Freddie Mac Single-Family Home Starts Here Podcast Episode Transcript:

CRTcast E6: Current State of the Market and Future Direction of CRT

VO [00:00:01] Welcome to the Freddie Mac Single-Family CRT cast a series under the Home Starts Here podcast. Now investors have a front row seat to conversations discussing economic and housing markets, portfolio management and analytics, servicing policy and credit risk management from Freddie Mac leaders and other industry experts.

Mike Reynolds [00:00:27] Welcome, everyone. Thank you for joining us on our podcast. My name is Mike Reynolds and this is our CRTcast, our continuing attempts to use multiple mediums to reach out to our CRT market. We're going to do something a little bit different today. My guests up to this point, have been external partners of ours. And what we're going to do this time is I've asked Christian Valencia, who's our vice president in charge of our Single-Family capital markets CRT team, and Jeff Shue, who's our senior director for our (re)insurance Single-Family CRT programs. I asked Jeff and Christian to join us today. I think given the turbulence in the markets and where we are currently, it would be good to just have a more of a very detailed, Freddie Mac heavy discussion, on the state of the markets. So first of all, Christian, Jeff, thank you for joining.

Christian Valencia [00:01:18] Hi, Mike. How are you? Thanks for having me on the call. Looking forward.

Jeff Shue [00:01:24] Great. Thanks, Mike. It's great to be on. You've had some pretty distinguished folks join you, including former CEOs, our own former CEO, Don Layton. So very honored to be on this podcast.

Mike Reynolds [00:01:37] There we go. That's right. It's been an elite list, Jeff. And now you're part of it. Glad you both were willing to do it. So, you know, we've been doing a lot of different outreaches to our market. So, we don't want to rehash everything. But I do think it's valuable to look back at earlier this year and just, you know, from your respective seats, what's your view on them, on the markets? You know, going back earlier this year, the general economic impacts to CRT. Christian, why don't we start with you.

Christian Valencia [00:02:05] Sure. Before we start with the impact, you know, I want to say, this year the supply has been significantly compared to any other year we've done CRT. And in the first half of the year on the capital markets side, we already reached the full amount that we issued in the capital markets all of last year for just Freddie Mac. And when you combined our competitor across the river, it was even more than that. And we're right now, the first eight months of the year, over 50% more in issuance combined compared to the 2021. And that has been a significant, I'd say, headwind on the capital markets side, which supply has been something that investors have brought up as a major concern and which resulted in a significant widening in the spreads in addition to some of the other issues that probably we'll talk a little bit more detail. But, that has definitely been a clear technical that has not impacted the fundamentals, but really, we've been mostly been moving wider because of technicals related to whether it's, you know, interest rates going up, mortgage rates almost doubling since the beginning of the year, already doubling given the latest mortgage rate that has reached over 6%, first time since 2008. And then on top of that, inflation and the crisis in Ukraine and Russia.

Jeff Shue [00:03:38] Yeah, Christian. So it has been quite a year, positive and negative, right. I think we've had the biggest year, the first half of the year that we've had in program history. We had on the reinsurance side the two largest quarters we've ever printed. You know, the first quarter we did two and a half billion in the first quarter. And if you go back to 2018, 2019, that's consistent with a full year's worth of buying behavior through the ACIS program. And we felt Q1 is a very strong number and then we rolled into Q2 and beat that with a 2.6. And you know, so by midyear we had, we were at

5.1 billion, putting us at the second largest annual issuance, if you will, in program history and still going, right. So last year we did 8.2 billion. We did 5.1 this year by the first half. So that's a positive, really good support from the markets year to date, they've responded very well. The negative, of course, is the uncertainty, volatility that we see in the market and the macro effects that that we'll talk about. But I would say this is certainly record-breaking year in terms of the deal sizes, participation. We hit an all-time high with 30 unique participants on a transaction. So in the history of the program and again, this started small, you got to go back you can go back and think about how far we've come. 2013, you know, we executed the first ACIS transaction with a single reinsurer, $75 million deal. And here we are today with, you know, doing 5 billion in a in a half of half of the year. So it's been a strong indication from, you know, around the capacity in the appetite of the market. We're very comfortable and happy about the response of the market, how robust that's been.

Mike Reynolds [00:05:31] Yeah. You both covered a couple of really interesting topics. Maybe I'll just kind of go back on a few of them for a minute. Jeff, the Ukraine situation, global political instability, certainly there's a slightly different view today than there was earlier in this year. But, you know, reinsurance markets tend to be very global. So what I don't know, just how was how did that impact their appetite for U.S. rising mortgage? If at all.

Jeff Shue [00:05:57] Yeah. So you brought up the war in particular. There are sort of limited, direct impacts on the participants that we have on our panels. I go back to some of the initial stories that we heard in the outbreak of the conflict and in the aviation space. A lot of concern about the airplanes that were grounded in Russia that, you know, had the lease arrangements that were likely to be broken. We're talking about potential losses in the aviation space. And then a marine, there were ships trapped in harbor in southern Ukraine, 150 ships was the number. So there were, you know, shipping marine impacts there that hit specific reinsurers. And those are very limited, very sort of confined impacts. But generally speaking, the uncertainty created and the impact on global supply chain certainly creates, you know, the volatility that impacts how reinsurers look generally at something like a credit line. So, there was a reassessment, I think broadly across the market around the forward outlook and the impact of the resulting inflation and where interest rates were headed and what that might mean more locally for their mortgage portfolios. You see, I think, a review of stress framework, so reinsurers taking a look at their probable maximum loss of PML's, gauging their exposure on their outstanding portfolios, and looking at the at the broad sort of macro environment that might impact borrower repayment. So you've got things like interest rates and just general inflation creating burden on borrowers. And I think, you know, as you assess the mortgage space, clearly a new pool is underwritten to high debt-to-income standards or strong debt-to-income standards. And they're judged to be able to handle the burden associated with the debt they're taking on. For an outstanding portfolio, you know, it's uncertain how higher inflation and what stress that might create on our outstanding portfolio, what that might mean for delinquencies, etc., on the on the portfolio. So as a reinsurer, you're doing a fundamental credit exercise where you take a look at the characteristics of the reference pool and also the macro environment for credit. I would say certainly more volatility and uncertainty baked into forward projections of how the mortgage portfolio might perform. And that has put some pressure on prices, understandably. Higher price requirements related to that uncertainty that's been created by global conditions.

Mike Reynolds [00:8:45] And then it really impacts both the ACIS and STACR execution. But, you know, Christian, you had both of you had talked about supply, but not only was there a lot of supply, but given how the paydowns work on our structures, the sequential paydown of the of the issued bonds, really the biggest needs to get sourcing of new capital resulted in the B bonds, the b-one's, b-two's, because you know, as, as transactions were cash flowing, they were paying off the m-one's and m-two's. And I don't know just what were your views on that dynamic and how it unfolded through the first few quarters of this year?

Christian Valencia [00:9:23] So yeah, Mike, we issued, you know, again, a little over 11 billion over the first, you know, through July and now we're at 12 billion. So that put a lot of pressure on supply. What happened is, like you said, the M1’s was where we issued 7.3 billion so far this year. And actually on the B2’s, we've decreased issuance compared to last year. Last year we issued just under 5 billion. And these year, including our most recent transaction, we're at 1.7 billion. So, you know, every time that we go to market and try to sell B2’s, that's new capital that needs to come into the space. Well, when we are selling them, once there are some pay downs, and on top of that we've started doing tenders. So we started last year and this year we've done already three tenders, close to $5 billion on bonds that we bought back. That was money that investors were able to use to offset some of the money that was being required from them. So we saw money, ya know, market funds and money managers having redemptions from investors and by selling more of the top of the stack, that money can get reinvested, and by the tenders probably we helped to reduce the amount of money that investors had to sell or bonds that they had to sell in order to get cash. Our product trades a lot. We trade, you know, between 2 and 4 billion a month in CRT, and that 2 to 4 billion is due because these bonds are deemed to be liquid, they need cash, investors are able to find other investors that see these as being very attractive investments, especially as the spreads have widened. That's one of the reasons that we've seen a record number of investors in this space this year. It's 139 investors that have been participating in the primary market. Last year was 106. So we're talking about an increase of over 30%. Also deal by deal we've seen an increase from an average this year of around 58 investors compared to 49 last year. So the significant volume spreads have resulted in a lot more investor demand. However, that has also resulted in spreads widening by quite a bit. The B2's at the beginning of the year and our first year was a 700 spread the DNA2, or DNA5, I'm sorry, B2 we priced at 1290, so almost doubling spreads, which also resulted in us to make a decision to stop issuing B2's and B1's for third quarter. And understanding what you just mentioned that, you know, that's new capital that needs to come to this phase. And we've seen some, some new type of investors across the stack, particularly the insurance companies at the top, and then more private equity or whole loan buyers at the bottom of this deck.

Mike Reynolds [00:12:30] And there's no easy there's no easy attribution of what of why you're seeing such a new demand from new investors coming in. Like those are those are new types, you know, heavier insurance money, as you mentioned, overall numbers are up. Clearly, there's a function tied to spreads, right, wider spreads make they make the asset class more attractive from a from a buyer perspective. Obviously, it makes it more expensive from an issue perspective. But also we've had all these, you know, fundamental views. So what you know, what are you hearing in the marketplace in terms of how is the market responding to rising rates? What about their outlooks on home prices? You know, the rising rates certainly have impacted the purchase mix. So, you know, how have the capital markets customers been markets been reacting to that?

Christian Valencia [00:13:11] Sure. One of the key things is, you know, prepayment speed. So long, bonds are longer. And the change in structure with the five year call that we implemented at the end of last year, those bonds have more volatility because sometimes what happens and what we hear is that when they rally, they write like a five year bond. But when things widened, they were more like a longer bond expectation of 10 to 15 years in some cases. From a house price perspective, we are starting to hear more conversations about, you know, what, what happens on a flat to potentially a down scenario on home prices. Still, the main concern is more of a macro environment, not necessarily a housing environment, because some of this supply demand, housing fundamentals, are still strong. But there's now hearing that there's certain markets, particularly recently on the West Coast, where there's some house declines that could impact, you know, the housing and what potential losses could come through. But that has been less of a concern so far. It's more about loans being much longer and what would happen for supply for going forward, because easier supply has been mainly a big concern. But how much would CRT issuance come? You know, once we get to the first July, August, September origination periods, which I expect to come significantly lower.

Mike Reynolds [00:14:48] Yeah. You mentioned supply. I'm going to I'm going to repeat that part. The housing supply dynamics are still very, very strong. Right. That was your first point, where most economists view the U.S. market as being underbuilt, having not fully recovered from the Great Recession compared to the household formation being driven by millennials and Gen Z. But then secondarily, the CRT issuance supply is also dwindling. We've kind of made it through our biggest year. As rates rise, total origination volumes are going down. I think maybe there might be a little bit of an offset with an anticipated, and it's all tied to a formula but it's not official, but an anticipated increase in the conforming loan limits as , you know, the home price appreciation leading up till now, you know, makes the average loan size increase. So that could be a little bit of an offsetting factor. But generally the view going forward is less originations and therefore there will be less CRT tied to that. So, you know, turning to you, Jeff, comments, kind of similar questions to you. How have reinsurance markets viewed the macro environment? Home prices? And then relatedly, you had mentioned 30 unique investors, I'm sorry, insurance markets. Any comments on what's been driving that expansion of participation?

Jeff Shue [00:16:07] Yeah. And I think it's a lot of it due to the sheer magnitude of the opportunity with the GSE demand, if you will, is three times what it was, just two years ago. So, you get a very large opportunity in CRT where you got, you know, two massive buyers with highly standardized portfolios bringing strong credit attributes to the market. And I would note a few things. You know, we had a lot of uncertainty in the outbreak of COVID with, you know, very, very high delinquency expectations initially. The question around how GSEs would respond from a loss standpoint, loss mitigation standpoint, what tools would be brought to bear to help address the stress created by the pandemic? And I think the clear lesson there, you know, you've seen support for borrowers that has been effective, you know, and really, really worked to keep losses in a manageable range and get borrowers through a troublesome time. So, you know, there was uncertainty. I think if you're, as a reinsurer, looking at the response that the GSEs had, that's very supportive of continued appetite. So you've got this large demand driven by the sort of the tail of the refi wave, you know, and coming into the year with some very clear signals that COVID wasn't going to produce or hadn't been producing the losses that some had feared. Also continued very strong HPA growth as we were as we were saying. And it's justifiable HPA based on the you know, where we stand from a supply demand standpoint, as you said, Mike. So I think that has all been very supportive. We've added several new reinsurers this year. The panel participations have been really strong. So I think moving, you know, the demand is, the supply for reinsurance is there. So there's good participation. The outlook for house price, I know Moody's is roughly flat outlook, you have some deceleration I think is what most are calling for. And that position, equity position, of borrowers is very strong. So it would take very severe stress, I think, to really start to make a dent or to turn the general attitude towards mortgage credit. It's really, really strong going in going into the end of the year. And what I'm hearing about reinsurer appetite for the for the coming year.

Mike Reynolds [00:18:41] And as we are wrapping up the year, Jeff, what are some of your thoughts and what are you hearing from the markets in terms of, you know, Q4 outlook and participation?

Jeff Shue [00:18:51] Yeah reinsurers are very curious this time of year to know what we have planned for the remainder of the year and for 2023. And this is a this is a time where, you know, the board meetings are ongoing and risk committees and underwriting committees and sort of assessment of what's needed in terms of mortgage capacity for the coming year. I think it's clear, I think a consensus is an expected continued decline in volumes. What we're seeing, I would note, in the high LTV space, since it didn't have as much of a run up as low LTV. So when I say that, I mean the 80 to 97, the HQ series or the SPH series on the ACIS side, it's actually held in volume a little bit more than we thought. But it will I think the expectation will be it will also be coming down. Low LTV we've seen some pretty rapid decreases and so you'll see that in our deal sizes, we've been issuing deals in the six, seven, 800 plus million range and I expect that to moderate along with overall volume. So for the remainder of the year, you know, we're busy just about every month. We've got a deal on the market right now. I expect that we'll have at least one per month through the end of the year and likely result in about 2 billion. That's what I'm estimating for the remainder of the year and that'll put us in the upper 7 billion range total for the year. So for next year, TBD. Right. But as we said, I think we'd expect reference pool sizes to be coming down and so likely a smaller bogey for next year, but still, you know, very, very substantial.

Mike Reynolds [00:20:29] And I'll just note since we're on a podcast for doing this recording in mid-September of 22. So Christian, how about for you? What are your views on Q4 and what are your expectations from you know, what are the things that the markets will be focused on in this final quarter of the year?

Christian Valencia [00:20:46] Sure. So, Mike, we still have one more deal in Q3 to start with that that's going to come up before the end of September. And then we have one deal per month for the rest of the year. So that puts us at 4 transactions, we're at 12 billion right now. We're going to end up somewhere between around 15 billion, which that would be a 40% roughly increase compared to last year on the capital markets side. That's significantly more than any. And if you look at the next largest year, that would be a 50% or more. From there, it's one of the things that I think investors are looking at is we stopped issuing B's in the third quarter, will we come back with B's in the fourth quarter? And that would be a determination of where spreads are and our view of that risk. So we'll make decisions and act on a deal-by-deal basis at this point. The other thing is, what are what does the home price environment look like? Because we've started to hear, you know, from some of the research that's going out from the dealers of a flattish type or even environment for the rest of the year are slightly down then going into next year, there's still views of from plus 5 to -5 kind of range going forward. But like Jeff said, our expectations are that the reference will become smaller, deals would be more looking like the deals that we issued in 2019, 2020, somewhere probably between half a billion to a billion instead of deals that have almost reached $2 billion, you know, in the first half of the year when we move on to 2023.

Mike Reynolds [00:22:37] All right. And as always, any views that we're expressing related to our calendar are all subject to market conditions at that time. So speaking of time, we need we need to wrap up. But, Christian, anything any final thoughts or takeaways that you want to give our listeners?

Christian Valencia [00:22:51] What I would say is with we do expect to see, you know, our high LTV, like Jeff said, that that would be a bigger part of our total of potentially getting close to about a half of originations. I think CRT will be beneficial for Freddie Mac. It allows us to manage the risk. And you know, we are going to see a positive to the sector in next year as there's going to be all these dollars and all these new accounts that have been buying CRT over the last year chasing a smaller amount of bonds. I think the investors that have purchased CRT can potentially benefit from spread tightening into next year.

Mike Reynolds [00:23:33] I like that outlook. How ‘bout you, Jeff, any final thoughts?

Jeff Shue [00:23:37] Yes. So a couple of times this year, we've gone to the reinsurance market with some innovations or we've gone out this year with our first cash out refi specific transaction. And we've also shifted more of what we do, more of our business through forward transactions. So, you know, innovations in the midst of, massive volume and standard deals along with, I guess what we would call the fog of uncertainty in global conditions, etc.. I think that's good signal around the strength of the appetite there that we're able to introduce some new things and still hit large targets for our overall standard program. So it says to me that we can expect continued good support, strong support from the markets, even in the midst of some uncertainty and volatility. And, you know, going into the coming year, I think we're well positioned with the reinsurers as a partner. So, I think we're looking forward to being out on a regular basis again throughout ‘23.

Mike Reynolds [00:24:42] Great. Well, thank you, Jeff, and thank you, Christian. Thanks both for taking the time to do the podcast and thank you for all the great work that you're doing for Freddie Mac. It really is a pleasure to work with both of you and your teams and thank you all your listeners. And if you have any questions, please reach out to us. And as always, we hope you found this helpful and educational in terms of your understanding the CRT markets. Looking forward to next time. Goodbye.

VO [00:25:08] Thank you for listening to Freddie Mac's CRT cast. A series under the Homes Starts Here podcast. Stay tuned and subscribe to catch additional interviews with key industry leaders and experts. Home starts here is available wherever you listen to your podcasts. We appreciate you rating, reviewing, and sharing with your network.