"Back To The Future": Highlights From S&P Global Ratings' 2019 European Structured Finance Conference

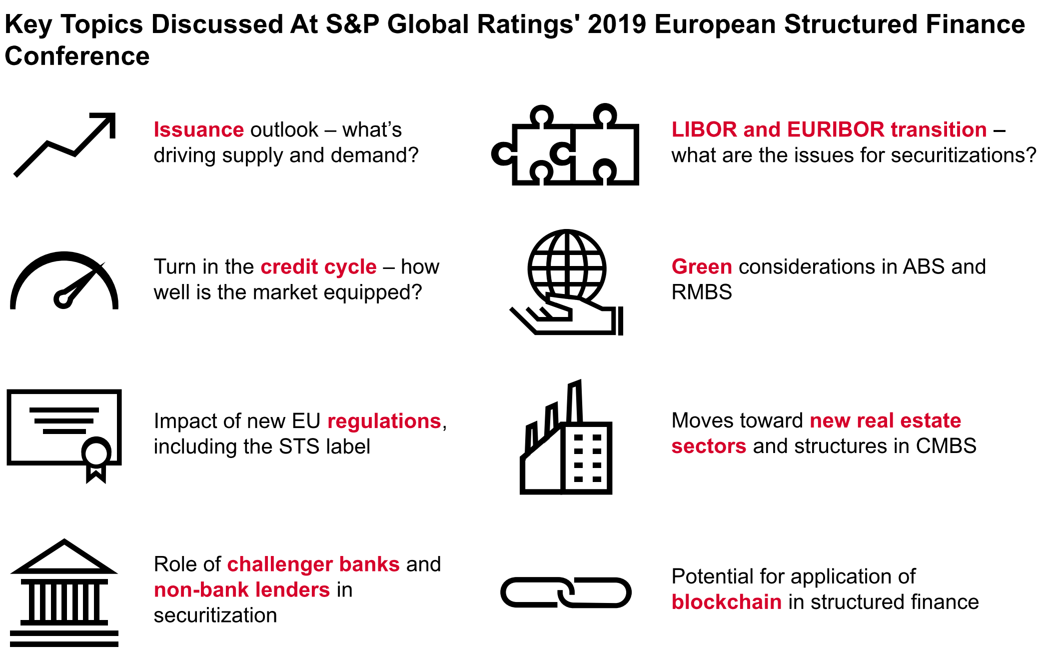
September 10, 2019

PRIMARY CREDIT ANALYST

Arnaud Checconi
London
(44) 20-7176-3410
ChecconiA
@spglobal.com

SECONDARY CONTACT

Andrew H South
London
(44) 20-7176-3712
andrew.south
@spglobal.com



On Sept. 5, 2019, S&P Global Ratings hosted its second annual conference on European structured finance. The event featured presentations and interactive Q&A streams led by our analysts, with panels comprising key market participants, including investors, originators, and arrangers. Here are the highlights.

Audience Mostly Positive On Securitization Outlook In Opening Panel

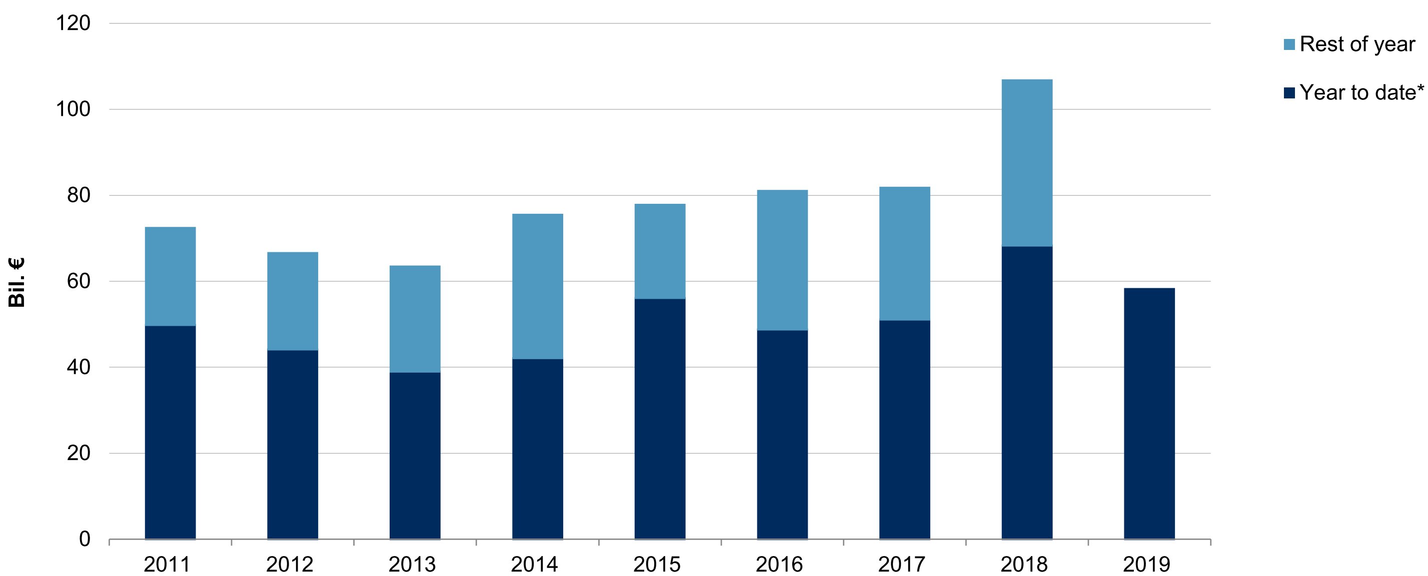
Most panelists and respondents to an audience poll suggested that the outlook for European securitization was "somewhat positive", despite depressed issuance early in Q1 2019 due to teething problems with the EU's new Securitization Regulation and ongoing uncertainty around

Brexit. Given this backdrop, some panelists thought that a year-to-date volume decline of only 15% should be seen as a positive (see chart 1). Although issuance so far this year has been heavily skewed toward the U.K. and the collateralized loan obligation (CLO) sector, there is still significant diversity and new originators continue to come to the securitization market. For example, the U.K. market has seen a few debut originators so far this year. There has also been a continued broadening of motivations for using securitization technology, including an increase in risk transfer and balance sheet management transactions.

Panelists thought that the issuance-dampening effect of the new regulations should gradually disappear, as investors and originators become increasingly comfortable about the requirements and technical standards are fully rolled out. That said, the return of cheap central bank funding schemes—such as the European Central Bank's third round of targeted long-term refinancing operations (TLTROs)—is a clear negative for issuance volumes in the short to medium term.

Chart 1

European Investor-Placed Securitization Issuance



*Year-to-date figures are as of end-August each year. Source: S&P Global Ratings.

STS issuance may develop pricing differential in the medium term

Originators' increasing familiarity with the "simple, transparent, and standardized" (STS) label over the course of 2019 has led to its application in a wider variety of transactions, according to one panelist. For example, some master trust transactions—for which STS-compliance may be more challenging—managed to obtain the label in Q2. This required legal advice and significant due diligence, given the regulatory sanction regime.

Panelists added that the STS-labeling process can add an extra three or four weeks to the issuance timeline, between announcement and pricing, as more dialog is needed with investors. However, originators hope that the STS label will increase demand across the investor spectrum, in particular from bank treasuries and, potentially, insurers, both of whom can benefit from reduced regulatory capital charges. At the moment, large asset managers are the main investors of STS securities.

From an originator perspective, there is still little evidence of a pricing benefit to STS issuance, with no apparent basis in the secondary market between STS and non-STS issuance. However, this may be partly because there is an expectation that several legacy issues could become STS-compliant retrospectively. Panelists thought that some pricing differential could start to emerge in six to nine months, once the STS market has further matured.

One originator on the panel said their issuance has to date not been STS-compliant, given the typical presence of buy-to-let (BTL) mortgage loans in their transactions' collateral pools. However, they may consider establishing a separate shelf, where pools would be selected to allow STS-compliant issuance. However, this would be unlikely before 2020.

Credit performance has been strong, but clouds may be gathering

According to several ratings-based metrics, credit performance for European securitizations has been strong over the past few years. For example, the upgrade rate was 16% in 2018 and has been in double-digits for several years. The downgrade rate of close to 2% was an 11-year low, and the default rate was below 1%. However, there are clearly risks on the horizon.

S&P Global Ratings believes the top risks to credit conditions in EMEA include global trade tensions, the potential for a disruptive Brexit, Italian fiscal imbalances, and weakening political cohesion across the region. All these risks could have a knock-on effect for credit performance in the European securitization market. In a recent article titled "When The Cycle Turns: How Would Global Structured Finance Fare In A Downturn?," we analyze the effects of a hypothetical macroeconomic downturn, concluding that default risk is low and downgrade risk is primarily constrained to speculative-grade classes, albeit with some risk in low investment-grade classes for the CLO and commercial mortgage-backed securities (CMBS) sectors.

The LIBOR replacement project is another area that may present a risk for legacy transactions. On the asset side, there is some uncertainty to what extent documentation may allow a switch to other reference rates for Libor-linked loans, and lenders are working with regulators and consumer bodies on this issue.

Could there be a TFS2?

According to some panelists, it has become increasingly possible that the Bank of England may launch another iteration of its Term Funding Scheme (TFS), if there is a disruptive Brexit. Drawdowns under the original TFS ended in February 2018 and there are still more than £110 billion outstanding, according to the Bank of England.

If there were a new TFS, some high street lenders might decide once again to continue with limited securitization issuance (e.g., one issue per year per platform), in order to keep the investor base engaged. However, such renewed cheap central banking funding would likely become the biggest impediment to issuance growth in the coming years. Another consequence could be downward pressure on securitization spreads, which halved during the original TFS.

RMBS: What's The Shape Of Things To Come?

Challenger bank landscape

In our RMBS panel, participants discussed the growing significance of challenger banks as securitization originators. There are four categories of challenger banks:

- Those that attempt to replicate high street lenders. These include Virgin, Metro, or TSB;
- The fintechs, which emphasize the customer experience through their use of technology;
- Banks that focus on an efficiency strategy. They could for instance offer plain-vanilla BTL lending and focus on a low cost of funding; and
- The ones that focus on customers that are not served well by high street banks (e.g., Shawbrook).

Some panelists considered the U.K. mortgage market to be very crowded, potentially forcing some players toward more risky lending. They also deemed the market very efficient in terms of pricing transparency, with price comparisons widely available to current or prospective borrowers. Another risk may be the reliance on automated/credit bureau data. This process may not work well and capture all the facets of credit risk in cases where the challenger bank is focusing on niche markets.

Innovation trends

The U.K. mortgage market has been at the forefront of innovation, although there are some developments in other countries too. Here are a few of the recent and expected innovations mentioned by panel participants:

- Five-year (or longer) fixed rate BTL loans. This development was triggered by new rules on affordability assessment, applicable to BTL lending in the U.K. and introduced in 2016.
- Houses in Multiple Occupation (HMO) loans are becoming more commonplace.
- Retirement interest only/equity release loans, driven by borrowers living longer, properties becoming more expensive (meaning higher loan balances that take longer to repay), and borrowers buying their first property at a later age (see "Will Innovation Give The U.K. Mortgage Market A Boost?," in "Related Research").
- Private Help-To-Buy Schemes. As the U.K. government scheme is meant to end in 2023, there may be some appetite for a private equivalent, even if the private sector may find it difficult to compete with the five-year interest rate free period that the official scheme offers.
- Rise of the Dutch BTL market: The Dutch property market has an outsized social housing element and a traditional private owner-occupier sector, coupled with strong macroeconomic fundamentals. A similar rise could happen in Ireland and the Nordics.

CLOs: Will It Be Different This Time?

Panelists at the CLO session agreed that CLO 2.0 structures appear more robust than their pre-crisis siblings, with more subordination across the capital structure, greater transparency in documentation, and shorter reinvestment periods. The European CLO sector currently faces some headwinds, in the form of challenging arbitrage conditions and a more limited loan supply than in the U.S. However, strong issuance over the past two years likely reflects the structural evolution of the CLO 2.0 product, together with the product's impressively low default rate. Our recent report "Closing The Low European CLO 1.0 Default Chapter, Onto The Next," highlights that post-crisis CLOs have yet to experience any defaults, and have seen no significant downgrades, while the CLO 1.0 default rate stands at 1.4%.

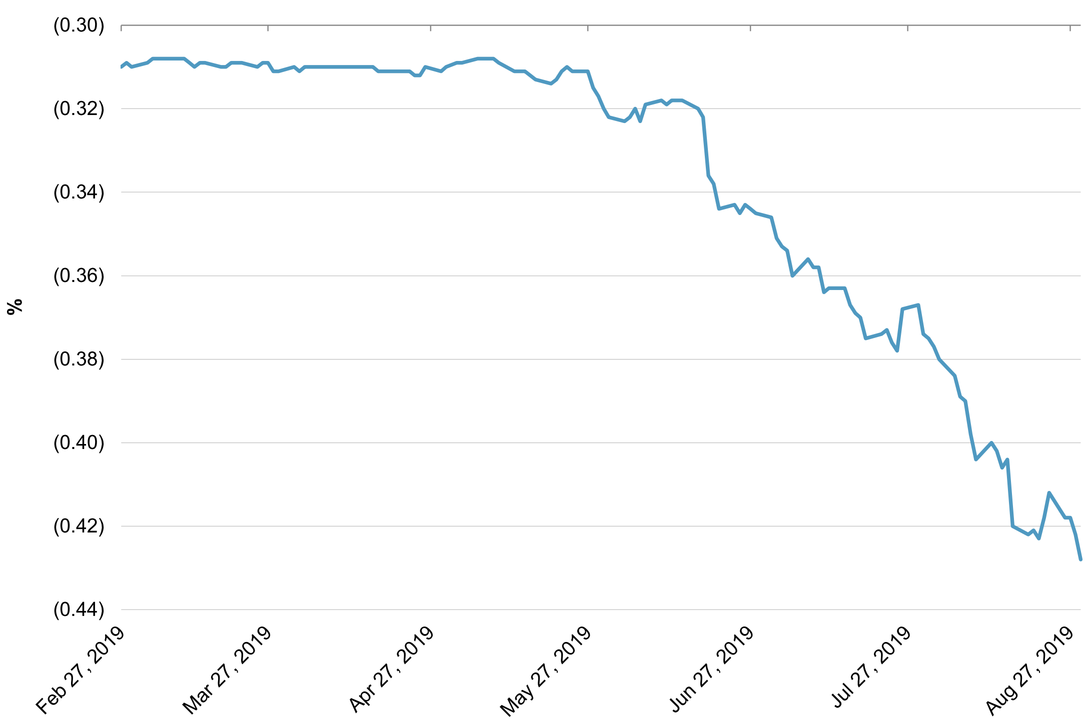
One panelist expressed that improved documentation has addressed previous "unknowns", which will provide investors and managers with more transparency to navigate the next downturn. Another said that because CLO investors learned what worked and what didn't work in CLO structures during the financial crisis, structures have evolved with better protection, more subordination, and increased transparency. For example, today's capital structures have a well-sized revolving credit facility (RCF), subordinated debt, and a higher average equity contribution. Therefore, the issuer has a lot more flexibility to navigate through an economic cycle. Panelists also identified risk retention as an important factor to align interests between managers and investors.

The panel agreed that the entrance of new CLO managers over the past two years is a welcome development, with one panelist saying that it would result in more diversity in collateral and manager pools, while also giving investors the opportunity to monitor manager styles.

It's likely the market will contend with a negative rate environment for some time. Against this backdrop, the panel focused on the recent drop in EURIBOR and EURIBOR floors in CLOs as a trigger for more refinancing and reset deals (see chart 2). One panelist highlighted an inflow of new investors, with some U.S. investors coming to the European market, for example. While Japanese investors have stepped away, this was viewed as more of a regular "ebb and flow" in market participants, rather than a permanent evolution, and shows that investors are active.

Chart 2

What's The Value Of A EURIBOR Floor Today In CLOs?



ABS: New Asset Types, STS, And LIBOR Replacement

Marketplace lending

On our asset-backed securities (ABS) panel, the securitization of marketplace lending (MPL) was a key topic. Panelists discussed how the credit analysis of MPL transactions tends to focus on the following pillars:

- Business strategy/operating history;
- Management experience;
- Financial performance; and
- Funding diversity and relationships with strategic partners.

One of the key challenges is the lack of historical data in terms of collateral performance and operating/business history. It is therefore difficult to size the risk and pinpoint weaknesses. The regulatory environment is also a challenge, as MPL transactions may not fit exactly into the regulatory framework established for traditional lenders, such as high street banks.

Electric vehicles

The rise of electric vehicles has generated a lot of buzz, but currently has little impact in European auto ABS, as they still represent less than 2% of car sales across Europe and a similarly small proportion of securitized collateral pools. Panelists however expected gradual growth to materialize in the next 18-24 months. This could introduce new considerations in the assessment of residual value risk: would a higher proportion of electric vehicles in a securitized pool result in a lower residual value? This may in turn depend on the extent to which the electric vehicle market depends on government funding. In terms of default probability, financing backed by electric vehicles has so far exhibited lower risk characteristics, given that the demographic of early adopters has been focused on "sophisticated buyers" with relatively high and stable incomes.

ESG factors

Panelists agreed that environmental, social, and governance (ESG) is becoming an increasingly hot topic in the securitization market, although there isn't currently strong enough investor demand for ESG bonds to warrant many originators pursuing this type of issuance. For those that have, there has been little evidence of a pricing differential.

One panelist noted that it's possible for "ESG-friendly" assets to pose a greater credit risk than those that have weaker ESG credentials. From a credit rating perspective, ESG factors could affect the securitized assets or a transaction's operations, but the risks are likely to be indirect or mitigated by legal and structural features already embedded in the transaction structure. S&P Global Ratings' panelists noted that ESG credit factors have historically been part of its analytical framework for rating structured finance transactions.

LIBOR replacement

Discussion on the panel also included the upcoming revamp in interest rate benchmarks. Euro-denominated securitization linked to EURIBOR may not be greatly affected by the reform of that benchmark's determination process. However, sterling LIBOR is instead being fully replaced, with many new U.K. securitization issuances now referencing the Sterling Overnight Interbank Average Rate (SONIA).

The issuance of new transactions using SONIA as a benchmark is encouraging, but some problems remain for legacy issues as there is no precedent. For U.K. securitizations issued before 2017, changing the index usually requires noteholder consent. For later-vintage transactions, panelists expected a smoother process, as these transactions typically incorporate benchmark transition language developed by the Association for Financial Markets in Europe (AFME). There could however still be some basis risk where assets and liabilities switch to different indices. Ideally, all transactions and documents should be amended by the end of 2021, but this is unlikely to happen according to the panelists. The short weighted-average life of most ABS transactions should partially alleviate the problem.

CMBS: Jumping On The Bandwagon

The CMBS panel started by taking stock of where the market is currently, and where it's going. Panelists observed that issuance for 2019 looks like it will surpass 2018 levels, both in terms of the number of transactions and the issuance volume. The panel explored whether there was still demand for this growing volume of issuance, and investors indicated that there was still a level of pent-up demand from the relative lack of issuance before 2018. In their view, supply may also drive demand to some extent in this sector.

Panelists also discussed the potential shift away from traditional CMBS asset classes and structures and whether there was appetite from investors for transactions backed by more operational based real estate sectors, such as hotels, multifamily, care homes, and student housing. The panelists generally agreed that, as long as they are comfortable with the underwriting and the pricing on a transaction-by-transaction basis, there is no reason why they wouldn't invest in these asset classes. Similarly, the panel explored potential new geographies and jurisdictions beyond those typically seen in European CMBS, as well as whether we are going to see more granular transactions following the success of the recent Pembroke Finance CMBS.

Tech Innovation In Structured Finance: Application Of Blockchain

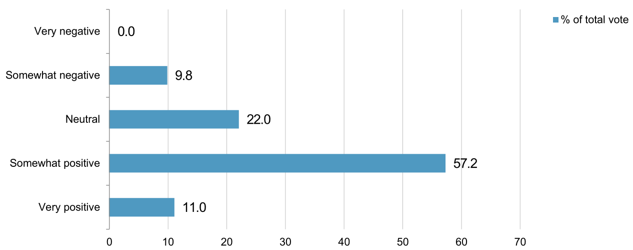
In a final panel on technological innovations, market participants discussed the potential for blockchain in a securitization context. While there are many proofs of concept for using blockchain technology in financial markets, the end-to-end "crypto-dream", where blockchain technology is used for the asset origination through to the issuance and payment of securitized notes, may take a while to become reality. One of the challenges noted is developing regulation for digital assets. Another concern raised was the custody of digital assets and protection of crypto keys. Market participants have also expressed concerns with using public, permissionless blockchains. Panelists believed however that there could be a parallel between the internet in the mid-1990s and public blockchains.

Panelists agreed that in the near-term, issuers could focus on how blockchain could be used for reporting on the underlying securitized assets. For example, could blockchain be used to provide investors with real-time performance information and to meet ongoing reporting requirements?

Polling Results

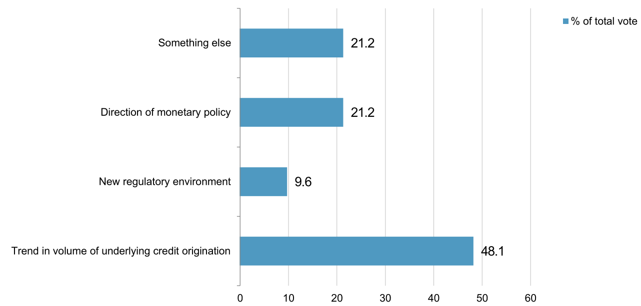
Question 1

What Is Your Outlook For The Future Of The European Securitization Market? (82 Votes)



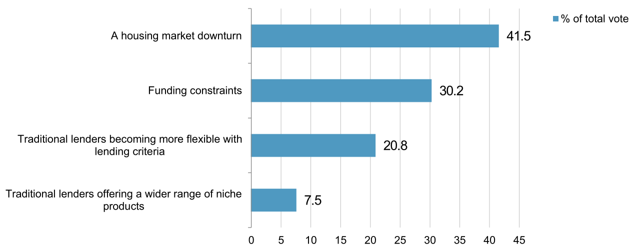
Question 2

If You Think Issuance Will Grow, What Is The Main Reason? (52 Votes)



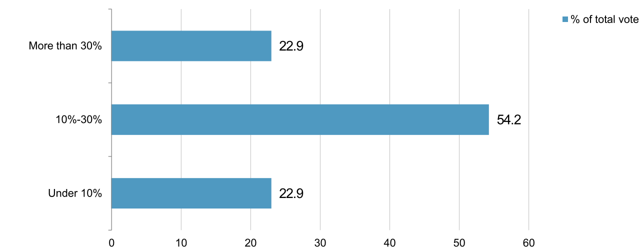
Question 3

What Do You Expect To Be The Largest Challenge For Specialist Lenders And Challenger Bank Growth Over The Next 12 Months? (53 Votes)



Question 4

What Do You Think The Percentage Of Total Market Fintechs/Marketplace Lending Will Comprise In 10 Years? (48 Votes)



Related Research

- When The Cycle Turns: How Would Global Structured Finance Fare In A Downturn?, Sept. 4, 2019
- Will Innovation Give The U.K. Mortgage Market A Boost?, Sept. 4, 2019
- More Than One-Third Of U.K. Legacy Borrowers Are "Mortgage Prisoners," Sept. 4, 2019
- Closing The Low European CLO 1.0 Default Chapter, Onto The Next, Sept. 4, 2019
- Game Of Loans: The Nitty-Gritty Of Granular European CMBS Transactions, Sept. 3, 2019

Co-writer: Claire S. Ellis.

This report does not constitute a rating action.