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RBC BlueBay
Asset Management

Insulate your portfolios this winter with Securitized Credit

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"Securitized Credit offers investors a compelling opportunity where bonds provide very high protection from defaults."

This winter looks set to be a harsh one for European consumers and businesses alike, as inflationary pressures and spiralling energy costs bite. These cost pressures could lead to an increase in defaults. Against this bleak backdrop, Securitized Credit offers investors a compelling opportunity where bonds provide very high protection from defaults.

Securitized Credit not only provides protection from defaults, but also offers protection against higher rates due to floating rate coupons. Bonds in Securitized Credit typically have shorter spread duration and higher yields versus other fixed income asset classes – and often yields are higher for significantly less credit risk.

Table 1 below shows indicative yields for Securitized Credit versus Corporate Credit to help frame the discussion; the attractive absolute and relative value persists across differently rated bonds. In this report we further explore the concept of protection against defaults.

Table 1: Indicative yields in Securitized Credit

Asset class		Average rating	Yield (Euro, hedged)	Weighted average life
Securitized Credit	High Grade	AAA	3-4%	1-2 yrs
	Investment Grade	AA	5-6%	2-3 yrs
	Sub-investment Grade	BB	12-15%	4-5 yrs
Corporates	Investment Grade	AA	2-3%	5-6 yrs
	Sub-investment Grade	BB	6-7%	4-5 yrs

Source: BlueBay, Bloomberg. Yields in EUR as at 1 September 2022. Investment Grade Corporates Index - ER20. Sub-investment grade corporates index HP10. Securitized Credit information based on indicative market data.

How does Securitized Credit protect against defaults?

Different collateral types and transactions offer protection in different ways, but in general there are two sources of protection:

1. **Protection from the underlying loan or asset**
2. **Protection from the securitization structure**

Below we outline the mechanics of how these protection methods work in practice.

Using a mortgage as an example, the first loss is absorbed by the borrower – they have put down a deposit and are the equity holder. If a borrower defaults on a mortgage, the lender can repossess the property (the collateral/asset in this case) and sell it to recover the outstanding loan amount and repay the loan as first priority. If the sales proceeds are insufficient, then a loss is created.

Table 2 shows how only small losses are generally created in "normal markets" as the property value is higher than the mortgage balance. This example shows that a 70% loan-to-value (LTV) mortgage might expect to have a loss of about 6% of the mortgage balance – or in other terms, the recovery is 94%.

Furthermore, in European markets, lenders typically have "full recourse" to individual borrowers – which means that if there is a loss, in this example £10,313, then the lender may pursue the individual for this amount in addition to repossessing the property. This further reduces the loss, which in many cases is zero.

In order for the loss to be more significant, a decline in house prices is required. In the second scenario in Table 2, it is demonstrated that a 40% decline in house prices would likely result in a loss of around 48% on a mortgage with 70% LTV today.

Table 2: Loss scenarios

Scenario	Normal market	House Prices down 40%
Property Value (A)	£250,000	£150,000
Mortgage Balance (B)	£175,000	£175,000
Loan-to-Value	70%	117%
Sales Proceeds:		
Forced Sale Discount (C)	25%	25%
Sales Proceeds (D = A x (1-C)%)	£187,500	£112,500
Repossession costs:		
Variable Sales Costs (E)	2%	2%
Fixed Sales Costs (F)	£20,000	£20,000
Total Costs (G = D x E + F)	£22,813	£21,688
Net Sale Proceeds (H = D - G)	£164,688	£90,813
Loss (I = B - H)	£10,313	£84,188
Loss severity (I / B)	5.9%	48.1%

Sources: BlueBay, LendInvest. The above information is provided for discussion purposes. There is no guarantee of the stated returns.

In the event that a loss is created, what happens then? This is where the securitization structure, the second method of protection, comes in and will typically have ample ability to absorb losses even in very stressed scenarios.

In the same way that the borrower absorbs the first losses on default on their mortgage, the junior bonds absorb any losses before the more senior bonds in a securitization. This means more senior bonds in effect have a dual protection.

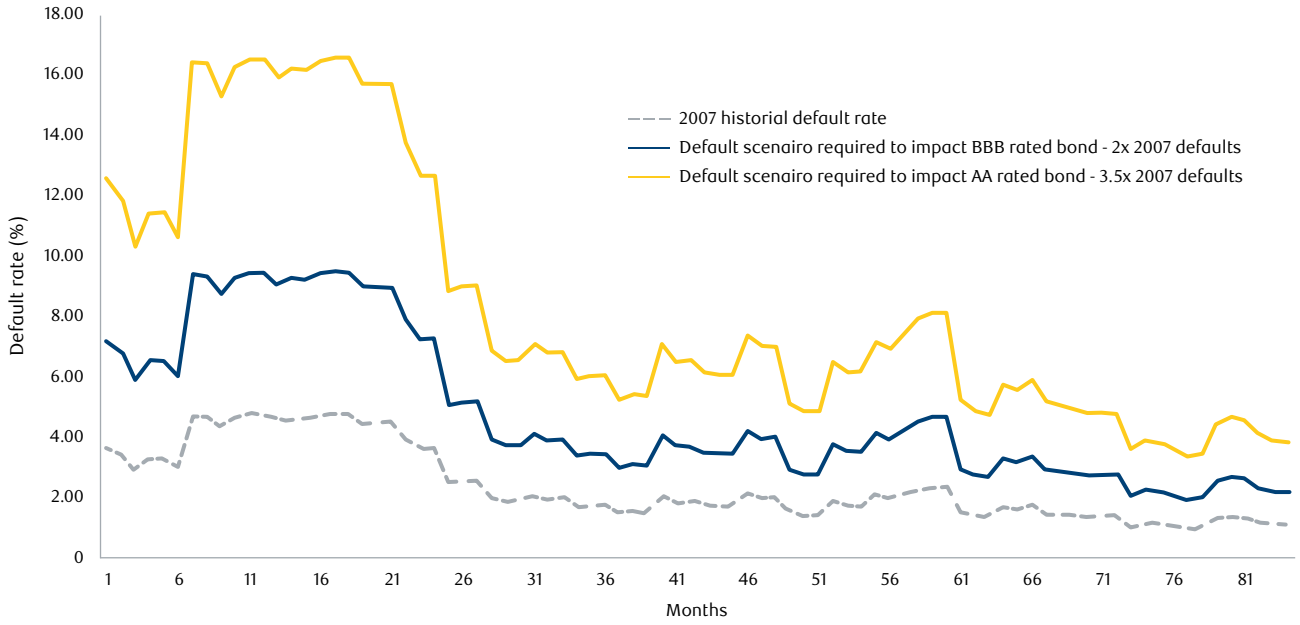
How many defaults can be absorbed?

Clearly this will depend on the seniority of the bond – but in short, the answer is a lot!

Sticking with our mortgage example, if we take the scenario in which house prices decline 40% then you would need to have defaults that are 2 times the levels that we saw in 2007 for a BBB-rated bond to take any losses and 3.5x for AA – and it's important to remember the standard of underwiring is much higher today than in 2007. In reference to Chart 1 – the chance of both of these things happening is very remote in our opinion. It is also worth noting that this example uses the UK mortgage market, which is in a particularly difficult position currently given the inflationary pressures being observed. The outlook for Europe in general is stronger and more extreme scenarios are required to impair bonds.

In conclusion, the protection against defaults is very high. This type of analysis can be extended to different collateral types and across different ratings. Significant protection is embedded for BB-rated tranches and once you move into high grade tranches the protection is extreme. Couple this with very attractive yields, an environment where these protections may well be needed and floating rate coupons to protect against higher rates, and we believe that the proposition for securitized credit is very compelling today.

Chart 1: Default scenarios



Sources: BlueBay, Moodys.

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