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International
Special Report

Excess Spread: Friend or Foe?
A Look at Prepayment Risk in Brazil

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Summary
The inherent risk of prepayment to investors in several Latin American structured finance markets has become increasingly evident. Greater competitive lending, fueled by steadily declining market interest rates, stable economic fundamentals and a growing track record of low-level inflation, has created incentive for expanding credit lending and, hence, the propensity for individuals to refinance existing higher cost obligations for new lower cost alternatives.

The goal of this report is to increase investors' awareness to the inherent risks of prepayments in their effects on available credit enhancement in residential mortgage-backed securities (RMBS) and asset-backed security (ABS) transactions across Latin America. These risks are highlighted through recent experiences involving prepayment in the Chilean and Colombian local structured finance markets. Furthermore, Fitch Ratings alerts to the potential effects of prepayments on ABS and RMBS transaction performance in other Latin American markets, such as Brazil.

Prepayments
For an ABS or RMBS transaction, prepayment is the repayment of a loan balance ahead of its expected principal repayment schedule. Such prepayment results in a reduction in expected cash flows originating from a loan portfolio. Prepayment usually occurs either due to a borrower refinancing the existing loan with one that is more attractive or repaying voluntarily after a change to their financial circumstances.

In measuring prepayment speeds in a securitized loan portfolio, Fitch calculates prepayments using a constant prepayment rate (CPR). This rate is expressed as the sum of all prepayment proceeds received in a given month divided by the beginning month's outstanding loan portfolio balance. This percentage is then annualized.

Effects on Credit Enhancement
In Latin America, credit enhancement in ABS and RMBS transactions is generally composed of available excess spread and subordination as protection for the senior class issuance. Excess spread is calculated as the effective loan portfolio yield, less servicing and transaction expenses and coupon interest to the senior class issuance. Such spread is available to absorb the portfolio's delinquent interest and loan chargeoffs. However, prepayments will reduce available excess spread by compressing the securitized portfolio's effective yield. In revolving transactions, which permit ongoing new purchases of loans with available cash flow, the transaction's portfolio yield can also be pressured, as these new loans are originated at lower interest rates.

Depending upon the senior/subordinate capital structure of the transaction, prepayments can also affect subordination/overcollateralization (OC) and, ultimately, senior issuances. Subordination is the issuance of one or more classes of junior notes, which are subordinated in favor of the senior notes, thereby providing the senior tranches with protection against losses. OC consists of the loan portfolio collateral amount in excess to the transaction's debt issuance. Depending upon the cash flow structure of the transaction, all of the principal and interest on the junior notes or just the principal may be subordinated for the benefit of the senior notes. In a situation where the outstanding principal balance of the loan portfolio is greater than the sum of the class issuances, it can be understood that the most subordinate class of debt may be partially or solely reliant upon excess spread to meet the subordinate's interest and principal obligations (please see the example in the Brazil section on page 4).

■ Chile

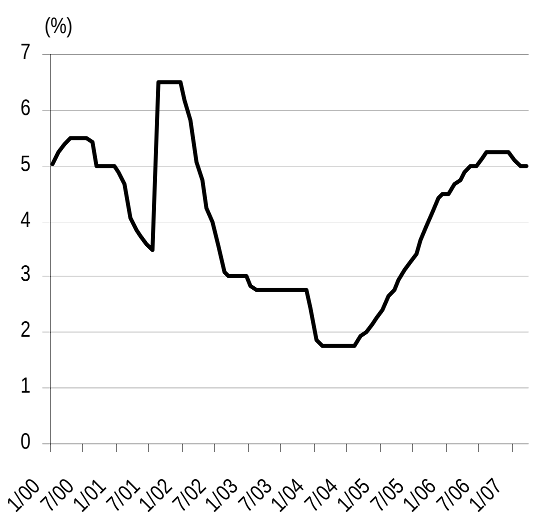
Over the course of 2004 and 2005, several factors regarding the Chilean mortgage market resulted in a substantial increase in loan prepayments in the sector. This had a negative effect in many existing RMBS transactions in the country. In Fitch's view, four key elements caused a sharp rise in prepayment rates: low interest rates, the introduction of new mortgage products, the increased competitive landscape of the mortgage market and lower costs for refinancing.

Fitch considers that the high prepayments rates in the RMBS market can mostly be explained by the overall decline in market interest rates in the preceding years. In the first half of 2004, interest rates reached a historical low. At the same time, mortgage-lending banks sought to diversify mortgage product lines, introducing adjustable-rate mortgages (ARMs), which results in introductory "teaser" interest rates over a certain period of years of the loan. In result, mortgage origination in Chile doubled year over year between 2003 and 2004. Incentive for prepayment was also fostered by regulatory initiatives in 2002, which eliminated prepayment penalties for existing mortgages.

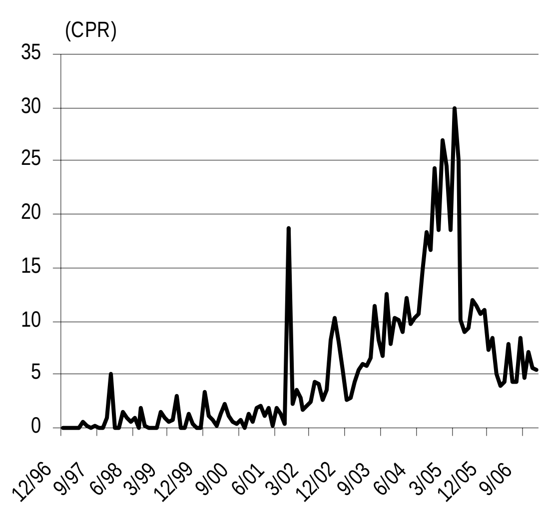
Although these high prepayment rates were widespread across the Chilean mortgage market, their degree of effect varied by borrower type. Prepayment rates among prime mortgage borrowers tripled from historical levels. Subprime borrower prepayment doubled over this period, albeit below that registered by the prime segment.

Prepayment rates in the low-income segment (which is basically composed of leasing contracts) also doubled in the same period. However, these rates have represented one-tenth of subprime borrower rates. Such a lower susceptibility to prepayment is due to a relatively low competitive environment for financing this segment, which is subsidized by the Chilean government. The subsidies offered in leasing

Chile — Central Bank Interest Rate

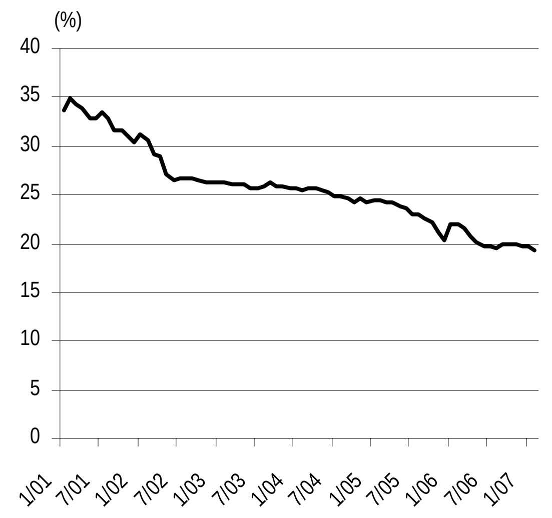


Chile — Subprime Mortgage Loans



CPR – Constant payment rate.

Colombian Market Interest Rate — Consumer Loans



contracts originated prior to 2004 highly discouraged prepayments, since these subsidies are paid out over the life of the loan and are lost once the borrower prepays. Leasing contracts originated post 2004 received full subsidies at closing and did not have a negative influence on incentive for prepayment by the borrower.

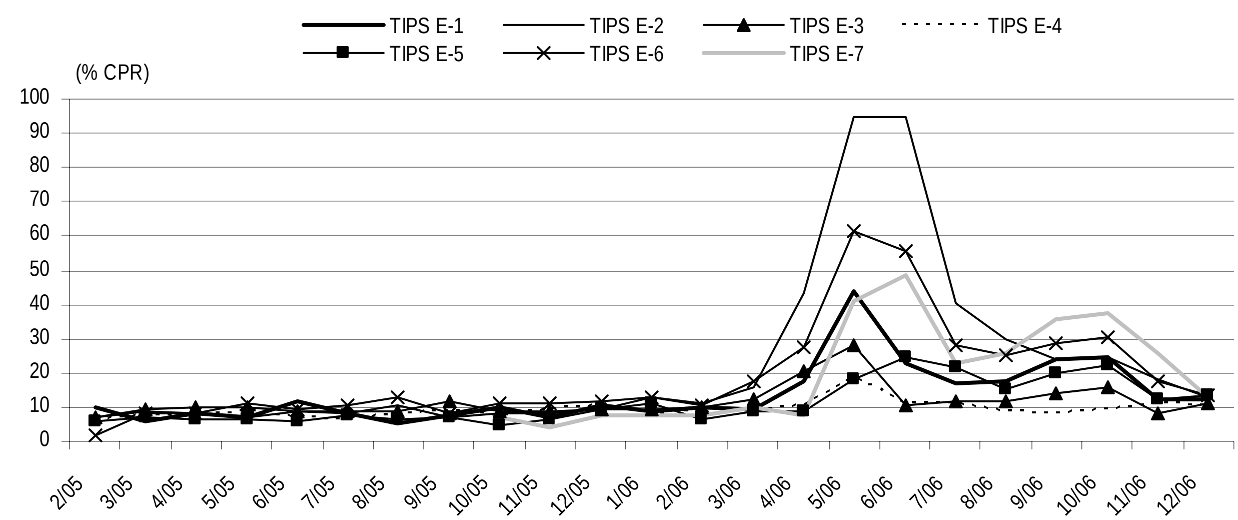
Currently, prepayment rates have gradually returned near to pre-2004 levels as market interest rates began to move upward between 2005 and 2006. This market trend highlights a modest correlation between prepayment rates and market interest rate movements as a predominant driver.

Colombia

During the second quarter of 2006, Colombia's RMBS market began to experience substantial increases in prepayment levels of securitized mortgage portfolios in prior years. Such prepayment was sparked by a steady decline in Colombia's market interest rates over the past few years, which translated into an important reduction in lower interest rates for new mortgages. In 2006, financial institutions initiated aggressive strategies to gain market share by offering historically low mortgage interest rates. In line with these strategies, new products were offered to new and existing homeowners, such as indexed and fixed-rate mortgages. These attractive financing alternatives drove many existing homeowners to refinance mortgages, which consequently were previously securitized.

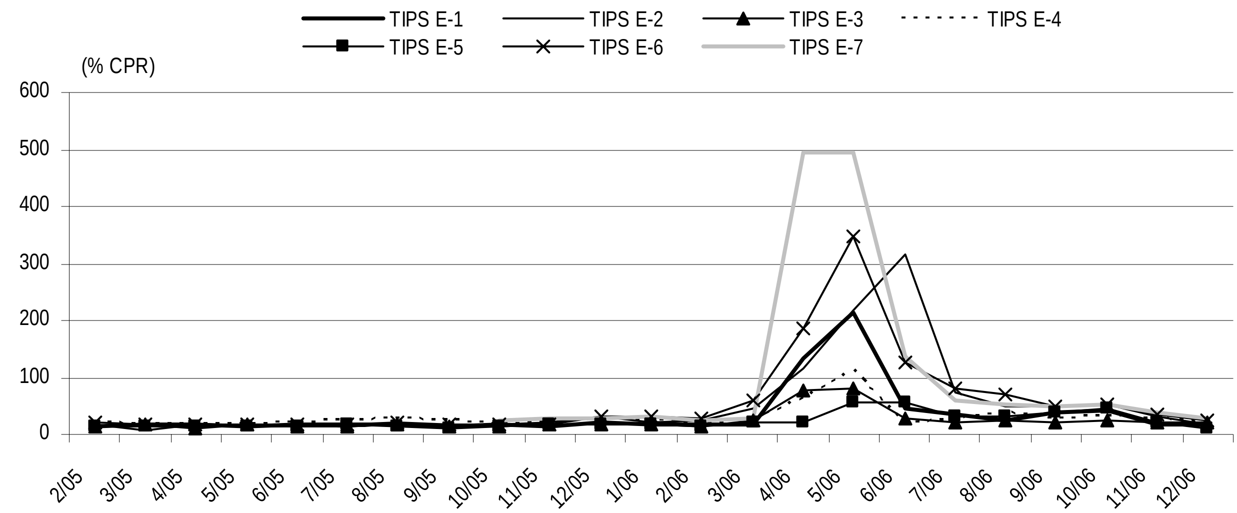
Overall, seven outstanding RMBS transactions issued by La Titularizadora Colombiana were affected by the rising prepayments (TIPS E-1, TIPS E-2, TIPS E-3, TIPS E-4, TIPS E-5, TIPS E-6 and TIPS E-7). These transactions were composed of 2–3 classes of debt, allocating cash flows in a pro rata pay structure. Under this capital structure, the lowest class of debt essentially was fully or partially funded by excess spread to be derived from the loan portfolio. Therefore, this class of

Colombia — Subprime Mortgage Loans (VIS)



VIS – Vivienda de Interés Social. CPR – Constant payment rate. Source: Titularizadora.

Colombia — Prime Mortgage Loans (No-VIS)



VIS – Vivienda de Interés Social. CPR – Constant payment rate. Source: Titularizadora.

debt's service is contingent upon the acquired loan portfolio's yield, less transaction expenses and senior class interest payments.

As prepayment rates rose over the course of 2006, available excess spread was dramatically reduced. As a result, Duff & Phelps de Colombia, an affiliate of Fitch, downgraded the majority of the most subordinate class issuances of these transactions to 'CCC' from 'BBB' and 'A' to reflect the increased probability of default. Ratings of the most senior classes of debt were maintained.

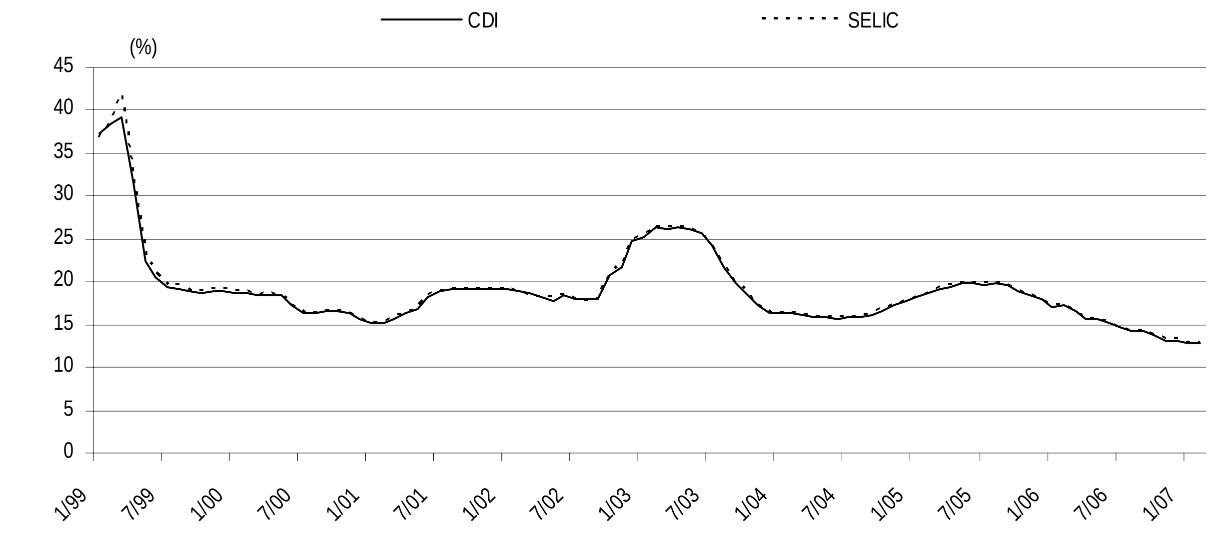
In addition to the effect of prepayments during 2006, in August of that year, Colombia's central bank issued Resolution No. 8, which reduced capped home loan interest rates from 13.9% to 12.7% per annum. This rate cap initiative was implemented retroactively, affecting all unsubsidized (No-VIS) loans that yield interest above the newly established 12.7% cap. This regulatory event further reduced available excess spread to subordinate classes of structured transactions.
The securitized mortgage portfolios are composed of prime and subprime mortgages, which are denominated as VIS and No-VIS, respectively. In general, prime mortgage borrowers are well-informed individuals as to market changes and have greater and easier access to a wider range of financing alternatives. To the contrary, subprime borrowers generally have limited access to financial institutions, are considered to be of high credit risk and are generally offered shorter term financings. Given these fundamental differences between borrower types, it is logical that prepayment behavior varied. Throughout 2005, the CPR averaged 18% and 8%, respectively, for the prime and subprime loan portfolios of the above-mentioned transactions. As CPR peaked in the second quarter of 2006, average prepayment for subprime reached 34%, while prime rose to and average 186%. After implementation of the interest rate cap in August, the CPR steadily returned to near historical levels by year-end 2006.

■ Brazil: A False Sense of Security?

As witnessed in the Chilean and Colombian markets, Fitch views Brazil's securitization market to be susceptible to similar prepayment concerns. Brazilian midcap financial institutions have become increasingly more competitive in providing consumer lending to private individuals. Furthermore, many of these niche banks look to the securitization market to secure funding for their credit origination. In an effort to decrease credit spreads further, banking system regulators have recently sought to foster loan refinancing between banks through the standardization of loan agreements and prepayment penalty expenses. However, such efforts have so far had minimal effects.

Although the various asset classes of ABS transactions in Brazil have differing degrees of prepayment risk (e.g., auto loans, personal loans, mortgages), Fitch has observed a higher propensity

Brazil: Market Interest Rates



for prepayment in Brazil's payroll deductible loan securitizations. Over the past five years, Fitch has observed a consistent rise in prepayment rates in securitized payroll deductible loan portfolios in tandem with increased competition among lenders. Payroll deductible loans are granted to individuals and monthly installments are deducted from salaries or entitled benefits, in the case of social security beneficiaries. For this asset class, Fitch has observed that prepayment levels (e.g., CPR) have, on average, doubled over the past three years, from 30% to roughly 60%. The vast majority of prepayment is due to proprietary refinancings, in which the originating bank is refinancing its own existing loans. A small portion of prepayment is due to refinancing from another bank.

Prepayment exposure in consumer ABS transactions is further elevated in securitized loan portfolios that are sold at a significant premium in relation to par value. On average, Fitch estimates that loan portfolios have been sold to senior/subordinate class structured transactions in Brazil at a price ranging between 115% and 135% of the loan portfolio's par value. From the originating bank's perspective, such a gain on sale accounting of an asset sale can dramatically inflate bank profitability ratios. From the transaction's perspective, initial available credit enhancement may be overstated, and available excess spread overestimated. In specific cases where the sale of assets occurs at high premiums, prepayments expose the transaction not only to a reduction in available excess spread but also to a loss of principal to the most subordinate class of debt. In Fitch's view, this is similar to the RMBS transaction structures in Colombia, in which the most subordinate class of debt is reliant upon available excess spread for repayment. As prepayments occur, this excess spread is reduced, potentially resulting in a principal shortfall for the subordinate class. Therefore, for ABS transactions rated by Fitch, careful consideration is made in regard to sizing credit-enhancement levels to protect against prepayment.

In acquiring a loan portfolio at a premium, the gain on sale effects on credit enhancement is explained in the following example. In this example, when acquiring the portfolio at 100% of par value, all available portfolio yield is transferred to the transaction. However, in the case of an acquisition at 115% of par value, the transaction will purchase a US$102.2 million portfolio that yields 35.0% per annum at 16.7% per annum, resulting in a US$117.6 million purchase price. The difference between the portfolio outstanding balance (US$102.2 million) and the purchase price (US$117.6 million) is the premium paid by the transaction, or contrarily, the gain to the seller on the assets. Therefore, the transaction does not have US$117.6 million in assets against a US$100.0 million senior issuance but only US$102.2 million. This results in an actual initial credit enhancement be adjusted from 15.0% to 2.2% in subordination.

In contrast to the events that occurred in Chile and Colombia, steadily increasing prepayment rates in securitized consumer loan portfolios in Brazil have not affected transaction performance. This is due to the ability of the seller to repurchase the prepaid loan from the transaction, substituting it with another eligible loan. Hence, no loss occurs within the transaction. Given that this occurs on a nonrecourse basis, it is important to note that the seller has no obligation to make such substitution. Furthermore, the credit-risk rating of the majority of these sellers is substantially below that of the rating achieved on the most senior class issuance by the transaction. Banks also generally do not consider proprietary refinancing as a prepayment, as they are proactively seeking to retain the borrower from leaving and going to another lender. Fitch is aware that such a practice can mask the portfolio's true prepayment behavior and create a false sense of security to investors.

Gain on Sale Effect in Securitization

	100% Par Value	115% Par Value
Loan Portfolio		
Outstanding Principal Balance	117,647,059	102,199,412
WA Term (Months)	24	24
WA Remaining Term (Months)	24	24
WA Portfolio Yield (%)	35.0	35.0
Portfolio Purchase Price	117,647,059	117,647,059
Capital Structure		
Senior Class	100,000,000	100,000,000
Subordinate Class	17,647,059	17,647,059
Initial Subordination (%)	15.0	15.0
Adjusted Subordination (%)	15.0	2.2
Excess Spread (%)		
WA Portfolio Yield	35.0	35.0
Purchase Rate	35.0	16.7
Senior Coupon Cost	12.0	12.0
Available Excess Spread	23.0	4.7
Commentary		
Portfolio Amount	Exact	Overstated
Credit Enhancement	Exact	Understated

WA – Weighted average.

■ Conclusion

The use of excess spread for credit enhancement is commonplace in Latin America. However, this type of enhancement is susceptible to prepayment risk and can potentially evaporate in a short period of time. Chile and Colombia are examples of countries that had relatively lower levels of subordination, as they relied on excess spread as a form of credit enhancement. Rate compression has been commonplace in many markets, and this has been amplified in fast-improving Latin American markets. While this report focused on the susceptibility of the Brazilian consumer loan market using Chile and Colombia as examples, this issue exists in other Latin American countries, such as Mexico and Argentina. Fitch will continue to monitor this situation and will write follow-up reports covering each particular country.