

U.S. Structured Finance Newsletter

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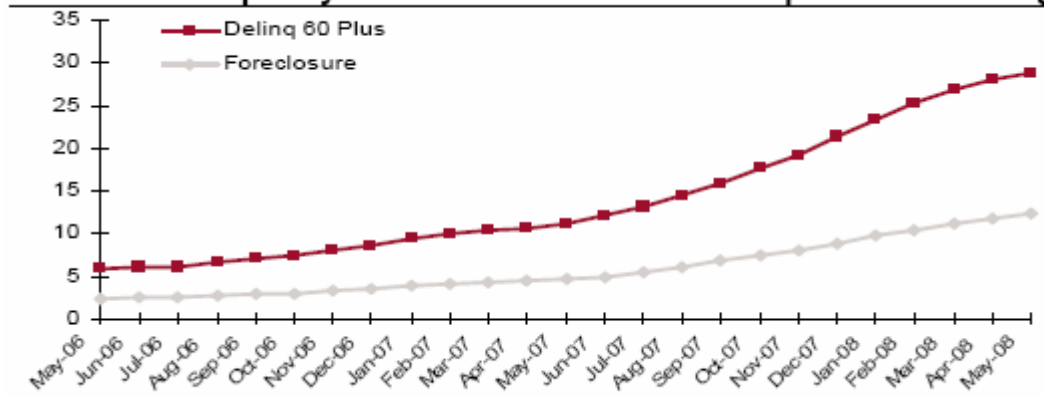
MODIFICATIONS STARTING TO IMPACT RMBS PERFORMANCE

A loan modification is a change made to the loan terms of a mortgage in order to stave off foreclosure and keep a borrower in the home, thereby minimizing losses to the lender and the RMBS. However, as the pace of loan modifications picks up (2,291 modifications completed in June 2008 compared with 2,005 in May 2008¹), investors are beginning to feel its impact in securitized mortgage transactions. The May 2008 remittance reports show that for certain transactions serviced by Ocwen Loan Servicing LLC (Ocwen), many noteholders experienced interest shortfalls rising as high as the senior classes. Within the affected deals, the servicer made a significant number of loan modifications.

A loan modification will have significant bearing on its treatment within the cash flow waterfall depending on the kind of modification extended to the borrower. For example, interest rate reductions result in a decrease in interest collections flowing into the trust. Partial principal charge-offs (i.e., principal reductions), which are becoming a more prevalent form of loan modification, result in an immediate loss to the trust. How that loss is handled is vitally important to the deal's cash flows. In the case of several Ocwen-serviced deals, the trustee/master servicer (Wells Fargo) apparently determined that partial charge-offs were payable out of the interest collection waterfall rather than being offset against excess spread, overcollateralization and, ultimately, subordination, if necessary. This determination effectively depleted interest collections available in several of the trusts, which, in turn, resulted in the interest shortfalls.²

While the issue regarding the Ocwen deals seemed to have been cleared in June after the trustees changed the way of recognizing the principal reductions related to modification as being part of principal loss instead of interest loss,³ a concern remains in the industry of how large-scale modifications will impact the future cash flows in securitized transactions. With delinquency rates ramping up to close to 29% on subprime loans (see Exhibit 1) and the use of modifications as a loss mitigation tool becoming more prevalent, reimbursement of non-recoverable advances and principal writedowns are likely to become more common. With respect to securitization performance, these modification techniques would generally affect the non-investment-grade bonds more than the senior bonds. However, senior credit support erodes when losses are allocated to the bottom of the capital structure. Furthermore, the current slow prepayment environment can leave senior classes vulnerable to potentially suffering a loss. As a result, DBRS will continue to monitor the industry for the impact of large-scale modifications on RMBS and its effect on cash flows.

Exhibit 1: Delinquency and Foreclosure Rates on Subprime Outstanding



Source: Credit Suisse, LoanPerformance

For questions or comments, please contact Kathleen Tillwitz at ktillwitz@dbrs.com.

1. Source: Credit Suisse ABX June 2008 Remits Update.
2. Barclays Capital research, June 19, 2008, "The Ocwen Situation."
3. Source: Credit Suisse ABX June 2008 Remits Update.