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Q&A

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David Finkelstein:

All right everybody, hopefully you all found the afternoon enlightening and now we're going to open it up to a little bit of Q& A and we have Sean and Danielle with microphones. And then for those who are on the video feed, you can type questions in and we'll try and get to them as well. So let's get started. Who's up?

Crispin Love:

Thank you Crispin Love from Piper Sandler for David or anyone that the last segment kind of focused a lot on, GSE reform, so just curious on your views there, privatization of Ginnie/Fannie and kind of probability and then how you think kind of broader kind impacts to Annaly and the Agency market as a whole.

David Finkelstein:

Yeah, great question. So to Mark's point about mortgage spreads, as we've looked over the last couple of weeks with Trump's election win, one of the barometers we look at is Ginnie/Fannie swaps to see if there's anything specific to Fannie and Freddie. And we haven't seen much movement in Ginnie/Fannie swaps. So we're reasonably comforted by the market's calmness associated with GSE reform. And look, ultimately we get it, the Trump 1.0 ended with an attempt to release the GSEs. They had bankers and they were ultimately going to raise capital and our expectation is that they will get back on that path. It is, to Jim's point, it's not an easy process. You have the $350 billion that's owed to Treasury and you have a really precarious political environment to release the GSEs. And our hope is that they will do it, or attempt to do it, in a very methodical fashion.

Now there's a couple of points to note. Number one is you will have a significant amount of capital in the GSEs when they are released. You're going to have an regulatory oversight that's going to necessitate that they maintain healthy balance sheets. And you have this process or this distribution of credit risk called credit risk transfer, which is a fully developed market. And our expectation is that it will certainly continue. And so ultimately when you do have the GSEs released, and we don't think it's necessarily a bad thing at all, if they do it responsibly, you're going to have pretty healthy institutions that we think will maintain the support of global investors, number one.

And number two, if you look back to pre-financial crisis, you did have this notion of an implicit guarantee, but certainly wasn't explicit and the market operated very well, spreads were tighter than they are today. And the global sponsorship was more significant candidly than it was today with Japanese banks and China and others. And the GSEs were obviously big supporters. We don't expect retained portfolios to grow, but nevertheless that end state if it materializes is not necessarily a bad thing. And if it suggests spreads are a little bit wider that's okay.

And another point to note is they will much be much more profit focused, which means that we in our residential credit business are much more competitive with the GSEs and it'll provide more opportunities to expand that platform further. So long story short, nothing's going to happen for quite some time. We'll hear a lot about it there. There's good things and there's some things to be concerned about and we will manage it responsibly. A good question, Crispin.

Doug Harter:

So Mike, you showed that about 60% of the residential credit book is OBX created. Kind of where does that number go over the next one, three years? Does that ultimately get to a hundred percent? How does that play out?

Mike Fania:

Yeah, I think a lot of it depends on market opportunity and where spreads are, but Dave mentioned CRT. So if you look at the CRT market right now, they're not issuing below investment grade bonds. They're only issuing IG bonds. At one point, CRT was $1 billion dollars plus, it was 25% of our portfolio. We've actually reduced that position post quarter end it's like $725 million. So I think being diversified within Resi is something that we think makes sense. So we have the ability to buy third-party CUSIPs, we have the ability to buy third-party sponsored deals. But I think when you look at the current landscape, if spreads do not change, that number should go materially higher. It should be 75-80% over the next number of years because at this point there's nothing really comparable to the assets that were created.

Doug Harter:

And you talked about that you now you have the ability to do HELOCs or closed-end seconds. How do those returns compare to the 15% you talked about on non-QM?

Mike Fania:

Sure. So closed-end seconds, a lot of commentary about it. But in terms of who's actually producing closed-end seconds, it's large originators. It's mostly non-bank originators that have large servicing portfolios and there's probably three or four very large originators. It's Penny Mac, it’s Mr. Cooper, it's Rocket, it's New Res. And they sell those out in the open market. So they're just in the bulk market and for a long period of time the market was paying 107 to 108 for a 9.5-10% closed-end second lien. So when we look at that when we're talking with our Agency team, I think our view on long-term speeds on closed-end seconds is a little bit different than the market participants who are currently buying and levering those assets.

So that kind of needs to bear out in terms of if rates rally, is there a consolidation of that closed-end second and you have cash-outs. But when you listen to the mortgage originators, when you listen to the non-banks and they talk about the opportunity, why they're doing closed-end seconds, they're doing it so they can ultimately cash out. So I think our view of long-term prepayment speeds is a little bit different than the market. So to pay a seven to eight point premium on a 20-year amortization is what we think relatively high risk.

David Finkelstein:

That highlights a good point about synergies between even Residential Credit and Agency. So the prepayment modeling that Srini's doing is even informing how Mike thinks about prepayments on seconds and HELOCs. And your typical credit investor isn't as focused on that as we are, but that's just another example of how the left side always knows what the right side is doing.

Ken Adler:

And just to expand, so on our book that’s subserviced we have the opportunity to buy those seconds that come out from there. Mike just shared with you, we're not happy with the prepayment and the valuation, but here's the thing. We have the recapture agreement, so the blended note rate, the CLTV, eventually that loan ends up refinancing through that borrower going to another home or doing a cash-out refinance on the first. If the mortgage rate goes down just a little bit, we get that recaptured MSR. So we kind of benefit there.

David Finkelstein:

And they do show us on loans, seconds and HELOCs that are done off of our MSR, we get the look on those before they go to market or contextual with market like a last look, and candidly they're just a little bit rich right now.

Mike Fania:

Yeah, and I'll say just the HELOCs, it's a little bit different. We are pretty active. We have about $175 million portfolio that's drawn. If you include the undrawn, it's probably closer to $200 million. I think we would like to do a securitization in Q1 of this year of 2025. The key difference there is that the number of market participants that are buying HELOCs is materially less than close end seconds. HELOCs is active management in terms of the draw. You have to hold capital against that HELOC. There's a lot of our peers that can't figure that out or they're buying loans and funds that they don't have that capital that they could hold against it. So I think we feel as we have a competitive advantage within the HELOC market, so have been a little bit more bullish there relative to just closed end seconds.

Ken Lee:

Hey, thanks Ken Lee, RBC Capital Markets. One question on capital allocation. You mentioned that capital allocation for agencies could go as low as 50%. What are the key factors that could drive potential changes over the near term in terms of capital allocation between MSRs, Resi Credit and agencies?

David Finkelstein:

It's valuation primarily and to a lesser extent, availability of MSR and Resi. Those two sectors do tend to be somewhat more episodic and MSR trades can be relatively chunky. So for example, as we approach year-end, if there's a need for liquidity and we think the valuation is right, you will see a shift from Agency to MSR. But generally speaking, we're nimble enough to where valuation can drive those differences in capital allocation.

Ken Lee:

And actually just one quick follow-up on that. Just from a broad perspective, how should we think about potential implications to ROE given potential changes in the capital allocation? Thanks.

David Finkelstein:

To ROE? So we've, we obviously have put out levered returns across the businesses and look Agency's in the mid-teens. Securitized Residential Credit through OBX is contextual with that, MSR is a little bit lower. So you would think that an allocation more towards MSR might adjust that down a little bit. But we're talking about a very marginal difference on an $82 billion balance sheet. So we wouldn't expect much change through capital allocation specifically on ROEs over the near term.

Bose George:

Hi Bose George from KBW. Actually I wanted to ask about the repo markets just in terms of the stress into quarter end, year-end. Do you think that persists, is there scenarios where that could potentially impact your net interest margin? And at Arcola, does it impact the funding at FICC at all in terms of the cost of funds there? And then just lastly, does the fed have to do something with the standing repo facility to help stabilize the situation?

David Finkelstein:

So I'll start and then Serena, you can jump in.

Just with respect to quarter end financing volatility, we did see a little bit of a spike in cleared DVP repo at the end of the quarter. And it's important when you look at that elevated level of rates, to put it in the context of how rates have typically traded in a pre-COVID environment where reserves weren't as abundant as they were in the post-COVID environment. And if you compare it to those periods, it actually looks relatively normal. So at quarter end, month end even, tax dates, large coupon settlements, you do get elevated repo rates. And so what we saw at the end of the third quarter was what we think a little bit of friction in the plumbing of the repo market, but really a normalization in terms of a little bit less liquidity at quarter end and it's isolated enough to those types of dates to where it doesn't have a meaningful impact on the overall cost of financing. And if you looked at the days subsequent to quarter end, rates normalized relatively quickly to get back to contextual or within the corridor, Fed Funds corridor.

As far as the standing repo facility, it did see $2.6 billion in demand at quarter end, which was very low relative to the need for financing. Not a lot traded at very high levels, but you would think when there's prints in the mid-fives in the repo facility, is it 5% more money would be channeled into there. However, there is a problem with the plumbing on the SFR. It's primarily that it's a triparty channel. So that means that you commit your collateral in the morning and you don't get your cash until the afternoon. And as a consequence on quarter end, you have banks that intermediate that they end up with daylight overdraft charges and also a regulatory hit on their CLR test. So there is an issue with respect to the SFR being a liquidity providing mechanism to all at those types of dates. They could put some common sense fixes in it or potentially use the cleared market to help things. But nevertheless, there's a little bit of friction with the plumbing.

As far as year-end, look, a lot of times when we have these events, everybody gets a little bit concerned and they shore up their balance sheets sooner rather than later. And everybody is often very well-prepared for year-end. We're not taking it for granted, we're going to make sure that our financing is buttoned up and we have a responsible approach to it at a year-end. But I do think it's a normalization. We're watching reserves in the system and liquidity and making sure that we're prudently managing our financing though.

Serena Wolfe:

Despite the volatility that David has referenced and we're all aware of going back to normal pre-COVID levels, there's been no concern or no issues with us getting the availability of repo, Bose. We've been able to obtain all the necessary funding that we need both on the bilateral side of things and through Arcola. So it's not an availability issue, it's just a pricing issue. And like David mentioned, it's for a short period of time. And so we take that into consideration when Pete sets his strategy around weighted average days and things like that to make sure that we can minimize the potential impact of that disruption. And it is both in the bilateral side of things and the FICC markets that we've seen those spikes at period ends.

Bose George:

Great. And actually just one more on the dividend. Any reason the dividend should not be at least in line with what you're doing this year in 2025?

David Finkelstein:

Serena can answer that. No, I'll just say look, we have given guidance that we feel good about the earnings power of the portfolio and even said publicly, the dividend’s safe through year-end. Look, there's a lot of fluidity to markets and particularly monetary policy. We are optimistic about the direction of the portfolio and we feel like earnings are well supporting the dividend and will continue to be. But look, we got to see how policy shakes out and whether the dividend has the potential go higher, or lower, we'll have to wait and see. But we feel really good about our earnings power currently both.

Bose George:

Thank you.

Serena Wolfe:

But nice try. We appreciate the effort.

Harsh Hemnani:

Thanks. Harsh Hemnani from Green Street. So you mentioned the non-delegated underwriting on residential credit in that correspondent channel. How much does that expand the opportunity set in the near to medium term in the context of that $1 billion dollars run rate that you mentioned and then doing the underwriting in-house, does that have some incremental efficiency costs in your mind and how are you weighing those against the delegated piece, which seems to be performing well given the delinquencies to date?

Mike Fania:

Yeah, so that's a good question. Thanks, Harsh. In terms of the actual lock volume that we have been doing, I'll say it's averaging closer to a $1.5 billion to $1.6 billion in terms of what we would consider success for non-delegated maybe to start the first couple months, it's something in the context of $25 to $75 million. So initially we don't think it's going to be a very large contributor to the overall lock volume. I think what's important is the sustainability of non-del relative to the fully delegated channel. We think it's a much more sticky relationship. So if you go back to 2022, you go back two, three years ago, only I'll say 35%, 40% of the loans that we were purchasing were through our correspondent channel. And a lot of that was because the bulk market originators were able to take down loans on balance sheet and then earn, call it two to three points above rate sheets, right?

So during 2022, a lot of originators took a lot of losses. They didn't know how to hedge their risk. They were still trying to bulk that risk. So now all the leverage has been on providers like ourselves where virtually the entire market is locking through correspondent channels. So I think what it does is it sets us up longer term that you're going to have a sustainable source of production that is not going to go away because they can't sell that asset two to three points higher in the bulk market. They need us to underwrite the risk. So I think in terms of how we think about the actual cost as well, it's probably, when we initially set it up, it'll be variable cost based. And to the extent that it is successful, we would bring it in-house, we would hire our own underwriting team. But I think the expectations that we have initially are modest, but we do think that there's market share out there that over the long term we'd be able to achieve.

David Finkelstein:

One more.

Alan Rochard:

First of all, thank you David. Given the record kind of opportunity, the MBS market, when you look at where OAS spreads are, I'm curious what your perspective is on the biggest governor in terms of your willingness to issue equity and if you had the opportunity, if the market afforded you opportunity, you could double your equity today and grow your portfolio, would that be something you'd look to do? I'm just curious anything about the size?

David Finkelstein:

Well, double is pretty ambitious, but folks probably saw we did issue a fair amount of equity in the third quarter and into the fourth quarter, roughly $1.2 billion. And as we've said, there's two primary conditions that need to be met for us to raise equity. Number one, it has to be accretive to book. And number two, assets have to be attractive such that there's accretion to earnings. And if those two conditions aren't met, we're not going to raise equity. One of the points I brought up on the earnings call is that we have the additional benefit of additional equity by gaining greater scale. Now you can look at us and say, that's relatively greedy. You're a $12 billion company, you're the biggest in the space, why do you need more scale? Well, we always need to make investments in technology and innovation and we'd like not to charge the shareholder to do it.

And so by issuing more equity, we can smooth that cost over a larger shareholder base. And so that is an additional benefit in a time where technology is moving rapidly and we can make some pretty solid investments and that helps as well. But in terms of our appetite to raise equity, we are well capitalized. We have all the liquidity we need, but if the market is telling us to go out and raise equity and it works for the shareholder, we'll certainly consider it. In terms of doubling the size of the company. Look, never say never, but we're focused on managing the portfolio in the most effective and efficient way possible and delivering the returns that we are capable of delivering to shareholders, not necessarily being a behemoth. Our primary focus is preservation of capital and delivering the dividend and making sure that our shareholders are happy. And that's a good-

Serena Wolfe:

What a perfect way to end

David Finkelstein:

Yeah, that is a good way to end it. And look, one point I'd like to note is I really do want to thank our communications folks for putting this all together. They did a tremendous job and it was a great effort on the part of everybody here today to get here in the rain. And I recognize that. And something to note is that we have gift bags for folks, and in those gift bags is actually umbrellas and-

Steve Campbell:

Annaly umbrellas.

David Finkelstein:

Annaly umbrellas. So you can see that our risk management culture extends all the way to investor relations. So nice work guys and thank you everybody. And we're going to have cocktails. Cocktails?