Significant Pressure builds on the Wachovia Pay Option portfolio

In Monday's 'Q2 Bank-Specific Resi & Non-Resi NPA Guide' **Wells and Wachovia** were profiled, but because the Wachovia portfolio saw such a sharp qoq deterioration I thought it was important to profile them individually.

I have pointed out on too many occasions to remember how "credit", as defined by a borrower going delinquent and then moving down the default and foreclosure pipeline, is highly volatile and influenced by a variety of factors most notably mortgage modifications or just when a certain bank feels like making a move.

Wells' treatment of WB Pay Option portfolio defaults and foreclosures has been highly volatile since the day they acquired it but in recent months has become much more consistent at elevated levels.

My assumption, based upon my proprietary default and foreclosure data presented below, is that they have finally have policy, procedure and systems in place, know what to expect from the borrowers, have experience with Pay Option modifications, and have devised a plan for this portfolio that involves a significantly higher liquidation pace than before. **They can't keep kicking the can forever and with an NOD-to-Foreclosure (shadow foreclosure) ratio of 24.7% they have a lot of liquidation catching up to do.**

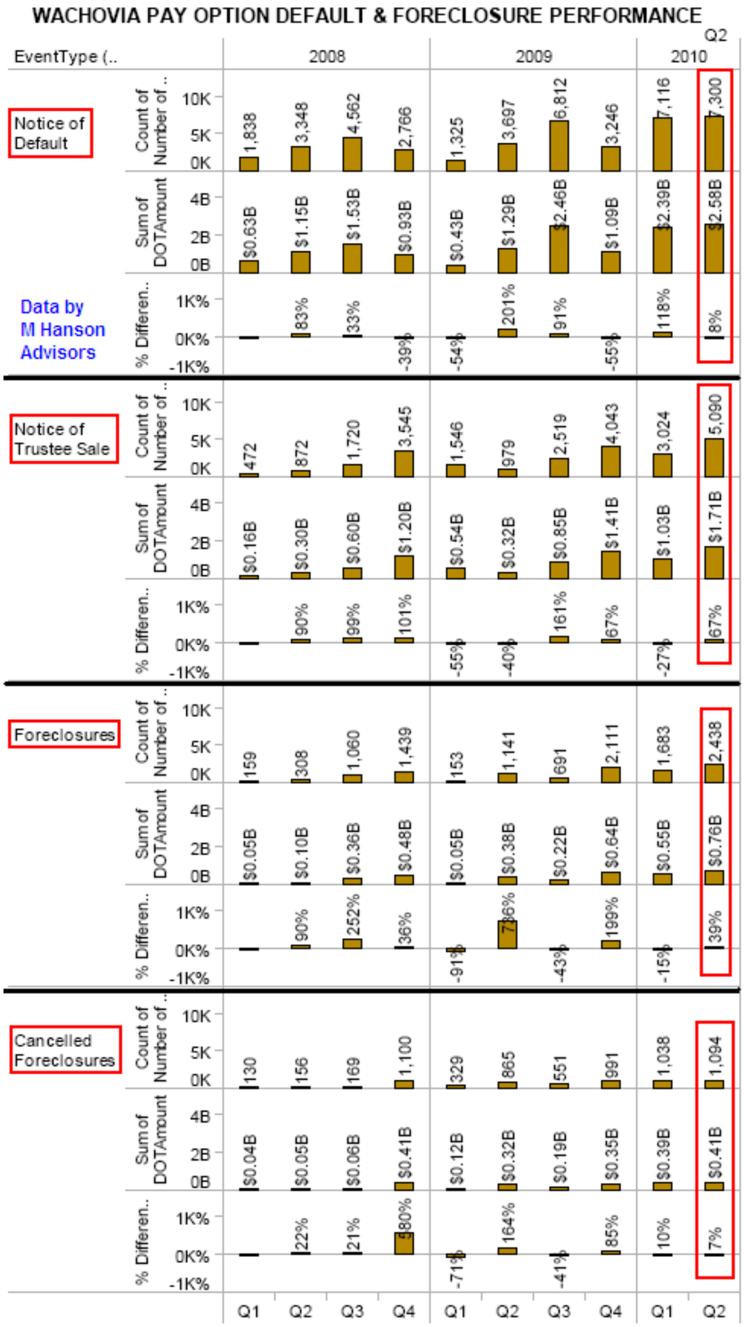
The chart below highlights quarterly Notice-of-Defaults, Notice-of-Trustee Sales (foreclosure ready), Foreclosures and Cancelled Foreclosure (indicative of mortgage mod) by count and dollar volume for the past two years.

Pressure is building in this portfolio both at the front end **(NOD up 8%)** and the back end **(NTS up 67% and Foreclosures up 39%).** These are big enough moves where I would think they would have to be addressed in their earnings call. Whether or not this deterioration is outside of expectations, I do not know.

Obviously they will default to their provision, which depending upon the analog may be enough to pacify investors for another quarter, maybe not...**these results are pretty bad.**

And based upon the NOD volume relative to NTS and Foreclosures, this pressure will continue to build in q3 albeit likely not at the q1 to q2 rate of change. With only half of the Pay Option portfolio provisioned -- and there being no such thing as a "good" Pay Option ARM -- based upon how bad I know World Savings loan underwriting was and how shaky their borrowers to be first-hand, I still believe that they are under provisioned for how badly this portfolio will perform over time.

These results are also a great example of how can-kicking will come back around to bite the banks. If not for the games played with this portfolio for so many quarters, the sharp increase in troubled loans and liquidations in q2 would have occurred earlier having the effect of spreading them out over a longer period of time, which would not been very note worthy this quarter, if at all.



Tier-1 Client Proprietary default and foreclosure data and reporting not for redistribution. Thank you.

Best Regards,

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