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Improving Macroeconomic Conditions Buoy Outlook For Australian Structured Finance In 2018

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Growth in issuance volume in Australia's structured finance market in 2018 is set to build on the strong performance of last year as economic activity continues to improve. S&P Global Ratings' credit outlook across securitized asset classes in Australia is stable, supported by improving employment conditions and low interest rates.

Economic headwinds--including high household indebtedness and low wage growth--will create debt serviceability pressures for some borrowers in a rising interest rate environment. However, we believe ratings and collateral performance across Australian structured finance securities will be relatively resilient given structural enhancements within transactions, strong collateral quality, and in the case of residential mortgage-backed securities (RMBS), the high seasoning profile of outstanding loan portfolios.

Overview

- Our credit outlook for Australia's structured finance market is stable, supported by improving employment conditions and low interest rates.
- A global search for yield has flowed through to increased demand for Australian RMBS from offshore investors.
- Our outlook for collateral performance in New Zealand is stable, supported by improving economic conditions.

Calendar 2017 was a record year for Australian structured finance issuance in the post-financial crisis era. After a relatively unremarkable first half, new issuance gathered pace in the second half, with RMBS issuance up more than double 2016 levels year on year. Issuance of asset-backed securities (ABS) was promising with repeat issuers coming to the market in addition to new asset types. Of note was the debut of the Latitude Australia Credit Card Loan Note Trust transactions, which attracted new investors with the use of a master trust structure catering to different liability profiles.

Global Search For Yield Sets The Stage For Further Growth

Across the globe, structured finance issuance came in at about $US930 billion in 2017, a 39% increase from 2016. Supporting this growth rate has been broad economic growth and market participants returning to utilize securitized products to diversify funding sources and play a larger role in financing the world economy.

A global search for yield, driven by major central banks' low interest-rate policies, has flowed through to increased demand for Australian RMBS from offshore investors, tightening spreads.

We expect new issuance levels in 2018 will be moderately up on 2017 (which, itself, was a very strong year). Key drivers of new issuance in 2018, in our opinion, include:

- The nonbank sector will continue to capitalize on lending opportunities created by a general tightening in lending conditions across the banking sector.

- Other ABS will continue to grow as investors seek to diversify away from RMBS and the adoption of master trust structures enables issuers to offer a greater diversity of liability profiles.
- Increased cross-border investment interest in autos, credit cards, and residential mortgages supported by flows out of European and Asia-Pacific markets to Australia, America, China, and some European products as the global search for yield continues.
- Regional banks may utilize securitization more than in prior years given the lowering of their financial ratings in 2017.
- As noted by the Reserve Bank of Australia, smaller banks may maintain a higher level of issuance of RMBS in the near term to boost their capital ratios, diversify funding sources, and take advantage of stronger demand for RMBS.

Economic Upturn Underpins Outlook

Macroeconomic conditions in Asia-Pacific have improved on the back of solid growth in China and Japan and a widespread upturn in the global economy (see "Asia-Pacific Credit Conditions November 2017: Better Prospects, Fatter Tail Risk," published on Nov. 29, 2017).

Australia's economy is also improving. Key macroeconomic themes that will influence performance of consumer loans including RMBS in 2018 include:

- Improving GDP growth. S&P Global Ratings' base-case scenario forecasts Australia's GDP growth to increase to 2.8% in 2018 from 2.4% in 2017. This is credit positive as the general health of an economy affects and influences households and corporates' debt repayment capacity.
- Continued improvement in employment conditions. Our base-case scenario forecasts unemployment to fall to 5.5% in 2018 from 5.7% in 2017. Underemployment, which reached a peak of 9.4% in February 2017, is also falling. Continued jobs growth should act as a buffer to the headwinds of moderating property prices, rising interest rates, and low wage growth.
- Rising interest rates. Wage and price pressures remain constrained across the region, so we expect central banks to begin to raise rates only gradually. Debt serviceability is a key risk for the Australian mortgage market given the country's high household debt and low wage growth. Our forecast of a gradual rise in interest rates supports our view of stable mortgage performance for the Australian residential mortgage market in 2018.
- Moderating property prices. Property prices appear to be moderating due in part to the regulatory speed limits imposed on investor and interest-only lending. The majority of loans underlying Australian RMBS are well seasoned and have modest loan-to-value (LTV) ratios. Provided employment conditions remain stable, we believe most Australian RMBS portfolios are reasonably well insulated from a moderate decline in property prices given the modest LTVs across most portfolios and structural enhancements available in most transactions.

Evolving trends in 2018 include:

- Transition from interest-only to amortizing loan profiles. Across Australian RMBS transactions, 50% of interest-only loans (which comprise around 22% of Australian RMBS portfolios), will reach their interest-only maturity date by 2019. Interest-only loans have a higher risk of repayment shock. The prudence of underwriting standards at loan origination is an important factor in mitigating this risk. Lending standards for interest-only loans were less stringent prior to 2015 than they are now following the Australian Securities and Investment Commission's (ASIC) review of this sector. Loans underwritten prior to 2015 may therefore be more susceptible to repayment shock.
- Resilience of borrowers to interest rate rises. A rise in interest rates will put pressure on some borrowers given the

high levels of consumer leverage in Australia. Loans with less favorable refinancing prospects, such as higher LTV ratios and interest-only loans, are more susceptible to these pressures. We expect that the majority of borrowers should be able to absorb a gradual rise in interest rates by adjusting their spending to stay on top of their mortgage repayments.

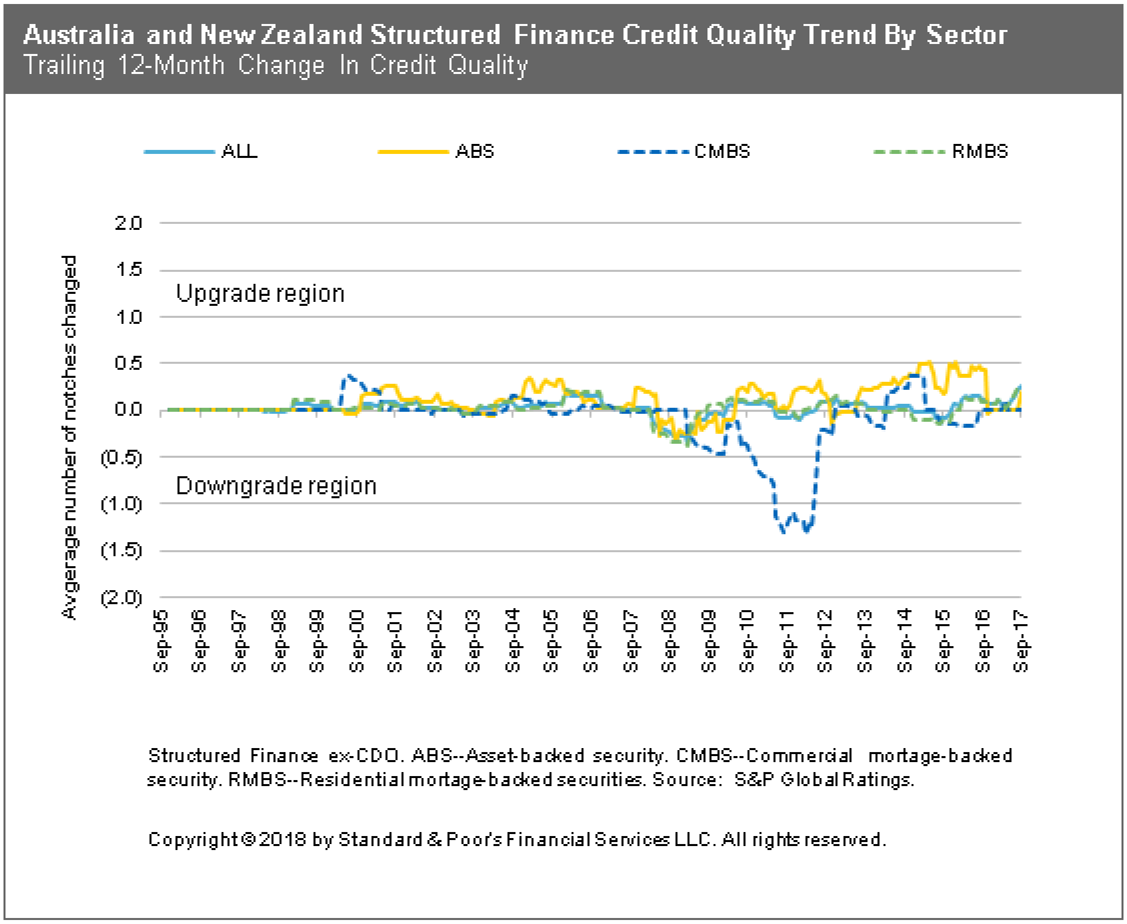
- Subdued consumption growth. Highly leveraged households are more likely to pull back on consumer spending in a climate of rising interest rates and prioritize mortgage repayments. With retail a large employer in the country and a significant contributor to GDP growth, any sharp cuts in household spending could have broader economic implications.
- Tail risk in small pools. Adverse selection and concentration risk remains a risk in RMBS transactions, particularly when the originator/servicer is no longer actively originating and when RMBS are less likely to be redeemed on their call dates. Subordinated tranches of RMBS transactions are more exposed to this risk, particularly those that have no hard credit support available and rely exclusively on lenders' mortgage insurance (LMI) and excess spread to cover losses. This risk has resulted in the lowering of ratings on several subordinated tranches of RMBS transactions in 2017.
- Increased scrutiny of debt serviceability standards. We expect the assessment of income and expenses to attract further regulatory scrutiny in 2018 against a backdrop of high household indebtedness and low wage growth.
- Growth in lending to nonresidents. Restrictions on lending to nonresidents in the banking sector have created lending opportunities in the nonbank sector. We have observed increased activity in this lending type although purchases of new properties by foreign buyers have eased over the past year. Lending to nonresidents presents unique risks as borrower default risk is influenced by macroeconomic conditions and sovereign risk across multiple jurisdictions. The exposure to nonresident borrowers across Australian RMBS transactions is around 1%.

Credit Performance Remained Solid In 2017

With macroeconomic conditions relatively benign and showing recent signs of improvement, the credit performance of structured finance securities that we rate in Australia and New Zealand (which comprises only a small portion of total lending) was relatively stable in 2017.

The 12-month-trailing average change in credit quality for Australia and New Zealand structured finance set a new record high of +0.26 in September 2017. This performance was mainly influenced by the solid performance of the RMBS sector, which also reached a record high in September 2017 of +0.27 (see chart 1). We define the average change in credit quality as the average number of rating notches by which ratings changed over a given timeframe. Positive movements denote upgrades.

Chart 1



RMBS ratings make up over 92% of total structured finance ratings in Australia and New Zealand. Over 60% of RMBS ratings are in the 'AAA' category. As such, their performance has a large bearing on the overall structured finance ratings performance in the region. The net upward movement of the RMBS sector in the past 12 months reflected the upgrades of several tranches of the subordinated and mezzanine classes of prime and nonconforming transactions due to the buildup of credit enhancement and strong collateral performance of underlying portfolios.

The ABS sector also recorded more upgrades than downgrades in 2017. Commercial mortgage-backed securities (CMBS) ratings performance was also stable after experiencing a small number of downgrades during 2010-2012. As the ratings universe of this sector is very small, the change in credit quality is magnified when measured on an average basis.

The performance of Australian and New Zealand structured finance ratings is partly constrained by the ratings on key counterparties, including lenders' mortgage insurers, who provide first loss cover in many loan portfolios. The decline in the use of LMI in recent years reduces this rating risk somewhat particularly for subordinated tranches, which have traditionally relied on LMI as their primary form of credit enhancement.

About 85% of structured finance transactions in Australia and New Zealand have a dependent relationship on the four major Australian banks. The four major banks are currently rated 'AA-/Negative/A-1+'. Under our "Counterparty Risk Framework Methodology And Assumptions" criteria, counterparties with long-term ratings of 'A+' can support 'AAA' ratings for a range of roles.

Despite Some Economic Headwinds, Performance Set To Remain Stable In 2018

Across asset classes, we expect collateral performance to remain stable supported by improving employment conditions and low interest rates. While we expect interest rates to rise in 2018, we expect these increases to be gradual and thus able to be absorbed by the majority of borrowers underlying Australian structured finance transactions given the high seasoning of many portfolios and demonstrated repayment history of many borrowers.

Loans in arrears across prime and nonconforming Australian RMBS transactions are below their decade long averages. Across prime portfolios, this decline has been most evident in the early arrears categories of 30-60 days and 60-90 days. By contrast, loans in arrears by more than 90 days have increased over the past decade to 0.63% in October 2017 from around 0.42% in October 2007. Over half of loans in arrears by more than 90 days are domiciled in the states of Western Australia and Queensland. As macroeconomic conditions in Queensland and Western Australia continue to improve, we expect fewer new loans to enter into arrears. However, the higher levels of arrears migration from the 60-90 to 90+ days arrears categories in these states will continue to pressure the more severe arrears category of 90+ days over the next 12 to 18 months.

Across nonconforming transactions, the decline in arrears more broadly over the last decade reflects the improved collateral quality of nonconforming transactions as loan pools are now more diverse with a mixture of near-prime, nonconforming, and traditional subprime mortgages.

Stable collateral performance and structural enhancements will underpin ratings stability in 2018, in our view. Continued buildup in credit enhancement to more senior tranches improves their resilience to any economic deterioration. This overall positive ratings bias will be offset, to some degree, by the increasing tail risk of small portfolios where the originator has exited the mortgage industry. For these transactions, we expect further ratings transitions.

Stable Economic Conditions Support New Zealand Collateral Performance

New Zealand structured finance new issuance in 2017 was moderately up on 2016 levels with The Co-Operative Bank RMBS Trust 2017-1 issued in July. Structured finance issuance in New Zealand comprises a small portion of total lending, however. The Reserve Bank of New Zealand (RBNZ), which acts as central bank and a regulator, is seeking to promote a deeper capital market by making available simple, comparable, and transparent mortgage bond instruments.

The RBNZ initiated a consultation process in November 2017 and is proposing an enhanced mortgage bond standard. The aim of this standard is to improve the quality and liquidity of collateral instruments through simple, transparent, and comparable mortgage bond standards. This standard adapts frameworks created internationally.

The RBNZ is currently seeking feedback on the terms under which it accepts mortgage bonds as collateral and the proposed new Residential Mortgage Obligations standard.

We see collateral performance across New Zealand structured finance consumer loan asset classes as stable, supported by improving economic conditions. Key macroeconomic themes that will influence the performance of consumer loans, including RMBS, in 2018 include:

- Improving GDP growth. Our base-case scenario forecasts New Zealand's GDP growth to increase to 2.9% in 2018 from 2.8% in 2017.
- Continued improvement in employment conditions. We forecast unemployment to fall to 4.7% in 2018 from 4.9% in 2017.
- Moderating House Prices. House price inflation has moderated in New Zealand. Over the past six months, pressures in the housing market have continued to moderate due to the tightening of LTV ratio restrictions in October 2016, a more general firming of bank lending standards, and an increase in mortgage interest rates in early 2017. The Reserve Bank of New Zealand is easing some of its LVR restrictions from January 2018 in light of this moderation.

Similar to Australia, household indebtedness is high in New Zealand. While risks stemming from rising house prices and household debt levels have stabilized in 2017, housing-related downside risks remain. The recent buildup of imbalances--credit growth relative to GDP and house prices relative to incomes--still have some way to unwind despite the recent slowdown.

Across the New Zealand RMBS sector, the level of arrears and losses is low. Given the high seasoning of this sector (56 months), most transactions have modest LTV ratios (the weighted average LTV is 56%, for example) which provide a reasonable degree of equity buffer to insulate against any declines in property prices. High seasoning levels also indicate that most borrowers have a demonstrated repayment history and should be able to absorb moderate increases in interest rates.

The key risk for New Zealand RMBS transactions rated by S&P Global Ratings is tail risk for smaller pools where the originator has gone out of business and transactions are unlikely to be called. We have lowered the ratings on notes issued by trusts where this is the case in recent years.