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PRIME CRAM-DOWNS: WHAT INVESTORS OUGHT TO KNOW

The topic of loan modifications has attracted greater investor attention after legislation called H.R. 1106 passed the House of Representatives last week.¹ The bill is expected to be taken up by the Senate shortly. It would, among other initiatives, enable bankruptcy court judges to restructure mortgages on principal residences for borrowers seeking Chapter 13 bankruptcy relief. Such restructuring may include extending the term, an interest rate reduction or principal forgiveness (otherwise known as a cram-down).

Principal forgiveness is the most controversial of the restructuring options. A cram-down is the reduction of the secured mortgage debt.² Such reduction is treated as an excess loss for certain residential mortgage-backed securities (RMBS). As discussed in our March 2, 2009, [U.S. Structured Finance Newsletter](#), losses arising from bankruptcy that exceed a threshold limit (a carveout) are allocated pro rata across the capital structure for some senior-subordinate shifting-interest RMBS. All prime and certain Alt-A RMBS employ senior-subordinate shifting-interest structures, although not all prime and near-prime RMBS contain carveouts.

Given the increased loss potential as a result of judicial principal reductions, investors in senior class prime and near-prime RMBS face considerable writedowns and rating downgrades. H.R. 1106 attempts to mitigate investor concern by rendering carveouts as unenforceable.³ That is, if H.R. 1106 were to become law, cram-down losses would follow normal loss allocation rules in reverse sequential order (i.e., from the bottom up) as they already do for RMBS structured as senior-subordinate with overcollateralization. In the current situation, bankruptcy losses that exceed a stipulated carveout limit will result in an unanticipated writedown to the senior RMBS class, which would not have otherwise taken credit losses at such time.

Investors in senior class prime and near-prime RMBS may take comfort once carveouts are declared unenforceable under H.R. 1106; however, bankruptcy losses could spike and eventually erode subordination altogether. Currently, a borrower with secured debt exceeding \$1,010,650 and unsecured debt exceeding \$336,900 is ineligible for Chapter 13 relief. H.R. 1106 notably eliminates the secured debt limit, which starkly contrasts with (1) efforts in the U.S. Senate that intend only for subprime borrowers to be cram-down eligible and (2) the Obama administration's Making Home Affordable program, which targets conforming balance mortgages on owner-occupied properties.⁴ Prime mortgagors, once characteristic of highly qualified borrowers, have shown deterioration in the ability to service high-balance mortgage debt⁵ amid a deepening recession. Thus, senior class RMBS could face additional loss exposure and rating downgrades from prime borrowers who are ineligible for recently expanded conforming balance limits.⁶ DBRS will continue to monitor the Senate for the final passage of this cram-down legislation as well as its impact on loss allocations for RMBS securitizations.

For questions or comments, please contact Bernard Maas at bmaas@dbrs.com.

1. The short title is *Helping Families Save Their Homes Act of 2009* (the Act). The bill was passed by the House on March 5, 2009.
2. A cram-down is the amount of undercollateralization of the mortgage. The cram-down amount is re-characterized as unsecured debt and included among other similar debt subject to the debtor's reorganization.
3. Section 124 of the Act.
4. See www.treasury.gov/press/releases/reports/housing_fact_sheet.pdf.
5. A study by LPS Applied Analytics showed that 2.57% of 2008 vintage prime jumbo borrowers were at least 60 days past due.
6. The conforming balance limit reverted to a ceiling of \$729,750 for single-family dwellings in 250 counties in the United States. See www.fhfa.gov/webfiles/1279/CLLarra022309_final.pdf.