

Residential Mortgage Outlook - More Trouble Ahead?¹

Delinquency rates on residential mortgages have risen in the last 18 to 24 months, a result of several factors, including slower economic growth, flat to declining home prices, lower credit quality and rising mortgage payments. The issue has become particularly acute in the last several weeks, as the sub-prime market has been hit by revelations about soaring delinquencies and a subsequent removal of capital for new sub-prime originations.

In this paper, we examine residential mortgage data, particularly first-lien mortgages,² for 8,683 commercial banks and thrifts. As of year-end 2006, these institutions held \$1.96 trillion in first-lien mortgages, \$216 billion in junior liens and another \$559 billion in home equity loans.

We expect delinquency rates to rise further, driven primarily by rising mortgage payments resulting from increased interest rates, and secondarily by weaker home prices and mortgage credit availability. Our base forecast for 2007 is for delinquency rates to rise to 2.6% to 2.9%, an increase of 15 to 45 basis points from year-end 2006. In our recession scenario, delinquencies would increase by approximately 100 to 150 basis points, to the 3.5% to 4.0% range. Our base forecast will likely have important implications for the industry as well as individual institutions, and our recession scenario even more so. However, it is worth keeping some perspective on the issue: even our downside forecast of 3.5% to 4.0% would not be as bad as the situation in the early 1990s, when delinquencies reached an estimated 5.5 to 6.0%.

Overall Trends

Delinquency rates on single family mortgages have been rising since 2004, mainly the result of higher interest rates. The Fed began its steady pace of tightening in June 2004, and we think it is not coincidental that residential delinquencies experienced a sharp uptick in mid-2005, as the impact of higher interest rates was felt in the form of increased mortgage payments on loans that were repricing or maturing. Delinquency rates made another sharp jump in the second half of 2006, as interest rate increases caused mortgage payments to rise further, with a particular impact on the subprime sector.

Our analysis suggests that major factors driving delin-

¹ The content of this report is partially based on Foresight Analytics' Bank Lending Reports. For more information, contact Foresight Analytics.

² Unless otherwise stated, single family mortgages analyzed are first-lien mortgages, as opposed to junior-lien or home equity loans.

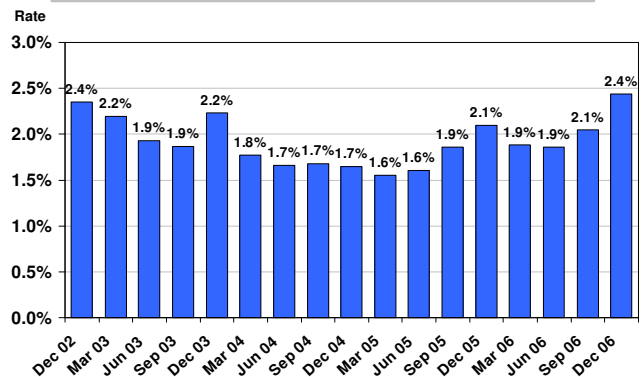
Residential Delinquency Rates Single Family First Liens

	4Q06	4Q05	4Q04	4Q03
Total	2.4%	2.1%	1.7%	2.2%
By Percentile*				
Highest 1%	42.5%	34.6%	22.8%	21.6%
Lower 99%	2.4%	2.0%	1.6%	2.2%
By Size				
> \$10 Billion	2.6%	2.1%	1.6%	2.1%
\$1 - \$10 Bill.	2.2%	2.3%	1.6%	2.4%
\$100 M - \$1 B	1.7%	1.6%	1.6%	2.1%
< \$100 Mill.	2.4%	2.2%	2.2%	2.5%

* Institutions in the highest 1% or lowest 99% by delinquency rate.

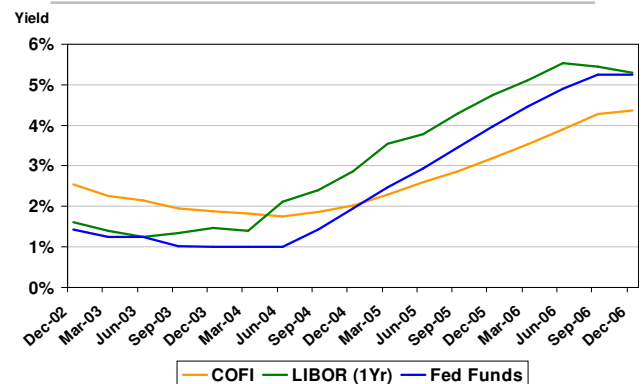
Sources: FDIC, Foresight Analytics

Delinquency Rate Single Family First Lien Mortgages



Sources: FDIC, Foresight Analytics

Rising Interest Rates 11th District Cost of Funds, LIBOR and Fed Funds Rates



Sources: FHLB San Francisco, Fannie Mae, Federal Reserve

quencies are: interest rates (by impacting mortgage payments), job growth, home price appreciation and mortgage credit availability. During 2001 to 2003, rapid cuts in short-term interest rates countered the effects of a generally weak economy, in particular, stimulating availability of credit and demand for housing. In this environment, the delinquency rate declined from 2.6% at year-end 2001 to 2.2% at year-end 2003. In 2004 and into the first half of 2005, a general economic recovery, coupled with still-low interest rates, caused delinquencies to fall further, reaching a low of 1.6% in the first quarter of 2005. During the rest of 2005 and through mid-2006, strong demand and high credit availability moderated the impact of interest rate increases, with the delinquency rate rising to 1.9% in the second quarter of 2006. In the second half of 2006, home prices leveled off or declined in most markets, and mortgage availability slowed. Although short-term interest rates have leveled off since mid-2006, they remain approximately 400 basis points above their lows in 2003 and 2004.

To illustrate the impact of higher interest rates on adjustable rate mortgages, we have calculated payments over time for a hypothetical mortgage originated at year-end 2002. We use the example of a \$242,000 mortgage, indexed on 1-Year LIBOR with a 2.5% margin. In this example, payments which started at \$1,500 per month would have risen to \$1,913 by year-end 2006, a cumulative increase of 28%. The Fed has kept the Fed Funds rate steady since June 2006, in turn causing LIBOR to remain fairly even. The 11th District Cost of Funds Index (COFI) tends to lag behind the other indices, however, so it is likely that many adjustable rate borrowers will still face higher payments, even if the Fed does not raise rates further. It should be noted that this analysis does not assume an initial teaser rate — a teaser rate at the outset of the loan would result in lower initial payments and hence

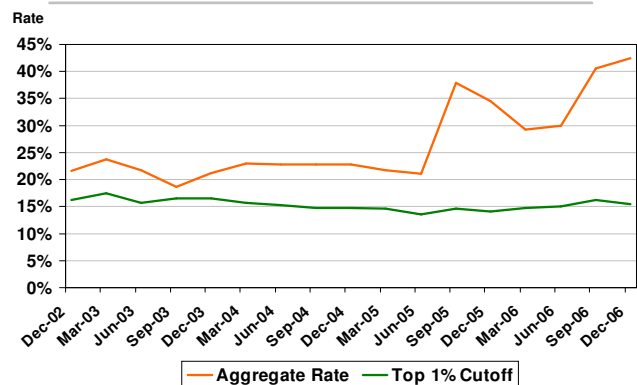
a larger increase in payments through year-end 2006.

Institution-Level Trends

An analysis of delinquency rates for individual institutions reveals that the worst problems are getting worse, no doubt a result of soaring sub-prime delinquencies. As shown in the chart below, delinquencies in the highest 1% of institutions (by delinquency rate) have soared since mid-2005. While the cutoff for the highest 1% has been relatively stable in the 14% to 17% range since 2002, the aggregate delinquency rate has increased to 42.5% as of 4Q 2006, up from 21.0% as of 2Q 2005.

The increase in delinquency rates has been more broadly based than just the subprime sector, as evidenced in the increase in the aggregate delinquency rate for the lower 99% of institutions. A histogram of institutions with rising, falling or stable delinquency rates shows a significant shift since 2004, when there were more banks with declining delinquencies than with increasing delinquencies. The shift since mid-2006 has been particularly noticeable, with

Biggest Problems Getting Worse
Delinquency Rate for Highest 1% of Institutions



Sources: FDIC, Foresight Analytics

Hypothetical Mortgage Payment Evolution Floating Rate Loan Originated in 2002

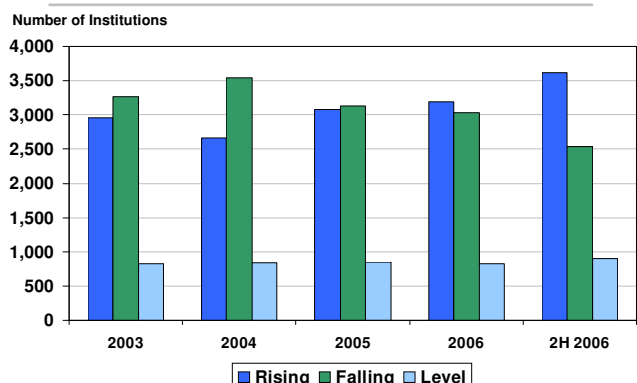
Assumptions

Loan Amount	\$242,000
Index	LIBOR (1 Year)
Margin	2.5%

	Index	Rate	Payment
At Year-End:			
2002	1.45%	3.95%	\$1,500
2003	1.46%	3.96%	\$1,501
2004	3.10%	5.60%	\$1,649
2005	4.82%	7.32%	\$1,849
2006	5.31%	7.81%	\$1,913
Feb-07	5.33%	7.83%	\$1,916

Sources: FHFB, Fannie Mae, Foresight Analytics

Delinquency Rate Trends
Banks with Rising, Falling or Level Delinquency Rates



Source: FDIC, Foresight Analytics

3,614 institutions with increasing delinquencies vs. 2,535 institutions with declining delinquency rates. We believe this is evidence of broader deterioration in the residential mortgage market.

Trends by Size Group

As a group, large banks (with single family 1st lien mortgages of \$10 billion or more) have experienced the sharpest increase in delinquency rates, with the delinquency rate increasing from 1.6% in 4Q 2004 to 2.6% in 4Q 2006. A handful of institutions in this group are primarily responsible for the sharp increase, however, it is worth noting that 28 of the 29 banks in this group experienced increasing delinquency rates during the second half of 2006.

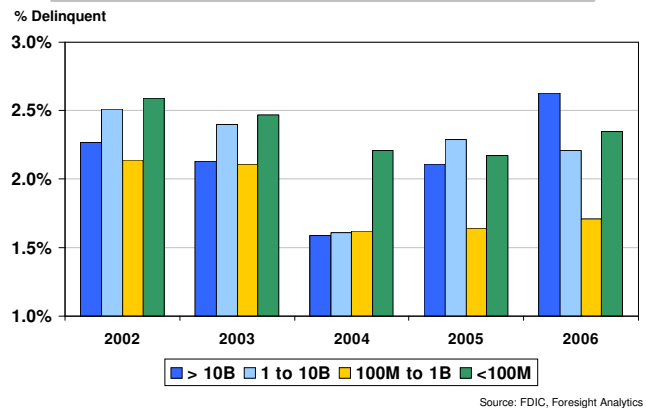
All groups have a meaningful amount of risk from repricing and maturing mortgages during 2007, as shown in the neighboring chart. As a group, smaller institutions (under \$100 million in single family 1st liens) have the highest exposure, with roughly 31% of their loans either repricing or maturing by year-end. If short-term interest rates fall, repricing could prove to be a positive factor by decreasing some payments or at least reducing the increase in payments that are resetting to higher rates. If rates rise further, however, especially without a corresponding increase in economic growth or home prices, higher payments would put further strain on borrowers and likely lead to higher delinquency rates.

Attribution Analysis

Another perspective on trends by size group is derived from analyzing the sources of institution-level over- or under-performance. Using our estimates of metro area-level delinquency rates, Foresight Analytics has analyzed delinquency performance versus the U.S. average from two sources: market exposure and underwriting / management.³ As shown in the neighboring chart, significant differences exist between size groups:

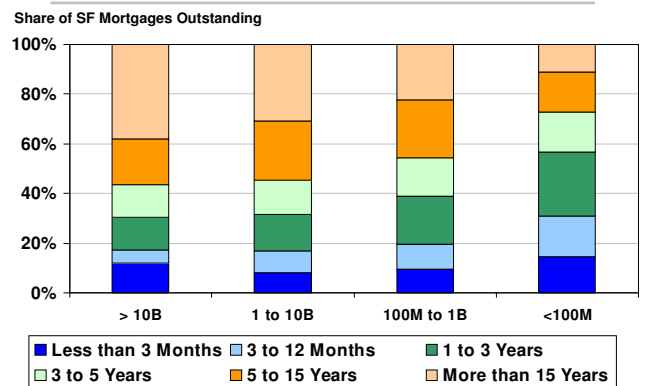
- For the largest institutions (> \$10 billion in first-liens outstanding), above-average delinquency rates are mainly the result of underwriting (e.g., credit) or management issues (+26 basis points). Because these institutions' portfolios are spread over a wide geography, market exposure is essentially neutral.
- For the next largest institutions (\$1 to \$10 billion outstanding), below-average delinquency rates stem mainly from better underwriting or management (-23 basis points). These institutions' portfolios are also

Delinquencies by Size Group
Single Family Mortgages 30 or More Days Delinquent



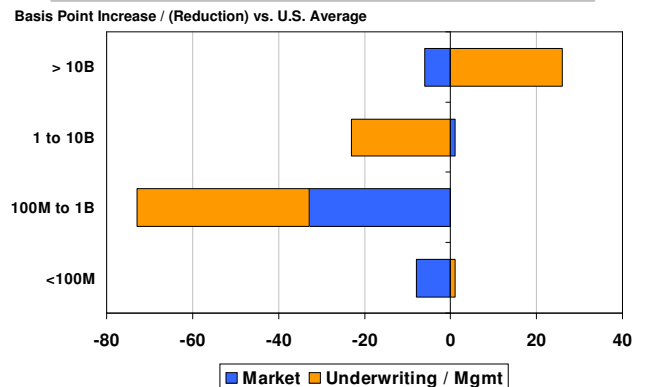
Source: FDIC, Foresight Analytics

Interest Rate Sensitivity by Size
Single Family Mortgages Repricing / Maturing, as of 4Q06



Source: FDIC, Foresight Analytics

Attribution Analysis
Source of Relative Performance, by Size Group



Source: FDIC, Foresight Analytics

³ Source: Foresight Analytics Bank Lending Report. For more information on our attribution analysis methodology, contact Foresight Analytics.

spread over a wide geography, with the result that net market exposure is neutral.

- For institutions with \$100 million to \$1 billion outstanding, below-average delinquencies were the result of both beneficial market exposure (-33 basis points) and underwriting or management (-40 basis points).
- For institutions with less than \$100 million outstanding, market exposure provided a small net benefit to performance (-8 basis points), while underwriting and management issues were neutral (+1 basis point).

Summary / Outlook

Our outlook is for a further increase in delinquencies through the end of 2007. Assuming economic conditions stay about where they are, or even strengthen slightly, we expect delinquency rates to reach 2.6% to 2.9%, an increase of 15 to 45 basis points from year-end 2006. In our Base Case Scenario, employment will grow in the 1.5% to 1.9% range, short-term interest rates will remain steady or increase in the 5.3% to 5.8% range, and home prices will increase by 2% to 4% nationally. Net real mortgage growth will be positive in the 3% to 6% range, but well below the 10% average pace since 2002.

In our Recession Scenario, delinquencies will increase by 100 to 150 basis points, rising to the 3.5% to 4.0% range. Under this scenario, employment growth will fall to between -0.5% to -1.5%, short-term interest rates will fall to 4.5% to 4.8%, home prices will decline by 0% to -2%, and net real mortgage creation will turn negative, in the 0% to -3% range.

Either forecasted delinquency rate scenario will put additional strain on the banking sector in general, and individual institutions in particular. Furthermore, problems in the securitized mortgage sector — arising from and exacerbated by sub-prime problems — could pose additional problems for the banking sector. One potential route to dealing with problem loans is to sell them off, for example, by packaging them into a securitized portfolio. However, if securitization volume drops significantly, which seems likely given the recent decrease in the market's appetite for risk in general and residential credit issues in particular, liquidity to deal with problem loans could be sharply reduced. Lower liquidity could exacerbate loan problems, pushing the delinquency rate even higher.

Delinquencies are substantially below rates of 5.5% to 6.0% in the early 1990s, but with increasing risks, we believe this sector warrants further attention.

Delinquency Rate Forecast Single Family First Liens

Scenario	Year-end 2007 Forecast
Base Case	2.6% to 2.9%
Assumptions:	
Emp. Growth: 1.5% to 1.9%	
LIBOR: 5.3% to 5.8%	
Home Prices: 2.0% to 4.0%	
Mtg Growth: 3% to 6%	
Recession	3.5% to 4.0%
Assumptions:	
Emp. Growth: -0.5% to -1.5%	
LIBOR: 4.5% to 4.8%	
Home Prices: 0% to -2%	
Mtg Growth: 0% to -3%	

Source: Foresight Analytics

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About Foresight Analytics

Foresight Analytics LLC is a California-based provider of real estate market consulting services. We focus on real estate market analysis and forecasting, for commercial and residential product types, in both domestic and international markets. Our clients are mainly institutional investors, lenders and developers.

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