

United States: Financial Services

Subprime mortgage credit outlook is bleak, prime is fine

Subprime credit quality: working through poor underwriting in '06

At our Housing Conference today, the view is that the outlook for subprime mortgage credit quality remains extremely challenging. This reflects very poor underwriting in late 2006 with the subprime mortgage market now hitting peak levels of early payment defaults and delinquencies in 2007 with peak losses to follow. Underwriting has tightened so far into 2007 with improvement in credit, consequently, resulting in 2008.

The fundamental issue is underwriting, as subprime underwriters lowered underwriting standards as volumes dropped with originators underwriting very high leveraged 90-100% LTVs to low FICO subprime borrowers.

Prime - stable credit, but profitability challenges remain

Prime mortgage credit quality remains fairly strong with lower average 80%+ LTVs in the market and better underwriting. However, profitability remains extremely challenging given the inverted yield curve, and moderating origination volumes.

Mortgage Finance: Still expecting a two-stage hangover

We continue to expect a two-stage hangover for the large-cap mortgage stocks, as even after fundamentals have troughed we expect regulatory developments to weigh on mortgage stocks. We remain Cautious on Mortgage Finance, and retain our sell rating on Countrywide Financial.

Mortgage Insurance: Key credit risks remaining for insurers

The mortgage insurers are in first loss position on the higher LTV loans within the mortgage market. We remain Cautious on the mortgage insurers as we continue to believe that slowing home prices, a potential uptick in unemployment, continued seasoning of the books, and subprime challenges will keep valuation pressured in 2007.

Banks: credit impact is limited

We expect limited impact from recent credit issues on the banks as bank portfolios consist almost entirely of prime loans, as detailed in our Feb 8 note, "Subprime mortgage: bleak outlook, limited impact for the banks". Consequently, we view banks as largely defensive in this environment.

SECTOR ANALYSTS AND VIEWS

James Fotheringham: Mortgage Finance - Cautious

Andrew Brill: Mortgage Insurance - Cautious

Lori Appelbaum: Large-cap Banks – Attractive
Mid-cap Banks - Neutral

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Mortgage outlook remains challenging

Subprime mortgage credit risk continues to deteriorate; underwriting now tightening

Subprime mortgage credit risk continues to deteriorate as evidenced by spreads on credit protection for bonds backed by subprime mortgages - which have more than doubled year to date (see Exhibit 1). Subprime credit losses are currently running 5x higher than one-year ago versus only moderate increases in prime losses (see Exhibit 2).

Subprime losses will likely remain elevated through this year given weak underwriting standards of the 2006 vintage which is expected to perform worse than the 2005 vintage - with delinquencies peaking in the 12+ months post-origination. Consequently, we are currently working through peak early payment defaults and delinquencies from weak underwriting of late 2006.

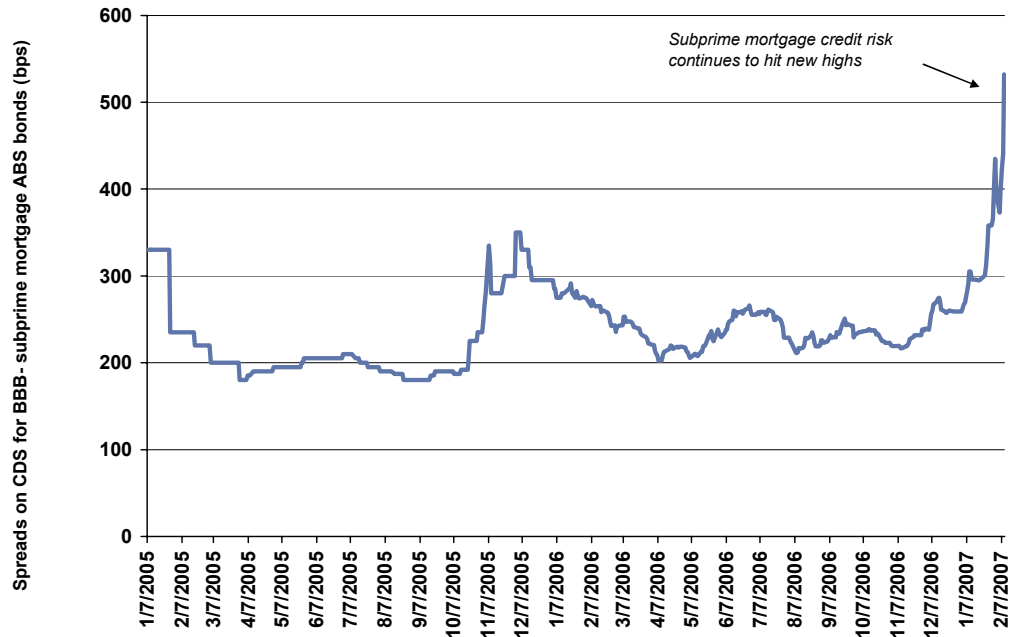
The fundamental issue is weak underwriting on 2006 loans coupled with flat to declining home prices nationally. Specifically, subprime consumers received mortgages with little money down and little in income documentation. Subprime lenders had been granted loans with 90%-100% LTVs (through both first mortgages and piggyback home equity). In addition, deterioration has been most evident where risk layering was the most pervasive - e.g. loans with a combination of low FICOs, low or no income verification, high LTVs and other higher risk characteristics such as investor loans.

The combination of low FICO score underwriting (mid/upper 500s) and high leverage at 100% LTVs is producing the greatest problems. The view is that 10% of the subprime market has very high risk given very weak underwriting - or 1.5% of the overall mortgage market. Cumulative losses on 2006 underwritings are estimated at 6% versus a lower 3%-4% for 2005 underwritings and a peak of 4%-5% in 2000-2001. Consequently, 2006 underwritings are likely to be worse than that experienced in the last downturn. Lenders have since tightened in 2007 and the expectation is that 2006 underwritings will produce peak losses and delinquencies with improvement thereafter.

Consequently, the key difference in underwriting in the prime versus subprime market is high leverage to consumers with poor credit histories while we estimate that cumulative LTVs in the prime market are a more prudent and lower 80%+. As a result, the credit performance of the two markets is likely to remain very different as has been the case in banks' portfolios so far.

Consequently, gain on sale has weakened by about 50-100 bp over the past month as the industry continues to struggle with early pay defaults, pricing pressure due to overcapacity, and rising losses. Specifically, based on conversations with our internal subprime mortgage trading desk, we estimate that gross gain on sale for subprime mortgage loans has weakened 50-100 bp from 101.5-102.0 at year end to 100.5-101.0 currently. Most subprime originators have a cost to product each loan of 101.5-102.0. Consequently, many subprime originators are selling loans at a loss.

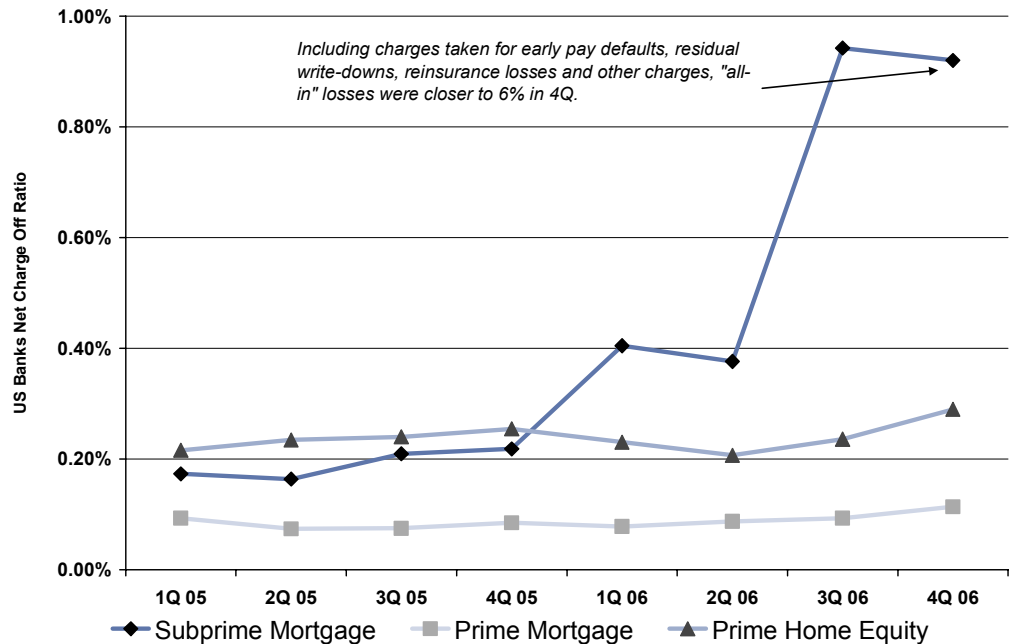
Exhibit 1: Subprime mortgage risk continues to rise
spreads on CDS for subprime mortgage ABS bonds



Note: From 2006 onwards data represents spreads on publicly traded ABX index. Prior to 2006, data represents internal Goldman estimates.

Source: Markit, Goldman Sachs Research.

Exhibit 2: Subprime losses are running 5x higher than one year ago (even before EPDs, residual write-downs, etc) – prime mortgage and home equity much more stable
based on credit statistics for GS covered US Banks portfolios



Note: Subprime = average of WaMu (Long Beach) and NCC (First Franklin), adjusted for loan sales at First Franklin. Prime mortgage and home equity based on GS covered banks with segment disclosure.

Source: Company data, Goldman Sachs Research.

Exhibit 3: Regional mortgage credit quality – and subprime in particular – remains weakest in the Midwest

States with the Highest Foreclosure Ratios			States with the Lowest Foreclosure Ratios		
State	3Q 2006 Subprime Foreclosure Ratio	YoY Change	State	3Q 2006 Subprime Foreclosure Ratio	YoY Change
Michigan	3.23%	0.68%	New Mexico	1.28%	-0.39%
Ohio	3.11%	0.33%	Louisiana	1.10%	-0.34%
Indiana	3.04%	0.22%	Florida	1.05%	0.32%
Iowa	2.88%	0.34%	Idaho	1.04%	-0.14%
Wisconsin	2.67%	0.83%	Maryland	0.98%	0.23%
Utah	2.44%	0.73%	Virginia	0.89%	0.22%
Minnesota	2.42%	0.79%	Oregon	0.87%	-0.04%
Nebraska	2.40%	1.14%	Washington	0.87%	-0.26%
Kentucky	2.34%	0.16%	Hawaii	0.84%	0.39%
Massachusetts	2.30%	0.95%	Arizona	0.77%	0.27%
Average	2.68%	0.62%	Average	0.97%	0.03%

Note: Excludes small states (those with less than 15,000 in total subprime loans sampled).

Source: Mortgage Bankers Association, Goldman Sachs Research.

Prime mortgage credit is more stable, but profitability remains challenging

Prime mortgage credit quality remains strong along with lower LTVs and better underwriting as shown in Exhibit 2. However, profitability remains extremely challenging given the inverted yield curve - which puts pressure on mortgage warehouse spreads and increases the likelihood of hedging losses – as well as moderating origination volumes coupled with industry over-capacity.

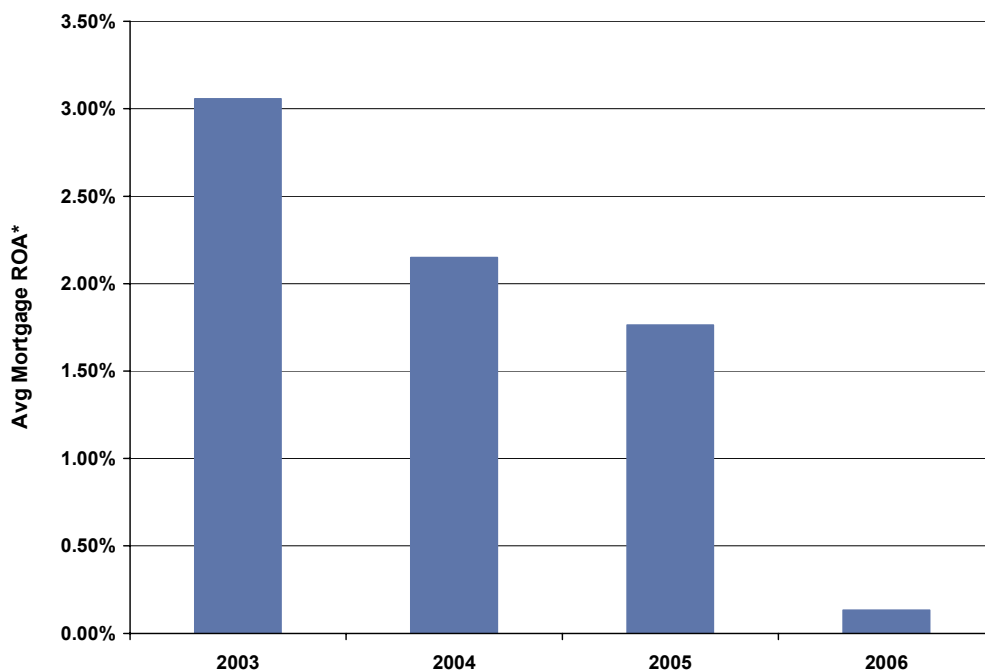
During the conference, Fannie Mae, Freddie Mac and the Mortgage Bankers' Association were stoic about their outlook for the mortgage industry; while they all acknowledge that it is increasingly difficult for mortgage originators to make money (due to slowing volume growth and rising credit costs), they have faith that industry innovation -- together with a benign macro outlook and supportive demographics -- will see many companies through this difficult time.

Still, in discussions following formal presentations, panel participants highlighted two key concerns:

- 1. Excess capacity still exists:** Incremental to significant cost-cutting across the mortgage industry, we count no fewer than 14 mortgage originators that have been sold, put themselves up for sale, or have exited the business since last summer. The panel participants feel that there is more to come; to use a baseball (or cricket) analogy, we sense we are still in the "middle innings".
- 2. Regulatory risk is rising:** Increased regulation is anticipated for the mortgage industry, most likely in the form of an anti-predatory-lending bill. There is wide expectation that Barney Frank (D-MA) will introduce an anti-predatory-lending bill to the House of Representatives in April or May 2007. We believe that any efforts to propose a "lending suitability standard" for mortgage originators would be met with significant industry opposition and, subsequently, would stand little chance of making it through the Senate; however, we still believe that legislation to encourage improved transparency (e.g., standardizing mortgage sales commission rates, open architecture for mortgage product distribution, separation of mortgage origination and distribution platforms) may enjoy support from both politicians and industry lobbyists.

Exhibit 4: The mortgage market continues to struggle with profitability – operating at break even levels overall

estimated avg industry ROA based on CFC, WM, NCC and FHN



* Average of: Countrywide (consolidated company), National City Mortgage Company (segment), First Horizon Mortgage (segment), and Washington Mutual Home Loans (segment).

Source: Company data, Goldman Sachs Research.

Impact by sector

Mortgage Finance: Still expecting a two-stage hangover for the large-cap mortgage stocks

Panelists representing the mortgage companies were sanguine about the outlook for their industry, but highlighted two key near-term concerns: excess capacity and regulatory risks. Incremental to industry-wide cost-cutting efforts, we count no fewer than 14 mortgage originators that have been sold, put themselves up for sale, or have exited the business since last summer; and panelists at our housing conference believe there is more to come.

Additionally, introduction of an anti-predatory-lending bill -- which may affect mortgage industry practices -- is widely anticipated this April or May; even after fundamentals for the mortgage industry have troughed, we expect regulatory developments to weigh on mortgage stocks. We remain cautious on Mortgage Finance, and retain our sell rating on Countrywide Financial.

Mortgage Insurance: Key credit risks remaining for insurers

We remain Cautious on the mortgage insurers as we continue to believe that slowing home prices, continued seasoning of the books, a potential uptick in unemployment, and subprime challenges will keep valuation pressured. That said we recognize that tenor of

the panelists were fairly positive with respect to the outlook for prime credit with most of the negative sentiment localized to the outlook for subprime credit. We believe that the mortgage insurers could experience more of the brunt of any challenges in the prime market that surface. We see particular risks as it relates to the slowing housing market. The insurers are taking the first loss position on the higher LTV loans within the mortgage market. The vast majority of the insurers' portfolios are comprised of loans with LTV's greater than 80%. (See Exhibit 10)

Challenges in the subprime market are particularly relevant for MGIC and Radian as both companies are noticeably more exposed to subprime credit than PMI. (See Exhibits 5-7). However, we would keep in mind two factors that could help to mitigate losses for the mortgage insurers relative to the broader subprime market. (1) Mortgage insurers are not at risk for loans that default due to fraud or misrepresentation. To the extent, those factors are driving the defaults, the mortgage insurers have the ability to put the loans back to the lenders. (2) Mortgage insurers have been less aggressive writing subprime business in 2006 and have increasingly been writing business with deductibles in place.

Exhibit 5: Total primary risk in force by FICO

1Q2006-4Q2006

	1Q2006	2Q2006	3Q2006	4Q2006
MTG				
620 or above	84.8%	85.1%	86.0%	85.8%
620 or below	15.2%	14.9%	14.0%	14.2%

PMI				
620 or above	90.9%	91.3%	91.7%	92.0%
620 or below	9.1%	8.7%	8.3%	8.0%

RDN				
620 or above	87.4%	88.1%	88.8%	89.5%
620 or below	12.6%	11.9%	11.2%	10.5%

Source: Company filings.

Exhibit 7: Bulk risk in force by FICO

1Q2006-4Q2006

	1Q2006	2Q2006	3Q2006	4Q2006
MTG				
620 or above	59.9%	62.2%	65.8%	65.0%
619-575	25.2%	23.7%	21.4%	22.2%
574 or below	14.9%	14.1%	12.8%	12.8%

PMI				
620 or above	79.2%	80.7%	82.8%	84.7%
619-575	13.2%	12.3%	10.8%	9.8%
574 or below	7.6%	7.1%	6.4%	5.5%

RDN				
740 or above	9.4%	9.8%	10.5%	11.8%
739-680	31.1%	21.9%	22.9%	23.9%
679-620	36.2%	36.1%	35.8%	35.3%
620 or below	33.3%	32.2%	30.8%	29.0%

Source: Company filings.

Exhibit 9: Loan type as a percentage of risk force

2002-2006

	2002	2003	2004	2005	2006
MTG					
Fixed	82.2%	77.3%	77.2%	74.5%	na
ARMs	17.8%	22.7%	22.8%	25.5%	na

PMI					
Fixed	90.8%	90.4%	85.5%	80.4%	na
ARMs	9.2%	9.6%	14.5%	19.6%	na

RDN					
Fixed	81.4%	75.9%	69.3%	67.7%	70.0%
ARMs	18.6%	24.1%	30.7%	32.3%	30.0%

Source: Company filings.

Exhibit 6: Flow risk in force by FICO

1Q2006-4Q2006

	1Q2006	2Q2006	3Q2006	4Q2006
MTG				
620 or above	93.7%	93.7%	93.7%	93.5%
619-575	5.4%	5.4%	5.4%	5.5%
574 or below	0.9%	0.9%	0.9%	1.0%

PMI				
620 or above	93.2%	93.3%	93.5%	93.7%
619-575	5.4%	5.3%	5.2%	5.0%
574 or below	1.4%	1.4%	1.3%	1.3%

RDN				
740 or above	25.8%	26.0%	26.2%	26.2%
739-680	36.8%	36.7%	36.7%	36.5%
679-620	31.0%	30.9%	30.8%	30.8%
620 or below	6.4%	6.4%	6.3%	6.5%

Source: Company filings.

Exhibit 8: Alt-A as a percentage of risk in force

1Q2006-4Q2006

	1Q2006	2Q2006	3Q2006	4Q2006
MTG				
Bulk	33.4%	37.9%	42.4%	42.1%
Flow	7.1%	7.3%	7.7%	7.9%
Total	14.0%	15.6%	17.2%	17.2%

PMI				
Bulk	na	na	na	na
Flow	na	na	na	na
Total	18.4%	17.3%	18.6%	na

RDN				
Bulk	27.1%	27.9%	29.0%	29.5%
Flow	14.7%	14.4%	14.0%	13.9%
Total	17.5%	17.3%	17.0%	16.7%

Source: Company filings.

Exhibit 10: LTV breakout

2002-2006

	2002	2003	2004	2005	2006
MTG					
95-100	8.5%	10.0%	13.5%	16.4%	na
90-95	36.9%	32.7%	32.4%	30.5%	na
80-90	45.4%	45.9%	45.7%	44.5%	na
<80	9.2%	11.4%	8.4%	8.6%	na

PMI					
95-100	9.7%	16.0%	18.5%	19.6%	na
90-95	41.3%	37.6%	36.4%	33.7%	na
85-90	39.0%	37.0%	35.9%	37.4%	na
<85	10.0%	9.4%	9.2%	9.3%	na

RDN					
95-100	8.4%	11.3%	12.7%	14.0%	17.6%
90-95	40.4%	37.6%	36.4%	33.5%	31.6%
85-90	38.2%	37.0%	38.1%	37.1%	35.8%
<85	13.0%	14.1%	12.8%	15.4%	15.0%

Source: Company filings.

Banks: limited impact from subprime mortgage credit deterioration

We expect limited impact of these issues on the banks as bank portfolios consist almost entirely of prime loans. On the Alt A front, we see no negative impact at Capital One/NFB as Greenpoint's Alt-A fundamentals have been stable along with the market. Similarly, we see no impact at Wachovia as Golden West's loans are held in portfolio rather than sold and the company is not a subprime lender - and credit remains very strong (0bps of losses) given low-LTVs below 70% (high 50% on a mark to market basis). Wells Fargo does not sell its subprime mortgage production, and credit quality has been more stable due to better underwriting - no subprime IOs or low docs.

National City is no longer affected by GOS as First Franklin was sold. National City will likely continue to face rising subprime credit costs as the portfolio runs off. At Regions, there could be a small impact in 1Q as the Equifirst sale has not yet closed.

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Definitions

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Coverage views: Attractive (A). The investment outlook over the following 12 months is favorable relative to the coverage group's historical fundamentals and/or valuation. **Neutral (N).** The investment outlook over the following 12 months is neutral relative to the coverage group's historical fundamentals and/or valuation. **Cautious (C).** The investment outlook over the following 12 months is unfavorable relative to the coverage group's historical fundamentals and/or valuation.

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