

Bond Basics

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Bond Basics: Evolution of Asset-Backed Securities in Europe

Asset-backed securities (ABS), which are bonds created from the cash flows on loans and other assets, have become one of the fastest growing fixed-income sectors in Europe over the last five years. The first European ABS actually took place in the late 1980s with growth in the market uneven until the early 2000s.

This article will examine the unique history of ABS in Europe and why the securities have become so popular in recent years.

Obstacles to ABS and Innovation

When the first asset-backed security was issued in the U.S. in 1985, the new financing technique filled a need, particularly from troubled banks and savings and loans institutions. The U.S. ABS market grew quickly in the late 1980s and early 1990s as a result.

The market in Europe, however, took root more slowly for several reasons. First, Europe's main lenders—banks—were in general well funded when asset-backed securities were developed. Even when banks needed to raise money, the larger banks could issue covered bonds, which are somewhat similar to mortgage-backed securities but more established in Europe. Most small banks in need of funds could not justify the cost of securitisation. Second, a different debt culture also played a part in Europe's slower growth: consumer lending was and remains modest in Europe compared with the U.S.; in addition, selling loans is sometimes considered to be a breach of the banking relationship, and lenders were required to notify borrowers of the sale in some countries. Finally, and perhaps most important, Europe encompasses different legal, regulatory, tax and accounting systems, many of which were not conducive to securitisation.

In common law jurisdictions, such as the U.K., securitisation has evolved without a separate law and has grown relatively quickly as it did in the U.S. Civil law jurisdictions, however, including France, Spain, Italy and Portugal, had to create specific laws to allow for securitisation. Some countries, including Greece and Luxembourg, have only recently enacted securitisation laws while several others, notably in Central Europe, still lack them, according to the European Central Bank. In Germany, the legal and tax codes long prevented "true sale" transactions, although initiatives in the past few years have cleared many of those obstacles.

While these impediments to asset securitisation translated into slow growth in Europe's ABS market, they also led to innovation and helped shape Europe's unique ABS market. For example, although European banks as a whole were not eager to securitise their assets in the 1990s and early 2000s, European governments were; many have used the ABS market to help meet European Union (EU) budget requirements—both for joining the EU and for remaining in it. In 2005, Germany securitised almost €8 billion in pension payments due from former state enterprises Deutsche Post, Deutsche Postbank and Deutsche Telekom, which helped plug the

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government's deficit. Italy launched a securitisation program in the early 2000s backed by future sales of its real estate holdings.

In part because governments have been involved in the securitisation market and also because consumer assets, particularly credit card debt, were not as plentiful as in the U.S., the European ABS market has seen more unusual, less standardised assets, ranging from future lottery ticket revenues (Greece and Italy) to electricity receivables (Spain) and soccer club ticket sales (Germany). Sparked by the movement toward privatisation in the 1990s, the U.K. developed **whole business securitisation**, in which securities are backed by the entire range of operating revenues generated by a business. Madame Tussaud's museum, Formula 1, London City Airport and many English pubs have completed whole business securitisations.

The combination of such unusual assets and the significant legal obstacles to securitisation has resulted in many unique, one-off transactions that required great time and effort to structure. For example, France's bankruptcy law tends to favour troubled companies rather than their creditors. So to protect bondholders in a €396 million securitisation of champagne receivables in 2000, France's Marne & Champagne used a law from 1804 governing the use of goods as security for a lender to transfer control over its champagne to a third party. Bondholders were thus legally protected if the company went bankrupt or other problems arose with the transaction. The ABS took about a year to structure and complete.

The legal obstacles to securitisation gave rise to another significant development in Europe: the growth of **synthetic securitisation**. Instead of selling assets to an SPV, a synthetic securitisation involves using a credit default swap in which a counterparty agrees to cover the losses on a pool of assets. Synthetic securitisation thus transfers the risk associated with the assets but does not transfer the assets themselves. Although the assets remain on balance sheet and no funds for the originator bank are raised (because securities are not sold), they can reduce bank capital requirements without the expense and complexity of traditional securitisation. First developed in the U.S. in 1997, synthetic securitisation was adapted by European banks in part to sidestep the legal issues involved in traditional securitisation. Several large Continental banks, particularly in Germany, have used the structure since the early 2000s to transfer the risk in their corporate loan portfolios; others, including several banks in France, have used it to transfer the risk in residential mortgage holdings.

Growth in the European ABS Market

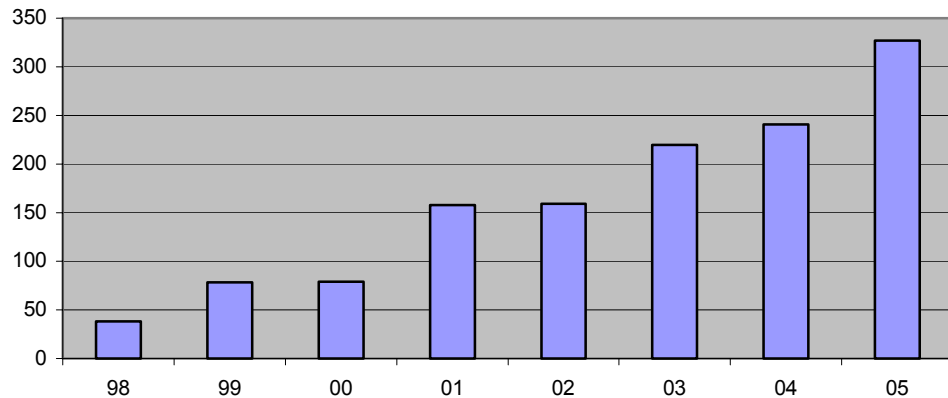
Growth in the European asset-backed securities market was uneven until the early 2000s, as the following chart shows. At that point, progress in removing the legal obstacles to securitisation, the low interest-rate environment, and investors' demand for yield helped boost volume continuously. Also, economic recovery in Europe translated into more lending and more potential assets for securitisation. In 2005, ABS issuance hit a record €319.6 billion, including residential and commercial mortgage-backed securities, up from a previous record in 2004 of €241 billion, according to the European

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Securitisation Forum. Based on volume in the first half of 2006, issuance was set to surpass €350 billion for the year.

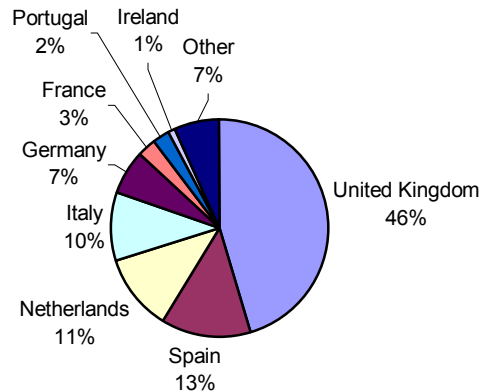
European Securitisation Annual Issuance 1998-2005



Source: European Securitisation Forum

The U.K., with its favourable legal environment, dynamic housing market and active credit card industry, remains the largest source of ABS, as shown in the chart below.

2005 European Securitisation Issuance By Country of Collateral



Source: European Securitisation Forum

Spain is one of the largest ABS contributors, driven in part by fast growth in the residential mortgage market. Spain has also created multi-seller securitisation vehicles

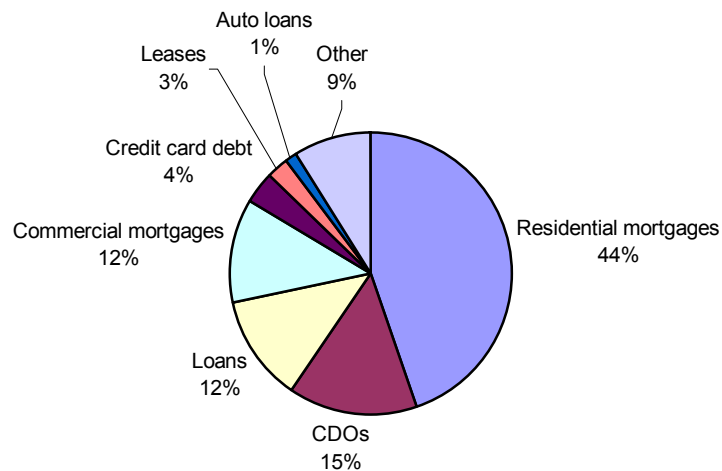
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so that smaller banks can afford to access the ABS market, an innovation that some other countries either have followed or are pursuing. Securitisation has grown quickly in the Netherlands and Germany over the past two years. Legal changes in 2004 in the Netherlands proved helpful to securitisation, and also that year, the first true sale transaction was completed in Germany. In general, as the government pulls back from supporting the banking sector, German banks will need more funding from the capital markets and ABS is likely to be a source. Italy has contributed significantly to ABS volume in recent years due to the government's real estate sales securitisation program. Italy also fostered securitisation as a way for banks to dispose of non-performing loans. Both programs appear to be winding down, however, and Italy's marketshare may decline in the near future.

In terms of asset types, residential mortgages form the largest segment of the European securitisation market, as the chart below illustrates. In recent years, the MBS sector has benefited from significant increases in mortgage lending. According to the European Central Bank, for the 12 months ending in April 2006, residential mortgage lending rose 19% in Europe, excluding Germany.

**2005 European Securitisation Issuance
By Asset Type**



Source: European Securitisation Forum

The fastest growing and now the second largest segment of the European ABS market is made up of **collateralised debt obligations** or CDOs, which grew 86% in 2005 from the previous year. CDOs are typically backed by corporate loans and/or existing bonds—in particular, emerging market and high yield bonds. CDOs created from loans are known as **collateralized loan obligations** (CLOs); those backed by bonds are

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called **collateralized bond obligations** (CBOs). Many CDOs today blend the two asset types.

Some banks create “balance sheet CLOs,” in which they securitise corporate loans to move them off balance sheet and thus lower their capital requirements. Others, including some of Europe’s largest international banks, issue “synthetic CLOs,” which are backed by credit default swaps on the pools of assets, instead of the actual cash flows from the assets, as noted earlier. Synthetic CLOs may give up some ground in the future to traditional securitisation now that true sale securitisation is possible in Germany.

The “arbitrage CDO” is also adding to ABS volume. Institutional investors, including insurance companies, investment banks and commercial banks, can create arbitrage CDOs by buying bonds and loans in the secondary market when they are undervalued and securitizing them; they aim to capture the difference in coupons between the highly rated ABS and the lower rated bonds and loans. These CDO originators—or “collateral managers” as they are known in the industry—can buy and sell the underlying securities to varying degrees, depending on the terms of the CDO. In the latest wrinkle, CDOs have been backed by asset-backed securities and even by CDOs themselves, creating very complex cashflows.

Commercial mortgage-backed securities, one of the top four sectors, are on the rise in Europe, reflecting the healthy state of the commercial real estate market. CMBS transactions are also more popular with investors due to an increase in pan-European transactions and greater transparency, including the development of a European CMBS index, according to the European Securitisation Forum.

Reflecting consumer lending patterns in Europe, the credit card and auto loan sectors are relatively small. However, securitisation of credit card receivables is active in the U.K., and volume may pick up as securitisation evolves in newer markets.

Future Growth in ABS

Europe’s asset-backed securities market should continue to grow as securitisation spreads throughout Europe. Germany represents significant potential as the barriers to true sale transactions fall and commercial real estate securitisation there grows. The markets in Central and Eastern Europe should open up as the countries in these regions adopt securitisation laws. Russia saw its first public mortgage-backed security in 2006, and ABS practitioners are optimistic on the prospects for Russia’s MBS market, particularly since President Putin set a goal for one-third of Russians to own their own homes by 2010. In general, consumer and mortgage lending is growing quickly throughout emerging Europe.

The ABS investor base, too, continues to broaden and now includes hedge funds and CDO collateral managers, in addition to banks, insurance companies, and pension funds. Lower capital requirements for banks in the EU holding the highest quality

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residential MBS are slated to take effect in 2007, which may help boost demand and in turn, issuance.

Conclusion

Europe's ABS market is unique, shaped by the active participation of European governments, a wide range of assets, and the different legal, tax and regulatory environments in each country. The low interest-rate environment in recent years has drawn more issuers and investors to the ABS market, and as the financing technique spreads to new countries, growth in annual volume should continue.

London

PIMCO Europe Ltd
Nations House
103 Wigmore Street
London W1U 1QS
England
44-20-78721300

Munich

PIMCO Europe Ltd Munich Branch
Nymphenburger Straße 112-116
80636 Munich
Germany
49-89-1221-90

Rotterdam

PIMCO Europe Ltd2
Regus Brainpark II
Lichtenauerlaan 102-120
3062 ME Rotterdam
The Netherlands
TEL 31-10-204-5722

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