Credit Performance of Agency Collateral vs. Non-Qualified Mortgages

Superior mortgage underwriting, robust housing market and strong economic fundamentals continue to support credit performance across the majority of U.S. mortgage space.

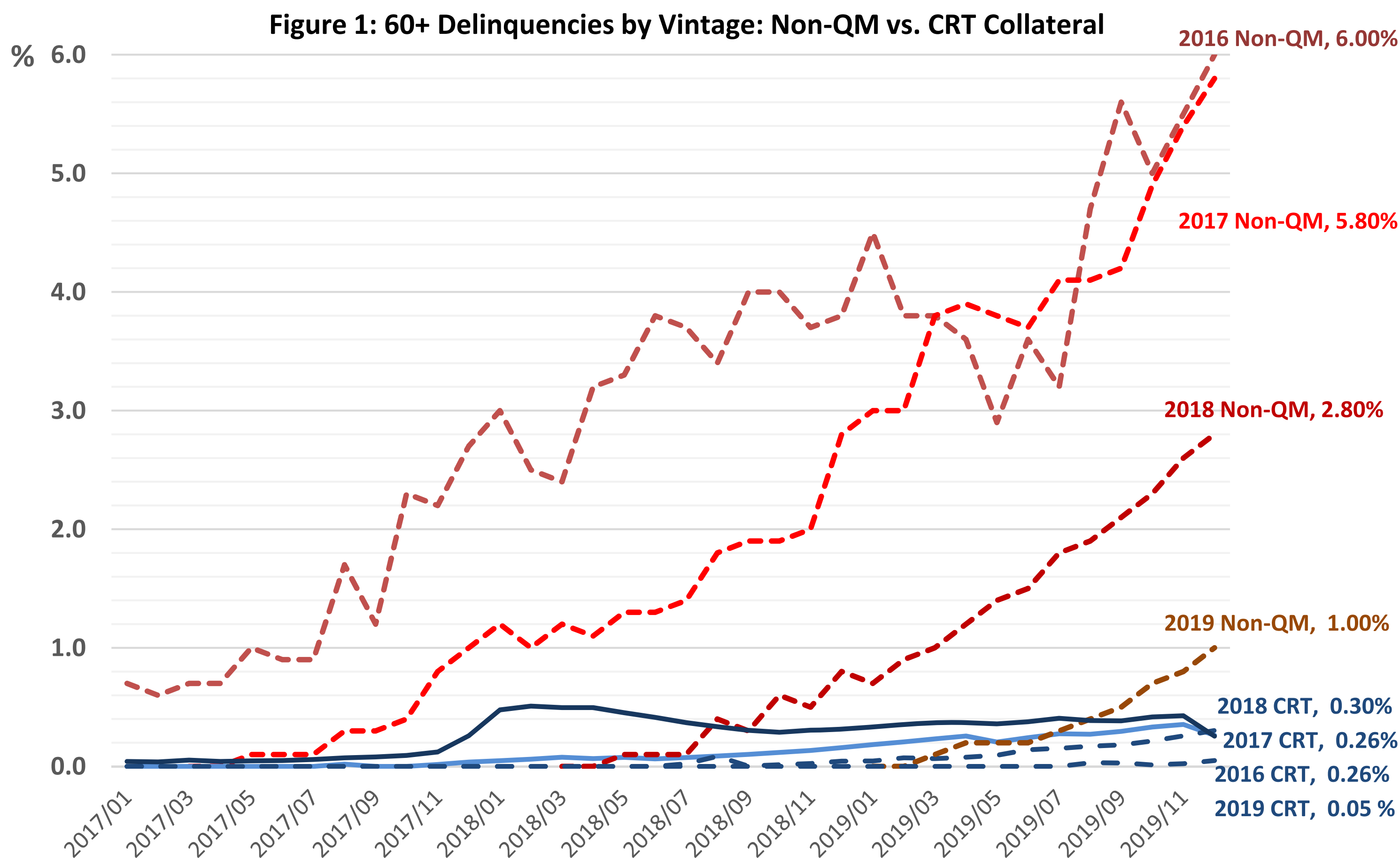
However, serious delinquencies are on the rise in **Non-Qualified Mortgage ("Non-QM")** deals, while collateral performance in Credit Risk Transfer ("CRT") issuance remains very strong. Government Sponsored Agency ("GSE") collateral continues to exhibit low serious delinquencies as borrowers show relatively low propensity to fall behind on their mortgage payments and have extremely high cure rates when a delinquency does occur.

- As of Dec 2019, 60+ delinquencies for 2016, 2017, 2018 and 2019 vintages are **26bps, 26bps, 30bps and 5bps**, respectively (Figure 1).

In contrast, Non-QM loans that mainly include borrowers who are self-employed, foreign nationals, borrowers with low credit scores, high debt-to-income ("DTI") or have non-traditional income sources have experienced a rise in serious delinquencies. The deterioration in their performance is mostly caused by looser underwriting (as evidenced by the many exceptions to the deal issuer's underwriting guidelines) and significant risk layering.

- As of Dec 2019, 60+ delinquencies for 2016, 2017, 2018 and 2019 Non-QM vintages are **6.0%, 5.8%, 2.8% and 1%,** respectively (Figure 1)

Figure 1: 60+ Delinquencies by Vintage: Non-QM vs. CRT Collateral



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Source: 1010Data, Morgan Stanley, FBC

CRT performance depicted in the above graph represents 60+ delinquency levels in across STACR deals.

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Risk Layering and Other Factors Contributing to Higher Delinquencies.

Non-QM borrowers frequently exhibit weaker credit profiles. Based on the 2017-2019 collateral composition, it is evident that Non-QM pools have much more risk layering relative to pools governed by stringent credit guidelines in CRT product.

- **The share of loans with both, lower FICO (<680) and higher LTV (=>70), that traditionally experience higher defaults is 3.5 times higher in Non-QM pools when compared to CRT collateral (Figure 2).**

Additionally, income verification standards are very different.

- All Agency borrowers are required to provide full documentation consisting of two years of tax returns, W-2 forms, recent paystubs. **Bank statements or other alternative sources of income verification are not allowed**.
- Non-QM programs allow bank statement underwriting as a part of their Full Doc/Alternative classification, **while approximately 38% of their production has very limited or no income verification.**

Figure 3: Documentation Type in Non-QM deals.

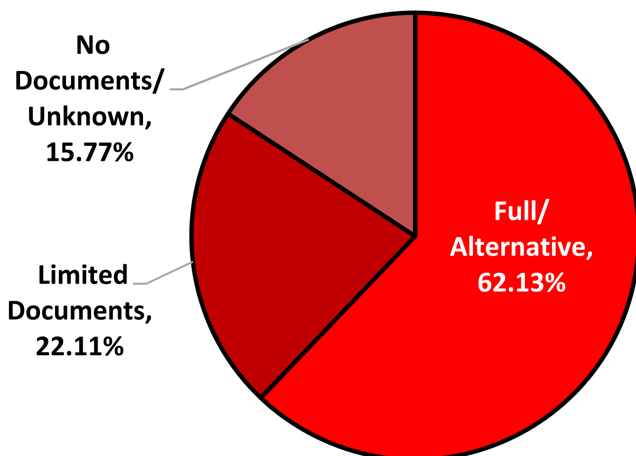

Figure 2: Collateral composition of CRT vs. Non-QM deals.

2017 - 2019 CRT Deals

	LTV Range			
FICO Range	<70	=>70 <80	=>80 <90	=>90 <100
<620	0.02%	0.04%	0.01%	0.01%
=>620 <640	0.43%	0.89%	0.18%	0.29%
=>640 <660	0.65%	1.44%	0.34%	0.62%
=>660 <680	0.92%	2.26%	0.57%	1.02%
=>680 <700	1.27%	3.69%	1.22%	2.17%
=>700 <720	1.49%	4.97%	1.66%	2.91%
=>720 <740	1.56%	5.66%	1.94%	3.47%
=>740 <760	1.75%	6.76%	2.35%	3.86%
=>760 <780	2.17%	8.18%	2.68%	3.90%
=>780	4.01%	14.22%	3.83%	4.61%

Risk Layering as a % of deal collateral weighing on delinquencies.

CRT Pools 7.66% vs. Non-QM – 26.55%

2017 - 2019 Non-QM Deals

	LTV Range			
FICO Range	<70	=>70 <80	=>80 <90	=>90 <100
<620	1.79%	1.86%	1.43%	0.14%
=>620 <640	1.05%	1.05%	1.43%	0.24%
=>640 <660	1.45%	1.57%	2.40%	0.36%
=>660 <680	2.59%	2.12%	3.80%	1.15%
=>680 <700	2.72%	3.17%	5.71%	1.88%
=>700 <720	2.55%	3.58%	5.10%	1.84%
=>720 <740	2.85%	2.39%	4.30%	1.77%
=>740 <760	2.28%	1.76%	3.00%	0.94%
=>760 <780	2.10%	2.13%	3.13%	0.75%
=>780	1.94%	1.92%	2.63%	0.56%
Unknown	5.57%	5.30%	3.10%	0.60%

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Source: 1010Data, Bloomberg, Morgan Stanley, FBC

CRT composition is based on collateral characteristics of CAS deals. Non-QM production is represented by select deals from the top Non-QM issuers.

What is a Qualified Mortgage?

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires mortgage lenders to make "a reasonable, good faith determination" of each borrower's ability to repay during the underwriting process. Qualified Mortgages, as defined by the Consumer Financial Protection Bureau ("CFPB"), are presumed to satisfy this criteria and in turn provide lenders legal protection from potential borrower litigation:

1. The loan cannot have negative amortization, interest-only payments, or balloon payments.
2. Total points and fees cannot exceed 3% of the loan amount.
3. The mortgage term must be 30 years or less.
4. The borrower's total monthly debt-to-income (DTI) ratio must be <=43% or the loan must be eligible for purchase by Fannie Mae/Freddie Mac or insured by the Federal Housing Administration (FHA), the US Department of Veterans Affairs (VA), or the US Department of Agriculture Rural Development (USDA), regardless of DTI ratio.

What is a Non-Qualified Mortgage?

Following the financial crisis most mortgages were originated to underwriting standards of GSEs that left a substantial number of borrowers unable to access traditional sources of mortgage lending. Non-QM mortgages provided financing to such borrowers who were underserved, however were considered comparable in their ability to perform under stress scenarios due to compensating factors. However, over the last few years, the pool of borrowers being underwritten to Non-QM standards has deteriorated in performance due to lack of uniformity in lending standards by non-QM lenders, relaxed lending standards, increased share of borrowers with layered risks, and substantial exceptions to broad Non-QM underwriting being allowed by such lenders.

1. Non-QM mortgage products are not limited to 30yr fully amortizing loans. Non-QM lenders offer Interest Only, 40yr Amortization, ARMS, Hybrid Arm Products; some that were considered exotic products during the financial crisis.

2. Use of alternative documentation like Bank Statements instead of tax returns or verification through borrower's assets may provide less certainty as to borrowers' actual income available to maintain the mortgage obligation.

3. Borrowers with recent credit events like foreclosure or bankruptcies do not require any minimum seasoning period with regards to previous credit event before being approved for a Non-QM loan.

4. Borrowers with limited or damaged credit history, higher than 43% DTI ratios, and lack of P&I reserves are becoming bigger part of pools rather than the exception in Non-QM securitizations.

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- Falcon Bridge Capital formed in January 2006 as part of joint venture with a large private equity firm, providing portfolio management to $1.6bn, at the peak, of U.S. Residential Mortgage Backed Securities ("RMBS").
- Firm manages SMA for large U.S. Foundation and recently exited an SMA of legacy U.S. RMBS securities.
- Firm provides loan acquisition, analytical and due diligence services to various Community Banks in CA.
- The firm has expertise across various mortgage and mortgage credit sectors.

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