Q&A: Non-QM Securitization Market Outlook

John Hsu, Head of Capital Markets, and Lauren Hedvat, Managing Director, Capital Markets, provide an outlook on the U.S. housing and mortgage market, the differences between qualified and non-qualified mortgages, and why we believe Angel Oak is competitively positioned as a leader in the non-QM securitization market.

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Q: What are Angel Oak's current views on U.S. housing and mortgage market fundamentals?

A (Hsu): Angel Oak is very bullish about the housing market in general. The key driver of our thoughts on this is the millennial population. There are 88 million people between the ages of 15 and 34 in the U.S., and historically they have been the largest source of household formation.

There are many factors that are causing millennials to be slow to adopt homeownership, but we believe that will happen over time. Morgan Stanley has done some good work on this. They see approximately 1.35 million millennial household formations over the next five years. Interestingly, that comes at a time when inventories for existing home sales are at historic lows. That historically tight supply is going to be facing this expanding millennial population as they look to put down roots. We think that's going to be particularly bullish for home prices and the housing sector in general. In addition, there is the expansion of mortgage credit that we're starting to see, and that credit expansion, in our opinion, is very, very prudent. It's been a long time coming, and we believe that both these factors are going to be very supportive for home prices as millennials form new households.

Q: Briefly explain the differences between qualified and non-qualified mortgages.

A (Hedvat): Qualified mortgages meet a certain criteria as outlined by the Consumer Financial Protection Bureau. Non-QM loans are often incorrectly equated with non-prime loans; however, the difference between QM and non-QM is not credit-driven. To be considered a qualified mortgage, a borrower's debt-to-income ratio must not exceed 43%, the borrower must meet all of the ability-to-repay criteria, the loan must be a fully amortizing loan with no interest-only or balloon terms, and for loans greater than $100,000 in size, the points and fees must not exceed 3%. The non-QM designation simply means a loan falls outside of those stated characteristics. A non-QM loan may still adhere to the ability-to-repay criteria. In the case of Angel Oak's origination, our loans are primarily considered non-QM due to points and fees.

Q: Angel Oak is one of the leaders in the non-QM securitization market, having completed five securitizations since 2015, accounting for over $850 million in total securitized residential mortgage loans. How is Angel Oak approaching the non-QM securitization market?

A (Hsu): There are really two ways that you can approach this. The first, is what traditionally has been done in the mortgage market, which is an aggregator model. You may not necessarily have an originator in-house, but you may be licensed, and you go out to other originators and ask them to follow your origination guidelines and provide you with product. That's the aggregator model.

On the other end of the spectrum is a vertically integrated model. This is the one that Angel Oak follows, where we have an originator in-house and the capital to back that up, so the sponsor of the securitization is actually separated from the originator, but it's all part of the Angel Oak umbrella.

Q: Discuss the different securitization platforms and strategies that are being implemented today, and why you feel Angel Oak is competitively positioned in the marketplace.

A (Hsu): There are three types of strategies that people are employing today. One is a pure aggregator model, where an originator or sponsor will buy 100% of the assets in the securitization from third-party originators. Second, there's a hybrid model, where an originator has its own production and is its own sponsor, but will supplement its own production via third-party purchases. The way Angel Oak does it is the third way, which is a fully integrated model where 100% of the assets that we securitize come from our originator. We think this is a competitive advantage because when investors perform due diligence on the sponsor, and therefore the originators, it's easy for us to say, "Well, we have only one originator and it's very easy for us to check the reps and warrants, and to make sure they are following the legal and regulatory guidelines." We believe we are rewarded for that simplicity in the capital market.

Q: What is the state of the current securitization market, and how many deals have been done post-crisis?

A (Hsu): The securitization market for non-QM right now is pretty healthy. It's still developing, but the marketplace has completed about 18 transactions post-crisis. Angel Oak has completed a quarter of these, and I think the total issuance is just about $5 billion and growing every year. If you look at the non-agency market pre-crisis, it was probably north of a trillion dollars a year. The current issuance is small in comparison, but we're hoping to build it up very quickly.

Transaction	# of Loans	Avg. Balance	Weighted Avg. Interest Rate	Weighted Avg. LTV	Weighted Avg. CreditScore
AOMT 2016-1	468	$283,436	6.90%	74.17%	697
AOMT 2017-1	529	$276,880	6.97%	76.12%	698
AOMT 2017-2	698	$301,502	6.87%	74.64%	700
AOMT 2017-3	691	$304,162	7.14%	77.69%	700

Source: Angel Oak Capital Advisors

Q: What types of deals are you seeing in the current market, and do you see that shifting in the coming years?

A (Hedvat): Post-crisis we've seen a significant volume in the non-performing, re-performing, and credit-risk transfer markets. Together, non-performing and re-performing loans have comprised approximately half of the approximately $47 billion total volume we've seen so far this year. Credit-risk transfers contributed around $13 billion of that total number. We project the total issuance volume this year to be around $55 billion with contributions of credit-risk transfer, prime jumbo, non-QM, non-performing and re-performing loans, and single-family rental collateral.

Two main drivers of supply and growth as we head into 2018 are expected to be the non-QM and prime jumbo securitization sectors. Non-QM originations have been steadily increasing. We see that trend continuing, particularly as a strong credit performance supports more origination and increased investor demands. We think the primary market conditions are favorable for a positive 2018.

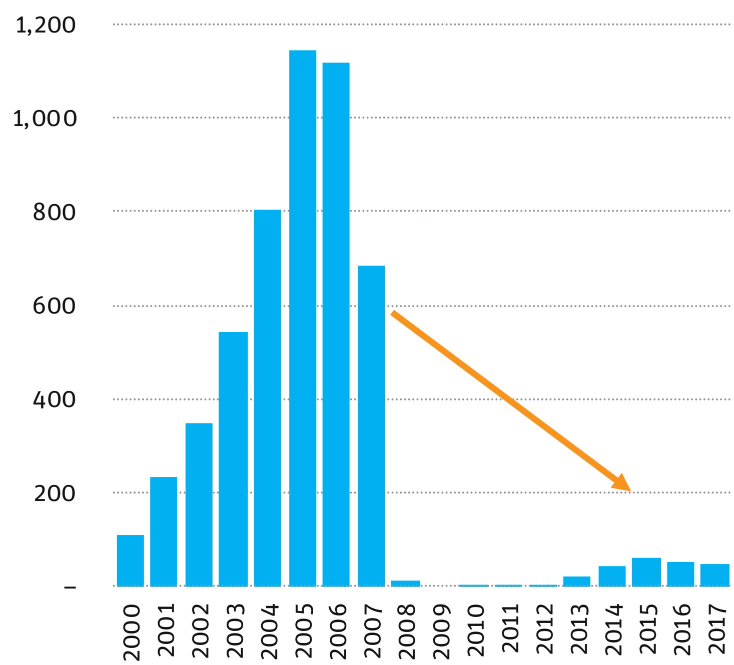
Q: Do you think we'll ever see a securitization market like the one we saw pre-crisis?

A (Hsu): I think $1.2 trillion was probably the high point in the non-agency market, and probably most market participants can say that was probably too large and caused a lot of the problems we saw during the crisis, but even if you get to a much lower number – say $200 billion to $300 billion per year – that's still well in excess of what we're doing today, and we believe that number, $200 billion, is a very healthy number when it comes to providing prudent credit. That's what the market ultimately wants: prudent credit underwriting, and we think there's so much runway left from where we are today to that number that we can really invigorate the non-agency market.

Q: Pre-crisis, large banks were the major players in the non-QM market, and today non-bank lenders are the ones driving the market. Do you think large banks will eventually re-enter the non-QM sector?

A (Hedvat): For several reasons, I do not think large banks will be entering the non-QM market soon. First, post-crisis changes including regulatory guidelines/compliance have made it increasingly more difficult for banks to become active in the space as an issuer and/or a risk retainer. When we look at the legacy market, we see how the industry, especially the large banks, are still grappling with legal issues related to transaction trustees and from a lender's perspective. These outstanding issues could potentially take a few years to resolve.

FIGURE 1: HISTORICAL NON-AGENCY RMBS ISSUANCE



Source: Bank of America Merrill Lynch.

As a result of these legacy issues, I think participation by the large banks in the non-QM and non-prime sectors will be more limited and will continue to be dominated by the non-bank lenders for the foreseeable future. From an origination perspective, large banks are more limited in the types of loans they can originate. For example, there is a large population of high-credit-quality borrowers who, because they may be self-employed, cannot access the more traditional source of mortgage credit through banks. The most value that large banks provide for support and growth of this market is through financing, both in warehouse and repo, and securitization transaction syndication. The shift we've seen post-crisis continues to be supportive of this business model.

Q: What needs to happen to develop the securitization market further?

A (Hsu): I think what needs to happen is more transactions and continued strong performance. Some investors are still hesitant to enter the market and are waiting for it to grow to see how the track record develops. Non-QM was originally painted as the new sub-prime, which is, of course, incorrect. Several factors need to come together to grow the securitization market. Number one: performance. Number two: participants in the asset management business buying and then others following. Other fixed income managers need to start saying, "OK, it's not so scary and I can invest in this asset class." Third: rating agencies need to get more comfortable with non-QM and refine their ratings process. All these will help, but what really needs to happen is having larger deal sizes and secondary market trading. Deal sizes are increasing, and as a result, secondary market trading will occur, and that is actually the ultimate sign of strength in the secondary market for securitization.

Q: How is Angel Oak approaching the securitization market today and going forward?

A (Hsu): We are approaching the market from both ends. We believe that is one of our advantages. We have an originator that's affiliated with the asset management business, and we flow information back and forth, so when we complete a securitization we can talk to the originator and say, "This is what investors liked or disliked about our transaction." Then we can ask, because we have the capital, "Are there any other products that you would like to develop or originate? Can you change the program slightly? How can you get more volume?" It's that free flow of information that's really an advantage for us; we can have real-time conversations, make changes and decisions rapidly, and therefore access the capital markets very quickly.

Definitions and Disclosures:

Debt-to-income ratio (DTI): A ratio that is calculated by dividing an individual's total recurring monthly debt by his or her gross monthly income.

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