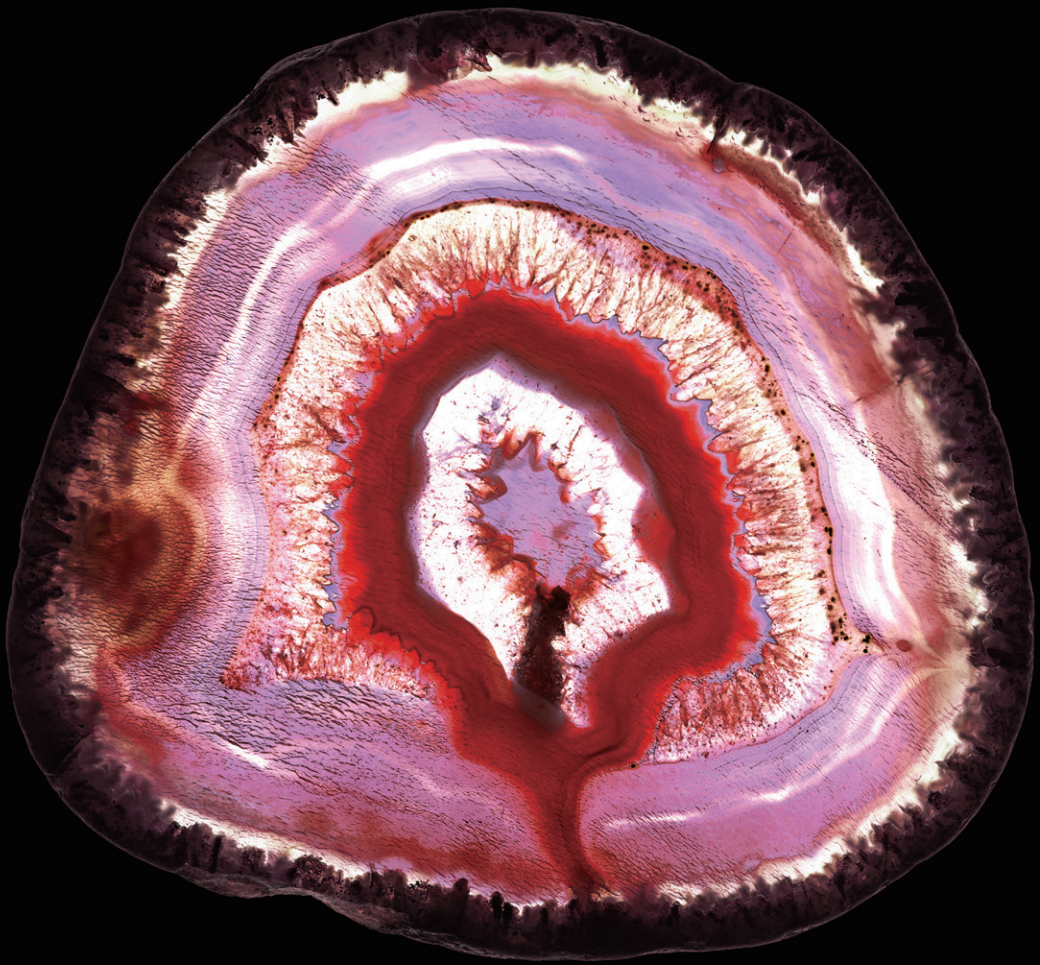
Understanding securitised credit



HSBC Asset Management | Opening up a world of opportunity

"Securitised credit are types of bonds. They comprise cash-generating assets."

What is securitised credit?

Securitised credit are types of bonds including 'Asset Backed Securities' (ABS) and 'Mortgage Backed Securities' (MBS), etc. They comprise cash-generating assets such as residential mortgage loans, commercial mortgage loans, credit cards loans, auto loans and leveraged loans. These illiquid cash-generating assets are purchased and restructured into various tranches of securitised assets by issuers such as financial institutions and are then sold in the financial market to investors who receive cash flow accordingly as the returns. Global securitised credit market has currently reached USD 4 trillion (Chart 1) in size.

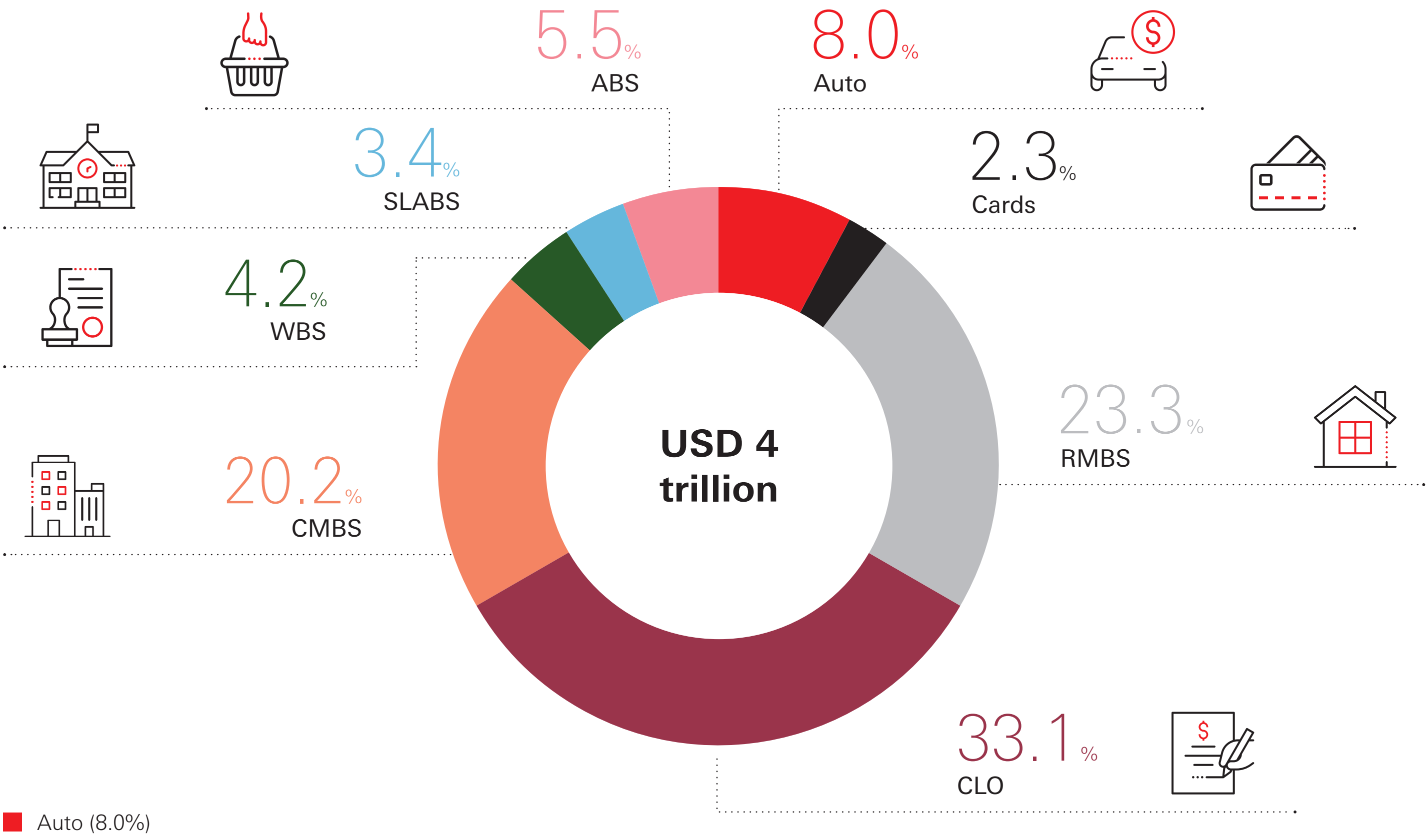
Differences between securitised credit and traditional bonds

Although securitised credit are types of bonds, they are backed by collateral and they differ from bonds in various aspects including the coupon payments, the maturities and the structures.

	Traditional bond	**Securitised credit**
Coupon	Generally fixed	Tends to be floating rate (with a premium over a reference rate)
Source of cash flow	Generated from the underlying business activities of the issuers	Generated from the underlying collateral such as repayments on mortgages
Maturity date	Usually fixed with all the principal received on the maturity date	Depends on the characteristics of collateral such as principal repayments, default rates and structure features
Tranches	• Untranched • All bond holders receive the repayments and bear the risk of losses equally	• Tranched • Repayments and risks of losses of securities holders depend on seniority of the securities
Credit rating	Depends on the solvency of the issuers	Varies among different tranches, depending on the underlying collateral and the structure of the securities

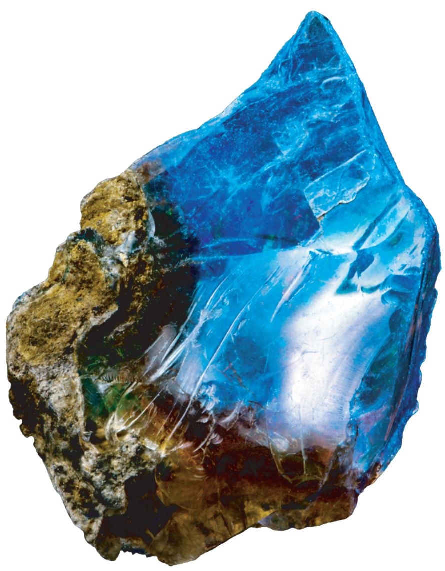
Source: HSBC Asset Management, March 2024

Chart 1 Securitised credit market

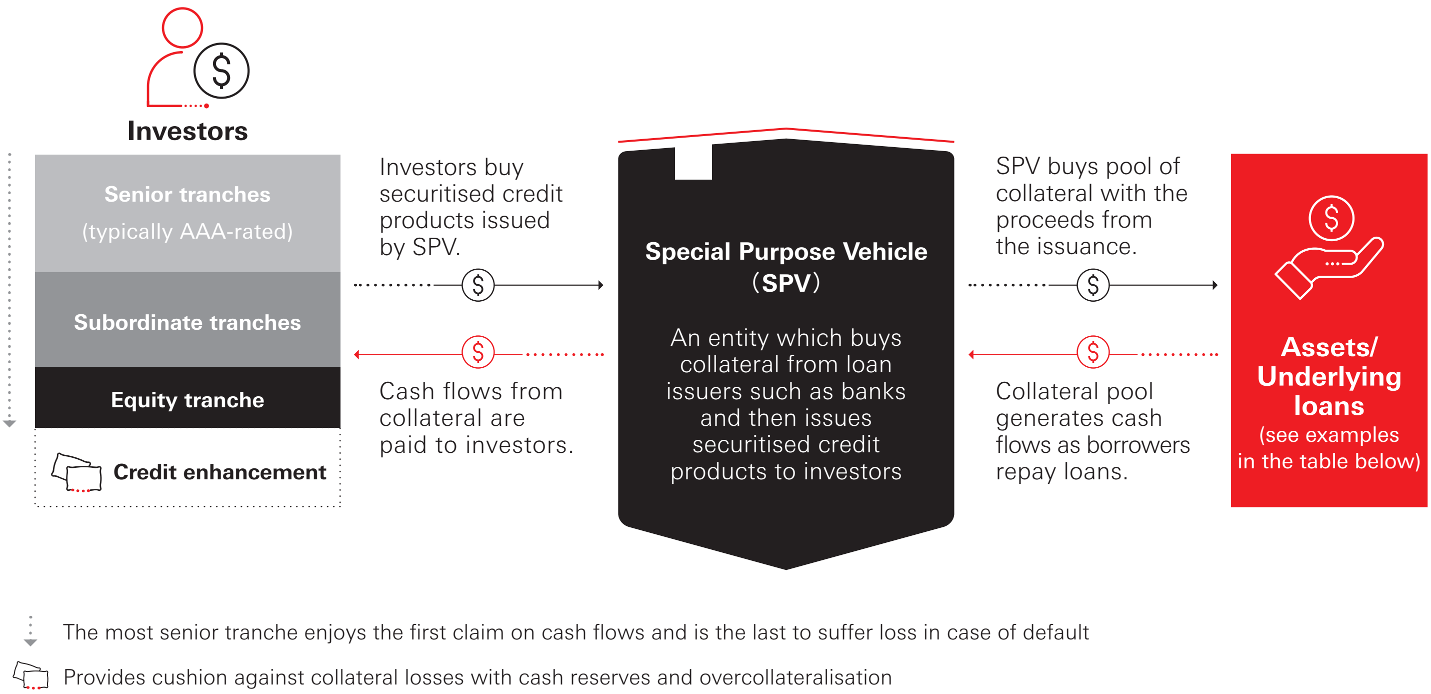


- Auto (8.0%)
- Cards (2.3%)
- Residential Mortgage Backed Securities (RMBS) (23.3%)
- Collateralised Loan Obligations (CLO) (33.1%)
- Commercial Mortgage Backed Securities (CMBS) (20.2%)
- Whole Business Securitisation (WBS) (4.2%)
- Student Loan Asset Backed Securities (SLABS) (3.4%)
- Other Asset Backed Securities (ABS) (5.5%)

Past performance does not predict future returns.
Sources: HSBC Asset Management; Australian Statistics Bureau; Reserve Bank of Australia, JPMorgan, BAML, Barclays; Data as of January 2024



Understanding the structures of securitised credit



Securitised credit categorised by the underlying collateral

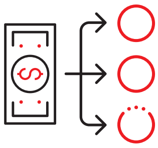
Securitised credit	Collateral
Collateralised Loan Obligations (CLO)	A pool of corporate loans • CLOs differ from other structure credit sectors as they are actively managed by CLO managers
Residential Mortgage Backed Securities (RMBS)	Residential mortgage loans issued by banks and other financial institutions
Commercial Mortgage Backed Securities (CMBS)	Commercial property mortgage loans (including housing developments, hotels, factories, shopping centres and office buildings) issued by banks and other financial institutions
Consumer Asset Backed Securities (Consumer ABS)	Credit card receivables, auto loans and other personal loans
Student Loan Asset Backed Securities (SLABS)	Student loans (these loans can be either privately originated or backed by government)
Whole Business Securitisation (WBS)	Cash flow generated from the business operation of corporates

Source: HSBC Asset Management, as of March 2024.

What are the advantages of investing in global securitised credit?

Higher potential yield

Securitised credit often has higher yields than similar-rated corporate bonds, compensating for the market's complexity and lower liquidity.



Diversified portfolio risk

Securitised credit exhibits a lower correlation to traditional fixed income asset, providing diversification benefits to investment portfolios.

Lower volatility

Traditional bonds usually have longer durations and tend to be more volatile. High-quality securitised credit enjoys a combination of attractive cash flow and shorter rate and spread duration profile. These help reduce volatility in an uncertain market environment.

"Securitised credit products usually come with yield premium and shorter durations."

Development of the securitised credit market

Securitised credit received a reputation for being 'toxic' assets following the 2007 global financial crisis triggered by the US subprime mortgage crisis, as the widespread defaults in the property market across the nation led to significant losses among the holders of sub-prime RMBS and CDOs.

However, not all securitised credit sectors suffered from massive defaults and losses. While the US sub-prime RMBS and CDO sectors suffered from heavy losses during the crisis, other sectors performed quite well. The poor performance of the sub-prime RMBS sector was mainly due to the widely adopted "originate-to-distribute" model, poor quality of collateral and inaccurate risk assessment by credit rating agencies.

Following the sub-prime crisis, regulators and policymakers in the US and Europe extensively tightened the overall market regulations, which enhanced transparency of the securitised credit market and protection for investors.

Mitigation measures targeting related risks

Risk	Details	Mitigation measures
Asymmetric interests	The uneven qualities of the sub-prime RMBS are partly due to the "originate-to-distribute" model adopted by issuers who aim at selling rather than holding the credit products	Regulatory authorities in the EU and the US have amended regulations which require issuers to hold at least 5% stake of the total issuance to align their interests with the investors
Credit ratings unable to truly reflect risks	During the global financial crisis, investors were unable to evaluate the risks properly as the credit qualities of some of the assets were not reflected in the credit ratings	Require multiple ratings, rotation of rating agencies, improvement in the transparency of rating methodologies and extra disclosure of related information from the issuers

In addition, securitised credit are types of bonds which involve the use of more complex derivatives. Therefore, investors need to be aware of its credit risks, liquidity risks and risks related to derivatives and asset backed securities and other related risks.

Conclusion

The compelling income and wide credit spread of securitised credit represent one of the most unique opportunities currently. A gradual normalisation of interest rates is favourable for securitised credit because not only can it continue to enjoy attractive income, but also benefit from potential capital appreciation as credit spreads tighten.

However, selection of securitised credit depends highly on the understanding of fundamental factors and credit conditions. Active management and in-depth analysis by an experienced research team with significant resources are required to capture the opportunities by selecting assets with the best potentials and building a portfolio that optimises potential returns with risk management.

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