The European ABS markets in 2013–The state of the union...

**Commentary**

- No such thing as a European, or even a Eurozone securitisation market
  - More a collection of disparate issuance jurisdictions

- Since the *distributed* securitisation market reopened in 2009:
  - Average annual Eurozone issuance stands at €29bn (YTD €28bn)
    - Ex-Eurozone issuance adds a further €42bn (YTD €8bn)
  - Cumulative real economy funding of €118bn (€259bn)

- *Retained-for-repo* bonds continue to provide issuers with significant liquidity asset balances
  - Cumulative Eurozone creation since 2009 stands at €898bn (YTD €57bn)
    - Ex-Eurozone creation adds a further €202bn (YTD €6bn)

- 2013 sees a divergent market from previous periods
  - UK’s dominant role in issuance terms significantly curtailed as originators require less wholesale market funding
    - NOT because of Funding for Lending
  - As ‘core’ Eurozone provides a larger share of issuance, market becomes less residential-mortgage backed

- **Transaction economics remain a major roadblock to the broader usage of securitisation**

Source: J.P. Morgan International ABS & CB Research
Peripheral assets are often unable to support elevated securitisation liability spreads, resulting in official sector reliance.

**Mortgage rates versus liability costs, %**

![Mortgage rates versus liability costs graph]

Source: ECB & J.P. Morgan International ABS & CB Research

**Economics 101**

- Peripheral issuers are almost entirely excluded from new securitisation issuance at current spread levels
- Despite the significant improvement from recent spread wides
- Assets throw off insufficient yield to support liability costs
- ECB ‘crowds out’ the markets
- Northern European issuers do however have a choice:
  - Issuance is the cheapest option, once haircuts are accounted for—covereds are cheaper than RMBS

**Securitisation vs Covered Bonds**

- Securitisation is overwhelmingly structured from stand-alone SPVs in the Eurozone
  - Master trusts starting to take off in the Netherlands
- Means transaction economics must work on a standalone basis
  - Asset spread must cover distributed liability costs
  - While repricing has occurred most notably in Northern Europe, ability to reprice consumer credit in the Periphery is limited by existing financial stresses on borrowers
- If reprice, will cause the performance deterioration investors fear
- Covereds can however ‘syndicate’ elevated costs across the programme (whole cover pool margin), allowing issuance
Why don’t we see more activity? From the issuers’ perspective

<table>
<thead>
<tr>
<th>Who is doing what?</th>
</tr>
</thead>
<tbody>
<tr>
<td>‘Core’ Eurozone</td>
</tr>
<tr>
<td>‘Core’ Eurozone fully supported by active, and more importantly, cheap access to funding through the covered bond market</td>
</tr>
<tr>
<td>Little prospect of challenging entrenched covered products, resulting in securitisation being a ‘residual’ funding instrument i.e. funding for collateral not eligible for inclusion in cover pools</td>
</tr>
<tr>
<td>Unsecured consumer assets are an area of growth</td>
</tr>
<tr>
<td>SME ABS offer an economically viable funding mechanism</td>
</tr>
<tr>
<td>Solid investor appetite, although official sector access remains a roadblock to potential supply</td>
</tr>
</tbody>
</table>

| Italy              |
| OBGs present an alternative, however transaction economics remain the biggest constraint on potential securitised issuance. Credit concerns largely driven by the sovereign, rather than the securitised collateral pools of existing bonds |

| Peripheral – Credit |
| ACS, OH and CH prove to be cheaper sources of funding for residential assets than RMBS alternative |
| Credit issues in existing collateral pools push investors to prefer the safety of dual-claim instruments (i.e. CBs), or early-vintage securitised bonds |
| Leaving more recent cohort paper comparatively wide in spread terms, and providing ‘unhelpful’ price points |
| Data inadequacy remains a roadblock to clearing the ‘backlog’ |
| For Greece, significant uncertainty overshadows investment in both secured instruments |

| Ex-Eurozone        |
| Similar to core Eurozone, mainstream residential assets are more cheaply funded through reliance on the covered bonds |
| Nascent emergence of a securitisation market for non-resi consumer assets allows: |
| Banks to get comparatively cheap funding (compared to deposits/senior) |
| Investors gain exposure to rare, solidly performing collateral from jurisdictions removed from the sovereign crisis |

| UK                 |
| Low issuance volumes attributed to official sector intervention, but should rather be ascribed to lower total funding needs across sector. Lack of supply for securitised and covered product causing headaches for investors. |

Source: J.P. Morgan International ABS & CB Research
Why don’t we see more activity? From the investors’ perspective, regulatory moves have much to do with it

<table>
<thead>
<tr>
<th>ABS &amp; Senior Unsecured impact</th>
<th>Covered Bond impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proposed rewrite leads to significant increase in capital charges for securitised positions</td>
<td>Securitisation Framework</td>
</tr>
<tr>
<td>Increases the risk around senior unsecured debt</td>
<td>Bail-in debate</td>
</tr>
<tr>
<td>Treats securitisation investment relatively harshly for insurers who cannot create their own internal models</td>
<td>Solvency II</td>
</tr>
<tr>
<td>Includes some securitisation bonds as an eligible liquid asset under Level IIb of the LCR calculation</td>
<td>CRD IV/ Basel III/BIS Liquidity Regime</td>
</tr>
<tr>
<td>Requires additional due diligence by investors in ABS and retention of 5% of any new issue by originators</td>
<td>CRD II 122a</td>
</tr>
<tr>
<td>Increases the risk weights for trading book ABS and all re-securitisations</td>
<td>CRD III</td>
</tr>
<tr>
<td>Minimum ABS haircut of 10% at the repo window, with loan level data requirements</td>
<td>ECB Repo</td>
</tr>
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</table>

Source: J.P. Morgan International ABS & CB Research

Overview

- Securitisation continues to face significant re-regulation following the financial crisis
  - Significant initiatives such as re/writing of the BIS Securitisation Framework (banks) and Solvency II (insurers) often incorrectly assume that the worst case in global securitised performance should be the base-case for European securitisation regulatory treatment
  - Securitisation industry initiatives often have to fight to standstill in regulatory terms, while the covered bond community can focus on improving existing treatment, therefore increasing the disparity in treatments between the two asset classes
Not all regulation unsettles investors however, with a number of initiatives designed to improve access to information being welcomed by investors...

What do you expect the impact of these forthcoming regulatory initiatives to be on the International ABS market?, %

<table>
<thead>
<tr>
<th>Initiative</th>
<th>Don't Know2</th>
<th>Don't Know1</th>
<th>Negative</th>
<th>Neutral</th>
<th>Positive</th>
</tr>
</thead>
<tbody>
<tr>
<td>BIS liquidity regime (LCR)</td>
<td>8%</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
<td>2%</td>
</tr>
<tr>
<td>BIS Securitisation framework</td>
<td>4%</td>
<td>10%</td>
<td>15%</td>
<td>17%</td>
<td>8%</td>
</tr>
<tr>
<td>Solvency II</td>
<td>6%</td>
<td>52%</td>
<td>60%</td>
<td>60%</td>
<td>38%</td>
</tr>
<tr>
<td>ECoI Loan-level data &amp; doc disclosure</td>
<td>8%</td>
<td>27%</td>
<td>27%</td>
<td>59%</td>
<td>46%</td>
</tr>
<tr>
<td>PCS initiatives</td>
<td>2%</td>
<td>27%</td>
<td>27%</td>
<td>49%</td>
<td>39%</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan International ABS Confidence Index, June 2013

Note: Don't Know 1 & 2 refers to the answers “Don’t know enough, my fault”, and “Don’t know enough, “their” fault” respectively.

From an investor perspective, what do ABS originators need to do to re-open the International ABS market?, %

<table>
<thead>
<tr>
<th>Initiative</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue ‘interesting’ bonds</td>
<td>20%</td>
</tr>
<tr>
<td>Improve collateral quality</td>
<td>20%</td>
</tr>
<tr>
<td>Divert supply</td>
<td>10%</td>
</tr>
<tr>
<td>Improve structural quality</td>
<td>31%</td>
</tr>
<tr>
<td>Improve disclosure</td>
<td>49%</td>
</tr>
<tr>
<td>Issue non-senior bonds</td>
<td>39%</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan International ABS Confidence Index, June 2013
...although it is still ‘early days’ to assess the full impact on counterparty behaviour

**Prime Collateralised Securities Label**
- Label awarded to senior-most ABS transactions which meet a subjective set of criteria, including
  - Simplicity
  - Asset quality
  - Transparency
- Since launch (end of November 2012), eligible tranches in 31 transactions have been granted use of the label
  - Some primary market interest in eligibility on transaction launch
  - No discernible impact on secondary market activity .... as yet...

**Market feedback**
- Too early to gauge the benefits of the Label
  - Limited number of deals
- Expected benefits include:
  - Alignment of best practices across jurisdictions
    - Minimum reporting standards
    - Help to standardise transaction docs
  - Increased likelihood of improved regulatory/repo treatment
  - Asset quality and potential to reduce stigma
  - Independent review by third party
  - Lower barriers to entry for new investors

**Loan Level Data Initiative**
- Loan Level Data (LLD) requirement for ECB window access commenced in Q1 2013, with a 9 month phase-in period for the larger securitised asset classes (RMBS and SME ABS)
- All major consumer assets now covered
  - CCABS latest to be added, in September 2013
  - Joining CMBS, Consumer Finance, Leasing, Autos, RMBS and SME ABS
- Tolerances recently announced permitting continued (temporary) acceptance at the window for minor infractions of data provision

**Market feedback**
- Welcomed by investors, allowing deeper analysis
  - Thereby improving confidence
  - Improved liquidity?
- Standardised reporting across the asset class
- ‘One stop shop’ for LLD
- Improved transparency
- Potential for improved regulatory treatment
So where does that leave us? Looking into 2014...

Commentary

- 2013 looks set to be a strange year...
  - YTD issuance volumes are suppressed by historical standards
    - We venture that bank funding needs are lower across the board... not a reflection of the merits of one funding instrument over another
    - Senior unsecured, covereds and ABS are all facing lower issuance volumes
    - Official sector continues to drain potential supply alongside the ‘driver’ of negative balance sheet growth
  - The mix of new issue assets presented to investors is fundamentally different to earlier periods
    - The bulwark of UK RMBS has gone AWOL
    - Increased issuance from international consumer finance operations, away from funding at group centre
    - Peripheral issuance economics still do not work
  - Secondary markets have not experienced the drop in activity that has been seen in the primary markets
    - Engagement with peripheral risk has improved following the almost complete aversion during the sovereign crisis
    - But still not to a breadth of risk-taking comparable to that in the covered market

- Fundamentals continue to deteriorate across the majority of jurisdictions
  - Most notable in peripheral jurisdictions, where systemic deleveraging is occurring
    - But northern European jurisdictions are not immune to performance corrections (i.e. Netherlands)
  - Propensity for regulatory tinkering appears to have increased of late
    - Numerous mortgage law amendments in Spain
    - Dutch mortgage tax regime changes
    - SMEs lending initiatives

- It remains unclear why 2014 should be fundamentally different from 2013 based on current analysis
  - 2014: More of the same. Just not much more
Discussion topics

Topics for consideration

- Where next for Eurozone securitisation markets...
  - How can economic peripheral ABS issuance be achieved?
  - Does securitisation investment make sense while the regulatory winds continue to vacillate around the asset class?
- Is greater transparency enough to kick-start the market?
- Will SME ABS be the panacea for the region’s smaller corporates...
  - How can securitisation lose its current name-taint, and be more closely associated with increases in real economy funding?
  - Are third party guarantees necessary for investors to engage with SME ABS?
Appendix
J.P. Morgan’s International ABS Investor Confidence Index results

- J.P. Morgan’s International ABS Investor Confidence Index\(^1\) shows that investors are feeling comparatively upbeat about the asset class: at +2.2, although less so than in January 2013 (+3.3).
- The Index has now been in positive territory for the last ten readings
  - Expectations for the period ahead show continued signs of confidence, with a reading of **+2.1 over the next six months**
- The Index shows that investors are not so sanguine about the **wider financial markets**, with the reading **standing at 0.8 currently** (+1.0 over the next six months)

- Investors and originators **expect relatively stable supply into the primary market**, combined with a tightening bias in terms of spreads
- **Sovereign risks** still seen as the most significant threat to this relatively constructive outlook...but this can be navigated

### ABS Confidence Index, through time

![Graph showing ABS Confidence Index from March 2008 to June 2013](image)

Source: J.P. Morgan International ABS Confidence Index

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\(^1\) Index methodology: Each available option is assigned a weight between +10 and -10. A result of +10 on the index would imply a unanimous response of “Excellent” from index participants. A result of -10 would imply a unanimous response of “Disastrous” from index participants.
Bank funding markets in 2013–Lower issuance from Eurozone banks across senior instruments

<table>
<thead>
<tr>
<th>Distributed senior unsecured, €bn</th>
<th>Distributed covered bonds, €bn</th>
<th>Distributed securitisation, €bn</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="image" alt="Chart" /></td>
<td><img src="image" alt="Chart" /></td>
<td><img src="image" alt="Chart" /></td>
</tr>
</tbody>
</table>

### Senior
- Declined due to deleveraging, market access precluded by uneconomic spreads (vis-a-vis CB or official sector alternatives)
- Durations have shortened:
  - Core: 5.52yr ('07) to 5.06yr ('12)
  - Periphery 4.18yr ('07) to 3.29yr ('12)

### Covered
- Distributed issuance declined due to LTRO, and peripheral exclusion from the market. Earlier stresses during the banking crisis
- Durations have shortened:
  - Core: 11.09yr ('07) to 7.14yr ('12)
  - Periphery 12.56yr ('07) to 4.90yr ('12)

### Securitisation
- Distributed issuance driven by UK & Dutch RMBS. Earlier periods saw significant retained collateral creation across all geographic groupings.

#### Notes
Core defined as 'Eurozone, non-periphery'. Periphery defined as Greece, Ireland, Italy, Portugal and Spain. 'Other Europe' covers EEA and Switzerland ex Eurozone.

#### Sources
- Senior Unsecured data sourced from Dealogic
- Covered Bond data sourced from Dealogic. Issuance defined as benchmark transactions (€>500mm) only
- Securitisation data sourced from J.P. Morgan International ABS & CB Research
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<table>
<thead>
<tr>
<th></th>
<th>Overweight</th>
<th>Neutral</th>
<th>Underweight</th>
</tr>
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<tbody>
<tr>
<td>Global Credit Research Universe</td>
<td>23%</td>
<td>58%</td>
<td>19%</td>
</tr>
<tr>
<td>IB clients*</td>
<td>63%</td>
<td>55%</td>
<td>51%</td>
</tr>
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</table>

Represents Ratings on the most liquid bond or 5-year CDS for all companies under coverage.

*Percentage of investment banking clients in each rating category.
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