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Alternative investment solution

European mezzanine ABS bonds

September 2019
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Un affilié de NATIXIS
INVESTMENT MANAGERS

EUROPEAN MEZZANINE ABS BONDS

Introduction

Institutional investors on the European market are finding it increasingly difficult to unearth investments with positive yield. European sovereign bonds are in resolutely negative yield territory, while investment grade corporate bonds are also struggling. If we look to the more risky asset classes – such as high yield credit and European equities – valuations do not look very attractive either after a sharp rebound over the first part of the year and against a particularly tough market backdrop characterized by geopolitical risk and trade tension.

So the same question remains across the board: *how can we enhance yield without increasing exposure to interest rate risk and exchange rate risk or suffering lower credit ratings?*

In today's environment, it may be worth looking to the European securitization market, which involves asset-backed-securities, or ABS. European politicians are keen to revive sustainable growth in Europe through increasing lending to households and businesses, so have publicly acknowledged the crucial role the asset class plays in financing the real economy. This move has gone a long way to providing new impetus for the European ABS market over recent years with the implementation of the new Simple, Transparent and Standardized (STS) regulatory framework on January 1, 2019, providing a certification for high-quality securitization products. In the fall of 2014, the European Central Bank also decided to include senior asset-backed securities in its asset purchase program, on a par with sovereign bonds, covered bonds and corporate bonds. This move put a squeeze on spreads for this type of bond and was widely seen as a vote of confidence in the ABS asset class as a whole, which has so far proven to be highly resilient, even during the 2007-2008 financial crisis. However, senior ABS bonds are now facing negative yield on a large majority of sub-segments of the European securitization market.

Against this backdrop, **a feasible alternative can be found in the shape of mezzanine ABS bonds**. This market segment remains small in size compared to the broader securitization market for various reasons. These investments are not currently eligible for the ECB's asset purchase programs or the liquidity coverage ratio (LCR), so they have not seen the hefty price distortion experienced by senior ABS bonds resulting from the ECB's programs over recent years. If we take a closer look, despite the fact that mezzanine ABS bonds have gained considerably, driven up by a frantic quest for yield from investors already familiar with the ABS asset class via senior ABS, this market still offers real investment opportunities for sophisticated investors. Yield is deemed to be relatively attractive compared to traditional bonds, while carrying relatively limited risks in our view.

In light of the macroeconomic context and the accommodative stance from all central banks in Europe and elsewhere, this quest for yield looks set to continue.

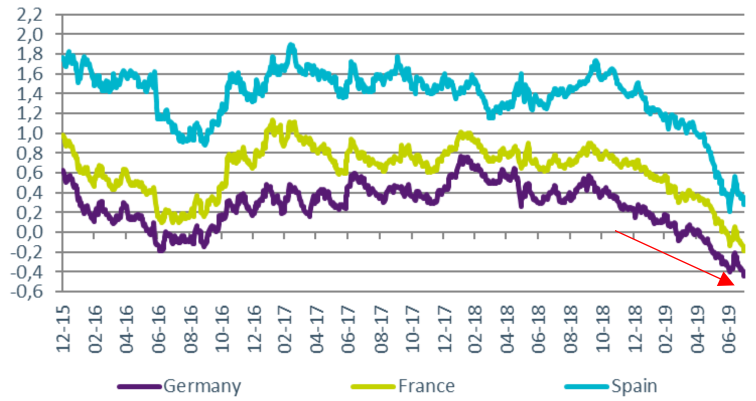
INTEREST RATES POISED TO STAY LOW

Over recent weeks, we have seen an increasingly accommodative stance from the central banks in light of declining economic growth stats, an inflation outlook that is moving away from central banks' targets on both sides of the Atlantic, and escalating geopolitical risk from Brexit, the US/China trade war, or even tension between the US and Iran.

The European Central Bank has been particularly accommodative, with recent statements triggering a massive downward shift in bond yields, bringing the total amount of debt carrying negative yield to an unprecedented amount of slightly under €13 trillion.

Sovereign bond yields have hit record lows, with the 10-year Bund sliding into negative territory since the start of the year, and the OAT hitting the symbolic 0% threshold for the first time.

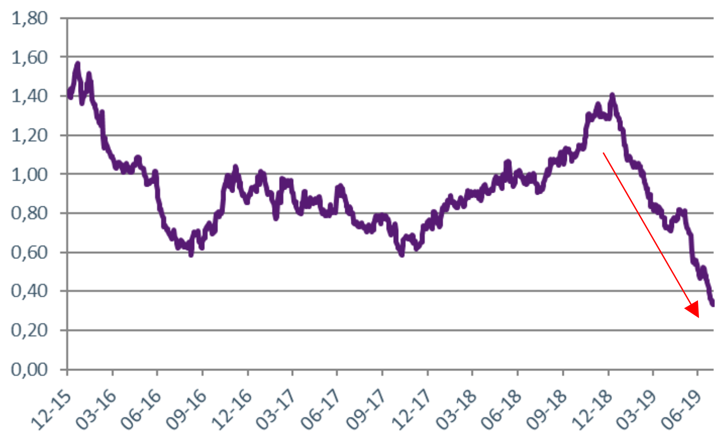
Yield to maturity for 10-year sovereign bonds



Source: Ostrum AM, Bloomberg. Data as at 07/31/2019. Figures mentioned refer to previous years. Past performance does not guarantee future results. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way.

Against this backdrop and with sovereign debt offering meager yields, the European credit market has provided an attractive alternative. Inflows into investment grade credit funds have recovered, and this factor has combined with the market's expectations of a resumption in the ECB's corporate bond asset purchase program before the end of 2019 to narrow spreads on this market, despite solid issuance volumes. By the end of June 2019, almost 25% of the euro-denominated investment grade corporate debt market carried negative yields.

Yield to Worst on the euro credit market



Source: Ostrum AM, Bloomberg Barclays Euro Corporate index. Data as at 07/31/2019. Figures mentioned refer to previous years. Past performance does not guarantee future results. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way.

JUST WHAT BOND SEGMENT SHOULD INVESTORS TARGET TO SEEK OUT POSITIVE YIELD?

Interest rates are set to remain low in Europe for a long time, but investors still need to track down yield. Investment grade credit has become much less attractive as spreads have narrowed massively over recent weeks.

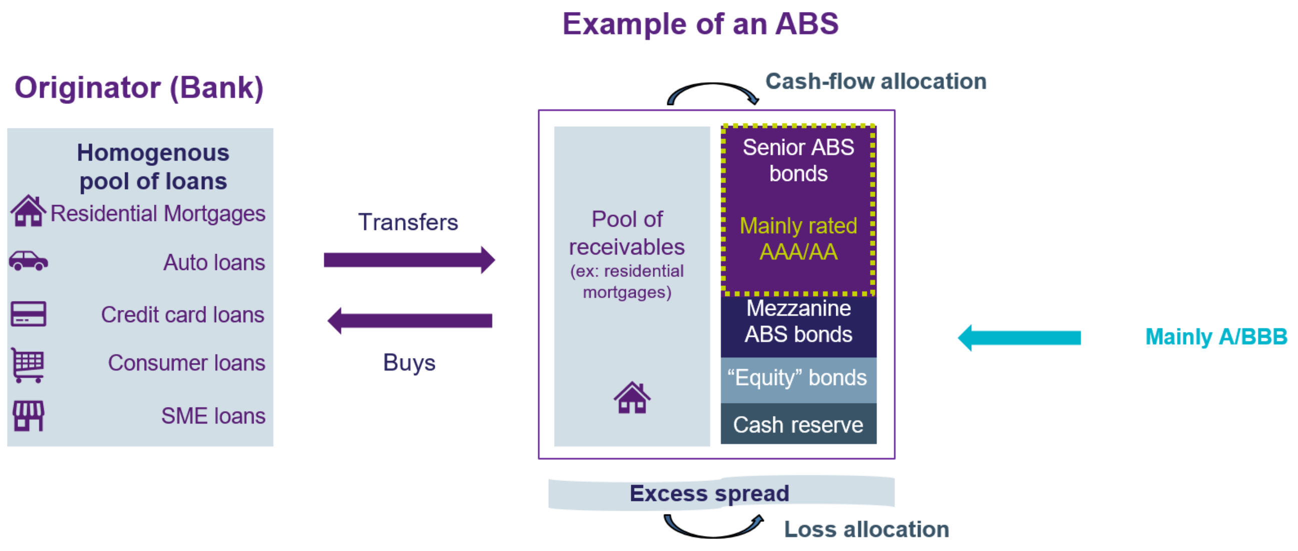
So a trend that kicked off among institutional investors a few years now seems to be on the cards again i.e. cutting back the share of traditional bond asset classes in their asset allocation and focusing more on so-called alternative solutions that can generate more sizeable yield.

Mezzanine asset-backed securities are something of a niche market within the broader European ABS market and these investments could help meet increasing needs for **so-called alternative solutions as they offer relatively attractive yield** in today's environment, **while also remaining in the investment grade universe**.

Introduction to the mezzanine ABS market

The European ABS market is in itself relatively extensive with almost €1,200 billion in bonds, largely dominated by the issue of senior ABS bonds. The financing structure for securitization transactions generally follows the set-up outlined below, based on the so-called tranching technique, which spreads out the risk of loss in a waterfall system:

- Senior bonds or tranches carry a high rating (AAA/AA) and account for between 80% and 90% of financing for the portfolio of securitized loans,
- Mezzanine notes or tranches have a rating ranging from A/BBB to B and provide between 10% and 20% of total financing,
- The first-loss or equity tranche, which is usually unrated and partly retained by the institution that sells the notes, provides the remaining 1-10%.



Three reasons can explain the small size of the mezzanine ABS market:

- Firstly, **risk modelling and deal structuring**. ABS bonds are structured using a detailed model of the loss of risk on the securitized loan portfolio and by applying the risk tranching technique, which distributes the risk of expected losses on the pool of loans between the various tranches i.e. senior, mezzanine and equity. These bonds therefore have very different risk/return profiles depending on the various types of credit enhancement techniques used when the transaction is being structured, as well as the degree of seniority, redemption priority and loss absorption. First losses are taken on the basis of a waterfall set-up, starting with the equity tranche, until it is depleted, then the mezzanine tranches, which absorb the next losses, followed by the most senior tranches. This risk tranching technique on securitization deals and the use of various forms of credit enhancement mean that the institutions selling the loans or the issuers can refinance mostly high-quality loan portfolios by issuing primarily very well-rated senior notes, which account for 80-90% of total financing. These notes are followed by the issue of relatively small mezzanine and equity tranches as shown above, which can make up 10-15% of overall financing.

- Secondly, **the high financing cost of ABS** for an issuer as compared to other traditional asset classes. Mezzanine ABS bonds carry a particularly high cost, and broadly speaking, ABS are not really the most advantageous source of financing for an issuer, given the range of other available funding sources, such as senior unsecured bonds, covered bonds or even long-term refinancing loans from the ECB's reasonably priced TLTRO program. So in this respect, when an issuer decides to use this kind of securitization financing solution, senior bonds are often offered to ABS investors on the open market, while mezzanine and equity tranches have traditionally been retained on the seller's balance sheet until maturity, due to the particularly high spread/yield that investors demand on this type of product. This has restricted the range of available opportunities for mezzanine ABS investors.

- A third point can help explain part of the second explanation outlined above i.e. **demanding regulation and prudential treatment for the ABS asset class** that regulators implemented after the 2007 crisis. Accounting on capital required for mezzanine ABS tranches under Solvency II still remains particularly demanding and is off-putting for some investors, such as insurance companies. Even after the recent easing in regulation for securitization operations eligible for the new STS program (Simple, Transparent and Standardized), this still remains true. Only senior ABS bonds with this STS classification are eligible for considerably reduced capital charge requirements, on a par with those for other highly liquid asset classes, such as covered bonds and well-rated corporate bonds. As shown below, capital charges for insurers' investments in the safest STS-classified securitization deals have been reduced from 2.1% to 1.0% vs. 0.7% for covered bonds and 0.9% for AAA-rated corporate bonds. For a BBB-rated mezzanine ABS with an STS classification, the capital charge was cut from 15.80% to 7.90% vs. 2.50% for a corporate bond with an equivalent rating.

Capital charges under Solvency II and changes under new STS regulation

Credit quality step	**0**	**1**	**2**	**3**	**4**	**5 and 6**
Credit rating	**AAA**	**AA**	**A**	**BBB**	**BB**	**B and below**
Corporate Bonds	0.90%	1.10%	1.40%	2.50%	4.50%	7.50%
Covered Bonds	0.70%	0.90%				
Old – Senior ABS Type 1	2.10%	3.00%	3.00%	3.00%		
Old – Mezzanine ABS Type 1	12.5%	13.4%	16.6%	19.7%	82%	100%
Current Senior ABS STS	1.00%	1.20%	1.60%	2.80%	5.60%	9.40%
Current Mezzanine ABS STS	2.80%	3.40%	4.60%	7.90%	15.80%	26.70%
Old - Type 2 (non-STS) Senior and Mezzanine ABS	12.5%	13.4%	16.6%	19.7%	82%	100%
Differential Senior ABS STS – Corporate Bonds	**0.10%**	**0.10%**	**0.20%**	**0.30%**	**1.10%**	**1.90%**
Differential Mezzanine ABS STS – Corporate Bonds	**1.90%**	**2.30%**	**3.20%**	**5.40%**	**11.30%**	**19.20%**

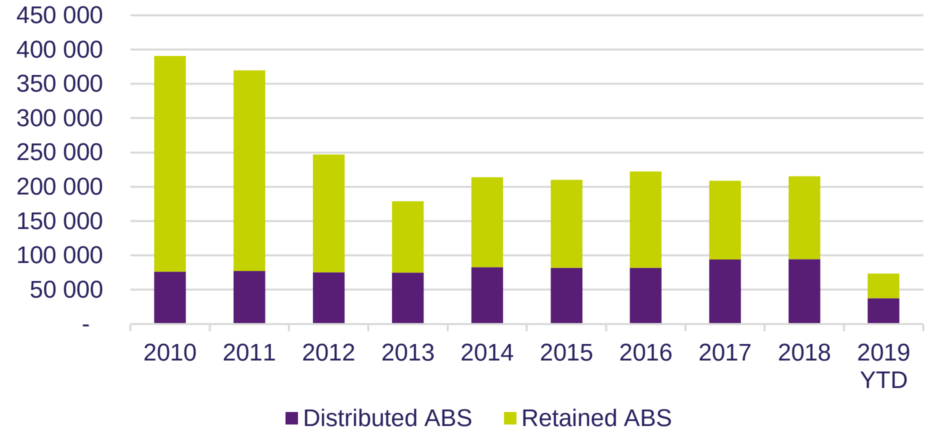
Source: European Commission; BofA Merrill Lynch Global Research. Figures mentioned refer to previous years. Past performance does not guarantee future results. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way.

Overview of the mezzanine ABS market

The European ABS market is worth close to €1,200bn, but less than half is taken up by investors, with the remainder held by issuing banks that have used them as guarantees in the ECB's refinancing operations since the financial crisis. In 2011-2012, 80% of ABS issues were kept on banks' balance sheets, while the figure for 2013 came to 70% and later stabilized at 55-61% until 2018. At end-June 2019, the proportion of issues available to investors finally hit the 50% mark.

Distributed ABS vs retained ABS (€mn)

Total issued per year between 2010 and June 2019



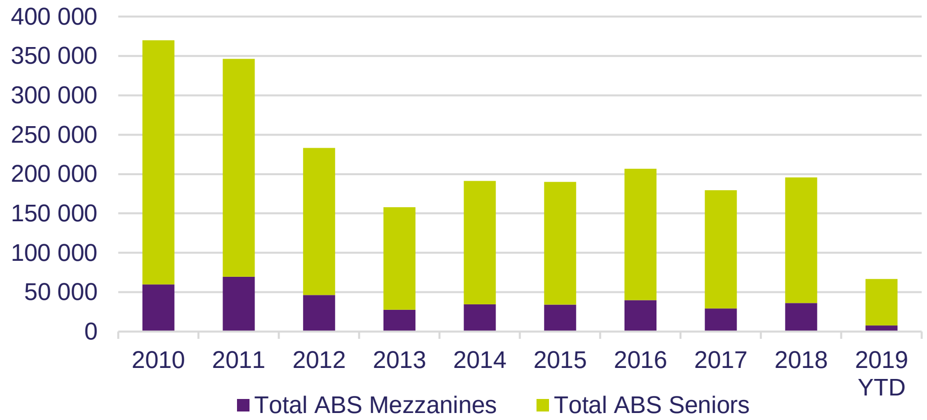
Source: Ostrum AM, JPM Morgan. Data as at 06/21/2019. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way.

The situation is somewhat different on the mezzanine ABS market, which accounts for only a small portion of the European ABS market.

Of the total nominal amount of European ABS issues between 2010 and 2019, only 16% were mezzanine ABS bonds vs. 84% senior ABS bonds. If we exclude amortization, this equates to a total of around €386bn in mezzanine ABS bond issues over the period.

Mezzanine ABS vs senior ABS (€mn)

Total issued per year between 2010 and June 2019



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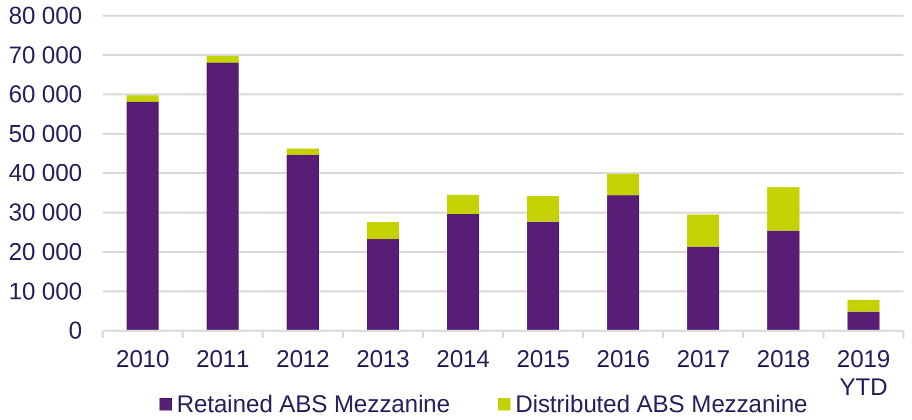
However, the nominal amount actually issued on the open market is much lower. As already mentioned, issuers opted to retain most mezzanine ABS bonds on their balance sheets due to the relatively high financing cost, so the available nominal amount on the market only came to €48bn over 2010-2019, i.e. a mere 8% of the total amount of ABS issued on the market over the period. Some banks do not have access to all traditional segments on the bond market, but were able to achieve the financing required via the securitization market and thereby deconsolidate all or part of the risk on the securitized loan portfolio, despite the cost of issuing the subordinated mezzanine and equity tranches on the public market.

Retained mezzanine ABS bonds vs distributed mezzanine ABS bonds (€mn)
Total issued per year between 2010 and June 2019



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What about liquidity?

Senior ABS bonds have been eligible for the European Central Bank's refinancing programs and ABS purchase program (ABSPP) since 2014. Only redemptions and coupons are now reinvested, which helps ensure strong liquidity on this market.

Liquidity on mezzanine ABS bonds remains robust, although admittedly lower than for senior ABS bonds for various reasons i.e. the market is smaller and not as extensive in terms of investor type as these notes are not eligible for repo transactions, or for the ECB purchase programs or the LCR under Basel III.

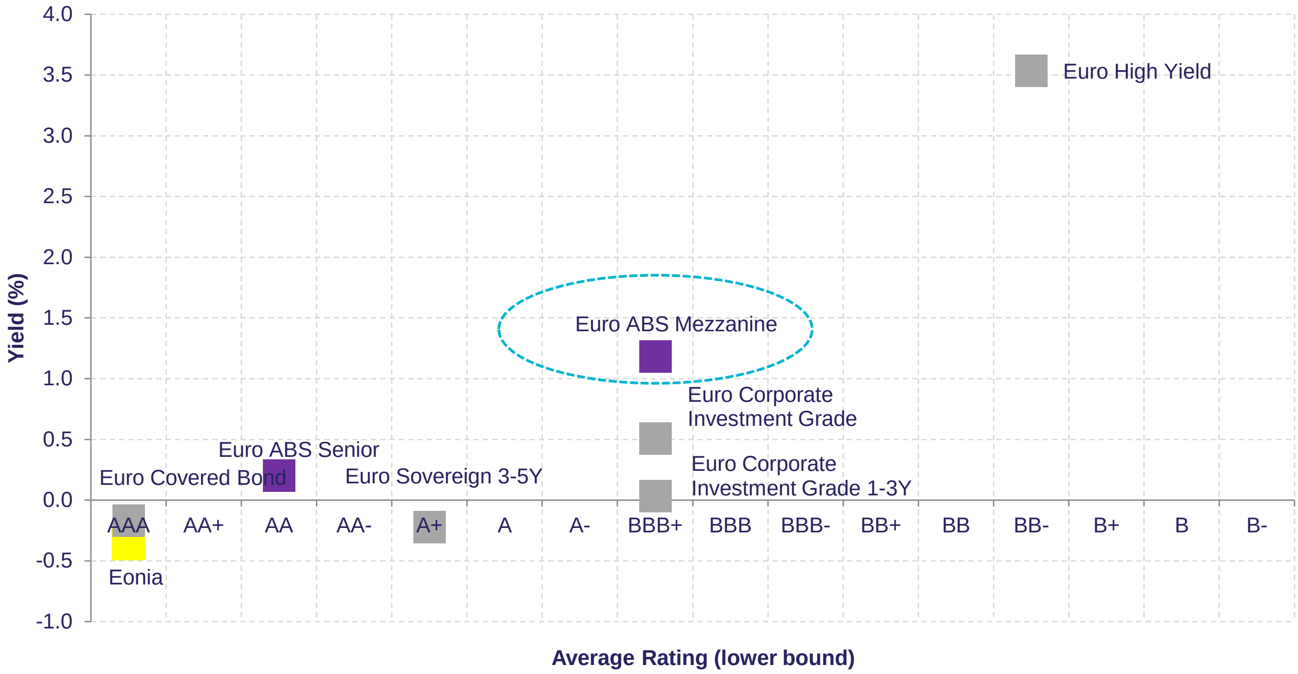
Liquidity on the mezzanine ABS bond market comes primarily from a more limited number of very specialized and sophisticated stakeholders, consisting mostly of certain banks as well as hedge funds and asset managers that know the market well and are able to assess the asset class' fundamentals and specific features. This group includes Ostrum AM. These same stakeholders generally invest with the aim of holding these positions over the long term to take advantage of attractive carry on this type of investment. **Trading volumes on the secondary market therefore remain relatively low, making this type of investment scarce. This also means that mezzanine ABS bonds are less affected by market stress,** as we saw at the end of 2018.

Another key factor that helps promote relatively strong liquidity on the ABS market – including mezzanine ABS – is the bid wanted in competition system (BWIC). This set-up has gradually become a tangible market practice and provides liquidity from end investors for ABS investors looking to sell their ABS bonds, in addition to liquidity from banks. This is a vital aspect when banks temporarily take a back seat and provide little or no liquidity, as we saw at the end of 2018. Meanwhile, this market practice also enables investors looking for investment opportunities to take advantage of these openings and simultaneously save a few bps on the bid/ask spread.

Attractive yield but why?

The ABS asset class offers a relatively attractive risk/return ratio, particularly as compared to traditional bonds, but mezzanine ABS bonds provide even greater returns, and while yield has gradually fallen, it is still resolutely positive.

Risk/return ratio for various asset classes



Source: Ostrum AM, Barclays, Bloomberg. Data at 06/30/2019. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way. Figures mentioned refer to previous years. Past performance does not guarantee future results.

A number of reasons can potentially explain this additional yield provided by mezzanine ABS bonds:

- A greater **liquidity premium** as compared to senior ABS bonds or even IG corporate bonds;
- A **premium resulting from the complexity** of the ABS asset class: the structuring process for securitization deals is complex and many investors lack insight into the asset class and are still reluctant to take positions on this market;
- A **premium resulting from regulatory conditions**: capital charges remain high for some investors, such as insurers and pension funds.

In our view, premiums resulting from the asset class' complexity and its discouraging prudential treatment are not a true reflection of the underlying risks of mezzanine ABS bonds. Rather we believe that this situation actually provides opportunities for all investors who are not hampered by stringent regulation and who have extensive knowledge of the asset class, such as our specialist ABS teams at Ostrum AM.

Solid credit fundamentals and a high degree of transparency

The ABS asset class is attractive as a result of a number of features, and in our view it boasts solid fundamentals, while also offering highly transparent investor information:

1. **Firstly, the asset class' long-term resilience has been statistically proven,** as shown by the following rating transition matrix published by Moody's:

Rating transition matrix for ABS, CMBS and RMBS in the EMEA region over five years
Calculation over the 1993-2018 period

From \ to	Aaa	Aa	A	Baa	Ba	B	Caa-C	Principal paid back	Impairment
Aaa	19.95%	7.80%	5.29%	2.39%	0.76%	0.25%	0.15%	63.36%	0.06%
Aa	2.75%	28.77%	6.29%	3.43%	1.81%	1.26%	0.84%	54.41%	0.43%
A	0.50%	10.52%	23.26%	4.65%	3.81%	2.18%	1.39%	52.79%	0.91%
Baa	0.21%	3.54%	6.68%	20.55%	5.09%	3.83%	4.75%	52.95%	2.40%
Ba	0.03%	2.21%	4.13%	5.07%	15.40%	7.02%	10.69%	49.70%	5.75%
B	0.20%	2.88%	5.90%	7.39%	7.82%	10.21%	11.12%	41.61%	12.88%
Caa-C		1.35%	1.43%	2.04%	7.11%	10.64%	21.92%	27.29%	28.23%

Source: Ostrum AM, Moody's. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way. Figures mentioned refer to previous years. Past performance does not guarantee future results.

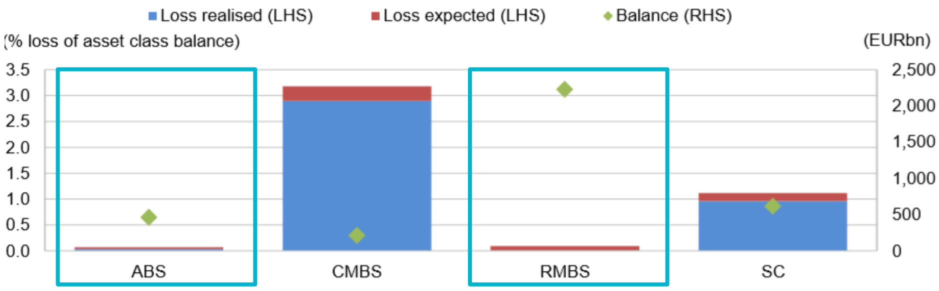
This transition matrix reflects how resilient ratings on investment grade ABS bonds have been over the long term, even during the 2007-2008 crisis.

It is worth remembering that the term impairment does not necessarily mean default, but rather it can reflect payment delays on coupons for example. In the event of impairment, the company managing the SPV – or Special Purpose Vehicle, which is the vehicle that issues the ABS bonds – ensures that payment continues so that ABS investors continue to receive both the principal and interest, which automatically implies extending the securitization deal's duration.

It is also important to highlight that these figures do not give a breakdown between the different types of ABS, and a significant proportion of these impairments actually involve commercial mortgage-backed securities (CMBS), which are an ABS market sub-segment where we only invest to a small extent. In our view, the securitized collateral is not sufficiently diversified – usually consisting of just a few loans – and performance primarily hinges on redemption or refinancing of these loans via the resale of the underlying assets, such as office buildings, shopping malls, etc.

This observation is reflected in the latest publication from Fitch Ratings, which looks into losses on the main asset classes on the ABS market in the EMEA region from 2000 to 2018. We can see that most of the losses on the ABS market in Europe are due to CMBS (3.2%), while on other highly granular segments such as ABS (auto ABS, consumer ABS, etc.) and RMBS (residential mortgage-backed securities), losses are close to zero at just 0.1% for these two segments.

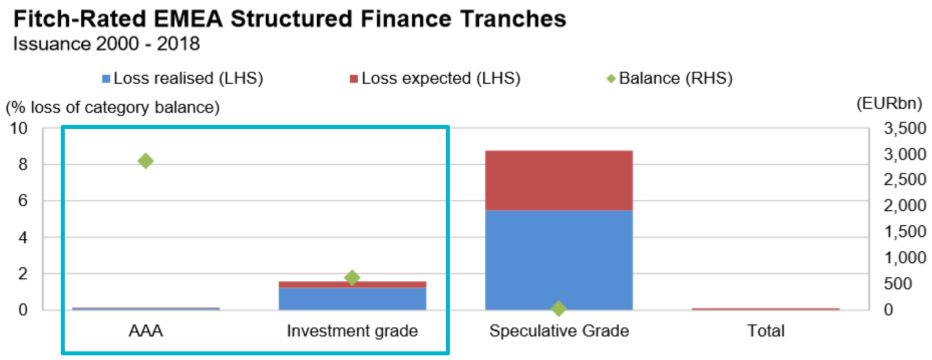
Losses per ABS asset class for issues between 2000 and 2018



Source: Ostrum AM, Fitch Ratings. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way. SC stands for Structured Credit, i.e. CDOs. Fitch Ratings makes a clear distinction between RMBS and ABS, which here involve vehicle loans and consumer loans. Figures mentioned refer to previous years. Past performance does not guarantee future results.

Another chart in this report also highlights the importance of taking positions on investment grade senior and mezzanine bonds, which held up very well over the 2000-2018 period.

Losses per rating type for issues between 2000 and 2018



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These figures reflect the positive aspects of the IG ABS asset class, and here at Ostrum AM, we focus on mezzanine ABS bonds with the highest ratings ranging from Aa/AA to Baa/BBB.

2. **ABS bonds carry higher ratings than corporate bonds due to their credit enhancement system, which helps safeguard investors**. This system includes four types of enhancement mechanisms:

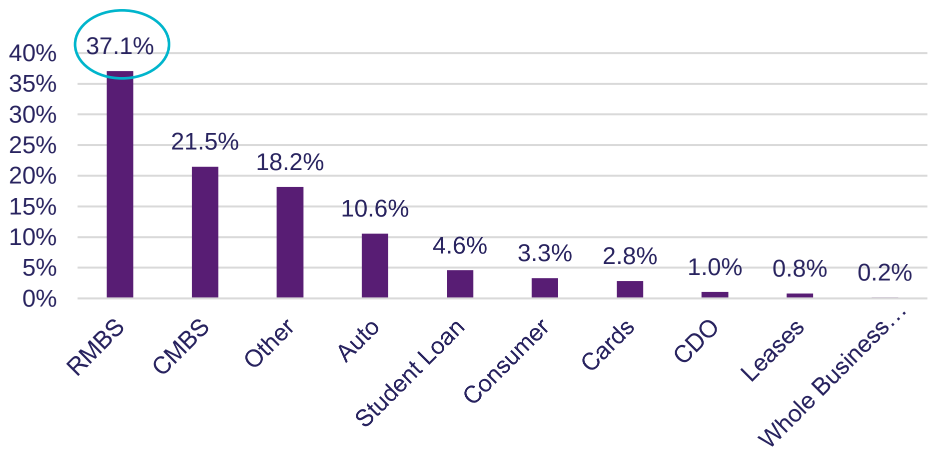
- **Excess spread,** or the difference between amounts received from the portfolio of securitized loans – or collateral – and interest costs on the ABS bonds. This spread is used to absorb the first losses.
- **A reserve fund** financed by the seller bank is set up when the securitization deal is structured and is the second line of defense in absorbing losses.
- **Over-collateralization**, resulting from the value of the underlying loan portfolio being higher than the value of the ABS issued, so even if there is a payment delay or default, interest payment and capital repayment on the ABS bonds are not affected.
- Lastly, the **tranching or subordination** principle, which we outlined above. The most junior bonds – the equity tranche – absorb any losses not already covered.

3. **Specific features of the European ABS market: prime and recourse loan**

The European mezzanine ABS bond market is dominated by residential mortgage-backed securities, which are prime securities i.e. they enjoy solid borrower solvency. These loans often include a guarantee – or recourse loan – which enables the lending bank to recover the mortgaged asset in the event of borrower payment default, and also recover any other asset if the value of the real estate asset is insufficient to cover the loan.

Mezzanine ABS distributed by type of ABS

Total issued between 2010 and June 2019 (€48.3bn)



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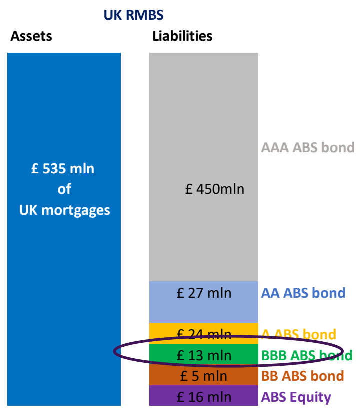
This is one of the key differences with the US RMBS market, which has a considerably higher volume of subprime loans and non-recourse loans, as the prime market in the US is dominated by federal agencies, such as the Fannie Mae and Freddie Mac.

4. **Transparent transactions and underlying portfolios:**

Unlike certain alternative or traditional asset classes, ABS are very specific in that they boast a high degree of transparency, with information available on the quality and performance of securitized loan portfolios. Detailed and transparent periodic reports – quarterly and/or even monthly – on performances from the securitized collateral and the ABS bonds are provided for each ABS issuance, thereby helping issuers assess credit quality and analyze the cashflow profile for the investment over time. The quality and detail of data make it easier for investors to develop stress scenarios and conduct a detailed analysis of the potential impact on their investments.

Analysis example: estimated impairment for a mezzanine bond with a BBB rating on a UK RMBS under different scenarios (% house price decline in the UK and total % mortgage defaults)



Cumulative mortgage defaults \ House price decline in the UK (from current levels)	0%	5%	10%	15%	20%	25%	30%	35%	40%	45%	50%	55%	60%	65%	70%	75%
0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
5%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
15%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
20%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
25%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	20%
30%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	37%	99%	100%
35%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	97%	100%	100%	100%
40%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	9%	100%	100%	100%	100%	100%
45%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	100%	100%	100%	100%	100%	100%
50%	0%	0%	0%	0%	0%	0%	0%	0%	0%	98%	100%	100%	100%	100%	100%	100%
55%	0%	0%	0%	0%	0%	0%	0%	0%	40%	100%	100%	100%	100%	100%	100%	100%
60%	0%	0%	0%	0%	0%	0%	0%	0%	98%	100%	100%	100%	100%	100%	100%	100%
65%	0%	0%	0%	0%	0%	0%	0%	20%	100%	100%	100%	100%	100%	100%	100%	100%
70%	0%	0%	0%	0%	0%	0%	0%	85%	100%	100%	100%	100%	100%	100%	100%	100%

Source: Ostrum AM, Analysis developed based on Intex. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way. Data as of Q1 2019.

Asset class' attractive features for Ostrum AM as a specialized ABS fund manager

As a specialized ABS fund manager, here at Ostrum AM we particularly welcome:

- **The asset class' potential flexibility to select mezzanine bonds from the same securitization transaction**: there is usually only one senior note (class A), which accounts for on average around 80-90% of a transaction, but there can be several mezzanine ABS tranches or bonds (B, C, D, E, etc.), each with different features in terms of rating, maturity, currency, degree of subordination and yield. These different mezzanine notes give ABS portfolio managers the opportunity to carefully select the risk/return ratio that best suits their investment requirements.

- **Highly granular portfolios of securitized loans** that can include several tens – or even hundreds – of thousands of loans in one single transaction. This means virtually zero specific risk on any one single issuer, unlike sovereign and corporate bonds. ABS in the broadest sense of the word are one of the only liquid asset classes that provide direct exposure to the real economy.

Low correlation to traditional bond assets

One of the most vital lessons to remember when studying portfolio management theory is the importance of developing a portfolio of assets that are not highly correlated i.e. lower than 1. This very basic idea sits at the very heart of portfolio construction for all asset managers and has been particularly relevant over recent years with the quest for alternative investment solutions with a lower correlation to traditional asset classes.

Mezzanine ABS display low correlation with all the main asset classes – equities and bonds – over the long term, and are even negatively correlated to sovereign bonds (-0.06).

Similarly, if we want to look at how the different asset classes are correlated, without taking into account mezzanine ABS, we can again see that the asset class stands out. By way of example, investment grade euro credit is fairly heavily correlated to most other asset classes (between 0.42 and 0.82) while the range for mezzanine ABS bonds is much lower at between -0.06 and 0.31.

Correlation between the various traditional asset classes over 10 years
(from 12/31/2008 to 12/31/2018)

	Euro Credit IG	Euro HY BB-B	EuroStoxx 50 TR	Euro Fin Sub. Debt	Euro Govies 3-5Y	Euro ABS Mezzanine*
Euro Credit IG	1.00	-	-	-	-	-
Euro HY BB-B	0.74	1.00	-	-	-	-
EuroStoxx 50	0.42	0.62	1.00	-	-	-
Euro Fin Sub. Debt	0.82	0.80	0.64	1.00	-	-
Euro Govies 3-5Y	0.57	0.18	0.01	0.27	1.00	-
Euro ABS Mezzanine*	0.15	0.05	0.07	0.31	-0.06	1.00

Source: Ostrum AM. Data at 12/31/2018. Correlation calculated month by month. The mezzanine ABS market is represented by Ostrum AM's Euro ABS Mezzanine strategy set up on 09/01/2019. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way. Figures mentioned refer to previous years. Past performance does not guarantee future results.

Projections for the asset class

New ABS STS regulation (Simple, Transparent and Standardized) was approved by the European Parliament in the fall of 2017 and implemented on January 1, 2019. This legislation is set to provide a fresh range of opportunities on the ABS market in the broadest sense of the word. ABS must comply with a wide range of underlying criteria in order to achieve this high-quality certified status, and notes with the STS certification will enjoy more favorable regulatory conditions with a reduction in capital charges.

Capital charges are now aligned for senior ABS bonds, covered bonds and corporate bonds. However, prudential rules on mezzanine ABS bonds still remain discouraging for some investors, such as insurers under Solvency II. In light of the quality of a large number of mezzanine ABS tranches recently issued with the STS certification, we hope that discussions will continue in the future to promote more favorable prudential treatment for these investments and provide most investors with access to the full range of opportunities provided by this asset class, which is still a clear source of value.

If this happens, it could provide a fresh influx of some of the investment heavyweights on the euro bond range, narrowing spreads for mezzanine ABS and enhancing liquidity for the asset class.

Ostrum AM's longstanding expertise is a source of value

Ostrum AM has served its clients on the European ABS market since 2005 with two areas of expertise: one global range, investing in senior and mezzanine ABS bonds, and another more specialized area on mezzanine ABS bonds, thereby covering the full spectrum of ratings with in-depth insight into the market.

We have a highly experienced management team, made up of three specialist portfolio managers, with close to 19 years' ABS experience. They have all witnessed various market cycles, including the 2008 financial crisis.

ABS portfolio managers have access to various resources and systems to help them build, develop and optimize their ABS portfolios, providing support across the various stages of their investment process:

- A team of credit analysts: 26 analysts including six analysts who cover international banking sector issuers, the main issuers on the ABS market.
- Three fixed income strategists who develop and apply macroeconomic scenarios and sector trends to support fund managers as they develop their views and opinions and take their decisions.
- The trading desk at Natixis AM Finances, an Ostrum AM subsidiary. The desk has an ABS trader who provides ABS portfolio managers with market access via contacts with almost 30 banking counterparties that operate on the ABS market, as well as the assurance of best execution for their orders.

- Two product specialists on credit and ABS strategies, who provide a contact point for portfolio managers so they can focus on their key role, managing our portfolios.

- Major external and proprietary analysis systems tailored to the ABS market i.e. Intex, Bloomberg, Moody's, etc.

We have developed close business relationships with the main issuers as a result of our longstanding presence on the ABS market, and are able to take part in some fairly rare club deals, which often provide the opportunity of investing in mezzanine ABS bonds with high value added.

For over 15 years, Ostrum AM's ABS management team - rated AAA by Citywire (rating* awarded on August 1, 2019 - has developed its extensive expertise across various market cycles based on in-depth fundamental analysis of each investment in our portfolios, while focusing on the most granular, transparent and diversified deals.

Conclusion – Suitable investment in asset allocation

Mezzanine ABS bonds provide relatively strong yield as compared to all other bond asset classes, and also boast interest rate sensitivity of close to zero. The asset class has sound fundamentals and is highly transparent, and these aspects make for robust credit quality and primarily investment grade ratings (A/BBB).

Mezzanine ABS bonds can provide investors with greater diversification in their overall portfolios: these notes display an attractive risk premium in our view and can therefore round out a yield investment within a broader asset allocation set-up consisting of high yield corporate bonds or even emerging debt for example, or in an investment portion focused on alternative investments.

--- WRITING ---

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LEGAL INFORMATION

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