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May 2021

Is there incremental yield to be found in the U.S. Structured Finance market for insurers? The answer is…Yes.

For insurers interested in casting the net wider in the search for income, delving a little deeper into non-established parts of Structured Finance or down in the stack of established segments might have the potential to provide increased income.

Executive summary

_ The Structured Finance market has largely recovered from lows reached at the height of the pandemic. But certain niches are still offering yields that are comparatively attractive.
_ The Asset-backed Securities (ABS) market, or "catch-all" segment, has held up well due to fiscal stimulus, forbearance programs, and central bank support. Today, delinquencies and defaults are around pre-pandemic levels, and issuance is roughly equal to that of 2019. Opportunities would appear to exist in some more esoteric areas around timeshare bonds, revolving auto loans, "whole business" and mid-prime credit card bonds, and better-rated super-prime auto loans.
_ As in the ABS sector, pandemic relief programs have benefited credit fundamentals in the non-agency Residential Mortgage-backed Securities (RMBS) market. Forbearance programs have caused delinquencies to decline since they peaked in mid-2020, and a moratorium on foreclosures could be extended through the end of the year. This has yielded some attractiveness in relatively new sectors of the non-agency RMBS market: Qualified Mortgages (QM), non-Qualified Mortgages (non-QM), and Credit Risk Transfers (CRT).
_ From a broader market perspective, Environmental, Social, and Governance (ESG) factors is still in its relative infancy in Structured Finance. DWS is developing its own framework, however, for how to evaluate the asset class.
_ Even going down in credit, the non-traditional and lower-rated parts of Structured Finance still demonstrate favorable capital efficiency characteristics for insurance companies.

The elusive search for yield? Maybe not so…

Insurers have been casting a wider net in the search for income, and an increasing number currently are looking to the Structured Finance market, given its size and scope, as a means to capture incremental yield. When comparing AAA Structured Finance spreads in the Bloomberg Barclays U.S. Aggregate Index at the end of March to where the market was approximately one year earlier, spreads are trading at, or through, pre-COVID levels. We believe the door has been opened to potential opportunities in both non-traditional segments as well as in more established segments but further down in the capital stack. With yields generally at historically low levels, it may be worth considering these non-traditional and overlooked niches.

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Asset-backed Securities

Credit fundamentals

The ABS market enters, what we hope to be, the latter stages of the pandemic in relatively robust health. In the early days of the pandemic, record unemployment gave rise to concerns about how the market would perform. Although performance did weaken between April and June, the weakness was short-lived. Financial support to households, small businesses, and industries as well as payment moratoriums and central bank efforts to promote market liquidity, enabled the ABS market to regain its footing quickly. Forbearance programs were beneficial in the beginning of the pandemic, but these have become less necessary as the economy has opened up.

Consumer credit metrics, including delinquencies and defaults, are currently at or near historically low levels, and aside from a handful of names, ratings downgrades have been rare. Those that have occurred have come mostly in areas heavily affected by the economic shutdowns, such as the aircraft finance and rental car sectors. (Sources: Moody's, Intex, LCD and DWS, March 31, 2021).

Outlook

Credit fundamentals continue to benefit from record levels of stimulus and extended unemployment benefits. Financial assistance to households should continue to support the consumer debt repayment cycle. For example, as the ABS market entered the second-quarter 2021, it was roughly back to pre-pandemic supply levels ($61.5bn), with new issuance forecast to be consistent with the record levels of 2019 ($59.3bn), according to Bloomberg data comparing March 31, 2021 and March 31, 2019.

Fundamentals could weaken late in 2021 and early 2022 if the economic recovery falters, fiscal stimulus is less than expected, or some hard-hit households are slow to recover. Any deterioration, however, will be off a historically low base and therefore not of great concern.

Historically, the credit card segment is considered "the backbone" of the ABS market. Prior to the global financial crisis, money center banks issued between $80 billion and $100 billion in credit card ABS annually, according to DWS research. After the crisis, the landscape changed dramatically. New accounting rules, coupled with alternative funding sources and smaller financing needs by the banks, led to a contraction in credit card ABS supply.

Today, those supply trends remain in place, and although we anticipate some growth as the economy opens up, large banks are likely to remain on the sidelines. In 2020, our calculations indicated that issuance totaled only $4bn, so new supply may be higher this year; but our research forecast does not expect a return to levels of $20–40bn as seen in 2016-2019.

Opportunities in the ABS market

DWS believes the ABS sector generally offers well-structured investment opportunities and diversification benefits, however, there are factors that require examination.

First, we prefer issuers that have a successful track record with a proven business model and have demonstrated the ability to perform through various economic cycles. Second, we look for an experienced management team and diversified funding sources. We also focus on an issuer's credit profile and their ability to not only originate loans, but also to adequately service their portfolio especially during times of economic stress.

Given these factors, we are constructive on the long-end of the curve, particularly "whole business" securitizations. These issues often have longer durations than traditional ABS and BBB-rated, seven-year bonds are offering yields between 2.5–3.25% (as of March 31, 2021 based on data from Bloomberg Barclays U.S. Aggregate Index).

At the shorter-end of the curve, we are optimistic about credit-linked note transactions, referencing super-prime auto loans. BB-rated tranches are offering yields in the 2.4% range (as of first-quarter end 2021 based on data from Bloomberg Barclays U.S. Aggregate Index).

Also attractive at the shorter-end but higher in the capital stack are BBB-rated issues in the "whole business" sector, which are offering yields of approximately 2.7%. In addition, three-year BBB-rated timeshares are yielding between 1.8–2.0%, depending on the issuer (as of March 31, 2021 based on data from Bloomberg Barclays U.S. Aggregate Index).

The timeshare segment is of note because it has been surprisingly resilient, especially issuers that have a consistent track record through many economic cycles. In addition, deal structures today appear more robust, with greater credit support and stronger borrower profiles.

Another sector offering value is a sub-segment of the credit card sector—mid-prime credit cards. Among BBB-rated bonds, yields are just under 2.5%. However, mid-prime card deals are difficult to find in size, as this is a new sector with fewer players and smaller transaction sizes (as of first-quarter end 2021 based on data from Bloomberg Barclays U.S. Aggregate Index).

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Non-agency Residential Mortgage-backed Securities

Some new developments when evaluating RMBS

Turning attention to another part of Structured Finance is the non-agency RMBS market. This market can be broken down by the underlying collateral type. Collateral may be classified as “credit dented” or impaired, which includes re-performing and non-performing loans, legacy, which are deals issued prior to 2008, and new origination.

The new origination subsectors consist of Qualified Mortgages (QM), non-Qualified Mortgages (non-QM), and Credit Risk Transfer securities (CRT). The QM designation is a relatively new category. QMs were initiated after the mortgage crisis when the Consumer Financial Protection Bureau (CFPB) enacted rules to protect borrowers from bad lending practices. The rules also provide lenders with legal protections as long as they comply with certain underwriting standards. Loans that met the CFPB standards became known as “qualified mortgages.”

The primary differences between a QM and non-QM loan are the loan features and the underwriting standards. QM loans are generally amortizing, 30-year mortgages. They cannot include risky features, such as an interest-only period, terms longer than 30 years, or balloon payments. As for underwriting standards, the borrower’s debt-to-income ratio must be calculated as prescribed by the CFPB and must be less than 43%.

Non-QM borrowers typically fall short of the strict debt-to-income calculation. Often they are self-employed and do not have traditional W-2 income documentation. In addition, others may have limited incomes but large asset bases.

The CRT subsector consists of deals that represent the bottom 2.5–5% of risk on Fannie Mae and Freddie Mac reference pools. The purpose of CRTs is to remove that risk from taxpayers and make it available to investors. CRTs have been issued since 2013.

Credit fundamentals

From DWS’s analysis, fundamentals have held up better than expected since unemployment peaked at almost 15% back in April 2020. From a delinquency standpoint, QM outperformed Fannie Mae and Freddie Mac loans, and both outperformed non-QM since the start of Covid-19. Seriously delinquent loans, which are late by 60 days or more, peaked in the summer of 2020, with QM hitting 5% and non-QM hitting 17%. Since the start of 2021, however, those levels have declined to the mid-3% range for QM and around 10% for non-QM. Fannie Mae and Freddie Mac collateral, which CRT bonds reference, saw similar delinquencies, which peaked in the single digits in the 2020 summer, and are in the 5% range as of first quarter end 2021. (Source: Intex, March 31, 2021).

Over the past three years QM issuance has averaged about \$17bn, based on Bloomberg data. While new supply tapered off in 2020, we are forecasting a record year in 2021. Low mortgage rates and higher home prices should fuel refinancing activity, and we project close to \$30bn in new QM issuance for 2021.

While QM is the larger sector, non-QM has been growing faster. New supply grew from \$3bn in 2017 to more than \$23bn in 2019, based on Bloomberg data. In 2020, issuance was expected to outpace 2019, but with the pandemic, new supply totalled only about \$18mn. DWS research expects the non-QM sector to improve on last year and reach close to \$25bn in new issuance for 2021. What is also noteworthy in 2020 was the number of issuers, which amounted to 24, up from just six in 2017.

New issuance in the CRT market has also been robust. Since the first issue came to market in January 2014, agencies have issued close to \$90 billion. This year new supply could total nearly \$12 billion, just from Freddie Mac alone. (Fannie Mae has put a hold on their program, given potential new regulatory capital requirements.)

Outlook

The housing market is in robust health. Mortgage rates are still low by historical standards, and homes are still affordable. So, we expect demand to pick up as the economy reopens and as millennials increasingly enter the market.

Recent data from the S&P/Case-Shiller Home Price Index showed an 11.2% appreciation in home prices year-over-year, the biggest jump since the global financial crisis. This has been driven primarily by a supply shortage that has resulted largely from underbuilding over the past 10 years. Supply in the single-family market is 3.8 million units short of demand, according to Freddie Mac, and likely underpin further price appreciation over the next several years.

Furthermore, price appreciation may also benefit from further constraints on supply. The CFPB has proposed extending the existing foreclosure moratorium through 2021, and forbearance plans have been widely initiated. Unlike in the past, loan servicers have allowed borrowers to delay payments, without any repercussions. Therefore, our outlook on the residential market is similar to our view of the consumer sector; we expect positive but slower home price appreciation with delinquencies perhaps rising modestly but from very low levels currently.

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Opportunities in non-agency RMBS

This sector can offer a number of opportunities in the lowest risk spectrum as rated by the National Association of Insurance Commissioners (NAIC). In the QM and non-QM sectors, over 99% and 97% of securitizations, respectively, that are submitted to the NAIC are rated NAIC-1 (lowest risk). However, the risk depends on the securitization and certain aspects of the market. CRTs, for example, will tend to have slightly higher capital charges. But broadly speaking, going down in the capital stack should be attractive to insurance companies, given the low capital charges and the additional yield pickup.

For investors with shorter duration needs, or who are looking to pick up some yield versus traditional auto and credit card ABS, DWS is constructive on AAA-rated non-QM issues, and view those as a “relative value play”. They have a two- to three-year weighted average life at issuance and are currently yielding around 1.0%, which is attractive versus certain other prime ABS AAAs, which are yielding around 0.5% (based on March 31, 2021 data from Bloomberg Barclays U.S. Aggregate Index). We also are constructive on A-rated bonds within these non-QM deals, so long as the basis is wide enough to pick up additional spread, while keeping a similar risk profile.

Within QM deals, subordinate bonds would also be worth considering. These could be more suited to investors who have both yield and duration needs, with an eye toward the investment-grade subordinates in these deals as they can offer a nice pickup in yield but also limit prepayment variability. Ten-year, AA-rated subordinates were yielding 2.75% to 2.85%, but are richer further down the capital stack at BBB, with yields closer to 3.5% (as of March 31, 2021 based on Bloomberg Barclays U.S. Aggregate Index).

DWS’s perspective is that while these bonds do have less credit enhancement than other non-agency RMBS sectors, the super-prime credit quality of the QM borrower, combined with the strength of the housing market, should provide plenty of compensation for that lower enhancement.

In CRT bonds, we are constructive toward M2s, which are aimed more toward unconstrained investors. These are typically priced at a four-year spread duration of around 200 basis points over Treasuries or 1-month LIBOR/SOFR depending on vintage. While the collateral that backs these pools is fixed-rate, these bonds are floating-rate, benchmarked to either the London Interbank Offered Rate (LIBOR) for the older deals, or to the Secured Overnight Financing Rate (SOFR) for more recent deals. We prefer the M2s, which are generally split rated BBB-BB. We generally prefer the new issues pools given that COVID-impacted loans are excluded and yield low 2%.

Some ESG green shoots in structured finance?

While Environmental, Social, and Governance (ESG) considerations are in their relative infancy in the Structured Finance market, DWS has taken to developing its own framework for the asset class until market standards become more accepted. Viewing the segment through a sustainable lense, certain sectors would appear to lend themselves more-so to responsible investment parameters. Examples of this in the ABS market could include solar deals and electric vehicle securitizations. Eventually, the market may start rating automobile deals by the average miles per gallon of the underlying vehicles.

In commercial real estate, the DWS Structured Finance team already has begun integrating LEED certifications into their ESG analysis as part of its research process. And in the CLO space, we have observed in the past 12 months, a number of CLOs coming to market in which the CLO manager can invest only in ESG-friendly sectors, which would preclude such industries as firearms, tobacco, and nuclear energy.

A capital perspective for insurance general accounts

Increasing allocations to Structured Finance has been a growing theme within the industry given the illiquidity and complexity premium that can be earned. While the higher-rated, more traditional parts of the Structured Finance market have typically drawn the most attention over the years, broadly speaking non-traditional or more esoteric areas of the market would still be capital efficient.

DWS observes higher risk-adjusted returns for Structured Finance compared to corporate credit across the primary risk measures that are important to insurers. This can be measured through incremental yield per unit of risk where risk can be defined as volatility (also represented as standard deviation) duration or quality.* This generally translates to greater efficiency in U.S. capital models including RBC, S&P and BCAR, however, implications on ALM positioning may also need to be considered for Life insurers.

Additionally, based on the above-mentioned measures, Structured Finance also offers a differentiated correlation profile to corporate credit, which can provide enhanced portfolio diversification benefits. And if an insurer is concerned about rising interest rates, the lower duration profile of the asset class, particularly ABS and CLOs, can offer protection in such an environment.

*Data as of March 31, 2021 for Bloomberg Barclays CMBS, ABS and Investment-Grade Corporate Indexes and JPM CLO Index

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Conclusion

The search for yield story is persistent and is not likely to meaningfully abate in the short- or mid-term. That does not mean insurers are devoid of liquid fixed income options that are still capital favorable. Sorting through the options in the various sub-segments requires the ability and resources to install a process to identify and analyze esoteric options. And with just the right tug of the net insurers might be able to realize some meaningful yield pickup over comparable Treasuries.

Risk disclosure

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate. Investing in high yield bonds, which tend to be more volatile than investment grade fixed income securities, is speculative. These bonds are affected by interest rate changes and the creditworthiness of the issuers, and investing in high yield bonds poses additional credit risk, as well as greater risk of default.

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