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Covid-19 and European asset-backed securities

Stress testing demonstrates resilience of asset class

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- Intensively stress testing ABS to assess their potential resilience to a range of extreme negative scenarios has been integral to our investment approach for decades.
- In light of the extreme price moves in European ABS, our analysts have applied Covid-19 specific stresses to a number of UK RMBS and European CLOs, to identify the combination of factors that would have to occur for us to lose the first pound of principal investment.
- The outcomes of these tests illustrate the robustness of these assets to repay at par even under worst-case scenarios that assume default, prepayment and recovery rates on a scale never previously experienced in either the UK or Europe.

European ABS: resilience under stress

Stress testing on ABS in all sectors is integral to our approach to this asset class. Both during and since the global financial crisis (GFC) we have used stress tests to demonstrate how the assets we acquire would perform should multiple variables trend in exceptionally negative directions for long periods of time.

In light of the extreme price moves in European ABS in recent weeks, our analysts have applied Covid-19-specific stresses to a number of UK residential mortgage-backed securities (RMBS) and European collateralised loan obligations (CLOs) we are currently able to source.

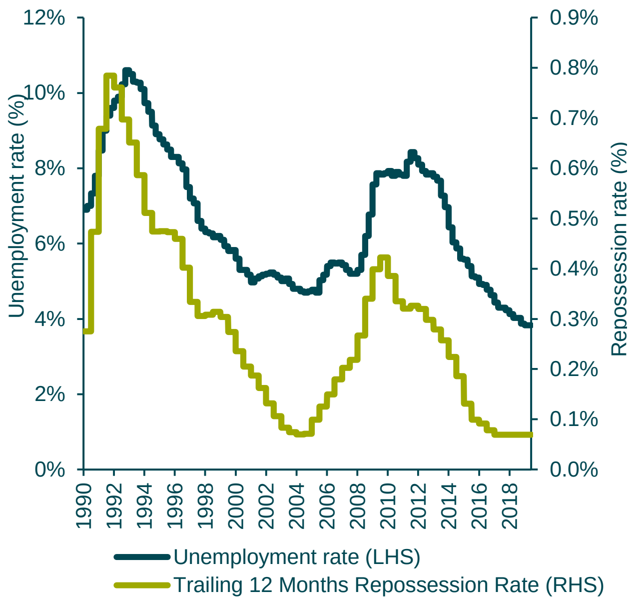
Our break-even stress test seeks to identify the combination of factors that would have to occur for us to lose the first pound of principal investment on an asset.

Examples of these results are below and in our view highlight the robustness of these assets under even extreme macroeconomic pressures.

The UK RMBS sector

UK RMBS in general performed very well through the GFC, proving the defensive ability of this sector to withstand periods of prolonged economic stress.

Figure 1. UK repossessions below 0.78% since 1990s



Source: Bloomberg, Council of Mortgage Lenders, as at 31 December 2019

Historical UK residential repossessions peaked at 0.78% per annum in the early 1990s – and even during the GFC the repossession rate peaked at only 0.42% p.a.

Since the crisis, greater structural features have further enhanced the defensive capability of the RMBS sector, with higher credit enhancement levels per rating band and larger call incentives (step-up coupons) for issuers to call deals at the first option.

It is also worth highlighting the much tighter mortgage underwriting standards with regard to the underlying loan pools following the GFC.

Stress test example 1: CCMF 2017-1 B RMBS

This is a second-pay tranche in a typical UK RMBS, originated by Charter Court Financial Services Ltd.

The underlying collateral consists of first lien mortgages on residential properties, with a current weighted average loan-to-value (LTV) of 64% as of March 2020. Features in the deal such as sequential amortisation contribute to the natural build-up of credit enhancement.

Applying our break-even stress test, we have modelled a worst case scenario of an immediate and sustained 40% house price decline in the UK, and a three and six month mortgage holiday for the entire loan pool, where prepayment speeds also fall dramatically from approximately 30% to 5%.

This is illustrated in Figure 2 below.

From it we can observe the constant default rate (CDR) – effectively the rate of repossessions on the loans in the pool – needs to reach unprecedented levels of close to 50% for four years and reverting to a long term rate of around 10%, in order for an investor in this bond to begin to incur a loss of principal. This is in context of a historical peak of 0.78% in the early 1990s, a period when the UK had double-digit interest rates.

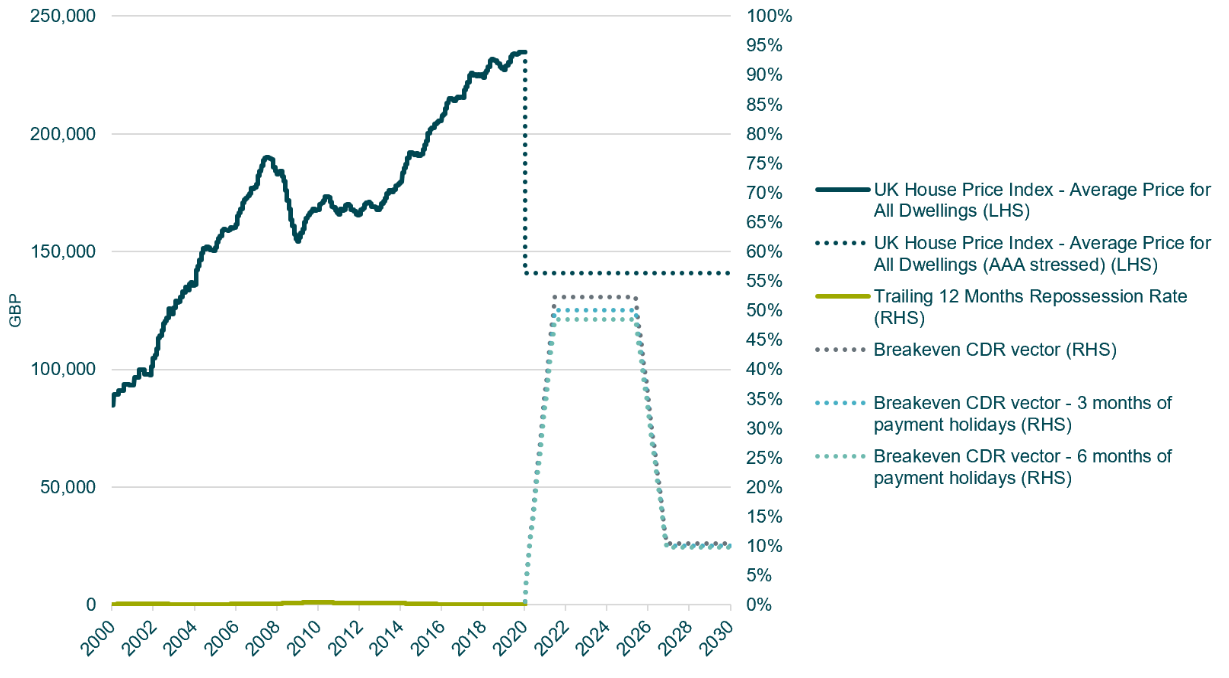
Stress test example 2: CLO AA tranche

Leveraged loan defaults are currently running at less than 1% p.a. A normal pricing base case for a CLO would be around a 20% constant prepayment rate (CPR), a 2% annual default rate (CDR) and a conservative 50% expected recovery rate.

We took the example of BECLO 3X B, an AA/Aa2 rated CLO. Our analyst team applied a Covid-19 stress scenario of increasing defaults – specifically, a 5% CDR for the first six months, 7.5% from months six to twelve, and a 2% CDR thereafter for the remaining life of the deal – coupled with no prepayments at all for six months and only a 5% CPR thereafter. Recoveries were assumed to only be 30%.

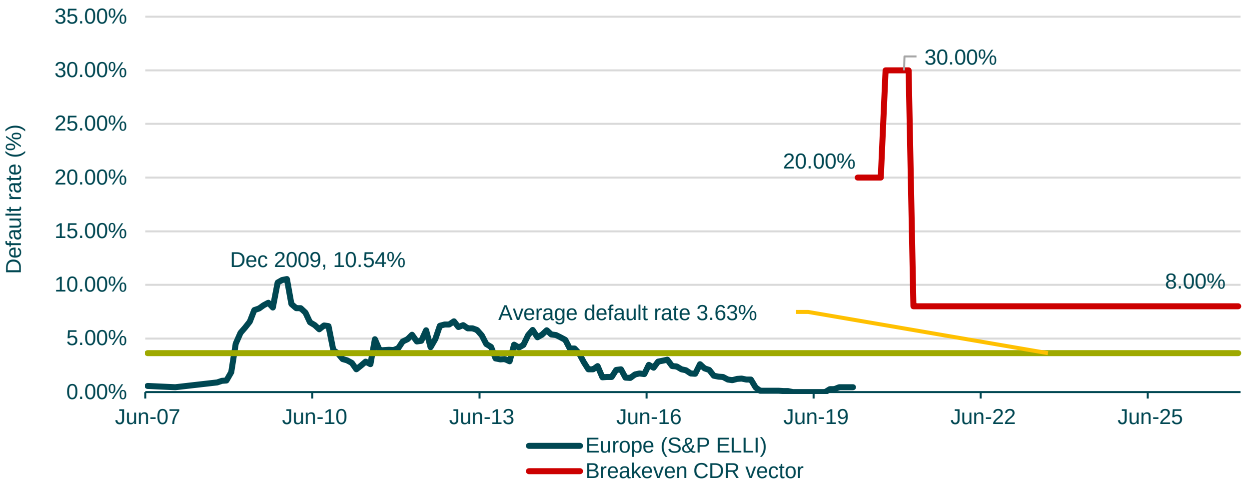
In addition, we assume underlying loan downgrades to CCC accounts for 12% of the pool for the first 6 months, 10% for months six to twelve, and 8% CCC thereafter, with 50% of market value.

Figure 2. Break-even stress test on UK RMBS tranche



Source: M&G, Bloomberg, Intex, CCMF 2017-1, as at 23 March 2020. Note: CDRs are annualised figures.

Figure 3. Break-even stress test on AA CLO tranche



Source: M&G. BECLO 3X. CPR: Constant prepayment rate. CDR: Constant default rate.

This specific default stress was calibrated by examining the portfolio for assets likely to be most negatively affected by current events, while the CCC stress was informed by how agencies reacted during the GFC.

The outcome is illustrated in Figure 3 overleaf. This scenario would result in no loss of principal to the AA tranche.

Finally, we ran an additional Covid 19 stress, in which on top of all the above, we defaulted all collateral trading below 70 cash price with a recovery of 25% less than the current market value. This resulted in a 13.5% default rate for this pool – and again, the bond is unimpaired.

Only by increasing defaults to 20% p.a. for the first six months, followed by 30% p.a. for the next 6 months and with a long-run annual default rate of 8% p.a. thereafter, do we reach the break-even point in our cashflow model.

Given that certain CLOs such as the one in this example are trading at around 80% to 85% of par at present, the spreads offered of around 450-500 basis points over Euribor appear very attractive in our view given its credit resiliency.

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