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SFA Research Corner

Call or Hold: Understanding RMBS Call Option Triggers

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Most residential mortgage-backed securities (RMBS) deals include a call option, allowing issuers or pre-specified other parties to terminate the trust before the scheduled maturity date. Upon calling a deal, the underlying loans would typically get rolled into a new RMBS deal with lower funding costs. As rates began rising sharply in 2022, the cost to finance loans through new RMBS deals has also risen, putting many issuer call options "deep out of the money," according to Deutsche Bank Research. About $14 billion of non-QM RMBS deals that are currently call-eligible have not been called, Deutsche Bank Research shows.

Calls may be triggered by a specific date such as the anniversary of the closing date (typically within 3 years after the deal has closed) or when the outstanding balance of underlying mortgage loans reaches a specified threshold (typically between 20% and 30% of the original pool balance). A call option may be structured to involve a combination of these features. The call option in these cases is typically held by the issuer or sponsor, financial institutions that originated or aggregated the loans securitized. Another type of call option is the optional termination and held by the Depositor or Master Servicer. Call options are exercised when the option holder has both the means and motivation to do so. Motivation typically arises when the primary market offers funding at more favorable costs compared to the existing transaction's funding costs. Meanwhile, the means to call exist when accessible funding sources are available.

Issuers use clean-up calls to manage their balance sheets effectively. In a low interest rate environment, a clean-up call allows the issuer to retire high-cost debt and replace it with lower-cost financing. In higher-rate environments, the decision becomes more nuanced, as increased financing costs prompt a closer review of optimal timing. Issuers may adopt a conservative approach during these times, preferring to wait for more favorable interest rate conditions before triggering clean-up calls.

Whether a deal is called or not impacts issuers, investors, and servicers. According to Deutsche Bank Research, 82 non-QM RMBS deals were called between 2019 and 2023, with most of the deals being called in 2021. The average number of days from call-eligibility to call for this group was 147 days. Since the sharp rise in rates, call activity has been muted. As of the April 2024 remittance date, 121 out of 316 non-QM RMBS deals with call features are callable but have not been called.

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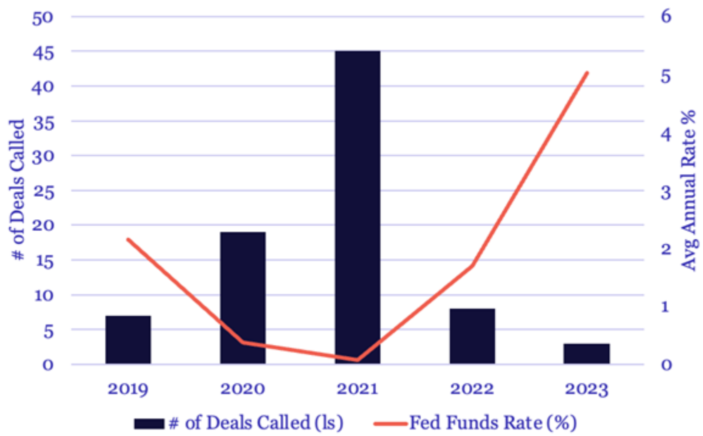
Non-QM RMBS Call Activity Vs. Fed Funds Rate



Source: Deutsche Bank Research, Intex

However, interest rates are not the only factors driving this decision; loan performance, housing market conditions, and macroeconomic factors also play significant roles. Typically, for a clean-up call to be advantageous for the issuer, the value of the underlying loan should be at or above par. This condition is satisfied when current loan values are high, and the values of seriously delinquent loans are not excessively low. This scenario may occur in a robust housing market and could suggest reduced default risks or improved prospects for loan value recovery. When issuers are confident that they can address delinquent loans and either sell, retain, or repackage performing ones, they are more likely to initiate clean-up calls.

The servicer of the RMBS deal, acting as an intermediary between the borrower and the trust, is also impacted by a decision not to call as it may expose the servicer to longer-than-anticipated administrative and operational costs. Furthermore, if the underlying loans experience high delinquency or default rates during this extended period, it can result in increased servicing costs and potential losses for the servicer. The servicer typically uses its own funds to cover delinquent payments to the RMBS trust for up to 180 days, ensuring continuous cash flow to investors during this time. Reimbursement for these advanced delinquency payments is expected from future mortgage payments made by borrowers.

Call options are essential tools for managing RMBS trusts, offering issuers flexibility and creating opportunities for investors. The execution of these options relies on a complex interaction of market dynamics, with prevailing interest rate environments being just one of the contributing factors.