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European securitisation market review and outlook

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A look back at the most tumultuous year in the market's history

The credit crisis that took hold from Summer 2007 was without doubt a fundamental market-reshaping event for the securitisation market, triggering what can only be described as the most tumultuous year in its history. The genesis of the credit crunch was essentially a run on structured finance, manifesting in a significant retrenchment and repricing of asset-backed market liquidity, with the catalyst in this case being, of course, the US sub-prime mortgage meltdown. And the impact of this run was seen not only in the securitised product marketplace, but also more spectacularly in all of its constituencies, whether the leveraged investor base (eg, structured investment vehicles (SIVs), arbitrage conduits), monolines or securitisation-dependent asset lenders, whether bank or non-bank.

One of the features that distinguished the European securitisation market since its inception from other fixed-income sectors is its investor base, dominated uniquely by the likes of SIVs and securities arbitrage conduits, as well as more recently by money market funds. The resurgence of SIVs and conduits as 'ABS carry trade' investors in recent years saw these bank-sponsored off-balance-sheet vehicles come to play a very influential role in demand in 2006/7, along with the 'enhanced' or 'dynamic' LIBOR-plus money market funds (many of which are domiciled in France and Germany), a sector which especially dominated as the marginal buyer of asset-backed product following tremendous growth of retail money inflows since 2004. Together, we estimate that these investor constituencies accounted for as much as 70 per cent of the primary bid for senior, AAA securitised bonds in 2007 and only moderately less in the market for BBB new issue paper. Beginning in late July 2007, there was effectively a collapse in asset-backed commercial paper (ABCP) appetite for SIVs and investment conduits, with a similar run seen on

Table 1: AAA spread comparison over the years (bp)

Asset class	2004	2005	2006	2007
Prime MBS	9	9	8	65
Non-conforming MBS	15	16	14	170
Credit card ABS	12	9	12	78
Conduit CMBS	21	26	19	89
Leveraged loan CLO	33	24	22	90
Cash SME CLOs	12	13	15	75

Source: Deutsche Bank Global Markets Research

Note: Based on observable secondary spreads at year-end

retail money invested in European money market funds. Compounded by sharp falls in asset valuations, these disenfranchised investor constituencies have been effectively forced into de-levering, with most expected to downsize over time and a few forced into an accelerated fire-sale of assets. With SIVs, conduits and money market funds no longer incremental investors in the primary market, the European structured finance market suffered a sharp contraction in its demand base, with potentially far-reaching consequences.

The spread widening across all securitisation asset classes over Summer 2007 has no parallel whatsoever. Liquidity was conspicuously absent as bid-offer spreads gapped out dramatically, while secondary price discovery characterised any trading in European asset-backed bonds. We make a number of observations on price action in the structured finance market over recent months. First, the liquidity crisis affected all financial credit, with the sharp sell-off extending from the short-term interbank and ABCP sectors to the term markets in bank debt and asset-backed securities (ABS) credit. The effect was systemic; indeed, the degree of spread retrenchment on securitised bonds was comparable (certainly no worse) to trends in other financial credit, to include senior bank unsecured paper and structured or non-legislated covered bonds.

Second, we note that within the ABS/collateralised debt obligation (CDO) universe, senior AAA bonds

Table 2: BBB spread comparison over the years (bp)

Asset class	2004	2005	2006	2007
Prime MBS	63	48	47	250
Non-conforming MBS	85	82	85	600
Credit card ABS			66	280
Conduit CMBS	95	105	85	336
Leveraged loan CLO	235	160	140	500
Cash SME CLOs	80	60	58	355

Source: Deutsche Bank Global Markets Research

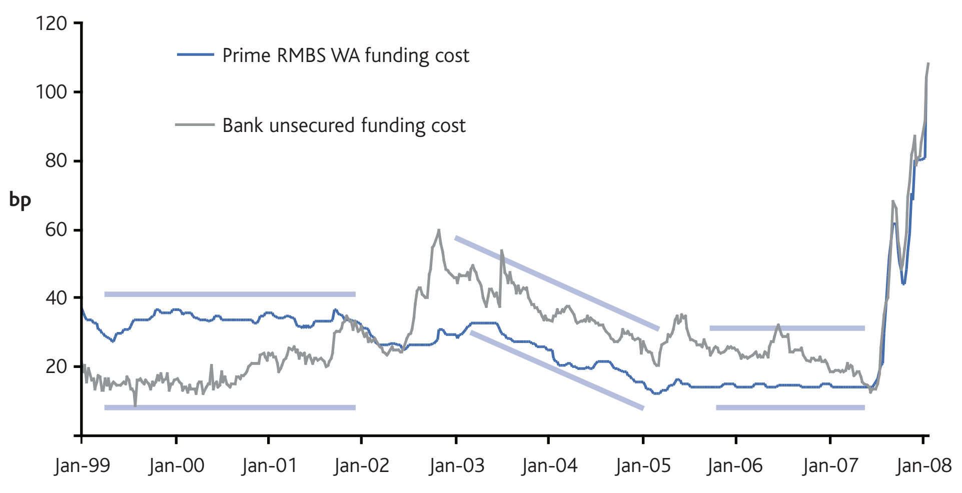
Note: Based on observable secondary spreads at year-end looked to have been disproportionately affected, as were the more vanilla, financial receivable-based securitisations such as residential mortgage-backed securities (RMBS). Short-dated dollar-denominated bonds (UK RMBS mainly) and sectors perceived as riskiest (UK non-conforming RMBS, Spanish RMBS) also underperformed, the former because of the heavy selling by US money market (2a7) investors. At the time of going to press, short-term credit markets such as interbank and/or ABCP appear to have almost fully normalised; however, the pricing dislocation in the term financial and ABS credit markets remain very apparent.

The unprecedented deterioration in demand technicals and pricing took a heavy toll on primary volumes in the European securitisation market in the aftermath of the credit crisis. Overall new issuance of structured product in Europe totalled €458 billion in 2007, a mere 3 per cent lower than the record volumes seen in 2006, but this masks the sharp fall-off in supply (-61 per cent year-on-year) seen over the fourth quarter – certainly when compared to other major securitisation jurisdictions such as the United States or Australia. Of the main asset classes, RMBS volumes fell 47 per cent in the second half of the year relative to the first half, while CDO and commercial mortgage-backed securities (CMBS) issuance declined by 28 per cent and 74 per cent respectively over the same period. While a few securitisation-based, non-bank asset lending platforms brought deals in the final months of the year in efforts to clear warehoused, legacy assets (namely leveraged loan collateralised loan obligations (CLOs), conduit CMBS and non-conforming RMBS), banks proved more resistant to the costlier funding environment, with most opting to retain securitised bonds for the purposes of internal or repo funding with the central bank. (Such trades, brought mostly by Spanish and Dutch banks, made up 56 per cent of primary volumes post-crisis.) Therefore, on our count, roughly €48 billion of paper was placed or syndicated to end investors following the onset of the credit crisis, which represents a decline of some 81 per cent relative to comparable volumes in pre-crisis 2007.

The outlook for the aftermath

In developing our view for 2008, we make the central premise that the banking markets stabilise – by this we

Figure 1: The correlation between bank and securitised credit pricing has been tight, historically at least



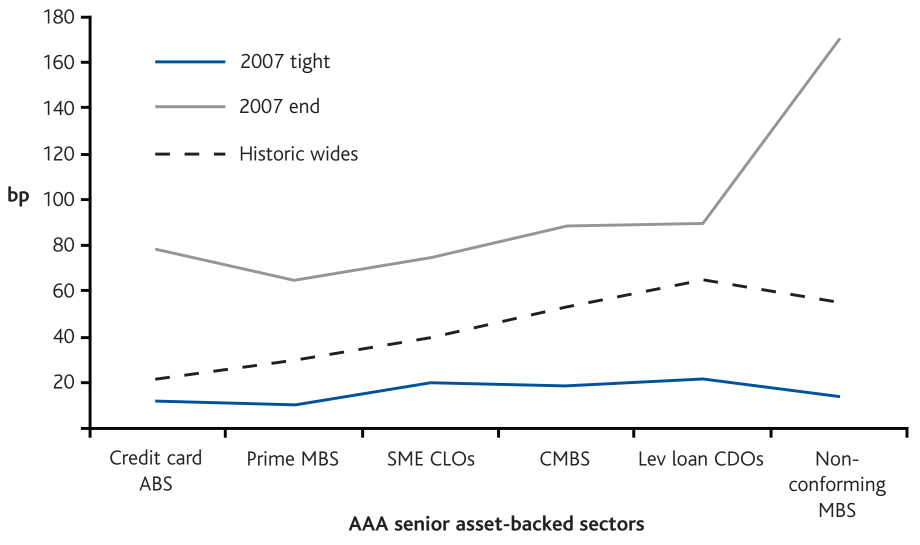
Source: Deutsche Bank, DBIQ

mean that prices can be reasonably re-established for financial credit. Any such stabilisation would create steady, more conducive conditions for the asset-backed markets to recover, noting the historically tight relationship between securitised bond pricing and bank (unsecured) credit in Europe. Some correction in structured finance spreads would also be fully justified, considering how oversold the market is currently from a fundamental or fair-value perspective – that is, from a default and/or loss breakeven basis. In this regard, we are most constructive on the senior AAA spread outlook for a number of reasons. First, the senior part of securitisation capital structures has generally been disproportionately affected by the credit crisis; thus, any mean-reversion would yield outperformance. Second, we expect the renewed bid for asset-backed product, even at the current historically cheap prices, to be defensive. Finally, the implementation of the Basel II capital accord should, at the margin, make AAA bonds more attractive for banks from a risk capital-adjusted return perspective or at the very least act as a greater disincentive for banks to sell senior paper.

But overall, we see structured finance bonds underperforming financial credit in any recovery leg to the current crisis. Given the loss of faith in tranching technology (stemming precisely from the destructive effect of systemic sub-prime losses on the valuations of senior AAA ABS CDOs in the United States), as well as the re-rating of the liquidity and defensive qualities of securitised products, we expect the asset-backed market generally to trade at a spread premium to plain vanilla credit, ultimately re-establishing a pricing relationship that characterised the credit markets back in the earlier days, specifically the period prior to 2002.

There are also more technical and fundamental reasons why we believe structured finance may lag the recovery in financial credit. The asset overhang risks in the European securitisation market remain appreciable, in our view, reflecting the fact that disaffected SIVs, conduits and most money market funds remain ready sellers, with business and funding models that are generally not recoverable at this point. We estimate that, collectively, these investors have either sold down

Figure 2: Asset-backed spreads today have no precedence whatsoever



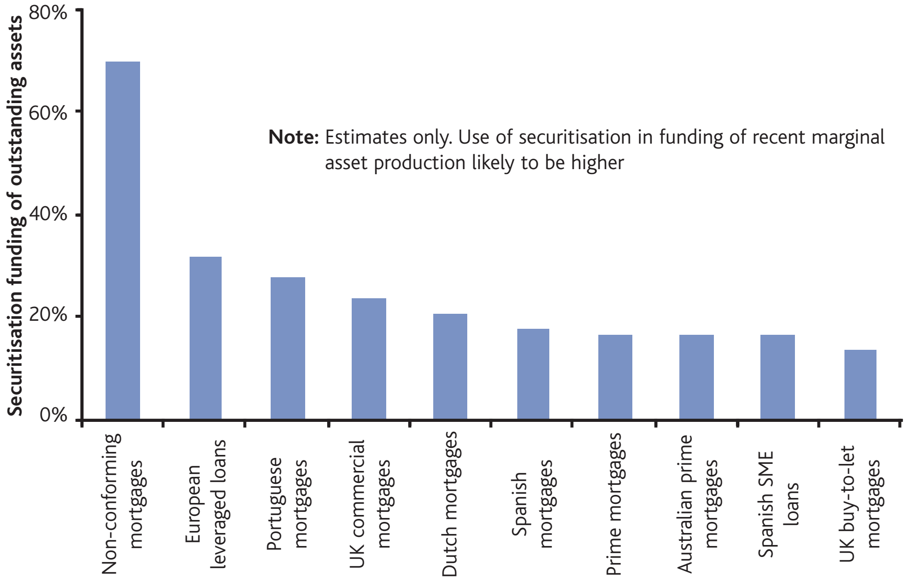
Source: Deutsche Bank

or transferred onto parent bank balance sheets around 30 per cent of European ABS/CDOs that were under management pre-crisis, which suggests on our estimates that some €200 billion to €250 billion of paper (netting expected redemptions near-term) is still positioned to be sold, an overhang amount that we believe is not insignificant. The overhang risks aside, we note also that the US ABS/CDO market is increasingly being branded and traded like a 'distressed' credit market, and to the extent that this investment mindset prevails, we believe it will be more difficult for a price recovery in the European securitisation market to be fully realised.

The other reason why we expect a more protracted recovery in the structured finance market is based on our expectations for credit fundamentals. In short, we are bearish about the credit and rating outlook for certain sectors in European securitisation over 2008, and fear that a better macro-backdrop for a recovery in asset-backed spreads may coincide with greater evidence of collateral weakness and/or rating risks, which could well serve to stall any such recovery.

To elaborate on our views for credit trends going forward, we begin with the observation that even prior to the credit crisis, a number of sectors – to include leveraged loans, UK mortgages, Spanish SME loans and mortgages – were clearly poised to weaken, given the growing pressures on affordability amid record high borrower gearing. The recent credit shock materially amplifies these risks, in our view. Put simply, the sharp contraction in credit supply to the front-end asset markets (this liquidity squeeze is already in evidence) is likely to impact on borrower payment behaviour, particularly in sectors where refinancing has come to be pivotal in borrower debt servicing ability. Consider that securitisation funding played a very influential role in

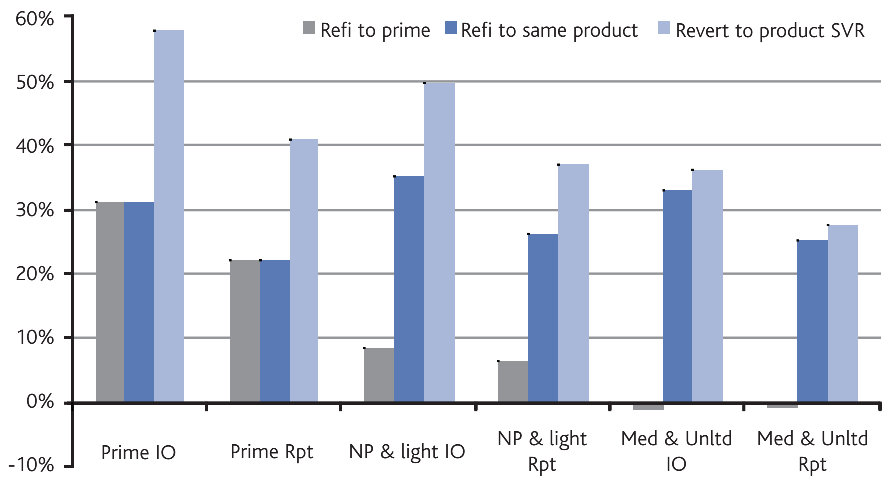
Figure 3: Securitisation was very influential in financing loan growth in many European asset markets, particularly from a marginal perspective



Source: Deutsche Bank (based on various sources) the marginal financing of many asset markets in the last two to three years, fuelling not only more borrower-friendly credit practices but also the proliferation of new non-bank lenders (eg, debut non-conforming platforms, CLO managers and CMBS conduits). Asset prices in such markets were also driven higher – sharply in some cases – again on account ultimately of the marginal liquidity channelled from the structured finance market.

We are generally cautious about the credit outlook for sectors such as UK and Spanish mortgages, Spanish SME loans, leveraged loans and UK conduit CMBS, and are especially bearish on the UK non-conforming RMBS market, where we see the degree of borrower refinancing needs as being the greatest and most imminent. (We estimate that around 30 per cent of securitised assets outstanding in the UK non-conforming RMBS market is scheduled to reset in 2008, with a further 40 per cent resetting next year. By contrast, the refinancing requirements in, say, the leveraged loan or UK commercial mortgage market is more tail-ended, spiking in three to five years.) UK non-conforming mortgage borrowers, arguably more so than any other borrower constituency, are thus facing sizeable payment shocks and a much less liquid mortgage market to refinance into in 2008. We also see further lender vulnerability playing out as the credit crunch takes a more complete toll on wholesale-dependent banks and non-banks, potentially adding a further layer of risk to credit performance in some asset classes. A likely further deceleration in asset prices – particularly real estate – will serve to heighten loss-given-default risks in some of the markets that have been over-inflated in the run-up to the credit crisis, in our opinion. Therefore, we are of view that the frequency of negative rating actions will increase noticeably over 2008; indeed, this coming year is likely to be the first time since the European securitisation market's inception that rating

Figure 4: A considerable payment shock is in store for UK mortgage borrowers on two-year fixed-rate products originated in 2005

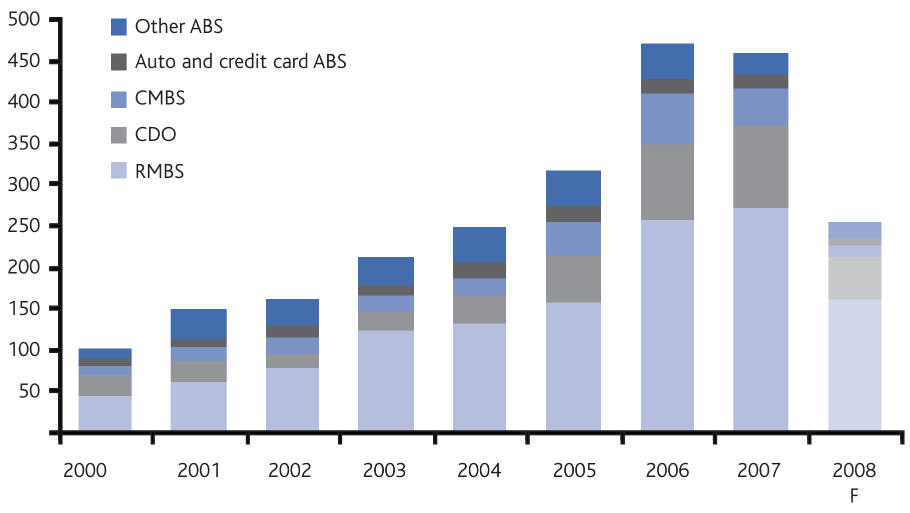


Source: Deutsche Bank (Mortgage products are prime, near prime (NP), light, medium, heavy and unlimited adverse credit mortgages. Also both interest only (IO) and repayment. Degree of payment shock based on mortgage rates as at end 2007)) risks become meaningful. Subordinated bonds among the weakest deal outliers (weaker collateral, less defensive structures, sellers or managers that do not survive or cannot steer adequately through the downturn) in the most vulnerable sectors will be most at risk.

Our forecast for primary volumes in 2008 is €250 billion, which would represent an unprecedented 45 per cent decline on 2007 full-year issuance, taking supply back to levels last seen in 2004. We expect the European primary market contraction to be more severe than in the United States, where our research colleagues are projecting a 30 per cent fall in new issuance over 2008. Deal flow totalling €250 billion would roughly equal the amount of redemptions expected in the European structured finance market over 2008, meaning that the outstanding market should remain broadly flat this year, which would be consistent if not accommodative of our expectations for trends in demand technicals over 2008. The decline in primary volumes is reflective of potentially sharp contractions in asset origination volumes by non-banks and banks alike, with the latter constituency likely also to de-emphasise securitisation in balance-sheet strategies going forward. (More generally, we see scope for bank re-intermediation in the European credit economy, a development that is outside the scope of this particular report discussion.) In terms of major asset classes, we expect CMBS to experience the sharpest fall in primary volumes this year with conduits having been completely priced out of the commercial mortgage lending market, while issuance of RMBS – the largest sector in the European securitisation market – is projected to decline by 40 per cent.

We believe the coming primary market vintage will be the most superior in recent memory, with better-quality borrowers and assets reflecting the tightening in credit standards that is already well underway currently. We expect structures to be tightened also (eg, in terms of hedging, substitution requirements, collateral eligibility, credit enhancement), with a greater credit de-linkage from sellers and other third-party risk likely

Figure 5: Primary volumes in European structured finance are expected to decline in 2008 for the first time since the market's inception



Source: Deutsche Bank

to be a key feature of securitisation templates to come. A greater simplicity to capital structures is also likely – in this regard, we anticipate more in the way of senior/sub, discrete SPV structures with a lesser degree of tranching compared to the preceding pre-crisis deal vintage. There is plenty of precedence in the history of the financial markets for such de-risking and/or simplification post-crisis – for example, in the US home equity ABS market in 1996/1997. Based on our assumption that any recovery in secondary bond prices may be prolonged, we see some possibility that the new primary deals clear inside of legacy paper, with this spread discount justified by superior credit and structural fundamentals.

All things considered, we expect a much greater focus on the secondary market in European securitisation over 2008, which we see as a fundamental shift in market dynamics considering the heavy emphasis historically on the primary structured finance market only. The extent of ready sellers currently (as we outline above in our discussion about asset overhang risks), coupled with the likely re-balancing of the investor base from buy-and-hold to total-return focused investors, should, in our view, underpin appreciably heavier secondary flows.

This chapter is taken from previously published Deutsche Bank research.