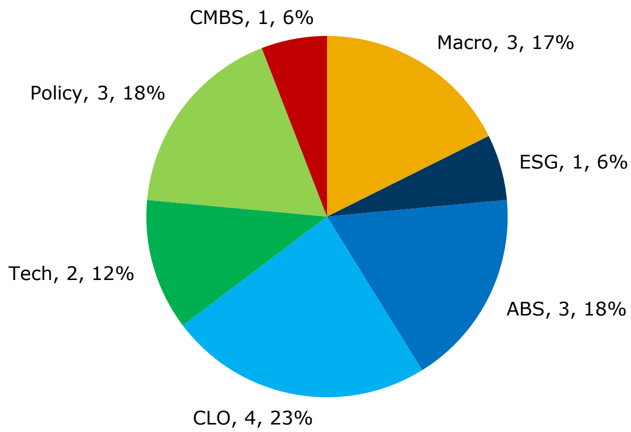
SFVegas 2022 Conference – Monday Recap

Structured finance market professionals assembled at the Aria in Las Vegas for the annual SFVegas 2022 conference held on July 17-July 20. Using the morning line at the conference Starbucks as a barometer, it appears that attendance has mostly recovered to pre-pandemic levels. The number of registered attendees on Monday totaled 6,400, well above the approximately 2,200 in October 2021 and closer to the pre-pandemic level of 8,000+ in February 2020.

Monday began with opening remarks from Michael Bright (SFA CEO), followed by a discussion focused on the outlook for macroeconomic and geopolitical trends. Later in the morning, Federal Housing Finance Agency Director Sandra Thompson and CNN Chief political correspondent Dana Bush each participated in fireside chats. The afternoon was allocated to a number of breakout panel sessions, with topics ranging from CLO, ABS, and CMBS market outlooks, to panels focused on ESG and macro/policy discussions. Below is a brief recap of some of the day's panel topics:

Figure 1: Breakdown of Monday Conference Panels



Sources: KBRA, SFA

Macro Panel Round-Up

The two major themes consistently discussed during the macro-focused panels were unsurprisingly: (1) the persistent and ongoing inflationary environment; and (2) rising recessionary risks. After the Consumer Price Index hit a 40-year high of 9.1% in June, the market expectation is for a 75 to 100 basis point (bps) rate hike at the Federal Reserve's July 26-27 meeting. The main concern expressed among many of the macro-focused panelists were two-fold: (1) that rate hikes will not solve the production/supply constraints that are contributing to higher inflation; and (2) that the Fed is committed to combatting inflation at the expense of economic growth.

Many panelists believed a recession is more likely than not in late 2022 or 2023, if the Fed remains committed to stamping out inflation by aggressively raising rates. It was pointed out that raising interest rates to temper demand will only go so far, as prices have also been driven meaningfully higher by continuing supply chain shocks. One panelist believed that if elevated inflation and strong labor markets remain toward year-end, the Fed will likely continue on its current course. But the more aggressive the Fed is in the near term, the more aggressively it will be in cutting rates as the economy enters a recession.

Although plenty of opportunities exist down the capital stack and in more esoteric corners of the market, most panelists expressed a preference for senior tranches backed by higher quality consumer assets, as recessionary risks rise. This is mainly because the U.S. consumer remains on very solid footing, with household debt-to-income levels at multi-decade lows and debt service coverage ratios at near cyclical highs.

Policy Panel Round-Up

Panelists on the housing finance session attempted to unpack the Biden administration's often complex and nuanced approach to policy—one that often has conflicting motivations or "constantly operating between tensions," according to one speaker. For example, while skyrocketing interest rates to curb inflation may discourage homeownership in minority communities, the administration is also prioritizing closing the racial wealth gap and increasing the Department of Housing and Urban Development's budget. New construction and starter homes are down, yet down payment assistance programs and other funding subsidies are receiving more support than previously. Meanwhile, appraisal reform is also expected to be front and center, given the drive to solve the bias that often leads to vast underappraisals for minority-owned homes.

The overarching sentiment was that market players were struggling to read the tea leaves of regulators, particularly when it comes to interpreting the direction that the Consumer Financial Protection Bureau's (CFPB) director, Rohit Chopra, will take. It has become difficult to divine his intentions in several areas. For example, there was an indication he may be looking at creating a "streamlined refinance" as an additional qualified mortgage (QM) category, although it still remains unclear. In fact, it is uncertain whether there will ever be a "final" QM rule at all, the panelists said, given there have been more than a dozen new sub-rules and notices pertaining to these mortgages over the last five years alone. One speaker perfectly summed up the never-ending QM story: "What's old is new again." Lastly, the panel looked at how servicers may integrate new technologies into their existing legacy processes. Once again, Mr. Chopra's intentions on this area are hazy. Servicers need leeway to test and implement new technologies, one speaker said, and it is still unclear whether the CFPB's approach will help or hurt this endeavor.

Ambiguity over Mr. Chopra's agenda was a prevailing theme on the Biden administration's approach to fintech, including its strategy on less-regulated nonbank companies. Earlier this year, the CFPB invoked a legal provision that allows it to use its "dormant authority" to hold fintechs to the same standard as regular banks when it comes to practices that may harm consumers. Anything the agency deems a "reasonable concern" may trigger more aggressive enforcement, the panelists said. This obviously raises red flags for the industry, although it is unclear whether the Supreme Court may eventually have a mitigating effect, one speaker noted. He suggested that the court's recent EPA decision, limiting the agency's authority, may imply that it could tamp down the progressive inclinations of the current CFPB on future policies. Another speaker disagreed, reasoning that a possible turn toward a Republican administration in 2024 may inspire the current CFPB to get as much done as possible in a limited time, implying that its supervisory role over nonbanks will lead to aggressive enforcement.

Climate Risk as a Hot Topic for Legislators, Regulators, and the Market

The moderator began the discussion with a sobering statistic. According to the National Oceanic and Atmospheric Administration (NOAA), there have been 332 weather and climate disasters in the U.S. since 1980 where overall damages exceeded $1 billion, in aggregate, totaling approximately $2.3 trillion. While climate change models are limited by the accuracy of their inputs—namely, human behavior influenced by the regulatory environment—the increased risk of flooding and wildfires is certain, and future damages to real estate from these elevated risks will likely dwarf the damages cited by NOAA. While every property type is exposed to these risks, the panelists centered their discussion on the U.S. housing market.

Addressing the underlying cause of climate change, namely greenhouse gas (GHG) pollution, has proved challenging. The Biden administration's target of reducing U.S. GHG emissions by approximately 50% of 2005 levels by 2030 is facing a variety of geopolitical, judicial, and legislative headwinds. While policy will ultimately affect future GHG emissions, investors are hungry for data and metrics on how near-term climate change is likely to affect residential real estate. Similar to traditional credit risk analysis but with different inputs, investors and originators seek to understand how climate change will impact asset values and aspects of a borrower's ability and willingness to pay. While environmental risk was generally mitigated with insurance policies in the past, namely for flood and wildfire risk, there is broad agreement that current flood plain data does not reflect the trajectory of climate change, with insurers in some coastal areas stating that properties in those markets will be uninsurable within the next five years. Ultimately, investors and originators will use climate risk metrics to inform their deployment of capital according to their risk tolerance and ability to lend against those properties, respectively.

Given the various headwinds affecting environmental policy at the federal level, the panel concluded with a discussion of what other policy developments can be expected. Activity at the state level is already happening, with California taking the lead and similar activity is expected in other "blue" states. In addition, multinationals will likely abide by climate regulation put forward in Europe, where robust environmental policy has been adopted in several countries. Ultimately, as the effects of climate change are realized, investors will demand more and better disclosure on climate risks, regardless of regulatory mandates.

Consumer ABS

Consumers are facing an economy that is starkly different from just a year ago, as inflationary pressures and the end of government assistance programs have begun to squeeze household balance sheets. Among low income and subprime borrowers, the savings built up during the pandemic have been eroded, impacting these borrowers' ability to pay lower priority obligations.

However, ABS securitizations continue to perform in line, and in some cases better than, expectations. Some consumer lenders believe this is a result of conservative underwriting over the past two years, thereby keeping losses in line with historical expectations. Additionally, delinquencies for auto and student loans in 1H 2022 have outperformed 1H 2021. That said, even though ABS securitizations have performed well from a credit perspective to date, credit deterioration is expected moving forward as consumer fundamentals continue to face increasingly persistent headwinds.

CLO and Leveraged Loan Market

Participants on the first CLO market panel agreed that rising input costs and rates, interest coverage, hedging costs, and uncertainty around future treatment of risk-weighted assets are the current headwinds to CLO issuance. Underlying borrowers will feel the effect of inflation and the stress on their debt servicing ability. Large banks, who continue to be the largest buyers of AAA paper, must deal with hedging costs, while insurance companies—currently most active in the mezzanine tranches—must keep a close eye on the capital treatment of their holdings. These dynamics, while fluid, touch all parts of the CLO structure and, along with the recent loan market sell-off, have contributed to a lower pace of issuance over 1H 2022.

In terms of underlying leveraged loans, the panelists contemplated an uptick in defaults toward the end of 2022, especially in sectors sensitive to the current macroeconomic backdrop, namely rising input and interest costs. The sectors most at risk due to a low ability to pass through costs and weakening EBITDA margins are consumer products; retails and restaurants; film and tv; and health car, which make up approximately 18% of a typical CLO portfolio. Credit ratings have also been shifting, with more B- credit in CLO portfolios than ever before and the pace of upgrades owing to the pandemic recovery slowing.

As for the outlook for the remainder of 2022, there was a moderate consensus among panelists that the glass is still half-full for CLOs. For one, CLOs performed well during the pandemic and their structures are intended to weather recessionary forces. However, as one panelist noted, the coming downturn will likely look much different versus COVID, which was generally characterized by a sudden drop and relatively quick recovery. The coming environment could be more prolonged. Managers will have to dig back into their toolbelt, applying lessons learned from the pandemic; to manage defaults and CCC holdings, preserve principal, trade via swaps or par-build to differentiate themselves and their CLOs.

CLO Manager Roundtable

With regard to collateral managers, panel participants were characteristically constructive on opportunities in the current market. With the backdrop of inflation worries, stagflation after the Russian invasion, and now the Fed's hawkish approach to decelerate the economy, panelists contemplated how CLOs can tactically evolve to mitigate the risk du jour. Shorter reinvestment period and non-call periods, gravitating toward top-tier managers to get deals executed, taking original issuance discount (OID) or requiring more par subordination, flipping to a static portfolio versus reinvesting—these and more structural changes are all on the table in the current environment. Further, market volatility presents trading opportunities for credit pickers, who can pick up par through discount purchases or swaps, a strategy that played out well after the peak pandemic period of spring 2020.

Panelists noted that opportunities may be more wide-ranging and inconsistent. With loan and tranche spreads widening, the arbitrage opportunity is shifting, and the risk must be borne somewhere in today's market. This could be either in assets (warehouses) or liabilities (issuing a longer WAL deal and partnering with an overseas investor). Further, with loans trading in the $85-$90 range, the implied default rate does not reflect where loans are trading. We should expect to see more dispersion in loan/corporate borrower performance. From a manager's perspective, getting the individual credit selection correct is going to be critical factor in this environment.

Recent consolidations of management platforms has also opened the door for new entrants, although investor acceptance of a new CLO manager may require more effort in the current climate. For consolidated managers and other platforms experiencing staffing turnover, a big question posed by investors would be whether styles or philosophy would shift as a result.

Auto ABS Market

Auto loan credit performance has shown signs of weakening, after experiencing historically low delinquency and loss rates in 2020 and 2021, driven by government stimulus and low unemployment. While delinquencies are rising back to or above pre-pandemic levels, losses have not risen in tandem, given elevated used car prices and some borrowers churning in delinquency to avoid repossession.

Originators have been mindful of loan affordability as vehicle prices have risen, maintaining discipline on debt-to-income (DTI), payment-to-income (PTI), ad loan-to-value (LTV) metrics. Furthermore, higher down payment requirements and increased trade-in values have helped to keep LTVs relatively stable. Meanwhile, one panelist noted that structures have demonstrated resiliency through prior economic cycles and that current rating agency assumptions have not accounted for elevated levels of recoveries, even as liquidation prices have risen dramatically, which will be supportive of auto loan ABS credit fundamentals if and when used vehicle prices begin to soften.

CLO Investor Roundtable

This panel mainly focused on the current recessionary outlook, CLO formation, and manager tiering. As in other panels, the economic forecast was for a mild recession starting the latter part of the year. One bank predicted three further Fed rate hikes by the end of the year for a total of 1.75% additional points, which will bring the terminal rate to around 4% by February 2023. For leveraged loan defaults, this base case prediction was a peak of 2%-3%, which is relatively benign, by the panelists' measure. Panelists once again touched on the resiliency of the CLO structure in times of stress; the "self-corrective" mechanism of cash flow diversion should keep senior notes well protected given another downturn.

As for new issuance, the arbitrage opportunity is challenging, and it is becoming difficult for managers to source equity. On the debt side, investors are looking for better quality structures owing to risk-off sentiment, a dynamic that is leading to more debt friendly transactions. Terms and conditions have been tighter as a result. Capital structures have been "choppier," with tranches seeking split ratings, loan formats over bonds, and wider spreads.

Investors are seeing managers underweight consumer-facing sectors such as autos, retail, transportation, and specialty health care, given the risks from rising input and interest costs. Investors are also being more selective with manager choice, with first-tier managers often winning mandates to limit execution risk.

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