

U.S. Structured Finance Newsletter

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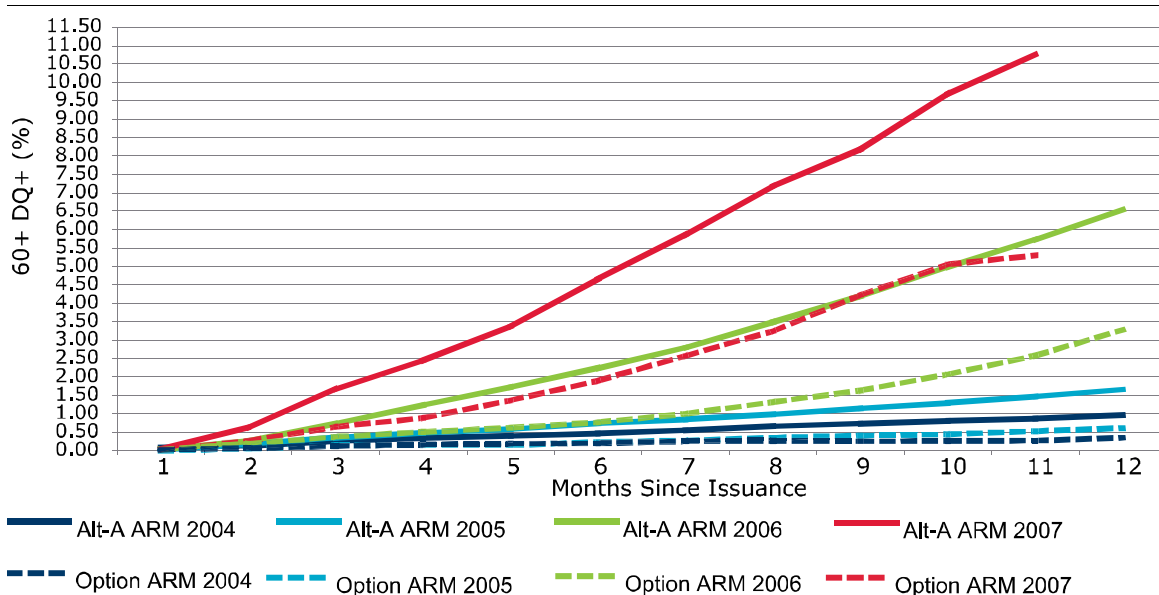
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OPTION ARM PERFORMANCE UPDATE

Recent vintages of RMBS backed by option adjustable-rate mortgages (option ARMs or OAs) have ill-performed market expectations within their respective first 12 months of issuance. Serious delinquencies of 60+ days among the 2006–2007 OA vintages have exhibited surprisingly negative results well before any expected payment shock on a year-over-year basis (see the chart below). Given the inherent optionality of an OA – that is, the ability to make discounted monthly payments that trigger negative amortization – it is evident that payment shocks alone cannot explain the rapid increase in serious delinquencies within the first year of issuance.

Option ARM and Alt-A ARM 60+ Delinquency by Vintage



Source: Intex and DBRS.

Amid the steep rise of U.S. real estate values over the past decade, borrowers found favor in “affordability products,” among them OAs. An OA enables a borrower to make a minimum payment that is less than the full month’s interest, provided that the resulting negative amortization does not exceed contractual limits. Such limits may range from 10% to 25% above the original mortgage principal balance. A borrower consistently making the monthly minimum payment may reach his negative amortization limit in the fourth year, depending on the spread between the minimum and the fully indexed payments.

As covered in the [October 1, 2007 newsletter](#), the 2007 OA vintage performance reveals that borrowers who are seriously delinquent to date are not remitting even the minimum negatively amortizing payment. This rise in serious delinquencies may be explained by the undercollateralization of loans concentrated in regions with significant housing price devaluation. Areas such as Los Angeles, Phoenix and Las Vegas have experienced declines of 13.70%, 15.27% and 15.34%, respectively.¹ While it is expected that payment shocks, such as interest rate recast, may complicate OA borrowers’ ability to pay, it is evident that the combination of a down housing market as well as lack of sufficient equity in the mortgaged property may frustrate borrowers’ willingness to pay.

For questions or comments, contact Bernard Maas at bmaas@dbrs.com or Sagar Kongettira at skongettira@dbrs.com.

¹ One-year change in Case-Shiller Home Price Indices as of December 2007.