

Net Interest Margin (NIMs)

Overview

Net Interest Margin (NIMs) deals are most commonly backed by either Home Equity (HEL) or Manufactured Housing (MH) deals. These structures are collateralized by the pooled excess spreads of different HEL and MH deals. Excess spread is the difference between the gross weighted average coupon (WAC) less servicing fees and the net coupon paid within the deal. This spread number usually ranges between 3.5% and 4.5%. In most deals, the excess spread is used as the first line of subordination in the case of defaults. Excess spread off of six different HEL or MH deals is pooled together to create NIMs.

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| AAA-rated Senior Bonds |
| Subordinated Bonds AA-B |
| Residual |
| Excess Spread |

NIM Structure

In order to create NIMs dealers take the entire pool of excess spread cash flow and separate it into both a senior and a subordinated tranche. At present the levels of subordination are 25%-35%. The subordinated tranche is commonly retained by the issuer. The senior tranche is then artificially separated into scheduled principal and interest. The senior tranche is 1 – 3 years in average life, 0.8-2.5 years in duration and is currently trading at spread of 200-250. It is important to realize that even though NIMs have assigned principal, they are based on interest only cash flow (i.e. excess spread). The senior NIM tranche is usually rated BBB. Each month's exceed spread is used to first pay down the NIM's coupon and then to pay down the principal.

Risks

In order to understand the risks of NIMs one must first understand the underlying cash flow. Excess spread, as a stream of future cash flow, can be negatively impacted by two different factors. First, prepayments lower the amount of outstanding balance in the underlying HEL or MH deals, therefore eliminating the future cash flow expected to be derived from the spread differential between the net WAC and the net coupon. Defaults also negatively impact the cash flows by both lowering the outstanding balance and using part of the actual excess spread cash flow as subordination to pay down the senior bonds in the underlying HEL/MH deals.

1. Increase in Prepayments