

U.S. Structured Finance Newsletter

Volume 6, Issue 30, August 16, 2010



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LIQUIDATING TRUST SECURITIZATIONS AT A GLANCE

Liquidating trust securitizations are transactions primarily backed by liquidation proceeds of non-performing assets. Today, given the continued performance deterioration in the residential mortgage sector, lenders and servicers have accumulated large portfolios of seriously delinquent loans. As such, many have thought of and have turned to liquidating trust structures as a financing option.

Due to the nature of the delinquent assets, DBRS default probabilities for liquidating trust pools have traditionally been at or very close to 100%. So estimating the risk of such a pool becomes an analysis of loss severities, the key to which lies in the accuracy of the property values. To calculate a reasonably conservative property price, DBRS generally starts with the lower of two values: 1) an updated broker price opinion (BPO) within the most recent three months¹ and 2) DBRS indexed current property value using MSA-based Case-Shiller home price indices. Our model then further stresses the property prices, usually by another 25% to 35% in a "B" base case and 45% to 55% in an AAA scenario, adjusted up or down by regions and property types. The further haircuts are necessary for two reasons. First, DBRS believes that the housing market will continue to experience price declines in the foreseeable future. And second, while the BPOs may be reasonable in the current environment, property sales in a liquidation scenario often represent distressed sales and therefore beaten-down prices.

To validate such assumptions, DBRS reviewed several recently-rated seasoned subprime and liquidating trust securitizations post closing, and noticed that there are indeed considerable differences between the actual liquidation prices and the BPOs provided at the time of rating. These market value declines (MVD) are highly correlated to property price buckets. On average, values have dropped 10% to 20% in liquidation sales for properties ranging from \$100k to \$400k. In the lower than \$100k category, the declines are much more pronounced, with MVDs hovering around 40%. Furthermore, when the prices drop below \$50k, it's not uncommon to see 100% MVD (i.e. no recoveries) when the properties are liquidated. It's worth noting that the average updated BPO loan-to-value ratios (LTVs) at closing for the reviewed securitizations generally ranged from 140% to 160%. DBRS does believe that MVD tends to moderate if the BPO LTVs will be reduced.

Once expected losses are assessed, DBRS undertakes a detailed cash flow analysis. We formulate conservative transaction-specific assumptions for the expected timing of liquidation proceeds and adjust these timelines based on the review of the servicer's capability and experience. Interest reserves are often needed to ensure timely interest payments to the rated bonds before liquidation proceeds begin. Aged REO properties or cash flowing mortgage assets (albeit still contractually delinquent) may help reduce the interest reserve amounts to the extent they can cover interest shortfalls early on in a transaction.

In a liquidating trust securitization, a portion of the principal cash (liquidation proceeds), which otherwise would have been used to amortize the bond balance, is almost always "borrowed" first to cover interest payments, thus prolonging the paydown of the rated bonds. Under such scenarios, an increased amount of credit support will be needed to account for the "borrowed" principal, resulting in higher credit enhancements than what the expected losses are for the pool, at each rating category.

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

1. DBRS asks the BPOs to be obtained within six months prior to deal closing. At the time of preliminary rating agency review, they are generally no more than three months seasoned.