An Update on European MBS and ABS Markets

An important trend over the past ten years has been the development of secondary mortgage markets outside the United States. The factors behind this trend are similar to the ones that drove the development of the market in the United States. At a governmental and social policy level, there is a desire to replicate the perceived success of the United States in making housing finance cheaper and more easily available to home buyers. For lending institutions, competitive and regulatory pressures have grown for efficient balance sheet management, and securitization of assets facilitates this process.

The largest MBS market outside the United States, and the one with the potential to grow to US levels (which comprises about $3 trillion outstanding of MBSs/ABSs) is Europe. Here we give a brief review of recent securitization trends in Europe.

The Danish MBS Market

Before discussing the development of the European MBS market, we note that one well-established secondary mortgage market already exists, in Denmark. In fact, the Danish market is older than the US MBS market; a mortgage credit system has existed in Denmark for 200 years. Although there are other established types of mortgage bonds in Europe, notably the Pfandbrief sector in Germany, Danish MBSs are the closest to US pass-through securities in cash-flow characteristics. They are mostly fixed-rate, level-pay (called annuity loans in Denmark), with original maturities of 10, 15, 20, or 30 years, and can be prepaid without penalty at any time. However, mortgage payments are quarterly rather than monthly. In addition, residential and commercial mortgage loans are mixed in the same pools.

The amount of outstanding Danish fixed-rate MBSs was DKr 970 billion at the end of second quarter 1998, or about $150 billion, a remarkable amount for a nation of only five million people. Danish mortgage pools (or series) tend to be large in size, typically $1 billion or more initially (some issues are more than $10 billion). This size is achieved by keeping a series open for up to three years; that is, new loans can be put into the pool anytime during a period of three years.

Prepayments in Denmark show extreme efficiency, because of very low refinancing costs, a national awareness of refinancing opportunities (a strong media effect), and the ability to prepay discount loans at market value (rather than at par). However, as in the United States, considerable resources have been devoted to developing prepayment and OAS models to capture prepayment risk.

Securitization in Europe

The first MBS deals in Europe (not counting the Danish MBS market) were done in the mid-1980s, with UK mortgages as collateral. There have also been securitizations of other asset classes, such as credit cards and auto loans. According to estimates by Moody’s Investors Services, annual issuance of European MBS/ABS was less than $10 billion until 1996, when it jumped to $30 billion, then further increased to $45.4 billion in 1997. Volume for 1998, however, was about the same as 1997, at $46.6 billion, as the flight to quality last fall led to a dramatic widening in ABS spreads and reduced issuance to a trickle. Despite the increase in issuance in 1996 and 1997, volume is still low relative to that in the United States and relative to the amount of mortgage loans outstanding in

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1 This article is excerpted from an updated edition of the 1995 Salomon publication, Guide to Mortgage-Backed Securities. The updated edition is expected to be available within the next week.

2 Pfandbriefs are collateralized bonds, with a total market size of close to $1 trillion, of which a quarter are backed by residential mortgages (although because the LTVs cannot exceed 60%, only a fraction of German mortgages are eligible for Pfandbriefs). However, prepayments are not allowed, and even if a loan is prepaid, the issuer typically does not pass on the prepayment to investors. For a description of the sector, see The Jumbo-Pfandbrief and its Future, Udo Herges, Salomon Smith Barney, July 1998.

3 For an introduction to Danish MBSs, see Mortgage Bonds, Den Danske Bank, September 1998. The figures on the Danish market are taken from this publication.

4 There is one difference in the way prepayments are passed through to investors: instead of the pro rata system used in the United States, prepayments in Denmark are distributed by a lottery system, each bond (nominal value DKr1,000) being one lot. Investors with large holdings would expect to see prepayments on their bonds close to the rate for the pool (or series), given the law of averages, but smaller investors may see deviations.
Europe. However, as the jump in volume in the past few years implies, many of the impediments to securitization have been diminishing, and volume is expected to surge in coming years.

Mortgages continue to form the bulk of collateral for European deals. Figure 1 shows a breakdown of European issuance by collateral type for 1997 and 1998. The total outstanding volume of European MBSs/ABSs has been estimated to be about $130 billion,\(^5\) of which perhaps half is MBSs.

**Figure 1. European MBS/ABS Issuance by Asset Type, 1997 and 1998 (Dollars in Billions)**

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>1997</th>
<th>Pct. of Total</th>
<th>1998</th>
<th>Pct. of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>MBS</td>
<td>$11.0</td>
<td>24 %</td>
<td>$22.7</td>
<td>49 %</td>
</tr>
<tr>
<td>CMBS</td>
<td>2.6</td>
<td>6</td>
<td>2.6</td>
<td>6</td>
</tr>
<tr>
<td>CBO/CLO</td>
<td>14.6</td>
<td>32</td>
<td>8.5</td>
<td>18</td>
</tr>
<tr>
<td>Other ABS</td>
<td>17.3</td>
<td>41</td>
<td>12.9</td>
<td>27</td>
</tr>
</tbody>
</table>

Source: Moody’s Investors Services.

For MBSs, the United Kingdom has been the major source of collateral; in fact, until the past year or two, three countries (the United Kingdom, France and Spain) provided the collateral for almost all MBS issues. However, in a sign of the gradual progress of securitization, in 1998 seven other countries were also represented in MBS deals (although the United Kingdom, France and Spain still accounted for two-thirds of the collateral). A notable entry into the MBS market was Germany, the largest mortgage market on the continent in terms of amount of loans outstanding, where three large deals were issued in 1998.

**Raw Material: Amount of Loans Outstanding**

What is the volume of European mortgage loans outstanding? A study\(^6\) by a consulting firm estimated that “retail” mortgage loans outstanding in 1996 totaled about $2.6 trillion in 16 western European countries. This compares with $3.8 trillion in one- to four-family mortgages outstanding in the United States at the end of 1996. However, the term retail, according to the study, “does not include loans to self-employed businessmen,” an exclusion that would knock out a significant fraction of the loans in the United States. We can probably conclude that the size of the primary mortgage market in western Europe is comparable to, or a tad smaller than, the US mortgage market.

**Why has the European MBS Market not Developed Faster?**

Despite steady issuance since the mid-1980s, securitization volume in Europe has lagged US rates, for a variety of reasons:

- Many institutions have not faced strong incentives to remove assets from balance sheets, because of favorable funding rates and excess capital;
- The severe recession in Europe in the early 1990s led to a sharp drop in loan originations, further diminishing pressure on balance sheets;
- A lack of legal and regulatory frameworks hinders securitization;
- Few analytic tools and an infrastructure exist for timely reporting of deal information to investors;
- A diversity of mortgage terms and conditions from country to country, such as different prepayment penalties, diminish the appeal of MBSs backed by loans from one country to investors in other countries;
- Currency differences have hindered cross-border transactions in the past; and
- Many European investors have tended to focus on sovereign debt, rather than spread products.

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\(^5\) These estimates exclude Danish MBSs and mortgage bonds, such as Pfandbriefs.

Faster Growth Expected
Many of these impediments to growth have been diminishing, as indicated by the substantial jump in issuance starting in 1996 mentioned earlier. The general expectation is for more rapid development of the European MBS and ABS markets over the next several years. Several factors are expected to contribute to this trend:

- The introduction of the Euro is expected to have a major impact, because it will gradually eliminate much of the existing sovereign bond markets, shift investor attention to spread products, especially MBSs and ABSs because of their high credit quality, and eliminate currency concerns;
- In the past few years, various countries have made legal and regulatory changes that facilitate securitization, and this trend is expected to continue;
- Competitive and regulatory pressures on institutions are mounting, leading to more focus on measures such as return on equity and on efficient balance sheet management;
- Gradual improvements in MBS deal information reporting systems and more familiarity with cash-flow characteristics should contribute to increasing investor comfort levels with MBS and ABS products;\(^7\)
- There has been a continuing broadening of the types of assets being securitized — for example, sub-prime mortgages, student loans, soccer receivables, pub leases, and so on. However, before the European MBS and ABS markets approach US levels, some impediments have to be removed. One is the variety of rules and regulations (or lack of them in some cases) governing securitization from country to country. Some securitization professionals expect that with a common currency and a single central bank, standardization will occur, although it may take a while. Second, and perhaps most important, there is no equivalent of Ginnie Mae, Fannie Mae or Freddie Mac in Europe. These entities have not simply played a critical role in the growth of the secondary mortgage market in the United States. The establishment of Fannie Mae in 1938 by the federal government also led to standardization of mortgage terms and underwriting practices in the United States. The establishment of a pan-European housing finance agency would likely have a similar effect in Europe.

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\(^7\) As an indication of this trend, we note that the Bond Market Association (formerly the PSA), a trade group in New York representing fixed-income dealers, recently set up a European Securitization Forum, to “promote the continued growth and development of securitization throughout Europe.”