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EUROPEAN BANK DELEVERAGING – POSSIBLE IMPACT ON SECURITIZED PRODUCTS

The Eurozone sovereign crisis dominated much of 2011, and while progress has been made, the crisis is unlikely to be quickly and cleanly resolved. But one thing is for sure – the process of nursing Europe back to health requires healthy banks. New European bank capital requirements which start taking effect mid 2012 will require the banks to deleverage as they recapitalize, and banks are positioning their balance sheets accordingly.

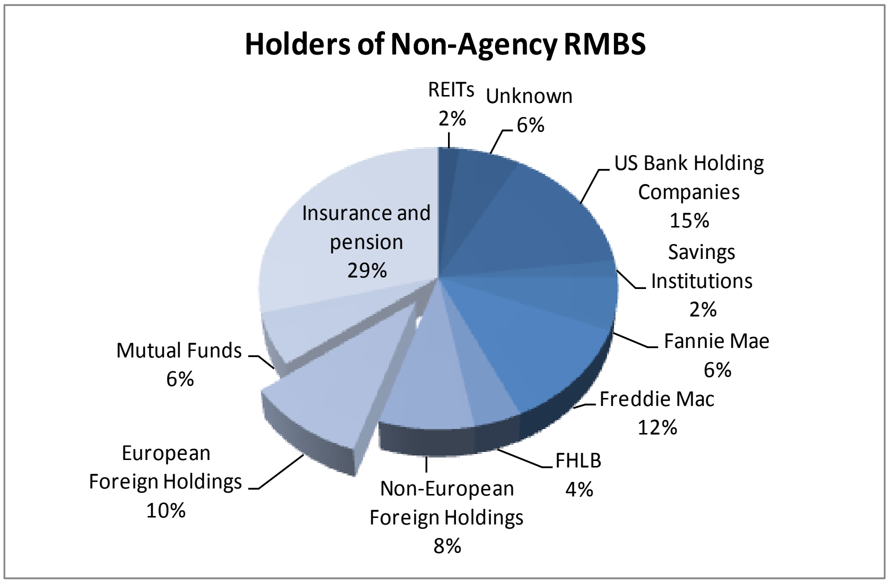
Knowing that these banks will now have pressure to sell assets, the key question for our market is, what might they sell and to what extent do they sell U.S. securitized products? The potential for the liquidation of bank held securitized products is what we hope to frame out here by looking at some of the reported data and discussing some of the consideration/motivations for banks to sell. The starting point is first understanding what they actually own (where information is not always timely or detailed). From there, what business considerations and economic considerations will drive their decisions to sell particular assets?

Size of European Bank Holdings

European banks were fairly large investors in both U.S. and European securitized products. Several analysts have estimated USD assets held by European banks to be approximately $200bn (the rest of the eurozone banks securitized holdings being euro-denominated). So what asset classes do they own, and where is the potential overhang in the market?

Because of the structure of typical bank funding, European banks largely invested in floating rate bonds, often with shorter maturities. Thus, for example, their holdings of U.S. CMBS, which is largely fixed rate paper, are very small. European banks were simply not big buyers of U.S. CMBS. Meanwhile, their holdings of ABS, like credit cards and autos, while significant, have very short remaining average lives. These deals had 2-5 yr. average lives when issued and have paid down substantially. While these assets would be relatively easy for them to sell (highly rated, trade close to par, short duration) such sales are unlikely to be disruptive to the market.

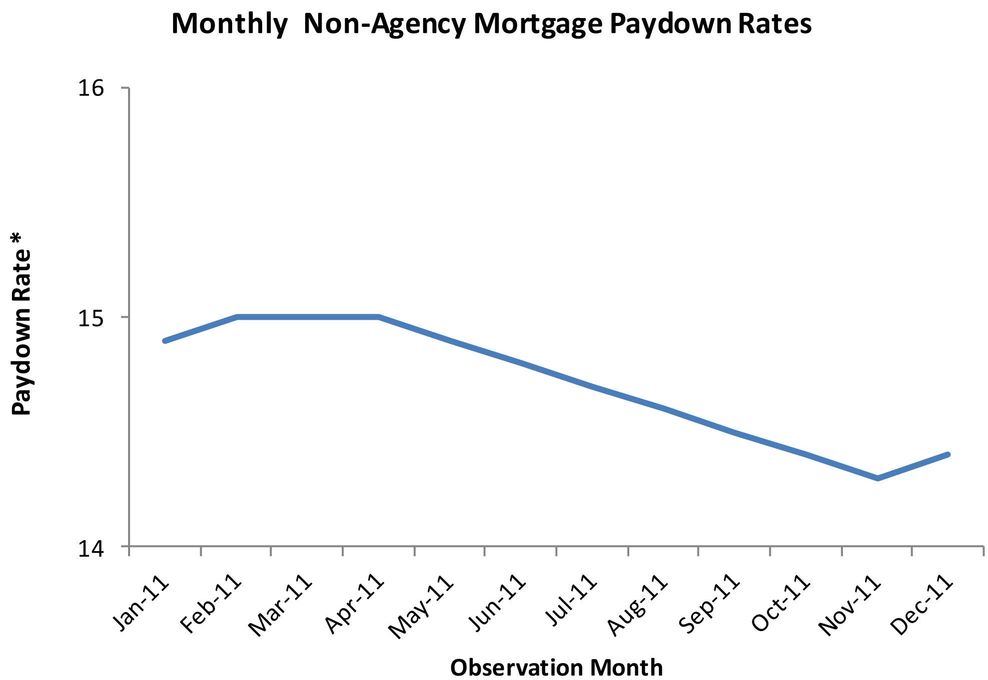
One sector in which European banks were active and where they still have sizable investments is U.S. RMBS, including subprime, Alt A, Pay Option Arms and Jumbos. Based on estimates from Morgan Stanley, Bank of America Merrill Lynch, Deutsche Bank, Amherst Securities et al, European banks hold, in carrying value, somewhere between $50 billion to as much as $90 billion in U.S. residential mortgage-backed securities (excluding government guaranteed Agency MBS).



Significance of European Bank Holdings of US RMBS

The first point is to compare European bank holdings of US RMBS to the size of the non-agency mortgage market. The non-agency RMBS market is approximately $1.3 trillion in current outstandings. Therefore, while European bank selling could have an impact on the market, what we have seen instead is banks selling large blocks (up to $1 bn) quietly in negotiated transaction as opposed to open auction (e.g., Maiden Lane II). The second point to note is that some of these assets were already spun off into separately funded legacy or workout portfolios which may not result in asset sales. Some of these legacy portfolios may have various levels of government backed financing and may never see the light of day.

A third, and perhaps more important point, relates to the unique nature of RMBS, which amortize every month. This leads to a natural contraction of outstanding RMBS over time. For example, subsequent to the credit crisis, non-agency RMBS balances have been paying down at an annual rate of ~14-15%. For 2012, the sector is expected to experience runoff totaling $150-175 billion or more, as the pace of foreclosures has picked up. For certain investors, this natural runoff will mean that they have to reinvest simply to remain neutral. All else equal, the demand from investors simply maintaining their existing allocations is significant. Certainly not all of the paydown will result in incremental demand, however the fact remains that the $150-175 bn in runoff will exceed European bank sales, even if we assume a conservative figure for their holdings and assume they will sell a substantial portion of those holdings.



**Principal received as a % of prior month's balance, annualized*

To Sell or Not to Sell

For any given European bank, Securitized Products generally, and U.S. RMBS specifically, are not going to be deemed a "core" business asset, if only by dint of the currency. That reason alone suggests that U.S. RMBS will be among the assets contemplated for sale as the banks delever. Beyond that, it is hard to forecast how attractive or unattractive selling may be to any given institution vs. other assets they hold. Were these assets funded on balance sheet, or off balance sheet (or even already transferred to a legacy portfolio)? Is the investment generating negative carry? Given the rapid rise in European bank funding costs, no doubt there are some high quality assets that now earn negative carry, (this is more likely in their credit card, ABS or CLO portfolios, while U.S. RMBS trade at higher yields).

Apart from funding considerations is the question of capital relief. Distressed assets may not be generating negative carry. But, if the bank can garner some capital relief, that could drive them to sell. As an aside, a complicating factor for the banks is that the capital relief is only a positive to the extent that the asset is already marked to market. If the asset is being held at a price that is above market they might be reluctant to sell, as the loss upon selling may outweigh the capital relief.

Therefore, as we see it, the main considerations for European banks as to what to sell or not are driven by balance sheet funding and capital relief. Simply put, funding issues favor selling high dollar price, higher rated assets, while capital relief favors selling lower dollar price distressed assets. And for assets "in between", i.e. that neither provide significant capital relief were they sold, or have negative carry, the new capital requirements do not create any particular incentive to sell.

Conclusion

Europe's woes have dominated investors' imaginations for many months now, both in the broadest sense as a reason for general risk aversion, and more specifically in sectors where policy and regulatory changes might have an impact. In dimensioning the potential threat of European bank deleveraging for U.S. RMBS, the size of their holdings, offset by natural runoff in the sector, portfolio sales, and certain "bad bank" structures, should mitigate its impact to the sector. Uneven timing of sales or concentration of sales activity in a given subsector may cause market choppiness over short periods. Yet these opposing factors should buffer the market reaction, and the volume of European bank asset sales is perhaps less daunting than the headline numbers may suggest.

Meanwhile, closer to home, the Fed is reportedly looking to sell its Maiden Lane II portfolio (acquired when the government took over AIG). This was triggered by broker dealer reverse inquiry which suggests a slightly more positive backdrop to the sale. While many people assumed that at some point the Fed would resume Maiden Lane asset sales, the sale comes at a time when prices have just started to rally and may be fragile. However, the Fed is not a forced seller and both logic and their past behavior suggest they may well step back if their actions appear to be disruptive or significantly depress RMBS prices.