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Western Asset Bespoke Mortgages Feeding Non-Agency Demand

By Alexis Leondis and Jody Shenn - Jun 9, 2014

Western Asset Management Co. plans to start buying non-agency mortgages the way a gentleman orders a bespoke suit.

The bond firm, with $469 billion in assets, will take on the role typically played by Wall Street banks, specifying to lenders the mortgages it wants them to make -- from interest-only to those with higher debt-to-income ratios -- then buying them. Other firms such as Caliber Home Loans Inc. are also seeking to capitalize on demand for loans that don't meet requirements for taxpayer-backed programs or qualified mortgages, known as QM loans.

"A large portion of people who don't qualify for government-sponsored loans now will become good borrowers," said Rob Bloemker, who started his mortgage career at Salomon Brothers in the 1980s and is now co-founder of San Francisco-based lender Dwell Finance. "We think non-QM lending is going to be really ramped up in a year from now and will be large enough to securitize."

Lenders and investors are targeting borrowers who can't get a mortgage backed by Fannie Mae and Freddie Mac, the Federal Housing Administration or Department of Veterans Affairs after home prices soared since March 2012. The Consumer Financial Protection Bureau's qualified mortgage rules, which took effect in January, add more barriers to credit. Government-run Fannie Mae and Freddie Mac limit themselves to buying loans that conform to some of those requirements.

The rules make lenders take steps to ensure borrowers can repay their loans. Lenders will have greater legal risks if the mortgages have terms such as interest-only periods or debt-to-income ratios above 43 percent and don't qualify for taxpayer-backed programs.

Buyers of mortgage-backed securities have little to pick from after outstanding non-agency bonds contracted to $767 billion on March 31 from a $2.3 trillion peak in 2007. Deals tied to new loans fell to $1.6 billion this year through May, according to data compiled by Bloomberg.

Returns also are shrinking on non-agency bonds after a surge in prices since the housing crash. Investors had gains of 10 percent in 2013 compared with 21 percent in 2012, according to Amherst Securities Group LP. This year through March, the debt returned about 3 percent, Amherst said.

Legg Mason Inc.'s Western Asset plans to buy mortgages made to self-employed borrowers who may not have the documentation for qualified mortgages as well as interest-only loans, said Travis Carr, chief operating officer of the firm's mortgage real estate investment trust.

The loans that Pasadena, California-based Western invests in will have a variety of FICO credit scores, which range from 300 to 850. Borrowers who have lower scores will generally have to make larger down payments for Western Asset to purchase the loan. The firm may also buy loans with debt-to-income ratios above 43 percent if borrowers have other assets.

Higher Rates

"That's how we've been going to the originators, that this is kind of the box we like within non-QM," Anup Agarwal, head of mortgage and asset-backed securities at Western Asset, said during a conference call in May. "And if you originate this, you will have access to us where we will be buying them along the way."

The rates charged to borrowers of the non-qualified loans will be 1 to 2 percentage points above conforming rates, Carr said. The average rate for a 30-year fixed mortgage was 4.14 percent last week, Freddie Mac said in a statement June 5.

Western Asset plans to work with as many as eight lenders across the U.S. to ensure geographic distribution of loans, Carr said. It will invest in the loans through Western Asset Mortgage Capital Corp. (WMC), its REIT, and may create a private-equity fund with a lockup period.

Foreign Borrowers

Banks including EverBank Financial Corp. in Jacksonville, Florida, and San Francisco-based Wells Fargo & Co. have said they're also on the hunt to make or buy non-QM or other non-agency loans.

Mortgage lender and servicer Caliber Home Loans said this month it was adding four new products focused on foreign buyers of U.S. homes, those with lower credit scores and borrowers with higher debt-to-income ratios. The company, backed by private-equity firm Lone Star Funds, which has invested in soured mortgages and related bonds, declined to comment on what it will do with the new loans, Alexandra Sowinski, a spokeswoman, said in an e-mail.

"We recognize that there are qualified, creditworthy borrowers with home financing needs that are not being served by the agency and government programs that are currently available in today's marketplace," Joe Anderson, chief executive officer of Irving, Texas-based Caliber Home Loans, said in a statement.

Another mortgage lender, Atlanta-based Angel Oak Funding LLC, started the Home$ense Program, which includes mortgages for borrowers with credit scores as low as 500 and loan-to-value ratios as high as 80 percent, according to its website. Borrowers can apply just a day after completing a foreclosure or bankruptcy.

The nontraditional loans being made by the lender are being bought by a limited partnership investment pool managed by Angel Oak Capital Advisors LLC, which oversees more than $3.5 billion, according to Brad Friedlander, a portfolio manager. It focuses on items such as how much money a potential borrower has in the bank to offer mortgages to weaker-credit consumers, and can compensate for other borrower flaws with higher down payments, he said.

Lending Dislocation

The firm is acquiring a range of unusual loans to "take advantage of some of the dislocation in the lending space, in terms of it not reaching a huge and underserved, but strong credit, population in the U.S.," he said.

Dwell Finance's Bloemker said his firm, which makes loans to investors in rental homes, is going to start providing mortgages to non-QM borrowers directly. He said he expects non-QM loan origination to be in the tens of billions of dollars in the next three years as more renters look to become homeowners and lenders have more clarity around the rules of foreclosure.

Securitizing Loans

If Western has the loans securitized, it would sell the senior bonds in the pools to third-party investors and keep the subordinate tranches, which tend to have higher yields, according to Carr.

Jeffrey Gundlach's firm, Los Angeles-based DoubleLine Capital LP, is having discussions around securitizations of non-QM loans, Vitaliy Liberman, a mortgage-backed securities portfolio manager, said last month. DoubleLine, with about $50 billion in assets, may be interested in buying the senior-most or lower-ranking classes of bond deals, depending on the structure, he said.

The credit box needs to widen to support the housing market, which saw a burst of activity last year from pent-up demand, Liberman said. "We've exhausted the 750 FICO guys."

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