Bank Strategy Insights

FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

July 24, 2020

Investment Focus: Freddie Mac Multifamily Small Balance Securities ("FRESB")

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

Broad market sentiment continues to improve, as the S&P 500 jumped to a 5-month high on July 22nd. While stocks have continued an impressive march upward over the last month, the yield curve has stayed on a flatter trajectory. Both the 2yr/10yr and 3m/5yr Treasury spreads are flatter by 5 and 4 bps on the month, respectively. The optimism fueled by the likelihood of a new spending bill and coronavirus vaccines appears to be outpacing fears of escalating tensions with China, which could likely spill into trade numbers. As banks begin releasing Q2 earnings, the tone in the financial sector appears strained, which is reflected in the sector lagging the overall stock market recovery. Many large U.S. banks increased reserves during the second quarter as hospitality, energy, consumer, and auto exposures continue to take direct hits from a rattled economy. Management teams are facing questions from investors searching for answers on credit quality, margin outlook, and plans for reducing noninterest expense. The backdrop of a difficult operating environment is likely to persist, and headwinds against margin and credit quality continue to mount.

In our Bank Strategy Insights Piece last week, we discussed the influx of excess liquidity on bank balance sheets and offered a case study on potential investment options. In keeping with that theme, this week we will explore one of the newest Agency CMBS products offering valuable call protection in an environment where banks are awash in funds to invest.

Background and Collateral Overview:

The Freddie Mac Multifamily Small Balance Loan Guaranteed Certificates ("FRESB") program was formally announced in October 2014 and the inaugural deal was issued in August 2015. Since inception, the program has issued 76 Deals for nearly $28B. Deals are issued programmatically each month, with recent pool sizes averaging around $520mm, which is smaller than the $1B+ deal sizes often issued via the Freddie K program. Deals are announced on the second Tuesday of every month. Piper Sandler participated as a co-manager in the most recent FRESB transaction in July; the next deal will be announced on August 11th.

The FRESB program targets small balance multifamily loans, which are often located in secondary and tertiary markets and lower-income geographies, not in the luxury, urban markets where $10mm+ loan sizes are the norm. With an average of 185 loans per deal, the program offers greater diversification and more stable prepays than other Agency CMBS security types. In fact, the loans comprising FRESB deals are often quite similar to the typical loans made by community banks, allowing for a greater comfort level when evaluating the underlying collateral.

Benefits of the Structure:

The loans are grouped by type and term to create tranches. This provides various advantages: Buyers have multiple tenors and structures to select from, as well as pricing differentials based on tranche. Buyers benefit from call protection, achieved through a mix of yield maintenance and fixed penalties, and from additional credit enhancement.

The loans backing FRESB deals are a mix of fixed rate loans with 5-, 7- and 10-year terms, in addition to hybrid ARMs with 5-, 7- and 10- year initial fixed periods. A typical FRESB deal can have 4-6 “A” classes, with each class representing an underlying loan structure. Overall, 10-year fixed and 5-year hybrid loans tend to be the most popular, leading to larger, more diversified “A10F” and “A5H” classes.

All collateral, regardless of loan type (fixed or hybrid), has a mix of declining fixed prepay penalties and yield maintenance to discourage prepayments prior to a defined open period. Penalty details are usually provided in the loan tape. While the prepayment penalties help mitigate early prepayments, any penalty income received will pass through to the interest only holder, not the “A” class holders.

Each deal has various “A” note classes, and 10% subordinate “B” class providing structural enhancement. In addition to the Freddie Mac guarantee, the “B” piece serves as additional credit enhancement, with support via the first loss and last payment piece. Principal payments are passed through pro-rata to the “A” and “B” piece, but will switch from pro-rata to sequential pay if certain default trigger events occur.

Yield Characteristics:
On average, benchmark FRESB bonds yield approximately 20-25 basis points more than Freddie K Certificates.

FRESB Pricing History

CLASS	SB76 7/15/2020 Spread	SB75 6/10/2020 Spread	SB74 5/21/2020 Spread	SB73 4/16/2020 Spread	SB72 3/11/2020 Spread	SB71 2/12/2020 Spread	SB70 1/15/2020 Spread
A-5F	43	49	56				
A-5H	63	70	72	72	82	54	57
A-7F				69		50	
A-7H	74		82		90		
A-10F	62	71	79	79	90	62	63
A-10H		79		86		66	70
CLASS	**Yield**	**Yield**	**Yield**	**Yield**	**Yield**	**Yield**	**Yield**
A-5F	0.70	0.86	0.87				
A-5H	0.89	1.06	1.03	1.14	1.41	1.97	2.17
A-7F				1.17		1.96	
A-7H	1.09		1.22		1.56		
A-10F	1.05	1.31	1.30	1.35	1.59	2.12	2.29
A-10H		1.39		1.42		2.16	2.36

This leads to a profile that yields more than other Agency CMBS sectors, with similar prepay protection.

(Note: Pricing Convention assumes 3PPS/5CPB: This means loans are run at 5CPR. Fixed Classes pay off on the balloon date, and Hybrid Classes will pay off at their rate reset date. If Hybrid Classes do not pay off by the reset date, the bond converts to a Floater at LIBOR +70bps with a 0% 1mL floor and transition language that contemplates index shifts).

Considerations:

Despite the guarantee from Freddie Mac, the default risk of FRESB should be considered. Institutions are encouraged to maintain prudent underwriting standards, and to take advantage of the transparency Freddie Mac offers in the data it makes available to investors. Early prepayments are also a risk, as they amplify the securities' premium risk on secondary market purchases above par. As with any other sector, the interest rate risk and convexity profile must complement the institution's overall yield and risk profile.

Community Bank Participation:

FRESB bonds have quickly become a popular investment among community and regional banks—over 70% of deal balances are placed into bank portfolios. These pooled and securitized multi-family loans receive a 20% risk weight with the Freddie Mac guarantee and often qualify for CRA credit. With much of the Agency CMBS sector trading at lofty premiums, new issue par-handle bonds are advantageous. Spreads approximately 20bps wider than DUS/K make for an appealing relative value.

If any of these observations pique your interest, please contact your Piper Sandler representative or email us at PSbankstrategyinsights@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

Other Thoughts from Around the Firm

- **FinTech Introductions:** We provide financial services companies with introductions to leading financial technology providers. Introductions are predicated on an understanding of your needs, refined by our deep knowledge of the sector and filtered for solutions that are actionable, enterprise ready, and cost-effective.

- **PPP Loan Buy/Sell Programs:** In addition to providing technology-enabled servicing and forgiveness solutions, the FSG Solutions Group can assist market participants in the buying and selling of PPP loans.

- Please contact FSG-Solutions@psc.com to discuss your financial technology needs as well as our PPP-specific tech solutions and loan trading capabilities.

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