3

US asset-backed securities market review and outlook

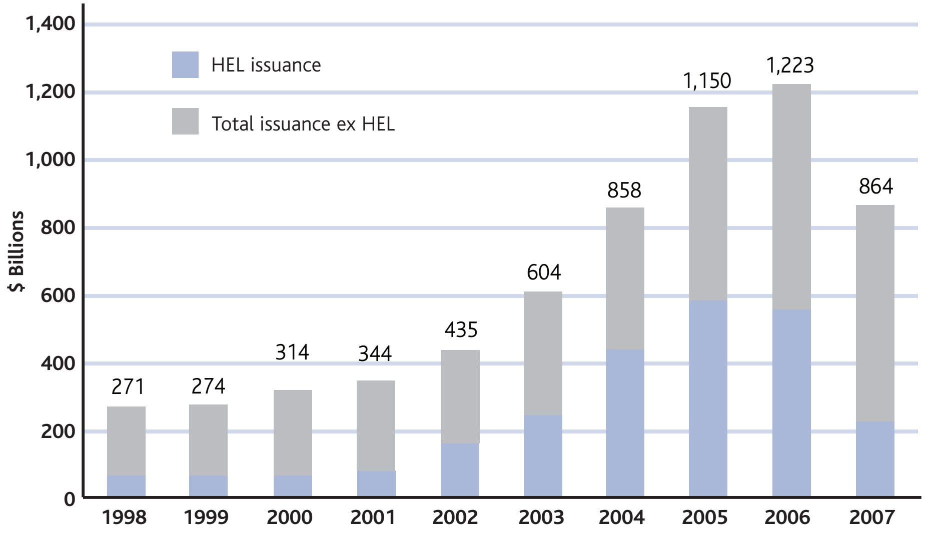
Karen Weaver
Deutsche Bank

After a solid decade of growth, overall asset-backed securities (ABS) issuance declined by 29 per cent in 2007 versus the full year of 2006 (see Figures 1 and 2). US issuance of approximately $864 billion was the lowest level since 2004, when aggregate securitisation volume was $858 billion. The sub-prime residential mortgage-backed securities (RMBS) sector, the largest source of securitisation activity, declined by an unprecedented 58 per cent, while collateralised debt obligations (CDOs), the second largest sector, declined by nearly 11 per cent. Wider spreads in the second half of 2007 led to an issuance slowdown in other sectors as well, notably equipment, student loans and autos. The credit card sector was the only major asset class to experience an overall increase in supply from the prior year's levels (see figure 2).

The year 2007 will also be remembered as a year of unprecedented rating volatility. An estimated $300 billion of securities were downgraded in 2007, the worst year on record. The next highest year was 2003, when $142 billion of securities were downgraded. Ninety-five per cent of the downgrade activity was related to two sectors: sub-prime RMBS and CDOs backed by sub-prime RMBS. Downgrades were heavily concentrated in the most recent vintage years; for example, by our estimates, nearly two-thirds of the 2006 ABS CDOs have been downgraded or are currently under review for downgrade.

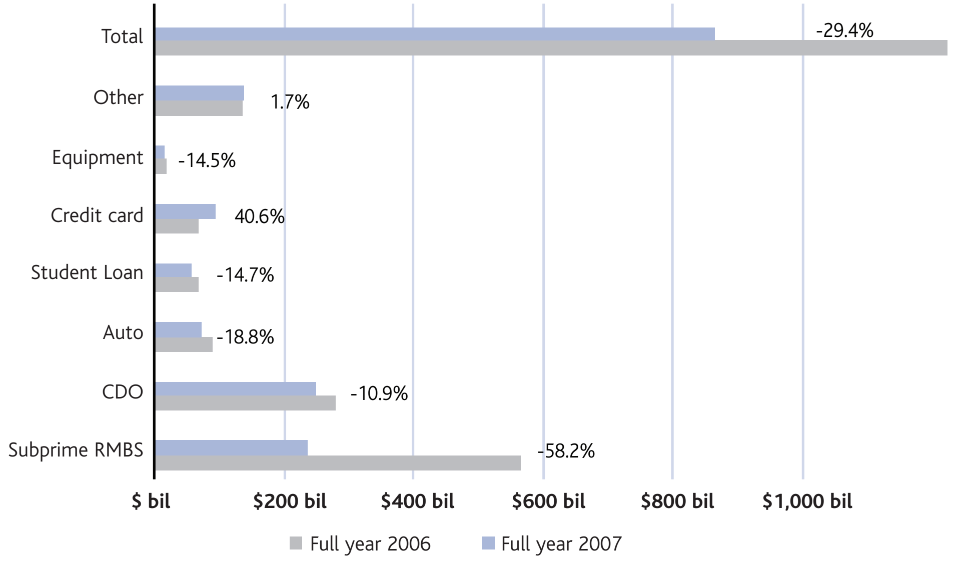
As we look ahead to 2008, we see several key themes emerging. First and foremost, the credit issues of 2007 are by no means in their final act. And barring widescale government intervention, which is unlikely, the level of delinquencies, foreclosures and downgrades in the sub-prime mortgage sector will continue to get worse for some time. This means more credit volatility and downgrades lie ahead.

Figure 1: A decade of growth comes to an end



Source: Thomson Financial Securities Data. Deutsche Bank

Figure 2: Issuance of US ABS falters



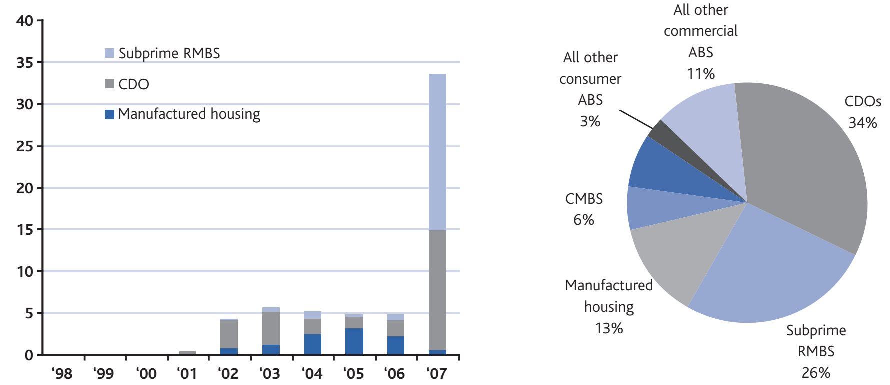
Source: Thomson Financial Securities Data. Deutsche Bank

Contagion, another theme, continues to be a much-feared prospect, given the importance of the mortgage sector to the overall economy. While it is true that the housing crisis did not occur in a vacuum, we also think that it is unlikely that other consumer asset classes will experience the same level of credit deterioration. Almost a year after the spike in sub-prime mortgage delinquencies, the major credit card issuers continue to report delinquencies and charge-offs that are in line with historical norms. All consumer assets will underperform relative to their track record in the 'housing boom' years, and of course the spectre of recession grows larger. Were the economy to soften much further, all consumer assets would suffer incrementally. However, credit card (and most other) lenders may have been aggressive in lending, but they were not as reckless as those sub-prime mortgage lenders with no 'skin in the game'. Lastly, we believe the major card issuers have at their disposal more options to contain losses than their peers in sub-prime mortgages.

A third theme that will continue to emerge in 2008 is greater scrutiny and differentiation among structured product investors, especially in the short-term sectors. As recently as four months ago, the entire asset-backed commercial paper market was in turmoil as investors pulled out funds fearing that sub-prime RMBS risk was everywhere. It wasn't. Those programmes which were exclusively focused on sub-prime mortgages and CDOs have paid the price and are either liquidating or in the process. But the largest issuers of asset-backed commercial paper market, multi-seller conduit programmes have seen improved stability in the US and a return to more realistic funding levels as investor confidence has stabilised.

At the other end of the market, we expect to see a fourth theme taking hold in 2008: the emergence of a *bona fide* distressed ABS market. The level of downgrade activity in 2007, which is expected to continue this year, has resulted in an unprecedented increase in the universe of distressed securities (see Figure 3). Nearly $35 billion in ABS experienced a downgrade to double-C or lower in 2007. The vast majority of impaired securities were in the sub-prime and ABS CDO sectors. And with downgrades continuing, we expect to see the universe of distressed securities grow even further in 2008. The

Figure 3: Expanding distressed market in US ABS (data as of year-end 2007)



(a) Securities downgraded to double-C or lower by at least one rating agency

(b) Cumulative totals of securities downgraded to double-C or lower by at least one rating agency

Source: : Deutsche Bank, Moody's, S&P, Fitch cumulative amount of ABS downgraded to double-C or lower is currently estimated to be about $80 billion.

In the past, historically low levels of rating migration meant that there were few opportunities in non-investment grade securities. The market for high-yield corporate debt creates a natural home for investment grade corporates that have been downgraded. And the distressed corporate market creates a home for high-yield corporate credit that has been downgraded. But these markets have historically not existed for ABS. One of the reasons why liquidity is so poor for downgraded ABS is that few investors have made a commitment to the tools and personnel needed to evaluate the bonds. That is no more the case. And while the emergence of distressed ABS funds has the potential to create a more efficient exit strategy for investors wanting to sell, it is likely that having a bottom buyer in this market could potentially have a positive impact on liquidity on higher parts of the capital structure as well.

This chapter is taken from previously published Deutsche Bank research.