NEW RULES, NEW OPPORTUNITIES:
A return to European ABS for insurers?

At the height of the global financial crisis, insurance company investors withdrew from the securitised debt market and sold down their asset-backed securities (ABS) holdings. But a decade on, new regulation offers the potential for securitised debt to re-emerge as an attractive investment opportunity for Solvency II-regulated insurers, believes James King, Fund Manager at M&G Investments.

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IN the wake of the crisis, insurance companies reduced ABS exposure in their portfolios, concerned by lack of confidence in the underlying assets that underpinned the securitisations. Their withdrawal accelerated with the announcement of revised Solvency II legislation, effective January 2016, which classified securitisations into Type 1 and Type 2 and imposed punitive capital requirements on insurers investing in most of the asset class in response to its perceived risk.

Three years on, however, in January 2019 the securitisation market received a welcome boost from the introduction of the Simple, Transparent and Standardised (STS) securitisation framework, designed to strengthen investor confidence in senior, high-quality European ABS. It is hoped that this will enable insurers who have waited on the sidelines for some time to re-engage with the asset class.

New regulation encourages re-engagement with ABS

The new regulation sets out a general framework for securitisation. It also creates a specific framework for STS securitisations, which benefit from preferential capital treatment for insurers, banks and investment firms.

STS aims to provide more consistency across investor types by replacing existing requirements with respect to insurers, Alternative Investment Funds and banks investing in securitised products, and introducing new requirements for UCITS and pension funds.

It also introduces a single set of regulatory requirements for investors' due diligence, as well as a direct requirement for risk retention and data transparency obligations on originators, sponsors or original lenders for new transactions. Institutional investors wishing to invest in securitisations will have to verify certain features and carry out specific due diligence activities. This includes thorough due diligence on the robustness of each individual transaction and brings the originator, sponsor and/or original lender into the scope of the investigations.

For insurers, securitised debt has the potential to offer compelling benefits including diversification from and a "complexity premium" over public bonds; secured, floating-rate returns; and liquidity, particularly at the senior end of the capital structure. They are secured by the cashflows of identified pools of assets in a variety of sectors, the largest asset class being residential mortgages.

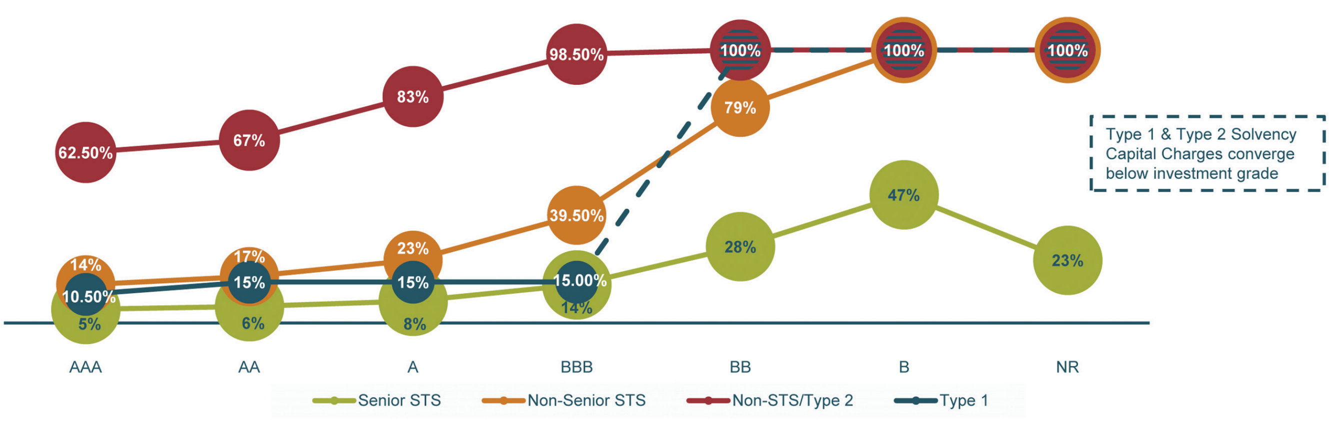
STS securitisations now also offer Solvency II-regulated insurers access to certain senior securitised debt at lower capital charges than the former high quality 'Type 1' ABS, and far preferable to the old 'Type 2' securitisations, as the chart below shows. Capital charges on the new STS securitisations are now similar to those on corporate bonds of comparable credit risk.

Market fundamentals support favourable outlook

We see value in both investment grade European ABS, and selectively in non-investment-grade bonds. Yield spreads across European ABS generally remain significantly elevated, above pre-crisis levels, despite significant tightening in other credit markets and a generally robust actual credit performance of these bonds since the crisis.

We believe current spread levels are not warranted by fundamentals in the

Solvency Capital Ratios of STS securitisations vs former Type 1 and Type 2



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

ABS market, given resilience in housing and commercial property markets in both the UK and mainland Europe, and we view spreads currently available as attractive for investors. Issuance in early 2019 was muted as the regulation on STS was not fully finalised until March. Demand greater than supply has exerted some downward pressure on spreads, but as the market becomes more comfortable with the STS concept there is some expectation that issuance will accelerate in the second half of 2019.

ABS remain attractive to insurance investors and not just because yield spreads have increased. UK consumer risk offers value as Brexit downsides appear to be overpriced in our view. Resilience of deals appears strong, with robust documentation helping to reduce impairment risks, while underlying collateral defaults remain low.

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From a risk-return perspective, both market opportunities seem compelling to us compared to other mainstream fixed income assets. The improvements in disclosure on the underlying assets and the greater robustness of deal structures than was commonplace prior to the crisis further support the market's attraction.

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