

Methodology

*U.S. RMBS Rating Methodology Update*

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*Insight beyond the rating.*

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# U.S. RMBS Rating Methodology Update

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## Summary

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The DBRS methodology for rating securitizations backed by U.S. residential mortgages includes a loan level analysis of default frequency and loss severity. On January 28, 2008, DBRS revises its residential mortgage-backed securities (RMBS) model default frequency methodology for loans with low (reduced or no) documentation and additional risk-layering. This revision is driven, in part, by the recent decline in performance of loans with these attributes. The updated methodology revises:

- The default frequency factor for loans with low documentation
- The default frequency factor for loans (a) with low documentation (b) that carry a simultaneous second lien (piggyback)
- The default frequency factor for loans (a) with low documentation (b) that carry a piggyback and (c) that are collateralized by an investor-owned property
- The default frequency factor for loans (without piggybacks) (a) with low documentation, (b) whose loan-to-value ratio is greater than or equal to 80% and (c) that are collateralized by an investor-owned property

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## Documentation Program Overview

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The DBRS criterion for a full documentation loan expects lenders to verify four types of borrower documentation. These four verifications, which are also defined as the GSE standard<sup>1</sup> for a manually underwritten loan, are met when a lender confirms the employment, income, mortgage history and assets of a borrower. The full documentation standard represents DBRS's baseline default risk tier because it provides the most complete picture of a borrower's financial stability.

For loans with fewer than four verifications, DBRS assigns a default frequency factor to reflect the greater uncertainty about a borrower's financial stability and the propensity to pay. The frequency factor is continuous based on a borrower's credit score.

DBRS performs a separate analysis of a lender's documentation program in order to reference the number of borrower verifications to a documentation level. DBRS uses informed judgment to analyze lenders' underwriting guidelines and map their documentation codes into a standardized form of the four verifications mentioned above.

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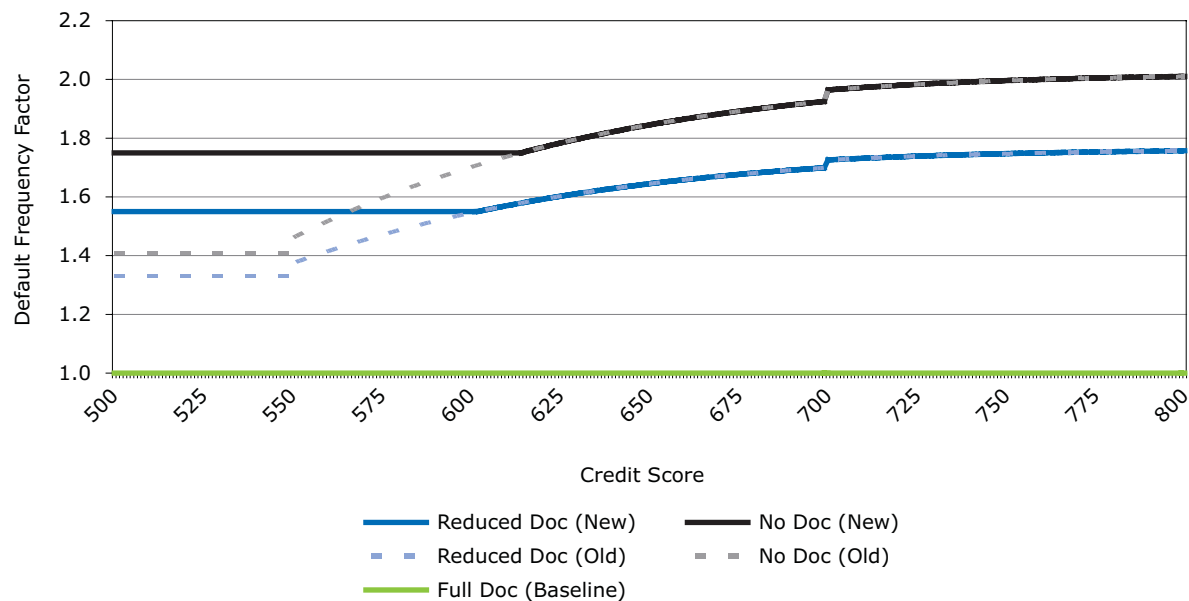
1. Fannie Mae 2006 Seller Guide, Part X.



## Methodology Update for Low Documentation Loans

DBRS has analyzed the poor performance of recent RMBS vintages (2005 and 2006). Much of the performance deterioration is attributable to low documentation loans made to poor FICO borrowers. DBRS believes that a more conservative approach is appropriate for analyzing the creditworthiness of these mortgages. As a result, DBRS will increase the “floor” or the minimum default frequency factors for poor FICO loans with low documentation. As illustrated in Chart 1, the new frequency factor floors for “reduced doc” and “no doc” loans have been increased to 1.55 and 1.75, respectively.

**Chart 1 - Default Frequency Factor for Low Documentation Loans (Old Vs. New)**



## Risk Layer Overview

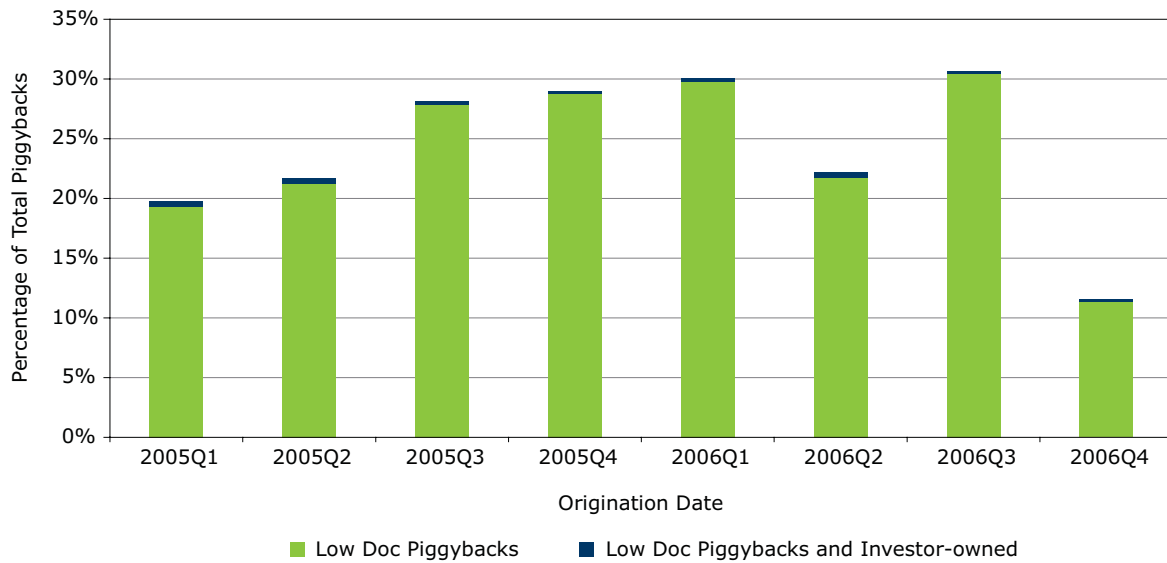
In recent years, loans underwritten to low documentation standards were not sufficiently priced based on their risk. The market environment encouraged borrowers to seek maximum leverage. Consequently, many borrowers financed most or all of the value of their properties in addition to stating their income or assets. Moreover, a portion of these risk-layered loans were also made for investment properties. The performance of recent vintages provides evidence of increased risk for such risk-layered loans, particularly in a weak housing market. Given the tightening of underwriting guidelines and re-pricing of risk since the second half of 2007, DBRS expects the future origination of risk-layered loans to decrease as lenders continue to tighten their underwriting standards.



## Loan Performance for Risk-Layered Loans

A December 2007 analysis of mortgage loans from DBRS-rated subprime transactions shows that approximately 20% to 30% of the total piggyback loans in the 2005 and 2006 vintages were extended to low documentation borrowers (Chart 2). It is of note that loans for investor-owned properties, together with low documentation and piggybacks, represent less than 1% of the total piggybacks analyzed by DBRS.

**Chart 2 - "Risk-Layered" Piggybacks as a % of Total Piggybacks**

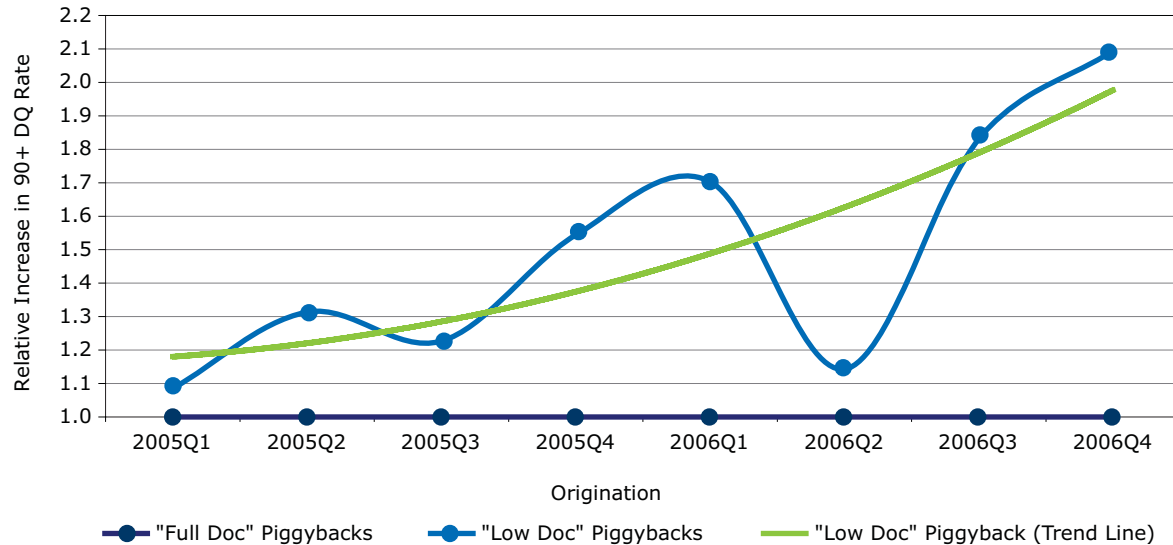


Source: DBRS, Intex.



DBRS compared the relative performance of “full doc” piggybacks and “low doc” piggybacks originated across the 2005 and 2006 vintages.<sup>2</sup> As illustrated in Chart 3, it is clear that recent piggyback mortgages with low documentation exhibited alarming increases in serious delinquency rates relative to their full doc counterparts. Beginning in the first quarter of 2005, the 90+ day delinquency rate of low doc piggybacks was only 10% worse than that of full doc piggybacks. Over seven quarters, low doc piggybacks defaulted at a rate of two times greater than that of the full doc piggybacks by the end of 2006.

**Chart 3 - Relative Performance of "Full Doc" Piggybacks vs. "Low Doc" Piggybacks**



Source: DBRS, Intex.

The sample size for piggyback mortgages with low documentation and collateralized by investor-owned properties was very small. However, DBRS believes that this additional characteristic (investor-owned), when combined with the two aforementioned risk layers, significantly increases the likelihood of borrower abandonment of the mortgaged property, especially in a weakening home market. Therefore, DBRS believes such risk layer warrants a much higher default frequency factor.

In addition, non-piggyback mortgages with loan-to-value (LTV) ratios greater than or equal to 80% have similar increased risk as piggybacks when combined with low documentation and investor-owned characteristics. DBRS adjusts the default frequency factors for these loans as well.

2. DBRS chose loans in the 2005 and 2006 vintages to ensure that the loans have sufficient seasoning and performance history.



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## Methodology Update for Risk-Layered Loans

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DBRS has increased the default frequency factors for various combinations of layered risk as indicated below.

For piggyback mortgages:

- The default frequency factor *doubles* for loans (a) with low documentation (b) that carry a simultaneous second lien (piggyback)
- The default frequency factor *triples* for loans (a) with low documentation (b) that carry a piggyback and (c) that are collateralized by an investor-owned property

For non-piggyback mortgages with  $80\% \leq \text{LTV} \leq 100\%$ :

- The default frequency factor *increases in a linear fashion between 2.0 times and 3.0 times* for loans (a) with low documentation, (b) with  $80\% \leq \text{loan-to-value (LTV) ratio} \leq 100\%$  and (c) that are collateralized by an investor-owned property

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## Conclusion

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As a result of our performance analysis of the 2005 and 2006 vintages, DBRS has identified increased risk in loans with low documentation, piggyback and investor-owned properties. These characteristics, when layered together in a single loan, represent amplified credit risks and are key drivers of defaults in these vintages.

DBRS herein revises its rating methodology by assigning higher default frequency factors to loans with the aforementioned characteristics. The revision affects modeled default frequency for such loans and will result in higher credit enhancement levels.

DBRS relies upon accurate representation of loan data from issuers and underwriters when providing credit opinions on mortgage pools. DBRS has made and will continue to make conservative credit assumptions to the extent a lender's documentation program cannot be fully clarified.

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