Why would WMD Capital want to buy assets where borrowers have no equity?

By David L. Solomon

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Second liens and sub-prime borrowers were not invented in 2005, even though it may seem that way. For decades, the market has had many different and successful second lien loan programs. Sub-prime borrowers with less than perfect credit could get second lien mortgage loans provided that the combined loan-to-value ratio of the first and second lien was 80% or less. Borrowers with really good credit could borrow up to 100% of a home's value.

When tax laws changed in the 1990's, removing the deductibility of credit card debt, the 125 ltv second lien mortgage loan was developed. On this loan, the lender relied on the "character of the borrower" to make future payments as there was no equity in the home as a source of repayment or recovery.

Today, with housing values continuing to fall, rather than trying to predict where values will bottom, we believe the character of the borrower is a better indicator of investment results. This assessment is the cornerstone of the theory behind why we like second liens — we think they are very cheap on a risk to return basis.

Ease of Evaluation — Fewer Variables

Whether you are valuing residential mortgage securities or whole loans, there are three (3) key variables: Voluntary prepayment rate, default rate and loss severity on defaults. Today's mortgage market is extremely volatile, and there is no floor in sight as to home values. If you are valuing first lien mortgage loan securities, loss severity and defaults are very important to the value of the loans or securities and if you are off by 10%, 20% or 50%, it can make a huge difference. Any firm that purchased California non-performing loans in the 4th quarter of 2007 knows this only too well.

We prefer second liens because we can essentially eliminate 2 of the 3 key evaluation variables, and we can be very conservative on the 3rd variable. Voluntary prepayment speed is nearing zero, so this variable is largely eliminated. Loss severity on defaults is 100% to 105%, depending upon whether the servicer is advancing. Again, change in this variable is eliminated. Only the default rate needs to be projected, and at today's prices, you can assume cumulative future defaults of 90% of more.

Projecting Default Rates

One question I am often asked is, "If the borrower on a second lien has no equity or more likely, negative equity, where is the incentive to pay?" My answer is on sub-prime loans originated 2005 and after, where the borrower did an 80/20 and the "20" was a piggy-back second, the borrower never had even $1 of equity. Even though that was the case, the vast majority of the borrowers that are current today have made every scheduled payment on time. This is what I mean by "borrower character." On WMD's second lien securities portfolio, approximately 75% of the underlying borrowers have never been delinquent.

So, how do we project defaults? We take two approaches. First, we stress test the loans or securities to see how many defaults we can take in the next 12 months and still get our money back plus a modest return. Second, we determine how much cumulative default we can incur over the next 1, 2, 3 years and thereafter. In general, we are using cumulative defaults over the remaining life of the whole loans or securities of at least 90%. This is an important point. We are not saying cumulative

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defaults on a prospective basis will be 20%, 50% or 70%. We cannot accurately predict that. What we are saying is we do not think it will be more than 90%. If it is less, then our return will be even greater.

Whole Loans vs. Securities

In the 4th quarter of 2008, we analyzed a lot of second lien whole loans and securities. In comparing the two asset types we found performing whole loans were priced two times as much as the interpolated value of current loans in an asset backed security. Why was there such a disparity? The main reason was seller motivation. Many securities were held by hedge funds and mutual funds that were forced to sell to meet investor redemption demands.

The holders of the majority of second lien whole loans are banks, and when they received TARP funds, they became disinterested in selling at the discount the market was requiring.

In 2009, we are seeing an increase in the price of securities and a decrease in whole loans, so pricing is coming together as one would expect. That being said, I still think whole loans should trade at a premium to securities to take into account the opportunity for an investor to micro-manage whole loans. Whether to accept a short pay or to enter into a subordination agreement to allow the modification or short payoff of a first lien are just two of many techniques that can be used more easily in servicing whole loans than securities.

Last Word — Government Actions

The proposed "cram down" legislation where borrowers can go into bankruptcy court and seek a reduction in the balances of their first and second mortgage notes is a topic being discussed by investors in second lien whole loans and securities. If a borrower has no equity or even 130% loan to value, why not go bankrupt?

For borrowers that are already delinquent and therefore have poor credit, this relief may make sense. However, borrowers who are employed, are making payments on time, and have good credit, will be unlikely to elect bankruptcy. Getting access to credit for homes, credit cards and other financing is very difficult today. The fact that a borrower has good credit, thus, would indicate that he probably is not insolvent, rendering him ineligible for bankruptcy relief. From our standpoint, we anticipate that a borrower's "threat" of bankruptcy will be cause for servicers to offer more meaningful modifications of first lien loans when the borrower's credit history reveals that it is a serious threat. When this happens, the borrower's second lien will still be in full force and effect, which is infinitely better for us as a second lien investor than either bankruptcy cram-down or foreclosure.

A question I would like investors/servicers of second liens to think about – given that a second lien has no equity: "Why should a servicer make any collection calls to borrowers? Would they not be better served spending their resources contacting the first lienholder to make sure they are being as pro-active and cooperative as possible?"

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