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An ABS renaissance?

Why it may be time for insurers to reconsider asset-backed securities

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Executive Summary

Asset-backed securities (ABS) have historically been a core holding for insurance companies. However, following the Global Financial Crisis (GFC) and subsequent introduction of Solvency II, they retrenched from the market leading to a decline in average holdings. We believe this trend could soon be reversed, as the regulatory developments of the last decade, including the introduction of the Simple, Transparent and Standardised (STS) designation, has enhanced capital efficiency for investors in the asset class.

In this article we revisit the investment thesis for ABS – and for insurers specifically, which we believe is more compelling than ever – and explore why the stage is set for something of a renaissance.

The ABS market

Securitisation performs a vital role in capital markets. It enables issuers to access low-cost funding and to diversify funding sources through the issuance of asset-backed securities, as well as allowing for diversification of the investor base. Additionally, it is an essential tool for maturity transformation, creates liquidity in otherwise illiquid asset portfolios and means risks can be parcelled out to other segments of the financial markets to help protect against unexpected shocks. Banks, in particular, use securitisation extensively to actively manage their risk profile and optimise capital usage.

European insurance companies were once key actors on this securitisation stage, being both significant buyers and holders of ABS historically. However, following the global financial crisis (GFC) of 2008-09 and the introduction of Solvency II in 2016, which featured more punitive capital treatments for ABS, they largely retrenched from the market (see "A brief history of the securitisation market," below).

At the same time, the EU Capital Requirements Regulation (CRR) made it increasingly attractive for banks to hold ABS, creating healthy demand from bank treasuries and helping support the market after the European Central Bank (ECB) purchase programme ceased in 2018. In addition, further demand for the asset class has come from pension funds and high-net-worth individuals, who see the benefits of holding ABS, most notably for diversification and stability reasons.

ABS regulation

We believe the introduction of the EU Securitisation Regulation (SR) in 2019, and subsequently announced changes to the UK Solvency II framework, could foster renewed interest from insurers for ABS.

The Securitisation Regulation addressed some of the factors in Solvency II that had reduced insurer demand for securitisation exposure. The Solvency II legislation, for example, featured particularly punitive capital charges for ABS.

New provisions in the Securitisation Regulation helped mitigate the previous behavioural inconsistencies and risks that had occurred in the market, such as misalignment of interests and information asymmetry between the originator and the investor. The new provisions set a higher bar, meaning all EU and UK regulated securitisations needed to meet the following regulatory standards as a minimum:

i) Five per cent risk retention requirement, to ensure alignment of interests;

ii) transparency on portfolio data and reporting (to prevent information asymmetry);

iii) extensive due diligence requirements (with the onus on investors to understand all risks);

iv) standardisation requirements (to limit the impact and use of complex derivatives);

v) ban on re-securitisations.

These requirements have vastly reduced the scope for information asymmetry and arbitrage in our view. Consequently, investors have been able to quantify all risks with greater precision, reducing the likelihood of ratings volatility and giving greater certainty around outcomes for performance.

This favourable governance regime and the higher level of transparency brought about by the reforms – as well as the absence of business risk, as is typical within corporate credit – makes ABS a particularly attractive proposition for insurers.

The Securitisation Regulation provisions also introduced the Simple, Transparent and Standardised (STS) designation, so that transactions based on homogenous asset pools, and in lower-risk sectors meeting specific criteria, could qualify for lower regulatory capital charges. However, it was not until subsequent changes were made to Solvency II in 2019 that this resulted in improved capital treatment for insurance companies.

As yet, we have not seen the real benefit of these changes filtering through in terms of increase in absolute holdings; however, we believe there should be some good demand for both STS and non-STS transactions from insurers. We take as a positive the results of a 2022 survey carried out by the Joint Committee of the European Supervisory Authority, which found 37 per cent of insurers expected to increase their investments in ABS in the next three years (with the balance planning to maintain at current levels).[1]

Under Solvency II, senior STS securitisations are subject to low capital charges compared with the charges on other exposures typically held in investment-grade bond portfolios (see Figure 1). Capital charges are materially higher on non-senior STS securitisations and significantly higher on non-STS securitisations. Additional rules apply to securitisations issued before January 2019 that qualified as type 1 securitisations, and designated transitional type 1 securitisations. These can apply the same capital charges as senior STS securitisations, even where those securitisations are not STS.

Figure 1. **Spread capital charge (per cent)**

Note: Displays spread capital charges for exposures with less than five years' duration. Actual spread capital charge amount is calculated as market value times spread capital charge.

Source: Aviva Investors, as at June 2024.

Further regulatory changes are expected that should help encourage recovery across the market. Some of these are likely to be particularly beneficial for insurers, such as the proposed reforms to Solvency II coming out of the UK, which will allow for the inclusion of assets with highly predictable cash flows to be recognised (this has previously been an issue for securitised products). This could create scope for ABS to play a bigger role in insurers' matching adjustment portfolios.

The forthcoming changes to the regulations likely to be implemented in 2024, and introducing a more principles-based approach, should be supportive for the sector. Most recently, the ECB Governing Council on advancing the Capital Markets Union again emphasised the importance of the EU securitisation market in playing a key role in transferring risks away from banks to enable them to provide more financing to the real economy, while creating opportunities for capital markets investors.[2] Indeed, the Council also said it would be "reviewing the prudential treatment of securitisation for banks and insurance companies and the reporting and due diligence requirements" and "taking into account whether public guarantees and further standardisation through pan-EU issuances could support targeted segments of securitisation, such as green securitisations to support climate transition". It remains to be seen whether the ECB will move towards the UK's approach, with securitisations potentially becoming more suitable for insurers' matching adjustment portfolios.

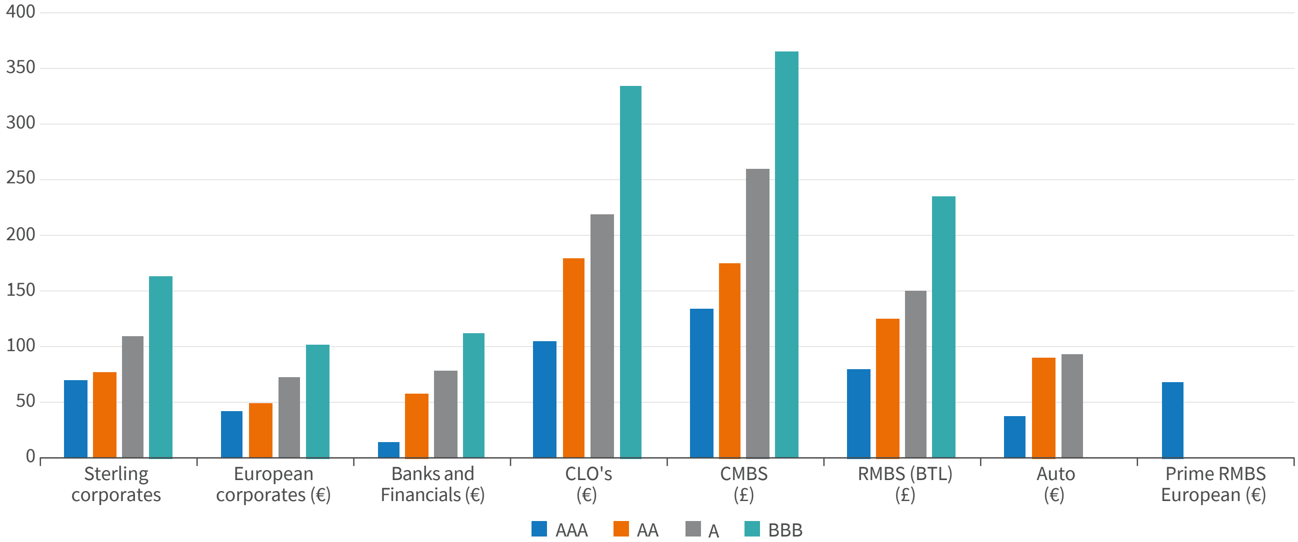
We detect positive sentiment amongst regulators supporting constructive change in the ABS market; it was evident, for example, in the regulatory panel sessions at the Global ABS 2024 conference in Barcelona in June.

The benefits of ABS for insurers

ABS have long been considered a core and liquid holding for fixed-income investment portfolios globally. Some of the key benefits include:

- **Premium over comparably rated alternatives like government and unsecured corporate bonds**. ABS have for many years attracted a complexity premium relative to other fixed-income asset classes, as specialist structural knowledge is required to assess the risks. In addition, history has demonstrated ABS spreads have tended to be more stable than some of the alternatives, as the bankruptcy remoteness of the investment means that they are much less sensitive to short-term news around the sponsor or issuer (unlike corporate bonds). This lower mark-to-market volatility relative to comparable asset classes has been particularly attractive to bank investors. In our view, the yield premium is likely to be diminished over time as more investors are attracted to the market, creating strong "technical" demand for the asset class.

Figure 2. **Corporate versus ABS spreads (basis points)**



Past performance is not a reliable indicator of future returns.

Note: CLOs: collateralised loan obligations; CMBS: commercial mortgage-backed securities; RMBS: residential mortgage-backed securities; BTL: buy-to-let; Auto: auto asset-backed securities (collateralised pools of auto loans and/or leases); Prime RMBS: prime residential mortgage-backed securities (loans that have low default risk and are made to borrowers with good credit records and reliable payment histories).

Source: Aviva Investors, BofA, Citi Velocity, as at August 19, 2024.

- **Strong liquidity.** The liquidity of ABS was significantly tested following the "mini-budget" in September 2022, when the UK Defined Benefit ("DB") community needed to raise significant amounts of liquidity. During this period, ABS did exactly what was expected of it with significant amounts of liquidity being raised. Indeed, many investors were surprised at the depth of the liquidity, and it is our view that that this has encouraged investors who were waiting on the sidelines to get involved. **Moreover, research by Risk Control in 2022 has shown that Senior ABS, since 2016 and through the pandemic, were actually more liquid than covered bonds (i.e. lower transaction costs) challenging the traditional dominance of covered bonds.**[3]

- **Credit resilience with outperformance relative to other asset classes (upgrades/ downgrades and lower defaults and impairments).** According to rating agency S&P, the post-GFC default rate on structured finance was 0.2 per cent across 7,500 tranches, with particularly robust performance from auto ABS and collateralised loan obligations (CLOs). **More recently S&P notes that since the end of 2022, the annual default rate for European structured finance has fallen back close to zero at 0.5 per cent.**[4] The lifetime default rate on average for ABS, residential mortgage-backed securities (RMBS) and CLOs has been no more than 1.5 per cent typically. Rating agency Moody's also notes that among all rated structured finance securities issued since 2009, there have only been 97 principal impairments and 14 interest impairments, demonstrating the especially strong performance of the ratings after January 2009.[5]

- **Diversification.** Mainstream ABS – including those collateralised by prime RMBS, autos and credit cards – provide diversification, as they tend to have a low or negative correlation to other asset classes including equity and credit, and are typically backed by highly granular consumer portfolios. The performance of these consumer portfolios is often closely linked to key macroeconomic fundamentals rather than the health of corporate balance sheets per se. Notably, low levels of unemployment and a particularly strong labour market and continued healthy savings balances in the UK (and across the euro zone) have all helped underpin performance. We also expect the protective measures taken during the COVID-19 pandemic and subsequent response to the cost-of-living crises, as well as the dramatically tighter underwriting criteria that was introduced post GFC, along with many years of rising property prices, to contribute to continued outperformance on consumer-linked ABS. We expect to see an uptick in arrears, albeit from a low base, and performance is expected to remain sound.

- **ABS have demonstrated resilience and defensiveness through multiple economic cycles.** Latterly, this has included the sovereign debt crisis, the COVID-19 pandemic, the liability-driven investment (LDI) and cost-of-living crises, as well as ongoing conflicts in Ukraine and Israel. This resilience can be attributed to the multitude of structural protections afforded to investors, such as: bankruptcy remoteness, structural subordination/overcollateralisation, excess spread as first line of defence, diversity of obligors and supporting parties, and the fact interest and currency risk is largely mitigated, as well as the benefit of active servicing and management of the underlying portfolios.

A brief history of the European securitisation market

The ABS market was established in the late 1980s and grew significantly prior to the GFC. Indeed, in the pre-crisis years of 2006-07 the market saw its zenith, with c.€450 billion of issuance in each of those years in Europe, according to the Association for Financial Markets in Europe (AFME), with a significant portion of this being retained by insurers.

Securitisation of mortgage debt played a well-documented role in the origins of the crisis in the US. Certain segments of the European market experienced elevated levels of defaults and impairments following the GFC. This was driven by poor underwriting standards and high loan-to-value (LTV) lending, primarily. But aside from the US mortgage market, the issues were limited to small pockets of the market i.e., more esoteric and opaque structures in asset classes that never lent themselves to being securitised in the first place. Subsequent default and impairment data show that these instances were indeed isolated, and most of these volatile and problematic asset classes no longer exist today. Indeed, mainstream European ABS demonstrated relatively robust performance throughout the GFC, except for commercial mortgage-backed securities (CMBS).

Since the GFC, underwriting practices have tightened materially and regulatory reform has ensued, resulting in structures that are more robust.

- **ABS offers some element of inflation protection, being largely floating rate in nature and limiting exposure to interest rate risk.** This has been especially beneficial given the unprecedented rate rises in recent years, resulting in significant falls in the price of fixed-rate bonds. Floating rate securities on the other hand have enabled investors to benefit from the carry trade as rates have increased.
- **ABS benefits from dual lines of defence and multiple structural protections that simply are not available to investors for normal corporate debt issuance.** The default rate on ABS is especially favourable due to the different layers of structural protections that exist, including bankruptcy remoteness, meaning the investments can survive and indeed prosper in the event of the sponsor's default.
- **Simplified structures and higher levels of disclosure and governance than ever before.** Significant lessons have been learnt following the GFC crisis, meaning that structures are more robust and benefit from greater transparency over asset portfolios and reporting. As indicated by the research into defaults discussed above, this has led to robust performance during periods of market turmoil in the post-crisis period.

Assessing the risks in ABS

At Aviva Investors we have invested in ABS since the market's inception and across a diverse range of asset classes and through the capital structure, gaining a depth of experience that is hard to replicate. We employ a highly detailed and rigorous approach to assessing the risks in any investment. This is partly a traditional, fundamental corporate credit approach, as well as a quantitative style approach. We employ a comprehensive "weak-link" type analysis where we seek to identify any one factor that cannot be sufficiently mitigated and thus may compromise the structure or the investment. We utilise a wide range of data points and a diverse range of research, generally to inform our view and test rating agency assumptions.

Conclusion

In conclusion, we believe ABS offers many benefits to investors and should be considered as a core holding for top-tier fixed-income strategies.

For insurers in particular, the existing capital benefits of STS ABS, in combination with potential changes to matching-adjustment portfolio rules, should make the asset class attractive. Given the liquidity and yields available, we also see an important role for STS ABS in liquidity portfolios, setting the stage for something of a renaissance for the sector.

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