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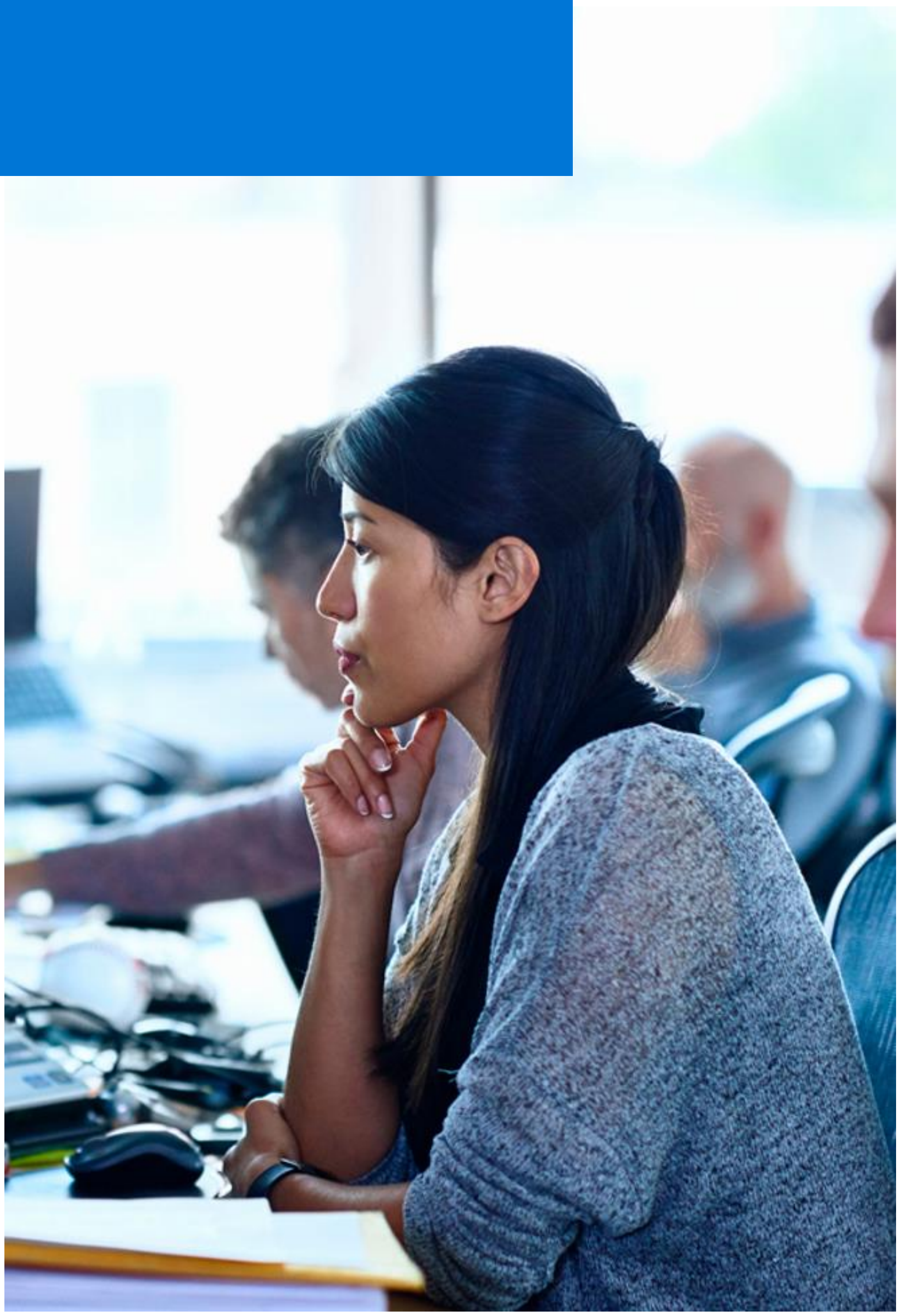
Debunking common myths about securitised credit



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Securitised bonds, often shrouded in complexity and financial jargon, have been a cornerstone of the US financial markets for decades. Despite their significance, these instruments are frequently misunderstood, giving rise to numerous myths and misconceptions. From the belief that they are inherently risky, to the notion that they were solely responsible for the 2008 financial crisis, securitised bonds are often viewed through a lens of scepticism and misinformation. This article aims to demystify these financial products, shedding light on their true nature, potential benefits, and the realities of their risks. By debunking common myths, we hope to provide a clearer understanding of securitised bonds and their role in the broader financial ecosystem.

Myth 1 – "I don't trust the ratings. Securitisation turns low-quality bonds into high-quality bonds – that's not possible".

The world of securitised bonds is often clouded by misconceptions, one of the most prevalent being the distrust in the ratings. This myth suggests that securitisation magically transforms low-quality assets into high-quality bonds, which is fundamentally inaccurate. This misconception overlooks the structured financial engineering involved in redistributing risk among different classes of investors.

Securitisation involves pooling various financial assets, such as mortgages or auto loans, and issuing new securities backed by these assets. The process is designed to manage and redistribute risk, not to magically improve the quality of the underlying assets. By employing credit enhancements such as subordination, overcollateralisation, and excess spread, issuers can create securities that meet the needs of different investors while maintaining a robust credit profile.

Subordination (credit tranching): This technique aims to be a form of structural protection and involves structuring the securitised bond into different tranches, each with varying levels of risk. Junior bondholders and equity holders, who hold the lowest tranches, are the first to absorb losses from defaults on the underlying loans. This helps to protect the senior tranches, which are typically considered safer investments. By apportioning losses in this manner, issuers can cater to different investor risk appetites and seek to enhance the overall credit profile of the security.

Overcollateralisation: This involves providing excess collateral beyond the value of the issued securities. The excess collateral acts as a buffer against potential losses, meaning that bondholders can be shielded even if some of the underlying assets default. Overcollateralisation is a common practice in securitisation, providing an additional layer of potential security for investors.

Excess spread: This refers to the difference between the interest received on the underlying collateral (such as mortgage interest rates) and the interest paid on the securities (including any transaction costs). The excess spread can be used to help absorb losses or build overcollateralisation to its target level.

Ratings agencies play a critical role in the securitisation process by assessing the creditworthiness of the issued securities. While it is true that ratings are not infallible, they provide a valuable benchmark for investors to gauge the risk associated with different tranches. The distrust in ratings often stems from the 2008 financial crisis, where some highly rated securities defaulted. However, it is important to recognise that ratings are based on extensive analysis and are one of many tools investors should use when evaluating securitised bonds.

Myth 2 – "Securitised bonds caused the global financial crisis. If it happened once, then it can happen again".

Securitised bonds are often linked to the 2008 global financial crisis (GFC), causing some investors to avoid them. While there is some truth to this association, it oversimplifies the issue. The crisis was caused by a mix of factors, including low interest rates, risky lending practices and inadequate regulation.

In the early 2000s, the US experienced a period of ultra-low interest rates, which spurred a housing boom and increased mortgage lending, including subprime mortgages. Most US subprime mortgages issued in the period leading up to the GFC were adjustable-rate mortgages (ARMs). These ARMs started with low initial interest rates that later reset to higher rates, making them initially affordable but vulnerable to rising rates. Additionally, many subprime mortgages were issued with inadequate documentation and were often based on self-certified income, also known as 'stated income'. The combination of lack of income verification and a rising interest rate environment created the ideal conditions for financial instability, culminating in the GFC.

The GFC highlighted several significant deficiencies in securitisation rules, such as lax underwriting standards, misaligned incentives between originators and investors, and lack of transparency about the underlying assets. This led to widespread reforms, principally under the Dodd-Frank Act. Prior to the Dodd-Frank Act, there was a misalignment of incentives. The act aims to reduce this moral hazard and improve the quality of securitised assets by ensuring that originators and sponsors maintain a stake in the performance of the assets they securitise. Under the act, issuers of securitised bonds (except for very high-quality issuers such as government-sponsored enterprises) are required to retain at least 5% of the credit risk of the assets they securitise. This helps prevent the securitisation of poorly underwritten loans.

Before the GFC, originators often lowered underwriting standards because they could quickly sell off the loans through securitisation. The Dodd-Frank Act introduced several measures to tighten underwriting standards for mortgage-backed securities (MBS), including limits on debt-to-income ratios and requirements for verifying the borrower's ability to repay. Regulatory bodies like the US Securities and Exchange Commission (SEC) were also given stricter oversight and enforcement powers to impose penalties and take corrective actions against institutions that fail to comply with the higher standards.

The Dodd-Frank Act also led to significant changes in loan-level data disclosure requirements to enhance transparency and help investors better assess risks. Issuers of asset-backed securities (ABS) are required to provide detailed, standardised information about each loan or asset in the securitisation pool. Enhanced disclosure requirements help reduce information asymmetry between issuers and investors, build trust in the market, and lead to more informed investment decisions. Ultimately, issuers are held more accountable for the quality of the loans they securitise, which helps to contribute to a more stable and trustworthy securitisation market.

While securitised bonds did play a role in the GFC, the regulatory landscape has changed significantly since then. The Dodd-Frank Act and other reforms have addressed many of the deficiencies that contributed to the crisis. Today, we believe securitised bonds can still offer value, provided investors understand the changes and approach the asset class with informed caution. The myth that securitised bonds are inherently dangerous overlooks the significant improvements in regulation and market practices that have been implemented since the GFC.

Myth 3 – "Securitisation only benefits financial institutions. It's too complex for average investors to understand".

Contrary to the belief that securitisation only benefits financial institutions, it actually offers advantages to a wide range of stakeholders, including investors, borrowers and the broader economy. For lenders, securitisation provides liquidity, allowing them to free up capital and extend more loans. This process helps financial institutions manage their balance sheets more effectively and supports continuous lending activities.

At its core, securitisation is the process of pooling various types of debt – such as mortgages, auto loans, or credit card debt – and selling them as consolidated financial instruments to investors. This provides access to capital/financing and serves as a risk transfer mechanism from the lender to the investor. These debts are combined into a single pool, which serves as the collateral for the new securities that will be issued. This pool of assets is then transferred to a special purpose vehicle (SPV), a separate legal entity created specifically for this purpose. The securities issued are essentially bonds backed by the cashflows generated from the underlying assets. These are then sold to investors in the financial markets.

A key feature of securitisation is the division of the securities into different tranches. Each tranche represents a slice of the total pool of assets and carries a different level of risk and return. The tranches are typically structured in a hierarchy, with senior tranches having the highest priority for receiving payments from the underlying assets. This structure allows investors to choose tranches that match their risk tolerance and investment goals, providing a tailored investment opportunity.

For investors, securitisation provides an opportunity to invest in a diversified pool of assets, which can help spread risk. Areas of diversification can also include underlying borrowers, geography, asset type and industry. By selecting tranches that align with their risk preferences, investors can build portfolios that meet their specific needs. For originators, securitisation offers a way to free up capital and improve liquidity, enabling them to extend more loans and support ongoing lending activities.

By pooling various types of debt and issuing securities, securitisation helps redistribute risk and provide investment opportunities across different risk levels. Understanding these basics can help demystify securitisation and highlight its role in the financial markets.

Investors benefit from securitisation by gaining access to a diverse range of investment opportunities. Securitised bonds can offer attractive returns and portfolio diversification, as they are backed by various types of assets. By investing in different tranches, investors can choose securities that match their risk tolerance and investment goals.

Borrowers also gain from securitisation. By enabling lenders to extend more credit, securitisation can lead to lower borrowing costs and increased availability of loans. This can be particularly beneficial for consumers seeking mortgages, auto loans, or other types of credit.

Overall, securitisation plays a crucial role in the financial system by enhancing liquidity, providing investment opportunities, and supporting credit availability. Understanding these potential benefits can help dispel the myth that securitisation only serves financial institutions and highlight its broader economic impact.

Securitisation: offering a number of potential benefits

In this article, we've debunked several myths surrounding securitisation, highlighting its crucial role in the financial system. Securitisation is not just a tool for financial institutions; we believe it offers significant benefits to a wide range of stakeholders, including investors and borrowers. By pooling various types of debt and issuing asset-backed securities, we believe securitisation has many potential benefits such as diversification, credit enhancement, structural protections, and a broader access to fixed income investment opportunities. In our view, the regulatory environment today is much safer than in the past, thanks to reforms like the Dodd-Frank Act, which have improved transparency, underwriting standards, and risk retention. Understanding these potential benefits helps dispel the myths and underscores the true value of securitisation in a stable and efficient financial market.

For more detailed information on how securitised assets could benefit your investment strategy, please reach out to us. Our specialised securitised credit team is ready to provide expert support.

Securitised strategies at Legal & General Asset Management

Our dedicated team of securitised specialists is committed to selecting assets for both the US Securitised Fund and the US Securitised Plus Fund. Securitised assets are also integral to our Buy & Maintain portfolios, available in both pooled and segregated formats, catering to institutional investors such as pension schemes and insurers.

Key Risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested. Past performance is not a guide to future performance.

Important Information