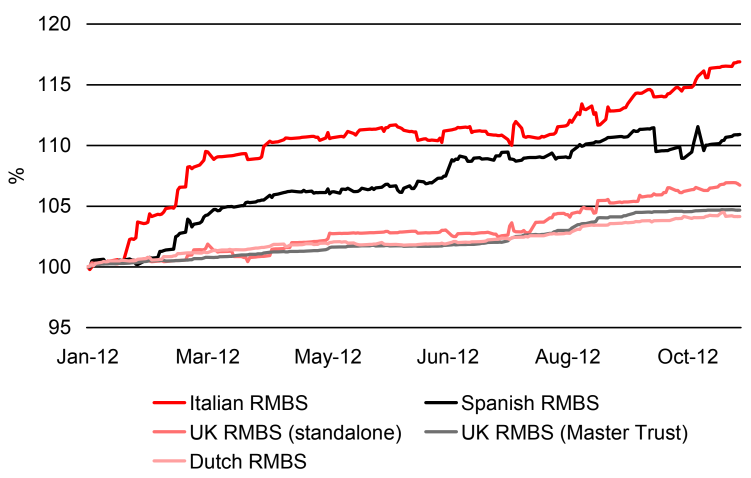
The 2013 guide to European Asset-Backed Securities: Carry on!

Securitized assets had a fantastic start to 2013 but it remains to be seen what the new year will bring. 2012 was definitely exciting in many ways: there was a new issuance-frenzy in Auto ABS, an unprecedented secondary market rally, and enormous bid and tender activity accompanied by robust fundamental asset performance... all this happened in spite of significant country risk-related downgrades – to name but a few key events. For 2013, we remain constructive on asset-backed securities. Despite imminent problems, e.g. restraints threatening from the regulatory side, credit risk factors are manageable, while primary and secondary market conditions remain vibrant. The normalization process in credit markets will proceed with respect to spreads, as will the recognition of asset-backed securities as useful and trustworthy investments.

The European securitization environment has hardly been more constructive since its 2007 meltdown: bids are back, spreads have rallied, transparency has further improved, and most European structures show rather robust performance while the stress factors stemming from the financial crisis are hardly having an impact. Returns have become largely positive in 2012 and abundant for most quality benchmark sectors. In the periphery, total returns for Spanish and Italian senior RMBS have risen to levels above 10% on average, and for UK and Dutch RMBS, total return performance YTD is still at around 5%. More risky sectors such as UK non-conforming RMBS clearly outperformed last year with returns above 30%. In Auto ABS and UK credit cards, returns are positive (3-5% in 2012) even though the earlier rally ran out of steam recently. From investors' side, the search for yield continues. Against the low-yielding environment, the trend for this year is comparable to the hype seen in other asset classes such as the high yield sector: Risk on! We would expect rising demand for transactions implying higher credit risk, i.e. down the capital structure as well as investments in the periphery or in longer maturities.

EUROPEAN SENIOR RMBS, TOTAL RETURN 2012



Source: UniCredit Research

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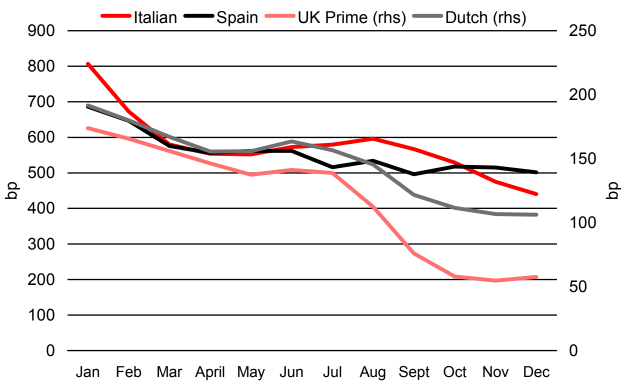
Secondary spread tightening bias remains intact

The technical correction is not yet over

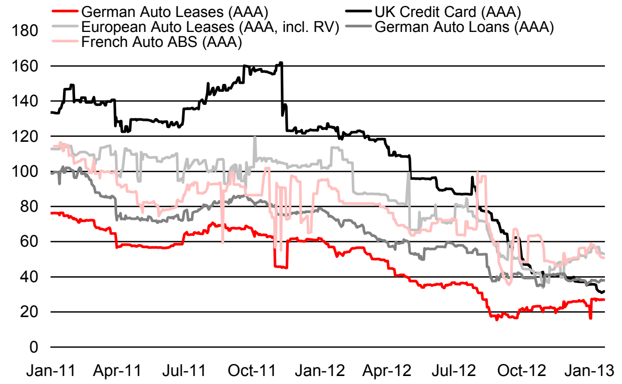
Last year securitization spread levels tightened by around 100bp in core senior notes and by more than 275bp in the periphery, which underlines the positive returns mentioned above. RMBS spreads in both core (UK and Dutch) and periphery tightened throughout the year. Auto ABS became so tight in the summer (German seniors dropped below 20bp) that investors started to shift exposure into higher-yielding alternatives. Also, spread levels in other asset classes followed the overall tightening trend, e.g. in UK non-conforming RMBS, the LevLoan CLO universe or within CMBS. There spread tightening was largely based on technical factors, e.g. the liquidity situation after the LTROs and/or central bank support as well as individual originator-based support. One good example of the spread tightening bias are Granite (ex Northern Rock originated) mortgage backed benchmark bonds, which benefitted mainly from the run on non-euro-denominated prime mortgage-backed debt but also from the fact that Granite's performance figures and fundamentals are intact. One good example for originator support are the German CMBS notes related to Grand, which are "on fire" and rallied massively after the announcement and successful completion of a restructuring deal by Deutsche Annington that directly addressed the refinancing issue in the underlying commercial real estate loan pool.

EUROPEAN SECURITIZATION SPREADS

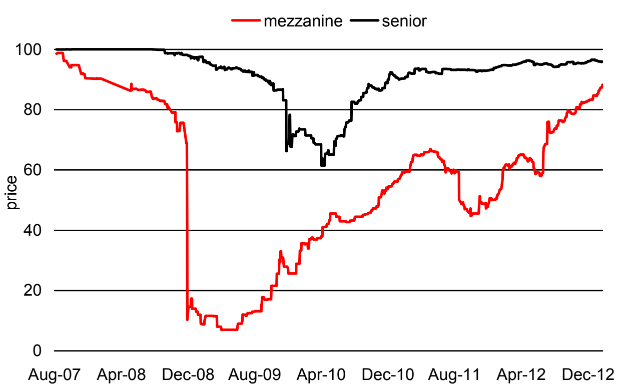
Prime senior RMBS, average spread per month 2012



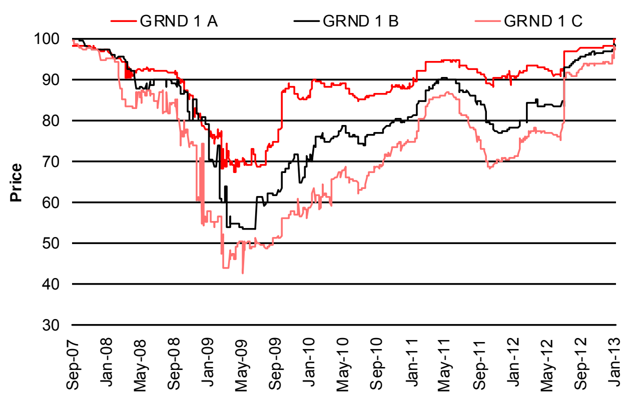
Back to "normal", Auto ABS and credit card spreads in bp



Granite price chart, UK prime RMBS rally



Grand price chart, German CMBS, rally after restructuring



Source: Markit, UniCredit Research

With the ongoing rehabilitation of securitized assets after the subprime meltdown, the secondary environment has switched from a prevailing sellers market into bid-only mode. The technical correction in relation to actual credit risk factors will likely continue this year, given continuous bids but limited offers. The broader search for yield in credit exposure is translating into rising demand for securitized debt (also down the capital structure) and rising maturities (WAL), a trend that is comparable to the risk appetite experienced in other asset classes such as high-yield or subordinated financial debt. One can expect further risk-premium adjustment, not only in secondary securitization levels in still relatively wider senior notes (e.g. in Dutch prime, high-quality Italian/ Spanish paper), but also in subordinated parts of the capital structure.

Spread compression to continue

This year, securitization spreads are likely to again tighten further and remain at least stable in those sectors that have already experienced significant price recovery (e.g. within German Auto ABS). There is no doubt that there is still potential for secondary spread volatility, either due to the sovereign-debt issue (election time in Italy, Spain) or a weaker-than-expected macroeconomic normalization process, but any spread impact from macro-economic or sovereign-debt-related setbacks are likely to be mitigated by sufficiently sized credit-enhancement levels as well as the dominant bid-only environment in securitization. the later is likely to prevail in 2013 as investors are unwilling to sell in an ongoing recovery environment that remains intact for asset-backed securities.

Macro situation challenging but supportive

The macro situation is not good...

Our economists' base-case scenario goes hand-in-hand with continuing normalization from a macroeconomic and sovereign-debt-crisis perspective, despite all ongoing challenges. Our 2013 projection for eurozone GDP growth is now 0.1%, and we continue to see stabilization in activity at the beginning of the year and a gradual recovery thereafter. 2013 should still see a significant, although slowly decreasing divergence in growth performance between the core and the periphery, and thus the spread differences between the core and the periphery securitization sectors are unlikely to adjust significantly. The transmission mechanism of monetary policy is likely to become progressively less persistent over the course of 2013. Underlying this view is the assumption that the ECB's LTRO and OMT actions led to a structural repricing of convertibility risk, with lasting positive effects both in terms of the level and expected volatility of sovereign yields in Italy and Spain, which is supportive of all kinds of bank-originated asset-backed loan pools. In turn, normalization in the sovereign universe is expected to lead to a gradual improvement in funding conditions for banks – a process that has already started for the big names but will probably be very slow to start for small and medium-sized banks. Still, as banks need to reorganize and support their capital ratios, the numerous securitization tender events of 2012 are likely to resume, but such auctions will go down in number as a price recovery will slow down the benefits of tendering. Bank lending rates for households and corporates in the periphery are set to enter a slowly declining trend in 2013, easing financing conditions for the non-financial private sector. In a context of weak economic activity and rising unemployment, the inflation risk over a 1Y forecast horizon is virtually non-existent in the euro area. Thus no major threats are expected from rate revisions with an adverse effect. This is particularly supportive of floating-rate (mortgage) pools securitized mainly in the periphery (no risk of payment shocks and declining borrower affordability).

...but good enough for asset backed exposure!

In terms of single countries, our economists forecast UK GDP in 2013 at 0.9%, which comes mainly on the back of higher-than-expected inflation slowing the pace of improvement of household real disposable income. In the UK, the recovery path remains challenging and housing markets are likely to move sideways. Unlike in France and Germany, growth developments are set to be weaker in Italy, which is expected to exit the recession in spring, according to our economists. In yearly average terms, Italian GDP in 2013 is likely to weaken by -0.7%, while the contraction is set to clearly ease compared to Spain. Spain will probably have to wait until 3Q13 to see the first positive qoq GDP number. In yearly average terms, the contraction is likely to remain great in Spain (GDP forecast of -1.4%). Housing market conditions in Italy and Spain remain challenging, with the downside potential in Spanish mortgages significantly more pronounced than in Italy (e.g. in terms of foreclosures, mortgage affordability, etc.). In the Netherlands, it remains to be seen whether the recent political reforms (resulting in lower mortgage-tax deductibility, among other things) have removed some economic and housing market weakness, e.g. will first-time home buyer reluctance end anytime soon? Overall, we expect a fundamental stabilization phase based on the macroeconomic normalization process described above while the interest-rate environment remains stable.

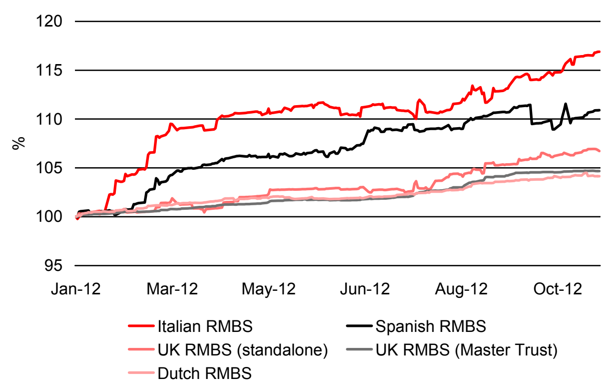
Robust fundamentals despite ongoing challenges

Fundamentals hold up rather well across most asset classes, thanks to central banks

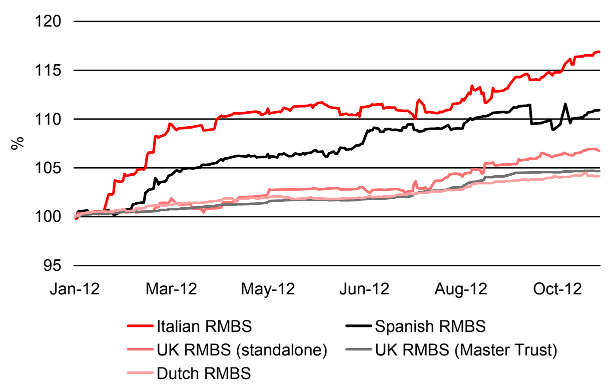
Fundamentals in the European securitization universe are not developing uniformly, i.e. asset classes implying higher credit risk are not automatically showing significantly weak performance. For example, in the RMBS universe, there is an increasing number of delinquencies in Spanish RMBS (60+day delinquencies are 3% of the outstanding pool balance) and slightly increased delinquencies from low levels in Dutch RMBS (the economic situation and housing markets are weakening, 60+day delinquencies account for 0.7% of the outstanding balance), while we see a relatively stable development of delinquencies in UK RMBS, whether prime or UK non-conforming (thanks to the low BoE rate). Default levels in RMBS are developing overall in line with expectations. They are on the rise in the periphery in Spain and Italy but overall quite bearable given available credit-enhancement levels, down to mezzanine. We expect diverging performance trends as seen in RMBS to continue across jurisdictions, but we see no risk of a drastic deterioration in fundamental performance data across all major sectors (RMBS, ABS, CLO, CMBS) in 2013 as was the case in 2007-2009. Fundamental performance to date is far better than during the immediate crisis (2008/2009) and the situation is unlikely to deteriorate markedly this year. Overall, European securitization currently offers well-sized credit-enhancement levels to offset more systemic credit weakness, e.g. in the periphery, even though on a transactional basis there are larger differences in terms of support mechanisms (e.g. for Spanish RMBS or with respect to reserve drawings). One reason why fundamentals are not weakening more drastically despite the ongoing challenges in the periphery and the banking system is related to central bank policy. Stable fundamentals, for example in Spanish RMBS and UK non-conforming RMBS, are to a large extent based on the prevailing low-interest-rate environment. This needs to be considered from a credit-risk perspective in the longer run beyond 2013. In Italian RMBS, performance may weaken in the nearer term but still remains within expectations. Defaults in Italian RMBS are likely to remain broadly in line with levels observed in earlier quarters.

EUROPEAN SECURITIZATION, DEFAULT AND DELINQUENCY TRENDS, E.G. RMBS

European RMBS, delinquency trends



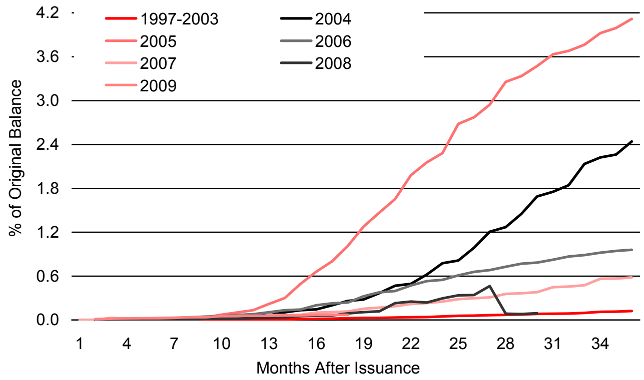
European RMBS defaults trend overall



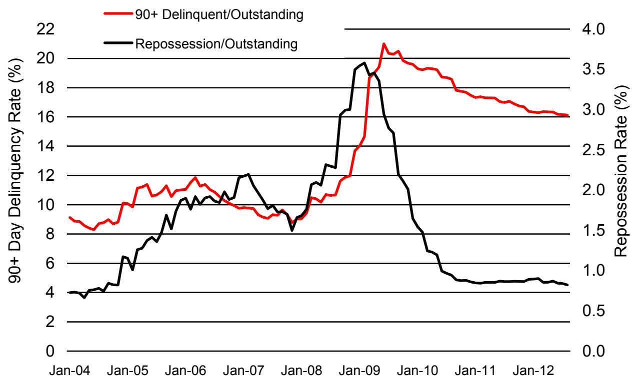
Source: Moody's, UniCredit Research

European Securitization, default and delinquency trends, e.g. RMBS

Spanish RMBS cumulative defaults, younger vintages are worst off



UK non-conforming



Source: Moody's, UniCredit Research

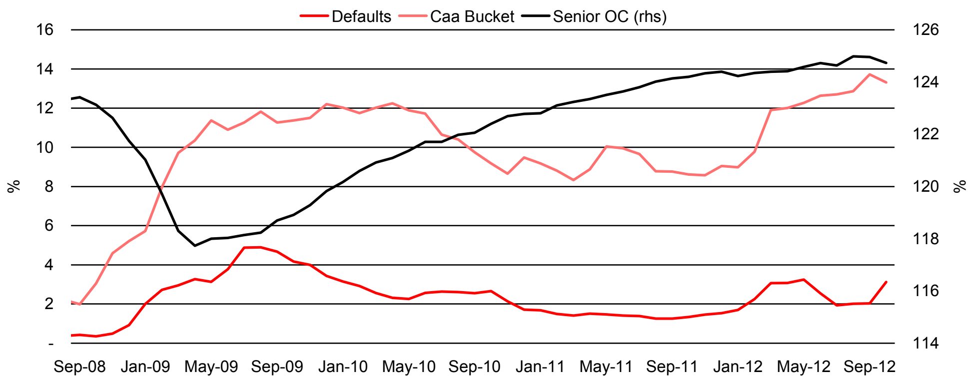
Defaults: it could have been worse, e.g. Greek RMBS or CLOs

Interestingly, the pace of defaults in securitized pools is not directly correlated to prevailing recession scenarios and weakening loan pool fundamentals. For example, in Dutch RMBS, weaker housing markets have resulted in average LTFVs of more than 100% in a number of Dutch RMBS pools. However, despite a rise in delinquencies, the number of defaults remains well in line with expectations and structures are holding up solidly, far defying weakening economic conditions. On the Dutch housing market, regulatory uncertainty with respect to tax deductibility is out of the way from the political side and, with a continuing lack of housing supply, the Dutch housing market could regain at least some traction this year. Even more drastically in this respect is the contradiction between performance variables and fundamentals in Greek RMBS. Greek transactions could easily become distressed from a systemic/counterparty perspective, but the fundamental performance is doing better than one would have expected, despite the country's economic downturn. According to Moody's performance data, Greek RMBS features elevated delinquencies, but the mortgage backed pools are not experiencing severe defaults. While on an upward trend, the index of cumulative defaults has not exceeded 1.50% of the transactions' original balance, with cumulative defaults for the worst-performing Greek RMBS remaining below 4.50% in 2012.

Similarly, the trend in 60+ day delinquencies (the most forward-looking performance indicator) remained below 5% in 2012. Even in asset classes that broadly traded at distressed levels in the securitization meltdown it could have come worse: For example, performance-wise, LevLoan CLOs turned out to be rather robust. According to Moody's data, European CLOs feature improving cash levels at 5.8%, a weighted average life of slightly above 4 years. Collateral defaults are at 3% and generally below US levels. In Europe, the leveraged loan universe is much smaller (less companies) than in the US, thus single-name defaults have a higher impact on the developments of 12m rolling default rates. S&P data show that defaults accumulated the most in more seasoned vintages, i.e. the percentage of defaulted assets in underlying collateral portfolios was ranging from 3.32% for the 2004 vintage to 1.71% for the 2008 vintage by last year. Senior Overcollateralization levels are at 124% (moving gradually higher since the 09 valuation bottom) and the lower rated Caa bucket in European CLO pools accounts for slightly more than 13% (elevated due limited new collateral). In the CLO sector, refinancing remains problematic: By the end of 2013, some 80% of all European CLOs are estimated to have entered into an amortization mode, as reinvestment periods are ending or performance triggers may be hit. However, this must not automatically lead to elevated defaults, in particularly if the high yield frenzy continues (on the loan and bond side financing conditions have improved significantly). A new LevLoan CLO announced at the beginning of

2013 is giving additional hope regarding the refi-threat. Comparably, even in German mezzanine CLOs, the refinancing problematic of subordinated SME loans has not led to a largely elevated number of backloaded defaults yet, as the liquidity situation for banks eased and the economy developed solidly.

EUROPEAN CLO PERFORMANCE DATA



Source: Moody's, UniCredit Research

Counterparty concerns slowly abate, credit enhancement levels have risen

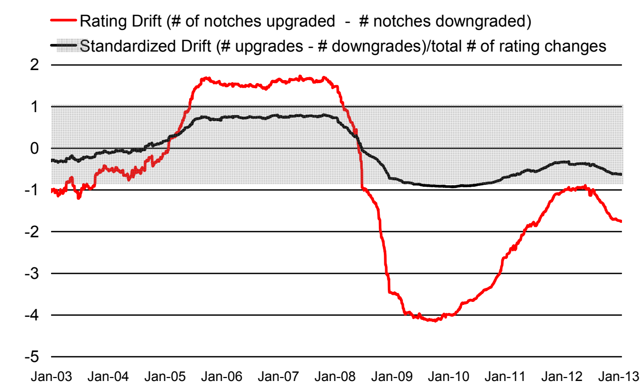
In CMBS, one of the major hurdles is refinancing of existing commercial mortgages. But even if refinancing situation is overall rather bleak, benchmark transactions such as GRAND cracked it last year (see above) with a direct restructuring approach by the originator! In Auto ABS, credit risks remain well manageable. There is no major downside in terms of Auto ABS robustness, but collateral related risk factors could rise due to weakening auto sectors, e.g. in France and Italy, while residual value components in a number of deals pose a risk factor against weakening automobile markets. Also, negative micro-newsflow related to counterparties and originating institutions is having an impact on pricing, rating triggers or issuance activity for single transactions (e.g. Spanish banks). Overall one would expect originator related risk factors to become less dominant this year than it was the case throughout the sovereign debt crisis earlier as the situation in the financial industry is slowly but steadily normalizing.No significant losses are expected to materialize in the largest European RMBS sectors, i.e. UK prime and Dutch prime RMBS going forward. Also for granular ABS, total losses should not exceed 0.2%. With higher credit enhancement levels than before the crisis, new transactions benefit from increased credit protection and can absorb defaults in the underlying portfolio to a larger extent. Today, old, pre-2008 deals account for more than 99% of the total losses projected by the rating agency's like Fitch.

Negative rating migration continues but pace of downgrades will slow down

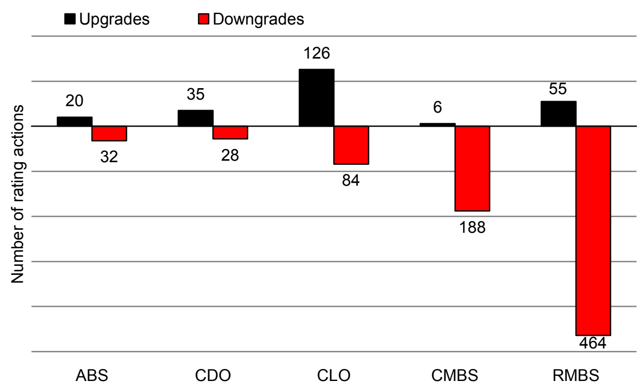
Rating statistics remain negative – mainly due to criteria changes — but the pace of negative rating actions is slowing, as depicted in our rating drift charts below. From a country ceiling perspective, 2013 downgrade activity should slow down in comparison to 2012 while the rating pressure related to new rating methodology adoptions is continuing in the short term. For example, the negative spiral of rating agency criteria adjustments is already taking its toll in the new year, as S&P has placed (or kept) the ratings on 100 tranches in 33 European SME CLOs on CreditWatch negative, following its criteria update related to CLOs backed by granular and well-diversified European SME loan pools. S&P's criteria update, which is now being implemented, factors a "b+" rated benchmark SME loan pool into the agency's rating process. The criteria update was initiated at the beginning of 2012, hence did not come unexpectedly. The list of affected tranches can be found in our rating section below.

RATING MIGRATION

Structured Finance rating drift remains negative



Rating actions per sector, last 90 days



Source: Moody's, Fitch, S&P, Bloomberg, UniCredit Research

Regulation vs. overregulation

The ongoing problem of overregulation

The regulatory environment for securitization remains unfavorable and brings along still many uncertainties. Investors as well as originators are worried with respect to new European regulations and rising capital costs for. Basel III/ CRD-II/III/IV and Solvency rules entail new regulations, some of them turned out better than expected already this year (LCR recognition), most are rather punishing (e.g. new Basel III securitization framework proposal from end 2012). The majority of new regulations are not in balance with actual credit risks posed by structured finance, in particularly when compared to other credit instruments (e.g. senior notes vs. covered bonds). From an investors point of view, regulators give rise to substantial controversy in terms of the regulatory treatment of securitization and very often the asset class is subject to overregulation from various official bodies and simply penalized for the subprime-failure. This does not prevent regulatory complex structures driven by regulatory motivations, e.g. Deutsche Bank has sold a new synthetic European CDO of ABS to specialized funds in 2013 in order to save regulatory capital.

Final words not yet spoken

Many new rules or their national implementation are still cooking in the kitchen and will likely have a severe impact on capital requirements/costs for securitization exposures going forward. However, we are cautiously optimistic regarding a change for the better, as the review and adjustment process is not over yet and the final word has not yet been spoken. Delays on Basel accord and Solvency side might bring further reasonable adjustments before the regulation process is finalized. For example in CRD IV, the Liquidity Coverage Ratio discussion finally ended in a recognition of ABS as a "liquid asset class" while there could be a recalibration in capital costs related to securitization under Solvency II, as well. Overall, we see the status quo of regulations as one of the major prohibitive factors with respect to the rehabilitation of asset-backed securities as a broader financing tool, as it prevents issuance activity and investor demand. For example, the CRD2 "skin in the game" 5% risk retention rule for securitized exposures poses an operational drawback for new CLO issuance, for which a workaround (e.g. via retention by a CLO manager's parent company) must be found, while refinancing is posing problems to the banking sector

A new Basel framework for securitization....

After a number of changes to the regulatory treatment of securitized exposure, e.g. under Basel 2.5 and with respect to trading book exposure or risk retention, a more fundamental review of the securitization framework had been under way. This review resulted in a consultative revisionary framework published by BIS on 18 December 2012. With the newly proposed framework, the Basel Committee aims to make capital requirements more prudent and risk sensitive, and to mitigate the mechanistic reliance on external credit ratings and corresponding "cliff" effects resulting from rating based risk weight allocation while reducing regulatory arbitrage. The new calculation methods are much more differentiated than before, and differentiation in terms of actual credit risk inherent in securitization transactions is generally welcome.

...will lead to increased risk weights for publicly-placed senior tranches

Nevertheless, clearly negative and a wrong signal, in our view, is the fact that minimum risk weights applicable are now significantly higher for senior positions (+13pp) for IRB banks. Risk weights are increasing by many multiples particularly in the senior parts of the capital structure, especially for high-quality exposure in STA-approach and IRB-approach. It is hardly comprehensible, why risk weights increase disproportionately to actual credit risks, e.g. the risk weighting for a AAA rated senior tranche with a 5Y maturity rises to 58% according to Fitch calculations under both proposed new hierarchies from currently 7% under the RBA. For a AA+ rated 5Y senior tranche, the risk weights jump to 75% from 8%! In contrast to these hikes, actual losses on EMEA securitization transactions remain significantly low (e.g. at 0.2%) and are unlikely to increase (see performance section above). From this perspective, newly proposed risk weight calculations seem to be disproportionate, particularly when compared to alternative asset classes, e.g. covered bonds where risk weights are 10% (STA) and lower (IRB)! If the proposed methods were to be implemented, one can expect the consequent rise in capital costs related to securitization to have a lasting negative effect on risk appetite for European structured finance. Investment returns may decline significantly if capital costs more than triple! A shift from structured finance exposures off bank balance sheets to unregulated specialized funds may be spurred. This could translate into declining primary activity and overall muted funding/credit origination from the banks side, and limited liquidity and financing sources from a systemic point of view. On the other hand, alternative funding instruments may increasingly hit the screens, such as "structured covered bonds" for which risk weights would be 20% when compared to senior bank debt in the STA. On a more positive note, the previously unavoidable capital deduction for subordinated securitization tranches down to CCC- has been addressed in the newly proposed framework, with capital deduction being less likely and risk weights up to 153% being possible for non-investment grade securitization which was not the case before. Going forward, the calculation of capital requirements for securitization issues will become even more complex. In the new framework, supervisors can restrict the use of the supervisory formula approaches (i.e. the MSFA and the SSFA) for certain exposures given that credit enhancement could be eroded for reasons other than portfolio losses, correlation or high concentrations. The Basel Committee is asking for industry feedback until 15 March 2013, while conducting a quantitative impact study this year.

RMBS recognized as high liquid assets for LCR

More favorable for securitization than the newly proposed Basel "securitization framework" are the new LCR rules that were introduced by the BIS at the beginning of the year. Basically, the LCR framework aims to ensure that a bank has an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash at little or no loss of value in order to meet a bank's liquidity needs for a 30-day liquidity stress scenario. New LCR rules foresee that, certain non retained (or repackaged), liquid, low LTV-RMBS that are rated AA or better can be included in the stock of HQLAs. The new rules are setting a positive impulse on future demand and do take away some selling pressure on eligible RMBS. However, we would consider a real, measurable spread effect to be limited, i.e. limits are set in terms of eligible volumes and HQLA RMBS-related criteria does exclude the majority of existing periphery RMBS (besides some senior Italian notes) due to rating inadequacy and all quite liquid high quality assets, such as short-running Auto ABS or credit card deals. While the majority of assets qualifying for Level 2B/HQLA are to be found in UK prime (and even UK non-conforming), it is hardly comprehensible that a huge portion of outstanding highly-rated Dutch RMBS transactions (the second largest public RMBS market) should be excluded. RMBS are an important source of funding for Dutch banks and the mortgage market in the Netherlands, and the Dutch RMBS market is well functioning.

New issuance outlook: stable origination activity

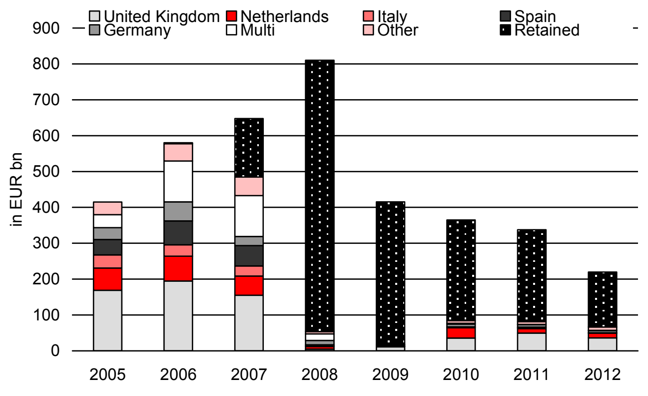
Cheap central bank funding and liquidity operations, i.e. the BoE's "Funding for Lending" scheme (FLS) and the ECB's LTRO, as well as a lackluster mortgage environment in the two largest public markets (UK RMBS, Dutch RMBS), weighed on new European securitization volumes in 2012. New issuance volumes remained low last year. Transactions that were not placed with investors accounted for 70% of total issuance volume, still indicating the importance of ABS collateral in central bank funding, particularly in Spain and Italy. This year, we expect issuance volumes to stagnate, despite the fact that significantly tighter spread levels also support issuance down the capital structure. Primary issuance premia is likely to tighten further and a restart of Leveraged Loan CLO issuance might be around the corner.

Steady new issuance activity, but overall volume low

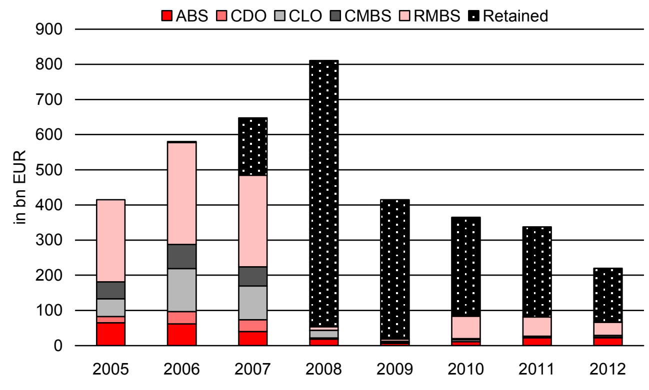
In 2012, total publicly-placed securitization issuance volumes accounted for slightly more than EUR 66bn, which is EUR 10mn lower than last year. In terms of publicly-placed asset classes, the majority of transactions involved RMBS (59%), while granular consumer ABS (i.e. Auto ABS and Credit Card ABS) accounted for 32% of all publicly-placed transactions. The majority of bonds that were placed with investors in 2012 again involved senior, EUR-denominated and short-to-medium term WALs in prime core RMBS and Auto ABS. In terms of currency, we would expect EUR and GBP issuance to dominate, although we see a trend towards increasing USD denomination. A number of non-retained less off-the-shelf issues came to the market in 2012, albeit with limited volumes. Overall, issuance activity is likely to stagnate in 2013 and to decline in the core benchmark deals for the reasons outlined below. Primary issuance premia is declining rapidly in benchmark transactions and will continue to do so in 2013. For example, the first pricing of a German Auto ABS in 2013, i.e. of the Driver 10 transaction, hit three post-crisis records: The deal provided the lowest AAA print, the lowest A+ print and the flattest curve between the two tranches (at 52bp vs. VCL-16's 63bp). For details please refer to the primary market monitor on page 11.

PRIMARY MARKET SNAPSHOT

Primary market activity by jurisdiction



...and by asset class



Source: UniCredit Research

UK RMBS, no uptick in new issuance

Placed UK RMBS deals amounted to about EUR 37bn in 2012 compared to EUR 54.7bn in 2011. With respect to the number of transactions, some 20 deals were placed with investors in 2012 (vs. 19 deals in 2011). What is worth highlighting is that we saw a number of UK non-conforming and buy-to-let (BTL) tranches (RMS 26, GMG 2012-1, ALBA 2012-1, PARGN 17). One would expect 2013 issuance volumes to be subdued, at around the same level as in 2012. While UK mortgage lending has remained relatively stable, the FLS has so far failed to significantly boost the housing market, with property prices dropping in the past ten months after the expiration of the tax break for first-time buyers in March 2012 (the "NewBuy" scheme). The UK's FLS scheme will likely boil down to lower UK RMBS issuance. Higher participation in the scheme will translate into a further reduction of new issuance from traditional UK RMBS issuers, as the FLS constitutes a much cheaper source of funding, even though the secondary market rally in UK RMBS has resulted in substantial spread compression and therefore lower financing costs for issuers. However, the scheme might have second-round knock-on effects and lead to rising mortgage lending activity and a further reduction in origination cost/mortgage rates. Hence, the FLS could trigger further issuance outside prime RMBS, e.g. in UK non-conforming and BTL. The latter could emerge as a silver lining in the relatively lackluster mortgage market, which is a modest positive for issuance growth. Landlords purchasing property in 3Q12 increased their portfolios by 1.8 properties on average, according to Paragon data.

Dutch RMBS

Non-retained issuance volumes of Dutch RMBS totaled EUR 11.9bn in 2012, roughly the same level as in 2011, which saw EUR 11.8bn in placed transactions. 13 new transactions were placed with investors in 2012 compared to 14 in 2013. Issuance volumes might have been negatively affected by some Dutch lenders, such as SNS tapping the ECB's LTRO and having problems with its real estate portfolio overall. Going forward, securitization issuance will remain a key funding source for well-established Dutch originators. Funding costs of senior unsecured bank issuance when compared to RMBS issuance levels suggest ongoing origination activity. In addition, growth in mortgage lending continues to be positive (at around 1.5% yoy), albeit at the lowest rate since 2003. Both the reduced demand for mortgages and the tightened lending standards are the result of the weak economic development and the situation in the country's housing market. As most of the regulatory uncertainty surrounding the property market was removed by the Dutch government, a normalization in mortgage lending could come about should the reluctance of first-time buyers be overcome. Hence, we expect issuance activity to be slightly higher in 2013 at around EUR 13bn.

European Auto ABS

In 2012, public issuance of Auto ABS increased for the third consecutive year to an all-time high in excess of EUR 13.5bn. We expect Auto ABS issuance to remain resilient in 2013 with EUR 13bn in new issuance, despite sluggish growth in car sales throughout Europe. The combined sector thus constitutes Europe's second-largest asset class in 2012, surpassing Dutch RMBS issuance for a second year. The growth is based on three main factors. First, issuers expanded their securitization activities into new jurisdictions (e.g. Scandinavia, Switzerland). Second, as investors' demand for yield increased, the market has seen a growing number of riskier assets such as the securitization of residual value components throughout Europe. Finally, French automakers (four captive deals YTD) can fund cheaper via ABS than via unsecured debt, while non-captive issuers (BNP, SocGen and Socram Banque) are increasingly tapping the ABS market. Conversely, funding costs for German automakers (six captive deals in 2012) are cheap, thus sharply competing with new Auto ABS issuance, which caused German issuance of placed deals to decline by about 40%. Declining car sales could feed through to ABS issuance volumes in that fewer loans are granted to customers, which would be refinanced through securitization. For example, vehicle sales for Renault in Europe fell 18% in 2012, and the company forecasts a 3% decline in the European market this year, which could come along with reduced refinancing activity by RCI Banque.

Outside core sectors, new issuance activity remains thin

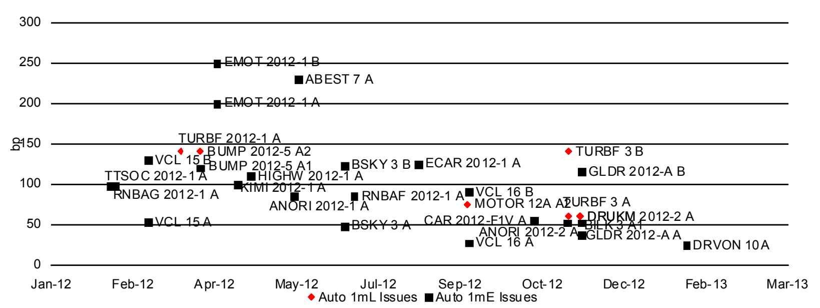
Outside the core sectors, new issuance will remain scarce. In 2012, several CMBS tranches were placed with investors (FLORE, ISOBF, VEST, DECO 2012) but issuance is unlikely to take off this year given the various obstacles related to the securitization of commercial mortgage debt. Issuance stood at EUR 4.3bn in 2012 vs. only EUR 0.8bn in 2011. While Italian RMBS issuance was non-existent in 2012, the country's RMBS sector might stage a comeback in 2013 on the back of increasing secondary market demand. In Spain, new issuance activity remains limited to retained transactions. While the local banking sector is still ailing and subject to restructuring (bad bank), we would expect to at best see occasional new issuance/private placements, as has been the case in the past. With respect to primary issuance, there is a fairly high likelihood of the Prime Collateralised Securities (PCS) initiative becoming one of the major driving factors of securitization this year. We hope to see more transactions being issued under PCS and other prime quality standards. The more quality-approved volume we see on the market, the higher the chances that PCS/DSA or TSI issuance will set new standards that could also be acknowledged by the regulatory side, leading to lower regulatory restrictions and regulatory-related expenditures. Still, to date, overregulation in the context of actual default risk in European securitization remains a Damocles sword for sustained financing/investment activity in the securitization sector.

CLOs, is a kickstart around the corner?

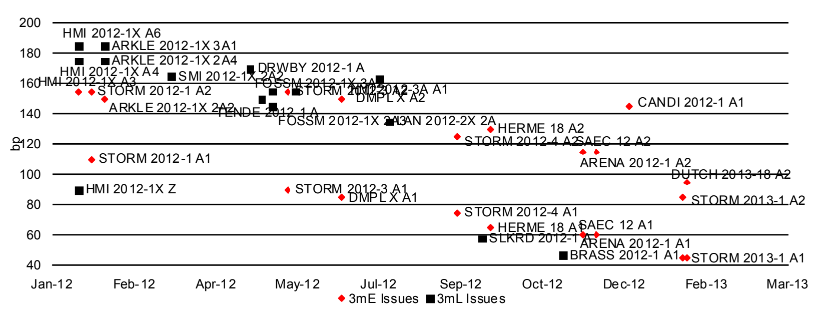
Finally, a new leveraged loan CLO transaction, Cairn CLO III (EUR 300.5mn), featuring a senior tranche of EUR 181.5mn, is being marketed in 2013. The reinvestment period of the new transaction will be three years, the non-call period will likely be two years. Cairn's CLO III pool will feature a minimum 90% of senior secured collateral. While the US market already experienced a renaissance of Leveraged Loans last year, there was no broader issuance of LevLoan CLOs in Europe post crisis so far. Nevertheless, despite a number of operational hurdles (e.g. related to the "skin in the game" risk retention rule), there was broader speculation that there might be a restart of CLO activity in Europe soon (for details please refer to our CLO market update published 29 October 2012). In particular the pricing of this new CLO transaction (its issuance premium) will provide interesting new guidance on the asset class overall given the ongoing hype on the high yield market and the price recovery on the loan side. As most CLO transactions are facing the end of their reinvestment period this year, a successful placement of new CLOs would also benefit leveraged loans from a refinancing perspective.

PRIMARY MARKET COMPARISON

Auto ABS, New Issuance Comparison



European RMBS, New Issuance Comparison



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