Non-Agency Mortgages

FALCONBRIDGE Capital

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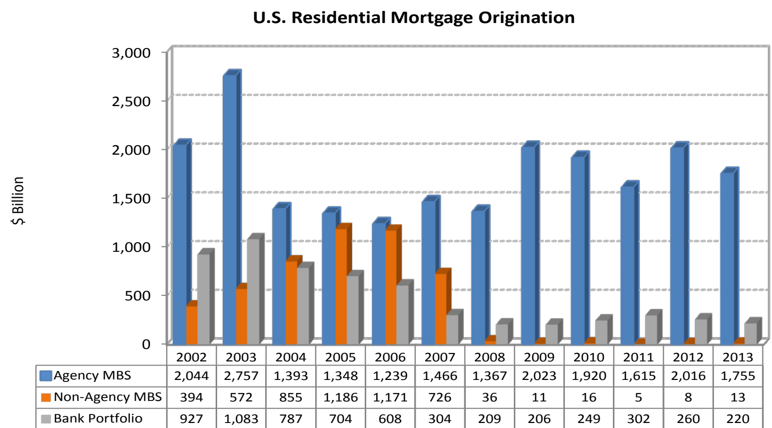
State of the "New Issuance" Housing Market

Over the past few years, the mortgage finance market has depended primarily on the support of the U.S. government after private securitization vehicles collapsed following the financial crisis in 2008. The majority of the recently originated loans have been securitized by government entities (funding 9 out of every 10 new loans: Figure 1 - Origination volume). As the government "tapers" its role in Housing Agencies over the next several years, private capital will be required to support mortgage financing needs of borrowers across the credit spectrum. In this report we will provide a brief overview of the non-agency mortgage market in 2013, review the collateral, illustrate a securitization structure, and highlight the opportunities and challenges.

Figure 1 - Origination Volume



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Agency MBS	2,044	2,757	1,393	1,348	1,239	1,466	1,367	2,023	1,920	1,615	2,016	1,755
Non-Agency MBS	394	572	855	1,186	1,171	726	36	11	16	5	8	13
Bank Portfolio	927	1,083	787	704	608	304	209	206	249	302	260	220

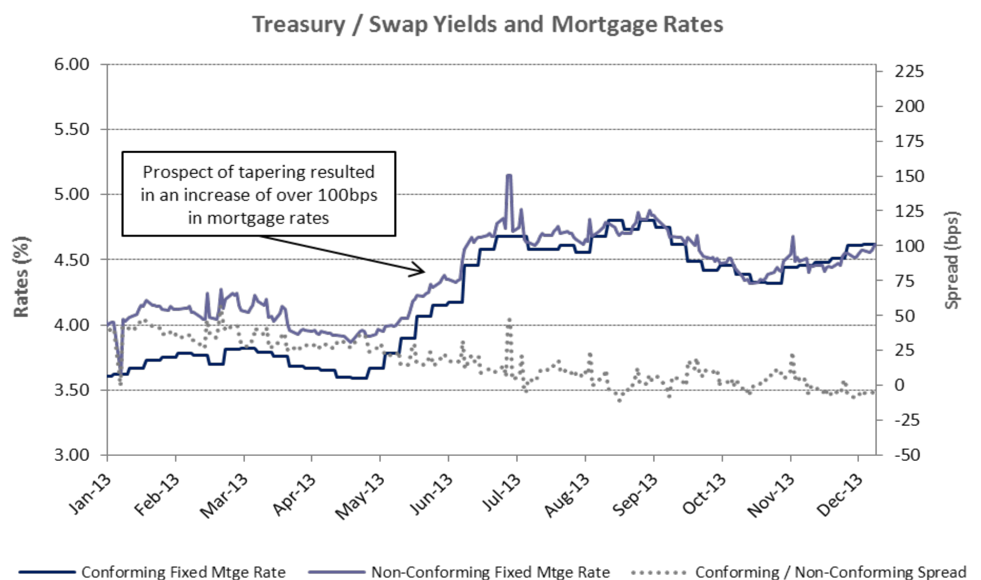
Source: CoreLogic, SIFMA, Inside Mortgage Finance MBS Database, and FBC

Sector Review

The Federal Reserve continuation of QE3 reflects an ongoing commitment to maintain lower rates, reduce unemployment and meet inflation targets. It also underscores concerns that the fragile U.S. economy will require further monetary policy support to achieve their dual mandate. Non-agency jumbo mortgages and securitization were among the beneficiaries of QE3 as mortgage lending rates reached historic lows of 3.9% in May 2013 (Figure 2 - Lending Rates and Spreads). Spurred by increasing loan volume the non-agency securitization market grew from $6 billion in 2012 to over $12 billion by June 2013. The growth was fueled by bullish sentiment on housing, investors' demand for AAA securities, and overall attractiveness of securitization economics.

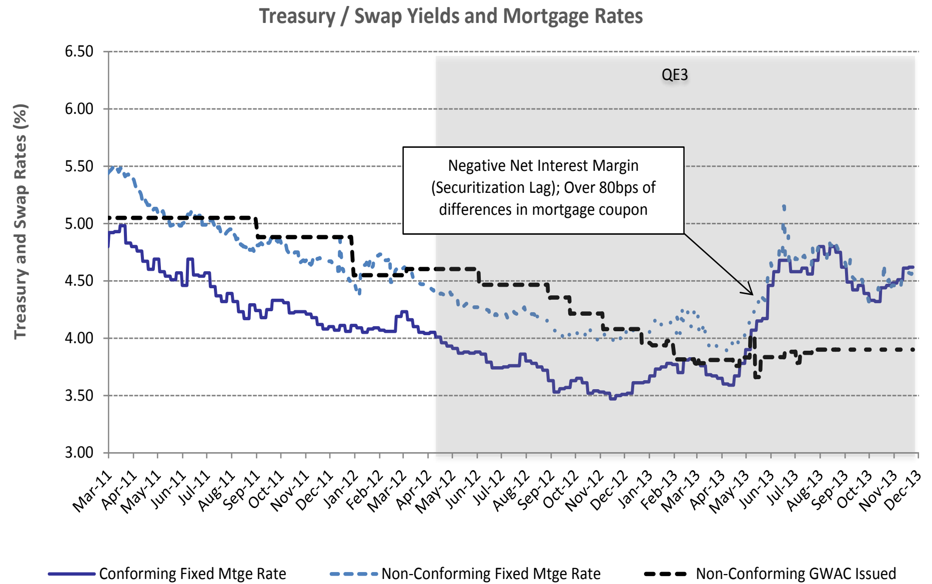
By mid-June 2013 investor sentiment turned negative with the prospect of QE tapering, leading to a precipitous sell-off in rates, mortgages and credit spreads. Issuers were in a precarious situation: selling AAA securities at higher yields and coupons relative to the mortgage coupon available

Figure 2 - Lending Rates and Spreads



Source: Bloomberg, Bankrate and FBC

Figure 3 - Interest Rates and Mortgage Coupons



Source: Bloomberg, Bankrate and FBC

from the underlying loans (Figure 3 - Interest Rates and Mortgage Coupon). The widening of AAA spreads made securitization economics prohibitive. An increase in mortgage rates by originators led to the re-emergence of banks with portfolio bids as better buyers of non-agency jumbo mortgages. Additionally, lower costs of funds and risk capital requirements allowed some banks to offer jumbo loans at lower rates than their conforming counterparts.

Collateral

Fannie Mae and Freddie Mac ("GSEs" or "Agencies") currently account for more than 90% of all new loan origination. They are expected to finance over $1.7 trillion in first-lien residential mortgages this year. In comparison, non-agency origination is expected to only reach $220 billion. The underwriting guidelines for borrowers that cannot meet the GSEs' standards are improving, but remain extremely constrained. In addition to having pristine credit history, documented income, and low debt-to-income ratios, borrowers are required to make sizeable down payments and show high tangible net-worth. Consequently, borrowers who are not able to qualify under the Agencies' guidelines are isolated into two groups: 1) a small contingent of high net-worth, super jumbo prime borrowers who are able to meet today's stringent non-agency guidelines and 2) a segment of underserved consumers unable to secure credit. As illustrated by Figure 4 - New Origination Loan Characteristics, the differences in the GSEs and more affluent non-agency borrowers are substantial.

Figure 4 - New Origination Loan Characteristics[1]

	Fannie Mae Connecticut Avenue Securities Series 2013-C01	Non-Agency Securitization YTD 2013[2]
Average Balance	$237k	$796k
FICO	765	771
Gross Coupon	3.85%	3.85%
Loan Age	n/a	3
Current LTV	75%	67%
DTI	32%	32%
Monthly Income	n/a	Over $25k
Verified Assets	n/a	Over $350k
30 Days Delinquent	n/a	0.11%
60 Days Delinquent	n/a	0.01%

[1] Weighted Average except for Balance
[2] Year-To-Date as of August 2013

Non-Agency Securitization Structure

Non-agency securitization accounted for $13 billion of new RMBS issuance in 2013. Securitization provides mortgage conduits and aggregators the ability to create permanent assets by packaging loans into debt instruments, and financing a majority of the capital structure by selling the AAA securities, while retaining the junior tranches. The economics changed as AAA spreads widened from 97bps in January to 282bps by late August. Adverse market conditions and lack of investor support exposed existing conduit businesses to duration, convexity and spread risks.

Premium loans were eventually securitized at a loss and AAA certificates traded at distressed levels ($95 to $97 or Swaps + 282bps). Historically, AAA spreads have typically been below Swaps + 215bps in non-distressed markets. At present, the securitization market remains depressed, albeit to a lesser extent. The fluctuation in loan rates and pricing will continue with the persistence of interest rate and spread volatility.

Figure 6 - Capital Structure, further illustrates the dislocation in pricing. For readers familiar with legacy RMBS, the AAA credit enhancement or “CE” of 7.70% is extremely restrictive given the quality of the collateral. The CE requirements should be reduced over time to reflect the positive collateral performance.

Figure 6 - Capital Structure

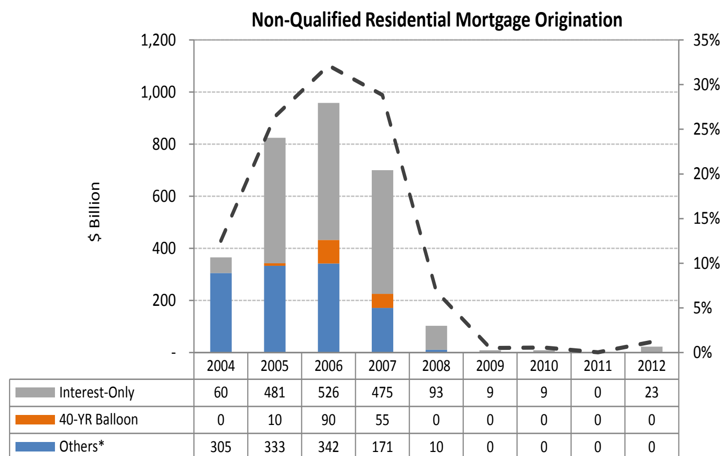
			April 2013			*August 2013*		
Tranche	***% of Deal***	***% CE***	*Price*	*Spread*	*Return*	*Price*	*Spread*	*Return*
AAA	92.30%	7.70%	$100	Swaps + 120bps		$95-28	Swaps + 282bps	
AAA IO			Retained		High double digits	Retained		Low single digits to negative
AA	2.45%	5.25%	Retained			Retained		
A	1.95%	3.30%	Retained			Retained		
BBB	1.45%	1.85%	Retained			Retained		
BB	0.80%	1.05%	Retained			Retained		
NR	1.05%		Retained			Retained		

Source: FBC

Conclusion

An unintended consequence of the Federal Reserve’s QE program is the subsequent increase in interest rate volatility and its effect on mortgage lending. Mortgage origination volume was adversely impacted with increase in rates; however, the velocity and magnitude of recent movements have magnified the risks in acquiring and securitizing non-agency loans. A turbulent 2013 in new issuance non-agency mortgages can be summarized by lending rates fluctuating over 100bps, AAA spreads widening over 150bps from historic lows, conduits aggressively acquiring loans intending to finance through securitization and aggregators postponing new issuances due to the lack of investor support and poor execution.

Figure 7 - Origination by Product



*Others include Option ARM and Other Alt-A

**Non-QM Origination is the share of total non-qualified mortgage loans out of total U.S. residential mortgage origination

Source: Inside Mortgage Finance MBS Database, FBC

Private capital is required to replace government support of the residential mortgage market since the collapse in 2008. Qualified Residential Mortgage (“QRM”) requirements, in effect starting in January 2014, are extremely narrow; thus creating the need for other sources of mortgage finance capital. Current tight lending standards for conforming agency mortgages displaced many responsible borrowers who may otherwise be excellent credit risk for investors (Figure 7 - Origination by Product).

Newly originated Non-Agency RMBS will provide excellent risk-adjusted returns to meet long-term investor yield targets. We believe that the current dislocation in mortgage rates, pricing and AAA spreads is temporary. We expect newly issued securitization in 2012 and 2013 to outperform loss assumptions projected by Rating Agencies resulting in lower credit enhancements requirements for future securitization structures, making the securitization economics more economical for aggregators.

The underlying loan data is provided by CoreLogic (subscription-based data repository) for a specific subset of loans. Our access to CoreLogic data includes approximately 95% of all U.S. Option ARM, Subprime, and Alt-A securitized product. Unless specified, Prime, Jumbo, or Agency Backed loans are not includes in the graphs and charts.

Algorithms and analysis to access the information and any interpretation are proprietary to Falcon Bridge Capital, LLC.

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