

“Shorting” the Sub-Prime Market

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There are so few times when being “short” or “small” is a benefit. As I pen this article, I am sitting on an airplane from Los Angeles to Boston. Being small here is a blessing. There is plenty of leg room and head room, and I don’t have to worry about the person in front of me reclining and crushing my knees. Another blessing of mine is having spent a significant part of my career on “small” loans: Manufactured housing loans, second liens, and small-balance first-lien sub-prime mortgage loans (I call them “Small Loans” here). This article provides answers regarding Small Loans, including:

- Why are default severities so high on certain Small Loans?
- What should Servicers of Small Loans do to reduce default severity rates?
- How can the borrower, residual interest holder and other bond holders of securities backed by Small Loans, all benefit at the same time from the loss mitigation actions of the Servicer?

The sub-prime mortgage market is becoming more challenging every day for Servicers, originators, Wall Street firms and bond investors. Most of the recent focus (and headlines) has been on problem loans originated in 2005 and 2006. There has not been a lot of attention paid to sub-prime loan Servicers.

As the owner and holder of hundreds of millions of dollars (current face value) of sub-prime residual interests and subordinate sub-prime bonds, affiliates of WMD Capital Markets, LLC (“WMD Capital”) are keenly interested in the actions (and inactions) of sub-prime loan Servicers. On the 25th day of every month, we wake up like children on Christmas morning and “open up” the monthly remittance reports related to all of our sub-prime loan securities. Sometimes we get “candy” (low default rates and losses) and at other times, “coal” (high default rates and losses). Still other times, we get something that astonishes us. Sometimes we look at the monthly remittance reports and default losses and ask, “How can you have a 150% loss severity on a single loan? How does that happen?”



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Why are default severities so high on certain Small Loans? If you ask this question to a Servicing Manager (as I have on multiple occasions), the most common response is, “Our hands are pretty much tied by the Pooling and Servicing Agreements and Trust Agreements. We cannot easily accept a short sale or offer a borrower ‘cash for keys’ on securitized transactions.”

This example may help illustrate the issue: Let’s assume a loan was originated in 2001 for \$40,000 based on an original appraisal of \$60,000. The borrower made payments relatively consistently for almost 4 years and then defaulted in 2005. When the loan became 60 days past due, the Servicer ordered and obtained a drive-by appraisal. The drive-by appraisal value was \$30,000. The Servicer started the foreclosure process. All of these actions are standard procedures.

The loan proceeds to foreclosure sale, with little or no contact with the borrower. At the foreclosure sale, the Servicer bids \$30,000 with no competing bids. The property securing the loan needs to have regular maintenance (such as lawn care) as well as security. There also are issues of taxes and insurance for the Servicer to deal with.

While all of this is going on, pursuant to the terms of the Pooling and Servicing Agreement, the Servicer is advancing delinquent principal and interest every month with the understanding that all of the Servicer’s advances for property maintenance, taxes, insurance, principal and interest as well as legal fees and expenses will be paid back prior to any money being paid to the Trust upon liquidation of the property.

Let’s say the property sits on the market, and two (2) years go by before a local investor offers \$5,000 cash for the property. The Servicer, with no other options, sells the property and calculates the loss as follows:

Principal balance of the charged-off loan	\$40,000
Total Advances	25,000
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Sub-Total	65,000
Less, Cash Recovered	5,000
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Net Loss	\$60,000
Net Loss as a Percentage of Principal	150%

What can Servicers do to reduce default severities? The best thing a Servicer can do, provided the borrower wants to stay in the home, is enter into a modification agreement with the borrower.

To gain more insight into modification agreements, I called the person that I consider to be one of the best collectors of Small Loans, Keith Anderson, Chief Operating Officer of GreenTree Servicing. Keith told me, “Cash is king. In these situations the last thing you want is to take back the home and have to sell it. The first question you have to ask the borrower is do you want to stay in your home? If so, the next question is determining whether they can afford the home, considering various potential loss mitigation techniques. If a borrower owes three payments and can only send in one, take the one and work to bring the borrower current using a modification or payment plan. What you do not want to do is return the one payment to the borrower and demand that the borrower make three payments quickly or he/she will lose the home.”

When modification agreements on Small Loans aren't possible, the two (2) techniques that I like best are (i) short sales and (ii) cash for keys. When a property has decreased moderately in value from the time its mortgage loan was originated to the time the borrower defaults, a short sale may be a good way to mitigate a default loss.

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A short sale is an arrangement entered between a borrower and servicer in which a loan is deemed to be completely satisfied by (i) borrower's payment of an amount that is less than the total debt due, or (ii) servicer's acceptance of proceeds of borrower's sale of his/her residence for a price that is less than the total debt owed. In situations where the property value has dropped considerably, the “cash for keys” approach may make sense. I particularly like the cash for keys approach in states that have a long foreclosure period and/or in redemption states. In a cash for keys transaction, the Servicer determines that there is simply no way for the borrower to make future payments on the home. The borrower has decided to move

into an apartment, but lacks the down payment. In this situation, the best thing for the borrower and the Servicer is to agree to a cash for keys transaction in which the Servicer gives the borrower several thousand dollars to move out of the home and into new housing. In doing so, the Servicer can shorten the foreclosure process by months and, sometimes, years. The shortened time frame usually results in a lower default loss.

On Small Loans, how can the borrower, residual interest holder, and other bondholders benefit at the same time?

The Servicer can help all parties by effectively mitigating losses. The Servicer can do so by entering into modification agreements to keep the borrowers in their homes, avoiding default losses entirely (the best result). Alternatively, short sales, cash for keys, and other techniques also may be used to moderate losses. These tools allow the borrower to move on and help residual interest and other bond holders lower their losses. The investment of residual holders is not eroded by default losses, and ultimately they will receive cash flow from the security. By maintaining the residual interest balance (also known as the “over-collateralization”), the more senior bonds will continue to be protected against future losses by the over-collateralization amount. In general, this will help the more senior bonds to maintain or improve in value.

When a default results in a 150% severity, I do not think anyone wins.

If you’re not active in the sub-prime mortgage market, you might say, “Modifications, extensions, short sales and cash for keys all seem to be reasonable approaches. Why don’t Servicers use these techniques all the time?” The truth is, Servicers tend to have one set of rules, and are not willing to adjust those rules because of loan size. But, as this article points out, if Servicers would set up Small Loan departments and establish collection guidelines geared toward keeping its borrowers paying, I believe they could mitigate losses and significantly improve the performance of seasoned, sub-prime securities. Their borrowers would benefit as well.



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