

Dominion Bond Rating Service

U.S. Financial Institutions Group Residential Mortgage Institutions Rating Methodology

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Dominion Bond Rating Service (DBRS) is a full-service credit rating agency established in 1976. Privately owned and operated without affiliation to any financial institution, DBRS is respected for its independent, third-party evaluations of corporate and government issues, spanning North America, Europe and Asia. DBRS's extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.

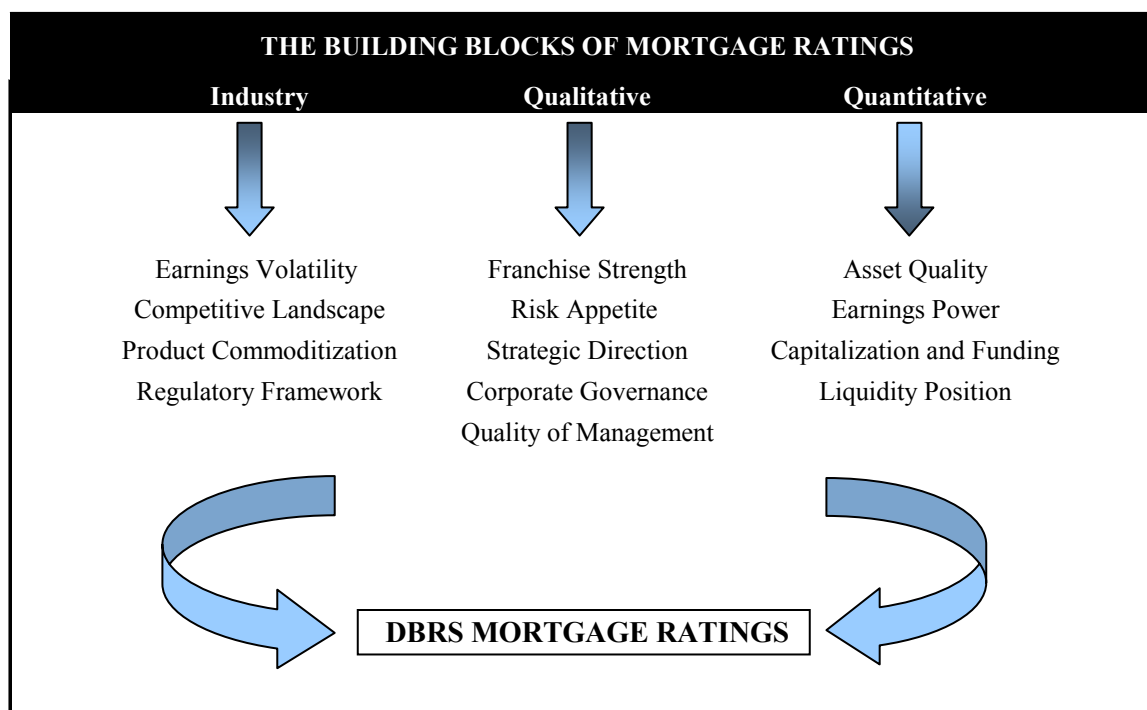
DBRS Mortgage Company Rating Methodology

EXECUTIVE SUMMARY

Dominion Bond Rating Service (“DBRS”) provides ratings as a forward looking measure of a mortgage company’s ability to meet its financial obligations. As with all ratings, the national and regional economic environment is the first consideration when assigning ratings to a company. In addition, DBRS takes into account a number of industry, qualitative, and quantitative factors. DBRS applies a ground-up approach, starting with the characteristics of the industry, such as earnings volatility, abundant competition, and a commoditized product have major weight on the ratings. Qualitative factors, such as the firm’s franchise strength, risk profile, strategic direction, corporate governance, and quality of management are key considerations. Additionally, the quantitative analysis of the company’s asset quality, earnings power, balance sheet management, capitalization and funding, and liquidity position are noteworthy factors in assigning a rating. DBRS employs a complex blend of quantitative and qualitative factors, and not a matrix approach, where key ratios and factors are entered and a rating is determined. Qualitative analysis uses a certain level of judgement based on industry analysis, historic factors, current and anticipated future trends, and general economic factors.

This rating methodology summarizes the factors that DBRS considers in its evaluation of the creditworthiness of mortgage companies. Taken together, these factors, while not intended to be all-encompassing, provide a relatively complete range of rating considerations for companies that operate within the mortgage sector. The relative importance of each factor will change with time and by company, and are not presented in order of importance. In certain cases, a major strength for a company can compensate for particular weaknesses, and conversely there are cases that one weakness is so critical, it overrides the strengths of an otherwise solid company. Custom analysis is crucial as the mortgage industry is a constantly evolving, robust industry with many participants of various pedigrees. For instance, mortgage companies often operate within a bank holding company; as such, bank analysis methodology is incorporated. The methodology that follows is intended to be an attempt to offer the analytical framework by which mortgage institutions are reviewed, and is the framework upon which DBRS’s mortgage company ratings are based.

THE BUILDING BLOCKS OF MORTGAGE RATINGS

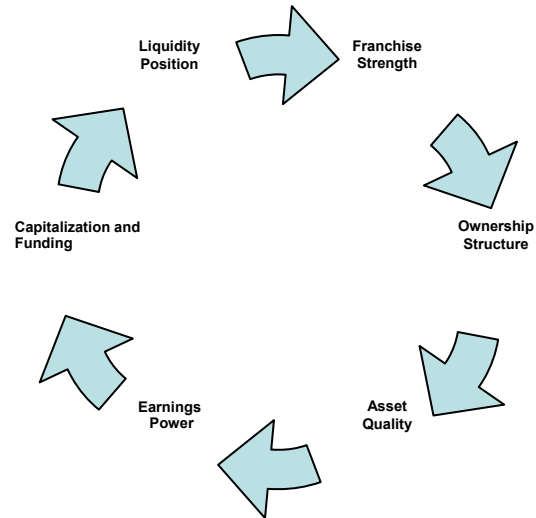


I. UNDERSTANDING INDUSTRY FUNDAMENTALS

The rating process begins with a comprehensive analysis and complete understanding of the dynamics and inherent risks of the mortgage industry. An historical perspective, along with current and future trend analysis, is employed. DBRS considers the mortgage industry a cyclical and volatile business. It is highly competitive, with a large number of players offering a commoditized product. Moreover, the barriers to entry are low; accordingly, the competitive environment is ever changing. Industry participants include banks, financial arms of large corporations, mortgage real estate investment trusts (REITs), and independent mortgage companies. Consequently, regulation, financial reporting, and transparency are not uniform. The intense competition has driven profitability down, which makes scale and efficiencies crucial to success.

Other risks such as headline (reputation) risk, regulatory risk, operating risk, interest rate risk, and predatory lending risks are inherent in the mortgage industry. Equally important are the interest rate environment and state of the consumer, which are factors that DBRS also considers when assessing industry risk.

DBRS's ratings are the sum of quantitative and qualitative strengths – franchise strength, which includes the quality of management; the ownership structure; the asset quality of the firm; the earnings power; the capitalization and funding; and liquidity position.



II. QUALITATIVE CONSIDERATIONS

Judging the Strength of the Business Franchise

DBRS integrates franchise strength and a company's competitive position in each rating. The company's ability to generate earnings, the ability to manage through competitive pressures and business cycles, and the firm's ability to defend its franchise are all essential rating factors and will be considered when assessing the strength of the business franchise.

In the current competitive environment, a strong franchise and scale are essential factors for success; smaller, less established businesses are at a disadvantage. Although there is the potential for size bias, as a few large players dominate the mortgage industry, small firms are often more nimble and are able to adapt more quickly to market pressures and conditions. Accordingly, small companies are not viewed as "unsuccessful" firms, but clearly have additional risks as they have less resources (both financial and managerial), and are often more at risk to actions by larger players. Other factors such as the strength of management, business strategy, and systems/technology are all included in the assessment of franchise strength.

The Corporate/Ownership Structure

The corporate structure of each rated entity is appraised. DBRS attempts to identify and discuss salient risks and rating implications within the corporate structure. Ownership status, corporate strategy, and corporate governance are all reflected in the rating. Public companies,

which are subject to more scrutiny, tend to be more transparent than private companies, and a public company's increased ability to raise capital are both positive influences to the rating.

Although there is some noteworthy regulation regarding consumer protection, the mortgage industry is not viewed as a highly regulated industry. DBRS looks positively at mortgage entities that operate within a bank holding company or other regulated financial institutions. The additional layer of regulation and the funding advantages will likely be reflected in a higher rating for this structure than for non-bank operated mortgage entities.

Parental considerations are also considered. If the rated entity is a subsidiary of a larger corporation, a stand-alone rating is determined prior to adjusting for parental support or drag, if the parent is a weaker entity. The tax structure of the rated entity is also considered. For instance, mortgage REITs are afforded certain tax benefits but, in return, are required to operate under defined restrictions that make capital retention more difficult. The REIT status limits the earnings retention; however, the existence of a taxable REIT subsidiary (TRS) offers some relief, as the subsidiary is not subject to the same dividend requirements as the REIT parent. Additionally, a REIT's likely dependency on the equity markets may hamper liquidity, especially in times of stress.

III. QUANTITATIVE CONSIDERATIONS

Asset Quality

Credit risk and asset quality vary widely from institution to institution, and are largely dependent on the firm's mix of borrowers (credit profiles) and to what degree the company retains or sells off its risk. Asset quality impacts future earnings through provisioning, and credit losses can eventually impair capital. Therefore, asset quality measures are an integral part of DBRS's analysis. However, analysis of delinquencies, net charge-offs, provisioning, and other traditional measures only start to tell the asset quality story; DBRS also looks to the risk of the firm's balance sheet, through retained interests (I/Os) in securitizations, mortgage servicing rights (MSRs), and other volatile asset classes.

(1) Traditional Asset Quality Risk Measures

In assessing credit quality, DBRS draws on analysis of traditional asset quality measures, such as delinquency levels, foreclosures, and loss rates. Asset quality assessment includes analysis of loan-to-value (LTV) and credit score trends, concentration in higher asset classes, and performance on securitized portfolios. Key ratios, averages, and trends are compared to historic performance, the company's expectations, and peers with similar asset classes. Asset quality measures are viewed on a risk-adjusted basis; as such, firms are rated based on their ability to absorb credit losses, while maintaining profitability. Typically the risks that concern mortgage lenders are macro-related, such as general economic trends, housing trends, and the health of the consumer. Although the strength of the consumer is factored in industry risks, both current and anticipated consumer health is considered when opining on credit risk and gauging adequacy of loss provisions.

(2) Residual Interest and MSRs

The presence of retained interests and MSRs on the balance sheet adds a key measure of credit risk. These asset classes have the potential to be among the largest on the balance sheet and are subject to significant valuation adjustments. Firms that employ off-balance sheet treatment of securitizations often retain the lower or non-rated tranches, which are typically in first loss position, to benefit from the cash flows of this highly speculative asset. Consequently, the firm has credit exposure to the level of bonds retained. In analyzing this exposure, DBRS considers the size and type of retained interests held to support the securitizations, the frequency and degree of any writedowns/impairments, and the assumptions used for valuation. Additionally, large levels of this highly volatile asset class add to the risk of earnings instability.

(3) Option ARMs and Other Negative Amortization Products

DBRS looks closely at companies that retain large levels of Option adjustable-rate mortgages (ARMs) or other loans with negative amortization potential. Loans of this ilk open the company to additional credit and balance sheet risk. Option ARMs, which give the borrower the choice to make a monthly payment less than the interest charges, often distort both the income statement and the balance sheet.

Moreover, DBRS includes geographic concentration as a measure of asset quality. Firms with loans concentrated in one geographic area have increased the risk of suffering losses due to regional economic downturns. However, this is often mitigated by the company's understanding of their home market.

Lastly, the originating source of the loan product is a factor when assessing asset quality. Retail originations, those originated from the firm's employees, are viewed as superior in quality to those loans that are sources through wholesale channels. Strong underwriting controls somewhat mitigate the credit risk concerns; however, prepayment patterns tend to be higher on wholesale originated production.

There are certain key ratios DBRS uses to track the asset quality measures. These ratios are reviewed for each company and compared to the peers. Managed asset quality numbers are used to compare the quality of the on-balance sheet portfolio to the entire portfolio.

ASSET QUALITY RATIOS (%)

Owned

60-day delinquencies/net receivables
 NCOs/avg. loans
 NCOs/reserves
 Reserves/owned receivables
 NPAs/owned receivables + OREO
 Reserves/NPAs
 NPAs/tangible common equity
 NPA/pre-provision income
 Loss recovery ratio

Managed

60+ day delinquencies/managed receivables
 Managed NCOs/avg. managed receivables

Quality of Balance Sheet

Residual interest/avg. assets
 Goodwill and intangibles/avg. assets
 MSR/tangible common equity

Stability of Earnings

Earnings Profile

DBRS looks at the quantity, quality, and sustainability of earnings when evaluating profitability and a firm's earnings profile. Considerable emphasis is placed on earnings, as they are the first layer of capital and liquidity that protects creditors. Moreover, strong and consistent earnings allow the company continued access to funding and enable a firm to build its capital position for growth and credit protection. DBRS's measure of earnings is consistent with its forward looking perspective and risk-adjusted return approach. In other words, DBRS reviews earnings on a risk-adjusted basis; earnings are judged relative to the risk the firm is taking.

The intense competitive environment continues to pressure yields downward in the mortgage sector. As such, profitability is exceedingly dependent on operating efficiencies, portfolio quality, and margin protection. General profitability measures include review of the absolute level of earnings, earnings trends, volatility of earnings, and fundamental profitability analysis. Earnings history, as well as earnings potential, is considered; DBRS favors firms with a long history of increasing earnings. In rating companies with a shorter history or companies that have not demonstrated the ability to overcome adversity, DBRS looks closely at the firm's franchise strength, future business prospects, and level of capital. Additional focus on the firm's appetite for risk and ambition to grow is considered, as history is less predictive of future performance.

As discussed earlier, DBRS asserts a firm's profitability is largely dependent on operating efficiencies, asset quality, and margin protection. DBRS looks to the firm's ability to manage its interest rate risk and to what level a change in interest rates impacts the company's balance sheet and income statement (on a historic and prospective basis).

DBRS employs several simple ratios to assess the quantitative measures of profitability. A standard profitability measure is return on average assets (ROAA), which is simply net income as a percentage of average assets (annualized). While a good starting point, this ratio often distorts profitability measures as tax rates differ among mortgage industry participants (particularly the mortgage REITs), and provision levels will differ for a portfolio lender and a securitizer. DBRS considers income before provisions and taxes to average assets a superior profitability measure. Additionally, DBRS removes any non-recurring extraordinary income or losses in this ratio, although this may be rating consideration, if earnings are viewed as particularly volatile.

Return on revenue (ROR), also known as net profit margin, is a powerful ratio as it is a quick measure of efficiency. The aforementioned ratios do not consider credit risk, so a seemingly profitable company may be considered less so on a risk-adjusted basis.

The box below outlines the key ratios used to judge a firm's profitability level and trends.

PROFITABILITY RATIOS (%)
ROAA
REAE
ROR (net income/revenue)
ROAMA
IBPT/avg. assets
IBPT/avg. managed assets
Net interest margin
Net interest income/avg. assets
Net income growth
Efficiency ratio

Earnings Quality

The quality of earnings is of equal importance to the quantity of earnings. Earnings quality is a function of stability, predictability, and diversity of earnings. Mortgage companies tend to have a lower quality of earnings, as profitability and profitability measures are often volatile and unpredictable, largely impacted by loan origination volume. Revenues are typically transactional in nature, mainly derived from origination fees, warehouse spreads, and secondary market sales. To offset earnings volatility and increase the quality of earnings, many companies opt to maintain on-balance sheet loan (held for investment) portfolios, which adds a layer of stable interest income. Additionally, mortgage companies also build services that provide fee-based revenue to the overall revenue mix. DBRS views companies that are successful in controlling earnings volatility positively.

Portfolio lenders and mortgage REITs with large on-balance sheet portfolios earn revenue, in the form of interest spread income, and thereby tend to exhibit less variability of earnings. The same could be said for companies that account for their loan securitizations as financings, as interest income is recognized throughout the life of the loan. Interest income from predictable, recurring sources, such as interest on loans held for investment, servicing fees, and other fees, is considered superior to transactional (origination-based) revenues. In addition, DBRS looks positively at firms that have demonstrated the ability to generate a meaningful percentage of total revenue from non-production related sources, such as third-party servicing fees.

A significant level of income variability is possible with companies that record securitizations as off-balance sheet transactions (sales), as the bulk of its income is front loaded and based on assumptions, such as the level of credit losses and prepayments. Should the company retain the residual asset class, much of the gain on the securitization transaction is recorded as a non-cash gain that is accreted into income throughout the life of the asset. This revenue source is considered of lesser quality as non-cash gains are subject to revaluation and potential market-to-market adjustment if the actual performance of the securitized assets differ from expected (this is discussed in more detail in the section titled Asset Quality). DBRS looks at the level of non-cash gains within the gain on sale of mortgage assets and opines on the assumptions used to calculate gains, as compared to peers and actual performance.

DBRS uses the following key ratios to gauge a company's dependency on its origination abilities as a chief source of profitability. Origination fees and gain on sale of mortgage loans as a percentage of total revenues indicates a firm's dependency on new loan originations. Net interest income as a percentage of revenues and loan servicing fees as a percentage of revenues assist in identifying firms with strong recurring and predictable earnings.

QUALITY OF EARNINGS RATIOS (%)

Gain on loans sale/revenue
 Net interest income/revenue
 Servicing and other fee income/revenue
 Origination income/revenue

Capitalization and Funding

Capital adequacy is the final line of protection against loss from credit risk, market risk, operation risk, and any other source of loss. In other words, capital is required to protect the investors and lenders for both expected and unexpected losses. Capital adequacy is judged against relative profitability, asset type, risk of the balance sheet, and the general risk profile of the firm.

Mortgage lenders tend to be moderately to highly levered institutions. Additionally, the level of required capital is impacted by the quality of the balance sheet. Firms with larger levels of MSR's, residual interests, and intangible assets need larger levels of capital to support these assets.

In assessing capital adequacy, DBRS typically removes all goodwill and other intangibles from the equity account. Additionally, retained interests from securitizations that have credit risk, or are in a first-loss position, are removed from total equity (on a tax affected basis). This provides leverage measures on an "at risk" basis. Loan loss reserves are added to equity as they are the first line of defense to absorb expected credit losses. The result, hailed as adjusted equity, is used in DBRS's analysis of leverage and capitalization.

Moreover, the company's ability and demonstrated history to raise new equity and its willingness and ability to retain earnings are considerations in determining a rating. The market appetite for mortgage companies, which is factored in the industry profile, is considered when assessing capital adequacy.

DBRS uses the following ratios to opine on a mortgage institution's capitalization and leverage. Particular focus is given to ratios that consider tangible equity and adjust for the first loss position. Differing accounting treatment of securitizations make peer comparison difficult. When applicable, DBRS uses bank capital ratios, such as Tier 1 and Total Capital ratios, in the analysis, as they are often more readily comparable.

CAPITALIZATION RATIOS

Debt/tangible equity + loan loss reserves (x)
 Debt/adjusted tangible equity + loan loss reserves (x)
 Debt/total capitalization (%)
 Equity/assets (%)
 Tangible equity/tangible assets (%)
 Equity/managed assets (%)
 Tier 1 Capital ratio (%)
 Total Capital ratio (%)
 Dividend rate (%)

In addition to quantity of capital, quality of capital is a key rating consideration. The quality of capital varies significantly within the mortgage industry. DBRS evaluates the extent to which a company is dependent on a lesser quality of capital, such as preferred stock and hybrids that may be considered debt in certain cases. DBRS views preferred stock and trust preferred securities as costly forms of equity. A capital haircut may be applied to preferred capital should DBRS determine that the company is overly dependent on this form of equity.

QUALITY OF EQUITY RATIOS (%)

Preferred securities/total equity
 MSR's/total equity
 Residual interests/total equity
 Goodwill and other intangibles/total equity

Liquidity

The need for well-developed and diverse funding sources is essential for market-funded companies, particularly for those that operate without the benefit of deposit gathering or other support such as a strong parent. Given a mortgage entity’s funding appetite (required to support current loan production), liquidity is a key factor in the rating. Lack of access to funding, along with weak liquidity, is one of the chief factors that leads to failure of finance companies. Without sufficient and dependable funding, a mortgage institution will find it impossible to continue as a going concern. Accordingly, DBRS believes that mortgage companies must have abundant liquidity. Moreover, to minimize risk of a liquidity crisis, in the case of a market disruption, DBRS believes that a firm should remain active in multiple funding channels and not be overly dependent on any one single source.

DBRS also looks at the company’s ability to sell or securitize loans and other assets to manage liquidity. As such, asset quality is a deliberation in assessing liquidity. Higher quality assets have characteristics that are easily measurable, predictable, and well understood, and as such are inherently more liquid. An institution that has a lower quality of illiquid assets and has highly volatile market value will face greater liquidity challenges than an institution with high-quality, easily quantifiable assets. Prime conforming mortgage loans are most readily convertible to cash, as this is the deepest, most liquid market. Other mortgage assets are less liquid as long-term investor commitment (through an economic cycle) to non-traditional loan products (option ARMs, 40-year mortgages, etc.) has yet to be demonstrated. In sum, investor confidence and acceptance of the institution’s loan product is tantamount to success.

Generally, mortgage institutions that operate without a significant banking operation have a propensity to be secured borrowers, owing to their limited access to unsecured borrowings. This often leads to structural subordination, principally in lower-rated companies. To achieve liquidity, these firms pledge most of their assets in securitizations and various forms of secured lending, such as warehouse lines, asset-backed commercial paper

(ABCP), secured lines of credit, and repurchase agreements. Consequently, pledged (secured or encumbered) assets are not available to the estate in the case of a default, placing the unsecured lender in a subordinate position. DBRS reviews the amount on unpledged (unencumbered or unsecured) assets as a ratio to unsecured debt and to total assets. In cases where unencumbered assets are limited, meaning the company’s balance sheet is largely encumbered, DBRS may notch the senior debt rating below the corporate credit rating, reflecting the potential structural subordination.

Mortgage companies that operate with strong bank charters will likely be rated higher than peers without the charter, citing superior liquidity, funding flexibility, and increased regulation. The bank/thrift charter offers steady access to deposits, federal home loan bank (FHLB) advances, and other forms of low-cost funding. The funding flexibility reduces the firm’s dependency on wholesale funding and the potentially fickle capital markets. DBRS reviews match funding, interest rate exposure, hedging effectiveness, and maturity schedules.

Key ratios for liquidity and funding profile include the following:

LIQUIDITY RATIOS	
Pre-tax income interest coverage (x)	
Total debt/EBIT (x)	
Total debt/EBITDA (x)	
Deposits/total funding base (%)*	
Short-term debt/total debt (%)	
EBITDA/debt maturing in one year	
Cash flow coverage (x)**	
Repos/total debt (%)	
Dividend date (%)	
* Total funding base = liabilities + securitizations.	
** Free cash flow/interest + debt maturities (next 12 months).	

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