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Investment in European Securitisation by European Insurers

Pre vs Post Crisis, and Prospects for the Future

Association for Financial Markets in Europe

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Executive Summary

Prior to the crisis, European securitisation played a meaningful role in the financing of the EU economy. In 2006 and 2007, pre-crisis issuance of European securitisation placed with third party investors was € 450 billion per year, which dropped significantly thereafter. In 2010 and 2011, placement to third party investors is still only € 80-90 billion per year, due in large part to macro volatility, regulatory uncertainty and government/central bank liquidity programmes. Going forward, greater investment in European securitisation has significant potential to assist the European economic recovery at much greater issuance levels, if the appropriate policy decisions are taken to encourage, rather than discourage investment in high quality securitisation. The purpose of this brief report is to provide estimates of the amount of European securitisations purchased by European insurers before and after the crisis, as well the potential for the future. In summary, based on the data analysed in this report, immediately before the crisis approximately € 45-70 billion per year of European securitisation new issue placement was to European insurers. Immediately after the start of the crisis in 2008, placed issuance dropped to approximately € 20-25 billion, which implies insurance investment of approximately € 2-4 billion. If capital charges for European insurers are recalibrated to a more appropriate level, and included where appropriate in the matching adjustment, it is envisioned that annual purchases by European insurers could rise again significantly to approximately € 55-110 billion per year or more. This represents approximately 5-10% of annual forecasted new business flows for European insurers.

All charts and tables are referenced in the Exhibits.

European Securitisation in a Global Context

The major global securitisation markets are in the US and Europe. Chart 1[1] shows the substantial size of the securitisation market relative to other markets in these regions, reflecting the major role it plays in financing real assets in the European and US economies. The European securitisation market is similar in size to the corporate bond market. 50% of the corporate bond market in Europe consists of financial issuers vs 33% in the US; this reflects the greater role played by banks in Europe in financing the economy. The ability of smaller banks to access the market directly has changed significantly after the crisis. For example, In 2007, banks outside the 18 biggest accounted for € 257 billion of senior unsecured bank debt issuance, or 70% of total bank issuance. In 2011, these small and mid-size banks accounted for just € 81bn of issuance, or 36% of the total. This indicates how the latter group has found it challenging to access unsecured funding in the market.[2] The mix of bank funding instruments used has also shifted, with less senior bank debt, covered bonds and subordinated debt issued, and more government-guaranteed bank debt issued.[3] For example, in H1 2012, € 17.6 billion of senior unsecured debt was issued, as compared to €

[1] Source: Banc of America Merrill Lynch fixed rate index qualifying bond indices, except for "Securitised". See detailed footnote in Exhibit.
[2] Source: Nomura International
[3] Source: Banc of America Merrill Lynch

262 billion in H1 2011. For covered bonds, issuance in H1 2012 was € 91 billion, vs € 143 billion in H1 2011. For bank subordinated debt, H1 2012 issuance was € 7.8 billion, vs € 12 billion in H1 2011. In comparison, government-guaranteed bank debt has risen to €19 billion in H1 2012, up from € 9 billion in H1 2011.

In terms of the size of potential funding needs, over €1 trillion of LTRO finance from the ECB is providing significant direct repo funding, which reduces the need for many European banks to access the capital markets directly. Maturity of the ECB funding in early 2015 could create a refinancing "cliff". Meanwhile, the possibility of bail-in for unsecured debt is currently planned for 1 January 2018 onwards in the Commission's June 2012 proposals. In this context, the covered bond and securitisation markets will need to play an even more important role in the European real economy. In addition, increased securitisation issuance is needed to simply refinance the maturities of existing mortgages and other securitisations, let alone new funding for growth purposes. Insurance company investment can be an important component of this funding, if there is not an artificial reason to discourage investment by insurers.

European Securitisation Market Overview

1. **Balances Outstanding:** As indicated in Tables 1.1 and 1.2, at the end of Q1 2012, European securitised debt outstanding was approximately € 1.89 trillion. Securitisations backed by real economy assets such as RMBS was the largest size asset class, with approximately € 1.1 trillion outstanding. Consumer ABS outstanding was € 199 billion, and securitisations backed by SMEs was € 172 billion[4].

2. **Size of Issuance**: As indicated in Tables 1.3 and 1.4, at the end of Q1 2012, € 58.9 billion of securitised products were issued in Europe (total, included both retained and placed). RMBS issuance was the highest at € 40.5 billion, followed by consumer securitisations (€ 7.4 billion) and SME loans (€ 7.7 billion). Approximately € 18.9 billion of securitised products were placed with third party investors, representing 32% of issuance[5].

3. **Placed vs Retained:** Of the outstanding total, as indicated in Chart 1.2, as of Q1 2012, approximately 45 % was placed with third party investors, while approximately 55% was retained on bank balance sheets, to be used for repo, or used for other secured funding, As a result, roughly € 900billion of currently outstanding securitisations have been placed with investors, compared to approximately € 1.4 trillion before the crisis[6].

[4] Source: AFME Securitisation Data Report Q1 2012, Summary of Outstandings by Collateral.
[5] Source: AFME Securitisation Data Report Q1 2012, European Issuance by Collateral.
[6] Source: AFME Securitisation Data Report Q1 2012, Retained vs Placed Issuance

Changes in EU Insurer Asset Composition and Securitisation Investment

1. **Asset Composition:** Tables 1.5 and 1.5(a) provide an estimate of the asset composition of major EU insurers by broad asset categories, such as fixed income, equities, property, alternative investments, cash and other assets. Notably, the percentage of total assets invested in fixed income has risen from 63% prior to the crisis to 82% at present. Also, it is useful to note: a) a decline in securitisation investment vs a steep increase in covered bonds b) a big increase in government bond investment, c) a jump in alternative investments and d) also the volatility in the "other" category.

2. **EU Insurer Investment in Securitisation**

   Pre-Crisis: Precise figures are not publicly available as to exactly what percentage of securitisations were purchased directly and indirectly by EU insurers. In terms of an estimate, based on AFME member data as described in Tables 1.6 and 1.7, it is estimated that insurers purchased approximately 10-15% of combined new issues and secondary purchases. This estimate, based on data provided by AFME member dealers, is comprised of approximately 3-5 % of direct purchases of new issues by insurers, plus approximately 20-30% of the new issues placed with asset managers since many insurers purchase securitisations through asset managers rather than directly. Based on pre-crisis annual placed issuance of approximately € 450 billion/year, it is therefore estimated that approximately € 45-70 billioin of European securitisations were purchased by European insurers. It is useful to note that prior to the crisis, European insurer investment in tranches rated below AAA was relatively higher than that of other types of investors. This can be explained by the very low absolute credit spread levels of most AAA tranches of securitisations prior to the crisis. Banks and their highly leveraged SIV/conduits were the primary investors in AAA tranches prior to the crisis, with the remainder of the tranches purchased by asset managers, insurers and other non-bank investors.

   Post-Crisis: In 2008, total new issuance placed with third party investors dropped very significantly, to less than €25 billion per year, so estimates of secondary market placement to European insurers is a better proxy for investment rather than new issuance placement. Table 1.8 provides post-crisis estimates of secondary market placements, indicating that roughly 5-10% of post-crisis secondary placements went directly to insurers or through asset managers. This can be explained by the withdrawals of many banks, conduits and SIVs from the investor base. However, in 2011 many insurers began to reduce their absolute levels of purchases due to concerns about Solvency II capital treatment of securitisations.

   US Securitisations: Please note that many EU insurers did purchase some US securitisations prior to the crisis. In the future, Solvency II will restrict EU insurers to the purchase of only those securitisations where the issuer has retained 5% or more of the net economic risk. As a result, many US securitisations might not be eligible for purchase by European insurers. It is therefore not necessarily useful to review the current aggregated securitisation holdings of EU insurers, since data is likely to include pre-crisis purchases of US securitisations.

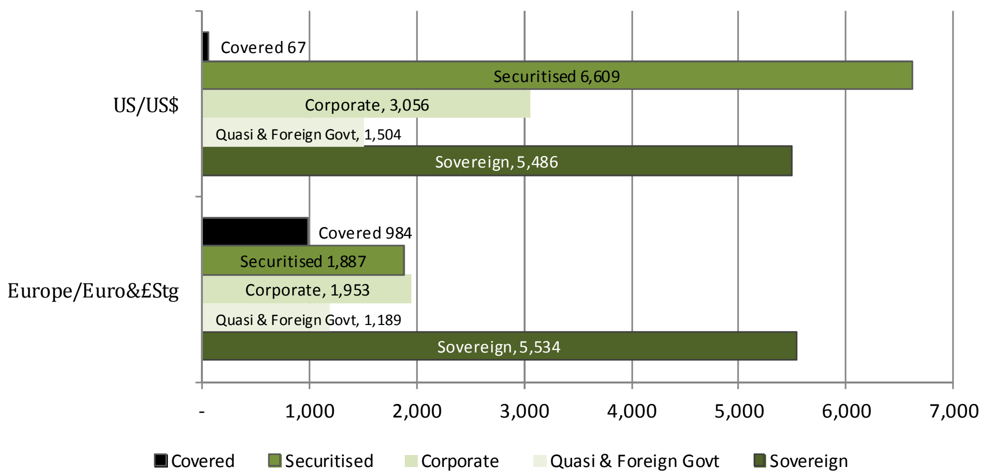
Prospects for the Future

1. **Size of Annual Insurer Industry Premium and Redemptions Inflows:** In 2011 European insurers held € 7.7 trillion of assets and had new cash inflows from new premium of € 1.1 trillion[7] for investment in all types of instruments. Assuming new securitisation purchases of € 20 billlion/year, this is only 2% of these inflows to EU insurers. Based on the solid credit and price performance of European securitisations, it seems very plausible that European insurer investment could easily rise to € 55-110bn/year, in line with or above the nominal level they purchased prior to the crisis. This would absorb 5-10% of overall insurer new annual cash available, and would seem to be realistic within the overall context of a confirmed trend toward increased fixed income investment by European insurers. However, this type of increased investment would be impossible if a 7%/year capital charge is implemented for European securitisations.

[7] European Insurance — Key Facts", Insurance Europe, August 2012

Exhibits: Tables and Charts

Chart 1.1: Bond Market Relative Sizes in US and Europe. € billions



Source: All data sourced from Banc of America Merrill Lynch fixed rate bond indices, except for Securitised. Securitised sourced from AFME Q1 2012 report. Note: All data in Euro billions or equivalent. "Securitised" categorisation is by region of collateral not currency. All data other than Securitised are for fixed rate index qualifying bond denominated in EUR, GBP or USD only. Index qualification criteria include minimum issue size of Euro250 million, GBP100 million and USD250 million. Covered Bonds: Index data used as full data not available as at 31March2012. The currency selection excludes DKK, NOK, SEK and CHF bonds among others from the index data used above. Total covered bonds outstanding globally in all currencies amounted to €2,501 billion equivalent at 31 Dec 2010 (Source: ECBC) of which €562 billion equivalent was floating rate and only €920 billion equivalent (47% of the fixed rate remainder) qualified for fixed rate index inclusion. Of the full 2010 total, €1,700 billion was denominated in Euro of which only €870 billion (51%) qualified for fixed rate bond indices at that date.

Table 1.1 Summary of Outstandings by Collateral Q1 2012, 2011, 2010; € Billions

	2012:Q1	2011:Q1	2010:Q1
ABS	199.5	205.5	229.6
CDO	186.8	235.6	260.9
CMBS	123.1	139.0	146.9
RMBS	1,149.1	1,268.8	1,346.3
SME	172.2	166.3	154.8
WBS	55.9	54.7	49.0
Total	1,886.7	2,069.8	2,187.5

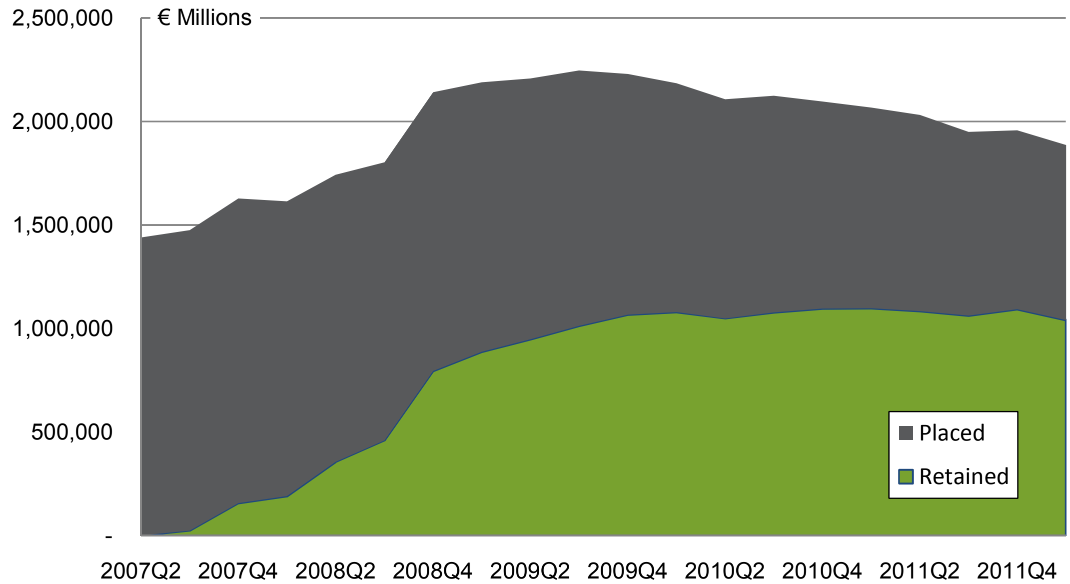
Source : AFME Securitisation Data Report Q1 :2012

Table 1.2 European Outstanding by Country and Collateral 2012 Q1; € Billions

	ABS	CDO	CMBS	RMBS	SME[8]	WBS	TOTAL
Austria	0.0		0.2	2.0			2.2
Belgium	0.1		0.1	71.1	14.5		85.9
Finland				3.7			3.7
France	18.1	0.2	3.8	18.3	3.8		44.2
Germany	35.3	2.5	16.2	19.0	8.5	0.1	81.6
Greece	15.2	3.0		6.0	9.4		33.6
Ireland		0.3	0.4	57.4	2.5		60.5
Italy	47.8	4.8	10.2	131.0	17.1	1.4	212.3
Netherlands	5.7	1.3	6.3	281.6	12.2		307.2
Portugal	6.5			38.2	9.6		54.3
Russia	0.9			2.7			3.5
Spain	21.7	1.2	0.3	163.0	80.4		266.5
Turkey	3.2						3.2
UK	38.0	7.8	61.9	354.6	7.2	53.8	523.2
Other	2.2	1.8		0.3	0.4		4.6
PanEuropean	2.8	40.2	20.9	0.2	5.8	0.1	70.1
Multinational	1.9	123.7	2.7	0.2	0.8	0.6	130.0
European Total	199.5	186.8	123.1	1149.1	172.2	55.9	1886.7

Source : AFME Securitisation Data Report Q1 :2012

Chart 1.2 European Securitisation Outstanding 2008: Q1 - 2012:Q1



Sources: AFME/SIFMA Members, AFME, Bloomberg, Dealogic, Thomson Reuters, SIFMA
Note: Retained outstandings do not contain retained, then subsequently placed, issues.

Table 1.3 European Issuance by Collateral Retained vs Placed Q1 2012; € Billions

RETAINED	2012:Q1	2011	2010
ABS	2.7	44.0	17.2
CDO	0.2	8.6	26.2
CMBS		0.2	1.7
MBS- Mixed		1.5	0.6
RMBS	30.7	170.1	209.6
SME	6.7	59.3	38.2
WBS			1.4
Total	40.3	283.7	294.8

PLACED	2012:Q1	2011	2010
ABS	4.7	29.5	14.2
CDO		0.6	3.5
CMBS	2.0	2.2	4.4
MBS-Mixed			
RMBS	10.1	52.5	61.5
SME	1.0	1.3	1.5
WBS	1.1	2.2	3.1
Total	18.9	88.3	88.1

Source : AFME Securitisation Data Report Q1 :2012. Note : Numbers in Table 1.3 have been selected from the revised Q1 2012 figures, performed in Q2 2012.Total sums may differ slightly from Table 1.4 below.

Table 1.4 European Issuance by Country and Collateral Q1 2012; € Billions

	ABS	CDO[4]	CMBS	RMBS	SME	WBS	TOTAL
Belgium				1.0			1.0
Denmark							0.0
France	0.5			1.4	1.4		3.3
Germany	3.7	0.2					3.9
Greece							0.0
Ireland							0.0
Italy		0.0		20.9			20.9
Netherlands				5.2			5.2
Portugal				1.1			1.1
Spain	0.4			0.5	4.5		5.4
UK	1.6		2.0	10.4	1.8	1.1	17.9
PanEuropean							0.0
Other Europe	0.3						0.3
European Total	6.4	0.2	2.0	40.5	7.7	1.1	58.9

Source : AFME Securitisation Data Report Q1 :2012

Table 1.5 Asset Allocation of Listed European Insurers 2007 -2011

	End 2007 %	End 2009 %	End 2011 %
Fixed income	62.6	80.0	82.0
Equity	19.5	5.9	5.0
Property	4.1	3.8	4.0
Ceding deposits	1.4	1.5	1.0
Cash	3.7	4.8	6.0
Alternative investments	0	1.1	1.0
Other	8.0	2.9	1.0

Source: BAML

Table 1.5(a) Fixed Income Asset Allocation of Listed European Insurers 2007-2011

	End 2007 %	End 2009 %	End 2011 %
Corporates	24.1	27.6	33.0
Securitisation	7.1	6.1	6.0
Covered Bonds	4.0	6.3	10.0
Other	3.3	8.0	10.0
Governments	24.2	32.0	42.0

Source: BAML

Table 1.6 Pre-Crisis (2005 and 2006) New Issue European Securitisation Investor Base Composition by Investor Type

	2006	2005
Banks	54%	47%
Sovereigns	4%	4%
Insurance Co.	3%	3%
SIVs	5%	10%
Corporates	1%	1%
Asset managers	33%	35%

Source: BAML

Table 1.7 Pre-Crisis (2004-2007) New Issue European Securitisation Investor Base Composition by Tranche Rating

Orig. Ratings	Asset Mgr.	Bank	Building Soc.	Conduit/SIV	Corporate	Insurance	Leveraged Money	Pension Fund	Supranational
AAA	**32.4%**	31.3%	2.1%	10.0%	0.6%	**3.9%**	3.8%	1.0%	1.6%
AA	**1.7%**	1.9%	0.2%	0.2%	0.0%	**0.3%**	0.4%	0.1%	0.0%
A	**1.0%**	1.2%	0.1%	0.1%	0.0%	**0.2%**	0.4%	0.0%	0.0%
BBB	**1.5%**	0.9%	0.1%	0.0%	0.0%	**0.3%**	0.9%	0.1%	0.0%
BB/B	**0.2%**	0.1%	0.0%	0.0%	0.0%	**0.1%**	0.4%	0.0%	0.0%
NR	**0.1%**	0.0%	0.0%	0.0%	0.0%	**0.0%**	0.1%	0.0%	0.0%
Grand total	**36.8%**	35.4%	2.4%	10.3%	0.6%	**4.8%**	6.0%	1.2%	1.6%

Source: Nomura International PLC

Table 1.8 Estimated European Securitisation Pre Crisis Distribution of New Issues, and Post-Crisis Distribution in Secondary Market

	Pre-crisis	Post-crisis
	2004-07 (primary)	2008-present (secondary)
SIV/Conduit	16.0%	0.0%
Asset Manager	37.0%	51.4%
Bank	32.5%	24.5%
Hedge Fund	6.0%	9.6%
Insurance	4.8%	11.1%
Other	3.7%	3.4%

Source: Nomura International PLC