

February 16, 2007

Structured Credit

CDO Market Insights Sub-Prime in Prime Time

Sub-Prime Meltdown: In the aftermath of financial results from sub-prime lenders and stress manifested in the ABX markets, we analyze implications for ABS CDOs.

TABX Debuts: Adding to the mix was the launch of TABX — tranche trading on ABX — as well as bespoke variations that are already in the market. Spreads in “comparably” rated tranches in TABX and the bespoke variations are significantly wider than mezzanine ABS CDO tranches.

Are ABX/TABX and Mezzanine ABS CDOs Alike?

We analyze 43 mezzanine ABS CDO portfolios of 2006 vintage to compare their composition with ABX/TABX in terms of underlying collateral type, ratings and vintage. Our analysis shows that TABX tranches and ABX-inspired bespokes are pure plays on relatively concentrated, static BBB or BBB- HEL ABS pools of 2006 vintage, while mezzanine ABS CDOs represent larger, more diversified managed pools with exposure not limited to the sub-prime housing sector.

Different Technicals: There is a natural base of protection sellers and protection buyers in the single-name CDS market. In the ABX index market there is no such natural constituency of protection sellers. As such, small changes in volume can result in material swings in the index.

Conclusions: Notwithstanding their differences, given the market action in ABX and now TABX, as well as emerging data about deteriorating HEL fundamentals, we expect re-pricing in the ABS CDO market, albeit more subdued than the extreme moves in ABX. Deltas of ABS CDO tranches to changes in HEL ABS spreads are likely smaller in magnitude relative to that of TABX- and ABX-inspired bespokes.

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Sub-Prime in Prime Time

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Over the last week, developments in the sub-prime housing market have taken the center stage — not just in the relatively narrow confines of securitized products, but on a much broader scale, touching the equity and corporate credit markets. Much of the action played out in the ABX indices, which suddenly became the spotlight of our dialogue with investors across asset classes. This also prompted analysts to wonder whether these developments should be seen as idiosyncratic but specific to the sub-prime mortgage sector or as symptomatic of a broader systemic credit crunch with broader macroeconomic implications (see Richard Berner's "Will the Subprime Meltdown Trigger a Credit Crunch?" February 12, 2007).

From our vantage point, our focus is less about the potential spillover risks into other sectors and is really about what implications these developments hold for the ABS CDO market and to the broader CDO market. To complicate our predicament further, TABX (Tranched ABX) debuted this week, in anticipation of which there are also bespoke variations of synthetic ABS CDOs in the market. In this report, we cover recent market developments; discuss the differences between cash flow ABS CDOs and ABX, TABX and similar bespoke variations; and put forth our thoughts on the implications for ABS CDOs. We conclude that the nature of risks measured by underlying collateral type, vintage and ratings as well as structure and technicals render the ABS CDOs and ABX/TABX to be significantly different. That notwithstanding, given the market action in ABX, ABS CDS, and now TABX as well as emerging data about deteriorating HEL fundamentals, there is likely to be re-pricing in the ABS CDO market, albeit more subdued than the extreme moves in ABX.

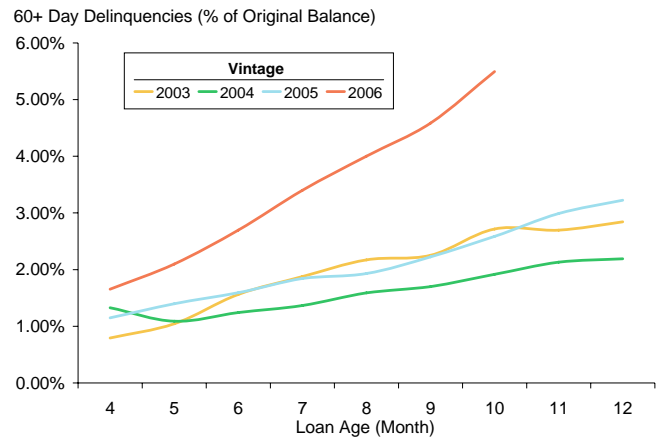
A February Surprise?

Substantial cooling in US housing has ceased to be a matter of debate. Nor is it news that the evolution of collateral performance in recent vintage sub-prime ABS pools, (particularly in the 2006 vintage) has been significantly worse relative to previous years at a comparable loan age (See "2007 Outlook: A Tale of Two Markets, December 15, 2006). As reflected in Moody's data on sub-prime ARMs, weakness in the 2006 vintage of transactions began to show up in the

form of higher rates of delinquencies from early on in their loan age and has continued since (Exhibit 1).

Exhibit 1

60+ Day Delinquencies in Sub-Prime ARMs

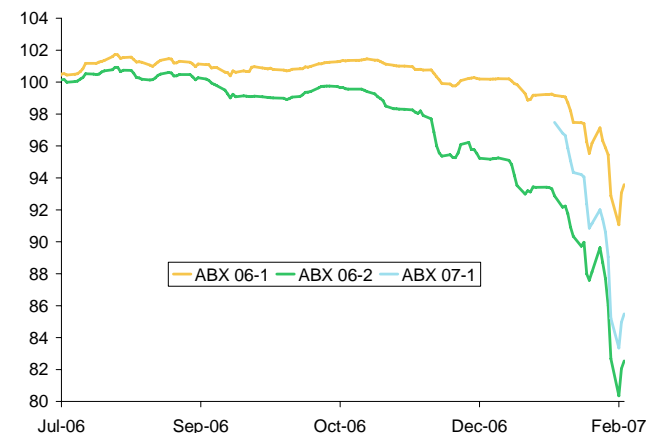


Source: Moody's

The differences in the market prices of ABX.HE 2006-1, 2006-2 and 2007-1 series amply illustrate the deterioration in HEL ABS credit quality in general as well as the differences across vintages (Exhibit 2). ABX.HE 2006-1 is composed of 2005 vintage collateral and both 2006-2 and 2007-1 series consist of 2006 vintage collateral. While there has been an across-the-board decline in all indices, the decline in the latter two has been significantly higher, reflecting the performance differences between 2005 and 2006 vintage collateral.

Exhibit 2

ABX HE Indices Have Fallen Steeply



Source: Mark-it

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Spooked by Stocks

Yet, we saw a massive meltdown across all the three indices, following a few significant announcements. On February 7 HSBC, disclosed that its loan loss provisions for 2006 would be \$10.56 billion, 20% higher than the consensus estimate of \$8.7 billion. The following day, New Century Financial, among the largest sub-prime lenders, reported that it would have to restate its financials for the first three quarters of 2006 and that it expects to report a loss for the fourth quarter. On February 13, ResMAE, yet another sub-prime lender filed for bankruptcy protection, joining a horde of sub-prime lenders, that have curtailed operations (22 since December 2006, by one count¹). The market capitalization of publicly listed mortgage lenders with sub-prime exposure declined by greater than \$7.4 billion since last week (Exhibit 3).

Exhibit 3

Mortgage Lenders Take a Hit

Company	Ticker	Market Capitalization (\$ Million)		% Decline
		6-Feb	14-Feb	
New Century Financial	NEW	1,666	1,096	-34%
Novastar Financial	NFI	685	643	-6%
Impac Mortgage Holdings	IMH	655	627	-4%
Fieldstone Investment	FICC	160	128	-20%
Delta Financial	DFC	253	246	-3%
Origen Financial	ORGN	145	145	0%
ECC Capital	ECR	98	93	-5%
Countrywide Financial	CFC	26,175	24,578	-6%
IndyMac Bancorp	NDE	2,818	2,766	-2%
Doral Financial	DRL	301	280	-7%
Accredited Home Lenders	LEND	712	647	-9%
Flagstar	FBC	945	936	-1%
HSBC	HBC	214,164	209,182	-2%

Source: Morgan Stanley, Bloomberg

It is this confluence of news from the equity markets that precipitated the steep declines in the ABS market in general and ABX.HE indices in particular. In spread terms, ABX.HE 2006-2 BBB- and BBB indices widened by over 270 bps and 200 bps, respectively, since February 7th, despite some recovery over the last couple of days.

TABX Debuts

The debut of TABX (Tranched ABX) added yet another dimension of complexity to the plot. The launch of TABX signals the beginning of trading of standardized tranches on ABX.HE indices. The first series of TABX refers to a portfolio of reference obligations combining the two most recent series of ABX indices (ABX.HE 06-2 and ABX.HE 07-1). At present,

¹www.ml-implode.com

only the “BBB” and “BBB-“sub-indices are tranced, resulting in standardized tranches on two separate portfolios, each consisting of 40 reference obligations. As noted earlier, there are bespoke variations of these tranches in the market. Following the meltdown in ABX, early indications are that both in TABX and in the bespokes, spreads are significantly wider (2-3 times) than in the new issue ABS CDOs, for “comparably” rated tranches, which naturally raises the question: Should spreads in mezzanine ABS CDOs also follow? We contend that the best way of approaching this question is to examine the similarities and differences between mezzanine ABS CDOs and ABX/TABX.

Are Mezzanine ABS CDOs and ABX/TABX Alike?

We argue that there are many differences between ABX/TABX and mezzanine ABS CDOs. Yes, both of them have sub-prime housing risk embedded in them. However, while ABX and TABX pools consist entirely of sub-prime HEL ABS reference obligations, mezzanine ABS CDOs have exposure to other asset classes as well as prime mortgages. We examined the composition of 43, 2006 vintage mezzanine ABS CDO portfolios to analyze their exposure by underlying collateral type (Exhibit 4). While sub-prime RMBS is the largest underlying collateral type in mezzanine ABS CDOs (on average 73%), it is by no means the only underlying sector. On average, the ABS CDOs in our sample had a 16% exposure to prime RMBS. Exposure to CDOs and CMBS was also not insignificant in some cases. Also there is a fair degree of variability across ABS CDOs in terms of collateral composition. ABS CDO portfolios are demonstrably more diversified, unlike ABX/TABX portfolios that consist entirely of sub-prime ABS.

Exhibit 4

Collateral Composition of Select 2006 Mezzanine ABS CDOs

Collateral Type	Average	Maximum	Std Dev
RMBS – Sub-prime	73%	98%	25%
RMBS – Prime	16%	85%	23%
CDO	6%	37%	6%
CMBS	3%	11%	3%
ABS MH	0%	1%	0%
ABS Other	1%	17%	3%
Other	0%	0%	0%
NA	1%	13%	3%

Source: Morgan Stanley and Intex

ABS CDO Portfolio Composition by Rating

The portfolios underlying each of the ABX/TABX portfolios consist entirely of one rating category. For the TABX

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portfolios, they are BBB and BBB- (or the Moody's equivalent). We analyzed the ratings composition of our sample of mezzanine CDO portfolios (all from the 2006 vintage), using the lower of Moody's or S&P ratings for each credit in each of the 43 portfolios. As summarized in Exhibit 5, while BBB and BBB- credits are clearly the dominant ratings and respectively account for 33% and 37% of the portfolio on average, there is a reasonable degree of exposure to other rating categories, including 14% to BBB+, on average.

In the Annex to this report, we demonstrate this point by showing the ratings composition of each of these 43 ABS CDOs. As with collateral composition, there is a degree of variability across these portfolios. In terms of ratings of the underlying collateral, ABX/TABX portfolios have no ratings diversity, while ABS CDO portfolios clearly do. To the extent ratings reflect credit quality, we argue that mezzanine ABS CDO credit quality is on average better than at least the ABX.HE BBB- indices.

Exhibit 5

Ratings Composition of Select 2006 Mezzanine ABS CDOs

Rating	Average	Maximum	Std Dev
AAA	1%	11%	3%
AA	3%	15%	4%
A	5%	37%	8%
BBB+	14%	35%	11%
BBB	33%	65%	14%
BBB-	37%	80%	17%
BB+	4%	17%	5%
BB	2%	17%	4%
BB-	0%	4%	1%
B and lower	1%	26%	4%
NA	0%	6%	1%

Source: Morgan Stanley and Intex

Vintage Diversity in ABS CDO Portfolios

As noted before, TABX portfolios are drawn entirely from ABX.HE 2006-2 and 2007-1 series, which consist entirely of 2006 vintage collateral. We have already noted that 2006 vintage sub-prime collateral has demonstrated significantly weaker performance thus far, measured by 60+ day delinquencies. As such, it is doubly important to examine the extent of vintage diversity of underlying collateral in ABS CDO portfolios. Remembering again that our sample of mezzanine ABS CDOs was all from CDOs that closed in 2006, we note with some degree of surprise that there is a notable vintage diversity in the underlying collateral of our sample of ABS CDO portfolios. In the Annex, we show the vintage composition of the underlying collateral in each of the 43 ABS CDOs. Clearly, 2005 and 2006 vintages are the most

prominent vintages, but again, they are all not of the 2006 vintage as is the case with TABX portfolios.

Exhibit 6

Vintage Composition Underlying Collateral: Select 2006 Mezzanine ABS CDOs

Vintage	Average	Maximum	Std Dev
2000	0%	1%	0%
2001	0%	1%	0%
2002	0%	2%	0%
2003	1%	17%	3%
2004	9%	45%	13%
2005	57%	95%	18%
2006	32%	82%	18%
NA	1%	5%	1%

Source: Morgan Stanley and Intex

We concede that since we have Intex as our data source and there is a time lag between deals closing and details of their portfolios becoming available on Intex, our sample is biased towards the transactions that closed during the earlier half of 2006, whose warehouses started collateral acquisition possibly in 2005 in certain cases. However, we argue that this very process of collateral acquisition over time through dealer warehouses enables a certain amount of vintage diversification of the underlying collateral in ways not duplicable in TABX portfolios.

Diversity in Numbers

Each ABX sub-series consists of 20 reference obligations and each TABX portfolio has 40 reference obligations. Typical ABS CDOs have significantly larger numbers – generally over 100 underlying credits in their portfolios. As such, ABS CDO portfolios are indisputably more diversified.

Static versus Managed Portfolios

By design, the reference obligations in ABX and TABX portfolios are static. Other than differential rates of amortizations of the underlying securities, the portfolio composition does not change by substitutions. While there are a few static portfolios in the mezzanine ABS CDO space, we think that the vast majority are managed. As such, the composition of these portfolios, for better or worse, will change over time due to reinvestments and substitutions. Some managers may anticipate upcoming distress in some securities and trade out of them. It is debatable whether all managers will be able to do that, but the reference obligations in the TABX and ABX portfolios are fixed and will remain so.

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Structure Matters

There are several obvious yet significant differences in structure between ABS CDOs and TABX, as well as bespoke variations in the market. With some exceptions, mezzanine ABS CDOs come with the standard cash CDO tool box (IC and OC triggers, optional redemption, auction calls, turbo features, combinations of pro-rata and sequential principal payments). TABX and ABX inspired bespokes lack most of these features and have much simpler structures – sequential payment of principal and reverse-sequential order applied to tranche notionals for writedowns and principal shortfalls. Also, TABX and most bespokes we have seen do not include payment of interest shortfalls under the PAUG, unlike the ABS CDS in mezzanine ABS CDOs that do.

Different Technicals

Most traders and other market participants readily concede that trading volumes in ABX are relatively modest. To put this into perspective, our best guess is that daily trading volumes in ABX are about 1-4% of the daily volumes in the CDX family of indices in the corporate credit market. Under such circumstances, small changes in volume can result in material swings in the index.

We argue that the technicals in the ABX, and from what have been seen in two days in TABX trading, have a very different tone relative to single-name ABS CDS and cash ABS markets. In the single-name ABS CDS market, there is a community of protection sellers – mostly ABS CDOs and to a smaller extent hedge funds – and also a community of protection buyers – mostly hedge funds and dealers. Despite the inclination of protection sellers to want to sell protection in better credits and the tendency of protection buyers to traffic in worse credits, by virtue of market mechanism, there is a natural base of buyers and sellers of credit risk in the single name ABS CDS market. In the ABX (and by extension TABX, with admittedly limited data points) there is no natural constituency of protection sellers. CDO managers cannot and, for the most part, will not participate in an index product. To a degree, selling protection on a standardized index or tranche defeats their *raison d'être*.

On the other hand, it can also be argued that it is the strong CDO bid that has kept the ABS CDS spreads lower and cash ABS prices bid up higher than they would otherwise be. In some cases, there probably is some truth to this argument. All we would suggest is that there are strong technical forces in both markets, but their natures are very different.

Conclusions

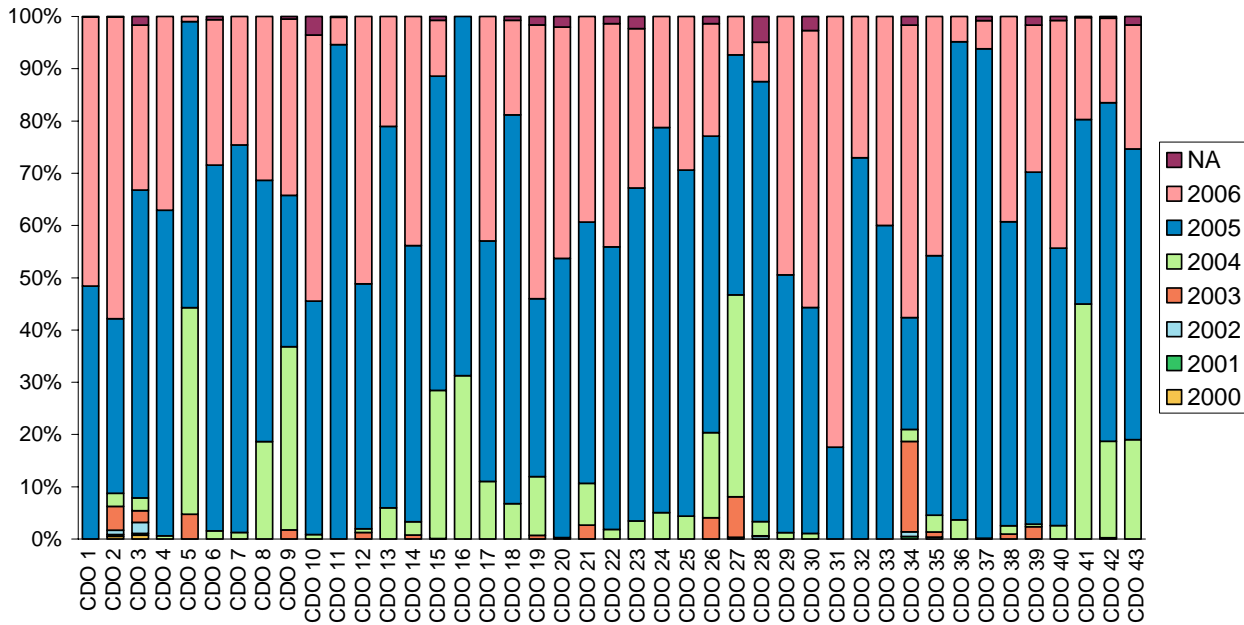
We have made the case that ABX/TABX are significantly different compared to mezzanine ABS CDOs. Whereas TABX tranches and ABX inspired bespokes are pure plays on relatively concentrated, static, BBB or BBB- HEL ABS pools of 2006 vintage, mezzanine ABS CDOs represent larger, more diversified managed pools with exposure not limited to sub-prime housing sector. Besides underlying collateral type, this diversity spans ratings as well as vintage composition of ABS CDO portfolios. Therefore, we argue that ABS CDOs do not necessarily have to follow the extent of spread widening we have seen in ABX.

That said, recent announcements by mortgage lenders do suggest that 2006 vintage collateral may end up being worse than previously perceived. Without a doubt, mezzanine ABS CDOs have exposure to this collateral and therefore need to re-price as a reaction. We expect this re-pricing to occur first in the mezzanine parts of mezzanine CDO capital structures. Just as market clearing levels for equity changed from earlier in 2006 to later in 2006, equity pricing would readjust to reflect higher asset spreads and higher costs of funding.

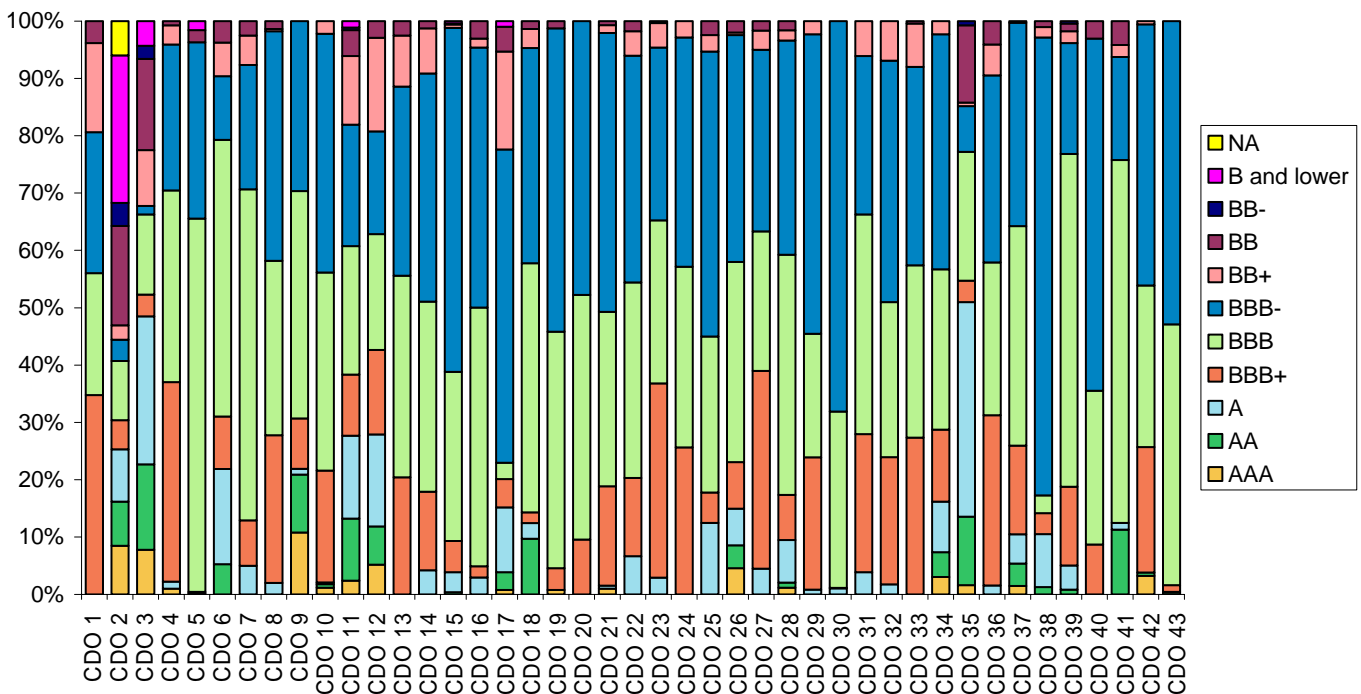
However, relative to the pure plays of ABX and TABX, the re-pricing in ABS CDOs should be relatively subdued in view of the case we have laid out. In other words, the deltas of ABS CDO tranches to changes in HEL ABS spreads are likely smaller in magnitude relative to that of TABX and ABX inspired bespokes. The reaction thus far in the ABS CDO market appears to justify the hypothesis we have posited here.

We acknowledge the contributions of Simmi Sareen to this report.

Annex
Vintage Composition Collateral in Select Mezzanine ABS CDOs



Vintage Composition Collateral in Select Mezzanine ABS CDOs



Source: Morgan Stanley, Intex

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CDO Sector Spread Data

CDO Sector Spread Data	Close as of:	Spread Change (bp)			During the past year				
		3 Months	6 Months	1 Year	High	Low	Avg	Std. Dev.	Dev. from Avg
Spreads to LIBOR	15-Feb-07								
US CLOs									
AAA Rated	25	0	1	-2	27	24	25	1	-0.1
AA Rated	40	-2	3	-7	47	36	42	2	-1.0
A Rated	70	-2	2	-10	80	66	73	3	-1.0
BBB Rated	140	-5	-5	-45	185	135	155	11	-1.4
Structured Finance (Mezzanine)									
AAA Rated (Jr)	55	11	12	-5	55	42	46	3	2.7
AA Rated	65	12	15	-5	65	48	55	5	2.3
A Rated	250	100	130	50	250	120	152	25	4.0
BBB Rated	550	225	255	150	550	295	341	47	4.4
Structured Finance (High Grade)									
AAA Rated (Jr)	47	7	8	0	47	39	43	2	1.7
AA Rated	57	7	11	0	58	46	53	3	1.5
A Rated	165	40	55	5	170	110	139	15	1.8
BBB Rated	400	110	100	70	400	290	316	21	4.0
Structured Finance (CMBS/CRE)									
AAA Rated (Sr)	26	-4	-2	-7	34	26	29	2	-1.4
AAA Rated (Jr)	31	-5	-1	-7	38	29	34	2	-1.6
AA Rated	38	-9	-1	-12	50	36	43	4	-1.3
BBB Rated	135	-30	5	-50	190	120	150	15	-1.0
European CLOs									
AAA Rated	24	2	0	-1	25	22	24	1	-0.1
AA Rated	40	5	2	2	41	35	39	2	0.8
A Rated	65	10	5	-5	73	55	62	4	0.7
BBB Rated	145	10	-5	-15	165	135	150	8	-0.6
Trust Preferred CDOs									
AAA Rated (Sr)	30	-4	-2	-3	35	28	33	2	-1.3
AAA Rated (Jr)	38	-4	-2	-7	50	38	43	5	-1.1
AA Rated	60	-5	0	-10	65	58	63	3	-1.1

Source: Morgan Stanley

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