

Securitized Products: Recent Performance and 2022 Outlook

Featuring:

David Zhang, Managing Director, Head of Securitized Products, MSCI

JENNA DAGENHART:

Joining us today to talk about Securitization, Recent Performance and a 2022 Outlook is David Zhang, Managing Director and Head of Securitized Products at MSCI. David, let's start with some fundamentals. What are securitized products and what's the relative importance within the broader fixed income markets?

DAVID ZHANG:

Thanks, Jenna. Securitized products are the second largest asset sector of the US treasuries. Among the \$51 trillion fixed income assets, securitized products accounted for roughly 1/3. If you take out the treasuries, they will actually account for slightly more than half of the fixed income universe. It's also very diverse, ranging from agency RMBS, which are the \$11 trillion is the largest SP sector, then to the CMBS, commercial mortgage-backed securities, that ABS, asset backed securities, credit card anti-steering rule, et cetera. [inaudible 00:01:09] collateralized loan obligations. In addition, there's also a robust private securitization market. The most of these sectors have also been large, pre-2008, in recent years.

JENNA DAGENHART:

Clearly a huge part of the fixed income universe. Why is the securitized product space so big? David, how is it different from other fixed income sectors?

DAVID ZHANG:

The reason that securitization is so big is because the securitization technology provides about half of the funding for consumer credit and the business credit in the US. This is one of the distinctive features of the US capital market. In many other countries funding is mostly provided by the banks and the bank deposits. In addition, often, not always, you will take a lot of small loans, mortgages, consumer loans, business loans and cash flows, who come together to form the collaterals for the securities, then the collateral cash flows are so called the tranche. Basically, cut up and the direct according to the cash flow rules. The pulling, the houses, the liquidity of this small loans in this tranche redistributes the risk return profile. For agencies securitization, the risks are mostly prepayment risk. For non-agency securities, these are mostly credit risk.

JENNA DAGENHART:

How do investors deal with these additional complexities caused by the securitization process?

DAVID ZHANG:

Analytics play a very important role in products investments. These include sophisticated market in the credit risk analytics, pre-trade analysis for both primary market and the secondary market, performance surveillance, and across the full cycle of the securitization, investor education is also important. For example, forums like yours, as well as participation at leading industry events. For example, I'm speaking at an upcoming EPS conference next week. That's one of the largest gatherings of the US securitization community, part of the ecosystem of investor communication and education.

JENNA DAGENHART:

You mentioned the securitized products market has seen large growth in recent years. What's behind the growth?

DAVID ZHANG:

Yes, securitized products, especially RMDs and mortgages had a role in the 2008 financial crisis. After the crisis, the market actually shrunk especially for certain products, for example, subprime RMBs, and CDOs, and other sectors. Many of the reform measures by the government and by industry, afterwards have built a more solid foundation for securitization. The market actually recovered to pre-crisis levels quickly.

The recent at the first accrues is driven by many factors, one is the current low interest rate environment, and the investors demand for yield. Securitized products can have relatively higher spreads, partly due to the complexity in a way risk premium for the complex. Another key factor is the government support. After the crisis, a lot of this complex financial transactions work is created by regulations, by accounting rules, by capital rules. On the other hand, securitization because of its importance to the real economy, is strongly supported by governments.

That takes a recent COVID example. After the onset of COVID in 2020, Federal Reserve in military ramped up the QE, the so-called quantitative easing, and about trending stories of agency RMBS to push down the mortgage rates and stimulate the market and economy. There's a similar support on the private labels' securitization side as well. All these factors contributed to the robust securitization market in the US.

JENNA DAGENHART:

What's the outlook for 2022, David?

DAVID ZHANG:

Well, each sector has their own set of performance drivers. Take agency RBS example, results the largest SP sector. The Fed has been buying trillions of dollars of agency RMBs as part of their QE program and that has pushed the US option adjusted spreads to near historical loans. Whether these spreads revert back to historical being levels depends on how fast the Fed taper these purchases. The Fed actually started tapering very recently, in late November, just two weeks ago. On a monthly basis, reduction is \$10 billion less in treasuries, and \$5 billion less in MDS. These are small compared with this \$120 billion a month the Fed was buying.

The spread the normalization will depend on longer term trajectory of the tapering. And this has a lot of dependency on how the economy recovers, and how inflation and the perception of inflation evolves. In addition, there are large uncertainties in prepayment behavior. Prepayment are key drivers for MBS performance. If rates keep rising, then the lenders will have less mortgages to refinance. They will concentrate the refinance business on a smaller pay and there will be more aggressive. That in turn, may actually hurt MBS performance. If you look at so called the primary/ secondary spread, that's the spread between the interest rate that the lenders charge the borrowers and the interest rates MBS investors get that spread has collapsed by almost 80 pips since last fall, signaling the aggressiveness of the lenders.

On the policy front, with a new administration in the US, the leadership at FHFA, which stands for Federal Housing Finance Agency, that's the regulator of the agency MBS market, and FHA, the Federal Housing Authority, which issues low-income loans for Ginnie Mae, mostly. These agencies are in the middle of potential leadership changes that actually may lead to regulation changes, and the prepayment default behavior change.

JENNA DAGENHART:

What about other sectors?

DAVID ZHANG:

Yeah. Take another example. For the non-agency and the sector, one of the key drivers is the future direction of house price. Over the last two years, the US House Price have risen the fastest in the last 30 years. Next year's performance is uncertain. Take another example CMBS by commercial mortgage-backed securities, the two lagging sectors under CMBS are the retail and hotel sectors, obviously, because of COVID. How fast is these two sectors recover will depend on how COVID evolves next year, especially with a new COVID variance and also with government policy. Each sector has its own set of performance drivers that requires focus analysis and analytics. Same with ABS, CLS and other sectors.

JENNA DAGENHART:

What about the securitized product market outside of the US? What are the differences?

DAVID ZHANG:

In Europe, securitized product sector is about 10% of the physical market is here versus that 30% US numbers that I mentioned before. The EU actually when slow similar reform measures, like the US. For example, at the end of 2018, the EU pushed through the so-called STS securitization regulation, that stands for simple, transparent and standardization. This is actually similar to many of the U.S. reforms. After some of the initial pitch, the market has started growing again in EU.

In Asia, the Chinese regulators restarted the securitization market around 2015, just a few years ago. In a few years, it has grown into the second largest market behind the US. I happen to be the co-director of the Chinese ABS market for the SFA, structured finance association. SFA is industrial organization in the U.S, it's securitization. Part of the role of this partnership is to help U.S investors access the Chinese labor markets. For the last few years, we actually see growing foreign investment in the Chinese fixed income market overall and in the Chinese ABS markets, in particular. The Chinese ABS market tends to have a higher yield spread, and the potential diversification benefits for Western investors.

JENNA DAGENHART:

Lastly, ESG and climate risks seem to be top of mind within financial markets. David, what's the latest development in these areas?

DAVID ZHANG:

Yeah, so that's very timely. My speaking role at the ABS East Conference next week, is actually on ESG including climate. Given that securitization is importance to landing in the credit in the U.S, many market participants recognize that ESG is a key factor to influence lending and allocation of credit. There are many aspects of lending, whether it's mortgages, auto-loans, USDA loans, business loans, that can be influenced by ESG investment practice. For example, whether the lending helps environment like for example climate change, or whether the lending helps improve particular social goals. That's why regulators and SFA representing the market participants are all focusing on ESG development in the securitization.

Some of the difficulties of applying ESG to securitization are due to the nature of the securitization. As we discussed previously, the two key aspects are pulling off small loans and the charging of cash flow. A lot of U.S loan our data may not be available publicly after the pooling, sometimes due to privacy concerns and a regulation, this makes ESG analysis difficult. [Inaudible 00:13:27] may lead to an even an often-dynamic ESG impact from the loan level ESG information. That actually creates additional difficulties. Other issues include data standardization, and the data disclosure standardization. We are working on all this issues, but we are confident that ESG will become an important driver in the securitization market.

JENNA DAGENHART:

David, great to have you and I appreciate your thoughts and insights into the securitized product market.

DAVID ZHANG:

Thank you, Jenna.

JENNA DAGENHART:

Thank you for watching. Once again, that was David Zhang, Managing Director and Head of Securitized Products at MSCI. I'm Jenna Degenhart with Asset TV.

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit www.msci.com.

This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of MSCI Inc. or its subsidiaries (collectively, "MSCI"), or MSCI's licensors, direct or indirect suppliers or any third party involved in making or compiling any Information (collectively, with MSCI, the "Information Providers") and is provided for informational purposes only. The Information may not be modified, reverse-engineered, reproduced or disseminated in whole or in part without prior written permission from MSCI.

The Information may not be used to create derivative works or to verify or correct other data or information. For example (but without limitation), the Information may not be used to create indexes, databases, risk models, analytics, software, or in connection with the issuing, offering, sponsoring, managing or marketing of any securities, portfolios, financial products or other investment vehicles utilizing or based on, linked to, tracking or otherwise derived from the Information or any other MSCI data, information, products or services.

The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information. NONE OF THE INFORMATION PROVIDERS MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS TO BE OBTAINED BY THE USE THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, EACH INFORMATION PROVIDER EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by applicable law, in no event shall any Information Provider have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not be applicable law be excluded or limited, including without limitation (as applicable), any liability for death or personal injury to the extent that such injury results from the negligence or willful default of itself, its servants, agents or sub-contractors.

Information containing any historical information, data or analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. Past performance does not guarantee future results.

The Information should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. All Information is impersonal and not tailored to the needs of any person, entity or group of persons.

None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), any security, financial product or other investment vehicle or any trading strategy.

It is not possible to invest directly in an index. Exposure to an asset class or trading strategy or other category represented by an index is only available through third party investable instruments (if any) based on that index. MSCI does not issue, sponsor, endorse, market, offer, review or otherwise express any opinion regarding any fund, ETF, derivative or other security, investment, financial product or trading strategy that is based on, linked to or seeks to provide an investment return related to the performance of any MSCI index (collectively, "Index Linked Investments"). MSCI makes no assurance that any Index Linked Investments will accurately track index performance or provide positive investment returns. MSCI Inc. is not an investment adviser or fiduciary and MSCI makes no representation regarding the advisability of investing in any Index Linked Investments.

Index returns do not represent the results of actual trading of investible assets/securities. MSCI maintains and calculates indexes, but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the index or Index Linked Investments. The imposition of these fees and charges would cause the performance of an Index Linked Investment to be different than the MSCI index performance.

The Information may contain back tested data. Back-tested performance is not actual performance, but is hypothetical. There are frequently material differences between back tested performance results and actual results subsequently achieved by any investment strategy.

Constituents of MSCI equity indexes are listed companies, which are included in or excluded from the indexes according to the application of the relevant index methodologies. Accordingly, constituents in MSCI equity indexes may include MSCI Inc., clients of MSCI or suppliers to MSCI. Inclusion of a security within an MSCI index is not a recommendation by MSCI to buy, sell, or hold such security, nor is it considered to be investment advice.

Data and information produced by various affiliates of MSCI Inc., including MSCI ESG Research LLC and Barra LLC, may be used in calculating certain MSCI indexes. More information can be found in the relevant index methodologies on www.msci.com.

MSCI receives compensation in connection with licensing its indexes to third parties. MSCI Inc.'s revenue includes fees based on assets in Index Linked Investments. Information can be found in MSCI Inc.'s company filings on the Investor Relations section of www.msci.com.

MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc. Except with respect to any applicable products or services from MSCI ESG Research, neither MSCI nor any of its products or services recommends, endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies and MSCI's products or services are not intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Issuers mentioned or included in any MSCI ESG Research materials may include MSCI Inc., clients of MSCI or suppliers to MSCI, and may also purchase research or other products or services from MSCI ESG Research. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indexes or other products, have not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body.

Any use of or access to products, services or information of MSCI requires a license from MSCI. MSCI, Barra, RiskMetrics, IPD and other MSCI brands and product names are the trademarks, service marks, or registered trademarks of MSCI or its subsidiaries in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and Standard & Poor's. "Global Industry Classification Standard (GICS)" is a service mark of MSCI and Standard & Poor's.

MIFID2/MIFIR notice: MSCI ESG Research LLC does not distribute or act as an intermediary for financial instruments or structured deposits, nor does it deal on its own account, provide execution services for others or manage client accounts. No MSCI ESG Research product or service supports, promotes or is intended to support or promote any such activity. MSCI ESG Research is an independent provider of ESG data, reports and ratings based on published methodologies and available to clients on a subscription basis. We do not provide custom or one off ratings or recommendations of securities or other financial instruments upon request.

Privacy notice: For information about how MSCI ESG Research LLC collects and uses personal data concerning officers and directors, please refer to our Privacy Notice at <https://www.msci.com/privacy-pledge>.