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SUPER-SENIOR RESECURITIZATIONS: A WAY TO ENHANCE AAA RMBS

Over the last 12 months, the volume of non-agency RMBS issuance has dropped precipitously. As a result, issuers have refocused their mortgage securitization efforts on several fronts. Resecuritization (colloquially known as a re-REMIC) is an emergent trend that repackages one or more real estate mortgage investment conduit (REMIC) securities into a new offering which redirects the underlying cash flows to a new series of tranches. Generally, the effect of carving, or retranching, a security is intended to accomplish one of the following: (1) credit tranching in which a new capital structure is formed or (2) a super-senior structure that provides extra credit enhancement to the most senior tranched cash flow. In this newsletter, we provide a closer look at resecuritizations as a restructuring tool for super-senior credit enhancement.

To date, 2008 has been difficult for participants in the securitized credit markets[1] in light of (1) the deterioration of underlying RMBS deal performance, (2) ratings migration and (3) the erosion of investor confidence. Given the current performance environment, in which certain near-prime RMBS capital structures may be insufficient, super-senior resecuritizations are a growing restructuring alternative.[2] The retranching of an underlying AAA-rated senior class into super-senior and mezzanine support tranches provides additional credit enhancement to the super-senior tranche via subordination. Such subordination is designed to further protect the retranched super-senior if losses are allocated to the underlying pledged senior class.

The current market for super-senior resecuritizations has settled on two conventional structures: sequential pay and pro rata pay. In a sequential pay structure, cash flows of principal (both scheduled and unscheduled) received each month from the underlying senior class are redirected entirely to the super-senior until its class balance is retired. In contrast, the pro rata pay structure directs all principal cash flows between super-senior and mezzanine support classes in a proportionate, or pro rata, manner. Notably, a pro rata pay structure has the effect of de-leveraging the mezzanine support class, which thereby erodes available subordination each month to the super-senior class. In a slow prepayment environment, losses allocable to the underlying senior class may experience disproportionately larger write downs than during a rapid prepayment environment and, by extension, in a pro rata pay structure, a retranched super-senior class can be especially sensitive to slower prepayment environments. Therefore, mezzanine support classes must be sized disproportionately larger in a pro rata pay structure than in a sequential pay one.

DBRS expects resecuritizations to comprise a significant share of non-agency RMBS issuance throughout the rest of 2008 for several reasons. First, issuers may find liquidity in retranching AAA-rated senior classes available for sale into super-senior tranches. Furthermore, investors may find confidence in the additional credit enhancement, thus making bonds in inventory more marketable. Second, investor portfolios comprised by senior classes that are subject to rating volatility may decide to use resecuritizations as an opportunity to mitigate such risk.

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1. Excluding resecuritizations, the non-agency RMBS issuance for the first five months of 2008 was approximately 6% of that issued during the same period last year (Inside Mortgage Finance data).
2. Resecuritizations represented 47% of the 2008 YTD non-agency RMBS issuance (Inside Mortgage Finance data).