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AlphaCentric Insights

A Guide to Excess Interest in the Mortgage Backed Securities Eco System

In this piece we'll explore:

1. **What is excess interest and how does it impact bond holders**
2. **How excess interest may bolster credit enhancement and provide additional performance**

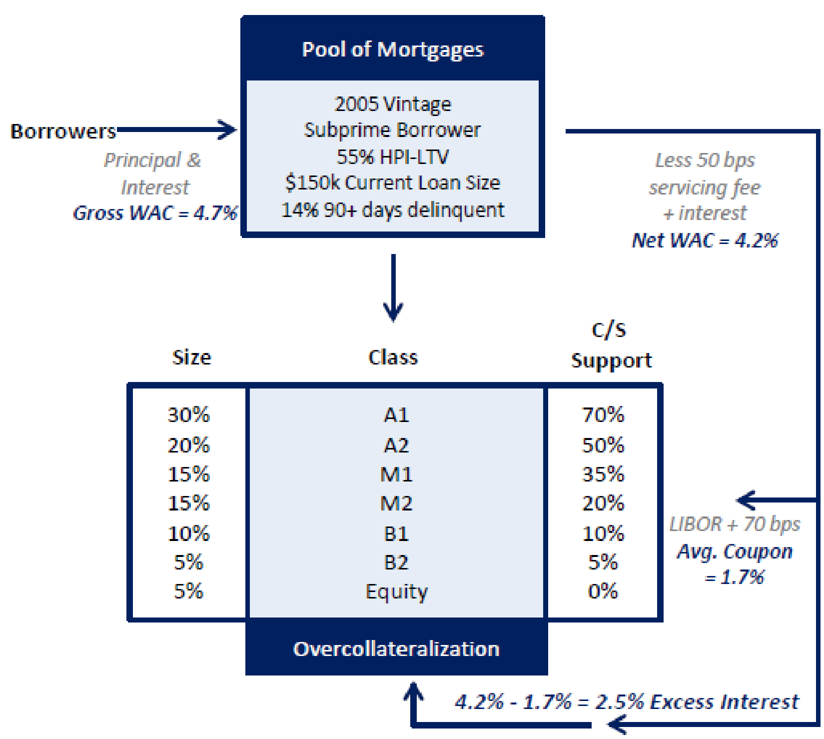
What is Excess Interest:

The concept of excess interest mechanisms is unique to subprime legacy non-agency residential mortgage backed securities (NARMBS). Excess Interest means any amount or rate of interest (including the Default Rate and, to the extent that they may be deemed to constitute interest, any prepayment fees, late charges and other fees and charges) payable, charged or received in connection with any of the Loan Documents which exceeds the maximum amount or rate of interest permitted under applicable law.

Excess interest is the residual cash flow after scheduled payments to servicers, agents, and tranche (bond) holders. It is usually the greatest in subprime structures by design and enhances internal credit of the deal structure. Furthermore, it serves as the first line of defense against losses from delinquencies and defaults and can potentially serve to repair credit support and write back losses.

Excess Interest and Non-Agency Residential Mortgage Backed-Securities:

The NARMBS consists of a pool of loans or collateral deposited into a trust where the pool is there to support the bonds after the servicers collect their portion of the fee. An example:



**This example is for illustration purposes only and shows a simple cash flow waterfall as it relates to excess interest. Specific figures are made to mimic an "example" subprime deal structure. There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses.*

For a typical securitization, what comes into the top pool gets paid out to the bottom pool in totality. This applies to prime, alt-A and newer securitizations. For example, if 3-4% comes into the pool from the borrowers, that 3-4% will also go out to the loans.

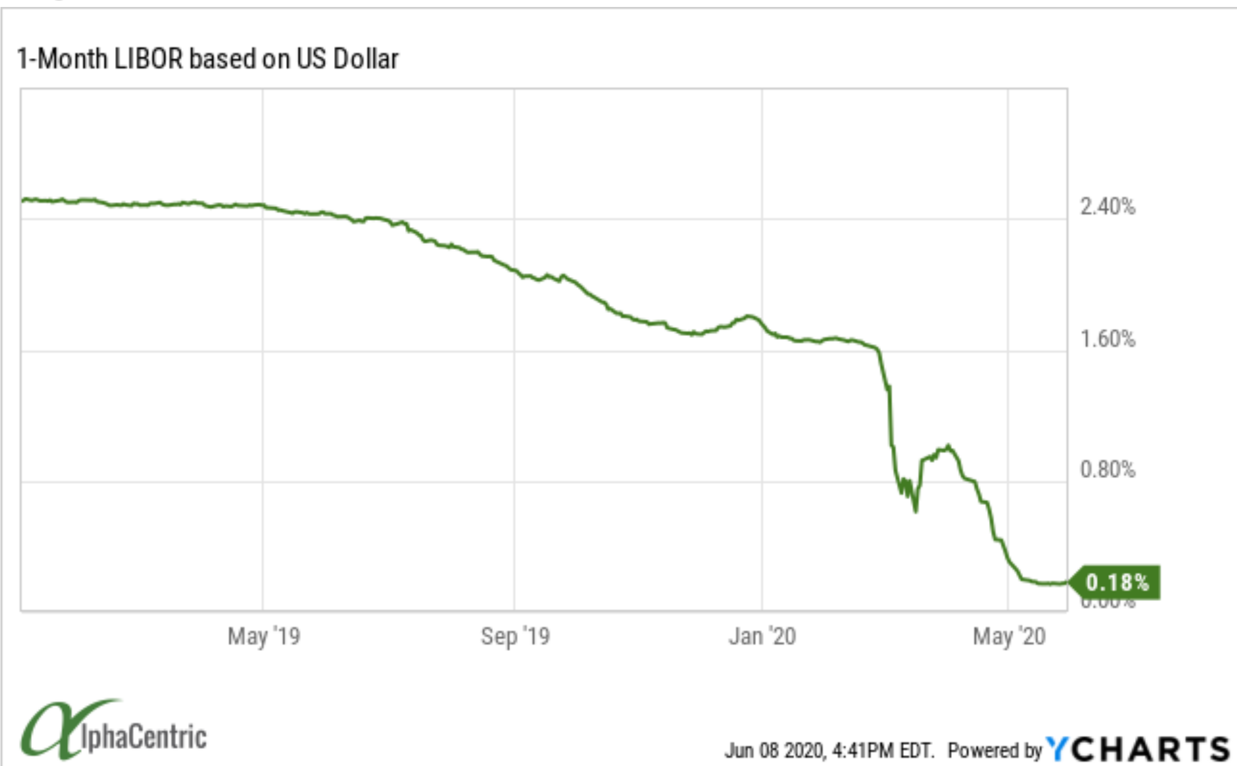
Sub-prime is different. In 2005-2006, when these loans were originated, rating agencies knew these were weaker borrowers so that in addition to subordination, the borrowers demanded excess interest. To manage this, borrowers paid out a higher rate to create that excess interest that would be made available to further enhance the credit structure.

Excess Interest's Impact:

Excess interest is available to cover things such as delinquencies, missed interest payments, loss, etc. Looking at the example above, 4.7% gross WAC comes into the pools from the borrowers. The servicers are paid about 50bps in order to service the loans leaving 4.2% left in the trust. That 4.2% will go out to the bondholders and certificate-holders. In a typical securitization such as the example, the average rate is 1.7% for the bondholders. This leaves about 2.5% in excess interest. This, over time, compounds and can provide an additional 10-30% of credit enhancement. This goes to bolster subordination.

Excess Interest and LIBOR:

Often, rates the borrowers pay are set in relation to 1-month LIBOR rates (image below from 1/1/2019 to 5/31/2020):



For the most part, the amount that comes into the trust, what borrowers are paying into the trust, remains consistent. However, it is what gets paid out from the trust that is influenced by LIBOR rates. As LIBOR rates drop, the amount of excess interest increases and, likewise, as LIBOR rates increase, the amount of excess interest decreases. In this case, the marketplace has created additional excess interest.

Excess interest is a key feature of legacy, sub-prime, mezzanine, non-agency, residential mortgage backed securities. Excess interest is made to further enhance the structure and act to bolster bondholders. The mezzanine level of the waterfall has a longer weighted life and tends to benefit more from the compounding effect of excess interest. Excess interest benefits bondholders by mitigating losses and pays down bonds faster.

> "The great thing about excess interest is the potential credit protection that it offers. It's available to cover things like delinquencies, missed interest payments, losses, and other potential detriments." – Tom Miner, Principal and Portfolio Manager, Garrison Point Capital

Key Takeaways:

- Excess interest is usually the greatest in subprime structures by design and enhances internal credit of deal structure
- Excess interest serves as the first line of defense against losses from delinquencies and defaults, and potentially for repair credit support and write back losses
- Excess interest is the residual cash flow post scheduled payments to servicers/agents and tranche holders