Ivan Gjaja
(212) 816-8320
ivan.m.gjaja@ssmb.com

Natalia Nekipelova
(212) 816-8075
natalia.nekipelova@ssmb.com

Recent Servicing Performance of Financially Distressed Subprime Issuers

The ranks of subprime mortgage issuers have changed dramatically over the past one and a half years. Many once-dominant players have declared bankruptcy or are experiencing financial difficulties, while new entrants, often crossing from conforming or jumbo lending, have joined the ranks of subprime lenders. For ABS investors one of the key consequences of the changing issuer landscape has been a deterioration of servicing performance by financially distressed issuers, often accompanied by an issuer-specific widening of spreads (in addition to an industry-wide widening of spreads). In this article we review the recent servicing performance of three struggling or bankrupt subprime issuers (UCFC, Conti Financial, and Conseco Finance) and contrast it with the servicing performance of a financially stable subprime issuer (Saxon Mortgage).

We review the servicing performance of three distressed issuers, UCFC, Conti, and Conseco, and one stable issuer, Saxon.

Two of the issuers, UCFC and Conti, have declared bankruptcy and are no longer issuing securities backed by subprime mortgages. UCFC issued its last home equity loan (HEL) deal, 1998-D, in December 1998, and Conti issued its last, 1999–3, in June 1999. UCFC announced it was selling its servicing operations as well as certain other assets to EMC in December 1999. The transaction is expected to close in two portions, in July and September of this year. Conti announced the sale of its servicing operations to Fairbanks Capital Corporation in June 2000. The transaction is expected to be completed in 30–45 days.

The third distressed issuer, Conseco Finance (Green Tree until April 1998), is a unit of insurance company Conseco Inc. Plagued by several large writedowns, weak growth, and inadequate risk-adjusted returns in its finance subsidiary, Conseco Inc. put Conseco Finance on the market at the end of March.[15] No buyer has been announced up to this point. On the strong issuer side, Saxon Mortgage is a unit of a utility company Dominion Resources, to which it contributed 11% of the earnings in 1998. Although Dominion Resources expressed an interest in selling Saxon in

---

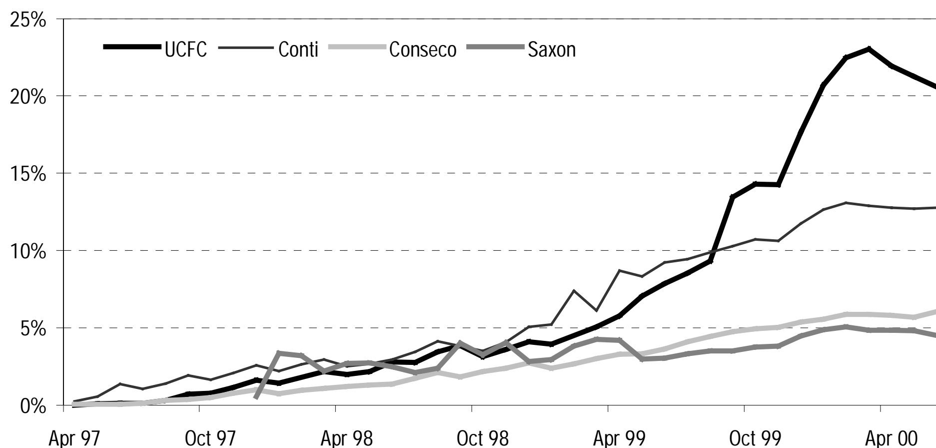
[15] See *Bond Market Roundup: Strategy*, April 7, 2000.

December 1999, the lender has enjoyed a strong backing by the corporate parent over the past several years.[16]

The quality of servicing can be quantified by the increase in the number of severely delinquent loans.

The quality of servicing can be quantified by the increase in the number of severely delinquent loans. Since the likelihood of default increases greatly when a loan is delinquent for 90 or more days, the issuer has a strong incentive to prevent a two-month delinquency from progressing further. On the other hand, once a loan has become severely delinquent, the issuer has a strong incentive to resolve the loan quickly, thereby lowering the expenses incurred from advancing interest and principal payments to the bondholder, paying for the upkeep of the property, etc.[17] Therefore a strong servicer is likely to work diligently to reduce severe delinquencies, both by preventing their occurrence and by expediting their resolution. Figure 34 shows severe delinquencies for 1997 and 1998 deals originated by UCFC, Conti, Conseco, and Saxon.[18] UCFC and Conti deals show a sharp increase in delinquencies starting at the beginning of 1999, whereas the uptick in delinquencies for Conseco and Saxon deals is much more modest.

Figure 34. Loans Delinquent 90 or More Days as a Fraction of Outstanding Balance, 1997–1998 Originations



Source: Salomon Smith Barney.

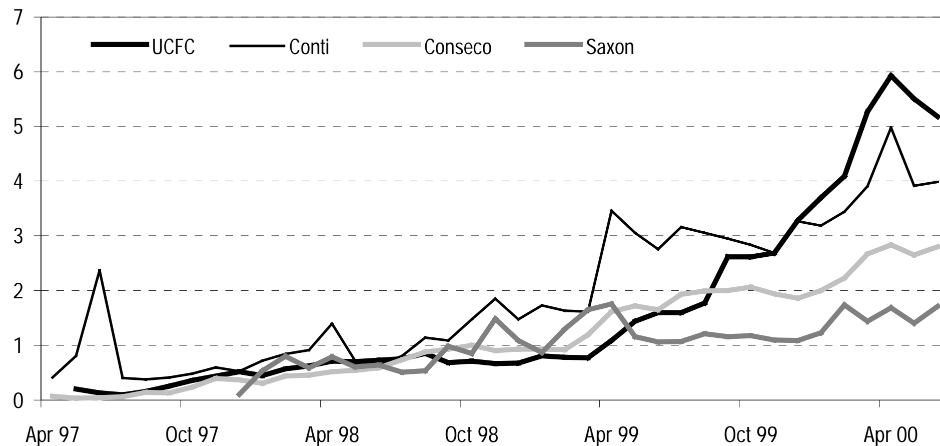
The display of servicing performance shown in Figure 34 can be refined. Since the fraction of the loan pool that becomes 90 or more days delinquent in any given month has a marked dependence on collateral characteristics in addition to servicing, we also consider the *ratio* of 90-plus day delinquencies and delinquencies of 60 or fewer days (60-minus). *This measure removes a reference to the total level of delinquencies*, showing instead the relative volume of 90-plus and 60-minus day delinquent loans. Results for the four issuers are shown in Figure 35.

[16] In the words of Dominion's CEO, Dominion Capital, of which Saxon is a unit, is a "hard-working member of the Dominion family."

[17] In virtually all cases the issuer retains a residual interest in the pool that exposes him to losses.

[18] Severe delinquencies include loans that are 90 or more days delinquent and those that are in foreclosure proceedings. We refer to these loans as 90-plus days delinquent. The delinquencies are shown as a percentage of the outstanding balance.

Figure 35. Ratio of Severe and Mild Delinquencies, 1997–1998 Originations



Source: Salomon Smith Barney.

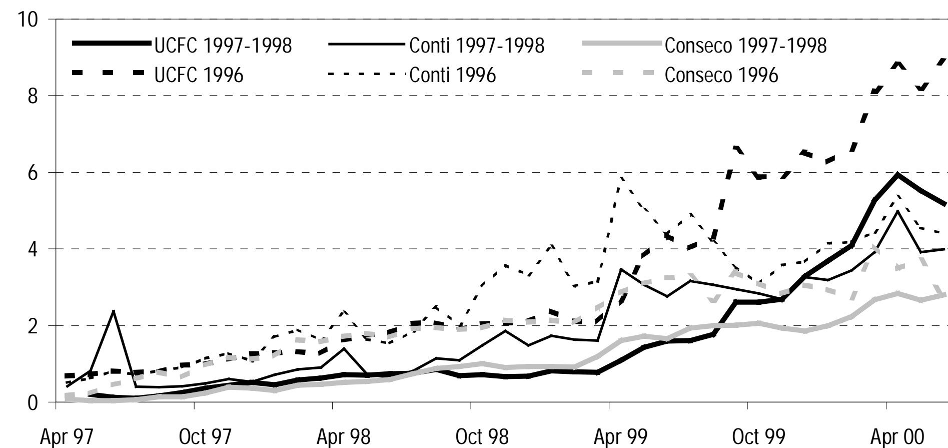
There is a large variation between issuers in the ratio of 90-plus and 60-minus day delinquencies.

In all cases, for seasoned loans the amount of 90-plus day delinquent loans exceeds the amount of 60-minus day delinquent loans, although the variation between issuers is large. For example, the ratio is about 1.7 for Saxon and about 5.8 for UCFC. The increase in the ratio is also markedly different across issuers. Between October 1998 and June 2000 the ratio of 90-plus to 60-minus day delinquencies increased at an average rate of about 0.27/month for UCFC, 0.13/month for Conti, 0.10/month for Conseco, and 0.02/month for Saxon. Of the four issuers, Saxon was the best at managing severe delinquencies for a given loan volume of 60-minus day delinquencies, and UCFC was the worst. Figure 34 and Figure 35 can also be used to show that at the beginning of 2000 the ratio of 60-minus day delinquencies for UCFC and Saxon was about 1.35. Therefore most of the differences between UCFC and Saxon in Figure 34 are owing not to differences in the volume of mild delinquencies, but in their progression to severe delinquencies.

Comparison of different vintages shows a deterioration of servicing over time.

The data in Figure 34 and Figure 35 demonstrate that the servicing procedures differ at different issuers. These figures alone, however, do not demonstrate a *deterioration* of servicing procedures for some of the issuers over time. Although indicative of poor servicing practices, the increases in the ratios shown in Figure 35 for some issuers may be customary for collateral that is not fully seasoned. To examine *changes in servicing practices*, we compare the ratios for UCFC, Conti, and Conseco shown in Figure 35, with the same ratios computed for loans originated in 1996. The results are shown in Figure 36. The difference in the average loan age between the two curves for a given issuer is about 18 months, indicating that on a loan age-adjusted basis, one should compare points on the curves separated by about 18 months.

Figure 36. Ratio of Severe and Mild Delinquencies, 1997–1998 and 1996 Originations



Source: Salomon Smith Barney.

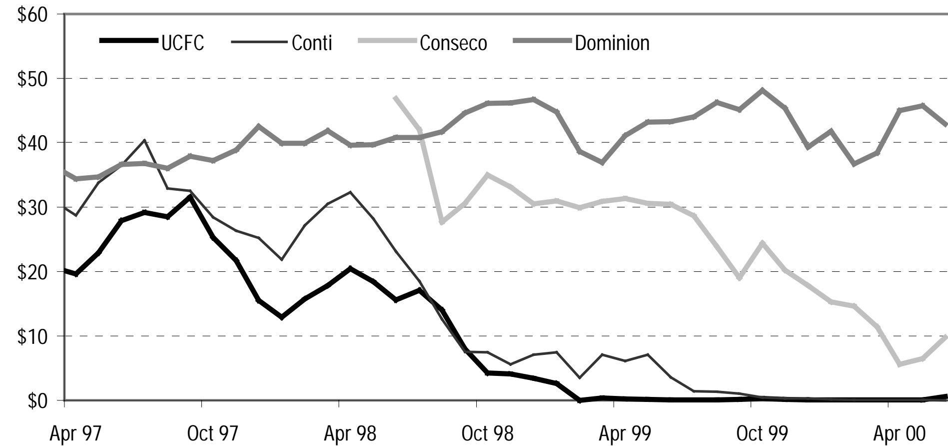
For UCFC the beginning of the sharp increase for both the 1996 and 1997–1998 vintages occurred in April 1999, implying that the servicing operation deteriorated independent of the collateral performance. The time nearly coincided with the filing for Chapter 11 bankruptcy protection, which took place in March 1999. It is likely that the incentive to continue servicing the portfolio, as well as management's focus and employee morale, declined significantly around the time of bankruptcy filing.

For Conti, the ratio of severe to mild delinquencies shows a seasonal pattern, with peaks occurring in April of each year. However, the runup in April 1999 was much stronger for 1997–1998 vintages than the similar runup for the 1996 vintage in April 1998, indicating the importance of servicing performance over collateral behavior. The pickup in the ratio for all vintages during the liquidity crises in the fall of 1998 offers another example. A similar conclusion follows from the fact that the ratio for the 1997–1998 vintage is significantly higher than the ratio for the 1996 vintage, even when lagged by 18 months. For Conseco the comparison of different vintages suggests some deterioration of servicing performance, although the effect is much smaller than for the other two issuers.

Deterioration of servicing is mirrored by the movement of stock prices and corporate credit ratings.

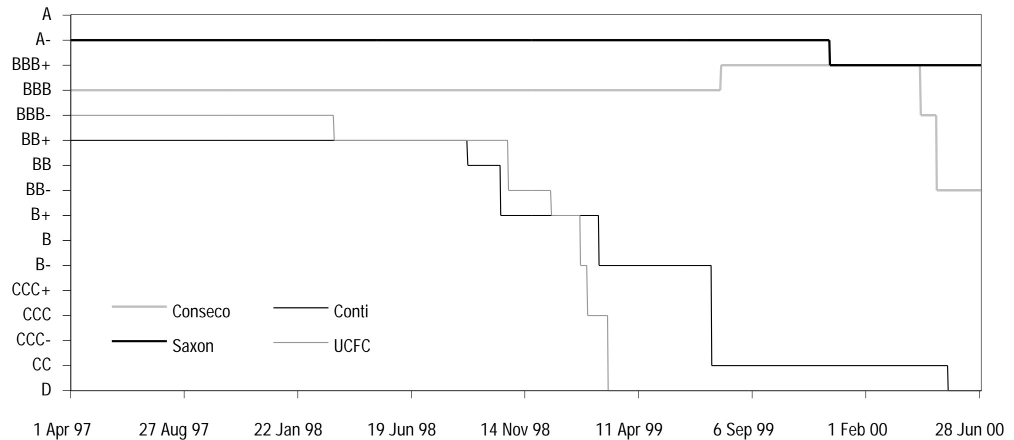
The deterioration of servicing performance for the financially distressed issuers is mirrored by the movement of their stock price and the credit rating of their corporate debt. Figure 37 shows the stock prices of UCFC, Conti, Conseco, and Dominion Resources since April 1997. (Conseco's stock price is shown only after the purchase of Green Tree Financial.) Figure 38 shows the history of Standard and Poor's ratings of senior unsecured debt.

Figure 37. History of Stock Prices for UCFC, Conti, Conseco, and Dominion, Apr 97–Jun 00



Source: Salomon Smith Barney.

Figure 38. History of Standard and Poor's Ratings for Unsecured Corporate Debt, Apr 97–Jun 00



Source: Salomon Smith Barney.

Implications for ABS Investors

Servicing performance affects bondholders directly.

A deterioration in servicing directly impairs the ability of the collateral pool to generate sufficient principal and interest payments to cover the payments due to bondholders.[19] The impact is strongest on the triple-B and single-A rated securities in a pool, but higher-rated tranches may be subject to the risk of ratings downgrades as well. For example, the double-A rated bond from the Conti 1997-1 deal was recently downgraded to single-A. Therefore it is not surprising that the deterioration in servicing, together with other negative developments that often accompany financial distress — such as increased headline risk and a decline in liquidity — lead to spread widening on the securities issued by the affected issuer. Figure 39 illustrates the development of spread tiering by comparing pricing spreads from the four issuers we discussed at four different historical periods.

[19] See *Bond Market Roundup: Strategy,* June 23, 2000, for a record of historical default and loss severity experiences for the issuers discussed here.

Figure 39. Spread Tiering Across Issuers by Deal Pricing Date

	Deal	Date	Five-Year WAL	Five-Year Spread	Long Sequential WAL	Long Sequential Spread
First-Quarter 1997	UCFC 97-B[a]	Jun 97	5	68	9.9	94
	Conti 97-2	Mar 97	5.01	73	6.95	84
	Conseco 97-A	Mar 97	5.01	71		
	Saxon 97-1	Mar 97	5.49	78	8.05	105
First-Quarter 1998	UCFC 98-A	Mar 98	5.05	98	7.50	127
	Conti 98-1	Mar 98	5.1	90	7.4	110
	Conseco 98-B	Mar 98	4.86	99		
	Saxon 98-1	Feb 98	5.9	105	7.72	145
First-Quarter 2000	Conseco 2000-B	Mar 00	4.5	137		
	Saxon 2000-1	Feb 00	4.91	128	7.9	160
Second-Quarter 2000	UCFC			210[b]		
	Conti			210[b]		
	Conseco 2000-D	Jun 00	5	195	5.71	220
	Saxon 2000-2	Jun 00	5	175	8.62	222

[a] The pricing for the first-quarter 1997 UCFC Deal (UCFC 97-A) is not available. [b] Secondary-market levels.
Source: Salomon Smith Barney.

In 1997 and 1998 Saxon traded at a discount to other issuers; now it commands a significant premium.

At the beginning of 1997 and 1998, five-year triple-A sequentials issued by Saxon Mortgage priced no less than 5bp wider than the bonds issued by other issuers. The difference for the longest triple-A sequential cash flow was even larger. Saxon was a relative newcomer to the field of subprime lending, issuing small volumes (about $680 million in 1996), whereas Conti and UCFC were much larger, well-established players and Conseco was making a large-scale entry into the HEL market, boosted by its strong reputation in manufactured housing lending. However, as problems emerged with UCFC, Conti, and Conseco, securities issued by Saxon Mortgage gained in relative value. The new issues are currently pricing 20bp tighter than Conseco HELs at the weighted average life (WAL) of five years and are not commanding a significant discount for a 2.9-year longer WAL at the long end. Although Conti and UCFC are not issuing securities anymore, the secondary trading levels for their five-year triple-A rated securities are at least 35bp wider than the levels for five-year triple-A rated Saxon securities.

Holders of long, high-rated UCFC and Conti bonds will likely benefit from the transfer of servicing.

A key question facing the holders of UCFC and Conti ABS securities is the future servicing arrangement for the outstanding collateral. The announced sales of UCFC servicing operations to EMC (a unit of Bear Stearns) and of Conti servicing operations to Fairbanks has drawn positive comments from the ratings agencies. However, it is unlikely that the new servicers will be able to return severely delinquent loans to performing status, indicating that over the next several months we may expect significant increases in losses on most UCFC and Conti deals. Going forward, though, the credit performance is likely to improve, benefiting holders of long-dated triple-A and double-A rated securities.