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Near-Prime RMBS

The charm of the hybrid adjustable mortgage over the past several years appears to be waning. DBRS believes that several factors should lead to both an increase in the origination of fixed-rate mortgages in the near-prime sector as well as a continued refinement of mortgage pools and structures. These factors include: (1) an acceleration of refinancing activity as the first wave of interest-only hybrids approach their reset dates in today's flat yield curve environment, (2) greater emphasis on individual transaction execution in an environment in which origination volume is receding, and (3) ongoing investor concerns with respect to the slow down in the housing market.

Within the near-prime sector, the dominant form of RMBS transaction credit enhancement has generally consisted of subordination with little to no enhancement coming from excess spread. In general, across structured finance sectors, the higher the credit quality of the collateral pool, the greater the structural reliance on subordination to provide transaction credit enhancement. However, more recently, DBRS has seen an increase in near-prime transactions in which the structure utilizes excess spread and overcollateralization accounts.

Catalyzing this change is a higher weighted-average coupon (WAC) on near-prime pools. The risk layering inherent in newer mortgage products has increased credit risk in certain near-prime pools. Although basic pool credit metrics, such as borrower FICO and loan purpose, have remained relatively consistent, more near-prime mortgages have been originated with lower borrower documentation standards, piggyback loans, and are secured by investor-owned properties. Consequently, the WAC on certain near-prime pools has increased in tandem with pool risk.

For traditional near-prime investors, recent vintage RMBS may be less appealing. Conversely, for subprime investors, these transactions offer an opportunity to move up in collateral credit quality. Compared to subprime, the near-prime senior bond may also carry a slightly higher coupon/yield because it potentially carries greater extension risk, a fragmented investor base, and longer tenure.

In the past, risk-layered loans that were sprinkled in pools across the credit spectrum may now emerge within their own pools. Several market dynamics should facilitate increased refinement in pools and structures during the coming year; those market dynamics include: (1) the continuing dispersion of near-prime collateral quality, (2) an adequate supply of loans, (3) potential execution benefits to issuers from pooling risk-layered loans into a single transaction, and (4) investor wariness of the housing market.

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