

DWIGHT ASSET MANAGEMENT COMPANY LLC

# Mortgage Market Update

MARCH 2009

## IMPACT OF RATING AGENCY ACTIONS AND MORTGAGE “CRAM-DOWNS”

Continuous changes to ratings methodology have plagued residential mortgage-backed securities (RMBS) investors throughout the financial crisis. Combine this with the growing potential for government legislation, and uncertainty surrounding the RMBS market is high. We would like to take this opportunity to provide you with an update on recent rating agency actions, as well as to address the impact of potential government legislation on the RMBS market.

### MASS DOWNGRADES

The rating agencies have continued to revise their models throughout the financial crisis, leading to significant, large-scale moves in ratings. Recently, over the course of just one week, there were over 8,000 security-level downgrades (per Bloomberg). It does not appear that the rating agencies are giving sufficient consideration to deal-level performance. Rather, they are applying blanket assumptions based on the year of issuance (or vintage) to all bonds in a given category.

Some of these securities have been downgraded from AAA to below investment grade in one move, though the analysis of collateral performance and existing credit enhancements may not warrant this level of concern. Both S&P and Fitch have taken these actions based on a probability of default model that treats a 100-dollar principal loss in the same manner as a 100-percent loss of principal. Therefore, a bond that may lose \$100 in principal in 30 years will have the same rating as a bond that may lose 100% of principal in just one year. While market pricing does not necessarily reflect rating agency valuations, these rating changes have weighed heavily on market sentiment, driving already-depressed prices even lower.

### MORTGAGE CRAM-DOWNS

Over the past year, the mortgage industry has increased loan modifications in an attempt to reduce loan defaults and resulting foreclosures. Unfortunately, the resulting rate of loan modifications has been too low from a public policy perspective. However, as has been widely reported in the press, the potential for widespread mortgage loan modifications is growing. In an effort to curtail foreclosures, legislation has been proposed to allow bankruptcy judges to modify mortgage loans by reducing the interest rate, mortgage term, or principal (a process known as cram-down) to create an affordable loan for the borrower. During a cram-down, the bankruptcy judge lowers the loan amount to the approximate market value of the home. Under these circumstances, the loss on the principal reduction would be incurred by the lender and bond holders. Furthermore, the typical allocation of losses for some deals would change in the event of a bankruptcy cram-down. Instead of first allocating losses to the subordinated bond holders until all losses have been completely written down (a structure often referred to as a waterfall), losses would be allocated pro-rata between senior and subordinated bonds.

*Continued on the following page*

## MORTGAGE CRAM-DOWNS, CONT'D

The potential for Congress to pass mortgage cram-down legislation alone could prove to be problematic for many bond holders. If loan servicers believe that cram-downs are likely, they may begin to employ mass principal forgiveness. While this could make sense for borrowers that are likely to default, it is possible that servicers could become overzealous and drastically cut principal for all borrowers that have loan-to-value ratios greater than 100%. Moreover, as borrowers become aware of this, they may threaten bankruptcy in an attempt to strong-arm loan servicers into writing down principal. For the servicers, the bottom line is that knowing and controlling the outcome is preferable to an unknown outcome that is determined by a bankruptcy judge. Therefore, if loan servicers become confident that cram-down legislation will pass, we may see a large spike in loan modifications and corresponding rating downgrades.

Congress is addressing this issue with additional legislation that attempts to eliminate, via contractual override, the allocation of losses on a pro-rata basis that would flow through to AAA investors in the event of significant bankruptcy cram-downs. This legislation has already been passed by the House; if passed in the Senate, it will restore the normal waterfall structure of RMBS, with the subordinated bonds suffering the first losses. However, the legality of the contractual override by Congress has come under question and thus has the potential to be challenged in the future.

## LOOKING AHEAD

The conclusions we have drawn from this are twofold. First, we do not expect any slowdown in rating agency activity in the near term. Furthermore, it is reasonable to believe that by the time the rating agencies are finished, virtually every non-agency RMBS bond from the 2006 and 2007 vintages (and several from 2005) will have been downgraded.

Second, the market continues to be buffeted by a number of factors that are completely outside of investors' control. In addition to the rating agencies, Congress, the Treasury, bankruptcy judges, and others continue to be major factors driving financial outcomes of existing debt, creating a significant level of uncertainty.

We continue to seek opportunities to reduce our exposure to non-agency RMBS bonds that we believe are at risk for significant downgrades. Amid the current uncertainty within the RMBS market, we favor seasoned, high-quality securities that provide significant protection against principal loss. We will continue to monitor this situation closely and keep you informed of any new developments.

This article was prepared for general informational purposes only, without respect to the investment objectives, financial profile, or risk tolerance of any specific person or entity who may receive it. This information reflects the viewpoint of Dwight Asset Management Company LLC as of March 2009 and is subject to change. This information should not be considered a recommendation to make any particular investment.