Structured credit
The outlook for 2024

In this webinar produced by *Risk.net* in association with Numerix, experts discuss the risks, opportunities and outlook for structured credit markets in 2024

High inflation and rising interest rates were the top challenges in the mortgage-backed securities (MBS) and leveraged loan markets in 2023, and will remain major challenges through 2024, a panel of structured credit experts stated in a *Risk.net* webinar. They noted there is an uncharacteristic lack of consensus in the market over the future direction of rates and the speed with which they might come down. This uncertainty is increasing the need for robust risk management, with firms carrying out more strenuous stress-testing and modelling a wider range of scenarios.


Kelli Sayres, Numerix

THE PANEL
Kelli Sayres, Senior managing director and head of product, Numerix
Audrey Blater, Head of risk and capital markets, Coalition Greenwich
Laila Kollmorgen, Managing director, business head and portfolio manager for collateralised loan obligation tranche investments into third-party managers, PineBridge Investments
Lawrence Kwoh, Former senior enterprise risk officer, Federal Home Loan Bank of San Francisco
Moderator: Stella Farrington, Commercial editor, *Risk.net*

Inflation and the economy
Research conducted by Coalition Greenwich found that buy-side firms consider inflation the biggest risk to their businesses, said Audrey Blater, head of risk and capital markets.

While market consensus is for the economy to have a soft landing, panellists discussed the possibility of inflation remaining sticky throughout 2024, which would delay rate cutting. In the US, fiscal stimulus policies, such as the Inflation Reduction Act of 2022 and the 2023 Creating Helpful Incentives to Produce Semiconductors and Science Act – while likely to lower inflation in the long run – could support higher inflation in 2024, said Laila Kollmorgen, managing director, business head and portfolio manager for collateralised loan obligation (CLO) tranche investments into third-party managers at PineBridge Investments.

Overall, she expects a slowdown in the economy next year, which will lead to lower company valuations and increased transactions throughout the structured credit space. However, she warned the slowdown will be "very, very challenging" due to strong fiscal policies energising the US economy. "I think that's why we are going to see some more stickiness in inflation," she said.

Firms are now putting more emphasis on inflation in their risk modelling, noted Kelli Sayres, senior managing director and head of product at Numerix. "Firms are looking at how their inflation risk measures up, [whether] they have [effective] hedges against it, and what it does to their day-over-day and month-over-month profiles."

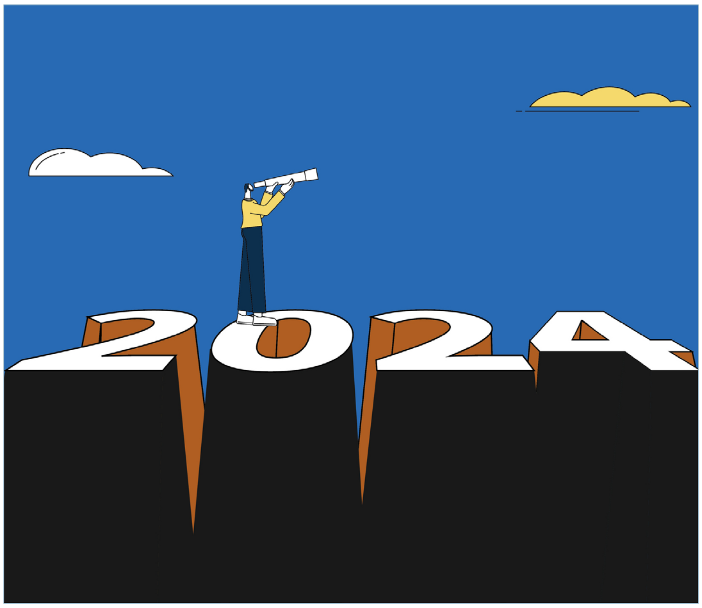
Interest rates
The steep run-up in interest rates worldwide over the past two years has increased the emphasis on stress-testing at most firms, said Sayres.

"When rates were close to zero, thinking about a 400-basis-point span was really not business-as-usual for many of our clients," she noted. "Now firms are looking at a much wider swathe of scenarios."

When it comes to agency-collateralised mortgage obligations, a big area of focus now is the change in embedded prepayment risk, she noted. With prepayment forecasts muted, especially on older collateral that is now far out-of-the-money, the duration profile of many products has changed. "People are asking how far rates have to go down before that prepay risk starts to kick in again, and the negative convexity profile [returns]."

People are also asking what will happen if rates remain high – or even move up. "There are often embedded caps in many of these floating rates, and so rising rates may start to impact the profile and change the profit and loss that you've been expecting," Sayres said.

While consensus is for rate cuts to begin somewhere between March and June 2024, Kollmorgen believes it could be later – especially given it is an election year in the US and the US Federal Reserve will be keen to get inflation under control. Therefore, companies could be refinancing at higher levels than expected – especially in the high-yield and leveraged loan markets, she added.



This could also have a big impact on the non-agency commercial MBS market, where around 18% of that market faces refinancing risk in 2024, said Lawrence Kwoh, former senior enterprise risk officer at the Federal Home Loan Bank of San Francisco. "This comes at a time when funding levels are high and loans on the asset haven't necessarily been adjusted," he said. As a result, the market is starting to see a return to interest-only floating-rate transitional loans in the security structure. "That's something to look out for as it's adding risk to the security structure."

Commercial mortgage loans will be harder to refinance as well, with lower loan balances and lower loan-to-value than was originally financed to maintain the same debt service coverage lenders require, Kwoh added.

US regional banking crisis

Panellists agreed that the collapse of several US regional banks in March 2023 was a liquidity – rather than a credit – crisis, but there are implications for stress-testing and asset-liability management.

As a result of this regional banking crisis, US bank regulators have proposed stricter capital requirements for banks with at least $100 billion in assets, making them subject to similar regulation imposed on banks with $700 billion in assets. Kwoh believes the market will see more credit risk transfer (CRT) deals as regional banks will need to raise more regulatory capital. He noted that CRT deals will provide an indirect way to help with capital raising.

He also pointed to a facility at the Fed due to expire in March 2024 that has allowed banks to pledge agency securities with no haircut to provide liquidity. "It's a very important mechanism and the question now is, what is the regulator going to do to help with banking liquidity and how might that impact the structured credit market?"

Kollmorgen noted that the regional banks that failed were holding MBS and Treasuries on their balance sheets. These long-dated, fixed-rate assets were purchased when interest rates were low and – as rates rose – they went down in value. "If they had been invested in floating-rate securities – such as CLOs, especially AA rated CLOs – they would not have suffered these very sharp mark-to-market declines, which precipitated the liquidity crisis," she said.

Banking regulation incentivises banks to hold MBS on their balance sheet as they are zero risk weighted, but perhaps a rethink is needed, as these may not be the best investments to hold in a rising rates environment, Kollmorgen suggested.

Lack of consensus

The panellists noted that geopolitical risk, market volatility and economic uncertainty are making forecasting and planning extremely difficult, leading to a wider range of expectations than usual for next year and beyond.

Blater said opinions on the outlook for rates are very scattered. "Usually we get a clustering of opinions, but I haven't seen much of that," she said. "That tells us there's a lot of uncertainty and that can result in risk as well." This environment increases demand for robust and sophisticated risk management, she added.

Sayres agreed, saying she has seen an increase in firms undertaking very granular modelling around different rate-change scenarios. "Because there's so much uncertainty, many of our clients are trying to run as many of those potential paths as possible, seeing how well their hedges hold up."

The uncertainty is also causing firms to run different volatility scenarios, looking at, for example, a span of potential interest rate outcomes, she added.

Investment appetite

Despite the current uncertainty, Coalition Greenwich still expects strong appetite for more investment next year, said Blater. "Managers we spoke to pointed to numerous dislocations that might be capitalised on, for instance," she said.

Kwoh said he expects a 20% increase in volume issuance next year in the non-agency commercial MBS and residential MBS markets, particularly in the non-qualified mortgage space and the prime jumbo.

Climate risk

An overarching risk beginning to impact company valuations and credit is climate risk. While there is a lot of climate-related data on listed firms, in the investment grade or high-yield markets it can be difficult to know if the underlying assessment of that credit has included a climate risk assessment, said Kollmorgen. "At PineBridge we have our own internal rating scale but, for some asset managers and institutional investors in the private markets – such as leveraged funds and private credit – this is still a developing area."

Many firms are now trying to model their potential default risk from physical climate risk – for example, by adding granular assumptions based on location and weather events such as flooding or wildfires, said Sayres. Kwoh also added that depository financial institutions are looking to learn from the property and casualty insurance industry, which has a long tradition of modelling physical climate risks.

Technology

Panellists discussed the impact artificial intelligence (AI) and machine learning might have on structured credit markets in the coming months. Blater said she has seen an increase in its use in pockets of fixed income where data is spotty or hard to discover. "The most likely applications of AI and machine learning we found were focused on the risk of default calculations and prepayment risks," she said. "However, we did see other applications in areas such as portfolio risk management and performance projections."

Sayres agreed that prepayment modelling, with its many complexities and different risk factors, is ripe for AI. "AI can be very useful in letting the data lead and discovering the functions," rather than applying data to a deterministic model, she said. However, she stressed that people are cautious around the use of AI in modelling and want their models to remain responsive to human intervention and tuning. ■

>> Watch the full panel discussion, *Charting the course for structured credit markets in 2024*