

Is Europe going to follow Big Brother?

In this update we ask ourselves the question whether the European securitisation markets are likely to follow the tentative revival of its big brother, the US. What are the drivers behind the US revival, is it likely to be sustained, how far has Europe come along compared to the US and what does the market have in store for European Issuers?

Each year, particularly in Europe, market participants in securitisation look forward to the annual fourth quarter market frenzy, where issuance volumes peak, investor books get filled, issuers achieve their funding targets and bankers, lawyers, advisers and rating agencies bolster their arranging credentials. We all know, or should know, that in the current environment, 2009's fourth quarter will be substantially different. But recently, slowly but surely, we're beginning to feel some adrenaline seeping through the veins of the European securitisation market. Buoyed by the unprecedented rebound of the equity market, the even starker revival of the macro credit market and talked up by the government rhetoric of "the recession bottoming out" and "the green shoots of recovery appearing", it seems that a degree of confidence is returning to the market for new issues in European securitisation. Is it for real, though, or is it based on wishful thinking and an envy of the revival of the US securitisation market? We tend to caution the optimists against overblown expectations.

The US market

It is true that historically trends in the US securitisation market have been leading indicators of European market performance. This can be explained by the far greater scale of the US market, longer history, much more liquid secondary markets, far greater abundance of data and the global nature of many investors who use the US securitisation spread levels as effective benchmarks for their European funds.

These fundamental reasons for looking West to predict the European securitisation market haven't changed. So let's examine the state of the US market and what has driven its revival.

After the Lehman collapse, the already tainted US securitisation market came to a complete standstill, regardless of asset class, sponsor or historic performance. In recognition of the importance of securitisation for the consumer credit market, and similarly the tremendous importance of consumer spending on GDP, the US authorities quickly saw the need for intervention aimed at kick-starting issuance of US securitisations so that the all-important providers of credit card loans, auto loans and student loans could regain their access to funding. They sought the solution in leverage. The US Treasury and New York Fed created the Term Asset Loan Facility that provided up to \$1 Trillion of leverage to eligible buyers of eligible US securitisations, at very attractive pre-determined terms. Each month, from March 2009 onwards, issuers could issue under the TALF banner and investors could access the Fed's low cost, high LTV funding.

After the first signs of investor acceptance, the authorities extended the programme and included CMBS. ABS facilities will be available till March 2010 and CMBS till June 2010, both unless the Fed extends the programme once again. To date, \$ 79 Billion of new issues have been launched under TALF, with \$ 48 Billion of that being funded by TALF loans (the remainder by investor cash). Spreads on AAA-rated securitisations rallied in the same period from 250-350 bps in March 2009 to 100-175 bps in October 2009.

Whilst the market clearly has taken comfort from the re-appearance of new issuance to the tune of \$ 79 Billion, a critical review of TALF also leads to some notes of caution.

Firstly, TALF loan volumes at \$ 48 Billion are still far behind the stimulus volume of \$ 1 Trillion that the authorities set aside.

Secondly, the government hasn't succeeded in tackling the real problem in US securitisation, namely the crisis in residential mortgage funding, because so far, issuance has been the exclusive domain of shorter term consumer loans (e.g., credit card, auto, student).

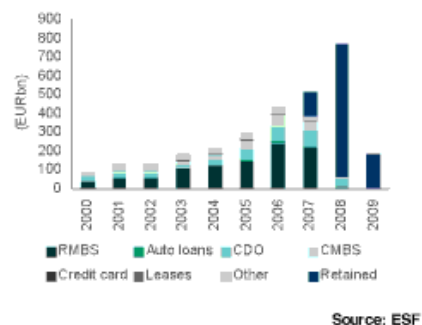
Thirdly, despite its availability and more attractive lending terms, the take up on TALF funding for CMBS has been virtually non-existent.

We conclude that the US securitisation revival is still predominantly a function of government support and has a long way to go before the stimulus package can be phased out without damaging market volumes.

The European Market

The European securitisation market has always had different volume drivers than the US. In America volumes were essentially driven by the needs of non-bank financial institutions for funding of non-agency collateral (sub-prime residential mortgages, commercial mortgages, auto-loans, student loans and credit cards) and investor-driven innovation (CDOs). In Europe the principal drivers were banks needing BIS capital relief for their lending businesses, both retail and commercial. As BIS rules tightened and funding became more problematic, the focus in Europe shifted commensurately and the volume was driven by morphing securitisation into covered bonds and creating ECB-eligible collateral for repo purposes, but still mostly for banks. The growth over the years, the importance of RMBS, the collapse at the end of 2007 from which the market still has to begin any recovery and the shift towards ECB-collateral ("retained deals") can all be clearly seen in this graph.

European/ABS New Issuance Volume



Will Europe follow Big Brother?

So, what can we conclude for the short term future of the European market? We believe that the enthusiasm for the fourth quarter prospects is unwarranted. There have been some new issues in 2009, but these are few and far between and can still be qualified as of an exceptional nature.

Lloyds Bank was the first mainstream bank to tap the primary market, arguably as a first step in reducing their reliance on government support so that their subsequent, more important step, a large rights issue, could gain momentum. £ 1.65 Bln of AAA PERMM bonds priced at 180 bps for a 5 year WAL. Lloyds being a quasi-nationalised entity provides a lot of comfort for investors.

The other ABS deal that came to fruition was also for a well-established sponsor that can rely on government support if the going gets tough: Volkswagen's € 500 Mln VCL 11, AAA-rated new issue priced at 110 bps spread for a 1.4 year WAL.

And finally, the much touted "CMBS market-reopening" deal for Tesco, was in fact a structured bond that provides full recourse to a powerful corporate balance sheet and the pricing clearly reflected this recourse: Tesco Property Finance 2, rated A- priced at 220bps over Gilts for a 20 year WAL.

So, in Europe, sponsor-selectivity is the name of the game. An optimist would draw the parallel with the revival of the corporate unsecured bond market in 2008 that also started in the quasi public sector, then expanded to household names and then broadened to a full-blown credit rally. A pessimist however would say that the securitisation market in Europe lacks the fundamental supply-drive that characterized the US revival as well as the macro-credit revival.

As the securitisation market in Europe is so dependent on banks as issuers, any meaningful recovery in primary markets would have to be bank-driven as well. In our opinion, this is unlikely to happen in the near term, as banks' liquidity has been assured by governments via other means, namely expanding the ECB-collateral eligibility and providing direct government guarantees to bank bond issuance. This is a stark contrast with the US, where TALF has been specifically aimed at restarting the securitisation market. As long as the ECB repo window is firmly open at attractive price levels, banks are disincentivised to tap the securitisation market. Moreover, the Covered Bond market has withstood the crisis better and consequently remains a formidable alternative to RMBS, as evidenced by Barclays' recent inaugural covered bond.

Perhaps we have to get used to permanently lower volumes in Europe and we are unlikely to follow Big Brother. Except, maybe, in one way: CMBS. The lack of traction that the TALF facility has given the US CMBS market does not bode well for a swift revival of European CMBS. Europe is still coming to terms with the fallout from market value declines, rating downgrades, restructurings and the dark shadow cast by a refinancing mountain in the coming years. The US has at least begun to tackle the problem by offering limited government support for both legacy deals as well as new collateral. We do not believe that the political climate in Europe will enable a government sponsored bail out of the CMBS market at a national or EU level on top of the massive financial burden already incurred in support of the banking sector. We

therefore foresee the banking market recapturing its previously dominant role in European property lending before the CMBS market rebounds.

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London

8 October 2009