The AFME / ESF European Structured Finance roundtable event, held at Bank of New York Mellon offices in London at the end of May 2010, delivered the latest insight on European structured finance, including the most recent performance figures, updated credit ratings processes and investors’ feedback.

The performance figures confirm that most types of European securitisations are not ‘toxic’ and show that, in Europe, the credit performance of the triple-A tranches of consumer and residential mortgage securitisations have largely performed well and within original expectations. Issuers and investors at the roundtable did however express their views that given many investors’ negative perception about securitisation in general, European policymakers may want to consider measures to constructively incentivise investors and issuers of real economy securitisations to re-enter the market.

Since the financial market was plunged into crisis in 2007, market participants have seen some very significant problems in certain securitisation sectors and therefore perceive many types of securitisations to be of concern. However, actual experience demonstrates that many parts of the European securitisation market have performed well. In Europe, one of the reasons why the underlying assets are of good quality is that the regulatory environment for financial institutions has always been relatively strict, thereby limiting the types of assets that could be originated by lenders and therefore securitised.

AFME / ESF conducted this open workshop, firstly, to provide the industry with current data on where the European securitisation market currently stands in terms of performance and ratings migration and, secondly, to discuss investors’ and issuers’ views on prospects for the European market.

The first session, featuring representatives from the three credit ratings agencies which have provided the majority of ratings on European structured finance transactions – Standard & Poor’s, Moody’s Investors Service and Fitch Ratings - provided delegates with a snapshot of ratings performance and migration across the Europe, Middle East and Africa (EMEA) region since the financial crisis started, as well as an update on initiatives they have undertaken to improve transparency and comparability of ratings.

The second session featured a panel of securitisation issuers and investors, who provided their insights on prospects for the future of the securitisation market.

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Market performance
“We need to understand how the European ratings have performed so that we can move forward,” said Simon Collingridge, Head of Outreach at Standard & Poor’s.

“Only 0.3% of the AAA issuance of all types of European structured finance transactions outstanding as of mid-2007 defaulted by year-end 2009, with only 9% of that AAA issuance experiencing downgrades in the period. This should be compared to the US, where a significantly greater proportion (38%) of the AAA tranches was downgraded in the same period. Within the European asset classes, RMBS and consumer ABS have
showed the strongest performance, with less than 2% and less than 3% downgrades of AAA issuance respectively, while CMBS and CDO performance has been weaker.”

According to Ian Linnell, Group Managing Director at Fitch Ratings, downgrades have been concentrated in the lower tranches of the capital structure, which is to be expected. Moreover, distinguishing among asset classes in Europe, RMBS and ABS have performed substantially better than CMBS, which have seen more downgrades on a relative basis since the second half of 2007.

Marie-Jeanne Kerschkamp, co-head of Moody’s EMEA Structured Finance Group added that Aaa-rated EMEA RMBS tranches have performed quite well during the recent crisis, with resulting limited rating migration. In a recent report, “Rating Stability of RMBS and ABS Transactions in EMEA since 2007 – Reality is Better than Fiction”, Moody’s found that for the EMEA RMBS sector, on average, 91% Aaa-rated in Moody’s-rated RMBS transactions have retained their original ratings over the period 12 Feb 2007 and 12 Feb 2010. The relative rating performance of Aaa-rated tranches ranges from 100% of the Aaa tranches of UK prime, Irish and Portuguese RMBS retaining their Aaa rating over the relevant period, to 83% of UK non-conforming RMBS.

**Improving transparency and comparability**

The rating agencies were clear on the issues for investors – there is a need for greater transparency and understanding of criteria changes, as well as a dislike of surprises.

All three ratings agencies have responded during the financial crisis through criteria updates and/or changes in the assumptions motivated by the different economic environment. They have also tried to improve the transparency of the methodology update process via market consultations and regular communication with the industry.

Moody’s has reviewed its rating methodology, for example, for small and medium sized company loans and also recently published a request for comment on Operational Risk. However, Marie-Jeanne Kerschkamp stressed that, despite changing some methodologies, the biggest impact to the ratings of outstanding transactions has come from changing model assumptions. She added that the provision of a new weekly update report. “Structured Finance Quick Check” has helped to improve transparency.

Fitch has responded to the crisis by setting up screening committees, establishing risk officers and providing increased levels of independent criteria review.

S&P has amended its requirements for AAA grading, with, for example, a goal of enhancing rating stability at higher rating levels, so that, under moderate stress, an AAA rating should not drop lower than AA in a 12-month period or lower than A in a three-year period. “It is important to maintain a frank and open discussion, to be more informative when ratings are updated and, when contemplating significant criteria changes, to give market participants and investors, in particular, an opportunity to comment,” said S&P’s Collingridge.
Given that the ratings are performing and rating migration is limited, what incentives can be used to stimulate issuance and investor appetite? The second set of panellists, representing originators and investors, offered perspectives on incentives and liquidity issues.

**Attracting investors**

On the issue of market incentives, widespread concerns were voiced about attracting investors to the European securitisation market. Edward Panek, Senior Portfolio Manager, Henderson Global Investors, said he believes that investors have changed in the last three years and “it will be many years before we get back to a similarly sized investor base as before the crisis”.

“It will be hard to lead the rebuilding of the investment community from the buy-side,” said Dominic Swan, Global Head of Fixed Income, Halbis “as mainstream investors want the banks to provide secondary market liquidity in these securities before they invest in scale. But banks are restricting the inventory that their traders and treasury departments can hold for two reasons. First, the amount of regulatory capital that they must hold against securitised assets is still uncertain. Second, because ABS held on their balance sheet is not treated the same way for liquidity purposes as holdings of other asset classes such as covered bonds.”

“Investors still can’t always compare deals and more work is needed in standardising definitions,” claimed Steve Gandy, Head of Securitisation, Santander Global Banking & Markets. “In addition, due to the relative newness and smaller size of the European securitisation market, there are not as many knowledgeable investors in Europe as in the US and the reaction to the crisis stems from this lack of knowledge,” he added. “The US has had government-sponsored purchase programmes to support the asset-backed securities market. In Europe, only the covered bond market has been supported. While some additional regulation is, of course, necessary, excessive regulation could be the straw to break the camel’s back of new issuance, since the cumulative effect might make the cost of issuance prohibitive.”

Edward Panek said he feared that the future market will be made up of only a few niche players who really understand the product, adding that it could get “too expensive for people to enter, thereby impairing development of the sector”.

“It (over disclosure) could become expensive from an issuer’s point of view,” agreed Rob Collins, a structured finance consultant from Coleva Solutions, “and the barrier to entry on both sides is becoming higher.”

Dominic Swan shared his view of the market in terms of three participant categories – the first covering institutions holding legacy assets, the second covering institutions with a funding gap and the third covering institutions with no structural funding gap. “The question to ask is whether policy-makers want the third group to issue in the securitisation market. The US has said yes, but Europe does not seem sure”, he added.
Swan said he believes that additional liquidity support is needed if the third group is to participate in the securitisation market: “There is a real perception of a regulatory preference for covered bonds. These securities received a big implicit subsidy compared to ABS when the policy makers supported the banks that issued them and when the ECB bought large amounts of covered bonds. As long as this perception persists, covered bonds will receive more favourable treatment than ABS when bank treasury departments analyse their liquidity risk and, as a result, they will not be willing to commit their balance sheets to provide the secondary market liquidity that the ABS market needs if it is to recover.” This was supported by Santander’s Gandy, who added, “There is a finite universe of demand for covered bonds – it won’t be the salvation of lending in Europe”.

Rick Watson, Managing Director at AFME / ESF, brought the event to a close, concluding: “Today’s event shows that many European securitisation asset classes are performing well and largely in accordance with original expectations. The industry is leading a significant number of initiatives to improve transparency and restore investor confidence. However, given the many potential obstacles in front of European issuers, as well as the importance of restoring the “real economy” securitisation market, it is possible that more incentives may be needed from policymakers to stimulate the market across Europe for both investors and issuers”.

To see the charts presented at the AFME/ESF event on European ABS credit performance please click here.