

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

CRTcast E8: 2023 Market Evolution from an ACIS® and STACR® Perspective

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 [0:00:24] Hello, welcome to Freddie Mac CRTcast. I'm your host, Mike Reynolds, and I'm very happy to continue our CRTcast series with our special guests. Kesi Wang, senior trader with Bank of America, and Jeffery Ryan, Executive Vice President, Business Unit leader, financial risk at PartnerRe. Kesi, Jeff, Thank you for joining us today. I'm glad you're here.

Hey, so before we before we dive into our topic, which is really looking back at the evolution of 2023 markets, both from a reinsurance and capital markets perspective.

Mike Reynolds [00:00:55] Jeff, can you tell our listeners a little bit about what your role is at PartnerRe?

Jeffrey Ryan [00:01:00] Yeah, no, thanks, Mike, and thanks for having me. It's a real pleasure to be here today. So, I've been in the reinsurance space for about 28 years and I've always been focused on non-property casualty products. So primarily in the credit space. So, I joined PartnerRe just over three years ago as a business unit leader for the Financial Risk Group, which we define as short term trade credit surety bond business, political risk insurance and of course mortgage.

Jeffrey Ryan [00:01:25] I've held similar positions, at various companies over my career, including 13 years at Axis and I actually started out in the primary surety underwriting side in 1991. So, just a quick comment on PartnerRe, we've been a supporter of CRT and MI transactions since 2013. So, we have kind of a deep history in terms of the history of the CRT product and evolution and, you know, remains a real cornerstone of our business practice here at PartnerRe, so we've been pleased to be big supporters over an extended period of time in this space and have only positive things to say about it.

Jeffrey Ryan [00:01:57] So, really glad to be here today.

Mike Reynolds [00:01:59] Thank you, Jeff. Kesi, tell us about your role at Bank of America.

Kesi Wang [00:02:04] Yeah, thanks, Mike. Hi everyone. My name is Kesi. I'm the CRT trader at Bank of America. I manage our CRT trading business on the RMBS desk, as well as conduit AAA and multifamily CRT on the CMBS desk. I graduated from Boston College, have been working at Bank of America through several banking and trading roles. But I think this is the first time, at least in my career, that I'm hearing bonds are cooler than stock – so, glad to be here to talk about our market today.

Mike Reynolds [00:02:34] Thank you, Kesi. Yeah, it's a great point. I also want to school up in Boston and in my finance, it was always stocks, stocks, stocks and it's been like that forever, right, for the past couple decades, frankly. But now it's

we're a little bit of a different environment. But that that might be a slightly different topic or maybe we'll touch on that towards the end.

Mike Reynolds [00:02:50] Yeah. So, Jeff, why don't we start with you looking back on '23, what are some of the dynamics that you were that you were seeing at the beginning of the year?

Jeffrey Ryan [00:02:56] Yeah, thanks, Mike. 2023 started off, you know, an interesting manner for us because we saw negative HPA or house price depreciation for the first time in a while and it was happening in a pretty dynamic rate environment with some macroeconomic uncertainty layered in. So, you know, we have a pricing model that we used to gauge this business and the model reacted in a way that suggested exaggerated tale development, and that just didn't seem reasonable to us.

Jeffrey Ryan [00:03:20] So, we paused our ratings until we could figure it out. You know, we maintain a fairly robust or a very robust governance process around our business that includes several key triggers, one of which is our probable maximum loss amount or PML, which we felt was largely overstated in our model. So as a result, we took the opportunity to review our model parameters to make sure we weren't missing anything.

Jeffrey Ryan [00:03:41] We also felt like that was a best practice for us. So, in parallel we were testing a new model which was showing different and what we found to be more reasonable results in the negative HPA environment and to make a long story longer, we did some rigorous back testing and we implemented a new model and a new PMO framework and we were comfortable returning to the space in Q2.

Jeffrey Ryan [00:03:59] All through that we saw the strong credit quality metrics of the pools that were being placed and they were attractive to us. And again, we were able to successfully redeploy our capital. So, so yeah, we like we missed a little bit of the market, but overall we feel good about our work, our ability to provide accurate price discovery to people like you.

Jeffrey Ryan [00:04:17] And we continue our support of the CRT programs. We also feel really good about the positive performance or in-force book through 2023. So, I think that the proactive management that Freddie Mac has put in place to solve for delinquencies and active remediation and, you know, high quality loan manufacturing has been very impactful to us.

Mike Reynolds [00:04:34] Yeah, I mean, you covered a lot. You covered a lot of ground there. And, thank you for the compliments for the underwriting and the and the practices here employed at Freddie Mac. That is absolutely a core component of our business. And that's what effectively we're selling in the credit markets as we are selling our ability to manage credit.

Mike Reynolds [00:04:49] You had you had said something called exaggerated tail development and maybe some of our listeners might be like, Well, what is that? And so that's basically along the lines of and not to be specific to your situation, but just as a general statement that's along the lines of when you do Monte Carlo simulation and you're putting volatility around like a mean path, you're going to have edges of that simulation.

Mike Reynolds [00:05:12] And so say, for example, if you normally expect home prices to increase 3%, the edges of your of your downside path might be your tail might be say, -25, something like that. But if you now go from 3% to say -5% or 8%, should your tail now go from -25 to -35 because your median moved? Or should it be is your tail kind or should be more consistent?

Mike Reynolds [00:05:37] So, I think that's generally speaking that the concept when you were talking about exaggerated tail development is that right now?



Jeffrey Ryan [00:05:45] No, that's exactly right. And the problem was there was so much volatility in the deep tail that suggests that we're going to have unbelievably large losses. And we just didn't see that volatility as being reasonable. So I think that drove a lot of our thought process and a lot of the work that we did. And, the good news is internally here, there was a buy in from our management that was not correct.

Jeffrey Ryan [00:06:04] So at that point we felt like digging in and trying to solve for that was really important. And I'm pleased to know that we had a reasonableness around this expected result. And, you know, it was bought into by our key stakeholders here at PartnerRe. And, as a result of that work, we were able to get our heads around it and continue to move forward.

Jeffrey Ryan [00:06:20] So yeah, it was it was a lot of work with a lot of people involved, a lot of eyes on this and it was a good result.

Mike Reynolds [00:06:26] Thank you, Jeff. Okay, so let's turn it over to you. I think CRT has been one of the best performing assets through most of 2023. Can you give us a recap on the key drivers events that you see that have been happening throughout the year?

Kesi Wang [00:06:39] Yeah, sure. I think, first of all, on fundamental, everyone sees HPA year to date up over 5%. But I think the biggest "aha" moment happened basically around the regional bank crisis back in March. The fact that we know fixed rate lending is a zero-sum game and we know on one side, banks and central banks' held-to-maturity portfolios have these unrealized losses. And then you look at the other side, is simply the unrealized gains for homeowner equity who locked in at 3% mortgage. So, they're really the "QE winner" in this cycle and that's a huge wealth creation.

Kesi Wang [00:07:15] So, in terms of pricing, regional bank crisis was the March event. And by mid-April when we priced the STACR23 DNA2 deal, the B1 class quickly rally through the pre-SVB level. And that was a bullish signal to confirm the shift in sentiment in this market. And we've been on a rally ever since essentially.

Kesi Wang [00:07:35] The other big driver is the new issue supply and it's impactful in terms of technical in two senses. Number one, the year-to-date issuance number is \$7 billion, which is only 30% of last year's record, \$22 billion issuance, or about half of the long-term average. With 4 tenders and the monthly paydowns, we are actually at negative supply this year.

The second order of impact on the supply dynamic is the power of forward guidance. Last year investor view CRT as a short-term source of funding given the liquidity and everything to deal with outflows. Knowing that if they sell CRT today, they can buy similar profile back given the frequent new issue window. Now, this year is the opposite. This is the one sector with a good fundamental story, with decent carry for uncapped floaters. With not much supply this year and into next year, investors just think twice before selling. And that becomes a much better technical in itself.

Mike Reynolds [00:08:33] So, Kesi on the STACR, our capital markets a product offering, is a floating rate instrument. And so clearly with rising rates and the curve steepening like how is the macro curve steepening backdrop affected the sector?

Kesi Wang [00:08:48] I think everyone can appreciate the uncapped floater aspect a lot more just given the where the front end of the curve is. I think in terms of where we are today, the next biggest driver is going to be when we see a bull steepener move and that's what's going to shift the money that's locked in the money market funds right now to bond funds, which will drive the next inflow for credit product.

Mike Reynolds [00:09:12] And so the to that point, the inflows to the to the fixed income markets I believe has been pretty flat. Is that what you're seeing?



Kesi Wang [00:09:20] Yeah, well, I think a lot of the inflow is essentially going to money market funds like on the on T-bills and everything, as opposed to credit funds at this point, just given the front-end is very attractive.

Mike Reynolds [00:9:33] Jeff, how about from your side of the business? How was the rising rate environment been impacting your view of the credit?

Jeffrey Ryan [00:09:40] Yeah, So I guess it's similar to Kesi, it's kind of a mixed bag, right? So, you know, it's been interesting for us as we continue to see house price appreciation in a rising rate environment. So, HPA has material impacts to our model output. So, for us to continue to see the supply and demand imbalance in the market continue to support home prices, it's impactful to our view on how we how we price these transactions.

Jeffrey Ryan [00:10:01] So, you know, overall risk factors as we see them continue to remain low, suggesting again, that loan manufacturing and quality is strong. So, we view the affordability pressure and the combination of HPA and rising interest rates has created as well managed by the market, and helping keep our expected results within the range we would expect.

Jeffrey Ryan [00:10:20] Also to that point, the downside, if there is one and again, Kesi alluded to this is, the drop of issuance volume, you know, which is expected, you know, I guess given the rapid rate rise in 22, followed by continued increase in 23. So yeah, for us, we like this business to see the issuance volumes kind of move down significantly.

Jeffrey Ryan [00:10:38] And I think you said, we say 50% plus, but I think, it's probably higher than that right now. You know, that that's certainly a natural flow of the market we're in, so we'll deal with it. I don't think it changes our risk appetite because, again, we can see through the data that you send to us, see through the, you know, the high credit quality and low risk layering that's in these pools.

Jeffrey Ryan [00:10:58] So for us, that still feels very comfortable. So, you know what, we talk to our management team about this. The performance has been exceptional through COVID. It's been, you know, managed well through the interest rate rises. So, you know, now that the pendulum swung a little further than we may have liked it to, I think we're still in it.

Jeffrey Ryan [00:11:15] I think we still see that the gain to be had internally as part of our product mix across our platform at PartnerRe, you know, mortgage continues to be a diversifying factor compared to our PNC businesses and that's viewed positively. So, with the low correlation that that it has with our business.

Jeffrey Ryan [00:11:30] So yeah, we'd like to see more of it, just not here right now. That market will change, too.

Mike Reynolds [00:11:37] Yeah, and I've talked about the COVID response in previous podcasts, but just to kind of cover that briefly, again, I think that was a great example of a living servicing guide. So, what is Freddie Mac doing? Freddie Mac has a servicing guide and we're constantly updating it. So, for those in the fixed income space from years ago, you know, you'd have this concept of like put everything down on a piece of paper and loans are going to be service to the exact specific way.

Mike Reynolds [00:12:02] And of course, the challenge with that is, is you can't anticipate what's going to happen the unexpected. And so with the emergence of COVID, you know, we took we took very successful forbearance strategies that were being employed in natural disasters. We made some adjustments to that. And then deployed it nationwide. You know, you saw forbearance and deferred payment plans in use like you've never seen before.

Mike Reynolds [00:12:26] Kesi, I remember a year ago one of the key challenges was the seasoning curve steepening, given the negative outlook on housing, how has the season curved, the seasoning curve evolved this year?

Kesi Wang [00:12:36] Sure. To put it in context, in 2021, the B1 season curve was around 100% bps. Then at the wide of last year, it widened to 400 bps given people were growing bearish on the new issue pools. Now that has flattened to roughly just around 200 bps in secondary. So, it's still steep versus 2021, but has retraced 70% of the steepening moved from 2022.

Kesi Wang [00:12:59] The single most important driver, aside from the fundamental, is really the B1 tender this year which anchored a level on seasoned B1 and unlocked a lot of the ERISA capital to rotate to newer vintage. To quantify it, just out of the \$4 billion that's tendered this year, about \$2 billion are seasoned ERISA B1s. That 2 billion alone drove several waves of ERISA fund reinvestments into secondary.

Given the fact that 2019/2020 B1s are not ERISA-eligible. And investors are now comfortable with the HPI, LTV on 2021/2022 pools, the reinvestment went into 2021 B1s and 2022 STACR M2s, which is a huge catalyst on the seasoning curve flattening move we saw this year.

Mike Reynolds [00:13:40] And so how is that dynamic and the other market dynamics, how has that impacted the investor base?

Kesi Wang [00:13:47] Sure. I think on the new issue front, it continues to be mainly driven by hedge funds across the stack, actually even including M1. Meanwhile, the real money and insurance pockets have been net buyers in secondary on seasoned paper. But just kind of going through the capital stack here are the biggest themes per capital stack:

On the M1A: As we're hearing more and more relative value discussion on M1 spreads versus mortgage basis, as well as other AAA products like CLOs.

On the M1-Bs, we see the return of the insurance demand, mostly for the NAIC1-rated STACR 2022 M1-Bs.

On BBs, we see two rotation trades as themes for hedge funds. One is selling ERISA BBs to buy new issues. The other is to sell B1 to buy B2s.

Kesi Wang [00:14:33] And finally on the B2s: which is very interesting. We saw the shift from this being a hedge-fund-only sector last year and earlier this year, to now a pretty balanced mix of real money and hedge fund demand at the current level.

Mike Reynolds [00:14:45] Thank you Kesi. We try to keep these podcast relatively short. So, Jeff, I'm going to come back to you. Do you have, you know, closing remarks and a general overview in the reinsurance market?

Jeffrey Ryan [00:14:56] Yeah. Thanks, Mike. And you know, for us, the reinsurance business overall, we've been seeing a hardening of sorts across our market, call it for the past 18 months or so, and it's been driven by the property casualty segment, you know, events like larger CATs, more frequent CATs, social inflation. They've been pushing a primary or reinsurance rates in a lot of key classes.

Jeffrey Ryan [00:15:15] One of our most important conferences just finished in Monte Carlo. And I think it's fair to say that the market expects similar behavior for the upcoming January cycle and into 2024. So, in our business on the mortgage side, you know, we have been pricing on the risk-based characteristics. So, we tend to have more of an expected loss view, which is largely not influenced by exogenous market factors.

Jeffrey Ryan [00:15:34] So, the upshot for us is that we expect the business continue to perform well. And when we think about that across our platform, it fits in well with what PartnerRe is trying to accomplish as we manage our own portfolio of

business. So, we're going to continue to compete for capital internally and the mortgage business continues to be a bright spot for us.

Jeffrey Ryan [00:15:55] The markets change as we see, you know, fewer refis and more, you know, primary purchase, really a primary purchase market that we're dealing with now that has some impact to how we view the expected results. But overall, we continue to see a very favorable market in terms of performance. And that's going to continue to be important for us and for PartnerRe as we as we manage our portfolio risks.

Mike Reynolds [00:16:13] So yeah, thank you, Jeff, again, Kesi, any other topics that you want to cover before we wrap up?

Kesi Wang [00:16:18] Yeah, sure. I think look at the beginning of this year, we highlighted 1 theme as the new issue GWAC going higher from the 3% GWAC deals we've been seeing in 2021/2022: that was the "4-dimensional relative value framework". I think that the GWAC relative value story will continue to play out next year. But another emerging theme, which I believe will dominate the secondary flow and relevant value next year is the 2021/2022 semi season deals.

Kesi Wang [00:16:45] So just to quantify it, right now, CRT Capital Market is a \$54 billing universe. If I take out the short season paper and the front-pay M1s, it is roughly around \$40 billion. Out of that \$40 billion, half of the universe are the late 2021 and the 2022 5-Year Call paper.

These were the 5-year weighted average life bonds at new issue. Today are 3+ years WAL, and next year they will be 2 to 2.5 years. If we plot that on a chart of spread versus weighted average life, back by well-seasoned collateral, it will fit a lot of investors pocket especially on the real money side. On relative value, I could see these being compared to the M1s in new issues next year.

Kesi Wang [00:17:27] So, given these profiles makes up half of the CRT universe or \$20 billion, it's going to drive a lot of the relative value discussions and trading activities not just next year, but into 2025/2026 as they get closer to the call date. So, I think it's going to be fascinating to see how our market evolves in the coming years.

Mike Reynolds [00:17:47] And of course, the secondary markets that are available for the STACRs bonds, STACR CUSIPs is an aspect that's available in that space, not necessarily in the reinsurance space, but it's well supported both on the primary, you know, for Kesi from you and your team at Bank of America. But then, as you're saying, the secondary trading has been a huge factor in that market, giving opportunities for investors to rotate in and out of what they see is a relative trade.

Mike Reynolds [00:18:17] So, Kesi, Jeff, thank you both. Appreciate the time that you've taken today and to prepare for today. And then just generally speaking, your support for the businesses and investing in the business or in trading support, Freddie Mac as an issuer, it needs partners like you. And so thank you again.

Mike Reynolds [00:18:34] And thanks for everybody for listening.

Kesi Wang [00:18:35] Thank you.

Jeffrey Ryan [00:18:36] Thanks, Mike.

VO [00:18:39] 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.

