

FitchRatings

Press Release

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Fitch: Underwriting & Fraud Significant Drivers of Subprime Defaults; New Originator Reviews

Fitch Ratings-New York-28 November 2007: Recent vintage residential mortgage-backed securities (RMBS), backed by pools of subprime mortgages continue to substantially under-perform initial expectations, which has resulted in significant ratings downgrades and heightened risk of losses to principal. Fitch's analysis of subprime defaults suggests that lax underwriting and fraud may account for as much as one-quarter of the underperformance of the 2006 vintage of Subprime RMBS transactions. Fitch will be utilizing the insights from its research to improve its RMBS rating process.

The very high delinquency and default performance of recent vintage subprime RMBS has a variety of causes, including declining home prices and the prevalence of high-risk mortgage products such as stated-income loans and 100% combined-loan-to-value loans. Fitch has commented extensively on these drivers of mortgage default, most recently in the special report 'Drivers of 2006 Subprime Vintage Performance', dated Nov. 13, 2007. However as noted in the report, these factors do not fully account for the large number of early defaults that are occurring. Many industry observers have noted that poor underwriting, together with borrower/broker fraud, also appear to be playing a role in high defaults.

While some degree of early defaults are to be expected in subprime mortgage pools, the extraordinarily high level of defaults encountered by the 2006 vintage cannot be explained by home price declines alone. It has become increasingly evident that loans originated with lax underwriting and higher instances of fraud can have a material impact on a securitization. In order to better understand the unexpected high level of early defaults in subprime RMBS, Fitch analyzed a small sample of early defaults from 2006 Fitch-rated subprime RMBS.

Fitch's findings from this review include:

- Apparent fraud in the form of occupancy misrepresentation;
- Poor or lack of underwriting relating to suspicious items on credit reports;
- Incorrect calculation of debt-to-income ratios;
- Poor underwriting of 'stated' income loans for reasonability;
- Substantial numbers of first-time homebuyers with questionable credit/income.

'In the absence of effective underwriting, products such as 'no money down' and 'stated income' mortgages appear to have become vehicles for misrepresentation or fraud by participants throughout the origination process,' said Fitch Managing Director Diane Pendley. 'During the rapidly rising home price environment of the past few years, the ability of the borrower to refinance or quickly re-sell the property prior to the loan defaulting masked the true risk of these products and the presence of misrepresentation and fraud. With home prices now falling in many regions of the country, many loans that would have paid off in prior years remain in the pool and are more likely to default.'

Fitch believes that high risk products and poor underwriting combined have had a substantial impact on defaults. For example, for an origination program that relies on owner occupancy to offset other risk factors, a borrower fraudulently stating intent to occupy will dramatically alter the probability of the loan defaulting. When this scenario happens with a borrower who purchased the property as a short-term investment, based on the anticipation that the value would increase, the layering of risk is greatly multiplied. If the same borrower also misrepresented his income, and cannot afford to make the payments, the loan will almost certainly default and result in a loss, as there is no type of loss mitigation, including modification, which can rectify these issues.

Fitch's research notes that in order to detect and prevent poor underwriting and fraud, a combination of technology and basic risk management is needed not only before, but also during and after the origination of a loan. 'There are several effective fraud indication tools available to originator/issuers; however, no process or tool can identify all instances of misrepresentations of fraud,' said Fitch Ratings Managing Director Glenn Costello. 'Through our enhanced originator review program it is our objective to help mitigate exposure to these kinds of risks in rated RMBS.'

Enhanced Originator/Issuer Reviews for U.S. RMBS:

In light of its research, Fitch believes that it is important to reassess the risk management processes of originators, conduits and/or issuers for product being

securitized going forward. Beginning in January 2008, Fitch U.S. RMBS rating process will incorporate a more extensive review of mortgage origination/acquisition practices, including a review of originator/conduit/issuer due diligence reports, and a sample of mortgage origination files. Additionally, Fitch is studying how a more robust system of representation and warranty repurchases could help to provide more stable RMBS performance..

Fitch will conduct enhanced originator/issuer reviews for all subprime transactions. Fitch will not rate subprime RMBS without completion of the review process. Fitch also intends to conduct enhanced reviews for Alt-A RMBS; however, these will be phased-in based on Fitch's view of the risk of particular Alt-A programs. High-risk programs include Pay-Option Arms and programs exhibiting substantial risk-layering. Such programs will be high priority for review.

Fitch's originator/conduit/issuer review process will feature the following elements:

1. Receipt of information package from originator/issuer containing:

- Operational Questionnaire
- Portfolio Statistics
- Due Diligence Reports
- Other Supporting Documentation, as Required

2. On-site Discussion with originator/issuer's senior management and risk management based on Fitch topics list including:

- Sourcing - control processes, level of due diligence, if not directly originating
- Underwriting - guidelines, exceptions, and controls over underwriting decision process
- Property Valuations - guidelines, exceptions, and controls over determination of value process
- Risk Management - audits and compliance to policies and procedures

3. On-site file reviews:

- Targeted sample of mortgage origination loan files
- Review conducted to confirm Fitch's understanding of originator/issuer's control environment

Fitch will provide a more detailed discussion of the originator/issuer review process in the form of a criteria report. Fitch will be communicating directly with originators, conduits, and issuers regarding reviews to be conducted in the interim.

Fitch's new report, 'The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance', is available on the Fitch Ratings Subprime market page at 'www.fitchratings.com/subprime'.

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