

2023 Structured Finance Outlook: Australia And New Zealand

Preparing for uncertainty

Jan. 20, 2023



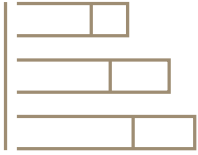
Australian Macroeconomic Environment

Narrow path to a soft landing

Challenges Ahead

- So far, so good. The average consumer is in relatively good shape and unemployment remains low.
- We expect our ratings across Australian structured finance transactions to remain broadly stable in 2023. This outlook is underpinned by low unemployment and the credit support available in many transactions.
- Should this change in 2023, however, we may see some performance deterioration in lower-rated tranches of nonconforming residential mortgage-backed securities (RMBS). Structural supports will influence ratings resilience here.
- Borrower optionality will be a key arrears differentiator across asset classes. Borrowers with more options to self-manage their way out of financial stress are less likely to go into arrears.
- A slowing economy will have flow-on effects on certain borrowers and asset classes. Borrowers whose income is more dependent on the services economy, particularly small businesses, may see increased cash-flow pressure as consumer demand slows.
- New issuance will be constrained by higher funding costs and reduced warehouse capacity as lenders encroach on warehouse limits.
- Lower lending volumes as higher interest rates constrain new mortgage lending will also weigh on new issuance volumes.
- Lenders will need to be adept at balancing competitive pressures with asset repricing to meet higher funding costs.
- Cooling property prices do not pose a significant risk for most borrowers, given the buildup in equity and modest loan-to-value (LTV) ratios across the broader RMBS sector as well as a stable employment outlook.
- House prices should be supported by limited new supply, a resumption of immigration, and broader household formation trends.

What To Look Out For



Arrears Momentum

Prime and nonconforming arrears have started to rise as consecutive rate rises take effect. Arrears increases in the nonconforming sector are likely to continue for longer because these borrowers have fewer options.



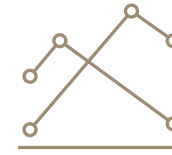
Prepayment Acceleration

The “great refinance” will influence originators’ prepayment behavior as borrower seek out better mortgage deals. Nonbank prime prepayment rates are likely to exceed bank prepayment rates in 2023.



The Nonbank Pivot

Several nonbanks have turned to new lending segments due to strong competition for prime borrowers. Auto loans, SMSF loans, and a focus on borrowers with more complex income streams will be a greater focus of nonbank lending in 2023.



Yield Compression

Higher funding costs are compressing yields in transactions. This will test the robustness of some transaction structures as structural features become increasingly important to cover losses in the face of deteriorating excess spread.

S&P Global Ratings Economic Outlook: Australia

	2023f	2024f	Outlook	Effect on credit quality
Real GDP forecast (% year over year)	1.7	1.9	Higher interest rates and rising inflation will drag on the economy, with constrained household budgets likely to dampen consumer spending. Positive GDP growth is still on the horizon, thanks to the economy's resilience in the face of uncertainty.	Negative. Strong balance sheets across the household and business sectors underpin household resilience. Inflationary and mortgage pressures will erode these buffers, creating debt-serviceability pressures for some borrowers.
Unemployment rate (year average; %)	4.2	4.4	Strong labor market conditions persist. Tight labor market conditions are keeping unemployment low. The return of immigration will help the labor market, though this could take time.	Positive. Lower unemployment is helping to keep arrears low. We note the correlation between unemployment and mortgage defaults.
CPI (%)	5.9	3.9	Inflation should return to its normal range of 2%-3% in 2025. Easing supply-chain pressures will help alleviate inflationary pressures, but it will take time for supply to meet pent-up demand.	Negative. Persistent inflation will add to financial pressures for lower-income households, with flow-on effects likely for prepayment rates. This is offset by a pickup in wage growth, which is positive for debt serviceability but could trigger a price-wage spiral that would add to inflationary pressures.
Policy rate, end of year (%)	3.6	3.1	We expect further rate rises this year to help tame inflation.	Negative. Rising interest rates will drive up arrears, given a high proportion of variable-rate loans in the RMBS sector. Low unemployment should temper the transition from arrears to default.

f--Forecast. CPI--Consumer price index. Source: S&P Global Ratings.

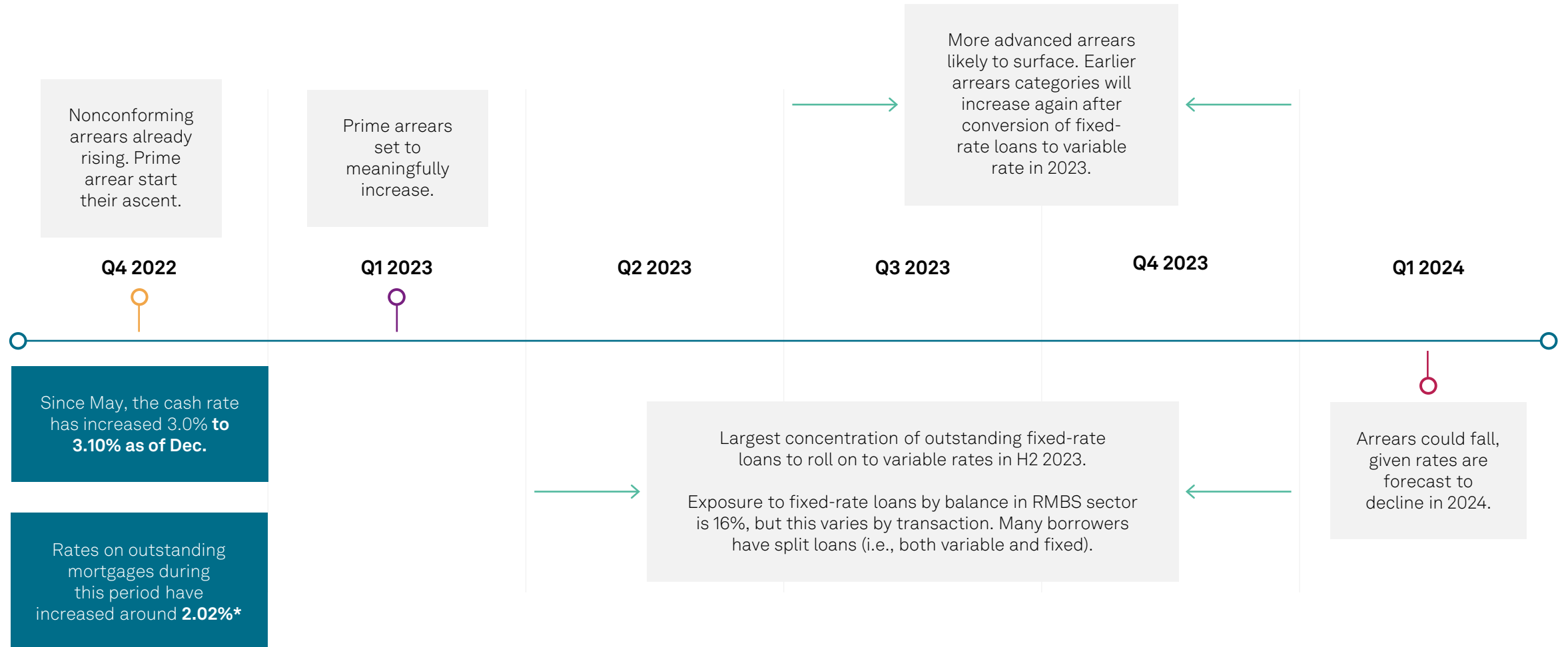
Australian RMBS Outlook

2023: The effect of rate rises

Australian RMBS Performance Outlook

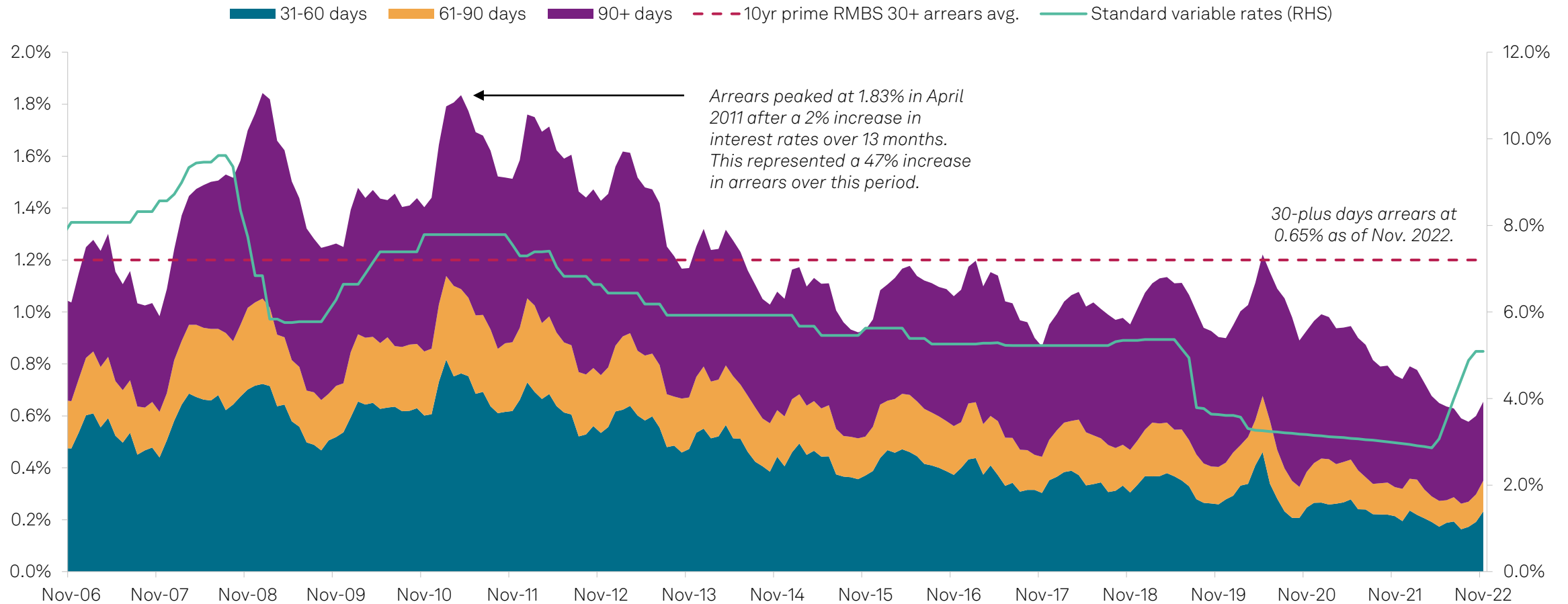
- Mortgage arrears have started to rise in the Australian RMBS sector. Prime RMBS arrears increased in October (monthly loan period) and nonconforming arrears have been increasing since July.
- Arrears rises in early arrears categories can be noisy because some of the increase may be due to administrative issues. The proportion of borrowers who transition to more advanced arrears is a more insightful marker of mortgage pressure.
- Cumulative gross losses across most vintages remain low and are unlikely to increase significantly above these levels, given the sector's modest LTV profile and our expectation of an orderly property price correction.
- While we expect property price peak-to-trough declines of 15-20%, this comes off the back of property price appreciation in excess of 20% during the pandemic, limiting the likelihood of losses resulting from borrowers being in negative equity.
- We expect prepayment activity to ramp up across the prime RMBS sector as borrowers shop around for better mortgage deals to decrease their debt-serviceability burdens.
- We expect prepayment rates to diverge between bank and nonbank lenders in 2023 as prime borrowers with modest LTV ratios seek out more competitive mortgage rates that are more likely to be offered by banks.
- Yield compression will add pressure to some lower-rated tranches as it slows the buildup of reserves that are commonly used to help cover losses, particularly in nonconforming transactions.
- Timing of losses will influence collateral performance in some of these transactions, in addition to the presence of structural features that enhance or inhibit spread utilization.

Predicting Arrears Movements



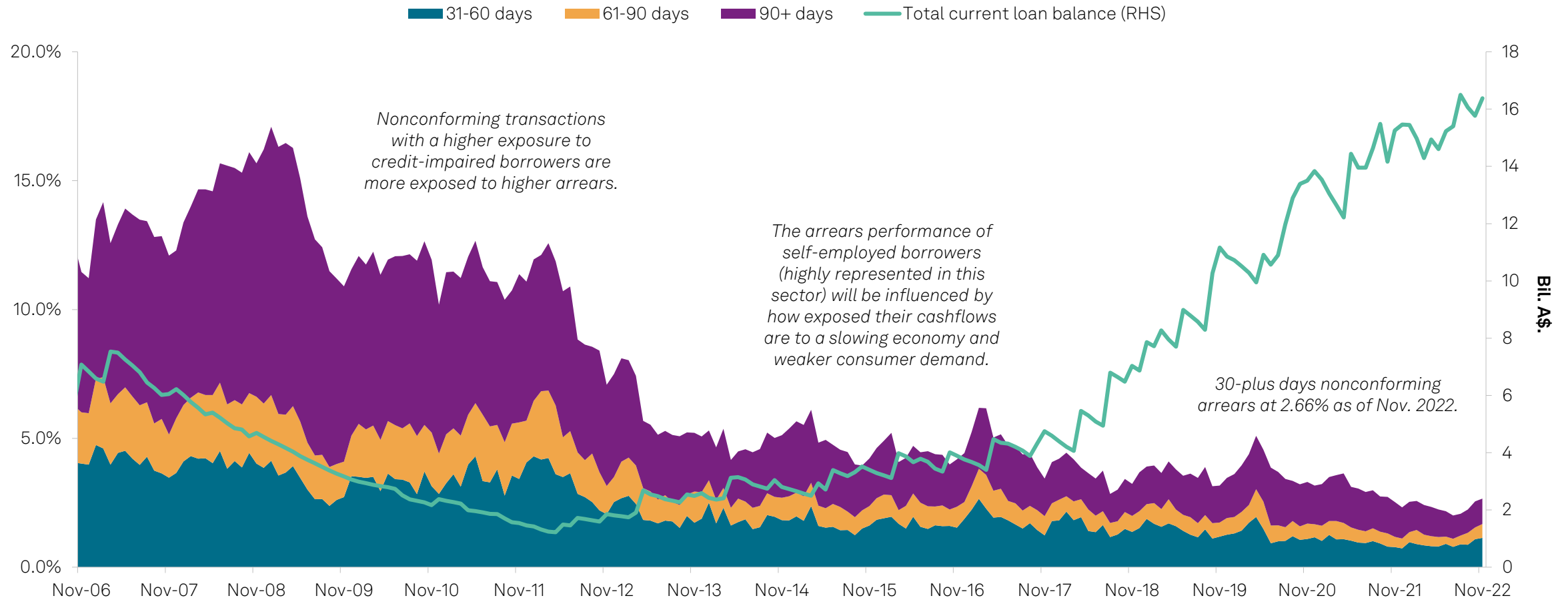
*This is based on variable lending rates for outstanding owner-occupied mortgages, All Institutions (latest period available Oct. 2022). Source: S&P Global Ratings, Reserve Bank of Australia.

Prime Arrears Rising From Historic Lows



Prime data SPIN shown excludes noncapital market issuance transactions. RHS--Right-hand scale. Source: Reserve Bank of Australia. S&P Global Ratings. Prime RMBS arrears exclude non-capital market issuance transactions.

Nonconforming Arrears Likely To Diverge Across Transactions



Bil.--Billion. A\$--Australian dollar. RHS--Right-hand scale. Source: S&P Global Ratings.

Australian ABS Outlook

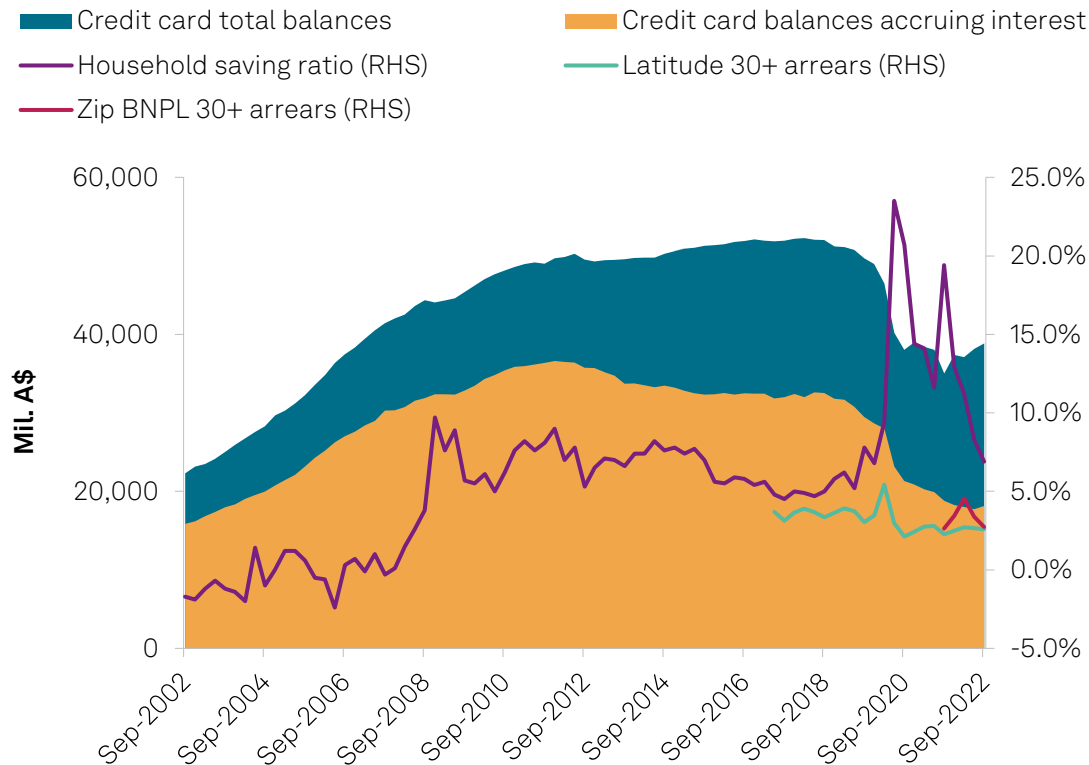
Ratings to remain resilient;
slowing economy to test some transactions

Australian ABS Performance Outlook

- Low unemployment will keep defaults low and ratings stable for most ABS transactions.
- The higher prevalence of fixed-rate loan contracts in the auto ABS sector provides a hedge against inflationary and rising interest rate pressures. We expect our ratings to remain stable for this sector, given its greater insulation from rising interest rates.
- Yield compression will be an issue for newer auto ABS transactions as spread is compressed by a steep widening of variable funding costs relative to fixed-rate asset margins on loan portfolios. These are not increasing at the same rate, making hedging costs much more expensive.
- This season will be a litmus test for how unsecured consumer lending performs in a less benign economic environment after a period of heightened competition, particularly for recent entrants.
- As cost-of-living pressures and interest rates rise, more borrowers could turn to personal loans and credit cards to cover living expenses and other financial commitments.
- Unsecured personal lending is likely to attract greater regulatory scrutiny in the current environment to guard against predatory lending practices.
- Small ticket CMBS have been largely resilient to rate rises and property price declines to date. The diversity of property types has had some pandemic upside as demand for commercial warehouses has risen, given a heightened focus on supply-chain resilience.
- The small ticket CMBS sector's performance could be more closely correlated with the construction sector, given the high obligor exposure to the construction industry in many of these transactions.

Unsecured Consumer ABS Could Provide A Taste Of Things To Come

Credit card balances rise as savings fall



Source: Reserve Bank of Australia, Australian Bureau of Statistics, S&P Global Ratings.

- Unsecured consumer credit securitizations are typically a harbinger of arrears performance for the wider structured finance sector.
- This reflects the increased prevalence of higher credit risk borrowers and the prioritization of home loan repayments over personal loans.
- Total credit card balances and credit card balances accruing debt declined sharply during the pandemic as borrowers built up savings and paid down debt.
- This, along with low unemployment, has helped keep arrears low for credit card receivables and other unsecured lending transactions.
- As the household saving ratio returns to prepandemic levels, credit card balances are rising again as spending resumes.
- The employment landscape will largely influence how arrears perform in this sector.
- With savings declining and cost-of-living pressures rising, credit card and other unsecured lending balances may increase as borrowers resort to credit to cover more of their living expenses.

Ratings Movements

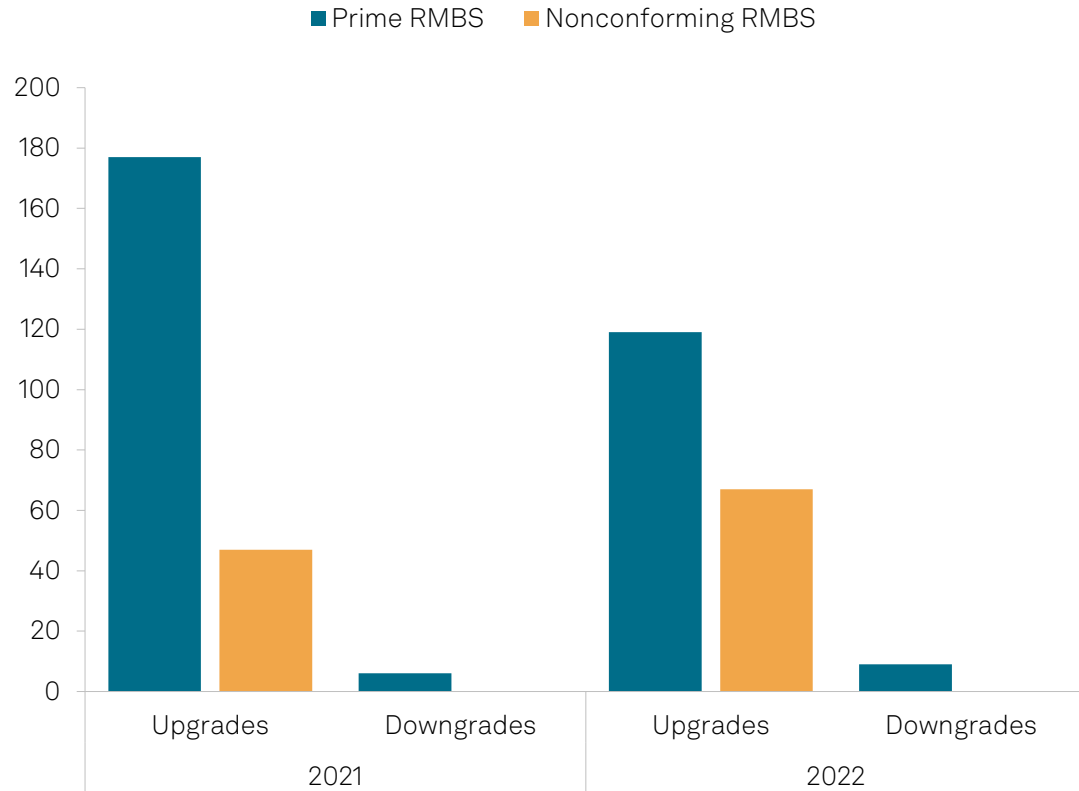
2023: Fewer upgrades

2023 Ratings Outlook

- Positive rating actions are likely to be lower in 2023. Credit deterioration and yield compression will likely limit some tranches' potential for ratings upgrades. Higher-rated tranches in more seasoned transactions will continue to benefit from strong prepayment activity, particularly in the first half of 2023.
- There might be ratings downgrades for lower-rated tranches of some nonconforming transactions and unsecured consumer lending transactions if collateral performance deteriorates beyond our base-case assumptions.
- Yield strain will be a key risk for some of these transactions, particularly recently issued transactions that have had limited time to build up reserves and credit support. Lower-rated tranches typically are more reliant on excess spread for credit support than higher-rated tranches.
- Rating actions driven by counterparty rating changes are unlikely to be significant at this point because most key transaction counterparties are on stable or positive outlooks. Any changes to key counterparty ratings will flow through to affected transactions.
- Ratings upgrades exceeded downgrades in 2022, though the number of upgrades was lower than in 2021.
- Ratings downgrades were all in the prime RMBS sector. These pertained to transactions that are now small pools with increased borrower concentration and tail-end risk.
- Ratings upgrades were due to a buildup in credit support and stable collateral performance. Higher prepayment rates in many transactions accelerated credit support buildup.
- The deleveraging in RMBS structures due to the initial sequential pay period creates a positive rating bias for lower tranches as credit support builds, provided asset performance is stable. Structural features such as reserves that trap excess spread add more support and this can enhance positive rating bias.

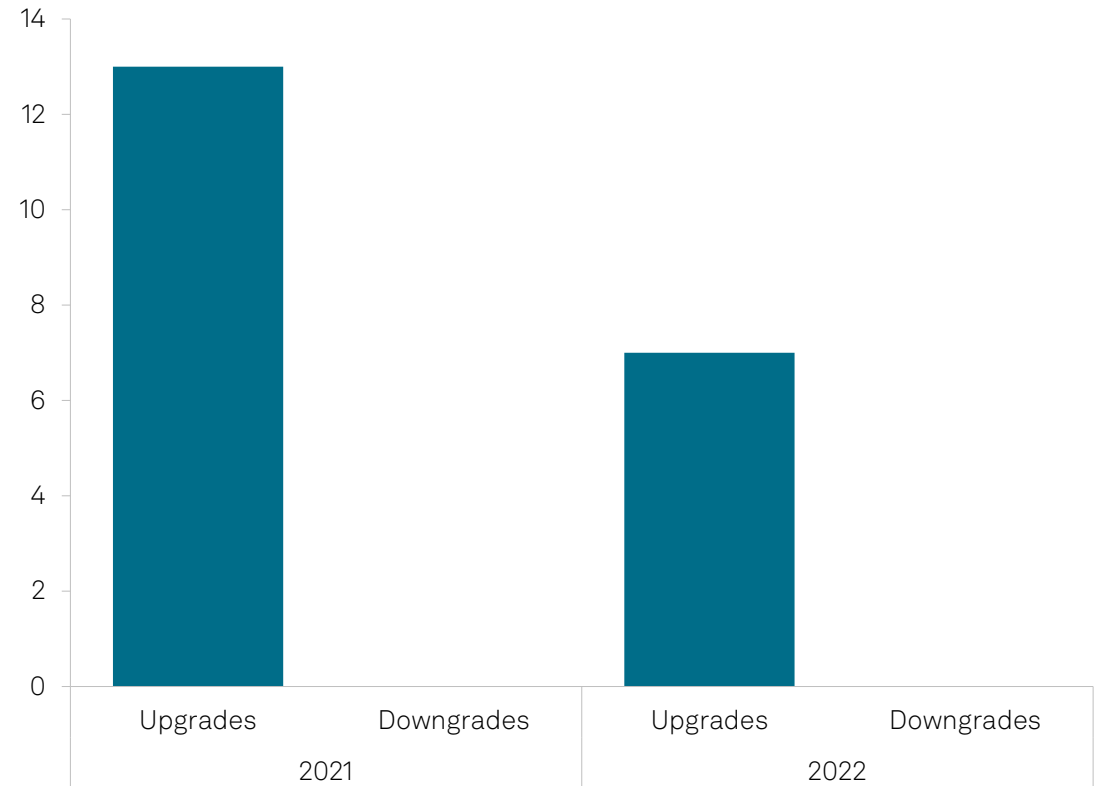
Rating Bias Remains Positive; Pace Likely To Slow

RMBS: Number of upgrades vs. downgrades



Source: S&P Global Ratings.

ABS: Number of upgrades vs. downgrades



Source: S&P Global Ratings.

New Issuance

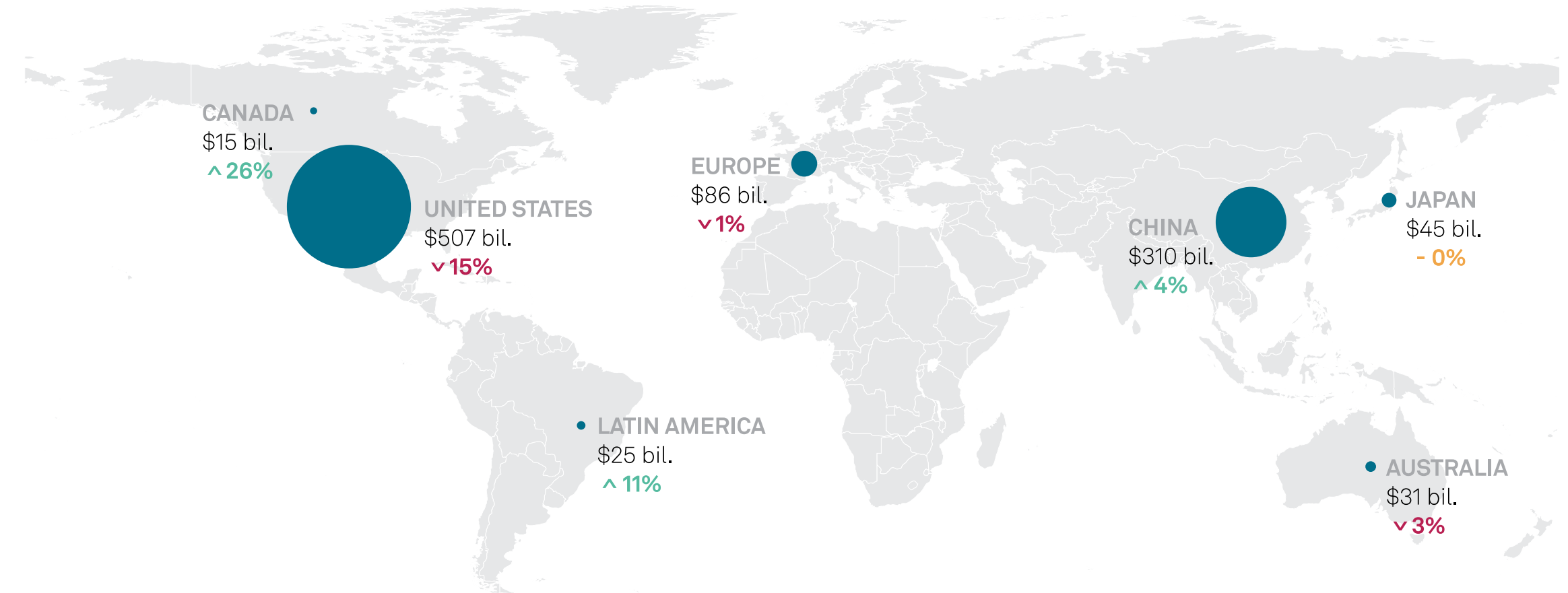
Momentum to slow as funding costs rise
and lending volumes fall

2023 New Issuance Outlook

- New issuance momentum is likely to persist in the first half of 2023 as issuers continue to navigate challenging funding conditions to term out warehouses and free up lending capacity.
- We expect issuance volumes to be slightly lower than 2022 levels overall.
- Nonbanks will be the dominant issuers again as banks utilize alternate funding sources that make more economic sense.
- New issuance activity is likely to tail off in the second half of the year, particularly for RMBS, as lending volumes decline given the slow down in property markets.
- There may also be some consolidation in the sector as persistently high funding costs force some players out of the market.
- As competition for prime borrowers heats up, nonbanks will need to pivot more to other lending segments, including self-managed superannuation fund loans, auto loans, and borrowers with more complex income streams.
- Despite the headwinds, demand for yield and relative value continues, with offshore interest in Australian structured finance products unlikely to be meaningfully deterred by the changing economic landscape.
- Global structured finance issuance fell about 29% in 2022. The declines were generally uniform in the largest global markets as high inflation, volatile interest rates, and geopolitical uncertainty kept issuers on the sidelines. We expect these conditions to continue to hamper issuance in 2023, with global issuance forecast to decline about 7% year on year.
- New issuance in Australia bucked the trend in 2022, with a record number of deals issued. However, smaller deal sizes saw overall new issuance volumes down from 2021 levels for both ABS and RMBS.

2023 Global Structured Finance Issuance Forecasts

2023 forecast vs. 2022 actual

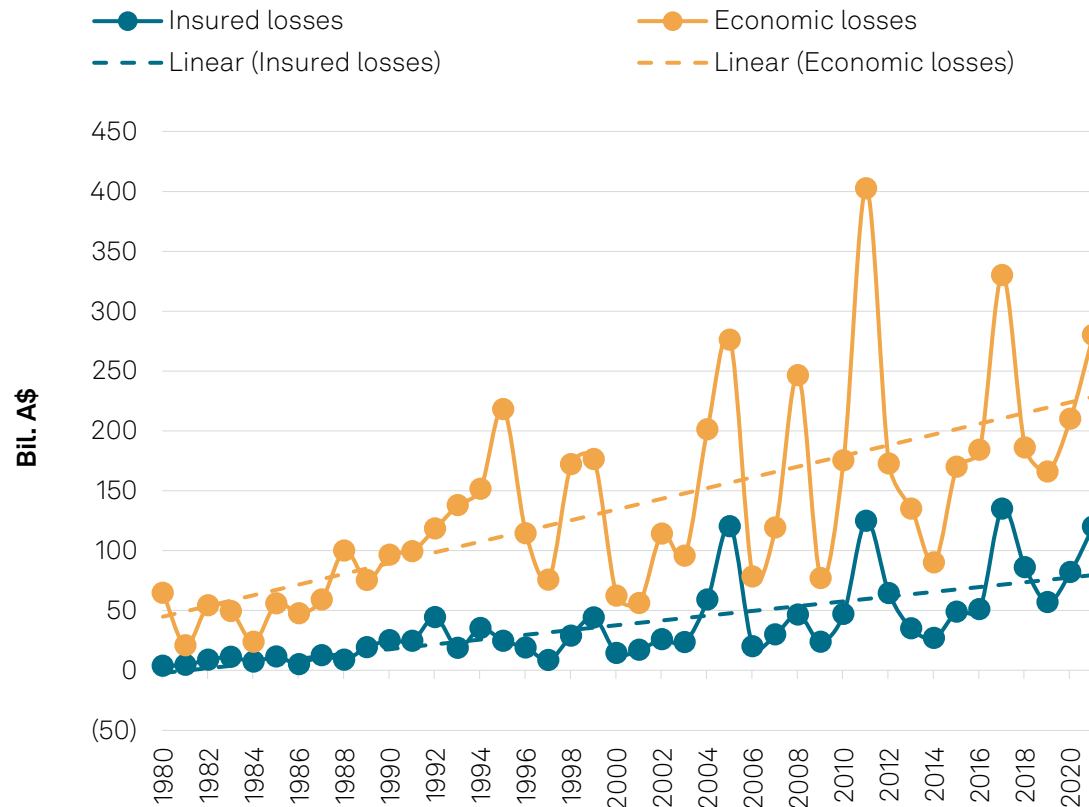


Source: S&P Global Ratings.

Watch This Space

Physical climate risk, sustainable securitization,
and new beginnings

Economic Losses Are Outpacing Insurance Coverage Globally



Source: Munich Re NatCatSERVICE.

- Rising global temperatures are contributing to the increasing frequency and severity of extreme weather events.
- The financial effect of extreme weather will continue to rise.
- Insurance against physical risks is a key mitigant for many sectors, including RMBS.
- The amount of insured losses from extreme weather is increasing more slowly than economic losses, leading to a protection gap in the economy.
- Underinsurance is a growing risk in Australia because the frequency and cost of damages from catastrophes have increased over the past two decades.
- Lenders are increasingly focused on how to manage physical climate risk across loan portfolios, but there is still more to do.

Looking Ahead

- Nonbanks face increasing competition from larger banks that are doggedly pursuing prime borrowers. Pivoting to new sectors therefore will be fundamental to growing loan portfolios amid a challenging economic landscape.
- Sustainable securitization is likely to gain more traction in 2023 as the energy transition and global efforts toward net zero gather pace.
- The ABS sector is likely to lead the transition to a green economy. Solar receivables, increasing new electric vehicle penetration, and charging infrastructure are among the ABS receivables that are likely to grow as consumers' preferences become more oriented toward global decarbonization efforts.
- The developments of the International Capital Markets Association's "Green Bond Principles" and "Social Bond Principles" in June 2022 will help support the sustainable securitization market.
- "Use-of-proceeds" securitizations, in which the collateral is not made up of sustainable assets, may be aligned with the association's principles if the proceeds are deployed on eligible projects in line with its Green Bond Principles.
- A lack of sustainable collateral originations and the absence of standardized data, disclosures, and definitions for securitizations remain challenges, despite the progress already made. Transparency will play a major role in the market's growth.
- A structural shift in the auto loan sector has created opportunities for nonbanks.

New Zealand

Harbinger of things to come

Mortgage Market A Test Case Of How Things May Pan Out In Australia

- The Reserve Bank of New Zealand (RBNZ) was a global frontrunner on monetary policy tightening and has taken a more hawkish approach to countering inflation than the Reserve Bank of Australia, with the official cash rate at 4.25% and further rate rises anticipated.
- Like Australia, New Zealand has high household debt. To date, the higher exposure to fixed-rate loans in New Zealand has shielded borrowers from rapid rate rises, but households will be tested when around 50% of outstanding residential mortgages to roll on to higher variable rates from low fixed rates this year.
- This will occur against a backdrop of falling property and higher cost-of-living pressures.
- Low unemployment has supported household spending and debt serviceability. Despite property price falls, many borrowers will have benefited from a strong build up in equity, given New Zealand topped the property price charts during the pandemic, with rises of up to 30%.
- The New Zealand RMBS sector has to date been relatively resilient to property price declines, given the modest LTV ratio profile of most transactions.
- New Zealand RMBS transactions have a high proportion of fixed-rate loans, ranging from 40% to 90%. This has shielded transactions from rate rises so far, with arrears less than 0.5% in most New Zealand RMBS transactions.
- New issuance in New Zealand is likely to be constrained by higher funding costs and lower demand for home lending as affordability pressures bite.
- The decision by the RBNZ not to pursue the Residential Mortgage Obligations (RMO) means that there is unlikely to be significant new mortgage-backed issuance from the banking sector.

S&P Global Ratings Economic Outlook

	2023f	2024f	Outlook	Effect on credit quality
Real GDP forecast (% year over year)	1.2	1.5	Economic fundamentals are strong. Household spending is holding up, despite high inflation, rising interest rates, and falling property prices. A recovery in international travel has been faster than expected, adding further demand-side pressures.	Negative. The economy is benefiting from a strong return to international tourism and higher global commodity prices, supporting New Zealand exports. But rapid rate rises will drag on the economy, given the sharp increase in interest rates.
Unemployment rate (year average; %)	3.9	4.4	Labor shortages are acute in New Zealand, holding back output in some sectors. Indicators point to New Zealand's employment being above maximum sustainable levels.	Positive. Lower unemployment is credit positive because loss of income is a key cause of mortgage default. Higher interest rates will cause unemployment to rise, though off low levels.
CPI (%)	5.3	3.4	High headline and core inflation and a tighter-than-expected labor market are driving up the cash rate. Wage price increases due to labor shortages are adding to inflationary pressures.	Negative. Higher inflation erodes real wages and will necessitate a longer period of monetary policy tightening. Wage increases will be supporting debt serviceability, but this will be offset by rising mortgage rates.
Policy rate, end of year (%)	5.5	4.75	The Reserve Bank of New Zealand raised the cash rate to 4.25% in November 2022. More rate rises are in the pipeline to counter inflationary pressures.	Negative. Rising interest rates can put pressure on arrears for more highly indebted households. New Zealand has a higher exposure to fixed-rate loans than Australia, which has delayed interest rate increases so far.

f--Forecast. CPI--Consumer price index. Source: S&P Global Ratings.



Erin Kitson

Primary Analyst

Melbourne

erin.kitson@spglobal.com



Narelle Coneybeare

Secondary Contact

Sydney

narelle.coneybeare@spglobal.com



Kate Thomson

Secondary Contact

Melbourne

kate.thomson@spglobal.com

Editor

Jason Mills

Digital Designer

Halie Mustow



Copyright © 2023 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.spglobal.com/ratings (free of charge) and www.ratingsdirect.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.spglobal.com/ratings/usratingsfees.

Australia: S&P Global Ratings Australia Pty Ltd holds Australian financial services license number 337565 under the Corporations Act 2001. S&P Global Ratings' credit ratings and related research are not intended for and must not be distributed to any person in Australia other than a wholesale client (as defined in Chapter 7 of the Corporations Act).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.

spglobal.com/ratings

S&P Global
Ratings