

Non-accelerated senior HELs are becoming a staple in the ABS diet.

### HEL NAS Bonds: New Kid on the Block

In the closed-end HEL sector, sequential-pay structures, wrapped by a third party, triple-A-rated insurer have been typical. Recently, some HEL issuers have introduced a non-accelerated senior tranche (NAS) to meet investors' desire for additional average life stability.

In a sequential-pay transaction, all borrower principal payments, including both scheduled and unscheduled principal, are allocated to the first bond in the structure until its outstanding balance has been reduced to zero, then to the second until it is fully paid, and so on. In a sense, 100% of the *pro rata* share of principal collections of all but the currently paying tranche are reallocated to the currently paying tranche for distributions of principal to holders of that tranche.

In contrast, a NAS tranche is usually structured with a lockout of all principal for three years, *followed by a schedule of increasing percentage allocations of the NAS's pro rata share of total principal collections through the remainder of the transaction.* The other tranches in a NAS

structure usually pay sequentially. The effect of the shifting principal allocation adds more cash flow stability to the NAS tranche. Figure 2 provides examples of two typical NAS pro rata principal allocation schedules. In both cases, during the first three years, the NAS is shielded from the receipt of any principal due to the lockout. In the fourth and fifth years, increasing percentages of the tranches' pro-rata proportions of scheduled and unscheduled principal payments are passed through. Because these allocations are on a pro rata basis, in Example 1 for instance, the NAS tranche *does not* receive 45% of total monthly principal payments in year four, but rather 45% of its pro rata share: If the NAS accounted for 15% of the remaining outstanding balances of all tranches in the structure, then it would receive 45% of 15% (or 6.75%) of the total monthly principal collections.

As a result, the other securities in the structure must absorb the NAS's remaining 55% pro-rata share of principal repayment. In essence, the NAS's prepayment exposure has been delivered through the first six years. The NAS class is relevered in year seven and accelerated in year eight. As our examples suggest, the pro rata principal percentage allocations vary from deal to deal. In some transactions, the acceleration of principal repayment in year eight has been as high as 300%, which would heighten the security's average life sensitivity to realized prepayment speeds during the back-end years.

**Figure 2. NAS Principal Percentage Allocations**

Month	Example 1 Proportion of Pro-Rata %	Example 2 Proportion of Pro-Rata %
0-36	0.0%	0.0%
37-60	45.0	20.0
61-72	80.0	80.0
73-84	100.0	100.0
85+	140.0%	300.0%

Source: Salomon Brothers Inc.

**NAS bonds are priced fairly relative to comparable average life sequential HELs.**

To quantify the value of NAS tranches, we use the Salomon Brothers' OAS and HEL prepayment models. In Figure 2, we analyze the 6.5-year average life NAS tranche from The Money Store Trust 1996-D (TMS96-D A9) and a comparable average life, plain vanilla HEL sequential — UCFC Home Equity Loan Trust 1996-D A6 (UCFC96-D A6). Although the UCFC96-D A6 has a nominal spread of 78bp, or approximately 18bp spread pickup over the NAS tranche, the option adjusted spreads for both securities are roughly in line with each other, after accounting for the embedded short call options. The premium or nominal spread giveup associated with the NAS over the sequential-pay HEL results from the more stable average life profile or lower convexity cost of the NAS tranche. Figure 3 shows the average life sensitivity under varying interest-rate assumptions and reveals a much flatter average life profile of the NAS. For example, under a +/- 100bp interest-rate swing, the NAS's average life drifts by approximately 5%, compared with a 14%-16% change experienced by the HEL sequential.