Reading 36

Moody's Investors Service 2010, International Structured Finance, Sector Comment, *Giving the bullet to the investors*, extracted from *Structured thinking: Asia Pacific*, 13 December.

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MOODY'S
INVESTORS SERVICE

SECTOR COMMENT

Giving The Bullet To Investors

Extracted from 'Structured Thinking: Asia Pacific', dated 13 December 2010.

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» Bullet structures return to Australian RMBS market with Bankwest's transaction; further deals in the pipeline

» Bullet RMBS opens up new investment opportunities; can help diversify funding sources – a clear positive for securitization markets.

» Can be structured in a variety of ways with rating implications typically limited; despite relative novelty structures, they are generally well-explored both in Australia and offshore.

This year's Bank of Western Australia Ltd (Bankwest) deal, Series 2010-2 SWAN Trust, has refocused the Australian market's attention on the issuance of bullet notes, a rarity in Australia.

Indeed, the last local transaction rated by Moody's that included fixed-rate bullet notes was issued by Adelaide Bank in 2005.

Here, we focus on the advantages offered by bullet RMBS issuance as well as, via a simple generic example, how bullet notes are structured – of which there are many ways -- and the relevant rating issues.

Bullet Bonds: A Way Forward?

Typical Australian RMBS are closed-end pass-through structures. Once the notes are issued, new mortgages are not added to the deal, and all the principal repayments received by a deal from the underlying mortgage borrowers are passed directly to investors to pay down the notes issued.

The advantage of traditional structures is that the assets (mortgages) are perfectly match-funded by the liabilities (notes). However, there is no guarantee as to how much principal the underlying mortgage borrowers will repay each month and, consequently, how much principal the investors will receive in a given period.

The result is that the life of the notes is uncertain and investors face significant reinvestment risk as borrowers are likely to make early unscheduled repayments of principal when interest rates decline and new investments carry lower yield.

What is Moody's Structured Thinking: Asia Pacific?

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To overcome this risk of prepayment and in order to expand their potential investor base, transactions can be structured with a "soft bullet". As such, they are akin to a typical fixed-rate note. Bullet RMBS notes offer a number of advantages:

» Reinvestment risk is mitigated by ensuring the notes are repaid at the scheduled maturity date only;

» Due to their fixed-coupon, fixed-maturity-date nature, bullet notes may qualify for UBS Composite Bond Indices, opening the RMBS market to a greater set of investors;

» There is some speculation bullet notes may be able to receive Level 2 liquid asset status under the next iteration of the Basel accords.

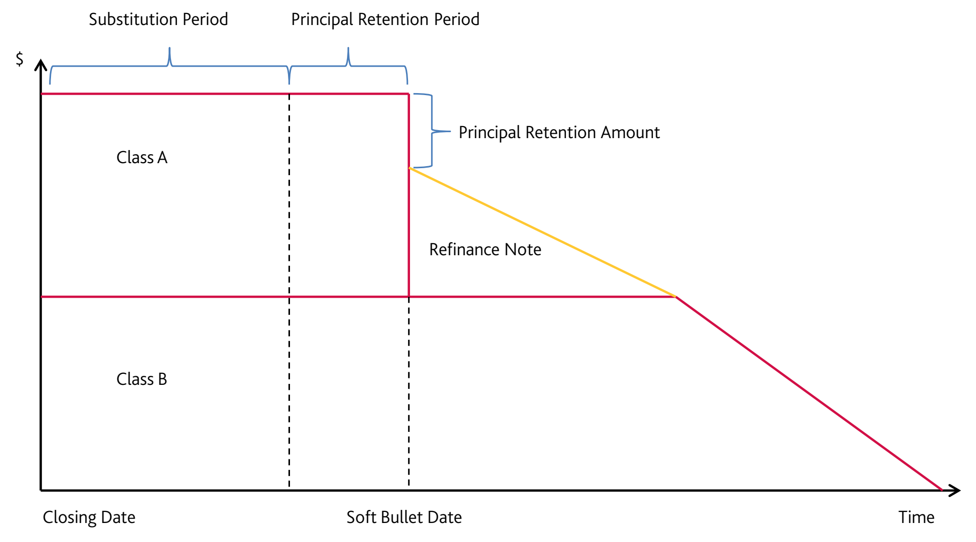
Whilst bullet RMBS had not been issued in Australia for the past five years -- that is until the Bankwest transaction -- this is not a new structuring technique: a number of such securities was issued locally pre-2005 and, in Europe, a large number of transactions have been structured in the UK (particularly, in the master trust sector) and Italy.

So, in our view, there are reasonable levels of comfort with bullet securities in the Australian market already.

Bullet RMBS: Mechanics

To illustrate the credit risks associated with such structures, it is best to go through a simple example.

CHART 1



In this example,

» The Class A note is the bullet note receiving a fixed rate of interest until the soft bullet date. The Class A note does not receive any principal payments until the scheduled maturity or 'soft bullet' date.

» The Class B note is a typical pass-through note receiving a floating rate of interest; it also receives principal payments, either after the Class A note has been redeemed or, in some cases, on partial basis during the principal retention period.

To maintain the principal balance outstanding on the Class A note, bullet structures incorporate a substitution period, or when all principal payments received from the underlying borrowers are used to purchase new mortgages from the originator.

To ensure that the transaction has principal to repay the Class A note on the soft bullet date, bullet structures incorporate a period wherein principal payments received from the underlying borrowers stop purchasing new mortgages, and are instead put into a "Principal Retention Account".

On the scheduled maturity date, the funds accumulated in the account are used to repay the Class A note. If they are not repaid in full, they will either:

» Convert to amortizing, pass-through floating-rate note with a 30-year legal final maturity (with some sort of pre-agreed margin); or

» Be refinanced with the issuance of a refinance note, the invested amount of which is equal to the invested amount of the Class A note, less the amount on the Principal Retention Account. In order to facilitate the refinancing process, a committed P-1 rated subscriber typically enters into a pre-agreed unconditional obligation to subscribe for the note, should no third-party investor be found. In this case, the legal final maturity date of the note may be quite short, including in some cases, one year.

Key Risks and Rating Implications

Bullet notes have some unique characteristics, raising risks not present in traditional RMBS structures:

a. **Asset substitution**. Because new mortgages are continually being added to the transaction, it is possible for the credit quality of the asset pool to change or deteriorate. Mitigating this risk can be accomplished by requiring that the new mortgages are subject to strict minimum quality requirements.

b. **Sufficiency of principal collections.** To ensure sufficient money is accumulated in the principal retention account to redeem the notes by the soft bullet date, Moody's stresses the prepayment rate of the underlying mortgages to simulate the lowest possible principal collections received. Typically, CPR rates are assumed as in the 0-5% range.

c. **Negative carry.** The balance of the Principal Retention Account gives rise to potential negative carry since moneys accumulated in the account earn less than the interest payable on the Class A and Class B notes, plus the expenses of the transaction. This risk is exacerbated under severe prepayment scenarios. As a result, Moody's would examine how the transaction addresses negative carry in relatively high CPR scenarios. Typically, the issue is addressed by a suitably rated bank (P-1] providing a Guaranteed Investment Contract (GIC), whereby it guarantees that money in the Principal Retention Account receives a rate of interest sufficient for the transaction to meet all its payment obligations. Alternatively, a cash reserve may be used to meet any future shortfalls.

d. **Repricing risk.** The refinance, floating-rate notes may be priced at a margin above that payable under the original fixed-rate bullet RMBS. The repricing risk is typically mitigated by pre-agreeing the margin payable to the refinance investors (effectively, representing a step margin to the bullet fixed rate). In our analysis, we examine how the transaction ensures that the set-up margin on the Class A notes, or the refinance margin on the refinance notes, does not result in the trust being unable to meet all of its obligations.

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