IFSL Research

Securitisation 2009

In partnership with:

CITY OF LONDON

UK TRADE & INVESTMENT

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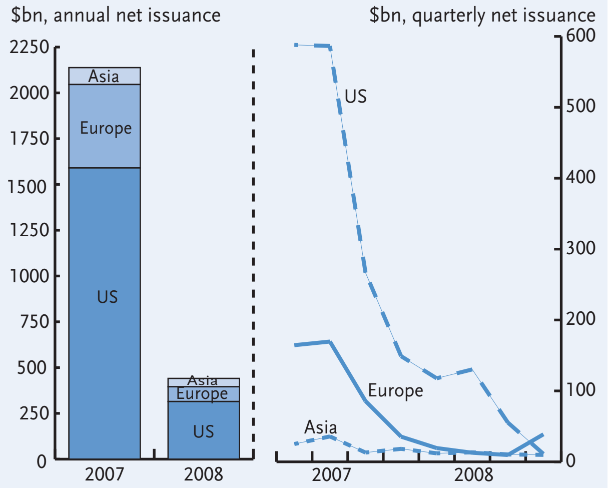
OVERVIEW

The global market for securitisation has slumped since September 2007 due to turbulence in credit markets, a lack of liquidity and a reduction in investors' tolerance of risk. These difficulties were triggered by the sub-prime crisis and compounded by the downfall of Lehman Brothers, as well as the nationalisation of the US federal agencies - Fannie Mae and Freddie Mac. Furthermore balance sheets of many banks were weakened by holding large tranches of mortgage-backed (MBS) and asset-backed securities (ABS). This resulted in the recapitalisation of some banks in a number of countries. Many of these overleveraged borrowers, including banks and other investors, which previously accounted for at least two thirds of global purchases of MBS and ABS, have exited the securitisation market.

Chart 1 Global net securitisation issuance*



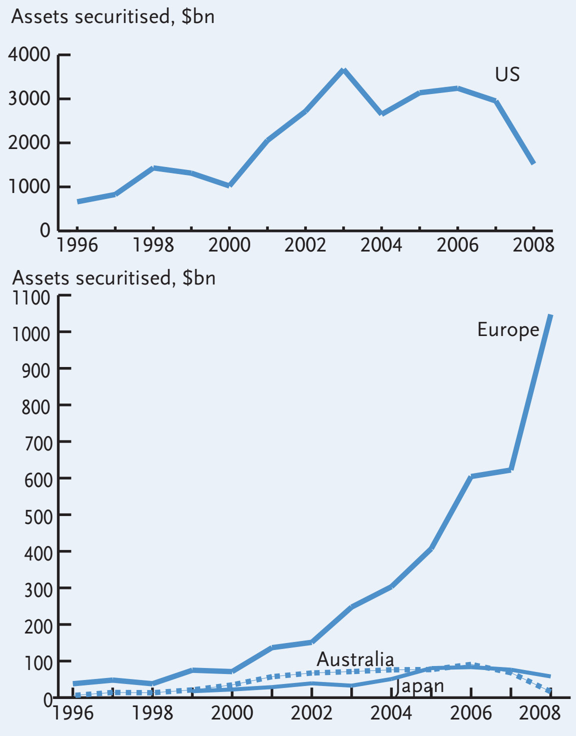
*Excluding securitisation issues retained by the issuing banks
Source: Dealogic

Gross global securitisation issuance showed a drop of about a third from \$3,817bn in 2007 to \$2,777bn in 2008 (Table 1). However, the majority of securitisation issuance in 2008 was retained within the issuing banks for repo agreements in order to enhance liquidity and availability of credit. Excluding securitisation retained with the issuing banks, which are not included in the gross figures, net issuance sold into the market and purchased by end-investors slumped by 79% from \$2,138bn to \$441bn (Chart 1). Quarterly data shows issuance falling through 2008 from \$149bn in Q1 to \$60bn in Q4. Dealogic figures on net issuance are not directly comparable with gross data as they are compiled on a separate basis, but they flag up the scale of decline in net issuance in 2008. Estimates for Q1 2009 point to issuance remaining at a very low ebb.

Leading industry groups in the securitisation industry have come together in a joint initiative launched in December 2008 that recognises problems and offers recommendations with a view to restoring confidence in the securitisation markets. In 'Restoring Confidence in the Securitization Markets' the groups recognise that multiple factors have contributed to the crisis including deterioration in loan underwriting standards, overreliance on credit ratings, growth of complex highly leveraged positions, misjudgment of liquidity risk, lack of a sense of shared responsibility and rising losses in the US subprime markets which triggered the global crisis in confidence. Recommendations focused on restoring confidence and liquidity are set out in detail on page 2.

Government measures in the US and Europe so far have focused on providing liquidity to the wholesale money markets and on recapitalisation of banks. The US government, recognising the importance of the securitisation market to the availability of credit, is allowing the Federal Reserve to lend at least \$200bn at favourable terms to investors under the Term Asset-Backed Securities Loan Facility (TALF) to facilitate buying of asset-backed securities. The facility has got off to a slow start with only limited applications for TALF loans. The EU has proposed that banks retain 5% of securitised products they sell to ensure good standards of underwriting.

Chart 2 Gross securitisation issuance



Sources: Securities Industry and Financial Markets Association, European Securitisation Forum, Reserve Bank of Australia, Fitch Ratings

Country breakdown for gross issuance shows that US remained the leading issuer in 2008 at $1,521bn, almost entirely based on MBS as issuance of ABS virtually dried up during the year (Chart 2). Issues in Europe totalling $1,047bn were inflated by the repurchase schemes operated by the central banks. The UK was the largest European issuer in 2008 because of banks' heavy funding requirements: the UK's share of the European market was steady at 38%. Stimulus to liquidity also boosted gross securitisation in Canada to $79bn. Issuance in Japan fell by a quarter to $58bn while in Australia a drop of three quarters to $16bn was recorded. South Korea also saw a slight drop in securitisation to $19bn as did the Latin American region.

SECURITISATION IN THE US

The fallout from high default rates related to the US sub-prime market has been at the root of the global crisis in the securitisation market, summarised in the overview on page 1. Many sub-prime mortgage loans were packaged and sold on to investors through mortgage-backed securities (MBS). These securities were given an overly high credit rating by the rating agencies and contagion was spread further because MBS were sold on to investors, through collateralised debt obligations and structured investment vehicles. Some investors, particularly a number of banks, acquired a vast quantity of these assets, which became toxic. Many investors subsequently have exited the market, contributing to the freezing of the US securitisation market beyond issues made by the federal agencies.

Mortgage-backed securities (MBS) Historically about two thirds of MBS issues in the US have been by the three federal agencies the Federal National Mortgage Association (FNMA or Fannie Mae), the Government National Mortgage Association (GNMA or Ginnae Mae) and the Federal Home Loan

Restoring Confidence in the Securitization Markets

Leading industry groups in the securitisation industry have come together in a joint initiative launched in December 2008 that recognises problems and offers recommendations with a view to restoring confidence in the securitisation markets. Participating organisations include the Securities Industry and Financial Markets Association (SIFMA) the American Securitization Forum (ASF), the European Securitisation Forum (ESF), and the Australian Securitisation Forum (Aus SF).

The study noted that without an efficient and smoothly functioning securitisation market banks could fail to meet some $2 trillion of demand for credit worldwide over the next three years. The initiative recognise that multiple factors have contributed to the crisis including deterioration in loan underwriting standards, overreliance on credit ratings, growth of complex highly leveraged positions, misjudgment of liquidity risk, lack of a sense of shared responsibility and rising losses in the US subprime markets which triggered the global crisis in confidence.

The shape of the securitisation market in the future will be determined to some extent by external factors such as macroeconomic conditions and stabilisation and recovery of the housing market in many countries. The industry may need to attract a new investor base. Four key priorities for action identified by the industry were to:
- Improve disclosure of information on underlying assets in residential mortgage backed securities (RMBS)
- Enhance transparency with regard to underwriting and origination practices
- Restore the credibility of credit reference agencies
- Improve confidence in valuations, methodologies and assumptions

Table 1 Securitisation issuance based on originating country or region

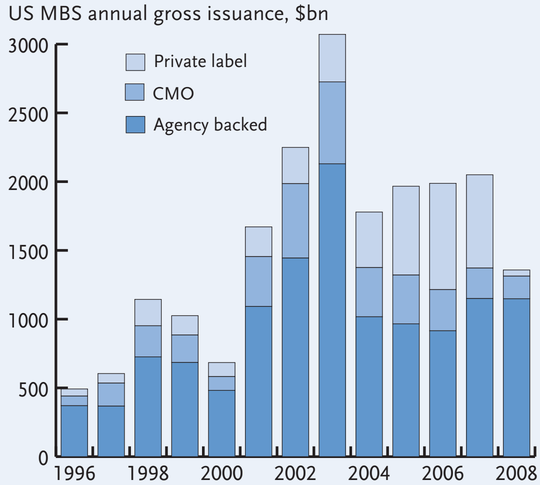
Annual value of gross issuance, $bn

	2004	2005	2006	2007	2008
US	2649	3139	3241	2952	1521
Australia	76	77	91	68	16
Japan	51	81	83	76	58
Canada	18	25	29	45	79
UK	130	157	242	237	400
Spain	41	50	55	84	119
Netherlands	23	49	36	56	107
Italy	43	41	38	36	121
Germany	10	19	47	26	74
Ireland	3	1	13	14	60
Belgium	3	1	3	6	51
France	10	9	10	5	21
Portugal	10	10	7	15	22
Pan-Europe	19	63	143	132	41
Other Europe	12	8	11	12	32
Europe total	303	407	604	622	1047
South Korea	24	28	24	21	19
Other Asia	7	4	6	3	19
Latin America	11	14	20	20	18
EEMEA	4	9	13	10	---
Emerg. mkts total	46	55	64	53	63
World total	**3142**	**3782**	**4112**	**3817**	**2777**

Sources as listed in subsequent charts and tables relating to countries and regions

Chart 3 Issuance of mortgage-backed securities in the US

US MBS annual gross issuance, $bn



Source: Securities Industry and Financial Markets Association

Mortgage Corporation (FHLMC or Freddie Mac). In September 2008 the Federal Housing Finance Agency placed the two larger agencies, Fannie Mae and Freddie Mac, into conservatorship (the US equivalent of nationalisation) in order to stabilise the two agencies and to reduce the growing systemic risks to the mortgage finance system. The US government has since been able to ensure an ongoing supply of affordable mortgage finance while taking responsibility for agencies' liabilities in excess of $5,000bn. Further federal funding has been required to finance continuing losses incurred by both agencies as a result of credit-related expenses and mark-to-market losses on derivatives and other assets due to spread widening and lower interest rates.

While the federal agencies have continued to securitise mortgages all other securitisation activity related to private label MBS has virtually ground to a halt. Statistics compiled by the Securities Industry and Financial Markets Association (SIFMA), indicate that MBS fell by a third to $1,358bn in 2008, from $2,050bn in 2007, with MBS in the two previous years also having been in the region of $2,000bn (Chart 3). Issuance backed directly by the federal agencies was virtually unchanged at $1,148bn in 2008 while collateralised mortgage obligations (CMOs), also based on agency issuance, fell by a quarter from $222bn to $165bn. Private label issuance by contrast collapsed from $678bn in 2007 to $45bn in 2008. The path on issuance trends in Chart 4 shows the steep decline in non-agency or private label issuance from over $200bn a quarter in the first half of 2007 to $56bn in the fourth quarter. This continued in 2008 with issuance falling to around $20bn in the first two quarters of the year and again to $1bn in Q3 and $5bn in Q4.

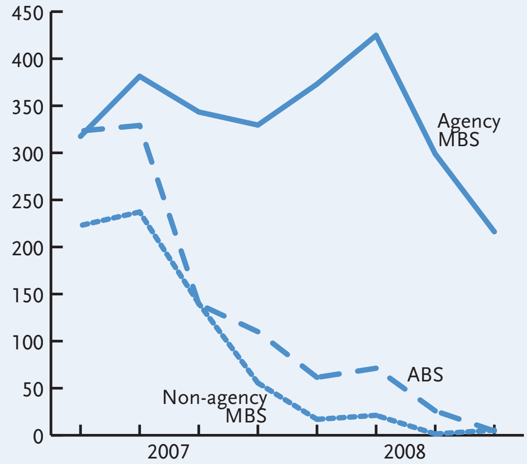
Asset-backed securities in the US (ABS) ABS are bonds or notes backed by financial assets that have been issued in the US since 1985. Having previously risen consistently every year since 1990, US ABS issuance, in common with private label MBS has collapsed since mid-2007 (Chart 4). Issuance fell from $652bn in the first half of 2007, to $249bn in the second half. The decline continued to $133bn in the first half of 2008 and just $30bn in the second half. Annual figures have fallen from a peak of $1,253bn in 2006 to $902bn in 2007 and $163bn in 2008 (Chart 5).

Sectors to have experienced a particularly sharp fall are home equity and mortgage loan issues which fell from a combined $309bn in 2007 to $7bn in 2008 (Table 2). The market was closed in the second half of the year with no issues at all. Credit cards, auto and student loans each fell by about a half in 2008 although much of the issuance was in the first half of the year.

Prospects for US issuance in 2009 Thomson Reuters estimates for Q1 2009 indicate that securitisation remains at a very low ebb: US issuance of $20bn was slightly up on the $10bn in the Q4 2008, but well below $80bn in each of the first two quarters of 2008 and down on issuance of around $500bn a quarter between mid-2005 and mid-2007. Some revival of securitisation in the US may emerge if investors are attracted by the design of the Term Asset-Backed Securities Loan Facility (TALF). The TALF is a $200bn lending programme created by the Federal Reserve that will provide financing for US entities that purchase newly issued ABS, including credit cards, auto loans and possibly commercial mortgages. While the facility could be increased to $1,000bn it has got off to a slow start with only limited applications in the first two months, partly linked to investor concerns about restrictions linked to taking up the loans.

Chart 4 US issuance of MBS & ABS

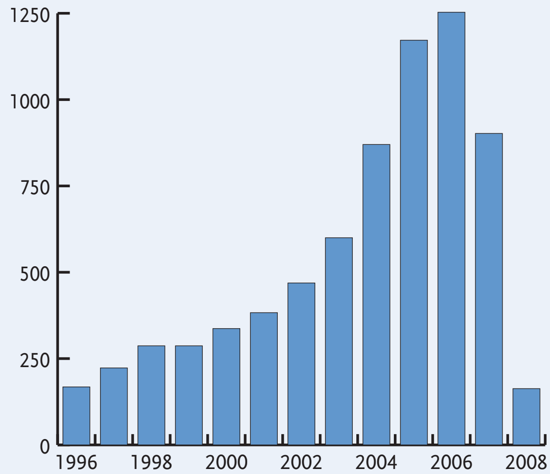
Quarterly issuance of US MBS & ABS, $bn



Source: Securities Industry and Financial Markets Association

Chart 5 US issuance of asset-backed securities

$bn, annual issuance of ABS



Source: Securities Industry and Financial Markets Association

Table 2 ABS sectors in the US

Annual issues, $bn

	2005	2006	2007	2008
Home equity	461	484	223	4
Credit card	67	68	95	57
Mortgage loan	251	138	86	3
Auto	85	81	74	36
Student loan	63	67	61	28
Other	245	417	362	36
Total ABS	**1172**	**1253**	**902**	**163**

Source: Securities Industry and Financial Markets Association

SECURITISATION IN EUROPE

The securitisation market in Europe was virtually closed in 2008 with net issuance in the primary market down 82% from $455bn in 2007 to $81bn in 2008, according to Dealogic (Chart 6). European Securitisation Forum (ESF) reports that 2008 was "characterised by deleveraging, low liquidity, tight credit markets and reduced appetite for risk".

The ESF's separate figures for gross securitisation issuance are heavily influenced by the repurchase schemes operated by the Bank of England and the European Central Bank. As a result of this bank funding, ESF data shows that gross securitisation in European countries reached $1,047bn in 2008, up from $622bn in 2007 (Chart 6).

In the UK, financial institutions pledged £287bn face value in securities to the Bank of England Special Liquidity Scheme in order to borrow £185bn. This contributed substantially to the rise in UK issuance from $237bn to $400bn between 2007 and 2008. The UK was the largest European issuer in 2008 because of banks' heavy funding requirements and its share of the European market was steady at 38%. The UK has taken additional measures in the first quarter of 2009 to support the UK Residential MBS (RMBS) and ABS markets. The next largest issuers in Europe in 2008 were Italy, Spain and the Netherlands (Table 1). The proportion of pan-European issues that cannot be attributed to individual countries was much smaller in 2008 at 4% of the total down from over 20% in the previous two years.

The banks' funding requirements have meant that securitisations have been more heavily skewed to RMBS in 2008 than has been the case in previous years when the primary market was functioning normally (Table 3). Other collateral types declined during 2008.

Spreads and ratings A lack of liquidity, increased credit risk and limited demand from investors has contributed to a substantial increase in spreads since the third quarter of 2007. Spreads for AAA-rated European ABS for auto loans, which previously had been stable at around 10 basis points (bp) between 2004 and mid-2007, initially rose to 67bp by end-2007 but soared during 2008 to reach over 350bp by the end of the year (Chart 7). Spreads for AAA-rated credit cards which had moved in line with auto loans up to end-2007 jumped even more to over 550bp by end-2008.

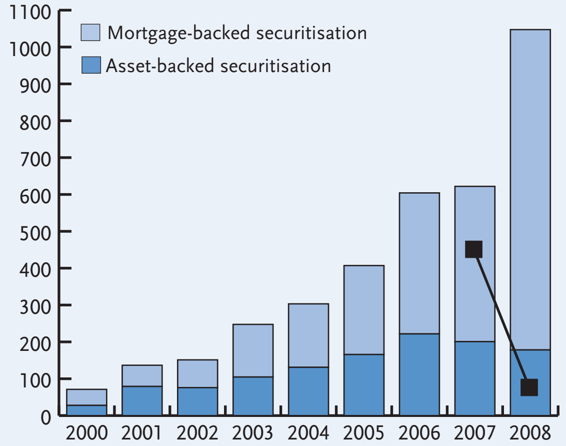
Many more European securitisation issues have been downgraded in the past year. In 2007, 481 upgrades were more than double the 214 downgrades, while in 2008 1,174 issues were downgraded compared with 184 upgrades (Chart 8). Nearly two thirds of these downgrades (728) were made in the fourth quarter, reflecting the deepening crisis in the securitisation market.

Reform in European securitisation market

ESF Following up the global proposals, noted on page 2, to improve disclosure of information on underlying assets in RMBS, the ESF has been working with industry participants to draw up a set of principles: "RMBS Issuer Principles for Transparency and Disclosure" are designed to govern reporting standards and improve transparency of European RMBS. Many

Chart 6 Securitisation issuance in Europe

Annual issuance, $bn
- *bars:* gross MBS & ABS issuance
- *line:* net issuance for 2007 & 2008



Source: European Securitisation Forum, Dealogic

Table 3 European securitisation by type of collateral

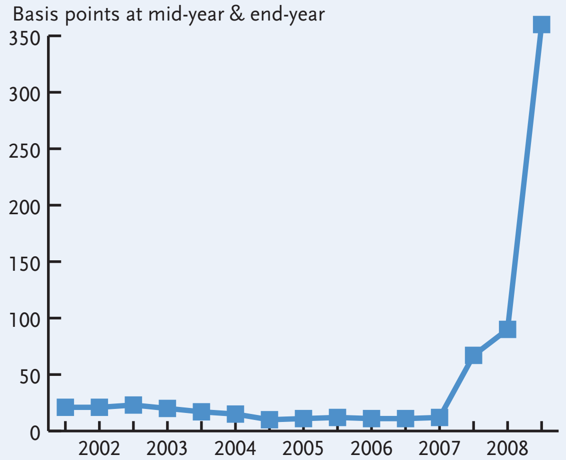
Issuance, $bn

	2005	2006	2007	2008
RMBS	180	307	356	862
CMBS	61	75	65	7
MBS total	*241*	*383*	*421*	*869*
CDO	15	138	122	71
Other ABS	151	83	79	107
Europe total	**407**	**604**	**622**	**1047**
% share				
RMBS	*44*	*51*	*57*	*82*
CMBS	*15*	*12*	*10*	*1*
MBS total	*59*	*63*	*67*	*83*
CDO	*4*	*23*	*20*	*7*
Other ABS	*37*	*14*	*13*	*10*
Europe total	*100*	*100*	*100*	*100*

Source: European Securitisation Forum

Chart 7 Spreads on AAA-rated European ABS

Basis points at mid-year & end-year



Source: Fitch Ratings, European Securitisation Forum banks and other firms have signed up to the voluntary principles while the rating agencies have agreed to use a common reporting template with regard to data concerning underlying debt for complex structure products.

EU Over and above measures proposed by the industry to improve the functioning of securitisation markets, the EU has proposed that banks retain 5% of securitised products they sell in order to ensure good standards of underwriting.

SECURITISATION IN REST OF THE WORLD

Japan Securitisation in Japan fell by a quarter to $58bn in 2008 from $76bn in 2007 (Chart 9). Volume declined significantly across all asset types especially Commercial MBS (CMBS), where the decline in transactions was caused by a lack of liquidity in the real estate finance market. Fitch Ratings are pessimistic about the Japanese securitisation market in 2009 because of the deteriorating economic conditions.

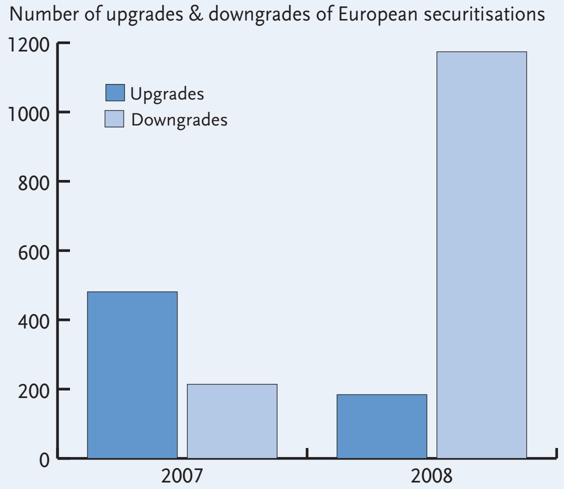
Australia Issuance of securitised bonds by Australian issuers has been substantially curtailed since mid-2007 (Chart 10). Annual issuance declined from the $91bn peak in 2006 to $68bn in 2007, with most of 2007 issuance in the first half of the year. Activity remained at a low ebb in 2008, with issuance totalling just $16bn. The bulk of these issues were purchased by the Australian Office of Financial Management as part of the Australian government's injection of liquidity into financial markets.

Historically, MBS, particularly RMBS, has been the mainstay of the Australian market, usually accounting for 80-90% off issuance. The Reserve Bank of Australia has indicated that the RMBS market remains depressed due to a lack of investor demand caused by the overhang of supply in the secondary RMBS market, which has pushed up AAA spreads to around 240 basis points in February 2009, mirroring similar trend in markets elsewhere. Excess supply rather than quality of the issues is therefore the overriding issue for investors.

Canada Canadian banks have not invested significantly in the securitisations which have become toxic to the balance sheets of many US and European banks but they have faced a deterioration of conditions in the wholesale funding market. The Bank of Canada has therefore indicated that while funding strains exist, 'Canadian financial institutions remain in much better shape than their international peers'. To counter the lack of liquidity, the authorities in Canada have committed to purchasing up to C$75bn of insured mortgage assets through the Canada Mortgage and Housing Corporation. This contributed to the 74% jump in gross securitisation in Canada in 2008 to $79bn from $45bn in 2007 (Chart 11). Previously, securitisation in Canada had grown steadily and become increasingly broad-based since its inception in the mid-1980s.

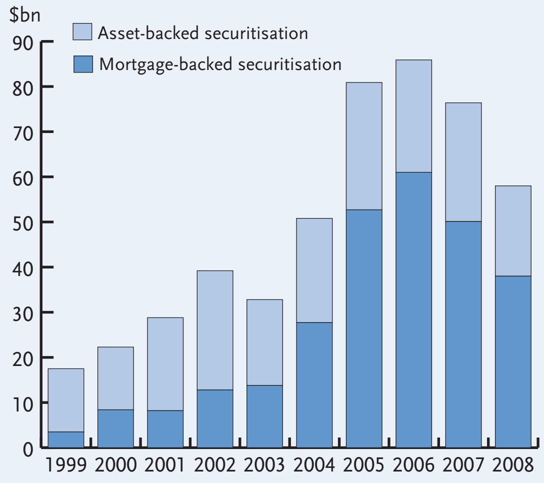
Latin America In Latin America Fitch Ratings data shows that issuance declined from $20bn in 2008 to $18bn in 2006 and 2007. Fitch Ratings has noted that activity in Latin America has been less affected by the credit crunch, as the markets have not been overly exposed to CDOs and subprime

Chart 8 Ratings changes to European securitisations



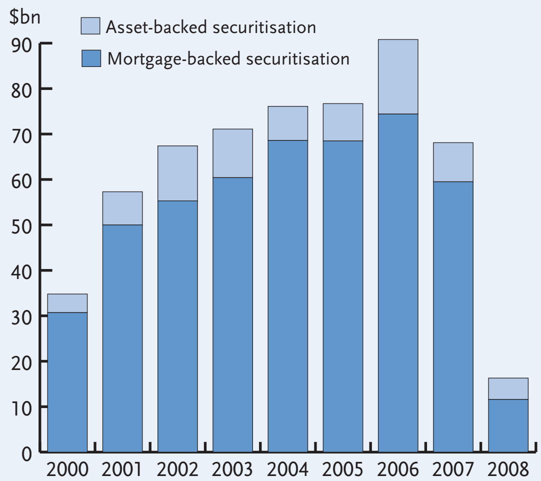
Source: Fitch Ratings

Chart 9 Securitisation issuance in Japan



Source: Fitch Ratings

Chart 10 Securitisation issuance in Australia



Source: Reserve Bank of Australia

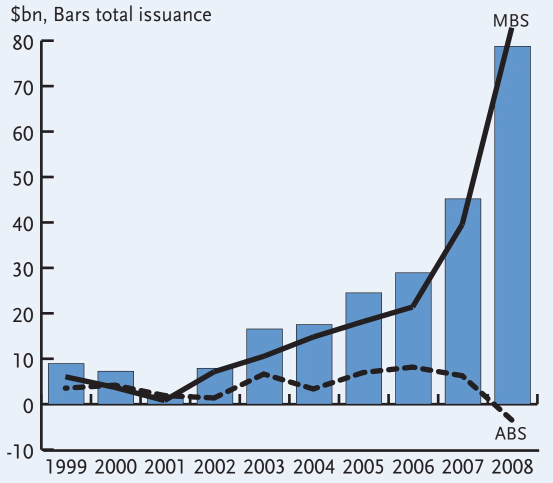
mortgages. International issues fell from $4.6bn to $2.9bn but local issues, the mainstay of activity, remained stable at $15bn. Brazil was the largest issuer in 2008 with $7.4bn, followed by Mexico with $5.7bn. The balance was mostly made up by Argentina, Peru, Columbia and Chile.

Asia South Korea remains the biggest issuer in Asia after Japan, although issues have declined steadily in recent years from $28bn in 2005 to $19bn in 2008. ABS related to credit cards and collateralised bond obligations rose during 2008 but these were offset by a fall in ABS issued by private non-financial corporations.

Since 2003, other Asian countries have entered the securitisation market facilitated by the introduction of an appropriate legislative framework. Fitch Ratings has indicated that key issuers in 2008 were India $15bn and China $4bn.

EEMEA Securitisation is also an expanding market in Eastern Europe, the Middle East and Africa (EEMEA), with issuance reaching $13bn in 2006 before falling back to an estimated $10bn in 2007. Much of the activity in this region is concentrated in South Africa, Egypt and Russia.

Chart 11 Securitisation issuance in Canada



Source: Bank of Canada

OTHER SOURCES OF INFORMATION

Bank of Canada
Weekly financial statistics
Financial System Review, December 2008
www.bankofcanada.ca

European Securitisation Forum
ESF Securitisation Data Report (quarterly)
www.europeansecuritisation.com

Financial Supervisory Service (South Korea)
Weekly Newsletter
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Statement on Monetary Policy (quarterly)
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Research Quarterly
www.sifma.org

Thomson Reuters
Debt Capital Markets Review (quarterly)
www.thomsonreuters.com

Securitisation and its main structures

Securitisation offers a way for an organisation to convert a future stable cash flow arising from a financial asset, usually some form of loan, into a lump sum cash advance. This is achieved by converting the future cash flows into tradable securities which are sold as a means of raising capital. Securitisation markets have been in crisis due to a variety of factors. Industry proposals to restore viability by attracting a new investor base are set out on page 2.

Mortgage-backed securities

Agency and private label mortgage backed securities are based on the 'pass-through' and have been the most common structure for US securitisation since the market was developed in the 1980s. Under a pass-through the MBS issuer acquires mortgages from the original mortgage lenders, which are then examined to ensure they meet credit quality guidelines. Loans with similar characteristics with regard to yield and maturity are pooled together and the servicer 'passes through' a pro rata share of all interest and principal payments to the investors. The actual packaging or 'pooling' can be undertaken by the US mortgage federal agencies or by private enterprises. Private label MBS are companies other than Fannie Mae, Ginnie Mae and Freddie Mac that create and sell MBS or other bonds. Private label MBS frequently are collateralised by loans that are ineligible for purchase by Freddie Mac.

Residential mortgage-backed securities (RMBS) are debt instruments secured by residential property.

Commercial mortgage-backed securities (CMBS) are debt instruments secured by commercial property such as offices, shops, factories and warehouses, as well as blocks of flats and hotels. They enable banks to pool their commercial property loans and repackage them.

Collateralised mortgage obligations (CMOs) CMOs were created because pass-through securities don't always match investor requirements, due to a lack of certainty of cash flow and mismatch of maturities. CMOs were first issued in the early 1980s and offered a full spectrum of maturities: banks and thrifts wanted a shorter term instrument while pension funds and insurance companies wanted long term securities.

Asset-backed securities (ABS)

ABS are bonds or notes backed by financial assets that have been issued in the US since 1985. These assets consist of receivables, other than the mortgage loans, that have been securitised. ABS therefore span home equity loans, credit card receivables, car finance, collateralised debt obligations (CDOs), student loans, equipment leases and manufactured housing contracts. CDOs refer to a debt obligation whose underlining collateral and source of payments consist of existing bank loans and other forms of debt obligations, such as emerging market and high yield debt.

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