# RMBS Research:

## Jumbo Issuance Remains Sluggish; As Goes Jumbo, so Goes RMBS. Resecuritization, NPL, RPL, and SFR Issuances Should Grow

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**Authors:**
Brian Grow | Analytical Manager | brian.grow@morningstar.com | +1 646 560-4513
Gaurav Singhania | Senior Vice President | gaurav.singhania@morningstar.com | +1 646 560-4532

**Morningstar Perspective**

The rebound in housing prices has reduced the industry's loss expectations for residential mortgage-backed securities and improved investor sentiment regarding the housing market. But the positive sentiment hasn't bolstered the private-label, or nonagency, RMBS market. There are three key reasons for this. First, the issuers find it easier to navigate the government-sponsored enterprise market. Second, selling loans through private-label securitization remains uneconomical and unfavorable for the issuers as compared with an agency sale (selling loans to GSEs) or a whole loan sale (selling loans into the secondary market). Third, issuers remain skeptical about originating outside the qualified-mortgage guidelines issued by the Consumer Financial Protection Bureau in January 2013.

This dry spell in jumbo issuance hasn't affected issuances of resecuritization, commonly known as re-REMICs, or issuances of transactions backed by nonperforming loans and reperforming loans. There is a steady flow of issuance on these transactions, but most are nonrated. In 2015, Morningstar Credit Ratings, LLC rated eight re-REMICs and one nonperforming loan transaction. We expect the flow of re-REMICs, NPLs, and RPLs to persist in 2016, and we expect a growing number of these transactions to be rated. This should bolster investment in the residential mortgage securitization market because ratings on these nonjumbo transactions expand the investor base and broaden market participation because of favorable capital charge requirements. Meanwhile, 2015 issuance of single-family rental transactions rose 1.7% from the previous year although most was in the first half of 2015.

## Dearth in Private-Label RMBS Issuance Continues

The rejuvenation of the private-label RMBS market depends on the revival of jumbo RMBS issuance, but the outlook for jumbo issuance this year is grim. Morningstar expects the dearth in private-label RMBS issuance to continue in 2016 for several reasons. Issuers find it easier to sell to the GSEs than to securitize nonagency RMBS, because they are able to originate and sell loans to the GSEs with a degree of certainty. In our July 2014 RMBS Landscape paper[1], Morningstar outlined the various reasons issuance has been impeded, and not much has improved since. In the paper, we cited the need to shrink the disproportionate share of the agency market to allow for a healthy growth of private-label securities. As of the second quarter 2015, private-label securities made up only 7.5% of the total mortgage market, according to the Urban Institute, a Washington, D.C. based think tank. More notably, private-label originations made up only about 0.96% of first-lien originations in the first-half of 2015. This disproportionate share enjoyed by the GSEs in the mortgage market has acted as a deterrent for private capital and has resulted in the GSEs bearing most of the risk for the country's mortgage market. More participation of private capital is needed to reduce the mortgage risk held by the U.S. government and to build a sustainable housing market.

Originators have three options after they originate a new loan. They can keep the mortgage on their books as a part of their portfolio, sell the loan to another buyer, or securitize the loan via the agency or the nonagency RMBS market. Their decision to sell (whole loan execution) versus securitize (via new-issue RMBS) the loan is based on the best execution outcome between the two choices. Until securitization offers a higher yield than whole-loan sales, it is unlikely there will be any meaningful increase in the pace of new-issue RMBS. Private-label transactions requiring due diligence on 100% of the securitized loans, additional third-party oversight, and other expenses add substantial costs to RMBS securitization, and the originators might find it more attractive to hold the loans instead. Morningstar believes a framework that balances investor protection with reasonable due-diligence requirements is a more desirable outcome from a practical standpoint.

Issuers remain skeptical about loosening their tight credit standards. The qualified-mortgage rules have been in effect for almost two years, and RMBS issuers have focused on originating QM loans, steering clear of so-called non-QM loans. This reluctance toward non-QM lending has confined RMBS issuances to jumbo loans. It is unclear whether there is pent-up demand from investors for non-QM loans, but if the pool of investors buying NPL- and RPL-backed RMBS is any indication, there is an investor appetite for nonjumbo RMBS. Morningstar has analyzed and provided feedback on indicative non-QM pools to the issuers. Despite the stagnant

1 Brian Grow and Gaurav Singhania, "RMBS Landscape," (July 2014). http://corporate1.morningstar.com/ResearchArticle.aspx?documentId=706824

jumbo outlook, we expect to see more issuance of re-REMICs, nonperforming, and reperforming loans and more issuances in the single-family rental market driven by multiborrower activity.

### Nonperforming and Reperforming Loans

Analysis of nontraditional RMBS loans such as NPLs, RPLs, and non-QMs, or nonqualified mortgages, requires some changes to rating assumptions, because loss estimates can vary depending on the individual loan credit attributes displayed in these assets. While the framework for analyzing these loans does not change, Morningstar adjusts certain elements of its loss methodology to appropriately analyze and account for credit risk in its ratings. For example, the potential legal liability and a correspondingly higher cost associated with nonqualified loans that are not QM-safe harbor require adjustments to Morningstar's projected loss severity.

### More Re-REMIC Issuance Expected

Resecuritizations of seasoned RMBS bonds continued with a steady flow throughout 2015, and Morningstar expects this trend to continue in 2016. The number of rated re-REMIC transactions is small but increasing thanks to the attractiveness of rated transactions for certain institutional investors. Morningstar assigned its first re-REMIC rating to the LSTAR Securities Investment Ltd. 2015-6 transaction in May 2015 and since then has rated seven additional re-REMIC transactions from three different issuers. Ratings range from AAA to BBB-. Deal structures on re-REMIC transactions have varied from the plain-vanilla senior-subordinate re-REMIC bonds that are backed by a single underlying bond, as in the GSMSC 2015-7R and GSMSC 2015-8R deals rated by Morningstar, to the most creative exchangeable re-REMIC bonds that allow the investors to switch back and forth among combinations to achieve varying levels of credit enhancement that carry different ratings, as with CSMC Series 2015-9R. In other variations of re-REMIC structures, issuers have combined multiple underlying bonds into a single portfolio (as many as 30 in LSTAR 2015-8) that have backed a common senior subordinate re-REMIC bond structure.

## SFR Continues to Grow

The single-family rental asset class continues to evolve as we mark the two-year anniversary of the first such transaction. To date, 27 single-family rental transactions, totaling $13.81 billion in issuance, have closed. Issuance of single-family rental deals in 2015 amounted to $6.72 billion, up from $6.61 billion in 2014. Despite higher-than-expected capital expenditures, performance of the securitized pools has met Morningstar's expectations, cash flow coverage of debt service remains robust, and delinquency, vacancy, and retention rates are in line with or above expectations. Looking forward, growth in the single-family sector depends on the demand for rental financing by smaller noninstitutional investors and the ability of lenders to meet this demand.

Performance of all single-family rental transactions has met or outperformed Morningstar's original expectations. Vacancy levels are well within expectations, and rents have exceeded originally underwritten rents. Other income, which includes charges such as pet fees, parking fees, application fees, and reimbursed maintenance, is much higher than originally underwritten. Expenses have generally exceeded original issuer underwritten expenses, especially for the early transactions. Across the board, capital expenditures were higher than expected, often more than double the issuer underwritten capital expenditures.

Morningstar monitors the performance of rated single-family rental transactions for downside risks. Extension risks on single-family rental bonds appear to have been overblown by some market participants. Morningstar accounts for the embedded extension risk in its rated transactions before assigning its initial ratings. For example, under Morningstar's stress scenarios, the bonds are assumed to extend all the way out to maturity with no presumption of bond refinancing. Given rising home prices, single-family rental issuers have three options when faced with a bond extension decision: (1) call the deal and sell properties at higher values, thereby cashing out on house price index; (2) refinance the bonds at potentially more favorable terms given higher debt service coverage ratio; or (3) warehouse the properties and resecuritize at higher advance rates and lower loan-to-value ratios because of higher property prices. National home prices, as calculated by Morningstar based on data from CoreLogic, increased by 12.38% since Morningstar's first single-family rental transaction in November 2013, with a 6.18% increase over the past year.

## Advent of Multiborrower Transactions Could Accelerate Growth

To date, there have been two broad types of single-family rental securitizations: single-borrower and multiborrower. Single-borrower consists of a single loan to a large institutional investor, while multiborrower transactions contain many loans made to smaller investors usually backed by five or more properties. The majority of issuance to date has consisted of single-borrower securitizations, but the advent of multiborrower transactions could accelerate growth. Morningstar rated all four multiborrower transactions that launched in 2015.

The large institutional investors own a small percentage, approximately 2%, of the single-family rental housing stock, according to the Urban Institute. As institutional acquisition has slowed because of house price stabilization, Morningstar does not expect single-borrower issuance to be the driver of growth in the market in the near term. Most participants expect the growth of the single-family rental market to come from multiborrower transactions. However, for a variety of reasons, including the lack of borrower awareness and administrative challenges of underwriting the loans, multiborrower issuance has been slower than expected. The growth of this market ultimately depends on the demand of the smaller investor for financing.

To recap, as we look to the New Year, Morningstar expects the private-label RMBS market to remain stagnant. Nonetheless, we expect to see more issuance of re-REMICs, nonperforming, and reperforming loans, while growth in the single-family rental market is contingent on multiborrower activity.