For Investment Professionals only

Reintroducing securitisations to insurance portfolios

October 2019

Simple, Transparent and Standardised

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 new 'Simple, Transparent and Standardised' (STS) framework offers the potential for insurers to reintroduce high-quality securitisations to their investment portfolios.
- STS applies significantly lower capital charges to eligible securities than the former Type 1 and 2 charges under Solvency II, while placing stringent requirements on originators to increase market confidence.
- Eligibility is not restricted to new issues, which opens up a significant number of potential opportunities.

New regulations designed to revive ABS markets

Insurers were once among the most active investors in securitisations. However, following the introduction of Solvency II regulations in 2016, penal capital charges for holding asset-backed securities (ABS) have effectively driven insurers out of the market over time. This has had implications not only for investors, but the real economy due to the reduced ability for lenders to raise capital.

The European regulator has begun to address this through the new 'Simple, Transparent and Standardised' (STS) securitisation framework introduced in January 2019. This significantly reduces the capital charges on eligible ABS, namely those that meet stringent criteria in terms of credit quality and transparency of information on underlying assets. In doing so, the regulator hopes to restore confidence in high-quality areas of ABS markets, especially in sectors that fund the real economy, such as mortgages and consumer and SME loans.

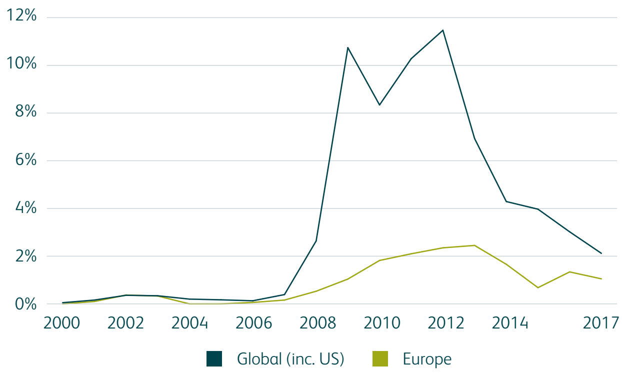
This paper examines some of the key aspects of the STS framework and the explores the available opportunities for insurers to reintroduce high-quality ABS to their investment portfolios.

The European market opportunity

The ABS market unsurprisingly earned a negative reputation following the 2008 crisis, due largely to the role of poor underwriting practices in US subprime mortgage markets. The subsequent lack of demand for securitisations has been driven by investors' reduced confidence in their ability to assess the risks of ABS and underlying assets. However, securitisation plays a key role in facilitating efficient financial markets and many misconceptions have developed around the asset class. In particular, there are significant differences – both historical and current – between securitisations in the US and Europe, which are important for investors to recognise.

European ABS have performed strongly over multi-decade periods, including during the financial crisis, as shown in Figure 1. This has been driven by their typically high-quality underlying loan books and strong protection for creditors. Issuers have historically had more 'skin in the game' (higher exposure to first-loss risk) in Europe compared to the US, given the propensity for European banks and lenders to treat ABS as a funding tool, rather than a hedging tool. The 'originate-and-distribute' model of selling pools of assets with no accountability, which encouraged irresponsible lending in the US, did not catch on in Europe. Today, it is further restricted by regulations requiring sponsors to retain exposure of at least 5% to a securitised asset pool.

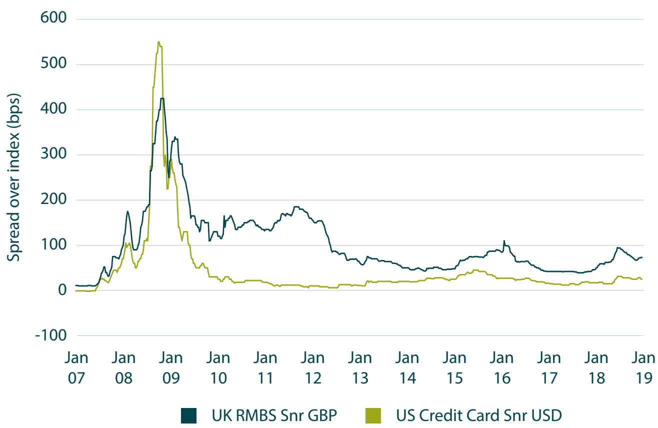
Figure 1: Structured finance one-year default rates, Europe vs global



Overall defaults (investment grade and speculative grade).
Source: S&P Global Fixed Income Research, 2018.

Despite far superior historical credit performance, some ABS still trade at higher spreads in Europe compared to the US, as shown in Figure 2. Discrepancies in value and quality within individual areas of European ABS markets also exist, including among STS-eligible securities, and generally these securities offer a material spread over government or corporate bonds of a similar credit rating. This is a direct result of market distortions following central bank and regulatory intervention in financial markets since the crisis, which creates significant opportunities for investors with sufficient capabilities to evaluate the risks and potential returns.

Figure 2. Senior ABS spreads, Europe vs. US

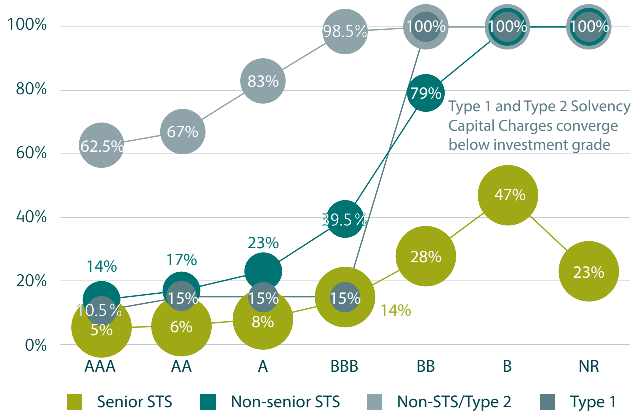


Source: J.P. Morgan, 'ABS Weekly Spreads and 'International ABS Weekly Datasheet', as at 27 June 2019.

As can be seen from the chart, UK RMBS backed by secured mortgage loans offer higher spreads than US ABS backed by unsecured credit card loans, indicating a value anomaly.

What are the new capital charges?

Figure 3: Solvency capital ratios of STS securitisations vs former Types 1 and 2



Source: M&G, EIOPA, as of 1 January 2019. Based on spread risk for securities with five year duration.

STS came into effect on 1 January 2019 and lays down a general framework for European securitisations. It is designed to improve market confidence by clearly differentiating high-quality securitisations from those with more complex structures or collateral[1]. The criteria therefore consider both the structure of the issue and the underlying assets.

Figure 3 shows the new favourable capital charges to eligible securities under the new STS framework compared to the former Type 1 and 2 ratios under Solvency II. As this demonstrates, high-quality STS ABS are significantly more attractive for insurers, carrying charges similar to those on corporate bonds. Meanwhile, charges on non-investment grade and non-STS securities remain prohibitive.

[1] Regulation (EU 2017/2402 of the European parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402&from=en

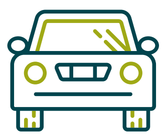
Which issues are eligible for STS?

Eligible ABS include high-quality auto loans; consumer, credit card and SME debt; and residential mortgage-backed securities (RMBS)[2]. Commercial MBS and synthetic securitisations are ineligible, as are issues backed by actively managed underlying pools of assets, as this reduces transparency.

Examples of some of the new issues that have come to market are illustrated below. As described earlier, there are significant differences in yields available, given the effects of European Central Bank (ECB) asset purchases. For example, Dutch RMBS and German auto loans are significantly more expensive due to ECB buying than UK RMBS, which were not included in the ECB's quantitative easing programme. Investors must therefore be selective in pursuing opportunities.

UK Prime RMBS AAA rated SONIA +80bps

Dutch Prime RMBS AAA rated EURIBOR + 27bps



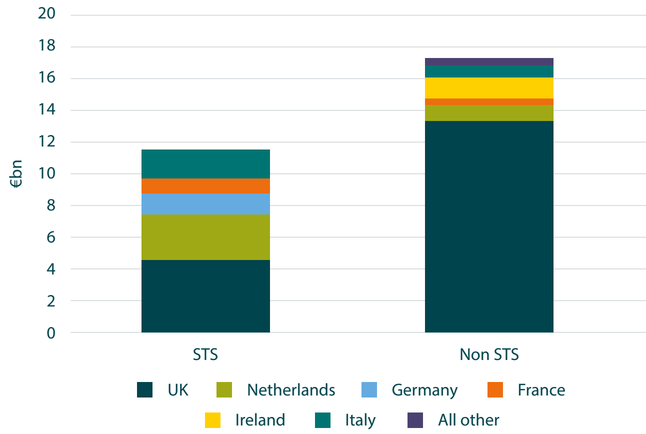
German Auto AAA Rated EURIBOR +19bps

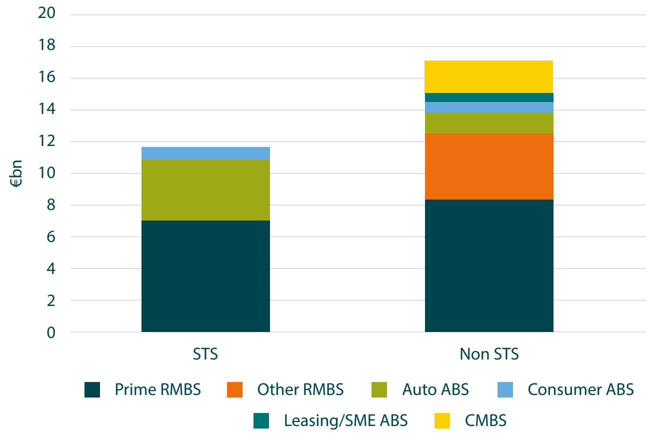
A case study demonstrating how this UK RMBS issue performs under stress can be found later in the document.

How big is the uptake?

In the first half of 2019 there were €11.6bn of STS issuance, comprising 40% of European issuance (see Figures 4 and 5). Deal volume is expected to increase slightly in the second half of the year, with a similar proportion likely to be STS-eligible. However, supply of STS securitisations is not restricted to primary issuance. Under the new framework, for securitisations issued before 1 January 2019, originators and sponsors may use the STS designation as long as they comply with the stated criteria. This potential 'grandfathering' of existing assets, which could be converted to STS, opens up a large number of opportunities.

Figures 4 and 5. STS: a scalable, growing opportunity





Source: Barclays Research, Concept ABS, Bloomberg; July 2019.
For illustrative purposes only.

[2] Source: Barclays Research, ConceptABS, Bloomberg; July 2019. https://live.barcap.com/PRC/publication/DR/CL_TEJ-IH4gfiB-_5d54e6d621386c0a85acf719

How would an STS issue perform under stress?

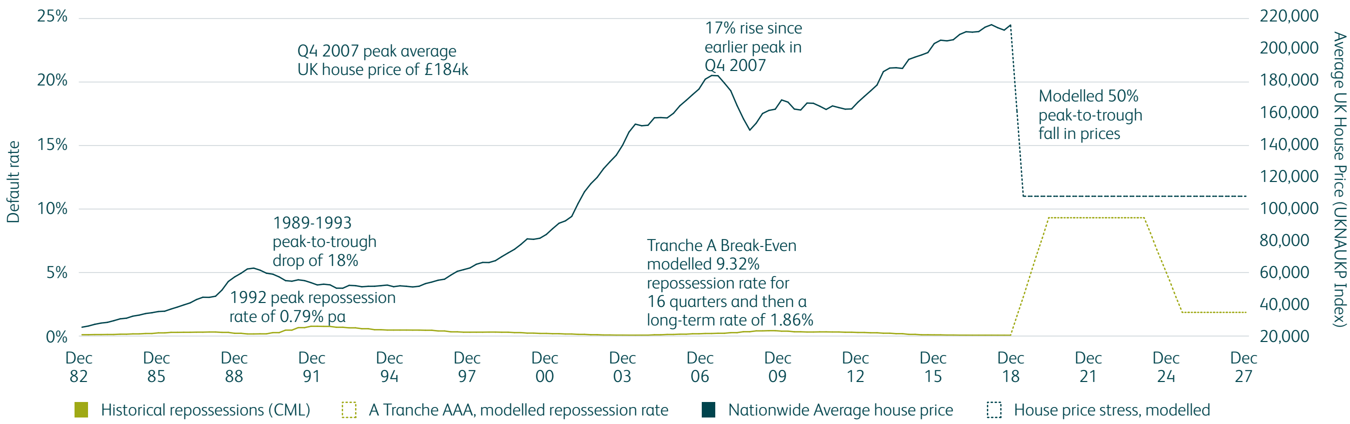
Due to the experience of the last financial crisis, understanding how an STS ABS can withstand a stressed environment is critical to determining its exposure to true economic risk.

Figure 6 demonstrates how a typical STS ABS would perform in a modelled worst-case scenario. Here we have used the aforementioned recent UK prime RMBS AAA issue, offering a spread over SONIA of 0.8%. We model a 50% sustained decline in UK house prices, noting the largest historical fall of 18%, which occurred over the period 1989 to 1993. For an investor to lose the first £1 invested, repossessions – effectively the default rate – would need to rise to 9.32% pa for a period of four years before reverting to a long-term rate of 1.86% pa, which is more than double the historical peak of 0.79% pa in 1992.

In short, for this AAA UK RMBS to even begin to lose money, the UK economy would need to experience a highly extreme, unprecedented and depression-like scenario.

The bond has a spread over SONIA of 0.8%, a spread duration of 2.65 years and a resulting solvency capital ratio of 2.65% under the new STS guidelines. The implied return on capital under the standard model of the Solvency II framework would therefore be 30.2%, which compares very favourably with what insurers would make on their core investment grade fixed income holdings.

Figure 6. Stress test: AAA UK RMBS



Source: M&G, ABSxChange, Nationwide, as at 30 September 2019. 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 a specific strategy.

STS designation

Designation of the STS label is the responsibility of originators, sponsors and issuers, but this may be outsourced to third-party verifiers (TPVs). TPVs cannot be insurance firms, credit institutions, investment firms or credit rating agencies and cannot provide any advisory, audit or equivalent service to the originator, sponsor or securitisation vehicle involved in the securitisation they assess. Notifications of eligible STS securitisations are sent to the European Securities and Markets Authority (ESMA). Mislabelled securitisations are liable for sanctions, likely to be fines.

Securing the opportunity

The introduction of STS enables insurers to reconsider securitisations for inclusion in their investment portfolios. The framework clearly differentiates between standardised, high-quality issues from other, more complex transactions, which should help build investor confidence in the market.

ABS is one of the few alternative asset classes with a large enough scale to provide meaningful diversification to an insurer's core fixed income book, while offering a risk-adjusted return premium over corporate and government credit. We believe insurers that have until now been restricted under Solvency II will be increasingly attracted to high-quality ABS. Asset managers with significant capabilities and resources in this area, such as M&G, are well-placed to support them.

An overview of STS criteria is provided below:

Simplicity	The originator, sponsor and Securitisation Special Purpose Entity ("SSPE") involved in an STS securitisation must be established in the EU. The securitisations must be: • Backed by pools of exposures that are homogenous in asset type • At the time of transfer into the securitisation, no loans should be in default or constitute exposures to credit-impaired obligors The following types of securitisations will not qualify as STS: • Synthetic securitisation (must be true sale) • Actively managed portfolios of underlying assets (this is aimed at keeping the underlying exposures transparent, allowing investors to effectively assess the credit risk of the underlying pool prior to making their investment decisions) • Commercial mortgage-backed securities (CMBS) • Non-performing loans and residential mortgage-backed securitisations of self-certified mortgages granted after 20 March 2014
Transparency	Must provide historical data on default and loss performance to investors. This data shall cover a period of at least five years, and: • There must be external verification of a data sample by an appropriate and independent party • Must provide investors with a liability cash flow model, both before pricing the securitisation and on an ongoing basis
Standardisation	The interest rate and currency risks must be mitigated and the mitigation measures disclosed: • The referenced interest payments must be based on generally-used market interest rates • The documentation must set out clearly what actions may be taken in relation to delinquency and/or default of debtors

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