RMBS Commentary:
RMBS Landscape

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Introduction
Issuance activity in so-called private-label, or nonagency, U.S. residential mortgage-backed securities remains tepid for the seventh consecutive year, due to several reasons, including regulatory uncertainty, new standards for servicers, and macroeconomic factors, such as interest rates and housing prices. This paper by Morningstar Credit Ratings LLC, which just last month published its methodology for rating U.S. RMBS transactions, explores the ongoing challenges facing the private-label RMBS market and offers Morningstar’s thoughts on what is needed to overcome these challenges. Morningstar begins by categorizing the challenges against two scales: the impact that Morningstar views the concerns having on the private-label RMBS market and the likely resolution timeline for these challenges.
Challenge for Private-Label RMBS Issuance

For purposes of this report, Morningstar has classified the challenges facing the private-label RMBS market under five categories: regulatory hurdles, stability of counterparties, the framework for representation and warranties, exogenous variables and technical factors, which are discussed below.

Regulatory Hurdles

Government-Sponsored Enterprise Reform: Nonagency RMBS securities currently make up only 12.8% of the combined agency and nonagency mortgage-backed securities market.¹ In Morningstar’s view, the disproportionate share of the agency market needs to shrink to allow for healthy growth of private-label securities. Therefore, the role of the federal government in reforming the government-sponsored enterprises, or GSEs, will probably have the biggest influence on the size of the private-label RMBS market. Reducing the footprint of the GSEs, Fannie Mae and Freddie Mac, will allow for great participation in the private-label RMBS market.

¹ Agency includes the Federal National Mortgage Association, or Fannie Mae; the Federal Home Loan Mortgage Corp., or Freddie Mac; and mortgage-backed securities and collateralized mortgage obligations from the Government National Mortgage Association, or Ginnie Mae. Nonagency includes RMBS and Home Equity, SIFMA.

Source: Congress.gov
An important step in the GSE reform was undertaken last year with the introduction of the “Housing Finance Reform and Taxpayer Protection Act” bill in the Senate. The legislation, voted out of the Senate Banking Committee in May, would replace Fannie Mae and Freddie Mac with the Federal Mortgage Insurance Corp., which would be setup as an independent agency of the federal government, similar to the FDIC. However, despite bipartisan support for GSE reform, the bill has stalled in the Senate, and there is uncertainty about passage in the House. The impact of such a reform on private-label RMBS issuance is hard to predict, to say the least.

In the near term, within the GSE context, decisions made about the GSE guarantee fees, or G fees, and the GSE conforming loan limits are likely to have a greater influence on private-label securitizations.

**G Fee:**
Fannie Mae and Freddie Mac buy single-family mortgages from mortgage companies, commercial banks, credit unions, and other financial institutions. In most cases, a lender receives mortgage-backed securities in exchange for the loans. Fannie Mae and Freddie Mac guarantee the payment of principal and interest on their MBS and charge a fee for providing that guarantee. The guarantee fee covers projected credit losses from borrower defaults over the life of the loans, administrative costs, and a return on capital.

**Conforming Limit:**
Fannie Mae and Freddie Mac are restricted by law to purchasing single-family mortgages with origination balances below a specific amount, known as the conforming loan limit. Loans above this limit are known as jumbo loans.

Lower G fees charged by the GSEs weaken the economics of private-label securitization as the lower fees make it harder for private capital to compete with the GSEs in making new loans. Similarly, higher conforming loan limits allow the GSEs to make loans in areas that otherwise would have been served by private capital. The GSEs’ current loan maximum of $625,500 in high-cost areas and $417,000 in all other areas continues to be higher than the precrisis levels. In 2004, for example, the limit was $333,700. The Federal Housing Finance Agency, the regulator of the GSEs, last December proposed reducing the current limits by four percent. The proposal would set the new conforming loan limits at $400,000 and $600,000, respectively.2

The proposed reduction is a good start; however, the limits would have to be further lowered to provide any significant boost to private capital, in Morningstar’s view.

**Unification of QRM and QM rules:** The qualified mortgage rule went into effect on January 10, 2014. The QM rule implemented “ability to repay,” or ATR, requirements adopted under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which was largely in response to the lending practices that contributed to the mortgage crisis of 2008.3

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2 The national conforming loan limit for mortgages that finance single-family one-unit properties increased from $33,000 in the early 1970s to $417,000 for 2006-2008, with limits 50% higher for four statutorily designated high-cost areas: Alaska, Hawaii, Guam, and the U.S. Virgin Islands. Since 2008, various legislative acts increased the loan limits in certain high-cost areas in the United States. While some of the legislative initiatives established temporary limits for loans originated in select time periods, a permanent formula was established under the Housing and Economic Recovery Act of 2008. Loan limits determined under the HERA formula will apply to loans: (a) acquired by Fannie Mae and Freddie Mac in 2013 and (b) originated after September 30, 2011, or before July 1, 2007. Source: FHFA

3 For a background on the QM rule and the potential effects the rule will have on rating RMBS see our paper titled, “Qualified Mortgage Rule and Securitization,” dated June 2013 and available at https://ratingagency.morningstar.com. Also, for Morningstar’s treatment of QM and Non-QM loans in RMBS transactions see our “RMBS Ratings Methodology,” dated June 2014 and also available at https://ratingagency.morningstar.com.
The QM rule creates a safe harbor for issuers from the liability of violating the ATR requirements. This safe harbor exists as long as the issuers originate non-high-priced loans that do not carry any non-QM credit characteristics. The regulation has had an obvious impact on restricting some lending activity, and no securitizations with non-QM loans have closed as of the date of this publication. Furthermore, the GSEs have been granted a temporary exemption from certain QM regulations. They are exempt up until the time they exit federal conservatorship or receivership or on January 10, 2021, whichever occurs first. While this exemption maintains certain QM guidelines and is meant to be a transitional measure designed to prevent any dislocations in the agency market, it has anecdotally further limited lending to QM borrowers in the private-label market, thus reducing the volume of loans available for securitization.

Qualified Residential Mortgage or QRM:
One important purpose of the Dodd-Frank Wall Street Reform and Consumer Protection Act is to reform the securitization of financial assets in the U.S. To that end, the legislation requires the federal banking agencies, the Securities and Exchange Commission, the Secretary of Housing and Urban Development, and the Federal Housing Finance Agency ("the Agencies") to jointly issue regulations to require securitizers to retain an economic interest in a portion of the credit risk for residential mortgages that they use to collateralize asset-backed securities. Dodd-Frank requires the agencies to exempt securities from this requirement that are backed only by loans with low default risk that meet a QRM standard.

Source: FHFA

The private-label market also awaits the final rules with respect to qualified residential mortgages. Loans that meet QRM definition will be exempt from the risk-retention requirement from the Dodd-Frank Act. If QRM turns out to be even more restrictive than QM, the pool of private-label securitizable loans could shrink further. The QRM rule is currently under proposal, and there is some uncertainty about the outcome of the final ruling. The rule will require RMBS issuers to retain risk for loans that do not meet the QRM definition. While it is expected that QRM will be aligned with QM, there continues to be uncertainty among issuers. Some of those who oppose the unification of QRM with QM have written dissents to the version of the QRM rule saying that it is inappropriate to adopt a rule essentially written by another agency, the Consumer Financial Protection Bureau, which isn't part of the mortgage-securities rule-making process.4

Regulation AB II (under proposal): The SEC has revised certain rules that were initially proposed in April 2010 related to asset-backed securities in light of the provisions added by the Dodd-Frank Act. The data collection and data delivery mechanisms under proposal are particularly relevant to RMBS issuance volume. The proposal seeks to establish standards for the format in which data are provided by the issuers of asset-backed securities. The goal is to facilitate data comparison across similar securities and allow investors to independently perform due diligence. While issuers of new RMBS transactions already follow a standardized American Securitization Forum format while disclosing data to the rating agencies, it remains to be seen if this proposal adds new fields for data disclosure. Also, there is the issue of what data fields need to be made publicly available to the investors and the data disclosure requirements for deals issued under Rule 144A (issued through a private placement). Market observers had expressed concerns over the prior proposal that required similar disclosure framework for deals issued under Rule 144A as those that were required for public placements. Any surprises on these two fronts could impact RMBS issuance in the near term.

Stability of Counterparties

There are various counterparties involved in RMBS transactions. The level of information that is available on these counterparties varies, and the strength of the counterparties plays a vital role in the qualitative assessment of RMBS transactions. As newer originators enter the mortgage loan origination business, clarity on their processes, business operations and underwriting standards could help RMBS issuance.

Third-party oversight and the ongoing monitoring of the performance of various counterparties that include originators, servicers, third-party service providers and due-diligence providers are important in RMBS transactions. A common industry framework to assess counterparty performance could facilitate RMBS issuance. Also, given the entry of new players in the residential mortgage market postcrisis, it is imperative that there are common benchmarks by which counterparties are measured. For example, servicers are now subject to new servicing standards that went into effect in January 2014 (see “New Servicing Standards” in the highlighted box). This is a good start in Morningstar’s view. Similar uniformity in performance standards for other counterparties would provide more clarity to the marketplace about the counterparties’ roles in RMBS transactions.

Representation and Warranties Framework

Standardization of the representation and warranties, or RW, framework across transactions will be an important step in providing clarity to the investors about the buyback remedies available on transactions.

The ongoing settlements that involved issuers paying penalties to resolve investor demand for repurchases on legacy RMBS transactions have left issuers scarred. Issuers have, therefore, adopted a conservative stand when granting RW to RMBS investors. Investors, on the other hand, have been resistant to any reduction in the scope of RW coverage, as they view this as limiting the issuers’ and originators’ long-term liability in RMBS transactions. Issuers and investors have locked horns over the recent introduction of sunset provisions in RMBS transactions, where the RW expires after a fixed period of time. A unified RW framework that is acceptable to issuers, investors and other market participants is needed for a fully functioning RMBS new-issue market. Furthermore, issuers have differing views on RW. For example, a well-capitalized bank may need to limit its long-term exposure to securitized asset risk; however, a real estate investment trust with limited purpose and fewer assets may be willing to provide more extensive RW protection.
Exogenous Variables

**Interest Rates:** Interest rates have a multipronged impact on RMBS nonagency new-issue volume. An increase in mortgage rates will increase the cost to mortgage borrowers, possibly reducing demand for new loans. Mortgage rates are generally tied to the 10-year Treasury, and Morningstar expects 10-year Treasury rates eventually to increase from their current levels. Rapid increase in interest rates would have an even greater impact on the demand for new mortgages than a gradual increase. A rise in interest rates will also dampen borrower refinancing incentives, resulting in fewer new loans.

**Housing Prices:** Home prices appear to have bottomed out in many regions and are on the rise. Rising home prices will reduce the number of borrowers who are underwater (where borrowers owe more on their mortgages than a home is worth), improving borrower confidence. With more equity in their homes, borrowers are less likely to strategically default and more likely to make their monthly payment or to refinance into a more suitable loan. Rising home prices also give servicers more options to liquidate or modify bad loans. Continued increases in housing prices would reduce loss expectations and thereby improve the sentiment in the housing market. All of this is likely to increase the number of loans available for securitization, resulting in an increase in RMBS new-issue volume.

Technical Factors

**Whole Loan Execution:** Loan originators generally have three options after they originate a new loan. They can keep the mortgage on their books as a part of their portfolios, sell the loans to another buyer, or securitize the loan via the agency or the nonagency RMBS market. Their decision between selling (whole loan execution) or securitizing (via new-issue RMBS) the loan is based on the best execution outcome between the two choices.

The economic feasibility of new-issue RMBS by issuers therefore depends on their whole loan execution. The higher the price issuers have to pay for collateral, the less economical securitization issuance becomes as compared to the price that they might receive via a whole loan sale. For example, recent RMBS transactions have had 100% due diligence. This adds substantial costs to RMBS securitization, and the issuers might find it more attractive to hold the loans instead. A framework that balances investor protection with reasonable due-diligence requirements might be a more desirable outcome from a practical standpoint. Some nonbank issuers have favored whole-loan sales over new-issue RMBS given better loan execution outcomes. Until securitization offers a higher yield than whole-loan sales, it is unlikely there will be any meaningful increase in the pace of new-issue RMBS.

**Bond Spreads:** Bond spreads demanded by investors have a material impact on the feasibility of new-issue RMBS. If bond spreads widen to a point that is not supported by the underlying mortgage coupons, it will not be economical for lenders to securitize loans, and they will either hold loans in their portfolios or stop originating certain loans. As confidence in the residential market improves,
investors should require lower spreads, which will lead to improved RMBS execution and an increase in RMBS new-issue volume.

**Quantitative Easing:** Quantitative easing has been a mechanism used by the Federal Reserve to keep rates low during the recession. QE consisted of the government purchasing massive amounts of mortgage-backed securities and Treasuries, which decreased the supply of RMBS available for private investors, and therefore reduced spreads and improved the economics of new RMBS issuance. The continued reduction and the planned phase out of QE by the end of October, as noted in recently released minutes of the central bank’s June policy meeting, could possibly result in widening spreads, causing a drop in new-issue volume.

**Conclusion**

The pool of investors willing to buy nonagency RMBS is relatively small given the above-mentioned uncertainties in the RMBS market. Many investors are sitting on the sidelines as they seek clarity on regulatory and policy changes before investing in nonagency RMBS. Mortgage loans backing recent RMBS transactions have been originated in an unprecedentedly tight lending market amid a low interest-rate environment. Issuers, rating agencies, and investors can expect to see RMBS that are backed by mortgage loans originated in a more traditional lending environment. This, combined with greater clarity on regulations from the government, should increase investor participation and result in an increase in new-issue RMBS volume.

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