
ABS East 2024 Conference Notes

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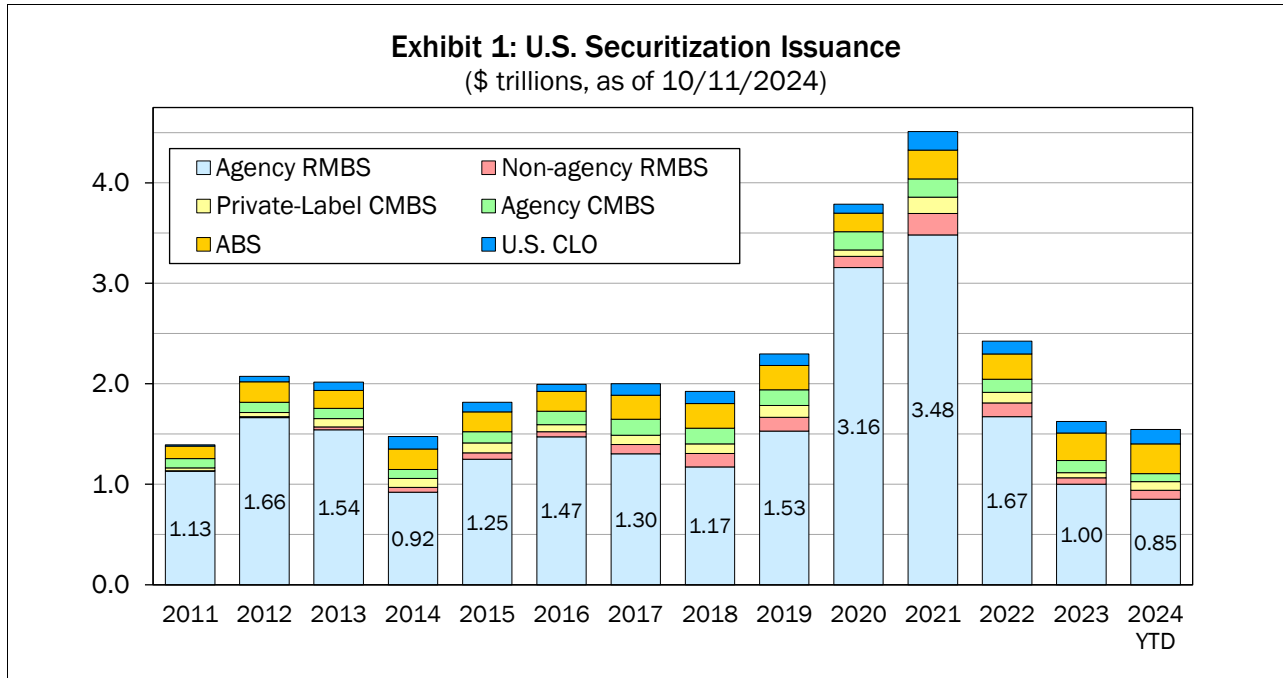
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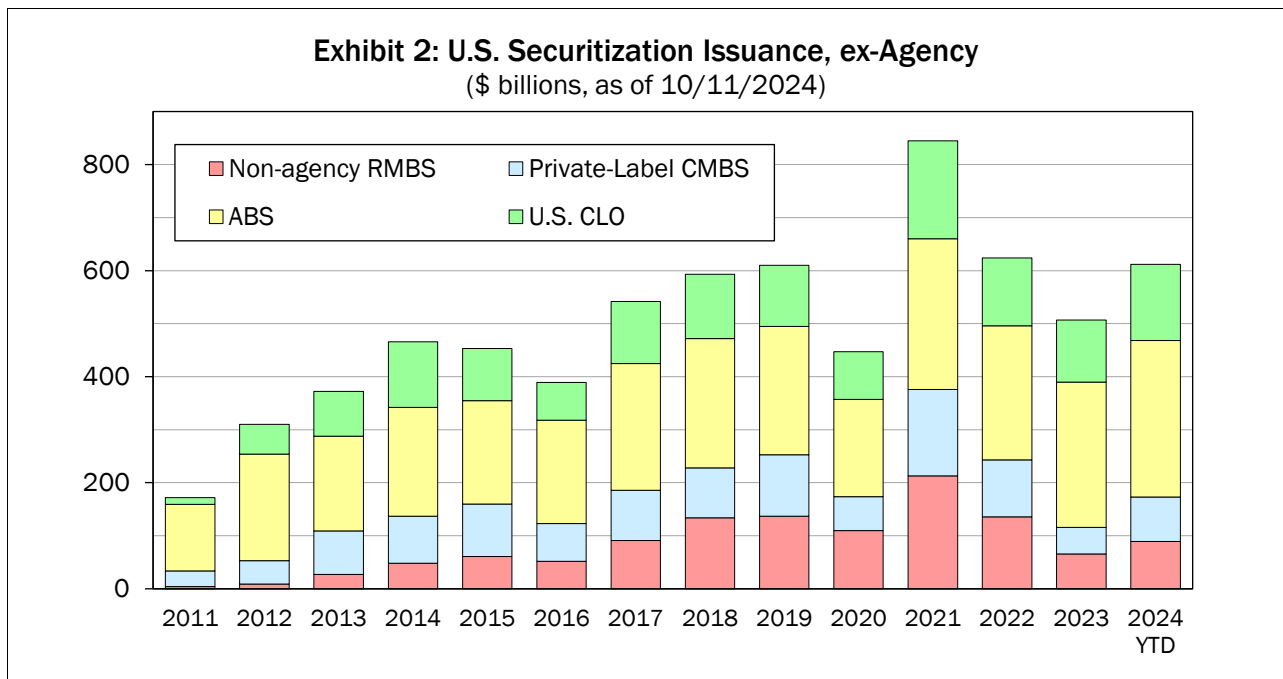
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1. The recent **ABS East 2024** conference at the Fontainebleau in Miami Beach attracted over 5,500 attendees. The conference started on Monday, October 21, 2024, and ran through Wednesday, October 23. The overall mood was positive with a strong outlook for 2025. This report covers 14 sessions from the event, including the general sessions on Monday and Tuesday, as well as breakout sessions covering auto loan ABS, non-QM RMBS, CRE CLOs, and others.
2. Many panelists voiced an expectation for falling interest rates and continuing strong conditions in both the labor market and the general economy. This itself may be a cause for concern. One panelist in Monday's market outlook session noted that the market has already priced in a healthy measure of optimism. This suggests that the balance of risks is likely skewed to the downside. Additionally, almost no panelists mentioned geopolitical risks. Geopolitical risk is hard to manage but should not be ignored. Today's geopolitical environment seems more fraught than it has been in years. The obvious areas for concern are Russia-Ukraine, China-Taiwan, and Iran-Middle East. The gravity of the current situation was highlighted in the recently leaked U.S. intelligence documents, which included an assessment that Israel would not "activate its nuclear deterrent" in connection with its anticipated retaliation strike. The mere mention nuclear arms is chilling. The potential for conflict-driven disruptions in supply chains, global trade, and financial markets should not be summarily dismissed. It argues for a tilt toward up-in-quality and safe-haven trades.

- Structured finance issuance has been strong so far this year, with aggregate year-to-date issuance nearly equal to full-year 2023 (Exhibit 1). As usual, agency MBS issuance dominates the overall securitization landscape, with non-mortgage ABS accounting for most of the non-agency component (Exhibit 2).



Source: Flanagan, C., and H. Brooks, *Securitization Weekly Overview*, BofA Global Research (11 Oct 2024) (Exhibit 29).



Source: Flanagan, C., and H. Brooks, *Securitization Weekly Overview*, BofA Global Research (11 Oct 2024) (Exhibit 29).

4. 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 while attending the sessions. The summaries have not been reviewed or approved by the panelists. While I have tried to capture panelists' remarks accurately, I apologize in advance for any inaccuracies and omissions. In addition, I wish to acknowledge the excellent work of Invisso and FIIN in organizing and hosting the conference.

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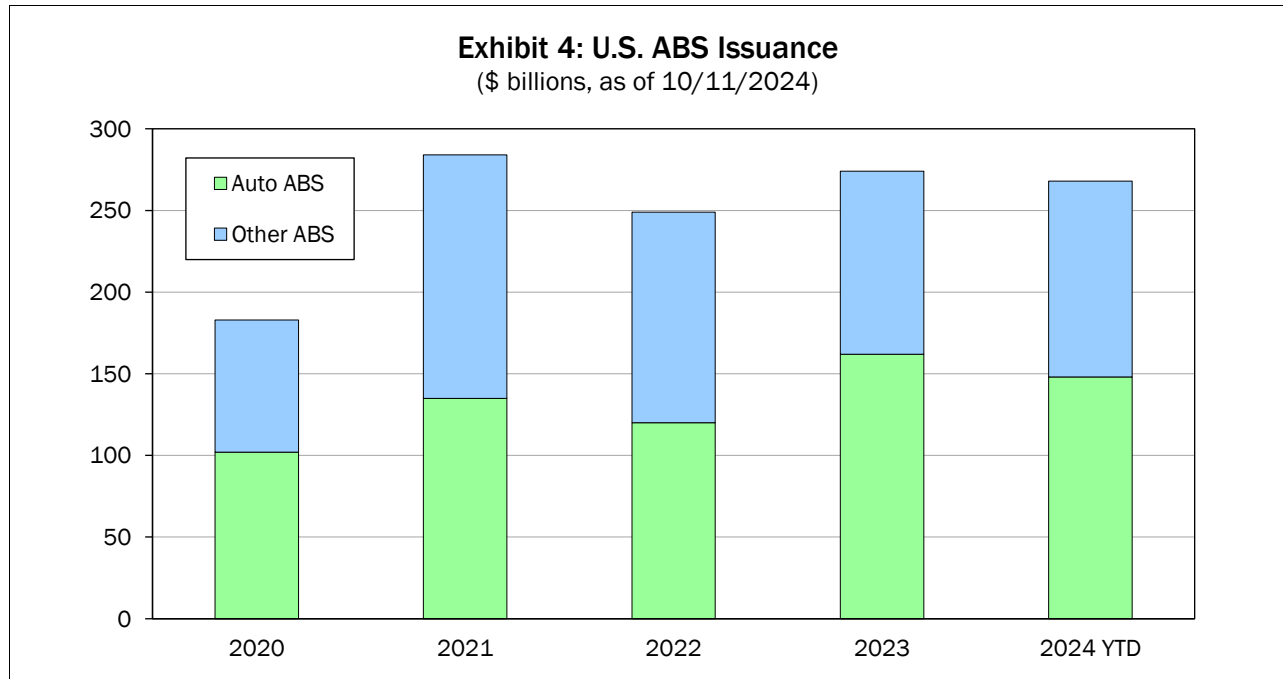
Exhibit 3: Acronyms in this Report

ABS	asset-backed security
AFS	available for sale
AI	artificial intelligence
ATR	ability to repay
bps	basis points
BSL	syndicated bank loan (bank syndicated loan)
CDFI	community development financial institution
CFPB	Consumer Financial Protection Bureau
CMBS	commercial mortgage-backed security
CLN	credit linked note
CLO	collateralized loan obligation
CLTV	cumulative loan-to-value ratio
CRE	commercial real estate
CRE CLO	CLO backed by commercial mortgage loans
CRT	credit-risk transfer
DOE	Department of Education
DSCR	debt service coverage ratio
DTI	debt-to-income ratio
EBA	European Banking Authority
EETC	enhanced equipment trust certificate
EOD	event of default
EV	electric vehicle (<i>i.e.</i> , without an internal combustion engine)
FCA	Financial Conduct Authority (UK)
FICO	Fair Isaac Corporation credit score
FIIN	Fixed Income Investor Network
GSEs	the government-sponsored enterprises Fannie Mae and Freddie Mac
HQLA	high-quality liquid assets
HTM	held to maturity
LCR	liquidity coverage ratio
LME	liability management exercise
LSTA	Loan Syndication and Trading Association
LTV	loan-to-value ratio
MBS/RMBS	residential mortgage-backed security
ML	machine learning
MSA	metropolitan statistical area
QM	qualified mortgage
RTL	residential transition loan
SASB	single-asset/single-borrower CMBS
SPV	special-purpose vehicle
SRT	synthetic risk transfer
UMBS	uniform MBS (issued by either Fannie Mae or Freddie Mac)
WARF	weighted-average rating factor

Monday, October 21, 2024

9:30 am Auto ABS

5. Auto ABS generally account for half or more of total U.S. ABS issuance (Exhibit 4): According to one panelist, they have the best structures of all ABS deal types.



Source: Flanagan, C., and H. Brooks, *Securitization Weekly Overview*, BofA Global Research (11 Oct 2024) (Exhibit 28).

6. Another panelist adds that this year's pace of auto ABS issuance has been amazing (so far). There is likely to be additional supply, bringing the total ABS issuance to the range of \$320 billion to \$330 billion for the year. Credit unions and banks are becoming bigger parts of the market. Despite the huge flow of new issues, spreads on auto ABS have remained very tight; they are at their tightest levels since 2022. There are four factors that explain the tight spreads: 1) relative value versus corporate bonds, which display spreads at pre-pandemic tight levels; 2) the inverted yield curve, 3) the expectation of future Fed action to lower rates and 4) the strong condition of consumer fundamentals and the expectation that they will remain strong the near-to-medium term.
7. A third panelist agrees that the market has been very strong and notes that investor preferences have recently shifted toward slightly longer maturities. A fourth panelist explains that auto ABS credit performance has recently shown slight deterioration as the effects of pandemic-era stimulus burned off and used car values have declined. Repossession delays and higher repossession costs also have been contributing factors. Although delinquencies have risen, consumers are making sufficient payments to avoid having their auto loans charged-off (with the consequent damage to their credit scores).

8. Another panelist adds that the 2023 and 2024 vintages are expected to outperform the 2021 and 2022 vintages. Consumers did not have the option to trade down to cheaper cars in 2023, which was a drag on credit performance. Underwriting standards have recently tightened, partly in response to perceived inflation of FICO scores.
9. A panelist from a trustee explains that, before an event of default, the trustee's job is to 1) facilitate a transaction in accordance with its governing documents, 2) ensure that the investors' rights are represented and protected, 3) handle payments, reporting, and maintenance of required accounts, and 4) ensure that any required monthly or annual certifications from servicers or other service providers are received.¹ If an event of default (EOD) occurs, then the trustee's main role is to minimize disruption. After an EOD, the trustee's standard of care changes and the trustee must make sure that the deal is operating under any applicable post-EOD provisions (*e.g.*, changes to the cash-flow waterfall). Also, if an EOD occurs, the trustee should check for conflicts, particularly any that might require it to resign. If a servicer must be terminated, a trustee must deal with the fact that it may affect numerous transactions. A trustee must identify the threshold of voting rights for investors to direct action. Some investors want to be involved in post-EOD situations and some do not. If there is a servicer bankruptcy, the trustee files proofs of claim to preserve repurchase claims on behalf of investors. A trustee may have to become heavily involved in a transfer of servicing.
10. Another panelist adds that past failures of subprime auto ABS issuers have caused credit deterioration of their outstanding ABS. Those episodes provide lessons for today's market.
11. Banks have recently issued credit-linked notes (CLNs) tied to their auto loan portfolios. The CLNs are risk transfer transactions and they are motivated by bank capital regulations. The CLNs generally use pro rata payment structures, which differ from auto loan ABS sequential-pay structures. Also, because CLNs do not isolate the underlying assets in special purpose vehicles (SPVs) they embody the corporate credit risk of the issuer.
12. The rental car area has experienced the same developments as the mainstream auto market. Rental fleets are exposed to developments with EVs and the used car market in general.
13. Geographic concentration risk can be an issue in auto loan ABS, particularly with respect to natural disasters. Some issuers have tools for working with borrowers following natural disasters (*e.g.*, granting extensions). Those measures can help mitigate performance deterioration caused by hurricanes and similar events.
14. **Predictions for 2025:** Panelists offer their predictions for the coming year: 1) Issuance will be a little bit higher. 2) Issuance will be roughly the same though perhaps with more floorplan deals. 3) Lower interest rates may boost issuance by spurring demand for new vehicles.

¹ The panelist offers a somewhat rose-tinted interpretation of with respect to trustees ensuring that investors' rights are "represented and protected." Following the mortgage meltdown and the financial crisis, securitization trustees have sought to narrow their duties, particularly in relation to enforcing repurchases of defective loans (*e.g.*, ones that breach representations and warranties). The norm in current deals is that trustees will *not* enforce repurchases unless directed to do so by investors holding a specified percentage of a deal's voting rights.

10:15 am CRE CLOs

15. One panelist states that CRE CLOs have had an interesting year. There have been negative headlines in the popular press. However, both CRE CLOs and their underlying commercial mortgage loans have performed well. Much of the underlying collateral in recent deals has been loans backed by multifamily properties (*i.e.*, apartment buildings). That is the most investible CRE property type right now. There is strong investor demand for CRE CLOs backed by multifamily loans. CRE CLOs have always been a great way for investors to get extra spread. Spreads on the triple-A-rated classes of CRE CLOs were at 200 bps at some point during the year. The spreads have since tightened to around 150 bps, which still represents great value. The sponsors are often strong entities. On the other hand, reinvestment periods have recently gotten longer in new deals, which increases risk.
16. CRE CLO structures has proven their resiliency through the worst CRE bear market in a generation. Additionally, the dealer community has shown its ability to continue providing liquidity for the product through the bear market.
17. Next year should be a strong year for CRE CLO issuance. New issuers are likely to enter the market. Investors will likely demand wider spreads on deals from new issuers—probably 25 bps to 50 bps wider than deals from established issuers.
18. The retail and office property sectors experienced notable stress caused by the pandemic and its aftermath. The retail sector has somewhat recovered, while the office sector remains depressed. The future of the office sector will remain uncertain for some time. Also, it remains to be seen whether the multifamily sector will likewise experience its own episode of stress. Even if it does, however, CRE CLO structures include ample protective features that should insulate investors from any realistic decline in multifamily values. The structural advantages of CRE CLOs, combined with inherent diversification, have made CRE CLOs attractive to smaller investors with fewer resources for analysis, due diligence, and surveillance.
19. Another panelist asserts that the office sector is becoming more investable right now. Investor portfolios have such high concentrations of multifamily and industrial exposures, that investors should seek to rebalance into other property types, including office. Pure 100% office CRE CLOs are unlikely to happen, but office properties might account for up to 20% of new deals.
20. A new property type is data centers. Those properties may offer another dimension of diversification. Most of the data centers built in recent years have not been financed through securitization. The operators are still figuring out the best options for financing.
21. Converting office buildings to multifamily properties is a new area, but it is not likely to account for a significant portion of loans in CRE CLOs.
22. The mezzanine layer of CRE CLOs has been very interesting over the past year. The spreads on triple-B-rated CRE CLO tranches are very wide in relation to the amount of credit enhancement that they have.

23. **Predictions for 2025:** Panelists offer their predictions for the coming year: 1) CRE CLO issuance will likely be in the range of \$15 billion to \$20 billion, with 20 to 25 deals. 2) Spreads on triple-AAA-rated CRE CLO tranches are likely to remain steady, though they could tighten to 125 bps. 3) CRE CLO issuance will likely be around \$20 billion and spreads could grind tighter. 4) Investors compare CRE CLOs to CLOs backed by syndicated bank loans and find that CRE CLOs offer spreads that are more attractive.

11:30 am Non-QM²

24. One panelist observes that the market for MBS non-QM loans has evolved in the past year. Borrowers on non-QM loans are more stretched. Issuance of non-QM MBS has increased since 2023. Another panelist asserts that there is stronger liquidity for non-QM loans because whole loans purchases are a new source of funding. The securitization rate on non-QM loans has declined. Another panelist emphasizes that housing affordability has declined. Delinquencies have increased, but the increase is from a very low level. Losses on non-QM loans are very low. They are almost nil on loans secured by owner-occupied properties. Another panelist observes that sentiment is very rosy on the origination side. The economics of non-QM securitization have improved compared to 2023, when the securitization market was muted and spreads were very wide.
25. **Prepayment Outlook:** One panelist states that the 2021 vintage is likely to display slow prepayments because the loans have low interest rates. The sponsors of securitizations backed by 2021 loans are unlikely to call those deals (*i.e.*, exercise their early redemption option) because those deals achieved a low cost of funds. Another panelist notes that the market is divided between premium and discount loans. Prepayments may be higher on loans from the 2019 and 2020 vintages. A third panelist notes that post-2022 pools have many DSCR loans (*i.e.*, loans originated based on the income on the mortgaged property).
26. **Ratings:** A panelist from a rating agency explains that their rating agency takes a holistic approach to rating non-QM MBS, starting with analysis of the issuer. On the loan level, the key factors are LTV and FICO score. Secondary factors include a borrower's debt-to-income ratio

² Non-QM MBS are MBS backed by loans that do not meet the criteria for being "qualified mortgages" under the truth-in-lending regulations. A mortgage loan that is a qualified mortgage ("QM") is presumed to comply with the CFPB's ability-to-repay ("ATR") rule. A mortgage loan that is not a QM (*i.e.*, a "non-QM loan") lacks such a presumption, and a lender must thoroughly document its determination of the borrower's ability to repay in accordance with regulatory criteria. Because they lack the presumption of compliance with the ATR rule, non-QM loans carry somewhat more regulatory/compliance risk than do QM loans. See Truth in Lending Act § 129C(b), 15 U.S.C. § 1639c (2023), <https://www.govinfo.gov/content/pkg/USCODE-2023-title15/pdf/USCODE-2023-title15-chap41-subchapI-partB-sec1639c.pdf>; 12 C.F.R. § 1026.43 (2024), <https://www.govinfo.gov/content/pkg/CFR-2024-title12-vol9/pdf/CFR-2024-title12-vol9-sec1026-43.pdf>; Bureau of Consumer Financial Protection [hereinafter "CFPB"], *Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): General QM Loan Definition*, 85 Fed. Reg. 86308 (December 29, 2020), <https://www.govinfo.gov/content/pkg/FR-2020-12-29/pdf/2020-27567.pdf>.

Nearly all prime-quality mortgage loans with full documentation of borrower income and assets meet the requirements for QM classification. Accordingly, in practical terms, the population of non-QM loans consists mostly of loans that would have been classified as "subprime" or "alt-A" during the U.S. mortgage bubble.

(DTI), loan documentation type, occupancy status, property type, and loan type. The rating agency also considers geography and the historical performance of the issuer's previous pools. Loans to foreign nationals are considered risky. A panelist from a different rating agency observes that DTIs on ordinary loans are going up and debt-service-coverage ratios (DSCRs) on investment property loans are going down. Both trends indicate weakening credit. Loans from community development financial institutions (CDFI loans) are an issue.

27. Another panelist highlights rising home prices and high interest rates as key sources of affordability stress for home buyers. Rising bills for property taxes and home insurance premiums amplify the affordability stress.
28. One panelist observes that insurance companies have a strong appetite for mortgage loans. Residential mortgages offer good yields and diversification from other types of credit exposures. The panelist asserts that unsecuritized whole loans are generally more attractive to his company than MBS.
29. Another panelist asserts that the prices of agency MBS pricing are the limiting factor on non-QM spreads. Some MBS had been viewed as substitutes for short-maturity corporate bonds, which allowed MBS spreads to tighten significantly. As prepayments have slowed, that view has receded, and spreads have widened. Spreads are expected to be roughly flat and range bound next year.
30. One panelist remarks that the non-QM sector has not yet proven its resilience by withstanding an episode of meaningful stress. Once it does, it will achieve wider acceptance.

12:15 pm CLO Debt vs. Equity Roundtable

31. Panelists have differing views about whether CLO debt or CLO equity is more attractive. Part of the story is investor risk preferences. One panelist emphasizes that investors in both CLO debt and CLO equity focus on preservation of capital. A key issue is whether a CLO manager adheres to the style that they claim to use. Another panelist notes that there is a tradeoff of liquidity for yield when investing with a new CLO manager. The ability to build par is a manager's most important skill. Building par is critical for both equity and debt. Another panelist agrees, and adds that maximizing spread is much less important. A third panelist emphasizes that CLO debt investors get no benefit for additional risk taken by a CLO manager. Debt investors should favor managers who do not seek incremental risk to boost equity returns.
32. **Declining Interest Rates:** One panelist states that the current environment of declining interest rates should not hurt CLOs. CLO debt is likely to remain attractive relative to other floating rate products. The equity arbitrage is likely to be preserved because both the asset and liability sides of CLOs have floating rates. Another panelist notes that both yields and spreads on CLO debt remain very attractive compared to other liquid spread products (based on their history since the financial crisis).
33. **Private Credit vs. CLOs:** Another panelist asserts that private credit has had a positive effect on the market for syndicated bank loans (BSLs) because it has absorbed many weaker credits. Fewer BSLs are trading at prices below 80% of par. Another panelist says that many loans in

2022 and 2023 went to the private-credit market because CLO activity was slow. The private credit area also helps CLOs by providing an outlet that can receive triple-C-rated credits when CLO managers want to sell them. On the other hand, private credit competes with CLOs as a source of funding for speculative credits, which creates pressure for lower loan yields and weaker loan terms.

34. CLOs of private-credit loans have higher credit enhancement levels than BSL CLOs. CLOs of private-credit loans offer wider spreads. The tradeoff appears to be favorable for CLO debt investors.
35. **CLO ETFs:** One panelist explains that there are now ETFs that invest in CLOs.³ The growth of the sector has been huge. Sixteen CLO ETFs have been launched. Most focus on triple-A-rated CLO tranches, but some invest in riskier tranches. The demand from the ETFs has caused CLO spreads to tighten. Another panelist asserts that ETFs may be the future of the asset class by providing an avenue to reach retail investors. A third panelist asserts that the market has not yet been tested by a stressed environment.
36. **Regulation:** One panelist remarks that expected changes to the Basel III capital guidelines are likely to encourage banks to buy floating rate investments. This will expand the AAA buyer base for CLO debt. Regulators recently announced that they will likely soften the proposed increase to bank capital requirements.⁴ CLO triple-A tranches are attractive from a risk-weighted asset perspective but they do not count as high-quality liquid assets (HQLA) for the liquidity test.⁵
37. Holding a majority of a CLO's equity gives the holder control over key decisions in the management of the CLO. This can be important at key points in a CLO's lifecycle, such as when it is time to reset the interest rates. Captive equity funds that did not hold controlling equity interests did not meet their investors' expectations. Minority equity investors have become more wary. They know that they will be bound by the decisions of the controlling equity holder.

³ Examples include: AXS First Priority CLO Bond ETF, BlackRock AAA CLO ETF (CLOA), iShares AAA CLO Active ETF (CLOA), Janus Henderson AAA CLO ETF, Janus Henderson B-BBB CLO ETF, Invesco AAA CLO Floating Rate Note ETF (ICLO), Panagram AAA CLO ETF (CLOX), Panagram BBB-B CLO ETF (CLOZ), PGIM AAA CLO ETF, and VanEck CLO ETF

⁴ Barr, M., *The Next Steps on Capital*, speech at The Brookings Institution (10 Sep 2024), <https://www.federalreserve.gov/newsevents/speech/barr20240910a.htm>; see also Dept. of the Treasury, Federal Reserve System, and Federal Deposit Ins. Corp., *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity*, 88 Fed. Reg. 64028 (18 Sep 2023) (notice of proposed rulemaking), <https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf>; Board of Governors of the Federal Reserve System, *Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)*, 88 Fed. Reg. 60385 (1 Sep 2023) (notice of proposed rulemaking), <https://www.govinfo.gov/content/pkg/FR-2023-09-01/pdf/2023-16896.pdf>; see generally Basel Committee on Banking Supervision, *Basel III: Finalising Post-Crisis Reforms*, Bank for International Settlements (Dec 2017), <https://www.bis.org/bcbs/publ/d424.pdf>; Basel Committee on Banking Supervision, *The Basel Framework*, Bank for International Settlements (undated), <https://www.bis.org/baselframework/BaselFramework.pdf>.

⁵ See, e.g., 12 C.F.R. Part 50 (2024), <https://www.govinfo.gov/content/pkg/CFR-2024-title12-vol1/pdf/CFR-2024-title12-vol1-part50.pdf>.

3:00 pm Invisso & FIIN Welcoming Remarks

38. More than 6,000 individuals registered to attend ABS East 2024. The Fontainebleau is expanding into more space, which should be ready for next year's conference. The annual ABS East conference is more than just an industry gathering; it has a history. It has grown with the securitization industry. Thirty years ago, the industry was small and did limited types of things. Today the structured finance industry is huge and is a powerful driver of innovation. It has expanded into financing nearly all types of assets and is a driver of financial innovation. The private credit conference being held at the hotel next door highlights the close linkage between securitization and private credit.
39. In a poll of the audience most respondents express a neutral to optimistic outlook. Most respondents expect private credit (36%) and esoteric assets (24%) to be the asset classes that generate the most positive excitement over the coming five years. The same poll last year had nearly half of respondents expressing a pessimistic outlook (49%)
40. The Fixed Income Investor Network (FIIN) is an organization dedicated to education and promoting investor interests. FIIN has launched a certification program. FIIN has a quiz at its booth.

3:15 pm Crystal Ball or Crystal Clear? Structured Finance Market & Performance Outlook

41. In a poll of the audience, 37% of respondents expect spreads in 2025 to be flat relative to 2024, 25% expect them to be slightly tighter, 20% expect them to be significantly tighter, and 16% expect spreads to be meaningfully wider.
42. One panelist predicts that the economy will have a soft landing and that the Fed will cut rates twice more in 2024 and four times in 2025. Another panelist agrees, focusing on the strength of the labor market, and expecting unemployment to peak at roughly 4.2%. A third panelist notes that small changes in the level of unemployment should not matter. Whether unemployment is 4.2% or 4.5% is not material; both are good numbers in a longer historical context. A fourth panelist pegs the likelihood of a recession in the range of 10% to 15%. Economic growth and the labor market are both strong. However, credit deterioration is starting to appear. Although the averages appear fine, challenges are developing at the weak end of the borrower spectrum. A fifth panelist calls for a bumpy landing for the economy. The market has already priced in lots of optimism. That makes it harder to find opportunities with upside.
43. **Issuance:** One analyst predicts that agency MBS *net* issuance will be \$300 billion. Non-agency RMBS issuance will increase by 25%. Issuance of deals back by residential transition loans (RTLs) will increase. CLOs are tracking the issuance levels of 2021, which was a strong year. However, net CLO issuance will be flat because outstanding deals are being redeemed. Another panelist says that changing capital requirements (the Basel III endgame⁶) combined with the

⁶ See materials cited in note 4.

growth of the U.S. banking system will push funding activity into securitization. Single-asset/single-borrower (SASB) CMBS transactions are overtaking conduit CMBS. There is a big push into private deals. Another panelist counters that public deals should be the cheapest source of funding for issuers. The recent surge of private deals may be merely a temporary phenomenon.

44. One panelist states that consumer credit performance appears to be slightly deteriorating, but securitization structures provide ample protection. Another panelist adds that deterioration started among subprime borrowers but has spread to prime. Subprime auto borrowers are displaying very weak performance. On the other hand, subprime lending standards have tightened over the past two years and recent vintages are outperforming the 2022 vintage. Many consumers are delinquent but still manage to avoid having their loans charged off. A third panelist notes that consumer balance sheets are very strong. Recent upward revisions in consumer savings are a positive indicator. The top 20% of consumers do not feel recessions; they have a sufficient income and wealth to weather downturns. The middle cohort of consumers can encounter problems from financial stress. However, that group has recently received wealth gains from home price appreciation. The bottom consumer cohort is where stress has the greatest impact. The question today is whether the adverse impacts of economic stress are advancing into the middle cohort from the bottom cohort.
45. Another panelist states that homeowners have generally been able to absorb recent shocks. Non-homeowners are more vulnerable.
46. One panelist explains that the office and retail CRE sectors underwent structural changes because of the Covid-19 pandemic. The long maturities of CRE loans means that there may be opportunities for troubled sectors to recover. The challenges affecting retail and office properties explain the growth of SASB activity. It is unclear how those sectors will evolve from the present and whether the current risk in those sectors has been properly priced.
47. **Private Credit:** One panelist states that insurance companies are diversifying into private credit. Another panelist notes pension funds are using securitizations to diversify holdings of Treasury securities and corporate bonds. A third panelist cautions that non-public transactions may have weaker assets and weaker structures.
48. **Esoteric Assets:** One panelist asserts that deals backed by esoteric or novel assets are appealing. They include deals for financing data centers. About 5% of data centers financed using securitization. Many more will be financed with securitization in the future. Buyers of data center CMBS include crossover investors from the corporate side. There is a spread pickup. Data center CMBS offer longer durations than ABS backed by consumer assets. Unlike most securitizations, data center deals embody a risk of technological obsolescence. Another panelist warns that understanding how to value esoteric assets can be challenging (*e.g.*, music royalties). A third panelist adds that balloon risk can be an issue in deals backed by novel or esoteric assets
49. Panelists expect a 25 bps rate cut as the next Fed action. They expect that the impact of the election will be positive for the market.

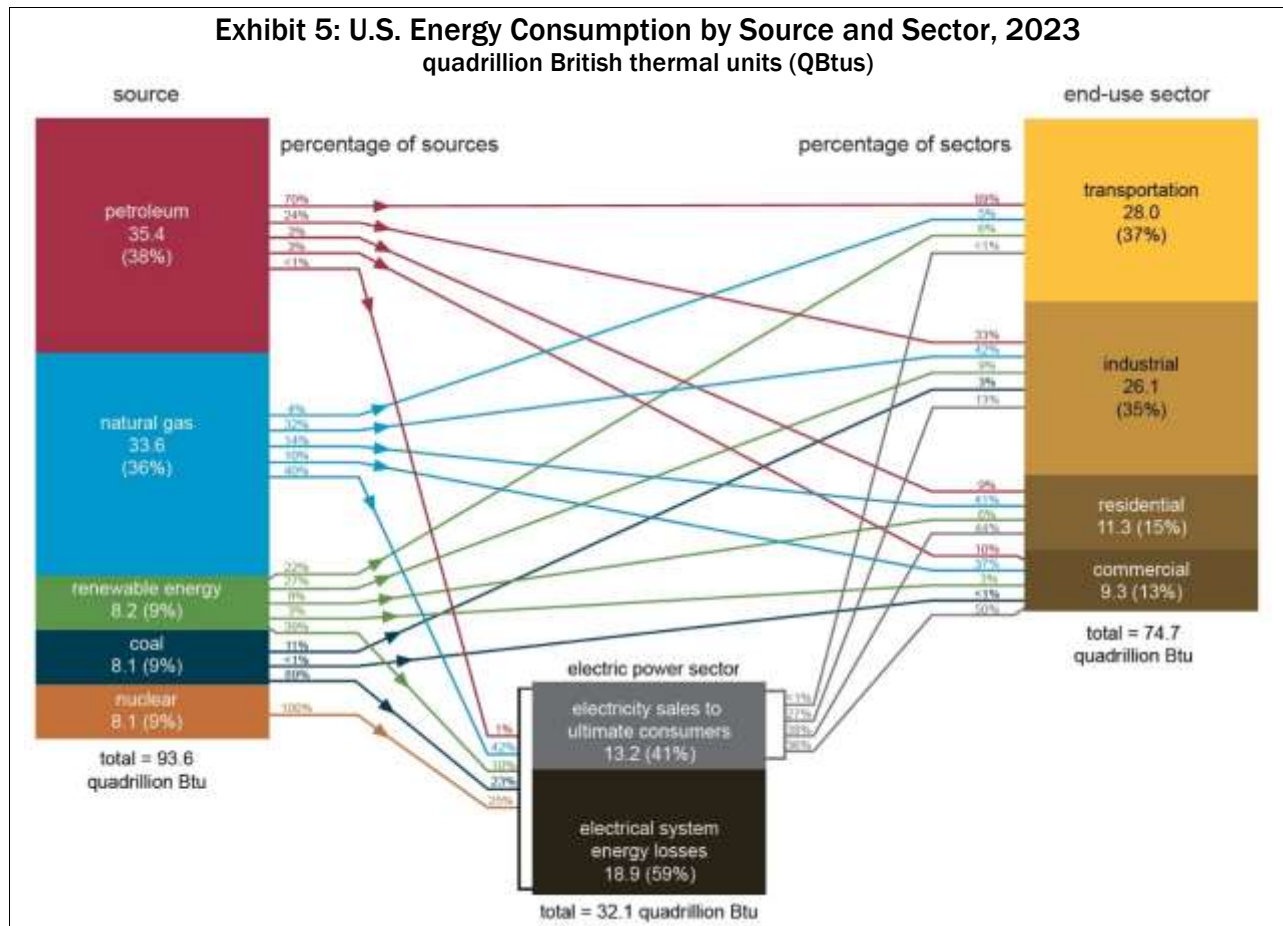
50. **Panelists picks for attractive sectors in 2025:** Panelists state their picks for attractive sectors in 2025: 1) Senior tranches from esoteric deals. 2) Non-QM loans. 3) Everything. 4) Everything. 5) Esoterics.
51. Solar panels combined with battery systems are becoming increasingly popular for consumer installations. They allow consumers to capture power produced during the day for use in the evening.

4:15 pm Energy Infrastructure & Financing the Transition

52. The Unit 1 nuclear reactor at Three Mile Island is being restarted to power a data center for Microsoft.⁷ The demand for power is growing quickly. Part of the demand is from data centers, but much more is from ordinary users. According to one estimate, 3% of U.S. power is used by data centers. One gigawatt powers a million homes. The construction of new data centers, particularly for artificial intelligence (AI) servers, creates incremental demand for electric power. It is unclear how much power the data centers will ultimately need.⁸ There are about 25 nuclear permits in the pipeline to serve data centers.

⁷ The Unit 2 reactor at Three Mile Island experienced a partial melt down March 28, 1979. That reactor has not operated since then. Clean-up and decontamination were completed in 1993 at a total cost of roughly \$1 billion. The Unit 1 reactor was offline at the time of the accident. Unit 1 operated until September 20, 2019.

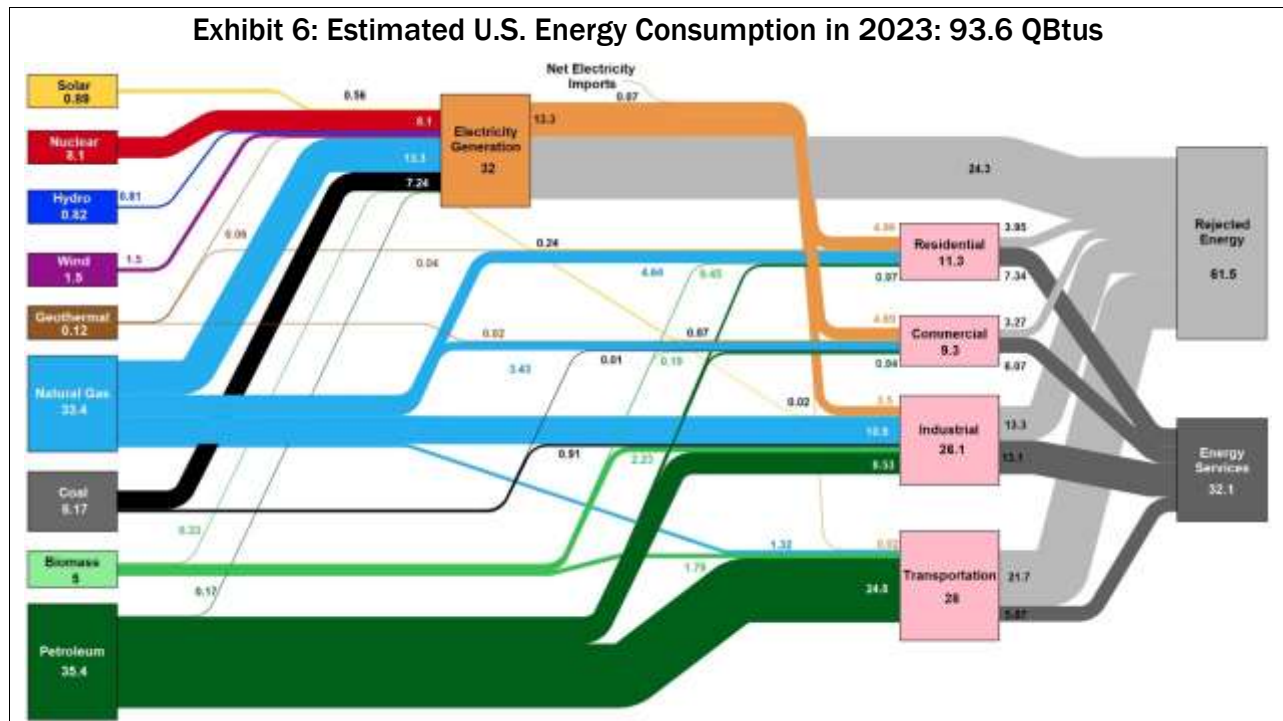
⁸ According to S&P Global, data center power usage for 2024 will be 371.6 TWh and is expected to grow to 760.7 TWh by 2029. Lenoir, T., and A. Wilson, *Executive Summary, Datacenters and Energy 101—Intermittent Renewable Power in a 24/7 World*, S&P Global (26 Aug 2024), <https://pages.marketintelligence.spglobal.com/Datacenter-Energy-101--download-page-EMC.html>.



Source: U.S. Energy Information Administration, *U.S. Energy Facts Explained*, webpage (updated 15 Jul 2024), <https://www.eia.gov/energyexplained/us-energy-facts/>.

53. One panelist explains that transportation and industrial uses account for significant share of total energy demand (Exhibits 5 and 6). Some local governments have taken aggressive steps to address carbon emissions and promote clean energy. An example is Local Law 97 (LL97) in New York City, which requires buildings to move away from fossil fuels and toward using renewable energy sources. However, only 36% of New York City buildings report that they are ready to meet the City’s standards for 2030. This could create problems in the CRE and CMBS areas if buildings are forced to use their reserves to pay for either fines (for non-compliance) or system upgrades (to enable compliance).⁹

⁹ New York City Local Law 97 of 2019, https://www.nyc.gov/assets/buildings/local_laws/ll97of2019.pdf; N.Y.C. Admin. Code §§ 28-320 and 28-321, https://www1.nyc.gov/assets/buildings/apps/pdf_viewer/viewer.html?file=2014CC_AC_Chapter3_Maintenance_of_Buildings.pdf§ion=conscode_2014. A panelist at ABS East 2022 characterized LL97 as “ridiculous.” Some property owners have challenged the law. See *Glenn Oaks Village Owners v. City of New York*, 211 N.Y.S.3d 329, 227 A.D.3d 523 (N.Y. App. Div., 1st Dept., 16 May 2024), https://www.nycourts.gov/reporter/3dseries/2024/2024_02754.htm. The first eight pages of the complaint in the case offer a sharp criticism of the law (<https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=A0VLbhVJ7vrRCwgnnUBkTQ==&sy>



Source: Lawrence Livermore National Laboratory and U.S. Department of Energy, <https://flowcharts.llnl.gov/sites/flowcharts/files/styles/orig/public/2024-10/energy-2023-united-states.png>.

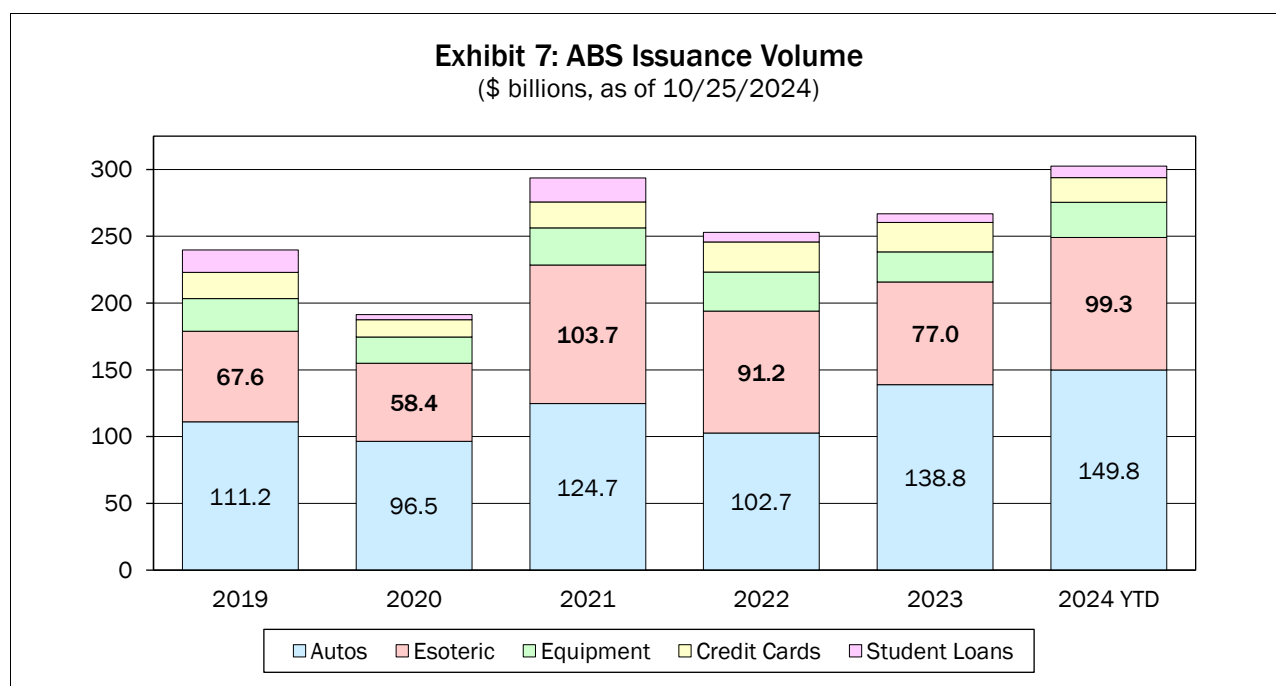
54. One panelist emphasizes that green hydrogen will be important for applications that require higher energy density than batteries can provide. However, the government has essentially killed green hydrogen by recently requiring collocation of green energy generation with electrolyzer facilities.
55. Lenders are financing projects that do not have committed buyers for the tax credits.
56. **Panelist Outlooks for Hot Energy Areas for 2025:** 1) Charging stations. 2) Offshore wind. 3) Efficiency improvement loans (e.g., solar installations, heat pumps). 4) Private credit will become active in project finance, “energy as a service” will expand financing options for green upgrade projects, and virtual power plants will become a larger source of electric power.

[stem=prod](#)). In my view, some aspects of LL97 appear ill conceived. Specifically, LL97 pushes buildings to use electricity for heat. That seems like an anti-green policy while fossil fuels are being burned to produce electricity. Burning fossil fuel to produce electricity that is then used to heat buildings is wasteful on two levels. First, there is an inherent limit on the efficiency with which heat can be converted to electricity (i.e., Carnot efficiency). Second, a significant portion of the electricity generated is lost in transmission (Exhibits 5 and 6). This means that, until fossil fuels are no longer used to generate electricity, it is greener and more efficient to burn them directly for heating instead of for generating electricity for that purpose.

Tuesday, October 22, 2024

9:20 am Esoteric Asset Finance

57. One panelist defines esoteric ABS as products that are more complicated to analyze: whole businesses, data centers, timeshare receivables, and others. Esoteric assets account for about a third of total ABS issuance: roughly \$96 billion so far this year (Exhibit 7). There are more than 100 active buyers for each of several esoteric ABS asset classes. Another panelist says that many esoteric ABS deals present heightened servicer risk (and, therefore, offer wider-than-average spreads). Esoteric ABS are less liquid than mainstream ABS. There is increasing interest in esoteric ABS from all types of ABS investors. Esoteric ABS offer an attractive alternative to investing in mainstream ABS deals from lower-tier issuers. Other panelists emphasize that esoteric ABS deals often have idiosyncratic structures and the need for greater investor education on the underlying asset classes.



Source: FinSight.com

58. One panelist likes data centers, music royalties, and triple-net leases because they provide diversification without much sacrifice of liquidity. The tight level of investment-grade corporate spreads is motivating investors to enter the esoteric ABS sector. Significantly, the new entrants to the sector are performing extensive due diligence and analysis. Another panelist states that data centers are a hot asset class and are projected to have large issuance volume going forward. The senior tranches of whole business securitizations typically does not receive triple-A ratings. Instead, they generally receive single-A or triple-B ratings and offer correspondingly wide spreads (*i.e.*, in the 200s). A third panelist mentions litigation finance as an esoteric asset class. The panelist notes the use of third-party insurance as a form of credit support in certain esoteric ABS deals. Life insurance companies have an appetite for exposure to property and casualty insurance companies. Another panelist notes digital infrastructure (apart from data centers) and

intellectual property (IP) royalties as sectors that will likely grow. Capital call finance and net-asset-value (NAV) lending are also potential areas for growth.

59. **Outlook for Interest Rates:** One panelist expects the Fed to cut rates by 25 bps at the next meeting. Rates are likely to be slightly lower in the coming year. Importantly, ABS activity is not highly sensitive to the overall level of rates because ABS issuance is an efficient form of financing. A more significant factor is the financial health of consumers. Another panelist states that interest rates are expected to decline in the near term, which has prompted some issuers to delay their financing activities in order to capture lower rates in the near future. On the other hand, macro forces, such as the bulging federal deficit, point to the likelihood of higher rates in the longer term. A third panelist does not expect a major drop in rates. ABS issuance activity is less sensitive than MBS issuance to the overall level of interest rates. A bigger factor in the near term is the shape of the yield curve. Another panelist emphasizes that the overall level of rates affects issuers' decisions about whether to use bank lines of credit or to lock in financing costs by issuing term ABS.

Audience Polling Question: Over the next year, do you think esoteric ABS issuance volumes will be...?	
up moderately	60%
up significantly	33%
flat	7%
down moderately	0%
down significantly	0%

60. **Volume Predictions:** In a poll of the audience, most respondents expect esoteric ABS issuance volume to increase moderately. One panelist observes that private equity (PE) firms are using ABS issuance. Aviation, whole business, and triple-net leases are the key esoteric asset classes that are fueling esoteric ABS volumes. Another panelist notes that an anticipated soft landing for the U.S. economy has driven spreads to very tight levels, which has spurred investors to chase yield in esoteric asset classes. Also, the Basel III endgame proposals—and the prospect of higher capital requirements for both regional and systemically important banks—prompts bank interest in executing credit-risk transfer (CRT) deals. Non-bank investors are becoming a larger source of funding. Another panelist notes that insurers owned by private equity firms are key investors in esoteric asset classes.
61. One panelist notes that some issuers start with issuing esoteric ABS as private placements. They later advance to become regular issuers whose deals achieve mainstream acceptance.
62. **Predictions for Hot Asset Classes in 2025:** One panelist states that music royalties are the most interesting asset class for the coming year. Performance is uncorrelated with consumer assets. The senior tranches receive ratings below triple-A. The sector is growing. Another panelist identifies whole business securitization as a hot asset class for 2025. Collateral performance has been strong and the cash flows are senior in corporate capital structures. A third panelist asserts that financing chip purchases for AI calculations has potential to become a hot area. A fourth panelist picks C-PACE and digital infrastructure as hot areas for the coming year. A fifth panelist picks cross-border deals and non-U.S. activity. Another notes litigation finance.

10:10 am Investor Roundtable

Audience Polling Question: Where will the Fed Funds rate be at the end of 2025?	
down by 50 bps or less	16%
down by 100 bps	45%
down by 150 bps	32%
down by 200 bps	5%
down by 250 bps or more	3%

63. One panelist asserts that the result of the presidential election will affect the ABS market because the candidates embrace differing views about regulation and the federal deficit. Another panelist asserts that Trump would neuter the CFPB if he wins the election. On the other hand, it would be difficult for Trump to dismantle the Inflation Reduction Act because it is legislation.¹⁰ Student loan forgiveness and incentives for home buyers are other areas that would depend on the outcome of the election.
64. One panelist observes that the yield curve has been inverted for an unusually long time. A policy-neutral Fed funds rate would be significantly below current levels, which are very restrictive. A steepening yield curve will benefit securitization investors by providing returns from roll-down as deals season.

Audience Polling Question: If you are a buy-side investor, what is your investment strategy before the election outcome is known?	
Cautious/slower pace	45%
Business as usual	40%
On hold until outcome known	15%

65. Another panelist states that investor appetite for structured product has been brisk. Corporate spreads are at the tightest levels since the 2008 financial crisis, which makes securitized products attractive on the relative basis. A steeper yield curve would likely motivate banks to buy more agency MBS. Another panelist expects investor appetite to remain brisk.
66. One panelist asserts that esoteric asset classes will be important in 2025 and post strong issuance for the year.
67. One panelist states that deals backed by data centers are likely to move from the private placement arena to the public/144A market. Increased supply of data center deals will likely spur increased demand. Additionally, non-QM MBS issuance is likely to grow. Another panelist states that securitization will likely have a larger role in sustainable finance. A third panelist emphasizes strong demand for financing solar projects and data centers. Credit card ABS issuance is likely to grow. Cross-border securitization issuance is also likely to grow. Another

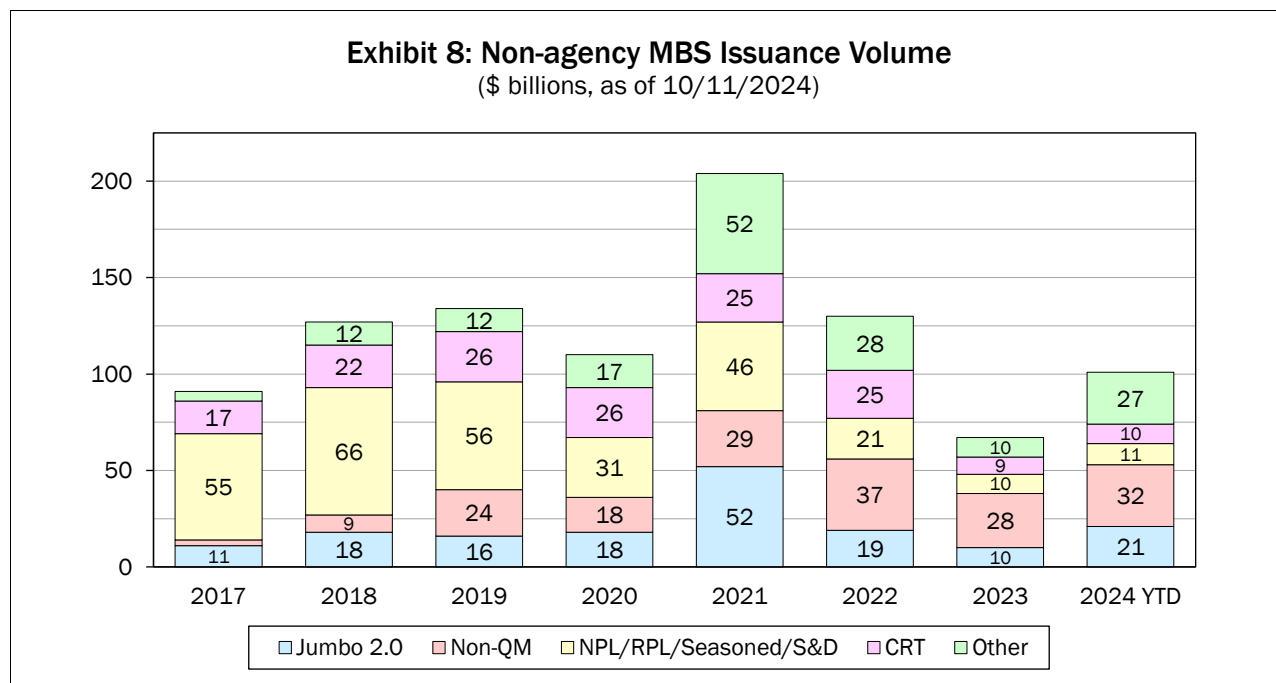
¹⁰ Pub. Law 117-169, 136 Stat. 1818 (2022), <https://www.govinfo.gov/content/pkg/PLAW-117publ169/pdf/PLAW-117publ169.pdf>.

panelist notes that the CRE/CMBS area has been under stress and will display growth when it eventually recovers.

68. **Private Credit:** One panelist explains that spreads have converged between the public/144A and private markets. That is appropriate. Private ABS is a separate market but the process for investors should be the same. Investors should analyze collateral, servicing, asset underwriting, deal structuring, and relative value. The key step is evaluating relative value between public and private deals. A key risk in private deals is a potential lack of transparency. Public deals that get into trouble are visible to the whole market. By contrast, troubled private deals remain hidden. This is a danger for investors. The overall market would benefit from having a larger proportion of deals executed in the public market. Another panelist states that the risks in private deals are the largely the same as risks in public deals. A third panelist returns to the issue of the lack of transparency in the private market. The panelist also notes a decline in liquidity for public deals.
69. **Consumer ABS:** One panelist notes that inflation is pressuring consumers. Natural disasters are another source of stress. The recent hurricane affected 300,000 to 500,000 cars. Insurance on the vehicles is a mitigant for auto ABS deals. Most of the rental fleet operators moved their fleets to safe areas to limit damage. Timeshare ABS are vulnerable to hurricanes/storm damage because they are predominantly located in coastal areas. Franchise and triple-net lease deals are well diversified and less affected by natural disasters.
70. One panelist states that the outlook for office properties is uncertain. In the current environment, a CRE investor can have their pick of opportunities. Operational risk is a key issue for legacy deals. Music royalties are a great opportunity, but there is significant exposure to the operator/manager of the portfolio.
71. **Relative Value:** In a poll of the audience most respondents state that a republican sweep in the election would be best for securitized products (*i.e.*, cause the greatest spread tightening). One panelist favors triple-B-rated securitization tranches (other than CMBS) over triple-B-rated corporate bonds.
72. **Favorite Trade Idea:** One panelist claims that there are attractive opportunities in all areas of the ABS landscape. There is lots of dispersion. Active management is about knowing where to be. Another panelist agrees that there are opportunities in every sector, and even within transactions at different tranche levels. A third panelist states that esoteric ABS offer good opportunities for investors, but that they have to “do a lot of work” (*i.e.*, analyze opportunities and be selective). A fourth panelist recommends the whole business securitizations. A fifth recommends commercial real estate and C-PACE deals. A sixth recommends 1) non-QM MBS for investors focused on triple-A-rated investments, 2) mezzanine tranches of prime MBS for investors focused on medium-grade credit exposure, and 3) CLO equity for investors with the highest risk appetite.
73. **Tone of the Conference:** Panelists summarize their impressions of the overall tone of ABS East 2024: 1) Positive; everything is good. 2) Positive, if not bullish. 3) Curious to understand what others are thinking. 4) Constructive regarding the resilience of the economy. 5) Times are good and the conference is celebrating innovation and the market’s success.

11:30am RMBS Market Outlook

74. Non-agency MBS issuance is up significantly since 2023 (Exhibit 8).



Source: Gupta, P., J. Curro, C. Flanagan, G. Chu, Y. Yin, A. Gupta, and L. Wang, *Non-agency MBS Weekly*, BofA Global Research (11 Oct 2024) (Exhibit 1).

75. **Outlook:** One panelist states that the recent 50 bps rate cut by the Fed is like an insurance policy for near-term uncertainty. The labor market appears strong and there has been other positive data. The market has repriced the likelihood of future rate cuts; down from 50bps to less than 25bps. The market is signaling to the Fed what to do. The strength of the economy has been positive for RMBS, even though high interest rates and home price appreciation have strained affordability for new potential homeowners. Despite the positive economic conditions, it seems likely that the Fed will continue to cut interest rates, though not by as much as if the economy needed stimulus. Another panelist states a similar view. The environment is good for fixed-income and spread products. Mortgage rates declined significantly even before the Fed’s recent 50 bps rate cut. The housing market is on a very healthy foundation. A third panelist notes that a year ago many market participants were expecting 7 or 8 rate cuts in 2024, which did not happen. A key factor is the spread between the Fed Funds rate and PCE inflation index. The Fed can see the economy and conclude that restrictive policy is not warranted. The strength of consumers seems to defy predictions. The marginal buyers of homes are Millennials and Gen Zers. The housing market is likely to be slow for the near term.

76. **Home Price Appreciation:** One panelist says that home price appreciation has slowed as mortgage rates have come down from their peaks in 2023Q4. It has been roughly 2% for 2024 and will likely be 3% for 2025. A second panelist generally agrees, highlighting that there is likely to be dispersion in home price appreciation across regions and MSAs. Rising insurance premiums may create a drag on home price appreciation in certain parts of the country. A third

panelist states that home prices should be expected to rise as mortgage interest rates move lower. Home prices will likely stay high even though affordability remains a challenge for Millennials.

77. **MBS Basis:**¹¹ It is unclear what the main source of demand for mortgages will be. Demand from banks and the GSEs remains uncertain. One panelist states that his firm recommends overweighting mortgages. A key factor will be the bank capital treatment for conventional loans. Banks are likely to gravitate to shorter-duration products. Another panelist predicts agency MBS net issuance of \$250 billion for 2025.
78. One panelist asserts that demand is outpacing supply for non-agency MBS. Life insurers are key buyers. Fixed annuity sales by insurers have been an underlying driver of demand by life insurers for MBS.
79. **Regulatory and Legal:** One panelist explains that there are now five key legal and regulatory issues. *First*, the securitization risk-retention rules in the UK are completely changing.¹² Most MBS deals try to comply with UK requirements. *Second*, the SEC's conflict of interest rule becomes effective next year.¹³ Within a year there will be conflict-of-interest compliance requirements at issuers. *Third*, FINCEN will impose a reporting regime for sales of residential real estate, which will affect management of REO properties.¹⁴ *Fourth*, a recent court decision could make many securitizations vulnerable to interference from the CFBP.¹⁵ The decision was from a federal appeals court and has been appealed to the Supreme Court. *Fifth*, in June the Supreme Court threw out the longstanding *Chevron* doctrine, which required courts to give deference to regulatory interpretations of ambiguous laws.¹⁶ The elimination of the *Chevron* doctrine may undermine existing rules and create uncertainty.

¹¹ The term "MBS basis" generally refers to the yield spread between the current coupon agency MBS and the 10-year Treasury. The MBS basis fluctuates over time and is quite sensitive to whether the Fed is a net buyer of agency MBS.

¹² Financial Conduct Authority, Policy Statement PS24/4—Rules Related to Securitization (April 2024), <https://www.fca.org.uk/publication/policy/ps24-4.pdf>.

¹³ 17 C.F.R. § 230.192 (2024); Securities and Exchange Commission, *Prohibition Against Conflicts of Interest in Certain Securitizations*, Release no. 33-11151, 88 Fed. Reg. 9678 (14 Feb 2023), <https://www.govinfo.gov/content/pkg/FR-2023-02-14/pdf/2023-02003.pdf> (quick fact sheet at <https://www.sec.gov/files/33-11151-fact-sheet.pdf>).

¹⁴ Financial Crimes Enforcement Network, Department of the Treasury, *Anti-Money Laundering Regulations for Residential Real Estate Transfers*, 89 Fed. Reg. 70258 (29 Aug 2024) (final rule), <https://www.govinfo.gov/content/pkg/FR-2024-08-29/pdf/2024-19198.pdf>.

¹⁵ *Consumer Fin. Prot. Bureau v. Nat'l Collegiate Master Student Loan Tr.*, 96 F.4th 599 (3rd Cir. 2024), <https://www.govinfo.gov/content/pkg/USCOURTS-ca3-22-01864/pdf/USCOURTS-ca3-22-01864-0.pdf>.

¹⁶ *Loper Bright Enterprises v. Raimondo*, No. 22-451 (U.S., decided 28 Jun 2024), https://www.supremecourt.gov/opinions/23pdf/22-451_7m58.pdf.

80. **RTL Securitization:** Many RTL (residential transition loans) deals were unrated before Morningstar published criteria for rating them.¹⁷ Now Morningstar rates many of the deals. The release of the rating criteria has spurred a tightening of credit characteristics, including eligibility criteria and concentration limits. There has been standardization of deal features, such as minimum credit enhancement for all tranches. RTLs have a role in alleviating housing shortages because they finance rehabilitation of existing housing stock. Another panelist notes that there is both a shortage of new housing units and a need to rehabilitate old housing stock. RTL loans have a short performance history; once the sector experiences a period of stress there will be greater confidence in its resiliency.
81. **Risks and Tailwinds:** Panelists identify risks and tailwinds for RMBS 1) Geopolitical risk, deficits, oil prices. 2) Same risks as the first panelist; a steeper yield curve would be a tailwind. 3) Risks include an inflation surprise or rising unemployment; a tailwind would be greater bank demand for mortgages to tighten the mortgage basis.

12:15 pm CLO Manager Perspectives

82. One panelist predicts continuing strong demand for CLOs. Market volatility can be a benefit for CLO managers. Another panelist states that his firm anticipated rising inflation and positioned itself accordingly. Higher interest rates mean higher interest costs for floating-rate, leverage-loan borrowers. A third panelist expresses a similar view about interest rates and adds that spreads are likely to remain tight for at least three to six months. Half of the loan market is trading above par. CLOs are not the only source of demand for leveraged loans but they are an important one. CLO issuance fuels demand and spread tightening on the underlying loans. Current yield levels are very attractive relative to what they were pre-pandemic.
83. One panelist states that defaults and distressed exchanges are increasing. A sizable proportion of companies that go through so-called “liability management exercises” (LMEs) end up ultimately defaulting.¹⁸ The panelist states that the rate of defaults in the near future is likely to remain flat,

¹⁷ Tang, Q., S. Kongettira, K. Tillwitz, and C. Mezzanotte, *RMBS Insight 1.3: U.S. Residential Mortgage-Backed Securities Model and Rating Methodology* at 58-63, Morningstar DBRS (28 Jun 2024), <https://dbrs.morningstar.com/research/435279/rmbs-insight-13-us-residential-mortgage-backed-securities-model-and-rating-methodology-archived>; Gonzalez, C., M. Branton, and Q. Tang, *Residential Transition Loans—A Primer*, Morningstar DBRS (19 Sep 2024), <https://dbrs.morningstar.com/research/439707/residential-transition-loans-a-primer>.

¹⁸ Baker, N., J. Mitnick, and D. Bechade, *The Latest Developments in Liability Management*, Global Turnaround (Aug 2024), <https://www.stblaw.com/docs/default-source/publications/globalturnaroundsaugust2024.pdf>; Marsh, B., *Liability Management Transactions*, LSTA news release (12 Apr 2023), <https://www.lsta.org/news-resources/liability-management-transactions-lmts/>; Petrova, L., E. Tam, and S. Boyd, *Most Liability Management Transactions Only Delay Default, Clip Recoveries*, Fitch Wire (17 Apr 2023), <https://www.fitchratings.com/research/corporate-finance/most-liability-management-transactions-only-delay-default-clip-recoveries-17-04-2023>; Morse, D., *What’s a Lender to Do? A Review of Some 2020 Cases on “Liability Management Exercises” and the Covenants to Address Them*, Program for the Association of Commercial Finance Attorneys (21 Jan 2021), [https://www.otterbourg.com/assets/htmldocuments/Liability%20Managment%20Exercises%20Article%20ACFA%](https://www.otterbourg.com/assets/htmldocuments/Liability%20Managment%20Exercises%20Article%20ACFA%20)

but the rate of downgrades is likely to climb. Legacy telecommunications and cable services are sectors that are particularly under stress. Technology and healthcare are sectors with pockets of stress. Syndicated bank loans (BSLs) generally have weak covenants, but that is not a problem if the underlying business is strong. Another panelist emphasizes that relying on contractual covenants for protections means that a lender has already lost the “credit battle” and will end up with a bad outcome. Achieving positive outcomes depends on a lender’s ability to select borrowers that will not default.

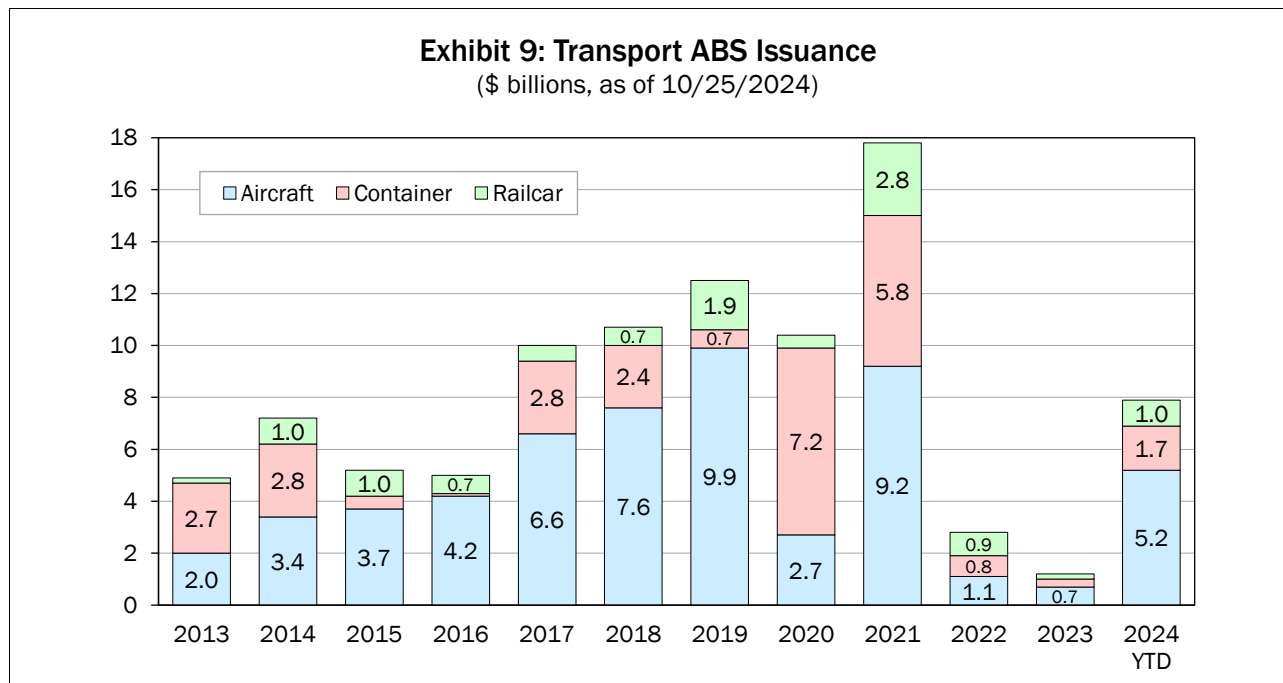
84. One panelist explains that recent reset/refi transactions have lowered the weighted-average cost of debt of for many CLOs.¹⁹ There will likely be more reset/refi activity as the advantage of lowering interest costs outweighs the cost of executing the transactions.
85. Another panelist explains that there are key differences in manager performance and styles. This is reflected in different portfolio characteristics across managers. Examples of portfolio characteristics that vary across managers include average credit quality (as measured by WARF), collateral marks (*i.e.*, prices), and the number of credits in a CLO portfolios. Trading frequency also varies across managers. Some trade only when there is a problem while others also trade positions that have experienced gains. There is a wide range of variation in portfolio characteristics and manager trading activity. A significant proportion of managers may be considered “outliers” with respect to the overall averages.
86. One panelist asserts that there are limited opportunities to acquire loans at prices below par. Current areas of concern for CLO managers include 1) the possibility that interest rate cuts will be delayed, 2) the impact of the election, and 3) the vulnerability of over-levered credits. Another panelist describes a strategy of not making/buying loans that are initially priced at very tight spreads and later buying them in secondary trades at discount prices. Another strategy is to purchase a short-term exposure with strong covenants to a distressed borrower and later to get bought-out as a precondition to an LME.
87. **Bond Buckets:** One panelist explains that bond buckets are a useful feature in a CLO because they allow a manager to include bonds in the portfolio when bond prices are more attractive than loan prices. Another panelist explains that his firm uses CLO bond buckets as a risk mitigation tool. There may be opportunities to buy low-coupon, deep-discount bonds from strong issuers like Apple or Amazon. A key consideration is to avoid failing overcollateralization tests; buying deep-discount, high-quality bonds helps in that regard.

[20Panel%20January%202021.pdf](#) ; Morse, D. and V. Mason, *What’s a Lender to Do? Some 2020 Cases on “Liability Management Exercises” and Covenants to Address Them*, Webinar slides (20 May 2021), <https://www.otterbourg.com/assets/htmldocuments/Liability%20Management%20Exercises%20Slide%20Deck%20May%202020%202021.pdf>.

¹⁹ Resets are transactions that lower the interest rate on a CLO’s outstanding notes. Refis (*i.e.*, refinancings) are transactions that involve redeeming a CLO’s outstanding notes and issuing replacement notes with lower interest rates.

3:30 pm Transport Assets

- 88. Most of the discussion will be about aircraft finance. Four of the five panelists come from that sector. The fifth panelist focuses on shipping containers.
- 89. One panelist asserts that commercial aviation is poised to grow. The worldwide fleet will likely grow from 25,000 to 50,000 aircraft. Aircraft ABS is rarely used to finance new airplanes. Aircraft deliveries were down during the Covid-19 pandemic. The secondary market for used aircraft is roughly \$700 billion. That is where aircraft ABS has a is generally used. Aircraft ABS account for a large share of all ABS backed by transport assets (Exhibit 9):



Source: Finsight.com.

- 90. Another panelist states that containers are an interesting asset classes and are highly correlated to shipping. The asset class is sensitive to any disruption in supply chains. The period immediately following the COVID-19 pandemic was an interesting one for the container sector. Shipping companies were generally choosing to own containers rather than leasing them. Lessors were not as active as they had been. In contrast to the past two years, 2024 has been an active year for container lessors. Container leasing activity is expected to be strong next year, in the range of \$1.5 billion to \$3 billion.
- 91. One panelist emphasizes that aircraft lessors issue both corporate debt and ABS. Another panelist explains that aviation finance activity is tied to the geopolitical environment. The Covid-19 pandemic was a major disruption. After an issuance slump in 2020, aircraft ABS issuance recovered in 2021. Then it slumped again in 2022 with Russia’s invasion of Ukraine. Issuance remained slow in 2023 and has significantly recovered in 2024 (see Exhibit 9).
- 92. Another panelist counters that Russia’s invasion of Ukraine was not as big a factor as higher interest rates. Also, the issuance statistics include private aircraft, which are subject to different

influences than commercial aircraft. Recent aircraft ABS deals have included C notes but not E notes.²⁰ Investors who want exposure to equity are sometimes investing alongside the servicers and lessors. Panelists agree that aircraft ABS structures in the near future are likely to include C notes in 2025 but not E notes.

93. One panelist explains that airlines lease aircraft because they have weak credit and it is more economical than outright ownership. About 55% of commercial aircraft are leased.
94. **Market Fundamentals:** One panelist observes that China and Singapore are big players in air travel. The number of stored aircraft is declining. Another panelist adds that collections are stable. CLTVs are decreasing. There are many lease extensions because airlines want to retain their aircraft. Dispositions are healthy. Deleveraging of aircraft ABS deals has produced upgrades. Moody's rates senior tranches new issue aircraft ABS single-A. This contrasts with the time before the 2008 financial crisis, when Moody's would assign initial ratings of double-A or triple-A to the senior tranches of aircraft ABS deals.²¹
95. One panelist explains that the values of narrow-body aircraft values are more stable than the values of wide-body aircraft. This is because the former are more fungible (easier to move between operators). The Covid-19 pandemic was a major shock to the value of wide-body aircraft. One panelist posits that the current strong aircraft valuations are a bubble caused by manufacturing interruption at Boeing. Another panelist explains that the backlog of orders for new aircraft is likely to persist for five to ten years.
96. The Covid-19 pandemic caused a storm of downgrades of both aircraft ABS and EETCs. The pre-Covid deals had higher (*i.e.*, weaker) LTVs and higher concentrations of wide-body aircraft. Many bonds fell behind their payment schedules and the remarketing of wide-body aircraft that came off their leases was slow. Deals breached their DSCR triggers. There has been a partial recovery as conditions have improved.

²⁰ Many recent aircraft ABS transactions have been structured with three rated classes, generally designated A, B, and C. Class A securities generally received initial ratings of single-A. Class B securities generally received initial ratings of triple-B. Class C securities generally received initial ratings of double-B. *See* Runte, D., and J. Vivek, *An Introduction to Aviation Debt: Enhanced Equipment Trust Certificates (EETCs), Aircraft Asset-Backed Securities (ABS), SGR Financings, and Other Types of Airline Secured Debt*, at 75-79, Deutsche Bank (13 Sep 2021), https://conferences.db.com/files/documents/americas/21-AFL_Airlines/Presentations/1100_Introduction+to+Aviation+Debt_Runte.pdf; *see generally* Structured Finance Association, *Alternative and Emerging Asset Class Spotlight: Aircraft ABS* (20 Mar 2020), <https://structuredfinance.org/wp-content/uploads/2020/03/SFA-Primer-Alternative-and-Emerging-Asset-Class-Spotlight-Aircraft-ABS.pdf>; S&P Global, *Sector Intelligence—Aircraft Index Report* (20 Nov 2023), <https://www.spglobal.com/assets/documents/ratings/research/101589676.pdf>. In the past, senior classes received higher ratings and there were more classes in transaction structures.

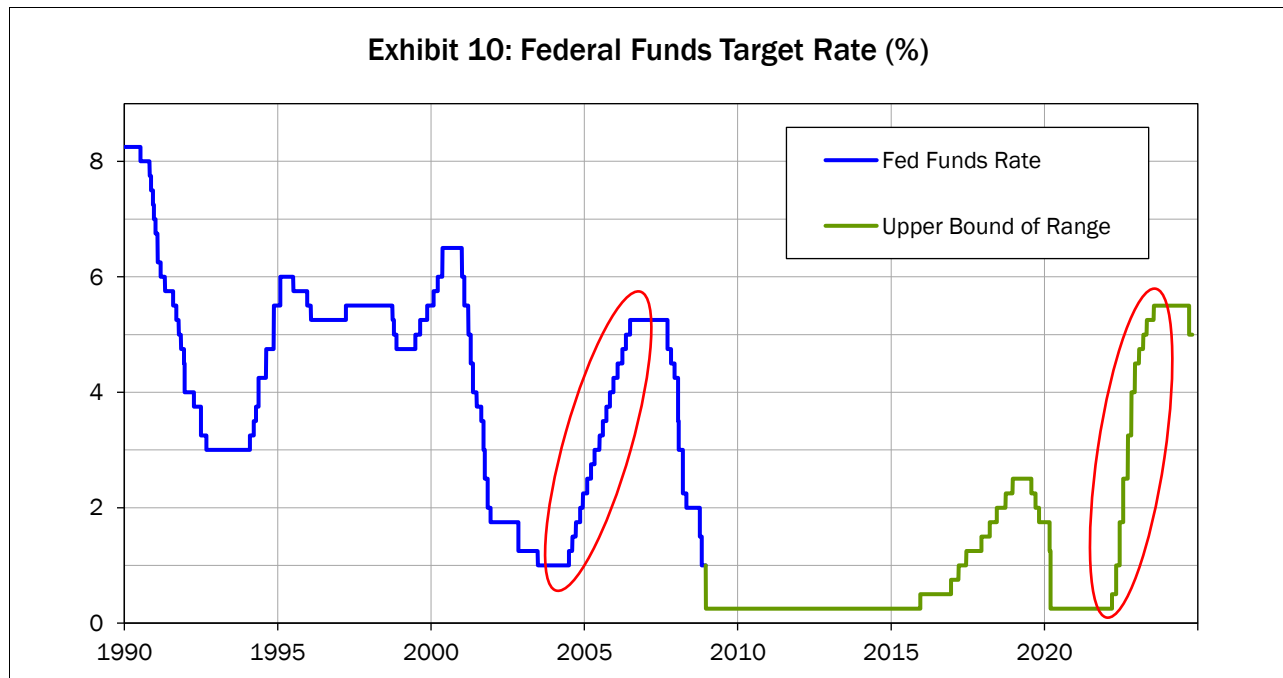
²¹ Tuminello, M. and Z. Chen, *Moody's Approach To Pooled Aircraft-Backed Securitization*, Moody's (12 Mar 1999) (the original authors' names were replaced with M. McDermitt and G. Eiger when the report was re-released in 2013), https://www.moodys.com/research/doc--PBS_SF7341; Tobey, A., J. Joseph, and B. Shih, *Moody's Approach to Monitoring Pooled Aircraft-Backed Securitizations*, Moody's (15 Nov 2018), https://www.moodys.com/research/doc--PBS_1131660;

97. Ratings of container deals have improved. The sector is delivering solid performance and establishing a strong track record. Some container deals have received double-A ratings on their senior tranches. The rating improvements, however, have not improved pricing.
98. Investors want deals with younger aircraft and narrowbody aircraft.
99. Creditworthy U.S. airlines have increasingly been using operating leases, which will be included in securitizations and may support the issuance of C tranches. There is strong demand for older narrowbody aircraft. A high proportion of newer narrowbody aircraft are currently parked.
100. One panelist highlights the risk of aircraft ABS becoming “zombie deals” that amortize very slowly.²² Another panelist notes that in some cases the best outcome for ABS investors may be a slow amortization (because they can receive higher interest and avoid defaults).
101. One panelist states that the quality and experience of an aircraft lessor’s management team is a key consideration in rating ABS backed by the lessor’s aircraft leases. The management team’s track record—even at a different firm—is more important than how long the leasing company has been in business. Another panelist states that some aircraft lessors typically start with temporarily warehousing leases before financing them with ABS. A third panelist highlights that leasing companies with larger staffs have greater capacity to get things done. A team of just four people does not work.

4:15 pm The Rise of Bank SRT & BSO

102. Twenty years ago, in 2004, there was a 300 bps jump in interest rates. The recent jump in interest rates has a historical precedent (Exhibit 10). Bank assets represent roughly 80% of U.S. GDP. There are about 4,700 U.S. banks today, compared to roughly 10,000 in the past. It is more important than ever to manage the \$2 trillion of aggregate bank capital. Banks are highly regulated and must operate in a rules-based framework. They are at least partially taxpayer supported.

²² Aircraft ABS transactions are often structured with an “anticipated repayment date” (ARD), which comes much before the legal final maturity of the securities. Deals with ARDs generally provide that interest on the securities increased following the ARD. This feature is supposed to give the issuer an incentive to redeem the securities on or shortly after the ARD.



Notes: The Federal Funds target rate started being given as a range on December 16, 2008. Values shown after that date reflect the upper bound of the target range.

103. Synthetic risk transfer (SRT) is an innovative area. According to a recent news story, about \$1 trillion of loans have been covered by SRT transactions representing roughly \$16 billion of issuance.²³ The nation's largest bank has announced a new SRT transaction.²⁴ Another recent news article reports that the SRT may pose a risk to global financial stability.²⁵
104. Another panelist states that the level of SRT activity has increased over the past year following the Fed's release of its FAQ on SRT transactions.²⁶ SRT has been much more prevalent in Europe than in the U.S. Broader U.S. regulatory acceptance (helped by the FAQ) is the key development. SRT transactions allows investors to participate in risk alongside banks without diluting bank equity. It is unlikely that SRT will merge completely with mainstream securitizations. SRT can be applied to very esoteric assets. SRT transactions are sometimes

²³ Duarte, E., *Loans Tied to SRTs Reach \$1 Trillion on Record Pace of Sales*, Bloomberg Law (21 Oct 2024), <https://news.bloomberglaw.com/private-equity/loans-tied-to-srts-reach-1-trillion-as-sales-run-at-record-pace>, <https://finance.yahoo.com/news/loans-tied-srts-reach-1-111704270.html>.

²⁴ Duarte, E., *JPMorgan Plans Risk Transfer Linked to \$3 Billion Loan Portfolio*, Bloomberg Law (16 Oct 2024), <https://news.bloomberglaw.com/banking-law/jpmorgan-plans-risk-transfer-linked-to-3-billion-loan-portfolio>, <https://finance.yahoo.com/news/jpmorgan-plans-risk-transfer-linked-164942182.html>.

²⁵ Noonan, L., *SRTs Pose Potential Risk to Financial Stability, IMF Says*, Bloomberg Law (22 Oct 2024), <https://news.bloomberglaw.com/capital-markets/srts-pose-potential-risk-to-financial-stability-imf-says>; International Monetary Fund, *Global Financial Stability Report*, at 44-45 (Oct 2024), <https://www.imf.org/-/media/Files/Publications/GFSR/2024/October/English/textrevised.ashx>.

²⁶ Board of Governors of the Federal Reserve System, *Frequently Asked Questions about Regulation Q—Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks* (28 Sep 2023), <https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm>.

called credit risk transfer (CRT) transactions or credit-linked note (CLN) transactions. SRT deals are not likely to become standardized, which may slow their acceptance and limit their liquidity.

105. One panelist explains that his firm covers 4,700 banks. It started introducing SRT to regional banks around 2017, drawing on the experience of some of its staff from working with European banks. It introduced a menu of choices to the banks and focused on the reasons for doing transactions. Next year is likely to be a big one for SRT transactions from regional banks.
106. *Is SRT a Solution in Search of a Problem?* One panelist from a small regional bank describes how executing an SRT transaction allowed the bank to restructure part of its balance sheet. It sought a cost-effective way to accrete risk-based capital. It used a portion of the proceeds to cover a realized loss. The SRT transaction was the most cost-effective option for achieving the bank's goal. Now it views SRT as part of its standard toolbox for addressing future challenges.
107. Another panelist explains that SRT deals come in a variety of different structures that address varying issuer needs and varying investor preferences. The panelist emphasizes that SRT transactions allow for wide customization.
108. A third panelist re-emphasize that there is a huge variety of structures for SRT transactions. Most of the European transactions were driven by banks. Most SRT transactions in the U.S. do not involve consumer assets. Rather, most U.S. SRT transactions involve corporate exposures. Some SRT deals provide security interests or collateral held by a third party. Those types of structures can achieve ratings higher than the issuing bank's rating. There is lingering uncertainty and apprehension about CRT among regulators. This creates an imperative for simple structures and small investor groups.
109. The industry suffers from broad lack of expertise about how effective SRT can be for many banks. Knowledge must be disseminated to reach the banks that can use it. Implementation of the Basel III endgame proposals²⁷ will be a key driver.

Wednesday, October 23, 2024

10:15 am In to the Matrix: Developments in AI for Financial Markets

110. The session will focus on AI and on how it is revolutionizing the securitization markets. One panelist explains that his firm uses artificial intelligence (AI) in the residential mortgage area for analyzing loans and their underlying homes. A new area is using photos of properties to score their quality. For example, satellite imagery provides information about the state of a home's roof. Satellite imagery also reveals other aspects of property condition. Another panelist states that his firm is embracing machine learning (ML) enhancements of traditional mortgage models. Generative AI systems can be tools for document processing and model validation. A third panelist describes using generative AI for summarizing and classifying notices and reports from CLOs. Generative AI is expected to figure into CLO management and operations. Generative AI

²⁷ See sources cited in note 4.

also helps with handling the huge volume of reports on other types of structured finance deals, which come in various formats (*e.g.*, PDF, text, Excel, etc.).

111. A fourth panelist explains that his firm uses AI to harvest and analyze three years of data on potential corporate borrowers. The firm's system uses the data to create financial projections and score a potential borrower against a cohort of similar companies. The system augments, but does not replace, human capability. The system also helps with credit monitoring. The AI features allow the company to operate with a smaller team.
112. One panelist explains that traditional mortgage models remain very popular because they offer straightforward explainability of their outputs. Younger staff members embrace ML models more readily than do older staff. Another panelist explains that generative AI models achieve roughly 70% accuracy in interpreting complex legal documents. Improving the models' accuracy is a key goal. They need to become more accurate to become truly useful.
113. One panelist explains that certain information must be redacted from satellite information to avoid legal violations. Examples include picture elements that reveal a borrower's religion or ethnicity. AI will likely bring major changes to the property appraisal process
114. Another panelist remarks that ML systems become more capable as they accumulate experience. Another highlights that deepfake technology is a malicious use of AI. Another explains that having separate datasets for training an AI model and then validating it is essential for constructing a model that will be effective across a range of environments.

11:30 am Endgame: Basel & Other Major Regulatory Considerations

115. One panelist explains that the Basel III endgame process has been in the works for a long time. Basel II was implemented in the U.S. in 2007, which was a full decade after it was proposed. The Basel III endgame process is called Basel IV in other jurisdictions. The U.S. implementation proposal²⁸ was 1,100 pages (in manuscript form) and attempted to address a broad array of issues. Last year's regional bank dislocation was a further issue on top of the ongoing Basel III endgame proposal.
116. Another panelist observes that banks have been largely absent from the mortgage market for several years but are now starting to return. A question for their trading desks is how will the banks rebuild their balance sheets under new capital requirements?
117. One panelist notes that the largest institutions will be the initial focus of regulatory interest. Certain aspects of the initial Basel III endgame proposal generated pushback from banks. Another panelist explains that there are four size categories of banks under the proposed framework (systemically important, >\$700 billion, >\$250 billion, and >\$100 billion).²⁹ Banks broadly oppose higher capital requirements. Other issues also matter. Small banks oppose the

²⁸ See sources cited in note 4.

²⁹ See, *e.g.*, 12 C.F.R. § 252.5 (2024), <https://www.govinfo.gov/content/pkg/CFR-2024-title12-vol4/pdf/CFR-2024-title12-vol4-sec252-5.pdf>.

market risk component known as “the fundamental review of the trading book” (FRTB), which would require two sets of calculations. Large U.S. banks broadly object to being required to hold higher levels of capital than their foreign competitors.

118. Another panelist emphasizes that banks oppose the operational risk component as well as the FRTB. A third panelist notes that Fannie Mae and Freddie Mac would be treated as separate entities under the proposal (*i.e.*, separate credit exposures), which may have the effect of splitting the uniform MBS (UMBS) market and undermining the fungibility of UMBS.³⁰ Based on Fed Vice Chairman Barr’s comments, category IV (smaller) banks may be unscathed.³¹ The proposals are still challenging for category III and IV banks. They used to have small teams of 3 or 4 people for handling regulatory capital compliance; now they need departments of 50 employees.
119. One panelist explains that classifying an asset as either “available for sale” (AFS) or “held to maturity” (HTM) has key implications. Another panelist observes that new purchases by category IV banks are have all been classified as AFS in the aftermath of the Silicon Valley Bank collapse. Small banks like CMO floating-rate classes. Regulators may limit CMO exposures. Larger banks can hold products with greater complexity and use hedges to manage risks. Small banks do not have the ability to replicate what large banks do. Also, small banks do not have as much fee income to sustain themselves when net interest income is low.
120. One panelist speculates that the liquidity coverage ratio (LCR) might come to include a duration constraint. Another panelist asserts that Fannie and Freddie are no longer the “policemen” of the mortgage basis. The private sector is holding an increasing share of mortgage loans, which implies that the basis should widen.
121. One panelist explains that the presidential election will strongly influence how the Basel III endgame proposal will evolve prior to its implementation. So far, there has been an unprecedented degree of regulatory acquiescence to industry objections. Foreign regulators will also have a voice in the timing of the U.S. Basel III endgame implementation because they must delay implementing their regulations if other jurisdictions are too slow. U.S. implementation will likely be no sooner than July 1, 2026, with the potential for delays.
122. One panelist says that Barr’s speech was a huge concession to the banks. If Trump is elected, he will push for further deregulation.
123. The European Banking Authority (EBA) is implementing the non-FRTB portion of its Basel III endgame on January 1, 2025. Another panelist states that the FRTB may push banks to tilt away from modeled products and toward liquid products.

— END —

³⁰ See 12 C.F.R. Part 1248 (2024), <https://www.govinfo.gov/content/pkg/CFR-2024-title12-vol10/pdf/CFR-2024-title12-vol10-part1248.pdf>.

³¹ Barr, M., *The Next Steps on Capital*, speech at The Brookings Institution (10 Sep 2024), <https://www.federalreserve.gov/newsevents/speech/barr20240910a.htm>.