



Growth prospects?

Economic, regulatory uncertainty dogs the outlook for US ABS

US ABS issuance volumes are expected to increase by about 10% in 2011 – largely as a function of growth in the underlying consumer sector. Although the market is likely to continue benefitting from positive fundamentals and technicals, regulation remains the wild card going into next year.

The US ABS market has gradually opened up as the months go by and this is likely to continue next year, according to Mathew Van Alstyne, md and head of research at Odeon Capital Group. A question mark remains over how FinReg is implemented, however, as well as its timing and whether there are any surprises.

"The regulatory environment is clearer, but so much of the decision-making has been left to different entities. Much of the minutiae will likely be more impactful: there are so many variables that it's difficult to know which will be the inflection point," Van Alstyne observes.

For example, he suggests that as more securitisations are required to be disclosed via TRACE, issuance prices could be impacted. "Increased transparency is likely to help liquidity, but there are many unknowns," he explains. "In particular, there is concern about the disclosure of prices on highly illiquid bonds, especially when different factoring schedules are involved. In any case, the rules aren't as helpful as they could be because banks are still protected by the relaxed mark-to-market accounting regime."

Elton Wells, head of SecondMarket's structured products group, agrees that regulation continues to be a wild card for the market. "We're in a better place than we were last year, where there was concern about over-regulation, but now there is concern about the details," he says.

Nonetheless, he believes that US ABS activity in 2011 will be similar to this year's, but perhaps with a few more new issues. "Volumes will likely remain flat to a 5%-10% increase. It's quite clear that, since the end of TALF, the market can sustain itself without government guarantees."

ABS analysts at JPMorgan have a similar forecast: they predict that gross US ABS supply in 2011 will reach US\$115bn, an increase of roughly 10% on this year's volumes. They expect auto ABS to be the most active sector, accounting for US\$65bn, with gains seen in the prime auto loan and lease segments.

Commercial receivables-backed ABS sectors – such as equipment, auto-fleet, trucks and floorplan – should also enjoy another solid year of issuance. Supply from esoteric sectors will likely stay flat to slightly higher year-on-year, given the stable and regular financing needs of the active issuers. In contrast, student loan ABS volumes are expected to fall to US\$10bn, due to the termination of FFELP and weak demand for private student loans.

The credit card ABS sector is the wild card in JPMorgan's supply forecast for 2011. Based on the low 2010 gross issuance total of US\$6bn (versus approximately US\$90bn in run-off), they estimate that supply will reach US\$10bn next year (versus approximately US\$50bn in run-off).

However, Wells expects credit card ABS to make a come-back. "Volumes in this segment, as well as in autos, are a function of the economy," he says. "The overall forecast for the economy – barring any unforeseen events – is slow growth at around 5%-10%. I have a positive outlook for US ABS, but believe that the market won't return to normalcy until 2012."

He concurs that esoteric deals – such as structured settlement, aircraft and timeshare ABS – will continue to be a feature of the market. "As there are no non-agency RMBS transactions to speak of and agency deals only yielding so much, esoteric ABS are the only alternative. Investors in these deals are typically looking for tailored structures and so they're often completed privately."

Indeed, investor appetite also drives market growth. "A low interest rate environment makes certain asset classes less attractive because the absolute return is lower. Investors are therefore searching for more yield – hence the demand for off-the-run assets, such as life settlement and XXX securitisations. Negative net supply is also driving appetite for esoteric transactions because investors need to reinvest their cash as deals mature," Van Alstyne notes.

Consequently, subordinate and off-the-run ABS spreads should find it easier than benchmark ABS spreads to push through 2010 levels. The JPMorgan analysts suggest that single-A ABS spreads in benchmark asset classes could reach 45bp-50bp during 1H11, while triple-B ABS spreads could narrow to 75bp-80bp.

Higher up in the capital structure, three-year triple-A credit card and prime auto loan ABS levels are anticipated to retrace the tightness seen this summer, given the potential increase in Treasury yields. "We expect triple-A benchmark ABS will return to swaps +15bp-20bp by the end of 2H11, but with the bulk of the tightening in the spring. Over the rest of 2011, we see swaps +10bp as an optimistic target, given the rate forecast and considering that investors will have reached another psychological barrier, returning back to single-digit ABS spreads," the analysts note.

The US market is characterised by a core investor base – the large insurance companies and some pension funds – as well as distressed debt funds and dealers. Van Alstyne observes: "There is a balance in the investor base between traditional and non-traditional accounts, with non-traditional accounts being more demanding of yield and more willing to take positions in esoteric assets. But it's not like it was at the height of the crisis: the investor base is overall more sophisticated."

Investing in European ABS, where double-digit returns can be found, is also an attractive option for some US accounts. "US investors are comfortable with European markets and understand them well," Wells confirms. "But there is some caution around sovereign issues and the lack of clarity regarding the ECB's eligibility criteria. Meanwhile, Asian investors are looking to invest in US corporate/esoteric ABS and CLO issuance and I expect this to continue next year."

Looking ahead, CLO issuance is a bright spot for next year (see also separate outlook article), according to Wells. "The credit quality and credit enhancement is better and the structures simpler in the latest generation of deals. This market has held up well and strong names should continue to perform well."

But the question mark for next year is around non-agency RMBS. "I don't think you can say that the market has returned until non-agency RMBS comes back. It should account for around 30%-40% of the market," Wells suggests.

Investor appetite exists for non-agency RMBS, but regulatory and foreclosure-related issues continue to dog the market. For example, the 'right' way to structure deals still remains unclear.

"It will be 6-12 months before these issues are hammered out," Wells says. "The market will determine the rest of it; for instance, investor due diligence has increased significantly. The market is more efficient these days and smarter about these issues."

Finally, in addition to further NCUA and FDIC issuances, investors should be able to gain exposure to secondary assets through increased distressed selling in 2011. The failure of many regional banks was expected to precipitate a sell-off in legacy assets this year that ultimately didn't materialise.

"We've seen a decent amount of selling, but not to the extent warranted by the overhang," Wells concludes. "However, banks are now at the stage where they've raised capital and want to sell distressed positions, so we should see some secondary supply in non-agency RMBS, CDOs and European CLOs come on to the market next year. Trups CDOs alone, for example, account for US\$30bn-US\$40bn of such assets."

Hope for CMBS 2.0?

US CMBS has this year earned the moniker 'CMBS 2.0', due to its apparent reinvention post the financial crisis. However, some of the differences between the old and new generation of CMBS transactions are expected to be chipped away in 2011.

A number of examples in 2010 vintage CMBS already exist where the reality of the structure differs from the ideal suggested by the moniker 'CMBS 2.0'. For example, MBS analysts at Barclays Capital indicate that collateral in 2009-2010 deals isn't substantially better than in prior vintages. They note that half of recent-vintage collateral comprises loans that either matured or were refinanced out of older CMBS.

Further, new issues are much smaller than older ones and are often highly concentrated in retail, offering less diversification to the investor. The quality of assets is also limited, according to the BarCap analysts, as originators find it increasingly difficult to compete with insurance companies and foreign banks to win loans for trophy properties.

However, they concede that underwriting criteria has tightened significantly since 2007, being based on the actual trailing 12-month numbers rather than pro forma expectations – and that loans are typically being originated at lower leverage. But the analysts expect this criteria to loosen "faster than most investors expect", with conduit leverage reverting to the historical mean of low- to mid-70% LTV by the end of next year.

"In terms of loan structure, we are already seeing stray instances of interest-only loans (period and life) and loans with subordinate debt (both B-Notes and mezz) being included in newly issued deals," they continue. "While some 2010 CMBS deals were structured to give controlling rights to the senior note, we do not expect this language to be very commonly used in 2011. As leverage heads higher, the B-piece buyer will require control and a say in resolutions."

Two other structural changes are likely to remain a feature of the market next year, however – the shift in control due to a combination of realised losses and appraisal reductions, and the sequence of liquidation proceeds allocation by which ASERs are reimbursed after the principal is paid to the top of the waterfalls.

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