Credit -
The joy of structured finance

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We examine the three most common investor concerns about ABS, MBS, CLO and other structured finance vehicles. We show that their bad reputation following the financial crisis is undeserved and that current yields reflect a large margin of safety against a deterioration of lending standards and an increase in default rates.

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Structured finance is a joy? You must be kidding…

The terms "joy" and "structured finance" are rarely used in the same sentence, let alone in the title of a research note on the topic. Structured finance investments have got a bad reputation ever since investors incurred steep losses in some of these vehicles during the Global Financial Crisis (GFC) a decade ago. Additionally, these instruments are not plain vanilla and require some education before investors feel comfortable with them. And most recently, a plethora of news articles about the surge of covenant-lite loans that are part of many structured finance investments has created the impression that these investments are soon going to implode.

When we talk to investors about structured finance investments we hear these and a lot of other reasons as to why these investments are far too risky for pension funds, insurance companies and private investors alike. Obviously, we cannot know the ability and willingness to take on risks for every single investor, but we can show that blanket rejections of structured finance investments are a mistake for almost every investor. In this report, we want to take the common fears, objections and criticisms of structured finance investments head on. By analysing the current market prices of these instruments and their likely losses in an economic downturn, we can help readers ignore the hyperbole in the financial press and focus on a realistic assessment of the risks and opportunities.

What do we mean when we say structured finance?

Before we tackle the common objections to structured finance investments it is useful to define what we mean by this term. Structured finance is used in different ways by the general audience and specialists in the sector. In this report we will use structured finance as a catch-all phrase that captures any kind of investment in credit vehicles that are based on a pool of securitised loans or mortgages. In general, these pools of assets are transferred to a Special Purpose Vehicle (SPV) which creates different securities with different characteristics out of this pool – hence the name securitisation. These securities are designed to appeal to different investor groups ranging from very safe "senior tranches" with risk and return characteristics similar to investment grade corporate bonds, to "mezzanine tranches" with risk and return characteristics like high yield corporate bonds up to the riskiest equity tranches with, you guessed it, risks similar to equity investments.

Depending on the underlying pool of assets these structured investments are known as:

- Asset Backed Securities (ABS) if the underlying loans are consumer loans such as credit card or auto loans, or asset finance loans like aircraft loans or loans to finance solar plants etc.
- Mortgage Backed Securities (MBS) if the underlying loans are mortgages. Here, one often needs to differentiate between residential mortgage backed securities (RMBS) and commercial mortgage backed securities (CMBS).
- Collateralised Loan Obligations (CLO) if the underlying assets are syndicated or senior loans to leveraged businesses (senior loans).

All of these instruments have their own intricacies, so we have decided to write a series or introductory and educational notes

called Alternatives 101 that provide an overview for investors on the mechanics and characteristics of these instruments. We have recently published Alternatives 101 reports on ABS, MBS and on Senior Loans (as the foundational piece for a future report on CLO).

Common features give rise to distinct advantages

No matter the actual structured finance vehicle under consideration, all of these vehicles have some common features that differentiate them from traditional corporate bonds and give rise to different risk premia, providing investors with potentially higher returns than comparable corporate bonds in the long run.

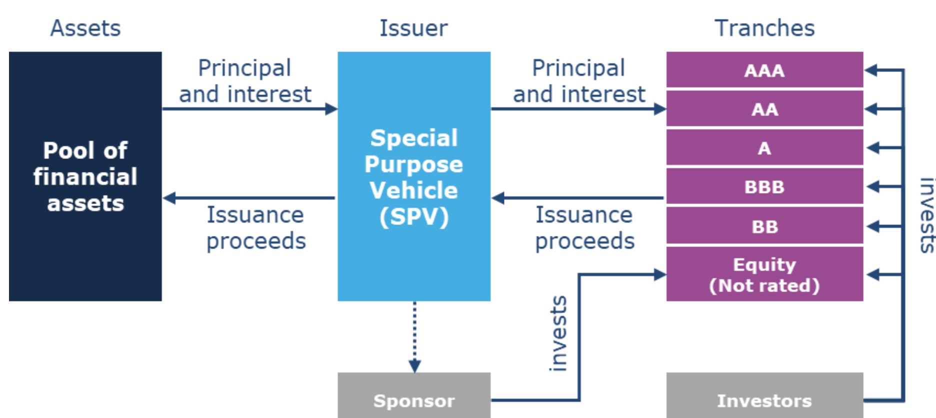
The basic structure of ABS, MBS and CLO is shown in Fig. 1. A pool of financial assets is transferred into an SPV which acts as the issuer of the structured finance securities. The pool of assets is then securitised into different individual bond-like securities that are sold to investors. The sponsor of the SPV (typically an investment bank or a specialised asset manager) will invest in the equity tranche.

As shown in Fig. 1, different investment tranches have different credit ratings starting with the senior tranches with a rating of AAA to BBB, then followed by the mezzanine tranches with a credit rating of BB or below and the unrated equity tranche. The reason why the different tranches have different credit ratings is due to the fact that losses in any of the underlying assets are first absorbed by the equity tranche. Once the equity tranche is wiped out, losses will be absorbed by the next highest tranche (in our example the BB-rated mezzanine tranche) and only when the lowest tranche in existence is exhausted will losses occur to subsequent tranches higher in the structure. Thus, a AAA-rated tranche will only incur losses once all the other investments have been exhausted.

The common features of the underlying pool of assets and the structuring process give rise to different advantages of structured finance investments over comparable corporate bonds:

- **Securitisation:** Because the loans and mortgages underlying the structured investments are secured against assets, they generally have lower risk of loss when a company defaults on its debt. Bankruptcy laws around the world ensure that secured debtholders get paid before any unsecured debt gets serviced in the event of a bankruptcy.

Fig 1: A stylised structured finance investment



Source: Fidante Partners.

- **Credit enhancement:** On average 0.68% of all corporate bonds with a BB rating default in any given year and the average recovery rate in case of default is somewhere around 50%. Over twenty years, that means that somewhere around 15% of all BB-rated corporate bonds default. Because BB-rated tranches of structured finance investments only incur losses once the entire equity tranche has been used up, only 2.3% of BB-rated CLO tranches have defaulted in the last twenty years. Overcollateralisation leads to fewer losses in times of crisis or economic downturn.
- **Excess spread:** A form of "soft credit enhancement" comes in the guise of excess spreads. Excess spreads are all the remaining interest payments and fees collected on a structured finance vehicle after all expenses are covered. This excess spread provides additional protection against losses should one or more of the underlying securities in the structure default.
- **Liquidity premium:** Because the underlying pool of assets (mortgages, loans, etc.) is illiquid, as are the individual tranches of the structured investment, they command a liquidity premium over similar assets that are liquid and publicly traded.
- **Complexity premium:** Because structured finance investments are more complex than traditional plain vanilla corporate bonds, many investors shy away from investing in these vehicles and will only buy them if the excess return over comparable corporate bonds is high enough to justify investing in what they perceive as a "black box". Investors who take the time to understand the structures and their risks are at a clear advantage in being able to reap this complexity premium.

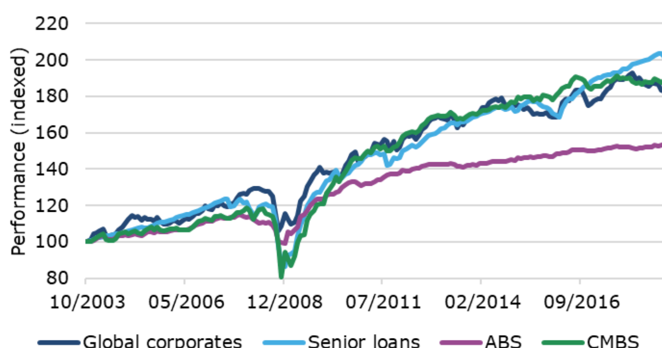
Investor concerns, part 1: 2008

Never mind the advantages of structured finance investments over traditional corporate bonds, one of the most commonly voiced concerns of investors about these vehicles is the sentiment that they were responsible, or at least at the heart of, the GFC ten years ago. As a German living in the UK, I always have to think of the famous episode "The Germans" of Fawlty Towers. In it, Basil Fawlty (played by John Cleese) constantly reminds a group of German guests in his hotel that they have lost the war by making references to Nazi Germany despite his own warning of "don't mention the war".

Many investors have been severely burned by the experience of the GFC and mentioning structured finance investments to them is like mentioning the war to Germans in the 1970s. They have not quite got over it, yet.

And indeed, depending on the type of investment, the losses in structured finance vehicles during the GFC were severe, as can be seen in Fig. 2. Global corporate bonds declined 8.7% in the calendar year 2008 in US Dollar terms. ABS declined on average by 12.7% and CMBS by 20.5%. Senior loans, which are the foundation of CLO, declined by 29.1%.

Fig 2: Performance of different credit investments in the last 15 years



Source: Bloomberg, Fidante Partners. Data as at 31 December 2018. Past performance is not a reliable indicator of future results.

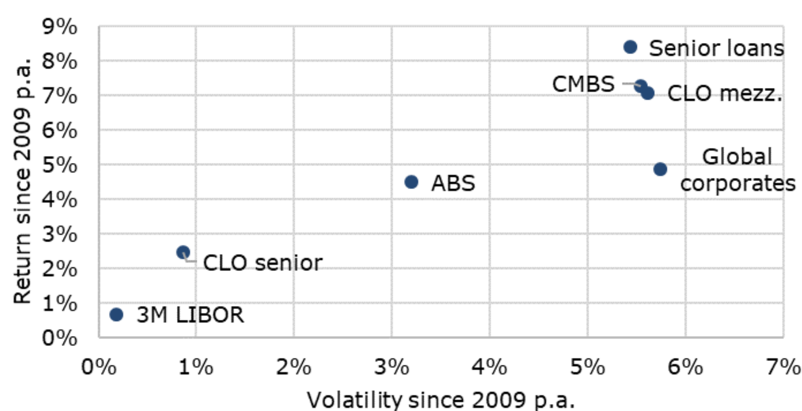
A large part of these declines was due to the credit crunch and the fact that markets for these illiquid investments completely dried up for most of 2008 and early 2009. However, once markets normalised, these investments recovered their losses incredibly quickly. It took corporate bonds until July 2009 to recover all their losses from the financial crisis and by that time ABS had also recovered all their losses while only two months later, CMBS and senior loans had recovered their losses as well.

Since the beginning of 2009, CMBS and the mezzanine tranches of CLOs have outperformed traditional corporate bonds by 2.3% and 2% per year, respectively (Fig. 3). And that performance came with similar volatility to corporate bonds. ABS, on the other hand, have achieved about the same return as corporate bonds since 2009, but the volatility of ABS has been 3.2% per year compared to 5.7% for corporate bonds.

Senior CLO tranches have had lower returns but a volatility so low that it is more comparable to money market investments than bonds. And at a 2.5% annual rate of return, senior CLO tranches have outperformed money market investments in US Dollar terms by about two percentage points per year.

The experience since 2009, as well as the experience of the years leading up to the GFC, show that structured finance investments can offer an attractive alternative to traditional corporate bonds. Investors can find investments that offer higher returns for comparable levels of volatility or investments with similar returns but much lower volatility. And the experience of the GFC has shown that investors who were disciplined and stuck to their investments into the year 2009 did not face any underperformance compared to corporate bond investments.

Fig 3: Annualised risk and return since 2009



Source: Bloomberg, Fidante Partners. Data as at 31 December 2018. Past performance is not a reliable indicator of future results.

Investor concerns, part 2: Erosion of lending standards

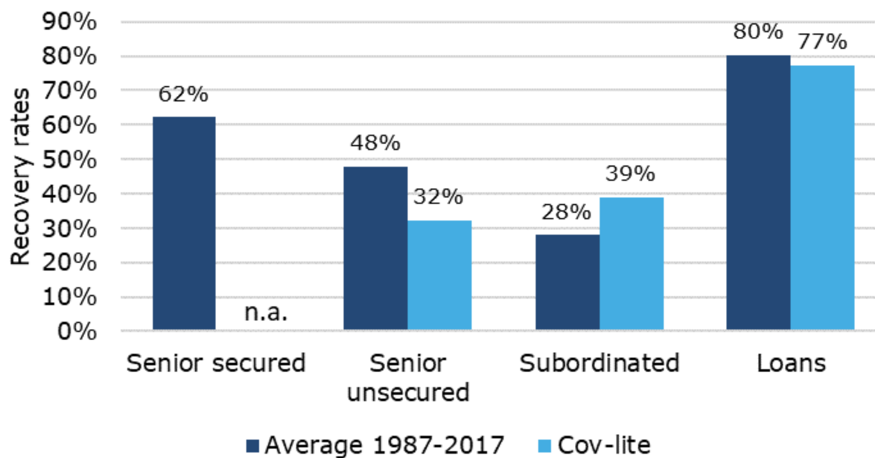
The erosion of lending standards in the US residential mortgage market was the key source of the upheaval that almost brought down the global financial system in 2008. While these excesses have stopped after the GFC and hopefully will not return, lending standards in other markets have eroded in recent years. Most notably, covenant-lite loans have grown from about 4% of the senior loan market in 2009 to more than 80% of the market today. Traditionally, creditors introduced different covenants to loans that prevented the debtor from engaging in activities that would reduce the company's ability to pay its debt (e.g. by paying dividends or investing too much in new equipment etc.). In case any of these covenants were violated, the loan could be called by the creditor and a technical default triggered. The advantage of these covenants is that they allow creditors to recoup their money before the borrower might be in a situation where the loan cannot be paid back in full.

During the last decade, these covenants have increasingly been dropped by creditors, which has created significant media attention and concern with regulators who are afraid that loans could incur bigger losses once the economy enters a recession and highly leveraged companies get into financial difficulties. In effect, the covenants of most loans issued today are identical to the covenant standards for traditional high yield bonds, so investors who are not afraid of high yield bonds should not be afraid of cov-lite loans either.

The main problem with cov-lite loans is that we have no historical precedent on which to model the potential increase in credit losses, should these companies default. It will be of little solace to investors to know that the companies that do issue cov-lite loans tend to have on average a better credit rating (typically a rating of BB) than companies issuing loans with covenants. After all, the GFC taught us what these credit ratings are worth in a crisis.

But based on a small sample of cov-lite loans that have gone into default in the past we are able to get some indication about the potential recovery rates for cov-lite loans vs. traditional loans. Fig. 4 shows the average recovery rates of cov-lite bonds and loans in the Moody's database. Compared to other bonds and loans with covenants, the recovery rates historically have been similar in the case of senior loans and lower for senior unsecured bonds. With the little experience we have, all we can say at the moment is that recovery rates in case of a default may be substantially lower for cov-lite loans than in the past.

Fig 4: Recovery rates for cov-lite loans

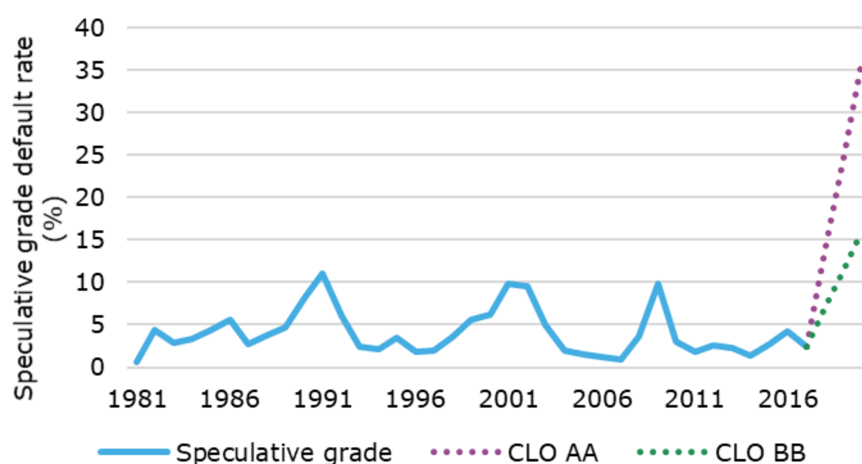


Source: Moody's Annual Default Study 2018, Fidante Partners.

If the proliferation of cov-lite loans exposes the investor to potentially lower debt recovery rates in case of a default, then the next question is, how large default rates have to be before the return of a given structured finance investment will become unattractive? We will tackle this question in more detail in the next section but before we do that, we want to point out once again the advantages of credit enhancement in structured finance investments.

CLO are based on a pool of senior loans and thus are directly exposed to the risks of cov-lite loans. Fig. 5 shows the historic default rates of speculative grade credit. Because different tranches of a CLO will only experience a default once all the lower tranches are exhausted, it is possible to calculate what kind of default rates we need to observe in CLO before a loss is triggered. This is what we have done in Fig. 5 for a typical CLO structure (the exact default rate depends on the individual structure, but the numbers shown in Fig. 5 are qualitatively correct for almost all CLO issued in recent years). For a BB-rated mezzanine tranches, the speculative grade default rate would have to rise to about 16% and thus much higher than the 10% default rates we observed in every major credit crisis since the 1980s before losses would be incurred. For AA-rated senior CLO tranches, the default rate would have to rise to more than 35%.

Fig 5: Historical default rates and different default scenarios for CLO



Source: Standard & Poor's Annual Global Corporate Default Study, Fidante Partners.

Investor concerns, part 3: Insufficient margin of safety

Default rates are only one side of the coin. It is the combination of default rates and recovery rates that leads to losses. The job of interest payments is to reward investors for taking on this risk of loss. More and more investors are worried that the current yield of structured finance investments is too low to adequately compensate for these risks. The usual argument of sceptical investors is that investments like CLO, ABS or MBS have become so popular that spreads over government bonds are insufficient to provide a margin of safety in case the economy goes south and lenders default due to a recession or another credit crisis.

To address these concerns, we have done the following exercise. In one scenario, we have assumed that recovery rates for CLO, ABS and CMBS remain identical to historical averages. Then we can calculate the default rate at which the entire option-adjusted spread would be eaten up by losses from defaults in the underlying pool of assets and the return of the investment would be the same as the return on a comparable government bond. We can then compare this breakeven default rate with the historical average default rate and the peak default rate at any time in the past.

Fig 6: Breakeven default rates for structured finance investments

	Breakeven with av. recovery rates	Breakeven with 50% higher loss given default	Peak default rate since 1981	Average default rate 1981 - 2017
Senior loans	17.3%	7.3%	11.1%	4.0%
CLO senior	4.8%	2.0%	0.0%	0.0%
CLO mezz.	24.5%	10.4%	8.5%	2.3%
ABS	1.8%	0.8%	1.2%	0.4%
CMBS	3.2%	1.3%	n.a.	0.1%

Source: Standard & Poor's Annual Global Structured Finance Default Study, Fidante Partners.

As we have discussed above, recovery rates may not be the same going forward as in the past. Thus, we have calculated the breakeven default rate for a second scenario in which recovery rates in case of a default are one third lower than the historical average. In other words, we assume that losses in case of a default are 50% higher than in the past due to the erosion of lending standards. Fig. 6 shows the results for both scenarios and the historical default rates for the most important structured finance investments.

In each of the cases we examine in Fig. 6 we can see that if recovery rates turn out to be at or close to historical averages, then the default rates typically seen at the peak of a recession or during the GFC in 2008 are not high enough to cause a lasting underperformance vs. government bonds. That is not to say that in a liquidity crunch the prices of these investments cannot drop more than government bonds or corporate bonds. It is exactly this potential drop in prices in an illiquid market that gives rise to the liquidity premium included in structured finance investments. Therefore, we would never recommend that these investments should be a dominant part of an investor's fixed income portfolio. However, as a diversifier and return enhancer, they continue to make a lot of sense in our view.

If we look at the breakeven default rates in Fig. 6 for a higher loss given default, we see that these breakeven default rates are still significantly higher than the average default rate for each asset class. However, given the more extreme default scenario we should expect to see an underperformance vs. government bonds during a recession or a credit crisis. Peak default rates for senior loans and ABS have been higher than the breakeven default rates implied in these markets today. Only for CLO (both senior and mezzanine) have peak default rates never come close to the default rates necessary to cause a significant dent in returns. This is the above-mentioned complexity premium in action. Investors today are still so reluctant to invest in CLO that the risk premium associated with these investments is so high it would cover even a repeat of the GFC.

With ABS, MBS and similar investments the market is already pricing in a significant margin of safety for investors and potentially much higher losses given default than historically observed. The memory of the GFC is lasting a long time and it is still reflected in the yields paid by structured finance products.

Closing arguments

Structured finance continues to have a bad reputation in the financial press and in the eyes of regulators and investors alike. The 2008 meltdown in many structured finance vehicles is still fresh in the memories of many investors. Add to that loosening credit standards in some corners of the loan market in recent years and investors have become very reluctant to invest in ABS, MBS or CLO.

In this report we have tried to address these common investor concerns and showed that:

- While losses in structured finance investments during the GFC were exacerbated by a frozen credit market, these investments recovered their losses very quickly once markets became unfrozen again. Since the GFC, structured finance investments have outperformed traditional corporate bond investments by achieving higher returns with similar risk or achieving similar returns with lower volatility. [1]
- Given loosening credit standards, markets are already pricing in a significant margin of safety in case an economic downturn leads to higher default rates. If losses in case of a default are similar to historic averages, then default rates even at the height of a recession should be far lower than those necessary to lead to an underperformance vs. government bonds. If losses given default are 50% higher than historical averages, we should expect some underperformance vs. government bonds in a recession but still a significant outperformance over an entire cycle.

Of course, structured finance investments are not the low risk investments they were often (mis-)sold as before the GFC. These investments are illiquid and have their very own set of risks stemming from the economic fundamentals of the underlying asset pools. Investors need to be able to cope with this lack of liquidity (for example by limiting position sizes) and understand the mechanics and economics of these investments. To help investors better understand structured finance vehicles, we are publishing a series of educational notes covering everything from senior loans to ABS, MBS and CLO. On top of that, we recommend investors not to engage in direct investments in individual issues. Given the level of detailed knowledge about these markets necessary to make informed decisions, specialist fund managers are the only reasonable way to incorporate these investments into a portfolio. Once these basic precautionary measures have been heeded, investments in structured finance vehicles are capable of bringing a lot of joy.

[1] Past performance is not a reliable indicator of future results.

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