Non-Qualified Residential Mortgages: A Compelling Asset Class for US Life Insurers

Non-qualified residential mortgages offer attractive returns, favorable capital charges, and are typically FHLB eligible collateral.

Non-Qualified MBS Issuance and Life Insurer Non-Qualified Residential Mortgage Whole Loan Acquisitions Have Increased Substantially in Recent Years

Both MBS issuance and whole loan acquisitions by life insurers increased in 2018 by more than 50% over 2017 volumes.

Non-qualified MBS issuance			**Life insurer non-qualified residential mortgage whole loan acquisitions**	
2017	$3.2 billion		2017	$5.2 billion
2018	$10.0 billion		2018	$8.0 billion
2019	$20.8 billion		2019	$12.3 billion
Significant issuers: • Angel Oak • Caliber Home Loans • Deephaven • MFA Financial • Neuberger Berman • Verus / Invictus • Western Asset			Significant purchasers: • AIG • Allianz • Athene • Brighthouse • Global Atlantic • Metlife • Reliance Standard • Security National	

Source: Montshire analysis of BAML Research and SNL Financial data

The Non-Qualified Residential Mortgages Category Includes a Wide Range of Loan Types

At one end of the spectrum are so called "near miss" loans that typically price in the swaps plus 200bps to 300bps range. These loans are underwritten with both full documentation and through alternative means such as bank statements and debt coverage ratios. Like qualified mortgages, these loans may be underwritten with an automated underwriting process.

On the other end of the spectrum are super jumbo loans, foreign national loans, and business purpose loans. These loans are often underwritten primarily based on the bank statements of the borrower (or their business) rather than tax returns. The loans often have an initial interest only period of 5 to 7 years with a fixed rate of interest followed by a fully amortizing period with an adjustable interest rate. These loans can price from swaps plus 400bps to swaps plus 600bps depending on the loan facts and circumstances. The underwriting is typically a high touch manual process.

Larger loans, loans with $2.5m or more loan balance, may be less likely to be included in securitizations due to diversification requirements and thus may face less yield pressure going forward. These properties are typically the borrower's trophy asset creating a dynamic for the borrower to vigorously defend this asset from default. In the pre-2008 era, companies like Thornburg Mortgage, who focused on large balance mortgage with lower LTVs and borrowers with relatively high FICO scores, experienced relatively low default rates through the last credit cycle.

How Can Life Insurers Participate in The Non-Qualified Residential Mortgage Market?
There are a variety of ways for life insurers to participate in this market including: purchasing non-qualified residential mortgage MBS securities, partnering with one or more originators to acquire whole loans, or hiring a high-quality investment manager (e.g. Western Asset management) to implement a non-qualified residential mortgage investment strategy.

Further, a life insurer might consider offering a warehouse line to an originator as a component of an origination program.

What Are the Requirements to Acquire Non-Qualified Residential Mortgage Whole Loans?
Third party servicing of these loans is relatively inexpensive and there are several firms to choose from. Loans can be acquired from specialized and licensed originators who focus on serving high net worth borrowers. Working with a licensed originator alleviates the need for the loan buyer to obtain mortgage origination licenses.

What Is the Weighted Average Life of This Asset?
The weighted average life (WAL) will vary depending on the loan structure. For example, a portfolio of super jumbo loans with a five-year interest only period might have a conditional prepayment rate (CPR) of 20. Most loans pay off prior to the end of the interest only period. A specific WAL can be targeted by targeting a specific loan structure (e.g. targeting 5, 7 or 10 year interest only period).

What Is the RBC Charge for Non-Qualified Residential Mortgage Whole Loans?
Capital charges on non-qualified residential mortgages for life insurance companies are relatively favorable. Non-qualified residential mortgages carry a 0.68% base risk charge under RBC which is between a NAIC 1 and 2 bond risk charge level.

Are Non-Qualified Residential Mortgages Eligible FHLB Collateral?
Non-qualified residential mortgages are an FHLB eligible collateral type with a 60%-90% advance rate. Non-qualified residential mortgages should generate a net spread over FHLB borrowing cost of 200bps or more. As compared with commercial mortgages, a spread based borrowing program with non-qualified residential mortgages can offer the ability to become more diversified given the generally smaller average loan size. Criteria for residential mortgage loan collateral eligibility may vary by regional FHLB and may include coverage minimums and leverage maximums.

Montshire Advisors can assist you in implementing a non-qualified residential mortgage origination program including:

- identifying optimal loan criteria,
- coordinating with FHLB for a FHLB spread based borrowing program
- partnering with loan originators
- identifying suitable servicing firms
- sourcing portfolios for acquisition
- identifying a quality investment manager
- structuring warehouse lines