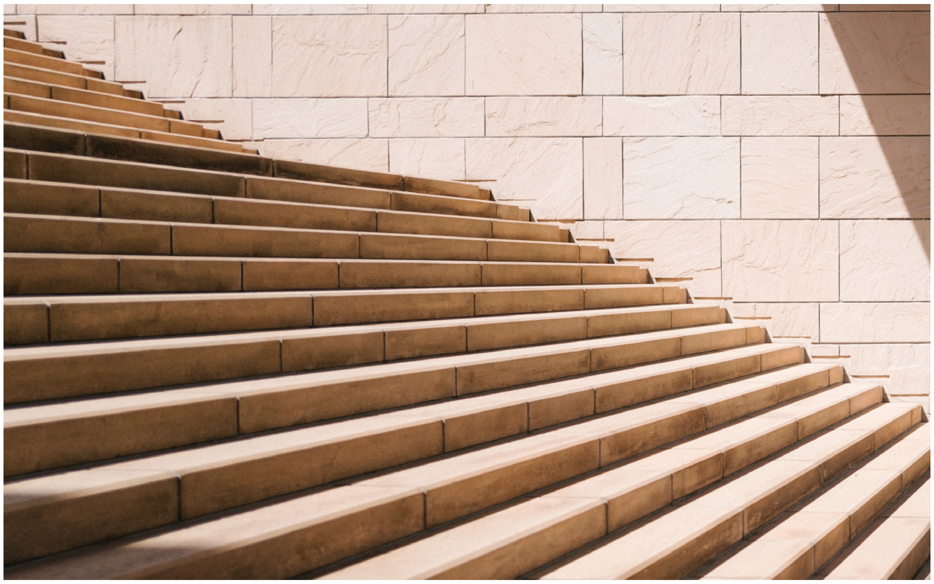
Understanding Sequential Pay Structures



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Introduction

In a January 2019 newsletter, DBRS discussed the Evolution of the Shifting Interest Structure in residential mortgage-backed security (RMBS) transactions. Another common structure in RMBS transactions is the sequential pay structure.

The sequential pay structure is one of the most elementary and straight-forward structures in RMBS. Post-crisis, the sequential pay structure and its variations have been widely used in seasoned re-performing loan (RPL) and non-Qualified Mortgage (QM) transactions. Such structure largely benefits the senior classes in payment priorities over the subordinates.

In this newsletter, DBRS reviews the key elements of a sequential pay structure, its variations as well as its adaptations.

Understanding Sequential Pay Structures

Transactions that use a sequential pay structure often contain similar features. Many securitizations contain variations of these features, but they generally conform to the fundamental principles described below.

Interest Payments

Interest payments in both RPL and non-QM securitizations are typically paid in a sequential fashion starting with the most senior class and ending with the most subordinate class. Many transactions contain provisions for any unpaid interest or previous interest shortfalls to be paid to the more senior certificates before the subordinates receive any interest. This provides additional protection to the senior bondholders.

Principal Payments
In a sequential pay structure, principal payments are typically allocated to the securities in order of seniority. As cash flows are received from the loan pool, principal payments are paid to the most senior class until retired. They are then directed to the next most senior bond and continue in this fashion until all class balances have been reduced to zero. Exhibit 1 shows an example of this simple sequential structure, which is used in most RPL transactions today. Variations on this structure are discussed in more detail below.

Allocation of Losses
When applicable, realized losses in a sequential pay structure are first allocated to reduce any overcollateralization (OC) amount available. The remaining losses and note writedown amounts are allocated in a reverse sequential order to the outstanding bonds from the most subordinate class to the senior classes until the principal balance of each class is reduced to zero.

Sequential Pay Structure Variations
<u>Pro Rata Seniors</u>
Sequential pay structures may vary from the traditional waterfall discussed above. For example, principal payments may be distributed on a pro rata basis rather than sequentially among the senior certificates. Such concurrent, or proportionate, principal distribution to the senior classes can last throughout the life of the transaction or until specified triggers are breached. In the latter situation, such triggers are typically tied to the delinquency rates or cumulative losses of the securitized pool known as a Credit Event. Once a Credit Event is in effect, the principal distribution reverts to a standard sequential structure among the affected senior classes in order of seniority.

Exhibit 1: Simple Sequential Pay Waterfall

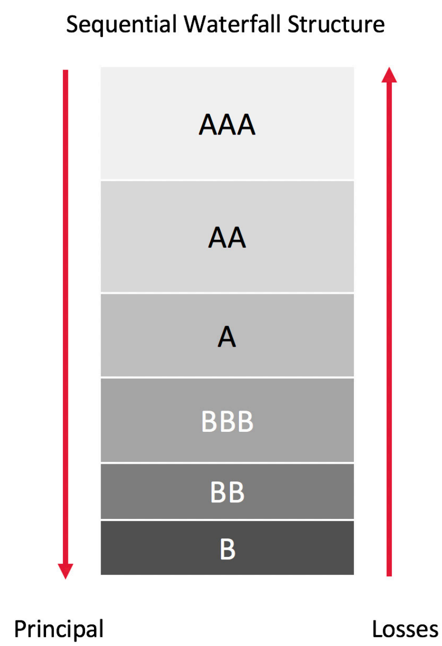
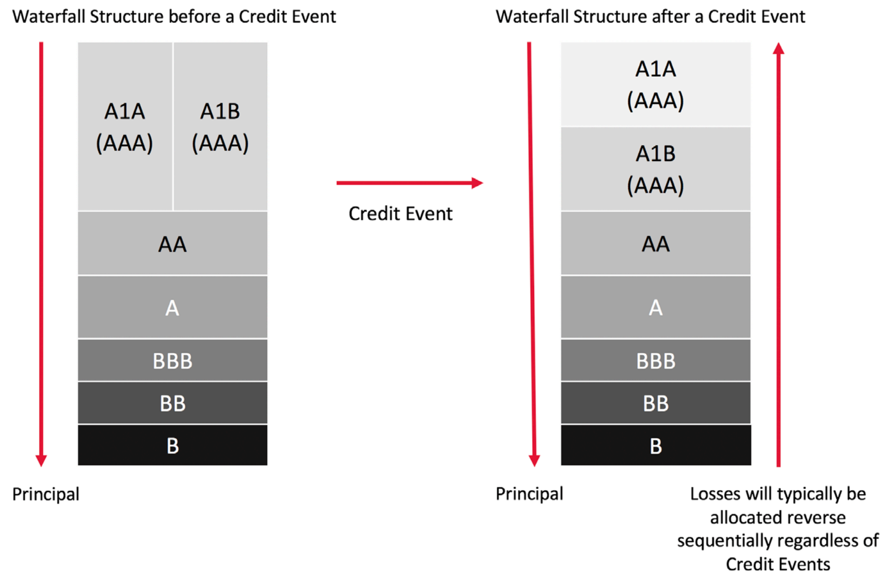


Exhibit 2 shows how a typical waterfall would adjust after a Credit Event has occurred.

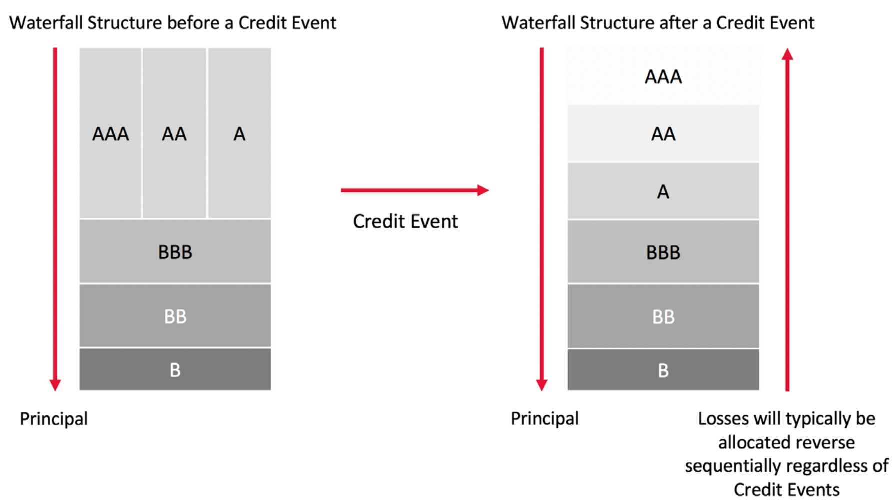
Exhibit 2: Sequential Pay Waterfall with Senior Credit Event Triggers



<u>Pro Rata AAA through A – Non-QM Structure Variation</u>
Non-QM structures have become relatively standardized across issuers, consisting of typically three top classes, A1 (AAA), A2 (AA) and A3 (A) and four more subordinate classes (ranging from BBB to unrated). As shown in Exhibit 3, the AAA through A certificates in a non-QM securitization generally begin principal payments pro rata with the ability to switch to a pure sequential structure based on a delinquency or loss trigger (together, a Credit Event). This structure allows the AA- and A-rated securities to receive principal sooner while still protecting the more senior classes in an event of performance deterioration.

In either of the above variations, realized losses are generally allocated in a reverse sequential order, even among the seniors.

Exhibit 3: Sequential Pay Waterfall in a Non-QM Structure



Sequential pay structures have been a simple yet fundamental part of both pre- and post-crisis RMBS transactions. Post-crisis enhancements such as the elimination of the OC step-down tests were made to preserve credit enhancement in a securitization. DBRS believes that the enhanced sequential pay structure along with improved collateral quality and more stringent origination practices provide robust protections to senior bondholders in many of the post-crisis securitizations.

For questions or comments, please contact Quincy Tang at qtang@dbrs.com, Jason Yang at jyang@dbrs.com or Natalie Triana at ntriana@dbrs.com.

Note:
All figures are in U.S. dollars unless otherwise noted.

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