Sector in Brief:

Securitised Credit

bfinance

Resource

What's new?

Securitised credit is attracting heightened attention from investors in today's 'lower for even longer' climate. Demand is supported in part by long-term data on diversification and return enhancement and in part by the perceived dislocations in this asset class, with particular focus on CLOs.

This report contains a round-up of key trends, market developments and available investment strategies, supported by a **recent survey of securitised credit funds**.

The sector has evolved considerably over the last decade: this is no longer an asset class that should be tarnished by pre-GFC practices. There has been a marked improvement in the quality of underwriting, structural protections and regulatory requirements. In the EU, new securitisation regulation (2019) has added further protection. The number of standalone pooled funds focusing on this asset class has risen considerably and now stands at more than 100. Separately managed accounts are also available for clients investing over $50m. A diverse line-up, these strategies range from aggressive (cash plus 5-10% target return) to conservative (cash plus 1-2%). The latter have become increasingly popular as an alternative to Absolute Return Bond funds, particularly after these struggled to deliver positive returns net of fees in 2018.

The 2020 upheaval has driven notable further changes. For example, we see managers launching strategies with longer lock-up periods following the liquidity woes of March 2020. Fund liquidity profiles have typically varied a great deal in this asset class, ranging from daily dealing to semi-annual redemption (page 3). However, investors should ensure that liquidity provisions are in line with the underlying opportunity set and are sufficiently compensated by yield.

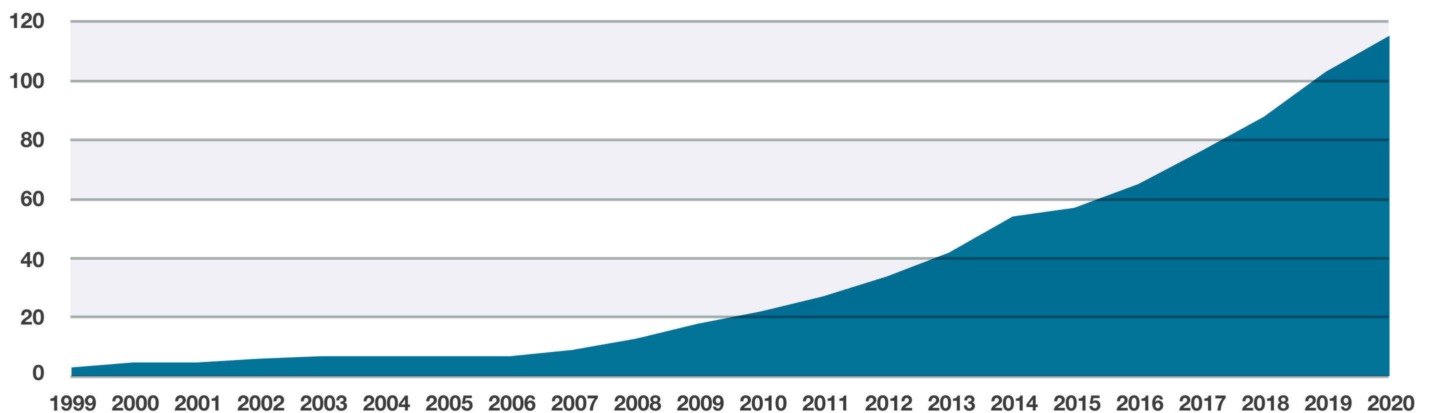
We hope that this 'Sector in Brief' proves useful to investor readers. It begins with an overview of available strategies (pages 2-4), followed by a recap of the asset class (pages 5-6) and its sub-sectors (pages 8-10).

Facts & figures

>US$15trn
global securitised debt market.

>180 securitised debt strategies from 75 asset managers. Includes global and regional, multi-sector and sector-specific.

NUMBER OF POOLED FUNDS FOCUSED ON SECURITISED CREDIT



Source: bfinance Securitised Debt survey of 185 strategies (pooled funds and SMA). Readers should note survivorship bias: former that have now closed are not shown here.

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Investment strategies

Securitised credit plays a role in various diversified fixed income strategies, including Absolute Return Bond funds and Multi Asset Credit funds. However, recent years have seen the growth of a large group of strategies dedicated specifically to this asset class. We hope that this portion of the report provides readers with insight on this family of strategies.

A recent survey undertaken by bfinance reveals the diverse range of pooled and separately managed solutions available to investors. Solutions vary from **regionally focused, single sub-sector strategies** (such as US CLOs or Dutch RMBS) to **globally diversified, multi sector funds** that seek to offer exposure across the entire breadth of the securitised debt landscape. Overall, we identified over 180 strategies run by 75 managers, with over $600bn in AuM. 116 of these strategies are available in pooled fund format with the remainder accessible through bespoke separately managed accounts.

Regional vs global focus

Broadly speaking, strategies operate with either a global or a regional focus, with the latter being more common. For global strategies, exposure to US assets represents about 49% on average, while European exposure represents approximately 43%. We would advise European investors to exercise caution and diligence in selecting US-biased or US-focused strategies, particularly given EU regulations on holding **risk retention compliant securities**. At present, any US bonds issued prior to January 2019 can benefit from inclusion under grandfather clauses; any bonds issued after this time must comply with regulations, meaning that over time the number of compliant US bonds will decline.

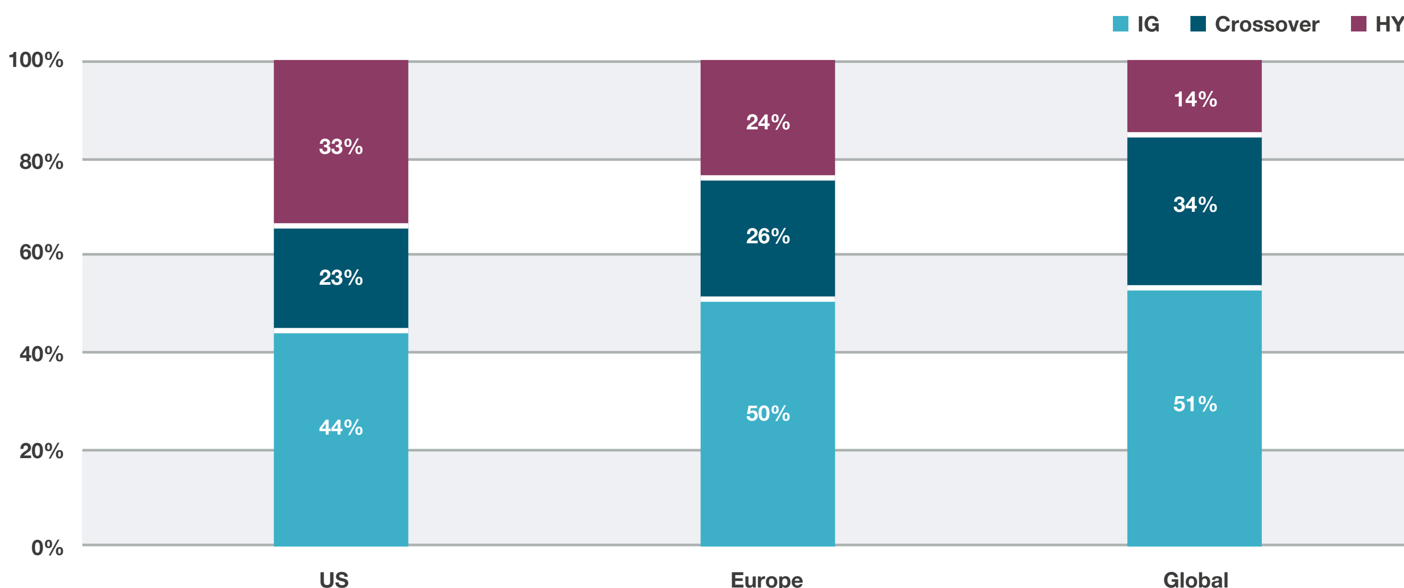
Sub-sectors

Strategies vary from diverse portfolios allocating across the breadth of the securitised debt spectrum to those with a sole focus on one sub-sector (see page 8). Our analysis of 185 strategies showed average asset allocation split as follows: 37% to CLOs (note that the group includes a number of CLO-only specialists), 25% MBS (US Agency & Non-Agency RMBS, as well as European Prime RMBS), 12% CMBS, 9% Consumer ABS, and the remaining 17% to other sub-sectors and cash or cash equivalents.

Credit quality

Among the range of solutions available from asset managers, investors have a variety of options in terms of investment seniority. We find a large number of **investment grade focused strategies** alongside a substantial number of **high yield** and **crossover strategie**s; US strategies have lower average credit quality.

SECURITISED DEBT FUNDS, CATEGORISED BY REGION AND CREDIT QUALITY



Source: bfinance Securitised Debt survey of 185 strategies, 2020

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Return targets and liquidity

Strategies can broadly be grouped into three types chasing different return targets.

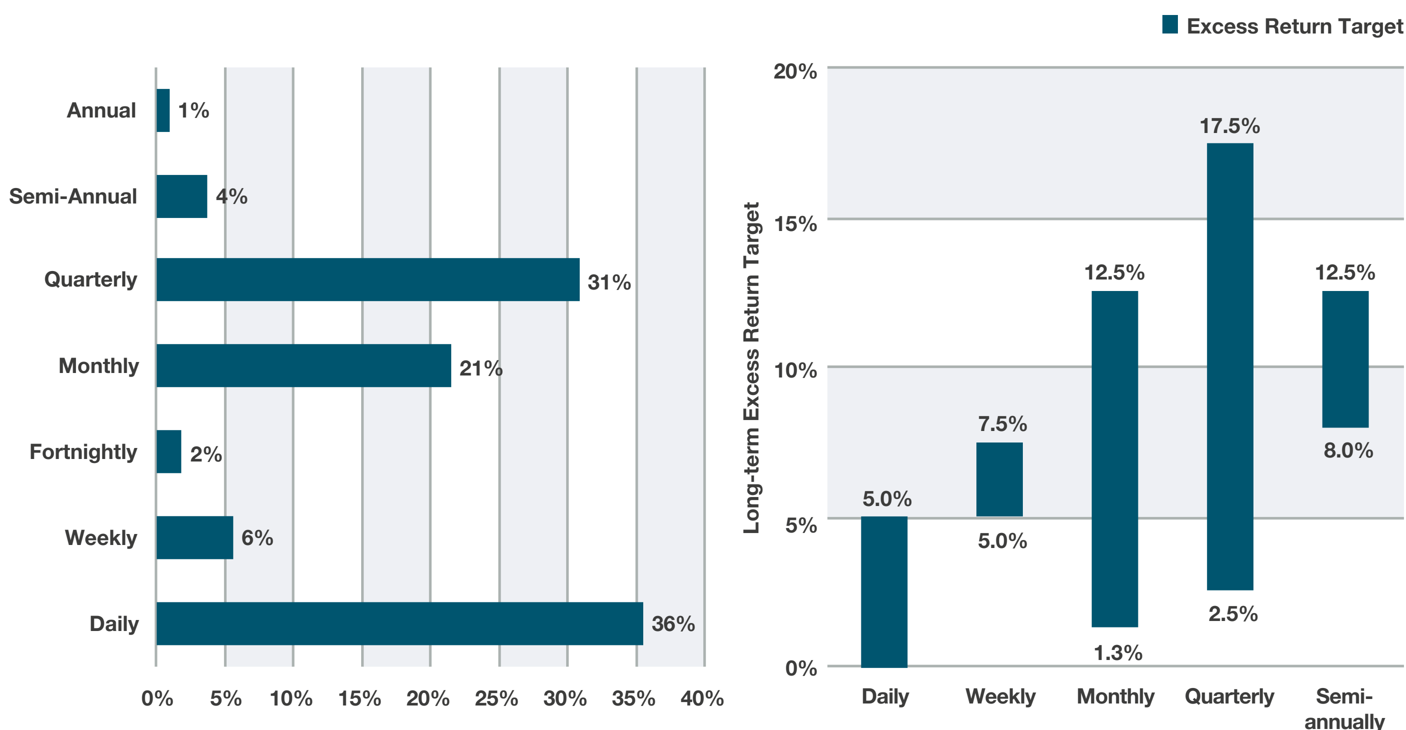
- **Conservative**, with a focus on capital preservation and liquidity. Often used as "cash proxies"; an alternative to Absolute Return Bond strategies. Target: cash plus 1-2%.
- **Balanced**, with exposure to a mixture of senior and subordinate tranches. Target: cash plus 3-6%.
- **High-yielding**, focusing on sub-investment grade and equity tranches as well as niche sub-sectors. Target: in excess of cash plus 7%.

These target returns tend to be long-term expectations set at fund inception; investors should carefully discuss how the prevailing market environment has affected these expectations prior to implementation.

The chart below shows the range of returns targeted by strategies, categorised by the liquidity provision of the funds. In general, senior tranches tend to be larger and more liquid than lower-rated counterparts in the same securitisation (e.g. in a CLO deal the AAA-rated tranches may represent 60% of issuance). As a result, more conservative strategies are generally able to offer high liquidity while more aggressive strategies tend to target more illiquid segments of the market and thus typically offer less liquidity to investors. Yet, as shown below, the connection is far from a straightforward one.

While this particular study reviewed strategies that are able to offer some level of periodic liquidity, we do also note a number of managers who are **fundraising in 2020 for closed-ended strategies** that resemble an illiquid asset drawdown structure.

VEHICLE LIQUIDITY (LEFT), AND EXCESS RETURN TARGETS BY LIQUIDITY PROFILE (RIGHT)



Source: bfinance Securitised Debt survey of 185 strategies, 2020. Note: liquidity classifications come with some important caveats, such as gating provisions (e.g. quarterly but a maximum of 25% per quarter) and soft lock-ups (e.g. an initial twelve-month period of illiquidity after investment).

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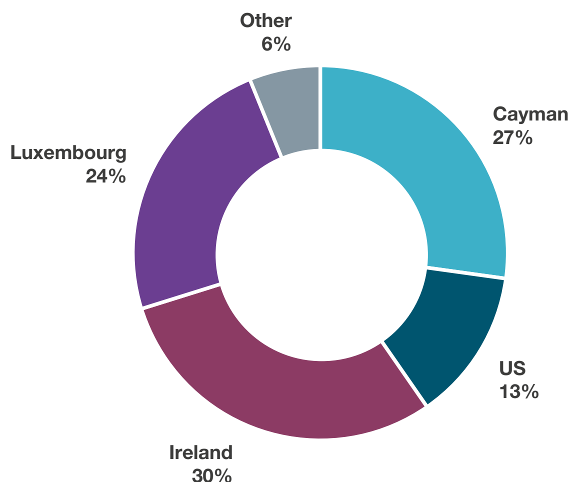
Domicile

Fund domiciles or availability of structures in different jurisdictions can often be a deciding factor for certain investors (although less problematic in the case of Separately Managed Accounts). There are now a variety of different vehicles available to suit a wide range of investor types, from European UCITS, SICAVs and QIFs to US and Cayman domiciled vehicles.

Our analysis of 68 European-domiciled vehicles shows approximately half with a bias in favour of European assets, but a substantial number with a US or global focus. Conversely, of the 51 US or Cayman domiciled vehicles analysed, the vast majority had a strong bias towards US assets, with a small proportion offering European-biased strategies.

FUND DOMICILES



Source: bfinance Securitised Debt survey, of 185 strategies 2020

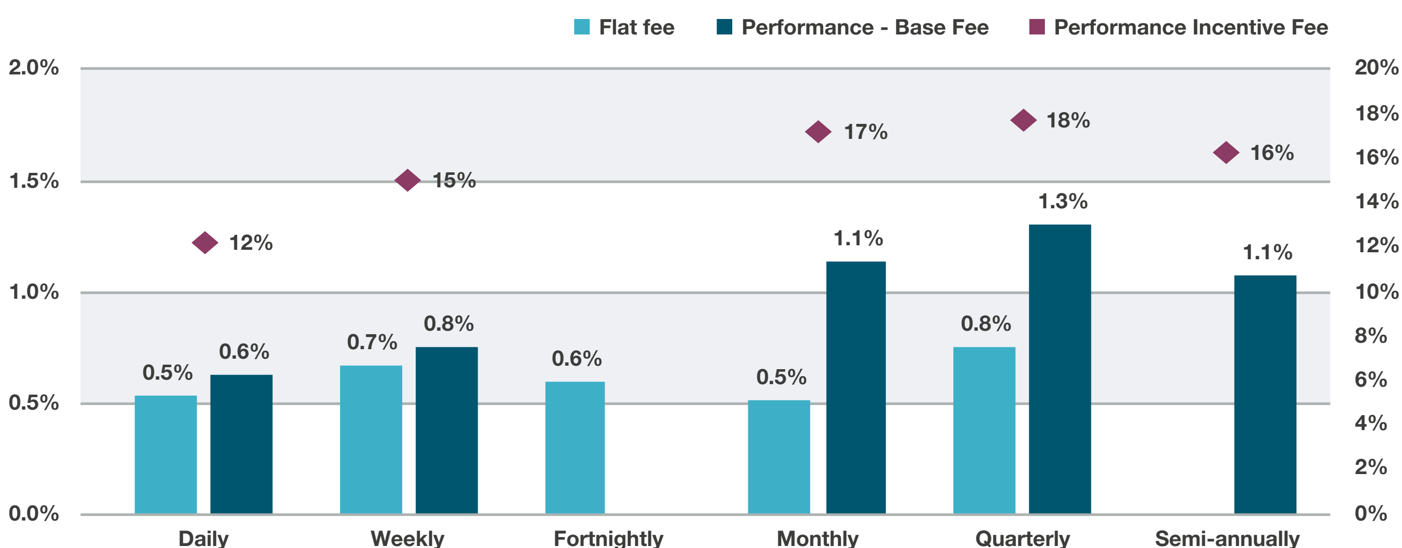
Management Fees

Securitised debt is a complex corner of the fixed income universe where managers require highly specialised investment teams with strong capabilities in modelling the vast amounts of data behind each bond in a portfolio. Fee levels and structures do reflect this complexity, but there is substantial variation based on factors such as the underlying asset allocation, investment style, liquidity provision and return target.

Almost half of pooled funds incorporated some form of performance fee overlay, charging investors anywhere between 5% and 20% on returns on top of base fees, should the manager meet or exceed a pre-disclosed hurdle rate over a given period. A small number of managers reserve the right to full 'catch-up', meaning that the performance fee would apply to the entire return over a period if it exceeds the hurdle rate.

Investors are strongly urged to consider each manager's fee structure thoroughly and ensure it is aligned with their approach, opportunity set and expected returns. We advocate for managers to embrace transparency around fee structures, enabling investors to understand the cost components involved.

AVERAGE FEES FOR SECURITISED CREDIT FUNDS OF DIFFERENT LIQUIDITY PROFILES



Source: bfinance Securitised Debt survey of 185 strategies, 2020

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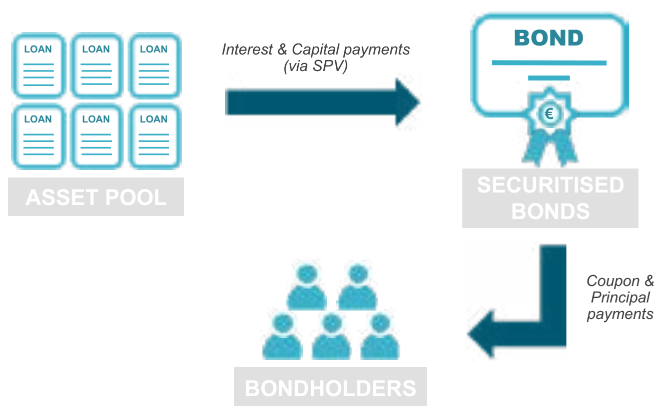
What is securitised credit?

Securitised credit allow investors to gain exposure to specific types of consumer risk (page 6). They are largely liquid and frequently tradeable in secondary markets. Key types include Residential Mortgage Backed Securities (RMBS), Commercial Mortgage Backed Securities (CMBS), Collateralised Loan Obligations (CLOs) and other Asset Backed Securities (e.g. credit card receivables and auto loans).

All ABS are fundamentally similar in terms of structure: they are bonds backed by pools of underlying loans, enabling originators such as banks to transfer those loans off their balance sheets so they can continue originating new loans. The underlying collateral is grouped together based on asset type and then split into tranches that vary by credit rating (typically from AAA to BB), with the lower tranches absorbing losses first. Investors are then able to select tranches at the desired level of risk.

Some defining features include:

- **higher yields** versus corporate bonds; regulatory burdens (for EU investors) and the cost of building specialist teams means that the market remains relatively under-researched;
- **diversification** from traditional bonds, driven by prepayment risk (page 6) and other factors;
- **structural protection**, with more junior tranches (e.g. Equity and single B) absorbing losses to protect senior tranches and the entire asset pool ring-fenced to protect cash flows from bankruptcy events;
- **interest rate protection** through floating rate exposure;
- **high transparency** about the underlying loan pools, with monthly reporting to asset managers giving incredible detail on the constituents of each asset pool.



There are big differences between the US and Europe on these points, as illustrated in the table shown here. For example, structural protections are broadly higher in the EU, where rules require issuing entities to retain at least 5% of any deal on their balance sheets – typically they keep the most junior tranche (e.g. equity). In the US, non-recourse lending practices and higher degrees of leverage on underlying mortgages within asset pools meant that RMBS and CMBS saw more defaults following the 2008 financial crisis (~16% for both, according to data from S&P), whereas European RMBS did not have any defaults through that period and European CMBS saw only a small number (~1.5%).

Together, these two regions make up the vast majority of the global market; there is also a very small amount of Australian issuance.

OVERVIEW OF ASSET CLASS - US VS EUROPE

	US	Europe
Origination of Asset Pool Loans	Mixture of Banks, Mortgage Lenders & Intermediaries ('Alt-A')	Majority by Banks
In Event of Default	Non-Recourse market	Full Recourse on borrower
First loss on loans	Bondholders of junior tranches – originators not bound by risk retention rules	Mostly absorbed by Banks that own junior tranche due to European risk retention rules
Borrower Profile	Mixture of prime and sub-prime borrowers	Mostly borrowers with good financial health ('Prime')
Total Market Size	$13.9tn*	€595.4bn**

** Source: SIMFA as at 31 Dec 2019*
*** Source: AFME as at 31 Dec 2019, based on 50% retention by securitization issuer.*

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Issuers of securitised credit employ various methods of credit enhancement designed to provide protection to investors – typically the holders of the more senior tranches – in the event of stressed scenarios. They include:

- **Subordination**. Losses on underlying loans are first absorbed by junior bonds, resulting in a write-down in principal, protecting the senior bondholders. Any interest shortfalls will affect the most junior bonds first.
- **Overcollateralisation**. The face value of an underlying loan pool tends to be larger than the par value of the issued bonds.
- **Excess spread**. This is the difference between the coupon on the underlying collateral (e.g. mortgage interest rate) and the coupon payable on the securities.
- **Third party guarantee**. These can be from governments (e.g. US agencies) or monoline insurance companies which provide guarantees for securitisations (though this does add counterparty risk).

Jargon buster:
prepayment risk, reinvestment risk, consumer risk

These risks are primarily responsible for giving securitised credit its diversifying profile versus corporate and sovereign bonds.

Consumer risk is the risk that individual borrowers will be unable to pay the interest on their debt, which is heightened during economic slowdowns or recessionary environments.

Prepayment risk is the risk that borrowers pay off loans early, shortening the average maturity and reducing overall returns. Interest rate volatility is unhelpful for securitised credit: falling rates may encourage prepayments (since consumers can refinance debts at cheaper rates); rising rates discourage prepayment, lengthening duration precisely when duration becomes unappealing. Prepayment risk is famously hard to model, since it is not only interest rate-dependent but interest rate path-dependent. It is linked to the consumer cycle, unemployment and more.

In the event of prepayment, the issuer of securitised debt then has to reinvest the repaid principal at market interest rates (**reinvestment risk**). For this reason, securitised bonds trading in secondary markets do not tend to increase in price during periods of declining rates.

Certain types of securitised debt are less exposed to prepayment risk (e.g. auto loans, credit cards), while others are typically more exposed (e.g. RMBS, CMBS).

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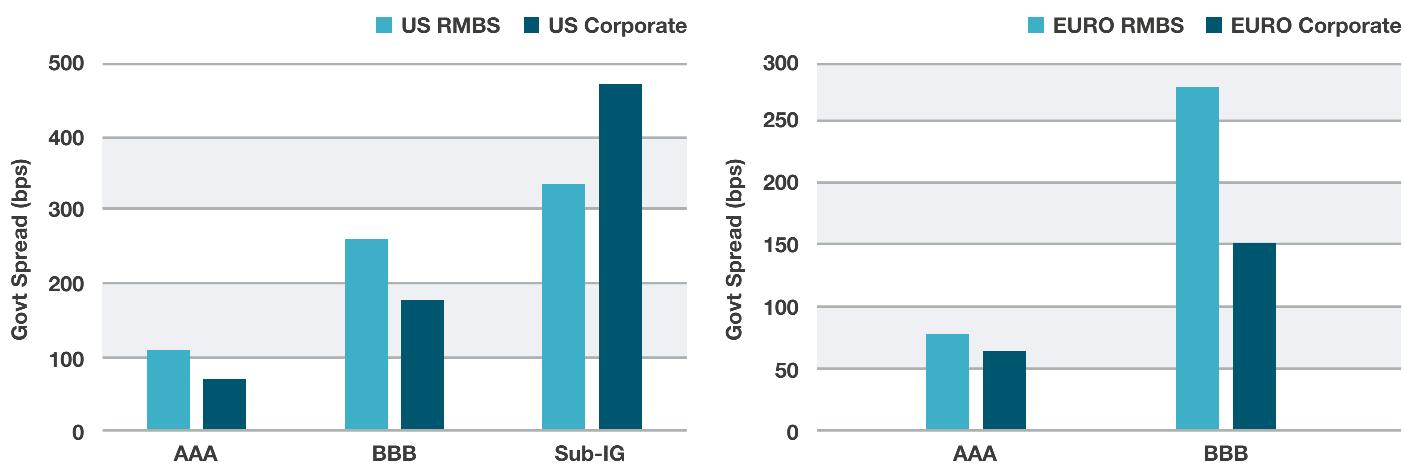
Sub-sectors in focus

Sub-sector	Description	Size, liquidity
Residential Mortgage Backed Securities ('RMBS')	Bonds backed by an underlying pool of (single family) residential mortgages issued to borrowers by banks and mortgage lenders. In US, market includes "Agency" and "Non-Agency" mortgages.	Large and liquid; $7.4trn in US (89% Agency); $760bn in Europe. Represents 83% of US securitised credit market and 54% of the European market. Issuance at $1.4trn p.a. in US since 2008 and $155bn p.a. in Europe.
Commercial Mortgage Backed Securities ('CMBS')	Bonds backed by an underlying pool of first lien commercial mortgages issued by banks and specialist lenders. Includes apartments, offices, hotels, shopping malls, warehouses.	A smaller part of the market, typically less liquid than RMBS. $1.3trn in US (58% Agency), $61bn in Europe (>75% UK). Issuance at $72bn p.a. in US since 2008, $6bn p.a. in Europe.
Asset Backed Securities ('ABS')	Bonds backed by pools of corporate and consumer loans, mainly credit card receivables and auto loans. Other types: student loans; loans used to purchase commercial equipment or other tangible assets.	Liquidity varies by type. Consumer debt ABS (credit cards, auto loans, student loans) typically offer good liquidity. Market size: $1.8trn in US, $257bn in Europe.
Collateralised Loan Obligations ('CLO's)	Bonds backed by an underlying pool of senior secured loans to corporates rated BB+ or below. Largely involves companies that have been involved in a leveraged buyout or are subject to some form of Private Equity led M&A activity.	A small-yet-significant market with varying degrees of liquidity. Size: $600bn in US, $153bn in Europe. Annual issuance has ballooned post-2008, driven by supply in the leveraged loan market (which has grown from $554bn in '07 to $1.3trn in '19).

Need-to-know: RMBS

The European market is far smaller and less complex than its US counterpart. Dominated by UK and Dutch mortgages, it has a low-risk profile with virtually no sub-investment grade piece. Unlike in the US, all mortgage debt in Europe is issued with **full recourse** to the lender, resulting in borrower behaviours that prioritise repayment; the US, on the other hand, is a non-recourse market, meaning that borrowers can vacate their homes and hand possession to the lender without facing bankruptcy proceedings.

FIVE-YEAR AVERAGE SPREADS (BPS) ON RMBS AND CORPORATE DEBT, US (LEFT) AND EUROPE (RIGHT)



Source: Bank of America Merrill Lynch, JP Morgan & HSBC Asset Management. Average spreads calculated over a five-year period, October 2015 to September 2020. Based on indicative mid-spreads in local currency.

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Jargon buster:
Government Sponsored Entities

The biggest difference between the US and European markets, of course, is the role of the Agencies or Government Sponsored Entities (GSEs) – Ginnie Mae, Freddie Mac and Fannie Mae. Non-Agency MBS, issued by the 'Alt-A' sector (banks and mortgage lenders), represent just over 10% of the US RMBS market. 'Fannie & Freddie' have the ability to issue and guarantee MBS but, although the agencies operate under a congressional charter, the guarantees are based on the financial strength of each entity and are not government-backed; 'Ginnie' does not issue MBS but does provide guarantees with government backing. GSEs abide by strict criteria to reduce the likelihood of default, including a cap on overall loan size; mortgages included within Agency MBS are thus often described as "conforming" loans or "qualifying" mortgages.

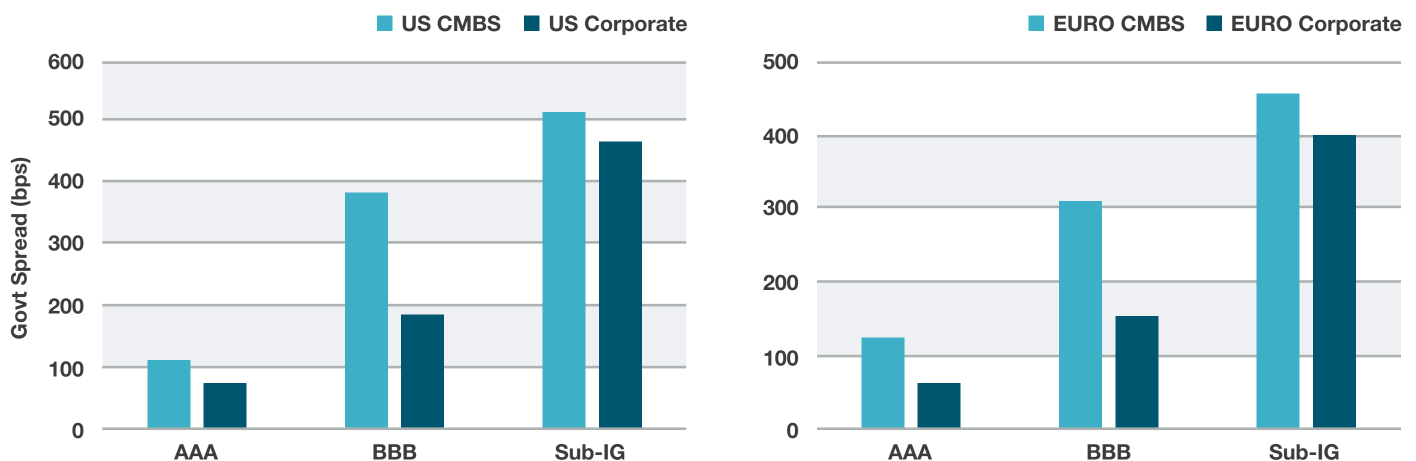
Since 2013, investors have been able to access **Credit Risk Transfer** ('CRT') securities – a market that has emerged in the US from a desire to protect Government Sponsored Entities (GSEs) from being in a 'first loss' position and thus reduce the risk of a future taxpayer bailout. CRTs transfer a portion of the risk associated with the credit losses within pools of MBS from Fannie Mae and Freddie Mac to the private sector. As of December 2019, over $99bn in CRT securities had been issued, effectively transferring a portion of risk on over $2.9trn in unpaid principal balance on mortgage loans. It is widely expected that the market in CRT securities will continue to grow providing a steady flow of new issuance to investors over time.

Need-to-know: CMBS

CMBS differ from RMBS in a number of important ways. The asset pools are **more concentrated**, generally with fewer than 100 loans and 10-20 of them comprising a significant portion of the pool, although they're typically well diversified by property type. It is common to see single-asset single-borrower CMBS come to market, with one large loan financing, for example, a high-value prime real estate asset. The duration is generally longer, since typical commercial mortgage loan terms are ten years in length, based on a fixed interest rate and to be repaid in full at the end of their term – usually via refinancing. **Loan-to-value (LTV) ratios** at the time of issuance tend to be modest (versus RMBS), with borrowers typically expected to contribute 30-40% of equity towards the purchase.

European issuance, which is UK-dominated, declined significantly in 2016 and 2017 following the Brexit referendum result, forcing a re-pricing of sterling denominated assets. Since then we have seen a gradual pick up, with new issuance in 2018 and 2019 returning to pre-Brexit referendum levels.

FIVE-YEAR AVERAGE SPREADS (BPS) ON CMBS AND CORPORATE DEBT, US (LEFT) AND EUROPE (RIGHT)



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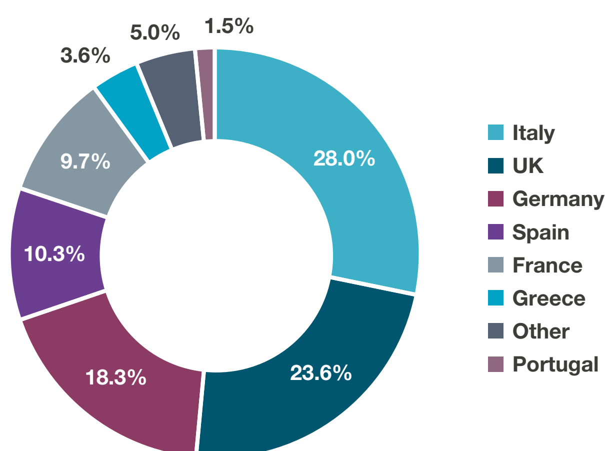
Need-to-know: ABS

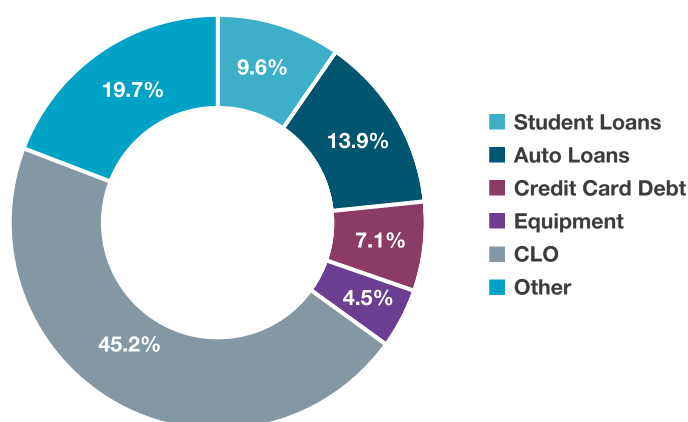
The different subsets of ABS exhibit very different characteristics, risk profiles and liquidity.

- **Auto loans**, like mortgages, have an interest and capital repayment structure but with much shorter duration and smaller loan balances. The value of the underlying collateral depreciates rapidly, whereas house prices are generally expected to increase over time.
- **Credit card ABS** combine thousands of credit card receivables (unpaid balances) into one portfolio. There is no tangible collateral underpinning those receivables, meaning that recoveries will be low in the event of non-payment, making this a riskier portion of the securitised debt universe – and one with higher expected returns as a result.
- **Student loan ABS ('SLABS')** are typically found in the US and make up a meaningful portion of the US ABS market. There are two types: those guaranteed by the government and private loans without any form of guarantee (the latter is riskier and returns are higher). Cashflow profiles are not stable due to exemptions and limits on how/when students are obliged to pay back loans. Sallie Mae is the largest private American lender of student loans. Similar to credit card receivables, SLABS do not have any direct tangible collateral, but parents will commonly act as guarantors for the debt, increasing the chances of repayment.

EUROPEAN ABS MARKET - €218BN



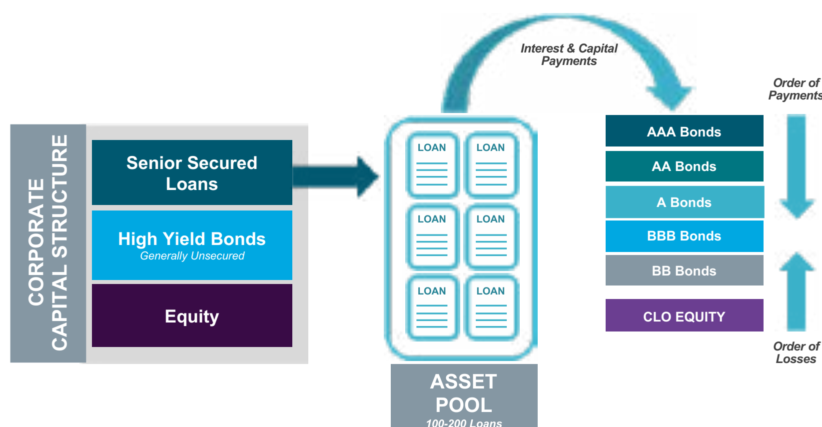
US ABS MARKET - $1.8TN



Source: SIMFA & AFME as at 31 Dec 2019.

Need-to-know: CLOs

This is the sub-sector that has received perhaps the most attention from investors in 2020, in part due to widening spreads and in part due to the significant changes in this market since 2008. Annual issuance has soared, driven by supply in the growing leveraged loan market. There is a diverse client base for these securities including banks, asset managers, insurers, pension funds and hedge funds.



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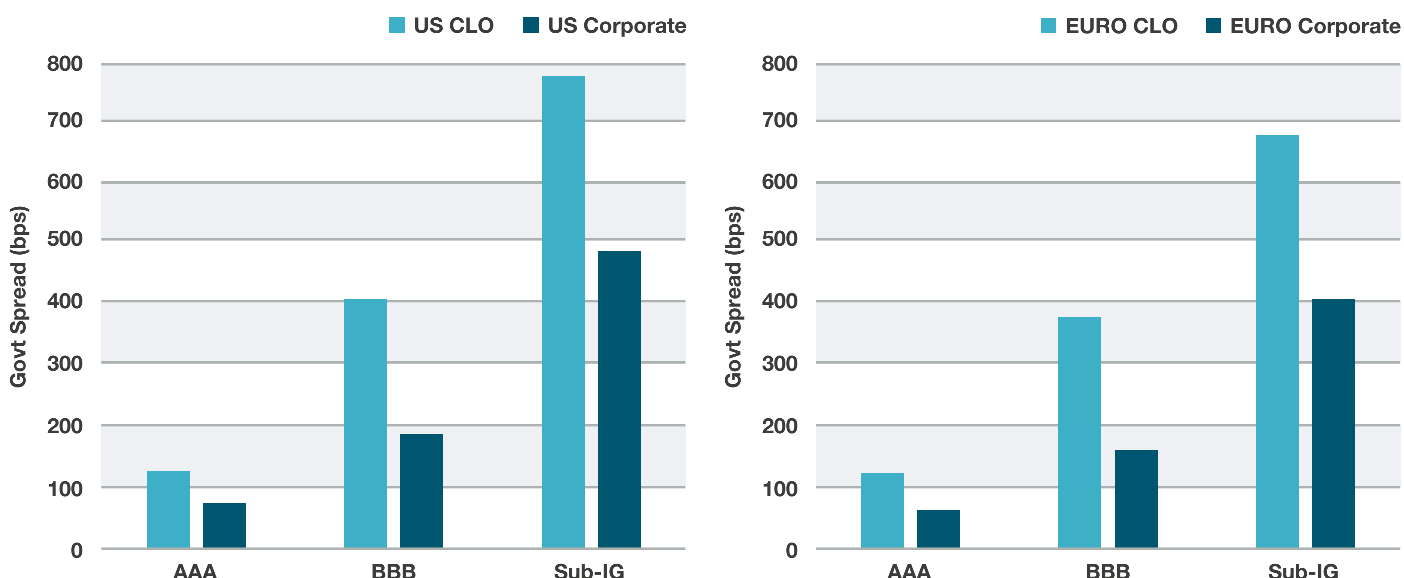
How are CLOs made?

A typical CLO asset pool will hold 100-200 loans which are accumulated in a Special Purpose Vehicle (SPV) for a period of up to twelve months prior to bond issuance ('warehousing'). A portfolio manager is appointed to oversee construction and management of a CLO portfolio, selecting each loan to be included in the final structure and fine-tuning exposure across industries and sectors. Following warehousing, the structure is subject to a re-investment period of two-to-five years, over which the portfolio manager is able to re-invest all proceeds from underlying loan maturities or early repayments, as well as sell holdings to ensure compliance with the structure's risk parameters. Once the re-investment period has ended the portfolio enters the run-off phase in which underlying loans reach maturity and the manager seeks to repay tranches sequentially in order of seniority, with any remaining balance paid to equity tranche holders.

CLOs are bonds backed by an underlying pool of senior secured loans to corporates rated BB+ or below – usually firms that have been involved in a leveraged buyout or some other form of private equity activity. As with other forms of securitised debt, even though the underlying loans may be rated sub-investment grade, the structure allows asset pools to be split into several tranches – some of which are rated investment grade. Liquidity varies across the tranches, with higher rated CLOs offering better liquidity than junior tranches. All CLOs have an equity tranche.

FIVE-YEAR AVERAGE SPREADS (BPS) ON CLOS AND CORPORATE DEBT, US (LEFT) AND EUROPE (RIGHT)



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Key takeaways:

Recent years have seen the growth of a large group of strategies dedicated specifically to securitised credit, spurred by continuing evidence on diversification and returns. There are now more than 180 such strategies available from 75 managers, including 116 pooled funds. Securitised credit can also be accessed through various types of diversified fixed income strategy, including Absolute Return Bonds and Multi Asset Credit.

Securitised credit strategies represent a diverse family: there are regional and global offerings; some are focused on a single sub-sector of the securitised credit market while others operate across multiple sectors. They can broadly be categorised into three families: conservative (target cash plus 1-2%), balanced and high-yielding (target in excess of cash plus 7%). The conservative strategies have become more popular during the last two years as an alternative to Absolute Return Bond funds.

Key themes for the asset class in 2020 include: the launch of a number of more illiquid drawdown-type vehicles; rising investor interest in CLOs, where pricing has seemed particularly appealing; a broader rise in appetite for securitised credit amid a 'lower for even longer' climate.

Note on external data used:
US Corporate spreads based on data from Bank of America US Corporate Investment Grade Index. Euro Corporate spreads based on data from Bank of America Euro Corporate Investment Grade Index. Euro CLO, US & Euro RMBS, US & Euro CMBS spreads based on data from JP Morgan & HSBC Asset Management. US CLO spreads based on data from JP Morgan CLOIE Index. bfinance accepts no responsibility for any errors or omissions contained therein.

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