis. These illiquid assets are vulnerable to frequent revaluations and may not produce cash to meet debt service requirements, at least in the near term. We believe that these characteristics must be reflected in any measurement of the capital adequacy of firms in this industry.

CALCULATING EFFECTIVE LEVERAGE

Moody's effective leverage ratio is the ratio of adjusted debt to adjusted equity. Adjusted debt is balance sheet debt plus debt issued by securitization trusts through securitizations where the sponsoring corporation retains virtually all credit risk. Adjusted equity is equal to tangible common equity less the after tax amounts of retained interests in securitizations. Additional adjustments may also be made for the effects of Financial Accounting Standard 91, which requires deferral of certain direct costs and discounts related to loan origination and acquisition. These deferred items are written off when a loan is "sold" (securitized), but would be held on the balance sheet if a securitization were treated as a financing. Adjustments may also be needed for the effects of overcollateralization, a portion of which might represent net interest income to a portfolio lender, and reserves for credit losses. (For a complete discussion of the calculation of effective leverage, please refer to *Alternative Financial Ratios for the Effects of Securitization*, Moody's Special Comment, September 1997.)

5. "Alternative Financial Ratios for the Effects of Securitization - Tools for Analysis," Moody's Special Comment, September 1997.