Payden&Rygel

Securitized Credit: More Relatable and Connected to Daily Life Than You Think

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Good morning! The first thing you likely did today was turn off your alarm on your **mobile phone**. You showered, got dressed, poured your fuel for your day, and left your **house**. You hopped in your **car** which only has a handful of monthly payments left, and made your way to the **office**. You had lunch at your favorite **fast casual restaurant** chain, and on your way home from work, you stopped by the **gym** for a quick workout. Sounds like a pretty typical day in one's life.

Cell phones, residential housing, autos, offices, franchise restaurants, and fitness centers — what do they all have in common? Two key traits: (1) all have important touchpoints in daily life, and (2) all are collateral that can be securitized.

Securitizations are all around our daily lives, so why do they strike most of us as a complex, financially engineered labyrinth?

Why'd You Have to Go and Make Things So Complicated?

In the short 303-page Offering Memorandum for the latest Credit Risk Transfer deal from Fannie Mae (CAS 2024-R02), the principal payment terms on any class are defined with a mere 95 words.[1]

Terms like overcollateralization, excess spread, subordination, delinquency triggers, and the like give the reader plenty to be confused about. It's no surprise, then, that many talk about a complexity premium embedded in securitized bonds.

Securitized bonds are debt obligations that most frequently derive their payments, both principal and interest, from the contractual cash flows of asset receivables (e.g., loans or leases) that are backed by something tangible (e.g., autos, houses, railcars, cell towers, etc.). Other types of securitized bonds, like corporate collateralized loan obligations (CLOs), generate cash flow from a diversified pool of bank loans.

Now that we've established the basics, let's walk through why securitizations exist, what opportunities they offer, an example of a transaction, and perhaps most importantly, the benefits securitized credit offers a multi-asset portfolio.

Why Does It Exist?

Consistent and stable financing is one of the hallmarks of a well-functioning economy. Governments and regulatory bodies aim to encourage lending and facilitate access to capital. Businesses and individuals require access to capital to address both short and long-term needs. Access to capital is critical in both good times and bad, serving to smooth economic outcomes and improve the standard of living.

Access to debt capital can take many shapes and sizes: traditional bank lending, broadly syndicated unsecured debt, secured loans, unsecured loans, etc. Corporate treasurers, CFOs, and issuers at large evaluate these financing channels in pursuit of diverse, reliable, and cost-efficient access to capital for their business. The securitized market plays an important role in this pursuit, providing a stable means of financing alongside alternatives like unsecured debt. Moreover, the securitized market can help lower the cost of capital for the borrower as financing rates can be superior when compared to unsecured debt.

Let's consider a simple example. In November 2023, Toyota Motor Credit Corporation (TMCC), the debt issuer for the U.S. financial services arm of the world's leading auto manufacturer, issued an unsecured bond in the corporate credit market and an asset-backed securities (ABS) transaction in the securitized market. (See Table 1)

So, what jumps out? Perhaps the extra four months of funding for an additional 22 basis points in the ABS transaction? Seems costly. But one would need to consider that TMCC issued over $19 billion in unsecured Corporate USD debt in 2023. In addition, they issued another €1.85 billion, AUD 600 million, and £300 million.

To maintain competitive funding in the unsecured space and not oversaturate investors, TMCC looked to the securitized

[1] Source: Connecticut Avenue Securities Trust 2024-R02 Offering Memorandum

Table 1

Characteristics	Unsecured Corporate	Secured ABS
Deal	Toyota 5.4% 11/20/2026	TAOT 2023-D
Proceeds	$900mm	$1.56bn*
Coupon	5.40%	5.62%
Expected Maturity	11/20/2026	3/16/2027
Maturity (yrs.)	3.00	3.33
Credit Spread	+75bps	+97bps

**$40mm in retained Class B securities excluded*
Maturity estimated from 11/15/2023; SOFR for Class A2-b referenced as of closing date

market where they were able to borrow more money when compared to unsecured debt at reasonably consistent yields.

What's The Opportunity Set?

The first modern-day securitization was issued in 1970, when the Government National Mortgage Association (GNMA) guaranteed the first mortgage pass-through securities.[2] Since then, the securitized market has meaningfully expanded in size and scope. While that may not be surprising given the ballooning of capital markets over the last 50+ years, what is more notable is the rapid growth observed in the securitized market over just the last decade.

The table below captures the broad opportunity set for credit investors across public fixed income. Notably absent are developed market government bonds, such as Treasuries, and the largest segment of the securitized market, agency MBS, which has an aggregate market value exceeding $10tn.

There are a few important considerations regarding the securitized credit opportunity set. First, the market has grown in both size and scope since 2012, with sectors like Asset-Backed Securities (ABS), Collateralized Loan Obligations (CLO), and Commercial Mortgage-Backed Securities (CMBS) expanding alongside corporate and emerging market debt alternatives. Second, new areas of opportunity have emerged within securitized credit since 2012, with Single Family Rental (SFR) and Credit Risk Transfer (CRT) collectively surpassing $100bn in market value. Third, and perhaps most importantly, the securitized credit market offers a wide array of collateral types. The main tenants of the market including ABS, CLO, CMBS, and RMBS offer strong diversification but are quite nuanced. For example, ABS encompasses consumer and commercial loans such as autos, credit cards, student loans, containers, railcars, and cell towers, among others. CMBS includes various property types such as multi-

Table 2

Sector	Sub-Sector	Scope	Size Dec 2012	Size Dec 2023
Developed Corporates	Corporate Bonds	Investment Grade (IG) to below-IG rated corporate entities	$8.5tn	$15.9tn
	Leveraged Loans	Senior secured to below-IG rated corporate entities	$600bn	$1.4tn
Emerging Market	Emerging Market	Sovereign, quasi, corporate debt	$2.3tn	$2.3tn
Asset-Back Securities	Consumer ABS	Autos, credit card receivables, student loans	$500bn	$535bn
	Commercial ABS	Shipping containers, aircraft, other equipment	$150bn	$276bn
	Whole Business Securitization (WBS)	Franchise royalty, brand royalty, billboard leases	$5bn	$45bn
	CLO	Corporate leveraged loans	$325bn	$1.0tn
Commercial Mortgage-Backed Securities	Conduit/SASB/CRE CLO	Office, retail, multifamily, hotel, industrial, data center	$700bn	$705bn
	SFR	Single-family rentals	–	$52bn
Residential Mortgage-Backed Securities	CRT	Residential mortgage loans	–	$54bn
	Non-Agency	Residential mortgage loans	$1tn	$614bn

[2] *https://financialservices.house.gov/media/pdf/110503cc.pdf*

Table 3: Example 2024 U.S. CLO Transaction

Class	Rating	Size (% of Transaction)	Credit Enhancement	Expected Maturity	Credit Spread
A	AAA	65%	35%	4	135
B	AA	11%	24%	5	175
C	A	6%	18%	6	225
D	BBB	6%	12%	6.5	325
E	BB	4%	8%	7	600
Equity	NR	8%	–	–	–

Source: Payden

family, hotel, retail, office, and industrial. In addition to collateral diversification, the securitized market provides varying degrees of rating, maturity, yield, and credit spread, enhancing its appeal as a diverse and growing asset class that offers investors an important means of diversification and yield in a multi-asset portfolio context.

Example Transaction – Corporate CLO

A corporate CLO is a securitization backed by a diverse pool of bank loans, typically senior secured in nature with ratings ranging from BB to CCC. These are the assets. The CLO issues a series of notes (debt), typically rated AAA through BB. These are the liabilities. The assets generate income via interest from the bank loans, while the liabilities have a coupon that is paid to bondholders. Any cash flow that remains after debt service (residual) goes to the equity investor if compliant with deal cash flow tests. Importantly, a priority of payments exists in these transactions, whereby interest from the assets is used to service AAA-rated notes first, and then remaining interest to the AA-rated and so on. Any credit losses associated with the assets (loan defaults) are absorbed in reverse order, meaning the equity takes losses first and then the lowest rated notes and so on.

This broad outline contains some very powerful features that are unique to securitizations. First, there is embedded diversification in the transaction given a granular set of assets (loans), typically around 200 loans that are actively managed by those managing the securitization. Second, the priority of payments feature allows for varying degrees of comfort around receiving interest and avoidance against loss. For example, the AAA class gets paid interest first and has 35% credit enhancement, meaning asset losses must exceed 35% to lose any principal on this class of debt. Third, the series of notes (debt) provides bondholders with a very wide-ranging profile with respect to risk vs return, evident via credit spread.

While not homogeneous across all securitized transactions, these key features are reasonably common and underscore the differentiated nature of the asset class versus corporates and sovereign debt.

Other Multi-Asset Portfolio Benefits

Correlations: Securitized credit can help reduce portfolio correlation with more traditional fixed income sectors like corporate credit. This is largely due to the diversification across the securitized market, coupled with the flexibility surrounding rating, maturity, and coupon type. Furthermore, correlations are also low within the individual securitized subsectors, highlighting the diverse nature of opportunities and profiles within the asset class. Lower portfolio correlation can contribute to a more stable experience during periods of market volatility, ultimately enhancing the risk-adjusted return profile within a multi-asset portfolio. *(See Tables 4 and 5)*

Ratings Migration: Over time, credit ratings within corporate credit and emerging market debt tend to drift downward as companies and countries may experience downgrades and, in some cases, defaults. However, the securitized credit market often presents a different narrative, with credit ratings exhibiting an upward migration trend. Why is this? The primary reason lies in the mechanics of principal payments that occur throughout the life of a transaction that serve to reduce leverage at both the underlying loan and bond level. For example, in an auto ABS transaction, principal from the auto loans payments

Table 4: Correlations Between Securitized Credit and Corporates/Emerging Market Debt

Cross Sector	ABS	CLO AAA	CLO BBB	CMBS	RMBS	CRT Front Cash Flow	CRT Last Cash Flow	CRT B
IG Corp	0.84	0.61	0.56	0.93	0.85	0.80	0.45	0.52
HY Corp	0.73	0.71	0.70	0.70	0.48	0.76	0.50	0.63
Loans	0.73	0.92	0.93	0.56	0.18	0.82	0.56	0.85
USD EMD	0.79	0.75	0.74	0.82	0.61	0.79	0.57	0.64

Table 5: Correlations Within Securitized Credit

Securitized Intra-Sector	CRT B	CRT Last Cash Flow	CRT Front Cash Flow	RMBS	CMBS	CLO BBB	CLO AAA
ABS	0.75	0.55	0.90	0.69	0.92	0.77	0.80
CLO AAA	0.83	0.65	0.85	0.27	0.64	0.93	
CLO BBB	0.92	0.52	0.84	0.21	0.60		
CMBS	0.54	0.47	0.83	0.87			
RMBS	0.16	0.33	0.53				
CRT Front Cash Flow	0.78	0.49					
CRT Last Cash Flow	0.45						

Securitized subsectors are ***moderately*** *correlated*

**5-year correlation of monthly returns ending 12/31/23, Source: ICE BofA Indices and Payden calculations.*

Table 6: 10 Year S&P Averages

Rating Transition Matrices

U.S. ABS

Started As	Upgraded	No Change	Downgraded
AAA	0%	83%	17%
AA	15%	69%	16%
A	**25%**	**64%**	**11%**
BBB	23%	59%	18%
BB	22%	45%	33%
B	13%	24%	63%
CCC	4%	19%	77%
CC	0%	30%	70%
C	0%	83%	17%

Global Corporates

Started As	Upgraded	No Change	Downgraded
AAA	0%	34%	66%
AA	2%	43%	55%
A	**8%**	**59%**	**33%**
BBB	20%	60%	20%
BB	26%	33%	41%
B	21%	22%	57%
CCC/C	14%	1%	85%

Source: S&P Research, 2013–2022

that are received each month pass through the transaction and pay down the bond's principal (amortize) immediately and tend to increase credit enhancement over time. This is typically not the case with corporate credit or emerging market bonds, where the principal will remain outstanding in full until maturity. To illustrate this difference, Table 6 on the prior page compares U.S. ABS to global corporates and the associated ratings migration over time.

Relative Value: While typically less liquid when compared to corporates and emerging market debt, adept securitized credit research can be rewarded with complexity and liquidity premiums given higher yields across similarly rated securities.

Flexibility: The securitized market offers investors a diverse opportunity set that has expanded significantly over the last decade. The opportunity set encompasses various collateral types across the entire rating spectrum, from AAA to unrated securities. Such diversity provides investors with a broad menu of exposure with respect to rating, maturity, credit spread, and yield. Importantly, this exposure can serve to lower portfolio correlation versus traditional parts of fixed income like corporates and emerging market debt.

Wrapping It Up

The clang of weights and the rhythmic thud of treadmills slowly fade into the background as you walk over to the front desk of the gym to renew your membership for another month. With a swipe of your credit card, the transaction is complete, and you're reminded of the intricate financial web that underpins even the simplest of activities. Your credit card payment is just a drop in the vast ocean of securitization, where your credit, along with countless others, is bundled and transformed into a financial security.

With the engine humming softly, you drive through the bustling streets, passing by shops, restaurants, and office buildings. It's in these everyday scenes that the impact of securitization becomes apparent – from the loans that finance commercial properties to the credit card transactions that keep businesses afloat. What once seemed like a distant financial concept now feels tangible and real, influencing even the smallest details of your daily routine.

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LOS ANGELES | BOSTON | LONDON | MILAN

LOS ANGELES
333 South Grand Avenue
Los Angeles, California
90071
213 625-1900

BOSTON
265 Franklin Street
Boston, Massachusetts
02110
617 807-1990

LONDON
1 Bartholomew Lane
London EC2N 2AX
United Kingdom
+ 44 (0) 20-7621-3000

MILAN
Corso Matteotti, 1
20121
Milan, Italy
+39 02 76067111