

AEGON INSIGHTS

# Simple, Transparent and Standardised Asset-Backed Securities

*Simple, Transparent and Standardised ABS offer insurers a compelling option to increase their return on capital, diversify their portfolio and decrease downside risk.*

<b>Yield pick-up</b>	An attractive 90 to 120bp+ yield pick-up over swaps
<b>Favourable Solvency II capital treatment</b>	STS ABS receive a favorable capital treatment under Solvency II. Combined with the yield pick-up, this gives STS ABS an attractive return-on-capital relative to not only non-STS ABS but also relative to other short-dated fixed income strategies.
<b>Diversifying credit exposure</b>	The cash flows produced by STS ABS bonds are typically generated by the underlying consumers paying their mortgages, car loans and credit cards. These tend to follow a different cycle than sovereign and corporate markets where insurers have the majority of their fixed income exposure.
<b>Floating rate Exposure</b>	STS ABS are comprised of 100% floating rate notes. This minimizes risks driven by interest rate sensitivity and can help act as a hedge in a rising rate environment for non-life insurers.
<b>Low correlation with other asset classes</b>	At times of stress many asset classes tend to behave highly correlated. This has been the case with credit and government bond markets. European STS ABS offers clients a degree of diversification versus traditional credit and government bonds.
<b>ESG risk</b>	We only select bonds with a positive ESG profile. ABS bonds with a favorable ESG profile tend to be more liquid, as the investor base grows with the increasing focus on ESG in the investor community.
<b>Liquidity</b>	The asset class provides a liquid strategy that compares well with other credit fixed income options.



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Daniel Torres is an Investment Solutions Consultant within the Fixed Income, LDI and Investment Solutions team. Daniel focuses on capital-efficient solutions and responsible investing for institutional investors.



**Russell Baird**  
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Russell Baird is responsible for delivering investment solutions and strategic asset allocation advice to clients with a strong focus on their liabilities and financial regulations.

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Aegon Asset Management is the global investment management brand of Aegon N.V. See disclosures for more detail.

## Defining Simple, Transparent and Standardised (STS) ABS

Asset-backed securities are loans that are covered by specific collateral pools. The European asset-backed securities market is large and diverse. At over £1 trillion it is comparable to the size of the European investment-grade corporate credit market. It offers a broad range of opportunities across countries and underlying sectors, including residential mortgages, consumer loans (credit card and auto), commercial mortgages and loans to corporations.

The Simple, Transparent and Standardised (STS) label was introduced in 2019 to stimulate activity in the ABS market. The STS framework applies significantly lower capital charges to eligible securities than the former 'Type 1' and 'Type 2' charges, and offers an attractive return on capital under Solvency II, with a yield pick-up over liquid short-dated corporates. The STS investment universe offers a robust and scalable market with the current outstanding market value exceeding £250bn.

## Attractive features for insurers

The extra yield available on STS ABS brings welcomed investment grade opportunities for insurers.

**Table 1: European Investment Grade STS ABS strategies**

Strategy	Spread over swaps	SCR*	Return on capital	Weighted Average Life	Modified Duration
Senior AAA STS ABS	+90 bps	3.2%	~31%	3.2 years	0.25 years
Senior STS ABS	+100 bps	3.0%	~37%	2.9 years	0.25 years
Investment Grade STS ABS	+120 bps	4.4%	~32%	2.9 years	0.25 years

Source: Aegon Asset Management, 31 December 2023. Indicative spreads in GBP. SCR under Solvency II standard formula. Return-on-capital = spread / SCR

## How insurers can incorporate STS ABS into their asset allocation

The following outlines ways in which insurers can incorporate STS ABS into their portfolios. We highlight several of the most common themes.

<b>Seeking a yield pick-up</b>	Many insurers have been drawn to STS ABS because of the yield pick-up it offers over traditional credit and cash. STS ABS is often overlooked by investors as it can be structurally more complex to understand than other traditional fixed income options. This means investors in STS ABS can benefit from an attractive yield premium.
<b>Floating rate exposure</b>	In a rising interest rate environment, some investors have been keen to reduce duration within portfolios. Given the floating rate nature of ABS, it can act as a hedge in a rising rate environment.

*The STS investment universe offers a robust and scalable market with the current outstanding market value exceeding £250bn.*

**Diversifying credit exposure**

At times of stress many similar asset classes tend to become highly correlated. This has been the case with credit and government bond markets. European STTS ABS offers clients a degree of diversification versus traditional credit and government bonds.

As global markets swing from risk-on and risk-off, European STS ABS offers investors an opportunity to diversify their fixed income exposure.

**Access to the consumer**

The cash-flows produced by STS ABS bonds are typically generated by the underlying consumers paying their mortgages, car loans and credit cards. These tend to follow a different cycle to sovereign and corporate markets, providing a different return profile for most portfolios.

## ESG risk categorization in European ABS strategy

At Aegon Asset Management we are active and responsible investors. We believe that responsible investment helps us to identify opportunities, manage risks and contribute positively to sustainable capital markets – all while meeting growing client expectations for ESG. The analysis of environmental, social and governance issues is central to our investment processes. With respect to asset-backed securities, we systematically integrate ESG considerations into our analysis of STS ABS transactions, where it sits alongside fundamental credit-risk analysis, valuation assessments and technical analysis.

Aegon Asset Management’s ABS team performs the ESG analysis of ABS by evaluating collateral data, engaging with ABS originators, and assessing the transaction structure and the country of the collateral. The analysis eventually results in an ESG score for each specific ABS transaction we assess.

We categorize the ABS collateral, the ABS originator and the country of collateral on a scale from 1 to 5, to come to an overall ESG risk assessment for ABS bond. The majority of our ABS bonds are assigned an ESG risk category between 2 and 3, with (very) low ESG risks. We estimate that the average ESG risk category of the ABS universe is 3, with ~10% classifying below 3.5. ABS bonds with lower ESG risk tend to be more liquid, as the investor base for such bonds grows with the increasing focus on ESG in the investor community. We do see reputational risk in ABS bonds with a high (bad) ESG risk category, and so we only invest in ABS with a favorable ESG profile. This means that we avoid investing in bonds with a score of either 4 or 5.

## Our approach to managing STS ABS

To capture inefficiencies across STS ABS markets, we believe it is essential to have genuine and committed asset-class expertise, coupled with an inquisitive attitude. We have a seasoned and experienced team of 12 ABS professionals in Europe and 20 globally who share a common philosophy and cover the whole ABS universe. The demanding nature of STS ABS markets and instruments requires a disciplined and thorough analysis of various investment dimensions. Our proprietary ‘meso’ or sector view, goes beyond the usual ‘macro’ (top-down) and ‘micro’ (bottom-up) inputs to rank the most attractive STS ABS sectors. Furthermore, each investment idea undergoes in-depth scrutiny from a multitude of research angles prior to approval.

*We believe that responsible investment helps us to identify opportunities, manage risks and contribute positively to sustainable capital markets.*

We believe in the value of our in-house tools and models. They offer clear advantages over off-the-shelf systems: there is no ‘black box’ to interpret. Our own solutions give us full control and we have conviction around the inputs and outputs. Our models enable us to simplify multiple dimensions and extensive sets of data into clear decision parameters. Most importantly, our proprietary tools help us to quantify risks and opportunities.

## Serving our clients<sup>1</sup>

Given our insurance heritage, and expertise managing assets on behalf of insurers globally, we are well positioned to understand the importance of your asset manager appointment. Our dedicated insurance portfolio managers and analysts understand the bespoke nature of insurance companies and the challenges you face. We have built an infrastructure from a process and reporting standpoint that allows us to directly address the unique capital and regulatory concerns of our individual insurance clients.

## Contact us



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Aegon AM manages  
GBP 90 billion on behalf of  
189 insurance clients globally



<sup>1</sup> AuM as at 30 September 2023.

## Disclosures

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The principal risk of this product is the loss of capital. Please note that the investments underlying this particular strategy are illiquid and investors should consider fully the consequences of investing in illiquid assets. Other risks will be present. The materiality of these risks will be accounted for in the mandate which will be governed by an investment management agreement.

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