Mortgage Market Q&A

with Portfolio Manager Ken Shinoda

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Ken Shinoda, CFA
Portfolio Manager

Mr. Shinoda joined DoubleLine at its inception in 2009. He is the Chairman of the Structured Products Committee and Portfolio Manager overseeing the non-Agency RMBS team which specializes in investing in non-Agency mortgage-backed securities, residential whole loans and other mortgage-related opportunities. Mr. Shinoda is also a permanent member of the Fixed Income Asset Allocation and participates in the Global Asset Allocation Committee. Prior to DoubleLine, Mr. Shinoda was Vice President at TCW where he worked in portfolio management and trading from 2004-2009. He holds a BS in Business Administration from the University of Southern California and is a CFA® charterholder.

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What is mortgage forbearance and how do borrowers request forbearance?

Mortgage forbearance is an agreement between the borrower and the mortgage servicer to temporarily suspend mortgage payments for a period of time. Missed payments are not forgiven and the borrower must make those payments back in the future.

Forbearance is not a new relief mechanism for struggling mortgagors and has been part of the mortgage market for quite some time. For example, the Federal Housing Administration (FHA) has guidelines in place that provide forbearance relief to affected homeowners after certain natural disasters.

A borrower requesting forbearance would call their servicer. The servicer would initially work with the borrower for a specified forbearance period. At the end of the forbearance period, the borrower has different options to make up missed payments:

- **Reinstatement:** full repayment immediately following the forbearance period
- **Repayment plan:** catch up payments in addition to normal monthly payment
- **Payment deferral:** add payments to the end of the mortgage term
- **Modification:** may involve extending the number of years to repay the loan, reducing the interest rate, and/or reducing the principal balance

What is the mortgage servicer's responsibility to the homeowner and the bondholder?

The servicer's role is to keep in contact with borrowers to collect principal and interest (P&I). If the mortgage is part of a mortgage-backed securitization (MBS) trust, then the servicer remits those P&I payments to the trust.

The servicer has a contractual obligation to the MBS trust to service those assets appropriately by advancing P&I following the guidelines set by Fannie Mae, Freddie Mac, Ginnie Mae or the trust.

What are the potential implications of increased forbearance on the servicers?

Prior to the COVID-19 pandemic, the aggregate mortgage market was approximately 4.5% delinquent. As of April 26, the overall share of home loans in forbearance was approximately 7.5%.

- While delinquency rates are highly correlated to forbearance requests, there may be a lag time in reporting loans as delinquent. Borrowers who request forbearance after making their current monthly mortgage payment are not reported as delinquent during that reporting cycle. In other cases, borrowers apply for forbearance but continue making payments, holding forbearance as a future option.

Broadly speaking, if the delinquency rate was 100%, servicers would go bankrupt. Servicers lack the capital to advance that large of an amount of P&I.

- During March, the number of borrowers who would eventually request forbearance was uncertain. Consequently, investors of MBS struggled to forecast what the burden from advancing P&I on servicers could be.

What actions have been taken to help ease the financial burden of servicers?

On April 21, the Federal Housing Finance Agency (FHFA) announced servicers would be required to advance only four months of P&I on loans held in Agency pools.[1] Thereafter, Fannie and Freddie will be responsible for P&I advancing costs.

Under current policies, Fannie and Freddie do not buy loans in forbearance. Given the rise in forbearance due to COVID-19, recent actions from the FHFA remove that restriction for a limited period of time and only for mortgages that meet certain eligibility criteria.

- This is likely a near-term solution. There could potentially be more stress if the forbearance numbers continue to increase beyond four months.

On April 10, Ginnie Mae announced the Pass-Through Assistance Program (PTAP), a facility to help servicers facing a temporary liquidity shortfall directly attributable to COVID-19.[2]

How does forbearance impact Agency MBS investors?

Agency MBS investors attempt to forecast prepayment speeds. If a borrower defaults on a loan, investors are exposed to faster prepayments. However, if the loan is in forbearance, it may not lead to a default, reducing the risk of prepayment.

When a borrower formally misses a mortgage payment, that loan goes into delinquency. Typically, the mortgage servicer advances P&I until a defaulted mortgage is eventually bought out of the Agency mortgage pools by Fannie, Freddie, or Ginnie.

Agency MBS investors are not exposed to losses on principal. Agency MBS investors are exposed to prepayments. Broadly speaking, prepayments can be a benefit or a concern to investors, depending on underlying bond characteristics.

- If an investor owns an Agency mortgage at a discount, prepayment can be a benefit.
- If an investor owns an Agency mortgage at a premium, prepayment can be a concern given the asset is at a premium and the bond would likely get paid back at par value.

What are the implications for the non-Agency MBS market?

The non-Agency residential MBS (RMBS) market has experienced requests for forbearance since the Global Financial Crisis (GFC). The systems, technology, and training to handle forbearance requests have been in place well before the COVID-19 pandemic.

Forbearance is typically requested in the wake of natural disasters. While it is still too early to forecast industry-wide peak delinquencies and recovery timelines, the precedent set from Hurricanes Harvey (Texas) and Irma (Miami) in 2017 can provide guidance on the current environment.

In those more geographically contained instances, borrower missed payments under forbearance generally peaked within the first few months following the hurricane. Missed payments subsequently declined over the next three to nine months, before stabilizing at levels modestly higher than pre-hurricane delinquencies.

- It is important to note that an increase in forbearance does not necessarily translate to an increase in defaults. While delinquency rates increased following Hurricanes Harvey and Irma in 2017, cumulative losses and defaults on Jumbo 2.0 and non-qualified mortgage (QM) transactions were negligible.

What is the potential opportunity set in non-Agency MBS?

In the current environment, legacy RMBS issued prior to the GFC, appears to offer attractive relative value. As of April 29, legacy RMBS bonds yield approximately 5%. Relative to corporate credit, the yield for legacy RMBS bonds is lower than the yield for U.S. high yield bonds but higher than that of U.S. investment grade corporate bonds.

- For legacy RMBS, the length of payment history of the underlying borrowers reinforces our expectations of continued performance. Amortization of underlying loan balances and appreciation of home values in recent years further strengthens fundamental value.

[1] Federal Housing Finance Agency. April 21, 2020. **FHFA Addresses Servicer Liquidity Concerns, Announces Four Month Advance Obligation Limit for Loans in Forbearance**

[2] National Council of State Housing Agencies. April 13, 2020. **Ginnie Mae Releases New COVID-19 Pass-Through Assistance Program**

What is the potential opportunity set in non-Agency MBS? (cont'd)

Loan originations since the GFC have upheld disciplined underwriting standards largely in response to regulatory measures enacted post-GFC. This has resulted in higher credit quality borrowers than prior to the GFC as these originations generally have a lower loan-to-value (LTV) than those issued pre-GFC. This implies borrowers of the underlying mortgage have more equity in their homes. Generally speaking, home equity is something borrowers would want to protect by avoiding default.

The credit risk transfer (CRT) sector, conversely, has been one of the most adversely affected asset classes within the RMBS sector over the past few months.

- CRTs are highly levered structures, and there are concerns that an increase in mortgage forbearance plans will activate delinquency triggers in many CRT deals and extend several of the senior tranche bonds, while the subordinated tranches could potentially take impairment losses.
- CRT securities were first introduced in 2013 as a mechanism for transferring their mortgage credit risk from the GSEs to the private markets. While liquidity needs linked to mortgage real estate investment trust (mREIT) de-leveraging and redemption requests may have led to initial price weakness in the space, recent spread widening generally reflects the potential for write-downs given the uncertainty of borrowers' ability to make mortgage payments.

What is your outlook on home prices?

Home price appreciation (HPA) is likely to decline this year given the outlook of rising unemployment and economic uncertainty. However, HPA is unlikely to fall to 2008-type levels, given the low supply of available single-family housing units relative to pre-GFC.

HPA is driven by fundamentals and technicals. Home sales are expected to decrease in coming months, as the COVID-19 pandemic and resulting labor market stress delays and/or halts home purchases. However, housing inventories remain low, and constraints to homebuilding should further limit supply in coming quarters.

What has been the impact to the rental market?

Thus far, the data from real estate investment trusts (REIT) and property managers has largely exceeded expectations. As of April 19, the National Multifamily Housing Council (NMHC) found that 89% of apartment households made a full or partial rent payment for April.[3]

Urban centers, where employment is generally higher, had a multifamily collection rate of approximately 95%.

There are different types of Commercial MBS (CMBS) multifamily properties. Class A is the higher priced, higher quality multifamily units relative to Class B and Class C.

- Class A tenants, in higher priced units, are likely to have more "white-collar" jobs that have steadier cash flows relative to Class C multifamily.
- Class B properties generally have a middle class resident base of both white and blue-collar workers.
- Class C tenants tend to be hourly wage workers. Generally speaking, these tenants may be more impacted from COVID-19 due to the shutdowns in retail and hospitality sectors.

How does the current environment compare to the GFC?

The current crisis has differed from the GFC in that the price declines in March were largely driven by technical factors, namely, a lack of liquidity. In 2008, the prices of securities declined due to fundamental reasons over a significantly longer span of time. During the GFC, it took 12 to 18 months for mortgage related securities prices to drop 30 to 40 points. In March 2020, prices for certain mortgage credit assets declined by similar amounts in the span of 10 business days.

Heading into the GFC, there were a number of fundamental warning signs that eventually lead to the housing market crisis:

- A significant growth in the proportion of originations with lower documentation and higher LTV ratios as a result of relatively weak underwriting standards. Some of these borrowers were speculators, buying multiple homes with the intent to "flip" and make a profit.
- Oversupply of homes was another issue, as housing starts and existing home sales inventory continued to grow at a high rate in the years leading up to the GFC.

Following the GFC, stricter underwriting, more balanced supply and demand, and lower LTV ratios are supportive of mortgage assets in the current environment. Consequently, mortgage assets are likely better able to withstand economic volatility relative to pre-GFC mortgage assets. ■

[3] National Multifamily Housing Council. May 1-6, 2020. **Rent Payment Tracker**

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Definitions

Cash Flow - The net amount of cash and cash-equivalents being transferred into and out of a business.

Investment Grade - A quality designation ascribed by rating agencies to bonds that have little risk of default.

Par Value - The face value of a stock or other security.

Spread - The difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings and risk.

Yield - The earnings generated and realized on an investment over a particular period of time.

As of April 30, 2020 the DoubleLine Total Return Bond Fund held 0.68% of Ginnie Mae (GNMA); 24.86% of Fannie Mae (FNMA) and 21.72% of Freddie Mac (FHLMC). As of the same time period, the DoubleLine Income Fund held 0.00% of GNMA, FNMA, and FHLMC. Portfolio holdings are stated as a % of the Fund's total assets.

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