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INSIGHT

VIEWPOINT

Return of the Non-Agency Market

MICHAEL HSU | 29 AUGUST 2019

Having contracted ever since reaching a peak of over $2 trillion before the financial crisis, the private label securitization market finally reached an inflection point this year. Non-Agency RMBS has now become a net growing asset class due in large part to tremendous growth in issuance of bonds that fall outside of the Qualified Mortgage (QM) Rule. In broad terms, newly issued Non-Agency RMBS hold either of two types of loans – those that follow the Rule and those that do not follow the Rule. The Consumer Financial Protection Bureau (CFPB) enacted the QM provision in January 2014, requiring lenders to make a "reasonable and good faith determination based on verified and documented information" that borrowers have a reasonable ability to repay their debt. Mortgages falling under the QM category are presumed to comply with ability-to-repay (ATR) requirements pertaining to such borrower characteristics as income, assets, debt, employment, and credit history. Moreover, QM loans complying with ATR requirements afford lenders certain legal protections from lawsuits, ranging from Safe Harbor (with the borrower unable to challenge whether the lender met its ability to repay obligation) to Rebuttable Presumption (where the borrower has the ability to raise a legal challenge but must overcome a legal presumption that the lender complied with this obligation).

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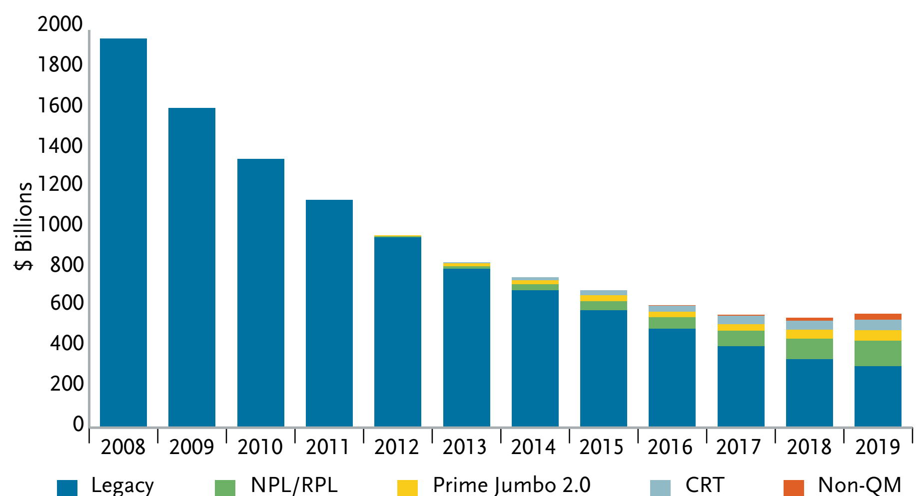
Non-Agency RMBS Outstanding



Source: Nomura

While a central purpose of the QM/ATR Rule was to make the mortgage market safer by preventing potential homeowners from obtaining loans they could not afford and at the same time maintaining credit availability by protecting lenders from litigation, it also made the Non-Agency origination landscape rather homogenous. For several years after the housing crisis, the Non-Agency primary market was open exclusively to originators serving pristine borrowers. Post-crisis deals only contained prime collateral with Safe Harbor protection. In addition to compliance with ATR standards, qualified mortgages also had to meet the following QM requirements:

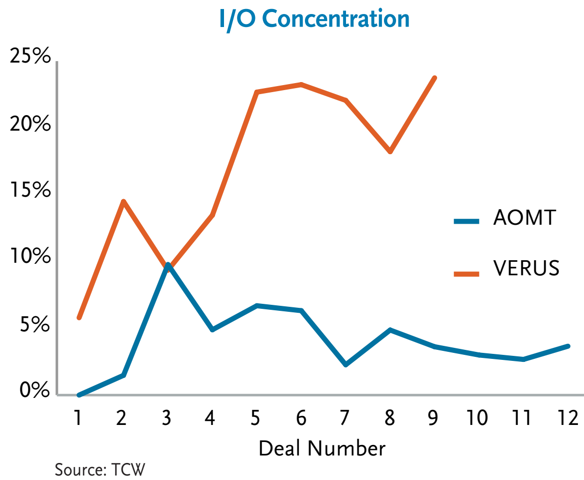
- Debt-to-Income (DTI) ratio less than 43%
- Not higher priced loans with excess points and fees (>3% of total loan amount)
- No negative amortization, IO, balloon payment, and/or greater than 30yr terms
- No Home Equity Lines of Credit (HELOCs) or reverse mortgages
- No loans for business purposes or investment properties

It was not until 2015 that the first issuer pushed into new territory with transactions that included mortgages originated with exceptions to the above conditions. With large money center banks focusing solely on traditional QM underwriting, non-banks led the charge into new generation RMBS products not defined within the QM category. Non-bank entities continue to dominate this market. Even though the borrowers on these mortgages have riskier parameters and do not fit neatly into one particular credit box beyond GSE standards, they are still credit worthy and need paths to homeownership. The individual circumstances that had prevented these types of loans from obtaining qualified mortgage status ranged from dented credit histories to alternative forms of income documentation.

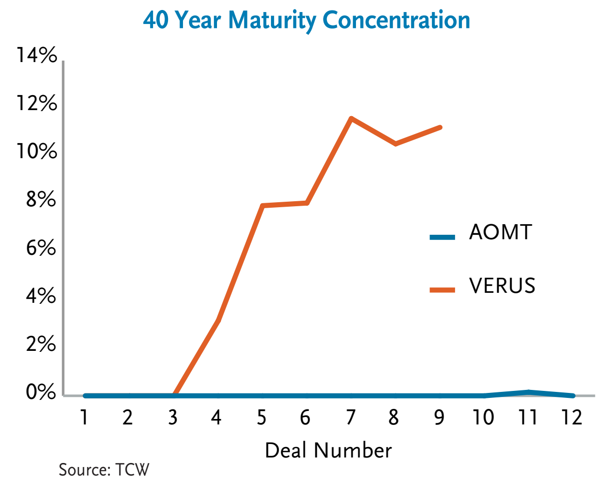
Since its start in 2015, which saw approximately $400 million brought to market, Non-QM has continued to grow in size and extend in scope. As investors have become more familiar with collateral performance and as deal economics have improved, different loan types and borrower features have made their way into newer transactions. The expansion in collateral and number of issuers is making the non-QM sector multi-dimensional; it is also making it harder to fit every transaction under a single descriptor and to apply uniform analysis. Year-to-date through July of this year, issuance of new generation RMBS has grown to over $25 billion with deals containing a variety of loan types. These ranged from investor properties to junior liens as well as more noticeable concentrations of so-called affordable loan features such as interest-only periods and longer terms. Additionally, there have been introductions of unfamiliar collateral (Community Development Financial Institution) and reintroduction of long forgotten forms (HELOCs), all of which emphasize the importance of identifying and differentiating collateral characteristics. In this paper, we will attempt to summarize some of the recent trends in collateral that we believe are worth highlighting and could potentially shape the Non-Agency market going forward.

Interest Only and Longer Maturity Loans

During the pre-crisis days, affordability mortgage products came to define and constitute the majority of Non-Agency production. While negative amortization loans are still absent from today's market, other loan features such as interest only (I/O) and longer maturity loans are making a comeback and occupying larger concentrations on particular shelves. An I/O mortgage improves affordability by requiring borrowers to pay only interest for periods generally ranging from three to 10 years, while an extended term subsequently lowers monthly payments that are stretched over a longer period than the traditional 30 years. In its early stages, Non-QM issuances from 2015-2016 had I/O percentages extending from 1-2% with original terms to maturity of no more than 30 years. In contrast, some recent deals have an observable trend toward higher shares of both I/O and longer-term loans. Take for example Angel Oak and Invictus Capital, both of which are non-bank financial institutions with several deals under their belts. For Angel Oak, which issues deals under the AOMT shelf, loans with I/O features and 40-year maturities still make up a very small portion of collateral. However, Invictus Capital's VERUS shelf has seen both features progressively rise with each subsequent deal. In fact, 11% of loans in Invictus' most recent transaction, VERUS 2019-3, have 40-year maturities on top of I/O periods. These loans have a weighted average DTI ratio of 39%, but that figure becomes 43% if they were originated as 30-year fixed mortgages (keeping everything else constant).



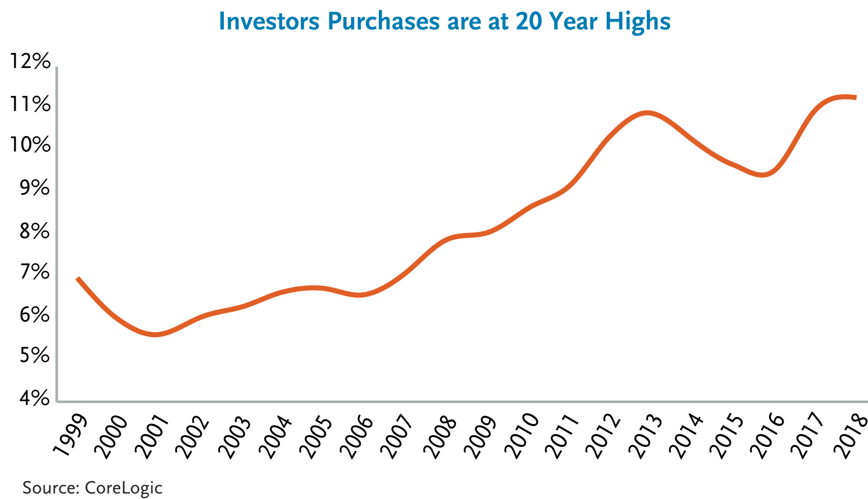
Source: TCW



Source: TCW

Investor Loans

Purchase activity in non-owner occupied single family homes has been a significant driver of housing recovery over the past several years. According to CoreLogic, investment property buying reached new highs in 2018 with investors accounting for over 11% of home purchases. Rather than large institutions that were responsible for a predominant share of investor home buying following the recession, smaller "mom and pop" investors with 10 homes or fewer have been driving the recent increase, where activity has been concentrated in starter home markets.



Source: CoreLogic

Although most financing is currently executed through Agency channels (the split between Agency and Non-Agency was 93%/7% last year), the Non-Agency share is rising at a disproportionate rate. Investor loans securitized in Non-Agency totaled at least $3.3 billion in 2018, a considerable jump from $800 million in all of 2016 and 2017. That number is expected to continue to grow as originators currently receive better execution in the private label market due to high loan level pricing adjustments from the GSEs (LLPA is a risk based fee assessed to borrowers based on loan traits). Non-Agency securitization is also likely to increase further as FHFA Director Mark Calabria has expressed a desire to shrink the GSE footprint. In addition to becoming a larger contributor to the Non-Agency market, investor loans are increasingly being underwritten to income generated by the property rather than the borrower. Since these are business purpose loans, exempt from the QM Rule as mentioned above, originators are turning more to non-traditional methods such as Debt Service Coverage Ratio (DSCR), which utilizes projected rental income in place of traditional sources of income like a borrower's W-2 or tax return.

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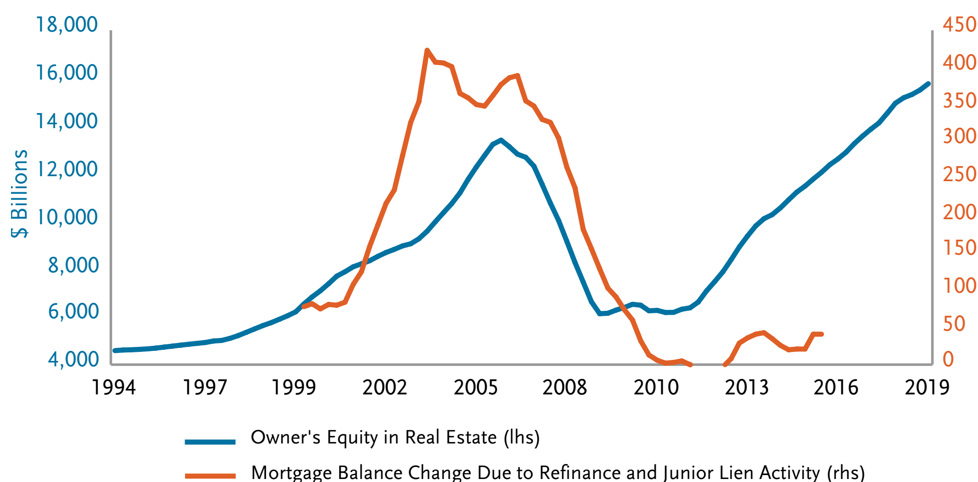
Home Equity Line of Credit (HELOC)

A notable absence during the rebound in the housing market has been the withdrawal of home equity, either through junior liens against property or through cash-out refinancings. During the housing boom, borrowers were using their homes as ATMs and levering up to fund purchases ranging from cars to home renovations. From 2003 to 2007, homeowners were tapping more than $350 billion per year in equity as the orange line shows in the chart below. Beginning in 2008 as housing values began to collapse, borrower behavior reversed course with equity extraction declining dramatically alongside a drawdown of over $7 trillion in aggregate equity ownership (represented by the blue line).

Total Equity versus Equity Withdrawal



Source: Federal Reserve Board Flow of Funds; New York Fed Consumer Credit Panel; TCW

Even as the housing market steadily recovered and the value of real estate equity moved beyond pre-crisis highs to $16 trillion, equity withdrawal and the need for home equity loans have remained subdued. The vast majority of HELOCs outstanding currently reside on bank balance sheets. The amount held by banks has consistently declined from a peak of over $600 billion in 2009 to just over $330 billion this year. New issuance of HELOC transactions dropped to zero following the financial crisis and stayed there until this year. In June, Towd Point, a non-bank entity affiliated with Cerberus Capital Management, issued the first post-crisis Non-Agency RMBS backed by HELOCs. Underwritten conservatively to prime borrowers, the loans are floating-rate products containing an interest only draw period of 10 years, after which repayment begins. The milestone deal was well received by investors and ushered in a potential growth area for Non-Agency RMBS. However, expectations are guarded considering that HELOCs were a small sector within RMBS even before the crisis. It remains to be seen to what degree the HELOC market can grow given the lack of appetite from banks to originate and hold this type of risk.

Community Development Financial Institution Loans

A completely new type of collateral made its way into Non-Agency securitization this year. The alternative investment management firm Angelo Gordon issued its inaugural Non-QM transaction in June with nearly half of the loans issued by Community Development Financial Institutions (CDFI). CDFIs are private institutions such as banks and credit unions dedicated to promoting economic development and growth in distressed areas. They do this by providing financial products and services to homebuyers who are ignored or underserved by traditional banks and lending channels. As it relates to Non-QM issuance, loans originated by institutions with CDFI designation fall outside of QM and ATR Rules, which means they can be originated using expanded

underwriting guidelines and do not require securitization sponsors to retain risk in the deal. Exemption from risk retention is afforded to all mortgages originated by the CDFI and not limited to specific areas. While this new type of collateral lacks performance history to accurately determine its potential influence on bond performance, issuers might still be inclined to include an increasing number of CDFI loans because their exempt status improves securitization economics.

Conclusion

The private label market for Non-Agency RMBS today looks markedly different from just a few years ago following the rise of the Non-QM sector. From new types of loans such as CDFI to trends in increasing I/O composition, the market for Non-Agency RMBS continues to evolve and break existing boundaries. Now a recent development in the regulatory realm is also helping to push the expansion further along and potentially lead to considerable growth in Non-QM loans. The CFPB announced in July that it plans to let the QM patch expire in January 2021. The patch is a provision that allows QM status for loans guaranteed by Fannie Mae and Freddie Mac even if they exceed the maximum 43% DTI threshold. From 2014 to 2018, approximately 3.3 million GSE loans were designated QM as a direct result of the GSE patch. In other words, almost one in five loans guaranteed by the GSE over the past five years would have been Non-QM. If the QM patch were allowed to expire without any revisions to the QM definition, the Non-Agency market along with the FHA (which has its own QM Rule without an expiration date or maximum DTI requirements) would be left to absorb the future supply. While this could lead to significant growth in both FHA and private label securities, there would also be costs, both intended and unintended, for this segment of high DTI borrowers. As these potential homeowners would not qualify for the lower interest GSE loans, they would be led down a path to affordability products. Lenders as well as investors have shown growing comfort in the expansion of the credit box, allowing Non-QM securitization to grow significantly. However, will they become comfortable with or allow for an environment that brings us back to pre-crisis days? We are of the opinion that the market for private label RMBS securitizations can continue to grow for years without the fraudulent and unabated excesses in lending that led to the great financial crisis. Nonetheless, we are watching closely as many of the trends that led to the implosion of both the Non-Agency market and the overall housing market in 2008 all began several years prior if not earlier. ■

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