

U.S. Structured Finance Newsletter

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NOT ALL REREMICS ARE CREATED EQUAL

In previous newsletters, DBRS introduced the concept of ReREMICs as a restructuring tool. These ReREMICs, backed originally by AAA-rated underlying certificates, frequently employ a simple A1/A2 (or senior/non-rated) structure. With principal paid on a sequential basis and losses allocated reverse sequentially, Class A2 effectively provides additional credit enhancement (CE) to A1 via subordination, thus ensuring improved rating stability and liquidity for Class A1.

Throughout 2009, the underlying collateral for ReREMICs has predominantly been front-pay senior certificates that are currently factoring down. As prices began to rally on these certificates, DBRS has noticed an increased interest in ReREMICs backed by non-front-pay seniors that are currently locked out from principal payments. Although both types of bonds can be resecuritized, the resulting CE sizes are often considerably different.

Front-pay seniors are usually substantial in size. It is relatively easy to carve internal CE out of a certificate with a reasonable thickness. For example, when a front-pay senior class is 80% in size (i.e. 80% of the underlying transaction's size), a ReREMIC of such a bond with a 50% (A1)/50% (A2) split represents a significant CE of 40% for the A1 class. Comparatively speaking, non-front-pay seniors that have been presented to DBRS are usually thinly tranced. For example, a 5% non-front-pay senior class with the same 50%/50% split only results in additional CE of 2.5%, inconsequential when compared to the large amount of projected losses in today's environment.

More importantly, the two types of bonds can have very different levels of sensitivity to cash flow assumptions. When expected losses significantly exceed current CE, as is the case for most RMBS vintages, it is often a race between how fast the bonds are paying down and how rapidly the losses are being applied from the bottom of the capital structure. Front-pay seniors certainly have a head start while the non-front-pays are still mostly locked out from principal distributions. The complexity of the capital structures in RMBS transactions these days requires testing various combinations of cash flow stresses to properly analyze a bond. When rating ReREMICs, DBRS performs a minimum of 40 cash flow runs in Intex based on combinations of prepayment speeds, loss timing patterns and interest rate stresses. The goal is to test the resilience of the newly rated Class A1 under various cash flow scenarios. One may think that fast prepays and a back-loaded loss timing pattern would always result in the least amount of principal writedowns to senior classes. This is not always the case. For example, in many RMBS structures, principals are allocated sequentially and losses reverse sequentially until the subordinates are depleted, at which point, the principal and loss allocation becomes pro-rata. In such structures, certain non-front-pay seniors actually perform worse under fast prepayment speeds and a back-loaded loss timing pattern. This is because in such scenario, the front-pay seniors have paid down substantially relative to non-front-pay seniors since issuance. When losses hit all the senior bonds on a pro-rata basis, the non-front-pay seniors now have a larger proportion of losses allocated to them. This would not have otherwise been known to us unless various cash flow combinations were tested when analyzing a ReREMIC.

Finally, loan modification adds another layer of uncertainty to the performance of non-front-pays. Principal forgiveness accelerates losses and rate reduction erodes excess spread that is otherwise available for loss coverage. Both modification techniques can cause write-downs to migrate up the capital structure sooner than expected, and as such, erode the non-front-pay seniors quickly.

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