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Rally drivers

US ABS recovery subject to potential shocks

The US ABS market rallied strongly in 2012, with CLO and CMBS issuance volumes in particular surprising many. A substantial recovery is anticipated in most areas next year, although this remains subject to potential fiscal and regulatory shocks.

“Across the spectrum of securitised products, 2012 has turned out to be an impressive year for investors, with substantial double-digit returns – 30%-40% plus in some cases – in several products. This is particularly notable as the recovery came after investors suffered through a particularly tumultuous turn the year before,” note structured product strategists at Morgan Stanley.

While the magnitude of 2012 returns is unlikely to be repeated in 2013, the investment case for securitised products remains strong, they suggest. First, in a world of low yields and shrinking risk premia, securitised products offer considerable pick-up relative to comparable credit assets. Second, their structural leverage is unique and provides an attractive opportunity in sectors where a fundamental recovery is underway, such as US housing.

US ABS issuance volume, excluding agency RMBS, is forecast to close 2012 at around US$313bn – including US$51.5bn (as at press time) of CLOs and US$47bn of CMBS – up by about 50% on 2011. ABS, CMBS – including conduit, agency and single-borrower deals – and CLOs should see US$200bn, US$150bn and US$75bn in issuance respectively next year. Non-agency RMBS issuance is expected to surprise to the upside with US$30bn.

ABS

The story of 2012 for the US ABS market is the Fed crowding out investors from agency RMBS, according to structured credit consultant Dan Castro. This had the effect of driving them into credit card and auto ABS, and then esoteric assets in the hunt for yield.

“The movement into less liquid assets is expected to continue, as the Fed maintains its activity in agency RMBS for the next few years at least. Investors still have money to put to work and yields remain low in other asset classes,” Castro observes.

Credit quality isn’t an issue for most sectors, with the only potential area of weakness likely to be in autos. “Auto ABS issuance is tied to sales. Some consumers may decide to wait before buying a new car, but Superstorm Sandy could fuel demand to replace them,” notes Castro.

He says that issuance in three segments surprised to the upside this year: credit card ABS, student loan ABS and CLOs. “Regulatory issues had previously kept credit card issuers away from the market, but there is more clarity around this now. Although credit card balances across the US are reducing, this isn't expected to affect volume in 2013."

Equally, demand remains for student loan ABS, so issuance in this sector is expected to continue next year. However, Castro warns investors to differentiate carefully between the relative safety of FFELP-guaranteed and private paper.

"Credit quality is patchy in the private student loan sector, so investors will be relying on credit enhancement for protection. Student loan ABS isn't an homogeneous asset class: private bonds are considered to be more esoteric than FFELP bonds, with different investors targeting each segment," he notes.

Private student loan ABS is, however, one of Bank of America Merrill Lynch's top picks – due to current spread levels and the potential for at least 25bp of tightening. The incremental spreads offered by floorplan ABS and Canadian credit card ABS are also compelling, according to ABS analysts at the bank, and demand for incremental spread could result in nearly 15bp of tightening in both sectors.

Finally, the demand for incremental spread should be supportive of tighter spreads for the container and time share asset classes. But spreads are expected to be range-bound for the auto, card, equipment and short-dated FFELP sectors.

CLOs

Meanwhile, CLO issuance volumes in 2012 came in at above revised forecasts, with the vehicles accounting for about 50% of leveraged loan investment for a second year in a row. Chandrajit Chakraborty, cio and managing partner at Pearl Diver Capital, notes that issuance volume this year is about the same as the level seen in 2005. He predicts that volume will reach US$70bn in 2013.

Chakraborty agrees that the hunt for yield is driving more investors to enter the market, which has also been supported by healthy loan issuance. "Equity returns have tightened but are still in the low- to mid-teens range. CLO 2.0 structures have embedded optionality and the ability to lock this in means that high-teens returns are possible. However, there are concerns that the rally has made the market too rich."

CLO triple-A spreads remained range-bound at 140bp-155bp for most of the year, while generic triple-B spreads fell from 625bp to 500bp. CLO analysts at RBS believe that both new issue and legacy CLOs offer value up and down the capital structure.

"We prefer triple-B and double-B CLO 2.0 tranches to single-A and triple-B CLO 1.0 bonds respectively. For similar levels of credit enhancement, we see close to 200bp of pick-up in some cases when comparing them side-by-side," they explain.

They add: "Despite greater convexity, new issue offers fresh ratings, cleaner portfolios, higher current coupons and generally better defined and more debt-friendly indenture language. In addition, we believe that new issue triple-As are still pricing wide of their fair value, suggesting there is more room for spreads to tighten."

Further, the RBS analysts favour CLO equity in both vintage and new issue deals, due to the stable supply of assets yielding greater than 10%. "Loan spreads remain wide, producing robust 34% cash-on-cash returns for equity holders in the legacy space. In the new issue space, cleaner portfolios with nearly all loans having Libor floors should produce sizeable returns. In addition, NAV has risen in many deals as loan prices – especially defaulted collateral – have increased significantly in 2012, offering more back-end principal value."

CMBS

Arguably the biggest surprise in 2012 was the strength of the rebound in US CMBS. Spreads tightened significantly during the year: senior benchmark legacy bonds were generically trading at 270bp at end-2011 and are now trading at 150bp. New issue CMBS 2.0 A4 bonds were trading at 120bp at end-2011 and are now at 90bp; AJs were at 265bp and are now at 140bp; double-As were at 400bp and are now at 180bp; and triple-B minus bonds were at 700bp and are now at 470bp.

Malay Bansal, senior director at Freddie Mac, says his personal view is that – despite this year's tightening – CMBS spreads will continue to tighten, but there is less scope for tightening compared to 2012. CMBS 2.0 last cashflow triple-A spreads could realistically tighten by a further 15bp-20bp and triple-B minus spreads by around 140bp in 2013.

The main reason for the rebound in US CMBS is that financing has improved, according to Bansal. "As spreads tighten, CMBS becomes more competitive with other sources of financing. As more financing becomes available in CMBS 2.0, legacy CMBS bonds benefit as loans on the cusp are able to refinance into new deals instead of going into default, reducing losses for legacy CMBS deals. This has created a sort of virtuous circle – the exact opposite to what we saw in previous years."

A big factor behind the spread tightening is rising pay-offs: net/net the CMBS market is shrinking by US$20bn-US$30bn per annum. Investors have to put the money they receive from redemptions back to work, thereby creating more demand for product. QE3 has also driven demand for safe assets, with CMBS fitting the bill.

However, given the increased competition, credit standards are becoming a little looser – although not to the extent that they are an egregious concern. Bansal also warns that the market remains subject to shocks.

"Investors should be watchful and look out for anything that could reduce the availability of financing in commercial real estate. The positive cycle could easily reverse," he explains.

Equally, security selection remains important for legacy bonds, as loans are resolved. By end-2013, uncertainty around maturity outcomes is expected to have reduced significantly, leaving the higher quality paper outstanding.

Nearly US$8bn of CMBS loans were modified this year, bringing the current total fixed-rate modified loan balance to US$36bn or 6.7% of the fixed-rate CMBS universe. But CMBS strategists at Citi anticipate that loan mods in 2013 will look somewhat different compared to 2012.

"We expect most modifications in the coming year will be aimed at addressing term problems," they explain. "Fewer of them will be needed for refinancing difficulties at loan maturity. As such, more mods will likely include provisions alleviating term payments, such as rate reductions, while simple maturity extensions could be less prevalent."

Although most loans maturing in 2013 are expected to be able to refinance, several large loans are unlikely to do so. Examples include the US$328.3m RREEF Silicon Valley Office Portfolio (securitised in JPMCC 2006-CB16 and JPMCC 2006-LDP8) and the US$273m 777 Tower (BACM 2006-6).

Additionally, the focus on already modified loans is likely to increase next year, according to the Citi strategists. About US$2.3bn of modified loans mature in 2013, with the potential to drive re-default rates up. In turn, long prepayment periods could introduce cashflow uncertainty.

Looking further ahead, maturities will spike up again in 2015-2017, with around US$100bn of 10-year loans coming due. “This may be an event that causes distress, but the hope is that the commercial real estate market will have recovered enough by then to absorb the maturities. However, it is something that we need to be mindful of in next few years,” Bansal observes.

Finally, the catastrophe bond market is on track for a record year in terms of issuance. “We’ve seen mortality, longevity and pension risk transferred to the capital markets in 2012. It will be interesting to see whether terrorism becomes the next risk to be transferred, potentially next year,” observes Paul Forrester, partner at Mayer Brown.

He is modestly bullish about US ABS heading into 2013 and anticipates a substantial recovery in a number of areas. “Issuance volume next year will be similar to this year’s levels, comprising traditional student loan, auto and credit card ABS and CLOs. Esoteric assets will also remain popular as investors continue to chase yield. However, private label RMBS isn’t going anywhere soon.”

Fiscal, regulatory issues

At present, the market’s focus is on the fiscal cliff – which could have a minor or major impact, depending on the outcome and how long it takes to fix. “If a problem does develop, the more liquid ABS sectors will be impacted less, but they will also come back the least once it’s fixed. More volatile esoteric classes will fall further off the cliff and have a much larger rebound once it is resolved,” Castro suggests.

He adds: “There is more uncertainty at the moment than is typical for the time of year and many issuers will wait until it’s resolved before tapping the market. A resolution – whether it’s good or bad – is better than no action.”

Castro points out that pay roll tax will come back into force in any scenario – a fact that some investors may not have considered. “It will hit paycheques of the middle class and lower. Even if there is some relief, budget cuts will still have an impact. There won’t be clarity on this issue for a while.”

Forrester agrees that the fiscal cliff is the headline risk for securitisation going into 2013. “While this issue appears to be sucking some oxygen out of the market, issuers are still bringing deals and recognise the economic value of securitisation – that it remains a cost-efficient financing tool.”

He also suggests that an element of bureaucratic fatigue is emerging regarding the Dodd-Frank regulations. “A rational approach to the risk retention rules, for example, is necessary. The premium capture proposal is flawed and creates unnecessary economic costs, while the definition of a qualified mortgage remains sketchy. These rules require some heavy-duty thinking and I’m not sure whether the regulators are up to it at present.”

In addition, current commodity pool operator definitions are concerning for securitisations – because the structures entail swaps, they fall under the remit of the CFTC. “There has been some exemptive relief since the proposals were first issued, but the treatment of synthetics and insurance-linked securities remains an issue. The former because there is no differentiation between cash and synthetics, and the latter because the risk transfer mechanism and the variable return on the swap means they look more like commodity pools," Forrester explains.

The Volcker Rule is another barrier to the full recovery of the ABS market, as it significantly impedes traditional structures. But while Volcker is a first-quarter event, there is no clear timeline regarding risk retention.

Against such an uncertain backdrop, Forrester indicates that market participants will continue dealing with legacy and transition deals in the same way they did in the past until they're told they can't. "There is no sense in amending old structures just for the sake of it," he observes.

Given the considerable feedback and pushback that regulators have received related to the draft versions of these issues, the Morgan Stanley strategists are optimistic that their eventual resolution will be less constraining to credit availability than initially proposed. "We are encouraged by how regulators incorporated market feedback on their initial proposal for risk capital requirements for debt and securitisation positions on banks' trading books. The final rule pertaining to the Simplified Supervisory Formula Approach (SSFA) published earlier this year was a notable improvement over the initial proposal," they conclude.

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