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Who's Pulling the Trigger?

Subprime home equity securitizations typically allow for a reduction in overcollateralization levels (OC) once certain performance tests are met. This reduction in OC permits a release of cash to residual holders and occurs at the step-down date¹ if the transaction is in compliance with certain deal covenants or triggers. These triggers typically consist of limits on collateral delinquencies and cumulative losses. If certain triggers are not breached at the step-down date, the subordinate classes will begin to receive their pro rata share of principal distribution.

The step-down/trigger mechanism may be flawed. Senior credit enhancement grows with the sequential paydown² of notes while thresholds for delinquency triggers are typically expressed as a percentage of senior credit enhancement levels. The impact of the "flaw" will be exacerbated when senior notes rapidly de-lever due to faster prepays. Consequently, as the transaction seasons, it becomes much more difficult to trip the delinquency trigger. Therefore, the release of OC and excess spread can occur at and after, the step-down date even though there may be a significant delinquency pipeline.

Additionally, as servicers begin to gradually migrate from "timeline" servicing (e.g. aggressively meeting legal deadlines for foreclosure) to "cash flow" servicing (e.g. maintaining borrower payments through forbearance plans and workouts), potential losses in HEL transactions and serious delinquencies may become understated. As servicers defer the foreclosure process, realized transaction losses will be delayed and may also occur more frequently after the step-down date.

In a softer housing market, a hard (static) delinquency trigger may be more effective than a soft (dynamic) trigger. A hard trigger (three-month rolling 60+ days) limits delinquencies to a specified percentage (typically from 15%-17%) and keeps a tighter rein on securitization performance. Instead of a single delinquency trigger, some securitizations have also employed a multiple-trigger structure. A delinquency trigger is in effect for each rated class when it becomes the most senior class. The multiple triggers serve to protect all the rated classes rather than just the senior classes.

The one-time release of OC at step-down can serve to diminish transaction credit enhancement too easily, especially if the pool performance is lumpy. Instead, a gradual release of OC phased in over several periods could serve to better support credit enhancement.

Finally, in addition to a delinquency and a cumulative-losses trigger, the idea of a cash flow velocity trigger is quite intriguing. Since the more creditworthy borrowers refinance at their reset dates to avoid higher payments, collateral pools can become "adversely" selected as the transaction seasons. Also, as discussed earlier, "cash flow" servicing will likely defer the default or delinquency status of certain troubled loans. A stressed loan that is cash flowing is less risky than one that is not. Therefore a cash flow velocity trigger may be more appropriate in reflecting the actual performance of a securitization.

For questions or comments, please contact Quincy Tang at qtang@dbrs.com.

¹ The step-down date is typically the earlier of: (i) once the senior note balance has been reduced to zero, (ii) once the senior credit enhancement has doubled, or (iii) three years after closing.

² Prior to the step-down date, senior notes are typically paid sequentially.