> Structured credit may be a rare thing: a defensive source of yield in a low interest rate world.
Structured credit is, in our view, one of the most underappreciated asset classes in credit. This, we think, is partly because many still associate it with the ‘toxic’ assets of the 2008 global financial crisis. However, many of the larger structured credit markets have never experienced a default.

Despite this, structured credit frequently pays a premium over standard corporate bonds of similar credit ratings. In our view this is largely because they command a high degree of skill and expertise to properly analyze and model. It’s a premium for complexity and not additional credit risk.

We would go as far to say that structured credit is quite possibly the most defensive source of yield still available in today’s low interest rate world.
STRUCTURED CREDIT DE-MYSTIFIED

What is structured credit?
The structured credit, or asset-backed securities (ABS), market is a credit market in which the coupons and principal payments are backed by collateral.

The investments typically derive their coupons and principal payments directly from underlying pools of loans. Examples of these loans can include mortgages or corporate loans which are often secured against hard assets like real estate in the event of default.

Broadly, there are three types of collateral in the ABS market: residential and consumer, commercial real estate and secured corporate, as illustrated in Figure 1.

Investors also could potentially benefit from other structural protections like covenant packages, which are essentially terms and conditions that help lenders manage the risk of default.

The key difference between structured credit and more mainstream corporate bonds is that the latter are typically unsecured (particularly in the investment grade market) and also offer comparatively little in the way of structural protection.

How ABS is structured
Banks create ABS structures by taking loans from their books (such as mortgages previously written to customers) into separate legal structures (known as a ‘special purpose vehicles’). The loans are then repackaged into bond structures that investors can buy.

This step may sound like a technicality, but it is crucial, since it makes the structure of these bonds something we refer to as ‘bankruptcy remote’. This means if the originating bank ends up going bust, it will have no direct impact on the ABS structure. This is what differentiates the market from say, covered bonds, which, despite their security, still ultimately leave investors exposed to the issuing bank’s credit risk.

Figure 1: The three types of secured finance
How ABS enhances credit quality

ABS are structured into different classes of bonds with different credit ratings.

As Figure 2 illustrates, the principal and interest payments from the underlying loan pools flow through to the special purpose vehicle which then distributes the payments to holders of the highest rated bonds (senior bond holders) first. It’s only once these bondholders have been paid in full that proceeds are then distributed to the holders of lower-rated bonds (mezzanine or junior). This cascading pattern continues all the way down the capital structure, and is known as a ‘waterfall’ structure.

We call this ‘credit enhancement’. Effectively, the bonds higher up the capital structure have a higher credit quality than the underlying loan pool in aggregate, as they will generally still be repaid even if a portion of the underlying loans default. However, those at the bottom of capital structure would suffer losses immediately should the loans in the pool begin to go bad, which is why we call them ‘loss absorbing’.

Figure 2: The structured credit ‘waterfall’ structure visualized

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1 Past performance is not indicative of future results.
3 For illustrative purposes only.
S&P’s data also shows that US collateralized loan obligations (CLOs – not to be confused with CDOs) have seen an average annual default rate of only 0.1% since 2001.

Europe: remarkable resilience through various crises
Outside the US, structured credit has also shown remarkable levels of resilience. There are no losses ever recorded in the largest sectors such as French, German or UK prime and buy-to-let. According to FitchRatings, only 0.25% of losses have been cumulatively realized on €3.23trn of European structured credit assets between 2000 and 2016, which equates to around 2bp per year.

In stark contrast to the famous horror stories of 2008, according to analysis from JP Morgan, the UK would require a housing crisis that inflicts 56 times the losses experienced than during the 1990s housing crisis (the largest one on record) before senior investors risk an irrecoverable loss.

STRUCTURED CREDIT – A RARE EXAMPLE OF HIGHER RETURNS FOR LOWER RISK?

Traditionally, in our view, investors expect that in order to achieve higher returns they must be comfortable with taking more risk. This assumption has been a cornerstone of portfolio theory since the original mean-variance models of the 1950s.

However, structured credit may turn this assumption on its head. We have seen that ABS markets offer higher credit spreads than comparable corporate bonds with lower credit ratings. An example of this is provided in Figure 4 – where AAA US CLOs offer comparable credit spreads to the US investment grade credit index, which is unsecured and today has a 50% weighting to BBB credit. AA and A rated CLOs have consistently offered materially higher spreads.

Where it went wrong:

<table>
<thead>
<tr>
<th></th>
<th>Default rates</th>
<th>Recovery rate</th>
<th>Loss rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK Prime RMBS (AAA / AA)</td>
<td>0%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>UK buy-to-let (AAA / AA)</td>
<td>0%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Dutch/Italian/Spanish RMBS</td>
<td>0%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>European CLO (AAA / BBB)</td>
<td>0%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>European auto/credit cards</td>
<td>0%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>US buy-to-let (AAA / AA )</td>
<td>0%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>US auto/credit cards (AAA / AA)</td>
<td>0%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Figure 3: The default history of structured credit may surprise you

<table>
<thead>
<tr>
<th></th>
<th>Default rates</th>
<th>Recovery rate</th>
<th>Loss rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK Prime RMBS (AAA / AA)</td>
<td>15.86%</td>
<td>50%</td>
<td>7.93%</td>
</tr>
<tr>
<td>CDO of US subprime RMBS</td>
<td>21.30%</td>
<td>50%</td>
<td>10.65%</td>
</tr>
<tr>
<td>European CMBS</td>
<td>2.52%</td>
<td>50%</td>
<td>1.26%</td>
</tr>
</tbody>
</table>

Figure 4: Top-rated US CLO spreads are well above lower-rated corporate credit

The structured credit ‘complexity premium’

We strongly believe the main reason structured credit can frequently offer higher credit spreads for higher credit ratings is due to complexity. It is a lot more onerous for a manager to invest in structured credit, which means there are fewer eligible buyers. Lower eligible demand leads to higher credit spreads.

When investing in corporate bonds, investors need to analyze the credit metrics of the company they are investing in. However, when investing in an ABS instrument they need to analyze every single underlying loan backing a deal. This takes a great deal of sophistication as well as specialist expertise and manpower.

Furthermore, as most of the loans underlying a structured credit instrument tend to be floating rate, pre-payable and extendable, investors would need to run mathematical stress tests to gain a good understanding of how they might perform under different economic stress scenarios.

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This requires sophisticated mathematical modeling techniques. Ideally, investors should be able to mathematically re-run historical recessions (such as the 2000s recession and the 2008 global financial crisis) as well as far more severe (and of course unprecedented) hypothetical stress scenarios to gain a good understanding of the risks.

Some assets, such as CLOs, pose further challenges. CLOs differ from more standard ABS in that the underlying loan pools are not static – instead they are dynamically managed by a dedicated portfolio manager.

This adds an additional layer of due diligence to investors’ research; evaluating the CLO portfolio managers, their historical performance, manager style, the manager’s platform, organization, resources, underwriting capabilities, as well as their portfolio construction and monitoring processes.

This is all in addition to the line-by-line analysis of all the loans the manager is investing in. Finally, when purchasing multiple CLOs, investors would also need to be wary of collateral overlap as different managers may own the same securities.

Figure 5: Analytical complexity can potentially provide higher spreads for equivalent credit risk

**THERE IS VALUE IN COMPLEXITY**

In a low yield world, it is challenging for investors to achieve attractive income without migrating up the risk spectrum. We believe in this environment structured credit stands out as compelling and fundamentally defensive.

At Insight, we have been managing global structured credit portfolios since before the 2008 financial crisis and have never suffered a default. On behalf of our large institutional clients we also invest in yet more complex related private structured credit markets, across the secured finance universe.

We believe that, if investors have access to skilled, experienced and well-resourced asset managers, then investing in structured credit could represent a strong opportunity to which they may be underexposed.

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SECURED:
- Assets or
- Designated cash flows

MATURITY:
- Short medium maturity: 3-8 years

BENEFITS:
- Structural protections
- Diversified collateral
- Covenants

FLOATING COUPON:
- Coupons change with short-term interest rates

COMPLEXITY PREMIUM:
- Structures require different analytical skills
- Barriers to entry for asset managers

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