

U.S. Structured Finance Newsletter

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ORIGINATION TRENDS IN SUBPRIME LENDING

In order to address the underwriting problems that have plagued the 2006 subprime vintage, lenders are tightening their underwriting guidelines. This tightening process includes a more thorough verification of borrower-supplied information, the increased use of fraud prevention techniques, increases in minimum FICO scores on stated wage earners and piggyback borrowers, and a reduction in the percentage of first-time home buyers. The practice of underwriting purchase loans to a 100% loan-to-value (LTV) ratio utilizing limited documentation has been reduced significantly as more firms have now capped the LTV for these programs at 90% or below. Also, certain lenders have started verifying assets, ensuring that borrowers have sufficient reserves to cover closing costs as well as two to six months of mortgage payments. Furthermore, some lenders are implementing a more rigorous appraisal process including requiring full appraisals for certain loan programs where drive-by appraisals were previously acceptable. At a minimum, most firms are conducting a more detailed in-house desk top review of appraisals prior to approving the loans.

While the full implementation of these underwriting adjustments remains to be seen, DBRS has witnessed incremental collateral improvements in recent pools that accompany RMBS transactions. Most noticeable is the reduction of piggyback mortgages as well as the increase in FICO scores for these borrowers. However, it will take some time for these changes to be reflected in pool performance as issuers continue to securitize the remainder of the 2006 pipeline.

As expected, the tightening of underwriting guidelines along with the poor performance of the 2006 vintage has resulted in subprime securitization volumes declining approximately 20% in the first quarter of 2007. DBRS believes that the market will see further declines in securitization volumes during the second and third quarter as the debate for national and or state-legislated underwriting standards unfolds. Although DBRS acknowledges that prudent underwriting practices are essential in order for the secondary market to continue to function properly, state-mandated or overly rigid underwriting criteria could result in the restriction of mortgage credit to borrowers who can afford to purchase homes.

As the industry awaits the outcome of the proposed guidance for subprime lending, some investors are gaining comfort by increasing their up-front due diligence percentages prior to purchasing securities. However even with the increased due diligence, some dealers are finding it necessary to extend the length of time that the representations and warrants are in effect in order to entice investors to buy subprime securities. DBRS believes further changes in underwriting standards will continue to evolve as the industry and the regulators work together to find a solution to the subprime lending problems. In the interim, investors in this product will continue to exercise caution until all the current issues have been adequately resolved.

For further details on servicing and origination trends, please see the DBRS report entitled [*Ongoing Challenges in the U.S. Subprime Mortgage Industry*](#), published May 2007.

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