RMBS Research

Credit Risk Transfer and Less Traditional Nonagency to Paint the RMBS Landscape in 2018

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Morningstar Perspective

Morningstar Credit Ratings, LLC expects to see continued issuance growth across residential mortgage-backed securities this year, fueled by less traditional nonagency RMBS and credit risk transfer deals. On the nonagency side, in addition to increased nonqualified mortgage, or non-QM, RMBS and reperforming loan RMBS, we expect mortgage insurance risk transfer and reverse mortgage deals to be issued more frequently in 2018. For single-family rental securitizations, we anticipate that 2018 volume will be roughly in line with 2017 levels.

The RMBS market sprang to life last year amid 2017's rising-interest-rate environment, making securitization a more economically viable option for some issuers versus a whole loan sale. Issuers became more adept at meeting risk-retention requirements, while investors became more receptive to holding RMBS, as the search for yield remained a challenge. Morningstar observed heightened interest in the nonagency RMBS, single-family rental, and CRT sectors, with increased activity in non-QM, RPL, and Freddie Mac Structured Agency Credit Risk securities. Morningstar rated $12.4 billion in RMBS last year, with the majority composed of single-family rental, non-QM, and RPL transactions.

Morningstar-Rated RMBS*

	2015		2016		2017	
	# Deals	$Bil	# Deals	$ Bil	# Deals	$ Bil
RMBS	24	10.9	22	8.8	25	12.4

*Includes non-QM, RPL, NPL, single-family rental, CRT, mortgage insurance risk transfer, resecuritized real estate mortgage-investment conduit, investor property, and reverse mortgage securitizations
Source: Morningstar Credit Ratings, LLC

Tax Reform Changes Cloud the Landscape

Looming changes from tax reform bring some uncertainty to the residential mortgage landscape in 2018 as it is difficult to determine yet whether there will be a shift away from homeownership to a rental market. As the year unfolds, we'll see whether the limits to the mortgage interest deduction to a maximum $750,000 mortgage and the reduced state and local taxes deduction, now capped at $10,000, will suppress homeownership, especially in more expensive states such as California, New York, and New Jersey. In our view, home prices will likely adjust accordingly on the basics of supply and demand. In addition, there may be more families taking the higher standard deduction, which would make the cap irrelevant. Additional factors, such as lower overall income taxes for some borrowers, interest rates, wage growth and household wealth, will also influence homeownership demand.

Private-Label RMBS Comes Out of Hibernation

Despite muted activity in the prime RMBS sector and the near disappearance of resecuritized real estate mortgage-investment conduits last year, nonagency RMBS, or private label RMBS, finally awakened from their extended hibernation. According to think tank Urban Institute, approximately $56.42 billion in nonagency RMBS was issued in 2017, a 30.2% increase over the $43.32 billion issued in the prior year. Adding in $14.30 billion in CRT issuance brings the 2017 yearly total to $70.72 billion. Less traditional RMBS, such as CRTs and RPLs, or scratch-and-dent securities, filled the void and met the appetite of investors searching for higher-yielding fixed-income securities. Although nonagency prime RMBS issuance showed slight improvement in 2017, volume, at $10.880 billion, is still a fraction of precrisis levels. Meanwhile, re-Remics were largely absent from the market last year as risk-retention requirements diminished their appeal.

RPLs, previously delinquent loans from lower credit borrowers who are generally paying timely interest, experienced a resurgence last year, as $32.40 billion came to market, a 31.2% increase over the prior year's level. Investors have reconsidered RPLs as due diligence reviews, representations and warranties, and borrower quality have improved.

Non-QM Has Momentum

By including borrowers with a significant amount of equity in their homes as well as reasonable loan-to-value and debt-to-income levels, non-QM loans completed last year have helped dispel the notion that such loans are of lower credit quality. Morningstar conducted a study[1] last year that revealed that non-QM loans, while admittedly lower than QM metrics, still exhibited generally strong credit profiles, with a weighted average original FICO of 688, a weighted average original LTV of 75%, and a weighted average original DTI of 36.6. For the transactions that Morningstar has rated, we attribute the non-QM designation to be due to alternative income documentation, higher DTI or loan features such as interest-only.

[1] Non-Qualified Mortgages are not the New Subprime, June 2017

Issuers have also become more comfortable with meeting risk-retention requirements, whereby the sponsor is required to retain at least 5% of the credit risk of any securitization. For non-QM transactions, most issuers have used the vertical interest structure, where they retain a proportion of each tranche issued. Morningstar rated six non-QM deals in 2017 and expects heightened interest to continue this year.

Credit Risk Transfer Appetite Grows

As CRT issuance has helped to fill the void left by the absence of prime RMBS, the agencies have continued to innovate their offerings to meet growing investor demand. Last year, both Fannie Mae and Freddie Mac announced that they were considering enhancements to their current CRT securitizations by creating trusts that would issue the notes, enabling qualification as a Remic. This move would make the agency CRT programs more attractive to REITs because it would facilitate improved treatment of CRTs under eligibility requirements. In a year when interest rates are expected to rise, investors are likely to be attracted to CRT securities, which are floating rate bonds often tied to Libor. Morningstar rated three CRT transactions in 2017 and sees a healthy pipeline this year as both Fannie Mae and Freddie Mac announced their plans to issue approximately a dozen deals collectively, using the securitization program to offload risk from their balance sheets.

Mortgage Insurance Securitization Gets First Rating

In October, Morningstar assigned a BBB rating to the senior M-1 tranche of the first rated mortgage insurance-linked security, Bellemeade Re 2017-1 Ltd. While there have been other mortgage insurance deals done in the past, this marked the first transaction to receive a rating. The $368.1 million deal was backed by mortgage insurance policies issued by Arch Capital Group Ltd. Morningstar expects to see at least two issuers coming to market this year with rated mortgage insurance risk transfer deals as mortgage insurers seek to increase protection for their existing mortgage portfolios.

Stable Single-Family Rental Volume in 2018

After a somewhat sluggish start, single-family rental issuance closed out 2017 with a strong fourth quarter, finishing the year with Morningstar rating eight deals. The year was marked with several key events, including a new deal structure that for the first time allowed voluntary property substitution, natural disasters, consolidation among issuers and SEC investigations regarding property value calculations. Nonetheless, from a credit perspective, vacancy levels mostly remained within expectations.

Morningstar affirmed approximately 63.9% of its single-family rental ratings in 2017 as net cash flows were sufficient under each rating stress to make the required payments during the life of the certificates. Meanwhile, Morningstar upgraded 12.4% of classes as those bonds outperformed our original expectations. We withdrew the remaining 23.7% of ratings as bonds paid off.

The distribution of single-borrower versus multiborrower transactions in 2017 was heavily skewed, with only one multiborrower deal, CoreVest American Finance 2017-1 Trust, coming to market. Securitization financing demands from smaller niche players have yet to materialize at significant levels because of the high costs of issuance and the dominance of the large agencies. Overall, Morningstar expects to see roughly the same level of new single-family rental issuance in 2018, with at least a couple issuers coming out of the gate early in the first quarter as spread tightening in the fourth quarter of last year resulted in more favorable market conditions for issuers. In addition, a handful of transactions also paid off in late 2017.

A New Mainstream Takes Shape

Morningstar expects the RMBS landscape in 2018 to be concentrated in the CRT, non-QM, and RPL sectors. While nonagency prime RMBS issuance will likely improve, growth will be muted as CRTs have attracted a wider investor base. We expect single-family rental issuance to be unchanged, whereas more deal activity will likely occur across smaller categories, such as mortgage insurance risk transfer and reverse mortgages.