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INSIGHTS

Global structured finance, 2024 outlook

Modest gains expected amid global macroeconomic headwinds, changes in capital regulations and stable consumer credit

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Executive summary

Global structured finance issuance volume declined 11% y/y to USD1tn in 2023 (-3.8% vs S&P's forecast) owing to the global economic crisis, fuelled by record inflation, the consequent high interest rate regime employed by central banks and geopolitical uncertainty stemming from the Russia-Ukraine crisis, which led to major supply-chain disruptions. The structured finance sector is expected to grow at a CAGR of 11.8% over 2023-28 and was valued at USD1tn at end-2023, equivalent to c.1% of global GDP.

A few key areas need to be monitored closely in 2024. First, US banks have now completed the USD LIBOR transition and shifted their existing exposures to alternative reference rates. Although other regions have seen successful LIBOR transitions, the large volume of deals historically linked to the USD LIBOR and the lack of adequate fallback language in legacy deals may pose risks. Apart from this, ESG is poised to see continued importance and growth in the structured finance sector, buoyed by the development of innovative transaction structures, multi-lateral green agencies and global green initiatives.

From a regional perspective, the US, Canada, China, Japan, Australia and Latin America recorded noticeable declines in 2023, while Europe experienced modest gains. Following a hampered year in 2023, markets expect a modest recovery in 2024, with global issuance volume estimated to grow a modest c.5% to c.USD1tn, driven by stable consumer credit and easing macro headwinds.

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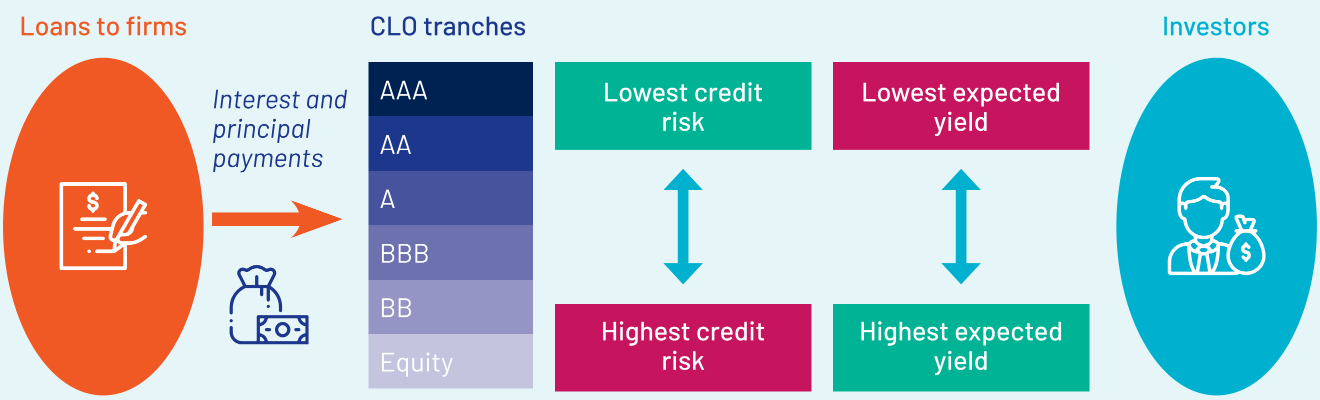
Latest trends and key credit themes across the structured finance market – an overview

Structured finance refers to the process of creating bespoke financial products. These products are created for large financial institutions and investment vehicles. They often have complex financing requirements, which cannot be satisfied effectively by using conventional financial products. There are three main processes involved in the creation of structured finance products. These are securitisation, debt tranching and credit enhancement.

Securitisation involves the financial practice of pooling together various types of contractual debt. This collateral is then transferred to a special-purpose vehicle (SPV) to insulate against the residual risk of the originating company. Subsequently, underlying cashflow is sold to third-party investors as securities. Investors are then repaid from the principal and interest cashflow stemming from the underlying collateral.

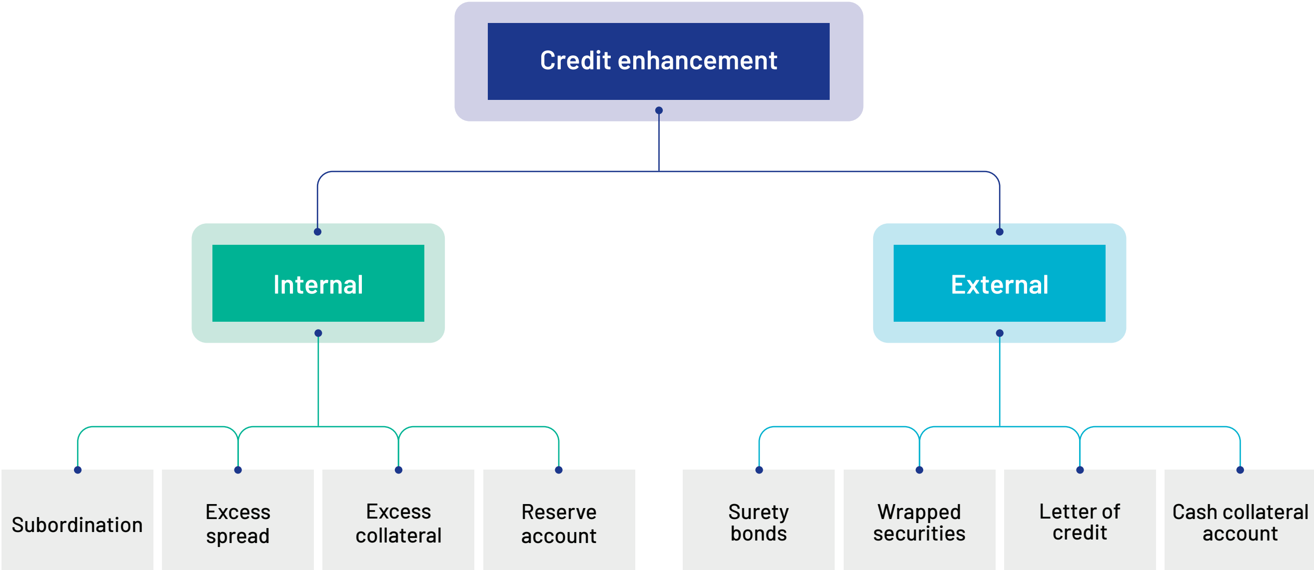
Tranching refers to the creation of different asset classes of securities, backed by the same pool of assets. Tranching enables cashflow from the underlying collateral to be diverted to various investor groups. A key goal of tranching is to create at least one class of securities whose credit rating is higher than the average credit rating of the entire company. The deal's indenture (its governing legal document) usually details the payment structure of the tranches, in a section often referred to as the waterfall. Lower-rated tranches consist of higher-risk securities. They are targeted at investors with high risk appetite, e.g., hedge funds. Investors who invest in lower-rated tranches will receive a higher coupon. However, they must accept a lower priority for repayment. Conversely, higher-rated tranches consist of lower-risk securities. They target investors with low risk appetite, e.g., pension funds. Investors who invest in higher-rated tranches will receive a lower coupon. However, they have a higher priority for repayment in the event of liquidation.

Collateral



Source: PineBridge Investments, Acuity Knowledge Partners

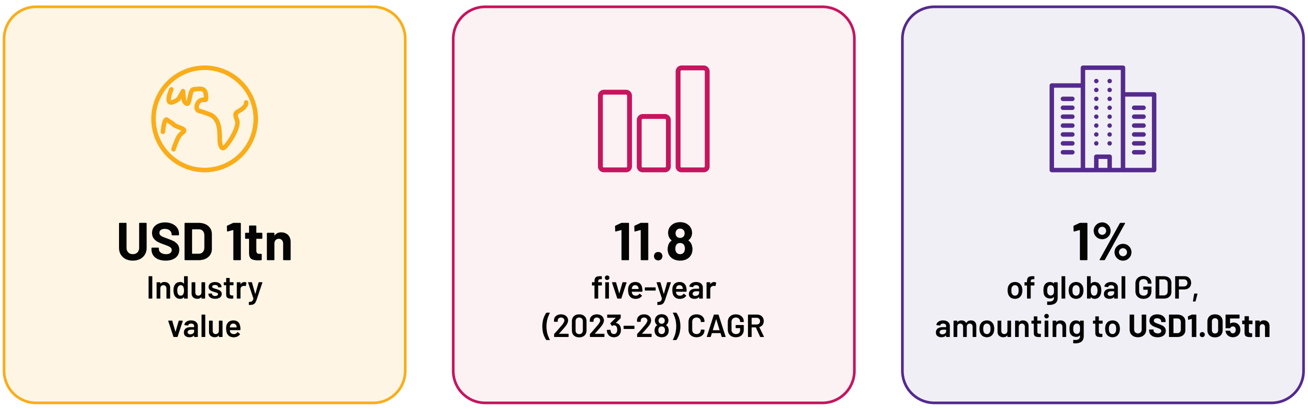
Credit enhancement is a key concept in structured finance. It involves creating a security that has a higher rating than that of the underlying collateral pool. Higher-rated securities can be sold to investors for higher prices, generating higher revenue for the SPV and originator.



Source: Wikipedia, Acuity Knowledge Partners

Global structured finance issuance volume declined 11% y/y to USD1tn in 2023 (-3.8% vs S&P's forecast) owing to the global economic crisis, fuelled by record inflation, the consequent high interest rate regime employed by central banks and geopolitical uncertainty stemming from the Russia-Ukraine crisis, which led to major supply-chain disruptions. The structured finance sector is expected to grow at a CAGR of 11.8% over 2023-28 and was valued at USD1tn at end-2023, equivalent to c.1% of global GDP.

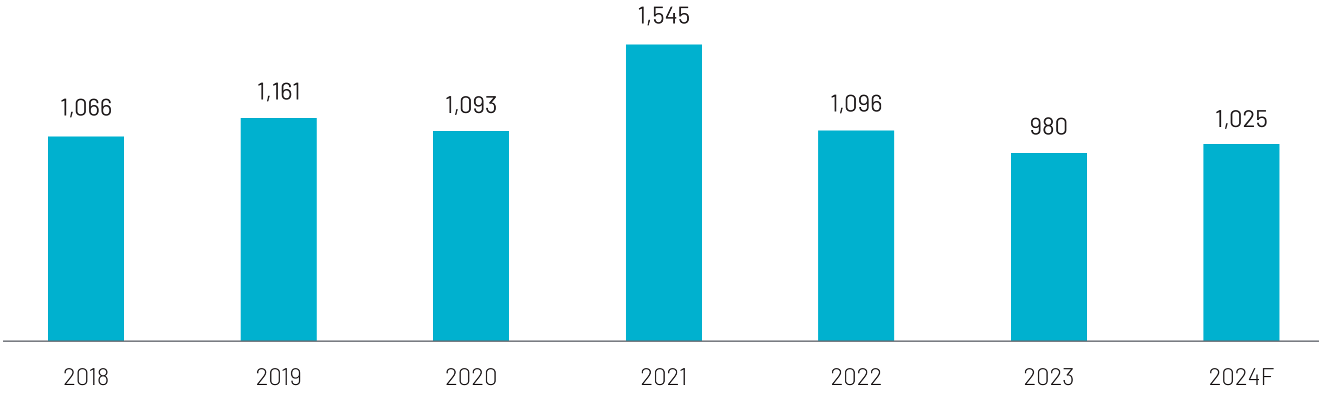
Structured finance sector – an overview



Source: S&P, Statista, Business Research Insights, Acuity Knowledge Partners

We expect the credit environment for structured finance to recover modestly in 2024, driven by stable consumer credit and easing macro headwinds. Consequently, issuance volumes are expected to grow a modest 5% y/y to USD1tn in 2024.

Global structured finance issuance (USDbn)

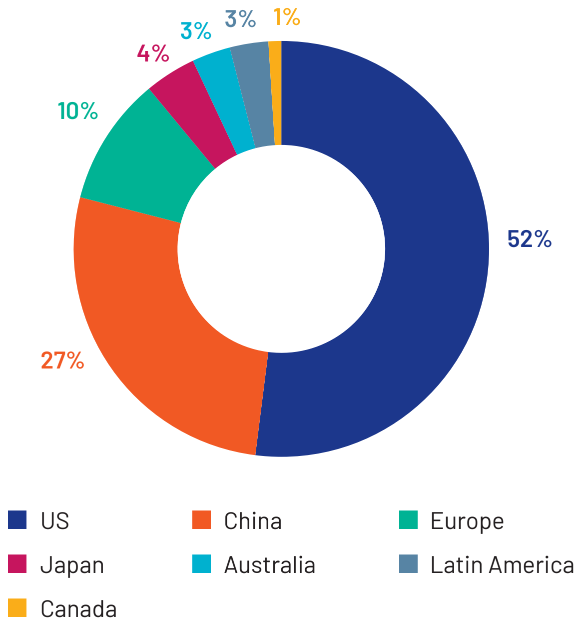


Source: S&P, Acuity Knowledge Partners

From an external economic viewpoint, ESG criteria are likely to continue to grow significantly for investors in the medium term (one to three years). Another important factor is that US banks have now completed the phase-out of LIBOR settings and shifted their existing exposures. Furthermore, inflationary pressures and the global disruption to certain supply chains remain key focus areas that need to be monitored owing to their potential to impact global economic growth.

The US and China remain the largest markets for structured finance transactions: 52% of issuance in 2024 was booked in the US, followed by 27% in China, 10% in Europe, 4% in Japan and the remainder across other regions. This trend is likely to continue, with the US and China expected to be the main markets driving the sector's recovery over the medium term. Additionally, structured finance products have been gaining in prominence across Asia Pacific in the past five years.

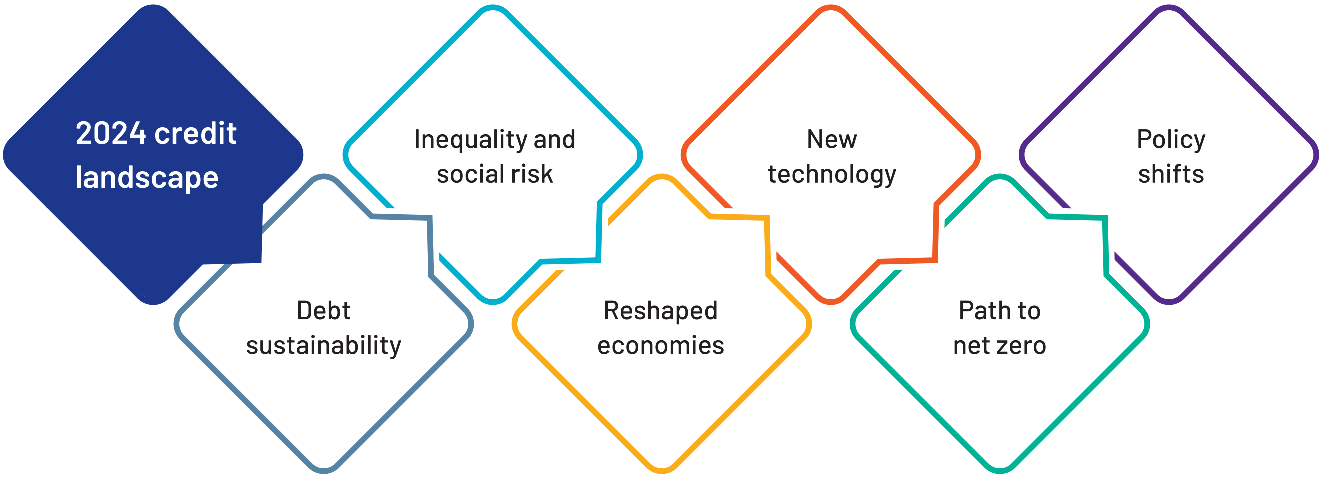
Issuance by region, 2024



Source: S&P, Acuity Knowledge Partners

Rating agencies believe that the prevailing credit background is largely volatile but expect conditions to improve modestly in the coming year. While there are minor segments of distress, most asset classes, on an aggregate basis, have returned to a stable performance. Additionally, central banks have indicated a break from the recent monetary tightening, which should help yields on structured products become more attractive than historical levels.

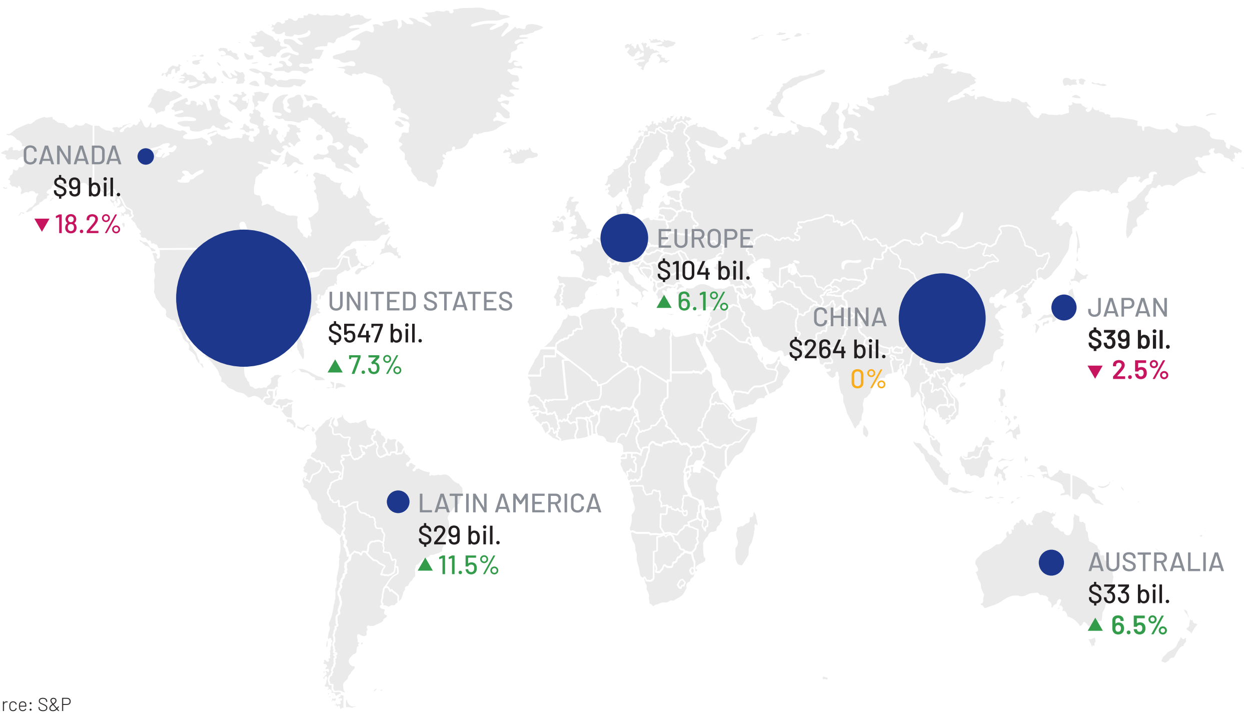
Credit landscape – focus areas in 2024



Source: Moody's, S&P, Fitch, DBRS, Kroll, Acuity Knowledge Partners

Many consumers have favoured increased savings to stabilise their financial positions in the past three years. Conversely, most corporations have taken on more debt. Many programmes that provided pandemic-related relief such as mortgage forbearance schemes ended in 2022, leading to pockets of performance deterioration in some asset classes such as RMBS; nonetheless, this also prompted the resumption of payments in others. Regulations, mainly Basel IV, have the potential to sway issuance volumes, depending on the finalised bank capital rules that are attached to various forms of lending.

2024 global structured finance forecasts



Source: S&P

03

Outlook by region and asset class

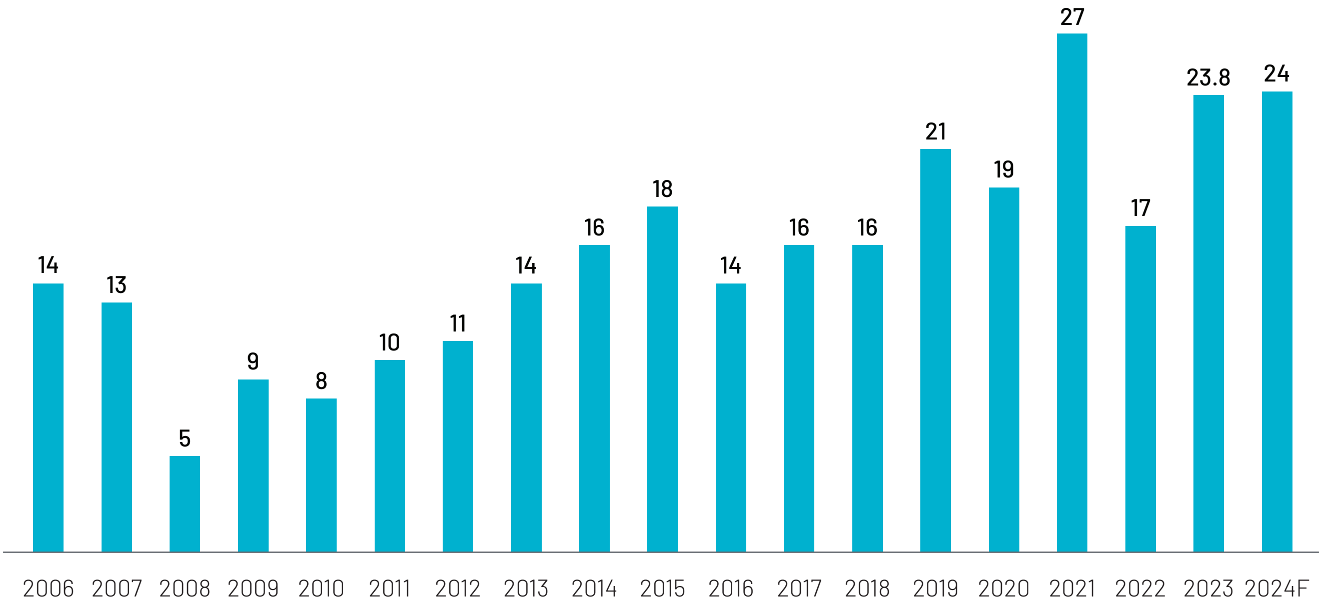
US outlook

Deterioration in performance across asset classes pressured 2023 issuance

US structured finance issuance declined 14.4% y/y to USD510bn in 2023, with most asset classes recording a deterioration in performance.

US auto lease ABS issuance grew by a significant 38% y/y to USD23.8bn in 2023 on the back of 13.1% growth in new- vehicle sales to 15.5m units, driven by the easing of residual supply constraints, improved inventory levels and resumed fleet sales. However, 2024 issuance is expected to grow only marginally, to USD24bn, owing to slower economic growth and weakened consumer purchasing power, which should limit retail auto sales growth.

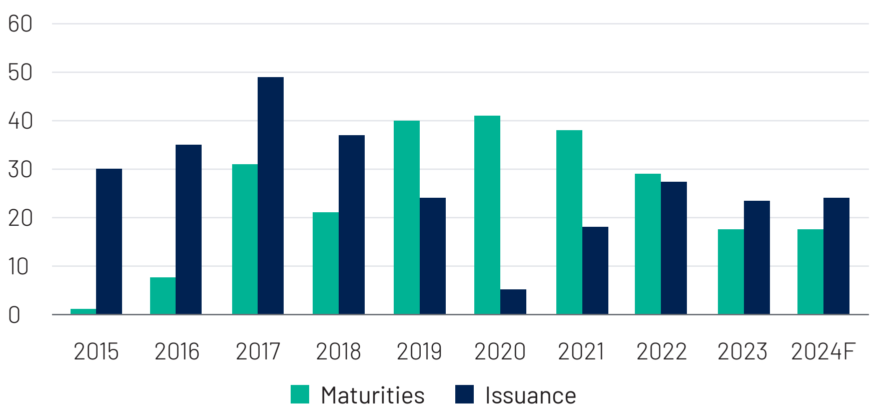
Auto lease ABS issuance (USDbn)



Source: S&P

US credit card ABS issuance declined a significant 17.9% y/y to c.USD23bn in 2023 (albeit higher than estimated maturities of USD18.1bn) on the back of the relative funding advantage, driven by the higher and more volatile interest rate environment. 2024 issuance is expected to grow a modest 4.3% y/y to USD24bn, with the Federal Reserve (Fed) likely to pivot from its tightening cycle and as banks use securitisation as an alternative funding source.

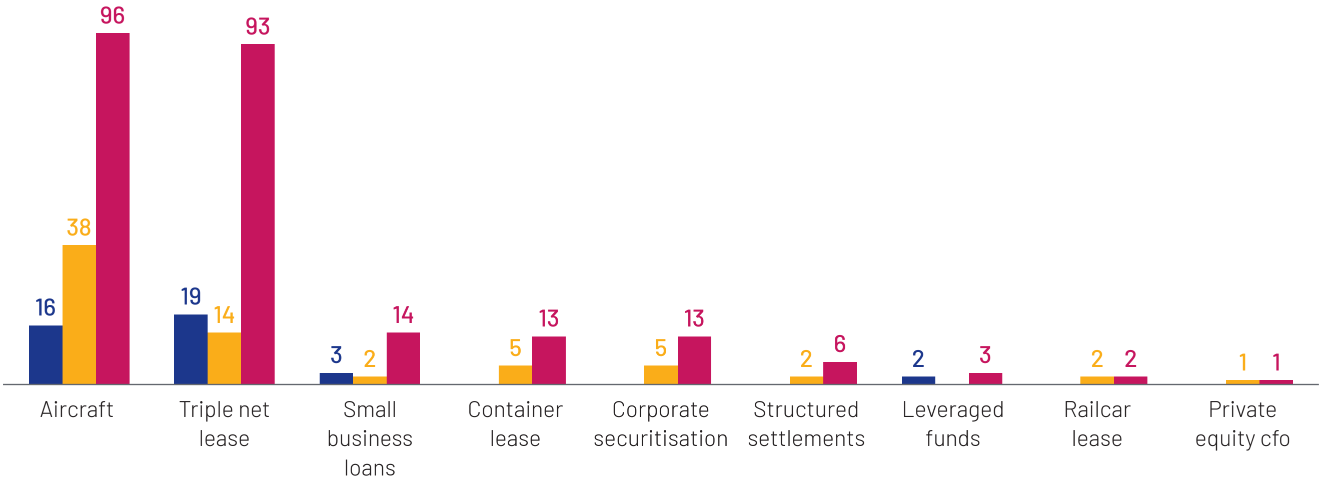
US's credit card ABS issuance and maturities (USDbn)



Source: S&P

US non-traditional ABS origination volumes declined in 2022 owing to adverse market sentiment but picked up again in 2023 on the back of stable ratings, investors' need for diversification and high yields. Rating action in 2023 remained stable across most sub-sectors. For example, S&P 500 reviewed 576 ratings within this sub-sector, resulting in 94 upgrades, 441 affirmations and 41 downgrades.

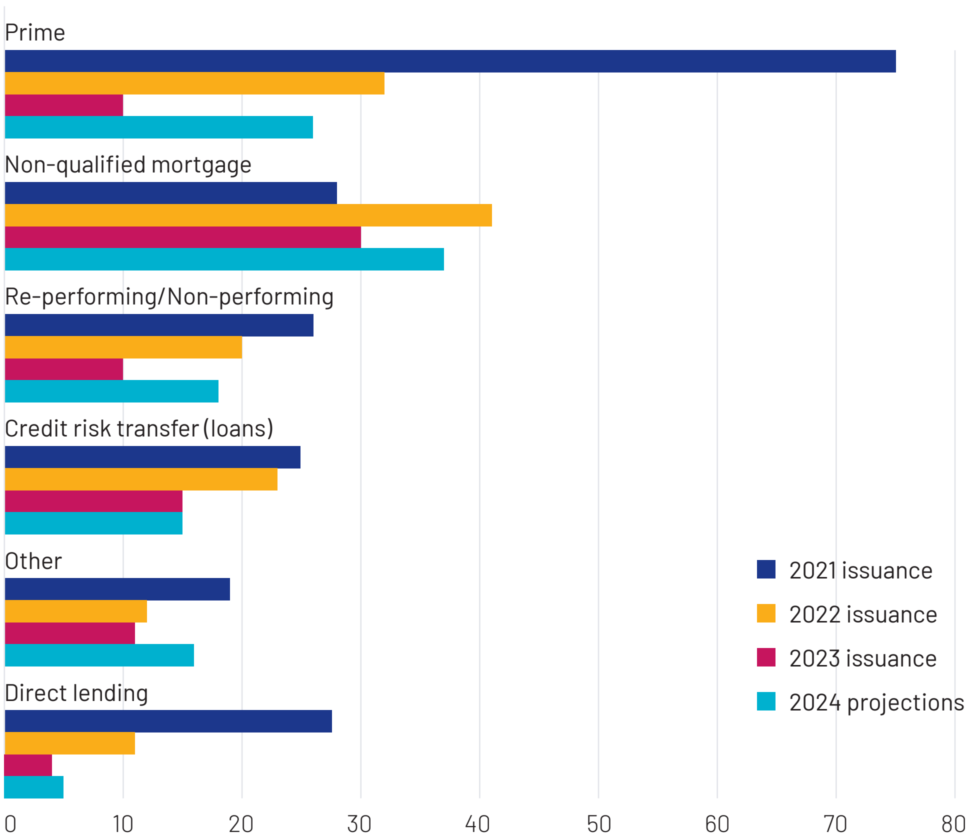
US's non-traditional ABS rating actions in 2023



Source: S&P

Non-agency RMBS issuance in the US declined significantly, to c.USD80bn, in 2023 due to sustained interest rate volatility and refinance burnout, given the recent uptick in mortgage rates. However, the market is expected to pick up in 2024 to c.USD107bn, as most homeowners have now locked in low mortgage rates and enjoy a natural inflation hedge.

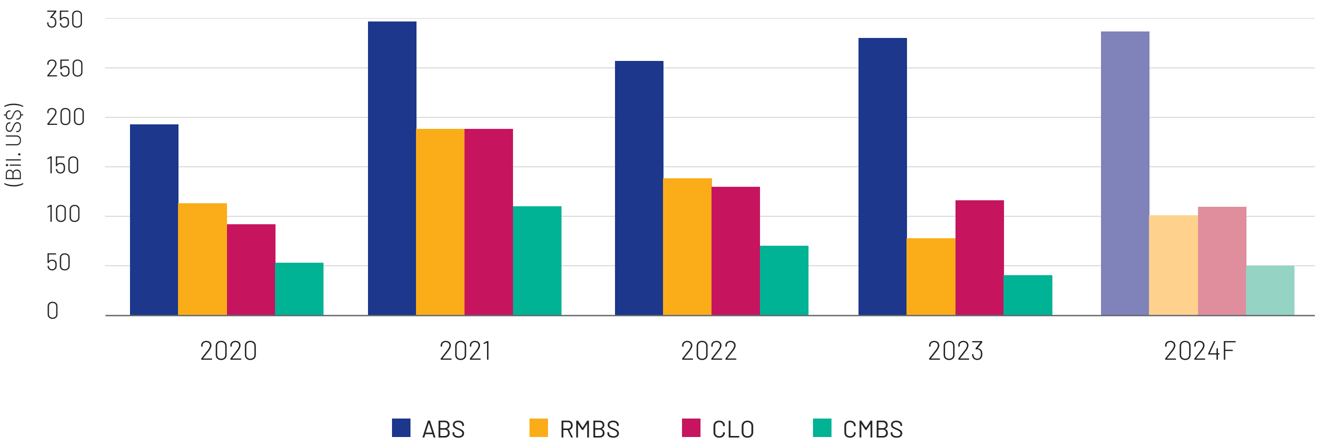
US's non-agency RMBS issuance (USDbn)



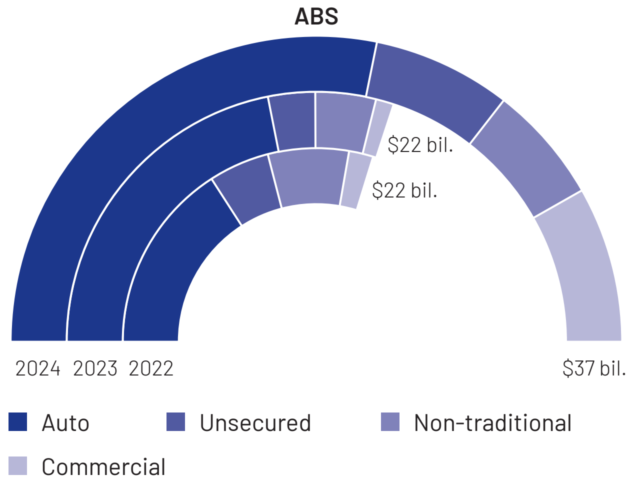
Source: S&P

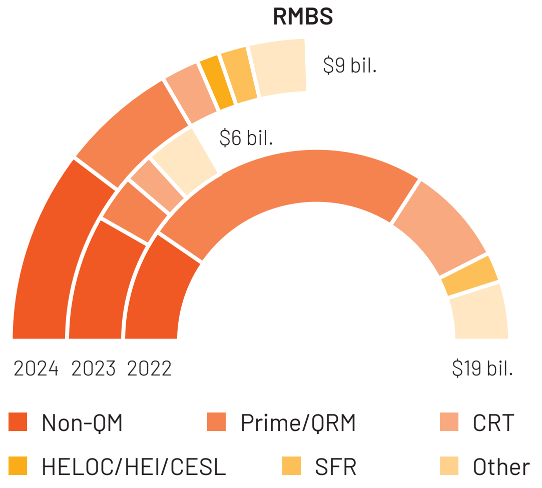
Market-Wide Structured Finance Issuance | 2024 ABS And CLO Issuance Off To A Swift Start

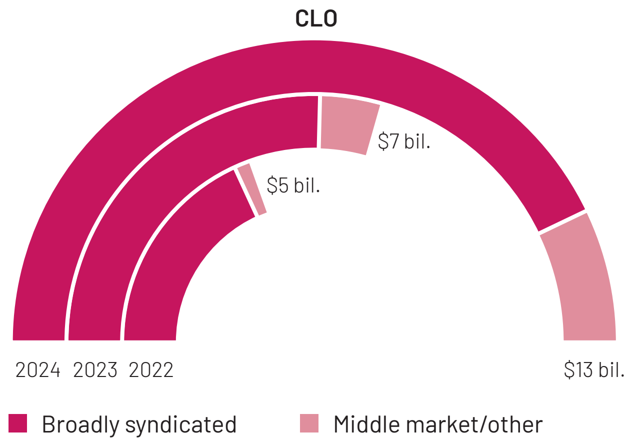
Annual new issuance

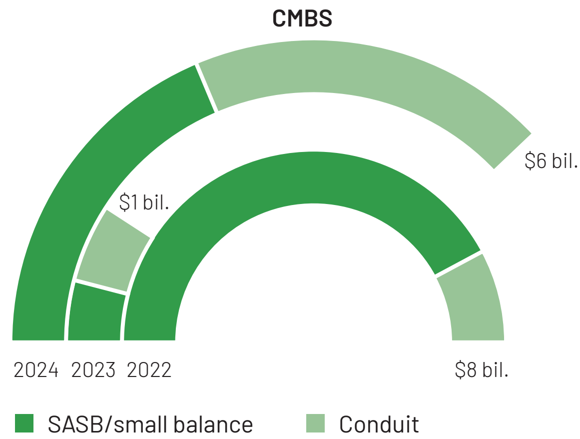


New issuance through end of January







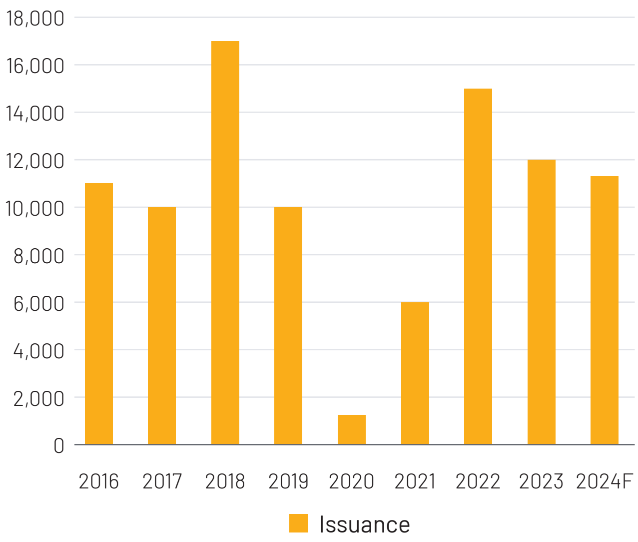


Source: S&P

Canada outlook

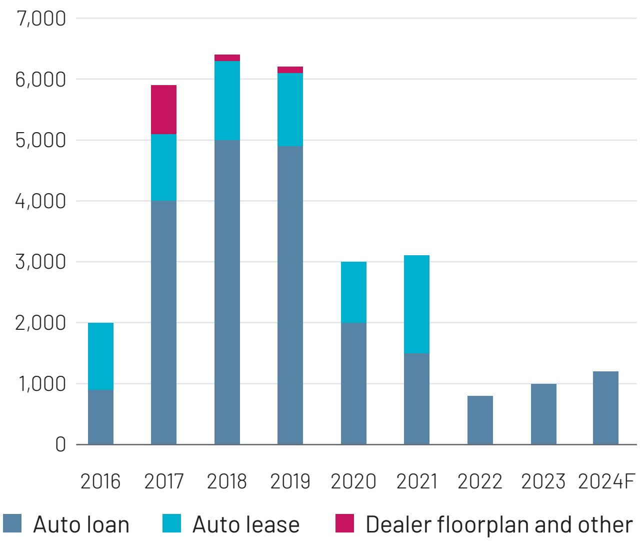
In Canada, structured finance issuance declined 17.6% y/y to CAD14bn in 2023 owing to a muted performance across most asset classes. Credit card ABS dipped a significant 20.0% y/y to CAD12bn (from CAD15bn in 2022) due to adverse market conditions. However, this was partly offset by (1) farm equipment ABS issuance picking up again after flatlining to zero in 2022 owing to spread volatility that discouraged new issuance and (2) 25% y/y growth in auto ABS issuance to CAD1bn, driven by the normalisation of vehicle wholesale prices, residual values and labour-market strength.

Canada's credit card ABS (CADm)



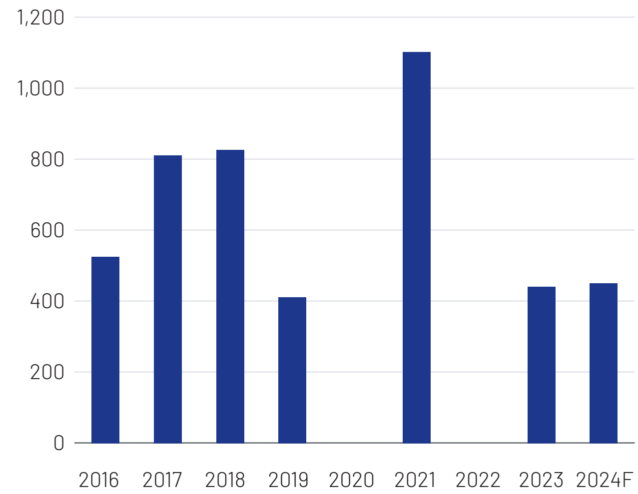
Source: S&P

Canada's term auto ABS issuance (CADm)



Source: S&P

Canada's term equipment ABS issuance (CADm)



Source: S&P

S&P expects a similar performance in 2024, with issuance volumes expected at c.CAD12.7bn on (1) CAD11bn in credit card ABS, (2) CAD1.2bn in auto ABS and (3) CAD0.5bn in commercial ABS. RMBS and CMBS issuance are expected to be minimal. Within these issuance volumes, 25-30% of credit card and auto loan ABS volumes are projected to stem from cross-border issuance into the US.

Europe outlook

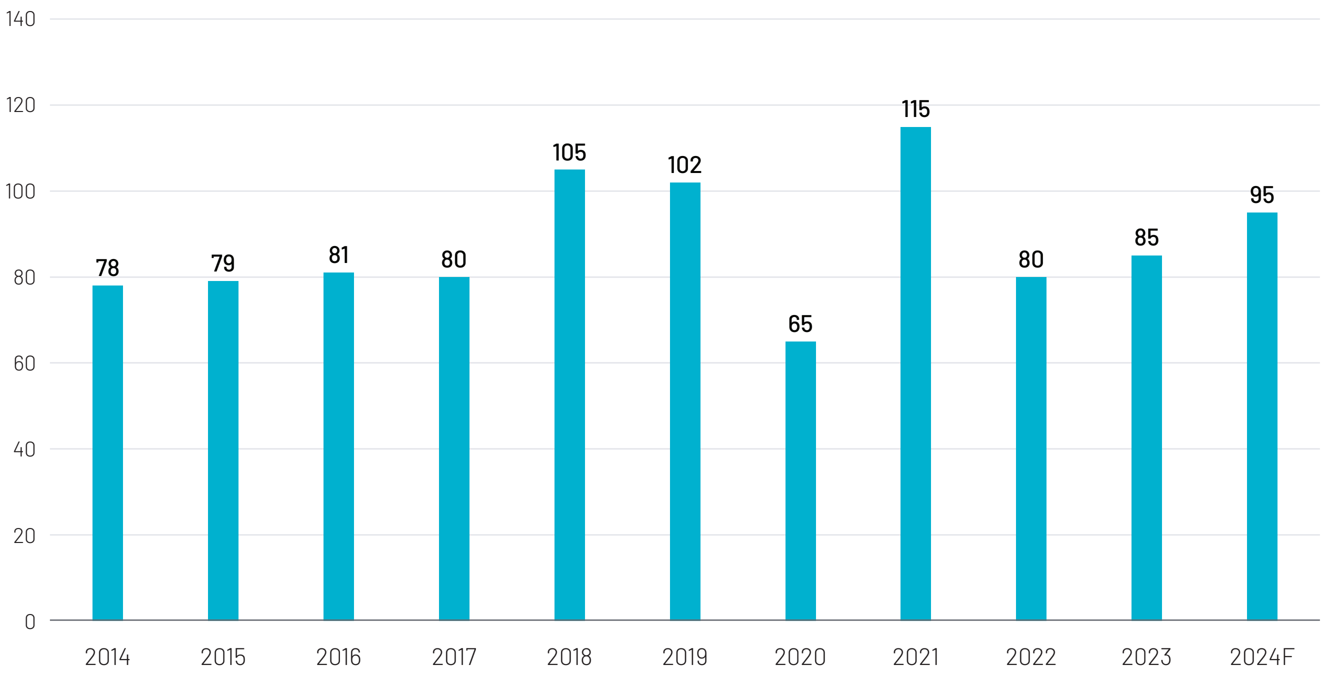
In Europe, structured finance issuance increased by 6.3% y/y to EUR85bn, driven by a strong second-half performance following a tepid first half.

S&P expects 2024 issuance to grow a further 11.8% y/y to EUR95bn owing to (1) a larger volume of legacy transactions reaching their call dates and (2) a modest recovery in areas of credit origination such as auto financing that back most ABS issuance.

Bank-originated securitisation recorded a five-year high in 2023 and is expected to be the main driver of issuance in 2024 as well. This is likely to be buoyed further by the end of central-bank liquidity schemes, coupled with the slowdown in deposit growth.

Many non-bank originators have turned to warehouse funding over the past 24 months due to recurring bouts of market volatility. However, we can expect more securitisation exits in the future, stemming from greater certainty over spreads and underlying rates.

Europe's structured finance issuance (EURm)



Source: S&P

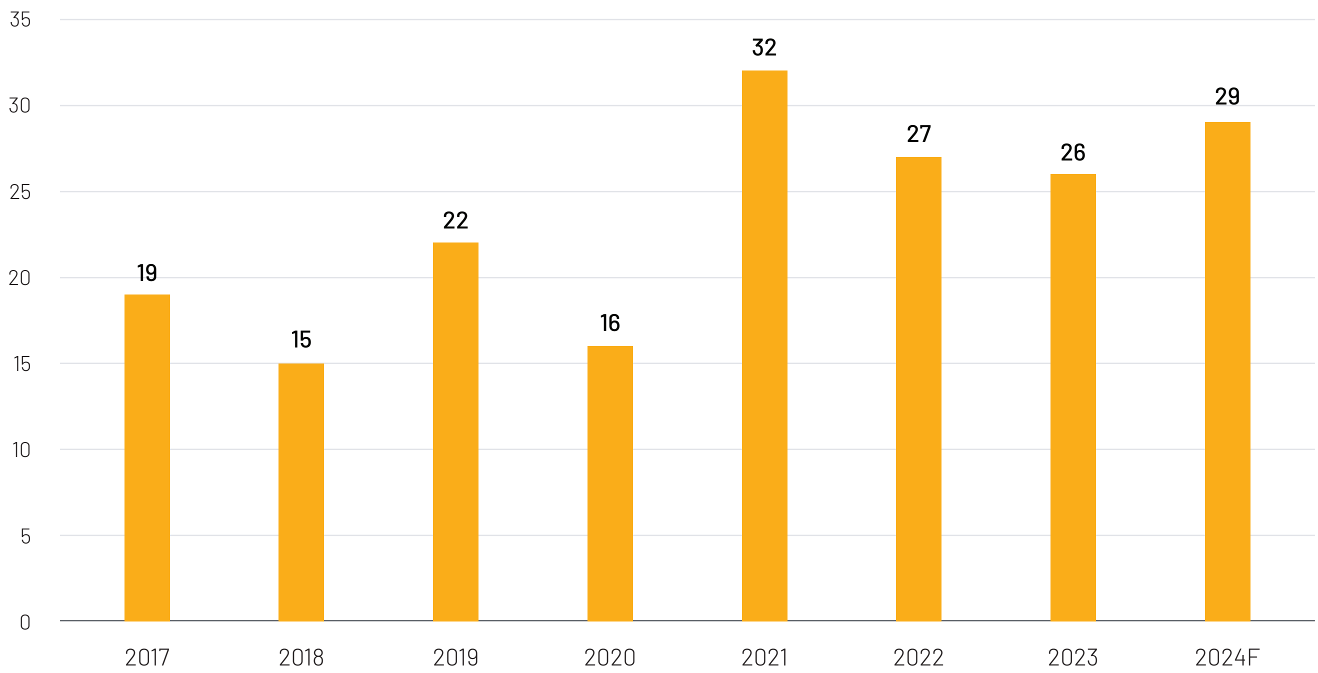
Latin America outlook

In Latin America, structured finance issuance volume declined a marginal 3.7% y/y to c.USD26bn in 2023, in line with the region's deteriorating macroeconomic conditions. Most of the issuance was from Brazil, backed by consumer credit, trade receivables and residential financing.

S&P expects 2024 issuance to grow 13.1% y/y to c.USD29.4bn and its ratings to remain largely stable, driven by (1) growth in Brazil on the back of fiscal support, low interest rates and a recovery in investment; (2) growth in Mexico, backed by companies looking to secure financing ahead of the presidential election, further buoyed by robust remittances based on strong consumption, resilient manufacturing output and increased public non-residential investment; and (3) potential growth in Argentina if the new administration succeeds in restoring macroeconomic stability.

Fitch espouses a stable outlook for the region based on the positive impact of receding inflation and interest rates returning to single digits, expected to be fully offset by a deterioration in the trade receivables, consumer loans and credit card asset classes, owing to low GDP growth and exposure to international markets.

Latin America's structured finance issuance (USDbn)



Source: S&P

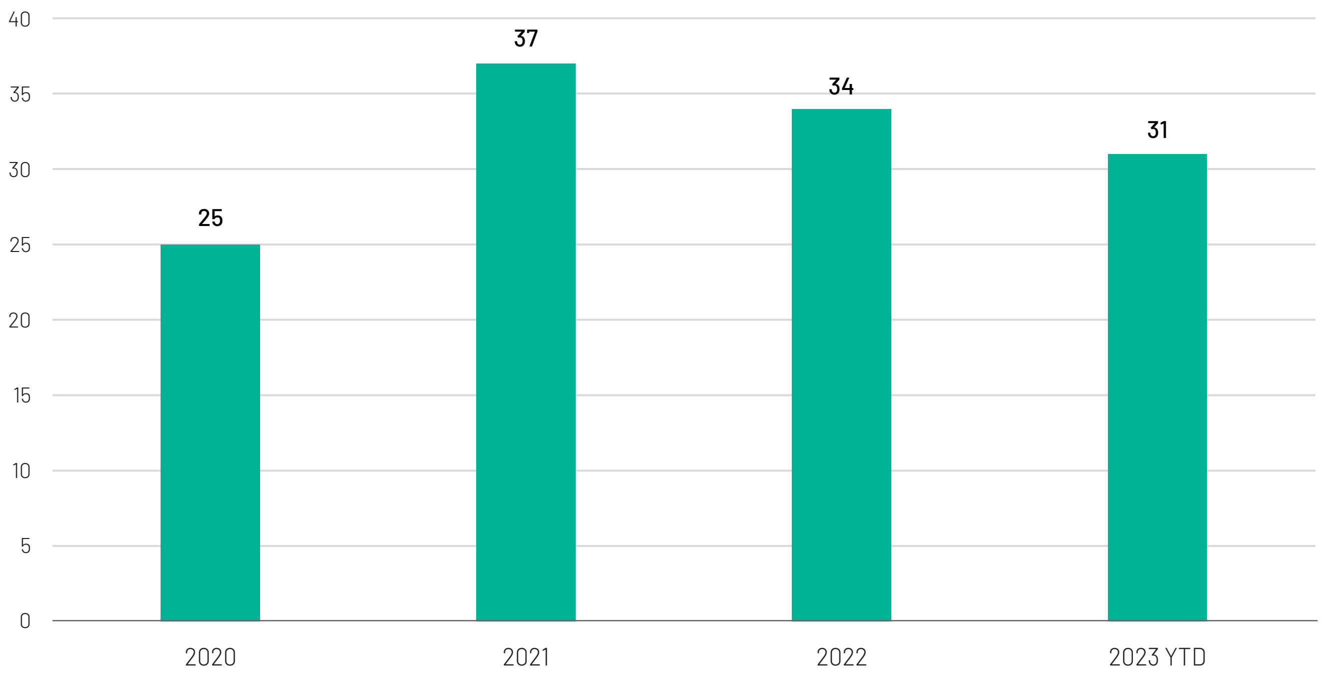
Australia outlook

Structured finance issuance volume in Australia grew significantly, to USD1bn, YTD October 2024 (achieving 91% of 2023 issuance in three quarters). This was buoyed by sustained global and domestic demand, reflecting the sector's longstanding relative value, notwithstanding macroeconomic headwinds owing to an extended period of monetary policy tightening. This led to some consolidation in the securitisation sector as new entrants with less warehousing capacity struggled to continue issuing at elevated spreads.

S&P expects 2024 issuance to grow by c.5% y/y, driven by (1) lower unemployment, (2) a broadly stable economic outlook and (3) structural shifts in the auto sector, which are expected to offset the impact of higher interest rates. This impact is likely to be further buoyed by the sustained presence of non-bank issuers in the market and their continued reliance on securitisation.

However, Fitch expects a slight deterioration in asset performance across Australian structured finance transactions. Upward pressure on arrears is expected to be sustained, amid central-bank cash rate hikes and high inflation. Nonetheless, the deterioration is expected to peak mid-year and then moderate on the back of low unemployment, disinflation and potential rate cuts.

Australia's structured finance issuance (AUDbn)



Source: S&P

China outlook

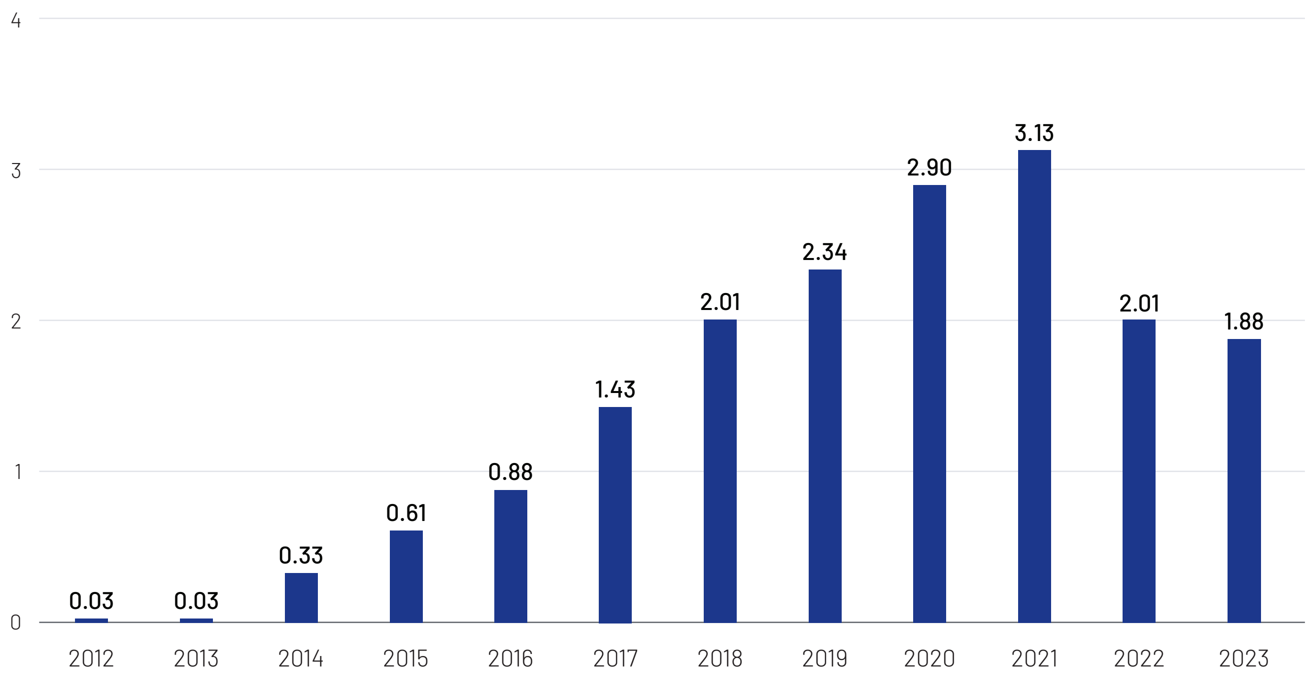
Structured finance issuance volume in China declined 6.5% y/y to RMB1.9tn in 2023 due to a sluggish property market, further aggravated by volatile delinquency ratios, owing to large prepayments that shrank underlying pool balances substantially.

S&P expects issuance volume to remain flat in 2024, on the back of modest growth in auto loan ABS, driven by modest growth projected in light-vehicle sales, further buoyed by steady auto loan penetration rates, notwithstanding high utilisation of facilities that employ revolving structures. RMBS issuance is expected to remain muted as a result of (1) the sluggish property market, (2) the current regulatory stance and (3) banks' mortgage loan origination trajectory.

The country's structured finance market grew consistently and at a healthy pace until 2022. It remained resilient to economic conditions, registering growth for the 10 years to 2021. Delinquencies have been low and the market has been stable since 1Q20, reflecting the low loan-to-value (LTV) ratios of underlying receivables such as leveraged loans. Despite the recent slowdown in overall issuance, there were pockets of burgeoning issuance momentum in 2023 (across consumer loan ABS and micro and small enterprise loan ABS under China's credit ABS scheme); these are worth watching closely in the coming year.

Fitch envisages stable performance amid healthy labour-market conditions, notwithstanding a moderating GDP outlook. Defaults and delinquencies are expected to remain largely flat y/y, underpinned by robust underwriting standards, further bolstered by rigid eligibility criteria for ABS transactions. RMBS issuance will likely be pressured by the ongoing property stress, coupled with recent mortgage rate cuts. However, the recent spike in defaults and delinquencies was distorted by the spike in prepayments, with many older loans refinanced with new effective rates. Once this one-off effect diminishes, we expect RMBS performance to bounce back.

China's structured finance issuance (RMBtn)



Source: S&P

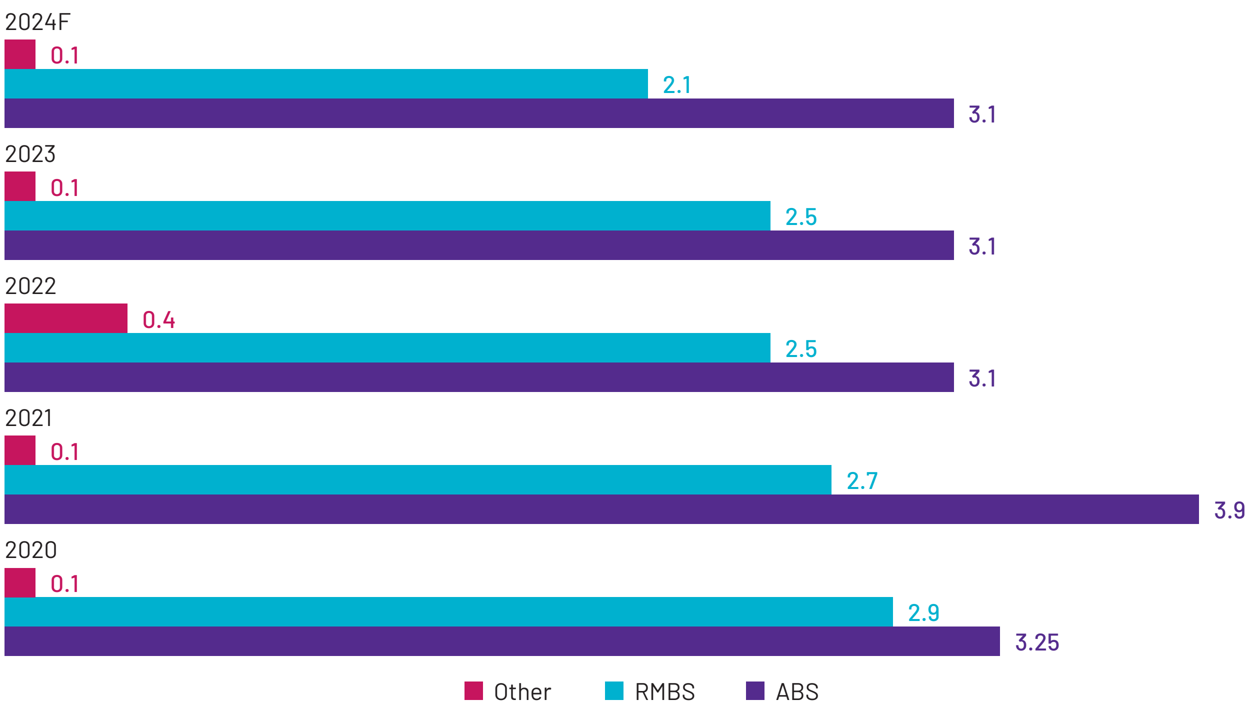
Japan outlook

ABS issuance volume in Japan declined 5% y/y to JPY5.7tn in 2023 due to the decline in RMBS issuance, owing to an increase in interest rates on fixed-rate mortgages on the Bank of Japan's 2023 monetary policy revisions (most Japanese RMBS transactions are backed by fixed-rate mortgages). The widening fixed-/floating-rate gap resulted in a significant increase in the number of floating-rate mortgages, leading to a reduction in RMBS issuance. Japan's structured finance market has historically been dominated by the ABS and RMBS asset classes, while CLO and CMBS originations have generally remained low. This trend continued in 2023, with c.98% of total issuance stemming from ABS and RMBS.

S&P expects ABS issuance volume to remain flat in 2023 at JPY3.1tn. This view is underpinned by the fact that most Japanese ABS issuances are backed by auto ABS loans to individual borrowers. The country's unemployment rate is expected to remain at c.2% over the next three years, and GDP is expected to grow c.1% through 2026; hence, the performance of such loans can be expected to remain largely stable. However, RMBS issuance is likely to dip by c.16% y/y to JPY2.1tn, as the interest rate differential between fixed- and floating-rate mortgages is expected to persist through 2024.

Similarly, Fitch maintains a stable outlook on Japan's ABS sector due to the following factors: (1) the stable performance of underlying receivables, (2) no material change in borrower portfolio characteristics and (3) healthy excess spreads, ensuring sufficient credit enhancement. Fitch projects a stable unemployment rate in Japan over the next three years, which should result in a sustained conducive macroeconomic environment for structured finance issuance in the country over the medium term.

Japan's structured finance issuance (JPYtn)



Source: S&P

04

The changing role of credit analysts and how Acuity Knowledge Partners can help

The changing role of credit analysts

Credit analysts' work in structured finance transactions was in the past mainly in the context of periodic monitoring of covenants, early warning signals and trigger events, and the intermittent assigning of external credit ratings to tranches of issued securities. However, with the sector's landscape continuing to evolve, credit analysts' scope of work has grown exponentially. They now need to continually analyse the financial performance of the underlying originator, particularly for revolving ABS transactions, to ascertain the prospects of transactions and potential cross- selling opportunities.

Owing to the granular nature of these transactions, a large volume of financial indicators needs to be monitored on a regular basis. Covenant monitoring for structured transactions increasingly requires more specialist analytical and financial knowledge, as (1) most structured deals have monthly reporting cycles (compared with quarterly reporting cycles for traditional transactions) and (2) there is a large volume of early-amortisation events, eligibility criteria, replenishment criteria and trigger events that need to be monitored – in addition to traditional financial covenants.

The risk rating mechanism for securitisations has grown in complexity over time. It is now necessary to conduct rigorous stress testing, based on robust modelling of gross default rates, net default rates, etc., by thorough analysis of the underlying receivables to ensure accurate pricing. Apart from this, unlike with unsecured lending, the calculation of regulatory capital often requires the use of complex models such as the internal assessment approach (SEC-IAA), standardised approach (SEC-SA), internal ratings-based approach (SEC-IRBA) and/or Basel II advanced internal ratings approach (AIRB), in line with the EU securitisation regulatory framework.

Furthermore, the increasing importance assigned by investors to ESG considerations has created a need for credit analysts to assess the ESG standing of transactions via scorecard analysis. Analysts also have to monitor ESG compliance periodically, flagging any potential rating or pricing implications that may arise.

Most structured transactions are tied to an advance rate on the eligible collateral. This also brings into the picture collateral monitoring, borrowing base reviews and cover validations, which are crucial aspects of securitisation portfolio management. Frequent (often weekly) and diligent monitoring of the quality of the pledged assets and the borrower's compliance with the specified borrowing base criteria is an integral component of managing structured transactions.

Transaction participants would also be interested in analysing the composition of their collateral and, hence, their exposure to various regions and sub-types of assets. This has led to the emergence of granular exposure analysis as yet another crucial credit analysis function in structured transactions. Additionally, increasingly important tasks are monitoring the exposure and liquidity position of transactions and flagging opportunities for cross-selling associated with structured derivative products, such as liquidity and swap facilities, as deemed appropriate.

Acuity Knowledge Partners is well positioned to support structured finance markets

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Our lending services combine subject-matter and delivery expertise with domain-specific technology, offered through our proprietary suite of Business Excellence and Automation Tools (BEAT).

We conduct (1) credit reviews of relevant SPVs (and originators of non-ring-fenced transactions), (2) detailed periodic analysis of covenant compliance, as specified by the respective credit agreements, (3) financial spreading, (4) cover validations to monitor fluctuations in the asset base of the borrower, (5) borrowing base reviews to ensure client compliance with borrowing conditions, (6) collateral monitoring to analyse the composition of underlying collateral, (7) granular exposure analysis, (8) sub-portfolio reviews and (9) appropriate pricing of structured products via product-tailored risk ratings.

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