

Angel Oak Private Strategies: Non-QM vs. Agency Relative Value



In this white paper, we examine the overall relative value case for Non-QM as compared with Agency or conventional mortgages. We take a closer look at the convexity profile for Non-QM, along with comparing the credit characteristics relative to Agency mortgages. With relative value a consistent topic in our conversations with clients, we hope this analysis sheds some light on our views, especially in the context of the volatile market environment. As always, we welcome your feedback, and please reach out if you have any questions.

Potential Convexity Advantage in Non-QM

When evaluating relative value in Non-QM, one advantage over Agency loans is the better convexity, or a flatter S-curve profile. The S-curve is the prepayment response function for borrowers at different rate levels or incentives. Looking at the S-curve based on the past 2 years of observations in the chart below, Agency loans, for example, prepaid in the mid-30s CPR (annualized prepayment rate) at 100 bps of rate incentive, whereas Non-QM speeds have hovered around a high-teens CPR. On the other hand, deep out-of-the-money prepayment speeds in Non-QM tend to be slightly faster than in Agency, as shown in the chart below when the X-axis dips below zero.

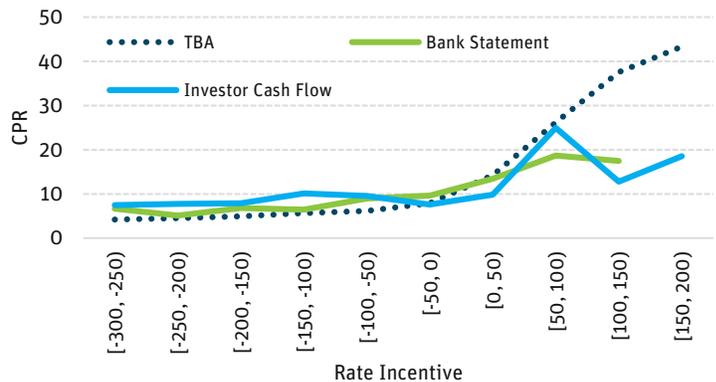
There are several reasons for this, in our opinion:

- With alternative documentation underwriting, Non-QM loans have more limited refinancing channels compared with Agency loans, thus reducing the ability to refi at the margin.
- Underwriting cost/time/complexity: Non-QM underwriting is still a manual and costlier process, whereas automated underwriting systems for Agency loans are well established.
- For investment property collateral within Non-QM, debt service coverage ratio (DSCR) loans come with prepayment penalties, thus significantly reducing the refi incentive in the loan's first few years.
- In the recent environment, Non-QM rates have come much closer to Agency rates. The spread between Non-QM and Agency has shrunk to inside of 100 bps compared with 150-200 bps historically. This has led to slower prepayments in Non-QM loans – down to mid- to high-teens CPR compared with mid-20s CPR historically.
- Non-QM Bank Statement loans typically cater to self-employed individuals and small-business owners. For those borrowers who are looking to expand their businesses, tapping into their home equity even at higher rates could be a compelling option. We saw this play out in the 2022-2023 sell-off environment, when cash-out refinancing volume was consistent while rate refinancing volume vanished.

Looking at historical data, this relative convexity advantage still held in very fast prepaying environments. During the refi boom back in 2021, conventional Agency mortgages prepaid at 50%-60% CPR on average, even at slightly in-the-money rate incentives. By contrast, Non-QM Bank Statement prepayment speeds generally stayed in the high-30s to low-40s CPR range, while Investor Cash Flow (ICF) loans ramped only to mid-30s CPR.

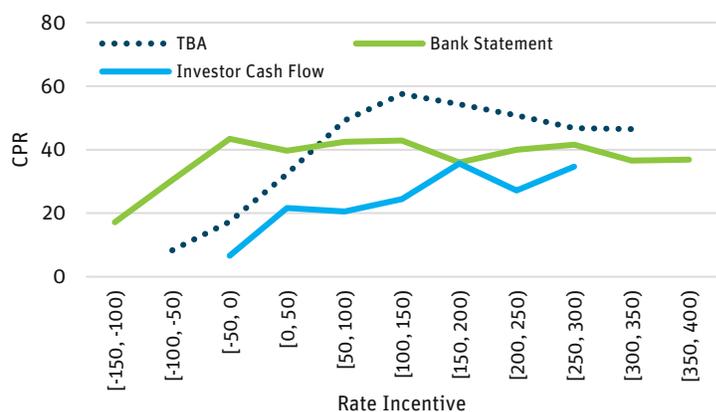
Non-QM vs. Conventional S-Curve (13-24 Month WALA)

Rate incentive is calculated vs. respective prevailing base rates
Jan 2023 – Jan 2025 Observations



Non-QM vs. Conventional S-Curve (13-24 Month WALA)

Rate incentive is calculated vs. respective prevailing base rates
2021 Observations



Source: Bloomberg, Fannie Mae, Freddie Mac as of April 2025.

Non-QM Credit Profiles Rival Conventional Agency Production

Credit profiles in our Non-QM production have been strong – with average FICO credit scores at 750 and low-70s LTV, these are more akin to Prime borrowers. As an example, if we compare our 2024 Non-QM purchases with conventional 30-year fixed rate mortgage production from Fannie and Freddie, FICO scores are comparable in the mid-750s range. However, our LTVs were almost 8 points lower, and DTIs were 6 points lower. In addition, high LTV (>80%) tails are significantly lower in Non-QM, which we believe would provide a strong buffer to offset any potential housing downturn.

2024 AOCA Vintage Origination Stats

	WAC	Average Loan Size	WA FICO	WA LTV	WA DTI	% < 680 FICO	% > 80 LTV
Conventional	6.69%	\$340,223	757	78.1%	38.6%	5.70%	40.70%
AOCA Non-QM Total	7.63%	\$499,381	755	70.5%	32.2%	1.90%	6.30%
AOCA Bank Statement	7.70%	\$706,578	750	73.0%	30.7%	2.80%	11.10%
AOCA Investor Cash Flow	7.59%	\$332,325	758	67.2%	N/A	0.30%	0.00%

The Bank Statement product makes up the majority of our origination and typically caters to self-employed borrowers who have strong credit history but lack the necessary income documentation to qualify for a conforming loan. We have primarily focused on traditional Bank Statement underwriting, requiring at least 12 months of bank statement cash flow history to corroborate income. Despite the growing popularity of more alternative products in the market, such as CPA P&L statements and Written Verification of Employment (WVOE), we have shied away from those income underwriting methods as we believe they are less robust and present higher risks for fraudulent income reporting. Through years of experience and development, our affiliate mortgage company has continually improved and streamlined its Bank Statement underwriting process, utilizing artificial intelligence tools to more accurately and efficiently extract information from documents.

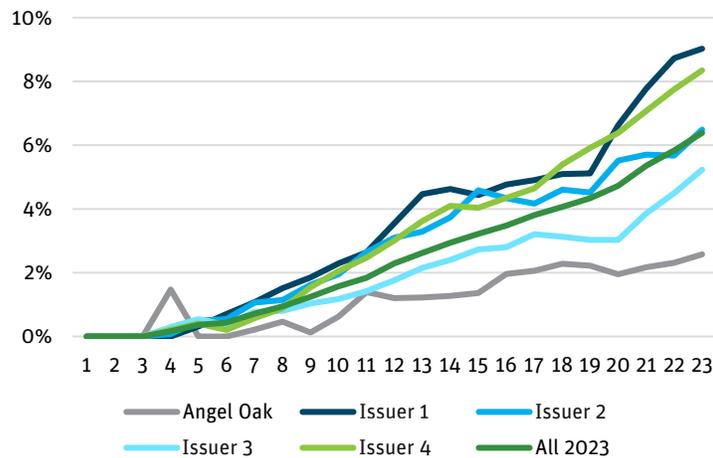
The ICF product caters to rental property operators, usually seasoned landlords who manage multiple rental properties. The loan is underwritten to the property’s underlying rental cash flows, and we generally require at least a 1x DSCR including monthly mortgage and tax/insurance payments. Our 2024 ICF purchases averaged around 1.17x DSCR. As a mitigant for otherwise potentially higher risk in an investor borrower, ICF LTVs generally are lower than those in Bank Statement loans – on average 5-6 points lower with an 80% LTV cap. ICF loans also tend to skew higher in FICO than do Bank Statement loans, with a higher minimum FICO floor in our credit box, which helps mitigate tail FICO risk.

Realized Delinquencies

With strong underwriting and clean credit profiles, our delinquencies have thus far been benign. Our 2024 vintage (about 1 year of aging) has been tracking less than 1% in 60+ day delinquencies, and 2023 vintage has been around 2% as it ramped up over 2 years. Especially when comparing our production versus the broader Non-QM market, we have well outperformed our securitization peers. Both our 2023 and 2024 vintages have so far seen 60+ day delinquencies running at less than half of the market average.

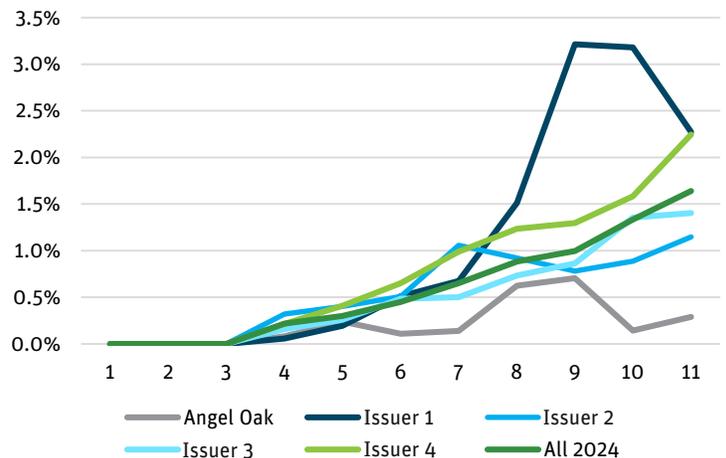
2023 Loan Origination Year: Delinquency Rate by Loan Age (Months)

60+ Day DQ (% of current loan balance)



2024 Loan Origination Year: Delinquency Rate by Loan Age (Months)

60+ Day DQ (% of current loan balance)



Source: Bank of America Securities as of April 2025.

Notable Option-Adjusted Spread and Loss-Adjusted Return Profile in Non-QM

To control for the prepayment optionality and determine relative value, we used Yield Book to calculate an Option-Adjusted Spread (OAS) in both sample Agency and Non-QM loans. For Agency, we used TBAs as our example. In Non-QM, we looked at some typical credit profiles seen in the market and priced them at comparable WACs to FN 6.

On an unlevered and loss-adjusted basis, our Bank Statement sample saw OAS on average at around 173 bps, compared with 52 bps in FN 6s. Z-spread was 227 bps in Non-QM vs. 144 bps in FN 6. The option cost in Non-QM, at 54 bps, is close to half that of FN 6.

While Agency loans do not incur credit losses, Non-QM still exhibits a significantly superior spread profile in the base case after accounting for credit losses (83 bps pickup in Z-spread over FN 6, and 121 bps pickup in OAS). For context, in our Bank Statement sample, Yield Book projected 45 bps of loss in the first 5 years, and about 2.1% cumulative lifetime loss. Long term CDR or annualized default rate was projected to be around 1.3% at 33% loss severity.

Yield Book Spread and Performance Projections (as of April 16, 2025)

Agency Sample

Security	Price	Gross WAC	Yield	WAL	Z-Spread	i-Spread	OAS	Option Cost	Effective Duration	Effective Convexity
FNCL 5.5	\$99.23	6.52%	5.63%	8.00	138	149	42	96	4.06	-1.75
FNCL 6.0	\$101.09	6.97%	5.71%	5.33	157	177	52	106	3.08	-2.03
FNCL 6.5	\$102.81	7.44%	5.48%	3.58	144	166	52	92	2.09	-1.82

Bank Statement Sample

(Inclusive of Credit Losses)

Loan Characteristic (FICO / LTV / DTI / Occupancy / Purpose)	Price	Gross WAC	Yield	WAL	Z-Spread	i-Spread	OAS	Option Cost	Effective Duration	Effective Convexity
760 / 70% / 35% / OwnerOcc / Purchase	\$102.56	7.00%	6.22%	5.80	210	225	150	60	4.91	-0.78
740 / 75% / 35% / Investor / Refi Cash-Out	\$102.31	7.88%	6.73%	4.35	271	286	220	51	3.78	-0.57
720 / 80% / 40% / OwnerOcc / Refi No Cash-Out	\$102.69	7.38%	6.26%	5.09	218	234	164	54	4.25	-0.73
700 / 75% / 30% / OwnerOcc / Refi Cash-Out	\$102.44	7.88%	6.36%	3.84	236	253	189	47	3.28	-0.58
Average Bank Statement	\$102.55	7.45%	6.33%	4.92	227	242	173	54	4.16	-0.69

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