

U.S. Structured Finance Newsletter

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SWAP TERMINATION PAYMENTS

Interest rate swaps were commonly used in RMBS transactions to protect the capital structure against rises in interest rates. Typically, the RMBS trust pays a fixed rate payment to the swap counterparty in exchange for a floating rate (LIBOR) payment by the counterparty to the trust. Currently LIBOR rates have fallen to nearly zero, if these swap contracts were to terminate today due to a trust failure to pay, there would be sizable termination payments owed to the counterparty.

In most RMBS transactions, the swap termination payments owed to the counterparty are senior in the payment priority to the certificate holders if the trust is the defaulting party. In addition, the size of the available collateral cash flow from each distribution date (and from future distribution dates if the termination payment is not paid in full in a given period) often significantly exceeds what is needed to pay off the termination payments. Therefore, these termination payments have long been regarded as secure cash flow, certainly as good as, if not better than, interest owed to the senior certificates. Due to the considerable deterioration in RMBS performance, DBRS became concerned that certain RMBS trusts may not be able to fully pay off the swap termination payments, especially in stressed rating scenarios.

In our analysis, DBRS first uses our RMBS methodology to evaluate the collateral quality and project expected losses of existing pools. DBRS then assesses the risk that the collateral may exhaust, due to fast prepayments and/or fast loss occurrence, before the interest rate swaps expire. DBRS cash flow analysis includes running multiple fast voluntary prepayment speeds and passing through expected losses in a front-loaded pattern under various rating scenarios. Once cash flows are run, the stressed collateral cash flow is compared against each period's swap termination payments to determine if there is sufficient coverage to make these termination payments by the legal final maturity date of the RMBS trusts.

To calculate the swap termination payments, DBRS first derives the net swap cash flow for each period by comparing a) the fixed stream of payments from the trust to the swap counterparty against b) the LIBOR payments which the counterparty would expect to pay to the trust. Next DBRS calculates the swap termination payments to be the present value of the future stream of net swap cash flow. In the analysis, swap termination payments are conservatively stressed for each distribution date by flooring interest rates at 0% and assuming a 0% discount rate for the present value calculation.

A fair percentage of the RMBS transactions DBRS analyzed ended up failing to pay the swap termination payments in full under the DBRS triple-A rating stress scenario and a certain few even failed under a B rating stress scenario. This confirmed our belief that many of the swap termination payments are not commensurate with top rated securities despite their top of the waterfall position.

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