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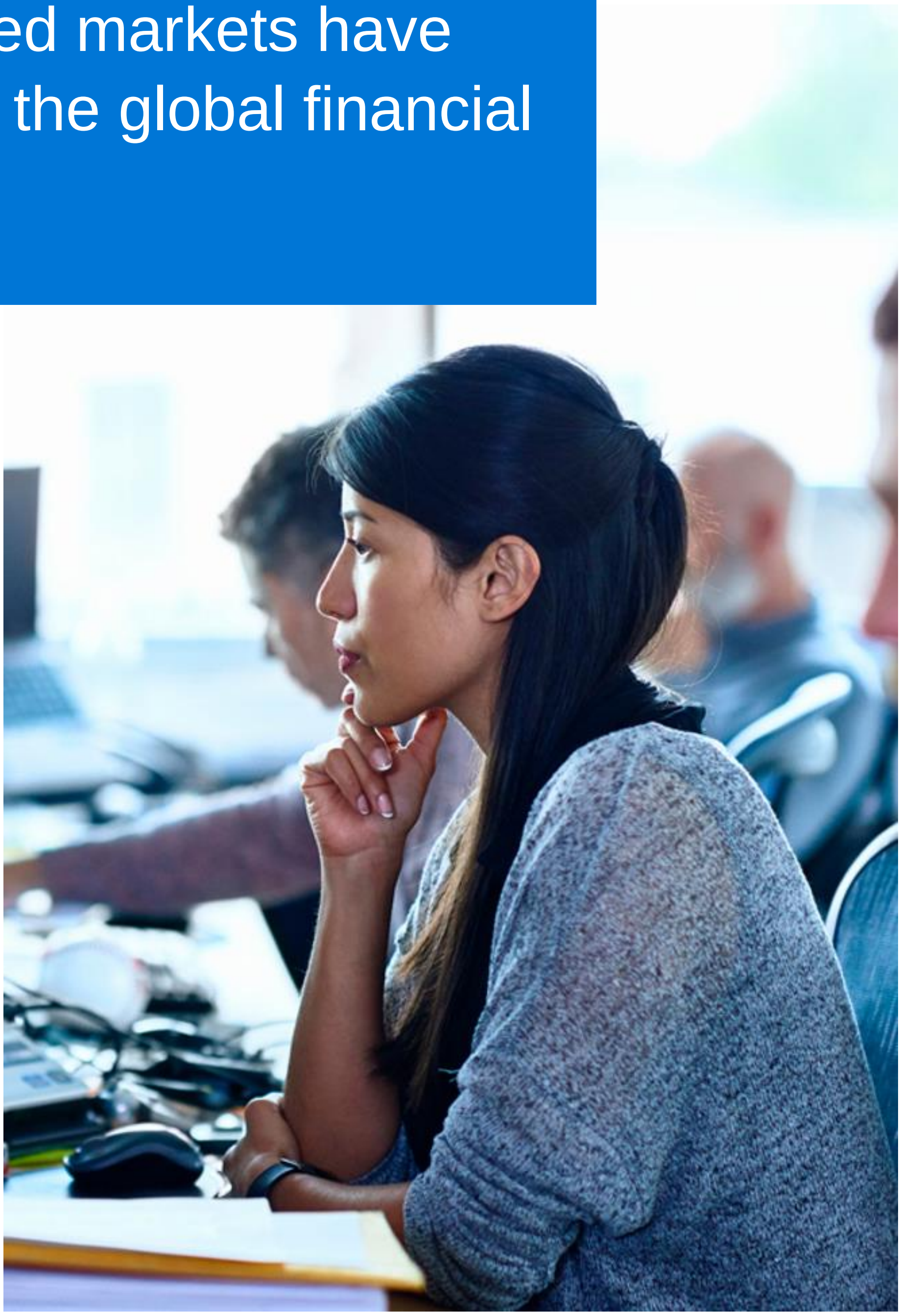
From crisis to confidence

How securitised markets have evolved since the global financial crisis



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The global financial crisis (GFC) highlighted several significant deficiencies in the securitisation rules. It had a profound impact on the US securitised market, leading to widespread reforms in regulation and market practices. Despite this, some investors still associate securitised bonds with the 2008 crisis and avoid this asset class. However, the landscape has significantly changed since then. In our opinion, with improved regulations and market practices, securitised bonds now offer valuable opportunities for informed investors. Understanding these changes could help investors recognise the potential benefits of diversification[1] and yield enhancement that securitised bonds can provide in an investor's portfolio today.

The conditions that led to the subprime crisis

In the lead up to the GFC, the market backdrop was characterised by relatively low interest rates and a surge in economic optimism. In response to the early 2000s recession and the aftermath of the dot-com bubble, Federal Reserve Chair Alan Greenspan significantly lowered the federal funds rate. By 2003, the rate was reduced to 1%, the lowest level in 50 years. This policy spurred a housing market boom, driving up house prices and creating a 'wealth effect', where homeowners felt wealthier and spent more. The low interest rates and housing boom led to a surge in mortgage lending, including subprime mortgages.

Approximately 80% of US subprime mortgages issued during this period were adjustable-rate mortgages (ARMs). These ARMs typically started with low initial interest rates that would reset to higher rates after a few years. While initially affordable, these loans became more vulnerable to higher interest rates. The resetting of these adjustable rates was a major factor contributing to the wave of defaults and foreclosures that triggered the financial crisis.

Additionally, many subprime mortgages were issued with inadequate documentation and were often based on self-certified income, also known as 'stated income' This meant that borrowers could state their income without providing proof, and lenders did not conduct adequate due diligence. These loans were then bundled into residential mortgage-backed securities (RMBS) and sold to investors. The combination of lack of income verification and a rising interest rate environment created the conditions for financial instability, culminating in the GFC.

The GFC exposed several significant deficiencies in securitisation practices, such as lax underwriting standards, misaligned incentives between originators and investors, and a lack of transparency about the underlying assets.

[1] **It should be noted that diversification is no guarantee against a loss in a declining market.**

Following the GFC, there have been major areas of change

Less financial engineering and synthetic products

Securitised transactions today are primarily collateralised by first lien, senior secured loans on income producing assets. The first lien position means it has the first priority claim on collateral which is secured by a physical, income-producing asset.

There is also no longer the use of synthetic securitised products and transactions that theoretically mimic the performance of cash bonds, which has improved transparency and simplicity in the securitised market.

Tranche sizes have widened

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 investment opportunities called tranches.

Tranche sizes today are thicker, allowing for better attachment and detachment points. Tranche sizing does not include individual tranches for every ratings subcategory below AAA (i.e. AA+, AA, AA- and so on). Now for example, we typically tend to have one ratings tranche at the AA band (vs. AA+/AA/AA- that create smaller tranche sizes with less credit enhancement). The same applies for the lower credit ratings.

Fewer, larger-sized tranches offer several advantages in our view. They simplify the structure for investors, allowing investors to easily identify investible tranches post underlying asset due diligence. They can also improve market liquidity and efficiency by making the buying and selling of these securities more simple and transparent.

Increased transparency

Industry governing bodies such as the Structured Finance Association (SFA) and the Commercial Real Estate Finance Council (CREF) have developed reporting frameworks allowing for transparent and timely dissemination of information for investors to perform due diligence. These organising bodies have also established proper lines of communication between trustees / servicers of securitised assets and investors.

Improved underwriting standards

Before the GFC, originators often lowered underwriting standards because they could quickly sell off the loans through securitisation. Since then, underwriting standards have become more conservative and transparent. Issuers and originators of loans now provide clearer assumptions. Rating agencies also collaborate more closely with the investment community, seeking and incorporating feedback on any model or sector changes.

Regulatory bodies, such as the US Securities and Exchange Commission (SEC), have been granted stricter oversight and enforcement powers. They can now impose penalties and take corrective actions against institutions that fail to comply with these higher standards.

Risk retention (i.e. 'skin in the game')

Prior to the GFC, there was a misalignment of incentives, with originators having little incentive to ensure the long-term performance of the loans. The implementation of the Dodd-Frank Act, among other regulations, has helped make issuers and originators of loans more accountable regarding the collateral they use for securitisations.

The Dodd-Frank Act aimed 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.

Increased disclosure requirements

The Dodd-Frank Act 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. This includes data on the credit quality, terms, and performance of the underlying loans. The US Regulator, the SEC, has defined specific data points that must be disclosed, such as loan terms, interest rates, borrower credit scores, and payment histories. Loan-level data must be updated and reported on an ongoing basis, not just at the time of securitisation. The data must be made freely available to investors and provided in a tagged, computer-readable format for easier analysis and comparison.

Enhanced disclosure requirements can help to reduce information asymmetry between issuers and investors, build trust in the market, and can lead to more informed investment decisions. Ultimately, issuers are held more accountable for the quality of the loans they securitise, which could collectively contribute to a more stable and trustworthy securitisation market.

A reformed market?

Since the GFC of 2008, the securitised market has undergone significant reforms. The Dodd-Frank Act has been pivotal in addressing key deficiencies. One major reform is risk retention, or 'skin in the game', which requires issuers to retain at least 5% of the credit risk of the assets they securitise. This ensures that originators have a vested interest in the long-term performance of the loans, reducing the likelihood of poorly underwritten loans. Improved underwriting standards and increased disclosure requirements have significantly enhanced transparency.

These reforms have created a more stable and trustworthy securitisation market. For investors, we believe this means securitised bonds now potentially offer a more transparent investment opportunity with enhanced liquidity and a diverse range of options. Understanding these benefits could help investors appreciate the value of securitisation in today's financial markets.

For more detailed information on how securitised assets could form part of your investment strategy, we invite you to reach out to us. Our specialised securitised credit team is ready to provide 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.

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