A Deep Dive into Non-Agency Credit Performance

Asset-based investing has seen significant interest in recent months, with private credit managers, insurance companies, and other investors looking for the "new frontier" away from corporate private credit and focusing on areas with contractual cash flows and hard assets. The Angel Oak platform that allows investors to participate in securitizations and own mortgages in whole loan form is a leader in providing investors access to this growing asset class. Credit performance in the Non-Agency residential mortgage sector has been noteworthy post-GFC. In this paper, we do a deeper dive into credit performance in the sector and highlight Angel Oak's performance.

Key Takeaways

- The Non-Agency borrower base continues to expand, with record growth in small business formation providing a tailwind for investors with an imbalance of credit availability relative to the borrower base.

- Delinquencies for Non-Agency residential mortgages relative to other sectors, including autos, corporates, and commercial real estate, continue to be low. The percentage of borrowers in foreclosure remains just 1% of the current outstanding balance of mortgages in the Non-QM sector.

- Angel Oak's performance relative to the competition stands out with lower delinquencies as shown in this report. The ability to source mortgages through a leading affiliate wholesale originator and third parties allows Angel Oak to build carefully curated diversified portfolios. A sourcing advantage for the firm is coupled with industry-leading proprietary analytics in order to minimize delinquencies.
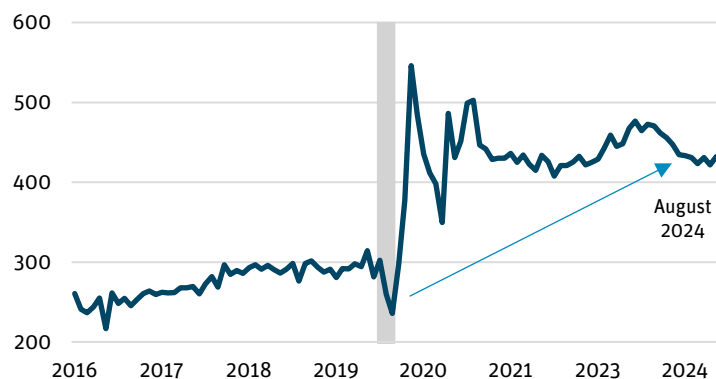
Residential Mortgages: A Safe Haven

As delinquencies have increased in the past three years across areas of credit including high-yield corporates, commercial real estate, and the consumer credit markets including autos, the residential mortgage market has stood out as a top performer. The 60+ day delinquency rate on Non-QM has increased to approximately 3%, whereas other areas of credit — such as subprime auto, which has increased to almost 8%; SASB CMBS at 4.3%; and conduit CMBS at 5.6% — have seen delinquencies accelerate much more sharply in 2024. According to Fitch, the 12-month leveraged loan default rate was 4.47% in August 2024. Tightening credit conditions have led to an increase in delinquencies across a range of credit sectors, with arguably the worst yet to come in areas such as commercial real estate, where developers are holding out hope for swift Fed rate cuts.

So, what's the secret behind the relative outperformance of Non-QM or Non-Agency mortgage credit? Certainly, the macro factors have been supportive with robust employment levels and tailwinds specific to the Non-Agency borrower base. Small business formation continues to accelerate, allowing for a favorable supply/demand dynamic with limited mortgage credit availability for these borrowers. As shown in the charts below, the borrower base continues to expand, with limited competitive pressures that would traditionally erode credit standards over time. We would argue that all these aspects have been supportive, but an element of active management has also played a role in navigating credit performance specific to the Angel Oak lending and investing platform. Adjustments to the credit box in anticipation of tougher times ahead has been a key component of Angel Oak's industry-leading credit performance in the Non-QM sector since 2022. Recognizing the turning point in the housing market from a one-way market with price appreciation throughout the country to one that is much more balanced, with some local areas doing better than others, has also been a key aspect of differentiated performance.

Small Business Growth Increases Need for Bank Statement Mortgages
Total Small Business Applications in the U.S. per Month (Thousands)

Residential Mortgage Credit Availability
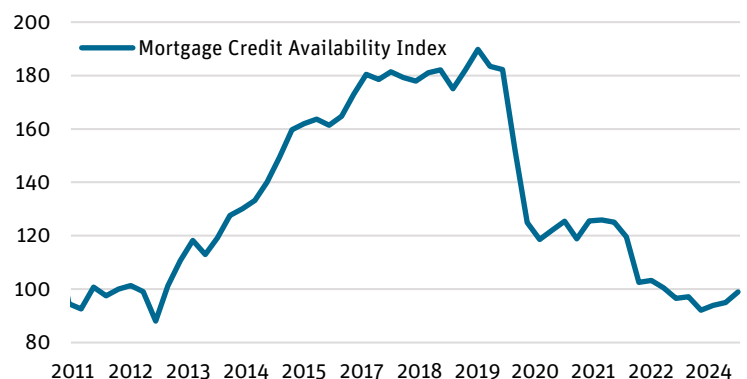
## Tail Risk: FICOs and LTVs

Looking at historical delinquencies in the sector, it's no surprise that the key drivers are borrower FICO credit score and loan-to-value (LTV) ratios. The mortgages that have transitioned from delinquent to default and liquidation mainly consist of FICO scores below 700 and LTVs above 80%. While loans with credit scores below 700 make up 18% of the outstanding Non-QM universe, they are responsible for approximately 40% of the mortgages in foreclosure and REO. Mortgages above 80% LTV make up 11% of the outstanding unpaid principal balance of Non-QM loans but are responsible for approximately 22% of the FC/REO balance.

FICO Score: Outstanding Distribution of Non-QM Loans for the Universe vs. FC/REO Collateral Across Cohorts
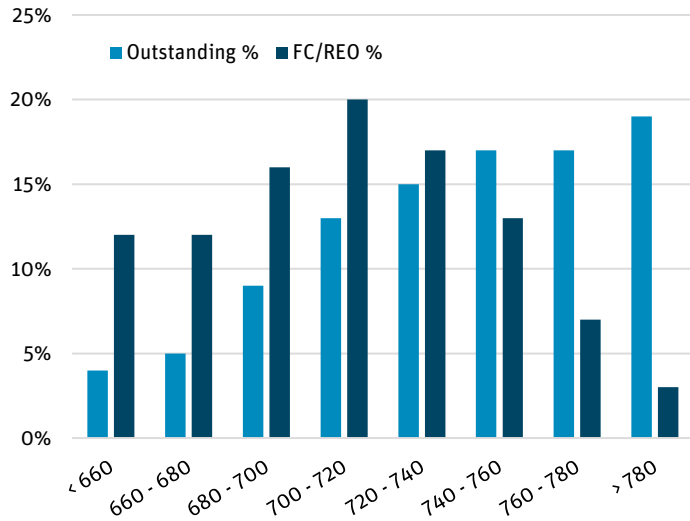
Original LTV: Outstanding Distribution of Non-QM Loans for the Universe vs. FC/REO Collateral Across Cohorts
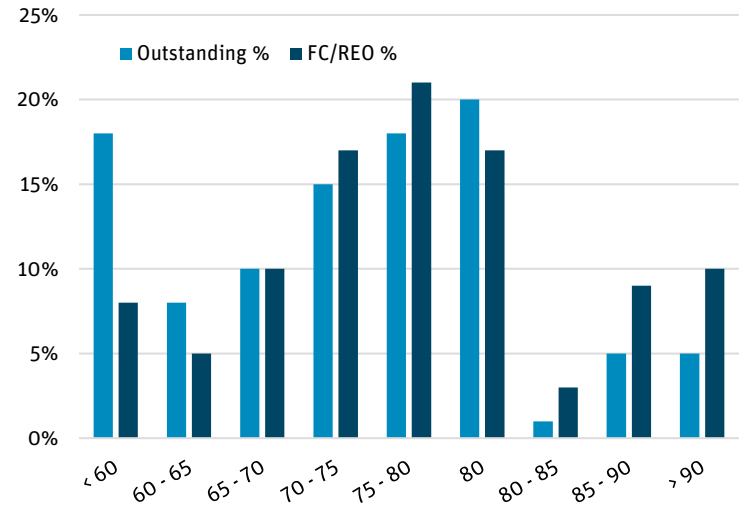
Source: Morgan Stanley Research as of Q3 2024.

Both of these variables (FICO and LTV) demonstrate the borrower's ability and willingness to handle life events or hardship over time in terms of repaying debts. The LTV functions as a significant risk mitigant in an environment of uneven home price appreciation (HPA) by ensuring the willingness of the borrower to protect their equity investment in the home. HPA is not providing the positive tailwind to credit performance that it did in prior years. Therefore, we believe these variables are more meaningful than perhaps they have historically been, given the macro backdrop of softening home prices, particularly in specific regions that have seen significant price growth prior to the past two years.

We look to price and address risk appropriately in our underwriting and rate sheets (purchase price and credit matrices provided to originators), combining top-down factors such as the housing market environment and bottom-up factors specific to each mortgage. Documentation type (bank statement vs. full documentation), occupancy type (investor loans vs. owner-occupied), and fixed-rate vs. interest-only loans are all important factors which are helpful in understanding and forecasting credit performance. Understanding these risk factors and pricing them appropriately is critical in ensuring a successful loan investing program; however, the most important are FICO and LTV.

Bottom 12 MSAs by YoY HPA

MSA	YoY Sep 24	YoY Sep 23	YoY Sep 22	YoY Sep 21
Greenwood, MS	-14.4%	-9.9%	4.6%	16.2%
Natchez, MS	-8.3%	-16.8%	11.4%	14.2%
Punta Gorda, FL	-6.2%	-3.7%	29.3%	28.0%
Taos, NM	-5.2%	-3.6%	9.2%	18.1%
Meadville, PA	-5.2%	3.6%	4.3%	17.3%
Sulphur Springs, TX	-5.1%	-0.6%	10.9%	18.1%
New Orleans, LA	-4.8%	-8.3%	5.0%	10.2%
Cape Coral, FL	-4.5%	-1.5%	30.3%	27.4%
Austin, TX	-4.4%	-11.6%	12.8%	39.5%
Huron, SD	-4.0%	-5.8%	8.3%	15.1%
Laredo, TX	-3.8%	3.1%	6.8%	8.6%
North Port, FL	-3.8%	-2.1%	30.7%	26.0%

Source: Zillow as of 9/30/24.

Angel Oak: Market-Leading Credit Performance

Since late 2015, Angel Oak has been aggregating loan-level data, allowing us to build robust, time-evolving models based on a substantial volume of data spanning multiple market cycles. Our proprietary model relies on two key data sources: in-house mortgage origination and servicing database and macroeconomic data.

The macroeconomic data includes features such as housing prices, unemployment rates, and prevailing Agency mortgage rates. This macroeconomic data is paired with our originated and serviced Non-Agency mortgages to provide us with a framework for pricing credit risk appropriately in our investing program. The model is the basis that eventually leads to our rate sheets or where we look to price or set coupons on the mortgages that we invest in on behalf of our clients. We combine our modeling with our views on the macro environment to create what we believe to be best-in-class performance. Qualitatively, we try to stay conservative with regard to income underwriting and shy away from areas that we believe to have riskier profiles. For example, Angel Oak's concentration of loans where income is underwritten based on a letter or written verification is less than 5% of the collateral we invest in, whereas our competition or other Non-QM deals in the market have as much as 20% of their collateral based on this income verification method.

In addition to clean income underwriting, our focus on marrying the macro environment with our modeling has led to strong performance in the post-COVID-19 era. As shown in the charts below, Angel Oak securitizations have demonstrated the proactive stance toward credit risk with a focus on curtailing mortgages with LTVs above 80% and FICOs below 700. It is especially apparent in examining delinquencies for 2023-vintage mortgages, where peers have seen rates climb to as high as 7% while Angel Oak stayed well below 2%.

Non-QM Sector vs. Angel Oak Non-QM: 60+ Day Delinquency Rates

60+ Day Delinquency Rate (%)
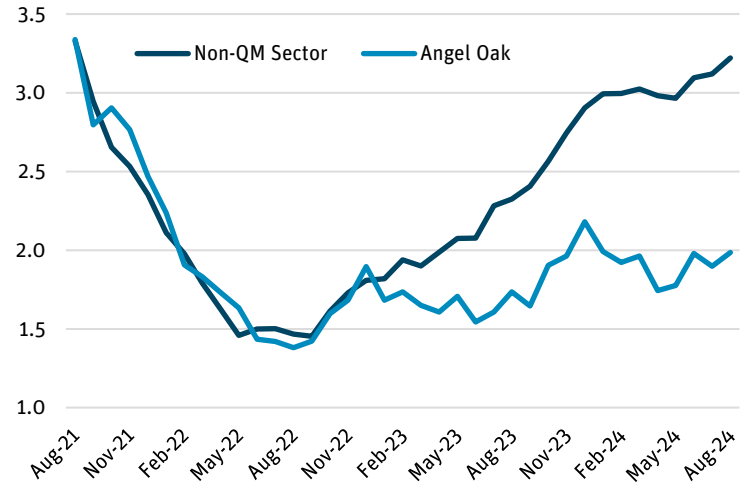
Source: Intex, AOCA as of 9/30/24.

60+ Day Delinquency Rates by Loan Age: 2022 Loan Origination Year
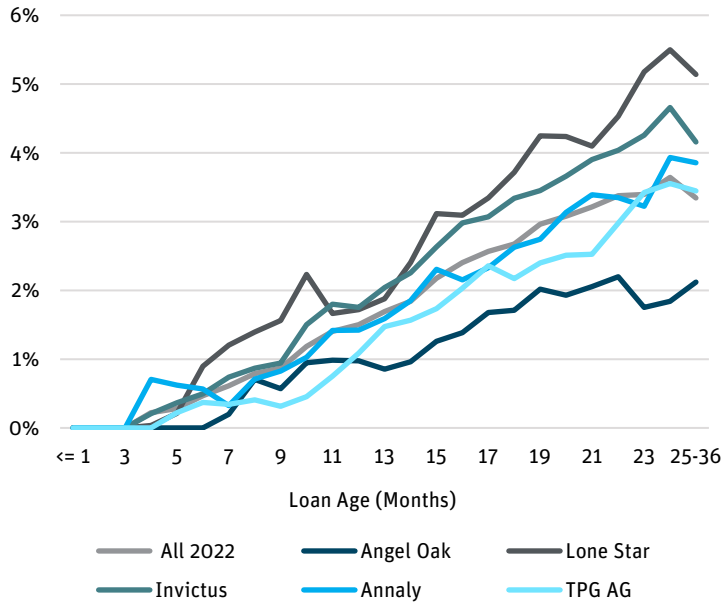
60+ Day Delinquency Rates by Loan Age: 2023 Loan Origination Year

Source: BAML as of 9/30/24.

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