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The US Sub Prime RMBS Market

A Week in Review: 01 – 06 November 2007

The meltdown of the sub-prime mortgage market has been at the center of attention this year.

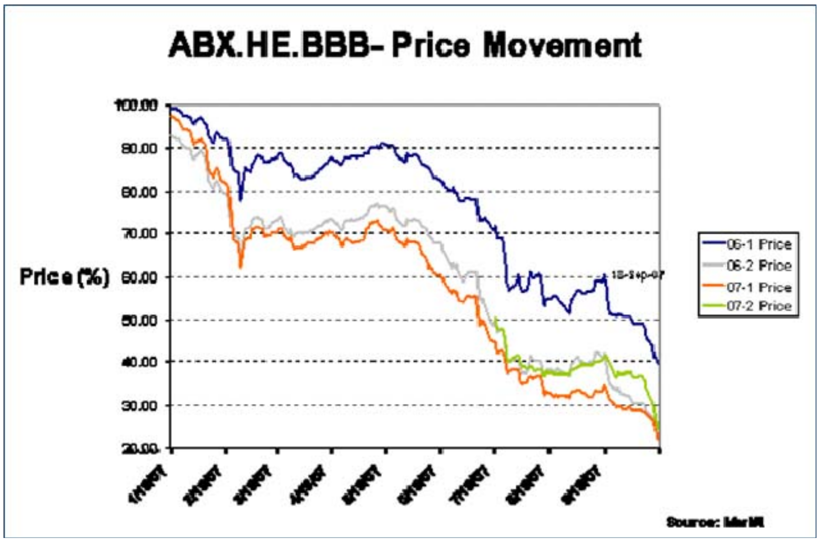
This crisis was anticipated by numerous institutions given the deterioration in mortgage loan underwriting practices, notably those mortgages originated in late 2005 and in 2006. Many now believe that sub-prime asset-backed securities (ABS) are primed to experience significant writedowns in the future given increasing delinquencies and foreclosures among the underlying mortgage loans. Though the anticipated writedowns remain be seen, the ABX index, created by CDS IndexCo, a consortium of major ABS market makers, in conjunction with Markit, has been invaluable in providing market participants with a vehicle to express their views.

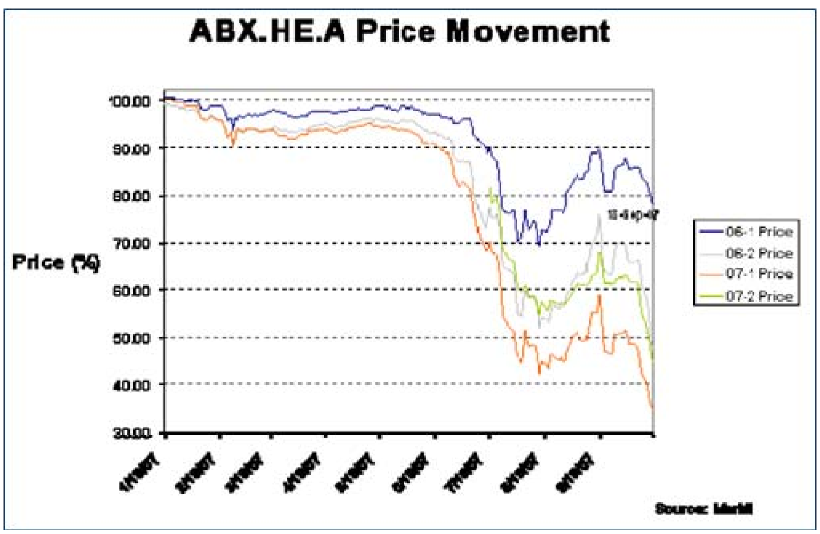
ABX was designed to be a tradable synthetic instrument and has grown to be regarded by the broad marketplace as a key barometer of the health of the sub-prime market. The first set of tradable ABX indices was launched in January 2006 and the index family has been widely traded and referenced since. The ABX, which rolls every six months, is composed of a static basket of 20 home equity reference entities selected from the sub-prime ABS universe. Five sub indices are created from the selected 20 reference entities, which are determined by rating, namely AAA, AA, A, BBB, BBB-. Each index series contains the same 20 constituent reference entities with each reference obligation corresponding to the appropriate sub-index rating.

The ABX indices provide transparency and liquidity to the synthetic sub-prime mortgage market by allowing market participants to take positions on a basket referencing sub-prime ABS. Investors can take a long or short view on the ABX by buying or selling protection. Shorting ABX is equivalent to buying insurance on the basket of bonds referenced in the index to protect against realized losses due to interest shortfalls and principal writedowns.

Each ABX sub-index trades with a reference coupon, which the protection buyer pays to the protection seller. In any case, where the current cost of protection is not equal to the coupon of the index, an upfront cash payment will be exchanged between protection buyer and seller to resolve any intrinsic discount or premium on the trade. In cases where protection premiums are above the coupon, the protection buyer will pay the protection seller cash upfront. The difference between par value and the amount paid upfront determines the prices of these indices. The protection buyer is essentially shorting the index while the protection seller is taking a long view.

Since the beginning of 2007, there has been dramatic deterioration in the prices of the ABX indices, due to a significant increase in the premium payable for protecting these baskets of bonds. The ABX.HE.BBB- indices have seen a fairly consistent price decrease this year, and a sharper decrease since the Fed rate cut on 18 September, breaking new lows day after day.





These price movements are consistent with the performance of ABX.HE.BBB. Those ABX subindices with more subordinate ratings have had a much more consistent downward trend relative to sub-indices that represent bonds higher up in the capital structure. This is evident in the recent price movements of the ABX.HE.A indices.

During August 2007, the ABX.HE.A indices recovered 28.4% before the Fed rate cut which saw them resume their downward trend. Even so, the recovery of the "A" class relative to the "BBB" & "BBB-" classes demonstrates the market's changing perception of the value of different bonds in the capital structure. The ABX.HE.BBB- indices recovered on average 6.64% during the same period, and fell more dramatically after the Fed rate cut. These movements provide valuable insight into the future values of mortgages underlying the reference obligations of the

ABX.HE indices. The recent ABX.HE.BBB- prices seem to indicate deteriorating confidence in the value of the more subordinate bonds in the ABX.HE index and there is increased trading at the A level.

In the collateral pools backing the deals in the ABX.HE indices, and in the sub-prime mortgage market in general, there is a good deal of concern due to the reversal of the trends of the first half of the decade. Rising home values had provided more leeway for many individuals, resulting in increased lending to sub-prime borrowers (borrowers with FICO of 660 and below), often with lax underwriting practices.

The biggest concern among ABS investors centers on adjustable rate mortgages, especially for borrowers facing their first resets in the coming quarters at a time of more stringent lending practices coupled with a soft housing market. Some research reports have estimated that over $400 billion of sub-prime adjustable rate mortgages will reset between the end of 2007 and 2008. Over the past months, increases in foreclosures and delinquencies as well as declines in the prices of the ABX.HE indices have meant a less than rosy outlook for the sub-prime mortgage market.

It must be noted, however, that there has not been a single writedown on any of the ABX subindices thus far. Of the 1,088 sub-prime deals issued since the initial launch of the ABX.HE index that are tracked by Markit RCD, only 3 bps of the total notional have been written down. However, even though there have not been realized losses in any of ABX.HE reference obligations, market participants are still able to take positions based on projections of what is to come. The fate of the higher tranches of the ABX.HE indices remains unclear from their recent increase in volatility, notably at the single A level. However, the indices continue to provide market participants with an increased ability to gauge values of sub-prime mortgages and mortgage-backed securities.

The sub-prime debacle in the U.S. brought about a global credit crunch this summer with the ABX leading the charge. Subordinate tranches of the 06-2 and 07-1 series have lost over 75% of their value since the end of May. Even with the Fed rate cuts, the ABX free fall continues, particularly for the lower rated tranches. Early signals were seen in February 2007, a month where prices of the ABX BBB- tranches plunged more than 20%. Shareholder values of sub prime mortgage lenders deteriorated in the following weeks, with the stock price of Accredited Home Lenders Holding Corporation dropping just over 80% between February month-end and the mid-March low.

ABX.HE acts as a vehicle for investors to hedge their sub-prime exposure and to express their views on the sub-prime market using a liquid and transparent instrument. The recent performance of the ABX does not bode well for the outlook for the sub-prime mortgage market but time will tell how far losses will extend. For the time being, the ABX.HE index is the acting weatherman of the sub-prime mortgage market, predicting a rough storm ahead.

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