1999 Year In Review and 2000 Outlook: Up, Up And Away - Aussie ABCP Programs Are Here to Stay

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HIGHLIGHTS

- Review & Outlook
- Programs Diversify Funding To US
- More Conduits with Minor Consolidation
- Repackaging MBS Remains Most Popular Asset Class
- Asset Quality Remains Sound
- Dynamic Outlook For 2000

REVIEW AND OUTLOOK

The A$ asset-backed commercial paper (ABCP) market continued its growth during 1999, although its 19% rate was at a far more sombre pace than 1998's 123% growth. The real story is in the dynamics of this now permanent fixture of the Australian capital markets, including the increasing use of cross border issuance to fund domestic assets and the established strategy of repackaging term assets.

Asset quality remains strong for investors within Australian and New Zealand sponsored programs.

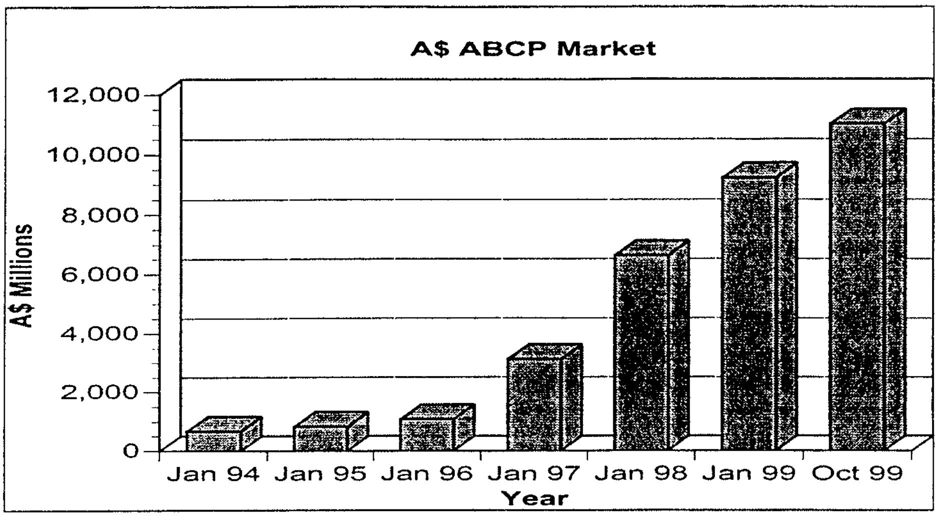
During 2000, we expect the ABCP market to change in response to pressures and challenges on a number of fronts. Consolidation and restructuring are likely to continue among the smaller programs in the face of contracting margins, particularly for those programs that cannot pass-on their cost of funds. The ongoing decline of fully supported programs will require greater analysis of underlying collateral by investors. Finally, as funding costs rise, we anticipate that even more domestic programs will introduce a cross border leg to access the deep US and Euro investor bases, ultimately reducing the amount of A$ ABCP on issue.

1999 REVIEW

Programs Diversify Funding To US

While total assets held by Australian and New Zealand sponsored ABCP programs increased only 9% to A$16.9 billion, A$ ABCP outstandings grew by 19% to A$11 billion (see Figure 1). Growth in A$ outstandings was well down on last year's 123% growth, however domestic investors are acutely aware of a continuing trend of the larger Australian programs to finance their asset portfolio's with US$ ABCP.

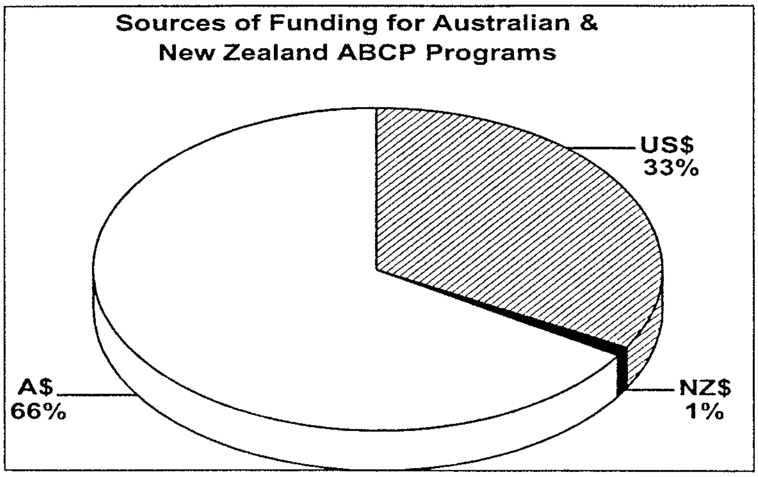
FIGURE 1



The Westpac-sponsored Waratah program and the ABN AMRO-sponsored Tasman program increased their cross border funding activities during the year and are consistently sourcing over half of their funding requirements from the US$ ABCP investors. Australian and New Zealand programs collectively sourced 33% of their funding requirements from the US$ market (see Figure 2).

The extent of this trend is not immediately obvious as headline US$ outstandings at the close of the year was static at US$3.8 billion when compared to the same time last year. The impact of an additional A$1.1 billion in funding sourced from the US market by three multi-seller programs was reversed by the refinancing activities by another program. By contrast, if this new issuance was financed in the local market, A$ outstandings would have increased to over A$12 billion, recording the same nominal increase in outstandings as last year's record increase!

FIGURE 2



More Conduits with Minor Consolidation

Five new ABCP programs were established during the year, including the ANZ Bank sponsored Coast program and the CIBC sponsored Asset-Backed Securitisation Corporation program, taking the total number of programs to 39.

Consolidation in this sector was evidenced by the wind down of the Westpac sponsored WISDOM Trust and a general slowdown in asset acquisition particularly among the smaller programs. The impact of consolidation was also felt on the cross border front, with the equivalent of A$1.2 billion being either sold or re-financed out of Societe Generale's ACE Overseas' bond portfolio.

Repackaging MBS Remains Most Popular Asset Class

As term mortgage-backed securities (MBS) and asset-backed securities (ABS) pricing increased from mid-1998 lows, the higher asset margins accommodated increased liquidity costs for the term arbitrage conduits -- thus sustaining their appetite for MBS and ABS. Of the net A$1.7 billion increase in A$ outstandings, A$1.5 billion came from the repackaging of MBS and ABS by 5 large term arbitrage programs, including National Australia Bank sponsored Titan and AXA sponsored Mustang No.1 Trust.

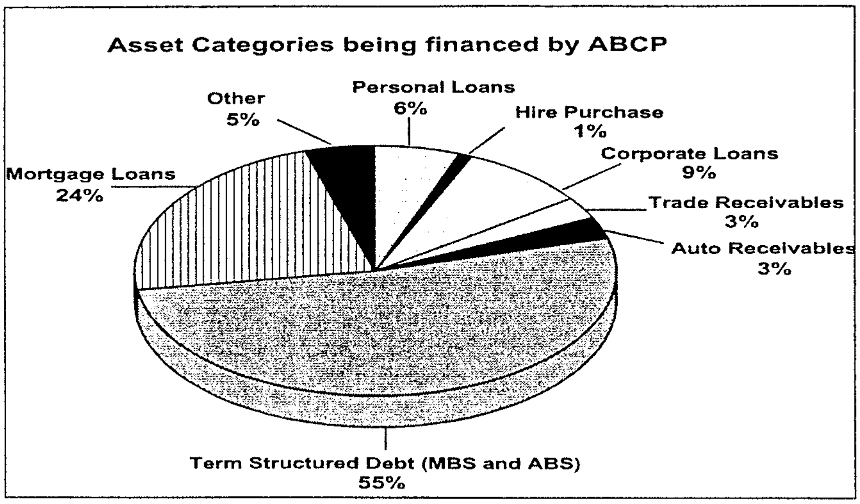
In total, 64% of ABCP outstandings from Australian program finance repackaging activities, which include term-structured debt (MBS and ABS) and term corporate loans (see Figure 3). This seemingly insatiable appetite for term arbitrage is indicative of a global trend which now represents the fastest growing asset category for the US and Euro ABCP markets.

The high proportion of MBS (49%) and mortgage loans (24%) in Australian and New Zealand ABCP programs is attributable to the fact that mortgage-backed assets remain the most popular asset class for securitisation. Given the availability of primary mortgage insurance to protect investors from losses and the accessible channels of asset origination outside of traditional banking circles, we expect mortgages to continue to feature predominantly in ABCP conduits.

Moody's considers the emergence of new asset classes in ABCP programs as a positive trend of 1999 that contributes to increased issuance. Non-mortgage deals included trade receivables, credit cards, auto loans and equipment leases, although the aggregate proportion remains small (11%) when compared to the mortgage-backed sector.

An ABCP program is a portfolio of exposures to asset classes, sellers/servicers, liquidity and credit providers. Diversifying for these factors helps to minimise investors' exposure to event risk. Given the trend to structuring programs with less program level credit enhancement to take account of these risks, diversification is likely to become increasingly important in the overall risk assessment of a program.

FIGURE 3



Asset Quality Remains Sound

Asset quality did not pose a concern for investors in Australian and New Zealand sponsored programs, given the sound economic environment in Australia, and improving outlook in New Zealand. In any event, programs are typically structured with triggers so as to limit ABCP investors' exposure to deteriorating assets.

1999 saw one ABCP program downgraded to Prime-2 due to a change in the provider of an important facility. The Prime-1 rating of SPARS No.2 was lowered to Prime-2 on August 31, 1999 following the novation of the fully supporting liquidity facility to Prime-2-rated Macquarie Bank. The novation coincided with Macquarie's acquisition of the investment banking business of Bankers Trust Australia, the previous facility provider.

OUTLOOK FOR 2000

We anticipate that the ABCP market will have marginal asset growth, with pressures and challenges on a number of fronts will see continued consolidation. Those programs that can anticipate the trends will continue to thrive.

- **Strategic relevance will bring consolidation; most likely for smaller programs**

  With the five major Australian banks now sponsoring ABCP conduits, the stage is set for more assets to be funded by ABCP. Increasingly, the ABCP programs will be seen as an ongoing funding business rather than an opportunistic play, and we expect consolidation and restructuring to continue among the smaller programs.

  Given that many programs use the ABCP market to warehouse assets prior to a long-term issue, we expect ABCP outstandings for some programs to fluctuate based on the costs of short-term versus long-term financing.

  At its simplest level, consolidation will lead to less domestic programs in the Australian market place. Unprofitable assets and programs will be taken out of the market and either restructured or re-financed elsewhere. Smaller programs that do not have flexibility over maintaining conduit margins in the face of increasing funding costs will be particularly sensitive to this issue.

- **Decline of fully supported transactions means more analysis**

  The increasing cost of providing credit is likely to lead to the restructuring of fully supported exposures. For restructured transactions, investors will need to analyse the differing risks being absorbed by the parties in the partially supported framework, and assess their remaining exposure. Investors can follow Moody's opinions in the weekly ABCP press release or in our quarterly Investor Reports

- **Funding cost pressure and investor diversification could see money go offshore**

  Programs that are able to fund cross-border will be able to take advantage of cheaper offshore fund. We expect that if the all-in offshore funding cost is consistently more attractive than A$ ABCP, more domestic programs will consider a cross border leg to access US and Euro investor bases. This could mean a reduction in A$ ABCP on issue.

- **More repackaging at the will of available liquidity**

  More repackaging is on the horizon as the route to the easy money. This play will again put to test the classic folly of funding long and borrowing short – this generation is doing it synthetically. The extent of growth in repackaging is directly related to the appetite of liquidity providers to continue to stand in the market to support this paradigm; we expect that appetite to hold steady, subject to the all-important issues of cost, availability of third party liquidity, capital allocation and regulatory intervention.

  Presently investors are not exposed to losses as a result of negative spread, although outstandings may decrease if CP funding costs increase over the asset yield. This situation would create new pressures for programs, and we anticipate innovative responses - such as conduits re-financing into longer term funding certificates, structuring alternative forms of liquidity or allocating credit enhancement in lieu of passing market value to investors. To date, Australian investors have not been subject to changes in the market value of securities.

RELATED RESEARCH

- Asset-Backed Commercial Paper: Understanding the Risks
- Forever Prime-1? Downgrade Risk in Asset-Backed Commercial Paper Programs
- On Being A Prudent Investor: Understanding the Nuts and Bolts of Australian ABCP Structures
- Serialised ABCP: The Hidden Dangers
- Understanding Structured Liquidity Facilities in Asset-Backed Commercial Paper Programs

For a complementary copy of any of these reports, please contact Investor Relations in New York on (1-212) 553 7941 or the Sydney ratings desk (61-2) 9270 8100.