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TRANSCRIPT

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 securitize 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, preusse, 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 secprod 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 is 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 horse 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.

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