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Risk Review

Aurora and BNC

February 2007

LEHMAN BROTHERS

Executive Summary

Industry Update

- More than two dozen subprime lenders have been forced to close in recent months. Some firms have reduced their risks in recent months by cutting off troubled lenders' credit, pushing some to the brink creating fire-sale prices for other firms.

- **New Century** announced that it has been informed of a federal criminal inquiry into its accounting and trading in its securities and that a failure to obtain waivers from lenders or find new funding sources could prompt its auditors to warn of "substantial doubt" over its ability to remain in business. A cease and desist order issued this week by the FDIC to **Fremont** specifically citing ineffective risk management practices and inadequate underwriting criteria. Merrill Lynch demanded that the **ResMae** buy back $308 million worth of loans that were in default, pushing ResMae to bankruptcy court .

- **H&R Block** swung to a net loss in its fiscal third quarter on increased loan-loss reserves in its subprime unit, **Option One**. **HSBC** said it would be taking a $10.5 billion charge for bad loans in its mortgage portfolio, 20% more than analysts expected. **J.P. Morgan Chase** recently sold most of the subprime mortgages that it originated last year. **Impac** said that it had discovered a material weakness tied to the reporting of its cash flows, and that it too would delay filing of its 2006 results. **Opteum** reported that in the fourth quarter it had set aside $7.3 million, or about 54.9% of its total loan-loss provision for 2006, due to higher early-payment defaults. **First Magnus** has filed a civil suit against 26 defendants alleging a fraudulent investment scheme that has damaged the company more than $925,000.

- **Argent** said it has given **Citigroup** an exclusive option to buy its business of lending through mortgage brokers as well as its mortgage-billing and account-management operation. **Accredited** said that it would postpone filing its 10-K until March 16 because of "the considerable effort to integrate" Aames which it bought in October.

- **Countrywide** said in an SEC filing that payments were late last year on 19% of subprime mortgage loans it serviced. Data from **UBS** show that the default rate for Alt-A mortgages has doubled in the past 14 months. The credit deterioration has been almost parallel to the one of the subprime market.

Executive Summary

Industry Update (Continued)

- The riskiest BBB-minus portion of the current version of the **ABX index** widened by approximately one percentage point in a day, continuing its widening streak and setting a fresh record of weakness. The sharp move is driven by a paucity of sellers of index protection after a recent spate of bad news around loans to home buyers with shaky or inadequate credit histories.

- **S&P** took an unusual step by putting mortgage-backed securities on review for possible downgrade before any actual losses had been incurred. The rating agency said it did so because of extraordinary levels of early defaults. Bonds from 11 transactions that closed in 2006 were put on the watch list, including an alt-A deal from Countrywide. **Freddie Mac** announced that it will cease buying subprime mortgages that have a high likelihood of excessive payment shock and possible foreclosure. Freddie Mac will only buy subprime ARMs and mortgage-related securities backed by these subprime loans that qualify borrowers at the fully-indexed and fully-amortizing rate.

- The new **Interagency Statement on Sub-Prime Lending** addresses underwriting sub-prime hybrid loans at a fully indexed rate that were not addressed in the previous Interagency Guidance published in September, 2006. While the Statement used 2/28 loans as an example, and we presume that it applies to 3/27 loans, the Statement does not mention 5/25 loans. The Statement is proposed and is out for comment for 60 days. The Statement raises concerns about payment shock for borrowers who do not fully understand the risks associated with sub-prime loans. The recommended lender action is very similar to what was proposed in last year's Interagency Guidance on non-traditional loans. While 27 states have adopted the old guidance, we have not seen anything from the states saying that they will adopt this Statement.

- **MGIC** said it agreed to acquire Radian Group in a stock swap valued at roughly $4.9 billion.

- **Home prices** declined from a year earlier in about half of all metropolitan areas in the fourth quarter, the National Association of Realtors reported. It was the first time the trade group has recorded declining or unchanged prices in the majority of cities covered since it began collecting the data in 1979, a Realtors spokesman said.

Executive Summary

Originations

- **BNC Originations** were just over **$750 million** for February, with 2.5% of this in **2nd** liens. Overall **DTIs** and **CLTVs** remained at similar levels like the last quarter - DTIs have been increasing substantially for Select Lending and 80/20s. **FICOs** decreased by 3 points and **Rates** went up by 20 bps. Other loan characteristics remained similar, with **Full** doc production gaining 2 points vs **Lite** and **Stated** doc. **100% CLTV** has stabilized to 20% of production, with half of it being **80/20s**. The **50 Year** product continues gaining share (11% of production), while **IOs** account for 23%. Loans with **Prior Foreclosure** have been increasing, reaching their highest level ever to almost 1%. There was an unusual spike on CLTV by 2 points and a decrease in prepayment penalty coverage by 4 points on **Score Advantage** loans. Finally, Mortgage Histories have been constantly deteriorating since last year (8 points in 1x30, 2 points in 1x60, 1% in 1x90).

- **Aurora Originations** in February were **$3.3 billion**, which is a reduction of 12% from January. 6% of the production was in **2nd** liens. **Wholesale** accounted for 30%, **Conduit** 69%, **Retail** 1%. 58% of the total production was **Delegated**. **Mortgage Maker** production is at an all time high of 55%, while **Alt-A** has dropped to 40%. Choice Advantage is picking up, with 228 loans funded for $73 million. Overall **FICOs** are at an all time low at 703, with **DTIs** and **CLTVs** to an almost all time high at 39.5% and 91.5%. **Stated-Stated** production has stabilized to 8%, with more than half of this in 100% financing. This is expected to get reduced going forward, given the guideline changes that were put in place in March. The same applies to the **No Ratio** loans that currently run at 14%, with more than half on the 100% financing. **No Doc** production runs at 11%, with one third of which is also 100% CLTV. **Non Owner Occupied** loans increased to 18%, with almost half of it in 100% CLTV (this segment has more than doubled in volume since Sept-06). Stated and No Ratio loans with low FICOs (<640) hit an all time high with 4.3% and 1.2% of the production, while Stated-Stated and No Doc with low FICOs (<660) remained flat at 2.3% and 0.8% respectively.

- **Non Quality loans** decreased in both Wholesale and Correspondent channels. Wholesale non quality decreased to 10.16% from 12.23%. Correspondent non quality reduced to 8.54% from 12.32%. The findings driving non quality loans are program violations, undisclosed debt and assets.

- **Special Investigations** completed the review of 240 LXS loans which resulted in 50% of the loans contained material misrepresentation.

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Claims/Reserves

- **BNC** reserves were $60.6 million for February and $92.6 million for the quarter. The prime and non-prime desks increased the **Aurora** rep and warrant reserve levels to a total of $26MM.

- **BNC rep and warrant claims** were in February, compared to in January. The Finance America claims were in February, compared to in January.

- **Aurora Contract Admin** received $104.3MM of new claims this month. This is almost 4 times the monthly average for the 4th quarter of 2006. End of Month open claims were $194.0 MM. This is 3 times the monthly average of the 4th quarter of 2006.

- **QC referred** 94 loans for $37 Million in balances to Contract Administration for repurchase. The trend for findings for these indicate investment scams, significant undisclosed debt and straw buyers.

- **Central Pacific** closed their doors causing us to lose $400k in repurchase claims ($400k actual loss). We are holding a $189k incentive check that will offset some of the loss as well as losses due to early payoffs and pair-off fees. **First Magnus** wired $6.5MM as a good faith deposit on outstanding claims - it roughly equals 50% of the exposure on the claims that are delinquent.

Executive Summary

Performance

- **BNC** First Payment Defaults declined in February to levels similar to those of a year ago. The 30s at 30 were **3.6%** dollar-wise and **3.6%** unit-wise. The 60s at 60 were **1.5%** dollar-wise and **3.6%** unit-wise. Since February is a short collections month, the results are looking very encouraging.

- **Aurora** First Payment Defaults results were mixed. The 30s at 30 declined to **2%** dollar-wise and **1.9%** unit-wise. The 60s at 60 increased to **1.1%** dollar-wise and **0.9%** unit-wise. The 60s at 60 increase was substantial (40% higher than the month before). Please note that the Aurora FPDs are not scrubbed for servicing transfer issues at this time. The increase was uniform across products (including Alt-A) and more pronounced for First Magnus.

- The deterioration in **BNC** performance starting with late 2004 originations continues. The **60+ rate after 6 months** has been constantly increasing from 1.96% in mid-2004 to 6% for late 2006 originations.

- The **Aurora 60+ rate after 6 months** has been constantly increasing from 0.5% in mid-2005 to 3.5% for late 2006 originations. The 60+ rate after 3 months does not show any signs of relief either. It has been constantly increasing from 0.2% in mid-2005 to 2% for late 2006 originations. The deterioration rate has been increasing by almost 50 bps per quarter during all 2006. The 60+ rate after 12 months more than doubled in a quarter's worth of production in early 2006.

- **Subprime** delinquency keeps climbing on all fronts. The **30+** rate for Lehman loans serviced by Chase runs at 13% currently. **60+** is over 8%, **90+** runs at 6%. The **Foreclosure** rate has doubled since last year running at almost 6%, while **Bankruptcies** are flat at 1%. The **REO** inventory is over 1.5%. **Prepayments** have been slowly going down.

Executive Summary

Performance (Continued)

- **Aurora** delinquency keeps climbing on all fronts as well, like the rest of the industry. Overall **30+ rate** increased from 3.57% to 3.96% on a dollar basis, while **60+** increased from 3.28% to 3.65%. The unit rates for February were 6.8% and 3.9% respectively. The increase in delinquencies was seen across all products, with Mortgage Maker and First Magnus seeing the largest percentage increase. **Alt-A 60+** rate has almost tripled since the beginning of the year from 0.6% to 1.8%. Expanded Options is running at 7.6% and Mortgage Maker at 5.3%. **Foreclosures** have doubled since last year, running at 1.2% dollar-wise, while **Bankruptcies** have stabilized to 0.4%. One third of Bankruptcies are Chapter 7. **REOs** are currently running at 0.4% of total servicing.

Servicing

- **Rollrates** at **Chase** were back in line, after the spike last December.

- **Rollrates** at **Aurora** were worse than the month before across the board. Seasonality is the main factor, since February is a short collections month. At an absolute level, rollrates are higher than last year in all buckets.

- **New Foreclosures** at **Aurora** have almost tripled since last year. The amount of **Resolved Foreclosures** has almost doubled since last year. **Bankruptcies** in and out are running flat. **New REOs** have more than doubled since last year. The number of **Resolved REOs** has increased slightly.

Executive Summary

Other

- The following changes to **guidelines** took effect in **BNC** on February 12:
  - Maximum of 90% CLTV on First Time Homebuyers
  - Maximum 1 unit on First Time Homebuyers
  - Maximum of 50% DTI on Stated Docs
  - Maximum of 90% CLTV on 2-4 Units
  - Increase minimum FICO to 660 for Stated Doc 100% CLTV
  - Increase minimum FICO to 620 for Full Doc 100% CLTV
  - No Secondary Financing on Select Lending or Score Advantage
  - Minimum FICO of 660 for 95% LTV on Select Lending
  - No exceptions to the above guideline changes

- The following changes to **guidelines** took effect in **Aurora** in March 5:
  - Increase on Minimum FICO Score on Mortgage Maker No Ratio 100% CLTV loans from 620 to 660
  - Maximum CLTV of 95% on Stated Income/Stated Asset and No Doc programs with a minimum FICO of 660
  - The Expanded Options program will be discontinued as of March 16 given poor performance and low volume

- There was a significant surge in locks in the days prior to the effective date of the Aurora guideline changes. Concentrations were reaching as high as 40% on the discontinued product.

- The **Aurora National Client Relations** received 689 broker applications and 42 correspondent applications. There were 523 broker clients and 14 correspondent client approvals. 78 brokers were denied. 231 brokers and 31 correspondents were terminated without cause predominantly due to no business for the brokers and failure to recertify for the correspondents. 24 brokers and 9 correspondents were terminated with cause due to misrepresentation or declining net worth.

Executive Summary

Other (Continued)

- **Appraisal reductions and rejections** have steadily and dramatically increased since September 2006. The reduction/rejection rate in September was 8.18% which was consistent with prior monthly findings. As of January 2007 the reduction/ rejection rate had increased 128% to 18.66%. Loans of $950,000 or higher and loans where the sales price or value is $1,495,000 or higher continue to have the highest reduction/ rejection rates at 29.80% and 34.15% respectively. Every high risk appraisal criteria bucket has increased dramatically over the same September to January time frame.

- The need for **field reviews** of appraisals has also risen significantly over the same period. In September 3% (63) of the desk review volume resulted in field reviews. In January of 2007 13.57% (442) of the desk reviews resulted in required field reviews.

- **Fraud Awareness Training** has been scheduled for Aurora Loan Administration and Operations employees beginning March and continuing through July.