

U.S. Structured Finance Newsletter

Volume 5, Issue 5, February 2, 2009



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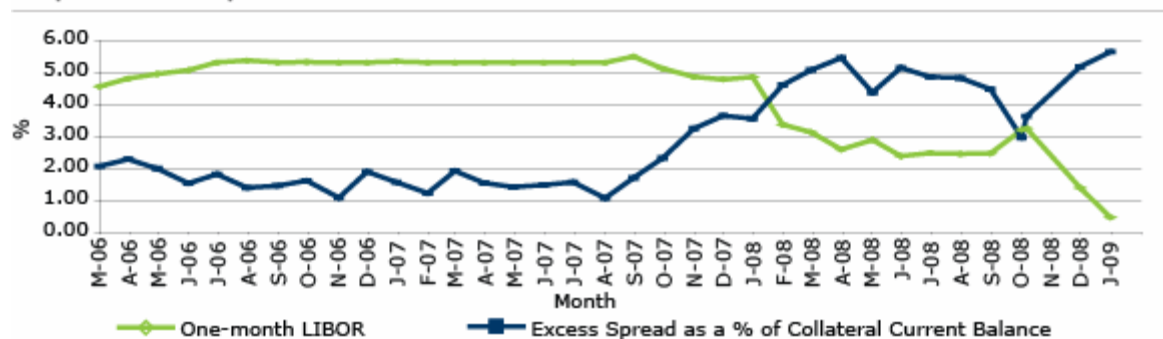
A LITTLE BREATHING ROOM FOR RMBS INVESTORS

There is no denying that since 2006, residential mortgage-backed securities (RMBS) performance has been adversely affected by declining home prices, risk layering and, more recently, an economic recession with high unemployment rates. As of December 2008, the subprime 60+ day delinquency rate for the 2007 vintage rose to 35.3% and losses reached 9.0%.¹

However, RMBS investors may have found a little breathing room lately. DBRS noticed that certain transactions have benefited from the drop in LIBOR, particularly in the past few months. While net interest rates on the mortgage pools remain little changed, the rapid reduction in one-month LIBOR on the bond obligations has resulted in a substantial increase in excess spread. Excess spread, the difference between the net interest rate on mortgages and the weighted-average coupon on the bond obligations, is, of course, the first layer of protection against credit losses before the overcollateralization (OC) and subordinate bonds start to absorb losses.

In many instances, the amount of current excess spread on subprime transactions can range between 450 and 550 basis points. Graph 1 illustrates the impact of the change in LIBOR for a representative 2006 subprime transaction. The plunge in one-month LIBOR² from 3.26% (November 2008) to 0.47% (January 2009) has resulted in a 56% upsurge in excess spread.

Graph 1: Excess Spread versus One-Month LIBOR



Source: DBRS and Bloomberg.

Since a majority of the outstanding collateral are hybrid adjustable-rate mortgages (ARMs), DBRS also reviewed the impact of interest rate resets on excess spread. Although most hybrid ARMs are benchmarked to the six-month LIBOR (which declines with but trails the one-month LIBOR), surprisingly, a fairly steep drop in six-month LIBOR only resulted in a marginal decline in the mortgage rates after reset thanks to the overall high gross ARM margins. An analysis of DBRS-rated subprime securitizations revealed that 2/28 hybrid ARMs originated in 2006 and 2007 typically had an initial fixed rate of 7% to 9% for two years then reset to an adjustable rate of six-month LIBOR plus a gross margin of 5% to 7% (with an initial rate cap of 2% to 3%). With the six-month LIBOR at 1.6%, a mortgage that has an initial fixed rate of 8% and a gross margin of 6% will have a new rate of 7.6%, representing only a 5% decline from the initial rate. Therefore, even after the mortgages reset, excess spread levels are expected to remain abundant.

DBRS believes that as long as LIBOR remains low in the near term, the resulting increase in excess spread will prevent some subordinate securities from being written off and will therefore extend their timeline of interest receipts. Evidently, during this period, the senior bonds will continue to benefit from the credit support provided by the subordinate classes, which would have otherwise been written off.

That said, several factors can quickly reverse the effect of this spread increase. First, securitizations with interest rate swaps (in which the trust pays out a fixed rate in exchange for one-month LIBOR from a counterparty) may not benefit much from this drop in LIBOR. Depending on the strike rate and the swap schedule, the swap mechanism may extract sizable cash from these transactions. In addition, large-scale loan modifications, including interest rate reductions on mortgage loans, will undoubtedly put downward pressure on excess spread.

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

1. Intex Solutions, Inc.

2. The LIBOR determination date is typically the second New York or London business day preceding the commencement of the interest accrual period. For the January 26, 2009, distribution, the LIBOR determination date was December 23, 2008.