# Alternative Mortgages

The asset class discussed here is designed for Sophisticated and Certified High Net-worth investors only and will not be suitable for all investors

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# Alternative Mortgages

Alternative Mortgages is one component of the Direct Lending/Alternative Credit asset class. Capturing the return stream in this asset class is a variant of traditional lending that banks undertake every day with our deposits. We make bank deposits every day. Bank's credit teams take these deposits and provide a variety of different loans to both individuals and those looking for finance on a commercial basis, to match assets against liabilities and earn a spread in the middle. This is traditional banking as it always was.

One of the most common types of loan made by banks against deposits is collateralised loans against property, in other words, mortgages. Let's review the US mortgage market, the world's largest, with $13.5 trillion of loans outstanding, and examine where the opportunities can be for alternative lenders.[1]

## Residential Mortgage Overview and Alternative Lending Opportunity

The US mortgage industry is dominated by residential mortgages. Of the nation's $13.5 trillion total mortgages outstanding, $9.9 trillion or about three quarters are residential mortgages, according to Fed data.

About two thirds of these residential mortgages or $6.7 trillion are held by government-sponsored enterprises (GSE) such Fannie Mae or Freddie Mac, or in the mortgage backed securities issued by the agencies.[2]As a result, a large proportion of US households benefit from long term, mortgage credit: the 30-year fixed rate mortgage average across the US is 3.93% according to the St. Louis Fed data. This also means that the core business of most mortgage originators is to generate mortgages that meet the GSE eligibility criteria.

Residential mortgages held on the banks' balance sheets represent $2 trillion or the bulk of the non-agency mortgages outstanding[3] Following the 2008 crisis, consumer protection regulations were introduced to prevent lenders from offering unaffordable loans. Lenders are required to determine the borrower's ability to repay based on a set of criteria and "verified and documented information". Mortgages that meet these criteria are called "qualified mortgages" and provide lenders with a potential "safe harbour" from liability from borrowers and regulators.

By contrast, underwriting mortgages outside of these criteria has become a high-risk business for the banks. Based on a survey by Fannie Mae, 81% of the lenders have stopped offering non-qualified mortgages. The remaining 19% plan to limit the volume of non-qualified mortgages to 5% or less. Not surprisingly, lenders charge significantly higher rates for non-qualified mortgages: typically between 7% and 9%.[4]

Who are the borrowers who have to turn to these more expensive mortgage loans?

» Borrowers who are self-employed and as a consequence do not have the tax documents (such as form W-2) required to evidence income, but otherwise may have cash reserves, substantial non salaried income and high credit scores.
» Borrowers who have other debt outstanding (student loan) or obligations (medical bills) that push their debt to income ratio beyond the prescribed 43% level, but who otherwise have documented income and even perhaps high credit scores.
» Borrowers who recently arrived in the country from abroad and as a consequence, do not have historical income or credit scores but otherwise may have cash reserves and substantial income.
» Borrowers with a historic "poor credit history" but improving financial situation;
» All the way down to genuinely weak credits.

Some but not all borrowers 'technically turned down' may become eligible for qualified-mortgages after a time period and subsequently refinance at cheaper rates.

Alternative mortgage lenders, funded by private risk capital as opposed to deposits may find attractive risk-adjusted lending opportunities, by targeting borrowers outside of the qualified mortgage framework. However, the risk of default still exists.

The US mortgage landscape at a glance
Mortgage debt outtstanding, USD billions, Fed data Sep 2015

| | | |
|---|---|---|
| Total Outstanding | 13,585 | |
| **Property Type** | | |
| Residential | 9,901 | 73% |
| Multi-family | 1,042 | 8% |
| Commericial | 2,438 | 18% |
| Farm | 204 | 2% |
| **Holder type** | | |
| Agencies | 5,004 | 37% |
| Agency MBS | 1,674 | 12% |
| Banks | 4,248 | 31% |
| Mortgage cos, REITS, other instituitions and lenders | 1,568 | 12% |
| Private MBS | 1,090 | 8% |

## Commercial Mortgage Overview and Alternative Lending Opportunity

Commercial mortgages encompass the loans secured by commercial real estate including office buildings, industrial property, warehouses, shopping malls, and multi-family apartment complexes. A borrower will use the mortgage advance to acquire, develop, build the property or leverage an already operating property.

Based on Fed data, there are $3.4tn of commercial and multi-family mortgages outstanding of which $ 1.tn or half approximately held by banks. Insurance companies are large investors in commercial and multi-family mortgages and hold approximately £371bn. Commercial mortgage backed pools represented $623bn.[5] GSE's provide loans for multi-family apartment

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buildings; they hold $74bn in mortgages and back $185bn in securitized mortgage pools. In contrast with residential mortgages, the commercial mortgages industry is dominated by private lenders.[6]

There are several types of commercial mortgages. Long term GSE backed mortgages on multifamily apartment buildings, with terms up to 30 years. Three to ten years loans to finance commercial or industrial properties with existing lease or operating revenues. One to three years pre-development or construction loans.

In the third category, the borrower intends to add substantial value and hopefully achieve a multiple of original investment. The ability of the borrower therefore to pay interest and repay principal can be a function of the technical and commercial success of the development. The value of the collateral real asset can vary very significantly depending on the progress or the difficulties experienced by the project. It is the riskiest category of loans, but the interest rates can be in the high double digits..

Commercial real estate lending is the bread and butter business of certain banks. It requires specialized credit skills and non-standard case-by-case underwriting. The loans are non-recourse, secured only by the collateral property, but risk lies as much with the developer or operator, as with the property itself.

For banks commercial real estate mortgages attract a higher risk weight in relation to the risk-based capital rules than residential mortgages.

Non-regulated alternative lenders, funded by private risk capital as opposed to deposits or wholesale debt, operate in certain niche segments. The competitive advantage of alternative lenders vis-a-vis traditional lenders is largely a function of the specialized skill and experience of the lender's underwriting and management teams. Strong alternative lenders tend to specialize in a specific niche market and focus on their geographic area of expertise.

## Opportunities for Alternative Credit Investors

Most of the capital coming into the Direct Lending / Alternative Credit universe is concentrated on the short term/maturity end of the market. Investors are looking at the relative attractiveness of short dated corporate fixed income with high liquidity and are considering alternative short dated mortgages with a dose of illiquidity.

Like any asset class one can capture returns at either end of the risk spectrum. The key when considering an investment into Alternative Mortgages is the diversification of the underlying credits.

Towers Watson, a consultant that advises pension funds on their investments says that $7bn of its clients' money globally is invested in 'illiquid credit' and mortgages make up a large amount of this figure. Five years ago this amount was close to zero. [11]

Alternative Mortgage lenders are opening up the potential for returns that were historically only available to banks and institutional investors and are now becoming available to private investors via new fund structures.

For those investors who can afford a degree of illiquidity in their portfolios and are comfortable with the collateral of their fixed income investment being property rather than corporates then alternative mortgages could prove an attractive alternative. In a world of low interest rates and efficient markets, 'Illiquid Investors' can now consider investing in Alternative Mortgage funds to attempt to capture potentially uncorrelated returns.

## Risk Warnings

Investing in this asset class is for Sophisticated and Certified High Net-worth Investors. Always consult a Financial Adviser before making a decision to invest. Past performance is not a reliable indicator of future performance. Currency fluctuations may increase or decrease the returns of any investment. The value of investments can fall as well as rise. You may not get back what you invest. This article is distributed for educational purposes and should not be considered investment advice or an offer of any security for sale. Information contained herein has been obtained from sources believed to be reliable but is not guaranteed.

Examples of alternative lenders business models :[7]

| Type | Duration | Average Size | Loan to Value | Yield | State |
|---|---|---|---|---|---|
| Bridge loans [8] | 3 to 24 months | $250k to $3mm | Up to 60% LTV | 8% to 10% interest only | California |
| Pre- development and[9] Construction | Up to 24 months | $5mio to $70mm | Up to 65% LTV | 11% average | Canada |
| Non-qualified whole loans [10] | 5Y to 7Y | $300k to $2mmm | Average 74% LTV | 7.5% average | U.S. |

1. Federal Reserve
2. Federal Reserve
3. Federal Reserve
4. Angel Oak Capital Advisers – Opportunities in Non-Qualified Mortgage Loans 2015
5. Federal Reserve
6. Federal Reserve
7. This is for illustrative purposes only and should not be relied on for investment purposes.
8. Lone Oak Fund
9. Romspen Mortgage Investment Fund
10. Angel Oak Strategic Mortgage Income Fund
11. Financial Times December 17th 2015