RISKSPAN RE-CAP

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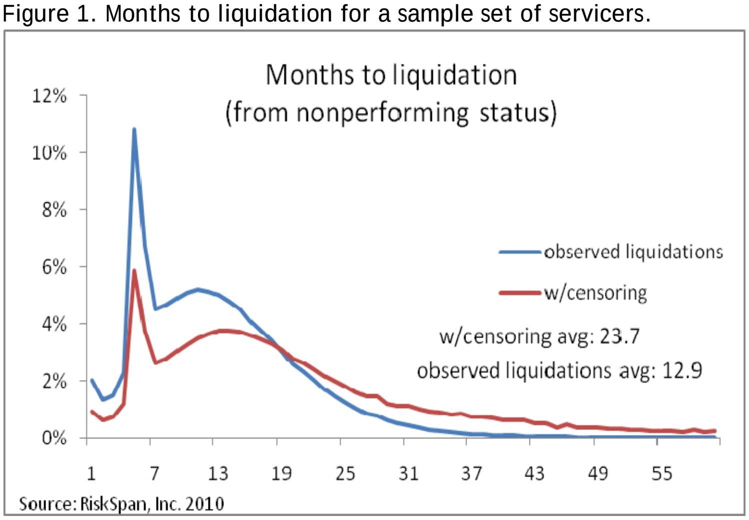
Liquidation Timing

As mortgage servicing portfolios swell with nonperforming loans, analysts have struggled to develop estimates of the average time to liquidation. While development of appropriate liquidation timeline estimates is not necessary for accurate lifetime default estimates, it can be important for estimating severity (especially in a changing HPI environment) and for the timing of cash flows, which can be critical for various tranches of a securitized deal.

Riskspan has performed extensive analysis of trustee data on liquidations to address two factors that present challenges in making average-time-to-liquidation estimates: 1) the pipeline of delinquent loans that have not yet liquidated; and 2) timing that varies by servicer. Key findings from this analysis are incorporated into our credit model.

A traditional approach might look at the average time to liquidation for loans that have already liquidated, but this would exclude loans that are currently nonperforming but have not yet liquidated. An estimate of the average time to liquidation based solely on realized liquidations is likely to understate the true average time to liquidation, because the loans which will spend the longest time in the pipeline are more likely to be excluded from the analysis—or in statistical lingo, "censored". Thus RiskSpan incorporates these censored observations into its estimates of a survival curve that describes the probability that a nonperforming loan will liquidate in any given period. For the typical servicer, including the censored observations doubles our estimate of the average time to liquidation (see Figure 1).

Figure 1. Months to liquidation for a sample set of servicers.



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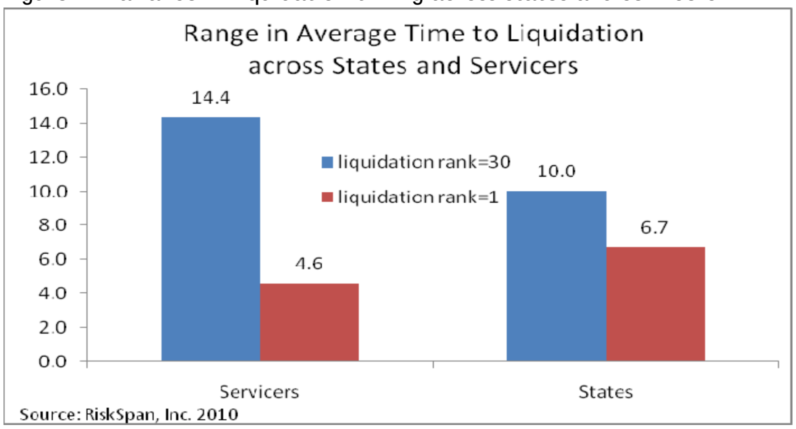
A second common theme in the analysis of liquidation timing is the search for drivers of variance across loans. A typical approach might use state-level foreclosure timelines as a guide to liquidation timing. While we find that these foreclosure timelines do indeed explain a significant portion of the variance in liquidation timing across states, the level of variance across states is lower than that across servicers. If we look at the top 30 servicers and top 30 states by loan volume and compare the slowest and fastest liquidating of each, the difference across servicers is almost 10 months, whereas the difference across states is a little over 3 months (see Figure 2).

Figure 2. Variance in liquidation timing across states and servicers.



So what is the impact of these enhancements on modeled cash flow projections and liquidation timing?
As alluded to before, the lifetime defaults will not be affected by our method for estimating liquidation timing, but the timing will be. In this next section, we look at two side-by-side liquidation timing comparisons using different assumptions to see the impact of different methodologies.

Consider a sample unseasoned portfolio that experiences a net roll rate of 1.4% per month and a CPR (constant prepayment rate) of 10%. After 5 years, the cumulative default rate will be 34%.

In the first comparison, we take a servicer where the average time from nonperforming to liquidation is 17 months. First, we assume the loan liquidates 17 months after the loan becomes nonperforming. And second, we apply the survival distribution curve defined using the historical liquidated events in addition to the loans still in the pipeline. Not surprisingly, the cumulative default curves and the CDRs are smoother when we apply the distribution curve, especially in the early months.

Figure 3a. Cumulative Liquidations-17 month lag between nonperforming and liquidation vs. survival curve

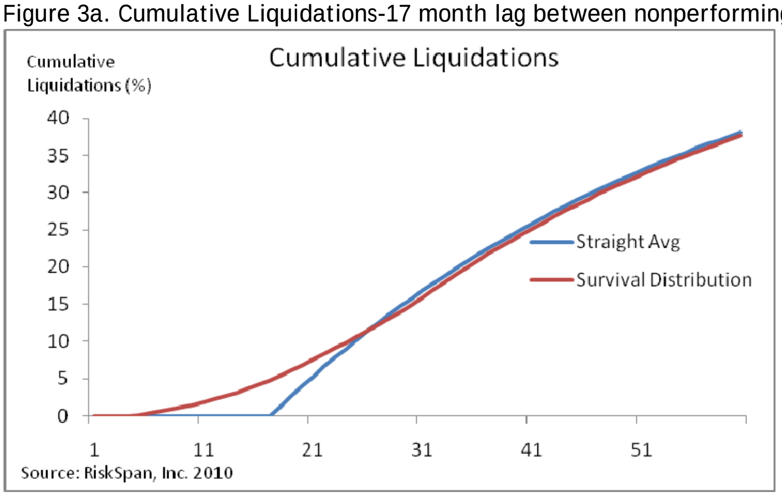


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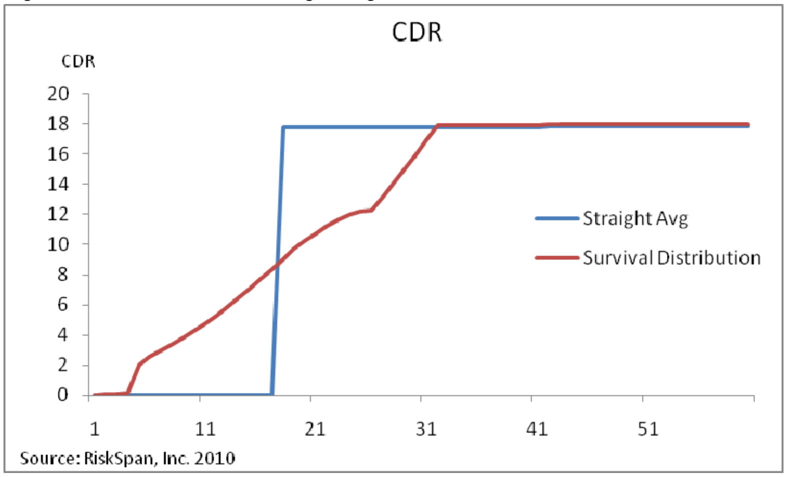
Figure 3b. CDR vectors-straight lag vs. survival distribution function



In the second comparison, we compare two servicers with different average times to liquidation: 20 months vs 15 months. Again, not surprisingly, the servicer with the slower time to liquidation (Servicer 1) sees cumulative liquidations rise more slowly and CDRs start out lower.

Figure 4a. Cumulative Liquidations-20 month avg vs. 15 month avg

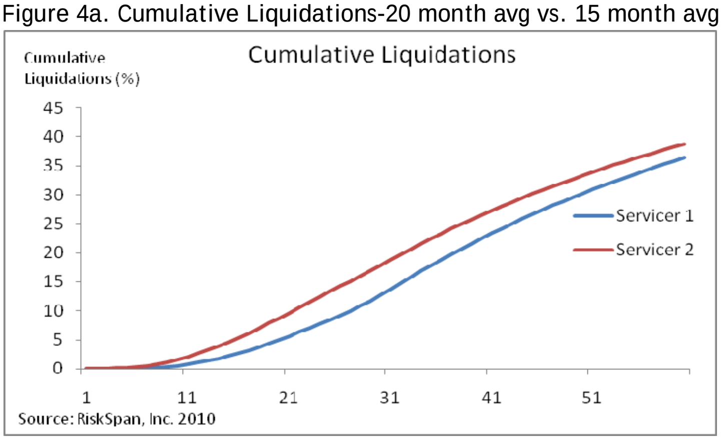
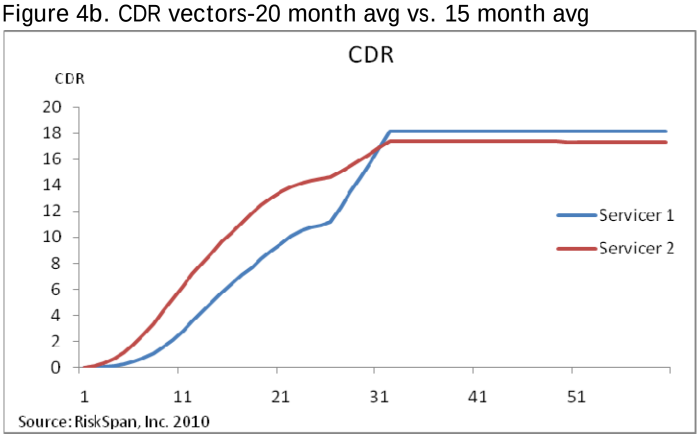


Figure 4b. CDR vectors-20 month avg vs. 15 month avg



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RiskSpan Provides Services for Credit Card Industry

With the passage of new credit card legislation, and the January 1, 2010 adoption date for SFAS No. 166 and 167, RiskSpan is working with Credit Card issuers and investors to analyze and address a variety of important topics. RiskSpan's Subject Matter Experts leverage years of financial services audit and structured finance experience to help credit card issuers with:

1. **Examining and Developing Financing Strategies.** With the new accounting standards SFAS No. 166 and 167, and while the market awaits the final safe harbor rule from the FDIC, securitization and off-balance sheet financing remain difficult for credit card issuers. Even with a final rule, issuers may wish to examine and establish a variety of asset disposition or financing options. These can include sale of receivables, funding with deposits and new securitizations. We assist issuers to understand the economics, potential structuring issues, and capital impact of these options.

2. **Analyze Fair Value and Carrying Value Accounting**. If a bank or financial institution currently uses carrying value or historical cost for financial reporting, RiskSpan can use its methodology to estimate fair value and its impact on the balance sheet and capital to help management quickly understand the implications of moving to fair value. . This analysis can be easily extended to the Income Statement, if needed.

3. **Review Trust, Pooling and Servicing and other agreements**. For investors, it is critical to review security documents in detail to ascertain the future potential for consolidation under 166/167. Investors may believe that they are not the 'primary beneficiary' of a trust because they have no obvious control. However, a deeper review of trust documents, pooling and servicing agreements and prospectus' can identify potential future risk. For example, we have found that certain rights may be assigned to more senior classes in the event of default in subordinate classes. These rights could indicate power and the need to consolidate. Since SFAS No. 167 requires on-going analysis on the part of companies, this review can be an important element of monitoring.

4. **Compliance with the new Federal standards** – The *Credit Card Accountability Responsibility and Disclosure Act of 2009*, requires the development of empirical models for the establishment of fees and the review of APR increases. With our servicing and asset-backed modeling experience, RiskSpan is prepared to help issuers build the models and processes to support this requirement efficiently.

Call or E-mail us

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