# Thinking outside the box

Investor demand is driving an expansion of the US prime RMBS credit box. Following years of issuance focused on what could be termed 'super prime' mortgage securitisations, the market has now moved on to what may instead be classified as 'expanded prime'.

The US prime RMBS market has been dominated by super prime from the crisis right up to 2016. It is in this last year that the box has started to loosen.

"That super prime issuance had very impressive metrics: weighted average credit score of high-760s to the low-770s; no credit blemishes; moderate LTVs; DTI of high-20s to low-30s. Expanded prime does not differ radically, but it might include minor blemishes, for example, but always with compensating factors; so for example where FICO is lower the LTV might also be kept low," says Jack Kahan, md, RMBS, Kroll Bond Rating Agency.

Neil Aggarwal, portfolio manager and head of RMBS, Semper Capital Management, believes the expansion beyond what was previously being securitised in the non-QM space is a function of rates, yield and origination targets. He says that a big contributor to the expansion of the RMBS securitisation credit box has been demand-driven.

"The focus in non-QM had been on loans which look like agency collateral for all intents and purposes other than the fact that they were jumbo loans. Now we are seeing lower FICO scores being included and a few other changes. 2017 has been the year in which yield spreads have rallied such that the demand from investors for higher spread assets has fed into origination channels," says Aggarwal.

He adds: "The origination spreads on non-QM versus QM rates have compressed. Borrowers have been willing to pay these rates more recently because the spread on non-QM mortgages has compressed – and it has compressed precisely because these originators are now able to securitise."

Redwood Trust has brought its first two Sequoia Mortgage Trust CH deals – Sequoia Mortgage Trust 2017-CH1 and Sequoia Mortgage Trust 2017-CH2 (see SCI's deal database) – to the market in the second half of this year. The CH series designation explicitly sets these deals apart from Redwood's previous Sequoia super prime transactions.

The CH series RMBS include loans that possess expanded credit collateral attributes such as credit scores as low as 660, DTI ratios as high as 50% and LTVs above 80%-85%. The loans also have less stringent income qualification requirements.

Sequoia Mortgage Trust 2017-CH2 closed last month, just one week after Sequoia Mortgage Trust 2017-7, which was a traditional super prime RMBS. Comparing the two is instructive.

The two deals have similar sized pools, but the 2017-CH2 transaction has a weighted average LTV of 75.2% compared to 68.5% for 2017-7. Weighted average FICO is 740 for 2017-CH2 (compared to 772 for 2017-7) and DTI is 37.28% (compared to 32.7%).

While the collateral may be slightly different to the super prime deals, Kahan notes that expanded prime remains worthy of being called prime. Investors are happy with the risk profile and higher coupon.

Kahan notes: "We have rated two transactions – both Sequoia Mortgage Trust 2017-CH1 and 2017-CH2 – with a significant percentage of expanded prime. Both have senior classes we have rated at triple-A with credit enhancement two times as high as the senior classes in Sequoia super-prime transactions."

Investor comfort with the product is a point which Aggarwal also makes. He adds: "In many ways, whether this product is labelled 'prime' or 'expanded prime' is not too important and comes down to the interpretation of individual investors. The market has become much better at doing its own upfront due diligence and what really matters is whether investors believe in the credit and the collateral."

As for an expansion of the non-prime credit box, Kahan notes that there are very few boundaries left to push. He says: "Non-prime RMBS is already using alternative documentation, although even there they must use some form of income verification. Non-prime right now looks similar to pre-crisis subprime but with better underwriting."

Kahan continues: "There is not much room to loosen credit. We have already seen FICOs down to 500, LTVs of up to 95%, and even very patchy documentation, with income verification based on as little as one month of bank statements, for example."

While the market is moving from a focus on super prime to more accommodation of expanded prime, another change is also anticipated. When the FOMC meets next month, the overwhelming market expectation is that there will be a rate hike.

"While the Fed moving the front-end of the curve has been telegraphed, the real story might be at the long-end. Comparing the 10-year with the two-year note, the spread at the start of 2014 was 260bp and now it is inside of 60bp, so we are flatter than we have been since before the crisis," says Aggarwal.

He adds: "The 10-year is buoyed, partly because of some market sentiment that the Fed may be looking at out-dated or less relevant metrics, so while the pressure on the front-end of the curve has been expected, the demand and depth has been robust at the long-end." RMBS typically trades at a discount and shortens through outperformance of prepayments and accommodative policy, but this is founded on the idea that longer rates will stay low.

JL

This article was published in Structured Credit Investor on 24 November 2017.