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A Guide to Securitized Credit

The securitized credit market has evolved, through economic cycles and crises, into a popular fixed income allocation. However, its breadth, relative youth, and perceived complexities can be challenging for new investors, causing them to miss out on the asset class's opportunities. Here's what you need to know.

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Table of contents

Executive summary

Large, liquid asset class: Securitized credit is a $3.3 trillion ecosystem of U.S. bonds repaid by cash flows from loans and other contractual agreements, with a structural dimension that prioritizes repayment across tranches of debt.[1]

Natural source of alpha: Historically, securitized credit has offered a spread premium to similarly rated corporate bonds due to its securities' structural complexity, while also being under-represented in major fixed income indexes.

Distinctive credit exposures: Securitized credit offers unique, liquid forms of direct consumer, housing and commercial real estate exposure, with a scalable supply of floating-rate securities and a broad menu of credit ratings.

Important diversifier: The wide range of sectors which make up securitized credit all have distinct credit cycles and low correlation to other fixed income assets, helping improve risk-adjusted returns in multi-sector/multi-asset portfolios.

Evergreen opportunities: Given the breadth of the asset class and its varied fundamental drivers, there are always attractive opportunities within it. As such, securitized credit should be a standard part of sophisticated fixed income portfolios.

Recommended allocation: While portfolio goals and risk tolerance must be considered, our advanced modeling shows that allocating approximately 40-55% of sophisticated investors' non-core fixed income portfolio to securitized credit is optimal.

[1]Market size estimate as at 12/31/24. Source: BofA, Voya IM.

What is securitized credit?

Securitized credit has historically offered higher spreads than similarly-rated corporate bonds.

Securitized credit has evolved into one of the largest segments of public fixed income, a $3.3 trillion market that has historically enticed investors with higher spreads than those offered by similarly rated corporate bonds (Exhibit 1).[2] It is a broad, liquid ecosystem of bonds repaid by cash flows from loans and other contractual agreements (i.e., collateral), with a structural dimension that prioritizes repayment across tranches of debt.

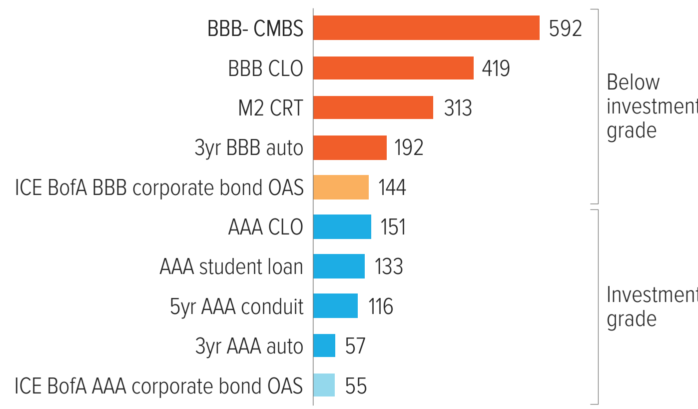
Securitized credit traces its roots back to the government-sponsored agencies Fannie Mae, Ginnie Mae and Freddie Mac (the GSEs) and the advent of securitization via the agency mortgage-backed security (MBS) markets in the 1960s. Then, in the 1980s, the market expanded into securitizations that involved investors taking credit risk associated with the underlying collateral.

The securitized credit market has enjoyed healthy issuance over the past few years (Exhibit 2). If you are new to this asset class, we'd say it's time to get to understand it—but, chances are, you already do. If you have ever had a mortgage, or a credit card, or an auto loan, your money has likely been involved in the securitized credit market, and you certainly understand the risk in a borrower's willingness and capacity to repay that obligation.

If you have ever had a mortgage, a credit card, or an auto loan, your money has likely been involved in the securitized credit market.

Exhibit 1: Securitized credit tends to offer higher spreads than corporate bonds

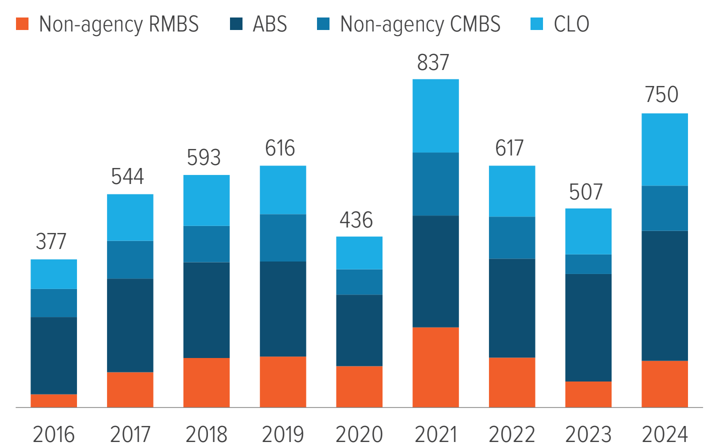
Four-year average spread to U.S. Treasuries (bp)



Source: Bloomberg, FRED. BBB spreads are to the ICE BofA Baa OAS Index; AAA spreads are to the ICE BofA AAA OAS Index. Student loan spread average is from 07/31/24 to 12/31/24; other spread averages are 12/31/20 to 12/31/24. Investment grade, fixed-rate auto ABS and conduit CMBS with WAL > 1 year are included in the Agg, whereas the other securities shown are not, which helps account for their tighter spread to corporates. Past performance does not guarantee future results.

Exhibit 2: Securitized credit issuance reflects a healthy, scaled market

Annual U.S. securitized credit issuance ($ billions)



As of 01/17/25. Source: BofA Global Research, Intex, Bloomberg.

[2] Market size estimate as at 12/31/24. Source: BofA, Voya IM.

Why is securitization important?

Securitization is critical to the liquidity and efficient operation of the U.S. economy.

Almost any type of asset that is contractual and has a recurring cash flow can be securitized.

Securitization—the process of pooling similar loans or other cash flows and selling them off as bonds—is critical to the liquidity and efficient operation of the U.S. economy.

Without the ability to securitize, lenders with their loans on their balance sheets would have difficulty approving new loans until the previous ones paid back. This would concentrate capital, limiting credit availability and, ultimately, economic growth.

In other words, securitization allows lenders, such as specialty finance companies and banks, to specialize in and profit from originating loans. It also allows a diversified buyer base of individuals and institutions to generate return from holding these securities as investments.

Securitization allows...

banks and other lenders to operate more efficiently and profitably as originators of credit.

borrowers to access a larger, more diversified, regularly renewed, and generally more predictable supply of lending capital.

investors to access a universe of bonds that has different risks and return drivers than broader fixed income (in a scalable, liquid form).

Almost any type of asset that's poolable, is contractual, and has a recurring cash flow can be—and usually is—securitized: mortgages, auto loans, student loans, corporate loans, franchise payments, credit card receivables and more.

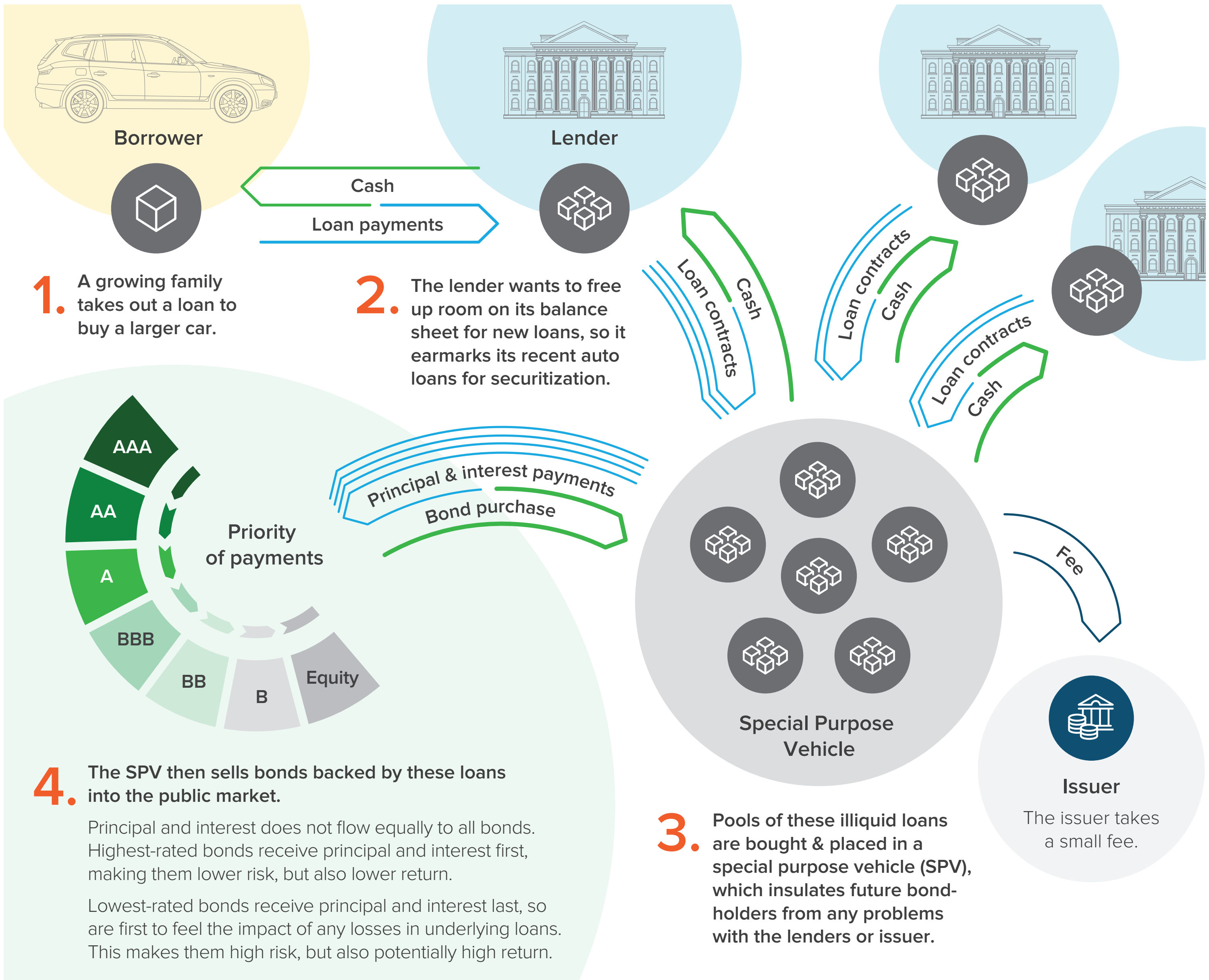
In order to properly isolate the assets from their originator, a bankruptcy-remote special purpose vehicle (SPV) is created, and it purchases the assets in a "true sale" transaction (Exhibit 3). As the market has broadened and evolved, various forms of issuance vehicles have been used (master trusts, owner trusts, REMICs), but these can collectively be referred to as SPVs for now.

To finance the purchase, the SPV will then issue bonds, typically structured in various tranches—these are dictated by their respective priority of payments, mapped to degrees of credit quality. Tranches can command credit ratings of AAA all the way down to an unrated, first-loss "equity" tranche.

The principal and interest these bonds pay out will be drawn from the cash flows of the underlying private loans according to their payment priority, as established in governing deal documentation. Tranche ratings are usually done by at least one major rating agency (a nationally recognized statistical rating organization, or "NRSRO").

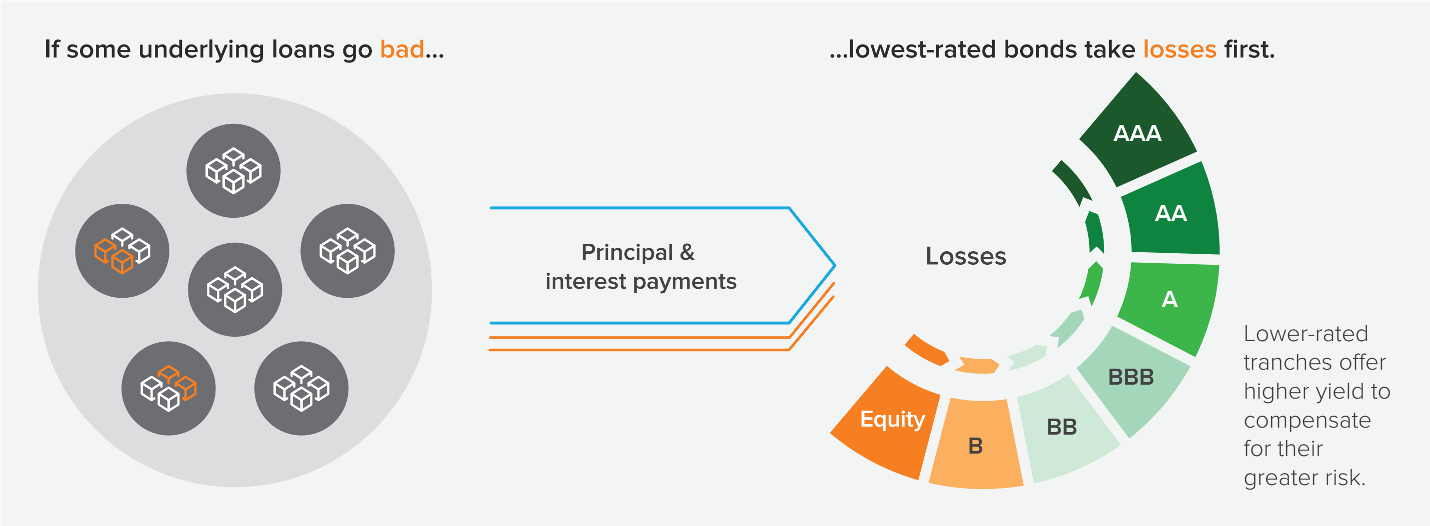
Each of those tranches will pay a different interest rate, intended to reflect their varying degrees of credit quality. However, the weighted average interest rate of the entire securitized bundle will typically be lower than that of the original pool of loans, leaving "excess spread" that can function as credit support or potentially be financed in the market as well.

Exhibit 3: How securitization works



Source: Voya IM. For illustrative purposes only.

Exhibit 4: If loans stop paying, then the lowest-rated tranches absorb the loss first



Source: Voya IM. For illustrative purposes only.

Interest and principal flows to the highest-rated tranche first.

Tranching allows securitized bond issues to appeal to a broader range of risk appetites.

Interest and principal cash flows from the loans are prioritized towards paying out the highest-rated tranche first, then descending in a waterfall to the lowest-rated tranche. Therefore, issuers are able to obtain a higher rating for a portion of the bonds than would otherwise be assigned to the overall pool of loans. The size of that portion will be directly related to the risk of the underlying collateral. In other words, a pool of loans with high-quality collateral will have a much larger AAA tranche than a pool of loans with lower-quality collateral. This increases the liquidity profile of the collateral pool, fueling the securitization engine and attracting more issuers and investors to the market.

Of course, there is still risk in the timing and ultimate certainty of the collateral repaying. If any of the underlying loans move into nonpayment or default, the resulting losses are prioritized in the opposite direction: The lowest-rated bonds in the offering absorb everything, until they're wiped out. Losses then hit the next-lowest tranche, and so forth (Exhibit 4).

The benefit of tranching, rather than dividing up the risk pro rata, is it allows the bond issue to appeal to a wider variety of investors, with different risk levels and duration options to best suit the goals of individual fixed income portfolios.

For example, banks and other regulated financial institutions (e.g., insurers) are typically attracted to the higher-rated tranches due to their structural protections. Hedge funds and other high-risk investors are typically attracted to the lower-rated tranches, due to the structural leverage that ties to increased risk but higher return potential.

What are the most common types of securitized credit?

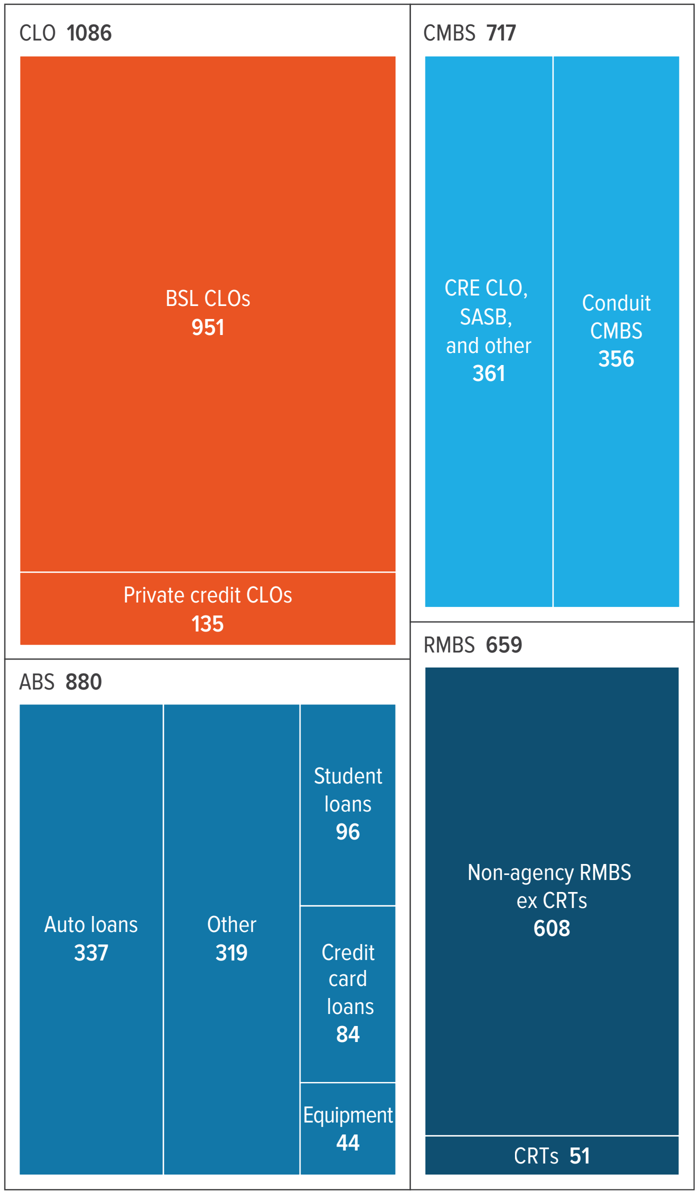
As mentioned previously, almost any type of asset (i.e., collateral) that has a contractual, recurring cash flow can be securitized. Given the breadth of collateral with these attributes, securitized credit markets have evolved into four major "food groups," generally delineated into mortgage-backed and non-mortgage-backed sectors.

The mortgage-backed sectors are CMBS (commercial mortgage-backed securities) and RMBS (residential mortgage-backed securities). Securitized pools of corporate loans become CLOs (collateralized loan obligations), and all other asset types are classified as ABS (asset-backed securities), the broadest and least homogeneous of the sectors. These four primary groups can each be broken down into a number of subsectors. Exhibit 5 depicts the primary sectors and some example subsectors.

Securitized credit breaks down into four major collateral groups, the biggest of which is CLOs.

Exhibit 5: Securitized credit's four food groups

U.S. securitized credit outstanding by major category ($ bn)



As of 12/31/24. Source: Voya IM, BofA. Size of slices corresponds to amount outstanding.

What about agency mortgage-backed securities?

The modern securitization market began in America in 1968, when Ginnie Mae issued the first mortgage-backed security (MBS)—taking a pool of residential mortgages and turning them into a publicly tradeable security. The other two government-sponsored entities, Fannie Mae and Freddie Mac, soon followed, and thus the $9 trillion agency MBS market was born.

While agency MBS are often compelling investments, they should not be conflated with securitized credit. Agency MBS interest and principal are guaranteed by the entities themselves (or, in the case of GNMA, the U.S. government). This means that investors in agency MBS are not exposed to credit risk, which is otherwise central to risk-taking in securitized credit sectors.

Agency MBS are not considered securitized credit because they do not have credit risk.

Agency MBS do have other risks, primary among them **prepayment and convexity risk**—the adverse and asymmetric impact of changing interest rates on a bond's price due to homeowners' option to refinance/prepay.

Some bonds issued by the GSEs, such as CRTs and parts of multi-family CMBS, do carry credit risk (a carry-over from the GSEs' conservatorship terms), and as such they are included in securitized credit portfolios.

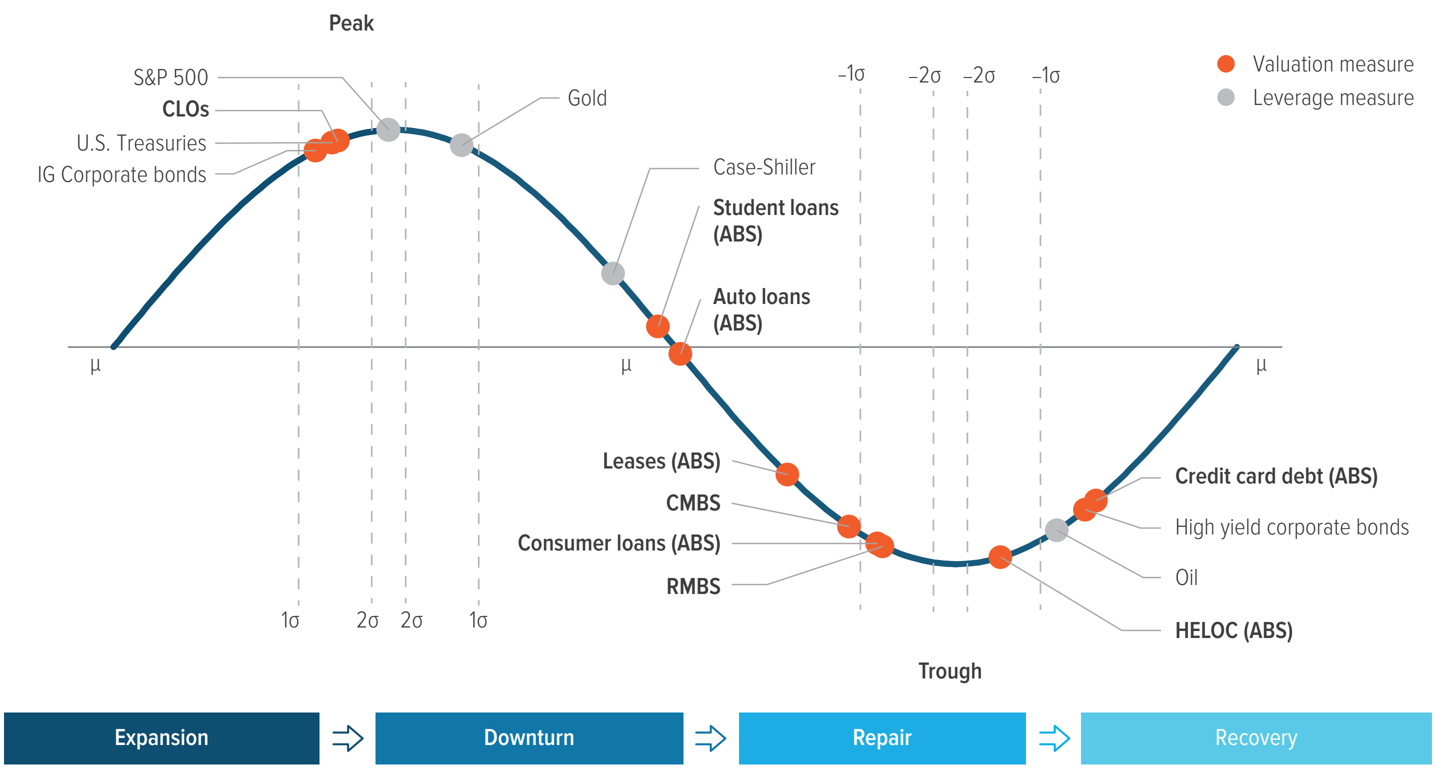
Securitized credit sectors follow a range of credit cycles, which aids diversification.

What drives securitized credit valuations?

The fundamentals that drive behavior in each of these sectors (and, for ABS, subsectors) tend to track differently across their respective credit cycles (Exhibit 6). This is where the potential for diversification and reduced correlation comes in.

At the highest level—and, in some cases, stating the obvious—CMBS performance depends on commercial real estate markets, RMBS on housing, CLOs on corporate credit, and ABS on the consumer and other sectors of the economy. Some of these are shown in Exhibit 6.

Exhibit 6: At any given time, securitized credit offers options across the credit cycle



As of 01/08/25. Source: Voya IM estimates.

Securitized credit is distinctive for its liquid forms of direct consumer and real estate exposure.

How much variety does securitized credit offer?

Given the breadth of their fundamental drivers, securitized credit sectors vary in terms of weighted average life, duration, coupon type and credit rating (Exhibit 7). These characteristics each offer dimensions along which to take risk and construct portfolios, generating a combination of attributes often simply not available in other fixed income sectors.

Securitized credit is distinctive for its liquid forms of direct consumer, housing and commercial real estate exposure, with a scalable supply of floating-rate securities and a broad menu of credit ratings.

Exhibit 7: Duration, coupon type, driver and typical rating varies between sectors

	ABS	Non-agency RMBS	Credit risk transfers	CMBS	CLOs
Cycle	Varies	Housing market	Housing market	Commercial real estate	Corporate credit
Coupon	Mainly fixed	Mainly fixed	Floating	Fixed & floating	Floating
Rating	AAA to below IG	AAA to below IG	Low IG & below	AAA to below IG	AAA to below IG
Weighted average life	3-5 years	4-6 years	4-6 years	3-10 years	5-10 years

Source: Voya IM.

Securitized credit comes with structural protections designed to mitigate nonpayment risk.

Credit enhancement can also help investments get better with age.

What is credit enhancement?

A crucial part of securitized credit's underwriting process is **credit enhancement**, which refers to structural protections within a transaction that are designed to mitigate nonpayment risk from the underlying assets. This is another factor that sets securitized credit apart from most other forms of public fixed income.

The primary way credit enhancement is accomplished is via **subordination/tranching** (Exhibit 3). However, that's far from the only method of loss mitigation baked into securitized credit.

Other forms of credit enhancement include:

- **Excess spread:** This refers to when the coupon of the underlying loans is higher than the weighted average coupon paid to investors. The excess interest income not paid to investors functions to absorb credit losses, such that full coupon payment can still usually be made even if some of the underlying loans are delinquent.
- **Overcollateralization:** This is like excess spread, but for principal—in other words, the principal of the underlying loans is higher than the principal of the bonds issued from it. Again, this creates a cash cushion that can be used to absorb credit losses.
- **Reserve/spread account:** A reserve account is like a sliding-scale overcollateralization, where assets are set aside to absorb potential losses before they would be allocated to bondholders. These accounts may be increased or decreased over time, or they may be static. The reserve account assets can be placed back into the general loan pool when certain performance triggers are hit, or they can be structured to be non-declining for the life of the transaction. With a non-declining reserve account, investors benefit increasingly as underlying bonds repay over time, since a growing share of the principal balance is protected from losses (also called deleveraging the structure).

Credit enhancement helps set the stage for an investment that only gets better with age. As collateral is repaid and senior tranches are repaid, subordinate classes see their protections increase as the overall deal structure deleverages. Ratings upgrades may follow, and risk-takers can be rewarded.

How has the securitized credit market evolved since 2008?

The securitized credit market has changed significantly since the global financial crisis. While some underlying loans still go bad, and risky loans are still made, there is significantly more regulation and transparency. This mitigates the chances of issues with particular sectors or loan groups becoming systemic, as they did with subprime mortgages in 2008 (Exhibit 8).

There is significantly more regulation and transparency in today's securitized credit market.

Exhibit 8: Regulation has improved collateral, transparency and risk management across the lending landscape

2008

Global Financial Crisis

2010

Dodd-Frank Act

Increased financial stability of the banking channel and consumer financial protection via the Volcker Rule, CFPB (RIP), NRSRO regulation, and the risk retention rule

2013

Credit Risk Transfer program

Moves some mortgage default/delinquency risk off Fannie Mae and Freddie Mac's balance sheets into the private sector

Qualified Mortgage Rules

Sets limits on risky loan features, borrower debt to income ratio, APR and other loan characteristics with the idea that banks must make a good faith effort to make sure borrowers have the ability to repay their mortgage

2014

Regulation RR

Requires securitizers to retain at least 5% of the credit risk of the assets collateralizing the securities, essentially forcing a base level of credit enhancement

Regulation AB II

Increases disclosure rules for asset-backed securities, such as a monthly delinquency and loss information, greatly improving transparency

TILA, RESPA, TRID, HOEPA

Comprehensive amendments of mortgage lending and servicing laws and regulations to improve lender and servicer behavior

2015

2021

Basel III (ongoing)

Increases banks' capital adequacy requirements, reducing their capacity to make subprime loans

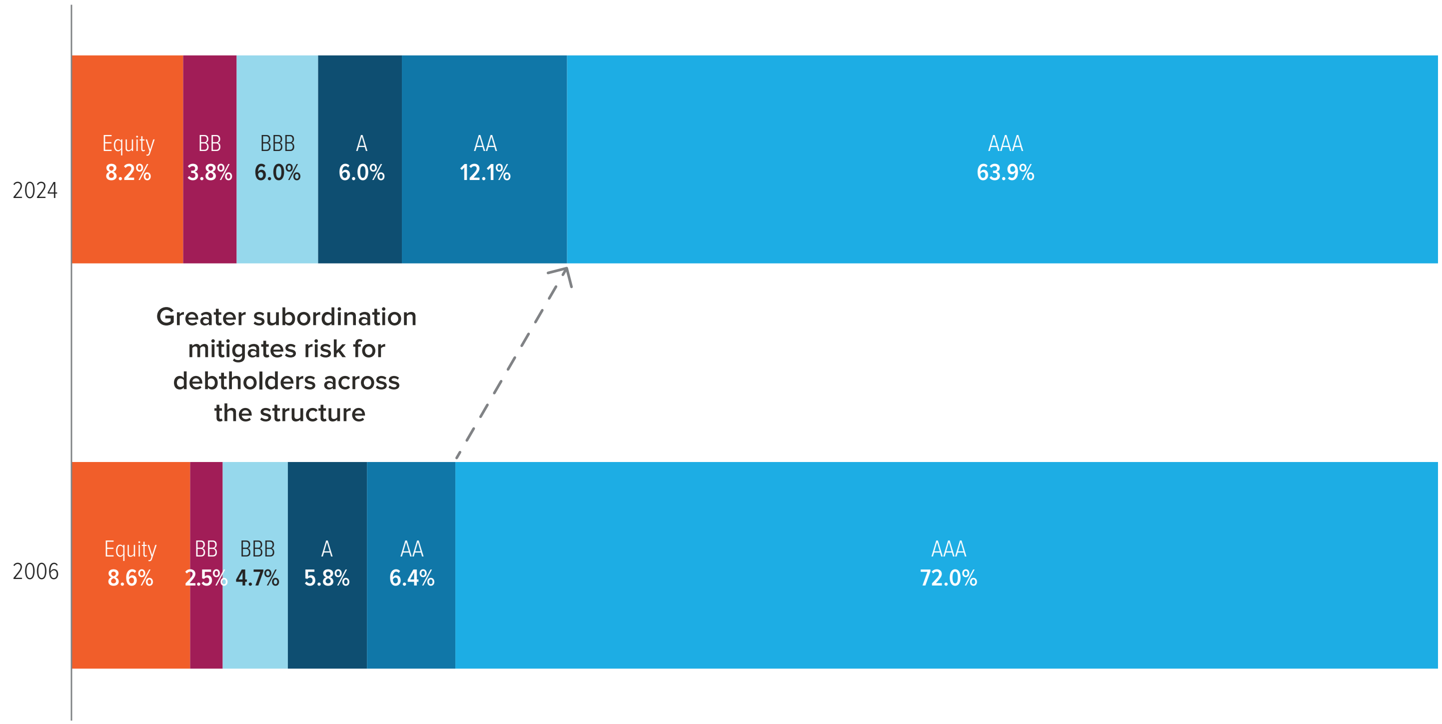
How have investor preferences changed since 2008?

Subordination has increased in the average CLO from 28% to 36%

Here's one example of the private market also moving towards improved safety in the securitized market. While CLOs have been exempted from Regulation RR's risk-retention requirements, the average structure of a collateralized loan obligation has still shifted significantly towards increased subordination since the global financial crisis. This has resulted in more protection for debtholders across the CLO capital structure (Exhibit 9).

Exhibit 9: CLO structure has become more conservative in the past two decades

Median structure of a broadly syndicated loan CLO, 2006 vs. 2024



As of 01/30/25. Source: Voya IM estimates.

Which is riskier, corporate bonds or securitized?

On the whole, increased regulation and transparency have led to sharply improved rating stability and lower default rates over the past 10 years (Exhibit 10).

Below investment grade securitized bonds have a lower default rate than similar corporate bonds.

Exhibit 10: Securitized credit's default rate compares favorably with corporate bonds

Annual default rates for U.S. corporate bonds and securitized credit (%)

	IG sec credit	IG corp bond	Below IG sec credit	Below IG corp bond
2014	–	–	5.2	1.6
2015	–	–	2.8	2.9
2016	–	–	1.6	5.2
2017	–	–	2.2	3.1
2018	–	–	2.1	2.4
2019	–	–	2.0	3.1
2020	–	–	0.0	6.7
2021	–	–	0.5	1.5
2022	–	–	0.7	1.7
2023	–	0.2	0.7	4.5

As of 12/31/24. Source: S&P Global Ratings Credit Research & Insights.

How does securitized credit benefit a fixed income portfolio?

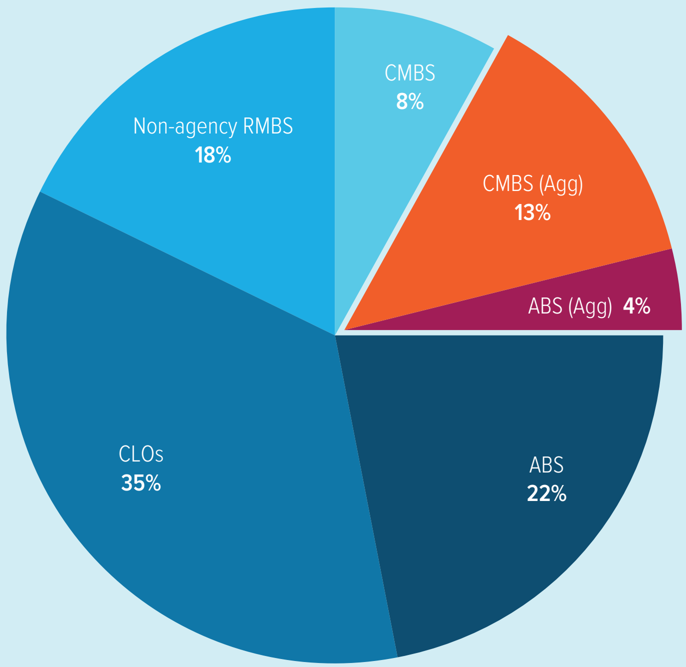
Securitized credit is deeply underrepresented in the Bloomberg U.S. Aggregate Bond Index (the Agg). It makes up 8% of total public fixed income issuance but only 2% of the index. And that 2% only includes high-quality, low-risk/return ABS and CMBS (Exhibit 11), which means more passive Agg-oriented strategies are poorly diversified within the asset class.

Adding securitized credit to a fixed income portfolio has two primary potential benefits.

1. **Diversification:** Securitized credit assets have distinct credit cycles and low correlation to other fixed income assets, helping improve risk-adjusted returns in multi-sector/multi-asset portfolios (Exhibit 12).
2. **Yield:** Every fixed income investor wants the most yield they can get for their level of risk, and securitized credit has traditionally offered a higher spread than comparably rated corporate bonds (Exhibit 1), while also having one of the most attractive risk/return profiles in fixed income (Exhibit 13).

Securitized credit is deeply under-represented in the Agg, making it a potential source of alpha.

Exhibit 11: The Agg only covers 17% of securitized credit



As of 12/31/24. Source: Voya IM, Bloomberg Barclays, BofA Global Research.

How much should you allocate to securitized credit?

While allocations depend on portfolio goals and risk tolerance, our models estimate that allocating approximately 40-55% of your non-core fixed income portfolio to securitized credit is optimal.[3] For example, a fixed income portfolio that is split 70/30 core and non-core would allocate around 15% to securitized credit.

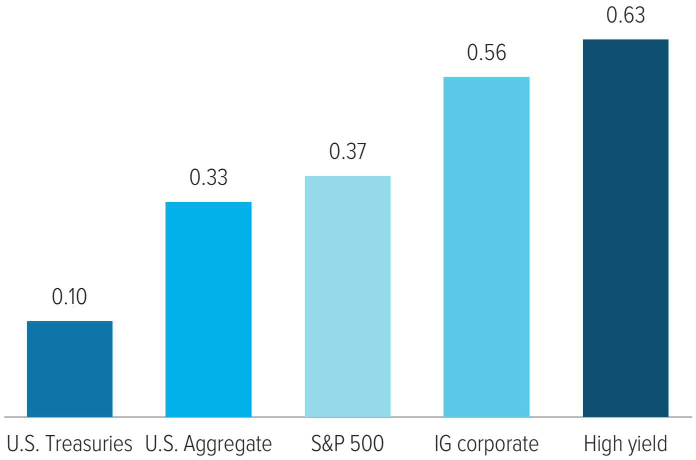
We estimate the optimal securitized allocation is 40-55% of non-core fixed income.

At Voya, we view securitized credit as an evergreen allocation. Because its major segments have different macro drivers and out-of-phase credit cycles on top of a range of micro opportunities, we believe there are always attractive securities within the asset class.

Voya has a large, dedicated securitized credit desk with the skill and resources to undertake deep fundamental analysis into the sectors and bonds that make up the securitized credit universe—enabling our team to uncover attractive investments and time allocation shifts. We would welcome the opportunity to discuss how securitized credit could help you achieve your investment goals.

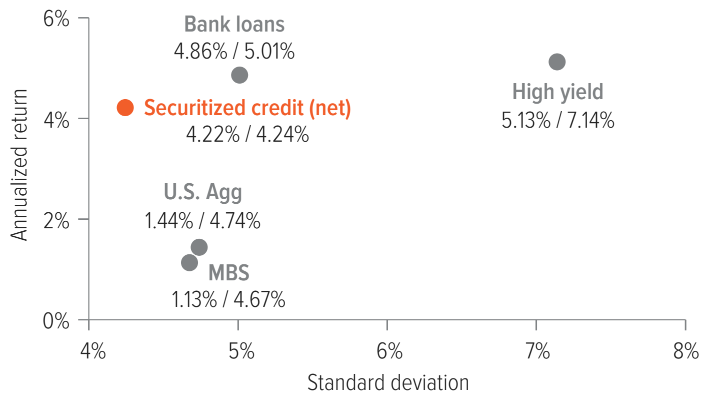
Exhibit 12: Securitized credit has low correlation to other major fixed income sectors

Voya Securitized Credit correlation to other asset classes, 01/31/15-12/31/24



As of 01/17/25. Source: Voya IM.

Exhibit 13: Securitized credit has among the best fixed income risk/return characteristics of the past 10 years



As of 12/31/24. Source: YCharts, Voya IM. Calculations based on monthly data. See back page for index definitions and additional disclosures. **Past performance is no guarantee of future results.**

[3] For more details, see our white paper Modeling Securitized Credit.

A note about risk

The principal risks are generally those attributable to bond investing. Holdings are subject to market, issuer, credit, prepayment, extension, and other risks, and their values may fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition. The strategy invests in mortgage-related securities, which can be paid off early if the borrowers on the underlying mortgages pay off their mortgages sooner than scheduled. If interest rates are falling, the strategy will be forced to reinvest this money at lower yields. Conversely, if interest rates are rising, the expected principal payments will slow, thereby locking in the coupon rate at below-market levels and extending the security's life and duration while reducing its market value.

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