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NEW TRENDS IN RMBS REREMICS

Motivated by the desire to create securities with enhanced credit support, investors have increasingly turned to the ReREMIC market for restructuring efforts. In the last three months alone, the RMBS sector has seen 39[1] ReREMIC transactions, close to 60% of the total number of ReREMICs issued in the entire year of 2008.

In previous newsletters, DBRS introduced the concept of AAA Re-REMICs as a restructuring tool. These Re-REMICs, frequently backed by originally AAA-rated underlying certificates, often employ a simple A1/A2 (or senior/non-rated) structure. With principal paid on a sequential basis and losses allocated reverse sequentially, Class A2 effectively provides additional credit enhancement (CE) to A1 via subordination, thus ensuring improved rating stability and liquidity for Class A1.

Having been active in rating ReREMICs, DBRS noticed several trends in recent transactions. First, the underlying collateral has evolved. Following substantial downgrade actions in the prime sector, the collateral for ReREMICs has expanded from primarily Alt-A securities to a blend of Alt-A and prime bonds. In the meantime, as loss expectations continue to rise, the universe of suitable ReREMIC candidates has quickly shrunk to first-pay super-seniors exclusively, while last year transactions backed by senior-mezzanine bonds weren't uncommon. Most recently, due to better performance and competitive pricing on fixed rate securities, some issuers have turned to hybrid or even option ARM collateral in order to create profitable ReREMICs.

Next, innovative structural features are proposed more commonly as investor appetite grows. Rather than a simple A1 (AAA) / A2 (NR) structure, a full capital structure down to BBB or B is sometimes sought. In addition, when the issuer is retaining the subordinate ReREMIC tranche, it would often propose a z-accrual structure, by which the interest on the most subordinate bond will be directed as principal payments to the senior tranche, as such shortening the weighted average life of the senior and making it more marketable.

Finally, although DBRS thinks CE for recent ReREMICs should be sufficient, precautionary measures in the form of exchangeable securities are regularly utilized these days to protect against future rating volatilities. This feature allows Class A1, at a future date (often when it is anticipated to face downgrades), to be exchanged into a combination of two (or more) exchangeable securities, namely Class A1-A and A1-B. Class A1-B represents additional credit support for A1-A, thus allowing it to preserve the AAA rating. For example, assume an initial Class A1 sized at 60% with a 40% CE. If the 40% CE turns out inadequate at a later date, A1 bondholders will have the option to exchange into a 50% Class A1-A and a 10% Class A1-B. The purpose of this exchange is of course to maintain the AAA rating on Class A1-A, with a newly-carved 10% CE provided by A1-B, on top of the initial CE of 40% at issuance.

For questions or comments, please Quincy Tang at qtang@dbrs.com.

[1] Inside Mortgage Finance