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Credit FAQ:

How Standard & Poor's Evaluates Representation And Warranty Variations In U.S. RMBS Transactions

Primary Credit Analysts:
Sharif Mahdavian, New York 212-438-2412; sharif.mahdavian@standardandpoors.com
Vandana Sharma, New York 212-438-2250; vandana.sharma@standardandpoors.com

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Given the recent rise in variations to standard representations and warranties (R&Ws), Standard & Poor's Ratings Services is commenting on how it evaluates R&Ws provided on specific rated U.S. residential mortgage-backed securities (RMBS) transactions and the associated remedies for breaches of these loan-level covenants.

R&Ws and the associated remedies for breaches remain central elements of Standard & Poor's RMBS analysis, which centers on credit quality. When we evaluate subjective elements of our credit analysis, among other factors, we consider underwriting practices and the alignment of interests between the originators of and the ultimate investors in the underlying mortgages, both of which include the likelihood that breaches will occur and, if so, be remedied. Today's underwriting standards are, in our view, particularly strong: we are currently seeing high-quality loans made to high-quality borrowers at a time when home prices are significantly below their peak from a few years ago. The potential difficulty we foresee, however, is whether originators will employ strong underwriting guidelines as housing market activity picks up speed. We view the second factor--the alignment of interests between originators and investors--as more difficult to apply. For example, the originate-to-distribute model, in which sellers retain minimal--if any--risks on their own, does not support any such alignment.

However, we do not evaluate R&Ws in isolation. The overall loan quality, the operating experience of transaction participants and sellers, and the R&W provider's ability to remedy a breach are also critical factors in our overall risk assessment of securitized pools. In addition, we consider the amount and quality of due diligence as compelling evidence of the originators' underwriting standards and the resulting loan credit quality. Moreover, going forward, we believe that investors and other market participants in the agency and non-agency private RMBS market will likely seek a more comprehensive pre-purchase understanding of mortgage loans and deal structures to reduce their reliance on R&Ws and the often protracted and costly post-default loan workout process.

In this FAQ, we address some of the frequently asked questions about our approach in evaluating R&Ws as part of our RMBS credit analysis. Please note that Standard & Poor's has discussed R&Ws in previously published criteria and transaction-specific reports in the Related Criteria And Research section below.

Frequently Asked Questions

Do R&W's play an important role in today's RMBS securitizations?

R&Ws are important components that we factor into our overall evaluation of the associated risks in RMBS, influencing how we determine the appropriate credit support or enhancement levels and ultimately the ratings we assign. In our view, they represent the provider's commitment to quality, particularly for loan characteristics that are difficult to verify.

As issuance in the private non-agency RMBS market grows, we expect R&Ws will remain critical features in such transactions. Standard & Poor's also believes that investors will continue to actively seek stronger protections, including upfront third-party loan-level due diligence on the loans and effective R&W provisions and enforcement mechanisms.

Can third-party due diligence effectively detect R&W breaches?

A critical element in our analysis is the ability of the due diligence process to spot and differentiate breaches that are related to different issues, such as underwriting misrepresentations and loan enforceability. These reviews provide a proactive and loan-level approach to quickly addressing risk from breaches before investors have to resort to R&W reviews and enforcement procedures. Going forward, Standard & Poor's thinks that upfront due diligence reviews will continue to be highly important to RMBS securitizations.

We believe that compliance with underwriting guidelines and applicable laws are potentially well-evaluated under due diligence reviews. However, R&W terms related to loan enforceability, for example, in our view, may be more difficult to detect with traditional due diligence reviews. Therefore, language that limits investor remedies if basic loan documentation is not enforceable or the title has not appropriately passed will typically affect credit enhancement or our decision to rate a given transaction.

Nevertheless, for all issues, we overlay our adjustments while considering the overall collateral quality and our default expectations.

Why is the link between the level of due diligence and R&W provisions important to Standard & Poor's overall RMBS analysis and how does it affect credit enhancement levels?

Since 2010, the quality of post-crisis non-agency RMBS credit and origination standards has been relatively strong. As a result, we believe it is less likely that transactions issued between 2010-2012 will experience R&W breaches than, for example, the 2005-2007 vintages, when looser credit standards were well-noted. Still, due diligence reviews have the potential to significantly lessen the overall risks potential breaches present.

Credit support or enhancement levels are driven not only by our view of the loan and borrower characteristics of a given RMBS transaction, but also subjective considerations of loan quality as inferred from the due diligence, R&Ws provided, and if applicable, origination review results. Our decision whether or not to limit or assign a rating or adjust credit enhancement levels in an RMBS transaction are based on a combination of these analytical factors. All things considered, for instance, Standard & Poor's may allow greater variance from standard R&W provisions for issuers/arrangers who conduct 100% loan-level due diligence and have high-quality origination platforms, as we have seen in recent RMBS transactions that we have rated. However, as credit conditions change and the due diligence process deviates from 100% in newer securitizations as we expect, our assessment of appropriate credit enhancement will reflect the additional risks in R&Ws and other variations to these covenants.

A few recent RMBS transactions have included sunset provisions, or time limits for investors to enforce claims on certain R&W breaches. How does Standard & Poor's view the use of time limits and their long-term implications on RMBS performance?

When a transaction contains sunset provisions, Standard & Poor's considers the type of R&W subject to the sunset provision (i.e. underwriting, enforceability, etc.), the length of the sunset period, and also the quality and level of due diligence conducted on the underlying loans. Based on these considerations, a sunset provision's effect on our RMBS ratings could vary significantly, ranging from a limited impact to one that could preclude assigning a rating if we cannot estimate the potential loss to investors.

In our view, R&Ws subject to sunset provisions should relate to issues that would logically appear, for the most part, before the sunset has expired, such as false financial disclosures, which fail to reveal the borrower's inability afford loan payments. Conversely, legitimate borrower life events, rather than certain R&W breaches, may cause a default after a prolonged period of time, especially after several years of timely and consistent payments on the loan. For instance, while a breach of underwriting guidelines may occur, it is extremely unlikely to be a key contributing factor to default if the borrower has paid mortgage for a number of years.

Does Standard & Poor's give any credit to the strength of the R&W provider?

Although we consider the R&W provider's financial strength and operational experience in our analysis, we believe market participants should be sensitive to overreliance on this factor. The U.S. mortgage market has experienced significant stress that has weakened, and in some cases eliminated, many R&W providers that previously had significant financial resources. Those that did survive were and still are resistant to providing remedies.

The fact remains that we believe loan and borrower quality are the most important factors for evaluating RMBS transactions because post-securitization attempts to remedy any slip in loan quality through repurchase demands could be futile. We believe that the limited prime securitizations that have recently come to market from Redwood Trust and Credit Suisse are strong mainly because of their loan characteristics and not because of the likelihood that breaches will be remedied. These securitizations result from unusually high credit standards, as well as high loan origination and aggregation underwriting standards consistent with the current credit cycle.

Do efforts to clarify what constitutes a breach introduce additional subjective elements into the breach review process?

Yes. Currently, a remedy is typically triggered in a standard R&W provision when a breach is considered to have a "material and adverse" effect on the RMBS trust, which in our view is highly subjective. Transaction sponsors have attempted to clarify this standard, but varying levels of subjectivity remain. In our view, causation standards, independent breach review procedures, and provisions that limit remedies when life events immediately precede default may clarify responsibilities up front but could also limit investor recourse.

Standard & Poor's will continue to evaluate R&W provisions, including those related to market participants' efforts to clarify repurchase standards on loans. We expect transaction sponsors will try to further clarify repurchase standards, and we will closely look into areas where R&W providers could limit investors' access to legitimate repurchase remedies.

How are enforcement mechanisms such as arbitration quantified in Standard & Poor's analysis?

Efforts to provide more timely and inexpensive resolutions of disputes--such as arbitration, which generally offers expedited resolution timelines--in new RMBS transactions could theoretically reduce loss expectations. However, attempts to distinguish credit enhancement levels based on the expected benefit of such procedures presents a challenge.

Standard & Poor's believes arbitration will likely reduce loss severities in the longer term, but it has limited data today to quantify that impact. Additionally, given the high credit quality of current originations, we believe enforcement mechanisms may have less of an overall effect on losses for recent transactions compared with the legacy non-prime transactions issued before the credit crisis (pre-2010 RMBS). Our assessment could change if, as expected, credit quality starts to serve a larger borrower population.

What is Standard & Poor's R&W outlook for 2013?

The loan and borrower characteristics of the Redwood and Credit Suisse pools do not represent the broader U.S. mortgage demographic. Standard & Poor's expects that as the market accommodates a wider range of borrowers and as future securitizations include borrowers from the lower credit spectrum beyond the "super prime" segment, credit profiles as well as credit support and rating levels will likely begin to shift further away from those in the Redwood and Credit Suisse transactions. We do not believe that only including the highest credit quality borrowers in recent post-crisis residential mortgage securitizations is sustainable in the long term.

From a credit perspective, we believe that reducing upfront due diligence and lower origination standards will inevitably lead to greater losses in future RMBS pools, especially as the credit environment starts to shift. However, we think there is strong interest among many market participants, including the Federal Housing Finance Agency (FHFA), to place more emphasis on upfront due diligence and high origination standards before securitization.

In addition, R&W enforcement is associated with high costs, whether in arbitration or traditional litigation proceedings, and the risk that R&W providers will be unwilling or unable to provide remedies to breaches when needed always lurks. Therefore, Standard & Poor's expects upfront due diligence on the veracity of loan characteristics before purchase, as well as careful evaluation of origination platforms that will prove more helpful to investors than R&Ws in the long term.

R&Ws should continue to evolve and generate interest among market participants in 2013. We believe R&W provisions will increasingly be scrutinized by all market participants as loans from borrowers in the lower credit spectrum begin to enter RMBS pools. Standard & Poor's will continue to monitor developments in R&W provisions and enforcement mechanisms as the market evolves.

Related Criteria And Research

Related Criteria

- Mortgage Originator Review Criteria For U.S. RMBS, April 17, 2012
- Standard & Poor's Revised Representations And Warranties Criteria For U.S. RMBS Transactions, March 14, 2012
- Incorporating Third-Party Due Diligence Results Into The U.S. RMBS Rating Process, March 14, 2012

Related Research

- Comment On The Nontraditional Aspects Of Credit Suisse's Recently Rated CSMC Trust 2012-CIM3 Transaction, Nov. 30, 2012
- New Issue: CSMC Trust 2012-CIM3, Nov. 30, 2012