Triple Threat: Opportunities in US Residential Credit for Global Insurance Companies

April, 2024
Time to read: 7 minutes

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Introduction

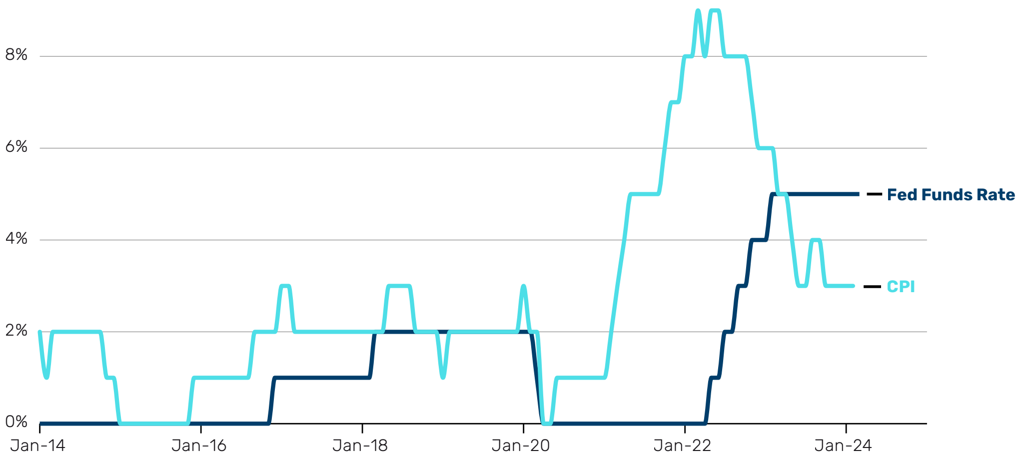
> Underlying residential fundamentals are healthy, providing an opportunity to achieve attractive returns through credit investing, with a cushion against any future value declines, while diversifying existing exposures to Commercial Real Estate.

The US residential private credit market offers a differentiated and scalable value proposition for global insurance companies. Underlying residential fundamentals are healthy, providing an opportunity to achieve attractive returns through credit investing, with a cushion against any future value declines, while diversifying existing exposures to Commercial Real Estate ("CRE"). Further to this, risk-based capital charges ("RBC") can be as low as <1%-2% and Federal Home Loan Bank ("FHLB") financing can be accessed to lever at a reduced cost. The granularity of the asset class is a driver of the opportunity but can also be a challenge. Finding partners who can structure customised solutions for insurance companies and reduce the investment and administrative burden is crucial. Get this right, and the results are compelling.

1: The Residential Asset Class

During periods of economic downturn or macroeconomic challenges, investments tend to respond in order of liquidity: first bonds, then loans, then real estate. With the emergence of inflation and interest rates moving from near-zero to over five percent, we witnessed bonds and then loans repricing while US house prices remained sticky.

Figure 1. While rising interest rates prompted a repricing of liquid assets house prices remained sticky



Source: Federal Reserve Bank of St Louis.

For institutions acquiring and aggregating single-family homes (the equity side of the residential business), rapid home price appreciation and accretive leverage, coupled with attractive capitalisation rates (cap rates), led to substantial investment volumes before and during the COVID-19 pandemic.

Today, financing costs have backed up while home prices nationally have continued to rise to the point where the cost of financing may be higher than the cap rate/yield, i.e. we're in a period of negative leverage. Yet, this exact challenge for institutional Single-Family Rental (SFR) investors underscores the opportunity within residential credit today: stability amid volatile rate cycles, with house prices reflecting healthy market fundamentals and strong consumer demand.

Paradigm shift for financing investment properties

For credit products, banks have historically served as the primary conduit for borrowers to access debt financing and capital markets. However, in the current climate following the regional bank crisis, banks have continued to adopt a risk-off approach to certain types of lending. This has been attributed to a range of factors including: (i) increased capital requirements stemming from Basel III regulations, (ii) higher interest rates, (iii) a flatter yield curve, (iv) deposit outflows, and (v) growing risk in banks' existing portfolios. Private markets investors have increasingly stepped in to fill this void, particularly prominent in areas like commercial real estate, non-Agency residential, loans to smaller sponsors, and consumer lending. For investors, we believe the shift from public to private markets financing is emerging as an attractive source of income-driven returns at low attachment points to underlying collateral.

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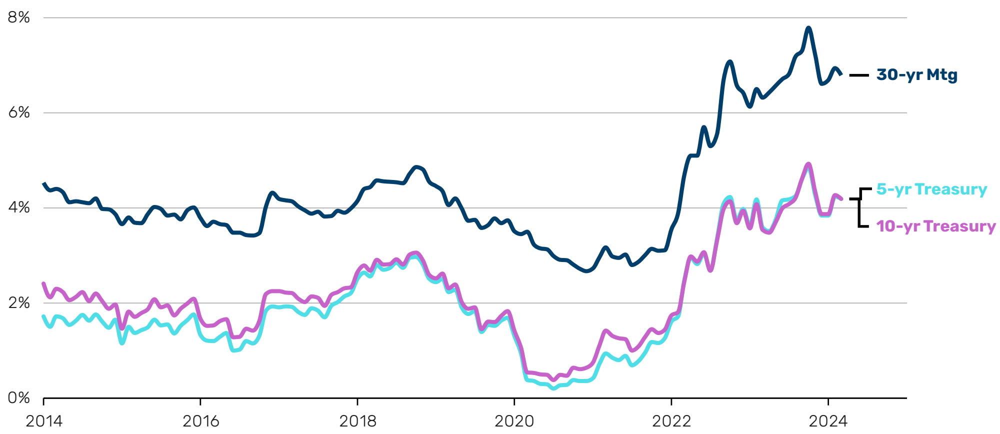
Rates are up, yet home prices grind higher due to lack of supply

While yields and spreads have increased in many sectors, we see the residential credit space as particularly compelling given the strong underlying fundamentals and opportunity to diversify other credit exposures. Conforming 30-year mortgage rates reached nearly 8% for consumers after the Fed rate hike campaign and have since rallied into the mid-high 6%s following treasury moves. Despite affordability levels at all-time lows, we've seen home price resilience due to a stark lack of supply – a shortage estimated at around 3.6 million single-family homes based on household formations between 2015 and 2022 [Source: JP Morgan, Census Bureau as of 4Q 2022].

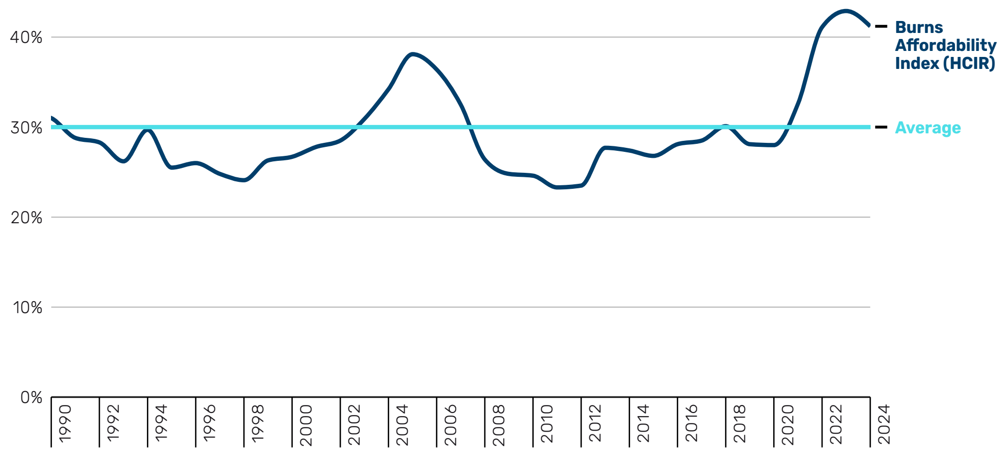
Figure 2. 30-year mortgage rates surged after Fed hikes



Source: Freddie Mac, Pensford, Federal Reserve Bank of St Louis.

This equilibrium between scarcity and affordability has made home price stability for the near-term future feel probable, a sentiment also recognised if macroeconomic conditions continue to improve.

Figure 3. Despite affordability hitting an all-time low (housing cost as proportion of income), home scarcity is keeping prices stable



Source: John Burns Research and Consulting, LLC, as of March 2024.

Government agencies provide stability through cycles

Residential real estate provides investors with a unique opportunity to gain the benefits of real estate exposure without some of the traditional limitations of other real estate classes. Unlike assets that rely solely on debt capital markets, residential real estate has support throughout credit cycles from government-sponsored enterprises ("GSE" or "Agency"), such as Fannie Mae, Freddie Mac, and Ginnie Mae. The existence of permanent agency financing for single-family and multi-family, typically 30-year and 10-year terms, respectively, makes for an even more stable investment over time.

Role of the consumer in residential real estate

In addition to attractive Agency-financing, which is unique to residential real estate, the residential market has distinct features that support the sector. Unlike other property types, the single-family market is granular and driven by the individual homeowner primary residence bid. Meaning, as long as the job market remains healthy and people have the means to pay their mortgage, there's no margin call putting downward pressure on housing due to 30-yr agency mortgages, which are primarily fixed rate.

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2: Capital Treatment & Financing

The capital treatment of these assets should further appeal to insurance companies. The mortgages are typically classified as commercial loans with residential collateral given their business-purpose nature. We focus on residential investor loans; typically residential transition loans ("RTL" / "Fix & Flip"), single-family rental ("SFR") loans, institutional development loans and bridge loans. The borrowers are property investors, not home owners.

We expect this exposure to fall under the 'Commercial Mortgages – Category CM2' classification on a NAIC-regulated balance sheet, using the US regime for example, with a fixed income risk factor of 1.75%. This compares favourably to commercial real estate equity at ~11-13%, or equities/alternatives at ~30-40%. At current yields, the return per unit of RBC would be as high as 500%+, in this example.

Once these assets are owned by the insurer and held on balance sheet, they qualify generally for FHLB loans, an attractive way to access inexpensive financing. The FHLBs are a consortium that provide liquidity to finance housing and economic development activities at subsidised rates, and members of the system include insurance companies, meaning low-cost leverage is available.

3: Customised Solutions For Insurance Companies

The benefits outlined typically require insurance companies to hold the exposure on their balance sheets, rather than committing equity or debt funding to third-party vehicles that invest and hold the assets on their behalf.

This comes with its own challenges, particularly asset management and accounting. When something goes wrong with a granular residential loan, it goes delinquent. Dealing with this requires expertise in asset management to resolve issues, work out the loan or step in and dispose of the asset.

The accounting treatment, which may be new to insurance companies, is also complex. From a real estate perspective, their focus has likely been on tens to hundreds of million-dollar loans. What we're discussing here is a large number of smaller loans with even smaller renovation draws as developer milestones are achieved.

It’s therefore important to partner with experts who retain responsibility for investment and asset management, as well as accounting. Structuring options include purchasing assets directly onto insurance company balance sheets, trust structures that reference single line items and the world of Rating Agency ratings, where capital charges can be reduced further.

Conclusion

The macroeconomic environment has been supportive for private US residential credit investors, as rates have risen, spreads have widened, leverage has decreased, and regional banks have pulled back. Meanwhile, underlying residential real estate fundamentals are healthy and anticipated to remain so. Amid this unique market dynamic – rates, spreads, and home prices all rising together – we see a compelling opportunity for insurance companies seeking a differentiated source of income with a yield pick-up and exposure to a healthy underlying market. This is coupled with attractive capital treatment and inexpensive FHLB financing for balance sheet investors. Partnering with an experienced investment manager is key though, to create a seamless way for insurers to access that yield pick-up, diversification, capital treatment and financing option, without taking on the burden of buying and asset managing thousands of individual residential mortgage loans.

All data sources Bloomberg unless otherwise stated.

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