The Return of Non-Prime U.S. RMBS

What Investors Need to Know

Special Report

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A new non-prime mortgage market is beginning to emerge in the U.S., almost 10 years after the subprime and Alt-A mortgage markets shut down amid dramatic underperformance. Fitch Ratings expects a notable increase in newly originated non-prime RMBS activity in 2017, though on a significantly smaller scale relative to pre-crisis volume.

This report provides an introduction to the developing sector and a summary of pre-crisis risks that have been addressed, those that remain, and new risks that have emerged since the crisis.

Non-Prime Gaining Momentum: Since the second half of 2015, 10 non-prime RMBS transactions totaling over $1 billion have been issued by five issuers. Fitch estimates those figures could double in 2017, and their growth could be rapid over the next several years. The growth will be driven by a handful of early market entrants gaining traction with brokers and correspondents, higher interest rates that will redirect lender focus from prime refinances to non-prime, and successful securitizations that provide visibility and incentives for potential issuers.

No Return to Pre-Crisis: Between 2005 and 2007, approximately $2 trillion of Alt-A and subprime RMBS were issued (roughly $60 billion per month). Even assuming rapid growth, volume in 2017 will remain less than 1% of peak-vintage volume. Legislative, regulatory and market changes will limit non-prime RMBS to a very small share of the total U.S. mortgage market.

Key Improvements: Legislative and regulatory changes such as the Ability-to-Repay (ATR) Rule and risk-retention requirements establish meaningful new standards and increase liability for lenders that make poor quality loans. Third-party due diligence and new fraud-risk tools confirm data quality. Changes to market practice, such as preventing loan officers from communicating with appraisers and including quality metrics for underwriters, help mitigate conflicts of interest.

Additionally, Fitch credit enhancement levels at each respective rating category will be significantly higher than pre-crisis levels, all else equal.

Key Risks: The credit quality of borrowers remains the primary risk. While early performance has been very good, borrowers in these programs are expected to default at higher rates and will be more vulnerable to economic stress than prime borrowers. The lack of historical performance for some characteristics, such as borrowers with recent major credit events, and the lack of precedent on how courts will interpret the ATR Rule add uncertainty to projections.

Lenders and issuers are expected to be almost exclusively non-banks with non-investment grade corporate ratings; presumably they will not be able to provide rep and warranty protection in a severe economic stress scenario.

Not All Programs Ready for 'AAAsf': The relatively recent entry of a number of market participants and the heightened risk of the sector will prevent some issuers from being able to achieve 'AAAsf' ratings with Fitch until a longer track record is established.

What's in a Name?

The re-emergence of the non-prime RMBS sector raises the question of what to call it.

To distinguish between newly originated loans and pre-crisis originated loans, Fitch currently uses the more generic term of non-prime RMBS to refer to the developing sector, rather than the legacy sector designations of Alt-A or subprime.

The collateral attributes of the pools securitized to date do not fit neatly into the profiles of legacy Alt-A or subprime based on credit score, loan-to-value ratio (LTV), occupancy and loan size. Moreover, the new requirements of the ATR Rule exclude several defining characteristics of the legacy sectors, such as a high percentage of stated-income loans. "Affordability" products, such as interest-only loans, negatively amortizing loans or short-term Hybrid ARMs with teaser rates, made up the majority of legacy Alt-A and subprime production and are almost non-existent in newly originated non-prime RMBS. Also notable to date is the higher "Purchase" money loan concentration, which results in more reliable property valuations.

Sector Historical Comparison

(%)	Initial Credit Attributes								
Transaction	Orig. FICO	Orig. CLTV	Orig. DTI	Avg. Amount ($)	Coupon	Affordability[a]	Full Doc.	Owner Occ.	Purchase
Prime (1998–2008)	736	70	33	456,741	6.0	35	58	93	43
Alt-A (1998–2008)	711	79	36	288,276	5.3	69	26	81	47
Subprime (1998–2008)	623	84	41	161,799	7.9	74	61	93	37
Non-Prime (2015–2016)	697	75	37	384,812	7.0	3	84	88	85

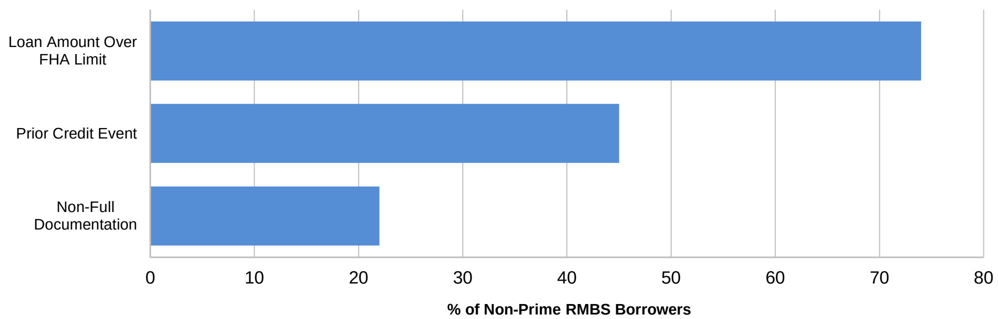
[a]Affordability includes: option adjustable rate mortgage (ARM), 40-year term, interest only, short-term hybrid ARMs (≤ 36 months to initial reset). Source: LoanPerformance, Fitch Ratings, Intex, transaction documents.

Why Not FHA?

When discussing non-prime RMBS with investors, the question arises of why non-prime borrowers would not use an FHA loan? The Federal Housing Administration's (FHA) loan program offers flexible credit standards and low interest rates. In non-prime RMBS mortgage pools analyzed by Fitch to date, the most common reasons borrowers cannot qualify for FHA loans are:

- A loan amount that exceeds the maximum eligible amount. In 2016, the FHA limit was $271,050 in most areas of the country.
- A prior credit event that causes a borrower to be ineligible for an FHA loan or requires extensive explanation and documentation.
- Non-full or non-standard income documentation.

Reasons Why Non-Prime Borrowers Cannot Use FHA Loans
(Many Borrowers Have Multiple Reasons [Sum of >100%])



Sources: Non-prime RMBS mortgage pools analyzed by Fitch to date.

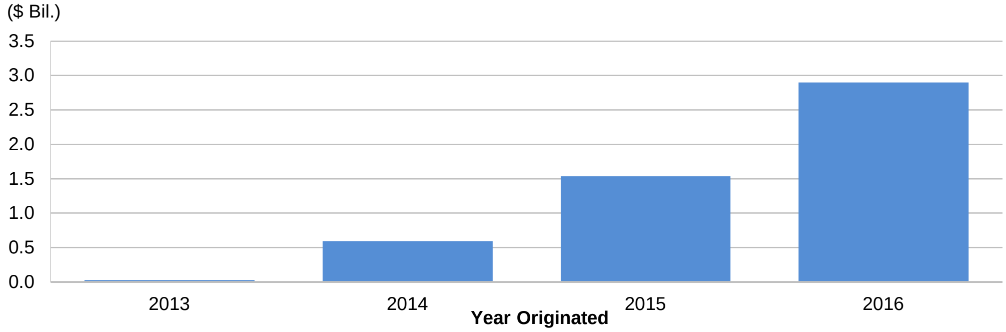
Growing Quickly, but Still Small

Volume remains well below 1% of pre-crisis volume.

Non-prime origination volume has roughly doubled each of the last two years and appears likely to continue relatively rapid growth into the near future. However, overall volume remains relatively low. Even if volume doubles again to roughly $6 billion in 2017, it will remain less than 1% of peak annual pre-crisis Alt-A and subprime volume.

The amount originated to date relative to the amount securitized to date ($1.2 billion) suggests issuers have pipelines ready to securitize.

Non-Prime Origination Volume



Source: Fitch Ratings estimate based on market survey.

Key Post-Crisis Improvements

Below is a list of post-crisis changes in the mortgage lending sector that create a different legislative, regulatory and market environment today than was present before the financial crisis. Predominantly, the changes have been positive and are expected to reduce (but not eliminate) risks related to conflicts of interest, misrepresentation and poor data quality.

CFPB and ATR: The Consumer Financial Protection Bureau (CFPB) and the ATR Rule provide strong incentives for lenders to make sound lending decisions, reducing pre-crisis affordability and misrepresentation issues that drove defaults. The ATR Rule prohibits stated income documentation programs for most mortgage loans and provides guidance on minimum documentation requirements for lenders to make a reasonable determination that a borrower can afford monthly mortgage payments.

Risk Retention: The Dodd-Frank Act of 2010 introduced rules for risk retention that became effective for RMBS transactions in December 2015. Risk retention is not required for all RMBS transactions but is expected to be required for all non-prime transactions. The purpose of the rule is to align the interests of issuers with investors by requiring sponsors of a securitization to hold a 5% "vertical" slice of the outstanding principal balance of each class of securities, a 5% "horizontal" interest of the fair value of the first-loss class, or a combination of the two. Retention requirements expire seven years after the transaction closing date but can expire after year five if the underlying asset balance falls below 25% of the cutoff date balance. Fitch believes that the five to seven year timeframe would adequately flush out poor underwriting quality.

Third-Party Due Diligence: A standard protocol for non-prime RMBS today is the independent third party review (TPR) of each loan file securing the transaction. The primary purpose of the review is to confirm that the loan was underwritten to the stated guidelines, the appraisal was conducted in accordance with the guidelines and standard industry practices, and the loan was made in compliance with law, including ATR Rule. The results confirm data reliability and provide an indication of a lender's or aggregator's risk management and control environment.

Related Criteria

U.S. RMBS Master Rating Criteria (December 2016)

R&W Frameworks: Post-crisis representation and warranty (R&W) frameworks have generally improved to allow for better identification and enforcement of breaches, though standardization and investor communication still have room for improvement. Loan level reps, automatic

New Improvements:

- CFPB and ATR
- Risk Retention
- Due Diligence
- Operational Controls
- Transaction Structure
- Higher Credit Enhancement

reviews for loans that become delinquent or experience a loss, and provisions for binding arbitration provide a clearer path for investors to pursue a repurchase and help align seller and investor interests. However, several non-prime RMBS issuers have elected not to include an automatic review, which dilutes the other improvements. Fitch makes credit enhancement adjustments when an automatic review is not present or when the rep provider is a non-investment grade entity that may not be able to repurchase loans in a stressed economic environment.

Operational Controls: Fitch conducts assessments of each aggregator, as well as every loan originator that contributes a significant amount to the pool (i.e. 10% or higher). The assessment, which may include an on-site review, involves a review of the lender's' or aggregator's platform as well as a review of its underwriting practices, risk management, and technology capabilities, among other things. Of those lenders and aggregators reviewed to date, Fitch has noted improvements that are expected to reduce fraud and operational risks pervasive with legacy Alt-A and subprime loans.

For example, lenders that rely on third-party originators (TPOs) as a source of loan production have enhanced standards for approving and monitoring sellers with the National Mortgage Licensing System (NMLS), a system introduced post-crisis by regulators. The selection of the appraiser now follows rules to maintain independence and secondary valuation products are used to confirm appraisal quality. Gap credit reports and Mortgage Electronic Registration Systems (MERs) checks are conducted to identify borrowers' undisclosed debts and liens. For W-2 borrowers, tax transcripts (4506-T) are obtained and verifications of employment are conducted before closing.

Transaction Structure: Non-prime transactions issued to date preserve loss protection for senior classes more effectively than pre-crisis structures. They have sequential or modified sequential bond payment structures, whereby the bottom classes of the capital structure are fully locked out from receiving any principal until the most senior classes have been paid in full. For modified sequential structures that allow distribution to some investment-grade mezzanine classes, performance triggers provide for the redirection of principal to the most senior class outstanding until paid in full if the loans underperform.

Higher Loss Expectations and Credit Enhancement: Fitch's loan loss model assumes loss projections significantly higher than those used prior to the financial crisis. The crisis provided expansive data on how borrowers with various credit attributes behave in a period of severe economic stress. Fitch's 'AAAsf' and 'AAsf' stress scenarios are intended to protect investors from an economic scenario more severe than the recent financial crisis.

New Post-Crisis Risks

Bank Statement Documentation: Although the ATR Rule requires that lenders consider a list of specific factors when assessing a borrower's ability to repay, it provides some flexibility in how lenders consider those factors as long as they are able to make a reasonable and good-faith determination. In addition to traditional income documentation products, non-prime lenders also typically offer products that qualify borrowers using only bank statements. Most lenders that Fitch has reviewed offer bank statement products only to self-employed borrowers, require 24 months of statements, and may review either personal or business accounts. Some lenders review only 12 months of statements, and one lender allows a one-month statement to document income for prime-quality borrowers.

While ATR compliance will ultimately be decided by the courts, the CFPB has provided the following two key guidance factors to help determine whether a lender's ATR decision based on the information gathered was reasonable and in good faith: (1) the standards used to underwrite the loan have historically resulted in comparatively low rates of default during adverse economic conditions, and (2) the consumer paid on time for a significant period after origination.

New Risks:

- Bank Statements
- Prior Credit Events
- Investment Funds

Since the programs are still relatively new and few lenders are able to demonstrate a meaningful amount of performance for bank-statement programs, Fitch currently applies significant loss adjustments by increasing both the default probability and loss severity assumption. The higher loss severity assumption reflects Fitch's assumption that bank-statement borrowers that default will actively challenge foreclosures using the ATR Rule as a defense, which will increase liquidation timelines and costs.

Prior Credit Events: Non-prime lenders typically offer products to borrowers that do not qualify for other loan programs due to the time since a prior credit event, such as a foreclosure, bankruptcy, short sale, or deed in lieu of foreclosure. Post-crisis, borrowers with prior credit events make up a larger percentage of non-prime mortgage pools than presumably in pre-crisis pools, although that information was typically not reported or tracked pre-crisis.

While performance data for borrowers that had a recent credit event is limited, early data indicate a 20% greater likelihood of default on their new mortgage compared to the entire population of new mortgage borrowers after controlling for credit score. The performance difference was observed in a benign economic environment, and whether the performance gap will widen in a stressed scenario remains unknown. Fitch currently increases base-case and stressed default projections by 20% for borrowers with prior credit events after controlling for all other attributes.

Investment Funds: Many current non-prime lenders and aggregators are operating companies owned directly or indirectly by private equity funds whose strategies are to invest in residential mortgage credit. Some funds have acquired operating companies with an existing infrastructure for loan originations, while others have formed aggregator platforms that rely on TPOs or bulk loan purchases for loan volume.

The funds' limited life and, in some instances, limited capital can potentially limit investor recourse in the event of R&W breaches, although the R&W providers are often the lending operating companies. Increased counterparty risk can be mitigated by higher credit enhancement where appropriate. Additionally, most of the funds retain more than the 5% risk retention requirement as part of their investment strategy, providing a meaningful incentive to uphold lending standards and reduce operational risks.

Transactions to Date

Ten newly originated non-prime RMBS transactions from five issuers have been completed since the start of 2015 backed by roughly $1billion of mortgage pools. Only three of the transactions have received credit ratings to date, all issued off the COLT shelf. As many as nine issuers are expected to securitize newly originated non-prime RMBS in 2017. All active issuers in 2017 will likely seek credit ratings in an effort to broaden the investor base and add liquidity to the bonds.

2015–2016 Transaction List and Transaction Parties

Transaction	Closing Date	Highest Fitch Rating	Largest Originator	Largest Servicer	Master Servicer	Underwriter
COLT 2015-A	8/7/15	Not Rated	Caliber	Caliber	None	Credit Suisse
COLT 2015-1	11/25/15	Not Rated	Caliber	Caliber	None	Credit Suisse
COLT 2016-1	6/23/16	'Asf'	Caliber	Caliber	Wells Fargo	Credit Suisse
COLT 2016-2	9/15/16	'Asf'	Caliber	Caliber	Wells Fargo	Credit Suisse
COLT 2016-3	12/15/16	'AAAsf'	Caliber	Caliber	Wells Fargo	Credit Suisse
Deephaven 2016-1	7/28/16	Not Rated	Angel Oak	Shellpoint Mortgage	None	Credit Suisse/Nomura
RCO 2015-NQM1	12/15/15	Not Rated	Citadel Servicing Corp.	Citadel Servicing Corp.	Wells Fargo	Nomura
SG 2016-1	10/28/16	Not Rated	RPM Mortgage	Nationstar	None	Credit Suisse
Angel Oak 2015-1	12/16/15	Not Rated	Angel Oak	Select Portfolio Servicing	None	Nomura
Angel Oak 2016-1	8/22/16	Not Rated	Angel Oak	Select Portfolio Servicing	None	Nomura

Source: Fitch, Transaction documents.

2015–2016 Transaction Credit Attributes and Performance

		Initial Credit Attributes									Performance to Date (Through 12/16)			
Transaction	Closing Balance ($)	Orig. FICO	Orig. CLTV (%)	Orig. DTI (%)	Avg. Amt. ($)	Coupon (%)	Full Doc.	Owner Occ. (%)	Purchase (%)	Deal Age (Mos.)	Pool Factor (%)	60+Day DQ (%)	Loss To Date (%)
COLT 2015-A	72,011,647	688	76	35	329,277	7.4	100	94	94		0	0.00	0.00
COLT 2015-1	105,603,796	697	76	37	384,014	7.0	100	91	89	13	56	1.65	0.00
COLT 2016-1	161,708,659	701	79	38	439,426	7.0	100	92	84	6	78	0.00	0.00
COLT 2016-2	216,966,529	702	76	37	433,067	7.0	84	89	88	3	86	0.19	0.00
COLT 2016-3	225,745,588	714	75	38	476,257	6.4	75	89	84	0	100	0.00	0.00
Deephaven 2016-1	154,330,119	678	73	35	269,337	7.4	73	82	79	5	80	1.40	0.00
RCO 2015-NQM1	56,256,372	691	69	36	281,282	7.9	52	79	69	12	54	2.59	0.00
SG 2016-1	108,092,736	702	73	36	509,871	6.4	82	81	81	2	93	0.00	0.00
Angel Oak 2015-1	150,352,998	683	75	35	270,906	7.5	90	92	90	12	56	1.52	0.00
Angel Oak 2016-1	132,647,944	697	75	37	283,436	6.9	78	88	83	4	85	0.33	0.03
Total	1,383,716,388	697	75	37	384,812	7.0	84	88	85	6	78	0.60	0.00

DQ – Delinquent. Source: Fitch, Transaction documents, Intex.

Early Performance Trends

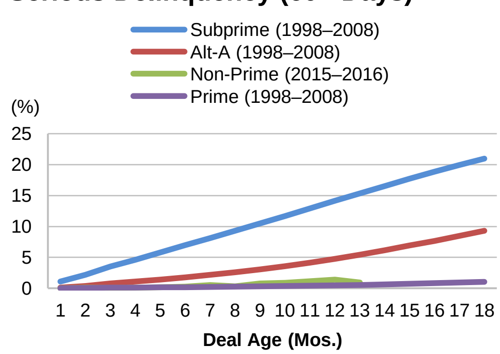
While performance data on securitized non-prime loans remain limited, the early performance trends provide some helpful insight into the behavior of borrowers with these credit profiles. Without controlling for credit attributes, the early delinquency trends have been relatively low and have been more alike to historical prime averages than historical Alt-A or subprime averages. While acknowledging that the economic environment has been very supportive, the early delinquency trends are reassuring and appear to be consistent with loans originated with solid operational controls.

The most notable early performance trend may be the unusually high prepayment rates. Average conditional prepayment rates (CPRs) across all issuers to date have often exceeded 40% annualized and appear to accelerate as the transactions season. The increase in speeds as the transactions season likely reflects credit curing with borrowers refinancing into lower coupon products. Although borrowers “flipping” properties for short-term gains could be a factor, it seems unlikely to be a large driver given the limited percentage of investor properties and the slower rate of home price growth. Most aggregators have “no solicitation” and premium recapture agreements with sellers; however, those can be as short as three to six months, and for loans originated through a wholesale channel, an unaffiliated broker cannot be prevented from finding another lender to refinance the borrower.

As lender competition has increased, loan coupons in this sector have declined. Consequently, non-prime loans originated today may not prepay as fast as those loans originated one or two years ago.

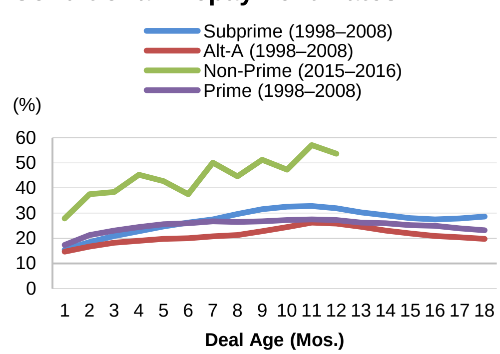
Early performance has shown low delinquency and high prepayments.

Serious Delinquency (60+ Days)



Note: Years in legend reflect origination years for samples shown. Source: Fitch Ratings, LoanPerformance.

Conditional Prepayment Rates



Note: Years in legend reflect origination years for samples shown. Source: Fitch Ratings, LoanPerformance.

Not all issuers and transactions will be eligible for 'AAAsf' initially.

This guidance is expected to be in place through 2017 but will likely evolve as Fitch's knowledge of the issuers grows.

Key Focus Areas:

- High due diligence percentage
- Consistent credit approach
- Credit better than legacy Subprime
- Solid R&W framework
- Subordinate class lockout
- Satisfactory operational review
- Sufficient track record

Path to a 'AAAsf' Rating

Not all issuers of non-prime RMBS will be able to initially achieve 'AAAsf' ratings. While one could argue almost any transaction can be structured to create some sliver of 'AAAsf' credit quality bonds through credit enhancement, Fitch plans to reserve 'AAAsf' ratings for non-prime RMBS transactions that also meet broader standards.

Although the guidance below describes characteristics consistent with a transaction that would likely warrant a 'AAAsf' rating, the guidance is not formal rating criteria and 'AAAsf' eligibility will be considered on a case-by-case basis.

This initial guidance is expected to be in place through 2017 but will likely evolve as the market develops and as Fitch's understanding of the issuers and sector grows.

The transaction features described below are consistent with attributes Fitch would consider eligible for a 'AAAsf' rating for a newly originated non-prime RMBS:

100% due diligence: A TPR of all loans, reflecting solid operational controls and reliable data quality.

Consistent credit approach: Mortgage pools with underwriting exceptions that are excessive, not well-reasoned or introduce credit risk that is difficult to quantify will not be eligible for 'AAAsf' ratings. This will be assessed through operational reviews and due diligence results.

Higher credit quality than legacy subprime: Fitch expects to initially reserve 'AAAsf' ratings for newly originated non-prime pools that have weighted average credit scores above 660, weighted average combined LTVs below 80%, and non-full or non-standard income documentation (such as bank statements) less than approximately 30%, unless compensating credit factors exist.

Robust R&W framework: A Fitch-designated Tier 1 or Tier 2 R&W framework, reflecting features that are generally consistent with what Fitch defines as a "full" framework. Although credit enhancement adjustments can mitigate the risk that non-investment grade companies may not be able to provide protection in a stressed economic scenario, Fitch expects a framework that supports an alignment of interest with investors.

Subordinate class principal lockout: No principal distribution to lower rated subordinate classes until higher investment grade classes have been paid in full and, for modified sequential structures that allow principal to mezzanine investment-grade classes, performance triggers that appropriately redirect all principal to the most senior class outstanding in the event of underperformance.

Satisfactory Operational Assessment: Fitch's operational assessments typically include a financial review, an on-site operational review and an analysis of historical performance. For 'AAAsf' rated non-prime transactions, the following guidelines describe the scope and required adequacy of the operational assessments:

- For single originator mortgage pools:
  - An originator assessment of 'Average' or higher.
- For multi-originator aggregators with at least a five-year track record and prior rated securitizations:
  - An aggregator assessment of 'Average' or higher.
  - An originator assessment of 'Average' or higher on any originator contributing more than 10% to the pool.

Level of Operational Assessments Consistent with 'AAAsf' Fitch Rating

Aggregator Type	Aggregator Assessment	Number of Originators	For Individual Originators Contributing >10%	For Individual Originators Contributing 1%–10%	Minimum % of Pool with Fitch Originator Review
No Aggregator	N.A.	Single Originator	'Average' or Higher	N.A.	100%
< Five-Year Track Record and No (or few) Prior Rated Securitizations	'Average' or Higher	Multi-Originators	'Average' or Higher	See note below[a]	≥ 85%
< Five-Year Track Record and Prior Rated Securitizations	'Average' or Higher	Multi-Originators	'Average' or Higher	See note below[a]	≥ 50% (includes abbreviated reviews for originators contributing <10%)
> Five-Year Track Record	Average or Higher	Multi-Originators	'Average' or Higher	See note below[a]	No Pool Minimum

[a]Information requested by Fitch for individual originators contributing 1%–10% of pool: name, year approved by aggregator, net worth, NMLS license unique identifier, number of states licensed in, years since lending license initially issued and years since first approved by government entity (FHA/VA/Fannie Mae/Freddie Mac).
[b]Abbreviated reviews may involve discussions with lender management and a focus on confirming at least a three-year performance track record supportive of solid operational controls through public data or investor scorecards, in addition to a review of the data provided on all originators contributing 1%–10% of pool. N.A. – Not Applicable. Note: Transactions with a level of operational assessments that do not meet the guidelines above will likely have a maximum credit rating of 'Asf' or, in some cases, may not be able to achieve a credit rating.
Source: Fitch.

  - A list of non-reviewed originators contributing more than 1% to pool, providing name, year approved by aggregator, net worth, NMLS license unique identifier, number of states licensed in, years since lending license initially issued and years since first approved by government entity (FHA/VA/Fannie Mae/Freddie Mac).
- For multi-originator aggregators with a track record less than five years:
  - The three features described above for aggregators with a five-year track record.
  - For issuers that have already completed rated transactions, a Fitch satisfactory review of ≥ 50% of originators in the pool by contributing balance. This does not require a formal assessment for individual contributors under 10% but could include informal abbreviated reviews that involve discussions with originator management and a focus on confirming at least a three-year performance track record supportive of solid operational controls (through public data or investor scorecards).
  - For first-time issuers that are multi-originator aggregators with a limited track record, a formal originator assessment on almost the entire underlying mortgage pool (≥ 85%) would likely be needed to achieve a 'AAAsf' rating.

Fitch will likely initially limit the maximum rating to 'Asf' for aggregators with limited track records unless Fitch has conducted satisfactory reviews on a large majority of the underlying originators.

Given the evolving nature of the sector, shorter track record of the aggregator, and lack of visibility into the originators and the operational risk, completing a full rating process helps vet considerations that may need to be addressed prior to assigning a 'AAAsf' rating. The number of rated transactions that need to be completed prior to achieving a 'AAAsf' rating with only 50% of the originators reviewed (with abbreviated reviews for individual originators contributing under 10%) may vary depending on the consistency of the issuer's program and whether any unanticipated credit issues were identified in the initial rating analysis.

Aggregators:

- Deephaven
- Ellington
- Hudson
- Invictus Capital
- SG Capital

Lenders:

- Angel Oak
- Caliber Home Loans
- Citadel Servicing Corp.
- Verus Mortgage
- LendSure
- Sterling Bank

Appendix A: Early Market Players

The non-prime RMBS sector is expected to be led by non-bank financial entities as banks are generally unwilling to expose themselves to the increased regulatory and legal liability of higher risk mortgage loans.

Almost all the entities active in the space today began originating or acquiring non-prime loans less than five years ago. The bulk of the participants entered the market around the time the ATR Rule was finalized in 2014, which provided some guidelines and legislative clarity for the sector.

Listed below in alphabetical order are market participants expected to play an active role in the non-prime RMBS sector. Greater detail on entities with Fitch assessments can or will be found in transaction presale reports.

Fitch has conducted full formal operational assessments on seven originators or aggregators of non-prime RMBS and has had informal discussions with an additional six entities expected to be active in the sector as either an originator or an aggregator. Not all of the entities that Fitch has reviewed or had discussions with are listed below per the entities' request.

Angel Oak Home Loans LLC (AOHL) and Angel Oak Mortgage Solutions LLC (AOMS): Angel Oak is a family of companies headquartered in Atlanta, GA. The companies engage in asset management, residential finance and financial advisory services. Non-prime residential mortgages are originated primarily by two companies, AOHL and AOMS. AOHL is a retail platform founded in 2011 that offers both agency and non-agency programs. Non-prime originations at AOHL began in late 2013, and the success of that program led to the creation of AOMS in late 2014. AOMS originates non-prime residential mortgage loans exclusively through a network of approved broker and correspondent seller relationships. Total non-prime origination volume was approximately $186 million in 2014, $357 million in 2015, and $565 million in 2016 (as of Nov. 30, 2016). Fitch has assigned Angel Oak an 'Average' originator assessment.

Caliber Home Loans (CHL): CHL is a full-service residential mortgage loan origination and servicing company owned by funds of the private equity firm Lone Star Funds and/or its affiliates (Lone Star). The company, headquartered in Irving, TX, originates both agency and non-agency loans. Agency originations represent approximately 95% of CHL's business and CHL has originated over $85 billion in agency loans since 2011. In 2014, CHL and Lone Star started Caliber Portfolio Lending (CPL), a non-prime lending program focused on originating loans for Lone Star's non-Qualified Mortgage (QM) securitization platform. CHL originated approximately $5 million in 2014, $261 million in 2015, and $472 million in 2016 (as of Nov. 30, 2016). Fitch has assigned CHL an originator assessment of 'Average' and rates the servicer as 'RPS2–'/Outlook Negative.

Citadel Servicing Corporation (CSC): CSC is an Irvine, CA based mortgage origination and servicing company founded in 2003 by CEO and majority owner Daniel L. Perl. While the company was initially founded as a servicing platform, origination of non-prime residential mortgage loans began in July 2013. Production to date has been primarily through a network of approved broker relationships. The company also originates a small percentage of loans through its correspondent sellers and its direct marketing retail campaign. CSC originated approximately $128 million in 2014, $332 million in 2015, and $429 million through November 2016. Fitch has reviewed CSC as an originator and servicer and an assigned assessment of 'Average' and servicer rating of 'RPS3–'/Outlook Stable, respectively.

Deephaven Mortgage, Inc. (Deephaven): Deephaven is an aggregator of non-prime residential mortgage loans headquartered in Charlotte, NC. The company was founded by Matthew Nichols (CEO) in June 2012 and, in 2014, was acquired by affiliates of Värde Partners, a $12 billion global investment firm. Deephaven began acquiring residential mortgage loans through its network of approved correspondent sellers in March 2013. Acquisition volumes for 2014, 2015, and 2016 were $73 million, $148 million, and $550 million, respectively. Fitch assigned Deephaven an 'Average' aggregator assessment.

Ellington Management Group (Ellington): Ellington is an investment and advisory firm founded in 1994. The firm's core competencies include developing and implementing fixed income relative value strategies based on credit, mortgage prepayment, and interest rate markets and has maintained residential mortgage credit opportunities as a core strategy since the firm's inception. Ellington is headquartered in Old Greenwich, CT, with offices in New York and London. Fitch has not conducted a formal assessment of Ellington.

Hudson Americas L.P. (Hudson): Hudson Americas, L.P. is a subsidiary of Hudson Advisors, L.P., a global asset management company that provides dedicated asset management for Lone Star Funds (Lone Star), a global private equity firm that invests in real estate, equity, credit and other financial assets. Lone Star and Hudson are both headquartered in Dallas, TX and were founded in 1995. Funds of Lone Star own national mortgage lender and servicer Caliber Home Loans, Inc. and purchase their non-prime loans through Lone Star Residential Mortgage Fund I (LSRMF). Fitch has reviewed Hudson and assigned an aggregator assessment of 'Acceptable'.

Invictus Capital Partners (Invictus): Invictus is a Washington, D.C. based investment management firm that focuses primarily on real estate credit strategies. The company was formed in 2008 and aggregates non-QM mortgage loans from various originators, both directly and indirectly through Verus Mortgage Capital (an entity that is indirectly owned by Invictus affiliates). Fitch has not conducted a formal assessment of Invictus.

LendSure Mortgage Corporation (LendSure): LendSure was founded in 2015 by three seasoned mortgage professionals who previously worked together as executive management at Accredited Home Lenders, Inc., a former subprime lender. The company is headquartered in San Diego, CA and funded its first loan in July 2015. LendSure originates mortgage loans that may not comply with CFPB's QM guidelines. Fitch has not conducted a formal assessment of LendSure.

SG Capital Partners, LLC (SG Capital): SG Capital was incorporated in 2013 and is the mortgage operating company affiliated with Shelter Growth Partners, LLP. SG Capital acquires jumbo prime and non-prime mortgage loans through a network of approved correspondent seller relationships. Fitch has not conducted a formal assessment of SG Capital.

Sterling Bank & Trust, FSB (Sterling): Sterling Bancorp, Inc. is a family owned bank holding company with $2.1 billion in assets as of December 31, 2016. The holding company wholly owned subsidiary, Sterling Bank & Trust, FSB, is a federally chartered stock savings bank and a member of the Federal Home Loan Bank (FHLB) system. Sterling was established in 1984 and operates 23 branches in California (mostly located in the San Francisco Bay Area) and one in Southfield, MI, where the bank is headquartered. Sterling's non-QM mortgage lending is centered on its Advantage program, which offers low LTV loans originated through the bank's retail channel. Fitch has assessed Sterling as an 'Average' originator.

Appendix B: Qualified Mortgage and Ability to Repay Rule Overview

Most non-prime loans are also non-Qualified Mortgages (QMs) or higher priced QMs (HPQMs). This appendix provides an overview of the QM and ATR Rule.

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) expanded on the 2008 Truth in Lending Rule mandating an assessment of a borrower's ability-to-repay (ATR) for higher priced mortgage loans by creating its own ATR directive applicable to almost all closed-end residential mortgages. The Consumer Finance Protection Bureau's (CFPB) ATR Rule lays out the minimum requirements under such directive necessary to ensure creditors make a reasonable and good-faith determination that a borrower can afford monthly principal and interest payments on the loan. First issued by the CFPB in January 2013 and last amended in September 2013, the final Rule pertains to mortgage applications received on or after January 10, 2014.

The primary tenet of the Rule sets out the minimum factors that must be considered to determine whether the borrower's finances are adequate to support payments on the loan. In particular, the CFPB outlines eight specific underwriting factors that lenders must consider when assessing a borrower's ATR as follows:

The ATR Rule outlines eight specific underwriting factors that lenders must consider.

- Current or reasonably expected income or assets.
- Current employment status.
- Monthly payment on the mortgage.
- Monthly payment on any simultaneous loan.
- Monthly payment for mortgage-related obligations.
- Current debt obligations.
- Monthly debt-to-income ratio (DTI), or residual income.
- Credit history.

The lender must be able to demonstrate they made a reasonable and good-faith determination that the borrower could repay the loan.

Whether a lender meets ATR requirements will ultimately be decided by a judge if a borrower challenges the lender's decision. Importantly, simply considering the eight factors alone is not sufficient for a lender to meet the ATR Rule. The lender must demonstrate it made a reasonable and good faith determination based on the information gathered. For example, a lender that considers the eight factors but provides a loan to a borrower with a very high DTI and low residual income would still be at risk for an ATR Rule violation.

Borrowers may contest lenders' compliance with the ATR Rule as affirmative claims within the first three years following consummation of the loan prior to default. Borrowers may also bring defensive claims against the creditor as a defense to foreclosure. As borrowers are likely to have difficulty proving they lack an ATR while still making payments on the loan, Fitch expects challenges to primarily be defensive in nature.

Loan Designation

Designation	Attributes	Protection
SHQM	Maximum 43% DTI; non-IO/negatively amortizing/balloon; full loan documentation; points and fees not to exceed 3% of total loan amount as defined under TILA; maximum (APR) of 1.5% over the APOR; maximum 30-year term.	Safe harbor
Temporary SHQM (GSE/Agency Eligible)	Eligible for sale (though not required to be sold) to the GSEs or federal government agencies per their respective underwriting guidelines; points and fees not to exceed 3% of total loan amount as defined under TILA; maximum APR of 1.5% over APOR.	Safe harbor
HPQM	Maximum 43% DTI; non-IO/negatively amortizing/balloon; full loan documentation; points and fees not to exceed 3% of total loan amount as defined under TILA; APR may exceed 1.5% over APOR; maximum 30-year term	Rebuttable presumption; damages capped at up to first three years of interest and finance charges plus fees paid by the borrower, statutory damages, actual damages, attorney fees and court costs.
Temporary HPQM (GSE/Agency Eligible)	Eligible for sale (though not required to be sold) to the GSEs or federal government agencies per their respective underwriting guidelines; points and fees not to exceed 3% of total loan amount as defined under TILA; APR may exceed 1.5% over APOR.	Rebuttable presumption; damages capped at up to first three years of interest and finance charges plus fees paid by the borrower, statutory damages, actual damages, attorney fees and court costs.
Non-QM	DTI may exceed 43%, IO/negatively amortizing/balloon features, no cap on points and fees, APR or term.	None; damages capped at up to first three years of interest and finance charges plus fees paid by the borrower, statutory damages, actual damages, attorney fees and court costs.

SHQM – Safe harbor qualified mortgage. HPQM – Higher priced qualified mortgage. DTI – Debt to income ratio. IO – Interest only. TILA – Truth in Lending Act of 2008. APR – Annual percentage rate. APOR – Average prime offer rate. GSE – Government-sponsored entity.
Source: Fitch.

Loans that meet the definition of a "qualified mortgage" provide lenders with a safe harbor against ATR claims.

Non-prime loans are typically non-qualified mortgages (non-QMs).

Qualified Mortgage

Under the Rule, the CFPB also outlines a set of underwriting parameters, which, when met for a particular loan, provide the lender with increased protection from any potential challenges to ATR compliance raised by the borrower. Loans that conform to these standards meant to safeguard creditors from undue litigation risk are defined as a "qualified mortgage" (QM).

In general, for a loan to be classified as QM, several conditions must be met. The loan must be fully amortizing (i.e. not have interest-only or negative amortization features) with the borrower qualified based on the monthly payment calculated at the higher of the note rate or the maximum fully indexed rate up to which the coupon could reset in the first five years, have a maximum maturity of 30 years and a back-end DTI no greater than 43% as calculated in accordance with Appendix Q, where applicable. In addition, points and fees on total loan amounts as defined under TILA in excess of $100,000 must not exceed 3%. However, the Rule provides for alternative definitions of QM in certain cases.

Section 1026.43(e)(4) delineates Special Rules granting QM status to loans eligible for sale (whether sold or not) to the Fannie Mae or Freddie Mac lenders that may rely on recommendations generated by either of the GSE's automated underwriting systems or published underwriting guides to determine eligibility. The Special Rule is effective for loan applications received through the earlier of the end of Fannie Mae's or Freddie Mac's conservatorship/receivership under the Federal Housing Finance Agency or January 10, 2021. Similarly, fully amortizing 30-year loans with back-end DTIs greater than 43% that qualify for guarantee or insurance from one of the federal government agencies, which include the Federal Housing Administration (FHA) and the Rural Housing Service, may also be designated as QMs.

Additional Special Rules under section 1026.43(e)(4) assign QM status to loans that would otherwise fail to comply with the standards in their entirety. For example, balloon loans extended by small portfolio lenders serving rural or other underserved markets can be considered QM where all conditions other than amortization type and DTI threshold are met. The CFPB considers such exemptions necessary to ensure the availability of "responsible, affordable" mortgage credit to more disadvantaged sectors of the market.

Assignee Liability

The trust could be subject to litigation expenses and damages for ATR violations.

While the ATR Rule may support lenders via increased protections on loans originated to QM standards, it introduces an additional layer of risk to residential mortgage backed securities (RMBS) by also holding mortgage assignees accountable for ATR violations committed at origination. Under the Rule, a borrower could pursue legal action against the lender as well as the securitization trust to which the loan has been assigned, subjecting RMBS investors to the costs of litigation defense, including any damages that may be awarded to the borrower if he/she prevails. The level of a transaction's exposure to such assignee liability depends on the standards to which the loans in the trust were originated.

The Rule provides for a presumption of compliance with ATR for loans underwritten to QM guidelines. However, all loans that qualify as QM do not provide for the same protection against borrower disputes. The type of presumption afforded to QM loans is dictated by the APR. The CFPB bifurcates QMs into those it considers to be higher priced and those that are not higher priced.

First liens and second liens that meet the criteria for QM are not classified as higher priced if their APRs do not exceed the Average Prime Offer Rate (APOR) by 1.5% or more and 3.5% or more, respectively. QM loans that are not higher priced grant the lender and any assignees a safe harbor against borrower challenges to the Rule. In such cases, if a court confirms that a loan meets QM standards, then it is conclusively established that the creditor has met the ATR requirements.

QMs that carry APRs that exceed the APOR thresholds, as noted above, are designated as higher priced QM (HPQM) loans and provide a lesser degree of protection to the lender and its assignees than QMs with lower APRs. QMs that are higher priced benefit from a presumption of compliance with ATR, but that presumption can be challenged by the borrower even if the loan is confirmed to meet the criteria for HPQM. The rebuttable presumption gives the borrower the opportunity to prove that he/she did not have enough residual income to support living expenses after accounting for monthly payments on the mortgage based on the income and expenses disclosed to the lender at the time the loan was consummated. Therefore, despite the presumption of compliance, HPQMs are nonetheless subject to increased litigation risk that could increase the costs and extend the timelines associated with foreclosure relative to QMs that are not higher priced.

Lenders and assignees of non-QM loans will not benefit from any presumption of compliance or safe harbor. In the event of a borrower dispute with respect to a non-QM loan, the burden of demonstrating compliance will rest with the lender or then current assignee of the loan, which could expose RMBS investors in non-QM mortgage trusts to litigation risk, the occurrence and expense of which could be higher than for HPQM, given the potentially weaker loan attributes (i.e. loans with interest only or balloon features or DTIs above 43%). However, Fitch also recognizes that non-QM loans may be of high credit quality, reflecting high net worth borrowers who choose non-standard products for wealth management purposes or have non-traditional sources of income.

ATR violations entitle borrowers to damages of up to three years of finance charges and fees paid, as well as actual damages, prescribed statutory damages, court costs and attorney fees.

The rule entitles borrowers to damages from the lender or assignee of the loan in instances of noncompliance, creating risk for RMBS. Specifically, a borrower may seek damages up to three years of finance charges and fees paid to date, as well as actual damages, prescribed statutory damages, court costs and attorney fees. Statutory damages are limited to a maximum $4,000 under the TILA, while actual damages are uncapped. However, given the high burden of proof on the borrower to show that he/she would not have otherwise taken the loan in the absence of such ATR violation, Fitch considers the likelihood that actual damages will be awarded to be remote.

The safe harbor afforded to SHQM loans, under the general definition or government-sponsored entity (GSE)/federal agency eligibility, precludes challenges to ATR violations unless the SHQM status is successfully contested. Taken together with the documentation retention requirements under the Rule and further supported by third-party due diligence review, Fitch expects challenges to SHQM status to be limited.

For HPQMs and non-QM loans, Fitch makes assumptions about the likelihood of claims, costs and damages based on research and discussions with market participants and legal advisors.

For HPQMs and non-QM loans, Fitch assumes borrowers will contest the Rule as a defense to foreclosure. Although HPQMs have a rebuttable presumption of compliance and the basis for a challenge is limited to insufficiency of residual income known at origination, Fitch nonetheless believes this provides less protection to lenders and assignees than safe harbor and, therefore, views the risk of borrower challenges closer to that for non-QM loans where there is no presumption of compliance with the Rule. Fitch based its conclusion on internal and external research, including discussions with market participants and legal advisors as well as information from market feedback provided to the CFPB as part of its request for comment in finalizing the Rule.

While rebuttable presumption of compliance shares some features with a safe harbor, the former allows for the introduction of evidence that the creditor did not appropriately assess the borrower’s residual income based on the facts known at the time the loan was originated. Therefore, a court could consider additional evidence presented by the borrower, even if minimally credible, to determine whether the lender met the presumption of compliance. Thus, in Fitch’s opinion, a rebuttable presumption increases the unpredictability and cost that could result from a borrower challenge to compliance with the Rule, which would nonetheless expose the trust to additional litigation risk.