

U.S. Structured Finance Newsletter

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EXTENDING LIQUIDATION TIMELINES AND ITS IMPACT TO RMBS CASH FLOW

In this continuously deteriorating mortgage market, DBRS has noticed a deviation in delinquency, foreclosure and REO timeline trends from historical norms. As servicers have stepped up loss mitigation strategies to deal with the increase in delinquent borrowers, some loans have spent a longer than usual time in each delinquency bucket. As a result, liquidation rates have been relatively low which in turn has delayed the timing of defaults. The back-loading of defaults can have a significant impact on the expected losses to senior tranches.

As a loan becomes delinquent, it typically moves from 30 to 60 to 90-days delinquent and then follows the state foreclosure timeline before becoming an REO and ultimately being liquidated from the trust. Currently however, due to forbearance plans, loan modifications and foreclosure moratoriums, loans have remained within a pre-foreclosure stage of delinquency for longer than one month. As a result, recent performance has varied depending on asset class and servicer, but in most instances nonperforming loans have remained in the 90+-day delinquency bucket for an average of three to four months before moving to foreclosure. In addition, foreclosure timelines and REO agings have increased, ultimately lowering current liquidation rates.

To analyze the difference in potential increased write-downs to senior tranches due to slower liquidation rates and a more back-loaded default timing curve, DBRS ran cash flow stress scenarios using the DBRS ReREMIC methodology across various transactions. In transactions where senior tranches pay principal sequentially and switch to pro-rata pay when subordinate tranches are written down, DBRS found senior tranches experienced up to 33% more write-downs compared to the opposite scenario of higher current liquidation rates and front-loaded defaults.

As an example, we evaluated a senior tranche from a 2007 vintage prime transaction that is currently locked out of principal cash flows. Current credit enhancement for the senior tranche is over 7.5%. Given the current delinquency pipeline, DBRS expects approximately 40% of the collateral to default over the remaining life of the transaction. When analyzing the cash flows for similar prepayment, severity, and interest rate stresses, write-downs with a front-loaded default timing curve are approximately 30% while expected write-downs with a back-loaded default timing curve exceed 40%. As loans default earlier in the life of a transaction, principal payments and losses are allocated to the senior tranches pro-rata reducing the outstanding balance and ultimate potential write-down to the locked-out tranche. In the more back-loaded default scenario, the tranche remains locked-out and is exposed to a higher potential write-down as liquidations flow through the trust. The tranche benefits from the trust realizing losses earlier and the principal priorities to the senior classes switching to a pro-rata pay mechanism.

DBRS believes as the current credit environment remains challenging, servicers will continue to use multiple loss mitigation strategies to manage their servicing portfolios. As a result, delinquency, foreclosure, and REO timelines will continue to deviate from historical performance and affect the cash flows in RMBS structures. When analyzing a mortgage pool, it is necessary to look at the waterfall for each deal, as timing of losses can have a significant and varying impact on each tranche in a transaction. Therefore, DBRS currently runs, at a minimum, 40 cash flow scenarios on each bond to analyze the effect of various loss timing, prepayment and interest rate scenarios.

For questions or comments, contact Keith Gorman at kgorman@dbrs.com.