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Why Supply Remains a Hurdle for Subprime Securitizations

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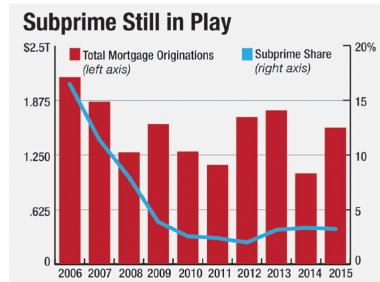

As a handful of new issuers enter the market and the implementation of a key regulation pave the way for subprime securitization's comeback, the volume of new loans that are actually available to the market remains a question.

John Hsu, head of capital markets at the Atlanta-based Angel Oak Capital Advisors, said his company got into new-origination securitization because it was concerned that the legacy deals it and other investors liked were dwindling. Legacy subprime deals burned original investors, but some discount buyers later profited as housing recovered.

Private-label RMBS investors have been buying a steady supply of legacy bonds backed by older subprime loans, said Grant Bailey, head of the U.S. RMBS group at Fitch Ratings in New York. Private-label RMBS data from CoreLogic/LoanPerformance show issuance backed by such subprime collateral has continued through the post-crisis years.

"The seasoned nonprime market is very active," Bailey said.

New-origination nonprime securitization needs more than investors to grow, though. It needs collateral.

"I think the constraint on the nonprime market hasn't been investor interest as much as it's been supply," Bailey said.

Lenders don't seem as interested in subprime as investors in some cases. "I think the banks aren't interested in making nonprime loans and the nonbanks are often dependent on selling the loans or securitizing them," said Bailey.

But securitized deals, even privately placed ones, could help overcome some of the uncertainty for nonbanks if word gets out as to what their execution levels are like, he said.

Otherwise, "they don't currently know what their takeout is going to be and so it's hard for them to kind of put the money up for a [nonprime] deal," Bailey said.

With the ability to pay higher points and fees, Angel Oak has been able to offer greater incentive for nonprime production.

Although Angel Oak does have some competitors, many lenders to date have remained primarily interested in originating government and agency originations, which currently have the equivalent of QM status to avoid more complex ATR liability.

Subprime loan counts and dollar volumes aren't growing as fast as new first-mortgages overall, but the average loan size for subprime is increasing at a faster rate than the average loan size in the overall first-lien market.

The year-to-date new subprime loan count through October 2015 was up 28%, according to an Equifax report released in January. The dollar volume at that time represented a 45.7% increase.

In comparison, the new loan count in the overall first-lien mortgage market was up 34.7% through October of last year, and the total dollar amount represented more than a 50% increase.

The subprime first-lien balance at origination in the first nine months of 2015 was up 6.29% at $154,835 on average, while overall first liens increased during the same period by just 2.21%, albeit with a higher average balance of $222,698. So by dollar volume, subprime share of the market is a little lower than by loan count and closer to 4% than 5%.

Trends that could be fueling more subprime origination volume could include some concern among lenders about risk in the competing Federal Housing Administration market.

"To the extent there might be some incremental redirection of loans that otherwise would have gone to the FHA, there might be some increased interest in a nonagency or nonprime securitization," said Bailey.

How much a market for subprime exists outside the agencies and FHA could be key to how much growth potential there is in private-label securitizations, said Suzanne Mistretta, a senior director at Fitch.

"Some of the lenders in the space believe there is going to be pretty decent volume, but how much of that is qualified for FHA vs. the private-label market? It's difficult to say," she said.

The FHA has boomed in the past year due to a premium cut that made its loans more affordable. There's some question of how long that boom will last though, unless the FHA cuts single-family premiums again.

Overall, nonprime's prospects for growth remain limited. As of October 2015, it represented roughly 5% of originations by number as compared to 10% at the market's peak, according to Equifax.

At least that's not worrisome from a credit perspective, especially so long as lenders remain loath to couple loose credit with other loose underwriting such as high loan-to-value ratios, said Equifax chief economist Amy Crews Cutts.

"Five percent a year is not crazy," she said. "As long as credit standards are balanced, then I'm not worried about the share that goes to subprime."

A certain amount of subprime is healthy for the market, given that some estimates as of last year suggested around 30% of households have credit scores in that range. Also, not every subprime borrower's checkered credit record is the result of sheer irresponsibility indicative of future ATR problems. Unexpected, short-term medical bills that can change a borrower's financial standing abruptly, for example, could be a cause.

"If we got to the point where we had zero subprime I think we would be doing a lot of damage," said Rebecca Walzak, a mortgage industry operational risk consultant.

But is the current level enough to fuel regular securitization, especially given some other hurdles in getting loans to market?

Even with private-label securitization being more feasible as an exit strategy for new-origination subprime, it's unlikely to accelerate production much in the short term because it has been taking longer to gets loans to market.

The implementation of new Truth in Lending Act-Real Estate Settlement Procedures Act integrated disclosures appears to be slowing some sales, although analysts argue over the extent of it. TRID has assignee liability for estimates as well as final disclosures that predecessor rules didn't have.

"For private-label RMBS, the biggest impact would likely be a delay in their securitizations while aggregators and lenders adjust their processes to cure and fix these violations," said Yehudah Forster, a vice president and senior credit officer at Moody's Investors Service in New York.

Due diligence vendors indicated some errors are minor, but it will take time to separate out the ones they actually have to worry about.

"The errors will vary from simple errors like spelling convention errors in counterparty names to untimely disclosures," said Debbie Hoffman, chief legal officer at Digital Risk in Maitland, Fla.

This leads to a situation where lenders selling any type of loan to a nonagency buyer, or even an aggregator of agency loans, have found the process slowed by discussions with buyers as to how to prioritize compliance concerns. Some aggregators of agency loans are telling their sellers, "I think that you're not compliant. What do you think?" said Brian Koss, executive vice president at Mortgage Network in Danvers, Mass.

Market participants have groused about the lack of additional guidance from the regulator responsible for TRID, the Consumer Financial Protection Bureau, since the rule's implementation. The CFPB also has blamed vendors for implementation delays, but some vendors blame the CFPB for the secondary market slowdown.

"All of the guidance is informal. I think that's what's leading to the majority of these secondary-market issues," said John Haring, director of compliance enablement at the technology vendor Ellie Mae in Pleasanton, Calif.

However, he and other market participants do think over time industry consensus on best practices will help reduce delays.

Jack Nunnery, executive vice president of correspondent lending at Texas Capital Bank in Dallas, said agency loan sales have benefited from Mortgage Bankers Association discussions on how to prioritize TRID compliance. There is an overriding theme to these discussions, he said: Harm to consumer that has a monetary value to it. "If we purchase that loans without that being cured, the financial institution could put itself at risk for making that consumer whole," he said.

Minor errors will likely be pushed aside over time, said John Levonick, a compliance officer at Clayton Holdings LLC in Shelton, Conn.

"I really have a hard time believing if the gridding or the shading of the disclosure is off, the consumer is actually harmed," he said. For now, some investors may err on the side of caution, while others are willing to buy loans with "scratch and dent" TRID errors.

How all of these factors balance out will determine how fast nonprime and non-QM/QRM securitizations and loan sales in general move in 2016.

So far the analyst forecasts for growth remain conservative, but the sell side is optimistic.

"I think any activity in that space is important, but I'm not expecting the nonprime volume to be very large next year," said Bailey.

But Carl Bell, managing director and co-head of investment at Invictus Capital Partners in Washington, D.C., thinks nonprime and other ATR originations are on the verge of becoming much bigger. Invictus has an affiliated correspondent investor that purchases closed non-QM loans.

"I expect to see a significant number of announcements certainly by March or April from large originators [those producing at least $500 million per month] saying, 'We have broadened our product suite to include non-QM offerings,'" he said.