ABS East 2021 Conference Notes

Mark Adelson

Mark Adelson
is an independent consultant, the editor of *The Journal of Structured Finance*, and the content director at Portfolio Management Research in New York, NY.
m.adelson@pm-research.com

KEY FINDINGS

- The structured finance market has had a good year in 2021, with issuance volumes exceeding the levels of 2020.
- The strong credit performance (low losses) on many asset classes during the pandemic is largely attributable to government stimulus and relief measures. This could create a challenge for modelers because performance data from 2020 and 2021 likely do not reflect what can reasonably be expected in the future.
- Market participants are increasingly embracing ESG goals as an aspect of the investment process. Key challenges remain, however, in precisely defining ESG goals and deciding what specific activities promote them.

ABSTRACT

The recent 27th Annual ABS East Conference at the Fontainebleau in Miami Beach attracted roughly 1,500 attendees from issuers, investors, and government entities. The conference started on Monday, December 13, 2021, and ran through Wednesday, December 15, 2021. The conference was a hybrid event that allowed remote participation via the Internet. The overall mood was strongly positive. This report covers 18 sessions from the event, including the general sessions on Tuesday and breakout sessions covering ESG, the pandemic, mortgage-backed securities, consumer ABS, equipment lease ABS, and aircraft ABS.

SESSIONS COVERED — PAGE

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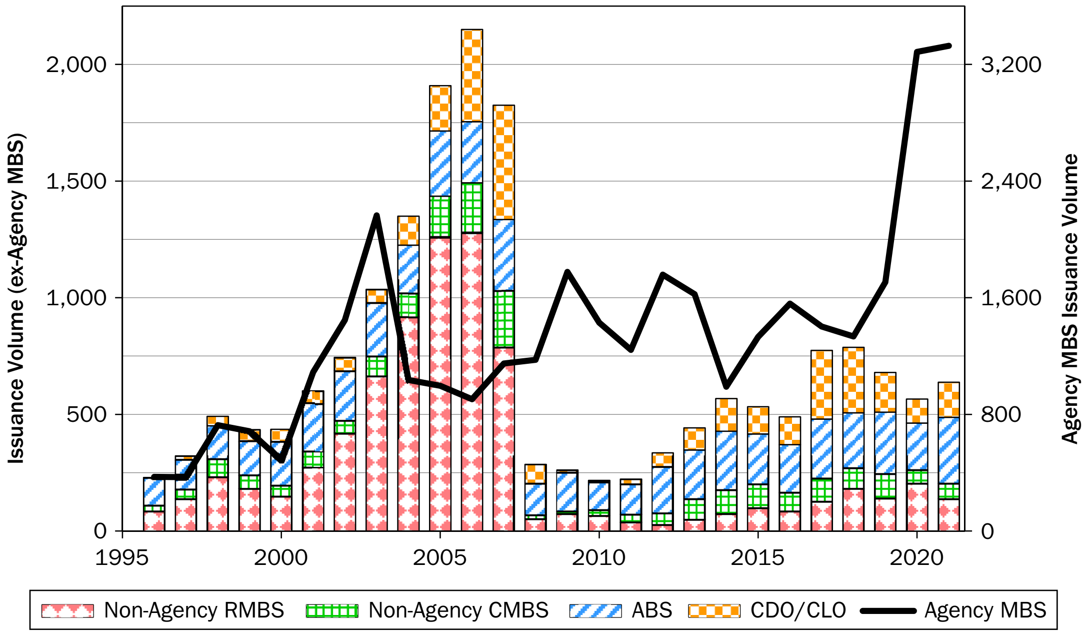
Key themes at the conference included consideration of environmental, social, and governance (ESG) issues by investors, the challenges of the COVID-19 pandemic, inflation, and the potential for home prices to experience a reversal following strong growth of 18% in 2021. With respect to ESG, panelists generally agreed that ESG considerations are likely to remain a permanent fixture on the investment landscape, but it is unclear how standards for promoting ESG objectives will evolve. Although the environmental dimension has reached a more advanced stage than the others, there is a lack of consensus about what environmental objectives should be. For example, is natural gas transmission an area that should be promoted or shunned? What about nuclear power?

Agency MBS continues to dominate the US securitization landscape, with 2021 issuance exceeding $3.3 trillion through November (Exhibit 1). Most other sectors have already beaten their issuance levels of 2020. US residential mortgage loan originations are on track to reach roughly $4 trillion for 2021.

The following summaries reflect the remarks of the panelists who participated in selected sessions at the conference. For the most part, the summaries are drawn from notes that I took during the sessions (attending virtually). The summaries have not been reviewed or approved by the panelists. Although I have tried to capture panelists' remarks accurately, I apologize in advance for any inaccuracies and omissions. In addition, I acknowledge the excellent work of Information Management Network in organizing and hosting the conference. For a list of the abbreviations used in these summaries, see Exhibit 2.

EXHIBIT 1

US Structured Finance Issuance Volume ($ billions)



NOTE: 2021 is through November.

SOURCE: SIFMA.

EXHIBIT 2

Abbreviations in This Article

ABS	asset-backed security
CFPB	Consumer Financial Protection Bureau
CMBS	commercial mortgage-backed security
CRE	commercial real estate
CRT	credit risk transfer
DTI	debt-to-income ratio
ESG	environmental, social, and governance
EV	electric vehicles
FHA	Federal Housing Administration
FIIN	Fixed Income Investor Network
GSEs	the government sponsored enterprises Fannie Mae and Freddie Mac
LTV	loan-to-value ratio
IC	internal combustion vehicles
LEED	Leadership in Energy and Environmental Design
MBS	mortgage-backed security
MISMO	Mortgage Industry Standards Maintenance Organization
NFT	non-fungible token
QM	qualified mortgage
REIT	real estate investment trust
RMBS	residential mortgage-backed security
SFR	single-family rental
TBA	"to be arranged" trading of agency MBS
TPR	third-party review
VA	Veterans Administration

MONDAY, DECEMBER 13, 2021

1:00 pm: ESG Hub: Analyzing and Implementing a Taxonomy

One panelist explains that investors should be careful in setting ESG goals. Measuring ESG progress can be difficult. For example, it can be impossible to measure the carbon footprints of all portfolio companies. ESG can be viewed as having three stages: (1) blacklisting certain industries or companies because of negative ESG attributes, (2) whitelisting favored companies and industries, and (3) active engagement with portfolio companies to promote ESG progress. Regulatory ambiguity and limited availability of data are challenges for investors pursuing ESG goals.

Another panelist explains that it has been possible to target environmentally and socially themed investments for some time. In considering potential investments in environmental assets, key considerations include credit risk, exposure to climate risk, and the impact of the asset on promoting sustainability objectives. Evaluating the ESG risk or merit of a potential investment should be approached broadly and holistically. Investors need to guard against unintentional greenwashing in their own ESG analysis by using overly rigid or narrow criteria. Significantly, there is only 0.6 correlation among the ESG ratings of key ESG rating providers.

A third panelist highlights the importance of property-level environmental issues, particularly in CMBS.

One panelist asserts that there are really four dimensions to ESG. The first is environmental, which is the most developed in terms of measurement. The second is the social dimension, which remains somewhat vague. The third is governance, which is viewed mostly at the company level for participants in a securitization transaction. The fourth dimension is transaction documentation, which can be viewed as another aspect of governance.

Another panelist notes that the social dimension of ESG includes aspects such as diversity of board membership (i.e., inclusion of women and minority board members).

A third panelist observes that investment in electric vehicles (EV) may be preferable to investment in internal combustion (IC) vehicles apart from any environmental considerations. IC vehicles may become stranded assets as operating EVs becomes more economical than operating IC vehicles over the coming decade.

Starting next year, the ECB will require banks under its supervision to report on the environmental aspects of assets in their portfolios.[1] It is likely that the ECB will implement favorable risk-weights for environmentally positive assets and higher (less favorable) risk weights for environmentally negative assets.

Several panelists remark on the difficulty of measuring ESG factors. One notes that investment in US affordable housing is important along the social dimension. The US EPA is a great source for ESG-relevant data on the auto sector.

1:45 pm: Distressed Credit Trading Opportunities in the Commercial MBS Market

One panelist explains that the onset of the pandemic brought widespread uncertainty and forced-selling in the structured finance market. This created opportunities in the public markets, but the opportunities were short-lived in most sectors. They persisted somewhat longer in certain sectors, such as the lodging and office subsectors within commercial real estate. Central bank intervention ameliorated the stressful conditions. Opportunities in the public markets ultimately evaporated. The private market offered opportunities for a somewhat longer time, but those ultimately disappeared as well. Current market conditions do not reflect a distressed environment.

Another panelist asserts that distressed trading levels persist for many subordinate CMBS tranches from the 2012 through 2015 vintages. Retail malls are the source of the greatest distress. Within that subsector, 73% of properties are underwater at a 12% capitalization rate. The enclosed mall industry faces a number of key risks including maturity risk. However, servicers are likely to allow borrowers a great amount of flexibility as loans reach their maturities. Current trading levels for CMBS with exposure to shopping malls may reflect an excessively pessimistic outlook for those properties. Consumer spending, the stock market, and home values are all at record levels. These factors suggest a positive outlook for shopping malls.

A third panelist asserts that there are pockets of opportunity in the CRE/CMBS area. The market recovered very strongly and quickly from its lows in 2020. The CMBS market offers opportunities of limited size: up to roughly $100 million at a time. Opportunities in larger size may be available in REIT equity.

[1] European Central Bank, *Guide on Climate-Related and Environmental Risks—Supervisory Expectations Relating to Risk Management and Disclosure* (Nov. 2020), https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.202011finalguideonclimate-relatedandenvironmentalrisks~58213f6564.en.pdf.

One panelist emphasizes the importance of scenario analysis and considering the full range of plausible scenarios: 20% unemployment, 30% unemployment, etc. It is important to consider the balance of upside opportunity and downside risk in the context of the scenarios. Another panelist asserts that there are potential opportunities in office and lodging properties. A third panelist observes that the market is very illiquid for "banged-up" subordinate CMBS tranches. Examples of opportunities includes tranches with thin credit support but clean collateral performance.

One panelist adds that the ability to exploit current opportunities depends on an investor's willingness to hold illiquid assets for potentially extended periods. Another panelist explains that future opportunities will arise when market psychology is driven largely by fear. A third panelist observes that the next episode of stress could be triggered by the tapering or termination of stimulus by the Fed.

2:30 pm: ESG Hub: Applications to MBS

One panelist observes that ESG is a big topic and it is here to stay as a fixture on the investment landscape. The E, S, and G aspects of ESG represent different missions, and different investors ascribe differing meanings and importance to each one. Additionally, some investors are willing to sacrifice returns to pursue ESG goals; others believe that pursuing ESG goals will enhance returns (i.e., doing well by doing good).

Another panelist notes that investors consider whether ESG-aligned securities price at a premium to non-ESG-aligned securities. Fannie Mae and Freddie Mac have long histories of issuing securities aligned with ESG goals. Securities that support affordable housing are aligned with social goals and those that support multifamily housing are aligned with environmental goals. A third panelist asserts that some of the premium attributed to ESG-oriented securities may be illusory and merely a reflection of data issues. A fourth panelist states that Ginnie Mae promotes the social dimension by specifically tagging securities backed by loans concentrated in low-to-moderate-income areas. Ginnie Mae also gives an insurance discount for loans on LEED-certified (Leadership in Energy and Environmental Design) properties.

One panelist re-emphasizes the importance of data in ESG analysis. Census tract (geospatial) data and climate hazard-risk information are the most important.

Another panelist asserts that low- and moderate-income homeowners have not received their fair share of the benefits from recent home price appreciation. This is indicated by the low share of recent cash-out refinancings by FHA/VA borrowers relative to borrowers on conventional GSE loans.

A third panelist observes that Fannie Mae claims to be the world's largest ESG issuer. Fannie Mae claims that it can accurately measure the environmental impact of its activities.

One panelist argues that investors should demand improved information and reporting on ESG factors. Improved information is necessary so that investors can guard against greenwashing and assess whether a given investment actually promotes ESG objectives.

Another panelist explains that an issuer's ESG representations may cause litigation if it does not adhere to them. Investors might sue issuers if they breach their ESG commitments.

A potential issue for the agency MBS market is that adding ESG considerations to MBS trading might undermine liquidity in the TBA market.

3:45 pm: FIIN Task Force: Consumer ABS

One panelist remarks that the recent strong performance of consumer receivables is partly attributable to economic stimulus. Another panelist states that although the recent performance of consumer receivables has been strong, households at the lower tiers of the economic spectrum are under stress. A third panelist asks what will be the “canary in the coal mine” to reveal when performance starts to deteriorate.

One panelist notes that recent increases in household wealth have come mostly from asset appreciation, which means that nonhomeowners did not share in the gains. On the other hand, overall household wealth has increased significantly. Going forward, the task for investors will be to discern which segments of the population are represented in the underlying pools of the securities in which they invest. When stress arrives, it will have a much more adverse effect on consumers from the lower economic tiers.

Auto ABS offer an example of the difficulties that investors face today. Used car values are currently inflated. This has been a source of wealth for some consumers. However, it seems imprudent to expect the values to remain high after the current supply chain issues and computer-chip shortages are resolved.

Consumers expect inflation to be high for the next 12 months. That expectation is a problem for the Fed. Wells Fargo recently predicted that 2022 inflation will be 5.2% and then return to slightly above 2% in 2023. The Fed is likely to raise interest rates by at least 1 percentage point in the near term.

Student loans are a wild-card asset class. Supportive policies are likely to expire next year. This could produce stress in 2022Q4. Likewise, a resurgence of Covid also could trigger the onset of stress. The US will likely be affected by the global progression of the pandemic; shutdowns and similar policies in other major countries like the UK and China will affect the US.

ABS issuance in 2021 is greatly outpacing last year’s issuance. Esoteric deals historically have offered wider spreads than mainstream ABS but now the margin is narrowing. Spreads are tight across the board.

Consumer ABS (and securitizations in general) have to compete with hot equity markets, SPACs, and private equity transactions.

Crossover corporate buyers are coming into the securitization market for senior ABS. The single-A level of capital structures is somewhat neglected.

The payday lending sector may face regulatory issues even if it does not encounter credit problems.

Certain sectors, like cannabis investing, may offer opportunities because many investors cannot invest in them. Also, ESG-negative assets may offer opportunities because many investors will shun them

Apart from raising rates, the Fed’s tapering of security purchases may reduce liquidity.

4:30 pm: Pandemic Recovery Assessment: The RMBS Market

One panelist asserts that the pandemic was the most severe shock to the economy since the Great Depression. However, the relief programs, including the Cares Act,[2] have had a strongly positive effect. Other relief measures included moratoriums on foreclosures and evictions and enhanced unemployment benefits. The GSEs were very quick to act in response to the pandemic. They allowed greater flexibility in loan originations during the pandemic.

[2] CARES Act, Pub. L. No. 116-36, 134 Stat. 281 (27 Mar 2020), https://www.govinfo.gov/content/pkg/PLAW-116publ136/pdf/PLAW-116publ136.pdf.

Another panelist observes that the impetus for the Cares Act was to get as much assistance to borrowers as quickly as possible. Forbearance programs were key. Fannie Mae and Freddie Mac took the approach of trying to keep loans in pools. Ginnie Mae was different because Ginnie Mae servicers were the ones to decide when to buy loans out of pools.

A third panelist explains that servicers faced major challenges during the early stages of the pandemic. Engineering work-from-home arrangements was one challenge. Funding mandatory advances on loans in forbearance was another challenge.

State law was also a key challenge for servicers because different states implemented differing relief measures. CFPB requirements (and enforcement) were another layer of challenges for servicers.

Another panelist emphasizes the unprecedented nature of the recovery from the period of severe stress during the early stages of the pandemic. Losses have been essentially nil, so far. Moreover, even though forbearances are now ending, there has been substantial home price appreciation, which mitigates the risk of defaults by borrowers that have used forbearance.

The pandemic has brought about major societal changes in terms of regional migration and working arrangements. The full effect of those changes on securitizations remains to be seen. For example, a push to return to in-office work may create pressure on home prices while providing a boost to office property values.

A near-term challenge for servicers will be contacting borrowers in forbearance programs because those borrowers may be reluctant to answer their phones. This may delay buy-outs of loans from agency pools. On the other hand, Fannie Mae has a 24-month limit on keeping delinquent loans in pools.[3]

The federal eviction moratorium has ended.[4] However, there is still a $46 billion federal rental assistance program. Also, there are local and regional rental assistance programs. This should prevent an avalanche of evictions for at least several months. Likewise, recent strong home price appreciation is likely to prevent an avalanche of foreclosures on loans that are coming out of forbearance. Modification programs will likely be used to help avoid foreclosures.

Redefaults on modified loans are likely to be high. Loan extensions may be a solution.

Mortgage rates are very low and the labor market is strong. This suggests a strong outlook for continued strong home price appreciation in 2022. On the other hand, homes may be currently overvalued. If home prices snap back, this could produce significant stress. Housing demand is currently strong and supply chain issues are constraining home supply. However, when pandemic-driven demand abates and supply-chain issues get resolved, the overvaluation may be reversed. Even if strong home prices persist through 2022, they could be reversed the following year.

The mortgage origination process changed during the pandemic. One development was greater use of appraisal waivers on GSE loans. Another development was greater use of electronic signatures. The use of credit score alternatives also became more common. Some changes are likely to persist in 2022 and beyond.

Servicer reporting has been a problem. Servicers have been overwhelmed and have had to outsource various activities, which has created gaps and inconsistencies in reporting.

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[3] Fannie Mae, *24 Month Delinquent MBS Loan Reclassification—Fannie Mae Process Requirement* (Oct. 28, 2020), https://singlefamily.fanniemae.com/media/24216/display.

[4] After a series of several extensions, the CDC moratorium on evictions was set to expire on July 31, 2021. The Supreme Court ruled in early August that the CDC had exceeded its authority in establishing the moratorium. *Alabama Assn. of Realtors v. Dept. of Health and Human Services*, 594 U.S.__ (2021) (No. 21A23), https://www.supremecourt.gov/opinions/20pdf/21a23_ap6c.pdf.

One panelist expects foreclosure rates to be very low in 2022, partly because many of the lawyers that used to process foreclosures before the pandemic now do other things.

TUESDAY, DECEMBER 14, 2021

8:45 am: IMN & FIIN ABS East Welcoming Remarks

Two key themes are the post-Covid world and ESG. The end of the pandemic is in sight and there is likely to be something of a return to normalcy. The structured finance market is gradually adapting to incorporate ESG considerations. There are varying definitions of what constitute ESG-favorable activities. Data remains the key for investors to effectively implement their ESG policies. The outlook for 2022 is positive.

9:20 am: The Corporate World Re-Emerging: Pandemic Recovery and Moving Towards a Sustainable Finance Agenda

One panelist observes that money managers are now required to consider ESG factors in managing funds for pension plans.[5] The investment management industry will need to continue to develop metrics and policies for ESG considerations. Increased consideration of ESG factors will extend the availability of the major financing channels to more types of borrowers.

Another panelist explains that the early stages of the pandemic produced a period of severe market stress during which many structured finance securities—particularly subordinate tranches—traded at deeply distressed prices. Most sectors have subsequently recovered. The exception is the CMBS area, where pricing on tranches at the triple-B and double-B credit grades remains deeply distressed. Consumers are doing very well along several dimensions. Unemployment is very low. Home prices are strong and the stock market is at record levels, both of which produce a wealth effect.

A third panelist addresses the social dimension of ESG. Providing financing for healthcare, especially in less-developed regions, is a potential area where securitization may be a tool for promoting progress along the social dimension of ESG.

A fourth panelist observes that the markets reflect the emotions of consumers, issuers, politicians, and others. A key lesson of the pandemic is that people can reach differing conclusions when looking at the same data. Also, it is difficult or impossible to predict the macroeconomic future. The cost of credit and credit availability are disconnected. Credit is cheap for business that can get it, but various sectors have not had access. Economic relief programs were not equally available to all businesses. For example, small business faced challenges participating in support programs. The commercial real estate sector received little or no support.

Even before the pandemic, a broad shift away from shopping malls was underway. However, the pandemic produced greatly heightened stress on commercial real estate. Office space utilization remains very low in some cities.

One panelist explains that the current price levels on CMBS reflect unreasonably pessimistic expectations for the future of shopping malls. The prices imply that many mortgage loans secured by shopping malls are likely to default. The capitalization rates currently being used in property appraisals of shopping malls indicate that 74% of the loans are underwater. However, servicers will probably allow loan modifications and extensions rather than foreclosing because the recoveries on foreclosures would

[5] Exec. Order No. 14030, 86 Fed. Reg. 27967 (May 25, 2021).

be weak and the malls are producing some cash flow with which they can make payments (though not cure all past delinquencies). The performance of shopping malls will be critical to the performance of mezzanine and subordinate CMBS tranches.

The Biden Administration has announced a goal of making the US carbon neutral for electricity by 2030 and carbon neutral overall by 2050.[6] Securitization has a footprint in promoting solar power but it can be greatly expanded on the commercial side. Additionally, securitization is a potentially untapped source of funding to advance nuclear power production.

Although the market is developing metrics for the environmental aspect of ESG, it lacks useful metrics for the social and governance dimensions. Eventually, such metrics will emerge and consideration of ESG factors will become an ingrained part of the investment process.

One panelist states that some investors are buying the control tranches of CMBS transactions while shorting the transactions using derivatives. They intend to direct the servicers to scuttle the deals to profit on the short positions. That practice is unethical and contrary to the basic principles of securitization. It should not be allowed.

10:10 am: Defining the Real Risks to Our Economy Today

One panelist states that inflation (measured by the core PCE price index) is likely to be in the area of 5% for the first half of 2022 and then to drop to the area of 2%. Key factors are the gradual waning of effects from both economic stimulus programs and supply chain disruptions. Another factor is the shortage in the labor supply, which will have continuing effects. Longer term, inflation is likely to exceed the Fed's target of 2%.

Another panelist counters that both fiscal and monetary stimulus have produced extraordinary inflationary pressures and states that inflation will likely exceed 3.6% in 2022. The Fed's current projections and economists' consensus projections are all too low.

The Fed's targeted "neutral" lending rate of 2½% is too low because it is based on a flawed assumption of a 2% rate of inflation and a real interest rate of ½%. The market appears to assume that the Fed will never even get up to a 2½% Fed Funds rate. To combat inflation, the Fed will need to get the Fed Funds rate above the truly neutral level, which likely is higher than 2½%. If the Fed acts slowly, with only two small rate increases per year, it could take several years to bring inflation under control.

There is the risk that significant tightening of monetary policy could trigger a recession. However, there are other challenges, including a declining labor participation rate, that will essentially cap economic growth somewhere below 2½%. In fact, the declining labor participation rate (driven partly by the retirement of baby boomers) could produce record low levels of unemployment. The unemployment rate could even fall below 3%. On the other hand, the recent decline in the labor participation rate cannot be fully explained by older workers retiring. It is possible that many younger workers who have left the labor force will return.

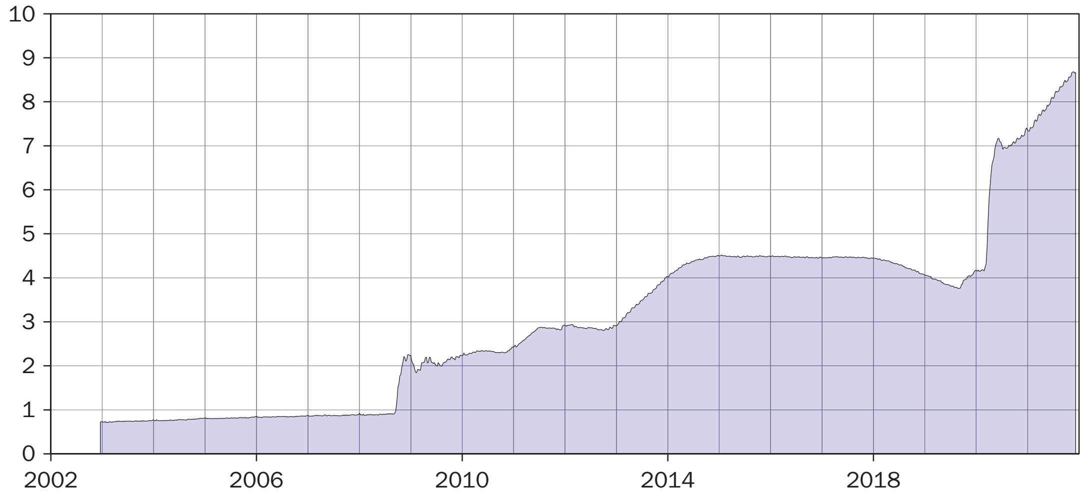
The Fed's balance sheet has gotten huge (Exhibit 3). There will likely be political pressure to shrink it. The process will likely start in 2022. However, previous attempts to shrink the balance sheet did not work. Shrinking the balance sheet would likely create pressure on rates to rise. The market is not expecting rates to rise.

There may be challenges for the treasury market in the intermediate term. Supply is likely to be high for the next five years because of infrastructure programs. At the

[6] Exec. Order No. 14057, 86 Fed. Reg. 70935 (Dec. 13, 2021).

EXHIBIT 3

Federal Reserve Balance Sheet ($ trillions)



NOTE: Starting from December 18, 2002.

SOURCE: Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis (Dec. 15, 2021), https://fred.stlouisfed.org/series/WALCL.

same time, Fed purchases are likely to slow down. These factors are likely to put upward pressure on long-term rates.

The level of the federal debt is a potential issue. Higher rates could significantly increase the burden of servicing the federal debt and create political challenges. It is somewhat ironic that the balance sheet of the household sector is quite strong but the federal government's balance sheet is quite weak.

11:00 am: Keynote Fireside Chat: The Big Gender Short—Presented by 100 Women in Finance[7]

The financial industry has little interest in increasing the proportion of women in its labor force. The proportion of women in the finance industry labor force is actually shrinking. In principle, all other things being equal, meritocracy in a knowledge-based industry should produce a labor force with a higher-than-observed proportion of women.

The absence of high-level female role models means that a lower proportion of women in college are drawn to pursue careers in finance. Another factor is that men in the financial industry tend to display unwarranted confidence in investment products that they are trying to sell; women will display competent and realistic assessments of an investment's risks and rewards. A third problem is that women are paid less than their male colleagues for the same work. A fourth factor is that ambition is viewed positively in men but negatively in women. Unconscious-bias training is unproductive; it actually increases bias. Companies should drop it.

Mentorship is when you talk about someone when they are in the room. Sponsorship is when you talk about someone when they are not in the room. Women need sponsorship and to receive promotions on the same basis as men. Currently, men are often promoted based on potential, but women are promoted based on performance.

[7] The content of this session was based partly on the book *Undiversified: The Big Gender Short in Investment Management* by Ellen Carr and Katrina Dudley (2021), https://www.thebiggendershort.com/.

To advance from the analyst level to become a portfolio manager, an individual must learn to give an "elevator pitch" summary of the key features of a company or other potential investment. Also, to become a portfolio manager, an analyst must learn to think about how different investments in a portfolio correlate, overlap, and interact with each other.

Diversifying a board or other group to include women tends to initially cause performance deterioration. The effect reverses when female representation reaches a level of 30%. Having a low level of representation creates inefficiency by introducing communication hurdles. However, at the 30% level, the hurdles are overcome.

Women are less willing than men to work in industries that engage in practices or activities to which they object.

To attract female applicants, a job description should be written to include only the absolutely necessary skills. The "nice to have" skills should be omitted. Men will apply if they lack listed skills but women are unlikely to apply unless they possess all listed skills.

12:00 pm: Trends in Non-QM MBS[8]

The pandemic created challenges for origination of non-QM mortgage loans. One challenge stemmed from the labor-intensive nature of non-QM originations. However, production volumes have recovered. The overall credit quality of non-QM production is holding steady from the standpoint of LTVs and borrower credit (FICO) scores. There is a small move on the fringes toward loans with weaker documentation of borrowers' ability to repay. On the other hand, strong home price appreciation is making homes less affordable, which creates pressure along the affordability dimension.

From 2012 until the start of the pandemic, non-QM credit criteria expanded gradually to permit somewhat riskier loans. The pandemic triggered a reset of the credit standards to a strict level. The need for forbearances and other relief programs during the pandemic are caution signals for the sector.

One panelist notes that recent non-QM securitizations include loans originated based on three months of borrower bank statements rather than traditional documentation of income (such as tax returns or pay stubs). Recent transactions also include income-based loans with coverage ratios less than one (i.e., the income from a mortgaged property is not sufficient to cover the payments due on the loan). However, even those loans are characterized by conservative LTVs and strong borrower FICO scores. A key point is that highly specialized products are not likely to become a problem as long as they represent only a small portion of securitized pools. Lenders must remain mindful that the highly specialized products are suitable for only a small population of potential borrowers.

Another panelist emphasizes the importance of adhering to underwriting guidelines and the importance of quality control processes to confirm compliance with underwriting guidelines. Maintaining the integrity of the process is key. A third panelist asserts the quality control process for non-QM originations is generally more exacting than that for loans to be delivered to Fannie Mae or Freddie Mac. A fourth panelist counters that Fannie Mae and Freddie Mac have much more power to compel lenders to repurchase loans that are discovered to be defective after delivery.

One panelist observes that the practice of having 100% third-party reviews (TPRs) on non-QM loans remains the norm for the sector. It seems likely that the sector

[8] Non-QM MBS are MBS backed by loans that do not meet the criteria for being "qualified mortgages" under the truth-in-lending regulations. *See* 12 C.F.R. § 1026.43 (2021); Bureau of Consumer Financial Protection, *Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): General QM Loan Definition*, 85 Fed. Reg. 86308 (Dec. 29, 2020).

will embrace a sampling approach, similar to what is used in the prime loan sector. Another panelist counters that many non-QM securitizers will continue to use 100% TPRs to manage their own risks.

A possible explanation for the recently observed high prepayment speeds on non-QM loans is that some borrowers may have taken non-QM loans because they “just missed” the criteria for an agency-conforming loan but can cure the factor that disqualified them reasonably quickly. Then they refinance into an agency-conforming loan.

The GSE underwriting process handles refinancing loans very quickly because strong home price appreciation is producing low LTVs on refinancings. This allows for streamlining the process. By contrast, purchase loans have higher LTVs. A greater share of non-QM production consists of purchase loans. High home prices are producing higher debt-to-income ratios (DTIs), which may prevent borrowers from qualifying for GSE-conforming loans.

One panelist states that 2022 non-QM loan originations could be in the range of $70 billion to $80 billion. However, currently high prepayment speeds mean that MBS backed by non-QM loans will have short projected average lives, which may limit their appeal to traditional MBS investors.

Technology can greatly accelerate the loan underwriting process. Optical character recognition is a key labor-saving technology. It allows computers to extract data from scanned bank statements and other documents to confirm a borrower’s income. The process still requires a quality-control review, but it saves time for the underwriter, who is the bottleneck in the process. One panelist asserts that the ideal case is to have borrowers supply their data in digital form (not PDF) that can feed directly into underwriting systems.

Home prices may be artificially inflated by easy credit availability. However, there is still strong demand for homes from millennials who previously deferred home ownership.

One panelist states that he is comfortable with loans that have DTIs as high as 50% to 55%. Another panelist says that DTIs are less important than a borrower’s residual monthly income.

2:00 pm: Single Family Rental: A Market Heating Up or Prone to Overheating?

One panelist asserts that growth in the single-family rental (SFR) sector is driven by high home prices and the difficulty that many households have in accumulating down payments of 20%. The SFR market may cool off when home prices do. Another panelist asserts that there are many renters who do not want to become homeowners and that there are many households that moved from apartments to SFR properties because of the pandemic. They are unlikely to return to apartments. A third panelist states that the SFR sector will probably continue to grow because many institutional investors are just starting to get into the sector (bringing new liquidity). A fourth panelist observes that 2021 investment in the SFR sector will likely top $100 billion, exceeding the level of investment in multifamily housing.

Securities backed by loans on large, geographically diversified pools of SFR properties display strong fundamentals from a macro perspective. The demand for the housing is very strong and unlikely to diminish. Several panelists assert that the mezzanine and subordinate tranches of SFR deals (tranches at the single-B, double-B, and triple-B credit grades) offer extremely attractive risk-adjusted returns. Rating agencies take conservative stances on the asset class and the effective LTVs for investors in triple-B tranches are in the area of 65%.

The flow of public SFR deals is fueled by both cash-out refinancings of old loans and new loans on new SFR properties.

Panelists have differing views about the interaction of the SFR market and the owner-occupied market. Some view SFR as a step on a household's path toward homeownership. Others view it as a broader solution for workforce housing (i.e., households that will likely remain renters). The fastest segment of the SFR market is operators that own several hundred or several thousand properties. The average value of SFR properties is substantially less than the average value of owner-occupied homes.

Refurbishing obsolete housing stock is a small but important segment of the SFR market.

The SFR market is probably less vulnerable to rising rates than other housing sectors because rents can adjust reasonably quickly in response to inflation.

Some SFR deals include call features. In some cases, the purpose of the call features is to encourage the market to price the deals to the call date. However, in some instances the call features increase average-life uncertainty, which can harm pricing from the issuer's perspective.

The SFR market is fundamentally about affordable housing. Whether or not it offers a path to homeownership, it provides shelter for households that currently cannot afford homeownership.

2:45 pm: Outlook for GSE Mortgage Credit Risk Transfer

Fannie Mae had paused its issuance of credit risk transfer (CRT) securities, but it has announced that it will resume CRT deals soon.[9] Both Fannie Mae and Freddie Mac have recently implemented structural changes in their CRT securities. One change was introducing a five-year call feature. That feature optimizes capital relief under FHFA capital rules for the GSEs.[10] Another development with a similar underlying rationale was the use of tender offers for outstanding securities.

Issuance of CRT securities for the full year will likely be in the area of $22 billion. CRT issuance next year could be significantly higher.

Subordination levels for B1 and B2 classes of CRT securities are likely to remain the same. The subordination levels for M1 and M2 classes might change as the mix of purchase and refinancing loans changes.

Even with high levels of gross issuance next year, net issuance might be modest because of prepayments, calls/redemptions, and tender offers for outstanding securities.

A key risk in recent CRT securities is that home prices may have advanced to unsustainable levels in 2021 and they might decline, causing unexpected losses. Another risk is that borrowers will withdraw equity from their homes with cash-out refinancing, creating risky new loans in the process.

The GSEs are operating with two potentially conflicting objectives: promoting affordable housing and maintaining their own safety and soundness. Although the second objective was temporarily deemphasized, it is recovering its former attention, as indicated by recent GSE statements.[11]

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[9] Fannie Mae, *Fannie Mae Announces Plans to Re-Engage in Credit Risk Transfer in 2021*, press release (Sep. 20, 2021), https://www.fanniemae.com/newsroom/fannie-mae-news/plans-re-engage-credit-risk-transfer-2021. The company priced a $1.2 billion CRT deal on Oct. 29, 2021 and has since executed a number of additional CRT transactions.

[10] 12 C.F.R. Part 1240 (2021); Federal Housing Finance Agency, *Enterprise Regulatory Capital Framework*, 85 Fed. Reg. 82150 (Dec. 17, 2020).

[11] *See generally*, Federal Housing Finance Agency ["FHFA"], *2022 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions* (Nov. 2021), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2022-Scorecard.pdf; FHFA, *2021 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions* (Feb. 2021), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2021-Scorecard.pdf; FHFA, *2020 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions* (Oct. 2019), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2020-Scorecard-10282019.pdf.

Mortgage delinquencies have recovered well since the peak of the pandemic. Interestingly, GSE loans had higher peak delinquencies than jumbo loans. As loans reach the ends of their forbearance periods, some are going to default. However, so far, the loans backing Freddie Mac's STACR CRT deals have outperformed the general population of GSE loans.

CRT transaction structures have evolved significantly over time. There have been significant changes in how they expose investors to risk.

4:00 pm: FIIN Task Force: RMBS

Panelists have differing views about the degree to which Fannie Mae and Freddie Mac expose taxpayers to meaningful credit risk on mortgage loans.

Risk retention requirements[12] and the QM standard[13] change the economics of lending. One panelist states that meeting the standard should not depend on whether a loan is originated through a GSE-conforming channel or otherwise. Another panelist states that mandatory risk retention on securitizations of non-QM loans has been highly beneficial to the market place. It encourages strong credit standards and careful practices. A third panelist agrees that risk retention helps protect investors—especially investors in subordinate tranches of non-QM deals—from having questionable loans slipped into a securitized pool "under the table."

One panelist states that the GSEs are likely to remain under FHFA conservatorship through the end of the current administration. They have charter requirements to promote affordable housing. Fannie Mae and Freddie Mac are profitable companies with a confusing hybrid status. Their dominance in the US mortgage market is constraining the level of fully private participation. There is no getting around the fact that the GSEs are instrumentalities of the federal government and that their affordable housing mission is connected to the larger social and political issues of racial inequality and income inequality.

By promoting home ownership as a social mission, policymakers have encouraged households to place the majority of their wealth in the least liquid and most volatile type of asset. Rental and multifamily housing allows households to place their wealth in other, possibly safer, assets.

Some lenders are offering shared equity (shared appreciation) loans as affordability products with lower down payment requirements.

Affordable housing development faces challenges from both the NIMBY (not in my back yard) faction and the antigentrification faction. Interestingly, though, promoting single-family rental growth also competes with affordable home ownership and cuts into the available supply of homes for purchase.

Home price appreciation was very strong in 2021, at 18%. The strong appreciation has prompted some borrowers to pursue cash-out refinancings to extract equity from their homes. Current guidelines permit borrowers to releverage to very high LTV levels. If home prices correct (decline), many loans could become underwater and be at risk of default.

One can view the ability-to-repay requirements embedded in the QM definition as a socially positive element in terms of ESG considerations. Requirements that lenders assess a borrower's ability to repay a loan help to prevent households from incurring obligations that they cannot meet.

Investors need to remain cautious about the possibility that lending standards will erode and that new MBS deals will be backed by riskier loans. One panelist

[12] *See* for example, 12 C.F.R. Part 43 (2021).
[13] 12 C.F.R. § 1026.43 (2021).

observes that rating agency credit enhancement levels on MBS transactions have been declining since 2012, just as they declined from 2000 through 2006 until stress emerged.

One panelist asserts that investors differentiate among issuers of non-QM MBS on the basis of their underwriting processes. Pricing of the deals reflects that differentiation. Another panelist emphasizes the importance of protective features (i.e., making sure that everything that is supposed to be getting done is getting done). To have a well-functioning market, new transactions must address the deficiencies of older deals with respect to oversight, supervision, and adherence to governing documents and laws.

Millennials are supercharging the housing market. However, homeownership appears less important to many of them. They are forming new households that require housing, which can be either rental or owned housing.

4:45 pm: Sector Update: Aircraft ABS

One panelist explains that aircraft ABS issuance paused in March 2020 with stress from the pandemic. Debt service coverage weakened, tripping triggers in some deals and causing rapid amortization. There were instances of cash flow interruptions. In 2021, conditions recovered significantly. New deals came to market, starting with one by Castlelake early in the year (backed by collateral with an average age of nine years). There was a solid flow of deals backed by strong pools of relatively young, narrow-body aircraft. Later in the year, there were deals backed by refinancings of mid-life aircraft.

Another panelist explains that investors can think of aviation investment as being comparable to investment in real estate. An advantage is that the assets are not tied to a particular location. However, they are often tied to a particular operator (airline). Also, there is a distinction between new assets, mid-life assets, and late-stage assets.

Aircraft ABS issuance was at an all-time high in 2019. It was virtually nil in 2020, and it has recovered strongly in 2021. The aviation industry is very exposed to COVID-19 because the first effect of the virus is to restrict travel, especially international travel. The narrowbody market has recovered more quickly than the widebody market because widebody jets primarily serve international travel. One panelist observes that many airlines are currently flush with cash from relief programs in many countries. Aircraft leasing companies did not receive the same benefits as airlines did, but they were able to survive the period of stress and they are now positioning themselves for growth. The ABS structure helped leasing companies by allowing them to pay just interest without triggering collateral liquidations.

Smaller lessors can be more investor-friendly than larger lessors. Investors will likely have better access to key executives at smaller lessors. Additionally, a large lessor is likely to have many conflicts of interest relating to assets that it manages for its own account versus assets that it manages for ABS deals.

Secondary trading of nonsenior tranches of aircraft ABS can be difficult because there are often stories associated with particular aircraft backing a transaction. Subordinate "C" tranches from legacy deals are trading at discounted prices in the area of 70% of par. Trading in equity tranches is the Wild West. Compared to four or five years ago, there is more liquidity for trading aircraft ABS.

The distinction between narrowbody and widebody assets is stark. Legacy widebody assets are particularly disfavored. Of note, the gigantic Airbus A380[14] aircraft have never been included in aircraft ABS pools (though they have been financed in other types of deals). A key consideration for investing in widebody collateral is the population of operators that use it. Both investors and lessors should want to have commoditized assets that are used by many operators. Even then there are issues: transitioning an aircraft from one operator to another can cost millions of dollars just for changing the seats in the business-class section.

The outlook for the aviation sector in 2022 and beyond is strongly positive. Travel is coming back strongly. One panelist asserts that ESG considerations in the aircraft sector should cover not only the environmental dimension, but also the social and governance dimensions. Another panelist acknowledges that the aviation sector needs to get greener. Newer aircraft designs are much more efficient (greener) than older models. A wildcard for 2022 is the possibility of new travel restrictions coming from surges of the COVID-19 pandemic.

WEDNESDAY, DECEMBER 15, 2021

9:00 am: The Fixed Income Investor Roundtable: Focus Areas for a Post-Pandemic Market

In a quick poll, a majority of the audience (as well as the panelists) expressed the view that COVID-19 will be part of our daily lives indefinitely. In other words, the pandemic will not actually end.

Although the pandemic is not over, people are learning how to live with it. The government intervened to protect markets and the economy both in 2008 and in response to the pandemic. This suggests that similar government intervention would be likely in the future. However, if market participants believe that, they may rely too much on assumptions of future liquidity, especially if the political climate changes and the government does not intervene in future market dislocations.

The spike in unemployment caused by the pandemic was followed by a boost in household income produced by relief and stimulus programs. This creates strange data that can distort the relationships built into models. It can promote complacency about credit. Performance data from the pandemic supports the view that nothing can ever go wrong because relief and support programs will save the day. So, psychological complacency and miscalibrated models come from a common cause: distortions in credit performance caused by government intervention (or other exogenous factors).

The pandemic may be changing how consumers use credit and manage their personal finances. The proliferation of alternatives for borrowing, such as marketplace lending, give consumers ways to borrow other than by paying high interest rates on their credit cards. Also, many households are saving more. On the other hand, there

[14] The Airbus A380 is a huge, four-engine, long-range aircraft. It is the largest airliner ever manufactured. Empty it weighs over 600,000 pounds. It was designed to carry up to 853 passengers in a single-class configuration or up to 550 in the traditional three-class configuration. The first A380 flew on April 27, 2005. Airbus originally anticipated 1,200 orders for the A380, but only 253 ultimately materialized. The final A380 delivery is scheduled for May 2022. The A380 had been intended to offer operating-cost advantages relative to the Boeing 747. However, the introduction of widebody, twin-engine jetliners capable of long-range operation, like the Boeing 777 and Airbus A330, eclipsed the A380's savings. Eventually, even the 747-800 variant surpassed the A380 in operating efficiency. Several dozen A380s have already been retired and a number are currently being processed for salvage.

is emerging evidence that other households are releveraging by taking equity out of their appreciated homes.

Inflation is the elephant in the room. Home prices have advanced strongly in 2021. Car values have also increased sharply. It seems unlikely that home and car prices can continue advancing at the rapid pace of 2021. Pricing of TIP securities reflects an expectation of a 2% inflation rate in the future. Many structured finance securities provide a hedge against future inflation because they are backed by assets that will appreciate in an inflationary environment. Subordinate and residual tranches also can provide the hedge.

A very strange feature of the current environment is that inflation is high but nominal interest rates are very low. (Note: This implies negative real interest rates.)

From an asset class perspective, litigation finance and art finance offer the benefit by being less correlated with the mainstream asset classes. NFTs and cryptocurrencies may become financeable asset classes in the future.

Even in traditional asset classes, seemingly similar approaches to investing can produce a wide range of outcomes. In residential real estate, i-buyers Zillow and Opendoor experienced very different results: negative results for Zillow and positive for Opendoor.

Securitization has allowed the development of new asset classes such as SFR. However, there is always an information asymmetry that disadvantages investors. Investors need protection against risks from information asymmetry. A partial solution is aligning the interests of issuers and investors. In this vein, a bad structure is one where investors essentially write a put option on deteriorating assets.

Major blow-ups tend to follow episodes of rapid growth. An episode of rapid growth in asset prices or origination volumes can serve as a cautionary signal.

Data is not a substitute for actual knowledge of market dynamics and the underlying drivers of performance. Models generally do not effectively capture the influence of adding or removing exogenous factors like government intervention, the introduction of new financial products, or changes in lending practices/standards.

9:45 am: Keynote Fireside Chat: Life Insurance Premium Finance—Evolution of a New ABS Asset Class

Insurance premium loans are used for financing large life insurance policies for high-net-worth individuals. The individuals typically use the life insurance policies as part of their estate planning. Insurance premium loans have been around for a long time but most have been unsecuritized bank loans. The loans are secured by the cash surrender value of the life insurance policies. Insurance premium loans benefit policyholders by facilitating the acquisition of the policies with leverage. The loans benefit insurers by increasing the persistence of policies. Securitizations backed by insurance policy loans benefit investors by offering a vehicle for taking exposure to diversified pools of insurance company risk.

Securitization of life insurance premium loans has the potential to reach several billion dollars per year. There is potential for securitization to expand to include loans for premiums on commercial insurance policies.

If a life insurance policyholder/borrower wants to drop the policy, the lender gets the policy's cash surrender value. Insurance companies generally pay the surrender value quickly when a policy is surrendered because they do not want to remain exposed to the risk of having to pay the death benefit.

One panelist asserts that insurance premium loans are a "zero loss" asset. From this point of view, subordinate tranches of insurance premium ABS are very attractive. The subordinate tranches have small timing risk but very little risk of ultimate loss.

10:45 am: Sector Update: Equipment Leasing

One panelist states that the equipment leasing industry is doing very well. Supply chain disruption is creating spikes in demand in blue-collar industries that need small- and medium-ticket equipment. Performance is very strong because lessees need the equipment. Even repossessions are working well. One company that expected to typically recover 40% of book value on repossessed equipment is currently realizing 50% to 55%. Medical equipment is a particularly hot area, especially equipment for elective procedures (which offer doctors a non-Medicare-related revenue stream).

An investor should focus on both historical performance and the strength of a leasing company's management team.

There is strong demand for short-duration ABS and equipment lease-backed deals fit the bill. Additionally, subordinate tranches of equipment ABS deals offer attractive yields.

Technology has allowed equipment leasing companies to function seamlessly during the pandemic (using remote working arrangements). Panelist have differing opinions about the use of remote working arrangements going forward.

11:30 am: Blockchain for ABS: Digitization and Automation

Blockchain technology helps to improve efficiency in securitizations. It does not fundamentally change the nature of securitizations. It helps to build trust in the reliability of data. It reduces the need for separate parties to separately validate data, which helps to reduce costs.

Smart contracts are another area where blockchain technology can add efficiency. Smart contracts offer the benefit of a clear audit trail of the triggers for smart contract events.

One panelist asserts that blockchain technology can facilitate giving investors access to real-time servicing information on securitized assets. This would be an improvement over getting a monthly snapshot view of performance several weeks after the fact.

Investors want reliable, verifiable data. Blockchain does not affect the reliability of original sources but it does improve the reliability of information transmission and distribution.

Investors want to have confidence that smart contracts work correctly. The way to test whether a smart contract works correctly is to examine the outputs. If a smart contract produces the expected outputs, then it is working correctly.

Transaction costs are not the main driving factor in securitization transactions. However, reducing transaction costs is a clear positive. That is where blockchain can help. Proponents of using blockchain technology should not fall into the trap of promoting a solution in search of a problem. Technology enhancements need to be able to co-exist with legacy systems and to work side-by-side with legacy systems during transitions that may take years or decades to happen.

The mortgage industry is looking at the use of blockchain through MISMO (the Mortgage Industry Standards Maintenance Organization). MISMO is in dialog with regulators on the subject.

12:15 pm: Developments in Online Lending

The expectations of an economic apocalypse from the pandemic were prevented from actually happening by government intervention. Ultimately, different industry sectors and subsectors experienced different degrees of stress. For example, within the restaurant sector, some subsectors (e.g., delivery) continue to thrive while others (e.g., fine dining) languish. Companies that were able to embrace technology and the ability to function remotely did better.

Underwriting standards for online consumer lending have evolved somewhat over the past years. Many lenders have been active and they are competing for business. Some are targeting weaker credits. Some lenders/issuers are loosening their underwriting standards. The loosening of standards has not yet produced an increase in defaults or losses, but it could do so eventually.

The number of banks in the US is shrinking and the cause may be that many small banks have been too slow to adapt to new technologies. The surviving banks are those that embrace technology and can operate in both the digital channel and the brick-and-mortar channel. As mainstream banks increasingly embrace digital channels, they will be competing with non-bank online lenders. However, many banks will, instead, partner with third-party online lenders and use them as an outsourced origination channel.

The effect of inflation and rising interest rates on banks and non-bank lenders is uncertain. Funding costs will increase, but so will the value of newly originated loans with higher interest rates.

Spreads on ABS backed by unsecured consumer loans are tighter than before the pandemic. They are comparable to spreads on subprime auto ABS. The market's strong appetite for unsecured consumer loan ABS points to a strong availability for consumer credit on an unsecured basis.

Modeling has been a big challenge for lenders because the pandemic was unprecedented. Trying to figure out which nondefaulting borrowers would have defaulted in the absence of government relief/support programs is a challenge for online lenders (as it is for others). Credit risk has not gone away but it has been masked for a while. Keeping staff motivated and effective in a remote working environment is another challenge. Attracting good talent is a third issue for online lenders (as it is for all companies).

Inflation poses a challenge and it may trigger regulatory changes. Headline risk in the online lending sector is also important.