Covid-19: The effects on the securitisation sector

TJ Durkin, head of structured credit at Angelo Gordon explores the immediate and longer-term effects of the pandemic on securitization markets

Since the Global Financial Crisis (GFC), structured credit markets have often been described as "resilient" given conservative underwriting and collateral fundamentals over that period. Household leverage has considerably declined, and debt-service sits near historic lows – in stark contrast to corporations which sharply re-levered post- GFC. Resiliency paid-off well in the wake of the pandemic as the initial rapid decline in asset values was largely technical. However, unlike the GFC, these markets did not "break," and, on the contrary, issuance volumes have now reached post-GFC heights. Nevertheless, the pandemic has unquestionably impacted the securitisation sector in several ways, some of which may be long-lasting.

In March 2020, significant outflows from daily liquidity fixed-income funds created a "run on the bank" effect, putting selling pressure on higher-quality securities before the stress eventually worked its way down the capital structure. This forced selling quickly overwhelmed the structured markets and resulted in a liquidity vacuum, coinciding with the near total shutdown of the economy. A coordinated effort between government and the private sector stabilized households with multiple forms of stimulus. Armed with excess cash, and, in many cases, the flexibility to choose which debts to service, households took advantage of payment deferment options in mortgages and other debts. As local economies reopened, collateral fundamentals were further supported.

The resilience of structured credit during *this* crisis was rooted not only in these accommodations, but also the strong underwriting in the prior decade, which established the foundation for resilient underlying asset values and limited losses. National home prices soared as household demand for single-family homes organically grew while supply was constrained due to limited existing listings, foreclosure moratoriums and a general shortage of labor and material. Autos have had similar supply issues also leading to record high prices. These factors have limited actual losses in bonds backed by those assets and have created positive momentum in structured credit products and securitisation markets more broadly.

Market participants were quick to realise these dynamics, and spreads quickly tightened from wide levels seen at the onset of the pandemic. For example, AAA- and BBB-rated subprime auto ABS were widest in the early weeks of the pandemic nearly 10x and over 7x of their year-end 2019 levels, respectively. However, by the end of July 2020, the AAA tranches had largely recovered, and by the end of January 2021, spreads had fully retraced to their pre-pandemic levels.

Yet, while this fundamental performance has been well-received by market participants, we believe it is unlikely to persist as the impact of stimulus fades. Rather, we expect delinquencies and other credit metrics to gradually return to pre-pandemic levels, ultimately settling near levels seen in early 2020.

These events have also altered the approach required to accurately underwrite securitised credit versus pre-pandemic practices. For example, pandemic-impacted borrowers who utilised available payment accommodations generally did so without impact to their credit because of reporting requirements set in the CARES Act. Where applicable, this "*credit score inflation*" creates an inaccurate depiction of a borrower's overall credit risk, necessitating other factors to supplement the weaker predictability of credit scores. Similarly, underwriting must consider the impact of excess household savings on record low delinquency rates and the path of normalisation as savings draw down. Accordingly, we expect performance degradation to vary among issuers, ultimately widening issuer tiers within sectors and creating an interesting environment for active trading and asset selection.

We note that securitisation structures continued to change over the course of the pandemic but generally attribute that more to the natural pace of innovation rather than a direct response to the pandemic, and we expect structures to continue to evolve to meet the balance of issuer and investor needs.

At Angelo Gordon, we believe structured credit provides diversified exposure to a large array of non-corporate asset classes that are well-positioned to benefit from resilient fundamentals. Further, credit risks for many collateral types may be positively impacted by wage and asset price inflation, housing being a good example. We expect the resiliency which was in full force during the height of the pandemic to persist and support investor demand, particularly in the context of the headwinds facing equity and corporate credit markets. We believe careful asset selection and trading capabilities for structured credit will be critical and that managers who implement these practices be well-rewarded.

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