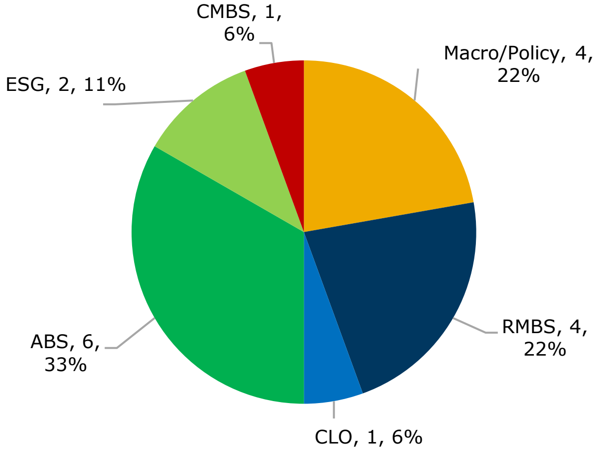
SFVegas 2023 Conference: Tuesday Recap

Tuesday began with opening remarks from SFA Board Chair Patricia Schulze, followed by a plenary session focused on the macro-political environment and the political headwinds that could affect markets in 2023. The afternoon was once again allocated to a number of breakout panel sessions, with topics ranging from ABS, CLO, RMBS, and CMBS market outlooks, to panels focused on environmental, social, and governance (ESG) and macro/policy discussions. A breakdown appears below, which is followed by highlights for select panel sessions.

Figure 1: Breakdown of Day 2 Conference Panels



Sources: KBRA, SFA

Project Finance CLOs

Panelists provided an overview of the project finance and infrastructure (PF&I) CLO ecosystem before jumping into trends and other topical issues. Underlying PF&I portfolios can be composed entirely of PF&I loans or, in some cases, a combination of PF&I loans and broadly syndicated loans (BSL) from more diverse corporate sectors. PF&I loan underwriters typically focus on visible, near-term contracted cash flows from specific projects that can be used to service debt. These loans typically come with mandatory amortization in the form of scheduled amortization or cash flow sweeps. Portfolios tend to be chunkier than pure BSL portfolios, with a majority of the loans categorized based on specific PF&I subsectors, which include infrastructure, power production, renewables, and utilities. The panelists indicated that the loans tend to have higher credit quality than typical BSL loans from both a ratings and recovery perspective.

Fitting a portfolio of PF&I loans into a CLO-style securitization creates a structured product that can be tranched and sold to different types of investors depending on risk tolerance. The CLOs look and feel like traditional CLOs, with three- to four-year reinvestment periods, non-mark to market term financing, cash flow diversion mechanisms that include coverage tests, and rating agency collateral quality tests. Balance sheet PF&I CLOs are typically used as financing vehicles, with ongoing sponsor commitment making them comparable to middle market CLOs. Others can be more arbitrage-driven.

As for investors, one panelist noted that there is typically more diligence performed for PF&I CLOs given the size of the portfolio. Investors typically look for a more fully ramped portfolio compared to a BSL CLO: While BSL investors can get comfortable with two-thirds of the portfolio purchased and/or assigned at close, a PF&I CLO investor might look for >90% portfolio visibility prior to investing capital. Panelists noted that given the groundwork laid in recent years, this asset class should continue to attract capital market financing interest going forward.

Unsecured Consumer ABS Market

The panelists kicked off with a discussion on the state of the U.S. economy and health of the U.S. consumer. One panelist expected a mild economic recession in 2023, with unemployment going up to 4.1% at year-end and 4.7% by mid-2024. Some were more optimistic, noting that lower interest rate volatility, less liquidity risk, and a potential soft landing may contribute to positive investor sentiment in 2023. Regarding consumer credit fundamentals, all panelists agreed that persistently high inflation, a decline in personal savings, customer behavioral changes, and relaxed lending standards have contributed to a deterioration in credit performance over the past year, especially in the subprime sector. Panelists also provided their thoughts on the consumer’s payment priority in a stressed economic environment, with one panelist noting a recent survey that indicated mortgage/rent, auto, and credit card payments are among the top priorities for consumers.

From a loan product perspective, the panelists discussed a divergence in asset performance between fintech and traditional lenders, with fintech loans deteriorating more than traditional ones. Most believed that lending for specific (such as home improvement, health care, veterinary, etc.) would be the next growth area in the unsecured consumer sector. The panelists also noted that a diverse funding strategy—with a combination of ABS, warehouse facilities, whole loan sales, and equity—would be best suited for supporting origination volume growth in an uncertain economic environment.

Solar ABS

While still considered esoteric, solar ABS was noted to be a robust asset class with growing market acceptance. The ESG component is also making the asset class more attractive to investors. Solar ABS issuance has been growing, and 2022 was a record year with 14 solar ABS transactions totaling approximately $4.4 billion in issuance. Last year also saw the issuance of two inaugural ABS transactions backed by commercial and industrial solar loan—a new asset class. The commercial and industrial solar space is less standardized compared to residential solar loans, which has made securitization in those areas loans more challenging.

Approximately 4% of U.S homeowners have solar panels, and panel participants expect continued growth in originations supported by new originators, including manufacturer-provided financing options. Panelists also pointed out that solar loan originations currently outpace leases and power purchase agreements. Recent trends in the sector include the lengthening of terms to 25-30 years, a slowdown in prepayment speed, and an increase in rates to 2.99% from 0.99% to account for the rising rate environment.

CRT Market

The panel discussed the current state of the CRT market and the outlook for 2023. While 2022 started off very strong, there was a noticeable pull back in the latter half of the year, which is expected to continue into 2023. Throughout much of last year, the housing market was seeing both rising house prices and mortgage rates, which was raising the question of what will happen down the road. Ultimately, housing went from roughly a 20% house price appreciation to nearly no appreciation at this point in 2023. However, due to the high price appreciation over the course of the past few years, there was limited concern from the panel for seasoned CRT deals that have benefited both from the previous house price appreciation as well as prepayments, which increases the credit enhancement in these deals.

The panelists' outlook for 2023 suggested that while a mild recession is expected, the drivers for the CRT market will be unemployment and whether the Federal Reserve raises rates. At present, the unemployment rate remains historically low, and borrowers have remained strong as demonstrated with slightly elevated FICOs. This can all help support the CRT market in 2023. On the other hand, if the Fed increases borrowing rates, then mortgage rates can continue to rise, which will likely bring down home prices and impact deals more adversely.

Auto ABS Market

The panel kicked off with a discussion on recent trends in auto loan credit performance. It was noted that prime auto loan delinquency rates are quickly rising, but they remain low versus pre-pandemic levels and well below those seen during the global financial crisis (GFC). However, non-prime delinquency rates climbed to the highest levels on record in January, and now stand at 6.1%, 40 basis points higher than pre-pandemic highs and a full percentage point above peak delinquencies during the GFC. Panelists believe that much of the current weakness can be explained by a "normalization" of credit performance, as the effects of federal stimulus have largely dissipated. However, with consumers continuing to face inflationary pressures, rising interest rates, and a slowing economy, consumer fundamentals will likely weaken further.

Eric Neglia, KBRA Senior Managing Director, Head of Commercial and Consumer ABS, discussed a number of collateral and credit metric trends. Loan balances have increased with rising car prices leading to higher monthly payments. However, loan-to-values have remained stable as down payments rose. Annual percentage rates remained steady through December 2022 as competitive pressures in the industry made it challenging for lenders to pass higher issuance costs to consumers.

From a capital markets perspective, panelists discussed how credit spreads widened during the 2H 2022 but over the past few months have tightened considerably. Increasing spreads toward the end of last year led to a compression in excess spread within new issue securitizations. To compensate for both this and higher expected loss rates, transactions had higher initial overcollateralization levels. New issue supply is expected to be flat in 2023.

Top Legal Issues Facing Our Markets

The panel started by covering Consumer Financial Protection Bureau (CFPB) v. National Collegiate Master Student Loan Trust (NCSLT), whereby SFA's counsel has filed amicus briefs in which the CFPB contends student loan trusts are subject to enforcement liability under UDAAP. The panel also discussed several other cases involving challenges to CFPB leadership and funding structures. The day before the panel was held, the U.S. Supreme Court agreed to hear the latest funding challenge involving a payday lender. That decision could have wide-ranging implications if the funding structure is held to be unconstitutional, and remedies are difficult to predict. One panelist noted that the current Supreme Court was not reluctant to take on controversial cases.

On the day the panel was held, there was also widespread publicity surrounding arguments before the Supreme Court that involve student loan forgiveness. This was also discussed by the panel, with many noting some critical questions regarding the plan's legality. The panel also discussed a case related to the limits of attorney-client privilege in the context of securitization as well as the implications and expenses of complying with corporate reporting obligations taking effect at the start of 2024.

The Next Phase of Credit Score Integration in RMBS

The panel discussed the use of VantageScore to gauge borrower risk in contrast with the more traditional FICO scoring models. They cited an advantage of VantageScore in capturing payment trends. The panel indicated that the new scores are built to be more inclusive of underserved communities, like millennials and minorities and lean heavily on payment patterns. This view, along with machine learning and the inclusion of different communities, allows these models to be more predictive than legacy scores.

This scoring method also includes alternative payment contracts that may not have been included in classical FICO scores, such as rental payments, auto payments, and telecommunications payments. Additionally, there is the ability to include other types of payments in the future as they become more prevalent, which should increase the predictive nature of these new scoring models. The panel contended that this is the first real innovation in the borrower scoring landscape in the past 15 years, guidance from the Federal Housing Finance Agency and government-sponsored enterprises is crucial, as well as the continuous inclusion of more data to help hone the model and prove its utility to investors and underwriters.

Concluding Remarks

The conference remained heavily trafficked throughout the day as market participants tried to make sense of the dynamic and complex market environment. As observed on Monday, there continued to be a general lack of conviction about where the market goes in the coming months. That said, it appears the primary market will remain relatively active, as investors have plenty of money to put to work and issuers continue to view the securitized market as an attractive source of funding. With that, we conclude our coverage of SFVegas 2023 and encourage market participants to reach out if they wish to discuss the general landscape.

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