2020 ABS outlook stable, but concerns abound over election, trade

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Published **January 13 2020, 9:30pm EST**

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Low interest rates, healthy employment levels, and minor corporate default rates make for a stable outlook for the 2020 securitization market.

But this year's wild cards - a U.S. presidential election, Brexit, resolving global trade wars - are fueling uncertainty and worries that market disruptions and rising credit risks would not be difficult to imagine among both consumer and corporate assets.

Fitch Ratings managing director Rui J. Pereira, in an industry outlook published in December, noted that it maintains a stable view for most ABS and structured finance sectors for the year, with potential downgrades or other negative rating actions only likely to be driven by "idiosyncratic risks and sector-specific concerns."

With that said, he added, "growing trade and political uncertainties represent notable downside risks to our 2020 outlook."

November's presidential election stands out as a major variable. A recent Deutsche Bank report outlining 2020 scenarios for structured credit, asset-backed and mortgage-backed securities identified regulatory policy in housing, climate change, student loans and healthcare as areas in which the election could have profound implications.

But Deutsche also says issuers are expected to carry along through the election campaign period with an ongoing steady volume of new ABS and structured finance deals: about $235 billion in asset-backed securities deal volume; approximately $135 billion in non-agency RMBS, $90 billion-$100 billion in collateralized loan obligations and $212 billion in CMBS volume.

CLOs

Despite strong economic indicators heading into 2020, many observers of the collateralized loan obligations market are on edge.

Skepticism stems in part from concerns over the end to the current long-running credit cycle. That has driven leveraged lending but also drove up multiples at which private equity firms are acquiring companies — encouraging bulging levels of leverage on corporate books.

In addition, the prevalence of "covenant-lite" loans and allegations of inflated earnings for speculative-grade rated corporate borrowers could provide little warning about upcoming defaults … which could result in hyper-vigilant rating agency downgrades, leading to overcollateralization-test breaches and deals amortizing prematurely.

On the other hand, the U.S. economy continues to chug along, and market participants expect the Trump administration to use the tools at its disposal—trade policy, farm bailouts, etc.—to keep it that way until after the presidential election.

"It is possible that spreads could tighten early in the year as investors put fresh allocations to work," said David Heilbrunn, a longtime participant in the CLO market and head of product development and capital raising at Churchill Asset Management. "But I think market skepticism is likely to keep things where they are for awhile.

"Investors in equity and lower rated portions of the capital structure are especially concerned about OC-test breaches, because they don't want deals to amortize," Heilbrunn added.

The CLO market enters 2020 coming off strong 2019 primary issuance of approximately $117 billion, which was slightly down from a record year in 2018 but above average compared to historical numbers. Most analysts see a drop in issuance volume to between $90 billion to $100 billion, but also with a decline in overall supply of deals that could favor a spread-tightening environment.

"We see the CLO market as caught between opposing forces: compelling relative value and a drop in net supply" which should promote spread tightening – which lowers the premium paid to investors, according to a report from Wells Fargo analyst David Preston.

Wells Fargo Securities' base-case scenario, described in a Nov. 27 report, predicts AAA tranches staying wide of corporate debt but ending the year at more or less the same level, around 134 basis points over Libor.

Steve Vaccaro, CEO and chief investment officer of CIFC Asset Management, which manages more than $19 billion in CLOs, also expects CLO debt spreads to tighten in 2020, “as the headwind from rapidly declining interest rates eases, loan fundamentals remain relatively healthy, and the premium vs. other risk asset classes including fixed-rate investment grade and high yield corporate bonds compresses.”

S&P Global anticipates new-issuance volume in the $80 billion-$100 billion range. But CLO investors are raising concerns of growing speculative-grade corporate default risk, which Deutsche Bank (on the high end of estimates) projects could rise from the current estimated 2% to 3.5% next year, driven by struggling energy-industry obligors. Investors are diversifying their portfolios and emphasizing a “conservation of par.” - *John Hintze*

Auto

New and used auto sales were flat in 2019 year-over-year, but asset-backed volume grew by 6.5% between 2018 and 2019, according to data from Finsight. What gives? According to Kroll, the growth in auto-related ABS supply “has been fueled by a substantial amount of auto lease deals coming to market,” which it estimated at $20.9 billion, or 39% above 2018 levels.

“In contract, auto loan volumes appear to be finally leveling off as new vehicle sales have plateaued,” with overall loan supply up just 4.1%. (While prime auto loan volumes are up 13.4%, non-prime loan totals dropped by 9.4%).

Other auto ABS asset types such as rental car, fleet lease and dealer floorplan securitizations, grew a total of 4.4% to $19.4 billion in deal volume. Kroll projects auto-related ABS deals to “remain mostly flat” in 2020 at $125 billion.

One potential area of growth in 2020 auto ABS volume could be the launch of credit unions pooling their auto-loan originations. In December, GTE Federal Credit Union became the first federal credit union to sponsor a deal when it issued a $175 million securitization of loans originated by the Tampa, Fla.-based CU.

“With roughly $1.1 trillion in outstanding credit union loans at the end of the third quarter of 2019, auto loans accounted for 34%, or $374.2 billion, second only to residential mortgages, which represented roughly 43%," according to a report from DBRS Morningstar. "The sizable pool of auto loans issued by credit unions also illustrates the future securitization potential for the sector."

Credit risks are rising in deals, particularly with more extended-term loans being included in ABS pools, and lenders issuing more loans to trouble buyers, according to Fitch Ratings.

But most of those deteriorating metrics are the result of more bottom-feeding "deeper subprime" lenders catering to borrowers with poor or no FICO scores. Larger subprime lenders such as Santander Consumer USA, AmeriCredit (GM Financial) and World Omni Financial Corp. that accelerated scheduled amortization and boosted credit enhancement to counter growing collateral risks in their 2019 issuances. - *Glen Fest*

Marketplace lending

.Marketplace consumer loan ABS volume is expected to rise in 2020, aided by strong 2019 economic tailwinds benefiting originations as well as favorable federal regulatory proposals that could encourage more securitizations.

The ongoing expansion of the unsecured online loan market should continue in 2020, with Kroll Bond Rating Agency projecting the asset class will total $17.5 billion in securitized volume next year, compared to $15.2 billion for 2019.

The annual total has grown annually the past four years, and as projected would be nearly double the $9.3 billion that priced in 2016, according to data from Finsight.

"When it comes to growth this year and next, we expect the growth trajectory of big players such as LendingClub and Prosper to continue into 2020," said Harry Kohl, director at Fitch Ratings.

The volume growth continues despite the fact consumer-loan losses and delinquencies have risen in 2019, and marketplace lenders have tightened their underwriting standards.

Jerry Marlatt, a partner at law firm Mayer Brown, said that marketplace lenders tightening their lending standards results partly from credit concerns, since competition prompted some to lend to less creditworthy borrowers in prior years.

But he says the stricter guidelines also signal that the industry is maturing, and could lead to a contraction of players in the market that in 2019 included 22 originators that placed loan pools with institutional investors, according to Finsight. The largest issuer in unsecured online consumer loan ABS was SoFi, with four note offerings totaling $2.2 billion. (SoFi compiles loans from a coterie of prime, higher credit-quality borrowers that it also targets for its more-established professional student-loan securitization platform).

“We will probably see some winnowing in the market—some consolidation, others dropping out or realigning” with banks, Marlatt said.

One of the ongoing concerns with marketplace ABS is that the sector has yet to be truly tested in a significant economic downturn. As unsecured loans they are particularly risky with limited recovery prospects, Fitch’s Kohl said “we’re still not convinced marketplace loans are high up on borrowers’ priority of payments.”

Mayer Brown’s Marlatt said another element to keep an eye on for 2020 is the likelihood of new federal regulation affecting marketplace ABS pools.

The most significant developments in 2019 were proposals by the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corp (FDIC) to allow national banks to bypass state usury laws when transferring loans to securitized pools.

According to Moody’s Investors Service, the new proposals could provide more certainty to investors that interest rates on loans won’t be cut after being transferred to securitization pools, which otherwise might be subject to usury caps within a borrower’s home state.

The proposals are the latest to resolve the uncertainty surrounding MPL and other securitizations since 2015, when a federal court decision (Madden vs. Midland Funding) held that a non-bank debt collector could not claim the same cross-state exemption from local usury laws that apply to originating bank lenders. (The Madden decision from the U.S. Second Circuit involved only New York, Vermont and Connecticut, which has frequently led to MPL ABS issuers excluding loans from those states from their collateral pools).

The Madden case (which the U.S. Supreme Court declined to hear) opened the door for potential consumer protection challenges in states where Prosper, LendingClub and other issuers originate loans but bypass local usury restrictions in favor of higher rates from the home states of partner underwriting banks. Madden was later cited in a lawsuit by Colorado's attorney general's office challenging marketplace lenders' ability to finance loans bundled into collateral for bonds.

"That's really important for all loans sold into securitizations, because a securitization trust is not a bank," Marlatt noted.

The OCC has also proposed giving federal special-purpose fintech charters to marketplace lenders, as a means to allow lenders a nationwide platform without having to obtain 50 state licenses. A challenge filed by the New York State Department of Financial Services was upheld in October, stating the OCC overstepped its authority by granting a charter to a non-depository institution. The regulator is currently appealing it.

"Federal action tends to simplify all that and would make marketplace securitizations more like those by banks," Marlatt said, adding, "It should make marketplace ABS a bit easier to sell." - *JH*

Bloomberg

RMBS

The Consumer Financial Protection Bureau is expected to let the so-called non-QM patch expire with its planned statutory sunset date of January 2021, a move that will potentially open the gates to more private, non-agency securitizations of mortgage originations this year.

The expiration would end a controversial exemption that provided QM safe harbor status to Fannie Mae- and Freddie Mac-backed loans that exceed a 43% debt-to-income ratio. (QM rules protect lenders - and ABS investors - from consumer claims stemming from ability-to-repay rules).

“Administrative reform to level the playing field between the government-sponsored enterprises (GSE) and private-label RMBS issuers would likely increase issuance volume,” according to a market outlook published by Moody’s Investors Service. It would also, as a byproduct of that market shift, “introduce some riskier pools to the prime jumbo market, but also boost credit quality for GSE credit-risk transfer (CRT) deals under certain circumstances.”

It is unclear exactly how much of the industry’s mortgage production would come under private-label domain, but as of Q2 2019, FitchRatings estimated that to be about $200 billion per year, according to Suzanne Mistretta, a senior director at FitchRatings.

The balance of liquidity between GSEs and the private-label sector might eventually impact credit, as RMBS production volumes increase. Kroll estimates that RMBS 2.0 volumes could reach about $70 billion in 2020.

Kroll says it expects more new issuers to come into the space, according to Jack Kahan, a senior managing director of RMBS for Kroll. Yet for new issuers to be competitive, some may decide they may need to go into areas not occupied by current or entrenched issuers, Kahan said.

“New issuers might decide to widen their guidelines, which might lead to lessening of credit over time,” Kahan said. “But I don’t think we’ll see that in dramatic fashion in 2020.”

The Federal Housing Finance Agency, under director Mark Calabria, will continue efforts to shift Fannie and Freddie out of government conservatorship in 2020. One of the early key steps will be an expected unveiling of Calabria's plan to finalize a post-conservatorship capital framework to be established before the GSEs would be spun out from government control.- *Donna Mitchell*

Student loans

Overall outstanding student loan ABS volume was down 24% in 2019, according to DBRS Morningstar, as the supply of legacy Federal Family Education Loan Program (FFELP) loans continues to decline (the program was terminated in 2010 in favor of direct federal student loans, which are not securitized).

The ratings agency projects that SLABS issuance will remain flat in 2020 from its 2019 levels of $5.8 billion in FFELP issuance, $5.6 billion in refinanced loans and private student loan pools decreasing to $2.5 billion. However, refi SLABS (like those sponsored by SoFi Inc.) might "increase modestly due to the continuation of the low interest rate environment."

The market could also could "face uncertainty on [the] outcome of U.S. presidential election, if a policy shift is made that directly affects the student loan market," i.e., proposed student-loan forgiveness programs. - *GF*

CMBS

Market observers expect the U.S. CMBS market in 2020 to slightly surpass its brisk volumes of 2019.

S&P Global, for instance, estimates that new U.S. CMBS will top $100 billion, compared to 2019's year-end level of approximately $96 billion - which was well above S&P's original estimate for last year ($80 billion). The 2018 level was $77 billion, according to S&P.

S&P's forecast is in line with other projections by banking and ratings agency analysts. DBRS Morningstar projects between $90 billion to $100 billion, and Deutsche Bank projects about $90 billion - split between about $50 billion for conduit fusion transactions featuring multiple loans and properties, and $40 million in single-asset, single-borrower deals this year.

Spreads from steady market cap rates are helping to provide protection against potential volatility in cash flows and property values, among other benefits, according to Moody's.

Moody's also noted that its haircuts to underwritten net cash flows would hold at around 10 percent. Low interest rates will maintain lower cost of capital, supporting historically high debt service coverage ratios (DSCR). Moody's found that the DSCR on CMBS deals that it rated ranged between 1.7x and 2.0x for three years, and will likely remain high in 2020.

But lower debt service costs to borrowers encouraged the prevalence of interest-only (IO) loans in CMBS portfolios. Interest-only loans are historically riskier than loans that consistently pay down principal, and they generally result in higher losses and default rates, even with higher DSCRs.

The CMBS market is a major source of liquidity for interest-only borrowers, and Moody's estimates that 85 percent of all conduit loans have some interest-only period during their original and/or etended terms. That trend should continue into 2020., Moody's believes.

The credit quality outlook is mixed for new and existing CMBS deals. As pre-2010 loans were aging out of deals, the loans were being replaced with fewer troubled post-crisis loans, and the delinquency rate has fallen, said Steve Jellinek, vice president of North American CMBS at DBRS Morningstar.

But the ratings agency expects the delinquency rates to potentially rise in 2020, as riskier commercial mortgage assets make their way into pools and potentially put greater performance pressure on the pools.

Another impact on CMBS deals for 2020 involve the commercial real estate loans for multifamily developments. While the sector has benefited from a falling vacancy rate - which hit 3.6% in the third quarter of 2019 - DBRS Morningstar expects potential rising vacancy rates due to a slowdown in employment growth, plus a robust supply pipeline for multifamily properties.

The glut could cause the vacancy rate to increase to 4.2 percent by the second half of 2020 and continue rising through 2021.

About $14 billion in outstanding partial interest-only loans for multifamily properties are slated to begin amortizing in 2020, and debt service on them increasing by 34 percent, according to Moody's.

Moody's also expects other potential drags on CMBS performance due to underlying deal assets: more loans with high levels of subordinate debt, and high concentrations of commercial mortgages that are dependent on single-tenant properties.

As for CMBS collateral, S&P says retail will continue to be a soft spot for deals, as continued store closures and the loss of rent revenues to certain retail properties placing debt service and loan performance under pressure.- *DM*

Esoteric

According to Kroll, some sectors of the "nontraditional" ABS sector faced the economic headwinds of the U.S.-China trade war. In particular, railcar and shipping container lease deals that rely on global trade activity as well as the equipment ABS deals reliant on the agricultural industry.

But overall growth across other sectors such as aircraft lease, whole business, servicer advance and mobile device payment plan deals totaled $53.1 billion, up 12% year-over-year, the agency stated. Kroll expects the asset class to expand to $56.5 billion in 2020. - *GF*

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