

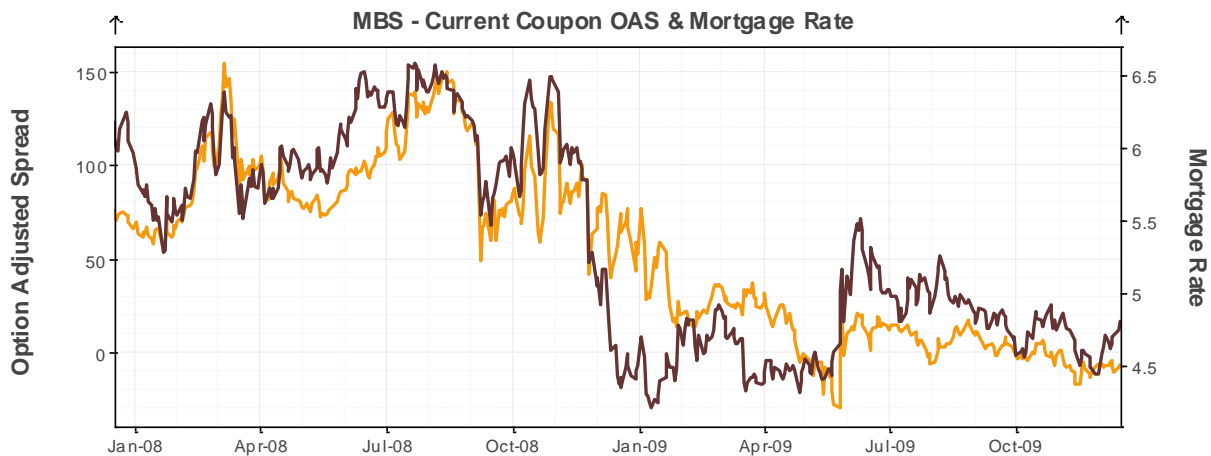
## A Review of Government Securitization Programs

Securitized products experienced an extraordinary rebound in 2009 following the blowout experienced in the 4<sup>th</sup> quarter of 2008. The government implemented many programs with the objective of stabilizing and restoring liquidity to the ABS, MBS and CMBS markets. From the Agency Mortgage-Backed Securities Purchase Program to the Public-Private Investment Program, these programs provided liquidity by either the government itself purchasing the securities or by providing non-recourse loans for investors who purchased those securities. As these programs are set to expire at the end of the first or second quarter of 2010, now is a good time to review the programs and the effect they have had on the various markets.

### Agency Mortgage-Backed Securities Purchase Program (Announced November 25<sup>th</sup>, 2008)

The program was intended to provide support to the housing and mortgage markets and to foster improved conditions in the financial markets. Through the purchases of Agency MBS, the program has lowered conforming mortgage rates, allowing borrowers to refinance at lower rates and thus lowering monthly payments. As seen in the graph below, the 30yr conforming rate has declined from a 6.0-6.5% range in 2008 to a 4.5-5.0% for most of 2009. While this has been a huge positive for homeowners, the MBS purchases have outpaced supply pushing the Current Coupon OAS into historically tight (negative) levels. The Federal Reserve and Treasury will purchase \$1.25 trillion and \$250 billion respectively of Agency MBS by March 31<sup>st</sup>, 2010. As of December 9<sup>th</sup>, the Federal Reserve has purchased \$1.07 trillion in Agency MBS Securities while the Treasury has purchased \$191 billion as of the end of November.

As this program comes to an end, mortgage rates and spreads may come under pressure as MBS investors, absent the Federal Reserve and Treasury purchases, will likely require higher yields in order to absorb the supply. It is possible that the government will decide to extend this program or create a new program should mortgage rates rise significantly. We have begun to scale back our allocation to mortgages because, in our opinion, mortgages are rich and the government would need to expand and extend this program in order to maintain these spread levels.

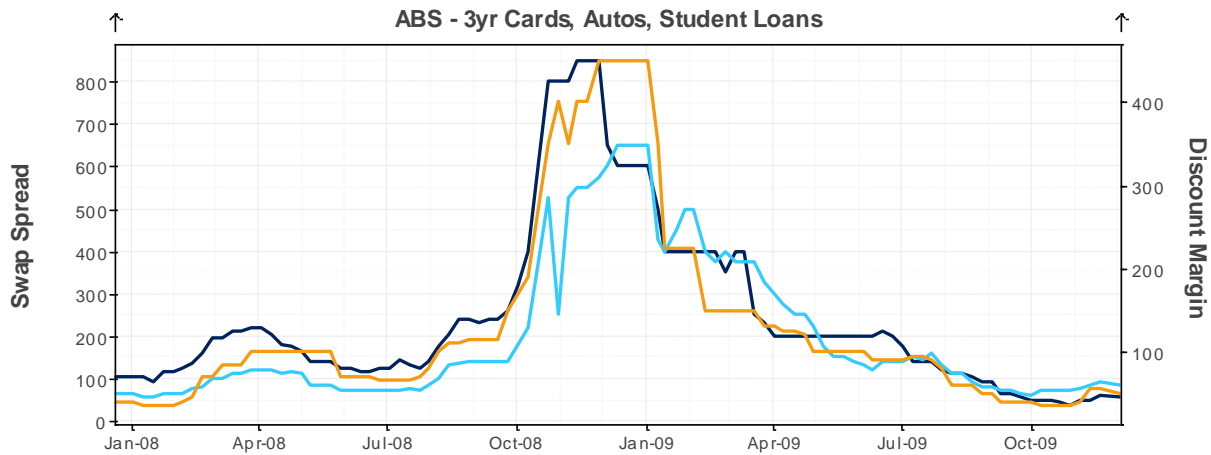


Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
—	Left	FNCL 0.0: Option Adjusted Spread	-6.282	-30.436	154.965	52.996	46.534	7.994
—	Right	Mortgage Rate Daily	4.824	4.212	6.585	5.347	0.696	0.105

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**TALF - Term Asset-Backed Securities Loan Facility (Announced November 25<sup>th</sup>, 2008)**

The intention of the Term Asset-Backed Securities Loan Facility (TALF) was to restart the new issue consumer ABS market by providing non-recourse loans to private investors to purchase new issue consumer ABS. The ABS market is a crucial source of funding for ABS issuers such as automakers and credit card issuers. Without these markets, consumers would be faced with less access to credit as well as higher interest rates. With credit card, auto and student loan spreads all returning to within 20-30bps (see graph below) of pre-crisis levels, many of the TALF-eligible deals no longer offer enough yield to cover the interest rate of the TALF loan, thereby making TALF financing uneconomical. As such, it has become very difficult if not impossible for TALF fund managers to meet their targeted returns at these spread levels. As of November 2009, a total of \$89.3 billion of TALF-eligible deals have priced year to date with a total of \$40.1 billion of TALF loans funded. One sector that has not recovered is the Home Equity market as many existing home owners now have negative equity and new home buyers are faced with more stringent lending standards.

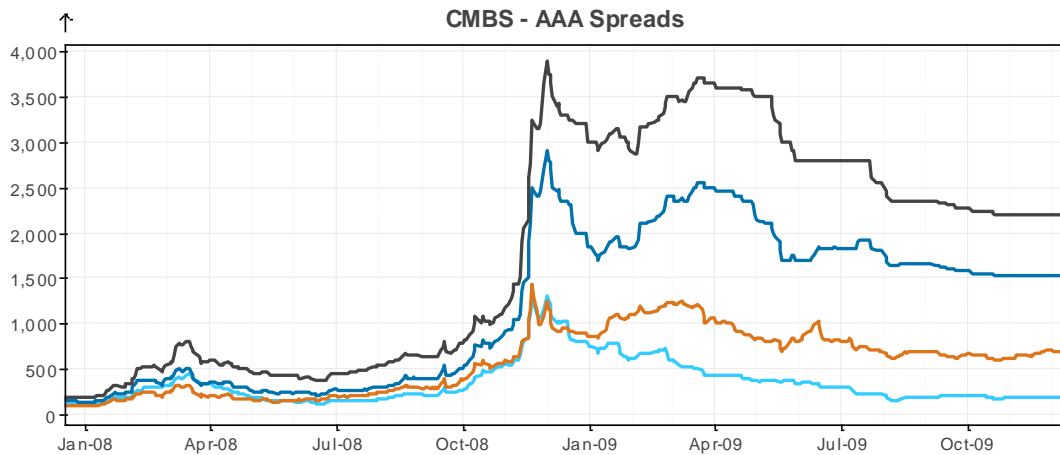


Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
—	Left	AUTO Fixed AAA 3Yr	55.000	35.000 10/29/2009	850.000 11/13/2008	244.755	200.954	44.023
—	Left	CC Fixed AAA 3Yr	85.000	55.000 01/17/2008	650.000 12/11/2008	197.843	170.507	52.953
—	Right	Student Loans AAA 3Yr	50.000	35.000 01/10/2008	450.000 11/28/2008	131.078	113.726	24.415

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On May 19<sup>th</sup>, the Federal Reserve announced the extension of the TALF program to include legacy Commercial Mortgage Backed Securities (CMBS). By extending the program to CMBS issued prior to 2009, the Federal Reserve intended to restart the market for legacy CMBS and, by doing so, stimulate the extension of new credit by helping to ease balance sheet pressures on banks and other financial institutions. The CMBS market, which accounts for 20% of outstanding commercial mortgages, came to a standstill in 2008 as the valuations of commercial properties declined and financing dried up. This program has worked to varying degrees. While the addition of Legacy CMBS to the TALF program has provided a new means of financing for CMBS investors, as of December 2009, only \$8.75 billion of Legacy CMBS TALF loans have been funded and new lending has failed to materialize as declining property values and upcoming loan maturities continue to weigh on the market. In November, Developers Diversified Realty issued the first new-issue CMBS deal in 18 months. Of the \$400 million of CMBS issued, the \$323 million AAA class was TALF-eligible of which \$85 million was TALF financed. The deal was well received by the market with all of the classes oversubscribed and the AAA class pricing at swaps +140.

With the TALF and legacy CMBS TALF programs set to expire March 31, 2010 and June 30, 2010 respectively, the ABS and CMBS markets will need to stand on their own as they will no longer benefit from having the government as the lender of last resort. The primary ABS market is functioning as spreads have narrowed and there has been less reliance on TALF financing recently as cash investor demand has increased with limited supply forecasted for 2010. The CMBS market on the other hand faces strong headwinds from declining property values and upcoming maturities, which will limit primary issuance in the near term. One positive for the CMBS market is a recent rule change that allows CMBS borrowers to modify the terms of the loan such as the maturity date prior to becoming delinquent on the loan. This is important because with limited access to new financing, CMBS borrowers would have a difficult if not impossible time refinancing the mortgage at maturity. This eases the near term risk of the borrower defaulting on the loan and extends the maturity out where financing conditions may be more favorable.



Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
—	Left	CMBS Fixed AAA 3 Yr	190.000	107.000	1300.000	338.990	237.758	22.881
—	Left	CMBS Fixed Sup Dup 10 Yr	685.000	83.000	1425.000	571.848	345.050	29.732
—	Left	CMBS Fixed AAA AM 10 Yr	1530.000	133.000	2900.000	1204.665	825.757	44.118
—		Barclays Capital Fixed AAA Jr 10 Yr	2205.000	180.000	3900.000	1809.665	220.249	53.962

**PPIP - Public-Private Investment Program (Announced March 23<sup>rd</sup>, 2009)**

This is a partnership between the government and the private sector to address legacy Non-Agency MBS and CMBS issued prior to 2009 that are stranded on financial institutions’ balance sheets and have become highly illiquid. The program is designed around three basic principles: First, it maximizes taxpayer resources by providing government financing to go along with the public and private investments. Second, this arrangement ensures that the investment manager invests alongside the government, with the investment manager standing to lose its investment in downside scenarios and the government sharing in the profitable returns. Third, it reduces the likelihood that the government would overpay for the securities due to the competition between the investment managers. The investment managers need to raise between \$500 million to \$1 billion which the Treasury will match dollar for dollar with an equity investment and provide up to one full turn of leverage through a non-recourse loan giving the program the potential to purchase \$40 billion of securities. Since the announcement of PPIP in March, prices have rebounded by up to 30% from their lows as evidenced by the chart below which graphs the prices of the AAA ABX indices. These higher prices have made it difficult for the investment managers to source assets that meet their desired return profile.



Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
—	Left	ABX.HE.06-1 AAA, Price	80.650	59.750	95.280	81.355	10.012	0.946
—	Left	ABX.HE.06-2 AAA, Price	44.440	28.720	87.610	54.600	18.644	1.102
—	Left	ABX.HE.07-1 AAA, Price	33.660	23.250	77.710	42.265	15.351	1.024
—	Left	ABX.HE.07-2 AAA, Price	33.730	23.100	76.710	40.595	14.027	0.939

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## Conclusion

The government, through these programs, has accomplished the main objective of stabilizing and restoring liquidity to the ABS, MBS and CMBS markets as evidenced by the substantial spread tightening experienced. While each of these programs has had varying degrees of success, the direct purchase of Agency MBS by the Federal Reserve and Treasury has proven to have a much greater impact on asset values than either the TALF or PPIP programs. As ABS, MBS and CMBS prices have increased, TALF and PPIP investors are finding it difficult to source assets that meet their targeted returns. The government's Agency MBS program does not have a targeted return. Because of this, Agency MBS spreads and mortgage rates have been driven to historically low levels. As these programs begin to expire at the end of the 1<sup>st</sup> quarter 2010, it will be interesting to see how these markets fare absent the extraordinary amount of support from these government programs.