

The Impact of HEL Collateral Performance on Spread Tiering

Spreads on HEL securities trading in the primary or the secondary market exhibit wide variation across issuers. For example, spreads on a triple-A rated HEL sequential issued this week by Conseco Finance was about 20bp wider than the spread on comparable securities issued recently by Chase, RFC, and Saxon, and about 10bp wider than the spread on a five-year security issued by Centex. The differences are even more pronounced on longer cash flows and on lower-rated securities. Many factors contribute to spread tiering, including: (1) differences in deal structures; (2) differences in issuance volume, with the associated implications for liquidity, (3) headline risk issuer specific; (4) expected prepayment performance; and (5) expected collateral credit performance. In this article, we focus on the differences in credit performance among four representative HEL issuers.

The issuers we examined are Saxon, Conseco/Green Tree, Conti, and, for some calculations, UCFC. Saxon is an upper tier HEL issuer whose securities are viewed favorably by investors and trade roughly on par with securities issued by RFC, Countrywide, and Chase. Conseco/Green Tree's HEL securities are significantly discounted relative to the top tier, but the company is still able to place deals successfully. Conti and UCFC are in bankruptcy proceedings and are no longer issuing HEL securities. The credit performance for these four issuers explains some of the spread tiering.

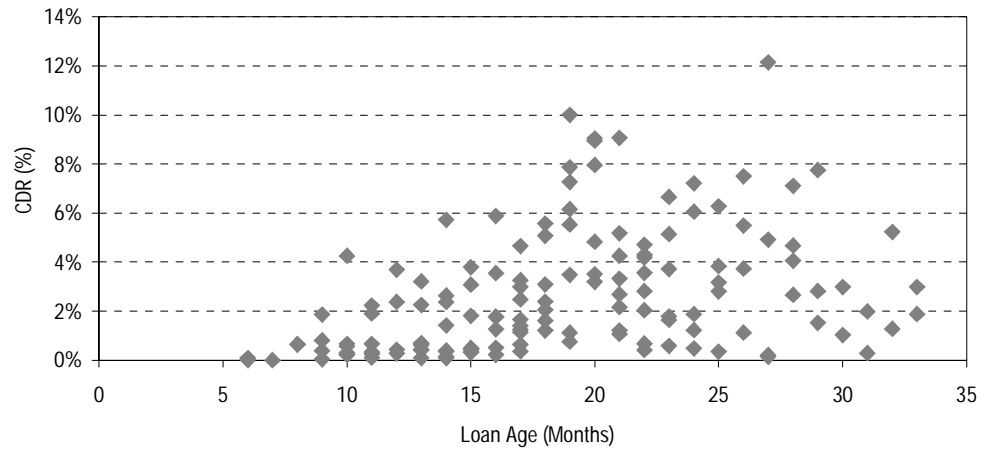
The wide variation in loss experiences for the different issuers is evident in Figures 17 through 25. The figures show defaults, loss severities, and cumulative losses for all deals issued by Saxon, Conseco, and Conti since 1995. Although the credit history is considerably shorter for Saxon than for the other two issuers, the available data indicate superior credit performance over the first three years of loan age. For example, loss severities on Saxon deals typically fall between 20% and 35%, compared with about 40% for Conti on recent deals⁷ and about 50%–70% on Conseco/Green Tree HEL deals. Similarly, the default rates on Saxon deals appear significantly lower than the default rates for the comparably aged collateral issued by Conti and Conseco.

We find that defaults and loss severity rates are significantly lower for Saxon than for the comparably aged collateral of Conseco and Conti.

The result of lower defaults and lower loss severities is lower cumulative loss, as can be seen by comparing 18 with Figures 22 and 25. At the loan age of about three years, cumulative losses on Saxon deals are about 1.0%–1.2% of the original collateral balance, compared with more than 2% for Conseco and more than 3% on recent Conti deals. Therefore, credit tiering between securities issued by Saxon and the other two issuers seems to be supported by differences in collateral credit performance.

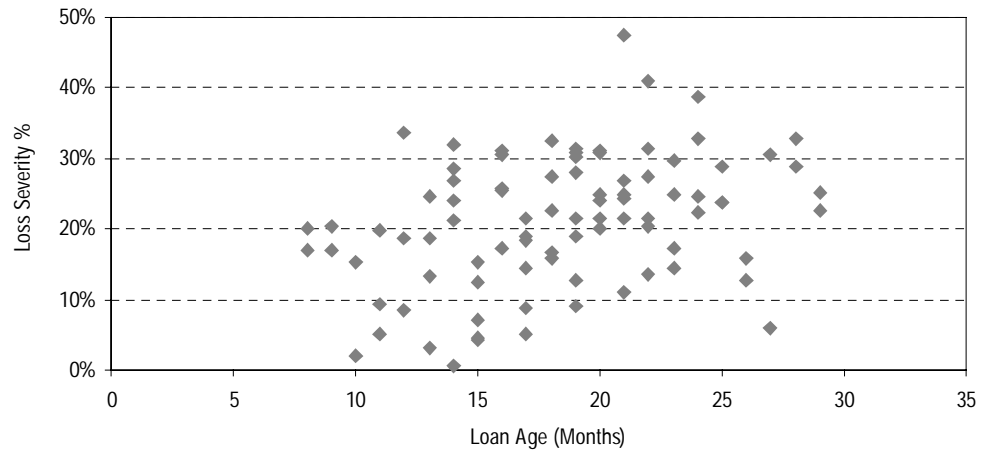
⁷ Credit performance data is available for Conti starting in February 1999, except for the 1998 vintage that starts April 1998. Therefore, lower loan ages correspond primarily to more recent deals.

Figure 17. Saxon HEL Defaults by Loan Age



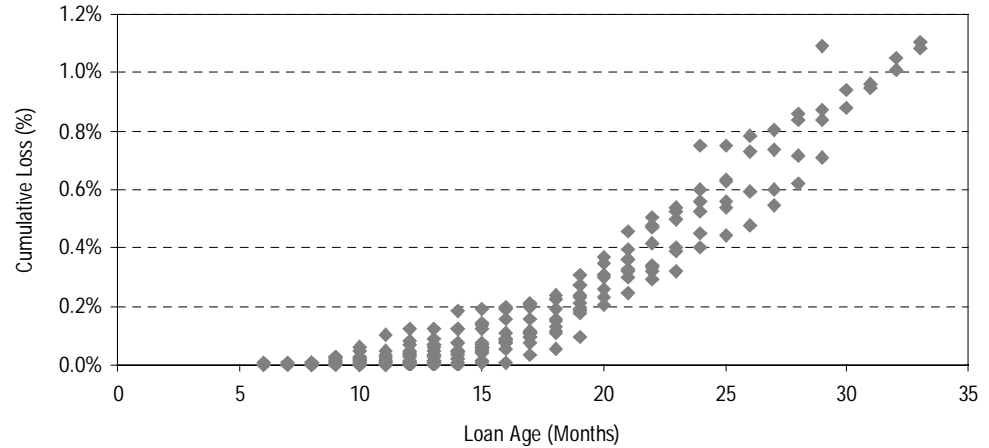
Source: Salomon Smith Barney.

Figure 18. Saxon HEL Loss Severity by Loan Age



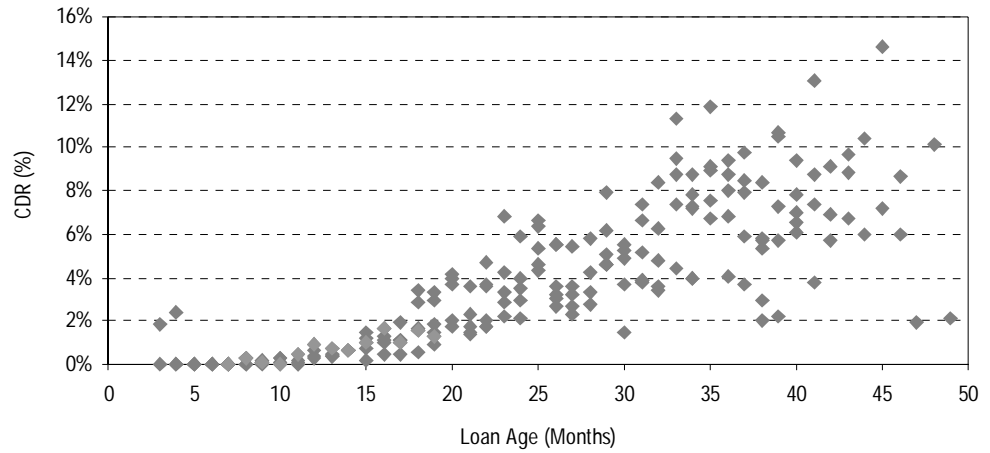
Source: Salomon Smith Barney.

Figure 19. Saxon HEL Cumulative Losses by Loan Age



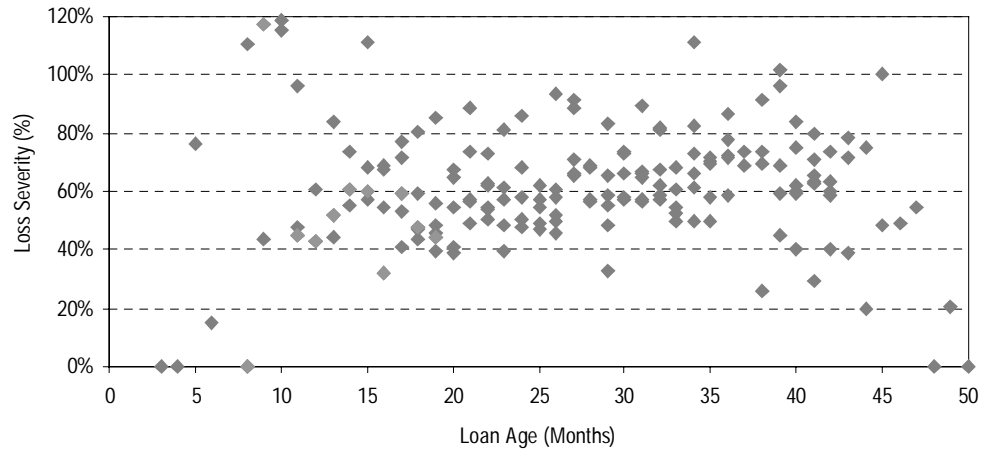
Source: Salomon Smith Barney.

Figure 20. Conseco HEL Defaults by Loan Age



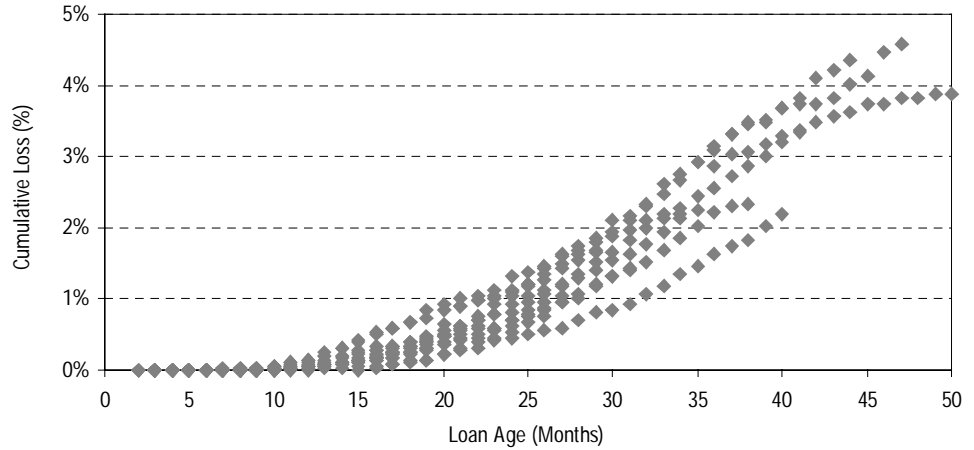
Source: Salomon Smith Barney.

Figure 21. Conseco HEL Loss Severity by Loan Age



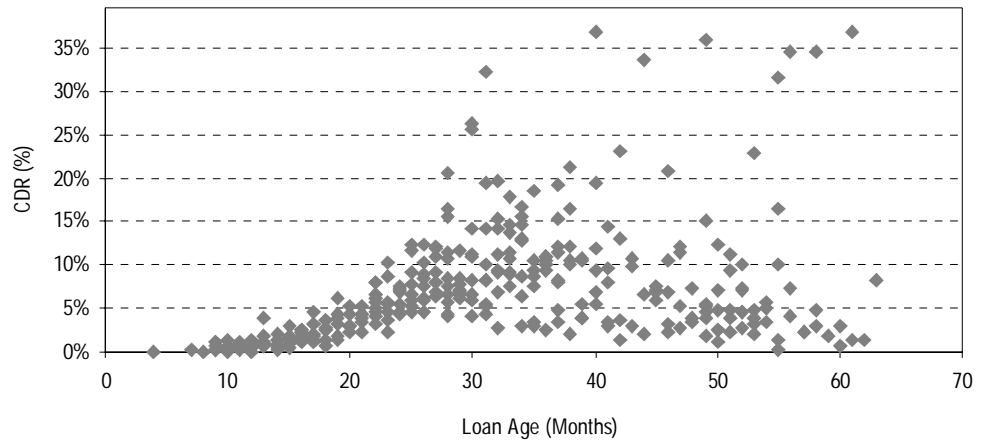
Source: Salomon Smith Barney.

Figure 22. Conseco HEL Cumulative Losses by Loan Age



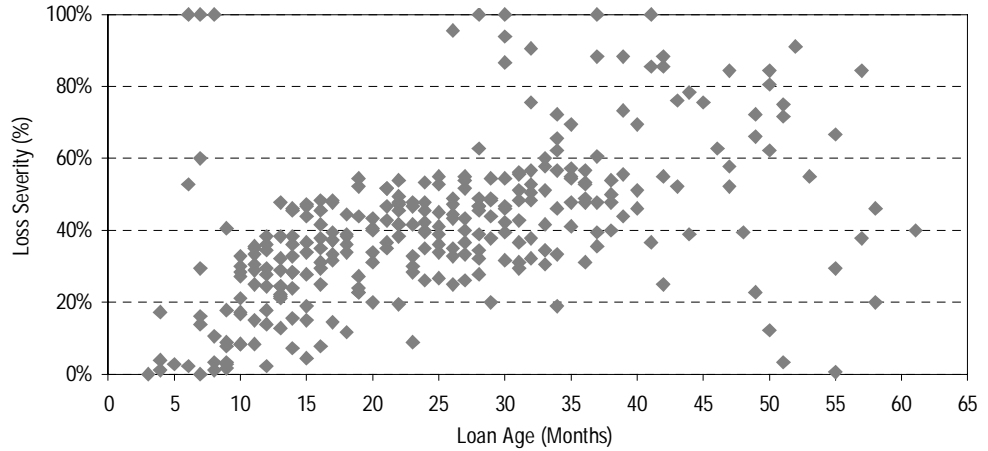
Source: Salomon Smith Barney.

Figure 23. Conti HEL Defaults by Loan Age



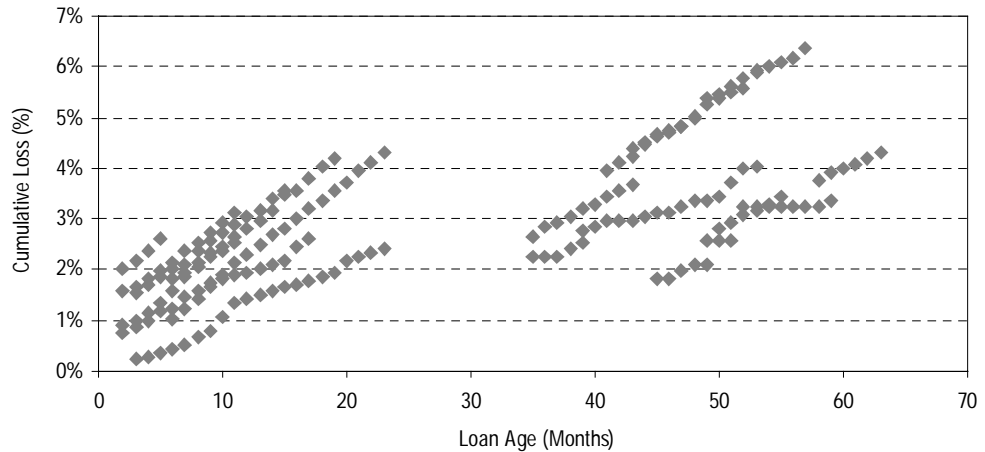
Source: Salomon Smith Barney.

Figure 24. Conti HEL Loss Severity by Loan Age



Source: Salomon Smith Barney.

Figure 25. Conti HEL Cumulative Losses by Loan Age



Source: Salomon Smith Barney.

Low default rates are not necessarily a sign of superior collateral, but can be a reflection of poor servicing, as in the case of UCFC.

In addition to the loan originator, the credit performance of HEL collateral depends on the collateral vintage and, because of changes in servicing practices, on the time at which the performance is observed. To examine some of these trends, we show the history of default and loss severities for several vintages in Figures 26 through 33. The numbers give evidence of changes in both underwriting and servicing practices by some of the issuers we surveyed.

Figures 26 through 29 show the history of default rates for collateral originated in 1996 through 1999 by Saxon, Consecoco, Conti, and UCFC. Except for 1996, the Conti collateral has exhibited the highest default rates and reached over 12% CDR for the three-year seasoned collateral.

Consecoco's default rates for 1997–1999 collateral are notably lower, with the widest differential of more than 4% observed for the 1997 collateral in March and April of this year. UCFC, while initially starting at abnormally low default rates for the collateral issued in 1997 and 1998, has experienced sharply accelerated rates of default since October of 1999 (see Figures 27 and 28), approaching those of Conti in the last few months. The most stable collateral, in terms of the lowest default rates thus far, was originated by Saxon in 1997. This collateral has been showing stable CDRs between 1% and 3% over the last 12 months.

The quality of underwriting and servicing may also significantly change the default seasoning ramp. In many cases, the default rates initially rise steadily, peak at about three years, and then decline as the collateral becomes more seasoned and borrowers build up equity. As shown in Figure 26, this has not happened for the Conti and Consecoco loans originated in 1996. In fact, between February of 1999 and this past June, the collateral, currently 44 months seasoned, was steadily defaulting at a rate between 8% and 10% CDR, with no obvious signs of slowing defaults. This stability of Consecoco's defaults is mimicked by the stability of its loss severities for the 1996 loans at about 65% over the past 12 months (see Figure 30).

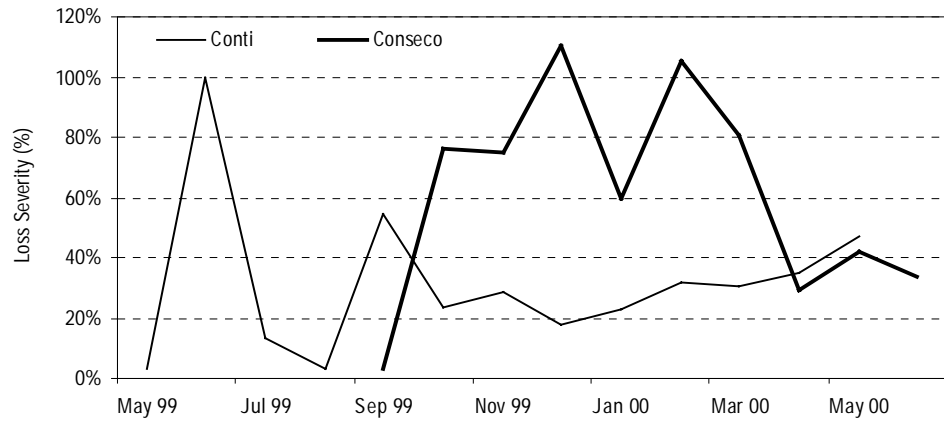
UCFC's property disposition process was poorly executed.

The shape of the seasoning ramp for UCFC default rates, shown in Figures 27 and 28, reveals that low default rates may not necessarily indicate better collateral and/or better servicing. In fact, the opposite could be the case. The default pattern may be indicative of a financially distressed issuer who is unable, or unwilling, to effectively foreclose and dispose of severely delinquent loans and finance the foreclosing costs, resulting in a slow resolution of delinquencies. Such a backloading of defaults initially results in very low reported collateral default rates. However, as delinquencies are finally resolved, the default rates increase sharply. This scenario is illustrated in Figure 27; the default rates on UCFC loans that were originated in 1997 skyrocketed from 0.5% to 10.4% over the last 12 months. Significantly, the extremely low default rates for the 1997 vintage between May 1999 and October 1999 were accompanied by a loss severity of 100%, indicating a poorly executed foreclosure and disposition process (see Figure 31). The 1998 vintage of UCFC loans has a shorter history of reported defaults, but still demonstrates a sharp increase in default rates, from 1% CDR in December 1999 to 6.2% CDR in June 2000.

Loss severity is issuer-tiered.

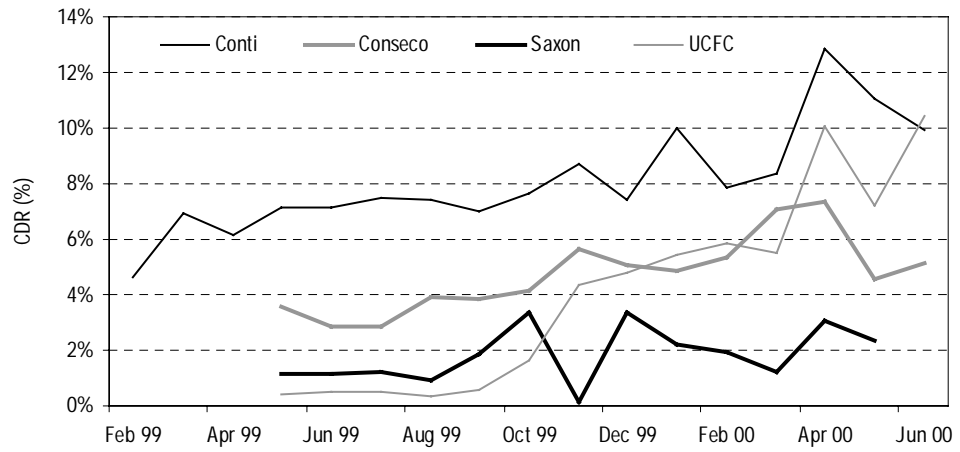
The borrowers' credit rating, along with the quality of the underlying collateral and underwriting standards, reveal themselves not only in the historical patterns of default rates, but also in the dynamics of the loss severities. Figures 30 through 33 show the same marked tiering between various issuers by vintage year with regard to loss severities. Saxon loans issued in 1998 exhibit the lowest and the most stable loss severity rates (averaging at 18.7%).

Figure 26. Defaults for 1996 HEL Origination by Conti and Cosenco



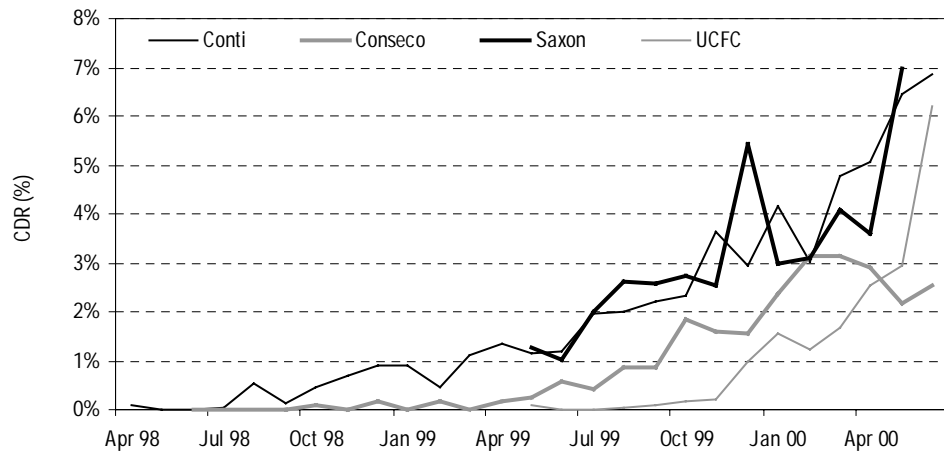
Source: Salomon Smith Barney.

Figure 27. Defaults for 1997 HEL Origination by Conti, Conesco, Saxon, and UCFC



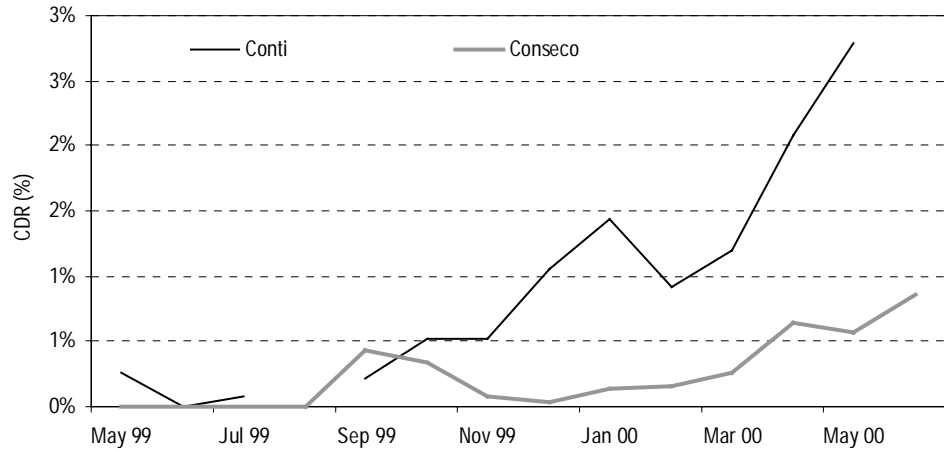
Source: Salomon Smith Barney.

Figure 28. Defaults for 1998 Origination by Conti, Conesco, Saxon, and UCFC



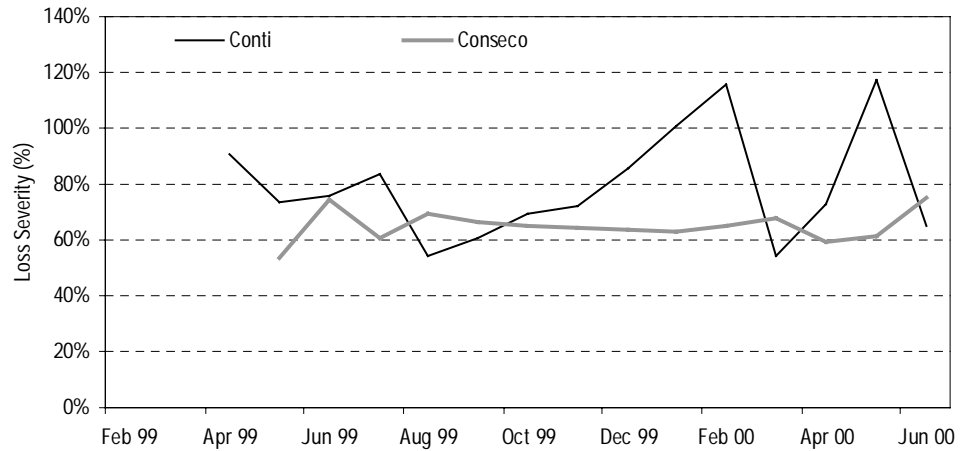
Source: Salomon Smith Barney.

Figure 29. Defaults for 1999 HEL Origination by Conti and Conseco



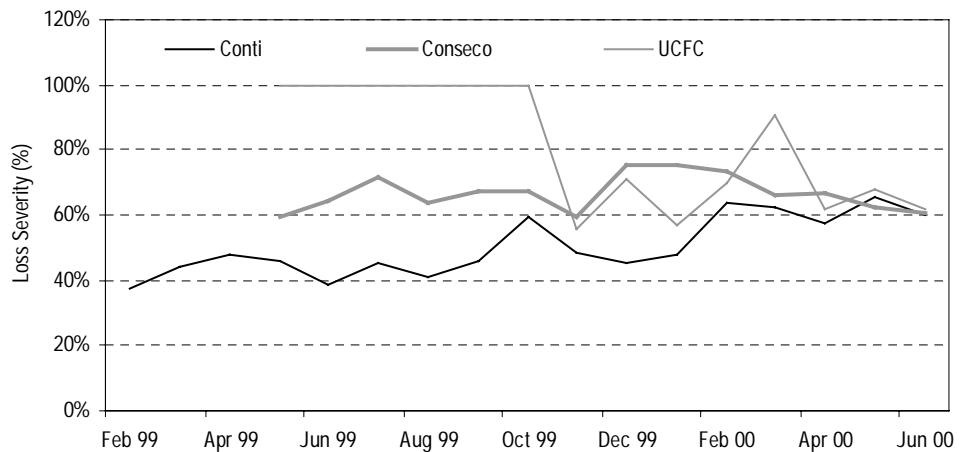
Source: Salomon Smith Barney.

Figure 30. Loss Severity 1996 HEL Origination by Conti and Conseco



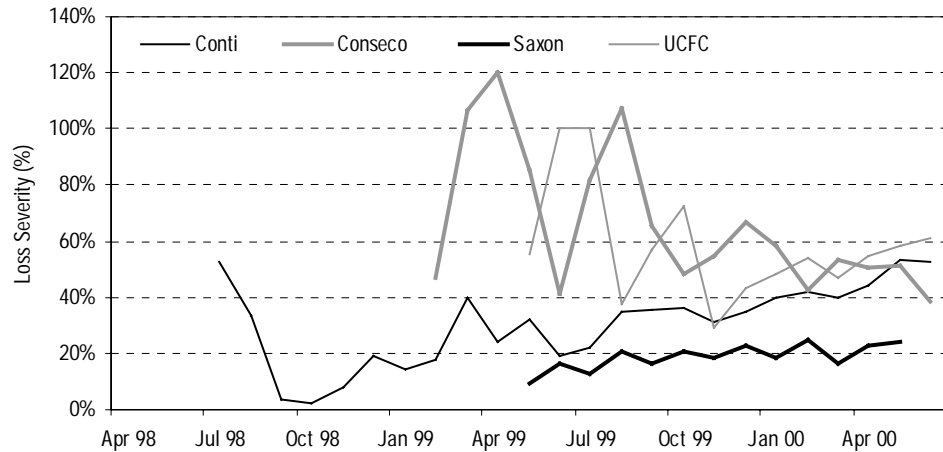
Source: Salomon Smith Barney.

Figure 31. Loss Severity 1997 HEL Origination by Conti, Conseco, and UCFC



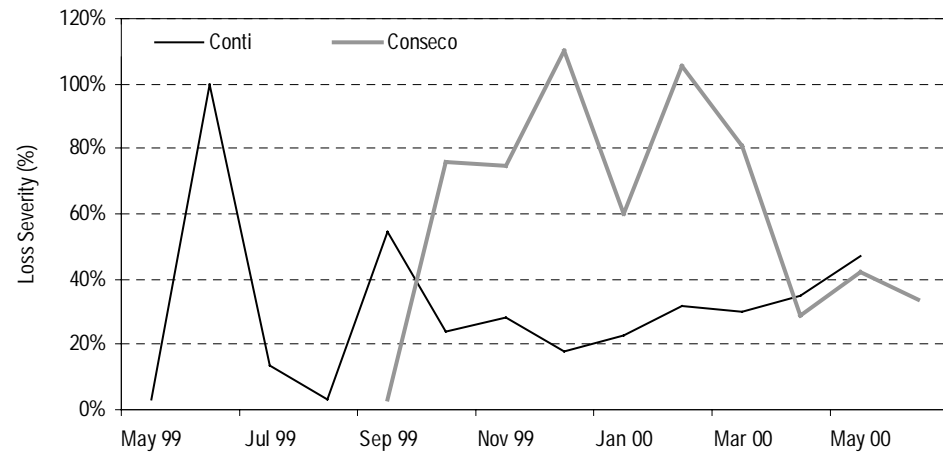
Source: Salomon Smith Barney.

Figure 32. Loss Severity 1998 HEL Origination by Conti, Conseco, Saxon, and UCFC



Source: Salomon Smith Barney.

Figure 33. Loss Severity 1999 HEL Origination by Conti and Conseco



Source: Salomon Smith Barney.

As the UCFC example shows, the quality of servicing has significant implications for the timing of defaults, likely for their cumulative magnitude and loss severities. In the next issue of the *Bond Market Roundup: Strategy*, we will review the servicing performance of several representative HEL issuers and examine the impact of the servicer's deteriorating financial condition on the quality of servicing.

The issuers surveyed in this analysis trade at levels significantly different from one another. We believe performance plays an important role in this spread tiering.

Figure 34. Percentage of ABS Floating-Rate and Fixed-Rate Issuance, Year to Date 1999–2000

	1999	2000 (YTD)
Floating-Rate	49.7%	83.0%
Fixed-Rate	50.3	17.0

Source: Salomon Smith Barney.

Figure 35. Year-to-Date ABS Issuance by Sector, 1999–2000 (Dollars in Millions)

	1999 (YTD)	Percentage	2000 (YTD)	Percentage
Auto/Vehicle Loans	\$25,219.1	25.2%	\$31,108.7	29.5%
Equipment Loans	3,322.6	3.3	4,475.2	4.2
Credit Cards	20,745.0	20.7	22,017.9	20.9
Home Equity Loans	35,908.2	35.9	31,242.9	29.6
Manufactured Housing	6,596.9	6.6	4,569.4	4.3
Student Loans	3,896.4	3.9	10,586.6	10.0
Other	4,365.4	4.4	1,430.5	1.4
Total	\$100,053.6	100.0%	\$105,431.2	100.0%

Source: Securities Data Corp.

Figure 36. Representative Fixed-Rate ABS Secondary-Market Spreads to Interest Rate Swaps

		AAA						A					BBB	
		23 Jun Swap Spread	23 Jun Spread	Spread Changes Over			1-Year SD of 1-Week Sprd Chgs	23 Jun Spread	Spread Changes Over			1-Year SD of 1-Week Sprd Chgs	Spread	Spd Chg Over 1 Wk
				1 Wk	4 Wks	52 Wks			1 Wk	4 Wks	52 Wks			
2-Yr	Retail Auto	80	8bp	0bp	0bp	-16	4.0bp	33bp	0bp	5bp	-11	4.8bp	78bp	-7bp
	Credit Card		3	-2	0	-14	3.7	27	2	4	-16	4.3	75	-5
	Equipment		25	3	7	NA	NA	50	-2	10	NA	NA	95	-2
	Stranded Assets		8	-1	-8	NA	NA	NA	NA	NA	NA	NA	NA	NA
	Home Equity		40	0	-5	-7	5.3	NA	NA	NA	NA	NA	NA	NA
	Man. Housing		40	0	-5	-4	5.1	NA	NA	NA	NA	NA	NA	NA
3-Yr	Retail Auto	87	9	-2	-2	-4	3.7	41	0	0	10	4.5	83	-8
	Credit Card		6	-1	3	-7	3.4	36	7	11	5	4.4	85	0
	Equipment		30	2	9	NA	NA	60	4	14	NA	NA	105	-1
	Stranded Assets		10	-2	-18	NA	NA	NA	NA	NA	NA	NA	NA	NA
	Home Equity		52	0	-1	5	5.1	NA	NA	NA	NA	NA	NA	NA
	Man. Housing		50	0	-1	8	5.3	NA	NA	NA	NA	NA	NA	NA
5-Yr	Credit Card	102	8	-2	0	-4	3.0	40	0	8	8	4.9	93	-7
	Stranded Assets		17	0	-17	NA	NA	125	0	10	NA	NA	NA	NA
	Home Equity		80	0	20	5	6.1	NA	NA	NA	NA	NA	NA	NA
	Man. Housing		75	0	15	16	6.4	125	0	15	NA	NA	NA	NA
7-Yr	Credit Card	111	14	-1	1	-4	4.1	51	3	11	10	5.3	105	-5
	Stranded Assets		24	1	-22	NA	NA	NA	NA	NA	NA	NA	NA	NA
	Home Equity		110	5	30	19	8.0	NA	NA	NA	NA	NA	NA	NA
	Man. Housing		100	5	15	32	7.4	NA	NA	NA	NA	NA	NA	NA
10-Yr ^a	Credit Card	125	19	0	3	4	4.4	60	6	12	15	5.5	117	-3
	Stranded Assets		28	0	-28	NA	NA	NA	NA	NA	NA	NA	NA	NA
	Home Equity		130	5	40	14	7.3	NA	NA	NA	NA	NA	NA	NA
	Man. Housing		115	7	20	19	6.8	NA	NA	NA	NA	NA	NA	NA

As of April 14, spreads are quoted versus interest rate swaps. Historical spread data was converted into spreads to swaps in order to avoid distortions in historical comparisons.

SD Standard Deviation. Source: Salomon Smith Barney.

Figure 37. Representative Floating-Rate ABS Secondary-Market Discount Margins (Over One-Month LIBOR)

		AAA					A					BBB	
		23 Jun Spread	Spread Changes Over			1-Year SD of 1-Week Sprd Chgs	23 Jun Spread	Spread Changes Over			1-Year SD of 1-Week Sprd Chgs	23 Jun Spread	Spd Ch Over 1 Wk
			1 Wk	4 Wks	52 Wks			1 Wk	4 Wks	52 Wks			
2-Year	Retail Auto	8bp	-3bp	-3bp	-4bp	1.0	31bp	0bp	0bp	-1bp	1.9	80bp	-1bp
	Credit Card	6	-2	-2	-4	0.9	28	0	5	-2	1.9	75	-5
	Home Equity	25	1	0	-2	1.1	90	0	NA	NA	NA	NA	NA
3-Year	Retail Auto	14	0	0	1	0.8	36	0	-8	4	2.0	85	-6
	Credit Card	9	-1	-1	-4	0.8	32	0	4	0	1.6	85	0
	Home Equity	27	0	0	-2	1.4	95	0	8	3	NA	NA	NA
5-Year	Credit Card	15	-1	-1	-4	0.9	42	0	6	3	2.4	95	-5
	Home Equity	32	0	-1	2	2.0	100	0	10	5	2.9	NA	NA
7-Year	Credit Card	19	0	-1	-4	1.0	52	0	7	7	1.8	105	-5
10-Year	Credit Card	24	-1	-1	-5	1.1	55	0	0	-7	1.9	115	-5

LIBOR London Interbank Offered Rate. SD Standard deviation.

Source: Salomon Smith Barney.

Figure 38. Floating-Rate CLO and CDO Indicative Discount Margins (Over Three-Month LIBOR)

	US Collateral, Prime-Quality CLO Balance-Sheet-Driven		High Yield Collateral CDO Investor-Driven	
	3-Year	5-Year	7-Year	10-Year
AAA	25bp	28bp	48bp	55bp
AA	—	—	70	75
A	65	70	120	130
BBB	—	—	220	230
BB	—	—	600	615

CLO Collateralized loan obligation. CDO Collateralized debt obligation.

Source: Salomon Smith Barney.

Figure 39. Recent Issuance

Date	Issuer	Asset Type	Class	Size (Mil.)	Credit Enhancement	WAL (Yrs)	Rating Moody's/S&P	Spread
21-Jun-00	Conseco 2000-D	DF	A-1	356.00	FSA Surety Bond	1.00	Aaa/AAA	45/EDSF
			A-2	74.00		2.00	Aaa/AAA	130/6.25 6/02
			A-3	226.00		3.00	Aaa/AAA	155/5.50 5/03
			A-4	141.00		5.00	Aaa/AAA	195/6.50 8/05
			A-5	138.00		5.71	Aaa/AAA	220/6.88 5/06
			B	6.00		4.71	Baa1/BBB	515/7.50 7/05
21-Jun-00	First International Bank 2000-A	BA	A	56.55		3.69	Aaa/AAA	58/1M LIBOR
			M1	2.60		3.69	A2/A	125/1M LIBOR
			M2	2.60		3.69	Baa2/BBB	225/1M LIBOR
			B	3.25		3.86	Ba2/BB	575/1M LIBOR
19-Jun-00	ARG Funding	AL		500.00		3.25	Aaa/AAA	21/1M LIBOR
19-Jun-00	Chase Funding 2000-2	HE	I-A1	39.00	Sr./Mezz./Sub.	0.96	NR/AAA	12/LIBOR
			I-A2	18.50		2.15	NR/AAA	115/6.375 8/02
			I-A3	17.50		3.14	NR/AAA	137/5.375 8/03
			I-A4	20.50		5.11	NR/AAA	170/6.125 8/07
			I-A5	16.28		9.42	NR/AAA	223/4.75 11/08
			I-A6	12.42		6.72	NR/AAA	155/6.50 10/06
			I-M1	4.05		6.61	NR/AA	205/6.50 10/06
			I-M2	3.71		6.61	NR/A	235/6.50 10/06
			I-B	3.04		6.51	NR/BBB	RETAINED
			II-A1	279.50		2.45	NR/AAA	28/1M LIBOR
			II-M1	17.88		4.92	NR/AA	55/1M LIBOR
			II-M2	15.44		4.86	NR/A	90/1M LIBOR
			II-B	12.19		4.81	NR/BBB	180/1M LIBOR
19-Jun-00	Dillard CCMT 2000-1	CC	A	200.00	Sr./Sub.	4.97	Aaa/AAA	27/1M LIBOR
16-Jun-00	Associates Auto 2000-1	AL	A-1	207.00	Sr./Mezz./Sub.	0.33	P-1/A1+	2/4M LIBOR
			A-2	92.00		1.00	Aaa/AAA	15/9M LIBOR
			A-3	301.00		1.89	Aaa/AAA	25/2YR MD-MKT SWAPS
			M	65.00		2.84	Aa1/AA	47/3YR MD-MKT SWAPS
			B	85.00		3.79	A2/A	80/4YR MD-MKT SWAPS
16-Jun-00	Chevy Chase Auto 2000-1 ^a		A1	\$79.00		0.34	A1+/P1	0/4M LIBOR
			A2	70.00		1.00	Aaa/AAA	16/EDSF
			A3	111.00		2.00	Aaa/AAA	23/INTERP SWAPS
			A4	73.50		3.34	Aaa/AAA	30/INTERP SWAPS
			B	7.06		4.15	A2/A	60/INTERP SWAPS
			C	8.82		4.15	Baa2/BBB+	100/INTERP SWAPS
16-Jun-00	GMAC Swift VI ^a	DF	A	\$1,250.00		4.80	Aaa/AAA	13/3M LIBOR
16-Jun-00	Toyota 2000-A ^a	AL	A-1	305.00		1.00	Aaa/AAA	11/12M SYNTH LIBOR
			A-2	523.00		2.00	Aaa/AAA	13/2YR SWAPS
			A-3	277.00		3.29	Aaa/AAA	16/3YR SWAPS
15-Jun-00	Greenpoint FSPC T-26	HE		\$240.00	Agency Gty	3.40	NR	13/1M LIBOR
				112.00		2.78	NR	25/1M LIBOR
15-Jun-00	Nissan 2000-B ^a	AL	A-1	\$225.00		0.30	P-1/A-1+	0/4M LIBOR
			A-2	286.75		1.00	Aaa/AAA	13/SYNTH 12M LIBOR
			A-3	288.00		2.00	Aaa/AAA	17/2YR SWAPS
			A-4	81.00		2.90	Aaa/AAA	20/3YR SWAPS
14-Jun-00	American Business Financial 2000-2	HE	A-1	\$255.00	100% AMBAC Wrap	3.30	Aaa/AAA	162/5.25 8//03
			A-2	45.00		3.30	Aaa/AAA	33/1M LIBOR
14-Jun-00	RASC 2000-KS3 ^a	HE	AI1	\$170.00	100% AMBAC Wrap	0.86	Aaa/AAA	11/1M LIBOR
			AI2	70.00		2.08	Aaa/AAA	115/6.25 6/02
			AI3	70.00		3.09	Aaa/AAA	135/5.38 6/03
			AI4	90.00		5.10	Aaa/AAA	171/6.50 8/05
			AI5	50.00		8.49	Aaa/AAA	222/4.75 11/08
			AI6	50.00		6.46	Aaa/AAA	153/6.50 10/06

^a Salomon Smith Barney has acted as a manager and/or co-manager of debt issues of this issuer within the past three years.

ABS Asset-backed securities. AD Auto dealer floor plan. AIR Airplane leases. AL Auto loan. ALE Automobile lease. BL Boat loan. CA Controlled amortization. CC Credit card. CCA Cash collateral account. CHC Charge card. CIA Collateral invested amount. CON Consumer loans. DF Dealer floor plan. EL Equipment loan. FEL Farm equipment loan. FF Fed funds. Whole first and second liens. FR Franchise loan. HE Home equity. HIL Home Improvement loan. MB Mortgage-backed. Mezz. Mezzanine. MH Manufactured housing. ML Motorcycle Loans. NA Not available. O Other. OC Overcollateralized. RIC Retail installment contracts. RV Recreational vehicle. BA Small business association loans. SL Student loan. TL Truck loan. Sub. Subordinate. UBA Utility bill allocations. WAL Weighted average life. WHL Wholesale inventory. WI When issued

Source: MCM "Corporatetwatch."