A decade after the financial crisis, the US RMBS landscape looks very different. At a fraction of its former size, the private label market is now a mashup of a range of asset types representing risks across the credit spectrum, and while banks have yet to jump back into the sector, non-bank and alternative lenders are moving quickly to meet investor demand.

The market in 2017 is a mix of non-performing and re-performing loans, non-prime and non-QM, prime jumbo and agency credit risk transfer securitizations, and even though volume has been low compared to the pre-crisis heyday, observers are pointing to growing strength in the US housing market as a driver of more issuance and increased RMBS demand from fixed income investors.

As millennials start to move out of the basement and into their first homes, the 75m people between 18-34 are expected to drive new home formation in the US. This comes at a time of historically low housing supply, which should provide a boost to home prices in the coming years.

And yet, many in the market note that credit availability is not keeping pace with growing demand for housing. In addition to dealing with the lasting effects of the financial crisis, US mortgage lenders have been slower to adapt to new technologies that other parts of the financial services sector have embraced. Fintech has the potential to increase the efficiency of the mortgage underwriting process, but could also open lenders up to new issues with regards to regulatory disclosure and reps and warranties.

GlobalCapital gathered a panel of experts in its New York headquarters to discuss the prospects for the US housing and mortgage market and the potential for growing the universe of private label RMBS.

GlobalCapital: I’d like to begin with a brief overview of what you’re seeing in US housing and mortgage market fundamentals and how you’re seeing things going for the rest of 2017.

Sam Dunlap, Angel Oak: We are very bullish, generally speaking, on housing. The key driver of that is just the millennial factor, approximately 75 million people between the ages of 18-34 that historically have been the largest source of household formation, and we think that will continue to drive household formation as the millennials come online.

I know that they’ve been slow to do so, but we do think that it will happen. Morgan Stanley has done some good work on this, they see approximately 1.3m-1.5m millennial household formations looking ahead. Interestingly enough that comes at a time when existing homes for sale are at historic lows. New homes for sale are 20% below long term averages.

So that historically tight supply is going to be coming in the face of this expanding millennial population as they look for shelter. We think that’s going to be particularly bullish for home prices and just good for the housing sector as a whole. And then there is the credit expansion that we’re starting to see, and that credit box expansion in our opinion is prudent. It’s been a long while coming, and we think that’s going to be very supportive for the millennials.

Sonal Patel, BNY Mellon: From my perspective, I think that the mortgage market overall is very strong. I think we’re seeing a lot more investor confidence, especially in the new deal flow seen in the past two years or so. There’s a lot of ancillary surveillance around the collateral performance that’s being
provided for the investor base. That’s providing additional confidence. I also agree with Sam about the millennial population. I think the dynamic and the mind set has changed a lot. I think there are going to be other products offered, and keeping the cost of down payment low is going to be very beneficial for the millennial population. In terms of the securitization market, we see a strong ongoing positive trend. There are a number of regular issuers who are working on their second and third deals this year (or more). The investor base has changed and the GSEs are paying attention, which is huge. We shouldn’t underestimate the significance of the GSEs’ influence in today’s market; that’s really important as the market and regulatory environment evolves because I think there’s going to be a lot to see in this space.

**Grant Bailey, Fitch Ratings:** We think the housing market looks solid right now. There’s a lot of optimism among buyers. Consumer confidence is near a 10 year high, mortgage rates have been at historic lows for almost five years now and unemployment continues to fall, it’s closing in on a 45 year low. And that’s translated into really strong home prices, which have been growing more than 5% nationally for several years now. Home prices nationally are up 40% from their trough, so there is a lot of home price momentum.

**GlobalCapital:** Do you think that the rental market and the shifts towards renting, particularly among millennials, is an impediment to growth of home ownership in the US?

**Patel, BNY:** I wouldn’t say that. While I think the rental market is still pretty hot, it’s not as affordable versus ownership in the various states that we’re talking about.

**Dunlap, Angel Oak:** I think the single family rental operators were very supportive during some of the darkest days of the housing recovery, particularly as you mentioned, in the sand states and areas where we are, for example, like Atlanta, where they were particularly active. If you think about the single family rental companies and their size relative to the overall single family rental market — there’s approximately 15 million single family rental homes available — the companies that emerged in the post-crisis period, operate call it 160,000 properties. So it is still a relatively di minimis part of single family rental market which is still dominated by mom and pop operations. But I completely agree that their support during some of the darkest days to shore up home prices was meaningful, and I’m still confident that there is value there, and I think it’s going to be a growing part of the housing complex. I will say, too though going forward, that although single family rental securitizations get a lot of attention, the securitization market is probably not going to be where those companies will finance themselves. Given Fannie’s recent participation in that marketplace for one, but consistency is still needed across the market; I think that’s one of the biggest factors to consider as the market evolves. There’s various programmes around the mortgage industry that people are trying to securitize. From a risk perspective, we see market appetite focused on traditional structures with good quality collateral, just because I think that’s where there’s more confidence. That’s just from our perspective, because of what we see in terms of various issuers, or banking institutions trying to securitize – I think the market is expressing a keen interest to avoid the problems and challenges of the past.

**Patel, BNY:** As one of the largest RMBS trustees who has the benefit of our market position and perspective throughout the pre-credit crisis and post-credit crisis eras, we are still encountering transactions post-crisis where the risk factors were not taken into consideration around quality control at the outset. In this new age of the mortgage market, it is critical for all participants that quality diligence is being done appropriately. Progress has definitely been made on this front, but consistency is still needed across the market; I think the single family rental operators are a growing part of the housing complex. I will say, too though going forward, that although single family rental securitizations get a lot of attention, the securitization market is probably not going to be where those companies will finance themselves. Given Fannie’s recent participation in that marketplace for one, but also the fact that they’ve become potentially publicly rated senior unsecured issuers, and I would think that’s probably where they’ll fund themselves going forward.

**Peter Morreale, Cadwalader:** I think you’re exactly right, and you’ve touched on a really important point vis a vis investors, which is that there’s a lot more work being done around ensuring that the assets are what we think they are, and were originated the way we were told that they were originated. So I think whereas pre-crisis maybe you saw a throwaway line about exceptions, now you’re seeing a real meaningful 50 pages of disclosure so that investors really can make a much better decision around whether they want to take a particular risk or not.

**Patel, BNY:** The GSEs are also trying to provide various ways to provide access to affordable housing, and they’re definitely influencing how the market evolves. I don’t think anyone should underestimate their influence and buy-in around what types of programmes are being created to attract different types of buyers to the market.

**GlobalCapital:** So if we agree that housing fundamentals are fairly strong at the moment, what in your view could potentially hinder that? Where do you see the problems or the obstacles for housing right now?
Patel, BNY: I think the investor profile has changed. Today’s investors are asking for more – information, transparency, and access. And not just from the issuer side, but also from service providers. I think their demands are creating more confidence in the market.

GlobalCapital: So you don’t necessarily think then that an expansion of the credit box necessarily comes with a loosening of a quality or a lowering of standards?

Morreale, Cadwalader: That’s a really important point. You can move down the credit curve and still have a quality asset. I think as long as you know that that’s where you are on the curve, then you can appropriately value it in that way.

Dunlap, Angel Oak: I couldn’t agree more. The mortgage integrity process in the post-crisis period has completely changed, and to Peter’s point on disclosures and the fabric of the post-crisis non-agency mortgage market — I don’t think that’s going away. And if we did have an uptick in unemployment or any unforeseen macroeconomic issue, that’s certainly something that investors in credit risk and investors in mortgage credit risk can certainly take on. It’s the fraud risk that investors, as we all know from the pre-crisis experience, are not willing to take on.

So the whole mortgage integrity process has improved dramatically. Clearly the income verification and documentation that’s come from the regulatory push, as we all know, from the CFPB’s perspective, and ATR generally speaking, is all new. I think moreover, too, the home price appreciation (HPA) has had a really nice ride. So the equity components, coupled with the income verification, the fraud prevention and a much more robust appraisal process in our view will help mitigate against an unexpected uptick in unemployment or some economic shock so to speak.

Lauren Hedvat, Angel Oak: I agree with all of that. I think it’s a much more tight process and I think the appraiser independence has helped significantly, in addition to the documentation. On the other side underwriters are also taking more time with the loan files, so they are doing one or two files a day versus multiple, which they would do pre-crisis. We’re seeing really positive performance as a result of that.

Morreale, Cadwalader: The only other thing I would say is around legal compliance, which goes right along with all this.

I think we’re seeing much better diligence around all of this. And there’s just a lot more thought going on around sampling, and sampling sizes, and what you need to look at in order to be confident.

Bailey, Fitch: I would also add that from a private label securitization perspective, the due diligence has been a big improvement as far as confirming that the data is reliable.

Morreale, Cadwalader: The disclosures are better at explaining to the investor, here is what we did, here’s what we didn’t do, here’s what this might mean, and you can make a judgement about whether you have confidence in that process.

GlobalCapital: We’ve mentioned the CFPB and some of the regulatory issues. Do you think CFPB and what it does being under more scrutiny from the current administration poses a threat to the mortgage underwriting process? If there is less oversight of underwriting, how are you all thinking about that?

Dunlap, Angel Oak: The way it could have an impact on the market would be if this deregulation theme continues, particularly as it relates to QM versus non-QM and potentially changing what defines them. And that could be a credit expansion component that could increase the amount of credit available that some of the non-bank and bank lenders alike have struggled with in the post-crisis period.

But that would be the deregulation of what’s come out of Dodd Frank. I’m personally in this camp that – I just don’t see much changing, given the political headwinds we’ve witnessed over the last couple of weeks, I frankly don’t see the definitions change as they relate to QM versus non-QM though it would be, very supportive for housing generally speaking. It’s taken years to figure out, from an investor perspective, and also from a lender’s perspective what is QM, what is non-QM, what’s a good loan, what’s not a good loan in the post-crisis period.

Patel, BNY: I agree. I think that if the provisions of Dodd Frank and CFPB are loosened from an oversight perspective, it could have a positive impact. I think the current environment is over-regulated, from my perspective; some sort of loosening of some of those regulations could have a positive effect.

Morreale, Cadwalader: I think you’re right, and picking up on something you alluded to earlier, the CFPB is not the only regulator in this space. I agree with Sam that you could see around the edges of QM and non-QM, and some changes to definitions. But one of the biggest headaches the CFPB has posed for a lot of these large institutions is that they’re not the only regulator dictating what they should and shouldn’t be doing. And so it’s been hard to reconcile various regulators’ views on what should and shouldn’t be going on.

Bailey, Fitch: I think ATR has been a really important improvement post-crisis. At its fundamental level, it’s a really important rule. I think that the areas where the regulatory landscape could improve is with better clarity. I think there’s still a lot of debate about what type of income documentation can satisfy ATR, and a bit more explicit guidance on that would be really helpful.

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The lack of clarity and the ambiguity around TRID has also caused a lot of problems. So I don’t know if I’d be in favour of unwinding anything, but rather just providing clearer guidance on how to comply with the existing rules.
Morreale, Cadwalader: I agree, there has been a lack of clarity, and it has been a struggle. The other thing, of course, is the whole public market and the privacy issues around the disclosures that are required there. I haven’t seen anybody really figure that out yet, so there’s a lot of work to be done in my view on the investor side in getting the capital markets working the way they want.

GlobalCapital: That brings us to a discussion about the investor base for some of the RMBS deals that we are seeing come to market. Sonal, you mentioned the GSEs are responding to changes in the investor base. So who are these investors and where do you see the trends in the investor base coming and going?

Dunlap, Angel Oak: Real money investors, insurance companies and money managers – particularly the senior tranches of these deals. They’re looking for the extremely high credit quality and relatively short duration paper.

I think that investors will continue to embrace that profile, and as the global supply of high quality AAA bonds continues to go down, and particularly as the legacy market continues to amortize, we see investors attracted to this mortgage credit story that we’re speaking to today. There is a huge need of supply in this market to replace the pay-downs that investors in legacy RMBS are experiencing.

We think that demand will continue, and will result in very healthy primary market conditions in our opinion, barring any unforeseen credit event or economic event. It’s probably the healthiest primary market we’ve seen in the post-crisis period. But we’re seeing this across all sectors, including in CMBS and high yield and investment grade corporate credit.

As far as the investors in the risk retention tranches, and really the catalyst for this new market are those that I would call opportunistic fixed income investors like Angel Oak for example, which has the AOMT shelf. I would describe the lower portion of the capital structure as opportunistic fixed income investors.

Patel, BNY: It’s not just the investor, or the profile of the investor that has changed. I think investors are also under increased scrutiny around the type of paper that they hold. Investors themselves more regulated, hence why they’re demanding more information and due diligence — including collateral quality and securitization mechanics. So I think the fundamental dynamic has changed, because investors need to apply additional scrutiny for their own institutions, either from a banking perspective or just the fund market.

GlobalCapital: From a trustee perspective, what are you seeing as far as new demands from investors?

Patel, BNY: In terms of the oversight that the trustee provides, investors engage us as an external service provider for additional reporting elements or due diligence around the collateral — providing data on asset performance and aggregate market exposure across portfolios, are examples of services we’re providing investors from a performance perspective.

Those are the type of needs that we’re seeing, I think, because it’s not just whether or not your payments have been sent to them, it’s really a little bit more due diligence around the reporting element that they’re looking for.

GlobalCapital: Grant, is there anything from a rating agency perspective that you are observing among investors? What sorts of conversations are you having?

Bailey, Fitch: I think that there’s strong investor demand for the non-prime transactions that are being issued today, but it’s difficult to say how deep and broad the investor base is. Specifically there are a number of large institutional investors who still are concerned about the lack of standardization with structures and reps and warrants, and still have concerns about potential conflicts of interest.

Getting the large institutional investors involved is going to be necessary for the market to really grow.

GlobalCapital: With regards to the deals themselves and the outlook for issuance, what are you seeing as the engine of private label RMBS issuance and its resurgence in 2017 and beyond?

Hedvat, Angel Oak: Post-crisis, what we’ve seen to date has been a lot of NPL, RPL and CRT. I think we’re going to see a shift into more CRT as well as growth in both the non-QM and jumbo securitization sectors as supply increases. Non-QM originations are steadily increasing, at least from the Angel Oak front. We see that trend continuing, particularly as the strong credit performance supports more origination and increased investor demand.

Lauren Hedvat
Angel Oak Capital Advisors

Dunlap, Angel Oak: The NPL or RPL deals have clearly been a big percentage of issuance to date, around $21bn of the total $44bn that we’ve currently seen so far this year. CRT is $12bn of that number. So from a supply standpoint looking ahead we project $54bn by the end of this year of the universe of CRT, SFR, jumbo, non-QM and RPL/NPL. As we look ahead at 2018, I think mid $60bn of issuance with the key area of growth coming from non-QM and jumbo. That’s going to be the real area of growth and supply. CRT – as we know, just from a pure mathematic standpoint – is just going to be a function of 3% to 4% of the agency new issue market.

The real question, and where we’re optimistic, is around the growth of the non-QM and jumbo market, as the new non-agency, non-QM market really takes hold. We think these primary market conditions are favourable for a very positive year in 2018. Non-QM will probably finish around $29bn for 2017, and t think you could easily see that number double in 2018.

Patel, BNY: Yes, our projections for non-QM have been about
$3bn for 2017. For last year it was $1bn. And so the forecast for 2018 is projected to be higher, and we definitely think that from a non-QM perspective that’s where you’re going to see a little more issuance.

Bailey, Fitch: I’d agree, and add that on the prime jumbo side, I think what could change the volume there is the banks getting involved again. I think banks have become increasingly interested in trying to dust off the cobwebs of their securitization processes, so I think we’ll probably see one or two more banks try jumbo securitization in the second half of this year. But I think they’re still having real challenges just with the economics, and with the reps and warrants. I think internally some banks are having a hard time getting comfortable with a rep and warranty framework that they feel offloads the risk, but would also be attractive to investors.

GlobalCapital: And is there something that would bring banks back to the non-QM sector or is that just not in the cards for the foreseeable future?

Dunlap, Angel Oak: I’m definitely in the ‘no’ camp. We look at the legacy market and see how we’re still grappling with some major legal issues at the large banks, on the trustee side but also from a lender’s perspective. That could potentially take years to resolve. And so the participation on the non-QM and non-prime front is going to be dominated by the non-bank lenders for the foreseeable future.

But I do think where the banks will become increasingly more involved is from a lending perspective, and facilitating that non-bank lending process from a financing warehouse, and from a repo perspective, as this market continues to evolve. I am optimistic that the banks certainly see the value, and they certainly want to assist and facilitate from a securitization standpoint, and a lending perspective.

Hedvat, Angel Oak: I fully agree with that. I think banks are still really important for the support and growth of the market, especially from the financing and transaction syndication. The shift we’ve seen post-crisis is really supportive of that business model. Post-crisis changes, including regulatory, have made it increasingly more difficult for banks to become active in the space as an issuer and/or risk retainer.

Bailey, Fitch: One development that we’re thinking about in the growth of the non-QM and non-prime space is actually interest rates. Our sense is that one of the big obstacles to non-QM lending has just been getting the salesforce and lenders focused on non-QM loans when there’s enough prime refi business to keep them busy. So if rates go up, and the prime refi volume drops, our sense is that there would be a re-direction of focus to products that require more work, like non-QM.

Dunlap, Angel Oak: One of the things that we’ve actually seen – this is very interesting – is as rates rise, and we have moments like we did the second half of 2016 during the Trump tantrum for example, is actually production on the on the non-prime, non-QM side increase. And so to your point, as rate rise, and your traditional non-bank lender is focused on what’s certainly keeping the lights on, which is the traditional agency production, as rates rise they focus on the harder credit, and the thicker loan piles, and so I think that – and we’ve seen this, just through our exposure, we think that as rate rise, non-bank lenders will tend to focus on these harder credits, and we’ll see more production and potentially rising rate environments, which is very unique and quite the opposite of some of the traditional non-bank models out there.

Patel, BNY: I also wanted to add that for the most part, the underwriting process is still very manual. It’s still very paper-based. I think that there’s still this evolution of electronic disclosure, electronic files, electronic information that can be much more accessible to the community. I think that that part of the process still has to evolve, to really provide a little more quality diligence with the innovation and the technology that exists today. As the mortgage market continues to develop, mature and evolve, the technology and innovation around the underwriting needs to evolve as well.

Hedvat, Angel Oak: There are underwriting systems in place, but they’re not perfect. I think we saw that especially around the time that TRID came into place. Some of the largest underwriting software programs did not incorporate the change as smoothly as the marketplace and originators would have hoped, and that created a lot of unnecessary complication throughout the entire process until it was ironed out. I think if we had better technology to help throughout the process, it would make the process from loan origination to securitization a lot smoother and more transparent.

GlobalCapital: To what extent would improvements in technology increase the speed of loan origination?

Patel, BNY: Fintech’s been a huge disruptor in terms of the capital markets in general. So you would think for the mortgage market and the housing industry that it would really provide the same sort of avenue of disruption.

Dunlap, Angel Oak: I agree, but also, in thinking about the spirit of the regulation, particularly the spirit that came out of Dodd-Frank, how do we prevent this from happening again? That’s what the new regulation, if you will, is trying to prevent. And fintech can solve a lot of these issues from a technology perspective to reduce a lot of the redundancy, a lot of data integrity issues that everyone faces. However, the spirit of the regulation wants that borrower to be at the closing table and...
being very clear on their ability to repay, and what their loan amount is, and what the risks are that lie in that loan. And so while fintech has been able to solve a lot of consumer credit needs, I think the spirit of the regulatory initiatives will be an issue that all mortgage participants will continue to have to grapple with.

Morreale, Cadwalader: I think you’re right, and I think the point that you’ve brought up is a really good one, which is that fintech and technology can solve a lot of problems, but it presents a whole new set of issues to grapple with. So to your point, a borrower, even if they’re going to do it on a screen at home, they’re going to still need to be able to go back and look at what it is exactly they agreed to, and some of the issues that came up in that market were that those things were not clear — that a borrower had the ability to go back and say, okay, on this day, this was the loan form, these are the terms I agreed to and, most importantly, that I can enforce.

And I think you’re right, the spirit of the regulation I wouldn’t say is necessarily to preserve the ability to come to the table, but to preserve the borrowers’ ability to know what they’re doing, what the risks are of what they’re doing, to get all the mandated disclosures in a way that they can read them, and they’re understandable.

GlobalCapital: Grant, is there anything that you’ve been looking at in this regard at Fitch?

Bailey, Fitch: I think there’s been two recent developments that are notable on the technology front. One is the GSEs have created a centralized database of appraisals over the last couple of years, and developed some tools that have been able to really take advantage of the information there. They’re starting to use that to streamline the appraisal process for some of their borrowers.

And then just more recently than that, Fannie Mae announced that they’re going to start to ask third party vendors to directly verify income for some borrowers, which I think has the potential, again, to streamline the process and experience for the borrower quite a bit. And so I think that there’s been some progress, but I think all the points that were made earlier are valid.

The average cost to originate a loan is now something like $7,000. It’s really increased since the crisis. And so I would agree that there’s a lot of opportunity to improve the efficiency of the process.

GlobalCapital: To close us out, GSE reform is something that people have been really keeping a close eye on since the crisis. What are your thoughts here? CRT has come along and people are now thinking that this may be what GSE reform looks like. What are your thoughts on how the GSEs move forward from here?

Dunlap, Angel Oak: In the current environment in Washington, we see GSE reform as increasingly unlikely. I would absolutely agree that CRT will be the model for reform. I think that market participants like us embrace it, it’s certainly an asset class that is gaining more attention. It’s a way to participate and I think it absolutely solves that riddle of the bottom portions of the mortgage capital structure being sold into the private sector as opposed to being on Uncle Sam’s balance sheet.

I could be wrong, you could have some shifts in Washington, but I think the credit risk transfer theme is not going away, and we see it continuing and market participants continue to be attracted to it.

Morreale, Cadwalader: I think that’s right. One of the things that’s perhaps behind that is a sense both in Washington and in the broader markets that the FHFA really has control now of what’s going on.

On the CRT side, I think the structures are very interesting. You’ve got a 12 year final maturity, a floating rate instrument, and you are participating in higher yielding parts of the capital structure. It’s a very unique market that I think will continue to evolve.

Bailey, Fitch: Yes, just from a credit and structure perspective, there’s a lot to like about the CRT transactions. The structure and the overall framework, where they retain quite a bit of risk, then act as a master servicer and risk manager. And it’s got a very well established process to identify and resolve breaches of reps and warranties. So it’s a very strong framework from a credit perspective and I think that’s why it’s been so successful. And sometimes the question gets asked — are there parts of that that we can apply in the private label market? But I think that some of those attributes are difficult to replicate in private label, specifically the standardisation and the consistency, which is what really helps the liquidity of that sector.

Sonal Patel
BNY Mellon

Patel, BNY: I think also the success of CRT is filling a gap in the private label market. So I think that it’s overshadowing the process of the reform a little bit, which is good, but we’ll see the continued success when the PLS market does actually come back.

Dunlap, Angel Oak: Lastly, and again, the theme of the discussion is, as positive as CRT has become, there is still clearly a lack of credit availability. The statistic that Morgan Stanley keeps pointing to in their pieces is the Mortgage Bankers Association’s mortgage credit availability index. The 2006 highs were 850. Today it’s 175. We’re starting to see the a turnaround as we all discussed, but CRT and all those positive attributes that distribute that growth to the rest of the private sector has really failed to expand the credit box.

And looking ahead, it’s going to be an excellent complement to non-agency issuance. We all look for growth and supply in this market, and it’s going to come through a combination, of CRT, non-prime, non-QM, jumbo, NPL and RPL, but the key drivers we think are going to be in the non-prime and non-QM and the jumbo sector, along with CRT.