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Global structured finance outlook for 2007

Fitch Ratings

This chapter considers the 2007 ratings and asset performance outlook for global structured finance on a sector-by-sector basis.

United States

Housing markets and the consumer were dominant themes in 2006 and look set to continue to be a focus of attention in structured finance in both the United States and Europe going into 2007. The US housing correction is fully underway as evidenced by the sizeable declines in housing starts and building permits issued and the lowest rate of annualised house price growth since the fourth quarter of 1999 (as reported by the Freddie Mac Conventional Home Price Index). The primary uncertainty surrounding the US economy for 2007 is the severity of the impact that the housing slowdown will have on the consumer. Consumer spending has been voracious due to unprecedented levels of house-price appreciation, which borrowers have cashed out to finance their expenditures. In particular, house-price growth has provided borrowers of affordability products (eg, hybrid and interest-only adjustable rate mortgages) with ample refinancing opportunities to avoid a rate reset and the accompanying payment increase.

Performance of US residential mortgage and non-mortgage asset-backed securities to date has been strong relative to historical performance. However, delinquencies and losses in both areas have begun to trend upwards and are expected to rise further as 2007 progresses. Although this is directly attributable to slower house price growth and a higher interest rate environment, the deterioration is also due to a noticeable shift towards more risky collateral attributes. However, prime credit-card and auto transactions are expected to demonstrate immunity to negative rating actions well into 2007, despite the housing challenges. In fact, it is likely that there will be more positive than negative rating actions in these sectors. Excessive competition in the credit-card lending arena or the failure of a major car manufacturer could spoil this fairly rosy outlook.

The potential impact of the housing correction will be more acute in the US sub-prime mortgage and credit-card sectors due to the slower rate of house-price growth, increased debt levels and upward rate adjustments facing borrowers in 2007. The degree to which US sub-prime hybrid adjustable rate and interest-only borrowers manage a rate reset has historically been sensitive to the rate of house-price growth. Earlier vintages of these products have demonstrated minimal sensitivity since low interest rates and high homeowner equity allowed even the most highly leveraged borrowers to refinance prior to the rate adjustment.

In environments of slow house price growth, fewer refinancing options are available, which is also likely to be the case in 2007. As a result, US sub-prime mortgage transactions are expected to be subject to further negative ratings pressure, which began to be reflected in the rating activity as early as the second quarter of 2006. Rating volatility in the sub-prime credit-card sector is expected to be minimal due to the relatively healthy levels of three-month excess spread available to cover the expected rise in charge-offs.

The US commercial finance sector has been supported by strong corporate profits, new job creation and growth in real private fixed investment. Although concerns about falling house prices and inflation have threatened to derail residential home construction and to spill over into the corporate sector, business spending patterns are expected to be at healthy levels. Risks in this scenario include ongoing inflationary pressures or a worse than expected housing slump, which would be likely to affect consumer spending and may indirectly restrain investment down the road. Although the equipment lease sector is expected to display continued strength, asset and ratings performance for certain commercial sectors, including the aircraft finance, franchise loan, small business and car-related dealer floorplan sectors, are likely to remain under pressure due to industry-specific factors and vulnerability to external shocks.

The US commercial mortgage-backed securities 2006 vintage is expected to be more sensitive to future economic downturns due to:

- the higher concentration of more volatile property types (eg, hotels);
- the higher concentration of interest-only loans; and
- the more competitive underwriting practices than other commercial mortgage-backed securities vintages.

Vintage 2006 has the highest share of hotel properties on record for commercial mortgage-backed securities - 16.3 per cent up to the third quarter of the year. For the first time, in the first nine months of 2006 the share of hotel properties exceeded the share of multi-family properties. The higher concentration of interest-only loans, combined with competitive underwriting practices, will also contribute to the higher volatility.

Europe

Continental European consumer assets, particularly in the credit card sector, are generally expected to show continued stability, but this is in contrast to the United Kingdom, where borrowers are typically more leveraged. Both UK consumer asset-backed securities and sub-prime residential mortgage-backed securities are areas to watch for declining asset performance in 2007. UK consumer asset-backed securities face pressure on disposable incomes from higher energy prices, interest rates and council taxes. In addition, sub-prime residential mortgage-backed securities face increased possession rates and competitive forces. The rising use of individual voluntary arrangements and bankruptcy by UK borrowers under financial strain is yet another factor to watch in 2007.

In general, European corporate and infrastructure asset-backed securities ratings have stable outlooks for 2007, as does asset performance, with the perennial exception of aircraft finance. European commercial mortgage-backed securities are showing stability across the board, but as in recent years, credit-linked single borrower deals are more exposed to downgrades.

Collateralised debt obligations

The outlook for global collateralised debt obligations predictably depends on underlying asset classes in many cases. For 2007 the areas to watch are:

- collateralised debt obligations with exposure to certain asset-backed securities and residential mortgage-backed securities assets; and
- the US car industry.

In total, six sub-categories have a declining asset performance outlook, but only two of these are associated with a negative rating outlook: investment grade corporate collateralised debt obligations and US late vintage structured finance collateralised debt obligations. Balancing these are two sub-categories with improving asset performance and positive rating outlooks: US commercial real estate collateralised debt obligations and US trust-preferred collateralised debt obligations.

Increasing leveraged buy-out activity, innovative products and potentially volatile recoveries could also have some impact in 2007.

Asia-Pacific

Asia-Pacific has a generally stable rating outlook for 2007. Australia is expected to continue the trend of increasing delinquency rates in residential mortgage-backed securities, albeit from a low base allowing a stable rating outlook. Consumer credit default rates in Japan have risen but existing deals are expected to be resilient due to conservative structures. Residential mortgage-backed securities remain the largest structured finance sector in Japan and the sector has a stable outlook for 2007. Non-Japanese Asia structured finance has both stable asset performance and rating outlooks for 2007. Again, as in 2006, Singapore real estate and refinancing activities by Korean consumer finance and credit card issuers will be key areas. Taiwan is expected to re-emerge in 2007 as an important market, having suffered from credit deterioration in the consumer sector in 2006. The collateralised debt obligation market is also expected to show continued and significant growth with widespread interest in innovative products.

Emerging markets

Emerging markets in Latin America and particularly in Europe, the Middle East and Africa are expected to show growth in 2007, with existing deals continuing to perform within expectations. Improved sovereign ratings in Latin America provide a stable environment for structured finance and high global liquidity makes low or speculative-grade rated assets viable. Development of rated structured finance markets in some European, Middle Eastern and African countries is held back by legal issues and limited historical data. However, more asset classes are expected to emerge in more countries during 2007. Growth across the Commonwealth of Independent States has been particularly intense. Legal issues remain a challenge in that region, but not one that is necessarily holding back market growth.

Distressed recovery ratings

During April 2006 Fitch introduced the concept of recovery ratings given default for currently distressed and defaulted structured finance securities. Distressed recoveries are designed to estimate recoveries on a forward-looking basis, while taking into account the time value of money. Distressed recoveries are issued on a scale of DR1 (the highest) to DR6 (the lowest) to denote the range of recovery prospects given a currently distressed or defaulted security. The issuance of distressed recoveries followed the publication of an exposure draft along with a commentary period where feedback was solicited from investors and other market participants (see Structured Finance Distressed Recovery Ratings (April 25 2006) and Asset-Class Specific Criteria (April 26 2006) at www.fitchratings.com). At the outset in April 2006, new distressed recoveries were assigned to 977 structured finance classes affecting 539 structured finance transactions:

- 60 commercial mortgage-backed securities;
- 64 asset-backed securities;
- 314 residential mortgage-backed securities; and
- 101 US and European collateralised debt obligations.

Table 1: 2007 US ABS outlook table

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
US consumer ABS				■ Competitive and manufacturer pressures/deteriorating financial performance
	Auto ■ Prime ■ Sub-prime ■ Leases	 Stable Declining Declining	 Positive Stable Stable	■ Pricing strategies, dealer incentives and financing programmes ■ Increasing loan terms, loosening credit quality and rising loan-to-value ratios ■ Wholesale vehicle market conditions ■ Lease turn-ins and residual value realisation
	Credit cards ■ Prime ■ Sub-prime ■ Retail	 Stable Declining Stable	 Positive Stable Stable	■ Impact of bankruptcies on charge-offs ■ Consumer credit quality, especially of the sub-prime borrower ■ Rising interest rates ■ Reloading of revolving credit lines ■ Higher available credit limits ■ Ongoing industry competition/consolidation ■ Underwriting and servicing of portfolios
	Student loans	Stable	Positive	■ Higher Education Act re-authorisation ■ Rising tuition rates and private loan growth ■ Rising interest rates ■ Deferment/forbearance trends' impact on liquidity/excess spread ■ Competition ■ Consolidation loan volume trends ■ Alternative loan underwriting/servicing quality
	Timeshare receivables	Declining	Stable	■ Consumer debt and household leverage ■ Developer growth and profitability ■ Product saturation in key markets ■ Consistency of underwriting policies and procedures

Table 1: 2007 US ABS outlook table (continued)

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
US commercial ABS	Equipment leases/loans	Improving	Positive	■ Spending on business equipment and software ■ Long disposition and weak recoveries
	Aircraft finance	Declining	Negative	■ Airline industry consolidation and increased financial leverage ■ Weakening demand ■ Event risk (ie, terrorism and SARS) ■ Oil price volatility ■ Labour and pension costs
	Dealer floorplan Auto-related	Declining	Negative	■ Impact of declining sales of auto manufacturers on payment rates
	Non-auto-related	Stable	Stable	■ Inventory turnover/sales rates versus credit lines ■ Interest-free and low loan rates ■ Increasing dealer concentrations ■ Asset-based lending
	Franchise loans	Declining	Negative	■ Depleted credit enhancement ■ Impact of higher petrol prices on convenience store and quick service restaurant margins ■ Competition in retail petrol and convenience stores
	Rental fleet finance	Declining	Stable	■ Air traffic volume ■ Non-programme vehicle exposure ■ Wholesale market conditions ■ Adequacy and utilisation of fleet
	Small business loans	Declining	Negative	■ Smaller net recoveries and longer than expected recovery times ■ Credit risk to manufacturing, hotel and franchise industries ■ Regional manufacturing concentrations ■ Decline in spending on business equipment and software ■ Pre-payment risk

Table 1: 2007 US ABS outlook table (continued)

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
US commercial ABS (continued)	Utility tariff monetisation bonds	Stable	Stable	■ Unexpected reduction in consumption rates ■ Litigation/remediation risk ■ Political risk ■ Geographical concentration of service territory
	Tobacco structured settlements	Stable	Stable	■ Industry competition ■ Reduction in profits and increased borrowing costs ■ Decline in US cigarette consumption rates ■ Negative outcome of pending litigation issues

Source: Fitch

Table 2: 2007 US RMBS outlook table

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
US RMBS	Prime and Alt-A	Declining	Positive	Slower pre-payments and higher delinquencies will reduce the number of upgrades from the unusually strong levels of recent years, but are not expected to result in significant increase in downgrades. Higher credit enhancement for recently issued transactions should help mitigate higher credit risk. Regulatory attention may result in a reduction of option ARM volume.
	Sub-prime, home equity and speciality products	Declining	Negative	Slowing house price appreciation, increased borrower leverage and upward rate adjustments for seasoned loans will result in continued collateral performance deterioration. While negative rating pressure will be primarily concentrated in seasoned transactions after the step-down, an increase in pre-step-down negative rating actions is likely.
	Net interest margin securities	Declining	Negative	Reduced excess spread and the deteriorating performance of underlying collateral will increase risk for seasoned NIMs.
	Manufactured housing	Stable	Stable	After several years dominated by negative rating actions, improved collateral performance resulted in a comparable number of upgrades and downgrades in 2006. The same is expected for 2007.

Source: Fitch

Table 3: 2007 US CMBS outlook table

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
US CMBS	Multi-borrower fixed rate transactions	N/A	Positive	Originator underwriting practices often included in current cash flow, which makes loans appear better initially with higher banker debt service coverage ratios and lower underwritten loan-to-value ratios. The rising share of interest-only loans should also be noted; interest-only loans have higher refinance and extension risk than their amortising counterparts.
	Large loan floating rate transactions	N/A	Stable	Non-traditional assets in large loan floating-rate transactions are becoming more prevalent. Loans secured by non-traditional assets have different risk characteristics than traditional commercial real estate loans, so investors are cautioned to understand fully those risks before investing.
	Single borrower transactions	N/A	Positive	Esoteric asset types, such as cell towers, land and timber loan deals, are on the rise. Esoteric asset types have different risk characteristics than traditional commercial real estate loans, so investors are again cautioned to perform extra due diligence to ensure they fully understand those risks before investing.
	Retail property type	Stable	N/A	Falling home values may negatively affect consumer spending and growth in retail sales. Home improvement store sales are expected to weaken as housing sales slow. Merchandising mix continues to drive same-store sales growth, with some retailers outperforming others.
	Multi-family property type	Improving	N/A	Continued job growth and household formations should bolster apartment occupancy levels and rents. Some markets may be negatively affected by failed condo conversions returning to the rental market.

Table 3: 2007 US CMBS outlook table (continued)

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
	Office property type	Improving	N/A	Positive office employment growth and low levels of new supply expected in most markets. Net absorption is expected to remain higher than historical averages and the positive rental growth experienced in 2006 is expected to continue in 2007.
	Industrial property type	Stable	N/A	Demand in the industrial sector is expected to be stable in 2007, with positive signs for high-tech markets and potential weakness in markets driven largely by consumer spending and the housing market. Ease of construction remains a concern for the sector.
	Hotel property type	Improving	N/A	Higher fuel costs, rising mortgage rates and declining house prices may negatively affect leisure travel. Although RevPar growth is expected in 2007, expenses are also forecast to rise, which will dampen net operating income increases.

Source: Fitch

Table 4: 2007 European SF outlook

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
European consmer ABS	All			
	France	Stable	Stable	Higher consumer indebtedness may lead to some deterioration in assets in the medium term.
	Austria	Stable	Stable	Continued stable asset performance in line with expectations will underpin existing ratings.
	Germany	Stable/ improving	Stable	The increase in the employment rate looks likely to outweigh the negative, and probably short-lived, effect of the value added tax increase effective from January 1 2007.
	Italy	Stable	Stable	Underwriting standards for consumer assets and general improvement in the economy.
	Portugal	Stable/ declining	Stable	Economy still in limbo and overall level of consumer lending remains a concern.
	Spain	Stable	Stable	Little seasoning, long-term trends yet to manifest themselves.
	UK credit cards	Declining	Stable/ negative	Charge-off rates do not yet appear to have reached a peak.
European commercial ABS	Corporate and infrastructure	Stable	Stable	This broad asset group has few general trends but all transactions are vulnerable to special event risk. Sagres, the Portuguese delinquent tax securitisation, where collections over the next two years are key, remains vulnerable.
	Aircraft ABS	Stable/ declining	Stable	High fuel costs remain a concern unless absorbed at the passenger level. Threat of terrorism.
	Whole business securitisation (WBS) pubs	Stable/ Declining	Stable	Smoking ban in England due in July 2007.
	WBS Care Homes	Stable/ improving	Stable Positive	Very strong demographics. The one black spot in the sector is Craegmoor.
	WBS Other	Stable	Stable	Transaction-specific event risk.

Table 4: 2007 European SF outlook (continued)

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
European RMBS				
	Prime	Stable	Stable/ positive	Germany still remains the area most likely to see losses crystallising; as in previous years this is particularly true for deals with a high concentration of investment properties or properties situated in the east.
	Sub-prime	Stable/ declining	Stable	The combination of affordability pressures and continued 'criteria creep' in the increasingly competitive UK non-conforming sector could lead to deteriorating asset performance.
European CMBS	Standard	Stable improving	Stable	Credit-linked tranches on single borrower deals remain more vulnerable to downgrade. Lower required yields can cause longer term refinance issues.
	Non-performing loans	Stable	Positive	As seasoning continues, upgrades are again likely in all areas.

Source: Fitch

Table 5: 2007 global CDOs outlook table

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
Global CDOs	Global investment grade corporate CDOs	Declining	Stable	Exposure to the US auto sector; increasing LBO activity.
	Global high yield bond CDOs	Declining	Positive	Some corporate bond issuers are emerging from bankruptcy.
	Global leveraged loan CLOs	Declining	Stable	Higher loan-level default rates and more volatile recoveries.
	Global market value CDOs	Declining	Stable	Performance has been strong but also dependent on underlying assets.
US CDOs	US diversified SF CDOs	Declining	Stable/ negative	Exposure to troubled ABS sectors and RMBS.
	US RMBS CDOs -Mezzanine -High grade	 Declining Stable	 Negative Stable	Potential deterioration for 2004-05 vintages due to HEL exposure.
	US CRE CDOs	Stable	Positive	More whole loans and transitional assets included in CDOs.
	US middle market CDOs	Stable	Stable	Recent deals include buckets of broadly syndicated loans and ABS.
	US trust preferred CDOs	Improving	Positive	TruPS CDOs hitting their call periods; heavy refinancing among banks.
European CDOs	EU balance sheet SMEs	Stable	Stable/ positive	Varies by country. CDO issuance to increase as more banks tap CDO technology.
	EU structured finance CDOs	Stable	Stable	Entry of CRE CDOs.

Source: Derivative Fitch

Table 6: Asia-Pacific outlook table

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
Australia/NZ	Australia RMBS	Declining	Stable	Interest rate increases and house prices.
	Australia ABS and CMBS	Stable	Stable	Interest rate increases.
	New Zealand	Stable	Stable	Interest rate increases and house prices.
Japan	Consumer ABS	Declining	Stable/ negative	New regulations concerning money lending business.
	Japan commercial ABS	Stable	Stable	GAAP concerning lease transactions.
	Japan RMBS	Stable	Stable	Evolving non-conforming market.
	Japan CMBS	Stable	Stable	Interest rate increases.
	Japan CDOs	Stable	Stable	New innovative products – ie, CPDO, CCO etc.
Non-Japan Asia	Taiwan consumer	Improving	Stable	Political uncertainty.
	Taiwan commercial	Stable	Stable	Political uncertainty.
	Singapore	Stable	Stable	Further property acquisition by listed REITs through increased leverage.
	Thailand	Stable	Stable	Political uncertainty.
	Korea	Stable	Stable	Security concern with North Korea.

Source: Derivative Fitch

Table 7: Emerging markets outlook table

Market sector	Asset class	Asset performance	Ratings	2007 areas to watch
Emerging markets	Latin America - future flow	Improving	Positive	The credit quality of the future flow segment will continue to improve as the sovereign and corporate environments improve.
	Latin America - existing assets	Stable	Stable	The collateral for existing asset transactions in most Latin countries should perform well as the overall credit environment continues to improve throughout the region. Many countries, including Brazil and Mexico, held elections and the future direction undertaken by the incoming presidents could have an impact on certain economies.
EMEA emerging markets	General – future flow	Improving	Stable/ positive	Rising coverage levels.
	General – existing assets	Stable	Stable	Clarification of securitisation legislation.
	Russia – existing assets	Stable	Stable/ positive	Russian consumer loans.
	Turkey – future flow	Stable	Stable/ positive	Rising coverage levels and further bank takeovers by foreign institutions.

Source: Fitch