STANDARD & POOR'S

COMMENTARY REPORT

Will The U.S. Subprime Downturn Impact The Australian RMBS Market?

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As the U.S. market deals with its subprime mortgage loan performance concerns, participants in the Australian RMBS market are questioning whether there could be any flow-on effects, or whether similar issues could impact the performance of the Australian RMBS market.

The Australian RMBS market is one of the largest RMBS markets in the world, with 268 transactions outstanding and a cumulative current balance of A$160 billion held by Australian and global investors as at the end of February 2007. Of these, only 20 transactions amounting to A$6.5 billion (or 5% of the total RMBS market by volume) are subprime transactions, including loans to subprime borrowers as well as other nonconforming mortgage products to prime borrowers.

Compared with the U.S. subprime mortgage market, Standard & Poor's Ratings Services expects the Australian subprime mortgage market to have a more modest impact on loan arrears as it consists of several distinguishing features that reduce concerns over subprime issues:

Compared with the U.S., subprime lending comprises a smaller proportion of the overall housing loan market, and subprime RMBS comprises a smaller proportion of the overall RMBS sector in Australia.

- Subprime lenders in Australia offer a mix of nonconforming products that include loans to subprime borrowers, but also other nonconforming products to prime quality borrowers.
- Australian loan agreements contain more-extensive full-recourse provisions for lenders than in the U.S.
- The Uniform Consumer Credit Code provides a level of accountability on lending practices among originators in Australia.
- Australian subprime lenders have exercised greater caution to date.
- Compared with the U.S., the Australian subprime mortgage market is less mature.

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Frequently Asked Questions

What is the extent of the U.S. subprime mortgage problems?

The current subprime mortgage performance pain in the U.S. will likely overshadow that felt in the 2000 U.S. subprime vintage. Standard & Poor's expects the current loss expectation for the 2006 subprime vintage to be between 5.25% to 7.75%. Although the majority of 'BBB-' and 'BBB' rated tranches would be protected, these tranches may experience significantly higher default rates than other similarly rated tranches in recent history. The performance issues might be aggravated by various market factors, such as stagnant house prices and more liberal underwriting standards that existed in late 2005 and 2006. In particular, defaults on loans to U.S. homebuyers with low credit scores and who bought their homes with little or no money down, have increased sharply.

Standard & Poor's has responded with rating actions on a number of subprime transactions, as well as several corporate credit rating actions, particularly affecting New Century Financial Corp. (D/-/-) and Fremont General Corp. (B-/Watch Neg/-), two lenders that specialize in subprime mortgages. The remaining large rated U.S. subprime lenders, such as HSBC, Citigroup, Countrywide, and Washington Mutual, have diversified mortgage-banking businesses, and other business lines supporting their core operating performances.

While the current performance of the U.S. subprime sector is justifiably a cause for concern, it is also important to consider the alternate case point. Increased availability of mortgage credit to subprime borrowers in the U.S. over the past two years has contributed to an increase in home-ownership rates across the country. This increase has occurred simultaneously with a rise in originators loosening their underwriting guidelines, including low equity and little-to-no-income verification loans to first-time homebuyers with weak credit histories.

Did securitization cause the problems in the U.S. subprime mortgage market?

Securitization, or any other form of market liquidity in our view does not in and of itself cause or drive behaviors in underlying markets. Sufficient accountability and/or incentives should exist at both the borrower and credit provider levels to support stability and adequate performance in markets over time.

Firstly, the underlying borrower should be accountable for setting the amount borrowed at an affordable level. It is dangerous to promote an environment where borrowers can absolve themselves of all responsibility for their own financial affairs.

Moreover, some level of accountability and/or incentives that influence underwriting decisions made by credit providers may also be beneficial. Before the use of securitization, the credit provider was usually the lender, and the lender retained the risk of the loans on their own balance sheet. Hence, future financial performance of the lender was in part contingent on the future performance of those loans. With the advent of securitization, it is not uncommon for the underwriting decision to be made by entities that make their profit on writing the loan, and who do not retain the risk of the future performance of those loans. All other things being equal, this may increase the incentive for credit providers to write new loans but may reduce the incentive to consider how these loans will perform over time. Since capital markets are self-correcting, and as these issues come to light, demand and price for these risks will adjust. Disaggregation in the market place, however, increases the probability of these issues being detected by lag indicators rather than leading indicators. However, once they are detected, arguably the correction in capital markets may be more efficient and swift. Therefore adequate measures to ensure credit providers appropriately align their interests with those of debt investors and other stakeholders in this new market paradigm should be considered.

Finally, prolonged periods of economic stability, prosperity, and rising house prices can lead to increased complacency. At the extreme, some people might think that the cycle will never turn. This can lead to borrowers and credit providers becoming more aggressive—taking on risk and leverage and/or building market share through more liberal underwriting standards. This economic prosperity is often accompanied by surplus liquidity in the financial system, which may add other elements to the mix. Asset price bubbles might appear, thus increasing the volatility of outcomes once the business cycle does turn (which will occur inevitably).

What does securitization do?

Essentially, the issuance of mortgage-backed securities channels funds from investors in the capital market directly to homeowners, through the intermediary of the mortgage originators. The securitization process allows subprime lenders access to liquidity to fund their mortgage originations. Furthermore, since most of the credit risk associated with mortgage lending gets transferred or sold through the securitization process, from the lender to the security-holder, securitization is not only a source of diversified collateralized funding, but also a critical risk management tool.

It is important to note that, absent the securitization market, the impact of credit stresses in the U.S. subprime mortgage sector would have been felt directly by the financial institutions. Thus, the securitization market has served to diffuse to a larger group of capital market investors, risks that 25 years ago would have gnawed at the foundations of the banking system. Securitization has proved to be both a source of increased liquidity in the mortgage market and a viable risk-mitigation mechanism in periods of credit and market stress.

What are some of the differences between the U.S. and Australian RMBS markets?

There are several features of the Australian residential housing loan market that distinguish it positively from its U.S. counterpart.

For prime Australian RMBS, the prevalence of lenders mortgage insurance (LMI) to credit enhance transactions is a significant factor. The use of LMI as credit enhancement in prime RMBS transactions has resulted in the LMI's underwriting criteria and guidelines providing a second-level filter on loan quality in these portfolios. However, the Australian subprime sector does not use LMI to the same degree as the prime RMBS market.

Structurally, at both the borrower and credit provider levels, there exists higher levels of accountability and incentives to perform or demonstrate somewhat less risky behaviors than have been observed in the U.S. subprime market over the past two years.

For instance, at the borrower level, all housing loans in Australia contain full-recourse provisions not only to the security property but also to the borrower. This means that upon default, the lender can pursue the borrower to personal bankruptcy. (This is the case in some, but not all, U.S. states). While the availability of loan products to Australian subprime borrowers is increasing, arguably, there still remains an increased stigma in Australia relative to the U.S. around personal bankruptcy.

Secondly, several years ago, the Australian state governments introduced the Uniform Consumer Credit Code (UCCC) that regulates loans advanced to individuals where the credit is wholly or predominantly for personal, domestic, or household purposes. Among other provisions, the UCCC puts the onus on credit providers to demonstrate that borrowers can afford the loan being granted to them. By virtue of indemnities to trustees under RMBS structures, irrespective of whether credit providers retain the credit risk of the loan post origination or not, they retain the risk of penalties that can be imposed under the UCCC if they advance loans contrary to the provisions of the Code.

Thirdly, to date, subprime lenders in Australia have typically retained some of the risk in their transactions, by either holding onto at least some of the equity tranches themselves or through associated investment vehicles. This practice aligns well the interests of the credit provider with debt investors.

Lastly, the Australian subprime market is less mature than the U.S. market. As a consequence, the Australian market is less advanced in its evolution of its product offering to subprime borrowers, and typically seeks to offset increased borrower credit risk not only with an increased margin on the loan, but with increased equity in the security property also. To date, the primary affordability feature that has been added to the subprime product offering in Australia is the 40-year principal-and-interest amortizing (P&I) mortgage (up from the standard prime 25-30 year P&I mortgage). As such, the Australian market is not yet seeing the prevalence of combining subprime borrower characteristics with riskier product types, such as affordability features (including negative amortization) and higher loan-to-value ratios than prime lending. This is the combination in the U.S. that appears to be causing the majority of the current performance concerns in the subprime sector.

Prior to the issues in the U.S. subprime sector coming to light, a number of Australian subprime lenders were starting to contemplate whether they would introduce other affordability products, including products containing negative amortization features into their product lines. Hopefully, the recent experiences in the U.S. subprime market will provide an opportunity for the Australian subprime lenders to learn from the U.S. market experience, and dampen the enthusiasm of local lenders to follow the same path.

While these are significant positives for the Australian market, it is important to balance them against two key macroeconomic factors. Firstly, Australian households are carrying more leverage than any time before, making household balance sheets more vulnerable to interest rate rises and unemployment or reduced income than in previous downturns. Some of this risk is offset by changes to employment demographics that have increased in flexibility, higher nonhousing wealth of many households, and the limited likelihood of a protracted economic downturn in the near future.

Moreover, Australia has experienced a long period of steadily increasing house prices. House price appreciation tends to mask underlying borrower default risk and stress, as this can be managed by selling the property and effectively prepaying the loan, thus avoiding default. As recently observed on a very localized basis in Western Sydney, when house prices fall, borrower default risk becomes more pronounced.

Diversification, both in terms of geographic locations and borrower profiles, as well as quality collateral and sound underwriting are key factors that can limit the impact of declining house prices on portfolio performance. This is particularly relevant for localized events, for instance the impact of Hurricane Katrina in the U.S. or the impact of the declining auto manufacturing sector on house prices in Detroit.

Do you see any contagion risk from the U.S. subprime RMBS on the Australian RMBS market?

We do not expect any significant contagion risk from the U.S. subprime RMBS market on the Australian RMBS market. In fact, for prime Australian RMBS, recent issuers have enjoyed very strong demand for their issues from investors locally and abroad, which may in part have been due to investor flight-to-quality, given the very strong performance and reputation of the Australian prime RMBS sector. Two Australian subprime issuers both launched transactions in the midst of the initial news of the issues in the U.S. subprime market, and we understand that both transactions priced and cleared with record tight margins at most rating levels.

The one caveat to this would be if the performance issues in the U.S. subprime RMBS market deteriorated further leading to a change in investor demand for subprime RMBS generally (irrespective of location), having the potential for a negative impact on liquidity and profitability of smaller, specialized subprime lenders. Equity investors might be deterred from participating in the market, and the price demanded and availability of mezzanine-and-subordinated investors could also decline. As a result, lenders could find it more difficult to write new business in line with their growth expectations. Initially, this would be expected to impact U.S. or global investors ahead of local investors. To date, there has not been evidence of this occurring or impacting Australian subprime lenders to any significant degree. The current handful of subprime lenders in Australia have also demonstrated their willingness and capability to purchase equity tranches, and perhaps lower mezzanine tranches themselves, or through associated investment vehicles, which gives some comfort of their ability to continue to originate new business through such a stress scenario.

Do you anticipate higher delinquencies and losses in Australian RMBS in the near term?

The Australian economy and residential housing market have enjoyed an unprecedented period of growth and prosperity. Recent interest rate rises, while modest, will place some households under increased financial stress. We may not have seen the full impact of this translated through to delinquency performance on Australian RMBS, as many borrowers strive to pay ahead of their scheduled mortgage loan balance to provide themselves with a buffer and/or to accelerate repayment of the loan. Some of these borrowers may still be ahead of their scheduled balances, but may be eroding that advantage over time, and at some point may cross over the line and fall into arrears.

Overall loss performance of residential housing loans is expected to increase modestly in line with slowdowns in house price rises and localized house price depreciation in certain areas. This is, however, off historical lows, and our expectations are that these risks remain low relative to current economic performance, record low unemployment, and short-to-medium term expectations for the market, and are consistent with protections afforded to investors in Australian RMBS transactions.