# Early Defaults Rise in Mortgage Securitizations

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## SUMMARY

Mortgages backing securities issued in late 2005 and early 2006 have had sharply higher rates of foreclosure, real estate owned (REO) and loss than previously issued securities at similar, early points in their lives. These "early default" measures have been primarily visible in the subprime universe, but are not limited to that sector. Moody's is currently assessing whether this represents an overall worsening of collateral credit quality or merely a shifting forward of eventual defaults which may not significantly impact a pool's overall expected loss. In this report, we will describe the recent trend in early defaults, explore its possible causes, and outline some of the market's efforts to mitigate its effects as well as the steps that Moody's has taken in adapting its surveillance procedures to current market conditions.

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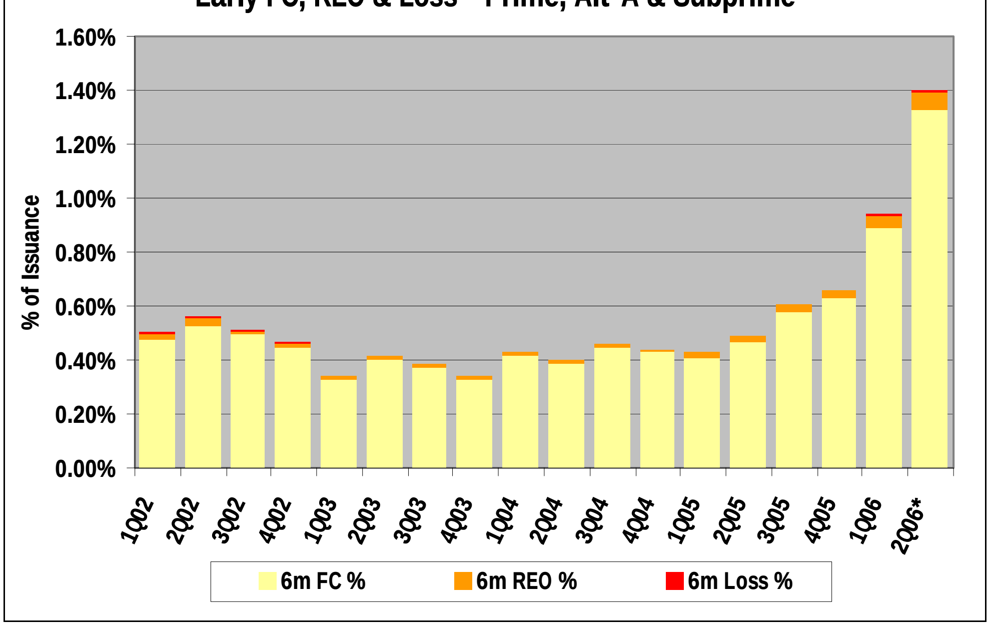
## EARLY PERFORMANCE DETERIORATING

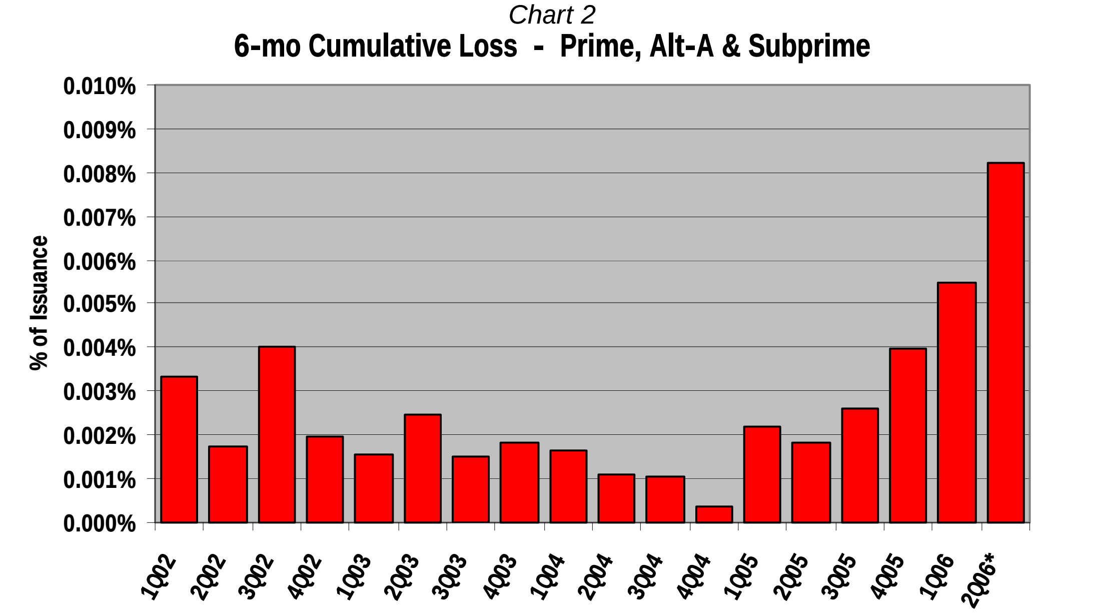
Benefiting from a benign credit environment, low interest rates and rapid home price appreciation, collateral performance of Residential Mortgage Backed Securities - prime and subprime - has been very strong in recent years. However, Moody's has noted that mortgage pools issued in recent quarters have exhibited some deteriorating performance trends relative to older vintages. One such trend is evident in the rising proportion of early defaults leading to foreclosure in recently originated mortgages. For all residential mortgage securities rated by Moody's in the second quarter of 2006[1], over 1.35% of the underlying collateral was reported in foreclosure, real estate owned (REO) or had already realized a loss as of the transactions' sixth month of seasoning. This represents a significant increase from the first quarter of 2005 when roughly 0.40% of mortgage collateral experienced such foreclosure, REO or had already realized a loss. [See *Chart 1*.]

*Chart 1*



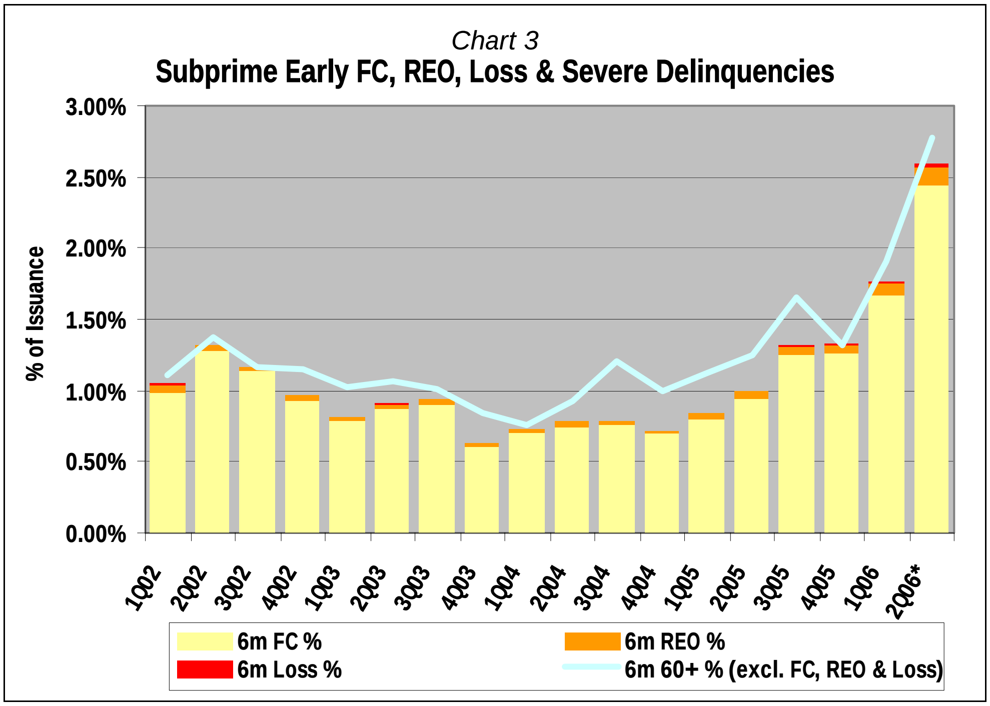

Along with early defaults, the proportion of cumulative losses in the first six months, although still very low, has risen consistently over the past six quarters. Cumulative losses in the first six months on residential mortgages securitized in the first quarter of 2005 totaled less than two tenths of one basis-point, but for deals closing in the second quarter of 2006 that total has increased to over 0.8 bps. [See *Chart 2*.] While the figures remain small, the trend seems clear, especially when coupled with the recent increase in early defaults.

*Chart 2*



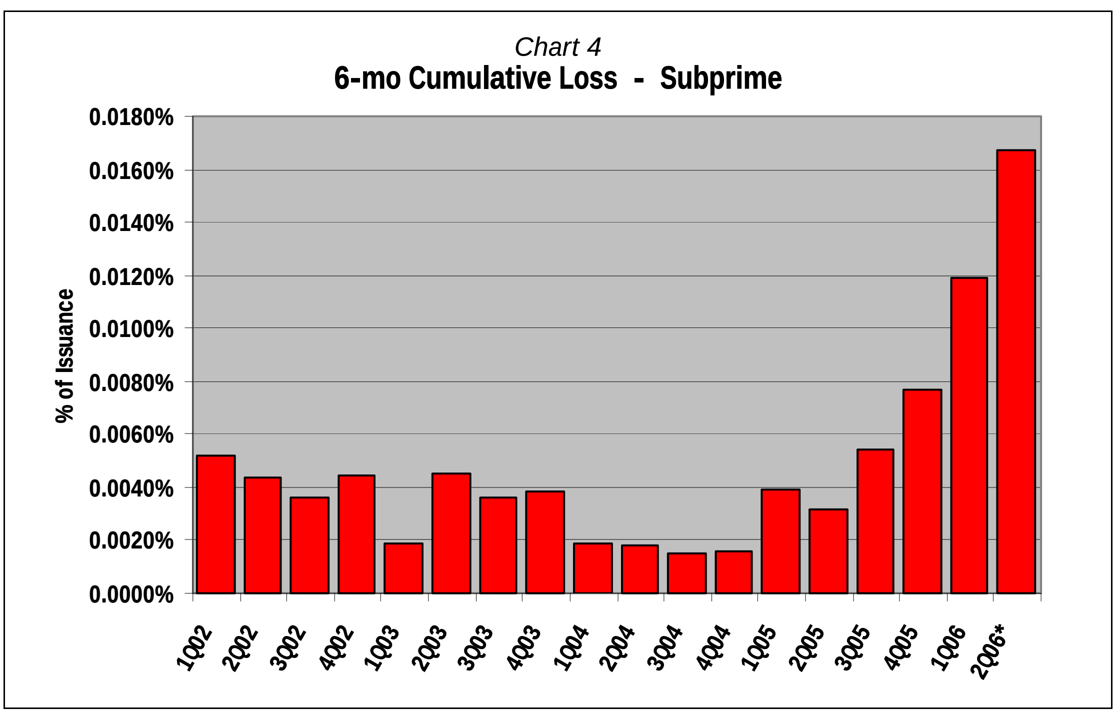

1 The second quarter figures referenced in this report include only deals closed in April and May due to insufficient seasoning for transactions closed in June.

## DETERIORATION MOST SEVERE IN SUBPRIME COLLATERAL




The performance deterioration has been most pronounced in subprime pools. For subprime mortgages, the proportion of six-month foreclosure, REO and realized losses more than tripled from the first quarter of 2005 (0.84%) to the second quarter of 2006 (2.59%). [See *Chart 3*.] Indeed, there appears to be a wide distribution of deals experiencing a high degree of early defaults as the median proportion of six-month foreclosure, REO and loss for subprime pools securitized in the second quarter of 2006 was 2.23% with such proportions exceeding 4% of original balance for only 13 of the 109 subprime pools. Additionally, the six-month cumulative loss figures for subprime pools have also exhibited deteriorating trends. [See *Chart 4*.] As of the sixth month of seasoning, the percentage of cumulative loss has risen steadily since the second quarter of 2005 reaching 1.67 bps of total subprime volume securitized in the second quarter of 2006.

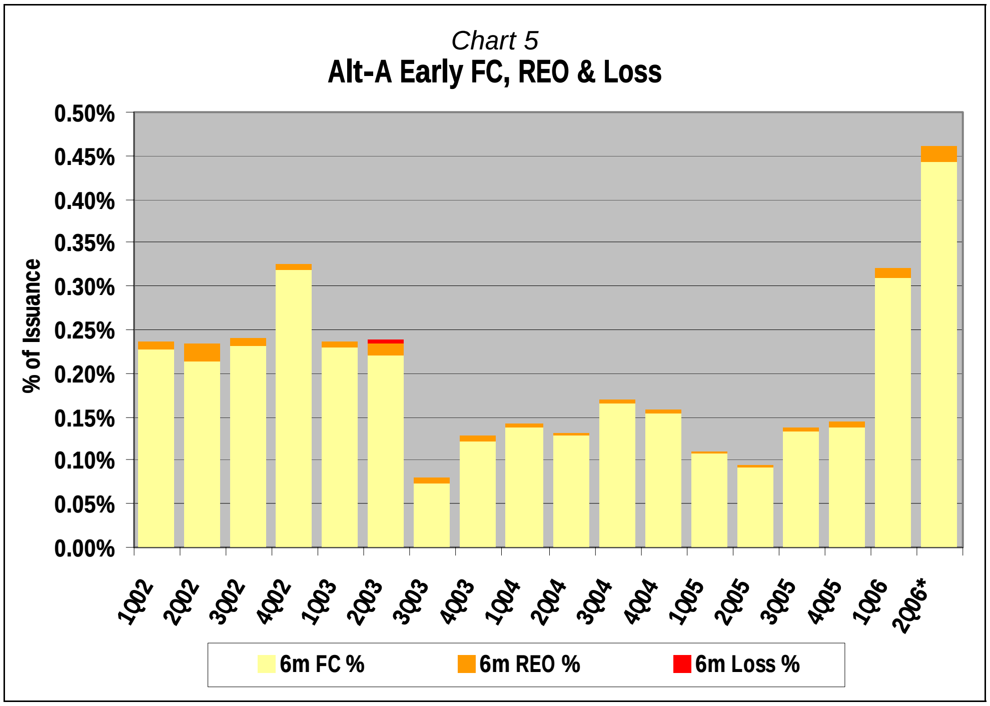
Moody's notes that beyond the loans in foreclosure and REO the delinquency pipeline is significant and may signal that performance may be an ongoing concern beyond early defaults. The line in *Chart 3* shows that the proportion of early severe delinquencies <u>not reported in foreclosure, REO or realized loss</u> has also increased for recent quarters. Of all subprime mortgages securitized in 2006's second quarter, over 2.75% were reported as sixty-plus days past due. This figure is more than double that of subprime loans securitized in the second quarter of 2005 for which less than 1.25% was at least sixty days delinquent at six months of seasoning.



## SIMILAR TRENDS OBSERVED FOR ALT-A COLLATERAL

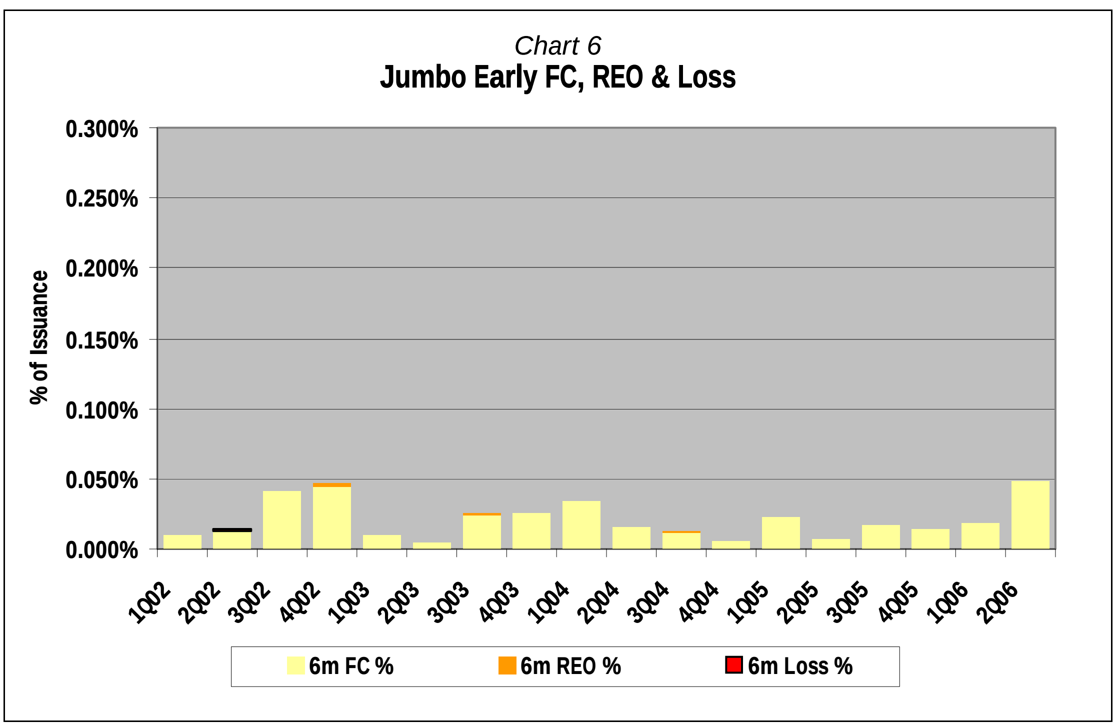
Early defaults on Alt-A collateral were stable from 2002 to mid-2005, but have risen sharply for transactions issued in the first part of 2006 where six-months of seasoning is now available, although the figures are still much lower than those observed on subprime loans. [See *Chart 5*.] For second quarter 2006 transactions, early foreclosure, REO and loss rates represented 0.46% of total Alt-A volume compared to just under 0.15% of Alt-A collateral securitized in the fourth quarter of 2005.

The number of Alt-A pools experiencing early losses has also risen. Of all Moody's-rated Alt-A pools closing from the first quarter of 2002 through the fourth quarter of 2004, only 11 of over 1200 pools incurred any losses within six-months of securitization. However, of Alt-A securitizations from the first quarter of 2006 alone 10 of the 268 pools realized at least one-dollar of loss within six months of deal closing.




## PERFORMANCE OF PRIME LOANS HAS REMAINED STABLE

Prime collateral has continued to exhibit stable and strong performance as the sector has thus far remained insulated from trends in early defaults. As illustrated in *Chart 6*, since 2002 early foreclosure, REO and Loss has never exceeded 5 bps of quarterly securitization volume with virtually no early losses.



## POTENTIAL CAUSES OF EARLY DEFAULT TRENDS

Several mortgage industry and macro-economic trends appear to be behind the increase in early defaults. As we have frequently commented on in recent years, originators of subprime loans have loosened underwriting guidelines and materially increased the layering of risk. In particular, loans without full documentation, loans backed by investor properties, loans to first-time homebuyers and so-called "80-20 borrowers" (buyers who simultaneously originate a first and second lien loan while having substantially no equity in the property) have all become materially more prevalent in transactions rated by Moody's.

Issuers are examining whether various degrees of underwriting or broker misrepresentation might be causing increases in early defaults; however, there is currently limited data to confirm this as a widespread phenomenon. To the extent that misrepresentations or even fraud are proven, investors may be protected by a securitization's representations and warranties that typically require originators to repurchase or substitute the noncompliant loans.[2]

Finally, preliminary data suggest that a majority of early defaults have been associated with loans originated for the purchase of a home rather than for refinancing. This may indicate that declines in home price appreciation nationwide also have played a role in these early defaults. The Housing Price Index (HPI)[3] measures the value of single-family homes nationwide. As the growth of this index has slowed, the proportion of early defaults has risen. Although a lack of home price appreciation may decrease a primary residence borrower's financial motivation to make regular and timely payments, it seems to have a greater impact on the motivation of investment related borrowers, who may account for a significant proportion of defaulting purchase loans. Because owner-occupancy data may not be reliable, the prevalence of investor-property loan defaults may be substantially understated. Moody's is also analyzing whether some early defaults may have resulted from obligors who were delinquent as of closing.

## WHAT ADJUSTMENTS HAVE BEEN MADE?

Early default has been a concern weighing on Moody's as well as investors, issuers, and originators alike. In an effort to combat weakening performance and limit exposure to riskier borrowers as well as repurchase obligations, a number of originators have, in recent months, implemented stricter underwriting guidelines. Such changes have included applying more stringent credit standards when dealing with first-time borrowers and when issuing 80-20 piggyback loans, which have accounted for a sizable portion of early defaults. Additionally, some issuers of subprime mortgage securitizations have become more proactive in efforts to identify potential breaches of representations and warranties and put loans back to originators when such a breach may have occurred, often enlisting the services of third parties to aid in the due diligence process. Such breaches may include, but are not limited to, early and first-payment defaults, as well as occupancy or stated-income misrepresentations. Although proactive efforts to identify defaulted loans for potential breaches of representations and warranties may benefit the credit quality of securitizations, such breaches are often difficult for issuers to prove and the proportion of loans actually repurchased by originators typically proves to be uneven across deals. The proportion of repurchases relative to early defaults can be tracked by investors as issuers are now reporting material repurchases in the monthly trustee reports. Moody's notes that such high levels of repurchase have compounded industry weakness by further stressing the liquidity of originators, some of which have recently filed for bankruptcy creating uncertainty regarding recoveries on their loans with early defaults.

For rated transactions with higher-than-anticipated levels of early foreclosure and REO, Moody's is assessing whether those trends may be indicative of continuing weaker-than expected performance. In a best case scenario, the problem may be short-term in nature. For example, a higher proportion of early defaults in a transaction may indicate that a more favorable selection of obligors remain as weaker borrowers have defaulted earlier than anticipated, which may actually benefit deals as they become more seasoned. On the other hand, although it is still too early to definitively determine, it is possible that these early defaults represent an overall weakening in collateral that may lead Moody's to upwardly adjust its overall loss expectations when monitoring the affected vintages. Moreover, the frequency, timing and loss-severity of liquidations stemming from early defaults may adversely impact credit enhancement provided by overcollateralization and excess spread, thus leaving bondholders less protected against subsequent losses. Moody's notes, however, that early losses can have the benefit of being covered by more available excess spread that would otherwise have been released to the residual holders.[4]

2 See: "The Importance of Representations and Warranties in RMBS Transactions," *Moody's Special Report*, January 2005.
3 Figures published by the Office of Federal Housing Enterprise Oversight

To date Moody's has initiated a number of early-default-related rating reviews and is currently conducting further analysis on the impacted transactions. Those transactions are reviewed in light of the potentially insufficient credit protection available to cover potential early losses. When assessing the protection available to the lower rated tranches, Moody's takes into account over-collateralization, subordinate tranches, excess spread, derivative contracts and mortgage insurance. In each reviewed securitization, Moody's seeks to identify the underlying causes of the early defaults and evaluate the credit quality of the contractually current loans relative to the original collateral mix as well as the recently defaulted loans by using our Moody's Mortgage Metrics® risk tool and other proprietary tools. Moody's is also engaging loan servicers in discussions regarding increased roll rates (i.e., the speed at which loans are moved from a delinquency status into foreclosure and REO) as well as updated appraisals and the resulting anticipated decline in recoveries on severely delinquent loans. Moody's is also reviewing the capacity and ability of servicers to manage the recent increases in serious delinquencies and foreclosures. Moody's also notes that unlike recent years, home price appreciation has decelerated and fewer refinancing alternatives may be available to some defaulted borrowers, thus increasing the number of loans that need to be worked out by servicers.

## RELATED RESEARCH:


"Understanding Metrics for Performance Monitoring, Volume 3: Residential Mortgage-Backed Securities," Moody's Structured Finance, October 2005

"Home Equity Securitizations: Increased Potential for Early Losses," Moody's Special Report, May 2006

"Excess Spread Crunch in Certain Residential ABS 2002 to Mid-2005 Originations: A Case Study," Moody's Special Report, October 2006

"Moody's Approach to Surveillance of Residential Mortgage Backed Securities with Reperforming/Nonperforming Collateral," Moody's Special Report, January 2006


4 For more discussion of early losses see "Home Equity Securitizations: Increased Potential for Early Losses," *Moody's Special Report*, May 2006

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