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GMAC Mortgage Portfolio Risk Rising Rapidly
General Motors Corporation (NYSE:GM) Update

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General Motors Corporation provides automotive-related products and services by primarily designing, manufacturing and marketing vehicles, as well as providing communications services and financial services. The company operates in two segments, Automotive, Communications Services and Other Operations, and Financing and Insurance Operations.

Summary of 3DAdvisors Findings for GM

- **Accounting:** GMAC mortgage portfolio risk rising rapidly
- **Accounting:** Other issues that have been disclosed that are worth monitoring

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Discussion of 3DAdvisors Findings

Accounting: GMAC mortgage portfolio risk rising rapidly

Further investigation into GM and GMAC Q3 10Q's shows further deterioration in capital access (outside of the pension situation) as the Company has made moves to replace revenues lost due to the prolongation of zero cost financing programs. There were some subtle disclosures that really caught our attention. GM's Q2 "Q" leads off its "Liquidity and Capital Resources" section by saying [the bolding is ours for emphasis]:"in the first six months of 2002, GM and GMAC experienced **excellent** access to the capital markets". The corresponding verbiage, from the more recently released Q3 "Q", however, has changed. The section now reads: "In the first nine months of 2002, GM and GMAC experienced **adequate** access to the capital markets…". Indeed, there have been some significant changes in this area in the past few quarters and we will attempt to highlight them here:

Our investigation has led us to GMAC's financials (GMAC files separate financials from GM's). In them, we found some interesting disclosures. It seems that GMAC has been picking up its Mortgage Banking activity, possibly in attempts to offset the effects of Zero Cost Programs. The most interesting aspect to this activity increase is that much of it seems to be coming from sub-prime and non-conforming loan activity. The company does not come out and say this directly, but it is there nonetheless.

The first sign is the noticeable pickup in "Mortgages Held for Investment." This category was not even mentioned, in text, prior to the Q3, 2001 "Q". In that Q3 2001 report, however, GMAC revealed that it held $1.4 billion of these, down from $1.9 billion as of Y/E 2000. But then, things began to grow exponentially. By Q4 2001 the total had ballooned to $3.4 billion, aided by the transfer of $1.7 billion of sub-prime adjustable rate mortgage loans from "Mortgage Loans Held for Sale" to "Mortgage Loans Held for Investment". This was the first-ever mention of sub-prime mortgage loans in GMAC's financials and evidence that GMAC was transferring non-performing loans to the more permanent asset category “Loans Held for Investment”. By Q1 of '02, Mortgage Loans Held for Investment had bulged to $4.5 billion, then to $7.9 billion at the end of the following quarter (Q2) then again, this time to $12.2 billion by the Q3 (as revealed in the most recent 10Q).

Although earlier mentions of this category divulged the sub-prime nature of at least part of GMAC’s Loans Held for Investment, later disclosures drop any further mention of sub-prime. The only GMAC Mortgage division that has been disclosed as dealing in sub-prime loans is Residential Funding Corp. (RFC). RFC specializes in, among other things, the purchase and securitization of "non-conforming" and sub-prime single-family residential mortgage packages from mortgage lenders. The Company further states: "Additionally, RFC acquires seasoned or distressed mortgage loans and other real estate for resolution or sale, as well as manages its own portfolios of distressed unsecured consumer receivables and other real estate for resolution for sale, as well as manages its own portfolios of distressed unsecured consumer receivables and mortgage-related securities that were acquired from unrelated bond issues."

GMAC does not get into much disclosure of its sub-prime activity. Looking into the nature of these "non-conforming" and sub-prime loans however, allows for a clearer understanding as to how they are more likely to remain on the books, simply because their securitization is more difficult.

To this, we point to a study, issued by Fannie Mae in 1995, that deals with "The Effect of Origination Strategies on the Pricing of Fixed Rate Mortgage Loans". One of the clear conclusions is that nonstandard loan contracts are more difficult to sell "through secondary market channels" and thus tend to be held as assets. Because of this they carry extra prepayment and reinvestment risk. The exact quote goes like this: " When lenders give up the freedom to sell loans by originating a large percentage of nonconforming debt or by allowing nonstandard contracts, they must hold those loans in their asset portfolios. This strategy entails greater prepayment and reinvestment rate risk than pass-through lending and should generate a commensurately higher reward."

Given this, combined with the fact that GMAC has been booking rapidly rising amounts of Mortgages Held for Investment, leads us to believe that there is a strong possibility that GMAC has been taking on much more risk in its Mortgage operations. This strategy is possibly to offset revenues lost in their zero interest dealer programs. Indeed, the prepayment risk, mentioned in the above Fannie Mae study, is now showing up at GMAC. Recent disclosures reveal that GMAC is getting whacked by prepayments and has had to write down $1.16 billion in impairment charges related to the value of its

Mortgage Servicing Rights (The asset is now at $2.85 billion, vs. $4.84 billion at Y/E. '01). These higher impairment charges "are primarily the result of increases in the actual and expected levels of mortgage prepayments". This seems to echo the results of the Fannie Mae study.

We do know that GMAC has been using this category, at least to some extent, as a place to put non-performing loans: Back in late '00, GMAC disclosed that a $200 million reclassification of non-performing assets from Mortgages Held for Sale to Mortgages Held for Investment was done "to more accurately reflect the nature of the asset". In Q4 of '01, GMAC reclassified another $1.7 billion of Mortgages Held for Sale to Mortgages Held for Investment. This time, however, the Company did not reveal whether the transferred loans were non-performing, as had been disclosed with the year-earlier reclassification. Our bet is that a significant portion of these may have been.

It would seem that these Mortgages Held for Investment represent a combination of non-performing loans and sub-prime, or otherwise non-conforming loans that cannot be securitized through typical channels. Consequently, the category grows on the books, revealing a significant shift toward higher risk. What makes this situation particularly interesting is that it occurred at a time when GM had been getting kudos for pulling back its exposure to sub-prime auto loans. It seems one problem may have simply been substituted for another.

But there's more. Earlier disclosures about that '01 transfer of the $1.7 billion of sub-prime mortgage loans from Loans Held for Sale to Loans Held for Investment reveal the fact that they were Adjustable Rate Mortgages (ARM's). GMAC fails not only to quantify its total exposure to sub-prime mortgage risk it also falls short of revealing how many of these loans are ARM's. The problem with ARM's and sub-prime loans is that these borrowers become increasingly at risk as interest rates rise. Banking industry sources tell us that default on sub-prime ARM loans tend to rise significantly when increasing rates make payments balloon. So the prepayment problems created by lowering trends in interest rates morph into a separate set of concerns that manifest themselves once rates go the other way.

<u>Accounting: Other issues that have been disclosed that are worth monitoring</u>

- One practical implication of GMAC's jump in Loans Held for Investment is that it may enable the Company to delay penalizing earnings with non-performing higher risk loans. Since these Loans are being "Held for Investment" they do not have to be "marked to market" as they would have to be if they were "held for sale". By reclassifying an increasing amount of these to "Held for Investment" the Company may be delaying taking big hits to earnings when these loans start falling behind. The Company has already demonstrated that it has shoved non-performing loans into this category in the past. It could easily be including a large component of these in the category now, in addition to loans that cannot be either sold, or resold, conventionally.

- Mortgage Group activities have tied-up assets. Aside from all the problems associated with the Pension situation and its potential need for significant additional funding and the credit situations mentioned above are two collateral situations that are worthy of mention. Under repurchase agreements, GMAC Mortgage Group has pledged $2.2 billion of the Company's Cash and Equivalents (Treasury Securities) as collateral for the same amount of short-term debt. In addition, $8.9 billion of GMAC's Mortgage Loans Held for Investment is held as "collateral for a borrowing arrangement".

- There is another debt covenant on the bubble. GMAC's Q3, 2002 "Q" discloses that it has leverage covenants tied to its syndicated multi-currency $14.7 billion credit facility, which serves as a back-up for the Company's unsecured commercial paper programs. These covenants restrict the ratio of consolidated debt to total stockholders equity (at GMAC) to no greater than 11.0 to 1 under certain conditions. This condition kicked in when S&P lowered GMAC debt to BBB. Although the company is not in violation of this new condition (ratio is now at 9.6 to one, up from 9.4 to one as of Y/E '01), the fact that the condition is now live brings yet another risk factor to the analysis of the health of GM's liquidity.