NATIXIS ASSET MANAGEMENT

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The evolution of European ABS markets

HIGHLIGHTS

- **The ECB purchase programme launched in 2014 contributes to restoring the bank credit channel in the euro area.**
- **The scarcity effect sought by the ECB exerts downward pressure on spreads which is favourable to a pickup in securitisation.**
- **The regulatory changes now impose new standards in terms of availability of information, transparency and alignment of interests between originators and investors.**
- **Diversity of underlying loans is an advantage for the asset class.**

The European Central Bank took a series of unconventional policy measures in 2014 in an attempt to improve financing conditions in the euro area and reduce deflationary pressures. The objective is to restore the bank lending channel which accounts for about two-thirds of total financing in the euro area economy.

In this piece, we review the asset-backed securities purchase programme. We look at the economic motives behind this policy which may contribute to reviving ABS markets. We also review the latest changes in the regulatory environment which could work to expand the investor base in an asset class hit hard by the financial crisis. The last section reviews opportunities in the ABS market in terms of spreads and underlying economic risk exposures.

Understanding ECB policy on ABS

The European Central Bank recognised in 2014 that the bank lending channel had become dysfunctional in the euro area. Interest rates paid by private-sector borrowers were no longer responding to Central Bank easing and policy rate cuts (-50bps in 2013). Credit standards had tightened, most notably at the euro area periphery, which resulted in a shortfall in demand that rippled across the euro area via trade links. Current inflation diminished sharply (-0.6%yoy for headline rate in January, +0.6%yoy on core) and medium-term expectations, measured by inflation-linked bonds, declined considerably.

- **The mechanisms to be activated by ECB intervention**

As deflation risks materialise, the ECB focuses essentially on restoring the monetary transmission channel. Among policy measures undertaken, the ECB announced in June 2014 a purchase programme of asset-backed securities (ABSPP) which should last at least 2 years. No target amount has been communicated. This programme was formally activated in November and later included in the Enhanced Asset Purchase Programme (EAPP) launched on January 22nd, 2015.

The objective of ECB purchases is to create a scarcity effect by reducing the available supply to the private sector. Banks will thus have an incentive to increase ABS issuance. In fine, this is only possible by providing more loans to the private sector, which are the collateral for asset-backed securities. As other measures including targeted long-term refinancing operations (TLTRO) and covered bond purchases, the policy is aimed ultimately at enhancing bank loan supply.

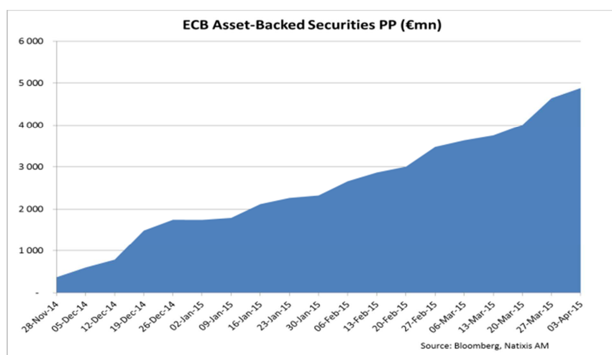
Given the size and liquidity of the European market for asset-backed securities, the quantitative aspect of the ABSPP programme is secondary compared with covered bond buying and, from March 2015, purchases of sovereign, agency and supranational bonds. The targeted action of the ECB reduced interest rates paid on senior tranches of ABS. The goal is to influence pricing (i.e. the interest charge) of underlying loans directly. In fact, the 'signal' sent by the Bank in June 2014 before the start of transactions caused a tightening in spreads in the asset class.

- **ABSPP details**

The Central Bank pays particular attention to the credit risk it assumes as it is a determining factor for the intrinsic value of the currency. ECB monetary policy consists essentially in lending to solvent banking institutions against high-quality collateral on which haircuts depending on rating and duration apply. It is hence natural to restrict transactions in the ABS market to senior tranches. Furthermore, the default rate of European securitized assets between 2007 and 2013 was held under 1.5%. Comparatively, US assets, in part due to subprime, underwent default rates of 18.4% over the period under review. If we consider RMBS and consumer loans targeted by the ECB, default rates amount respectively to 0.1% and 0.04%.

The modalities of the programme indicate that the ECB may buy senior tranches which are eligible collateral in the Eurosystem. The minimum credit rating will be the second-highest rating above or equal to BBB-. Transactions on mezzanine tranches have been envisaged but eligibility constraints have not yet been communicated. Purchases can be made in either primary or secondary markets. Asset-backed securities must be denominated in euros and issued by resident institutions in the euro area. Underlying assets must be loans to the non-financial sector.

The programme started on November 21st, 2014. As of April 3rd, 2015, ECB transactions amounted to €4.888bn. The average weekly purchase amount stands at about €257mn. At current pace, ECB buying may retire up to €13bn of ABS outstanding. It is worth noting that retained deals are eligible. According to Bank of France governor Christian Noyer, transactions include mostly Dutch RMBS (securitised Dutch mortgage loans).



New bonds, new standards

The 2007 subprime crisis unveiled significant deficiencies in credit standards and in poor underwriting practices. This fostered the implementation of mechanisms aimed at limiting transfers of poor-quality assets. Hence bank originators which securitise loan portfolios now have to retain at least 5% of the portfolio's risk. Alignment of interests between originators and potential investors generally materialises in originators retaining most junior tranches, which are hit first by potential losses on the underlying loan portfolio.

The ECB also imposed on banks using asset-backed securities as collateral for refinancing operations to publish standardised and detailed reporting of underlying loan performance. This new constraint of regular and standardised publication of information led to the launch of EDW (European Data Warehouse) in 2013. This warehouse facility collects, centralises and makes available detailed information at the individual loan level for all loans backing European asset-backed securities. Information is updated on a monthly basis by transaction originators.

In addition to new regulation, we also observe implementation of new standards or "good practices" in the marketplace. This may be on a national basis as is the case for Dutch RMBS (standard for Dutch Securitisation Association for RMBS) or on a broader basis with the launch of PCS (Prime Collateralised Securities) since 2014. This label, for which issuers can apply, allows checking a number of criteria regarding structuring of securitisation but also loan portfolios and origination.

In France, the recent reform of the Insurance regulatory framework (code des assurances) on August 2nd, 2013 to favour increased lending to small and medium-sized enterprises will introduce a new type of securitised asset fund, the "fonds de prêts à l'économie" in which insurance companies can invest.

Towards relaxed regulatory constraints?

The announcement of the ECB's ABS purchase programme was aimed at reviving securitisation markets. It provides incentives to originators to use this tool to refinance their balance sheets whilst investors may include asset-backed securities into their benchmark allocation. Several ECB officials have insisted on the need to revise and ease the treatment of securitised asset investments in various regulations.

Most regulators have used default rates and losses on the US subprime market through the crisis to calibrate risk models and the capital charge for banks (Basel III) and insurance companies (Solvency II).

Such capital charges are thus quite elevated in both absolute terms and relative to other asset classes, such as covered bonds. Taking low default rates into account for European ABS, including the 2007 crisis, and better segmentation of ABS markets should allow for reductions in such costs. Consultations are being held to define ABS transactions using criteria of simplicity, transparency and high credit quality.

Securitisation activity in recovery mode in Europe

After a collapse in the wake of the subprime crisis, activity in European primary ABS markets has improved since 2010 with the launch of new operations which were more transparent and standardised as concerns the structuring of the deals. The pickup in securitisation activity in Europe occurred primarily in the most sectors and jurisdictions to regain investor confidence. Only senior tranches (most secured) were initially sold to investors. Today, given support from the ECB purchase programme, mezzanine tranche offering will increase with placements of full capital structure deals (i.e. sales of all tranches of ABS, not only the most senior ones). The deconsolidating issuance from Crédit Foncier in May 2014 is one such example.

Having reached a peak at €700bn in 2007, European securitised asset sales hit a floor at €150bn in 2013. In 2014, new issues have reached €180bn (up 20%), likely a good sign for years to come.

Bond supply is now more diversified in terms of both underlying loans and countries. New issuance now concerns all traditional sectors (mortgage loans, consumer loans, auto loans…). Geographically, primary market remains concentrated on assets from Northern European countries (United Kingdom, The Netherlands) and Southern countries (Italy, Spain, Portugal). This segmented market context is justified for legal or regulatory reasons as well as different commercial practices across countries.

Issuance form the United Kingdom and The Netherlands account for as much as 70% of the total and is largely composed of RMBS, the main vehicle for mortgage refinancing in these countries.

In France and in Germany, primary markets rely mostly on securitisations of auto loans. These placements correspond to underlying short-term loans which are profitable, with low charge-off rates issued predominantly by banks owned by the carmakers, which have superior knowledge of their domestic markets.

Likewise in Italy and Spain, most bonds issued since 2010 and retained on issuer balance sheets were backed by residential mortgages. As lower rates and improved financing conditions, these old issues are again put to sale to investors allowing a large number of small banking institutions to find a funding source and an efficient asset-liability management tool.

What to expect in terms of spreads?

The announcement and the effective launch of the ECB's ABSPP allowed for significant spread compression for new issues and securitised assets traded in secondary markets. There has been a clear distinction between securities eligible to the purchase programme and other asset-backed securities. Spreads on securitisations of loans originated in the UK have indeed remained quite stable.

The two sectors offering the tightest spreads on Dutch RMBS (about Euribor + 20bps as at March 2015) and German auto loans (about Euribor + 18bps as at March 2015). These sectors remain more attractive than other fixed income asset classes (sovereign debt, private bonds of non-financial and financial entities) and thus should narrow further. The lowest-ever level of spreads dating back to 2007 may point to further tightening to the tune of 10bps. For A ratings, Dutch RMBS trade about 67bps whilst German autos loan ABS hover about 64bps.

Alternatively, Italian RMBS with AAA ratings have spreads close to Euribor + 60bps. For lower ratings (A), spreads may be about 110bps. In Spain, AAA RMBS trade at 55bps compared with 140bps on A ratings.

Conclusions

The ABSPP programme launched last year by the ECB should restore bank lending in the euro area.

All European securitisation markets have benefitted from the spread narrowing initiated by the ECB. Purchases now total €4.9bn and are likely to increase further in keeping with eligible supply.

Banks from peripheral countries have now at their disposal a new source of financing which is competitive with covered bonds.

Investors, reassured by favourable changes in regulation of late, are returning to ABS markets opting for granular portfolios (mortgage-backed securities, consumer loans).

Spreads offered by ABS are currently attractive vis-à-vis other assets including covered bonds.

As at April 9th, 2015.

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