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Credit FAQ: Standard & Poor's Rating Methodology And Assumptions For U.S. RMBS Resecuritizations

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Credit FAQ: Standard & Poor's Rating Methodology And Assumptions For U.S. RMBS Resecuritizations

Standard & Poor's Ratings Services is refining and adapting its methodology and assumptions for rating resecuritizations of outstanding U.S. residential mortgage-backed securities (RMBS). We are publishing this Credit FAQ to help market participants better understand our approach to reviewing resecuritization proposals. This article also addresses the "payment structure and cash flow mechanics" principle discussed in "Principles-Based Rating Methodology For Global Structured Finance Securities," published May 29, 2007, on RatingsDirect at www.ratingsdirect.com, Standard & Poor's Web site at www.standardandpoors.com, and Standard & Poor's CDO Interface at www.cdointerface.com.

Market participants are increasingly interested in RMBS resecuritizations, sometimes also known as re-REMICs (resecuritized real estate mortgage investment conduits). These transactions repackage one or more classes of securities from existing RMBS transactions, generally to provide them with additional credit support. The resecuritization vehicle in turn typically issues one or more classes of securities, and the subordinate classes usually offer credit support to the more senior classes. The repackaged senior classes thus may be better able to withstand deteriorating performance of the underlying mortgage loans and potential future negative rating actions on the underlying securities. For instance, if we downgrade an underlying security, we may or may not take a corresponding rating action on the senior class of the resecuritization, depending on the level of credit support available to the class.

Frequently Asked Questions

1) What types of U.S. RMBS resecuritization proposals has Standard & Poor's received?

The proposals we have received over the past few months have typically fallen into one of four general categories, which are determined according to the number of underlying securities supporting the proposed resecuritization transaction and the ratings on such securities:

Single 'AAA' rated underlying class.

These resecuritizations contain one underlying class of 'AAA' rated U.S. RMBS securities, and the resecuritization issues one or more classes.

Single formerly 'AAA' rated underlying class.

These resecuritizations consist of one underlying class of U.S. RMBS securities that we formerly rated 'AAA' but have since downgraded, and the resecuritization issues multiple classes, typically including senior and subordinate classes.

Multiple 'AAA' rated underlying classes (issuing senior classes).

These resecuritizations contain multiple underlying classes of 'AAA' U.S. RMBS securities, and the resecuritization typically issues one or more senior classes also rated 'AAA'.

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Multiple 'AAA' (or formerly 'AAA') rated underlying classes (issuing senior and subordinate classes).
These resecuritizations contain multiple classes of underlying securities that are either now or at some point were rated 'AAA'. These resecuritizations issue multiple classes, including senior and subordinate classes.

2) What is Standard & Poor's rating methodology for U.S. RMBS resecuritizations?

When rating U.S. RMBS resecuritizations, we first confirm the ratings on the proposed underlying securities. If Standard & Poor's did not rate the underlying securities, we take additional steps to assess their credit quality (for more information, see question No. 7).

We then evaluate the resecuritization's structure to determine which rating categories correspond with the proposed amount of credit enhancement for each class, according to our rating assumptions. We may incorporate the default probability, default correlation, and recovery assumptions of Standard & Poor's CDO Evaluator model into our analysis. (For more information regarding such analysis, see "Methodology And Assumptions For Rating U.S. RMBS Re-REMICs Clarified," published May 2, 2008, on RatingsDirect, Standard & Poor's Web site, and Standard & Poor's CDO Interface.)

We generally request information about the selection and acquisition processes for the underlying securities in the proposed resecuritization and the intended disposition strategy for the resecuritized classes. We also evaluate whether the resecuritization issuer complies with our bankruptcy-remoteness criteria and whether the flow of funds from the underlying securities to the resecuritization is consistent with our cash flow criteria assumptions. When analyzing the flow of funds, we assess the potential for exposing resecuritization securityholders to additional, unmitigated risks: for example, the potential risk of default for senior securityholders may be greater under a pro rata pay structure than under a sequential pay structure.

3) What are Standard & Poor's assumptions for the types of resecuritizations described in question No. 1?

Standard & Poor's generally applies the following assumptions for the four types of resecuritization transactions:

Single 'AAA' rated underlying class.
We look to our rating analysis of the underlying security to determine whether the rating on that security may be passed through to the resecuritization's classes.

Single formerly 'AAA' rated underlying class.
We first calculate whether the amount of additional enhancement granted by the structure of the proposed resecuritization covers our projection of the underlying transaction's expected cumulative losses for a given rating level. In certain cases, typically when the underlying transaction has experienced a severe deterioration in credit quality, is not sufficiently seasoned, or has a highly volatile delinquency pipeline, we may also perform a loan-level analysis of the remaining loans in the underlying collateral pool or apply additional stress tests to determine whether the proposed structure provides adequate support for the more senior classes in the proposed resecuritization.

Multiple 'AAA' rated underlying classes (issuing senior classes).
We review these proposals on a case-by-case basis, as described in our response to question No. 4 and in the article "Methodology And Assumptions For Rating U.S. RMBS Re-REMICs Clarified."

Multiple 'AAA' (or formerly 'AAA') rated underlying classes (issuing senior and subordinate classes).
We review these proposals on a case-by-case basis in accordance with our response to question No. 4 and the article "Methodology And Assumptions For Rating U.S. RMBS Re-REMICs Clarified."

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4) How might Standard & Poor's approach to rating underlying securities affect the subordination needed (if any) to meet the senior resecuritization securities' credit enhancement requirements?

Standard & Poor's ratings on resecuritizations represent our assessment of the likelihood that a security will receive timely promised interest over its life and full principal at its maturity. As a result, as with all securities we rate, we may downgrade resecuritization securities if the underlying collateral's performance deteriorates such that we believe the resecuritization securityholders are less likely to receive timely interest or ultimate principal.

In a resecuritization containing a small number of underlying securities, any risk of default above zero for an underlying security (which, although negligible, still applies even at the 'AAA' level) may impair the probability that the most subordinate resecuritization class will receive full principal payments. As a result, the rating we assign to the resecuritization's most subordinate class may be lower than the current ratings on one or more of the underlying securities.

In resecuritizations containing multiple underlying classes from various distinct RMBS transactions, the benefits of diversification may begin to outweigh the underlying securities' risk of default, so that the percentage additional subordination needed for a given rating on the senior resecuritization classes may decrease.

5) What other aspects or structural features have issuers included in recent resecuritization proposals, and how do these requests differ from past proposals?

Some of the more notable features that distinguish recent resecuritization proposals from those we have seen in the past include:

- Exchangeable resecuritization securities—whose respective underlying securities may themselves be exchangeable certificates—that the investor will exchange into one or more combinations of resecuritization securities;
- Accrual or accretion subordinate classes, which may benefit from the greater cash flows available from the underlying securities after the senior resecuritization classes have received their payments allowing different weighted average life profiles for the resecuritization classes; and
- Multiple classes of subordinate/support securities used to create "super-senior" securities. Past resecuritization requests rarely included more than one support class.

6) If the rating on a security underlying a proposed U.S. RMBS resecuritization is on CreditWatch with negative implications, will Standard & Poor's rate the resecuritization?

No, we do not rate resecuritizations containing underlying securities with ratings on CreditWatch negative.

7) If Standard & Poor's did not rate the underlying security or securities, what additional information should an issuer provide as part of the proposal?

On occasion, we have received requests to rate resecuritizations containing underlying securities that we did not originally rate. In order to rate the resecuritization, Standard & Poor's typically requests the following information to assess the creditworthiness of the underlying securities:

- A current collateral tape that complies with Standard & Poor's file format and which includes current consumer credit scores (not older than 180 days). We may request additional information depending on the underlying transaction's performance;
- The performance data for the underlying transaction;
- The current and original credit enhancement levels for each outstanding class; and
- The underlying transaction documents, which we will analyze to determine whether the transaction meets our

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criteria for representations and warranties, bankruptcy remoteness, and other factors.

8) How much seasoning do the underlying securities need before Standard & Poor's will rate the resecuritization?

Sufficient performance data should exist to evaluate the current ratings on the underlying securities. Typically, securities should be seasoned at least 12 months before we will rate a resecuritization, thereby allowing performance data to accumulate for our analysis. When the proposed underlying securities are seasoned less than 12 months, we may subject the resecuritization to additional stress tests.

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by the issuer-specific or issue-specific facts, as well as Standard & Poor's assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions change from time to time as a result of market and economic conditions, issue-specific or issuer-specific factors, or new empirical evidence that would affect our credit judgment.

Related Publications

- "Principles-Based Rating Methodology For Global Structured Finance Securities," published May 29, 2007;
- "Methodology And Assumptions For Rating U.S. RMBS Re-REMICs Clarified," published May 2, 2008;
- "Correlation And Recovery Assumptions Revised For CDOs Of ABS Backed By RMBS," published Feb. 4, 2008; and
- "Legal Criteria for U.S. Structured Finance Transactions," published in October 2006 (chapter three discusses characteristics of bankruptcy remoteness).

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