COMMENTARY REPORT

Asia-Pacific's Regional Diversity Influences Securitization Prospects And The Road To Recovery

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From Shanghai to Sydney, the Asia-Pacific region contains a rich tapestry of diverse cultures and economies. The spectrum is also broad in terms of each country's sovereign creditworthiness, economic development, and market sophistication. While some countries possess legal and regulatory structures to support domestic and cross-border securitization markets, relatively few have well-developed capital markets by international standards, and fewer still have the legal framework, stability, scale, and operational infrastructure to support vibrant and stable securitization sectors. Although data on the aggregate size of the securitization markets in Asia-Pacific is not readily available, in the table we estimate the current securitization outstandings by country.

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Estimated Total Outstandings Of Non-Agency Securitization Transactions In Asia-Pacific

Country	US$ equivalent (mil.)	% of total Asia-Pacific market outstandings	Cumulative total (%)
Australia	200,000	44	44
Japan	180,000	40	84
South Korea	30,000	7	91
India	20,000	5	96
Hong Kong	6,000	1	97
Singapore	5,000	1	98
China	5,000	1	99
Taiwan	4,000	1	100
Thailand	1,000	0	
New Zealand	500	0	
Balance of other domestic markets	0	0	
Asia-Pacific total	451,500	100	

Data as at October 2009.

And despite a strong history of trade cooperation and agreements within the region and beyond, Asia-Pacific's domestic capital markets are fragmented. Consequently, Asia-Pacific investors have tended to look to the U.S. and European markets for investment opportunities rather than their own region. Standard & Poor's Ratings Services believes these factors impede the growth and recovery of individual securitization markets as well as efforts to foster greater regional cohesion. However, we also believe the global financial crisis, a growing sense of independence and confidence in the region, increasing wealth, and a desire by several policy-makers to foster greater regional cohesion may spur changes that will improve the region's long-term prospects for greater integration of capital markets and the ongoing development of securitization markets around the region.

The Impact Of The Global Financial Crisis On The Region's Securitization Markets

The impact of the global financial crisis on individual countries has underscored the diversity of Asia-Pacific's securitization markets. The effects varied by both nature and degree among the individual markets, with the most pronounced occurring in securitization markets with the following characteristics:

- Markets with heavy reliance on cross-border investors and, in particular, structured investment vehicles (SIV)/conduit investors (for example, Korean cross-border transactions and Australian residential mortgage-backed securities (RMBS));
- Sectors where foreign banks dominate securitization activity. After the crisis, a few of these banks have scaled back or exited noncore markets and sectors as they focused their attention and resources on areas closer to home (for example, the Japanese conduit commercial mortgage-backed securities (CMBS) sector); and
- Jurisdictions where government interventions to protect and stabilize banking systems had broader unintended consequences. In Australia, the introduction of bank deposit guarantees led to shifts from managed funds to guaranteed bank deposits and increased issuance of government debt. In addition, government guarantees on bank-issued debt, coupled with increasing supply of government bonds, made Australian unguaranteed securitization bonds less attractive.

Two of the region's more developed securitization markets, Japan and Australia, had contrasting experiences as a result of the global financial crisis.

Japan's domestic market issuance was less affected in the early stages of the crisis

The vast majority of securitization transactions in Japan are issued domestically to Japanese investors and local branches of offshore or global companies. The more self-contained Japanese domestic market seemed largely immune from global events for a number of months after the onset of the crisis. Despite the tarnished reputation of securitization globally, many Japanese issuers of asset-backed securities (ABS) and RMBS were still able to gain access to the domestic market without government support and with significantly less price volatility than in most other markets. RMBS issuance by Japanese government agencies has been consistent throughout the entire period. The consistent narrowing of spreads on agency RMBS has begun to attract nonagency RMBS issuers back to the market. Recessionary conditions have ensured a steady trickle of ABS issuance, as typically bank lending becomes more constrained when economic conditions deteriorate and companies turn to securitization markets to supplement their bank funding lines.

Ultimately though, the exit of the U.S. investment banks from the Japanese CMBS conduit sector in 2008 and the tainted reputation of securitization have contributed to overall issuance volumes pulling back from their highs of previous years.

Australian new securitization issuance came to a virtual standstill

In contrast, the financial crisis hit Australian securitization early—and hard. The Australian RMBS sector's heavy reliance on offshore investors—and more specifically the European SIVs and conduits, which became forced sellers of RMBS—brought new Australian RMBS issuance to a virtual standstill. Notwithstanding continued strong performance of the underlying collateral and very stable ratings performance across the sector, investors have been concerned about price volatility, illiquidity, and issuers' ability to exercise transaction clean-up call options to repay noteholders once the transactions have amortized to a small fraction of their initial balance. Further, the exit of so many SIV and conduit investors from the market opened up a structural imbalance between the demand from issuers wanting to issue RMBS and demand from investors wanting to buy the product. Even the likely contraction in future demand from issuers seeking to issue RMBS as a consequence of the significant consolidation among nonbank originators and regional bank lenders, is unlikely to be sufficient to restore equilibrium in the short run. (Traditionally, the major banks have less incentive to securitize at prevailing credit spreads, given their superior access to funding off the back of high ratings.)

CMBS issuance, primarily a funding option for Australian listed property trusts (LPTs), came to a standstill when refinancing risks came sharply into focus as liquidity in global markets evaporated, leading to lower commercial property valuations. The LPTs have begun to rebuild after experiencing significant erosion in their equity values. In addition, market illiquidity and price volatility hampered new issuance of ABS, particularly in the first half of 2009.

The credit performance of most Asia-Pacific securitization transactions remains sound

Now, new issuance activity is showing signs of renewal after its recent slowdown, at least in part because of factors that contributed to the relatively strong performance of Asia-Pacific securitization throughout the crisis:

The relative strength of banking systems and asset quality in the region leading into the global financial crisis.

The Asia-Pacific countries have endured and recovered from several shocks to their financial systems in the past few decades, leading to significant structural reforms in many of the region's financial markets. These events include Australia's recession in the early 1990s, which revealed significant credit quality issues in several banks; the 1997/1998 Asian financial crisis; Korea's credit card crisis in 2003; and Japan's decade of restructuring following the bursting of the 1990s asset price bubble. As a result of these events, the region's banks recapitalized, improved risk management and credit systems, and maintained higher credit quality through the most recent credit boom relative to their U.S. and European counterparts. In particular, sub-prime lending comprised a negligible proportion of regional banking assets.

The performance of Asia-Pacific's economies relative to other regions.

The economic deterioration started later in Asia-Pacific than in the rest of the world, providing a strong performance buffer for a large proportion of the region's amortizing transactions, which have relatively short weighted-average lives and sequential payment structures. In addition, the slowdown was shallower or recovery started earlier than in the U.S. and Europe. Further, lower interest rates resulting from looser monetary policies have, to a certain extent, alleviated borrowers' financial stress and offset the impact of modest rises in unemployment on delinquencies and default rates of consumer portfolios. Before the crisis, interest rates had risen quickly in the region because of concerns about inflation.

The nascent state of Asia-Pacific's securitization markets.

Asia-Pacific's securitization markets are relatively less mature and lack the depth and scale of the U.S. and European markets. Further, the Asian cultures are far more traditional in their use of credit, demonstrated by their very high savings rates. As a consequence, only a small proportion of securitization transactions in Asia-Pacific comprise highly leveraged loans, or loans to lower-credit-quality borrowers, who are most vulnerable to performance issues as economic conditions deteriorate. Further, reflecting the lack of market depth, scale, and maturity, transaction structures remained quite straightforward, for instance, very few transactions relied on the ability to resell assets in a liquid market to repay noteholders.

The major exception to this very strong performance record through the crisis to date has been the Japanese conduit CMBS sector, reflecting both the worsening fundamentals for commercial property in Japan and the withdrawal of U.S. investment banks from the sector. This sector is now experiencing significant performance stress as local banks are unwilling to refinance maturing securities that included certain borrower types, loan terms, and/or collateral types that these conduit programs offered. Further, around the region, credit has deteriorated for a few transactions that include loans to self-employed borrowers or small and medium enterprises (SMEs), or that contain counterparty exposures to global financial institutions or monoline insurers who themselves have been adversely impacted by the crisis. Overall, however, these transactions represent a small proportion of the outstanding regional portfolio.

The Path To Recovery And Growth May Not Be Easy

Each market within the Asia-Pacific region may have to forge its own path to recovery and growth, depending on local conditions. In our opinion, this process may not be easy, due to the region's longstanding challenges to the development of securitization. In addition, the extent and timing of global and local regulatory and market developments in response to the global financial crisis will likely play a part, as uncertainty around the scope and timing of these developments and their impact on securitization markets may stall recovery efforts.

The availability of cheaper and easier financing alternatives.

Asia-Pacific's domestic banking systems are highly competitive, with a strong emphasis on relationship banking. Further, high savings rates in most markets (except in Australia and New Zealand) provide banks with a low cost, stable base from which to fund lending, as the savings comprise predominantly bank deposits. This reduces the impetus of the banks to use securitization to diversify and/or increase their funding bases. Indeed, for many potential issuers of securitized products in Asia-Pacific (perhaps with the exceptions of the Japanese conduit CMBS sector and the Australian nonbank-originated RMBS sector), securitization is not a necessity. For instance, Hong Kong, which has one of the most developed and international capital markets in the world, has had only a nascent securitization market for years due to easy availability of competitive bank financing. For individual securitization markets to grow and prosper, in our opinion, securitization would need to provide a compelling value proposition relative to other funding sources.

The complex structural environment.

The region comprises countries with distinctive and diverse cultures, different stages of economic development, sovereign credit quality, currencies (several of which are not widely traded in foreign exchange and swap markets), regulatory environments, and legal systems. Legal precedent is scarce for securitization issues, and without the ability to write legislation to facilitate securitization, these obstacles add layers of complexity for issuers and transaction participants, and increases time and costs of execution. For investors considering some of these newer markets, it may be too demanding to invest the time and effort to understand the complexities of an individual market if they aren't certain they'll be rewarded with a flow of ongoing opportunities in the future.

Lack of market transparency.

With the exception of Australia and New Zealand, historically Asia-Pacific's securitization markets have been opaque. However, a growing global emphasis on market transparency, led by the International Organization of Securities Commissions (IOSCO), may help to change this. Initiatives are underway in the U.S. (Project Restart) and in parts of Asia-Pacific. Japan's Securities Dealer Association introduced the SIRP, or Standardized Information Reporting Package, on June 1, 2009, to help improve transparency and comparability among transactions, while in Australia, the Australian Securitisation Forum is currently working on developing standards on pre- and post-issuance transaction and loan-level reporting for Australian RMBS.

The shape of future regional securitization markets will reflect emerging local and global regulatory frameworks.

While global and local policy-makers are developing and implementing various reforms, the ultimate impact of specific changes, as well as the combined effect of the myriad of local and global reforms, remains uncertain. We believe it will likely take well into 2010 for the implications of many of these significant changes on the design of, and future demand for, securitization products to become more apparent. Nevertheless, it's likely that for as many doors that close, others will open. We believe securitization can and will continue to provide valuable contributions to the credit creation process, risk management, and funding diversification needs and imperatives of issuers, investors, and policy-makers.

Catalysts Of Change May Drive Greater Regionalization In The Long Run

Despite these challenges to recovery and growth, changes seem to be emerging across the region. A noteworthy one is the rise of Asia-Pacific as an economic power. The region has become a significant global force in terms of the world's investable funds, and it's home to two of the world's economic growth engines, China and India. This has fueled a growing sense of independence and confidence. And Asia-Pacific investors are significant holders of U.S. securitization in particular, that as a result of the crisis has some of these investors beginning to rethink their strategies. Indeed, some investors in Asia-Pacific are considering ways to balance their global exposures with a more regional focus. In our opinion, this might be evidence of the global financial crisis' positive effect on the Asia-Pacific markets, especially when it comes to the future development of its domestic capital markets, securitization capability, and greater regional integration of its financial markets.

In our opinion, Asia-Pacific's more established securitization markets will likely recover, reinvent themselves, and find new ways to bring value and opportunity to investors, issuers, markets, and economies in the region. By definition, structured finance is flexible, enabling it to respond to the changing dynamics of the marketplace. For the less developed emerging markets, continued efforts of policy-makers and a compelling value proposition emerging for securitization in those markets will, in our opinion, be needed to underpin development and growth of those markets.

We expect some additional factors to support recovery and growth as well:

Familiarity.

While the numerous domestic markets in Asia-Pacific do not operate collectively, they understand each other and have strong ties. Moreover, corporations and banks operate in multiple markets in the region. Increasingly, in our opinion, these players grasp the fundamentals of regional credit performance and market trends.

Investor demand and influence.

At the height of the credit boom, spreads on ABS in Asia-Pacific were often so tight that they were a disincentive to regional real-money investors looking for higher-yielding investments. Now, with issuance margins widening, and likely to stay wider for some time to come, there might be more demand for simple securitization bonds backed by assets originated within the region. For instance, this year brought the first covered bond issuance in Asia by Korea's Kookmin Bank (see rating report, " New Issue: Kookmin Bank Senior Guaranteed Bond Issuance", published June 24, 2009 on RatingsDirect). Covered bonds are debt instruments issued by banks. In the first instance, they are a direct obligation of the bank, but should the bank fail to repay noteholders when due, recourse to a high credit quality collateral pool of assets is also provided. Generally, the credit and payment profile of these securities appeal to a broader range of investors than is the case for securitization. Further, with significant capacity to invest, regional investors will likely be able to influence the composition and quality of underlying collateral, as well as the design and terms of the bonds, to meet their preferences.

Choice.

With increasing intraregional trade and investment flows, and regional policy-makers' push toward closer integration of business and capital markets, over time, regional investors are likely to encounter a broader cross-section of asset classes and currency opportunities for investment. These options may become an attractive alternative or a complement to investments in their own markets, and the larger U.S. and European markets. In the long term, regional investors may be able to construct diverse regional fixed-income portfolios, which may lead to shifts in investment styles. For instance, domestic investment managers in Australia currently will often determine their fixed-income allocations via global fixed-income funds. We understand this strategy is often preferred to direct investment in local securitization transactions, due in part to asset allocators' concerns about lack of diversification in the domestic market.

Some believe that Australia's banking system and securitization sector may rely too much on short-term wholesale funding and offshore markets. At the same time, the country has the fourth-largest funds management industry in the world by virtue of its mandatory superannuation (pension) savings scheme. Paradoxically, a significant proportion of Australia's A$1 trillion funds under management is invested in offshore equity and fixed-income markets.

Specific Recovery And Growth Prospects

We believe there will be continued interest from the larger banks around the region in developing covered bond issuance capability. Such issuance may provide banks with additional access to a diversified investor base offering competitive pricing, and may stretch funding tenors to reduce reliance on short-term wholesale funding, particularly in Australia and Korea where this reliance has been more of a concern.

With increased economic growth and activity around the region, and to a lesser extent, the contraction in the use of off-balance-sheet funding vehicles, we believe there may be increased use of securitization techniques to structure on-balance-sheet facilities. This may serve two primary purposes for risk management. First, to provide flexibility so that on-balance-sheet exposures are "securitization-ready" and can be sold into the capital markets sometime in the future. Second, to provide more targeted use of regulatory capital should asset performance deteriorate, particularly in portfolios using the standardized approach under the Basel II framework.

In the immediate term, the significant reduction in securitization and off-balance-sheet financing activity in Asia-Pacific may put pressure on banks' balance sheets and their ability to fully meet the funding needs of their corporate and large commercial customers. Consequently, corporate bond issuance may increase at first, and later, when markets have stabilized, balance-sheet collateralized loan obligations (CLO) transactions to help manage bank capital and increase lending capacity, and cash flow collateralized bond obligations (CBO) issuance to lock in arbitrage profits as credit spreads contract – may increase as well, if they can be structured, enhanced, and priced to attract investors.

In our opinion, traditional ABS issuance will continue, partly due to their generally shorter weighted average lives, a feature investors tend to like when pricing is volatile. In addition, these transactions typically feature structures that enhance performance stability by virtue of fast-paydown profiles, which are often combined with sequential pay or conditional pro-rata pay structures that usually lead to a proportional increase in credit enhancement for the more senior notes as the transaction amortizes, because the subordinated and equity tranches are not repaid until the more senior tranches are repaid in full.

We believe CMBS issuance in markets around the region will continue to be more opportunistic, with bank markets and direct corporate issuance from real estate investment trusts (REITs) continuing to provide strong competition to securitization once the REITs have undergone their rebuilding phase and commercial property markets stabilize.

Japan

Japan's nonagency RMBS sector should continue to re-establish itself. Japanese agency RMBS issuance has been regular and consistent, providing a stable pricing benchmark (Japan Housing Finance usually issues monthly tranches).

The Japanese CMBS market is likely to be subdued for some time as the market digests the current performance and refinancing issues in the conduit CMBS sector. A significant proportion of assets are due for refinancing in 2010. While performance concerns are likely to focus largely on certain loan terms, borrower, and collateral types, broader investor appetite for CMBS is likely to remain subdued until there is more transparency and clarity in the marketplace.

Australia

In Australia, we believe spreads should start to stabilize and investors should begin to return to the RMBS sector. Over-supply of Australian RMBS available in the secondary markets is decreasing, outstanding RMBS is paying down quickly (annual repayment speeds are consistently in the range of 20% to 30% for prime RMBS), and underlying collateral performance continues to be strong. Australian RMBS may also bounce back because of the need to ensure that smaller lenders can provide an appropriate level of competition to the major banks in terms of pricing. Securitization will also assist in providing access to capital for self-employed borrowers in the SME sector, who have suffered from the inability of nonbank originators and smaller lenders to lend through the crisis. Consequently, there is strong support from policy-makers to assist the securitization sector's revival to help alleviate these constraints and increase competition.

The drivers for CMBS and ABS issuance remain largely unchanged from before the crisis. CMBS activity will remain opportunistic, in our view, and will reflect both the capacity of bank lenders and differences in pricing and options between the banking and securitization sectors. That said, even after the LPTs complete their rebuilding phase, credit spreads will likely favor bank markets for some time.

While auto and equipment issuance should continue to build momentum and benefit from becoming a more defined sector within the Australian securitization market, other ABS transactions will likely remain more sporadic.

Commitment And Continued Collaboration Are Keys To Sustained Recovery And Growth In The Region

Restoration of investor confidence in securitization markets is at the core of recovery and future growth in the sector. While time is a healer, the region also needs to take tangible steps to help boost investors' confidence in securitization and to foster increased regional collaboration to develop Asia-Pacific's securitization markets. In our opinion, such steps need to focus on:

- Improved transparency, standardization, and access to documentation, data, tools and models to help investors make more informed investment decisions with less reliance on rating agencies;
- Clarity, harmonization, and/or mutual recognition between global securities regulators, bank regulators, and accounting standard setters;

- Increased education about securitization products to better inform potential investors of their relative strengths and risks;
- Increased coordination between industry bodies to understand local and regional investor preferences and needs in terms of transparency as well as asset and structural preferences;
- Ensuring that securitization markets in Asia-Pacific are up-to-date with global regulatory and industry standards and developments, so as to keep the door open to global markets and investors when the markets pick up, which we believe will inevitably occur;
- Ensuring the simplicity, quality, and performance of new issues, because, in the long run, performance will speak for itself; and
- Ultimately striving for an ideal state where regulatory safeguards provide protection without stifling innovation, and the short-term benefits of leverage and cheap funding are balanced against longer-term stability and sustainability.

The broader market fundamentals and drivers in each country, as well as policy-makers' aspirations, may provide clues as to how and where securitization may emerge more strongly. They may also identify areas where the financial industry and policy- makers can work together to innovate and address market gaps. If they sustain a commitment to change, we believe greater collaboration will draw countries toward each other, and attract regional investors to new opportunities. In our opinion, securitization will be a viable funding, risk-management, and debt-structuring technique for Asia-Pacific companies and financial institutions, while at the same time providing more fixed-income investment opportunities to regional investors.

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