# RMBS Commentary

## With Private-Label RMBS Stymied, Nontraditional Deals Highlight Market Activity

July 2016

**Authors:**

Brian Grow | Managing Director | brian.grow@morningstar.com | +1 646 560-4513
Gaurav Singhania | Senior Vice President | gaurav.singhania@morningstar.com | +1 646 560-4532

**Morningstar Perspective**

While the securitization of jumbo residential mortgages remains in the doldrums, nonmainstream deals are coming to market. A review of deals analyzed by Morningstar Credit Ratings, LLC finds that rebounding home prices and, in the instance of reperforming and nonperforming transactions, repaired borrower credit, have reduced credit risk in these transactions. In an otherwise moribund market, Morningstar expects interest among originators to securitize single-property investor loans.

Nonagency issuance of residential mortgage-backed securities totaled $26.6 billion through June, down 41.3% from the same period last year, according to the Securities Industry and Financial Markets Association, better known as Sifma. One bright spot is seasoned deals. Seasoned deals, which generally include nonperforming and reperforming assets, totaled $8.1 billion through June, up more than eightfold from the same period last year.  Morningstar does not expect any meaningful boost this year in private-label RMBS. Because securitization is not currently an economical funding source, most plain-vanilla mortgages are being held on the originators' balance sheets or being sold as whole loans. According to the Urban Institute, the share of portfolio originations at the end of the first quarter this year was at 32.7%, the highest level we've seen since 2002. The industry has made progress related to the role of deal agents and representation and warranty reviewers in private-label RMBS securitizations. However, remaining aspects of private-label transactions, including full due diligence, add substantial expenses to RMBS securitizations. Most postcrisis transactions carry out due diligence on every loan, and we do not see that changing for a while because of the recent implementation of the TILA-RESPA Integrated Disclosure rule, also known as the know-before-you-owe rule. Meanwhile, issuers remain reluctant to securitize nonqualified mortgages, or mortgages that don't meet requirements of the Consumer Financial

Protection Bureau. Some of the newly originated nonqualified mortgages have made their way into private-label securitizations, but most are being held by the lenders in their portfolios.

Issuance in the single-family rental space is expected to increase in the second half of 2016 after a slow start in the first half, but will likely end the year down from last year. Widening of spreads in commercial mortgage-backed securities rippled across to the single-family rental market, causing many issuers to pause their securitization plans. Rising home prices, rising rents, low vacancy and delinquency rates, and strong tenant-retention rates have resulted in strong performance in single-family rental transactions. Separately, property managers are establishing longer track records, and these factors have solidified investor confidence.

**Nontraditional Deals Highlight Market Activity**

Resecuritization issuance remains well below 2015 levels. Issuance to date amounted to $1.97 billion, down 83.6% from same period last year, according to Sifma. Morningstar has rated four resecuritizations this year and analyzed many more. We find that issuers have adopted accretion-directed structures and other mechanics to increase their advance rates on the senior class. Accretion-directed structures divert interest from subordinate classes to pay principal to the senior class, increasing the proportion of the senior class that can be issued.

Over the past few months, issuers began underwriting so-called single-borrower, single-property, single-family rental loans as business-purpose loans. With this approach, underwriting is focused on verifying property rental income rather than the borrower’s creditworthiness, as is typically the case. It remains to be seen whether this approach will result in better loan terms for the borrowers or higher borrower approval rates.

Foreclosures in the wake of the subprime crisis led opportunist investors to flock to the housing market and invest in properties with the hope of capitalizing on home price increases. The properties are usually rented out during the holding period. Larger institutional players with a portfolio of these single-family houses partially financed their investments via single-family rental securitizations, while individual investors typically funded their investments through traditional routes such as cash, agency loans, or bank loans. Mortgage loans made to individuals for their investment purposes typically are underwritten as consumer loans. The property’s rental income may be part of the income used to calculate the borrower’s debt-to-income ratio, but the focus is primarily the borrower’s creditworthiness and income from other sources.

Earlier this year, Morningstar published a study[1] analyzing more than 920,000 nonagency single-property investor loans, examining the relationship between default rates and property rental income. Of the sample, 28.8% of the loans defaulted. While there are distinctive risks with this new type of underwriting, our research found that loans backed by a property where the rent exceeded the mortgage payment have a lower default rate than similar loans where the rent was less than the mortgage payment. We also found that the correlation is less significant when loans are backed by mortgages carrying higher loan-to-value ratios or borrowers with weaker credit scores. We found these two items the strongest predictors of default, but other factors, including geography and the amount of documentation, also affect default risk.

**TRID Increases Need for Comprehensive Due Diligence**

More regulatory oversight is dampening private-label RMBS new issuance. Due-diligence firms have been reviewing all loans in new RMBS transactions rather than just a sample of loans. Morningstar believes these reviews benefit securitizations, as they validate the quality of the collateral, and Morningstar does not expect to see much sampling anytime soon. A move towards loan sampling for due diligence likely will happen when demand for nonagency securitizations increases to a point where investors will buy bonds without 100% due diligence. Such reviews determine the extent to which loans comply with mortgage regulations, including the Truth in Lending Act, Real Estate Settlement Procedures Act, Ability to Repay and Qualified Mortgage requirements. The reviews also determine whether a loan was underwritten according to the originator's guidelines and identify compensating factors for exceptions to guidelines. Due-diligence firms may also review the appraisal quality and whether the appraised value is materially supported by a secondary valuation, such as a desktop review of the broker price opinion. Additional reviews include comparing the loan tape data to the loan and credit documents and reviewing the title report for appropriate vesting, which includes, among other things, verification that the title is free and clear.

The implementation of TRID in October 2015 reemphasized the current need for complete due diligence in RMBS transactions. TRID combines disclosures required under the Truth in Lending Act and the Real Estate Settlement Procedures Act. The Consumer Financial Protection Bureau, or CFPB, required the new disclosures to help borrowers better understand their loan terms and fees, but the rule has created industry concern amid instances of mistakes on disclosure forms and uncertainty interpreting the new requirements. Third-party reviews of loans subject to TRID revealed a large number of clerical or formatting errors, which Morningstar believes are nonmaterial, as well as some more meaningful errors, which market participants have struggled to cure or to understand the effectiveness of a cure.

[1] Olgay Cangur, Becky Cao, and Brian Grow, "Resurgence of Nonagency Single-Property Investor Loans," (February 2016).

As long as due diligence is performed on every loan, Morningstar does not expect TRID to be a significant source of credit risk to securitizations. Morningstar expects that only obvious errors, such as fee tolerance or disclosure timing violations, will result in assignee liability. Under TRID, many violations can be cured with revised disclosures for up to 60 days after closing. While there has been ambiguity as to which types of violations can be cured postclosing, Morningstar does not view any violations that are cured with revised disclosures and refund, if applicable, as material credit risks. However, violations that cannot be properly cured after closing, such as failure to provide a loan estimate within three business days of application, may present a risk. Morningstar may require modestly higher credit enhancement to transactions where we believe uncured violations with assignee liability are present. However, the due-diligence process should largely eliminate this risk.

The Structured Finance Industry Group, an industry advocacy group, drafted a proposal for due-diligence classification of TRID violations, which proposes limiting the due-diligence review to areas that carry assignee liability, the grading of the exceptions, and whether an error on a disclosure can be cured with subsequent disclosure. Morningstar supports SFIG's proposal, which is largely based on unofficial guidance from the CFPB and may change. The CFPB acknowledged industry concerns in an April 28, 2016, letter to trade groups. After discussing possible updates with trade groups, it will issue a so-called notice of proposed rulemaking this summer. Morningstar believes more clarity is needed to calm industry concerns. However, because of the uncertainty regarding TRID, Morningstar expects full due diligence in private-label RMBS to continue this year. Over time, Morningstar expects the number of violations to drop, as originators refine their origination processes and become comfortable with TRID requirements and as the CFPB provides additional clarity. In speaking with third-party due-diligence firms and lenders, Morningstar found that there already appears to be a noticeable decline in the number of TRID violations.

**Third-Party Oversight Needed to Re-Establish Investor Confidence**

Morningstar believes third-party oversight from deal agents and representation and warranty reviewers should help re-establish investor confidence in private-label RMBS securitizations. Morningstar recently issued its first RMBS deal agent and RMBS representation and warranty reviewer vendor ranking to Clayton Holdings, LLC. Morningstar gave Shelton, Connecticut-based Clayton our second-highest ranking, MOR RV2, in both roles. In assigning the ranking, Morningstar's Operational Risk Assessments group cited Clayton's experienced managers, its risk-management infrastructure, training, and other factors. Details about the ranking can be found at www.morningstarcreditratings.com under Operations Risk Assessments/Rankings.

Mortgage insurers may get more involved with the private-label market, and this may be another source of third-party oversight. While it is too early to predict the investors' response to the involvement of mortgage insurers, Morningstar expects renewed interest among nonagency issuers to incorporate mortgage insurance[2] to lower investors' exposure to credit risk.

**Single-Family Rental Property Managers Drive Operational Improvements**

Through the second quarter, issuance of single-family rental deals amounted to $1.24 billion, down 76.5% from the year-earlier period. Amid the lag in issuance, issuers are exploring warehouse lines, or other sources of funding, as stopgap financing mechanisms.

While single-family rental transactions have existed for less than three years, their performance to date has been within Morningstar's expectations. Vacancy and delinquency rates generally remain low, while tenant-retention rates are firm. The latest performance data across 24 single-borrower single-family rental deals shows that vacancies are at 4.4% and delinquencies are at 0.5%, both of which are slightly above their all-time lows, according to the data put together by Morningstar. Morningstar's monthly Single-Family Rental Performance Summaries are found on our website, www.morningstarcreditratings.com.

Housing fundamentals are generally sound. In the major single-family rental markets of Atlanta, Dallas, Houston, Phoenix, and Tampa, Florida, home prices appreciated by 22%-30% over the past three years, as shown in the table below. The rate of foreclosure filings dropped by at least 8% for the 12 months ended May 31, 2016, compared to the year-earlier period.

| | Home Price Appreciation April 2013 – April 2016 (%) | Change in Foreclosure Filings May 2015 - May 2016 (%) | Rental Property Vacancy Rate First Quarter 2016 (%) |
|---|---|---|---|
| Atlanta | 27.9 | ↓16.0 | 5.3 |
| Dallas | 30.2 | ↓42.0 | 5.2 |
| Houston | 26.3 | ↓ 8.0 | 9.3 |
| Phoenix | 21.9 | ↓ 8.0 | 4.0 |
| Tampa | 27.7 | ↓21.0 | 7.9 |

Home Price Appreciation Sources: 1010Data, Corelogic;
Foreclosure Rates Source: RealtyTrac website http://www.realtytrac.com/statsandtrends/foreclosuretrends
Rental Property Vacancy Source: Current Population Survey/Housing Vacancy Survey, U.S. Census Bureau

[2] Morningstar updated its original RMBS Ratings Methodology to include its mortgage insurance criteria in January 2016.

Although there are fewer opportunities to purchase single-family rental properties, the demand for rental housing should remain strong for the foreseeable future. According to the U.S. Census Bureau, the rate of homeownership for the quarter ended March 2016 was 63.5%, down from 63.7% in the year-earlier first quarter and 68.5% for the quarter ended March 2006. Demographic and financial factors are driving this shift, and it is not clear whether new household formations will bolster the demand for owner-occupied housing.

As home prices recover, it is more difficult for managers to find properties that meet their investment criteria. At the same time, declining foreclosure levels have shrunk the supply of available homes for acquisition. In response, institutional property managers are ensuring they have sufficient concentration in markets to build economies of scale. Institutional single-family rental operators have benefited from their scale and available resources, negotiating discounted rates from suppliers and using data analytics to aggressively raise rental rates more so than traditional mom-and-pop investors. The vacancy rates for institutional single-family rental property managers tend to be lower than market vacancy rates, as institutional managers have the resources to operate sophisticated marketing strategies.

As the institutional single-family rental market matures, Morningstar expects these companies and property managers to focus on their operations. Improved operations should lead to greater efficiencies, reduction in risk, and satisfied tenants. Proactive tenant management minimizes the vacancy rate, and adherence to tenant underwriting guidelines reduces delinquencies.
While issuance of private-label RMBS and single-family rental securitizations has stagnated, we are encouraged by recent securitization activity in nontraditional assets. Regulatory developments and the increasing involvement of third-party oversight lay the groundwork for private-label issuance going forward.

Brian Sandler, Monte Bays, and Diana Rosenberg contributed to this article.

## DISCLAIMER