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Spotlight on asset-backed securities

Market dynamics favour investors once more

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- Asset-backed securities (ABS) remain attractive to investors and it is not only because yield spreads have increased
- UK consumer risk offers value as Brexit downsides appear to be overpriced
- Resilience of deals appears strong, with robust documentation helping to reduce impairment risks, while underlying collateral defaults remain low

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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

Attractions of securitised debt are not confined to greater yield spreads

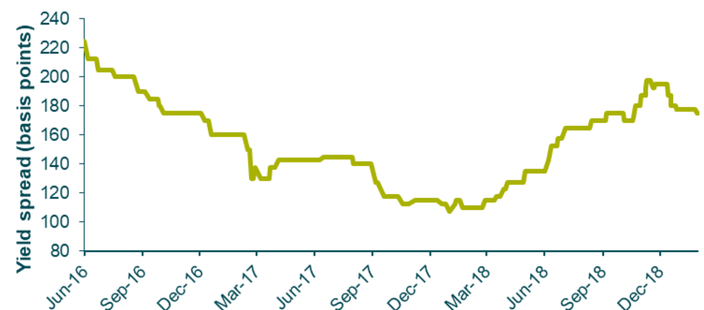
ABS can offer investors an attractive, floating rate alternative to corporate debt, being secured by the cashflows of identified pools of assets, within a variety of sectors, the largest being residential mortgages.

One example is ABS backed by corporate credit which offers an attractive risk return profile in our view. Senior AAA bonds in the collateralised loan obligation (CLO) market, backed by secured European leveraged loans, currently offer over LIBOR+100 basis points (bps). In the CLO market, much like in credit generally, the yield spread may only tell part of the story. Since 2016, as spread levels compressed across credit markets, the terms in CLO documentation generally became more friendly towards equity tranche holders. During this period, as debt investors, M&G's rejection rate for new deals increased significantly.

During the course of 2018 significant new supply was evident in both the underlying corporate loan and CLO markets and European CLO issuance in 2018 was the highest since the 2008 financial crisis. Over the course of the second half of 2018, CLO spreads in this market moved wider to more attractive levels, similar to where the market was in late-2016 (Figure 1).

This widening does not reflect specific concerns about the loans market but is in line with the more widespread increase in the reward available for taking on credit risk. At the same time, the issuance increase has provided debt investors with some negotiating power, such that documentation for new deals has been becoming more debt-holder friendly, thus adding to the attraction of the market. As a result, M&G's rejection rate for new transactions, having again been very high at the start of 2018, has started to improve markedly in recent months.

Figure 1: Spread movements in AA-rated European CLO paper



Source: M&G, Citi, as at 27 February 2019

UK consumer risk offers value

The largest ABS markets in Europe are backed by consumer risk, particularly residential mortgage backed securities (RMBS). RMBS has historically displayed the lowest underlying collateral defaults across European ABS markets. UK RMBS, in our view, are particularly interesting. Both issuance and spread levels increased significantly during 2018. In the first quarter, the spreads available on senior AAA UK prime RMBS were less than 40 bps (above sterling LIBOR), according to data from JPMorgan. The end of the Bank of England's Term Funding Scheme in February 2018 stimulated greater issuance, as banks' access to funds at ultra-low rates was removed. Since then, spreads on these bonds have widened to more than 60 bps.

Further down the capital structure, spread moves have been more pronounced with AA-/A+ rated paper in certain RMBS markets now available at yields around or above LIBOR+200 bps. Away from UK RMBS, in our view, European Central Bank (ECB) quantitative easing (QE) has led to lower spreads in most continental European RMBS, through a combination of adding to demand and simultaneously reducing the need for issuance by providing cheap alternative funding. As this unwinds we expect these markets to also become more attractive from an investment perspective.

Brexit's impact on UK RMBS may not justify recent spread widening

Brexit concerns may have contributed to reducing the appeal of the UK market and we believe that the current uncertainty for UK banks and borrowers regarding the post-Brexit landscape has led to some increase in the risk premium demanded by investors. Although we have no greater insight as to what market conditions will prevail following the UK's exit than other investors, an increase in volatility and tighter liquidity would not be surprising. The potential for increased uncertainty appears to be one factor why borrowers advanced their issuance plans in the early part of 2018. So far, 2019 issuance has been limited, as the market awaits further clarity on the Brexit negotiations.

While the increase in market issuance in 2018, coupled with Brexit concerns, has been one reason why UK spreads underperformed last year, we believe that this widening is probably greater than can be justified by underlying fundamentals. Consequently, the market currently offers attractive value for long-term investors in our view. Our analysis, which involves applying aggressive stress tests, indicates that even in extreme economic conditions consistent with house price falls and unemployment rates beyond even the most pessimistic hard Brexit forecasts, new investment grade issues coming to the market now should remain unimpaired.

Underpinning this belief is the evidence that no UK prime RMBS bond has suffered an impairment since the market's inception in the mid-1990s, regardless of its original credit rating, according to data from Moody's Investors Service[1]. With no impairments, to our knowledge, since Moody's published its data, this feature reinforces our confidence that UK prime RMBS offer attractive risk-adjusted returns compared to the corporate debt market.

The resilience of UK RMBS may be underappreciated

To gain confidence about the resilience of the deals we consider investing in, we analyse the underlying assets in the pool. We calculate the scale of default or the repossession rate that would be required to generate losses in the various tranches.

The resilience to significant stress (demonstrated in Figure 2), underpins our confidence in purchasing UK RMBS, despite the potential for an increase in borrower stress if the post-Brexit environment includes an unexpected UK economic downturn. We believe that investors will be well-rewarded at current market levels, given the scale of stresses that these deals are typically able to withstand.

For a recent UK RMBS transaction, we based our stress test on a 50% decline in house prices, which would far exceed the experience in 1989-1993 when the peak-to-trough decline in house prices was approximately 18%, which remains the largest fall in UK house prices on record. The repossession rate required for the securest (AAA-rated) tranche to suffer a loss in principal or interest would need to be more than 7.5% per annum (p.a.) for four years, and then more than 1.5% p.a. over the long term thereafter (Figure 2). To put this into context, the peak repossession rate in the UK since records began in the 1950s was just under 1% p.a. in 1992.

Figure 2: Default rates required for investment grade RMBS losses far exceed the worst case experience

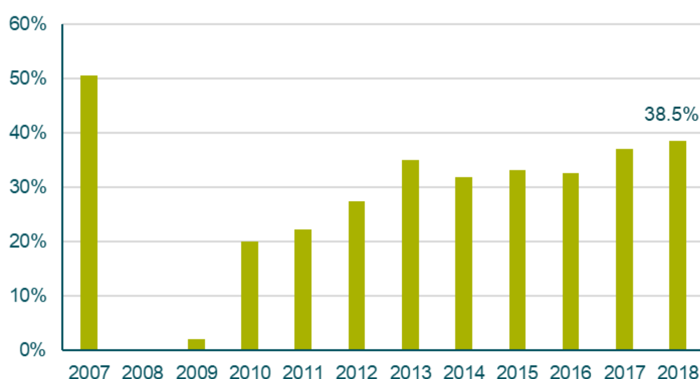
		Scenario for:		
	1989 - 1993	A-rated tranche	AA-rated tranche	AAA-rated tranche
Peak-to-trough decline in UK house prices	-18%	-50%	-50%	-50%
Peak repossession rate	0.79% in 1992			
Repossession rate when losses begin		4.5% for 4 years, 0.9% thereafter	4.9% for 4 years, 1.0% thereafter	7.6% for 4 years, 1.5% thereafter

Source: M&G, ABSxChange & Nationwide, as at 31 August 2018. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown. Not representative of specific strategy.

Investors interest in European ABS is increasing

Data shows that a greater proportion of Euro ABS issuance was distributed to investors in 2018, rather than being retained, compared to any year since the banking crisis escalated in 2008 (Figure 3). We believe this demonstrates further improvement in the end-investor appetite for ABS.

Figure 3: Percentage of Euro ABS issuance distributed to investors



Source: M&G, JPMorgan, as at 31 December 2018

The end of European QE may benefit unfavoured sectors

European quantitative easing (QE) entered a new phase from December 2018 as the European Central Bank (ECB) ceased making net purchases of securities under its Asset Purchase Plan (APP). It announced its intention to continue fully reinvesting principal payments however with plans to phase out its Asset Purchase Programmes (APP) holdings over the next few years. It is likely that some of the credit distortions that arose between assets eligible for purchase by the ECB and those not eligible, will unwind once the underlying demand from the ECB disappears.

[1] The transition performance of EMEA Structured Finance Ratings: 1993-2016, Moody's Investors Service – April 2017

At the end of December 2018, the total of the ECB's holdings across the whole APP stood at €2.57 trillion. Its ABS Purchase Programme (ABSPP) component represented just €27.5 billion (1.1% of the total), so we are not overly concerned about the effect on supply. However, we believe that the ECB's presence in the market has created something of a ceiling on spread levels in the sub-sectors of the ABS market that are eligible for QE purchase, which will now be removed.

The ECB has not yet announced a plan to begin reducing the stockpile of assets. A steady run-off is the most likely approach. However, even the simple absence of ECB buying may put upward pressure on the spreads of weaker credits. Additionally, we believe that when the ECB's supportive background demand for debt that was eligible for the ABSPP is removed, newer investors will look more closely and favourably at assets that were previously ineligible.

Our preference has been to focus on non-ECB eligible issues as we believe that issues which are currently eligible for purchase will be most vulnerable to negative pricing pressure when purchases cease. This is why, in our view UK RMBS and CLOs, offer the most attractive relative value in the European ABS market currently.

Recent market movements

European ABS spread levels were not immune to the general weakness experienced across credit markets during 2018, but the pace of spread widening was still relatively muted compared to other credit markets, which we think reflects a longer term investor base.

Past experience tells us that spread widening can often be quite sudden when it occurs, but we believe that current European ABS investors are now taking a longer-term perspective than was previously the case. Certainly we think it pays to focus more on credit and default resilience than on short-term market movements.

Defaults – should we be worried?

We remain confident about the credit strength of the European ABS market. In 2017 (the latest year for which full year defaults data are available), defaults declined further and now stand at just 1.0% p.a. for the entire European ABS market (including Southern Europe and Greece). Northern European consumer ABS, CLO and investment grade ABS defaults as a whole, remained at 0%, according to S&P, the global credit rating agency[2].

Default rates typically decline as the economic cycle advances but, in our view, terms in new deals have typically been offering greater protection to bond holders than was previously the case.

The improvement in default rates contrasts with what we observe to be signs of growing idiosyncratic risk appearing in the corporate bond markets. Credit markets are widely acknowledged to be facing late-cycle conditions as interest rates are generally rising, increasing the potential for some sudden and significant spread widening for individual corporate issuers. However, we believe that the ABS market as a whole is less vulnerable, particularly within consumer ABS. Underlying asset pools can consist of thousands of borrowers, so the idiosyncratic risk and impact of an individual problem loan is limited. The higher quality end of the securitised market is well positioned to withstand even a material increase in defaults.

New securitisation regulations effective from 1 January 2019

The Simple, Transparent and Standardised (STS) framework for ABS came into force at the beginning of 2019. However, as a lack of clarity in the reporting requirements remains, the issuance pipeline has yet to develop significantly.

It is anticipated that the capital treatment for STS ABS will make them more attractive to investors such as insurers, as the pressure on the capital requirements for such holdings is reduced.

The benefit of capital relief will surely be welcomed by the market, but it remains unclear how much additional demand will be stimulated.

The European Securities and Markets Authority (ESMA) appears to be encouraging issuers to adopt the requirements to ensure eligibility under the STS framework.

However, STS-eligibility does not guarantee that a deal carries less risk. Prospective investors should still subject deals to rigorous due diligence prior to investing.

Where do we currently see value?

We believe there is value in both the high-grade parts of the market (portfolios rated AA- on average) as well as in selected non-investment grade bonds. The expansion of yield spreads has been widespread this year due to combinations of increased issuance and geopolitical uncertainty. However, we believe that the degree of spread widening that has occurred is not warranted by fundamentals in the ABS market, so the yields-to-maturity that are currently available should be appealing to investors.

In our view, the attraction of both the high grade and non-investment grade securitised markets, relative to other credit markets remains strong. Higher yields and spreads can be positive for overall returns, given the floating rate nature of the market, particularly when viewed alongside the potential negative price impacts of higher spreads yields on fixed rate debt.

Currently we believe that, given careful credit selection, an investment grade-only portfolio, with an average rating of AA-, could be constructed to carry a yield of approximately LIBOR +2.0%. Building a non-investment grade-rated portfolio, which would carry greater risk, may be able to achieve a prospective yield-to-maturity of approximately LIBOR +6%-9%.

Both market opportunities seem compelling to us, from a risk/return perspective, when compared to other mainstream fixed income assets. The improvements in disclosure on the underlying assets and the greater robustness of deal structures than was commonplace prior to the 2008/9 global crisis, further support the market's attraction.

[2] 2017 Annual European Structured Finance Default Study And Rating Transitions, S&P Global. August 2018

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