

By Laurence Neville

Europe seeks resuscitation

The European market for new structured finance paper appears to have been hobbled more than other regions. Demand has almost completely collapsed, with issuers reliant on the ECB to get a deal away. Once it gets its breath back, the market will look very different, with a stronger focus on real money accounts and a better understanding of risk.

You could be forgiven for thinking that the subprime mortgage meltdown that precipitated the current credit crunch was a European affair. After all, the U.S., where all those home loans were actually extended, is still churning out deals in other asset classes like prime auto and credit card securitizations (see page 26), while in Asia a burgeoning local market is taking some of the strain from the seizure of the international asset-backed market (see page 31).

But in Europe demand has all but dried up — of the handful of deals that have been sold in recent months, almost all have been structured to be eligible for repo with the European Central Bank (ECB): the Frankfurt-based institution responsible for monetary policy for virtually the entire European Union appears to have become, in effect, the only significant buyer of asset-backed securities in the market.

What explanations are there for each investor group's decision to stay out of the market? If there are problems specific to each group of investors, what potential solutions are there? Or might the unique investor profile of the asset-backed (ABS) market never again be reassembled?

The bank story

The search for the answer begins — and ends — with the region's banks. Before the crisis hit, they held two of the most important roles in European ABS. First, as a group they were the largest sellers of new paper. In 2006, for example, the top 10 issuers of asset-

backed securities accounted for almost a third of the market, according to ratings agency DBRS. Of that group, only GMAC was not a bank. The rest comprised: Northern Rock, RBS, HBOS, Lloyds TSB, Abbey National (now Abbey), BSCH, ABN Amro, Barclays and Fortis.

But banks were the largest buyers, too. Research by Citigroup published this March shows that banks, including conduits, bought around 45% of triple-A asset-backed securities (ABS). Structured investment vehicles (SIVs) lapped up around 10% with the majority of the remainder bought by money market funds or asset managers (see diagram on page 42). Hedge funds accounted for only a small amount — they were more active in the lower-rated tranches. Banks — including their off-balance-sheet vehicles — also snapped up around half of all residential mortgage bonds in the region, according to Rick Watson, head of the European Securitisation Forum (ESF).

As the U.S.'s subprime problems spread last year, Europe's banks were faced with a quandary: the more their risk managers decided to restrict buying ABS, the harder it became for these same institutions to shift their own loans off their balance sheets via securitization. In other words, it turned into a vicious circle, exacerbated by the mounting hits taken by European banks.

German bank IKB's off-balance-sheet vehicle Rhineland Funding was one of the first casualties of the crisis. Europe was home for most of the 30 or so SIVs that had amassed some \$400bn in assets by the middle of last year before falling victim to the double whammy of falling asset prices and prohibitively expensive, or non-existent, short-term funding. The first bank run of the crisis was in the UK — on mortgage lender and large MBS issuer Northern Rock. And some of the worst subprime-related writedowns have occurred on the continent — such as UBS, which has taken a \$38bn hit so far.

Aside from SIVs, other bank-generated arbitrage vehicles such as ABCP conduits have also significantly cut back their activities. In large part that's because the excess spread that long existed between the vehicle's financing costs in the short-term commercial paper market and the coupon paid on the longer-

term paper it held has all but disappeared. Even buying less affected assets like trade receivables has become harder. One banker who talked to American Securitization complained that some corporates trying to borrow from conduits were still expecting to get funding rates that no one's enjoyed since last year.

Moreover, many banks no longer have much appetite for pure arbitrage, as distinct from conduits. Fabrice Susini, Euro-



Battered, parched, but still standing

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pean head of securitization at BNP Paribas, estimates that bank-sponsored arbitrage vehicles, in addition to SIVs, accounted for billions of funds under management.

Of course, the funding problems and capital constraints experienced by banks mean that their SIVs and some of their arbitrage vehicles have not simply stopped buying but are, in some cases, actively sell-

ing ABS. "They need to deleverage their balance sheets," notes Birgit Specht, managing director in Citi Securitised Products Strategy. "Around €100 billion (\$155 billion) of SIVs' MTN funding is coming due this year, and we expect them to continue selling, precisely due to those bank constraints."

The ESF's Watson agrees that the supply overhang in the ABS market, which is chiefly a result of warehoused loan assets sitting on bank balance sheets, has been exacerbated by the consolidation of SIVs and some arbitrage vehicles back on to those balance sheets. For example, in November HSBC was forced to consolidate two SIVs, the \$42 billion Cullinan vehicle and the \$8.7 billion Asscher fund, and also consolidated its Performance Trust ABCP conduit, suffering a \$900 million hit. Such consolidations are likely to lead to pressure from bank treasuries to offload assets. "Everyone has concerns that many investors will sell into any rally," he says.

Moreover, the conduit securitization model doesn't work at the moment because its basic premise is that they can finance themselves at a lower cost than the underlying asset yield — currently that is not possible for much of the banking sector. Triple-A MBS, despite widening dramatically, is tighter than some of the world's largest financial institutions can fund themselves in the capital markets.

Consequently, conduits are considering restructuring their

backlog of assets and, while not dumping paper, aren't really in a buying mode. There also remains the possibility that conduits may be subject to tougher regulation in the future with their assets consolidated in some way on to their parent banks' balance sheets. That threat, in itself, is enough to prevent them seeking further assets.

The importance of repo

What of banks' own books as a source of demand for ABS?

Observers say that banks are selectively looking for buying opportunities but are under strong pressure from their treasuries — and those that have experienced write-downs or have capital problems are clearly not buyers. "There is some bank money that is a potential buyer," says Susini at BNP Paribas. "But when they see the kind of performance that primary paper issued in January has enjoyed they, unsurprisingly, chose to stay out of the market. They are waiting for the bottom of price widening."

The main issue for banks is one of funding, according to Richard Curtis, head of European ABS and structured products bond syndicate at WestLB in London. "If an issue is eligible for repo with the ECB then it is easier to get European bank involvement in the transaction," he says. ECB criteria have always required that deals be in euros, that only the most senior tranche be eligible and that the waterfall structure be such that the tranche remains senior regardless of changing circumstances. However, because in the past most buyers of ABS were not eligible for repo and banks didn't need funding from the ECB, repo eligibility was of far less importance for deals.

The importance of ECB repo eligibility was vividly demonstrated in Driver UK One, a £500 million (\$1 billion) car loan securitization for Volkswagen at the end of February. The RBS and UniCredit deal was originally expected to be all sterling but a shortfall in investor demand resulted in the introduction of two euro tranches and, most notably, the changing of the nature of

its Jersey SPV because its waterfall structure made it ineligible for repo. Similarly, Santander and other banks are known to have securitized billions of euros of assets and retained the senior tranches to be used as collateral with the ECB.

Some bankers estimate that as much as €500 billion of ABS, both primary and secondary paper, has been deposited with the ECB in the past six months compared with €100 billion used as collateral in 2006, the last year for which figures are available. According to the ECB, there was around €746

billion of ECB-eligible ABS outstanding in August 2007, representing 58% of the European ABS market. If €500 billion really has ended up with the ECB, it is by far the biggest investor in the asset class in history.

Spreads must stabilize

Among money market funds, some institutions are prepared to sit back and wait rather than sell at the moment, and they may even be buyers — though not yet. Other mutual funds, especially those with retail investors, are faced with redemptions and are therefore looking to sell, according to Citi's Specht. She says that interest is definitely increasing but that crucially "only a handful will consider buying before spreads stabilize."

Last year's widening was driven mainly by technicals but the market has worsened in the past three months as the credit outlook has weakened — weeks of fear culminated in weaker U.S. employment figures in January, indicating that a recession was possible. "That further widening resulted in some ABS investors being forced to de-leverage," says Specht. "But there is still a long way to go in terms of deleveraging for SIVs, bank conduits and also some funds. And unfortunately, there is more economic stress to come."

BNP Paribas' Susini says that the continuing write-downs that have occurred despite the lack of specific credit events, save in the subprime area, are worsening the situation. "There was an assumption that there would always be a price," he notes. "But in reality, there are no buyers. However, that does not mean that the asset is worthless.



You know what they say about Europe when the U.S. sneezes...

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Birgit Specht, Managing Director, Citigroup

We need to see new benchmark transactions in order to establish a new equilibrium.”

But when new deals have come to market, such as Driver Five, a €1.25 billion car loan securitization for Volkswagen launched in January at 58 basis points over Euribor for the triple-A paper, they have widened out dramatically in the face of bad headlines. While the deal was initially hailed as a huge step towards recovery for ABS, spreads ballooned to as much as 80 basis points within a few weeks, leaving investors with a huge mark-to-market loss. “Consequently, many investors have been told by their boards to stay out of the market until the headline risk has died down,” says Watson at the ESF. “Everyone agrees that the market is cheap but there is no capacity to buy.”

WestLB’s Curtis says that when, for example, an asset manager can buy a UK bank’s unsecured debt or its RMBS program at roughly the same price, the relative value choice is straightforward. “People don’t want to be seen increasing exposure to securitization assets at the current time,” he says. “Spreads are wide but they are wide in corporates, financials and almost every other market — only the sovereigns, supras and agencies sector is performing efficiently — so the incentive to buy ABS, which currently has considerable uncertainty attached to it, is lacking.”

The mark-to-market mishap

The crucial issue then is to address mark-to-market, which as Watson notes, affects up to 80% of the investor base for ABS — including many hedge funds, most asset managers and all bank investment bar conduits. Mark-to-market has produced some significant discrepancies. For example, because triple-A MBS are marked-to-market while mortgage loans on a balance sheet are not, if you had to unwind a triple-A portfolio you would get far less for it than the lower-rated loans would be worth on paper despite the triple-A MBS being of a higher quality. In effect, banks are being encouraged to sell their highest quality assets.

Triple-A rated MBS, as explained above, has clearly been subject to headline risk that has taken spreads to levels that do not reflect the potential for default. “If you apply the losses that current triple-A MBS spreads imply to the entire mortgage book, the result suggests that 15% of the UK mortgage market would be wiped out. This shows how dramatically triple-A spreads have overshot. Triple-B spreads suggest much more moderate losses, potentially even understating actual losses,”

explains Specht. So how can institutions more accurately, or at least more usefully, value the ABS asset they hold?

There has been some discussion at government level that mark-to-market could be suspended temporarily to allow banks and asset managers a period to adjust to market conditions. Without exception, market participants spoken to for this article dismissed the idea of suspension as a red herring.

“The suspension of mark-to-market would be a distraction because if it is temporary it wouldn’t mean anything,” says Susini. “There’s no point breaking the thermometer because everyone has heat fever.”

Specht adds: “Simply suspending mark-to-market isn’t the solution. What is needed are government and central bank measures to fix some of the problems. At the moment there is too much fear and too few measures to tackle the loss of confidence in high quality products and to break the vicious circle fuelling illiquidity.”

One potential solution various governments and central banks are thought to be considering is the possibility of creating a non-mark-to-market industry vehicle to buy ABS assets. “It could be funded by the industry or retail-focused or could make use of tax incentives and guarantees provided by governments,” explains Watson.

Other alternatives being discussed include the establishment of a Freddie Mac-type organization in Europe. “There have also been discussions about expanding the range of assets eligible for repo — although there is some sensitivity about how that would change the role of central banks,” says Watson.

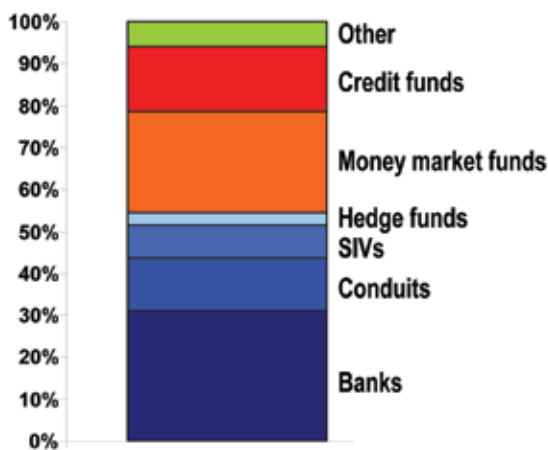
A possible route to greater price stability could be the establishment of a common framework for calculating fair value in different market circumstances. Watson at the ESF notes that the International Organization of Securities Commissions has worked with the hedge fund industry to find ways to value illiquid assets (Principles for the valuation of hedge fund portfolios, March 2007) — it specifies that hedge funds must have procedures in place to value whatever they buy because their business depends to such a great extent on leverage. “We need everyone who buys structured credit to have similar systems in place [to each other],” says Watson.

One specific change in line with this thinking that could resurrect the market is a convergence of U.S. and European GAAP accounting rules. In the U.S., accounting principles are based on three different paths to book a position. The first is based on there being a lively market in the security in question

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*Fabrice Susini, BNP Paribas
European Head of Securitization*

Buyers of Triple-A European ABS, Pre-Crisis



Source: Citi

and uses recent marketing pricing to mark-to-market positions. The second is where a market for this asset is less active but by benchmarking and interpolation with comparable assets it is possible to create a reference to mark-to-market. The third situation is where the market is almost dead and then a mark-to-model is applied.

In Europe, the system of fair value accounting has been interpreted as focusing only on mark-to-market. There is a reference to what might happen if there is no active market but there is no detailed prescription about what to do in that event. “There is evidence that the U.S. market has behaved differently partly because of the different accounting system,” says Susini. “Most players have taken their losses (and in some cases, the positive impact of the fair value on their liabilities as well) and life has gone on – although there are clearly still concerns.” However, the point is that there are still transactions printing whereas in Europe there are lots of uncertainties and the market is dead.

A real market for real investors

Dealing with mark-to-market will be politically contentious. As Curtis at WestLB says: “It is a rod that banks made for their own backs. Banks postulated they could manage credit risk using sophisticated value-at-risk models and therefore should be allowed to assign less capital against their holdings, creating leaner operations that could produce a better return for the shareholders. Unfortunately the wheels have come off the mark-to-market model and people are hankering for the good old days of only needing to provision for actual credit impairment.”

More importantly, while the volatility of ABS spreads and their precipitous widening are alarming, just because those spreads might not reflect implied default probability doesn't mean they are wrong. “If prices don't represent true value then why isn't everyone buying,” asks Curtis. “It's because everything is cheap as there has been a systematic re-pricing of risk. We have to get used to the idea of high double or triple digit spreads

for triple-A ABS.”

Susini at BNP Paribas says that the structured finance market was always going to have to change and that change may simply have been accelerated by the credit crunch. “Under Basel II there are disincentives for banks to securitize some assets. For banks using the advanced framework, the incentive to securitize a highly granular mortgage portfolio, for example, is extremely limited. And if you do have an interest in doing so, it makes more sense to go down the credit curve in order to save regulatory capital. But generally for this type of asset, it is more efficient to keep them on the balance sheet or, if you need funding, use the covered bond market.”

So the appetite of banks for securitization is likely to diminish and, coincidentally, banks' role as buyers of ABS has now been significantly curtailed. What is likely to emerge from the rubble of European ABS is a market far more focused on real money accounts and understanding risk — the investor base profile achieved in the halcyon days of ABS is unlikely to ever be reconstructed.

Such a focus is likely to be more sustainable in the long-term, according to Ilan Heimann, product manager responsible for structured products in Pimco's European product management group. “Investors have become more thoughtful about the underlying assets in a product rather than being focused exclusively on ratings,” he says. “The people that are willing to come into the market under current conditions are those that are willing to take time to understand how assets behave in different market conditions.” And that is something everyone in the market needs to consider.▼



If it weren't for the ECB, European bank assets would see no end of these Getty

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Laurence Neville is a freelance financial journalist and copywriter based in London who covers capital markets and risk management for publications including EuroWeek, Euromoney, Credit and Risk.