

Product Focus

January 2007

Felix Blomenkamp Discusses the European Market for Asset-Backed Securities



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Mr. Blomenkamp is a Senior Vice President, a portfolio manager for PIMCO Fixed Income Portfolio Management in Munich and the Head of the European Collateralized Sector team, responsible for ABS and Pfandbriefe in Europe. He joined the group in 1998, having been previously associated with Allianz Life Insurance Company in Stuttgart as Portfolio Manager for the loan portfolio. Mr. Blomenkamp has eleven years of investment experience and holds a Master's degree in Business Administration from the University of Wuerzburg, Germany.

Asset-Backed Securities (ABS) are a relatively new asset class in Europe in which PIMCO developed a broad expertise. In the interview below, Portfolio Manager Felix Blomenkamp provides an overview of the European ABS market and discusses ABS as an investment alternative for European bond investors.

Q: As a European specialist for Asset-Backed Securities (ABS) you are part of PIMCO's global ABS team. In your experience, what are the biggest differences between the European and the American ABS markets?

Blomenkamp: One of the main differences between the European and the U.S. ABS market is that the American market is significantly older than the European market. The U.S. market began in the 1970's when the classic mortgage-backed securities (MBS) were introduced. In the early 1990's, the American ABS market developed further with the advent of Commercial Mortgage Backed Securities (CMBS) and consumer credit ABS. The European ABS sector has been in existence only since the end of the 1990's in a notable size, and Europe followed the example of the U.S.

Another difference between the two markets, apart from the starting point, is size. The U.S. ABS market is still a lot bigger despite the strong growth rates we have seen in Europe. The difference in size affects the liquidity. Even though Europe is catching up, the U.S. market remains more liquid, and this is reflected in the spreads. We see narrower spreads in most American ABS asset classes, and it is not the quality of the issue that makes the difference.

Q: Why did ABS take so long to gain a foothold in Europe?

Blomenkamp: Generally, I think it is a typical phenomenon for capital market trends to develop in the U.S. first and then find their way to Europe. It also should be noted that Europe didn't have a homogenous market before the euro was introduced in 1999. ABS were issued occasionally in the mid 1990s, despite a fragmented market with different currencies. But it was the introduction of the euro that provided the basis for growth of the ABS market in Europe.

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Q: Was the size of the available asset pools in Europe a problem for securitisation?

Blomenkamp: Not necessarily. Naturally there were different structures in the U.S. and in Europe, especially when we think of the biggest segment, MBS, which are considered part of the ABS market in Europe. In Europe we have covered bonds. Many banks therefore have the option to finance themselves through covered bonds instead of MBS. This is not only the case for Germany with the "Pfandbriefe" but also other countries with similar covered bond products like Denmark. The U.K. has a large mortgage market as well but due to the lack of covered bonds banks make massive use of MBS to refinance themselves.

Q: Were there European countries that introduced ABS ahead of others?

Blomenkamp: The U.K. was a pioneer in the European ABS market, due to factors like its proximity to the U.S. in terms of language. We saw and still see MBS dominating the U.K. market because there is no common covered bond product available. The big mortgage banks therefore use the MBS market frequently, and issue sizes of £4 billion to £5 billion are not unusual. These high volumes also helped improve liquidity.

Q: Do you see different trends and preferences in European countries when it comes to ABS products?

Blomenkamp: Even if we exclude the U.K., we still have clear differences between the countries of the single European currency, the euro. The differences stem from the frameworks for securitisation because some countries were quicker than others to respond to ABS with a more ABS-friendly legal environment. Italy, for example, has a well-developed market for ABS, which, in addition to mortgages, also securitises leasing credits among other types of loans. We also see deals by the Italian government, which securitises assets to finance their budget. The supply of ABS in Italy is therefore highly varied, and other countries were maybe not quite as creative.

Germany also had an active market in recent years. Due to the legal framework, synthetic ABS made up the bulk of the issuance in the German ABS market while only a small part of the transactions were cash deals. In a synthetic ABS structure, risk transfer is achieved through credit derivatives known as credit default swaps (CDS).

Two aspects of the legal framework in Germany were responsible for the preference for synthetic structures. First, the framework created problems with the transfer of rights to the asset pool. Second, because banks may seek to release equity without the need for funding, a synthetic structure is often sufficient. Recently, the volume of cash transactions has increased significantly due to new legislation to improve the framework for cash transactions.

Q: Which aspects of the framework have the biggest influence on the development of the ABS market?

Blomenkamp: When we talk about the framework we generally refer to the laws that allow for the transfer of assets to another company. Tax aspects are also an element of

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it. To give an example, in Germany we had the question of whether the transfer of assets to a special purpose vehicle (SPV) should be subject to value added tax.

It depends therefore, to what extent each individual country wants to make ABS more attractive and foster local capital markets. Let's take for example a legislative body that doesn't allow for call rights in an ABS issue. MBS, in particular, have very long maturities and the lack of an option to retire the debt can make MBS relatively less attractive. The framework plays an important role in the development of a market.

Q: Which are the most important players in the European ABS market?

Blomenkamp: The U.K. clearly dominates the European ABS market. An estimated 40 to 45 percent of all transactions come from the U.K, driven by high-volume MBS. Italy is another important player, with a share of issuance of 15 to 20 percent. Spain also has a strong market for MBS, followed by the Netherlands and Germany. There have been relatively few shifts in this ranking over the past several years. While Germany, for example, gained in cash volume due to the mentioned legal change that made cash transactions easier, the risk transfer with synthetic ABS was already high.

Q: How are issuance volumes developing in the European ABS market?

Blomenkamp: Growth is still quite dynamic. In 2005 we had volumes of almost € 320 billion in total. This total comprises all currencies, although Euro and pound issuance account for most of it. In 2006 we expect volumes to remain clearly above the € 300 billion mark. In 1998 and 1999, the volume was still below € 50 billion. So growth rates have been quite high in Europe.

Q: Did demand in Europe keep up with the issuance of ABS?

Blomenkamp: Absolutely. The market segment is still quite young and it finds more and more interest among investors. Demand has not only kept up; it is so strong that issues usually are clearly oversubscribed. The biggest investors in ABS include banks, asset managers and insurance companies.

Q: What is the reason for such high demand for ABS?

Blomenkamp: The high demand is related firstly to the interesting characteristics of ABS. These include for example the rating stability compared to other credit products while spreads are at the same time attractive given the risk profile. Another characteristic is the possibility for diversification. Usually the asset pool of a single issue is already broadly diversified. At the same time it is possible to diversify within the different ABS segments like car loans, consumer loans or mortgages, and all this again in several countries. The diversification implies that the performance of ABS depends on long-term macroeconomic trends in the first place, like higher interest rates or unemployment.

Secondly, ABS are a new market segment, and this supports demand. As market participants become increasingly familiar with ABS, the effects of learning lead to a broader market with a growing number of market participants and specialists who analyse ABS. This increased familiarity with ABS is a necessary prerequisite for

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investors to invest. ABS are still an asset class that is very research-intensive. The more analysts look at the sector, the more demand can grow.

Q: What is PIMCO's approach to research of ABS transactions?

Blomenkamp: ABS research at PIMCO distinguishes itself because we analyse each transaction individually before investing. That requires a lot of analytical capacity, but PIMCO has the advantage of the necessary size and manpower. The expertise that PIMCO gained for decades in the U.S. and since the end of the 1990's in Europe also allows us to cover the ABS market very well. At PIMCO, we employ a global team of regional ABS specialists because we believe that local specialists are superior to global analysts.

Q: Have spreads narrowed for ABS like they did in other asset classes?

Blomenkamp: Yes. ABS spreads historically had a low correlation to other asset classes, but the direction of spreads is the same, as each investor is able to play the different asset classes and to benefit from relative value across sectors. When looking at spreads of ABS we also have to consider a complexity premium. This means investors also receive part of the premium for the fact that ABS are not a standard product and that each transaction requires a new analysis.

The question with respect to ABS is whether the narrowing of spreads is a technical aspect due to increased demand, or if the complexity premium dropped due to increased familiarity with ABS. Indeed I think both factors might have played a role.

Q: Are European ABS still attractive despite the narrower spreads?

Blomenkamp: Even though ABS spreads have converged in Europe, we still believe that ABS offer an attractive risk-return-profile. The AAA-rated category appears to offer a particularly attractive yield above Euribor in the floating rate segment, compared to other alternatives in the same rating spectrum.

In general we prefer high credit quality as well as transactions that have been in the market for two or three years and where we already know the performance a bit better. The spread differences across the various pool qualities and asset classes in a country are slim. PIMCO, therefore, places a lot of emphasis on in-depth analysis and we are very selective about which transactions we take into our portfolios.

Q: Are there specific asset classes or regions that PIMCO prefers?

Blomenkamp: CMBS are an interesting segment at the moment. We have seen a row of new issues in the CMBS segment this year. Due to the size of commercial real estate and hence the relatively low number of property loans in an asset pool, diversification is lower. Our analysis is therefore even more thorough by looking at every single object. At the same time, yields of CMBS are attractive. CMBS offer welcome yield premiums over other asset classes to investors who make the effort to analyse the risks.

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As far as the regions are concerned, we are currently a bit more cautious with respect to Spain. Homeowners in Spain – like in the U.K. – hold mainly adjustable rate mortgages. Further rate hikes by the European Central Bank increase the mortgage payments of homeowners in Spain. This could potentially lead to problems in some pools and impact the performance of MBS. Spain is therefore a region that we underweight in the MBS segment and that we watch closely. Other than that we are still very optimistic for MBS.

Q: Thank you, Felix.

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