XPS Investment

XPS Liquid Credit: Part 2 of 3

Looking beyond sterling investment grade credit

The case for **asset backed securities**

September 2023

Contents

Overview

The landscape for UK Defined Benefit (DB) pension scheme investment has changed dramatically since the beginning of 2022, in light of improved funding levels and a more stringent focus on liquidity and risk management.

This is expected to further increase the role credit assets play within UK DB pension scheme portfolios and the importance of having a well-built credit allocation. It will become increasingly important that trustees consider the full range of credit assets available to complement a core allocation to sterling investment grade corporate bonds within a low dependency portfolio.

In the second paper of this three-part series looking at the investment case for the lesser-utilised liquid credit assets, Emma Coleman explores the role of high quality asset backed securities (ABS) within a scheme's credit allocation.

In the first paper Steve Hickey discussed the use of non-sterling investment grade corporate bonds, to read this paper click here.

In brief:

1	**Return pick-up and diversification** – ABS provides scope for an additional return to be achieved above money market instruments or comparable quality corporate bonds as well as added diversification within a scheme's liquid credit allocation.
2	**ABS can improve the resilience of your LDI portfolio** – ABS can play an important supporting role due to its daily liquidity and lack of interest rate sensitivity. This means it doesn't fall in value in the scenario when it is required to top up collateral, and selling it doesn't reduce a scheme's overall level of hedging. Last year's gilts crisis provided a real life case study and the asset class stood up well under extreme conditions.
3	**Recent regulatory developments have impacted the investible universe** – Investors in European denominated ABS funds are somewhat restricted in the non-European issued ABS they can buy. As such, investors need to consider the geographic exposure of the ABS fund they select.
4	**Implementation and fund selection** – ABS is a complicated market with scope for overly simplistic risk modelling to underestimate risks. This becomes an issue with higher risk tranches, where there is more scope for interactions of risks to compound downside risks. As such, passive investment is not a viable approach and selecting a good quality manager is an important factor.

> Whilst the primary role for high quality ABS is likely to be supporting LDI collateral, their use also adds a return pick up relative to corporate bonds and increases diversification.

Emma Coleman
Investment Consultant

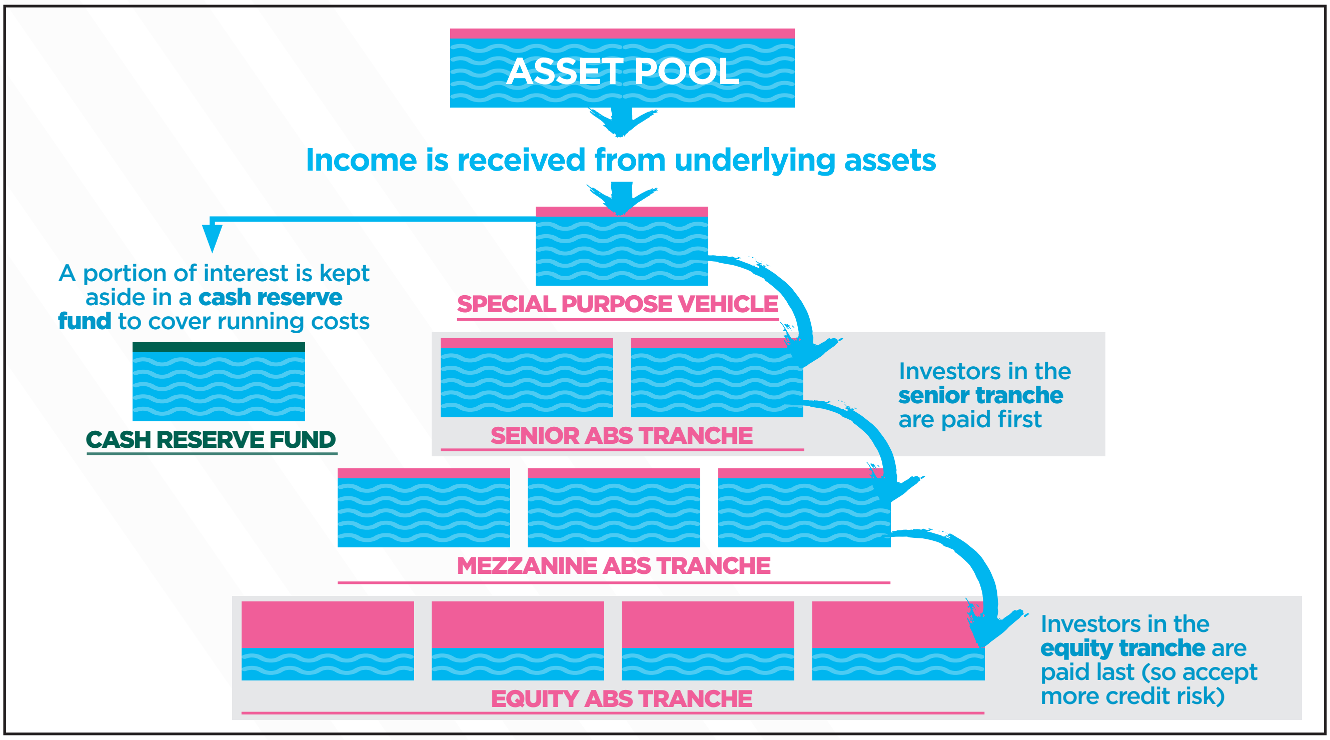
What are asset backed securities (ABS)?

ABS are debt securities typically issued by banks or other lenders (known as the ABS sponsor or originator) which are backed by an underlying pool of similar assets which generate income. Examples of the assets that back these securities are student loans, credit card loans and car loans.

Individual loans are pooled together and then as interest and principal payments are re-paid by the underlying borrowers, this money is returned to the ABS investors grouped in order of a pre-defined hierarchy, which determines who gets paid first. These groups of investors are known as 'tranches', which differ in seniority depending on how high up in the hierarchy they are. All investors in a tranche are treated the same. Tranches typically range from AAA rated (the highest quality) to B/C and equity rated tranches (the lowest quality), with the highest quality traches receiving the first payments.

Confusingly, as well as relating to a specific kind of asset as described above relating specifically to consumer loans, the term 'ABS' is also widely used to describe the 'family' of securitised credit assets that have an underlying pool of assets backing the payments ultimately received by an investor in the security. Other widely used ABS assets are:

- **Residential mortgage-backed securities (RMBS):** where the underlying collateral pool consists of mortgages on people's houses.
- **Commercial mortgage-backed securities (CMBS):** a pool of mortgages on buildings used for commercial or industrial purposes such as factories and shops.
- **Collateralised loan obligations (CLO):** a pool of senior secured loans, these are loans taken out by companies with banks to finance their general activity.
- **Collateralised Debt Obligations (CDO):** backed by a variety of different debt assets, not necessarily one particular type.
- More niche financings, such as **aircraft finance, small to medium-sized enterprise finance (loans to small and medium sized companies)** and **trade finance** (such as outstanding invoices).

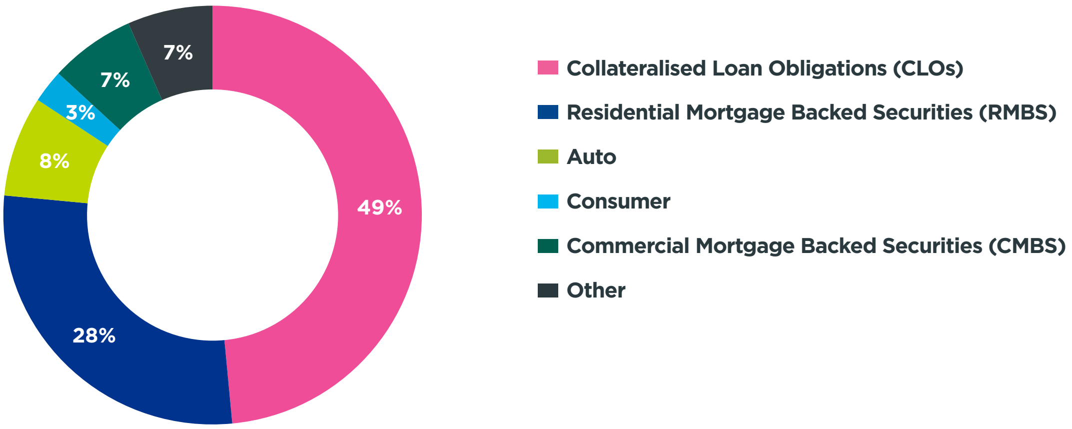


The role of asset backed securities

The universe of ABS assets is wide ranging and, as a result, different assets can have very different characteristics. This paper will focus on those ABS assets most suitable for a low-dependency portfolio, which are those that are publicly traded, liquid and generally high quality with an investment grade credit rating (AAA to BBB).

There are a variety of other types of ABS which have lower credit ratings or have been privately originated, and are therefore not as liquid. Whilst we are supportive of the use of these assets under suitable circumstances, this paper doesn't cover these.

Chart 1: Size of Outstanding European ABS Market: €449bn



Source: TwentyFour Asset Management, ConceptABS, Bloomberg, MS Research.
Notes: the pie chart shows the outstanding deals, i.e. those available for purchase, as at 30 June 2023. The market including the retained deals, for example those held by the European Central Bank, is over double the size of the outstanding market shown here.

Key features of publicly traded investment grade ABS

Risk/return (over gilts)	0	1	**2**	3	4	5
Level of GBP interest rate sensitivity	NONE	**LOW**	MEDIUM	HIGH		
Liquidity	LOW	MEDIUM	**HIGH**	VERY HIGH		
Size of investment universe	SMALL	**MEDIUM**	LARGE	VERY LARGE		
Requirement to hedge currency and interest rates to GBP	**HEDGE CURRENCY RISK**	HEDGE OVERSEAS INTEREST RATE RISK				
Fund management fees	LOW	**MEDIUM**	HIGH	VERY HIGH		
Level of manager skill required	LOW	MEDIUM	**HIGH**	VERY HIGH		
Trading costs	LOW	**MEDIUM**	HIGH	VERY HIGH		
Scope to incorporate ESG considerations and invest sustainably	LOW	**MEDIUM**	HIGH	VERY HIGH		

10 benefits and considerations of adding these assets to your portfolio

ABS can have a key role alongside sterling corporate bonds in pension scheme liquid credit portfolios due to their underlying characteristics.

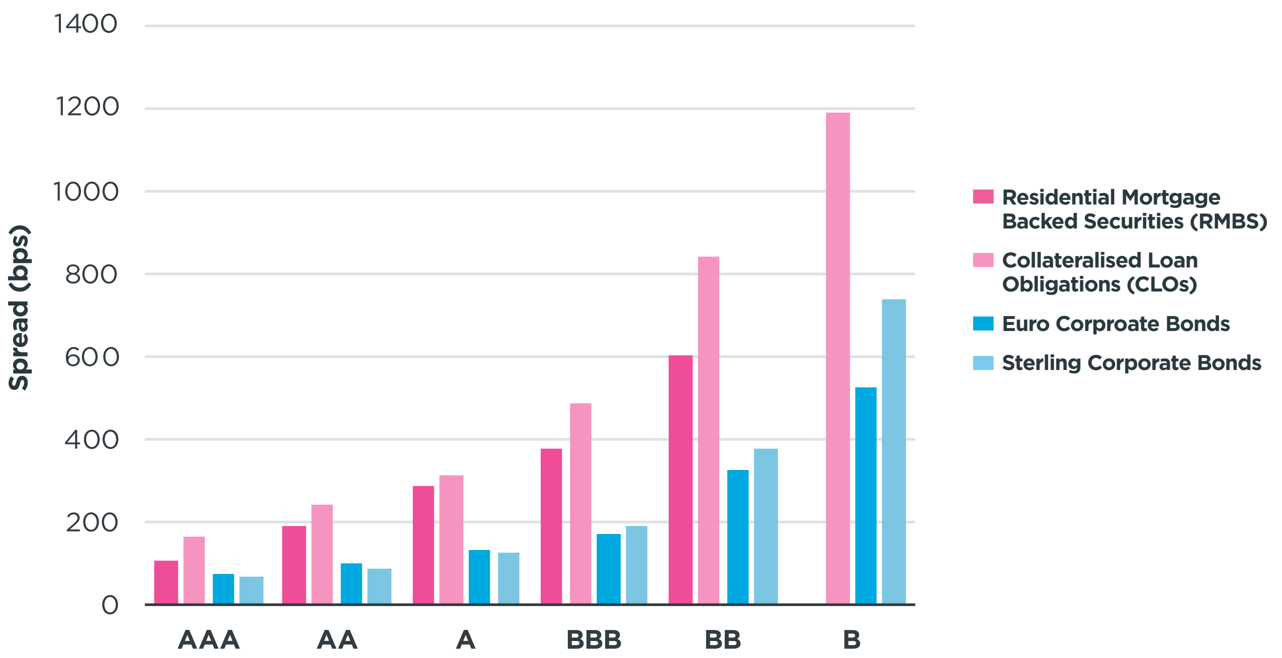
1 **Regular cashflow:** As with other credit assets, ABS will make regular payments to investors as the underlying pool of assets return the interest and principal. These contractual cashflows are typically floating rate, so vary with short term interest rates, and can be used to meet ongoing pension scheme cashflow requirements.

2 **Prepayment risk:** A typical feature of the underlying loans is that borrowers can choose to pay back their loan early if they wish. This introduces some uncertainty as to how long an investment will last, known as prepayment risk. In some situations this can lower the interest received by investors, for instance if loans are being paid back because credit premiums are lower so the loans can be refinanced at a lower rate.

3 **Spread premium:** ABS have historically provided a spread premium over equivalently rated corporate bonds. This premium is often explained as being driven by the ‘complexity’ of ABS assets. However, as the assets have different features it’s important for the fund manager to understand exactly how much of any difference is a genuine return pickup.

It should be noted that the management fees for ABS funds are typically higher than those for equivalent rated corporate bond funds to reflect the additional skill required, and this offsets some of this additional return premium.

Chart 2: ABS vs Corporate Bond Credit Spreads



Source: TwentyFour Asset Management (Citi Velocity, Bloomberg), 31 July 2023.

4 **Interest rate sensitivity and interaction with LDI hedge:** ABS mostly pay floating rate coupons to investors, as opposed to fixed rate coupons. This means that the price of these assets is not directly impacted by interest rate changes.

Given the above, an ABS allocation will have little to no interest rate duration, typically sitting below one year. This means buying or selling ABS does not affect a scheme's overall liability hedge.

5 **Liquidity and suitability as collateral to support LDI:** Good liquidity and reasonable trading costs make ABS highly suited to provide collateral support to LDI mandates, as it can be sold in good time to meet capital calls.

The LDI crisis provided a significant real life case study of this and, although total outflow in the ABS market exceeded £12bn (Source: Aegon), the market generally remained open and functioned as expected. Trading costs were elevated, as is expected in such events, but they remained within a reasonable range.

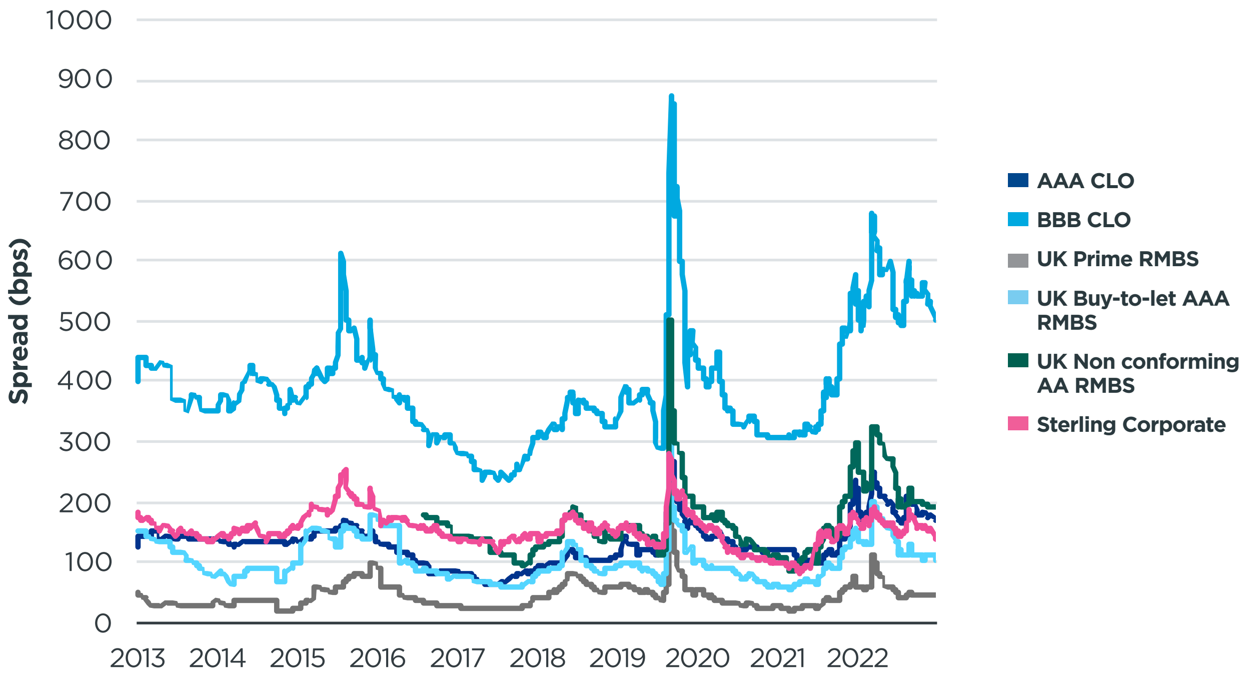
6 **Geographic exposure and currency risk:** ABS offers global exposure. The two largest markets are the US and European markets, but the UK and Australian markets are also sizeable. Where ABS are denominated in a currency other than sterling, the currency risk should be hedged back and this can be completed in a cost-effective manner using currency forward contracts.

The scope for investors in European funds to access US ABS has recently reduced, however, following a change to European regulatory guidance in 2022. Although the UK is no longer a member of the EU, this affects UK investors investing via European domiciled pooled funds. The guidance clarified the requirement for the strict use of European Securities and Markets Authority (ESMA) templates for an ABS issue to be eligible for European investors to purchase. Many non-European ABS issuers (particularly US issuers) haven't historically provided the full information now required. Australian issuers were also impacted by this, but they have been quick to make changes to meet the requirements given the importance of the European investor base to them.

7 **Recourse to assets backing the underlying loans:** The underlying pool of loans are often secured on assets. For example, a residential mortgage loan is backed by the home itself and a car loan is backed by the value of the car. In the event of default, the ABS has recourse to any assets which these loans are secured on and therefore a borrower defaulting on their loan doesn't necessarily lead to a loss for the investor.

Underlying assets are often secured. For example a residential mortgage loan is backed by property, meaning that even in event of default, recovery of value is likely.

Chart 3: ABS vs Corporate Bond Spreads



Source: TwentyFour Asset Management, ICE, Citi, Morgan Stanley.

8 **Diversification:** Similar to corporate bonds, investors can obtain exposure to corporate issuers (where the underlying borrower is a corporation) by investing in a CLO. ABS also offer scope for diversification through exposure to consumer (e.g. credit card loans, auto loans) and residential (residential mortgages) borrowers.

The underlying collateral pool supporting the ABS is also highly diversified and can be exposed to thousands of underlying borrowers.

That said, there is scope for the value of the assets to fluctuate through time, and this is likely to correlate to wider fluctuation in credit markets. However, whilst the spreads for ABS and corporate bonds have typically moved in the same direction, the size and timing of their movements has differed historically, as shown in chart 3.

9 **Environmental, Social and Governance:** The incorporation of ESG factors in credit markets has improved significantly across the board in recent years. However, securitised credit markets can be a challenging asset class in this regard given that a single security is exposed to thousands of underlying assets rather than just one underlying issuer, creating data transparency and reporting issues. An ABS manager with strong ESG credentials will understand the ESG characteristics of both the ABS originator and the underlying collateral pool. We expect the quality of ESG data and reporting to improve over time, particularly in public ABS, but this is an area that is lagging other markets currently.

10 Performance during the 2008 Global Financial Crisis: Investors sometimes associate ABS with negative connotations related to the 2008 global financial crisis. These are often misplaced and exaggerated.

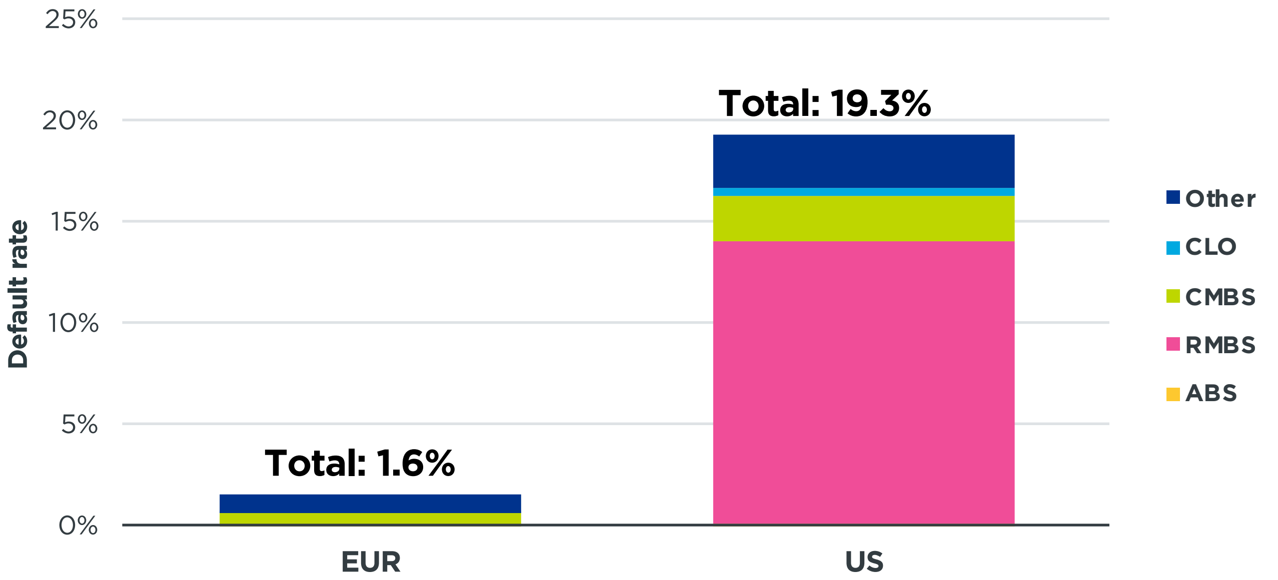
The reason for its association is that the crisis was initially triggered by a specific type of CDO which gave leveraged exposure to poor quality sub-prime mortgages. The leveraged exposure was created by combining, for example, the BBB tranche of a traditional US sub-prime CDO and creating a new security, called a credit default obligation-squared (CDO-squared). CDO-squared were structured like traditional ABS assets, i.e. split into different tranches, but the payments of the CDO-squared were dependent on the BBB tranche of the original structure receiving payments. The achilles heal is that even the most senior tranche of the CDO-squared will not receive any payment if the BBB tranches fail to pay out. Despite this, in many cases these senior tranches were still awarded AAA ratings.

Not only was the structure of these assets seriously flawed, but they were also based on a sector (US sub-prime – i.e. caravan parks) which had fundamental issues around a lack of lending standards and accountability, including rating agencies who gave credit ratings that weren't reflective of the underling risks.

When US homeowners began to default on their mortgages, banks were heavily exposed to losses on these securities and the global crisis was subsequently triggered.

The remainder of the ABS market, particularly European ABS, did not have any involvement in causing the crisis. Whilst the prices of these assets were significantly impacted at the outset of the crisis, they ultimately rebounded with few defaults. The US-specific nature of the impact is illustrated by the chart below which shows cumulative default rates in the US/EU.

Chart 4: ABS Cumulative Default Rates (2007-2014)



Source: Aegon Asset Management.

The market saw a raft of regulation following the 2008 global financial crisis to make the overall market more transparent and accountable. This resulted in improved lending standards and ultimately has benefitted investors. The key change was around risk retention requirements, which align the interests of the issuer of the bonds with the investor by ensuring that the issuers have 'skin in the game' through a holding in the equity tranche of the ABS. More complex structures, such as CDO-squared, are no longer allowed.

How to access these assets

The choice of fund will be informed by the purpose of the ABS allocation as part of a scheme's overall portfolio.

An allocation to ABS can be successfully accessed through a standalone fund, or through a multi sector credit fund. These funds are actively managed and typically have a cash-plus benchmark, given there aren't suitable benchmarks available.

The universe of funds that invest across the ABS market and are suitable for UK institutional investors is relatively small, reflecting that the management of ABS funds requires a team of highly skilled individuals who have the appropriate experience.

The key differences between these funds are typically the return objective being targeted and the geographic exposure obtained. Given the change in regulatory guidance for US ABS issuers discussed above, funds domiciled in the EU will tend to have greater scope to invest in the UK and Europe than in the US.

Some LDI managers will run ABS funds which can be incorporated into the automated recapitalisation process of a collateral waterfall.

Fund management fees

The fees for ABS funds are typically higher than those for a corporate bond fund, reflecting that they are more actively managed and require a high skillset. Management fees for these funds typically sit between 0.20% and 0.35% depending on the mandate size. Multi sector credit funds will be more expensive at between 0.15%-0.60%, but a range of competitive options are available to suit different requirements.

Conclusion

The features of high quality, liquid, ABS means they complement sterling corporate bonds within a low-dependency portfolio. Whilst the primary portfolio role for these assets is likely to be to support LDI mandates, due to their liquidity and low levels of interest rate sensitivity, their use also adds a return pick-up and diversification.

The choice of how best to access ABS will depend on governance constraints but access is achievable even for relatively small schemes.

Key actions for defined benefit trustees

1	**Consider the composition of your liquid credit portfolio and the role that ABS could play in helping to meet your scheme specific requirements and long term objectives.**
2	**Assess the suitability and robustness of your current LDI waterfall and the extent to which ABS could be incorporated to benefit the structure.**
3	**Understand the governance-related considerations related to any decision to invest.**

XPS Liquid Credit Series

Part 1

Our first paper in the series looked beyond sterling investment grade credit and explored the **benefits of non-sterling bonds.** Click **here**

Part 3

Our third paper in the series will look at **emerging market debt and high yield.** To be released in October.

How can we help?

If you'd like to find out more about ABS and the role they might play within your scheme's investment strategy, please get in touch with Emma Coleman or your usual XPS contact.

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