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Takeaways From RMBS Symposium

Housing Market Changes Are Slowly Creeping in

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Morningstar Perspective

While no one was sharing ghost stories, the vibe at the Conrad New York on a gray Monday morning was certainly uneasy, as the SFIG Residential Mortgage Finance Symposium kicked off with a discussion about the state of the economy and the housing market. With so many moving factors—midterms, trade wars, tariffs, rising interest rates, overwhelming student debt, and the sell-off last week in stocks—it is hard to predict anything with certainty, but the four panelists agreed that we may be nearing the end of a housing market cycle. One major theme was affordability, namely for millennials, who make up a large portion of first-time homebuyers. Not enough supply is available to meet the demand, and too few loan products serve this demographic.

Later in the afternoon, the end-of-cycle topic reappeared in a panel discussing the single-family rental market. The panelists were optimistic about SFR's future and believed the industry and its participants are equipped to handle a slowdown. J. Christopher Hoeffel, CFO of CoreVest Finance, said rents were stable in SFR. He found that borrowers are more focused on whether their homes are occupied, serving mainly a working-class tenant, and aren't focused that much on rent growth. Michael Peerson, a director at Wells Fargo, believes that the loans will perform in a downturn because demand for rentals will remain if owning a home becomes too unaffordable.

In August, the Federal Housing Finance Agency announced that Fannie Mae and Freddie Mac concluded their SFR pilot programs and plan to exit the market. "I was surprised they got out of the market so quickly," Hoeffel said. "It seemed to be a perfect asset class for the GSEs to be involved in because it is a way to provide affordable housing because a lot of these SFR [properties] fall in the affordable category… The difference is it is not affordable homeownership; it is affordable rental, and I think there is a lot of political pressure for the GSEs to be pushing homeownership above renting."

Regardless, the SFR market doesn't need Fannie or Freddie to survive. While the space appears to be at a standstill, with virtually the same issuers as last year in both single-borrower and multiborrower transactions, there are small gradual changes bubbling beneath the surface. For example, Hoeffel believes there is room for growth, and smaller players will emerge, but they are taking their time building their portfolios. He also said that smaller originators may pool collateral, similar to the commercial mortgage-backed securities market, in an effort to gain access to capital from Wall Street. Peerson agreed, saying "We'll see--and have seen--some aggregators using different originators to put together pools, which could see securitization in the future."

Another type of SFR loan that could become securitized is fix-and-flip loans. Kevin Dwyer, head of RMBS for Morningstar Credit Ratings, LLC, said that he has been talking to people about fix-and-flip loans for years. "A few securitizations did get done unrated this year, and that's usually the first step to get going," Dwyer said. On Friday, Morningstar published an article about the credit risks involved with these types of loans, such as overestimating the property's value after the repairs or the market demand for the home. Dwyer expects to continue working on refining the process of evaluating these loans, the data sources, and underwriting guidelines for fix-and-flip loans.

Fittingly, the day ended with a discussion on the epicenter of the last housing crisis, private label-RMBS. These days, the private-label sector looks much different and makes up such a small part of the RMBS market relative to the U.S. government. However, it is growing. Issuance stands at $30 billion so far this year, double the $15 billion from 2017, according to Daniel Kim, who moderated the panel and serves as Wellington Management's lead RMBS and housing strategist.

In terms of origination quality, it has remained similar in the years after the crisis. Dwyer noted that while originators may be looking into new loan products, they are usually doing it slowly and deliberately, especially for mortgages that fall outside of the Consumer Financial Protection Bureau's Qualified Mortgage definition. He also said that originators are pretty consistent within their own programs in terms of their origination practices, but their approach to a certain program may be different. Dwyer also believes that rating agencies know so much more now than before the crisis on how the originators created the loan. This bolsters originator reviews to a stronger level, allowing comparisons between the different originators, which aids Morningstar's analysis. One example of how originators can differ is for loans using bank statements as proof of income, rather than tax documentation, which is especially common for those who are self-employed. One originator may use bank statements across a 12-month period, while another covers a 24-month period.

Although the consensus might be that the end of a housing market cycle is approaching, the insights from the panelists on Oct. 29 hint that maybe this story could have a different ending.

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