Commentary

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RESEARCH

The U.S. Leads The Global Securitization Rebound, But Interest Rate Hikes Could Threaten That Trend

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The global securitization market's rebound is continuing in terms of both issuance and credit performance. However, with a diverging economic picture globally and various regional regulatory developments, the progress in some markets is far outpacing that in others.

Buoyed by its strengthening economy and increasing regulatory clarity, the U.S. securitization market is clearly ahead of the pack, with growing issuance and generally stable asset performance in its asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), and collateralized loan obligation (CLO) sectors. And while the nonagency residential mortgage-backed securities (RMBS) market remains a fraction of its former self, with diversity and growth mostly coming from nontraditional transactions in recent years, the agency RMBS sector is thriving.

Still, accompanying the U.S.'s economic recovery are the risks of loosening underwriting standards, rising corporate leverage, and, as the Federal Reserve looks set to begin normalizing monetary policy, probable higher interest rates and elevated spread volatility this year.

Steady growth in investor-placed issuance in Europe's securitization market looks set to continue this year, but there are some downside risks, with economic growth still weak in most European countries. However, there appears to be increasing support for the asset class among some policymakers, as the European Central Bank's Asset-Backed Securities Purchase Program demonstrates. The longer-term prospects for European securitization issuance continue to hinge on how punitively new regulatory regimes for various investors--such as banks and insurers--will treat their securitization exposures.

Solid collateral performance in Asia-Pacific has underpinned stable rating trends across various asset classes, amid a generally healthy economic picture. Risks have risen in Latin America, however, due to deteriorating economic profiles, especially in Brazil.

Overview

- The U.S. is leading the global securitization market rebound, largely because of its growing economy, with its labor market in particular showing signs of strength.
- The Fed's normalization of monetary policy could create unintended consequences--among them increased volatility--through the global credit markets in 2015, but our base case scenario calls for limited effects on issuance and credit performance.
- Geopolitical risks continue to trump economic ones for the overall health of the global structured finance markets, while other risks include the possibility of the eurozone falling into recession and continued turbulence in China's financial system.
- While there's been greater clarity on the regulatory front in the past year, there are still questions about how new rules change the economics of issuing structured debt, particularly in U.S. nonagency RMBS, CLOs, and ABCP.
- Despite last year's record issuance and positive credit performance for CLOs, risk retention rules and a lack of equity demand could create some headwinds in the early part of this year.

The Global Economy, While Strengthening In Some Areas, Remains Unstable

The diverging paths in the global securitization market reflect the bright and dark sides of the world's economic performance. Standard & Poor's Ratings Services expects global GDP growth to strengthen this year, as higher growth in the U.S. (3.3% compared with 2.4% in 2014) and the eurozone (1% versus 0.8%) more than offsets slightly moderating growth in China (7.1% compared with 7.4%) and the U.K. (2.7% versus 3.1%) (see Tables 1 and 2). We attribute ongoing economic instability to several factors:

- Residual headwinds from the Great Recession.
- The hybrid economic architecture of the eurozone, which greatly restrains the policy flexibility of member states.
- Japan's bid to end secular deflation and lift its flagging real growth while repairing its finances.
- China's need to rebalance and reform its economic system while digesting a credit and investment overhang from its state-directed expansion after the 2008 crisis.

Table 1

Standard & Poor's U.S. Economic Outlook*					
	2012	**2013**	**2014e**	**2015f**	**2016f**
Real GDP growth (% change)	2.3	2.2	2.4	3.3	2.9
Unemployment rate (%)	8.1	7.4	6.2	5.5	5.3
CPI (% change)	2.1	1.5	1.7	1.0	2.1
10-year Treasury note yield (%)	1.8	2.4	2.5	2.5	3.3
Mortgage rate (30-year conventional, %)	3.7	4.0	4.2	4.1	5.1
Residential mortgage originations (Tril. $)	2.04	1.85	1.12	1.20	1.17
Consumer spending (% change)	1.8	2.4	2.5	3.3	2.9
Saving rate (%)	7.2	4.9	4.8	4.5	4.9
Unit sales of light vehicles (Mil.)	14.5	15.6	16.5	17.0	17.1
Equipment investment, 2005$ (% change)	6.8	4.6	6.5	6.4	6.6
Revolving credit (% change)	0.6	1.3	2.9		

*Forecasts are as of Jan. 22, 2015. e--Estimate. f--Forecast. Sources: Standard & Poor's and Mortgage Bankers Association.

Table 2

Standard & Poor's Global Real GDP Growth					
(%)	**2012**	**2013**	**2014e**	**2015e**	**2016f**
U.S.	2.3	2.2	2.4	3.3	2.9
eurozone	(0.6)	(0.4)	0.8	1.0	1.4
U.K.	0.7	1.7	3.1	2.7	2.5
Japan	1.5	1.5	0.5	1.3	2.1
China	7.7	7.7	7.4	7.1	6.7
Asia-Pacific	5.3	5.4	5.3	5.4	5.4
Latin America	2.9	2.5	0.7	2.1	2.4
World	3.2	3.1	3.2	3.6	3.8

*Forecasts are as of Jan. 22, 2015. e--Estimate. f--Forecast. Sources: Standard & Poor's and Mortgage Bankers Association.

The U.S. Is Balancing Recovery And Rising Interest Rates

We expect U.S. securitization credit conditions and sector fundamentals to remain mostly stable in 2015, though higher interest rates and elevated spread volatility are likely because of the Fed's anticipated rate hikes. However, we believe higher rates will have a limited negative credit impact on structured securities--as long as there are no spikes in borrowing costs. Moreover, we continue to believe that exogenous factors--including geopolitical risks--are the main sources of risk to structured finance credit stability next year.

The U.S. economy has been steadily recovering, with the labor market in particular showing signs of strength. Standard & Poor's expects the economy to continue to improve in 2015 and projects GDP growth of 3.3% this year after 2.4% for full-year 2014. We expect the unemployment rate to average about 5.5% in 2015 and 5.3% in 2016.

New regulations--including risk-retention rules and the Volcker rule--could reduce liquidity and discourage securitization because banks will be subject to stricter capital, liquidity, leverage, and disclosure requirements. In our view, this could create refinancing risk for some sectors in the long run.

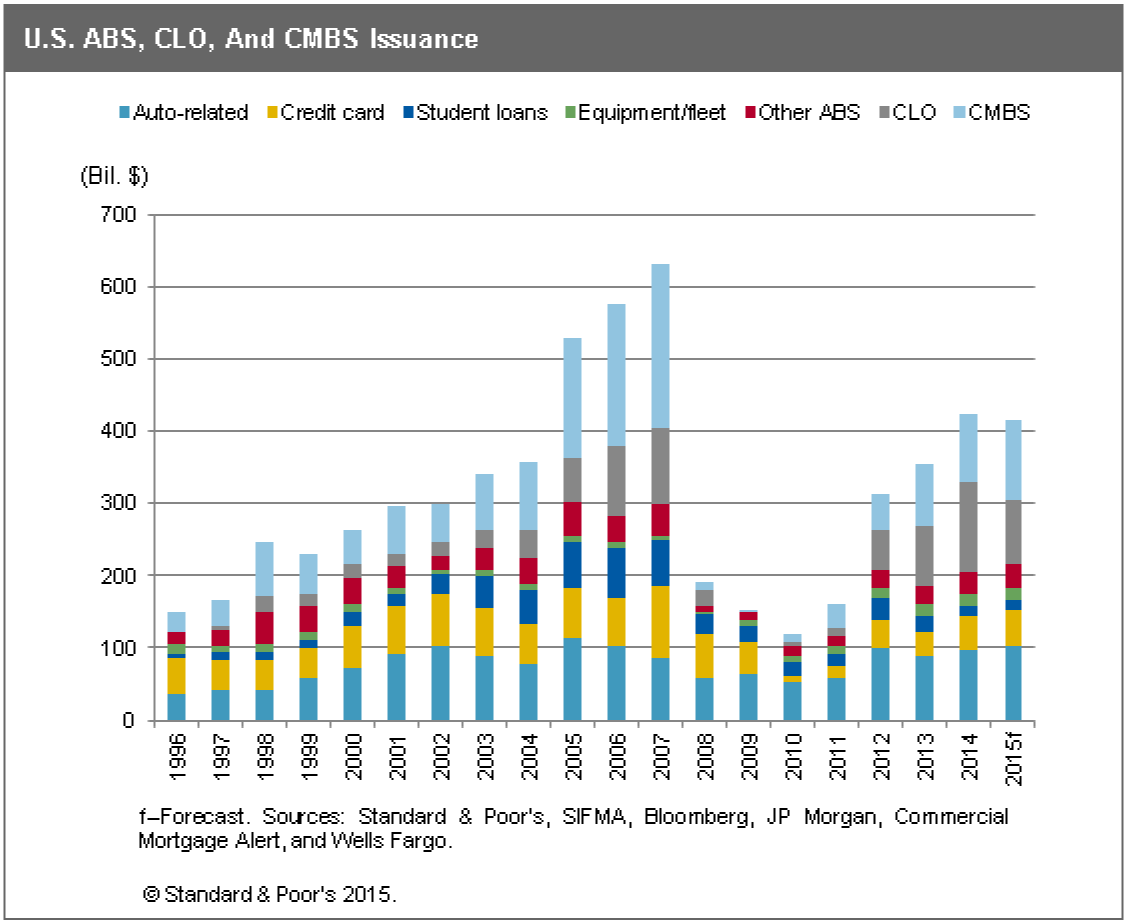
Still, the U.S. securitization markets have largely recovered, with ABS, CLO, and CMBS leading the pack. While nonagency RMBS struggles with lingering issues since the downturn, agency RMBS is showing solid issuance.

Rate hikes might not upset liquidity

In the second quarter, we expect the Fed to increase interest rates for the first time in recent years. Financial markets could be volatile during the Fed's well-telegraphed tightening of monetary policy, but our base-case assumption is that any rate hikes would likely be modest and gradual in an attempt not to disrupt market liquidity. Therefore, we expect historically attractive interest rates to prevail in 2015, with corporate debt issuance remaining elevated for at least the first six months of the year. From a rate-sensitivity perspective, under our baseline scenario, we expect corporates to be able to adjust their operational and financial policies to absorb a steady climb in interest rates. Still, low interest rates have been a major factor contributing to speculative-grade ('BB+' and lower) debt and stock valuations. The longer rates remain low, the higher the risk of overvaluation for these asset classes.

Small policy missteps and a market response similar to the "taper tantrums" that occurred when the central bank began to curb its asset purchases could lead to a less-optimistic outcome than our baseline projection, with credit spreads widening, issuance slowing, and asset performance deteriorating.

Chart 1



Consumer ABS

U.S. consumer fundamentals remain resilient in the aftermath of the recent financial downturn, as personal bankruptcies and defaults among consumers have fallen in the past several years. Declining crude oil prices could slow the U.S. shale boom, which has been a major growth factor for the economy since the Great Recession. However, our economists forecast that if gasoline prices fall further or remain at prevailing levels, the much-needed boost that would result for the consumer sector (which accounts for about 70% of the U.S. economy) would enhance consumer spending capacity and more than offset any negative ramifications associated with a soft oil market--especially as health care, food, education, and digital connectivity costs increase.

We still anticipate that the competitive landscape for consumer credit will evolve and affect ABS credit quality this year as lenders continue to ease underwriting standards from historically tight levels to grow their portfolios. We expect continued weakening of collateral credit quality and modest increases in delinquencies and losses in most ABS asset types.

We expect U.S. ABS issuance to reach $215 billion this year, from $206 billion in 2014. Auto-related ABS, which we expect to reach $102 billion in 2015, constitutes a significant share of overall ABS volume. Last year, auto-related ABS issuance was $96 billion, up from $88 billion in 2013 (see Chart 1).

Last year's credit card ABS issuance of $47 billion exceeded the $35 billion of securitization for all of 2013. Our 2015 credit card ABS issuance forecast is $50 billion, with the number of issuers increasing. We anticipate that volume will rise due to attractive funding costs, which motivate lenders to tap into securitization as a funding source.

We forecast student loan ABS issuance to slip to $15 billion this year from $16 billion in 2014. The breakdown between Federal Family Education Loan Program (FFELP)-backed deals and private student loan-backed deals was approximately 80%/20%. For this year, we are forecasting the split to be closer to 65%/35%. The private student loan ABS market remains a small portion--approximately 18%--of the total outstanding student loan ABS market.

Commercial ABS

The U.S. commercial ABS market is poised to be largely stable in 2015. We expect steady issuance and stable credit quality across each of the sector's three active segments: equipment loans and leases, fleet leases, and dealer floorplan loans. Our volume expectations reflect the continued entrance of issuers into the sector and the increased frequency of transactions from some relatively new issuers, offset somewhat by the growing availability of competing funding sources. Our stable credit outlook reflects continued record-low loss levels and the ongoing recovery of the U.S. economy, with scant chance of recession.

Commercial ABS issuance totaled $27 billion last year, in line with our projection. We expect issuance to increase to $28 billion this year. We also expect the segment mix to remain similar to that of 2014, with dealer floorplan accounting for the most issuance, followed by captive equipment.

On the nontraditional securitization front, issuance reached $26 billion in 2014, the same level as the previous year. The total includes $6.3 billion of aircraft-related ABS, $2.8 billion of timeshare, $3.2 billion of container, $2.3 billion of small-business securitizations, $1.7 billion of wireless spectrum, and $1 billion of railcar deals. Other smaller categories are stranded costs ($843 million), tobacco ($509 million), structured settlements ($666 million), and various deals including insurance premiums, merchant cash advances, royalties, commodities, and franchise securitization. We expect continued sector diversity in transactions, with steady issuance this year.

CMBS

Collateral performance in CMBS continued to improve in 2014, and property fundamentals have been strengthening modestly. As competition among U.S. CMBS loan originators heated up in the past year, underwriting standards have deteriorated, debt yields have decreased, and deals are being secured by a higher percentage of hotels, which can pose unique risks.

Meanwhile, the latest data indicate improved liquidity in recent years. Liquidity capacity is generally a risk factor in CMBS transactions. Rising rates aren't likely to hurt property prices or affect the refinancing of maturities in a growing economy, in our view.

The retail sector continues to struggle because of cautious consumer spending and increasing pressure from e-commerce sales. Online shopping continues to threaten the brick-and-mortar segment, but retailers' focus on their online platforms has kept supply in stores to a minimum. The industrial sector has benefited from online shopping as demand for distribution facilities increases.

We forecast $110 billion of U.S. CMBS issuance in 2015, up from $94 billion in 2014, driven by refinancing of maturing debt and strong fundamentals.

Nonagency RMBS

A revival in the U.S. nonagency RMBS market hasn't followed robust recoveries in the broader economy, employment, and housing. RMBS not guaranteed by one of the government-sponsored enterprises (GSEs), such as Fannie Mae or Freddie Mac, hit a high of $1.2 trillion in 2006. However, we expect that figure--which includes non-prime, seasoned, and distressed issuance--to be just $25 billion this year. Clearly, even with the ongoing recoveries in the overall economy and housing market, nonagency U.S. RMBS issuance remains negligible in a $10 trillion housing finance market.

We believe the slow pace of nonagency securitization reflects a market still grappling with the changing economics of complying with new regulations, a lack of standardization in nonagency securitization provisions, anticipated rate hikes, and thin investor confidence in new nonagency RMBS. Much clarity has emerged regarding those new regulations, but several factors continue to limit nonagency RMBS issuance.

Still, new prime-jumbo U.S. RMBS issuance has slowly ticked up in recent years, increasing to about $13 billion in 2013 from a low of $3 billion in 2011 and $6 billion in 2012. The issuance of high-quality new originations has benefited from rising economic confidence and housing market gains further bolstering collateral performance.

CLOs

U.S. CLO issuance has exceeded all expectations and reached a record of about $124 billion in 2014, up from $83 billion in 2013, but we forecast a decline to $90 billion this year due in part to the additional costs for CLO issuers to comply with the Fed's risk-retention rules.

Strong credit performance and elevated liability spreads have made CLO investments an attractive option relative to other asset classes, while the continued benign credit environment and low forecast for corporate defaults have added confidence in expected CLO performance. However, there are headwinds, notably in the form of impending regulatory issues and the uncertainty around them, in particular the Volcker rule and risk retention. In addition, the trends of higher corporate leverage and more aggressive lending in credit markets could affect credit performance at the obligor or loan level if the markets turn.

Several factors and trends could weaken credit performance, transaction volume, and market pricing as well as increase speculative-grade market volatility this year. These include the potential for rising interest rates, increasing leverage multiples, weaker creditor protections, and a likely decline in CLO new-issuance volume.

Falling oil prices and the Fed's start of monetary policy normalization have already led to a significant sell-off in speculative-grade bonds and an accompanying drop in prices. The sell-off has recently spread beyond the energy sector, and investor returns are likely to experience further volatility in 2015.

We believe that a prolonged downturn in prices could result in lower profitability, impeding U.S. oil and gas companies' cash flows and liquidity. That said, U.S. CLOs' exposure to this sector's debt is relatively muted, so we don't expect the plummeting oil prices to have a detrimental effect on CLO credits.

U.S. ABCP

The U.S. asset-backed commercial paper (ABCP) market will likely face another challenging year in 2015 as conduits address finalized regulations and continue to cope with sustained low interest rates. We believe the market is likely to decline modestly--to $200 billion-$220 billion--by the end of 2015 from the $225.5 billion as of Dec. 10, 2014.

Based on our conversations with market participants, we believe the wind-down of existing transactions will equal or possibly exceed new originations, despite some conduit sponsors signaling their intention to increase their commitments in the coming year amid strong investor demand. In addition, the slow pace of economic recovery, combined with complex ongoing and recently approved regulations (Basel III and Money Market Reforms, in addition to the Volcker Rule and risk-retention rules) could lead to declines in ABCP outstanding. Furthermore, as conduit sponsors assess many of the regulations and the related compliance costs, they could focus on restructuring their conduits to become compliant rather than expanding their portfolios.

Canadian Covered Bond Issuance Continues To Overshadow Securitization

Issuance of Canadian ABS, RMBS, and CMBS last year slipped to C$6.6 billion from C$11.6 billion in 2013. The drop stemmed from significantly lower credit card ABS volumes resulting from a lack of maturities to be refinanced. Credit card ABS accounted for C$2.4 billion of the total, followed by C$1.7 billion auto ABS, C$1.4 billion RMBS, and C$1.1 billion CMBS. In addition, there were C$27.6 billion covered bonds issued by Canadian banks in 2014, more than double the C$13.3 billion issued in all of 2013.

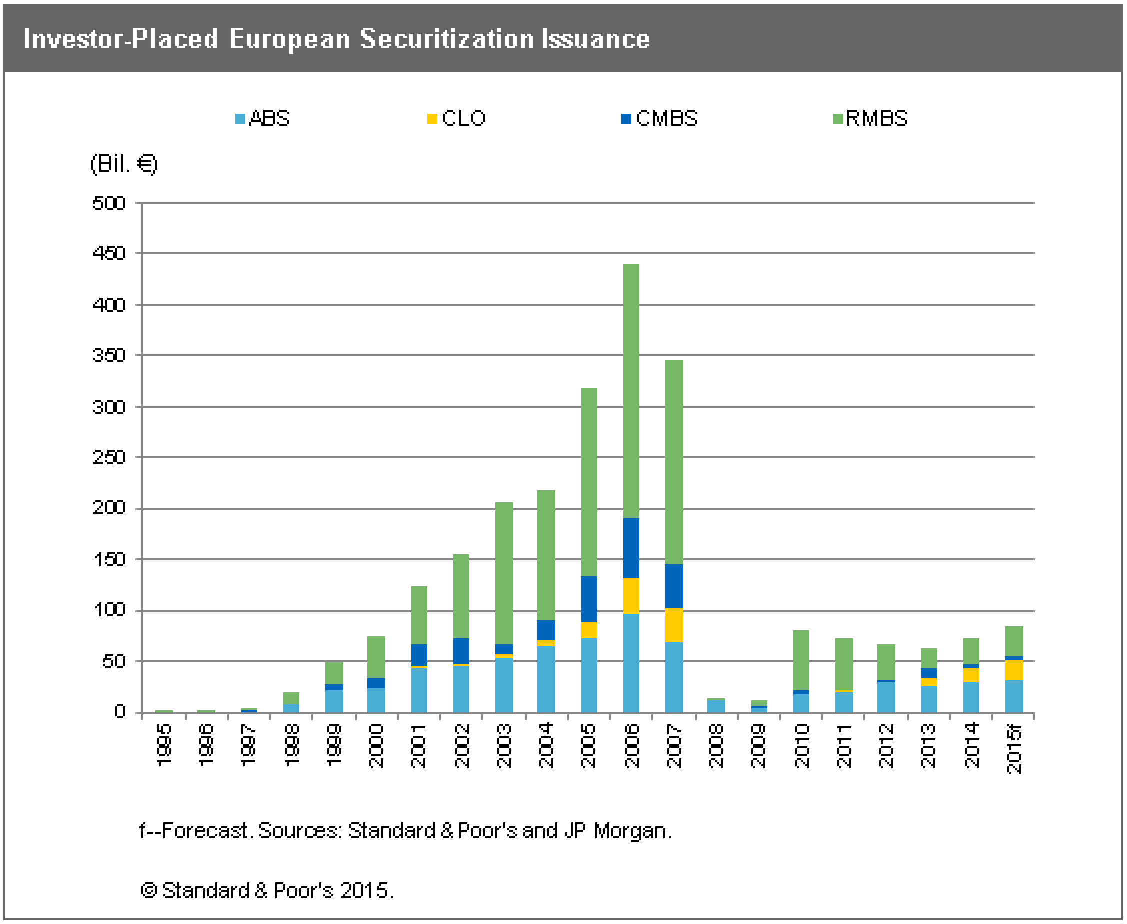
Europe's Structured Finance Markets Reflect Economic Trends

We generally expect securitization collateral pools to reflect renewed economic weakness in the eurozone. For example, average total delinquencies in asset pools underlying Italian RMBS that we rate are trending higher--in line with the ongoing rise in the unemployment rate--and recently reached about 4%, exceeding the previous peak in 2009. By contrast, in the prime U.K. RMBS sector, the average total delinquency rate recently reached a five-year low and will likely continue to decrease with the country's declining unemployment rate.

However, in the short term, we don't expect changes in collateral credit performance to be a significant determinant of ratings actions in most sectors. Rather, we anticipate some downgrades in the coming months due to the application of updated methodologies affecting certain sectors. For example, on Sept. 18, 2014, we published "RMBS: Italy And Spain RMBS Methodology And Assumptions" and "Methodology And Assumptions For Ratings Above The Sovereign--Single-Jurisdiction Structured Finance." As a result of these changes, we expect downgrades--of one to three notches, in most cases--for a number of Spanish and Italian securitizations and covered bonds. We also expect some upgrades and downgrades in Portuguese transactions.

Investor-placed issuance volumes for European securitizations were up about 15% year-on-year in 2014, to €73 billon--the first annual increase in volume since 2011. The strongest growth was in the leveraged loan CLO sector, which was up about 70%, but ABS and RMBS volumes also each grew about 25%. New issuance was also marked by increasing diversity of underlying collateral, with a marked return of investor-placed issuance backed by U.K., Spanish, and Italian collateral (see Chart 2).

Chart 2



Looking ahead, near-term issuance prospects might have benefited from tangible policy support for structured finance in the form of new central bank purchase programs. In October, the Eurosystem of central banks began executing the ECB's third Covered Bond Purchase Program (CBPP3), announced in early September as part of a package of "unconventional measures" to help meet its monetary policy objectives. An additional plan to purchase a broad portfolio of simple and transparent securitizations also got underway in late November.

According to ECB data, eurozone central banks purchased about €500 million-€600 million of covered bonds per day in the first few months of the plan--a substantially faster rate than under the ECB's two previous programs, launched in 2009 and 2011. New issuance of eligible covered bonds rose following the start of the program, and covered bond spreads have tightened markedly. Similarly, the announcement of the Asset-Backed Securities Purchase Program (ABSPP) has led to some tightening in securitization spreads, especially on transactions backed by collateral from the so-called peripheral eurozone countries, though the volume of ECB purchases under the ABSPP has been muted so far.

Tighter spreads could marginally increase the relative attractiveness of securitizations and covered bonds as funding tools for issuers. However, it remains unclear whether the ABSPP will significantly improve originators' ability to economically sell mezzanine and junior securitization positions. This could also reinstate securitization as a risk-transfer tool, helping bank originators achieve capital relief and deleverage, or otherwise free up new lending capacity. That said, we expect that investor-placed European securitization issuance could grow again this year, perhaps reaching €85 billion.

In the longer term, ongoing developments in regulatory regimes applicable to various types of structured finance investors will likely be the greatest driver of issuance. These now look set to depend on the outcome of various projects at the regional and global levels to define what constitutes "simple, standard, and transparent" securitization structures, which could justify less-punitive regulatory treatment.

The Asia-Pacific Securitization Market Stays On Course

The uptick in the issuance of Asian securitization for the larger asset classes of RMBS and ABS continued last year, a trend we expect to prevail in 2015. New issuance for Asian securitization will likely increase moderately, reflecting the different dynamics faced by the major securitization markets in the region and the resultant effect to credit growth. The collateral performance of loans underlying RMBS and ABS is strong, providing headroom for ratings to withstand any potential downturn in economic conditions.

For Australian RMBS, new issuance last year exceeded A$26 billion, continuing the strength in 2013. Deals came from a range of issuers. The margins on both senior and subordinated notes contracted further, reflecting the continued confidence from domestic and offshore investors. Offshore investors also expressed interest in ABS, which is constrained by the limited supply from a few issuers. We don't expect issuance to increase materially this year because of more subdued credit growth and the diverse range of funding options available to financial institutions, including deposits.

For Australia, 2015 will bring the implementation of loan-level data reporting required by the Reserve Bank of Australia and the implementation of Standard & Poor's revised methodology with respect to lender mortgage insurance as a form of credit enhancement in RMBS. We also expect further developments in respect of Australian Securitization Prudential Standard (APS) 120 and the recent Financial-System Inquiry. These changes will set the future standards of Australia's securitization market and reduce uncertainties.

Total rated new issuance in Japan's securitization market declined in 2014. In the RMBS segment, while private-sector deals grew slightly, issuance by Japan Housing Finance Agency (JHF) declined by about 20% following the termination of government-mandated lower interest rates. We expect issuance in Japanese RMBS to be more subdued this year because of slow building starts and mortgage loan originations, which is partly due to the effect of an increase in the consumption tax in April 2014. The issuance volume of ABS and CMBS has been very limited in recent years and is likely to remain so.

In South Korea, new securitization issuance during the first three quarters of 2014 amounted to approximately 25,185 billion Korean won, more than 30% lower than the same period in 2013 due to much-reduced issuance from Korea Housing Finance Corp. (KHFC), which included both domestic and cross-border issuance. The restrictions imposed on credit-specialized financial companies, the volatile cross-currency swap market, and the better liquidity and lower interest rate in the domestic market continue to have an impact on cross-border issuance, and the market only saw transactions for refinancing needs. Ongoing issuance for this market will come from traditional asset classes, such as credit card receivables and auto loans, with relatively short maturities. Residential mortgage securitization will likely dominate Korea's domestic market issuance.

China's securitization market grew quickly in 2014, with the full-year issuance exceeding 210 billion Chinese renminbi in the credit assets securitization program, more than twice the aggregate issuance amount from 2005 to 2013. The need for balance-sheet management and the desire to find alternative funding channels pushed up issuance. CLO dominated issuance in 2014, followed by auto loan ABS, RMBS, and micro-loan securitization. We expect the market to develop further in volume and asset variety as Chinese regulators continue their deregulation of securitization. Aside from CLOs, auto loan ABS and RMBS could grow this year.

Apart from Australia, the development of covered bond markets in Asia has been slow despite the release of final covered bond legislation in Korea and Singapore. We expect that some issuers have sufficiently prepared to tap the market if the opportunity emerges.

Rising Risks For Latin America

The performance of our Mexican securitization portfolio continues to be stable amid the slowly improving economy. Nevertheless, we expect to see continued deterioration in nonbank RMBS portfolios, while most transactions related to Infonavit and Fovissste (the government-owned mortgage lenders) and banks will continue to perform strongly. Commercial finance--including leases from ABS--continues to perform stably for the most part, and credit growth is solid. Risks could come from Mexico's new regulation regarding asset transfers, which could interrupt the flow of credit to securitized assets, particularly in revolving structures.

We continue to expect performance to weaken among the Brazilian commercial asset portfolios, especially those that exhibit high credit concentrations or exposure to rapidly growing portfolios. In addition, we believe that continuing weakness in the small- to medium-size enterprise sector could take a toll on the consumers' disposable income through higher unemployment. However, we don't expect significant deterioration in our rated portfolio because exposure to ABS transactions has shrunk in recent years.

Eroding real wages and rising unemployment in Argentina are increasing delinquency levels among credit card and personal loan transactions. At the same time, inflation is undermining trade receivable securitizations, as higher rejection rates on underlying deferred checks demonstrate. In both cases, the short-term nature of Argentine consumer ABS and diversification of asset pools backing Argentine trade receivables transactions are expected to mitigate performance deterioration.

Will Global Securitization Make A Full Comeback?

We believe it's unlikely the global structured finance market will count its annual issuance in the trillions of dollars--as it did a decade ago, before the downturn--anytime soon. Still, it has grown significantly from a small base in those dark years of 2009 and 2010, with global regulators and investors acknowledging its contribution to the funding diversity and liquidity positions of banks and other originators, along with improving the efficient allocation of resources to foster global economic growth.