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Michael Nelson
Managing Director
(212) 806-3251
mnelson@dbrs.com

Andrew Jones
Managing Director
(212) 806-3250
ajones@dbrs.com

Jack Toliver
Managing Director
(312) 332-0889
jtoliver@dbrs.com

Mark Adams
Managing Director
(416) 593-5577
madams@dbrs.com

Toronto Office
200 King Street West,
Suite 1304
Toronto, ON M5H 3T4
Canada
(416) 593-5577

New York Office
One Exchange Plaza
55 Broadway Suite 1502
New York, NY 10006
U.S.A.
(212) 806-3277

Chicago Office
101 North Wacker Drive
Suite 100
Chicago, IL 60602
U.S.A.
(312) 332-0889

Sharon McGarvey
Publisher
(212) 806-3261
smcgarvey@dbrs.com

RMBS Pools Contain Few Mortgages from Katrina-Stricken Gulf Coast

Preliminary estimates predict that damages caused by Hurricane Katrina will exceed \$100 billion, or approximately 1% of 2004's GDP. At the macroeconomic level, the GDP growth rate is expected to decline from a 4.1% annualized rate pre-hurricane to approximately 3.5%. Within the RMBS sector, Katrina's impact will depend largely on responses from insurance companies as well as government support to affected individuals.

DBRS expects Katrina to minimally impact DBRS-rated transactions, perhaps affecting only more subordinated securities, such as NR, B pieces or NIMs. First, Louisiana, Mississippi, and Alabama average less than 1% of mortgage pools included in DBRS-rated transactions. Second, the loan balances on properties in these areas are comparatively smaller than the average loan size in RMBS transactions. Third, many of destroyed properties are likely covered by flood insurance because mortgage originators require borrowers who live in designated flood zones to carry federally sponsored flood insurance. Although insurance may not cover a property's full loss, mortgage lenders generally require that minimum coverage equal the mortgage balance or the federally established maximum coverage of \$250,000.

While overall losses to RMBS portfolios should be small, specific transactions and securities may be at risk. Transactions with greater concentrations of properties from the affected areas may see cash flows to subordinated bonds interrupted if they are already close to their triggers. At the margin, losses from Katrina could cause these transactions to breach triggers and re-direct cashflows to senior noteholders. Delinquency rates on properties in the area should spike and remain high over the near term; mortgagors will need time to assess the damage to their homes and decide whether to repair, rebuild, or walk away. On an interim basis, though, RMBS servicers will be obligated to advance interest and principal payments on affected properties until they deem the advances unrecoverable.

The auto ABS sector is more vulnerable to Katrina's repercussions. Again, DBRS expects a spike in delinquencies, default frequency, and loss severities in transactions with greater loan concentrations in the affected areas (maximum concentration in DBRS-rated transactions has been 5%). However, unlike RMBS transactions, insurance proceeds received for damaged cars will on average be insufficient to cover loan balances, thereby increasing loss severities.

Actual transaction defaults and delinquencies attributed to Katrina will likely be masked by recent policies implemented by U.S. captive finance companies. The Big 3 U.S. automakers have announced that borrowers in the affected regions can defer their auto-loan payments; for example, DaimlerChrysler and Ford are deferring payments for up to 90 days, while GM is assessing borrower relief on a case-by-case basis.

Longer term, a significant, sustained increase in the cost of oil will both reduce consumers' disposable income through higher gas prices and increase the cost of many raw materials (e.g., components of plastic goods). Gasoline prices immediately soared in response to Katrina's significant disruption of U.S. oil refining capacity. Sustained higher gas prices could decrease demand for new vehicles as consumers potentially shift away from large, fuel-inefficient SUVs and light trucks. Used vehicle values would also decline.

For questions or comments, please contact Marc Daly at mdaly@dbrs.com or Quincy Tang at qtang@dbrs.com.