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STS ABS: Opportunities and expectations for European insurance investment portfolios

- In our view, 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 improved 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 Simple, Transparent and Standardised (STS) framework offers the potential for insurers to (re) introduce high-quality securitisations to their investment portfolios in a capital efficient manner. The framework, which was introduced in January 2019[1], 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 provides European insurers the opportunity to access a structurally robust and scalable asset class once again.

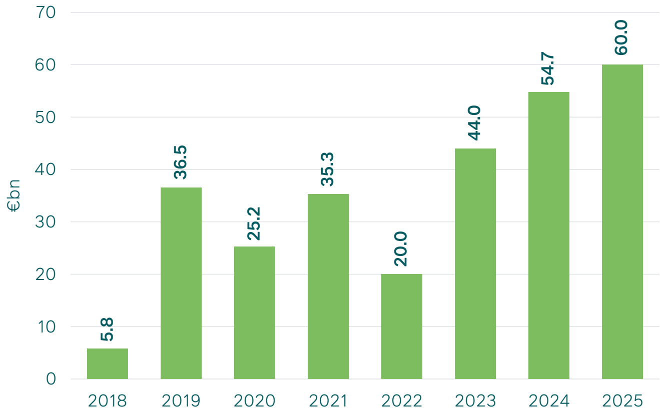
Investing in ABS and navigating the regulatory landscape requires significant expertise and resources, highlighting the importance of partnering with an experienced asset manager with a long-standing footprint in European structured credit, such as M&G Investments.

[1] The Simple, transparent and standardized (STS) securitisation framework was introduced on January 1, 2019 as part of the Regulation (EU) 2017/2401 (the securitisation Prudential Regulation, or SPR), which replaced certain provisions of the Capital Requirements Regulation (CRR) setting out a framework under which certain institutional investors (eg, banks and investment firms) can benefit potentially from more favourable regulatory capital treatment for STS exposures.

The opportunity

Since the STS framework came into effect, supply of STS paper has grown substantially. Despite the increased administrative and reporting burden required for STS issuance, European originators appear unperturbed. In 2024, we observed c.€55 billion of issuance and consensus among market participants points to c.€60 billion of STS issuance this year (see Figure 1) which would provide even greater depth and breadth of issuers to the existing €255 billion market.

Figure 1. STS issuance volumes



European Auto and Consumer STS ABS paper has been a consistent source of supply in recent years, with improving geographic diversity from across the continent.

Figure 2. European STS distributed issuance by country 2019-2025 YTD

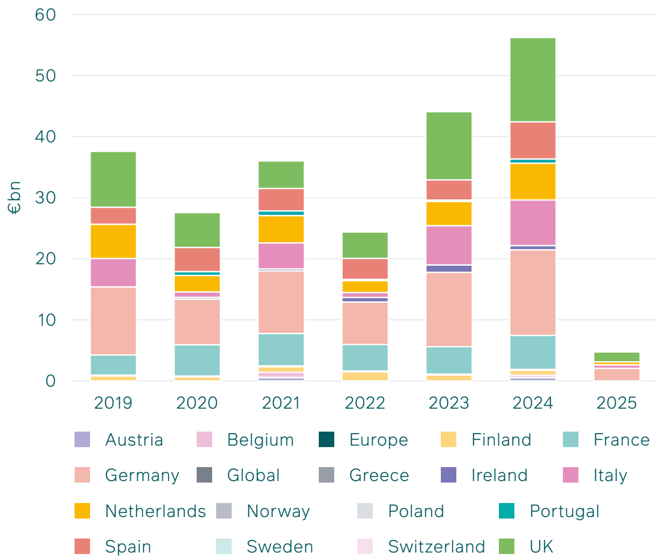
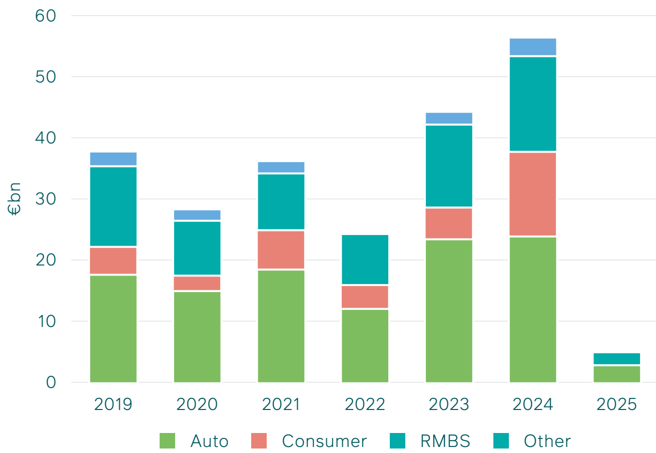


Figure 3. European STS distributed issuance by sector 2019-2025 YTD



Source (Figures 1-3): M&G, J.P. Morgan International ABS Weekly Datasheet, as at 7 February 2025.

European ABS – a good entry point

In our view, high-quality European ABS continues to offer a compelling value proposition relative to other areas of fixed income in the current market environment.

Figure 4. Yield comparison matrix –AAA STS ABS yields

	£ yields	€ yields
AAA STS ABS[1]	5.03%	3.29%
2-year government bonds[2]	4.22% (2-year UK Gilts)	2.12% (2-year German Schatz)
AAA rated corporate bonds[3]	4.29% (1-3-year AAA UK Non-Gilts)	2.56% (1-3-year AAA € Corporates)
AA rated corporate bonds	4.49% (1-3-year AA UK Non-Gilts)	2.58% (1-3-year AA € Corporates)
A rated corporate bonds	4.88% (1-3-year A UK Non-Gilts)	2.81% (1-3-year A € Corporates)
BBB rated corporate bonds	5.45% (1-3-year BBB UK Non-Gilts)	3.17% (1-3-year BBB € Corporates)

As at 31 January 2025.

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

2. Government bond indices: GUKG2, GDBR2. Source: Bloomberg.

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

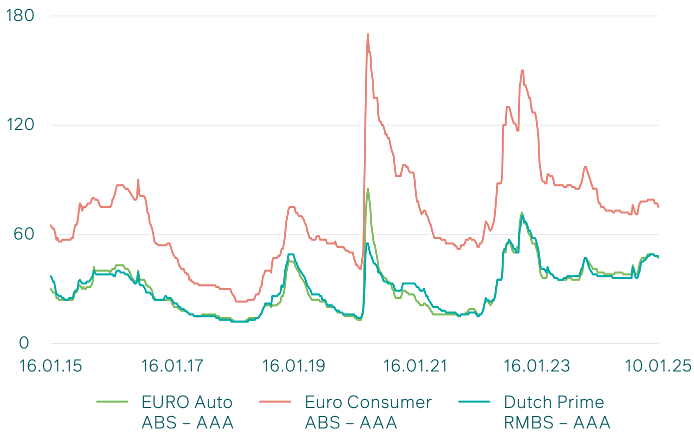
Potential advantages of STS ABS

We believe 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 (or lower) rated corporate and government bonds (see Figure 4 and 5)
2. While non-STS securitisations are treated very harshly under Solvency II, STS securitisations receive **much reduced Spread Solvency Capital Requirement (SCR) charges**. This means insurers can benefit from the yield premium available in the securitisation market without incurring high capital charges
3. **Structural protections** – Senior ABS are positioned at the top of the capital stack and therefore benefit from robust structural protections. 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 on page 4)
4. **Liquidity** – AAA ABS is the largest part of the public securitisation market, with secondary market volumes offering sufficient liquidity for daily trading. These assets are listed on regulated exchanges and have a minimum of two public ratings
5. **Risk diversifier** – Low correlation with other established asset classes can be appealing from a portfolio construction perspective (see Figure 8 below).

Rampant inflation in 2022/23 subsequently led to rapid rises in interest rates and the halting of the European Central Bank's (ECB) asset purchase programmes. Up until this point, the ECB had been a price insensitive buyer of continental European ABS paper which compressed spreads to artificially low levels. Since the ECB's departure from the market we have observed normalisation of ABS spreads in continental Europe, with AAA-rated Dutch Prime RMBS and EU Auto ABS in particular trading above the 90th percentile (based on historical spreads over the last decade).

Figure 5. European ABS spreads over the last decade



Source: M&G, J.P. Morgan International ABS Weekly Datasheet, as at 7 February 2025.

Asset type	Spread percentile
MA – Dutch Prime RMBS	91st
AAA – EU Consumer ABS	62nd
MA – EU Auto ABS	90th

Furthermore, 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 property and casualty (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.

Figure 6. Compelling diversification benefits of AAA STS ABS

Correlation since 31 August 2015	German Bunds	French OATs	EUR IG Corporates	EUR HY Corporates	Representative STS ABS portfolio
German Bunds	1.00				
French OATs	0.96	1.00			
EUR IG Corporates	0.74	0.80	1.00		
EUR HY Corporates	0.30	0.42	0.83	1.00	
Representative STS ABS portfolio	**0.13**	**0.19**	**0.40**	**0.45**	**1.00**
Annualised volatility pa	5.30%	5.75%	4.86%	7.34%	**0.75%**

Source: M&G, ICE (ref. G0D0, G0F0, ER00, HE00). Data as at 31 January 2025.

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. Under the spread risk sub-module of the Solvency II Standard Formula, the SCR for STS-compliant securitisations is around one-tenth of the capital charge of typical non-STS securitisations – a huge difference for insurers on the Standard Formula who are looking at the securitisation market. For insurers with internal models or excess capital, we believe non-STS AAA and AA rated bonds represent a strong investment opportunity, especially P&C insurers given the nature of their liabilities means short-dated, liquid credit is the pillar of their overall strategic asset allocation.

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 70 bps and a weighted average life (WAL) of c.1.8 years. Given the treatment of STS under the standard formula, we would expect the SCR to be c.2.3% and the ROC to be c.33%.

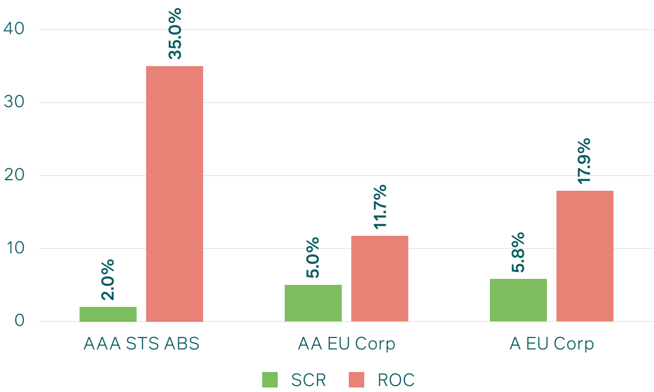
Figure 7. Pure STS ABS model portfolio

Key characteristics	
Weighted avg. credit rating	AAA
Est. Yield To Maturity (in EUR)	Cash+ 0.7%
Est. Portfolio SCR	2.3%
Est. Portfolio ROC	32.9%
Weighted Average Life (WAL)	1.78yrs

Source: M&G, as at January 2025. For illustrative purposes only. There is no guarantee of future results.

For context, the SCR and ROC for AAA STS ABS compares favourably versus lower rated European corporates (see Figure 8 below).

Figure 8. Estimated SCR and ROC comparison (%)



Source: M&G and ICE Indices, March 2023.

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

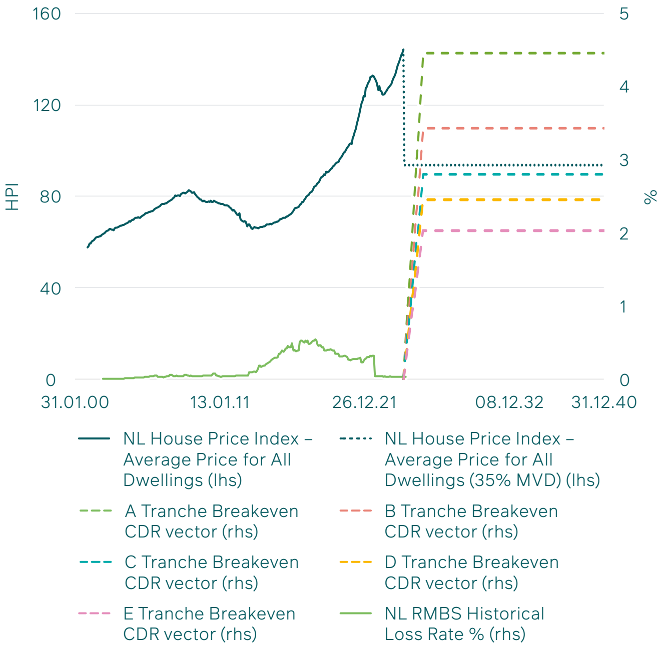
STS ABS are designed to offer high levels of resilience. Figure 9 shows how a typical AAA Dutch RMBS could be expected to withstand extreme market conditions applied through stress testing. In one stress test scenario, we have modelled the expected impact based on the following assumptions:

- Immediate 35% fall in Dutch house prices, with no expected recovery
- Over 43% of homeowners in this deal would need to default.

We note that the largest Dutch house price decline on record is 31%, which occurred from October 2008 to June 2013, so the first assumption could be considered fairly severe.

The peak historical Dutch RMBS Loss Rate was 0.5% per annum, which occurred in April 2018. Compared to the defaults required in this stress scenario demonstrates the resilience of a typical AAA RMBS, which combined with its yield premium over short dated government or corporate debt, makes it an attractive proposition, in our view.

Figure 9. AAA Dutch RMBS stress test – break-even constant default rates



Source: M&G Investments, Bloomberg, Intex, January 2025. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.

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. STS ABS issues have historically offered better yields and enhanced potential risk-adjusted returns on capital, relative to fixed income equivalent instruments, and can perform well in uncertain macroeconomic environments given the structural protections, short-weighted average life and floating rate nature. 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 investment 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.

In addition to having the appropriate expertise and infrastructure in place to invest in European ABS in a credible manner, the regular reporting requirements on STS portfolios for insurers is vital.

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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