

**Australia**  
Special Report**Australian Structured Finance**  
**2009 Outlook****Analysts**

Structured Finance  
Natasha Vojvodic  
+612 8256 0350  
natasha.vojvodic@fitchratings.com

Ben McCarthy  
+612 8256 0388  
ben.mccarthy@fitchratings.com

David Carroll  
+612 8256 0333  
david.carroll@fitchratings.com

James Leung  
+612 8256 0322  
james.leung@fitchratings.com

Claire Heaton  
+612 8256 0320  
claire.heaton@fitchratings.com

Yvette Tse  
+612 8256 0358  
yvette.tse@fitchratings.com

Leanne Vallelonga  
+612 8256 0306  
leanne.vallelonga@fitchratings.com

Sovereign  
Ai Ling Ngiam  
+65 6796 7216  
ailing.ngiam@fitchratings.com

**Related Research**

- *Australian Mortgage Delinquency by Postcode - 30 September 2008 (November 2008)*
- *The Dinkum Index - Q308 - Fitch Ratings' Quarterly Australian Residential Mortgage Performance Report (December 2008)*
- *Australian CMBS: Maturity Hump Approaching (November 2008)*
- *Global Structured Finance Quarterly Rating Review Q408 (February 2009)*
- *Fitch Ratings 1991-2007 Global Structured Finance Transition and Default Study (April 2008)*
- *Australian Residential Mortgage Default Criteria (April 2008)*
- *Counterparty Risk in Structured Finance Transactions: Hedge Criteria (August 2007)*
- *Counterparty Risk in Structured Finance: Qualified Investment Criteria (September 2007)*

**Summary**

Throughout 2008 the global financial crisis was slow to materialise in Australia and on the whole, the Australian economy performed well. GDP growth stood at 2.4% for the year and unemployment finished the year at 4.6% (near 30 year low levels). As a result of the resilient economy, underlying assets in Australian structured finance transactions generally performed well and ratings were largely stable throughout 2008. Entering 2009, it is Fitch Ratings' expectation that the economic fundamentals for Australia will change. Fitch is predicting GDP growth for the calendar year 2009 at negative 0.8%, resulting in a rise in unemployment to 6.0% by the close of 2009. The slowing economy, rising unemployment rate, and falling prices of both residential and commercial property will likely result in a deterioration in asset performance during 2009; however, Fitch expects ratings on outstanding transactions to remain stable.

All Australian structured finance issuers across all asset classes faced liquidity challenges during 2008, with what started out as a liquidity crisis morphing into a credit crisis, due mainly to the rationing of credit and the inability of some lenders to continue writing new loans. The Australian government and the Reserve Bank of Australia (RBA) introduced initiatives to ease the effect of the crisis on home buyers and the general economy and these included: expanding the criteria for eligible assets to be repurchased for liquidity purposes; enabling the government to purchase Australian conforming RMBS; introducing stimulus packages with cash payments; and establishing an auto receivables SPV.

Overall, Fitch expects ratings to remain stable in 2009, except for non-conforming RMBS and some transactions with specific issues related to the originator/servicer. In all cases, Fitch expects the higher rated classes of notes to remain stable as a result of the structural mitigants in place and the build-up of credit enhancement since closing. The majority of ratings changes in 2008 came from counterparty exposure, especially through changes in ratings as regards the lenders' mortgage insurers (LMIs). Fitch expects counterparty risk to remain a factor in ratings' performance in 2009, particularly given the broadly negative outlook given to many financial and corporate sectors across the globe.

**Sector Highlights**

**Conforming RMBS:** Fitch expects some deterioration in the performance of Australian conforming mortgage loans, due to a slowing economy and a predicted increase in unemployment. Some of this deterioration will be offset by the effects of the significant reduction in home loan interest rates. Any increase in delinquencies is still off a very low base. Performance remains within expected parameters and Fitch expects ratings to remain stable. Any downgrades of mortgage insurers will affect the subordinated notes but this is expected to have limited, if any, impact on the ratings of the senior notes (due to the build-up of credit enhancement or structural enhancements to protect ratings from volatility in LMI ratings).

**Non-conforming RMBS:** Fitch expects the performance of Australian non-conforming mortgages to worsen over 2009, due to the deteriorating economy and the expected increase in unemployment (which will impact such borrowers more so than conforming borrowers). The limited availability of financing for non-conforming loans in the current market places additional pressure on non-conforming borrowers

(as such borrowers are now less able to re-finance due to the limited availability of funds as lenders retreat from higher risk lending products). The lower rated notes may experience some downgrade pressure, whereas higher rated notes should remain stable due to structural features and the build-up of credit enhancement.

**ABS:** delinquencies and losses are expected to increase due to the slowing economy and reduced refinancing options. The increase is still off a low base and the majority of ratings will remain stable, due to the structural features in the transactions and the build-up of credit enhancement.

**CMBS:** limited liquidity in debt markets will constrain refinancing options for those large commercial CMBS transactions that are nearing maturity. Issuers are expected to utilise a combination of relationship bank funding, equity raisings, lowering of distributions and asset sales to meet scheduled maturities. With the present weight of commercial property sellers exceeding buyers, it is expected that property prices will continue to decline during 2009. Delinquencies and losses are expected to rise for small-balance CMBS transactions as the economy slows and asset values decline. Ratings should remain stable due to low loan-to value ratios (LVRs) on large CMBS transactions, whilst small-balance transactions may see lower rated notes experiencing some downgrade pressure. Higher rated notes should be stable due to the structural features in place and the build-up of credit enhancement.

**ABCP:** depending on the assets in the ABCP programmes, there may be some decline in performance based on asset performance and counterparty rating actions. Overall, the Rating Outlook for conduits is stable, as sponsors will remove downgraded assets or credit enhance for them.

## Economic Outlook

Fitch forecasts Australia's economy to contract by 0.8% yoy in 2009, the worst economic performance since 1991. Australia's heavy reliance on external borrowings - to fund its persistent current account deficit - and its elevated household debt-to-income burden have come to a head, against the backdrop of tight wholesale funding conditions. The rapid deterioration in the external environment has also depressed commodity prices and weakened Australia's terms of trade position. This is particularly damaging since Australia's commodity dependence is high (at 52% of current external receipts) and heavily dominated by mineral and resource exports, especially iron ore and metallurgical coal, thermal coal and petroleum products.

Weakening residential housing prices have depressed households' net worth position, particularly since the combined asset value of dwellings and land constituted as much as three-quarters of households' net worth at June 2008. During Q1-Q3 2008, household debt was at a historical high of 159% of disposable income on average, while the ratio of households' interest payments to disposable income averaged 15% (nearly double the interest-servicing burden experienced during earlier property market corrections of 1990-1991 and 1996-1997). The dampening wealth effect and higher debt-servicing burden have put the brakes on domestic consumption, as households struggle with lower post-housing cost cash flows and consumers strive to improve balance sheets in the presence of the debt overhang (particularly since the bulk of mortgage loans have been contracted on a variable rate basis). Consumer retrenchment has gathered pace since Q108, with Q308 household expenditure growth at the lowest pace (1.7%) yoy since Q393. Already, the seasonally adjusted household savings ratio has increased from 0.2% in Q407 to 3.9% in Q308, as households rebuild their savings on the back of heightened uncertainty over economic stability and job security. Fitch expects consumer spending to fall for the first time in 47 years in 2009, to 0.8% yoy.

Fitch expects private sector investment activity to fall by about 2.6% yoy in 2009, after seven successive years of expansion, averaging 9% yoy. Although Australian

corporates have built up strong cash reserve buffers in recent years (on the back of high profitability), higher borrowing costs, tighter lending standards, a marked reduction in access to international capital markets and weak domestic and international end-demand all point to a deceleration of investment activity. Although the prior tight labour market conditions and high capacity utilisation rates (low output gap) have delayed any observable effect of the economic moderation on unemployment rates and labour market participation levels (as at October 2008), Fitch projects the unemployment rate to reach 6% in 2009, up from 4.6% in 2008. Negative feed-through effects from worsening labour market conditions pose further downside risks to economic growth.

On a more optimistic note, aggressive cuts (totalling 400bp) in the target cash rate by the RBA since September 2008 have helped depress the short-end of the domestic yield curve, as well as the 90-day bank bill swap rate, which most corporate borrowings' are based on. The government's full deposit guarantee scheme and its guarantee on wholesale funding of financial institutions has also helped facilitate banks' access to offshore markets, while the 9% yoy AUD depreciation during H208 has provided upside support to the export engine. An initial fiscal stimulus plan in December 2008, worth 0.8% of nominal GDP has also been put in place to support pensioners, low income households and first-time homebuyers (to help buffer the shocks from the external downturn). A second stimulus package, amounting to AUD42bn, has also been introduced by the government in February 2009 to promote growth in the economy.

### **Australian Property Prices – Residential**

Fitch forecasts a reduction of up to 10% in average Australian residential house prices in 2009. Weakening economic conditions, along with slowing domestic and international demand and the challenging credit environment, is expected to push unemployment to 6.0%, up from 4.6% in 2008. This is expected to result in a drop in household income which will place downward pressure on house prices, particularly in the resource boom states of Western Australia and Queensland (which have experienced significant property price increases over the past five years). Property market indicators show that housing finance commitments have dropped 20.9% (in the 12 months from October 07), residential building approvals have fallen 34.7% (in the 12 months from November 07) and auction clearance times are stretching well above the liquid levels of 2006.

Fitch does not expect falls in property prices to the extent seen in the US, as Australian lending standards have been maintained at a relatively conservative level and the option of full borrower recourse remains standard in Australian mortgages.

However, a cause for concern is the high household debt to household disposable income ratio, which stood at 156% as of September 2008, three times higher than the ratio during Australia's last severe property price downturn in 1990. This situation could potentially perpetuate further slides in property prices if the initial price declines feed into lower household consumption, which could lead to further job losses and property foreclosures.

On a positive note, as inflation is not expected to increase in the current economic environment, the RBA has extra scope to influence demand in the form of interest rate cuts. A significant boost in disposable income will be received by those households in mortgage debt, as a result of the rate cuts of 2008 and expected further rate cuts of 2009. Those in debt that remain employed will in fact have a higher level of disposable income in the coming year. However, the additional aggregate demand created may be offset by the demand lost as a result of those becoming unemployed (and thus unable to continue making period loan repayments).

From an RMBS ratings standpoint, Fitch expects the movement in property prices to have limited impact. When rating RMBS transactions Fitch uses its Australian Mortgage Default criteria (see research, “*Australian Residential Mortgage Default Criteria*” dated 3 April 2008). In rating RMBS transactions, Fitch includes stress testing for falling property prices. At the ‘AAA’ level, market value declines (MVD) used to stress a standard RMBS portfolio range from 40% to 65%, depending on property type and location. For ‘B’ rated notes, the stress included ranges for 12% to 19.5%. The expected property price declines remain below the ‘B’ stress level and so are unlikely to impact ratings above this level.

### **Conforming RMBS**

**Asset Performance Outlook: Stable/Negative**

**Rating Outlook: Stable**

Fitch tracks the performance of conforming RMBS in its quarterly Dinkum index. Delinquencies and losses were on the rise in 2008 and, despite the 400bp reduction in interest rates by the RBA, Fitch expects this trend to continue in 2009, due to the expected weakening economy and rising unemployment levels.

In a falling property price environment, borrowers no longer have the option to refinance when they experience difficulties in making repayments; a contraction in available credit has occurred, with loan products no longer being provided due to a lack of available funding for non-bank originators and the increased cost of funds for financial institutions. Anecdotal evidence suggests few high LVR loans are being written and low documentation or no-documentation loans are difficult to obtain.

The Australian government and the RBA have introduced a number of initiatives to assist in the provision of funding and to improve competition between Australian lenders, especially non-bank lenders. On 26 September 2008, the government announced the provision of AUD8bn for investment in Australian conforming RMBS through the Australian Office of Financial Management (AOFM). The government has allocated a minimum of AUD4bn for funding non-bank originated transactions, with the express intention of fostering competition in the Australian mortgage market and supporting the non-bank sector through difficult circumstances. As at 31 December 2008, AUD1.996bn had been invested in Australian conforming RMBS by the AOFM across four transactions. In addition to the AOFM initiative, the RBA extended the eligible criteria for assets which can be repurchased to include Australian RMBS; this is expected to increase liquidity, and therefore demand, of such assets.

The RBA is expected to further cut rates in the first half of 2009, further improving mortgage serviceability. The key to the ultimate performance of conforming mortgages remains the economic conditions and the unemployment rate.

Fitch expects 30+ day delinquencies for Australian RMBS to be in the region of 1.5%-2.0% in 2009. The agency’s data indicates that low documentation loans perform worse than fully documented loans and 30+ day delinquencies for conforming low documentation loans are expected to be 3.5%-4.0%. The level of loan losses, prior to mortgage insurance being applied, increased off a low base through 2008 and Fitch expects this trend to continue through 2009 through the interaction of deteriorating loan performance and a softening property market. To date, no charge-offs have been made to any notes and lenders’ mortgage insurers and excess spread have covered any loan losses. Fitch expects this to continue to be the case in 2009.

Counterparty rating actions - especially those related to the lenders’ mortgage insurer ratings - caused consequential rating actions on conforming RMBS note ratings during 2008. Fitch expects that any further rating actions on the insurers would only have consequential rating action on the subordinated notes and little or no affect on the senior notes, due to the structure of the majority of transactions (which eliminates insurance downgrade risk on the most senior ‘AAA’ notes).

Delinquency and loss levels are still within Fitch's rating parameters and, subject to any counterparty rating actions, the agency expects a Stable Rating Outlook for conforming RMBS transactions.

## **Non-Conforming RMBS**

**Asset Performance Outlook: Negative**

**Rating Outlook: Negative**

There were a number of downgrades in non-conforming RMBS during 2008, due to the performance of the underlying mortgages and losses given default being higher than expected, based on the applicable rating of the notes.

The effect of falling property prices over the last 12-18 months, in combination with the financial crisis, has been more severe for non-conforming borrowers. Previously increasing property prices enabled borrowers to sell their property when they experienced financial difficulties, or else refinance into a new loan. Due to the current financial crisis, many of these loan products are no longer available and very few non-conforming lenders are writing new loans. In addition, falling property prices often mean that the borrower no longer meets the eligibility criteria for a new loan.

With the expected downturn in the economy and rising unemployment in 2009, Fitch expects the performance of non-conforming mortgages to further deteriorate. As with conforming mortgages, some of this deterioration will be offset by cuts in interest rates. However, an economic downturn is expected to affect non-conforming borrowers more severely because this sector tends to include a higher percentage of self-employed borrowers.

At present, the government and RBA initiatives available for conforming RMBS are not available for non-conforming RMBS, so non-conforming lenders have less capacity to continue writing business.

Fitch expects 30+ day delinquencies for non-conforming RMBS to be in the range of 18%-23% in 2009. The level of losses given default increased during 2008 and this is expected to continue and reach 15%-25% in the coming year.

Fitch expects there to be further downgrades in non-conforming RMBS in 2009. Any downgrades are expected to be concentrated on the lower rated notes, with less pressure on the higher rated notes due to transaction structural features and the build-up of credit enhancement.

## **CMBS**

**Asset Performance Outlook: Negative**

**Rating Outlook: Stable/Negative**

There were a small number of tranche downgrades within CMBS transactions during 2008. Downgrades were shared across small-balance and large single borrower CMBS. For small-balance CMBS, the size of loss given default was higher than expected, resulting in the downgrade of the Seiza Augustus Series 2007-1 transaction. The downgrade in single borrower CMBS affected the lower rated tranches of a Centro-originated CMBS transaction and stemmed from the perceived higher risk of refinancing due to the transaction sponsor's significant corporate debt refinancing issues.

2009 will see a rise in CMBS maturities, with approximately 44% (AUD3.4bn) of total outstanding Australian CMBS maturing during the year ahead. The global credit crisis has resulted in limited refinancing options for upcoming maturities of large commercial CMBS transactions, with issuers expected to utilise a combination of funding from relationship banks, equity raisings, the lowering of distributions and asset sales to meet scheduled maturities (for more information, please refer to Fitch's report, "*Australian CMBS: Maturity Hump Approaching*", dated 25 November 2008).

With the present weight of commercial property sellers exceeding buyers, it is expected that property prices will continue to decline during 2009. Property capitalisation rates have slowly risen during 2008, with a commensurate fall in property values. 2009 is expected to see a greater rise in capitalisation rates, which will result in steeper declines in values. Occupancy rates have held up well to-date, but are expected to evidence greater levels of vacancies - particularly sub-let space - as the economy slows. Rents are not expected to grow, resulting in no offsetting of the higher capitalisation rates; therefore, the full impact of falling values should become more apparent during 2009.

Delinquencies and losses are expected to rise for small-balance CMBS transactions as the economy slows and asset values decline. Ratings should remain stable, due to low LVRs and structural mitigants within existing transactions.

Fitch expects further tranche downgrades in small-balance CMBS during 2009; more so in the lower rated notes, with less pressure on the higher rated notes due to the transaction structural features and the build-up of credit enhancement. Whilst Fitch expects large commercial CMBS transactions to evidence asset value declines during 2009, these are not expected to impact ratings due to the historic build-up of asset values and generally high occupancy rates that underpin income.

## **ABS**

### **Asset Performance Outlook: Stable/Negative**

#### **Rating Outlook: Stable**

Fitch's expectations for auto loan ABS performance in 2009 are negative due to the downturn in the economy, the slowdown in consumer demand - with large reductions in car sales - and the expected increase in unemployment. Performance will be affected as regards both default probability and loss severity. Some of the deterioration in performance due to these macroeconomic factors will be offset by lower interest rates and lower petrol prices.

The financial crisis has already impacted two of Australia's auto finance companies, with GE Money and GMAC exiting the market in 2008; in addition, Ford Credit also announced its partial withdrawal from the market. As it has done in the conforming RMBS sector, the Australian government has announced an initiative to support the auto sector and has established a AUD2bn fund to assist with funding for car dealers. This will help provide liquidity to financiers of car dealerships.

Fitch expects 30+ day delinquencies for auto loans to cumulatively increase to 2%-3.5% in 2009, due to the increase in unemployment and slowdown in the economy; the agency expects net losses to rise marginally.

The expected decline in performance is still within Fitch's rating parameters and the majority of ratings are expected to remain stable (as a result of structural features and the build-up of credit enhancement).

## **ABCP**

### **Asset Performance Outlook: Negative**

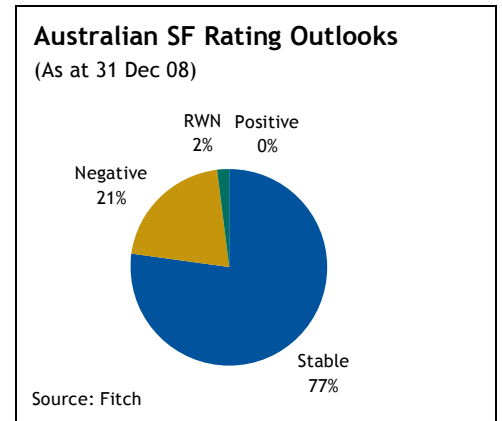
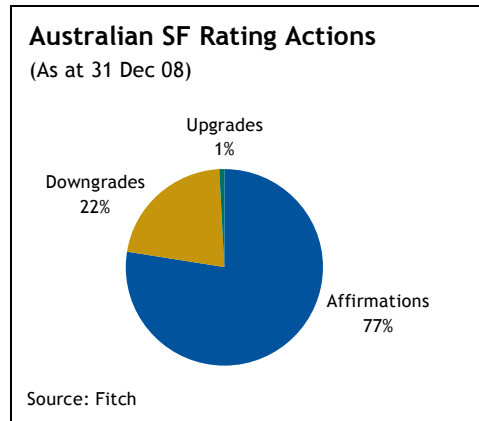
#### **Rating Outlook: Stable**

Underlying assets in Australian ABCP cover the whole range of structured finance assets, including conforming and non-conforming RMBS, ABS, CMBS and mono-line wrapped securities.

Due to the downturn in the economy, Fitch expects the underlying asset performance to be negative in 2009. The other main determinant of the ratings of ABCP programmes is the ratings of the counterparties to the programmes, including liquidity and hedge providers. Any rating actions on these counterparties could affect the ratings of the programmes.

Due to mitigants in most ABCP structures - which enable assets to be removed upon downgrade or further credit enhancement to be provided to a programme to maintain its rating - Fitch expects the ratings for ABCP to remain stable in 2009.

## Appendix: Australian Structured Finance Rating Actions and Rating Outlooks – 2008



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