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Strong Regional Economies Support A Stable 2012 Outlook For Asia-Pacific Structured Finance

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Strong Regional Economies Support A Stable 2012 Outlook For Asia-Pacific Structured Finance

Despite the economic turbulence abroad, Asia-Pacific's structured finance market enjoyed solid rating performance in 2011, with the exception of some weakness in Japanese commercial real estate. We expect this strength to continue into 2012, with support from modest macroeconomic growth forecasts, low regional unemployment rates, and easing monetary policy, along with the well-seasoned asset portfolios underlying many transactions.

In the residential mortgage-backed securities (RMBS) and asset–backed securities (ABS) segments, stable asset performance, paired with the continued buildup of credit enhancement as the underlying asset pools pay down, will support rating stability in 2012. Japanese commercial mortgage-backed securities (CMBS), on the other hand, will likely continue to underperform in 2012 due to the ongoing refinancing difficulties that commercial real estate borrowers in Japan (and elsewhere in the world) are facing.

Moreover, many securitizations in Asia-Pacific contain interest rate or currency exposures to U.S. and European financial institutions, which could pose a risk to their rating stability. As such, Standard & Poor's Ratings Services believes that while the sector will remain largely stable in 2012, global sovereign and banking credit performance--and issuers' responses should we downgrade key transaction counterparties--could influence credit quality.

Overview

- Asia-Pacific structured finance ratings should remain stable overall in 2012, with some continued weakness among Japanese CMBS transactions.
- RMBS and ABS issuance will likely remain steady, while CMBS maturities will continue to outpace new issuance.
- Issuance of covered bonds may continue to grow as they attract more interest from risk-averse investors.

Recent criteria updates may also have modest rating impact in 2012. The application of our revised counterparty criteria, published in December 2010 and expanded in June 2011, as well as the Australian RMBS criteria update in September 2011, could affect our ratings on a handful of transactions.

The sector's overall performance in 2011 was in line with our expectations for continued stability in most asset classes and weaker performance for Japanese commercial real-estate related transactions. This is despite the impact of global economic uncertainty and localized catastrophes during the year, including the earthquake and tsunami in Japan, floods in Australia, and the earthquake in New Zealand. Delinquency and default rates in Asia-Pacific have largely remained low and tracked historical norms for most asset classes. And although delinquencies spiked in certain pockets following natural disasters and other events, they tended to quickly return to normal. Regional banks and corporate entities have also generally performed well over the past three years as local economies improved.

Asia-Pacific Won't Stay Immune To Europe's Debt Woes

Global risks steadily increased over the course of 2011, and forecasts for macroeconomic growth have dropped in turn. Brittle market confidence is straining liquidity and funding for sovereigns and banking systems, particularly in the European Economic and Monetary Union (EMU or eurozone), with a knock-on effect on the rest of the world.

Economic growth fundamentals and government fiscal positions in Asia-Pacific are generally sound. But given that Europe is an important trading partner, the Asia-Pacific region cannot remain immune to the problems in the advanced Western economies. Export growth is likely to weaken in early 2012, although the region should remain cost-competitive, notwithstanding pressures such as wage growth in some markets. Domestic demand and intraregional trade is holding up, and inflation is easing given the drop in commodity prices and a less-stable world economic outlook. As a consequence, we expect monetary tightening to reverse, as it has already done in some markets, such as Australia.

Performance Will Remain Sound, But New Issuance Is Hard To Predict

Stable credit conditions across most sectors in Asia-Pacific will likely support solid asset performance in 2012. The amount of new issuance, however, is tougher to predict. The European debt crisis truncated demand and widened the margins for structured finance issues in Asia-Pacific, particularly in the later part of 2011. Instability in the eurozone could continue to contribute to tighter funding, persistent risk aversion and flight to quality, volatile capital flows, or a credit freeze in 2012.

The degree to which the global economy and international markets stabilize will be the key determinant of new issuance. While issuers were keen to bring new transactions to the market in 2011, investor confidence and demand seemed to be wavering in the face of global economic weakness and ongoing regulatory uncertainties in the sector.

RMBS And ABS Dominate, But Covered Bonds Are Looking Better

Covered bonds are gaining more notice

Covered bonds (obligations of banks that also benefit from recourse to a pool of collateral assets) will continue to attract attention as banks across the region seek to diversify their funding sources and offset a potential dip in demand for unsecured funding if global markets remain volatile. Participants from Australia, Japan, Korea, and New Zealand issued covered bonds in 2011--many for the first time. The diversity of underlying asset pools, issuer types, and legal and regulatory considerations in Asia-Pacific has given rise to a variety of new transaction structures. Australia is the only jurisdiction in the region that has enacted specific enabling legislation for covered bonds. This was necessary to overcome specific provisions in Australia's Banking Act precluding the issuance of obligations ranking higher in priority to depositors.

While some participants are evaluating the potential of aggregation structures (instruments that pool assets from several issuers within a covered bond program), such issuances seem unlikely in the next 12 months given the weak investor sentiment and overcollateralization requirements.

ABS issuance should be steady

We expect ABS issuances to remain stable in 2012. Investors appear to prefer the often shorter weighted-average lives of consumer ABS in Asia-Pacific to the longer terms for RMBS. Many also invest in ABS to diversify from traditional RMBS and senior unsecured bank debt. Most ABS asset classes in Asia-Pacific turned in strong performance in 2011. Stable employment and strong regional economies, along with the sequential payment structures on the majority of these transactions, all supported performance, which we expect to remain strong in 2012.

While delinquencies and defaults in some sectors rose temporarily due to earthquakes and other natural disasters, they have since moderated and remain within our expectations. Credit support--as a percentage of the outstanding pool balance--has increased overall for ABS in the region, reflecting the greater aging of the outstanding portfolios. This should help buttress ratings going forward, even if underlying asset performance were to deteriorate modestly.

RMBS issuance will likely stay strong in Japan and keep ticking up in Australia

Australia and Japan remain the dominant RMBS markets in Asia-Pacific. We expect the modest recovery in Australian new-issue RMBS to continue in 2012. Australia's Office of Financial Management (AOFM) continues to support RMBS under its A$20 billion investment program, which is part of the government's push to keep the nation's non-major-bank mortgage market afloat. The proportion of new issuances with subscriptions from real-money investors has grown significantly since the AOFM began providing support in September 2009, to more than 50% of new issuance, on average. But investors still show a strong preference for issuances from regulated financial institutions.

We expect Japan Housing Finance agency (JHF) issuances to remain strong in 2012. Issuance may, however, dip later in the year when the termination of Japan's favorable interest reduction program goes into effect in 2012, which could reduce demand and curb originations. Currently, the JHF is issuing extraordinarily large volumes of RMBS, and the thin issuance margins show that investor demand is strong.

Overall, we expect underlying asset quality and ratings performance for RMBS to remain sound. High home prices and affordability in Australia remain an issue; however, the high prepayment rates of the underlying mortgages, coupled with sequential-pay structures, help mitigate these concerns, as does issuers' tendency in recent years to provide additional credit enhancement to reduce the reliance on lenders' mortgage insurance to credit enhance the senior-ranking notes.

In Japan, while performance overall has been stable, a small proportion of buy-to-let RMBS and specific vintages of JHF RMBS have performed poorly compared with our initial expectations, which resulted in some downgrades in 2011.

Refinancing risks remain for CMBS

CMBS maturities in Asia-Pacific will significantly outpace new issuance in 2012, as they did in 2011, which will continue to reduce outstanding CMBS balances. While the CMBS market in the U.S. has revived somewhat, we don't expect demand for this asset class to pick up again in Asia anytime soon.

Balloon refinancing (of a lump sum at a loan's maturity), rather than the quality of underlying cash flows, has presented the biggest challenge for CMBS in Asia-Pacific because of declines in the value of commercial property. However, this re-pricing process has now worked its way through in most areas, so credit conditions for commercial property borrowers have improved somewhat. The liquidity of commercial real estate has also improved. However, highly leveraged assets financed when commercial real estate prices were at their peak will be tougher to refinance, and this could impact the credit performance of the related CMBS transactions.

Nevertheless, we expect CMBS ratings in Asia-Pacific to be less volatile in 2012. Large-scale use of highly leveraged financing in CMBS was limited to Japan, and the refinancing peak for Japanese CMBS loans has already passed.

Structured credit continues to languish

There has been virtually no new synthetic collateralized debt obligation (CDO) issuance in Asia-Pacific since 2008, and we don't expect this to change in 2012. Synthetic corporate CDOs of global reference names have historically dominated structured credit activity in the region, with some modest issuance of repackaged corporate or structured finance securities.

We expect CDO ratings to be largely stable in 2012, although economic developments in the U.S. and Europe could spur some rating actions. Ratings stabilized in 2011 in step with firming of credit conditions and corporate credit quality. But we believe global financial market volatility, particularly in the eurozone, could negatively impact ratings on outstanding synthetic CDOs if it causes the credit quality of referenced entities to deteriorate in 2012.

2012 Outlook Generally Stable But Clouded By Global Uncertainty

We expect underlying collateral performance on outstanding Asia-Pacific structured finance transactions to be largely stable in 2012. Ratings on transactions with counterparty exposures to institutions, located in the eurozone or the U.S. in particular, could be impacted should macroeconomic conditions worsen in those regions.

Securitization issuance made tentative steps toward recovery in 2011, and will likely return to being an important funding source for issuers in the future. The immediate outlook for issuance in 2012 is, however, difficult to predict. In the absence of market shocks, we expect issuance to continue to recover slowly in 2012. However, a softer U.S. economic outlook, the uncertainty surrounding European sovereign risk, and heightened market volatility continue to weigh on investors' risk tolerance and demand for structured finance securities in the short term.