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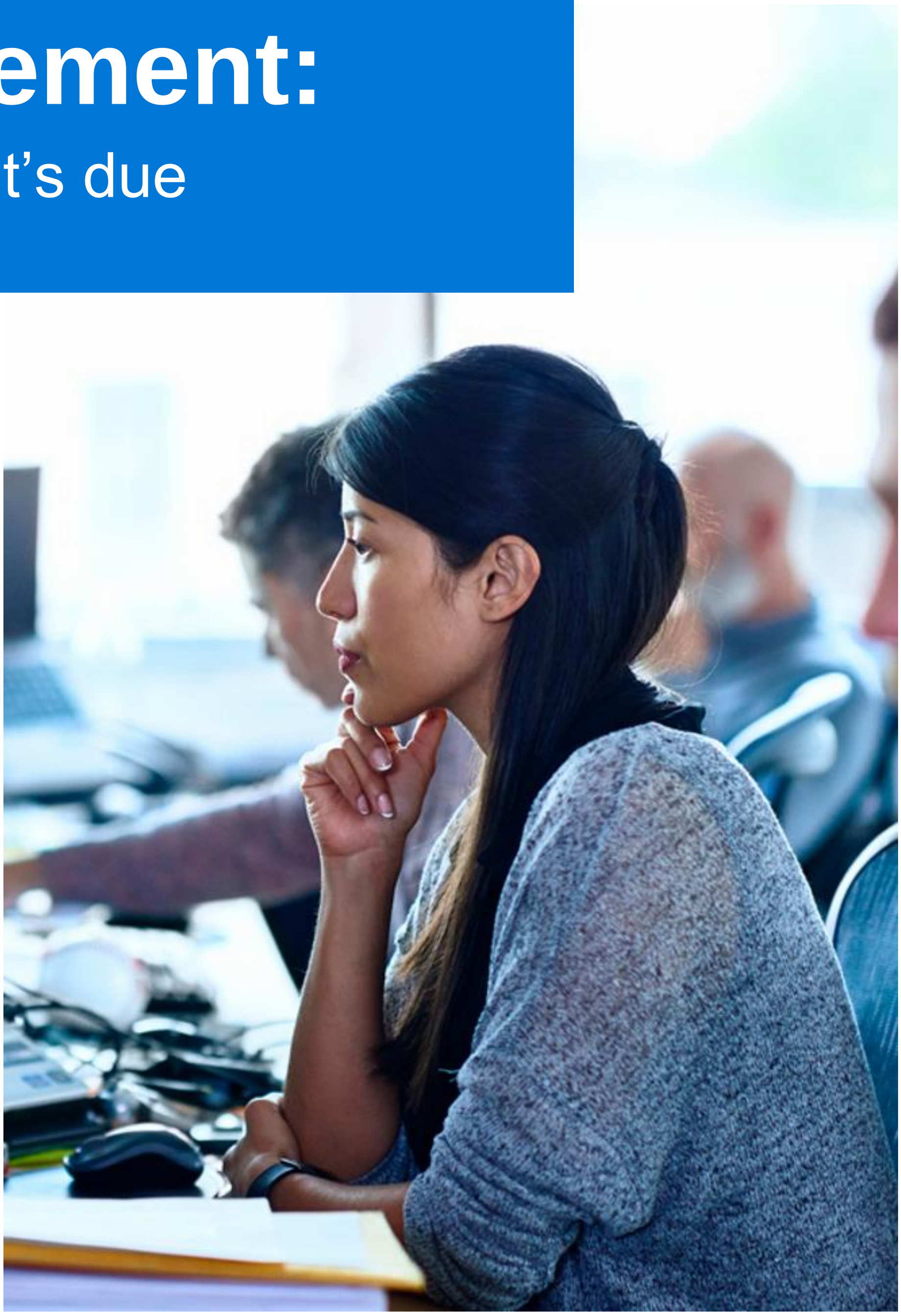
Securitised credit enhancement:

Credit where it's due



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The role of credit enhancement in bond securitisation is an important concept to understand as it aims to help senior bondholders mitigate potential losses in the underlying assets. It refers to a variety of methods employed in structuring transactions to help mitigate risks for certain investors.

The process of securitisation is not 'investment alchemy' in which low-quality credit assets 'magically' transform into higher-quality assets. Instead, it's a risk transfer technique that seeks to mitigate losses in stressed scenarios for risk-adverse investors holding senior tranches.

Types of credit enhancement.

The core principle of credit enhancement is that it builds more financial backing into certain tranches of a security than would otherwise be the case. The main types of credit enhancements are:

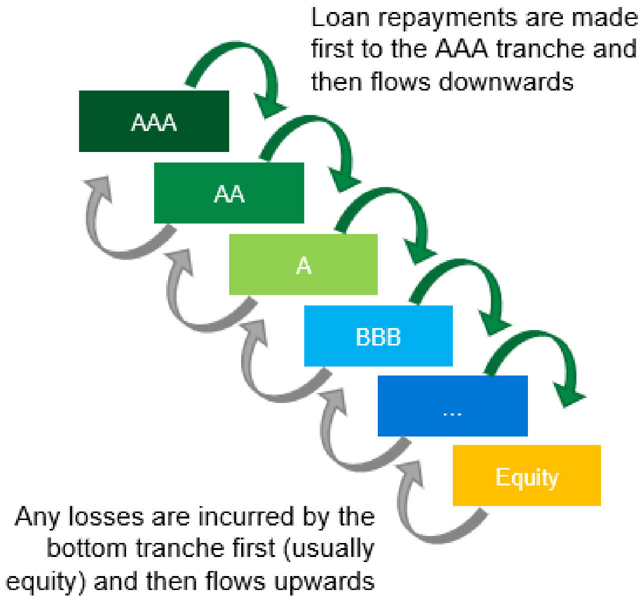
- **Subordination:** This is the process of dividing up and sharing losses. Junior bond holders in the securitisation structure absorb losses from defaults on the underlying loans first, helping to protect senior bonds. Subordination means that lower-rated junior bonds serve as credit support for the higher-rated senior bonds
- **Over collateralisation:** This is the process of providing collateral that exceeds the value of the loan or security when issued. This excess collateral acts as a buffer against potential losses for the bondholder. For the issuer of the securitised asset, the potential benefit is that it can lead to higher credit quality and more favourable borrowing terms
- **Excess spread:** This refers to the difference between the interest received on the underlying collateral (such as such as a mortgage interest rate) and the interest paid on the securities. The excess spread can then be used to absorb losses or build over collateralisation to its target level

How does subordination work?

In a conventional securitised bond, the underlying assets (such as mortgages, auto loans, or credit card receivables) are pooled together and then divided into different sections called tranches. Each tranche represents a different level of potential risk and return for the end investor.

- The **senior tranche** in securitised bonds typically receives the highest credit ratings, often AAA or AA. These high ratings reflect the lower risk associated with senior tranches, as they have the first claim on the cashflows from the underlying assets and are the last to absorb any losses
- **The mezzanine tranche** is in the middle of the capital structure. It typically has a credit ratings from A to BBB. The mezzanine tranche absorbs losses only after the junior tranche is exhausted
- **The junior / equity tranche**, also known as the subordinated or equity tranche, typically receives the lowest credit ratings due to its high risk. Bondholders here have the last claim on the underlying cashflows and are the first to absorb any losses from the underlying assets, making it the riskiest tranche. These ratings often fall into the BB or B categories

Subordination illustration



Source LGIM. For illustrative purposes only

We can use a hypothetical example to demonstrate the principle of tranche loss absorption. Let's imagine a commercial mortgage-backed security (CMBS) made up of 500 mortgages each worth $1m each. The total value of these mortgages is $500 million. There are three tranches:

- Senior tranche: $350 million (70% of the total pool)
- Mezzanine tranche: $100 million (20% of the total pool)
- Junior tranche: $50 million (10% of the total pool)

Let's assume that 5% of the mortgages default, resulting in a loss of $25 million. The junior tranche will absorb all these losses as they are the first to absorb any losses. In this scenario the mezzanine and senior tranches are unaffected.

Let's now assume a different scenario in that 15% of the mortgages default, resulting in a loss of $75 million – a highly unlikely scenario. The junior tranche valued at $50m would be wiped out – 100% loss rate. The mezzanine tranche, next in the loss absorption waterfall would absorb $25 million of losses or a 25% loss rate. As with before, the senior tranche remains unaffected, and they receive their expected payments with no losses as the losses have been absorbed subordinated tranches.

This simplified example illustrates how tranching helps distribute risk among different classes of investors, allowing them to choose investments that match their risk tolerance and return objectives. However, it is an example only and not a guaranteed outcome.

What have been the realised loss rates for holders of senior paper?

So that's the theory. Let's look at some actual realised loss rates for difference tranches, using US CMBS as an example.

CMBS tranche support

The table details the breakdown of impairments by original rating and region of issuance from 2009 to 2023 for various securitised assets.

Material impairments by original rating and sector

Principal impairments

Original rating	US ABS	US RMBS	US CMBS	Global CDOs ex CLOs	Global CLOs	EMEA SF ex CDO & Other	Intl SF ex CDO & Other	Other SF	Total
Aaa	0	0	0	0	0	0	0	0	0
Aa	0	0	2	0	0	0	0	0	2
A	0	0	5	0	0	0	0	0	5
Baa	0	0	15	0	1	0	0	0	16
Ba	2	0	35	0	10	0	1	0	48
B	5	0	42	0	15	3	2	0	67
Caa	0	0	3	0	0	3	5	0	11
Total	7	0	102	0	26	6	8	0	149

Interest impairments

Original rating	US ABS	US RMBS	US CMBS	Global CDOs ex CLOs	Global CLOs	EMEA SF ex CDO & Other	Intl SF ex CDO & Other	Other SF	Total
Aaa	0	0	0	0	0	0	0	0	0
Aa	0	0	0	0	0	0	0	0	0
A	0	0	2	0	0	0	0	0	2
Baa	0	1	0	0	0	1	0	0	2
Ba	1	1	1	0	3	0	0	0	6
B	0	2	0	0	4	5	0	0	11
Caa	0	0	0	0	0	4	0	0	4
Total	1	4	3	0	7	10	0	0	25

Source: Moody's Ratings

Source Moody's, Impairment and loss rates of structured finance securities: 2009-2023.

Since 2009 through to the end of 2023, US CMBS principal impairments total 102 and interest impairments total three. Impairments here refer to defaults, but it is worth nothing that even when these payments do default, there is typically some form of recovery payment (also known as the recovery rate) for the more senior tranches. There has been only one Aaa-rated US CMBS which incurred principal impairment over the period. The tranching protected the most senior bond holders.

Seeking to enhance creditworthiness

In summary, credit enhancement in securitised bonds, particularly through tranching, is a method that seeks to improve the creditworthiness of the securities and help protect senior investors from potential losses. By structuring the securitised bond into tranches, issuers can cater to different investor risk appetites and aim to enhance the overall credit profile of the security.

As with all forms of credit investing, security research is of paramount importance. At L&G, we undertake extensive due diligence and research when we invest and throughout the lifetime of our holding. And we typically invest in the senior and sometimes mezzanine tranches.

Securitised strategies at L&G

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.

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