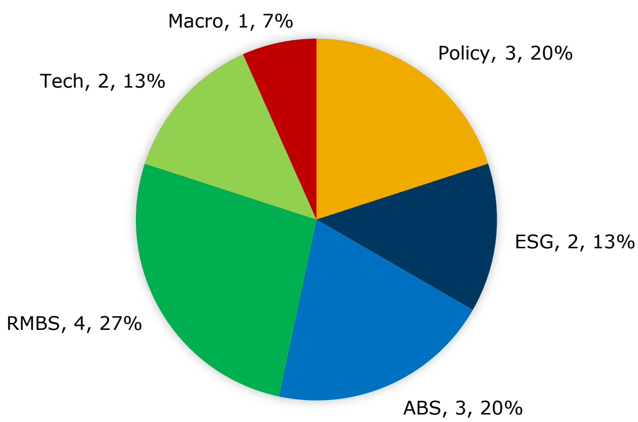
SFVegas 2022 Conference – Tuesday Recap

The morning began with opening remarks from Patricia Schulze, SFA Board Chair, followed by two plenary sessions focused on the impact of the midterm elections on the financial sector and broader economy, and environmental, social, and governance (ESG) considerations in the housing market. The afternoon was once again allocated to a number of breakout panel sessions, with topics ranging from RMBS, ABS, and CMBS market outlooks, to panels focused on ESG and macro/policy discussions. Below is a brief recap of the day's panel topics:

Figure 1: Breakdown of Tuesday Conference Panels



Sources: KBRA, SFA

ESG in Housing: Leading With Purpose

In the context of record-breaking temperatures in Europe and a global housing and affordability crisis magnified by U.S. inflation at 40-year highs, the panel began with a discussion of the current state of ESG. The panelists, who represented industry participants including two GSEs, a private label issuer, and an environmental advocacy group, broadly agreed there has been some progress on incorporating ESG in the multifamily market compared to the single-family market, where it is still in the early stages. More broadly, ESG as a concept took root in the financial markets in the 1980s and 1990s, with greater corporate backing over the past five to 10 years as boards have recognized ESG considerations (including climate change and inequality considerations) as fundamental to companies' overall missions.

After setting the stage with the current state of ESG, the conversation turned to investor demand for ESG products. Depending on their mandate, investor demand ranges from a simple "E," "S," or "G" bond label to verifiable use-of-funds impact, with investors ultimately keen to understand the securitization performance of ESG products. Above all else, investors are seeking data that allows them to evaluate financial risk and impact. However, the panelists acknowledged that we are in the early days of disclosure standardization, and the development of common, broadly understood standards will be critical for disseminating useful and comparable data that will facilitate growth of the ESG marketplace.

The panel concluded with a broader discussion of environmental and social issues, and where the two intersect. Insurability against flood and wildfire is important particularly in the context of 30-year mortgages—in recognition that flood zones are changing and flood severity is increasing. Regarding social considerations, the GSEs have a mission to promote home ownership and increase equity for underserved communities. Energy-efficient housing not only reduces carbon emissions, but also reduces operating costs for the underlying borrowers. Finally, technology was highlighted as the biggest ESG opportunity for the housing market in that it will facilitate the mortgage process, provide more information to investors, and hopefully lower operating costs, creating stronger returns for ESG products and greater stability for borrowers.

Esoteric ABS Market

Esoteric ABS remains a sizable portion of the overall ABS primary market, currently comprising approximately $5 billion of the roughly $20 billion-$25 billion of monthly new issue supply. While new issue volumes are expected to remain strong, some issuers have recently looked more toward 4(a)2 private placements and flow agreements, as a means to diversify liquidity sources.

Panelists discussed potential headwinds for the sector, including ongoing inflation and rising recessionary risks, but the overall sentiment for the sector was constructive. The esoteric market is typically more exposed to corporate credit risk than the consumer ABS market, which may insulate it from some of the headwinds that consumers are facing. While data availability in the esoteric market is a concern for some investors, issuers continue to enhance their disclosures as the segment matures. As a result, investor acceptance continues to widen.

Overall, panelists were optimistic for future issuance volumes and credit performance, even with rising economic headwinds. The sector also provides attractive yields for investors who are able to do more research to understand the nuances of the specific sub-asset class and issuer.

RMBS Market

The panelists expressed a somewhat muted sentiment about the current state of the U.S. economy and the implications to the broader RMBS market. A popular theme was the frequency and magnitude of the Federal Reserve's interest rate changes: if interest rates continue to increase in the short to medium term, home affordability will continue to decline and investor confidence will plummet. Minor home price corrections are emerging at the national level but there are certain geographical pockets experiencing deeper declines. Prime jumbo and GSE issuances are down from their 2021 and early 2019 levels, respectively.

Given the current state of the economy, refinancing opportunities are diminishing and contributing to the attractiveness of home equity lines of credit (HELOC) and closed-end second lien mortgages. Although there are some consistencies occurring in 2022 with the global financial crisis, there are notable differences, namely, low unemployment rates, transparent underwriting practices, and rising home equity levels.

CRT Market

Panelists described the changing spread environment for CRT (CAS and STACR) bonds and the main factors contributing to the spread widening. Panelists stated that spread levels have significantly widened for both the B1 and M2/M3 level tranches from their 2021 levels. The spread widening was attributed to: (i) increased deal issuance and supply, (ii) structural changes such as the optional call provision; and (iii) the macro environment. Spread levels have made issuance challenging and has resulted in reduced deal sizes and greater retention from Fannie Mae on the B classes (~50% versus 5%).

Panelists noted that the performance of CRT transactions has been strong. Earlier vintage deals have benefited from a strong housing market and increased home prices, while the panelists noted that the collateral characteristics of the 2021 vintage CRT transactions were historically very strong. Additionally, the panelists stated that strong home price growth coupled with the strong collateral characteristics and recent spread widening have made the CRT bonds attractive from a relative value standpoint.

Fannie Mae also provided an update to its expected CAS issuance outlook. The GSE initially expected issuance in a range of $13 billion-$15 billion, but now anticipates $10 billion-$11 billion with three to four more deals expected in 2022.

ESG Trends and Outlook in Structured Finance

The panel discussion opened with the increasing awareness of environmental impact as a risk factor and opportunity. Beginning with opportunities, large clients (including central banks and insurers) are seeking more environmentally conscious products to meet their mandates. Over the past several years, there has been a burgeoning of green bonds to meet this demand, namely Agency energy and water-efficient issuances. Regarding risks, the panelists noted the need to extend climate resiliency across the underlying collateral, as well as the need for building codes to be updated to reflect risks that are changing with the climate.

A second trend discussed was the proliferation of long-dated, aggressive corporate commitments, namely net zero commitments. While these types of corporate commitments have succeeded in other areas, including weapons proliferation, the discussion turned to how commitments made by a corporate issuer can transform into issuer lending practices and the ESG qualities of the underlying collateral. More broadly, ESG frameworks and regulatory proposals have generally been designed for the corporate and equity landscapes, and additional work is needed to translate these initiatives into the structured finance market.

The panel then turned to a discussion on how the recent Supreme Court ruling in West Virginia v. EPA will limit the agency's oversight in climate matters and, more broadly, how other regulators will likely be more constrained by the ruling. While panelists agreed that the ruling will likely result in regulators taking a more cautious approach to avoid being seen as overstepping their delegated authority, there is robust environmental rule-making being discussed at the state and local levels.

Aircraft ABS

The rising cost of capital has made securitization less attractive for some aircraft ABS issuers, while increased pricing volatility has led some issuers to seek financing in the private placement market. As the industry continues to face challenges, some panelists noted that aircraft ABS servicers are increasingly under the microscope as investors seek out servicers who can continually maximize lease cash flows.

As we emerge from the pandemic, new deals coming to market have added structural enhancements such as a more reactive DSCR test, using a three-month look-back rather than a six-month. The stronger post-COVID ABS structures and pent-up demand for travel should support credit fundamentals moving forward. In addition, inflationary pressures should positively impact future aircraft lease rates, especially for narrowbody new generation aircraft.

Single-Family Rental Market

The panel members expressed a positive view of the SFR market. While leverage has been increasing over the past few years, the last 12 months have seen leverage declines due to higher interest rates and lower rental yields. Additionally, the secondary market remains strong with trading volumes rising, which is a testament to the market appetite for the asset class.

Two areas highlighted by the panel were technology and ESG. Innovation in technology has decreased the reliance on manual appraisals, with models now providing more comparable home values at a much faster speed. Other technological innovations have improved overall operations of the rental properties—an example of this is the use of blockchain to track rental payments. There was a consensus on the panel that ESG reporting is needed and that standardizing will be crucial.

Questions about the skepticism and demonization of institutional investors acting as operators in the rental market space were poignantly addressed by the panel. Most notably, while roughly 15%-20% of the U.S. housing marketing is made up of rentals, large institutional investors only make up about 3% of those rental operators. Also mentioned by the panel was that large institutional investors can often have more flexibility than mom-and-pop rental operators to work with renters in tough times to help ensure tenants are able to stay in their homes.

Mortgage Servicing Rights

The panel began with a general discussion of economic factors, along with yet to be completed GSE servicer eligibility requirements. The mandates, likely to be implemented in 2023, will increase capital requirements as well as servicing costs. Panelists discussed the likely servicer consolidation that could result as a consequence of the regulatory mandates.

MSR hedging strategies were discussed, along with the impacts of home price changes. MSR securitization finance was also discussed. In the wake of the GFC, the historical shift from large depositor mortgages providers/servicers to nonbanks spurred the need for MSR financing, thus creating MSR securitization.

Investor demand for MSR-related assets was predicted to continue to be strong, with more financing options as the market has matured. The generally counter-cyclical nature of MSRs was discussed, along with recent more costly financing, given market conditions. Additionally, the servicer recourse nature of current deals and the potential, with increasing investor comfort, to explore non-recourse transactions was also discussed.

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