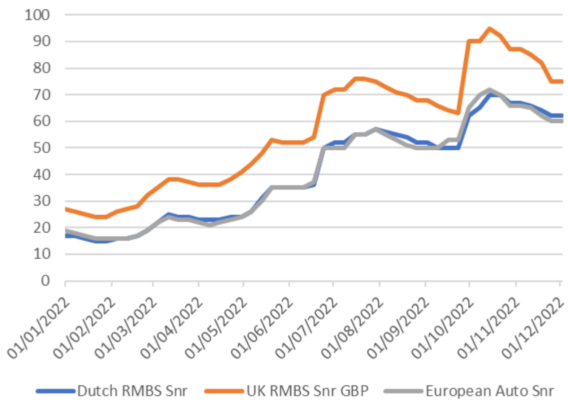
Fondsplattform

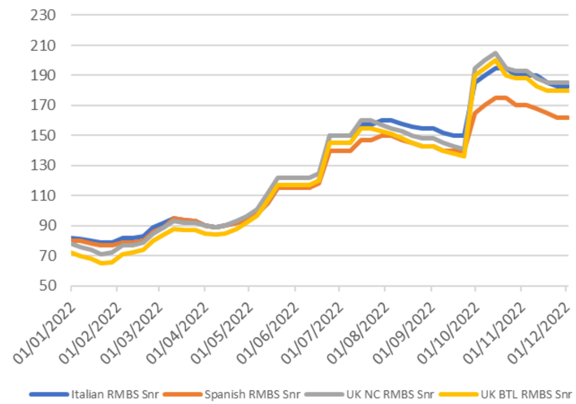
Structured financial products: Is it that time again?

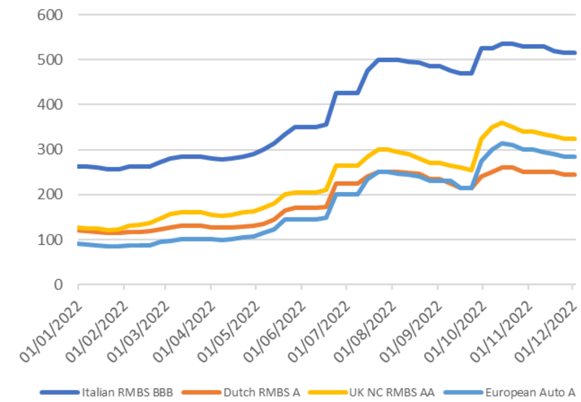
January 11, 2023

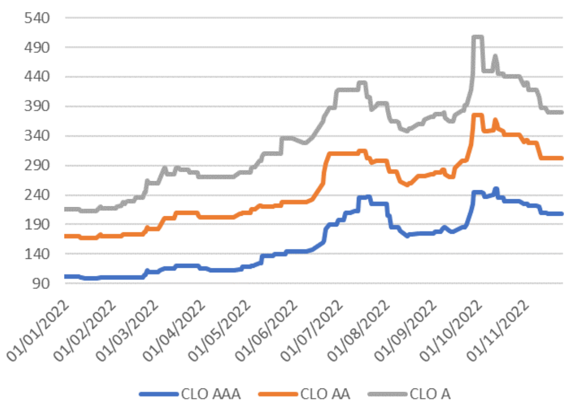
EURIZON
ASSET MANAGEMENT

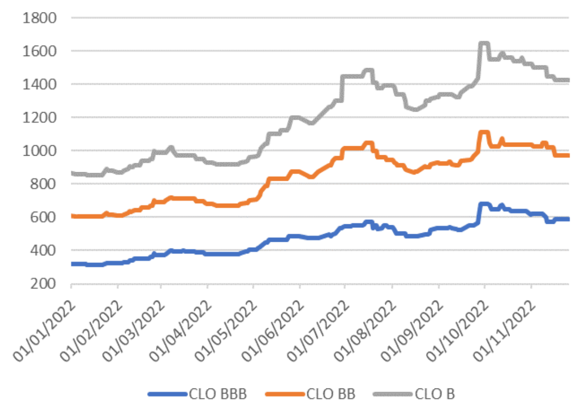
ABS/RMBS/CLO Credit Spreads in 2022







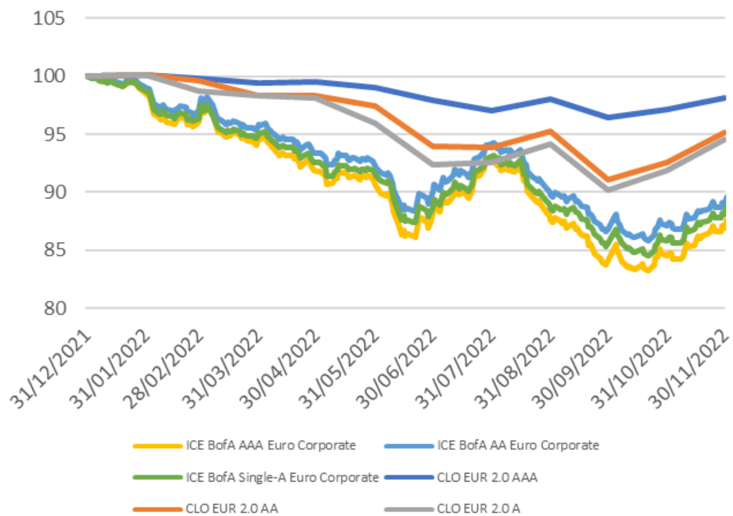


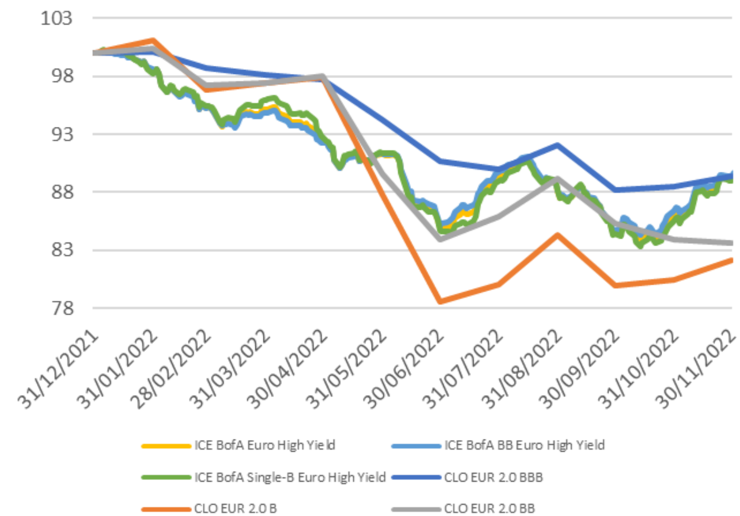


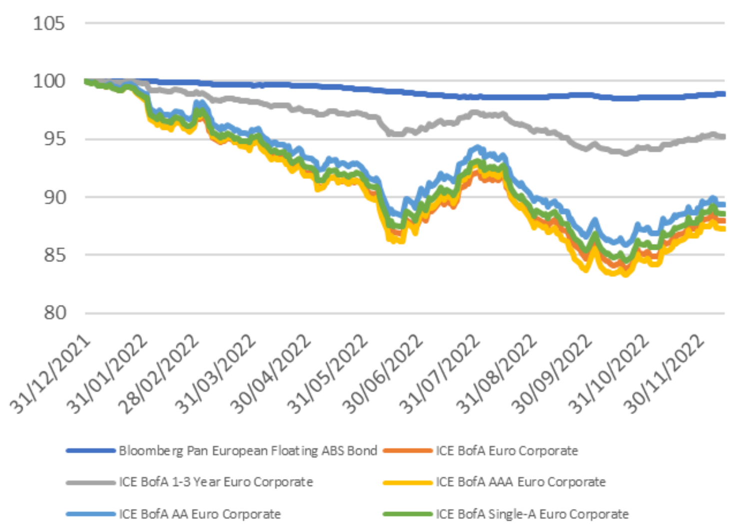
- European ABS spreads currently stand significantly wider versus the levels at the beginning of 2022: bonds sold off sharply in May and September amid persistently high inflation, increasingly hawkish central banks and a deteriorating credit backdrop.
- The repricing of European ABS has resulted in dispersion both in terms of asset class (secured vs unsecured assets), as well as credit curve (senior vs non-senior notes).
- Most of ABS sectors did not revisit the peaks of Covid, with some exceptions (mezzanine tranches of UK NCF and BTL RMBS, German auto ABS, peripheral RMBS and CMBS).

Source: JP Morgan, CitiVelocity; data as of December 2, 2022; indicative credit spreads.

ABS/RMBS/CLO Bond Returns in 2022





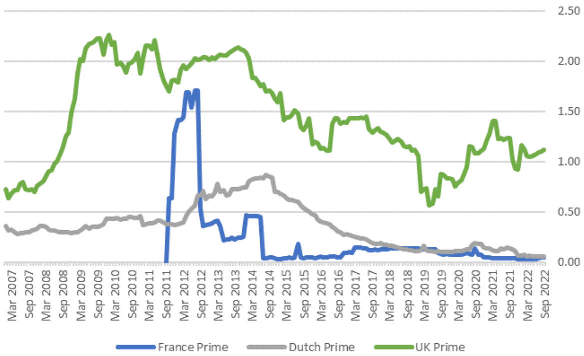


- Investment Grade ABS/RMBS/CLO notes outperformed the corporate bond sector thanks to the low/no sensitivity to the interest rates.
- The sub-IG segment suffered the volatility of the market, the illiquidity and the smaller investor base. For the CLO subsector increasing default expectations in the leveraged loans market penalized the performance of the tranches.
- The rise in monetary rates increased the attractiveness of the ABS sector in terms of yield/coupon to comparable corporates.

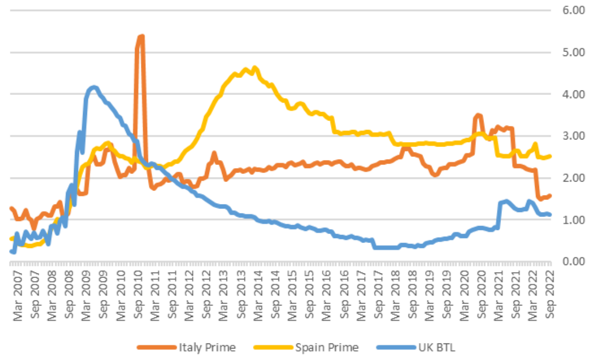
Source: Bloomberg, ICE, CitiVelocity; data as of December 13, 2022; CLO as of end of November.

ABS/RMBS/CLO Credit performance

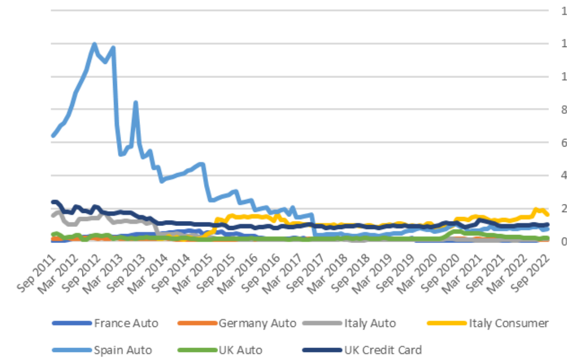
RMBS Delinq 90+ days



RMBS Delinq 90+ days

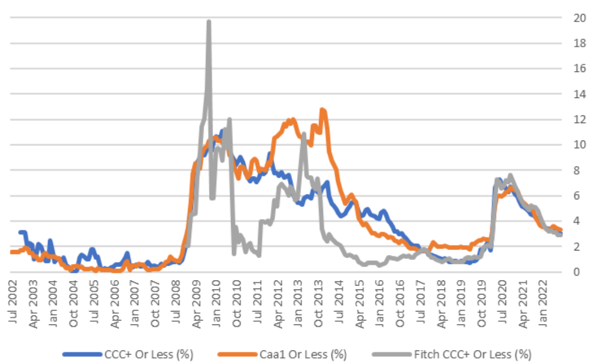


ABS Auto/Consumer Arrears 90+ days



EUR CLO - WARF

EUR CLO - CCC+/Caa1/Fitch CCC+ Or Less (%)



- Despite a deteriorating macro backdrop, European and UK ABS/RMBS collateral performance was stable in 2022. ABS/RMBS arrears have remained low thanks to the very strong labor market and the household's savings in the pandemic period.
- If we look at the Weighted Average Rating Factor, a synthetic indicator for total riskiness of a CLO portfolio, we can see that in 2022 there is no indication of a deteriorating credit quality, especially if we compare the actual situation with post – Covid numbers

Source: IntexCalc, Eurizon REAA, data as of Sep 2022. Moody's WARF = weighted average rating factor

ABS/RMBS/CLO are risky?

- Structure Finance pre- and post-crisis total loss rate is 0.42% (out of total issuance Eur 3.6 trillion)
- ABS and RMBS have a total loss rate of 0.05/0.09% between 2000-2020

EUR-equivalent balance (bn)

Vintage	Repaid	No loss expected	Loss expected	Loss realised	Total loss
2000	50.4	1.1	0.0	0.1	0.1
2001	123.3	1.0	0.0	0.3	0.3
2002	88.1	0.0	0.0	0.3	0.3
2003	154.9	1.7	0.0	0.5	0.5
2004	166.5	5.5	0.0	1.3	1.3
2005	292.2	12.2	0.2	1.1	1.3
2006	321.7	30.9	0.6	5.5	6.0
2007	357.0	23.8	1.0	4.5	5.5
2008	488.8	37.5	0.1	0.1	0.1
2009	141.9	13.2	0.0	0.0	0.0
2010	201.6	12.5	0.0	0.0	0.0
2011	171.1	7.1	0.0	0.0	0.0
2012	113.1	5.6	0.0	0.0	0.0
2013	77.1	11.2	0.1	0.0	0.1
2014	77.5	7.7	0.0	0.0	0.0
2015	95.0	13.4	0.0	0.0	0.0
2016	66.4	40.6	0.0	0.0	0.0
2017	48.2	71.9	0.0	0.0	0.0
2018	29.9	110.8	0.1	0.0	0.1
2019	17.8	72.4	0.0	0.0	0.0
2020	6.6	81.2	0.0	0.0	0.0
Total	**3,088.9**	**561.4**	**2.0**	**13.6**	**15.6**

% of original balance

Vintage	Repaid	No loss expected	Loss expected	Loss realised	Total loss
2000	97.6	2.2	0.0	0.3	0.25
2001	99.0	0.8	0.0	0.2	0.21
2002	99.6	0.0	0.0	0.4	0.36
2003	98.6	1.1	0.0	0.3	0.31
2004	96.1	3.2	0.0	0.7	0.73
2005	95.6	4.0	0.1	0.4	0.42
2006	89.7	8.6	0.2	1.5	1.68
2007	92.4	6.2	0.3	1.2	1.42
2008	92.9	7.1	0.0	0.0	0.02
2009	91.5	8.5	0.0	0.0	0.00
2010	94.2	5.8	0.0	0.0	0.00
2011	96.0	4.0	0.0	0.0	0.00
2012	95.3	4.8	0.0	0.0	0.00
2013	87.2	12.7	0.1	0.0	0.09
2014	91.0	9.0	0.0	0.0	0.02
2015	87.7	12.3	0.0	0.0	0.00
2016	62.0	38.0	0.0	0.0	0.00
2017	40.1	59.9	0.0	0.0	0.00
2018	21.2	78.7	0.1	0.0	0.06
2019	19.7	80.3	0.0	0.0	0.00
2020	7.5	92.5	0.0	0.0	0.00
Total	**84.3**	**15.3**	**0.1**	**0.4**	**0.42**

Originated post crisis

Asset class	Repaid	No loss expected	Loss expected	Loss realised	Total loss
ABS	408.2	97.2	0.1	0.2	0.3
CMBS	183.1	23.1	0.1	6.8	6.9
RMBS	1,983.5	303.3	1.7	0.4	2.0
SC	514.1	137.8	0.1	6.3	6.4
Total	**3,088.9**	**561.4**	**2.0**	**13.6**	**15.6**

Asset class	Repaid	No loss expected	Loss expected	Loss realised	Total loss
ABS	80.7	19.2	0.0	0.0	0.05
CMBS	85.9	10.9	0.1	3.2	3.24
RMBS	86.7	13.3	0.1	0.0	0.09
SC	78.1	20.9	0.0	1.0	0.98
Total	**84.3**	**15.3**	**0.1**	**0.4**	**0.42**

Source: Fitch Ratings EMEA Structured Finance Losses (2000-2020)

ABS/RMBS/CLO are non-transparent?

In 2019 a new regulatory framework was launched to promote a sound and safe securitization market (Regulation (EU) 2017/2402):

- Three main pillars: due diligence, risk retention and transparency
- A new instrument "simple, transparent, and standardised (STS) securitisation"

Pillar	Due diligence	Risk retention	Transparency	Credit-Granting Criteria
Article	Article 5	Article 6	Article 7	Article 9
Applies to	Institutional investors	Institutional investors, EU originator, sponsor, original lender	Originator, sponsor, SSPE (securitisation special purpose entity)	Originator, sponsor and originals lenders
Remarks	The requirements are broadly similar to CRR, Solvency 2 and AIFMD	The level of risk retention (rr) is set at 5% and five modes of risk retention will be permitted	Information to be made available before deal pricing - underlying information, prospectus or transaction structure and STS notification for STS deals	Securitisation of self-certified mortgages originated after 20 March 2014 (when the Mortgage Credit Directive came into force) is prohibited
	The regulation requires investors to make a number of verifications before buying a securitisation position including - structure, risk retention, credit granting standards, risk profile of the securitisation and ongoing reporting of performance. The regulation also requires adherence to Article 6 (risk retention)	The new regulation also places the onus of rr on the originator / sponsor / original lender. The failure to do so will result in penalties	Information to be made available on an ongoing basis - quarterly information on underlying exposures, quarterly investor reports with performance data and any relevant inside information. STS notification for STS securitisation. If a prospectus has not been drawn up (eg for private transactions) then a transaction summary needs to be provided	A securitising entity will be required to apply the same credit-granting criteria to exposures that are to be securitised as it does to exposures that are not to be securitised, must ensure that those criteria are "sound and well-defined", and have "effective systems in place to apply those criteria and processes to ensure that the credit-granting is based on a thorough assessment of the obligor's credit-worthiness".
	An institutional investor must also have written procedures in place to monitor compliance with its verification and due diligence obligations, and to monitor the performance of the securitisation position and the underlying exposures.	Even if the investors do not need risk retention (non EU investors) the EU originator / sponsor / lender still needs to retain the 5% skin in the game	Information to be made available to holders of the securitisation, competent authorities and upon request to potential investors. Information to be made available on a securitisation repository or a website	Subject to limited exceptions, the new Securitisation Regulation prohibits the creation of securitisations which include securitisation positions in their pool of underlying exposures.
	For an STS securitisation, the fulfillment of STS requirements needs to be ascertained by the investor	The definition of "originator" has been tightened so that only an entity of substance can act as originator, to ensure that the retention requirements cannot be satisfied by using an SPV whose sole purpose is to securitise exposures	The ESMA published draft RTS/ITS: https://www.esma.europa.eu/press-news/esma-news/esma-defines-disclosure-standards-under-securitisation-regulation	

Source: Eurizon REAA, European Commission

ABS/RMBS/CLO are solid? Let's do some calculation…

CLO rating A				
	Recovery rate: 50%		Recovery rate: 0%	
CDR	Yield	Total portfolio loss	Yield	Total portfolio loss
0.0%	6.48%	0.00%	6.48%	0.00%
1.0%	6.46%	2.74%	6.46%	5.44%
2.0%	6.42%	5.40%	6.40%	10.68%
3.0%	6.40%	8.02%	6.52%	13.77%
4.0%	6.42%	10.51%	6.56%	16.59%
5.0%	6.50%	11.87%	6.57%	19.80%
6.0%	6.65%	12.22%	6.53%	22.89%
7.0%	6.71%	13.02%	6.50%	26.03%
8.0%	6.71%	14.46%	6.46%	28.91%
9.0%	6.71%	15.73%	-2.00%	31.46%
10.0%	6.72%	17.14%	-17.52%	34.27%

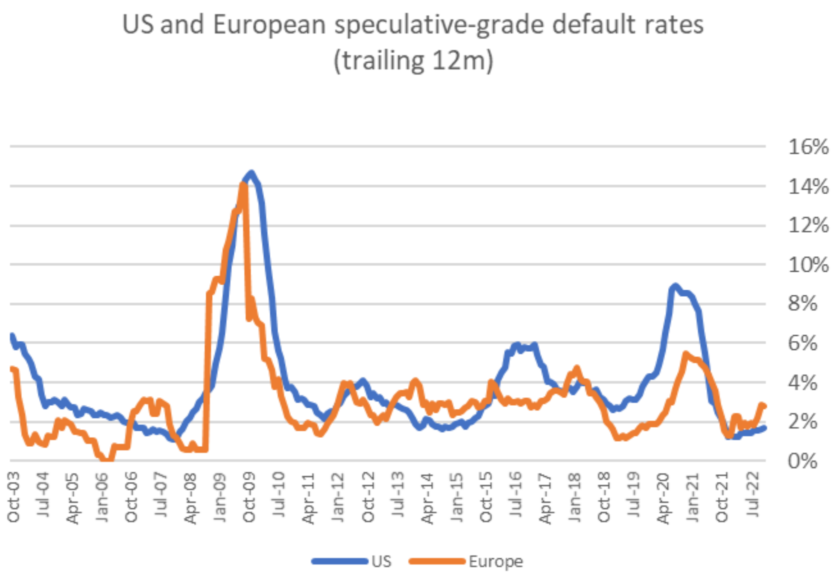
UK RMBS Buy to Let rating A				
	Recovery rate: 75%		Recovery rate: 50%	
CDR	Yield	Total portfolio loss	Yield	Total portfolio loss
0.0%	7.19%	0.00%	7.19%	0.00%
0.5%	7.19%	1.51%	7.19%	3.02%
1.0%	7.19%	2.90%	7.18%	5.80%
1.5%	7.19%	4.18%	7.18%	8.36%
2.0%	7.19%	5.36%	7.17%	10.72%
2.5%	7.18%	6.45%	7.16%	12.90%
3.0%	7.18%	7.45%	7.15%	14.91%
3.5%	7.18%	8.38%	7.06%	16.76%
4.0%	7.18%	9.24%	5.75%	18.47%
4.5%	7.17%	10.03%	2.36%	20.06%
5.0%	7.16%	10.77%	-4.27%	21.53%

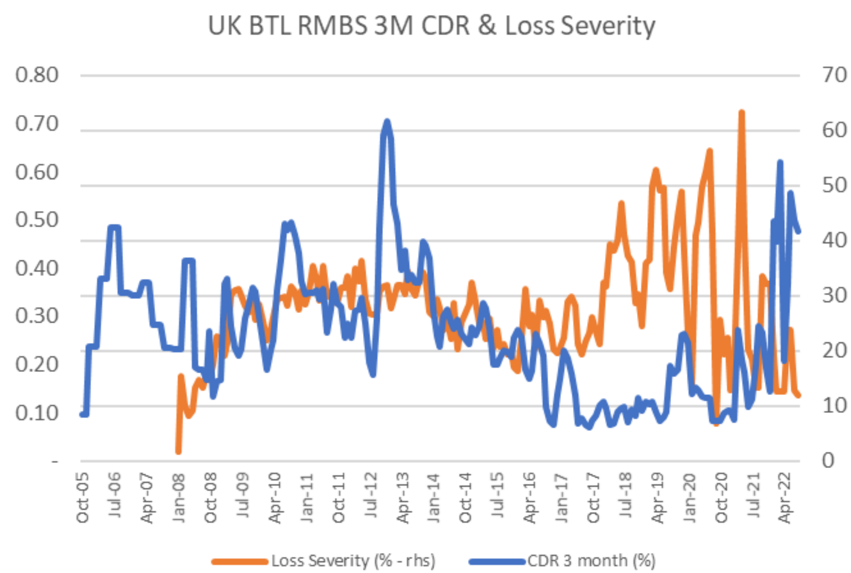
- This stress test performed on a CLO tranche rated "single-A" underlines the great resilience of the instrument in case of prolonged distressed periods: it is necessary at least a 9% constant default rate (every year) for the entire life of the tranche, assuming no recovery, to generate negative yields. This translates into more than 30% expected asset losses (after recovery), a theoretical and very unlikely scenario.

- Even for a UK RMBS Buy-to-Let (single-A rated tranche), the stress test evidences a negative yield only with a 5% constant default rate resulting into more than 20% total asset losses (50% recovery applied), a scenario which is deemed unlikely and theoretical.

Source: Eurizon REAA, IntexCalc

ABS/RMBS/CLO are solid?





- Real default rates for the European leveraged loans as well as for the bond with speculative grade, even during the Euro Sovereign Crisis or during the Covid pandemic, did not reach a peak level even close to the 9% (for a prolonged period of time) needed to have a loss on the CLO "single-A" tranche (see previous slide).

- According to Moody's, in the last 15 years the 3-month annualized CDR ranged between 0.07 and 0.70. The average losses severity is around 28%.

Source: Eurizon REAA, Moody's

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ABS/RMBS/CLO outlook 2023

- ABS spreads have significantly repriced over the course of 2022 amid aggressive central bank hikes, the breakout of the Russia/Ukraine war and the LDI-saga of pension funds in the UK. Dispersion and decompression of credit spreads increased in 2022 and will likely stay for a while.

- The down cycle should accelerate in 2023, higher interest rates and inflation are likely to lead to deteriorating performance in terms of arrears and defaults. These should be manageable based on expected severities and credit enhancement levels of transactions.

- European ABS spreads have already priced in a reasonable amount of the potential recessionary consequences and there are opportunities in some segment of the market (all-in yields to levels not seen in the past several years of ultra-accommodative monetary policies).

- We see no risks for a new GFC:
    - Borrower leverage is far lower (lower LTV)
    - Regulation of mortgages including affordability stresses (and no more self-certified mortgages)
    - Post-GFC originated pools are less sensitive to higher rates
    - ABS structure simpler and defensive (higher credit enhancement)
    - Strong labor market
    - European governments policies are more supportive (see Covid payment holiday regulation)

- We like the senior and upper-mezzanine bonds of ABS/RMBS/CLO, they should benefit from a return to normal activity of the primary market, are well shield in case of deterioration of collateral performance and offer attractive carry opportunities at current levels.

- We stay more prudent on the sub-IG and deeply subordinated bonds, where we see more risks of downgrades and extension risk for some transactions (CMBS). But for a patient investor there will be great opportunities in that space, selection will be crucial in 2023.

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