M&G Investments

STS ABS

Opportunities and expectations for European insurance investment portfolios

STS ABS: opportunities and expectations for European insurance investment portfolios

- The STS framework offers European insurers an opportunity to invest in a robust, high-quality and scalable asset class to diversify their core fixed income allocations
- STS capital treatment under the standard formula has significantly increased the attractiveness of eligible securities
- Asset managers with specialist resources and expertise can help insurers navigate regulatory requirements and potentially capture the best opportunities.

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. Where past performance is shown, please note that this is not a guide to future performance.

The Simple, Transparent and Standardised (STS) framework offers the potential for insurers to reintroduce high-quality securitisations to their investment portfolios. The framework, which was introduced in January 2019, applies significantly lower capital charges to eligible securities than the former 'Type 1' and 'Type 2' charges under Solvency II, while placing stringent requirements on originators in order to increase investor confidence.

Regulators designed STS eligibility to stimulate ABS market activity, particularly in areas that promote lending to the real economy, such as mortgages and consumer lending, as well as loans to small- and medium-sized businesses (SME loans). In turn, this has given European insurers the opportunity to access a potentially robust and scalable asset class once again.

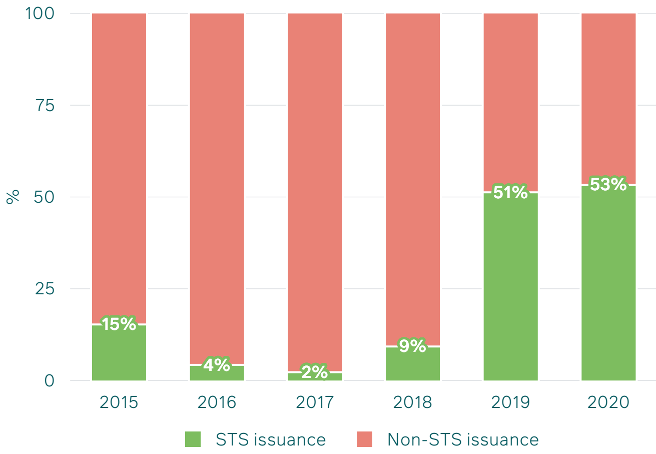
Insurers that partner with asset managers who have the resources and experience needed to conduct extensive due diligence and provide ongoing support to them, amid increasingly demanding regulatory requirements, may be ideally positioned to navigate ABS markets.

The opportunity

Since the STS framework came into effect, supply of STS paper has grown substantially. Despite the increased due diligence required for STS issuance, European originators appear unperturbed. In the year to date (see Figures 1-3), STS securitisations accounted for half of total distributed European ABS issuance volumes, at €19 billion. Looking ahead, and accounting for deals in the pipeline, it would be reasonable to expect c. €28bn of STS issuance this year. This is on top of the €38 billion of issuance in 2019. Moreover, €24 billion of pre-2019 distributed issuance has retroactively been re-documented to comply with the regulation, further increasing the opportunity set for European insurers.

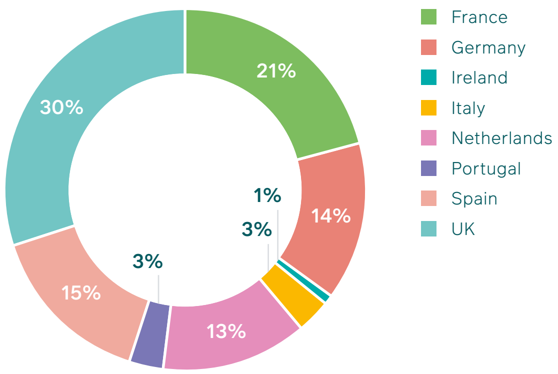
Looking at primary supply by region and sector, STS paper issued this year has been driven in large part by UK Prime RMBS and German and Spanish Auto ABS paper.

Figure 1: STS securitisations account for half of primary issuance



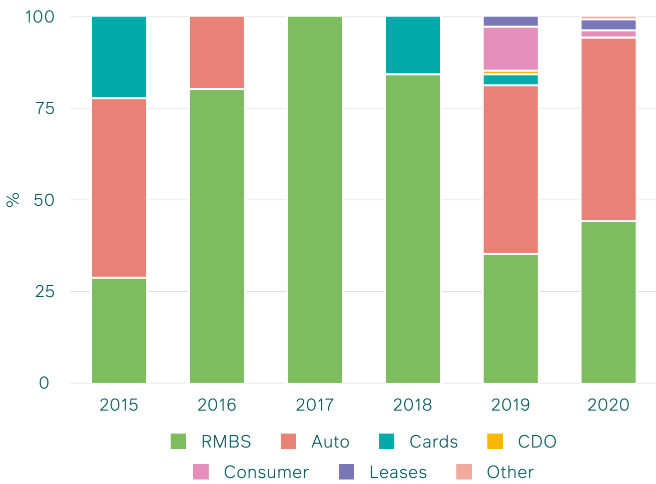
Source: M&G, J.P. Morgan International ABS Weekly Datasheet, as at 02.10.20.

Figure 2. European STS distributed issuance by country, 2020 YTD



Source: M&G, J.P. Morgan International ABS Weekly Datasheet, as at 02.10.20.

Figure 3: STS distributed issuance by sector, 2015 to 2020 YTD



Source: M&G, J.P. Morgan International ABS Weekly Datasheet, as at 02.10.20.

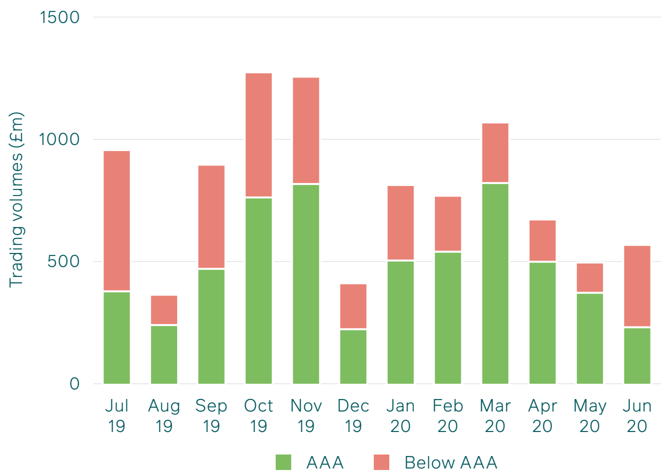
Potential advantages of STS ABS

STS securitisations offer a number of potential advantages for investors:

1. **Yield premium** A clear yield pick-up versus other credit assets with similar risk. Typically, AAA ABS offer higher all-in yields than other defensive asset classes, as well as higher spreads compared to AAA rated corporate and covered bonds (see Figure 5)
2. **Structural protections** Senior ABS are positioned at the top of the capital stack and benefit from robust structures. Given high levels of credit enhancement for the AAA senior tranche, these positions can withstand extreme market conditions (see RMBS stress test in Figure 7 later in this document)
3. **Liquidity** AAA ABS is the largest part of the public securitisation market, with secondary market volumes offering sufficient liquidity for daily trading (see Figure 4 for M&G traded volumes). These assets are listed on regulated exchanges and have a minimum of two ratings – often three.

Figure 4. M&G traded volumes of AAA ABS

- c. £800m traded a month on average over June 2019 to June 2020 across a variety of market conditions
- Almost £500m of AAA rated ABS traded a month on average over June 2019 to June 2020
- August 2019 and December 2019 trading volumes are low due to seasonality
- In March 2020, M&G purchased £128.7m and sold £687.9m of AAA rated ABS



Source: M&G, as at 30.06.20.

European ABS – a good entry point

STS is not the only way for insurance companies to capture the ABS opportunity in Europe. In our view, high-quality European ABS continues to offer a compelling value proposition relative to other areas of fixed income in the current environment, with 'lower for longer' rates compressing yields on government bonds and credit.

Figure 5. Yield comparison matrix – senior AAA ABS yields

	£ yields	€ yields
Senior AAA ABS[1]	1.04%	0.47%
2-year government bonds[2]	-0.05% (2-year UK Gilts)	-0.71% (2-year German Schatz)
AAA rated corporate bonds[3]	0.23% (1-3-year AAA UK Non-Gilts)	-0.30% (1-3-year AAA € Corporates)
AA rated corporate bonds	0.41% (1-3-year AA UK Non-Gilts)	-0.18% (1-3-year AA € Corporates)
A rated corporate bonds	0.80% (1-3-year A UK Non-Gilts)	0.03% (1-3-year A € Corporates)
BBB rated corporate bonds	1.63% (1-3-year BBB UK Non-Gilts)	0.46% (1-3-year BBB € Corporates)

As at 30 September 2020.

[1] Based on a representative M&G portfolio invested predominantly in AAA ABS. Source: M&G Investments, Aladdin.

[2] Government bond indices: GUKG 2, GDBR 2. Source: Bloomberg.

[3] Credit indices: UN11, UN21, UN31, UN41, ER11, ER21, ER31, ER41. Hedged yields are indicative. Source: ICE.

For insurers, not only does the asset class offer an opportunity to invest in high-quality, robust assets that have historically offered a return premium over corporate credit, but due to the capital treatment of these assets under Solvency II, European insurers could look to take advantage of the attractive return on capital (ROC) for senior STS ABS. Moreover, the solvency capital requirement (SCR) for STS-compliant securitisations is around one-tenth of the capital charge of typical non-STS securitisations. Nevertheless, we believe AAA and AA rated non-STS bonds represent a very good investment opportunity for property and casualty (P&C) insurers who have internal models, or excess capital.

To demonstrate the potential SCR benefit, we would expect an STS-eligible portfolio, with an average credit rating of AAA, to have a discount margin of 50 basis points (bps) and a weighted average life (WAL) of c. two years. Given the treatment of STS under the standard formula, we would expect the SCR to be c. 2% and the ROC to be c. 25%.

Figure 6. Pure STS ABS model portfolio

Estimated discount margin	Weighted average life (years)	Average rating
50bps (40bps pre-COVID-19)	2.05	AAA

SCR	ROC
2%	25% (20% pre-COVID-19)

Source: M&G, as at September 2020.

Investing in AAA or AA rated non-STS portfolios can be a way for investors to either diversify their core fixed income allocation or for investors to move some of their cash holdings into a robust asset class that is liquid and typically pays returns in excess of deposits. This is likely to be particularly relevant to the P&C community who can afford to be less focused on their SCRs, as underwriting risk is likely to somewhat diversify the additional market risk taken from a non-STS investment.

Mitigating downgrade risks

The portfolios of European insurers are typically highly concentrated in corporate and government bonds. The European corporate bond market has high levels of BBB issuance, which presents insurers with potential issues regarding downgrade risk and compressed yields.

We believe investing in STS ABS, as well as other areas of consumer lending, can provide a way for insurance investment portfolios to potentially: 1) improve diversification, 2) capture higher returns compared to equivalent-rated securities, and 3) lower downgrade and default risks.

ABS resilience

STS ABS are designed to offer high levels of resilience. Figure 7 shows how a typical AAA UK RMBS could be expected to withstand extreme market conditions applied through stress testing. In one COVID-19 stress test scenario, we have modelled the expected impact based on the following assumptions:

- Immediate 40% fall in UK house prices, with no expected recovery
- Mortgage payment holidays of 3, 6 and 12 months on the entire collateral pool.

We note that the largest UK house price decline on record is 18%, which occurred from 1989 to 1993, so the first assumption could be considered fairly severe. As it currently stands, UK homeowners can access up to six months of mortgage payment holidays. The take-up of payment holidays in a typical UK residential mortgage collateral pool is believed to be c. 10.5%[1].

The stress test identifies that the AAA RMBS will break even (ie incur no principal loss) at the following default rates:

Mortgage payment holiday	Constant default rate (CDR, annualised) for initial four-year crisis period	CDR (annualised) after four years
3 months	12.5%	2.5%
6 months	11.25%	2.25%
12 months	9.5%	1.9%

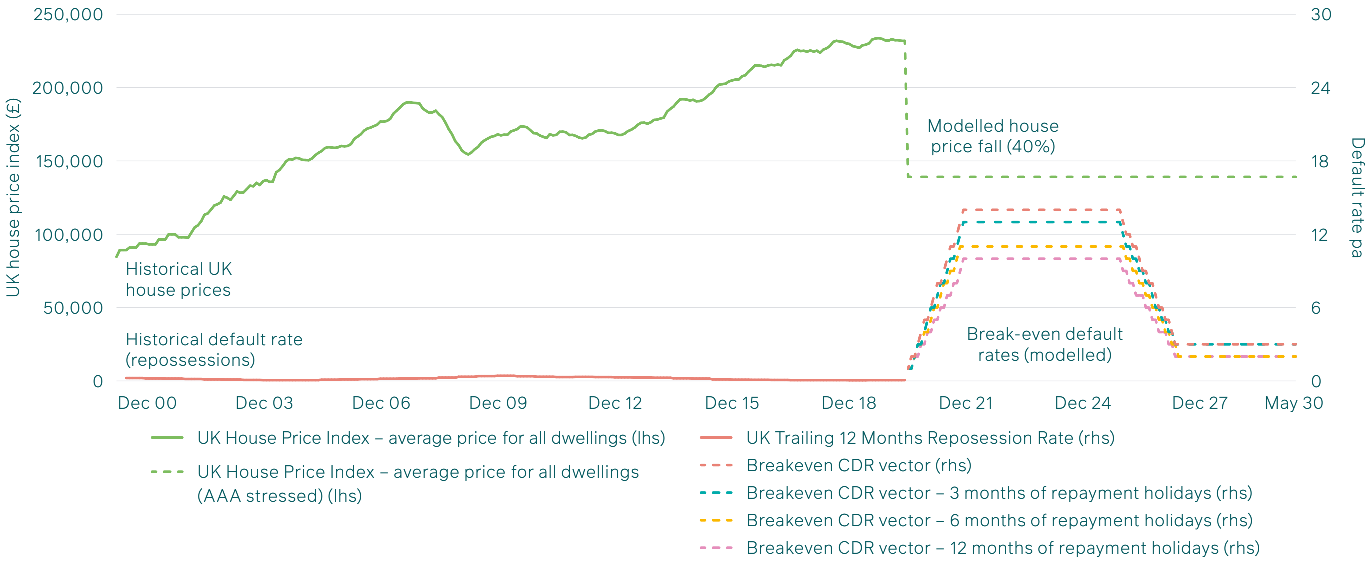
For illustrative purposes only. Source: M&G, Council of Mortgage Lenders, ABSxChange, Nationwide, as at 27 May 2020.

These modelled default rates compare to the UK's peak historical default rate of 0.79% pa, which occurred in 1992. In terms of cumulative defaults, the stress test identifies the following break-even rates:

Payment holiday	Cumulative default rate
3 months	46.83%
6 months	43.42%
12 months	38.44%

This demonstrates the resilience of a typical AAA RMBS, which combined with its yield premium over equivalent AAA government or corporate debt, makes it an attractive proposition in our view.

Figure 7. COVID-19 stress test – break-even constant default rates



For illustrative purposes only. Source: M&G, Council of Mortgage Lenders, ABSxChange, Nationwide, as at 27.05.20. 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.

[1] Source: J.P. Morgan International ABS & CB Research, UK RMBS COVID-19 Payment Holiday Tracker, October 2020.

The asset manager's role

We believe the treatment of STS under the Solvency II standard formula has significantly increased the attractiveness of eligible securities. Due to recent uncertainty about the prospects for the global economy and functioning of financial markets, STS ABS issues have historically offered better yields and enhanced potential risk-adjusted returns on capital, relative to pre-crisis levels even though spreads are off their year-to-date wides. However, there are demanding regulatory standards associated with these assets, which insurers are likely to rely on an appointed asset manager to navigate on their behalf.

Given the public and liquid nature of high-grade European ABS, we have found a tendency for insurers to treat ABS as part of a core fixed income mandate. In our view, ABS should be treated as a specialist allocation within fixed income, which requires extensive, dedicated resources and expertise.

We believe an insurer's core manager should demonstrate robust processes and due diligence, including in the following areas:

1. Performing its own due diligence checks on STS-eligible ABS to determine if it agrees with the designation. Typically, this involves reviewing over 100 individual criteria
2. Articulating its ongoing due diligence process regarding STS eligibility to clients
3. Possessing the ability to assume European securitisation regulatory responsibility on behalf of clients
4. Regularly stress testing cashflows for each transaction and documenting stresses and outputs
5. Using monitoring tools to track the performance of each underlying transaction and its associated liabilities
6. Periodically reporting the risks of securitisation positions to a management body.

Conclusion

Investing in STS securitisations is time-intensive and requires significant knowledge and experience. There are no shortcuts, particularly for the European insurance community, which typically relies on asset managers to conduct extensive due diligence on potential investments and provide support with increasing regulatory demands. However, by working with a manager that can demonstrate ability in these areas, insurers should be able to access an asset class with attractive potential risk-adjusted returns to complement their exposure to high-quality corporate and government bonds. □

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