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WHY CASH FLOW ANALYSIS IS IMPORTANT IN AAA RMBS SURVEILLANCE

Traditionally, cash flow analysis was only performed on subprime and certain Alt-A transactions where excess spread was being used to build overcollateralization (OC), cover losses and model the presence of triggers and complex waterfalls. For prime and other Alt-A deals that did not rely on excess spread for credit support (more commonly known as “shifting interest” or “six-pack” deals), no cash flow simulation was necessary as long as the credit enhancement (CE) was equal to or higher than the expected losses on the deals.

Times have changed. The traditional technique of disregarding cash flow analysis in prime and Alt-A deals has become exceedingly inadequate in residential mortgage-backed securities (RMBS) surveillance, particularly with respect to the AAA securities. Unlike past transactions, where CE generally increased as a senior bond paid down, in today’s environment, prepayment speeds have drastically slowed while at the same time revised expected losses have far exceeded initial loss expectations and existing CE. This often results in higher losses eroding the capital structure and credit support much faster than the AAA bonds pay down.

In addition to credit erosion, structural features, such as sequential pay and pro rata pay, or the inclusion of non-accelerating seniors (NAS) and accrual bonds has also added to the complexity of AAA RMBS surveillance. In many instances, the current CE may appear insufficient to cover the AAA expected losses; however, given a priority-pay schedule, a first-pay senior bond may very likely be paid in full before losses catch up to it, even in a AAA rating scenario. Conversely, a NAS bond, which is locked out of principal payment for several years, may experience further extension risk and will likely be more prone to writedowns and downgrade risk if performance deteriorates. These structural features have made it impossible to accurately assign and monitor bond ratings without performing cash flow stress tests.

DBRS’s surveillance process incorporates a dynamic cash flow simulation (fast/slow prepayments, upward/downward interest rate stresses, loss timing, etc.) in order to achieve the most conservative ratings for each bond. In the table below, DBRS demonstrates the differences among AAA bonds within the same transaction by applying varying prepayment speeds. The transaction reviewed is an Alt-A shifting interest transaction that has a sequential pay structure with NAS bonds and an expected loss of 5.50%.

AAA Cash Flow Simulation

Tranche	Type	Original Credit Support	Principal Writedown (% of Original Bond Balance)				Weighted-Average Life			
			10 CPR	15 CPR	20 CPR	25 CPR	10 CPR	15 CPR	20 CPR	25 CPR
A1	Front Pay Senior	4.4%	1.3%	1.0%	0.6%	0.0%	8.3	4.9	2.9	1.6
A2	Senior	4.4%	2.1%	2.8%	3.8%	5.2%	12.3	10.4	9.2	8.3
A3A	Super-Senior NAS	10.0%	0.0%	0.0%	0.0%	0.6%	12.5	10.6	9.3	8.5
A3B	Senior Mezz. NAS	4.4%	36.0%	47.9%	64.8%	79.2%	9.9	8.0	6.6	5.8
A4	Sr. Targeted Amort.	4.4%	0.6%	0.8%	1.1%	1.5%	5.5	4.9	4.5	4.2

Source: DBRS and Intex.

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