Investor Non-QM: Pockets of Value as Underwriting Tightens

Non-QM Segmentation Facilitates Diverse Loan Type Exposures

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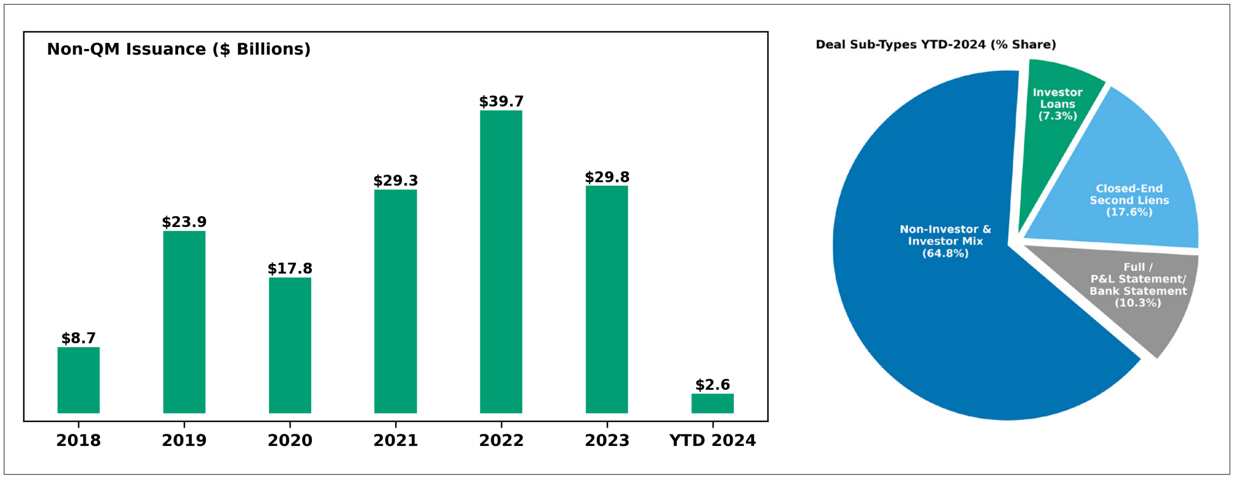
Recent non-QM issuance underscores the segmentation in the sector. Deals pricing since yearend already featured second lien collateral (TPMT 2024-CES1, $452 million), a pool of traditional bank statement and DSCR loans (OBX 2024-NQM1, $413.6 million), and pure play investor DSCR loans (COLT 2024-INV1, $204.4 million). The market is also poised to see fresh reperforming (RPL) deals, according to industry reports. The non-QM deal diversity facilitates exposures to collateral that go beyond just first lien, ability-to-repay-exempt (ATR-exempt) loans that in the past characterized many deals in the sector (Figure 1).

Figure 1. Non-QM Issuance, 2018-2024 YTD



Source: Bloomberg and Academy Securities

We are also seeing growing diversity within the various non-QM subsegments. Notably, debt service coverage ratio (DSCR) deals now feature a spectrum of differing collateral characteristics. Some characteristics suggest tighter underwriting on aspects that typically raise investor concerns. For example, the percentage of cash-out refinancing loans dropped to low-forties in some deals, compared to high fifties in others (Figure 2).[1] The percentage of interest-only loans

1 For comparison, the cashout loan percentage across non-investor deals is much lower. The non-prime industry average stood at 26.7% in 2021-2023, according to Fitch.

also varies quite a bit across deals. In turn, the share of adjustable-rate loans plummeted to 3.1% on the most recent DSCR deal, compared to a high of 25.9% in a 2023-vintage deal. Overall 60+ day delinquency levels on DSCR collateral in late 2023 were better than non-DSCR collateral, except on a couple vintages, according to rating agencies.

Figure 2. Investor Non-QM Deals Pool Characteristics

	COLT 2024-INV1	VERUS 2023-INV3	MFA 2023-INV2	VISIO 2023-2	JPMMT 2023-DSC2
Balance ($MM)	204.5	372.7	214.7	191.6	308.0
Adjustable Rate Loans (%)	3.1	20.9	45.1	25.9	4.1
Interest-only Loans (%)	15.6	21.8	8.3	4.9	14.2
Cash-out Refinancing (%)	43.2	42.6	60.6	51.5	58.3
Top-3 States	FL 21.5 CA 9.8 TX 8.6	FL 21.8 CA 14.6 NY 13.8	FL 12.7 OH 9.6 PA 9.7	FL 14.9 TX 9.5 NC 7.8	FL 16.7 CA 10.2 TX 10.2
Planned Unit Development (%)	14.8	15.6	NA	11.3	10.8
Condominium (%)	11.5	12.3	2.7	6.0	3.3
Multifamily (%)	NA	5.7	8.7	NA	0.2

Source: Deal Documents, Ratings Agencies, and Academy Securities

DSCR Collateral at a Juncture

The DSCR collateral diversity and stable performance happen just as the underlying rental properties face a mix of headwinds and tailwinds. Investor non-QM deals are backed by residential mortgages on single-family or two- to four-unit properties that are typically rented out. Property cashflows or rental income are the main underwriting parameters, rather than borrower's income. Amid an elevated rate environment and housing softness, we expected the rental market to remain relatively strong, especially in suburban locations, that are characterized by smaller properties and limited supply.

Several factors now put pressure on the property cashflows that underpin DSCR collateral. In particular, rising property taxes and insurance costs – two expense items that have buffeted the broader multifamily market – can depress DSCR levels (Figure 3). The DSCR is calculated by dividing (1) a property qualifying monthly rental income less taxes and insurance, by (2) the monthly mortgage payment. An alternative approach is to calculate the ratio of gross rental income to the sum of the mortgage payments, property taxes, and insurance on the property.

Figure 3. DSCR Loans Tailwinds and Headwinds

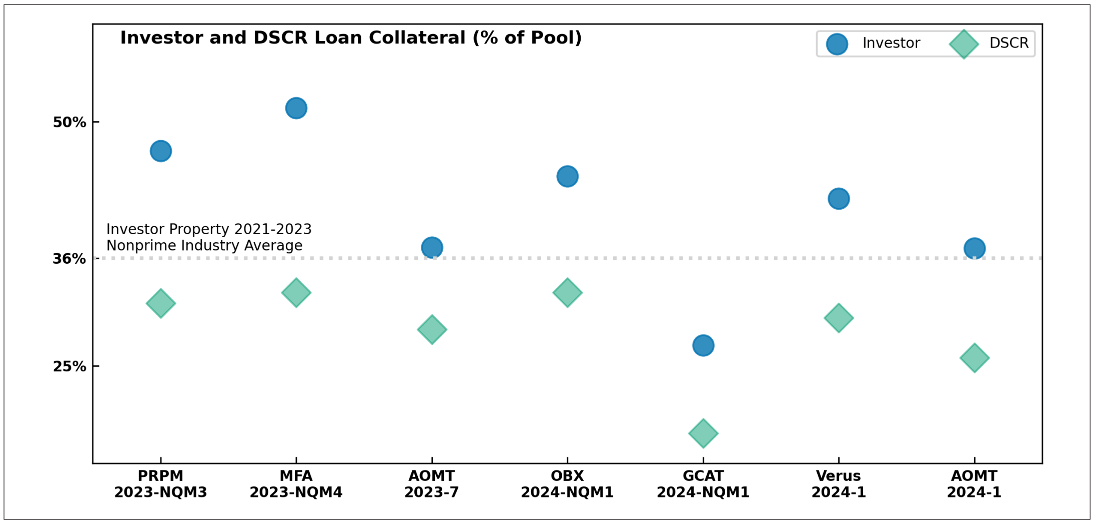
Headwinds	Tailwinds
• Rising tax assessments because of strong home price appreciation (tax expenses rose 10.5% in 2023) • Rising insurance costs and reduction in availability (insurance costs rose 3.4% in 2023; However, DSCR deals have elevated exposure to FL properties, where rising insurance costs is an especially acute problem) • Growing number of sub-unity DSCR ratios	• Rental demand remains positive • Elevated exposure to geographic areas seeing positive rent growth, such as Northeast and Mid-Atlantic • Demographic support for rental demand as the younger age cohort remains elevated

Source: Academy Securities

At-issuance DSCR levels on recent deals do not yet indicate distress. Weighted average DSCR levels ranged from 1.4x to 1.1X. We do observe differences in DSCR underwriting guidelines across issuers. Some issuers do not allow sub-unity DSCR collateral, or allow it under very strict exceptions. Other issuers do not have explicit minimums on DSCR levels, but allude to overlays on sub-unity DSCR loans.

Issuers do not underwrite all investor properties with a DSCR approach. Looking at the investor properties component in non-QM deals with diverse collateral types, we see that some of them are underwritten to standard borrower characteristics such as FICO score and DTI ratios (Figure 4). Still, even the non-investor deals contain a significant, though varying percentage of investor properties.

Figure 4. Investor Properties Collateral in Non-QM Deals



Source: Deal Documents, Ratings Agencies, and Academy Securities

Structural Features Amid Distress

DSCR deals structural features will become impactful if the sector delinquencies start rising. Notably, some investor deals do not include servicer advancing on delinquent loans, a key difference from CMBS transactions. The lack of advancing could lead to elevated interest shortfalls on pools that experience credit issues. On the flip side, investors should expect greater liquidation proceeds compared to advancing deals. Advancing reimbursements regularly drove large loss severities when servicer advancing accumulated over time. With no advancing, we would expect a greater alignment between liquidation values and bond paydowns.

Deals that require P&I advancing feature some variation in their advancing provisions. The length of the advancing period is typically three months, but some deals require a slightly longer period. Unlike P&I advancing, deals may require the servicer to make advances of delinquent taxes and insurance (and other property preservation advances) on any delinquent mortgage loan until the related property is liquidated. However, similar to CMBS advancing mechanism, the DSCR deal servicer may deem advances nonrecoverable, and stop advancing.

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