Boom & Boon: Residential Mortgage Loans for Insurers

Angel Oak Capital Advisors

Angel Oak Capital Advisors (AOCA) manages over $17 billion in assets across public funds, private funds, and separately managed accounts primarily focused on mortgage credit and financial strategies. The firm was founded in 2008 and has been an active investor in Non-Agency mortgages since its inception, investing in over 42,000 Non-Qualified (Non-QM) mortgages on behalf of institutional investors. Angel Oak is a consistent issuer of RMBS (AOMT shelf) with approximately 50 securitizations issued since 2015. The firm sources mortgages through various channels including an affiliated mortgage lender (Angel Oak Mortgage Solutions).

Key Takeaways

- U.S. life insurance companies have more than doubled their residential mortgage loan (RML) holdings over the past four years, now making up 2% of life insurers' total aggregate investment portfolios.
- The demand for RMLs has been driven by the significant growth in annuity sales, the 68 basis points (bps) NAIC risk-based capital charge (RBC) they receive, comparable to a single-A-rated bond, and the attractive yield per unit of RBC. Insurance companies can also obtain Federal Home Loan Bank (FHLB) financing to further enhance potential returns.
- Given the attractive return profile and credit characteristics, Non-QM has been particularly attractive for insurers. Compared to Agency mortgage origination volumes, which drastically dropped as rates increased in 2022, Non-QM origination volumes have remained robust.
- Key drivers of performance are default losses and prepayments on the Non-QM mortgages. Credit losses on Non-QM loans have been minimal, with only a 0.02% cumulative loss across the $150 billion of loans securitized since 2018.
- The spread between Non-QM rates and Agency mortgage rates is one of the key factors in determining expected prepayment rates, and recent mortgages are being originated at historically tight spreads to Agencies (~100 bps). We believe a scenario of slower-than-expected prepayment speeds on current Non-QM origination is likely if the spread to Agencies remains tight.

Market Overview

Through July, year-to-date Non-Agency RMBS issuance in the U.S. was $73 billion, with the largest volume coming from Non-QM at $24.6 billion YTD. Weighted average coupons (WAC) in Non-QM deals are now as high as 9%, and appetite for fixed-rate mortgage credit continues to drive oversubscription levels on new issuance as investors look to deploy capital. Non-QM AAA spreads have tightened over the past year from their one-year high of 195, down to 135 in July. In 2024, many off-the-run deals, such as second liens, home equity lines of credit (HELOCs), and reverse mortgages, have started gaining traction.

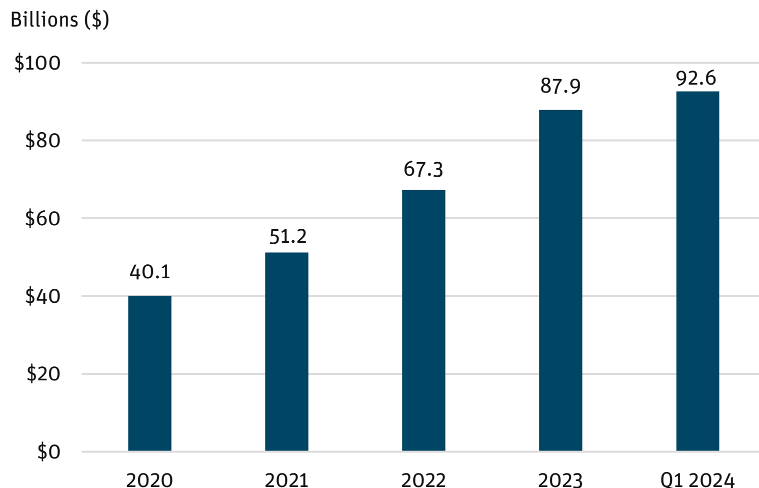
Non-QM is composed of several product or documentation types, including Bank Statement, Investor, Full Doc, CPA, and Asset Qualifier. Investor loans are designed for real estate investors using funds for a rental property, for which DSCR and borrower credit characteristics are used to qualify a borrower. Bank Statement loans are designed for self-employed business owners, using alternative income calculations to qualify. These two documentation types make up the majority of Non-QM, with YTD issuance consisting of 44% Investor and 36% Bank Statement loans. Since 2017, the collateral quality has substantially improved on these loans, with an average 740 FICO, 70% LTV, and only 15% adjustable-rate mortgages (compared to 80% ARMs in 2017).

U.S. Insurance Bid

U.S. insurance companies own approximately $750 billion of CRE and residential whole loans, of which residential loans account for ~11% according to S&P (as of 2023 year-end). As of Q1 2024, life insurance companies owned $92.6 billion of residential mortgage loans, compared to only $40 billion in 2020. With CRE facing more headwinds, the demand for residential whole loans has increased – particularly for Non-QM. There are currently five life insurance companies that account for 67% of total residential loan holdings, including large-cap legacy insurers Athene and Global Atlantic. However, with over 250 life insurance companies in the U.S., approximately 75% do not own any residential mortgages and approximately 88% have less than 1% of assets invested in residential mortgages. We believe insurer demand for residential mortgage loans will continue to increase, becoming a more permanent strategic allocation for insurance companies.

RMLs Outstanding for Life Insurers

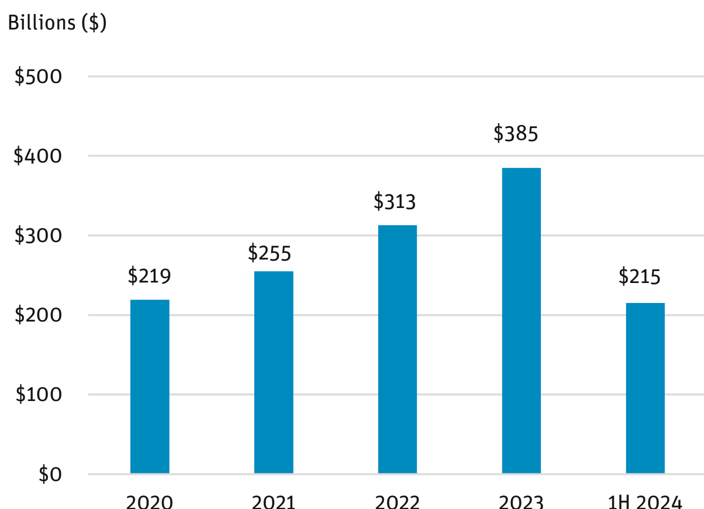
Billions ($)



U.S. life insurance demand for residential loans, particularly for Non-QM, has been bolstered by the significant pickup in annuity sales. Most of the life insurers that have seen the largest annuity sales growth have invested in residential whole loans, given the attractive relative value and scalability of the asset class. Life insurers receive a 68 bps capital charge from the NAIC for residential loans, which is similar to the capital charge for single-A-rated bonds. However, compared to bonds, residential loans offer a more scalable investment for life insurance companies, which are typically buy-and-hold investors. The FHLB also offers insurance companies financing options for residential loans, with typical advance rates from 70% to 80%, providing liquidity and optionality to enhance the total return profile for residential mortgage loans.

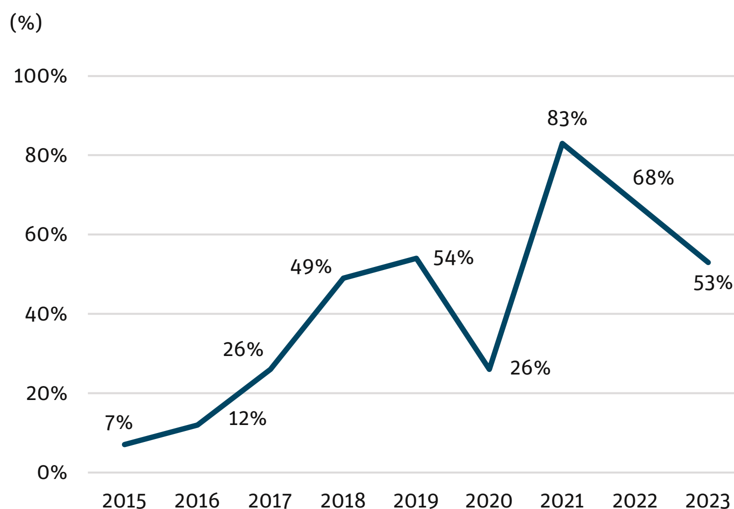
U.S. Annuity Sales

Billions ($)



Non-QM Securitization Rate

(%)



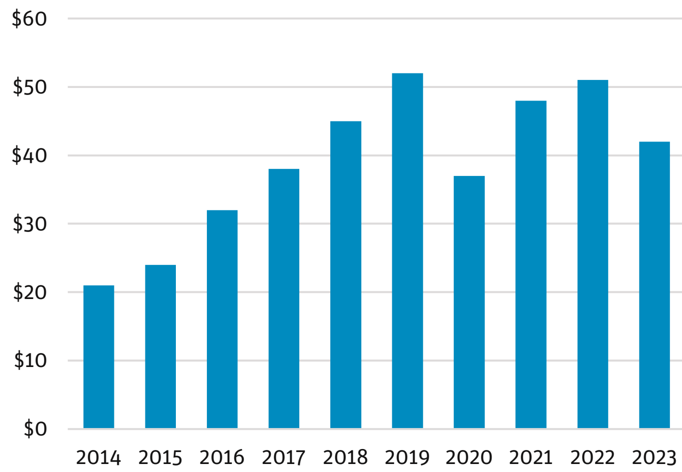
In 2021, approximately 83% of Non-QM loans were securitized compared to about 50% in 2024. As insurance companies have increased residential loan allocations, issuers are no longer the only major purchaser of loans. We believe that purchasers of residential mortgage origination will be a blend of approximately 40% insurance companies and 60% from the securitization market going forward. While the increased demand for Non-QM loans may be a headwind for issuance and the securitization market, we believe this will be a positive technical for further spread tightening.

Origination Volumes

Following the COVID-19 pandemic, a generational Fed hiking cycle, and the looming changes to Basel III over the past four years, banks have become more conservative in their loan product offerings. Many of the banks that historically offered Non-QM loans have eliminated or reduced their exposure to these products. Non-bank lenders have increasingly entered the Non-QM origination business since 2017. Over the past two and a half years, Agency mortgage volume has substantially decreased from it's recent high in 2021. Meanwhile, Non-QM mortgage origination volume has not experienced this steep decline. In Q1 2024, Non-QM origination volume was approximately $11 billion.

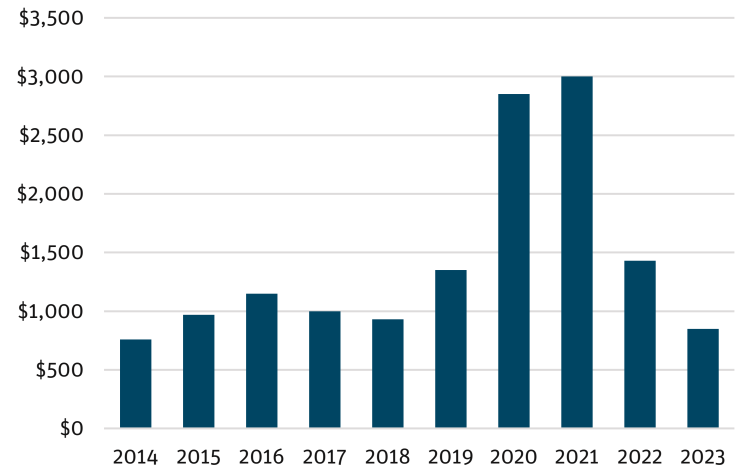
Non-QM Mortgage Origination Volume

Origination Volume ($bn)



Conventional/Conforming Mortgage Origination Volume

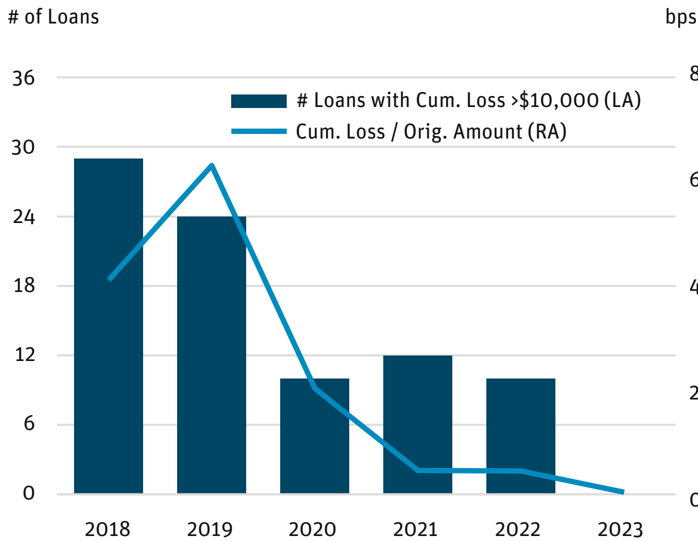
Origination Volume ($bn)



Credit Performance

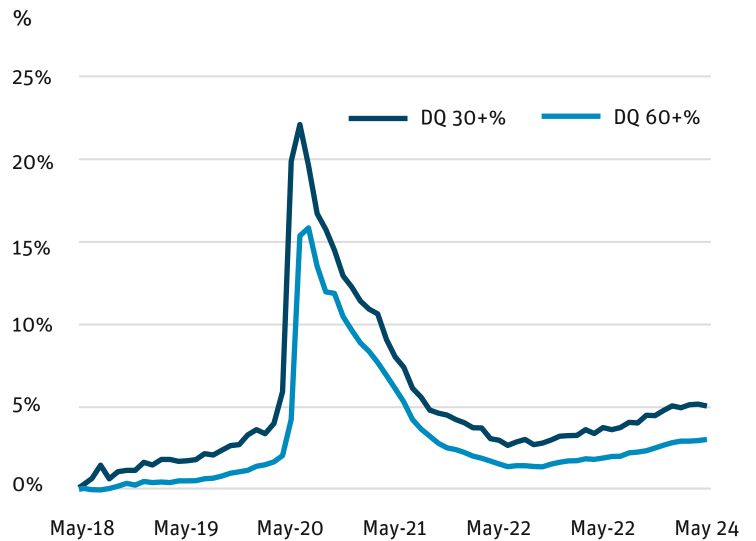
Across the $150 billion of Non-QM mortgages that have been securitized since 2018, cumulative losses have remained extremely low at 2 bps. A total of 85 loans have incurred a cumulative loss greater than $10,000. Delinquencies have seen a slight pickup, which could lead to eventual rate modifications and related losses. However, we expect these losses to be minimal, given that across the $150 billion of securitized Non-QM loans since 2018, the implied loss from rate modifications and forbearance has only been $20 million.

Cumulative Loss Of Non-QM Loans By Origination Year



Source: BofA Global Research, Loan Performance as of 12/31/23.

Non-QM Delinquency Rates Over Time



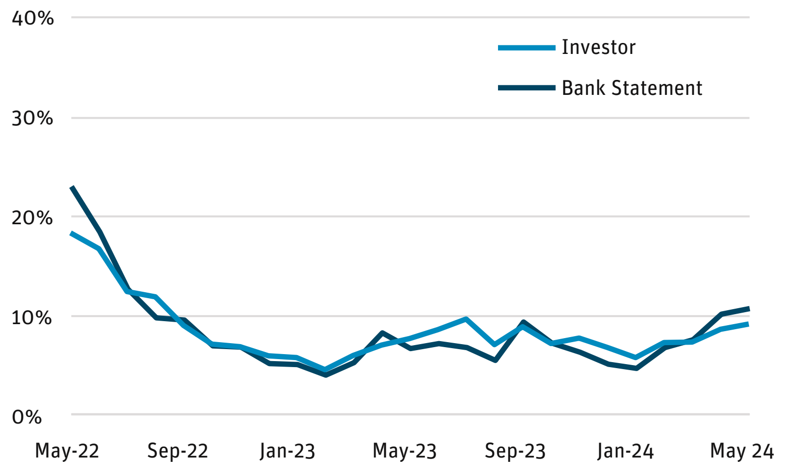
Source: BofA Global Research, Loan Performance as of 5/31/24.

Prepayments

The prepayment speed is a key return driver for Non-QM mortgage pools, given that loans are typically purchased at a premium above par.

The current prepayment rate (CPR) on Non-QM loans has been in the range of 5%-10% over the past two years, but historically CPR has been higher. Many U.S. borrowers today are locked into low-rate mortgages following the recent refi wave and disincentivized to move and forgo their low fixed rates. Historically, there has been a divergence in the prepayment speeds between different Non-QM loan types. Bank Statement loans have had faster speeds than Investor loans, given that most Investor loans carry prepayment penalties that discourage refinancing activity.

Non-QM Prepayment Speeds



Angel Oak has developed a proprietary prepayment model through our robust database of loan-level data from our in-house Non-QM loan origination and servicing database. Based on our modeling, we examine that the change in the prevailing Agency mortgage rate is a highly predictive variable of the change in prepayment rates. As observed from the model projections, we expect loans with 6% and 7% WAC to see the largest percentage increase in CPR in two years given a decrease in rates. The projections in the table below also highlight the prepayment protection in Investor loans. For example, in 8% coupon loans, if the Agency rate drops to 5% over two years, a Bank Statement loan is projected to prepay around 10% CPR higher than Investor loans.

Bank Statement Loan: Forward Projected CPR (%) in Two Years

		Base Agency Rate	Agency Rate After Shock From Base Rate: -50 bps	-100 bps	-150 bps	-200 bps
WAC	**WALA**	**7.00**	**6.50**	**6.00**	**5.50**	**5.00**
8%	**3**	24.03	31.92	41.72	42.14	42.56
7%	**3**	13.24	17.89	24.03	31.92	41.72
6%	**24**	6.75	9.04	12.16	16.36	21.94
5%	**27**	6.54	6.54	6.54	8.76	11.80

Investor Loan: Forward Projected CPR (%) in Two Years

		Base Agency Rate	Agency Rate After Shock From Base Rate: -50 bps	-100 bps	-150 bps	-200 bps
WAC	**WALA**	**7.00**	**6.50**	**6.00**	**5.50**	**5.00**
8%	**3**	17.63	23.76	31.65	32.00	32.35
7%	**3**	9.52	12.98	17.63	23.77	31.66
6%	**24**	4.73	6.39	8.67	11.79	15.99
5%	**27**	4.58	4.58	4.58	6.19	8.41

Based on our modeling, we attribute the slowdown in prepayment speeds for recent origination to be a function of the tight spread between the prevailing Agency mortgage rate and Non-QM. Historically, current coupon prepayment speeds had been in the mid-20s CPR area once they ramp up. However, we have seen recent loan production prepay at a slower rate, which has benefited investors, along with a lower premium paid for loans in the current market environment.

Other Opportunities

In addition to core Non-QM lending programs, other opportunities exist or are emerging in the Non-Agency residential mortgage sector that Angel Oak views as attractive. We believe the U.S. housing market is well positioned relative to other areas of credit due to a lack of single-family supply, all-time-high borrower home equity, pristine credit underwriting post-crisis, and a lack of credit availability. Homeowners are sitting on an unprecedented amount of equity in their homes – around $31.6 trillion as of Q2 2023. It is estimated that 94% of outstanding mortgages have a rate <4%, and 96% of mortgages are <80% LTV. Approximately $1.6 trillion of home equity could be extracted from Agency mortgages, assuming a CLTV below 80%. For most of those borrowers, it would be more economical to utilize a HELOC or second lien mortgage at a 9%-11% rate rather than a cash-out refinance at 7%-8%. Both HELOCs and second liens have seen growing securitization issuance given the addressable market size. In addition, we are seeing opportunities in Agency investor loans. Agency originators are increasingly seeking out the private market exit for investor and second-home production rather than selling them to the GSEs. We have modeled mismatches between the GSEs and private markets pricing, creating attractive economics for both unlevered and securitizing investors in an opportunity that we expect to continue.

Insurance companies may benefit from owning Non-QM, HELOCs, Second Liens, and Agency investor loans as part of a diversified investment portfolio with a potentially low risk-based capital charge and the ability to pledge the mortgages for FHLB financing.

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