RMBS Research

Solid Post-2010 RMBS Performance and Modest Issuance Growth Will Continue In 2019

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Morningstar Perspective

We expect private-label residential mortgage-backed securities issuance to grow modestly in 2019, likely at a pace consistent with that of a prior year. We don't expect rising interest rates, a trend in 2018 that might continue this year, to materially affect RMBS issuance. In fact, for some originators, higher rates might bolster issuance somewhat by making securitization a more economically attractive alternative to retaining or selling mortgage loans. The issuance might jump, however, if the share of mortgage origination guaranteed by government-sponsored enterprises, or GSEs, Fannie Mae and Freddie Mac declines. This could occur if the new head of the Federal Housing Finance Authority, or FHFA, who will replace current director Mel Watt whose term expires in January 2019, uses the position to limit the scope of GSE involvement in the mortgage market.

We also believe that the variety of mortgage types backing new RMBS will continue to expand as borrowers look for more affordable loans owing to potentially higher mortgage rates and issuers seek to improve funding costs for various mortgage types or to diversify funding sources. Overall, we expect RMBS collateral credit quality to weaken somewhat but remain historically strong.

We expect the credit performance of post-2010 RMBS and single-family rental securitizations we rate to remain solid and, if the headwinds do not materialize, to continue to strengthen, even if home prices grow at a slower pace. One potential headwind that could adversely affect RMBS performance is the decline of home prices because of rising interest rates or a weaker economy. In addition, borrowers in states with steep home prices and high local and property taxes might pay more in federal income taxes as a result of the Tax Cuts and Jobs Act[1], and this could weigh on their capacity to repay mortgage loans. That said, strong mortgage underwriting, available credit enhancement, servicer loss mitigation, and other factors will help offset the potential negative impact on bondholders.

Steady Issuance Growth Will Likely Continue Despite Potentially Higher Mortgage Rates

We expect that issuance in all sectors we rate will continue to grow modestly.

- Issuance of transactions backed by mortgage insurance, or MI, will likely increase because of the growing number of insurers embracing securitization and the potential steady demand for MI as borrowers seek to lower down payments.

- Modest growth in the issuance of various credit risk transfer transactions[2], or CRTs, backed by GSE-guaranteed loans is likely to continue. At the same time, the collateral composition of CRTs might shift because it's likely that the share of equity cash out loans among GSE guaranteed mortgage origination will grow and the share of purchase loans will decline as a result of slowing new home acquisitions owing to higher interest rates.

- We expect issuance of RMBS backed by non-qualified mortgage, or non-QM, loans[3] to continue to increase because of borrowers with other types of debt, such as student loans, seeking home ownership or more affordable mortgage loans. Also, the likely slower home purchase and rate refinancing activity would allow mortgage brokers and loan officers to focus more on originating non-QM loans, which typically require more time and effort than GSE-guaranteed loans and prime jumbo loans.

1 "H.R.1 - An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," also sometimes referred to as the Tax Cuts and Jobs Act, became law on Dec. 22, 2017.
2 Including transactions issued using real estate mortgage investment conduit, or REMIC, structure.
3 A nonqualified mortgage loan is a loan that does not have the characteristics of qualified mortgage loan. The ability-to-repay rules issued by the Consumer Financial Protection Bureau established the categorization of QMs, which must meet certain criteria, including underwriting standards established in Appendix Q of the Truth in Lending Act. See CFPB mortgage rules.

- Issuance of RMBS backed by reperforming loans, or RPL, and by mortgage loans culled from seasoned pre-2010 RMBS[4] will continue as issuers seek to optimize funding costs and diversify funding sources.

- We expect to see more transactions backed by performing and nonperforming reverse mortgage loans as securitization will likely remain an attractive source of funding. The deals will probably include both private-label reverse mortgages and home equity conversion mortgages guaranteed by the Federal Housing Administration.

- Issuance of RMBS backed by QM loans is also likely to grow because rising interest rates might make it costlier for some originators to fund retaining mortgage loans and might make securitization a more attractive alternative to loan sales.

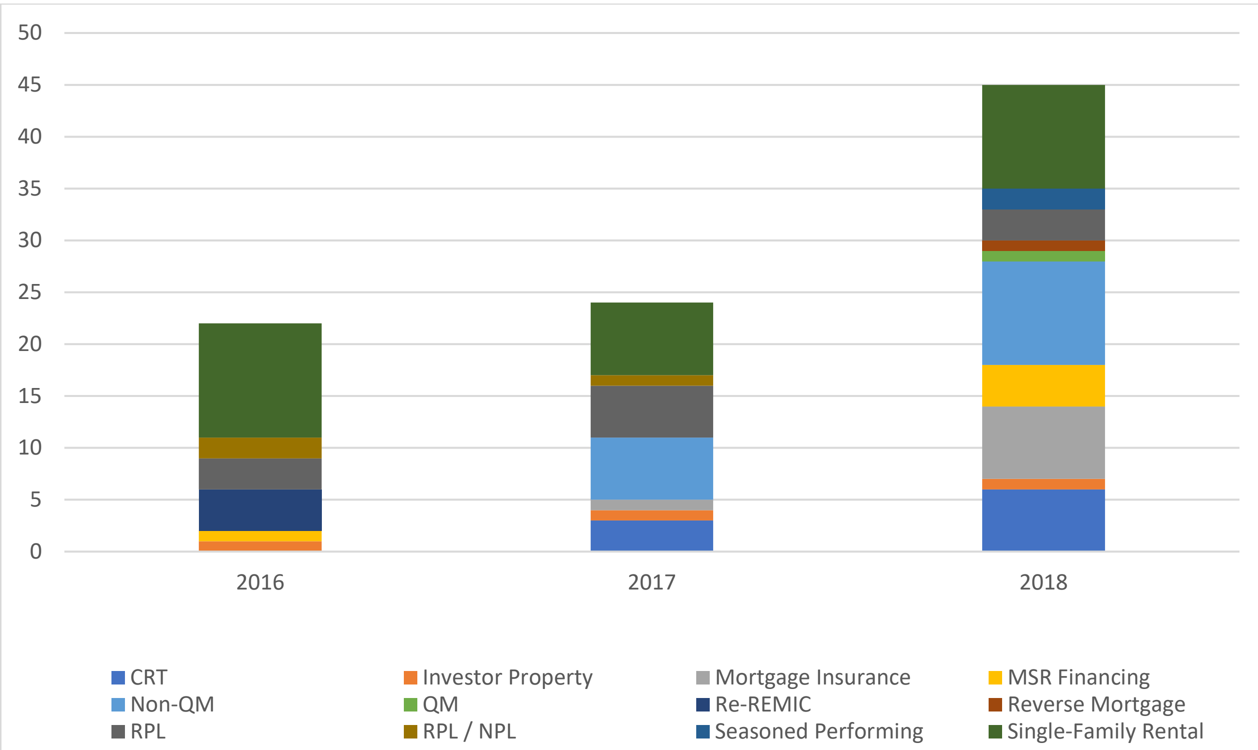
- We expect the issuance of deals backed by a single loan secured by a pool of single-family rental properties, or single-borrower SFRs, to slow because rising interest rates might lower issuers' incentives to refinance the outstanding loans that back the existing single-borrower SFRs. During 2016-18, many single-borrower SFRs were issued to refinance the existing deals into a lower rate, a trend that may taper off as rates rise.

- That said, the issuance of deals backed by many loans secured by single-family rentals, also known as multi-borrower SFRs, or MBRs, will likely remain steady because of new market entrants and the likely attractive economics of multi-borrower securitization.

[4] Pre-2010 RMBS that were collapsed via optional termination; sometimes also referred to as "called" transactions.

Chart 1 shows select RMBS transactions we rated in 2016-18, illustrating both the number and the variety of the rated deals growing year-over-year, a trend we expect to continue in 2019.

Chart 1. Number and Variety of Morningstar Rated RMBS Deals Are Growing Year Over Year



Source: Morningstar Credit Ratings, LLC

Policy Changes Could Affect Private-Label Issuance

Private-label RMBS issuance might receive a boost if the share of mortgage loans guaranteed by GSEs declines as a result of the policy shift stemming from the appointment of a new FHFA chief in January. Although the scope and timing of any potential policy changes are uncertain, RMBS should benefit from a decline in the GSEs' footprint because issuers might consider including loans that were previously guaranteed by GSEs in private-label RMBS transactions.

Collateral Diversity Is Likely to Expand and Include New Mortgage Types

We expect the variety of mortgage loan types backing new RMBS to expand in 2019 as borrowers look for more affordable mortgage loans owing to potentially higher rates. Home affordability is unlikely to improve significantly because of potentially higher interest rates and home prices that remain at historical highs in many areas. This, in turn, will probably bolster origination of mortgages that allow borrowers to lower monthly payments, such as adjustable rate mortgages, or ARMs, and loans with interest-only periods. As a result, RMBS backed entirely or partly by such mortgage loans may increase. Also, we expect the issuance of rated RMBS backed by new mortgage types to emerge, and securitizations backed by loans that were frequently securitized before 2010 to re-emerge in 2019. For example, we expect rated securitizations of manufactured housing loans and deals backed by second-lien loans or home equity line of credit loans to become more common. We also expect to see the first rated securitization of residential bridge loans, also referred to as fix-and-flip loans.

Collateral Credit Quality Will Likely Weaken but Remain Historically Strong

New-issue RMBS in 2019 will likely be backed by loans of somewhat lower credit quality because borrowers will seek ways to offset the impact of higher mortgage rates by taking out loans with lower initial interest rates, such as ARMs with five- or seven- year fixed periods, loans with interest-only periods, or loans with lower down payments. For this reason, we expect the share of ARMs, interest-only loans, and loans with higher loan-to-value ratios to rise. These loans pose more credit risk than fixed-rate fully amortizing loans because monthly payment amounts might increase as a result of a higher adjustable rate or a change from making an interest-only payment to full amortization. Also, rising interest rates will cause payments on other consumer debt, such as student loans and credit cards, to increase, causing borrowers' debt-to-income ratios to edge higher.

That said, ability-to-repay, or ATR[5] rules implemented under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and third-party due-diligence reviews of loans included in RMBS will continue to support a strong mortgage underwriting process, even for loans with weaker credit attributes. The ATR rules established a benchmark for mortgage

[5] On Jan. 10, 2013, the CFPB issued final rules, commonly referred to as ability-to-repay rules, amending Regulation Z under the Truth in Lending Act to implement the ability-to-repay requirement for residential mortgage loans and protections from liability for qualified mortgages and other consumer protections as required by Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). The ATR rules require lenders to make a reasonable determination that the mortgagor can repay the loan.

underwriting, which helped strengthen the overall underwriting process by using a common set of rules and definitions, such as the calculation of borrower income.

Transaction Structures Will Continue to Evolve

As issuers explore opportunities to maximize proceeds from RMBS issuance, we believe transaction structures will evolve further. We generally expect to see more deals with floating-rate bonds because of potentially rising interest rates. Also, issuers seeking to securitize relatively new mortgage types, such as residential bridge loans, might explore revolving structures to help fund acquisitions of new loans. At the same time, repeat RMBS issuers might try to test market acceptance of fewer loans undergoing third-party due-diligence reviews. Additionally, some non-QM issuers might explore the inclusion of stronger representations and warranties and other transaction features to broaden the non-QM RMBS adoption among investors.

Single-Borrower SFR and Multi-borrower SFR Performance Will Remain Stable

The performance of SFRs and MBRs we rate is likely to remain stable, bolstered by a healthy rental demand that causes vacancy rates to remain low and allows most issuers to steadily increase rents. However, capital expenditures may rise for some issuers as a result of one-off repairs needed to deal with the aftermath of natural disasters or because properties need upgrades. The unexpected spikes in capital expenditures and other expenses will not likely affect credit performance if they are temporary and not recurring. That said, we remain focused on reviewing SFR and MBR cash flows to assess a potential change in long-term performance.

Potential Hurdles Are Unlikely to Hamper RMBS Credit Performance

The credit performance of post-2010 RMBS will remain solid in 2019. The performance to date of post-2010 Morningstar-rated RMBS has generally been strong, a trend we expect to continue, especially if the potential challenges don't materialize. Deals should continue to perform well if home prices continue to grow, even at a slower pace than earlier. Although voluntary prepayment rates will likely decline as interest rates rise, a slight credit negative, the slowdown in prepayments by itself will not materially hurt RMBS performance in 2019 because of offsetting factors we discuss below. Also, losing some portion of interest deductibility as a result of the Tax Cuts and Jobs Act could reduce the incentive for some borrowers to keep the mortgage and increase the incentive to pay it off, which in turn could temporally bolster the overall prepayments.

That said, potential headwinds remain that could adversely affect RMBS performance:

- Home prices might soften somewhat or even decline as a result of rising interest rates or a weaker economy, trends that might cause borrowers' home equity to drop, and

- Some borrowers, particularly those in states with high home prices and relatively high real estate tax rates, may end up with higher-than-expected taxes in 2019 as a result of the Tax Cuts and Jobs Act. Although the impact of the law's provisions will remain uncertain until the first payments are made in the first half of 2019, higher potential tax payments would reduce borrowers' capacity to repay mortgage loans[6].

Although slower prepayments and other roadblocks might hurt RMBS performance by exposing more loans to credit risks or causing defaults to rise somewhat, several factors will help to offset the impact:

- Strong Mortgage Underwriting: Mortgages backing post-2010 RMBS we rate were created in a strong underwriting environment owing to the regulatory focus and promulgation of the ATR rules.

- Credit Enhancement: RMBS issued in the past few years built additional credit enhancement as a result of generally low defaults and increased prepayments owing to low interest rates. For example, credit enhancement to senior bonds in RMBS backed by non-QM loans we rated in 2017 has jumped to an average of 44% from about 36% at issuance[7].

- Servicer Loss Mitigation: Servicers have developed significant experience in loss mitigation by working with delinquent borrowers following the 2008-10 recession. As a result, many servicers improved the loss-mitigation process by engaging borrowers at risk of default sooner and by becoming better at identifying effective loss-mitigation strategies, such as loan modification. If delinquency rates rise somewhat, servicers will likely attempt to modify many of the newly delinquent loans to lower or avoid eventual losses.

6 See Internal Revenue Service IRS publication 5307, Further, see IRS publication Interest on Home Equity Loans Often Still Deductible Under New Law.
7 Average credit enhancement to the most senior tranche in RMBS backed by non-QM loans we rated in 2017.

For these reasons, even with the uncertainty surrounding interest rates and potential headwinds, we believe that performance for post-2010 RMBS will remain solid and the issuance will grow modestly in 2019.