Residential Mortgage Loans: A Compelling Investment Opportunity

SHELTER GROWTH CAPITAL PARTNERS

Key Takeaways

- US insurance companies have historically been under-allocated to residential mortgage loan (RML) investments
- Recently, insurance portfolios have become active in Non-QM loans with operational responsibilities managed externally
- Insurance companies benefit from attractive Federal Home Loan Bank (FHLB) financing of RML collateral
- Significant increases in annuity sales have been a factor driving insurance investment demand for high-quality RML assets
- Insurance demand for RMLs will continue, driven by excess returns, strong credit quality, and efficient capital treatment

Historical Activity Not Indicative of Current or Future Activity

US insurance companies have historically been under-weight residential mortgage loan (RML) investments in their portfolios. While the asset represents about 1% of the overall industry average portfolio, this figure is skewed by a handful of portfolios with allocations of 5-10%, mixed with a much larger number of portfolios that have 0% exposure.

Insurance companies have historically under-allocated to residential loans

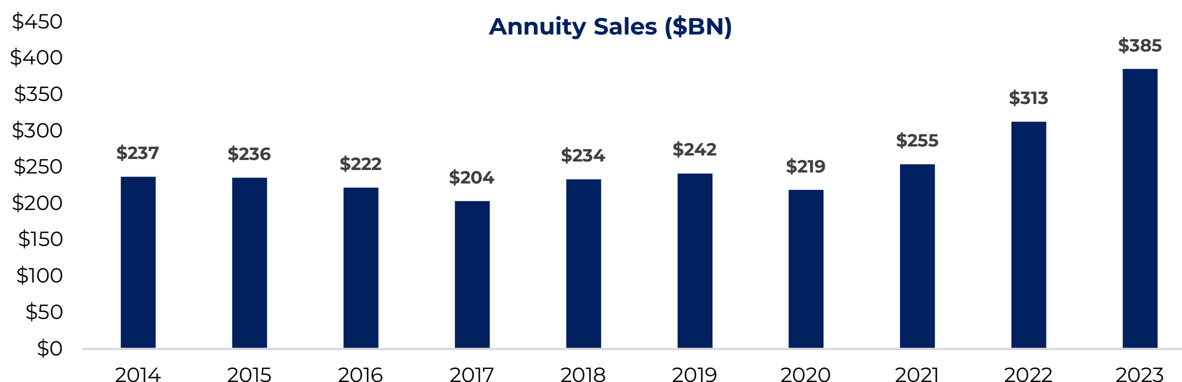
As of 12/31/23	Industry		RBC	
Asset	$bn	%	Low	High
Resi Loans	**83**	**1.5%**	**0.68%**	
RMBS	207	3.8%	0.82%	4.50%
CRE Loans	614	11.3%	0.90%	7.50%
CMBS	196	3.6%	0.82%	4.50%

Sources: NAIC, S&P

Many factors have contributed to insurance companies' historical under-allocation to RMLs. One major deterrent has been the operational complexity associated with RMLs. The granular nature of an amortizing portfolio, coupled with the need for specialized technology, additional personnel and state licenses hindered investment growth. Another contributor to low RML investment activity had been the limited availability of non-agency RMLs to purchase. Post-Global Financial Crisis (GFC), originations were almost exclusively delivered into GSE mortgage-backed securities, however, a sizeable, non-agency RML market has emerged in recent years with the growth of Non-QM. The emergence of Non-QM supply and the economic appeal of the asset class have incentivized insurance companies to begin allocating to RMLs. Specialized RML asset managers provide access to the asset class without the operational burdens. These partnerships provide insurers with turn-key solutions and deliver sourcing and investing expertise combined with full support across accounting, operational, risk management and reporting needs.

Shift in Insurance Company Behavior

The diversification, return, and liquidity appeal of RMLs has increased RML activity across all types of insurance companies including Life, P&C, Health and Reinsurance. One driver of the change in demand for RMLs has been the strong growth in annuity sales which has fueled insurance demand for high-quality spread assets in recent years. LIMRA reported that total US annuity sales were a record $385 billion in 2023, a 23% rise from the previous record set in 2022.



Source: U.S. Individual Annuities, 4th Quarter 2023, LIMRA, 2024.

This increased demand for spread product has driven a push into high-quality residential loans. Private equity-backed life insurers were some of the early movers into RMLs, capitalizing on high yields, strong credit quality, the associated available liquidity from the FHLBs and favorable risk-based capital treatment. The broader insurance industry has taken note, and many insurers will be starting RML investment programs in 2024 and 2025.

Certain private equity-backed and larger insurance companies have allocated north of 8% of their investment portfolios to residential loans over the past few years

As of 12/31/23	Industry	KKR /Global Atlantic	Apollo /Athene
Asset	%	%	%
Resi Loans	**1.5%**	**9.0%**	**12.4%**
RMBS	3.8%	5.1%	3.1%
CRE Loans	11.3%	14.4%	14.0%
CMBS	3.6%	5.3%	4.0%

Sources: NAIC,S&P and Regulatory Filings

While a handful of the largest insurance investors have their own dedicated residential whole loan investment and operations teams, most insurance companies are unlikely to add the significant resources required to manage a residential loan portfolio. Rather than undertaking an internal buildout, many insurers are partnering with existing residential loan investment managers and creating separately managed accounts (SMAs) specific to their investment goals. These SMAs allow insurers to take optimal advantage of asset yields with the associated efficient regulatory based capital of RMLs, while outsourcing the cumbersome operational aspects. SMA set-up costs are not significant, and investment sizes range from $50 million to several billon. SMAs can be customized, creating the ability to invest in a broad range of RML opportunities over time (e.g., prime jumbo, 2nd lien, reperforming, etc.).

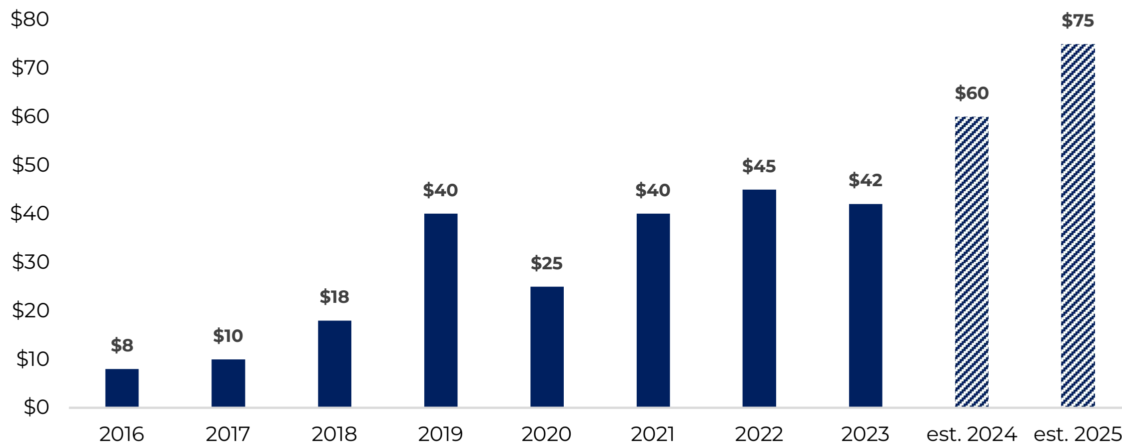
Non-QM Overview

While insurance portfolios have invested across different residential loan sectors including Prime Jumbo and Conventional Agency loans, their recent activity has been focused on Non-Qualified mortgage loans (Non-QM). The technical definition of Non-QM comes from Dodd-Frank regulation, but functionally the sector is comprised of strong credit loans that do not fit GSE or bank portfolio requirements. The primary reasons loans may not fit include loan size, income documentation, and occupancy.

The two dominant areas of Non-QM origination are self-employed borrowers and property investors, two sizable populations underserved by banks and the GSEs. Estimates of the number of self-employed Americans range from 16 to 30 million, representing a highly scalable lending opportunity. Property investors, who help to expand the availability of affordable, single family residential housing, represent another large underserved market, with 85% of the 23 million rental homes in the US owned by investors who own 10 or fewer properties. By filling this void left by banks and GSEs, insurance company participation in the Non-QM market helps to provide access to housing to strong credit but overlooked borrowers.

These substantial, addressable borrower bases, coupled with strong demand from securitizers and insurance portfolios, have led to significant growth in Non-QM originations post-COVID. We project 2024 origination volume will be around $60 billion. While this represents a sizable market already, it is still less than 10% of total annual mortgage origination, providing room for significant growth in the future. We believe annual originations have the potential to reach over $100 billion in the next several years.

Non-QM Annual Origination ($BN)



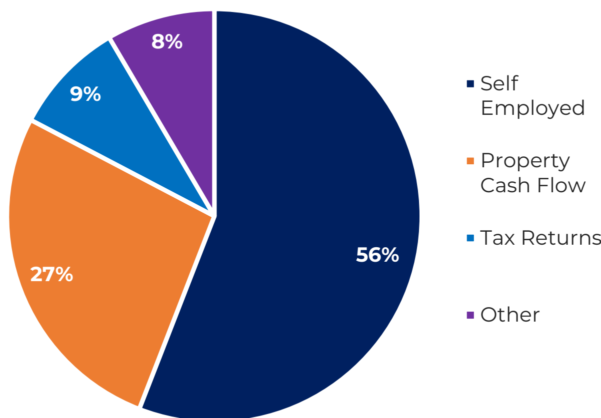
Source: CoreLogic, Nomura, SGCP estimates.

Post-GFC and the resulting Dodd-Frank legislation, a significant number of positive changes were instituted in the residential origination market, helping to improve credit quality. "Ability-to-Repay (ATR)" rules created a regulatory framework for sound underwriting and require originators to document and analyze income, employment, and assets. Third-party due diligence of loans was also institutionalized and significantly expanded. These third-party due diligence firms are reviewed and approved by the major RMBS ratings agencies and perform a loan level re-underwrite of credit, compliance, and property valuation. Pre-crisis, due diligence was generally performed on a 10-20% sample of loans by uncertified parties whereas today 100% of loans are subject to diligence by independent, certified service providers. Loans receive a diligence report and grade which is transferable to subsequent loan buyers. This independent third-party diligence, and its transferability, has increased liquidity in the loan trading market, as buyers are able to rely on the information.

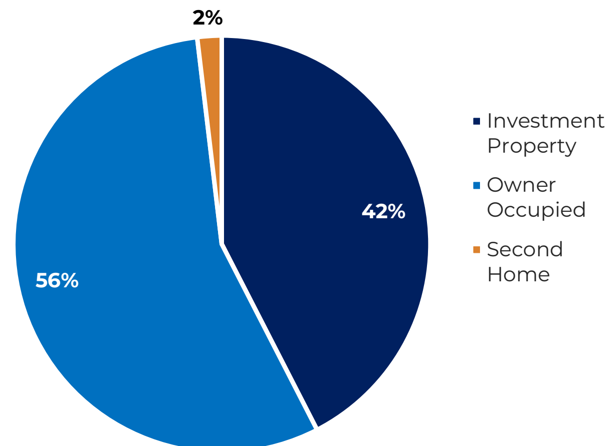
Aided by post-GFC regulatory changes, Non-QM credit quality has been strong. The metrics below represent over $12 billion of 2023 vintage Non-QM origination tracked in the Fitch dv01 database and are a good representation of market-wide production. Non-QM origination has consistently exhibited prime-quality FICO scores and borrowers have 25-30% home equity. Targeting the previously mentioned underserved areas of the traditional mortgage market, Non-QM production has averaged 40-60% self-employed borrowers and 30-45% property investors.

Avg Loan Size	WAC	FICO	LTV
$447,384	8.45%	739	70%

Income Underwriting

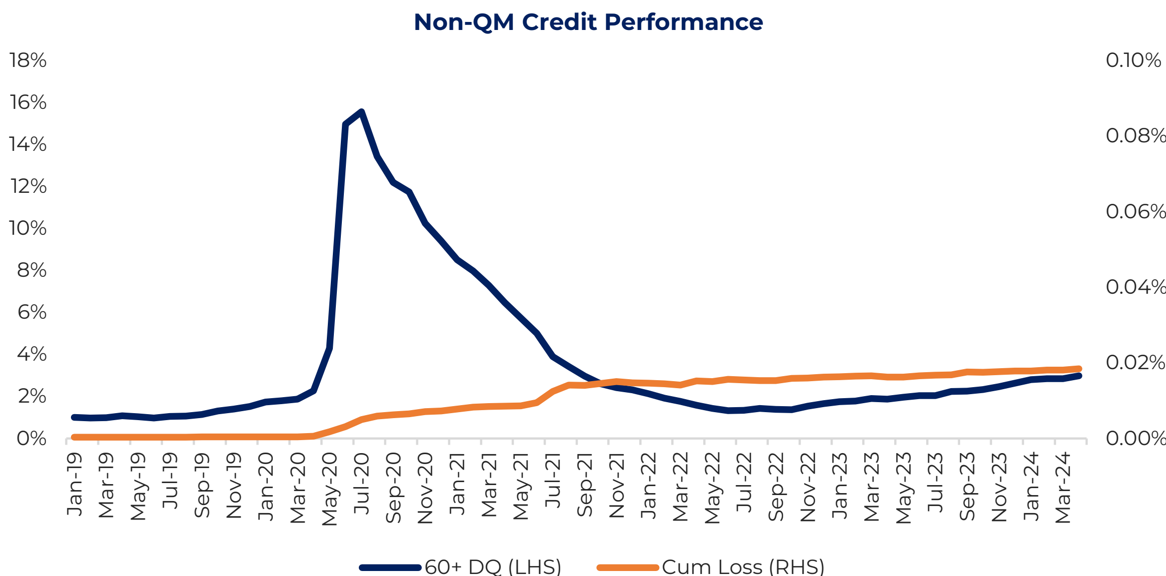


Occupancy



Source: Fitch Ratings. Dv01 Database 2024.

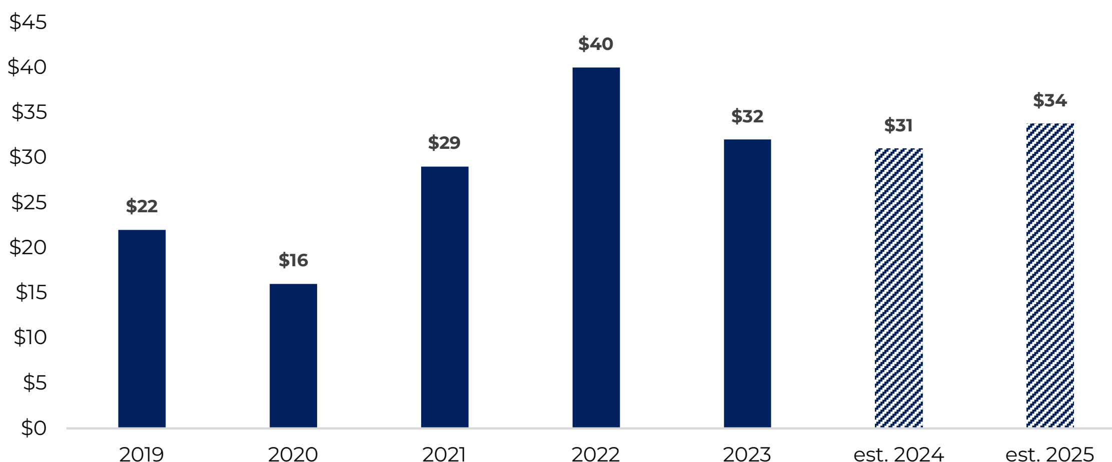
The strong underwriting quality of Non-QM has resulted in excellent credit performance. Cumulative losses have been minimal, with fewer than 5 basis points of loss to date over the last nine years. Delinquencies spiked during COVID, mostly driven by borrowers participating in widespread forbearance programs. As those temporary programs expired, borrowers quickly resumed making payments as evidenced by normalizing delinquencies and no significant realization of losses.



Source: Morgan Stanley.

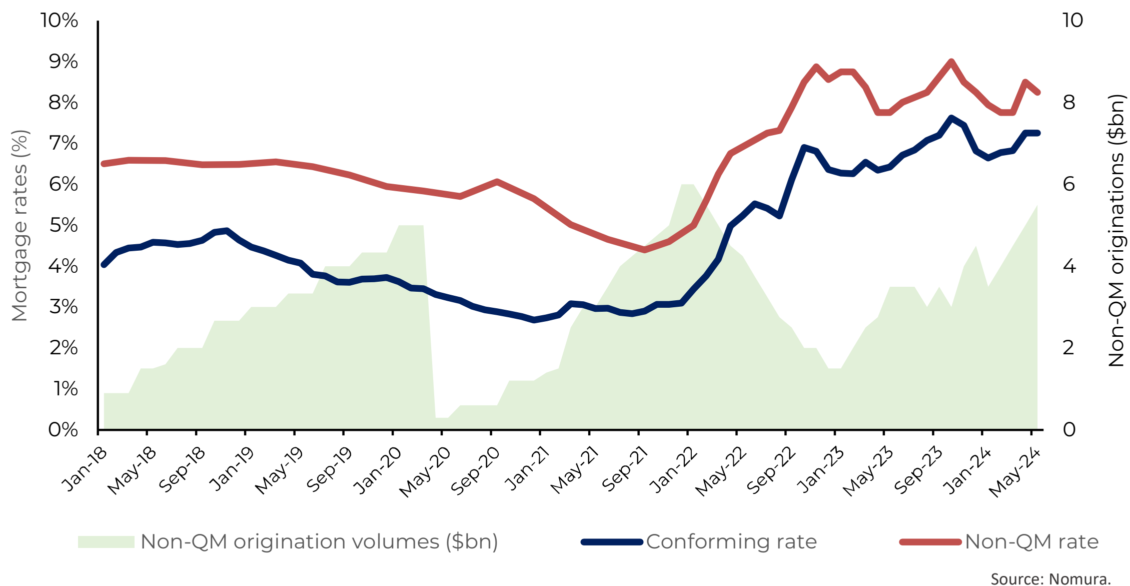
Non-QM Investment Opportunities

From its inception in 2015 through COVID, Non-QM was predominantly a securitized product. Debt funds were the main investors, aggregating loans and utilizing securitization for term, non-recourse financing. Securitization continues to be a sizable and efficient market, with $30-40 billion of rated, broadly distributed deals issued annually. Non-QM has become the largest issuance sector in RMBS with widespread investor participation across money managers, insurance companies and bank portfolios.



Source: CoreLogic, Nomura, SGCP estimates.

In contrast to the conventional Agency or Prime Jumbo markets, where buyers compete with GSE guaranteed MBS execution or bank portfolios, Non-QM is a market where non-bank private capital is the price setter. Non-QM has traditionally offered an attractive spread over other mortgage products, ranging from 50-200 basis points in coupon over conventional Agency and Prime Jumbo. While these conventional and Prime Jumbo markets offer opportunities for insurance portfolios, the excess spread, high credit quality and favorable competitive landscape of Non-QM have proven attractive for all types of investors.



Source: Nomura.

In recent years, market dynamics have shifted as insurance portfolios have become significant buyers of Non-QM whole loans. Following the lead of a group of PE-backed and large life companies, insurance activity accelerated in late 2022 as borrower coupons rose to 7-9%. Having largely navigated the COVID period with minimal losses, investors gained further confidence in the performance of the sector.

In addition to Non-QM's high yields and strong credit quality, insurance portfolios are attracted to RMLs' scalability, excess return versus RMBS, favorable risk-based capital treatment and accretive financing from the FHLBs. Scalability in RMBS can be challenging for insurance portfolios. Single A-rated RMBS tranches typically represent 5-10% of a deals total size and in the current environment are often over-subscribed. As the average size of an RMBS securitization is $250-400 million, allocations per deal can be inconsistent and are often $5 million or less. In contrast, RMLs allow for more sizable and predictable allocations with monthly purchase-programs ranging from $10-200 million and customizable to a portfolio's needs. Budgeting RML investment allocations is more predictable than RMBS since the RML programs do not rely on varying securitization issuance patterns.

In terms of portfolio optimization, RMLs are particularly attractive for life insurance portfolios, with a risk-based capital charge of 0.68%. In contrast, single A-rated RMBS has a higher capital charge of 0.82% and typically offers 50-100 basis points lower spread than RMLs. While RMBS is generally more liquid, the significant growth and regularity of RML trading has diminished the traditional liquidity advantage of bonds versus loans meaningfully.

The ability to borrow advances against RMLs at the FHLBs has proven to be another important feature for insurance companies. FHLB financing is appealing to insurers for a number of reasons. Advance rates and cost vary by residential loan product type but are generally attractive versus comparable alternatives. Insurers can use this financing to match fund residential loans themselves, for operating leverage or to have an as-needed source of ready liquidity. Additionally, investing in and financing RMLs fits within the stated mission goals for members of the FHLBs, a topic that has become of increased interest since the FHFA's report "The FHLB System at 100".

Conclusion

The combination of attractive yields, efficient capital treatment and favorable FHLB financing on mission-oriented collateral creates a compelling investment case for RMLs. The growth of specialized residential loan investment managers who can manage the operational complexities of the product has also made it easier for insurance portfolios to gain exposure to the asset class without requiring additional resources. SMA managers provide access to loans, oversight, reporting and investment expertise, while allowing insurers to benefit from the favorable capital charges and ability to finance loans with the FHLBs. In total, we estimate insurance portfolios are now the end buyer for over 50% of monthly Non-QM loan originations. We anticipate continued growth from insurance accounts in the sector.

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