The Investment Podcast

Episode 17: Opening routes of exposure to consumer assets
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Romil Patel: Hello and welcome to this instalment of the Investment Podcast, brought to you by M&G Investments. Today's topic is mortgage and consumer loans, an ancient and important financial services tool that continues to serve and facilitate our everyday necessities from housing to transport and education. Indeed, the mortgage and consumer loan market stands at a gargantuan $29 trillion across Europe and the US.

Following the global financial crisis in 2008, banks have no longer been able or willing to keep every loan that they originate from their balance sheet. The regulatory change has opened up an opportunity for asset owners to invest in an area traditionally dominated by banks, but what room is there for growth in this market and what safety can it offer? I'm your host, Romil Patel. Joining me to discuss the lending landscape is Jerome Henrion, Head of Specialty Finance at M&G Investments. Welcome, Jerome. It's great to have you on today's podcast.

Jerome Henrion: Hello, Romil, thanks for having me.

Romil: Thanks indeed for joining us. Now, Jerome, consumer lending is a substantial and diverse asset class with trillions of dollars in loan balances across residential mortgages, auto loans, unsecured consumer loans, and so on, but what new route of access can asset managers now offer to what is already an established asset class?

Jerome: Thanks, Romil. Well, as you say, this asset class has been in existence for decades and that's obviously very comforting because it means we have the legal framework and all the data available to a very mature asset class. What's new as you said is that it's finally available to institutional investors that want to get access to these assets. Post-financial crisis, banks have not been able to hold onto all these loans as they used to in the past due to regulatory changes.

Whether it's buying loans from banks or in partnership with non-bank origination platform, or indeed corporates such as auto manufacturers or mobile phone airtime providers, we've been able to acquire some of these loans and provide access to those loans to our investors.

Romil: Thanks for that, Jerome. Now, rising inflation is a big theme with central banks taking action by tightening monetary policy and consumers feeling the pinch globally, but mortgage loans is an asset class that can benefit from inflation. Jerome, can you guide us through this as well as the diversification benefits of this asset class?

Jerome: Thanks, Romil. I guess there's two points to your question here. Taking maybe the second one first, most investors have a lot of exposure to government bonds, corporate bonds, maybe infrastructure, hedge funds, private equity funds, but very few investors have exposure to consumer assets. Our transactions are diversified in nature because every time we acquire a pool of loans, it's hundreds, if not thousands of loans. I think the largest we bought was 705,000 loans, but also diversifying for most investors who, as I said, generally don't have much consumer exposure.

With regards to inflation, most of the mortgages that we buy are fixed-rate, and a typical mortgagee would pay between 30% or 40% of his net income to repay that mortgage. With inflation going up, you would anticipate nominal wages to go up as well. Not necessarily one for one, but there will be some positive correlation between the two. In the example of the mortgagee having 40% of the expenditure used to repay his mortgage, if that expenditure is fixed, as long as his nominal wage increase by 60% or more, he will actually be better off with inflation than without.

Romil: Thank you, Jerome. That's very interesting. Now this is a heavily data-intensive asset class, and I understand that we have over a billion historical data points, but how do you put these to use in a forward-looking context in order to model future scenarios and indeed to mitigate risk?

Jerome: That's right, Romil. That's indeed a very important point. This is a very data-intensive strategy. Extracting all this information modelling it, analysing it, making sense of it is critical. We use all these historical data points and by data we mean getting a lot of information on each of the borrower and the loans and the monthly payments over time and not just on the pool that we acquire, but whenever we acquire some loans from an originator, we get all the data history on the broader origination of that originator and that enables us to see how all these loans perform in any economic environment and therefore, predict how they will behave in the future.

Romil: Jerome, there are so many data points out there and this all seems terribly complicated. How do you make sense of it?

Jerome: Well, actually, when you think of it these are very simple and common products. Most people will borrow money to buy a house. A lot of people will borrow money to buy a car and a lot of people will borrow money to go to university or to buy a mobile phone. All of us are exposed to these loans in the everyday life for most of their lives. At the heart of it, these are very common and simple products.

Romil: As you say, with so much exposure to these loans, how resilient are the returns in this asset class?

Jerome: This asset class has a history of resilient returns as cash flows have proven to be resilient in the past. If you think of it, these are loans that are short-dated in nature, very high cash flowing and for the most part, these loans are – in particular houses and car loans obviously – secured on collateral, which for houses, again, are appreciating assets.

Romil: Jerome, what are some of the key risks that you're looking at, at present and how are these historical data points helping you?

Jerome: Yes, so the main drivers of value are default rates, recovery rates, and prepayment rates, and analysing the data that we receive as I just mentioned, enables us to assess and predict what those default rate, recovery rates and prepayment rates will be. If you look at the current environment we're in, we're probably in an environment where unemployment is towards its lowest. With the rise of inflation, with the rise of cost of living, you would expect those default rates to increase going forward and that is clearly what we are assuming.

Any loan pool that we analyse right now, we are obviously not assuming that we are going to have the same benign environment that we've experienced over the last few years, but that we are entering into a more difficult period where some borrowers might struggle a bit more to repay some of their loans. As long as the actual performance is equal or better than what we are modelling, which is a conservative assumption to what we expect it to be then the performance will be good to strong.

Romil: Finally, before we go, Jerome, we're sitting here in Europe where investing in loans is not as established as it is across the pond in the US. What can we learn from the US market?

Jerome: There are big differences between the US and Europe, which partly explained the very big difference in performance that we've observed over the years, in particular in the global financial crisis in terms of performance. If I can just name a couple as an example in the US, a lot of the origination is an originate and distribute model where the companies originating the loans were immediately selling them on and didn't really care how those loans would perform going forward.

[It’s] not at all the case in Europe, which is very much a bank-driven market where banks originate on their balance sheet with a view to keep the loans for themselves. The second big difference would be for mortgages specifically in the US. You make a loan to someone who wants to buy a house, if at some point during the life of the mortgage the value of the property goes below the value of the loan, the borrower can just hand back the keys and walk away – not at all the case in Europe where borrowers are on the hook regardless of what the value of the collateral is.

Maybe a third difference worth mentioning is [that] in Europe, you don't have anywhere near the negative complexity that you have in the US. What I mean by that is in the US, you tend to have also fixed rate loans but with the ability to repay at any time without paying any interest rate penalty if rates go down. If rates go down, you lose your loan because the customer repays, if the rate goes up when you may prefer for the loan to disappear so that you can reinvest at a higher rate somewhere else, the loan tends to stick around.

[It’s] not the case in Europe as prepayment penalties permit borrowers to repay anticipatively without paying the lender some compensation. In terms of the ability to get the data, analyse its source, the collateral finance of those loans, there is a lot to learn from what's happening in the US.

Romil: Well, that's all we have time for in today's episode of The Investment Podcast. Jerome, thanks very much indeed for sharing your expert insights with our audience.

Jerome: Thanks for having me.

Romil: Thanks to you, our audience, for tuning in. Until the next episode, it's goodbye for now.

Speaker 2: This podcast is for investment professionals only. For further information, please see the notes which accompany this episode.

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