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Interest Shortfalls in Nonagency MBS

In recent months, some nonagency investors have been dismayed to find shortages in their anticipated monthly interest payments. Interest shortfalls occur when the interest distributed is less than the amount of interest accrued as a result of mortgage prepayments. Servicing fees (referred to as compensating interest) usually cover this shortfall entirely. However, when prepayments are excessive, interest shortfall can exceed the coverage amount, resulting in nonsupported interest shortfall. Investors should be familiar with an issuer's interest shortfall provisions. Prepayment speeds in the whole-loan market peaked in March as a result of the first-quarter interest-rate rally, but June nonagency speeds indicate that prepayments are increasing. In the event that interest rates rally another 20bp-30bp, investors will probably have to weather another spike in mortgage prepayments.

Most issuers pay a maximum of 12.5bp of compensating interest annually, while NASCOR pays 20bp.

Since mid-1994 (when GE and RFC commenced offering compensating interest), all major nonagency issuers offer interest shortfall coverage. There are differences, however, regarding the maximum amounts paid, the type of prepayments covered, and prepayment remittance cycles.

Figure 38 captures this information for Citicorp Mortgage Securities (CMSI), Countrywide Mortgage, GE Mortgage, Norwest Mortgage (NASCOR), and RFC. As shown, the maximum amount typically paid to cover interest shortfalls is 12.5bp annually (one-twelfth of 12.5bp monthly), from servicing fees, with the exception of NASCOR (20bp annually). In any given month, however, the amount paid may be the less. For example, in the case of NASCOR, compensating interest amounts to the lesser of 20bp, or the master servicing fee plus interest income; in the case of RFC, compensating interest amounts to the lesser of 12.5bp, or the master servicing fee plus interest income. (See prospectus supplement for each issuers' coverage provisions.)

NASCOR and RFC do not compensate for curtailment shortfall.

The type of prepayments covered also varies. Figure 38 shows that CMSI, Countrywide, and GE provide for interest shortfalls resulting from prepayments-in-full, as well as from curtailments — however, curtailment interest shortfall amounts are minor. Nonsupported interest shortfalls from these issuers are spread pro rata among all classes. NASCOR provides compensating interest for loans that prepay-in-full only. Any nonsupported interest shortfalls are also spread pro rata. However, NASCOR's curtailment interest shortfalls are absorbed by the first-loss

[16] A lower turnover rate means that the CALPERS 8s will slow down more than generic 1992 8s if the rates rise to the point where the 8s are discounts. However, at current prices, with 8s close to 104, the adverse effect of this slowdown is outweighed by the benefits of overall slower speeds.

[17] Slowing down the turnover component to a more conservative 0.9 has roughly half the impact— i.e., it increases the value of the CALPERs 8s by about 3+ ticks.

Figure 38. Compensating Interest Policies for Major Nonagency Issuers

	CMSI	Countrywide	GE	NASCOR	RFC
Maximum Compensating Interest Paid Annually[a]	12.5 bp	12.5 bp	12.5 bp	20 bp	12.5 bp
Type of Prepayments Covered	Prepayments-in-full and curtailments	Prepayments-in-full and curtailments	Prepayments-in-full and curtailments	Prepayments-in-full only	Prepayments-in-full only
Prepayment Remittance Cycle	Previous month	16th day of previous month to 15th day of current month	Full prepays: 16th day of previous month to 15th day of current month. Curtailments: Previous months.	17th day of previous month to 16th day of current month[b]	Previous month

[a] Actual shortfall coverage could be less, see formula in prospectus supplement. [b] Some loans, known as Norwest Type 2 loans, pay the previous month's prepay. See prospectus supplement.
Source: Smith Barney Inc./Salomon Brothers Inc.

class. On the other hand, while RFC also covers interest shortfalls from full prepayments only, RFC allocates any nonsupported interest shortfall plus curtailment interest shortfall pro rata among all classes.

Midmonth remittance cycles eliminate some of the interest shortfall.

The third main difference involves prepayment remittance cycles. CMSI and RFC (as well as GE's curtailments) pass through all prepays received during the previous calendar month on the distribution date of the current month. Whereas, Countrywide, GE (full prepays), and NASCOR have prepayment remittance cycles that begin at the middle of the previous month (instead of the first day) and go to the middle of the current month. Thus, principal prepayments made before the middle of the current month do not cause interest shortfall, because this principal is passed through on the current remittance date. Prepayments made after the middle of the month are passed through the following month, with interest shortfall covered according to these issuers' compensating interest policies. The midmonth provision eliminates some of the interest shortfall, and reduces the amount of potential nonsupported interest shortfall.

With speeds increasing in the near-term, particularly for lower coupon California loans, nonsupported interest shortfalls may occur more frequently.

Prepayment speeds in the jumbo loan market peaked in March. June speeds indicate that new premiums have increased, while seasoned premiums have declined. A strong housing market in California has spurred substantially faster speeds in lower coupons. Jumbo borrowers have traditionally been opportunistic refinancers with greater financial incentive. Overall, we anticipate that speeds will increase roughly 10% in the near-term, because of the mini rally of the past two months. Cuspy coupons will probably follow Fannie Mae's lead with higher July speeds. If interest rates rally an additional 20bp-30bp, we would expect a new refi wave. With the typical nonagency transactions containing 20%-45% California concentration, fast speeds, particularly among the lower coupon cohort, will probably cause some transactions to exceed their interest shortfall limitations.

Generally, the yield erosion caused by interest shortfall is about 5bp across a wide range of speeds.

Yields are moderately sensitive to interest shortfall. Generally, the yield loss caused by interest rate shortfall is less than 5bp.[18] Yield erosion increases as prepayment rates and the number of days of lost interest increases. The yields of longer maturities and seasoned classes are more sensitive to interest shortfall (as are higher coupons) because for a given PSA percentage, CPRs are faster subsequent to the PSA ramp. For example, short sequentials experience a yield loss of approximately 7bp at 800% PSA, while 7-year sequentials lose about 20bp at the same speed (assuming 30 days of lost interest).