

## U.S. Structured Finance 2010 Midyear Outlook: Regulatory Issues May Temper The Market's Recovery

Lingering economic and regulatory uncertainties are keeping a lid on U.S. structured finance issuance. And high unemployment continues to adversely affect incomes and, consequently, the performance of collateral underlying U.S. structured finance transactions. We believe the liquidity situation will likely continue to improve and new issuance may continue to come from the non-mortgage consumer asset-backed securities (ABS) sector, especially auto loan ABS, as in the first half of 2010. New structured finance transactions have come to market with tighter underwriting guidelines and less leverage than before the downturn.

Standard & Poor's Ratings Services believes the positive momentum that began in 2009 should continue in the second half of 2010. Tightening credit spreads and stabilizing collateral performance for the structured finance assets, with the exception of commercial mortgages and private student loans, along with growing interest in issuance across most structured sectors are good indicators, in our view, of this continuation. However, new or proposed regulations have affected the securitization market because of various restrictions on sponsors of structured transactions, including higher capital requirements and proposed risk retention requirements, as well as a greater amount of required disclosures.

A fragile economy, combined with potential regulatory overhang and changes, hasn't necessarily been helpful for the structured market's positive momentum. While some economic indicators are positive, especially three consecutive quarters of GDP growth, the economy has been slow to recover. That's partly because consumers are in no position financially to lead this rebound, as they were in the previous two recoveries. The structured market recovery is also lagging the overall economic recovery, as expected. Furthermore, the amount of distressed "shadow" housing inventory continues to pose risks not only in the mortgage space but for the entire consumer sector, although the U.S. housing market is showing signs of stabilization.

The improved liquidity for structured securities has come mainly from federal government programs. These include the Term Asset-Backed Securities Loan Facility (TALF), the Federal Reserve's mortgage securities purchase program, and tax credits for homebuyers, which significantly contributed to increased liquidity and a tightening of credit spreads for structured sectors. This has effectively lowered funding costs and replenished liquidity in the capital markets. Most of these programs ended in the first half of 2010 as the U.S. government slowly dialed back its intervention in the capital markets.

We expect the following for the key structured finance sectors during the second half of 2010:

- The volume of new U.S. residential mortgage-backed securities (RMBS) issuance has remained low for several years now, and we expect it to stay low through at least the end of 2010. This is because most residential mortgages are being issued through the government-sponsored enterprises, and this isn't likely to change until Congress determines the fates of Fannie Mae and Freddie Mac. Elevated levels of delinquencies and additional home price declines are also likely to hurt residential collateral performance in the second half.
- Market interest in U.S. auto loan ABS appears to be intact even without the TALF program, including renewed interest in both subprime auto transactions and subordinate bonds. U.S. auto loan collateral continues to benefit from improved credit performance due to the tighter underwriting standards that auto finance companies have implemented since 2008.
- Our outlook on the U.S. auto lease ABS market remains stable to positive for the remainder of 2010. Collateral performance has stayed relatively strong, with credit and residual losses generally in line with or better than our initial expectations. This mainly reflects an improving economy and the strongest used-vehicle values we've seen in recent years.
- U.S. banks' overfunded position and the uncertain effects of regulatory and accounting changes have squeezed credit card ABS issuance to levels we haven't observed since the 1990s. We've seen an overall improvement in the performance of most credit card ABS collateral, however; as a result, we think our ratings on credit card ABS should remain relatively stable for the remainder of 2010.
- Although the Federal Family Education Loan Program (FFELP) is ending on July 1, our outlook remains stable on FFELP ABS for the remainder of 2010 due to the federal reinsurance of at least 97% on this collateral. At the same time, high unemployment continues to weaken the performance of private student loan collateral, as recent graduates are struggling to find jobs. Therefore, our outlook on private student loan ABS continues to be negative.
- High unemployment will continue to put pressure on commercial real estate fundamentals. As a result, we believe vacancies will continue to increase in many markets for the remainder of 2010. This is likely to keep rents down for the foreseeable future, which, in our view, will result in rising loan delinquencies. New commercial mortgage-backed securities (CMBS) issuance is likely to remain subdued until fundamentals and loan delinquencies stabilize.

- We expect asset-backed commercial paper (ABCP) outstandings to remain relatively flat to slightly down for the remainder of 2010. ABCP sponsors will probably continue the trend that began in early 2010 of cautiously increasing new transaction activity, mostly to replace exiting and/or amortizing transactions. Nevertheless, the U.S. ABCP market remains stable in an environment where participants continue to grapple with changes in the U.S. regulatory landscape and lower demand for credit.

## **Standard & Poor's U.S. Economic Outlook: A Sluggish Recovery Won't Do Much To Boost Securitization**

The incoming data have shown that the economy is growing, but at a sluggish pace, supporting our early views that this is likely to be a half-speed recovery. All of the recent recoveries from U.S. recessions have been "jobless recoveries," and this is no exception.

### **Consumer and business spending are up**

Despite the tepid recovery, demand continues to increase. Consumers are still spending money, although they remain cautious about borrowing. Businesses are spending more on capital equipment as demand improves.

### **Construction still hasn't recovered**

Construction remains a weak point. Although residential construction is beginning to stabilize, nonresidential construction—except for stimulus-related spending—continues to drop.

There are questions remaining about how the housing market will fare. Housing sales dropped in May, after the expiration of the homebuyer tax credit. Housing starts also dropped sharply in May. May sales of new and existing homes were down 37% and 2.2%, respectively. The S&P/Case-Shiller home price index (which covers 20 cities) was up 2.3% from a year earlier in March, the second consecutive year-over-year increase after three years of decline.

However, we believe that the overhang of unsold homes, including those in the process of foreclosure, will probably bring prices down. We expect higher mortgage rates and the end of the tax credit to cut home prices by another 5% through 2010, bringing them back to the lows in April 2009. Sales are also likely to drop over the summer. Lower housing starts will be another factor holding down GDP and employment growth late this year. While we believe the worst is over, housing appears to be stabilizing more than recovering.

### **The U.S. stimulus is winding down**

The massive stimulus package aided economic growth this year, but the government will withdraw most of it over the next year or two. Tax hikes and spending cuts seem likely in 2011, because of both the end of the current stimulus package and the expiration of the 2001 tax cuts. These changes are necessary to control the deficit, but they will tend to slow economic growth.

### **Will European debt troubles affect the U.S. recovery?**

European sovereign debt problems—particularly in Greece, Spain, and Portugal—pose a significant challenge to the global economy. The direct effect of the crisis on U.S. exports, however, is a minor problem. Although Europe accounts for nearly 25% of U.S. exports, most of those go to Northern Europe, which has not been hurt directly. The weaker euro is more of a problem because U.S. goods are less competitive than they were a few months ago, but the trade-weighted dollar is not much different than it was a year ago (up 1%). The real fear is that the Greek debt issue might escalate into a major financial panic, as followed the falls of Lehman Bros. and American International Group in 2008.

The financial turmoil in Europe will likely keep the Federal Reserve on hold for a few more months. Although Thomas Hoenig, President of Kansas City Federal Reserve Bank, has called for a summer rate hike based on the evidence of growth in the U.S., most members of the Federal Open Market Committee (FOMC) appear to remain nervous about the state of the financial market.

The economy is beginning to recover, but we believe the upturn is likely to be slow and fragile. Consumers cannot lead the recovery as they did after the 1991 and 2001 recessions, and thus demand for consumer loans is likely to remain relatively soft. The housing market appears to be stabilizing, but most of the mortgages are being issued through the government-sponsored enterprises. In our view, the issuance of RMBS isn't likely to revive until Congress determines the fates of Fannie Mae and Freddie Mac. Commercial mortgages are also in low demand because of high vacancy rates and resulting declines in construction activity. A weak economy is thus expected to keep the market for structured products stagnant.

### **Legislative And Regulatory Outlook Depends On Several Variables**

A number of measures being considered by the U.S. Congress and government agencies are likely to affect the

securitization market. These measures would impose restrictions on sponsors of securitizations and submit transactions to far greater regulatory oversight. We believe that, together with recent changes in generally accepted accounting practices affecting sponsors of securitizations and rules concerning the amount of capital banks will be required to hold against securitized debt, legislative and regulatory actions are likely to result in costlier transactions that take longer to get to market. However, these transactions will also provide a much greater amount of disclosure to investors. Another practical challenge for issuers to overcome is compliance with the SEC's amended Rule 17g-5, which became effective on June 2, 2010. This rule requires structured finance issuers to provide extensive information to credit rating agencies on a dedicated Web site.

The financial services regulatory reform bill (the Dodd-Frank bill), requires the SEC and Federal banking agencies to implement regulations that would affect certain aspects of securitization, such as risk retention and minimum disclosure and reporting obligations. Regulations the SEC and the FDIC are currently proposing already address some of the matters in the bill covers, but would likely have to be amended to comply with its final text.

A risk-retention feature is a condition of eligibility for the FDIC's proposed revised securitization safe harbor (FDIC's proposed rule), which would apply to bank-originated transactions. The SEC, in its proposed rules to amend Regulation AB, would condition shelf offerings of securitized debt to risk retention. The SEC's proposed rule would, in addition, mandate, among other things, greater disclosure of structural characteristics of underlying asset and transactions for public and privately placed securitizations and would substantially alter the offering process for securitized debt in a manner that would result in greater government oversight of these offerings. The FDIC's proposed rule also mandates expanded underlying asset disclosures for eligibility for its proposed revised securitization safe harbor.

In addition, a bill before Congress is proposing to allow the discharge of student debt in bankruptcy. Last year, a bill permitting the modification of certain residential mortgage loans in bankruptcy was abandoned, but could be revived. If passed, either of these bills could result in increased numbers of bankruptcy filings, which in turn would allow other debt, such as credit card debt, to be discharged under the U.S. Bankruptcy Code. This would likely cause a rise in losses in securitized student loan, residential mortgage, and credit card receivables pools and change our assumptions on transactions, which could result in greater credit enhancement levels.

The financial sector as a whole is going through a period of increased regulation aiming to address issues raised during the recent financial crisis. Until the dust settles and the final laws and regulations are adopted, however, we plan to review all the changes and take them into consideration in our analysis of securitizations in accordance with our criteria.

### **Stricter Underwriting Adds Up To A Stable To Positive U.S. Auto Loan ABS Outlook**

Despite the persistent high level of unemployment, Standard & Poor's expects the U.S. consumer auto loan ABS market to benefit from generally improved credit performance in 2010. We also believe that the tighter underwriting standards auto finance companies implemented beginning in the second half of 2008, along with lower credit losses on the 2009 securitizations and the rapid de-leveraging in most auto loan ABS transactions will generally support continued rating stability for the rest of 2010. Although there may be some downgrades, we expect most will be confined to the lower-rated classes from 2007- and 2008-vintage transactions. Furthermore, while new securitization rules may temper issuance for the remainder of the year, we believe higher auto sales and renewed investor appetite for auto loan ABS will support annual issuance growth of 10%, which would bring 2010 issuance to just under \$50 billion.

After restricting lending for two years, auto finance companies started increasing their loan volume since late 2009, most likely due to improved access to capital, tighter credit spreads, and stronger demand for new and used vehicles. In addition, even without the government's TALF program, which expired in March, market appetite for auto loan ABS appears to be returning. Investors once again appear to be investing in 'BBB' rated subordinate bonds, including those issued out of subprime auto loan ABS. Standard & Poor's has been rating subprime auto loan ABS since 1991. We define subprime auto loan collateral as those loan pools with expected cumulative net losses of 10% or higher. Also, the subprime collateral generally has a weighted average FICO score of 620 or lower.

We believe the TALF program was successful in re-starting the ABS market in 2009. The market's reliance on the program waned as spreads narrowed, however, which ultimately meant that its expiration was a relative nonevent. The June 2 implementation of the SEC's amended Rule 17g-5 for structured finance transactions is the latest issue facing the ABS market. It's unclear when auto finance companies will have their systems ready to accommodate the new rule and to what extent this might change their issuance behavior.

### **Issuance starts strong as investor appetite returns for subprime auto bonds and subordinate classes**

Year-to-date issuance of auto loan ABS has totaled approximately \$19 billion, which is up more than 45% over last

year's \$13 billion issuance through May of last year. Furthermore, the number of auto loan ABS transactions has more than doubled to 24 from 11. The rise in issuance largely reflects a 17% increase in vehicle unit sales for the first five months of the year compared with the same period last year, as well as issuers bringing new transactions to market before the 17g-5 rule took effect. Given the tremendous narrowing of spreads during the second half of last year, issuers found that TALF leverage financing was no longer feasible by January. Only one transaction obtained TALF certification this year (AmeriCredit Automobile Receivables Trust 2010-1), and in the end, investors bought its 'AAA' rated bonds without using TALF borrowings.

In addition to the spike in prime issuance this year, we've seen a renewed interest in both subprime transactions and subordinate bonds. Through May, subprime bonds from five transactions accounted for 13% of the total issuance in terms of dollar volume (compared with zero at this time last year). This amount is still down from its peak in 2006, when subprime represented approximately 24% of total auto loan ABS volume. With respect to lower-rated subordinate tranches, in May AmeriCredit sold 'BB' rated ABS for the first time since 2006 with its sale of the class E bonds from AmeriCredit Automobile Receivables Trust 2010-2. Also, in February, Ford Credit sold the subordinate tranches on its 2010-A transaction at issuance.

In looking at the static pool performance of auto loan ABS securitizations, cumulative net losses have swelled for the 2007 and 2008 vintages but have started to decline for the 2009 securitizations. We believe the improvement is predominantly due to tighter underwriting standards that auto finance companies began to implement in late 2008.

### **Deal structures withstand economic pressure, and ratings stay strong**

Despite the deterioration in credit performance of many rated auto loan ABS transactions, particularly those issued in 2007 and 2008, rating actions in 2009 and so far this year have been overwhelmingly positive. In fact, upgrades through June 17 outnumbered downgrades 19-to-1.

Most of the 2007 and 2008 deals are performing worse than we initially expected, which is why we have raised our net loss expectations accordingly. Loss trends notwithstanding, we have upgraded certain classes due to the solid mechanics of the transaction structures, which benefit from features like sequential principal payment waterfalls, performance triggers, and de-levering mechanisms that take effect as pool balances amortize.

We had initiated 57 upgrades through June 17. AmeriCredit, predominantly a subprime auto loan ABS issuer, experiencing 13 upgrades across five transactions--the most of any auto loan ABS issuer. While we have increased our loss expectations for most of these transactions, we raised the ratings because credit support has increased as a percent of each series' amortizing pool balance due to the benefits of deleveraging.

Our ratings outlook for the remainder of 2010 is generally stable to positive, and it's possible that upgrades for the full year may exceed 2009's total of 95. The number may even be in line with the historically high 117 we initiated in 2007. We may also lower some ratings throughout the rest of the year, but we expect the downgrades to primarily affect lower-rated classes.

Given the implementation of stricter underwriting standards that began in late 2008, combined with increasing credit enhancement for most of the 2008 and 2009 deals, we believe the ratings and collateral for the late-2008 and later deals will perform better than those from 2007 and early 2008. We also believe that the returning demand for new and used vehicles, albeit still not back to historical norms, flanked by the strong performance of used-vehicle prices, will continue to have a favorable impact on net losses.

### **Auto Lease ABS Performance Is Improving On Rising Used-Vehicle Prices**

Standard & Poor's overall outlook for the U.S. auto lease ABS market remains stable to positive for the remainder of 2010. Collateral performance has remained relatively strong, in our view, with credit and residual losses generally in line with or better than our initial expectations. We believe this reflects an improving economy and the strongest used vehicle values we've seen in recent years.

So far this year, issuance has been flat compared with that in 2009, and we believe it may slow in the second half of the year. Through the end of May, U.S. auto lease ABS issuance volume remained in line with levels in the same period of 2009, with two issuers, Ford and Nissan, bringing deals to market. Three transactions closed in the summer of 2009; however, we expect this number to be down in 2010 as the ABS market navigates through a series of proposed financial reforms—including the SEC's Rule 17g-5.

### **Fewer used vehicles on the market is helping the leasing business**

Many originators either cut back on or stopped leasing altogether during the recent downturn, thereby lowering the number of used vehicles in the market. This downturn ran from late 2008 through early 2009 as dislocated credit markets, spiking fuel prices, and increased inventory led to a roughly 25% year-over-year decline in used-vehicle

values. This hurt originators' ability to offer lease subvention, which lowers the monthly lease payments by inflating the residuals. Without subvention and the resulting lower monthly payments, leasing became less affordable for consumers—and uneconomical for originators.

Lower lease origination volume ultimately limited the number of off-lease (used) vehicles for sale, while lower new-vehicle production helped increase consumer demand for used vehicles. Additionally, as new vehicle sales dropped off, the turn-in of used vehicles that typically accompanies a new vehicle sale declined as well. Moreover, rental car companies cut back their purchases and held existing fleet inventories longer, which also contributed to a decline in used-vehicle supplies.

The recovery in used-vehicle values and third-party residual forecasts has been dramatic, and supply is having difficulty keeping up with demand. As of May 2010, the Manheim Index, which measures all completed sales transactions at Manheim's U.S. auctions, reached its peak. This represents a 10.9% increase over May 2009 and a 23.5% increase over the low point in December 2008.

### **Will the recovery last?**

The improvement in used-vehicle values may not be sustainable, however. New vehicle production, sales, and leasing volume have each begun to ramp up, although they continue to remain below historical averages. But even if used-vehicle prices were to soften over the next several years, we believe the stress scenarios we assume for our higher rating categories, combined with the sequential payment structures of these transactions and the resulting deleveraging, will be sufficient to maintain stable to positive ratings in the near term.

### **Credit Card ABS Issuance Falls To Levels Unseen Since 1990s**

Despite favorable ABS pricing conditions, U.S. banks' overfunded position and the uncertain effects of recent and future legal, regulatory, and accounting proposals have squeezed credit card ABS issuance back to 1990s levels. Our original issuance expectations earlier this year called for between \$45 billion and \$55 billion in publicly rated credit card ABS. Based on the relatively low volume we've seen in the first half of 2010, a forecast of about \$15 billion to \$20 billion now seems more reasonable.

The top six bankcard originators (Chase, Citibank, Bank of America, American Express, Capital One, and Discover) make up a smaller portion of total credit card ABS compared with previous years, accounting today for about 60% rather than 80%-90% that we have seen. We think that issuance will continue to be concentrated in 'AAA' and 'AA' rated securities, which are typically senior in the payment priority of capital structures.

### **Credit card losses may dip below 10% if receivables stabilize**

Following Standard & Poor's Chief Economist David Wyss' stable-to-declining forecast for the U.S. unemployment rate at 9.6% in a baseline (80% likelihood) and 10.4% in a pessimistic scenario (20% likelihood), we slightly lowered our expected credit card loss rates to 10%-11% for 2010 from 10.5%-12.5%.

Our loss forecast for this sector exceeds the unemployment forecast for a few reasons. The most apparent one is that loss rates are calculated as a percentage of principal receivables, which are steadily declining (the denominator effect). As of April 2010, revolving credit at \$838 billion decreased 13% since the peak in 2008. Absent the denominator effect, we believe loss rates would be about 9.5% if receivables stabilized. Also, credit card losses tend to lag behind the unemployment rate, and they're driven by other macroeconomic variables, such as household wealth, overall debt burden, saving rate, and bankruptcies, among others. For example, bankruptcies account for about 20%-40% of credit card losses, and we expect bankruptcy filings to increase by about 10% this year. This is on top of the 32% increase in filings last year.

We are also observing strategic defaults, which are decisions individual obligors make based on their unique circumstances. We believe that the traditional and somewhat predictable payment pattern of consumers has changed in the past couple of years. In the past, people would typically default on their credit card debt first and pay their car loan and mortgage obligations on time. Today, some people would rather maintain a good payment history with card lenders because they need credit to get everyday necessities, like groceries and gasoline. Others may choose to default on their mortgage obligations, especially when it exceeds the value of their home, but they may then need their credit cards to finance their monthly rent.

### **Lower delinquency rates and collateral characteristics point to better-quality pools**

Overall, we've seen an improvement in the majority of credit card receivables pools' performance. Delinquency rates are down about 10% year over year, the payment rate is stable in the high teens, and the most recent trustee reports (April 2010) show that losses are also down for the majority of bankcard lenders (although March and April data may be skewed due to benefits from tax refunds). Late payments on bankcards are also down about 17% from last year. In terms of point-in-time collateral characteristics, we are seeing higher FICO scores and increased account seasoning, and some trusts are exhibiting lower credit card limits and weighted average balances, compared with one or two

years ago.

The average debt per credit card consumer is down 11% from a year ago, averaging a little over \$5,000. We expect to see a more pronounced decrease in credit lines in the next 12 months based on the tighter card lender practices that started in late 2006 because it usually takes time to see the full effect of tighter credit management. The increase in highly seasoned accounts may also be masking lower credit lines on new accounts. Typically, credit lines increase as accounts age. On average, bankcard pools exhibit about 80% of accounts have been seasoned for at least 48 months, compared with about 70% two years ago. It may also be hard to see the impact of reduced credit lines on receivables if lenders closed inactive accounts with zero balances or cut credit lines substantially on accounts that the borrowers never fully used.

### **Credit card ABS ratings will likely remain relatively stable**

We believe our ratings on credit card ABS will likely remain stable. To test rating stability, we updated our sensitivity analysis for loss rates and purchase rates for the majority of the transactions. Our results indicate that some 'AAA' ratings may be vulnerable to a downgrade of up to one rating category, or 'AA', if we assume a 50% increase in our base-case loss assumptions. To put this in perspective, we currently assume about 9%-11% base-case losses for typical bankcard pools. A 50% increase would mean 14%-17% base case losses, which we would then multiply by 3 to 4 times for our peak loss assumptions.

When we assume a 100% increase to our base-case loss assumptions, some 'AAA' ratings would be vulnerable to a downgrade by more than one rating category, but they would likely remain investment grade. A 100% increase means that typical bankcard pools would experience 18%-22% losses in a baseline scenario. Applying our typical stresses, we're talking about 55%-65% peak losses.

Lender downgrades may affect credit card ABS ratings. Our purchase rate assumptions, 2%-3.5% for typical bankcard pools, currently reflects our view of an originator's strength and ability to generate and transfer new receivables to a credit card trust, and are sensitive to the originator's corporate credit rating.

We tested the impact on 'AAA' rated credit card ABS transactions of a one-category downgrade of an originator's unsecured debt, as well as more severe scenarios where all accounts and credit lines are shut down completely. The results of our testing indicate that a one-rating category downgrade of an originator's unsecured debt wouldn't affect the majority of related credit card ABS 'AAA' ratings, and some would likely be downgraded by no more than one rating category. When we tested the effect of shutting down accounts and credit lines, assuming a zero purchase rate, we found that we would likely downgrade most 'AAA' rated credit card ABS backed by bankcard receivables originated by currently investment-grade, diversified lenders by more than one rating category, but they would likely remain investment grade. Based on our current criteria and assumptions, we believe a purchase rate assumption of zero for general-purpose bankcard receivables originated by investment-grade originators would be more akin to a stress scenario that is beyond a moderate scenario.

### **Student Loan ABS Outlook Calls For Continued Stability For FFELP Deals, While Private Loan Deals Have A Negative Outlook**

In anticipation of the end of FFELP on July 1 and the shift solely to the Federal Direct Loan Program, student loan ABS issuance has been fairly robust in 2010 with nine FFELP transactions. This comes at the same time the market lost its ability to pledge eligible loans to the Straight-A Program, though we expect that the January 2014 maturity should still bring a wave of refinancing activity, given the nearly \$40 billion in outstanding loans pledged to the facility. Moreover, even with FFELP out of the picture, Standard & Poor's still expects FFELP issuance because several issuers with existing trusts that have auction rate securities or reset rate notes are evaluating possible refinancing alternatives. From a performance standpoint, our outlook remains stable on FFELP ABS throughout 2010, given the federal reinsurance of at least 97% on this collateral.

Standard & Poor's has rated three private student loan ABS transactions in 2010. Sallie Mae has only closed one transaction, though we're expecting more activity from Sallie Mae in the coming months. We also expect to see some of the state agency private loan issuers come to market before the end of the year.

We're keeping our negative outlook on private student loan ABS because the economic conditions, chiefly the continuing elevated U.S. unemployment rate, remain uncertain despite an economic recovery. Additionally, current legislation working its way through the House and the Senate would allow borrowers to discharge their private student loans in bankruptcy—in a manner similar to other types of consumer indebtedness, such as credit card debt and automobile loans. Under current bankruptcy law, borrowers cannot discharge their student loans except in extreme circumstances. If the legislation passes as proposed, we believe the law could hurt the credit performance of private student loans and, ultimately, the outstanding private student loan ABS collateralized by those loans because it would make it easier for borrowers to default. At this point, however, we believe that the magnitude of the effect on ABS,

should the legislation pass, is uncertain.

We initiated nearly 200 tranche-level downgrades of private student loan ABS in the first half of 2010, affecting 32 transactions. We currently maintain negative CreditWatch placements on 28 tranches across seven private student loan-backed transactions, which we expect to resolve in third quarter 2010. We will continue to closely monitor the collateral performance to assess whether the risks and credit enhancement are commensurate with the ratings outstanding.

### **The U.S. RMBS Market's Struggles Will Likely Continue Through 2010**

The volume of U.S. RMBS new issuance has remained low for several years, and we expect it to stay low through the end of 2010. For existing U.S. RMBS transactions with ratings from Standard & Poor's, we expect delinquencies and home price volatility to continue to adversely affect performance.

### **U.S. RMBS new issuance will probably not be up anytime soon**

We believe rated U.S. RMBS securitization volume will remain low for the remainder of 2010. While several privately placed and publicly offered transactions closed during the first half of 2010, the potential impact of Rule 17g-5, which went into effect June 2, 2010, on transaction volume for the rest of the year remains to be seen. Given the short time frame for implementation, it is our understanding that potential issuers are still devising systems and processes for compliance with the rule, which we believe may cause delays in issuing rated transactions, particularly during the summer.

In addition, the FDIC's proposed rule on a revised securitization safe harbor, if adopted, may affect transaction volume for bank-originated securitizations in late 2010 and beyond. The Dodd-Frank bill may also affect rated RMBS volume.

We continue to review and rate resecuritizations of senior classes from prime, Alt-A, and subprime transactions. In addition to the resecuritization activity, we have received inquiries and pool submissions from potential issuers exploring the possibility of rated securitizations backed by both seasoned and/or newly originated loans. But because of Rule 17g-5's disclosure requirements, the FDIC's proposed rule, the generally evolving regulatory landscape, and our potentially longer transaction timelines, we believe that market participants will likely continue to explore and execute unrated transactions and whole-loan trades.

### **Rating performance is still pressured by increased foreclosures, falling home prices**

We generally expect loss severities for subprime and Alt-A loans to continue to stabilize. However, we expect that loss severities may increase on prime 2006 and 2007 vintage transactions because of increased foreclosure timelines (especially if the loans have been modified and then re-defaulted), lower demand for luxury- and higher-priced homes, and current market values at the time of the properties' liquidation. We believe the inventory overhang (unsold new and existing homes) and continued use of auctions to sell foreclosed properties will likely maintain downward pressure on home prices. While the homebuyer tax credit expires on June 30 (for contracts signed in April), the summer months are typically stronger for home sales. These factors correspond with our chief economist's view that home prices may decline an additional 5% through late 2010 (with peak-to-trough decline of 33% from July 2006 levels).

We expect that delinquencies will remain high for subprime and Alt-A products, and with the approaching option adjustable-rate mortgage (ARM) resets this year and next, Alt-A delinquencies may increase further. Also, we expect prime delinquencies to increase for all vintages, as unemployment is projected to remain above 9% for the remainder of 2010 as unemployed borrowers continue to deplete their savings.

### **Property Fundamentals And Performance May Need To Stabilize Before New CMBS Issuance Gains Momentum**

Commercial real estate fundamentals and CMBS delinquency performance tend to lag the general economy. We believe that high unemployment will limit demand for tenant space, resulting in higher vacancies and lower rents for the foreseeable future; this likely means rising CMBS delinquencies and negative rating actions.

We also expect new CMBS issuance to remain subdued until fundamentals and loan delinquencies stabilize. A handful of smaller, multiborrower pooled transactions of 10 to 40 loans may emerge this year, but traditional conduit pools—those with hundreds of loans—aren't likely to resurface until 2011 or early 2012, in our view.

### **Delinquencies remain on the rise**

Our current delinquency rate forecast is 10.5%-11.5% by the end of 2010 based on:

- Our expectations for the unemployment rate and property fundamentals.
- Recent monthly increases in delinquency volumes.

- The limited amount of new CMBS issuance over the past few years, which places the delinquent amounts over a smaller principal base, thereby magnifying the rate.
- High seasonally adjusted delinquency rates among loans in the 2006-2008 vintages.
- A steady decline in the payoff percentages for maturing loans, reflecting the prevailing tight credit conditions for commercial real estate.
- Increasing delinquencies in California, which has the largest CMBS exposure of any U.S. state and one of the country's highest unemployment rates (third place at 12.6%, based on preliminary numbers for April 2010).

CMBS delinquencies have grown considerably, from 7.7% as of May 31 compared with 5.2% at year-end 2009, and 2.6% a year ago (May 2009). The amount delinquent in May 2010 was \$44.4 billion on a base of \$578.6 billion of principal balance.

Year-to-date through May, we initiated 1,698 downgrades and 22 upgrades on U.S. CMBS, CRE CDO (commercial real estate collateralized debt obligation), and re-REMIC (resecuritization of real-estate mortgage investment conduits) transactions. For full-year 2010, we're generally expecting a high volume of negative rating actions, reflecting our forecast for higher CMBS delinquencies and a continuing decline in property fundamentals, albeit at a slower pace than in 2009.

### **Refinancing is a challenge for maturing loans**

Loans that matured in 2010 have been less likely to find takeout financing and more likely to transfer to special servicing. Maturity payoffs for fixed-rate loans continued to exhibit weakness in the first five months of 2010. Of the 784 fixed-rate loans totaling \$8.4 billion that matured in the period, 54.4% (498 loans) paid off, while 37.3% were transferred to special servicing. In comparison, 59.7% of the maturing fixed-rate loans paid off in 2009, and 34.2% were transferred to special servicing. In 2008, 91.7% of the maturing fixed-rate loans paid off.

From June 1 through the end of 2010, 1,090 loans will mature, including 1,054 fixed-rate loans and 36 floating-rate loans with a total principal balance of \$16.9 billion. Loans from the 2000 and 2005 vintages make up the bulk of the fixed-rate maturities, while loans from the 2005 and 2006 vintages are predominant among the floating-rate loans. We believe that with property fundamentals still weakening, the refinancing or sale of loan collateral for the remainder of 2010 will remain difficult. In 2011, 3,324 loans with a principal balance of \$48.5 billion are scheduled to mature.

### **Small, multiborrower deals may hit the market this year**

New issuance of CMBS came to a standstill in 2008, and didn't revive until late in 2009, after TALF brought stability to secondary market bond spreads. Last year, three single-borrower transactions helped stimulate the market. The first multiborrower securitization since 2008—the \$307.9 million RBS Commercial Funding Inc., Series 2010-MB1—came in April. It was collateralized by six loans from four separate borrower sponsors at a conservative weighted average beginning loan-to-value (LTV) of 54.4% and debt service coverage (DSC) of 2.40x based on issuer numbers. The deal followed the trend of the three single-borrower CMBS securitizations in 2009 in that it consisted primarily of anchored retail properties (67.3% of the trust pool), and only investment-grade certificates were issued. Then, during mid-June, the \$716.3 million J.P. Morgan Chase Commercial Mortgage Securities Trust Series 2010-C1 came to market, collateralized by 36 loans to 19 borrower sponsors. Again, the collateral in this transaction was concentrated in retail (70.9% of the pool). It also had borrower concentration, as one borrower sponsor represented 42.5% of the pool. However, this deal was more progressive because the loans had a higher weighted average beginning LTV of 61.5% and lower weighted average DSC of 1.64x based on issuer numbers, and the issuer was able to sell subordinate securities rated down to 'B-'.

Though noteworthy as the first multiborrower CMBS deals in two years, these 2010 transactions are nowhere near the size of transactions reminiscent of the prior decade, which typically exceeded \$1 billion and were backed by a hundred or more loans. Looking ahead, Standard & Poor's still expects to see primarily smaller multiborrower pooled transactions of 10-40 loans. These pools will likely be backed largely by stable income producing retail, office, and industrial properties that are well-located in primary metropolitan statistical area (MSA) markets. Furthermore, the trust loans will most likely carry lower leverage and higher DSC than more recent vintage collateral, and the certificates issued may likely continue to be only investment-grade.

We don't expect the larger, more traditional conduit pools to return to the market until 2011 or even early 2012. And when they do, they'll likely involve issuers partnering together to reach the size and diversification that CMBS investors have traditionally been more accustomed to seeing in the past. Further growth in CMBS issuance depends on several variables that are causing uncertainty in the marketplace. Issuers currently don't have a good way to hedge the risk of holding collateral until securitization, which directly affects their ability to accumulate enough loans to attain a large and diversified conduit/fusion pool.

Also, CMBS participants are still looking for further property performance stabilization. Many property types continue to suffer from declining rents and occupancy, leaving lenders unwilling to commit enough financing. On the other

hand, class A properties that have maintained relatively stable rents and occupancy are attracting strong interest. As is common in real estate downturns, this flight to quality has caused a bifurcation in financing, whereby only the better-performing properties can attract capital. Participants are hopeful that as a new economic recovery unfolds, class B and C properties will rebound and attract the capital they need. Finally, the financial reform will also surely impact the future of CMBS. All of this results in a lack of certainty in execution for new transactions in the near term, as well as in the exact form they will take.

### **U.S. ABCP Ratings Should Remain Largely Stable While Outstandings Stabilize Through 2010**

Standard & Poor's overall ratings outlook on the U.S. ABCP market remains largely stable in an environment where sponsors continue to grapple with changes in the U.S. regulatory landscape and lower demand for credit from within their target customer base. On the heels of a period of protracted reduction in both issuance volumes and issuer numbers, we expect U.S. ABCP outstandings to remain relatively flat to slightly down for the remainder of 2010.

### **ABCP ratings expected to remain largely stable for the second half of 2010**

As of March 31, 2010, Standard & Poor's had outstanding ratings on approximately \$379 billion in U.S.-dollar-denominated ABCP. For ABCP ratings issued in the U.S., over 63% of the ABCP is backed by a combination of student loans (22%), auto loans (17%), credit cards (10%), trade receivables (7%), and equipment loans and leases (7%). We believe our ABCP ratings will likely remain largely stable for the balance of 2010 based on the financial institutions (FI) ratings on the banks providing program-wide credit enhancement and liquidity to ABCP conduits ("support-providers") and our views of the credit performance of the underlying assets financed by ABCP. As to the latter, our views of the credit performance of specific types of assets are set forth in other sections of this report.

As of March 31, 2010, Standard & Poor's had ratings assigned to the U.S. dollar-denominated ABCP issued by 105 conduits. Of these, the ABCP issued by 46 conduits, representing 44% of U.S. dollar-denominated ABCP outstandings, relied on support-providers that all had stable or positive FI rating outlooks. The ABCP issued by the remaining 59 conduits, representing 56% of U.S.-denominated ABCP outstandings, relied on one or more support providers with negative FI rating outlooks. Of these 59 conduits, 40, representing approximately 35% of U.S. dollar-denominated ABCP outstandings, relied on one or more support providers that had the same short-term ratings as the related ABCP. If we take any negative rating actions on the support providers for these 40 conduits, the related ABCP ratings would be vulnerable to a negative rating action.

In contrast, the ABCP issued by 19 of these 59 conduits, representing approximately 21% of U.S. dollar-denominated ABCP outstandings, relied on one or more support-providers whose short-term ratings were higher than the related ABCP ratings (i.e., the ABCP for each of these conduits was rated 'A-1' while all of the related support providers with negative rating outlooks were rated 'A-1+'). Apart from rating actions due to asset credit performance, the rating on the ABCP issued by any of these conduits would only be vulnerable to a negative rating action if the short-term ratings on one or more, if applicable, of the related support-providers were lowered below the ABCP rating (i.e., if the short-term ratings for one or more, if applicable, of the support-providers for any of these 19 conduits were lowered from 'A-1+' to below 'A-1').

We don't expect the passage of the Dodd-Frank bill to have an immediate impact on the ratings of ABCP support providers and other highly systemically important financial institutions. Although some aspects of the bill may adversely affect U.S. bank earnings and the government's ability to provide extraordinary support, we don't intend to change the ratings on these FIs as a result of the bill until we're in a position to fully analyze the final legislation and its implementing regulations. Our evaluation of the legislation could last through the end of the year or even early 2011. Additionally, the net impact of the bill, if passed, on FI ratings is difficult to gauge at this time because the bill also contains other provisions, such as higher regulatory capital requirements and underwriting standards that may help sustain the current FI ratings we've assigned to some U.S. banks.

### **ABCP U.S. dollar-denominated outstandings are likely to remain relatively flat to down for the second half of 2010**

In early 2010, U.S. ABCP conduits continued to pare-down their funding of non-traditional asset types and to focus on using ABCP as a funding source for the bank sponsors' core lending relationships. U.S. ABCP conduit portfolios now contain fewer mortgage and CDO-related assets and more trade, auto, and other commercial assets, which investors find more attractive. Investors responded by increasing their appetite for bank-sponsored ABCP, such that U.S. ABCP spreads over comparable-term LIBOR have returned to pre-2007 crisis levels.

Despite signs of a more stable U.S. economy and unused funding commitments of approximately 40%, we expect ABCP U.S.-dollar-denominated outstandings to remain in the \$375 billion to \$400 billion range for the remainder of 2010. We believe U.S. ABCP sponsors will continue the trend that began in early 2010 of cautiously increasing new transaction activity, mostly to replace exiting and/or amortizing transactions. However, we do not expect substantial growth in the U.S. ABCP market as market participants continue to implement necessary changes in response to

recent regulatory changes (such as SFAS 167 and SEC 17g-5 and 2a-7), while at the same time evaluating the impact of potential changes on the horizon (such as Basel 3 and Regulation AB II). These regulatory changes have already (or we expect them to) caused an increase in funding costs and disclosure requirements for U.S. ABCP sponsors.