Takeaways From ABS East

Rating Considerations Differ Among RMBS Types

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Morningstar Perspective

Much like the Gregorian calendar, time in the financial world is split, though instead of A.D. and B.C., residential mortgage experts view the divide in terms of precrisis and postcrisis. A little over a week after the 10-year anniversary of Lehman Brothers' bankruptcy, a panel of industry participants gathered at the ABS East conference in Miami Beach on Sunday, Sept. 23 to discuss the various types of residential mortgage-backed securities in the market today and how they differ from precrisis securitizations. Among the panelists was Morningstar Credit Ratings, LLC Managing Director Kevin Dwyer, who leads the RMBS team. The rest of the panel consisted of representatives from KPMG, Loomis Sayles, CoreVest, and Morgan, Lewis & Bockius.

During the discussion, Dwyer touched on Morningstar's general approach to analyzing RMBS deals. He explained that we conduct a loan-level analysis, with various stresses to project cash flows according to the specified payment waterfall structure. How well the classes can withstand these stresses and still receive enough cash to fully pay down the principal and interest by the maturity date determines our ratings. Dwyer pointed out, however, that we consider different factors when looking at each asset type.

For instance, RMBS deals from private-label companies typically have a small number of loans, with a few big loans that account for a substantial portion of the portfolio's balance. The fate of the deal depends on how well these big loans perform. To account for this, we include a large-loan adjustment in our analysis in which we assume that the biggest loans default.

Unlike with most other RMBS transactions, the original characteristics don't matter much for reperforming/nonperforming securitized loans. Usually, these loans are from before the financial crisis and have gone through some sort of modification. Because of this, Morningstar reviews the current characteristics of the loans, such as the current loan-to-value ratio and FICO score, rather than what they were at origination. Given that these loans have all defaulted at some point in their lives, we review their performance history as well.

Credit risk transfer securities are new to RMBS; Fannie Mae and Freddie Mac first implemented their credit risk transfer programs in 2013 as a way to unload some risk off their balance sheets. The model we use for these deals is based on performance data from agency-only loans, whereas we use nonagency data in the model for the other transaction types. Even though there is a transfer of assets, we still analyze the underlying collateral backing the bonds. The pools are usually very large and very strict in their selection. The loans included must fit within the agency's eligibility criteria, such as documentation limits, loan structure, and performance history, making the quality of the collateral somewhat predictable.

Dwyer explained that the only type of RMBS asset where we don't use our typical analytical approach is mortgage servicing rights financing. These are interest-only deals backed by the fees owed to the servicers of mortgage loans. Because the bonds pay only interest, our main consideration is the rate the balance declines, whether through defaults or, especially, prepayments. Our AAA stresses are based on the fastest rate of decline, whereas our lower ratings are based on a slower rate. We also review the interest rate on the bonds but give no credit for their lifespan until maturity.

Given that the RMBS landscape is still evolving as the postcrisis era progresses, new residential mortgage securities will most likely emerge with their own distinct set of characteristics. According to Dwyer, Morningstar will incorporate these factors in its analysis and make the necessary adjustments to determine its ratings.

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