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HOW LOAN MODIFICATIONS CAN AFFECT THE RMBS CAPITAL STRUCTURE

As momentum builds toward a greater use of loan modifications, the two most common, interest rate reductions and principal forgiveness, may cause shortfalls of some kind in the capital structures of residential mortgage-backed securities (RMBS) transactions.

Interest Rate Reductions

For a senior-subordinate overcollateralization (OC) structure, reducing the interest rate on the collateral will inevitably decrease excess spread and, in some cases, may lead to available funds cap (AFC) shortfalls.¹ In the event of AFC shortfalls, bonds can sometimes recover the shortfall amounts if the transaction has sufficient excess spread. However, since AFC shortfalls are typically paid back at the bottom of the waterfall after excess spread has been used to absorb credit losses, the chance of recovery is slim due to the high losses in this market. For a senior-subordinate shifting-interest structure, the collateral balance has to equal the bond balance at all times. These transactions typically have a payment priority of interest and principal to the senior notes followed by interest and principal to the subordinate notes (IPIP). The bonds will not have interest shortfalls with rate reductions to the extent that their coupons are capped at the net weighted-average coupon (NWAC) of the collateral. For transactions where the bond coupons are not capped and the interest rate reductions are not capitalized on the mortgage balance, the most subordinate class(es) will be forced to take writedowns (in addition to having interest shortfalls) in order to keep the collateral and bond balances in sync as available funds may be inadequate to pay principal on these bonds.

Principal Forgiveness

Losses from principal forgiveness modifications are almost always allocated on a reverse-sequential basis. Although securitizations of recent vintages have quickly deteriorated and largely failed performance triggers, many subordinate bonds continue to receive interest as property liquidations and losses take a significant amount of time to pass through to the bonds. However, as principal forgiveness modifications increase, the writedowns on the subordinate tranches will accelerate. Principal forgiveness can also be in the form of bankruptcy cram-downs, which can have a questionable loss-allocation mechanism for certain shifting-interest transactions. In such cases, if the cram-down losses exceed a stipulated carveout limit, losses will be allocated on a pro rata basis across the capital structure, resulting in writedowns in senior bonds that wouldn't otherwise have taken any credit losses.

The most common loan modification to date has been interest rate reductions. The results have not been very encouraging, with re-default rates reaching 58%.² The re-defaults were believed to be high because many servicers were not verifying income or reducing the monthly payments to make the mortgages more affordable. Going forward, DBRS expects servicers to use more principal forgiveness modifications or a combination of both interest rate reductions and principal forgiveness, which should reduce re-default rates as borrowers have greater incentive to stay in their homes when they have equity in the properties or lower mortgage payments. One issue that remains unresolved but is currently being addressed in the bill introduced on February 23, 2009, to prevent mortgage foreclosures and enhance mortgage credit availability,³ is how servicers can keep increasing loan modifications (particularly principal forgiveness) in securitizations without a "safe harbor" provision for liability protection.

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

1. DBRS's ratings do not address the available funds cap shortfalls.
2. In December 2008, John C. Dugan, the U.S. Comptroller of the Currency, announced new data that indicated 58% of loans modified in the first quarter of 2008 fell delinquent after eight months.
3. See [Sec 201. Servicer Safe Harbor for Mortgage Loan Modifications](#).