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# Canadian ABS Outlook: After The Household Debt Binge, Will Canada Have An Economic Hangover In 2014?

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# Canadian ABS Outlook: After The Household Debt Binge, Will Canada Have An Economic Hangover In 2014?

Is it closing time for Canada's recent household credit boom? Our baseline forecast for slow improvement in the labor market, subpar real GDP growth, and a cooling housing market will contribute to continued sluggish economic expansion in Canada for 2014. This is in contrast with the country's relatively quick rebound from the November 2008-May 2009 recession, when record amounts of household credit--including, but not limited to, residential mortgage credit--helped to sustain growth in consumer spending. Although credit conditions in Canada generally remain favorable, demand for credit has been slowing, a sign that financial deleveraging could constrain the economy's growth potential in 2014 while consumers focus on paying down debt. We believe consumer deleveraging could disrupt broader economic activity, and stretched household finances have made creditors vulnerable to a housing downturn.

As a result, while the performance of collateral backing Canadian asset-backed securities (ABS) transactions generally improved year-over-year in 2013 and loss rates are at or near record lows, we believe the recent pronounced increase in household debt remains a latent source of credit risk. We therefore see the potential for some erosion in collateral performance in 2014, although we expect our ratings to remain stable overall.

**Overview**

- Standard & Poor's expects Canadian consumer ABS credit ratings to remain stable in 2014 despite the likelihood of moderate deterioration in underlying collateral performance.
- Unlike in the U.S., where we believe consumer debt reduction has come to an end in this credit cycle, the repair of Canadian households' balance sheets is just beginning.
- We believe new issuers will balance the lack of upcoming maturities from existing ABS issuers, and total structured finance issuance will remain around C$11.5 billion in 2014, split among credit card ABS (C$6.0 billion), auto and equipment ABS (C$2.0 billion), CMBS (C$2.0 billion), and RMBS (C$1.5 billion).
- Significant ongoing changes to the mortgage finance system during the past several years could spur the development of a private-label RMBS market in Canada.

When rating ABS, our forward-looking base-case assumptions reflect our performance expectations given the current economic and industry outlook. While actual loss rates are at cyclical lows, our current base-case loss assumptions for Canadian issuers are generally set higher than their actual performance. Therefore, while we believe there will likely be some collateral weakening in consumer asset classes in 2014, including credit cards, auto loans, and residential mortgages, given our forward-looking assumptions and the robust structural protections available in ABS, we believe Canadian ABS ratings will likely remain stable if the potential deterioration in collateral performance remains in line with our expectations.

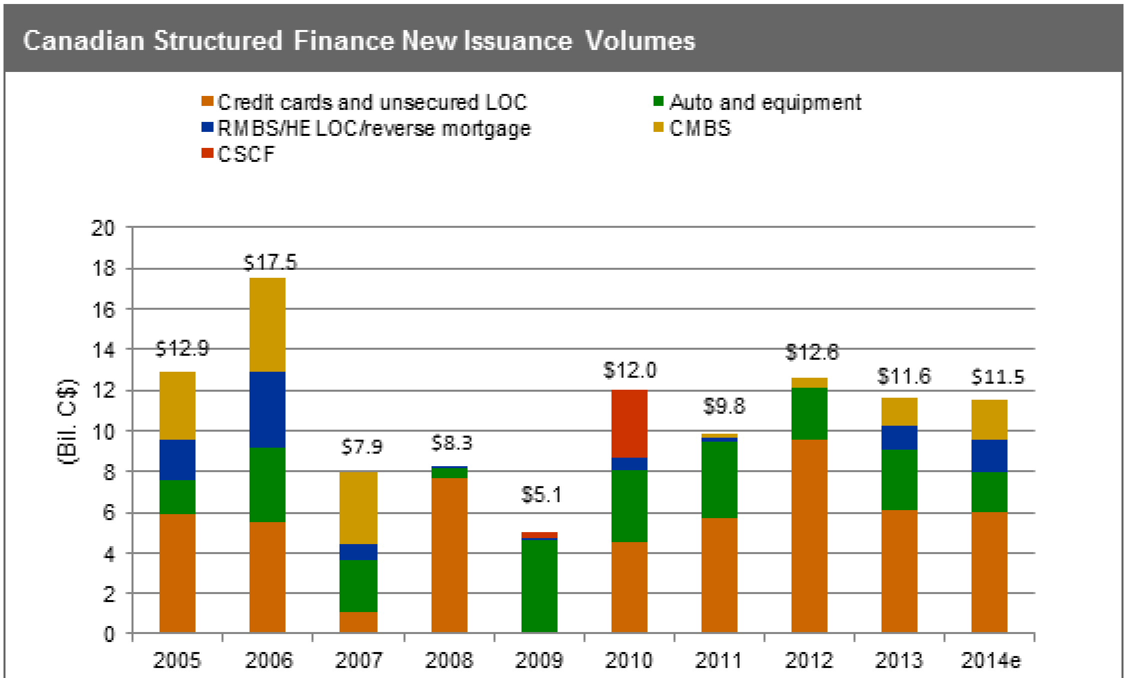
Although demand for credit is now slowing, total household credit reached an all-time high of C$1.7 trillion in 2013.

However, this didn't translate into larger structured finance issuance volumes, comprising ABS, residential mortgage-backed securities (RMBS), and commercial mortgage-backed securities (CMBS), which in total were down 8% year-over-year to C$11.6 billion from C$12.6 billion in 2012. Credit card ABS (including unsecured lines of credit) remained the largest asset class, with C$6.1 billion in new issuance, followed by the auto and equipment ABS sectors, with a combined C$3.0 billion. New issuance activity is beginning to pick up in the CMBS sector, with four deals totaling C$1.4 billion issued in 2013. While we have yet to see any significant volumes in the private-label RMBS/home equity line of credit (HELOC) sector, some familiar names returned to the market this year, completing C$1.1 billion in issuance. Outstanding asset-backed commercial paper (ABCP) was up approximately C$1.8 billion year-over-year, with C$29.1 billion outstanding as of September 2013, according to Bank of Canada statistics. Lastly, covered bond issuance resumed in July 2013 after several issuers registered with Canada Mortgage and Housing Corp. (CMHC) under the new legislative framework. Total covered bond issuance was C$13.3 billion in 2013, down from C$17.0 billion in 2012.

## Consumer ABS Issuance Will Likely Drop In 2014, While CMBS Finds A Second Wind

At C$11.6 billion, total Canadian structured finance issuance (excluding ABCP, covered bonds, and transactions primarily retained on sellers' balance sheets) in 2013 was slightly behind 2012's post-recession high of C$12.6 billion (see chart 1). Given the outstanding transactions' maturity profiles, we believe non-mortgage-related new issuance volumes may decline to C$8.0 billion in 2014 from C$9.1 billion in 2013, although potential new entrants or growth in existing credit card and unsecured line of credit programs could surprise on the upside. We anticipate that the return of some bank sponsors in the CMBS conduit market will push up CMBS issuance to C$2.0 billion in 2014 from $1.4 billion in 2013, which may partially offset the decline in nonmortgage ABS. In addition, market participants continue to evaluate the effect of ongoing changes to the residential mortgage finance system and the economics of private-label RMBS. However, this sector is still in its infancy, and we don't expect private-label RMBS issuance to exceed C$1.5 billion in 2014. Therefore, our aggregate Canadian structured finance issuance forecast is C$11.5 billion in 2014, in line with the C$11.6 billion issued in 2013.

**Chart 1**

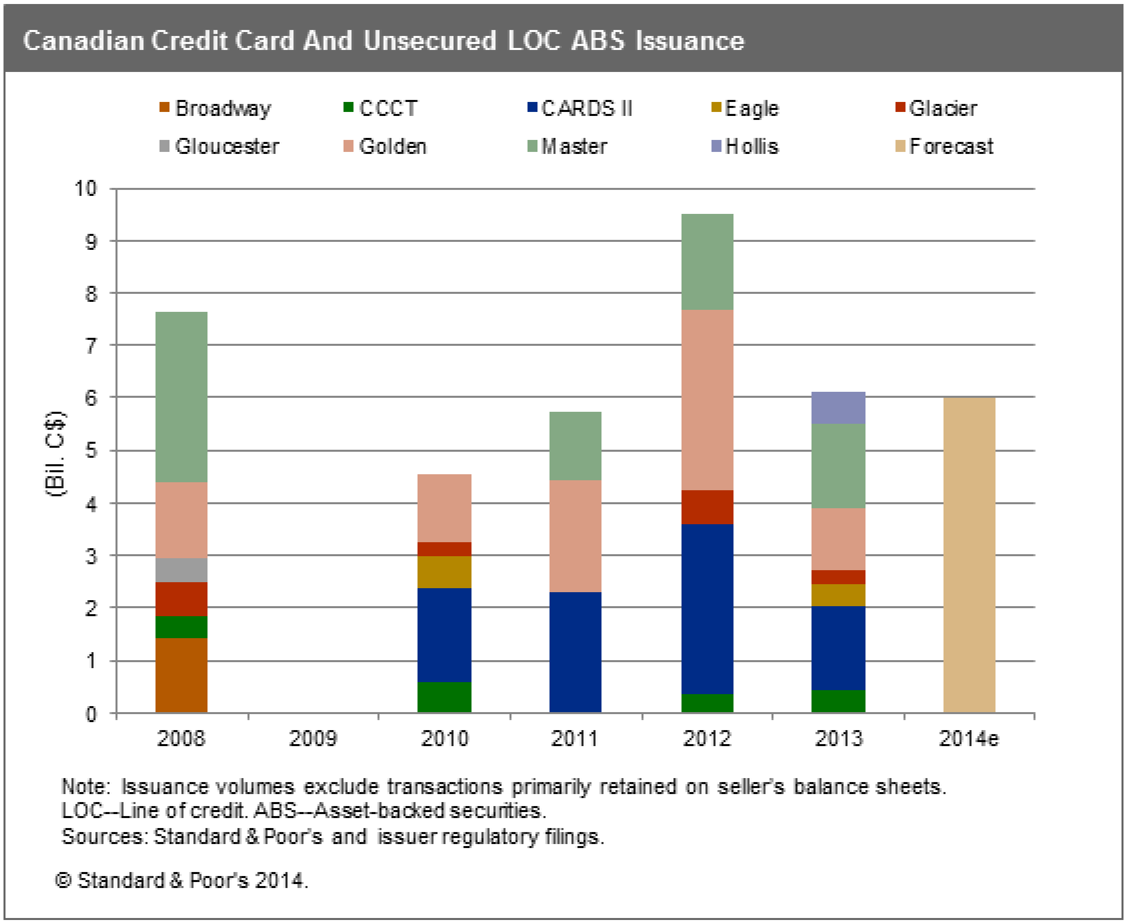



Note: The new issuance statistics include private placements disclosed within issuer regulatory filings, excluding private placements identified as being acquired by Canadian asset-backed commercial paper conduits. Issuance under the CSCF is reported separately from the respective asset classes financed. LOC--Line of credit. RMBS--Residential mortgage-backed securities. HELOC--Home equity line of credit. CMBS--Commerical mortgage-backed securities. CSCF--Canadian Secured Credit Facility. e--Expected.
Sources: Standard & Poor's and issuer regulatory filings.


## Credit card and unsecured line of credit ABS

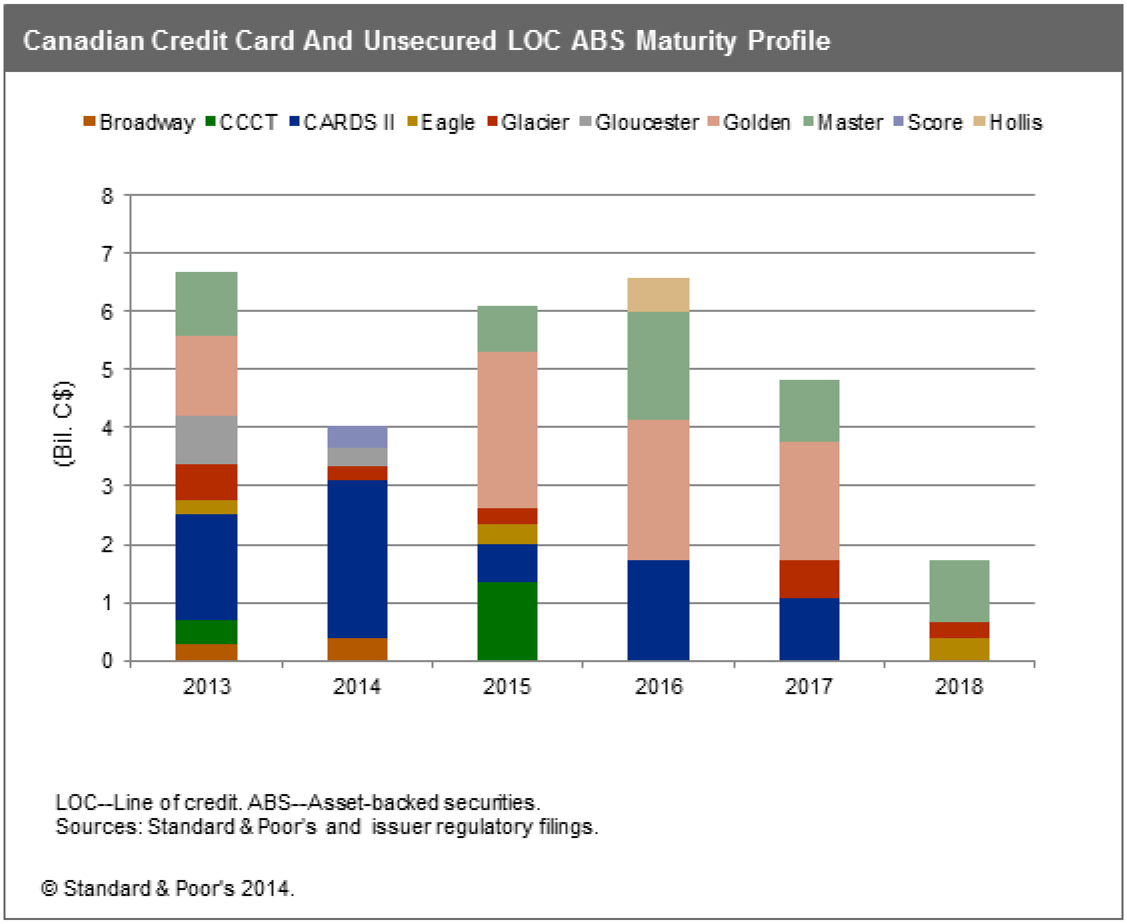
Canadian-domiciled sellers issued C$5.5 billion of credit card ABS in 2013, a sharp decline from the record high C$9.5 billion issued in 2012. However, the launch of Bank of Nova Scotia's unsecured consumer loan program, Hollis Receivables Term Trust II, helped to offset the drop with an inaugural C$0.6 billion deal in the fall of 2013 (see chart 2).

**Chart 2**




We expect credit card ABS issuance from existing trusts to decline further in 2014 as the amount maturing from active issuers will decline to C$3.0 billion, compared with C$5.6 billion in 2013 (see chart 3). We don't expect any future issuance from Score Trust, Gloucester Credit Card Trust, or Broadway Credit Card Trust. However, we believe other Canadian banks may launch credit card or unsecured line of credit securitization programs or expand their existing programs by adding accounts to their master trusts, which could result in issuance volumes exceeding the amount of scheduled maturities. As a result, our total issuance forecast for credit card and unsecured line of credit ABS is C$6.0 billion in 2014. Many Canadian-domiciled sellers will likely continue to issue cross-border transactions placed with U.S. investors, as long as the relative funding cost advantage or diversification benefit exists.

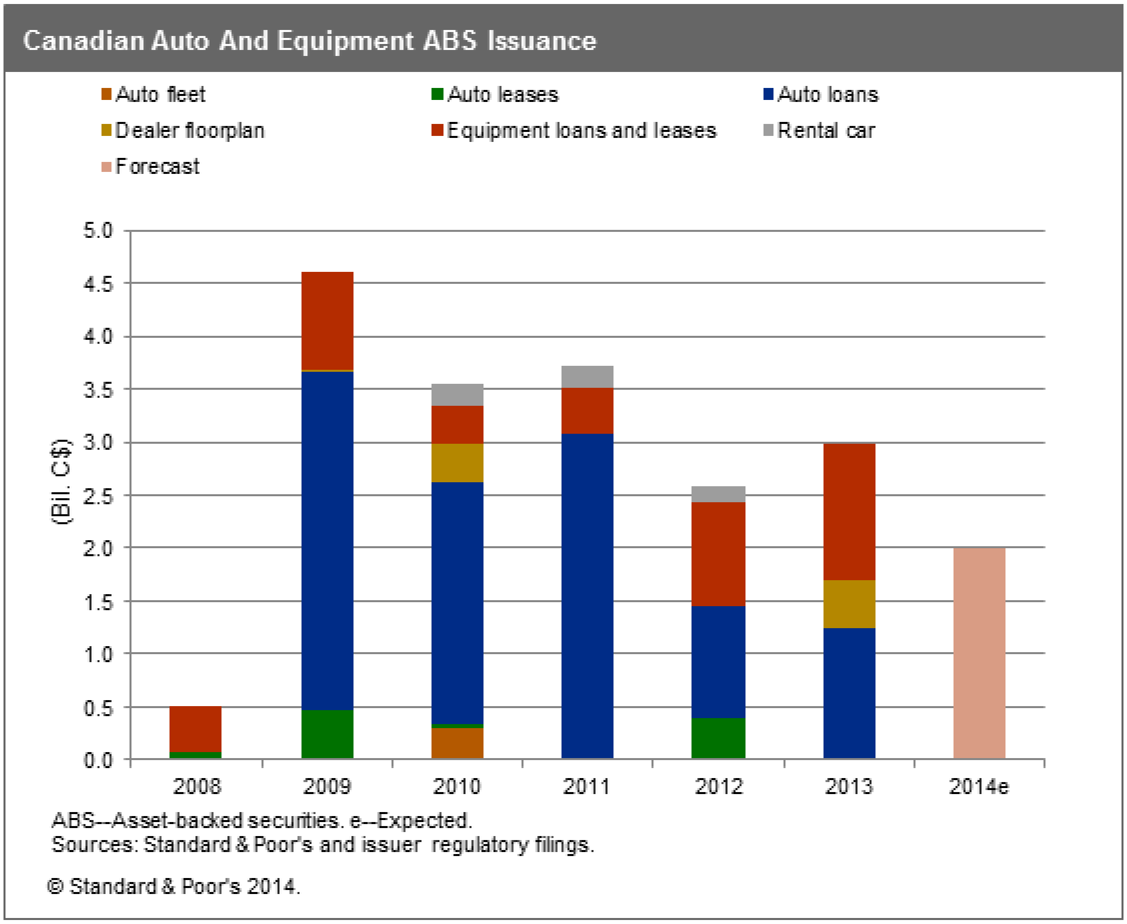
**Chart 3**




## Auto and equipment ABS

Canadian auto and equipment ABS issuance increased to C$3.0 billion in 2013 from C$2.6 billion in 2012 (see chart 4). We attribute the increase largely to a C$0.46 billion dealer floorplan transaction from a captive finance company that returned to the ABS market following a two-year hiatus. In addition, we observed that certain auto and equipment issuers with established securitization programs were more active in 2013 than in 2012. However, total new auto loan ABS remains significantly below pre-2012 volumes, decreasing after Canadian banks acquired the Canadian operations of several large captive finance subsidiaries with securitization programs. We believe that lower auto loan ABS volumes will persist in the near term while these banks complete the integration of the auto finance operations and utilize cheaper deposit funding to finance those receivables. Lastly, for those finance companies remaining as captives, issuer credit rating (ICR) upgrades could reduce their reliance on ABS funding, as many of them are accessing the corporate unsecured bond market at historically favorable rates.

**Chart 4**



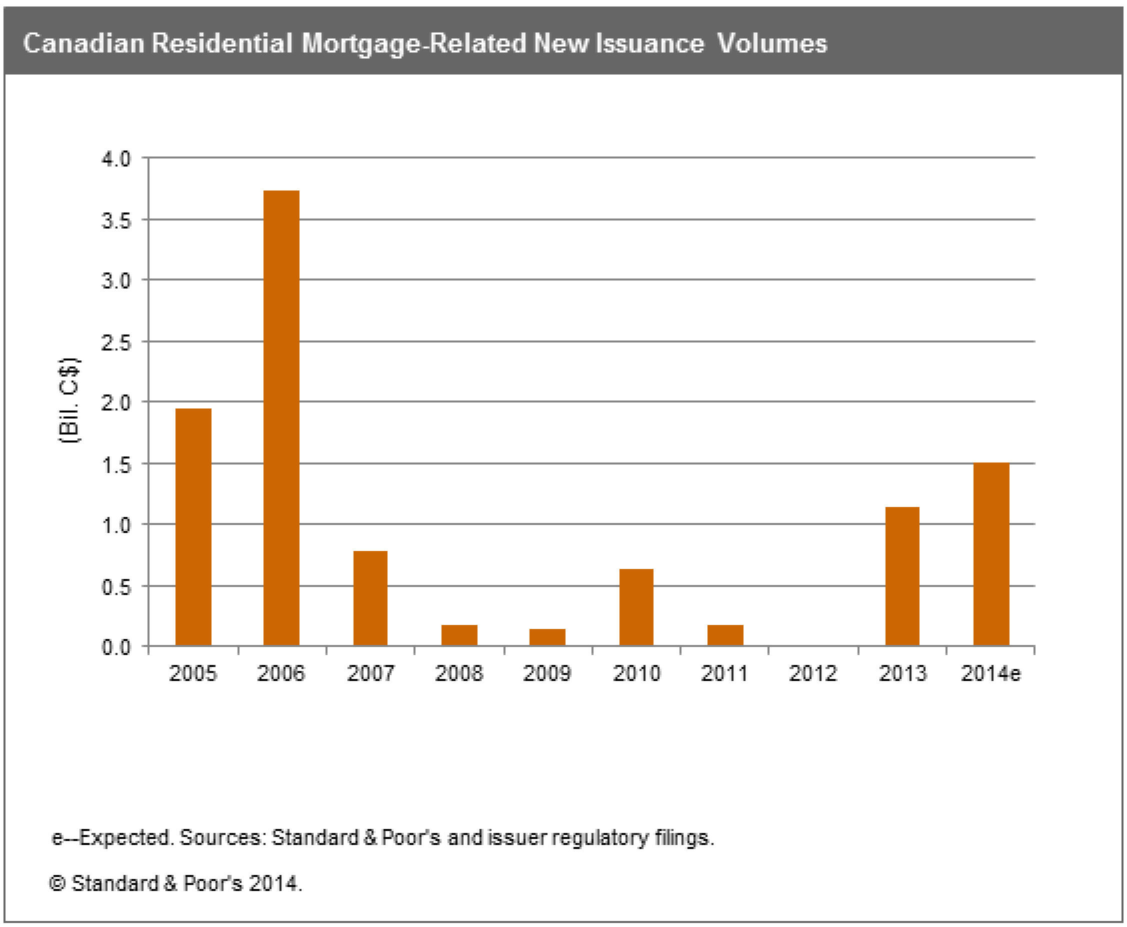

Auto and equipment related collateral continues to be in high demand from Canadian ABCP conduit sponsors, and we believe they will continue to fund the lion's share of securitizations in these asset classes. Our issuance forecast for Canadian auto and equipment term ABS is C$2.0 billion in 2014. Auto lenders favored long-term loans (in some cases up to 96 months) as affordability products in recent years, but leases are now making a comeback, and we're beginning to receive inquiries about potential term ABS funding for auto leases. However, transactions involving lease collateral and concurrent lease structures may face additional obstacles in light of the September 2009 changes to Canada's Bankruptcy and Insolvency Act that provide new guidance on potential disclaimer or resiliation of leases. The biggest surprise may come in the equipment ABS sector: Following significant acquisitions both in Canada and the U.S., larger originators may now have the scale to efficiently tap the public securitization markets and further diversify their funding bases to support expansion.

While we don't include enhanced equipment trust certificates (EETC) in our structured finance issuance volumes, we believe that the public capital markets will likely play an increasing role in aircraft funding following Canada's adoption of the Cape Town Convention (an international treaty intended to boost credit for airlines by committing countries to predictable and favorable treatment of lenders and lessors in airline bankruptcies). Air Canada completed its first EETC transaction in 2013, and we believe other Canadian carriers may explore this funding alternative given the favorable borrowing costs the structure provides. These secured bonds have been the largest single source of debt funding for U.S. airlines since the 1990s, as they typically provide low-cost asset-based financing (for further information, see "Top 10 Global Investor Questions For 2014: Transportation Sector," published Jan. 9, 2014).

## RMBS

Some familiar issuers with residential mortgage-related collateral returned to the Canadian market in 2013, with a total of C$1.1 billion in issuance following a dry 2012 (see chart 5). Lenders are adapting to the numerous changes in Canada's mortgage finance system over the past several years, but it remains to be seen how these changes will influence their financing strategies. While the total outstanding amount of private residential mortgage-backed issuance is mere basis points of the amount of mortgage credit outstanding, we're observing increased interest in establishing a private-label term RMBS market. There are also calls to reduce the government's role in Canada's mortgage finance system and transfer risk to the private sector.

**Chart 5**




Still, the government-related National Housing Act Mortgage-Backed Securities (NHA MBS) and Canada Mortgage Bond (CMB) securitization programs continue to be some of the primary sources of funding for insured residential mortgages in Canada. By our estimate, the NHA MBS and CMB programs account for approximately one-third, or C$400 billion, of the total C$1.2 trillion in residential mortgage credit outstanding (however, some lenders may retain market NHA MBS on their balance sheets for capital or liquidity purposes instead of for funding purposes). This figure has increased significantly from C$100 billion in 2005, or approximately 15% of the total C$660 billion in residential mortgage credit that year.

CMHC receives an annual guarantee limit on NHA MBS and CMB, which the Minister of Finance authorizes. The limits for 2014 will be C$80 billion for market NHA MBS and C$40 billion for CMB. The CMB guarantee limit is consistent with historical issuance volumes and should be sufficient for lenders to refinance the C$36.2 billion of notes scheduled to mature in 2014 (see charts 6 and 7). However, the market NHA MBS limit has dropped C$5 billion to C$80 billion in 2014 from C$85 billion in 2013. We believe this reduction follows the government's stated objective to reduce taxpayer exposure to the housing sector, and may continue to decline in combination with reduced portfolio insurance to gradually bring NHA MBS issuance closer to pre-recession levels (see chart 8).

CMHC announced a new allocation methodology for market NHA MBS in 2013 after receiving significant demand in the first half of the year, which could have caused requests to exceed the annual authorized limit. We believe the new allocation methodology, under which the available amount of market NHA MBS will be allocated equally to requesting issuers, will be a relative disadvantage for larger originators, but could also indirectly reduce liquidity and increase funding costs for smaller lenders if banks and aggregators reduce whole-loan purchases to preserve coverage for their own originations.

**Chart 6**

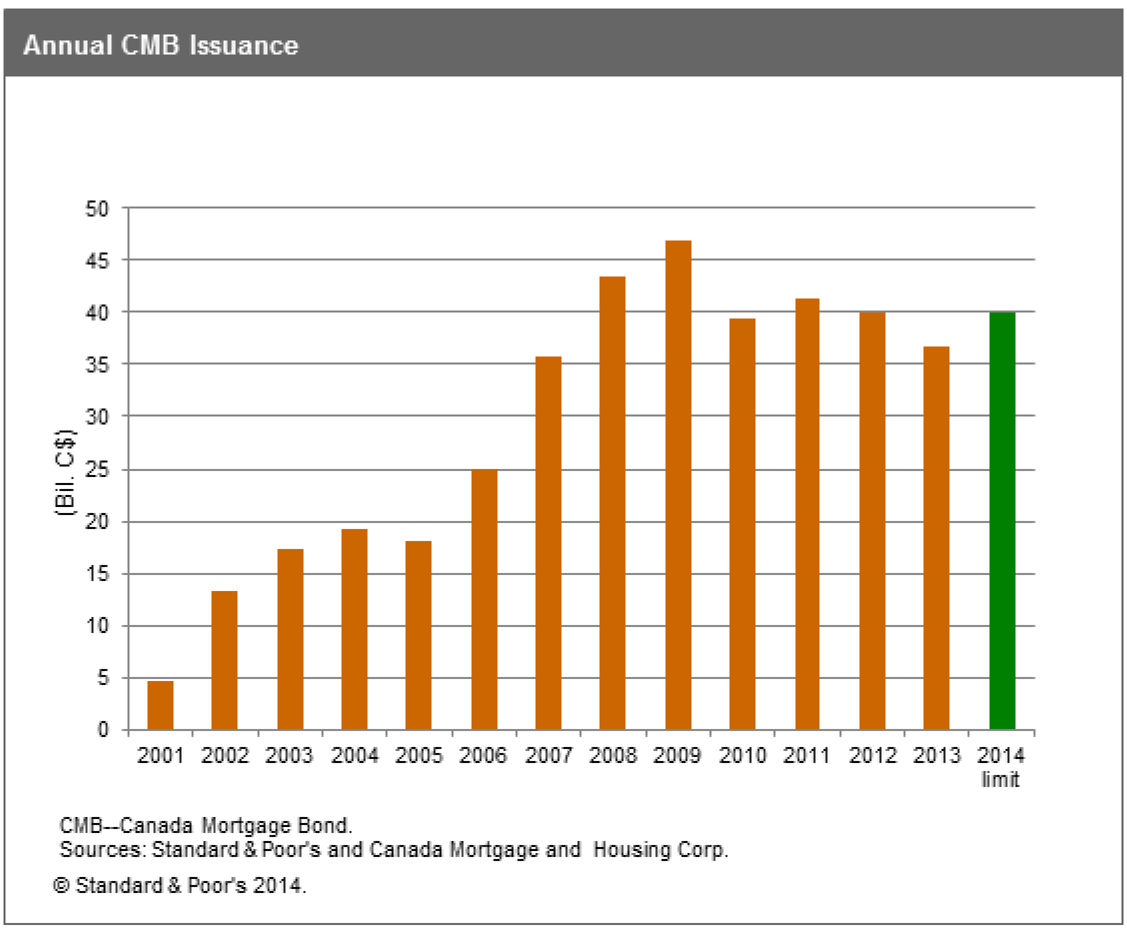
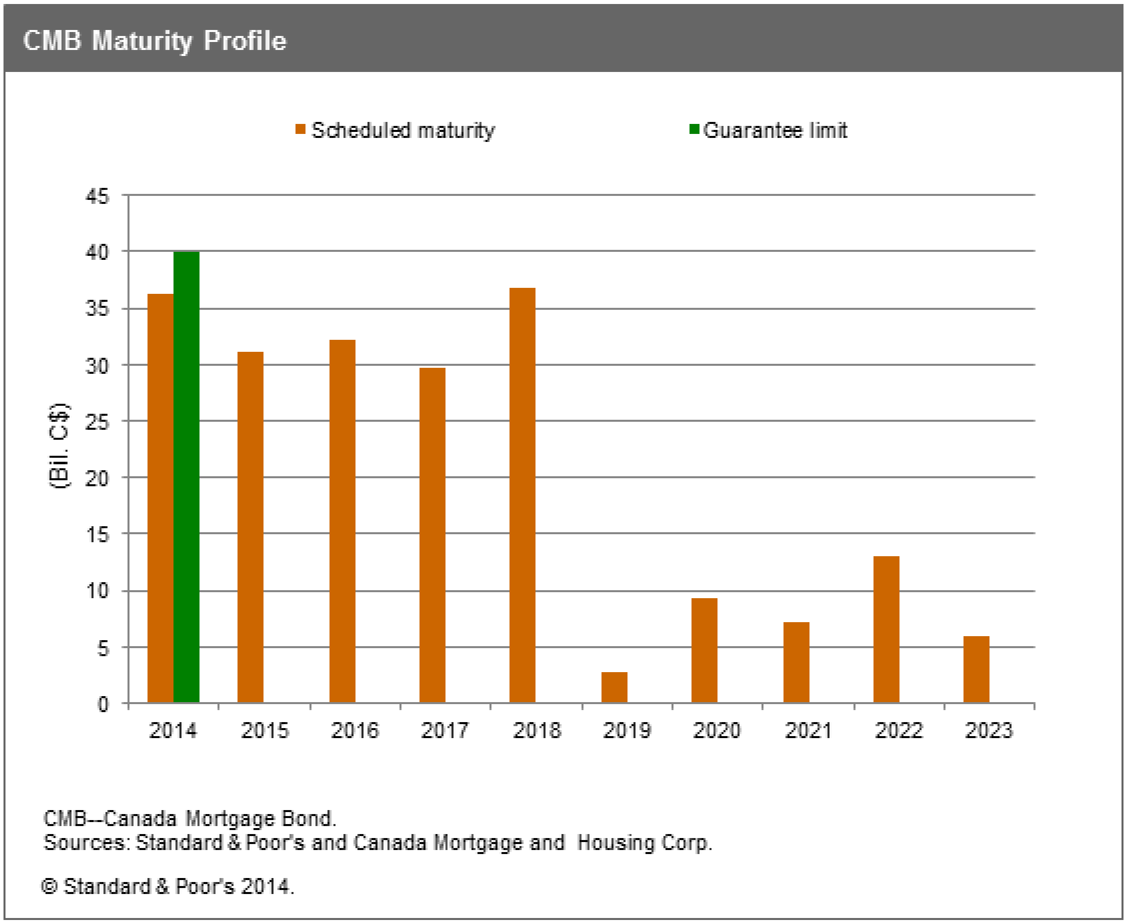
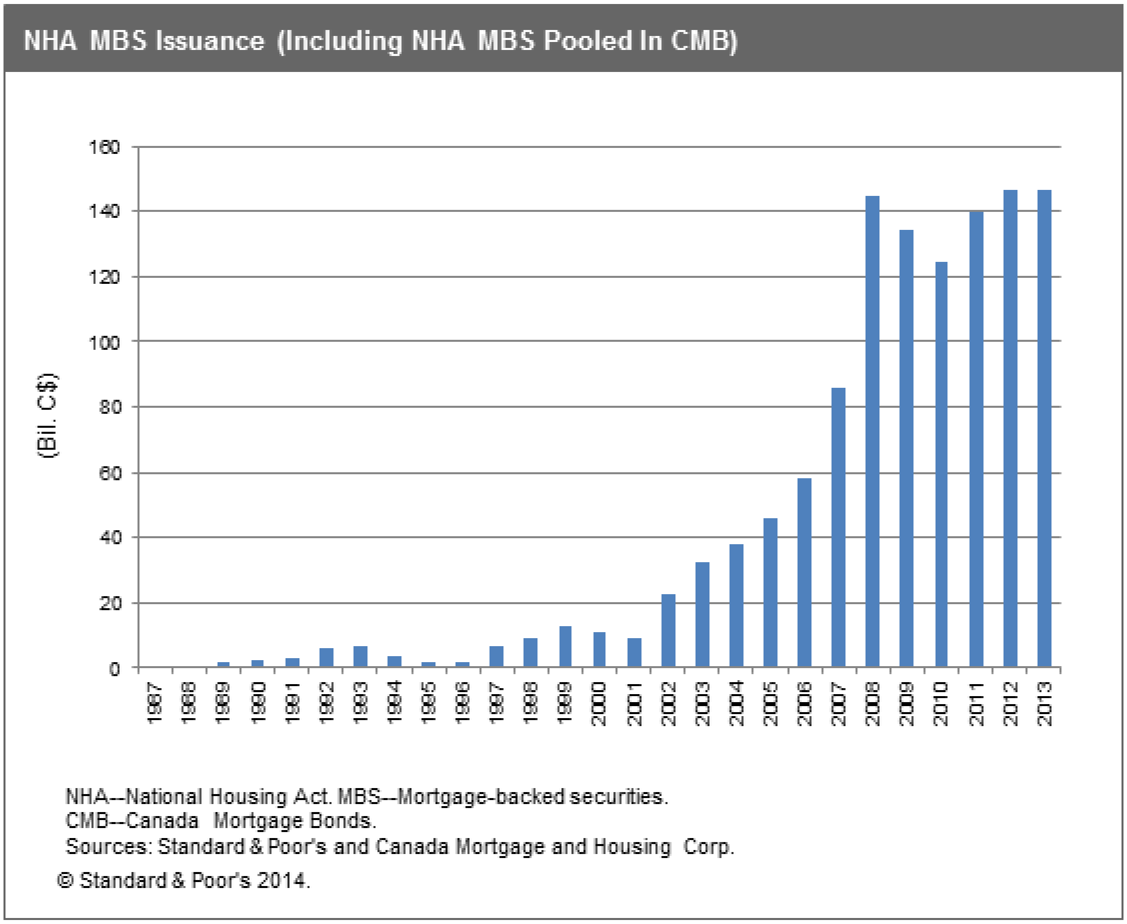


**Chart 7**




CMB--Canada Mortgage Bond.
Sources: Standard & Poor's and Canada Mortgage and Housing Corp.

**Chart 8**



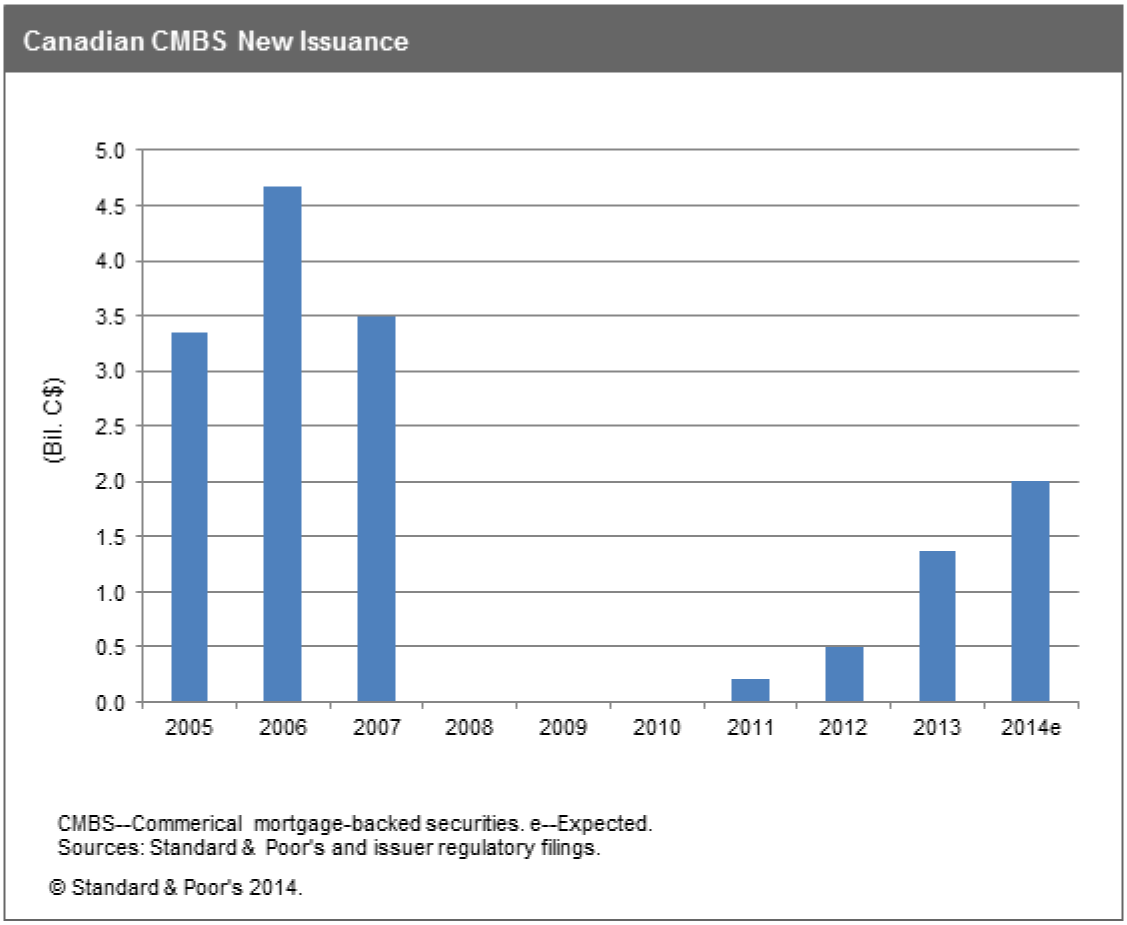

Following numerous tightening measures on insured mortgage eligibility criteria in 2012 aimed to cool the housing market, Canada's 2013 budget contained two further announcements that are likely to influence lenders' funding strategies. The first was to gradually limit portfolio insurance to only those mortgages in the CMB or NHA MBS programs. The second was prohibiting the use of insured mortgages as collateral in private-label RMBS and ABCP conduits, which we understand presents more obstacles for nonbank lenders with existing conduit facilities. Residential mortgages are currently one of the largest asset classes financed through Canadian ABCP conduits, and the proposed restriction could significantly shrink this market. The government is consulting with industry stakeholders on the potential effect of these announcements, and the restrictions' timing and details are not yet final.

In our view, the significant changes to the mortgage finance system could help spur the development of a private-label RMBS market in Canada and gradually reduce reliance on government-related securitization programs for low ratio mortgages (with loan-to-value ratios less than 80%). Nonbank lenders without access to cheap deposit funding that desire to diversify their funding bases will likely be the first to test the market, but we believe growth will be slow and forecast issuance of C$1.5 billion in 2014.

## CMBS

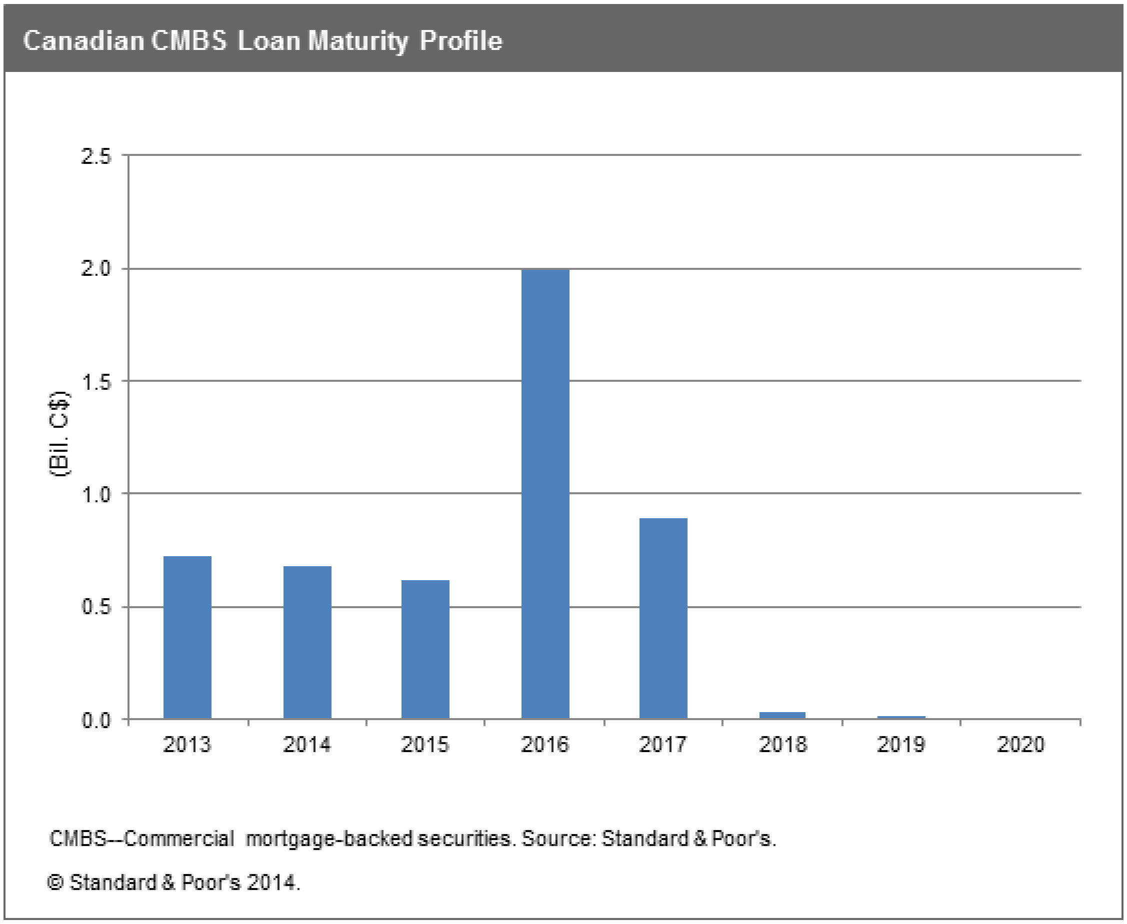
Unlike the credit card and auto sectors, the return of Canadian CMBS issuance following the 2008-2009 recession has been slow. Since the market reopened in 2011, there have been only a handful of deals, all from nonbank sponsors, with mortgage loan collateral primarily from secondary and tertiary markets. However, deal sizes have been gradually increasing, and the market continued to gain momentum in 2013, with four deals totaling C$1.4 billion versus two deals totaling C$0.5 billion in 2012 (see chart 9).

**Chart 9**




As of Dec. 31, 2013, we had ratings outstanding on 22 Canadian CMBS transactions with an aggregate loan balance of approximately C$4.1 billion. More than 80% of the outstanding loans will come due by the end of 2016, reflecting a large issuance year and 10-year term maturities (see chart 10).

**Chart 10**

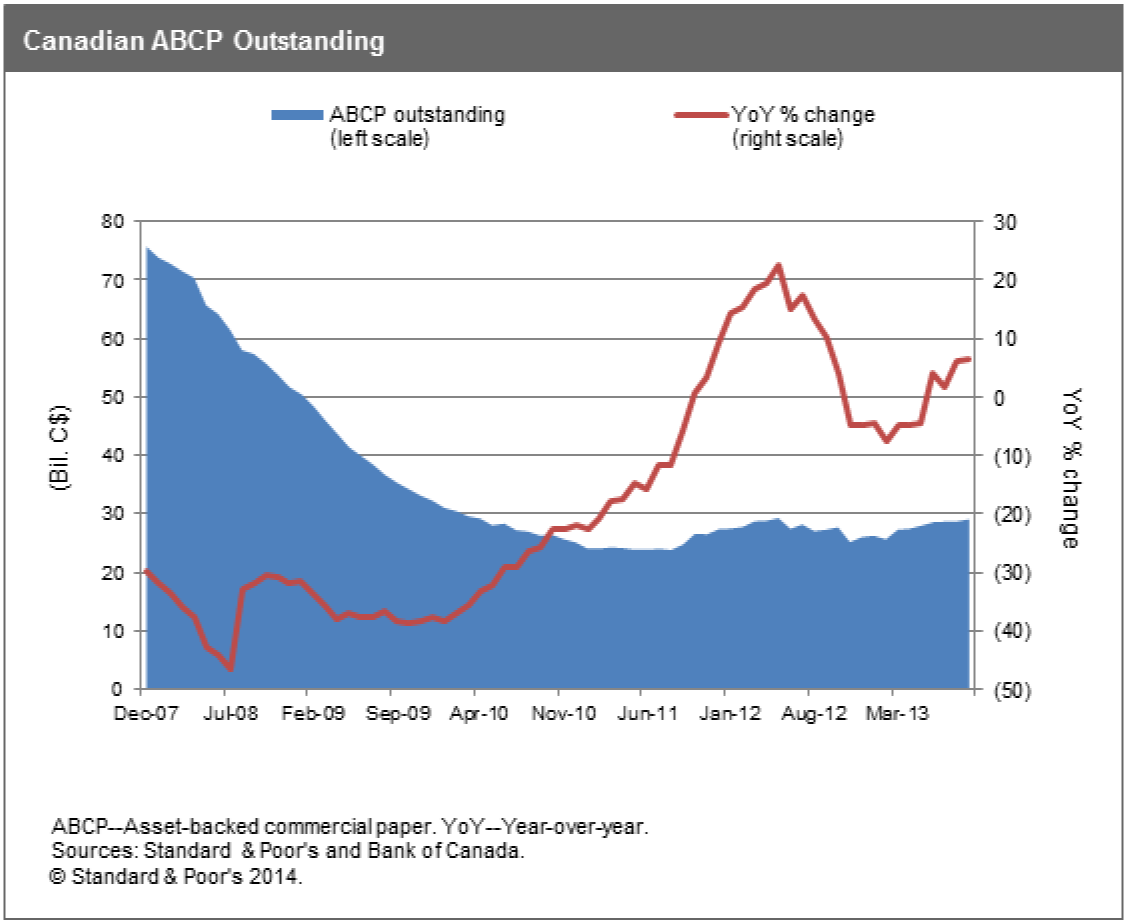



Although still above pre-crisis levels, conduit spreads have been tightening, and we understand that CMBS economics are once again feasible for larger bank originators. As such, we expect the Canadian banks to gradually return to the CMBS conduit market in 2014 following a six-year absence, and some new niche players will likely enter the market as well. When we combine nonbank with bank-sponsored transactions, we expect that Canadian CMBS issuance could reach C$2.0 billion in 2014, with more collateral sourced from primary markets. Furthermore, as we observed for recent transactions, we believe Canadian issuers will increasingly look to U.S. investors by selling cross-border to maintain price discipline and access a deeper investor base, which generally wasn't economical until 2008, following the abolition of withholding taxes between the U.S. and Canada.

## ABCP

Total ABCP outstanding was C$29.1 billion as of September 2013, according to the Bank of Canada, up 6.6% year-over-year and C$5.3 billion greater than the post-recessionary low of C$23.8 billion in August 2011 (see chart 11). While the market is modestly expanding with the addition of some new facilities, increases in existing facilities, and the launch of new conduits, we believe the ABCP industry will continue to face obstacles to growth in 2014--specifically, complex regulations (including the Basel II liquidity coverage ratio [LCR] constraints), the sluggish economy, and prolonged low interest rates.

**Chart 11**



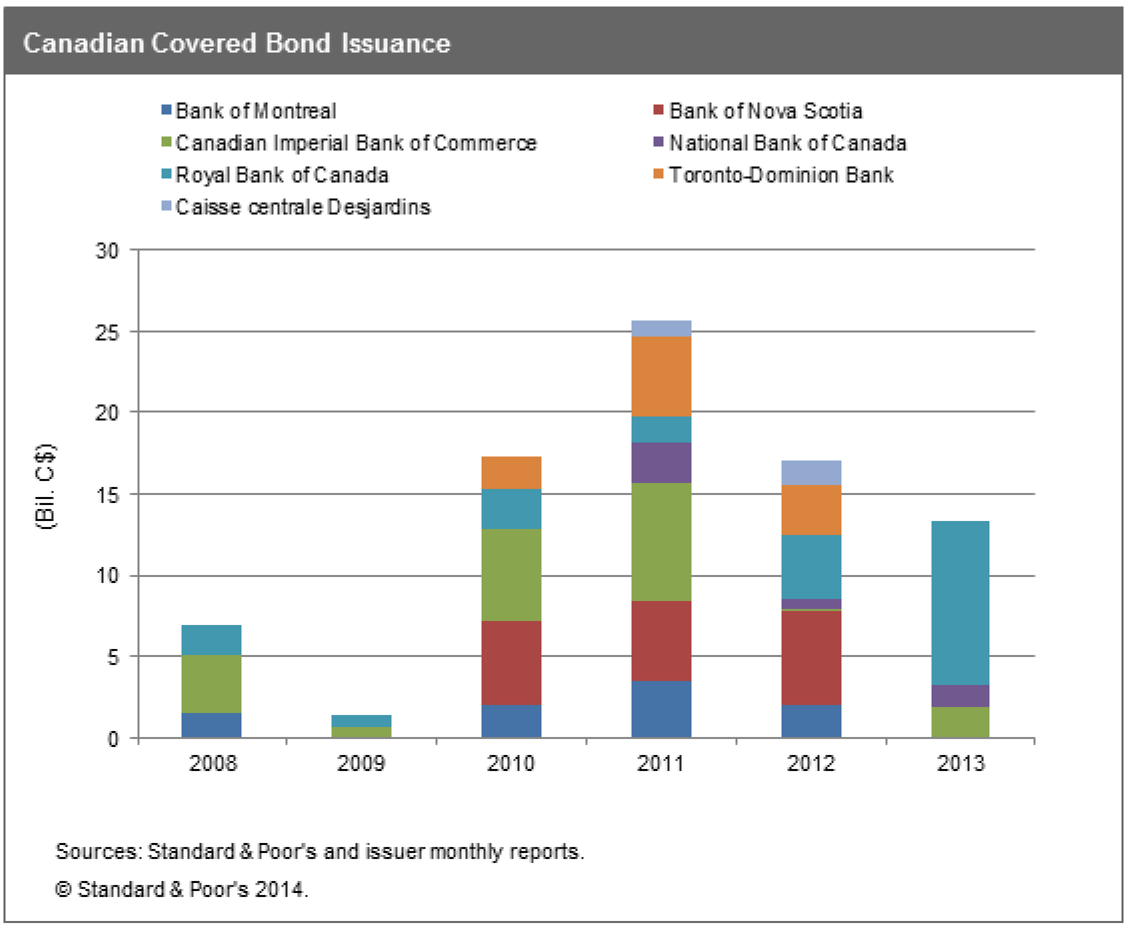

The slow economic recovery has prompted the Bank of Canada to maintain a prolonged period of expansionary monetary policy. In our view, the historically attractive rates have persuaded some companies that previously might have used conduits for short-term funding to borrow funds via alternative means, such as long-term corporate bond issuances and bank loans. We expect short-term interest rates to remain low through 2014 and possibly into 2015, which may continue to restrain ABCP market growth.

Many Canadian sponsors have been making amendments to mitigate increases in ABCP program fees resulting from the introduction of the Basel III LCR. The LCR generally increases the cost of issuing ABCP by requiring notes due within 30 days and liquidity and credit facilities to be backed by relatively low-yielding high-quality liquid assets. We believe the higher costs will ultimately be passed on to sellers, which may reduce the availability of credit to their customers. While the LCR is not yet in effect, according to the Office of the Superintendent of Financial Institutions' draft guideline, the minimum LCR requirement for Canadian banks will be 100% beginning in January 2015. To further mitigate increases in ABCP program fees, we believe Canadian sponsors may introduce callable ABCP issuance to their conduits before the LCR goes into effect. Callable ABCP allows sponsors to better manage their liquidity exposure by giving them the option to call the ABCP before being included as a cash outflow in the LCR. We have already observed this trend from U.S. conduit sponsors; 14 of the 57 U.S. ABCP conduits we rate have added this feature to date. Notably, some of these U.S. programs are administered by Canadian banks familiar with the operational requirements and that have an established track record in managing these liability types (for further information see, "Heading Into Extra Innings, U.S. ABCP Conduit Sponsors Declare It Ain't Over Till It's Over," published Dec. 23, 2013).

## Covered bonds

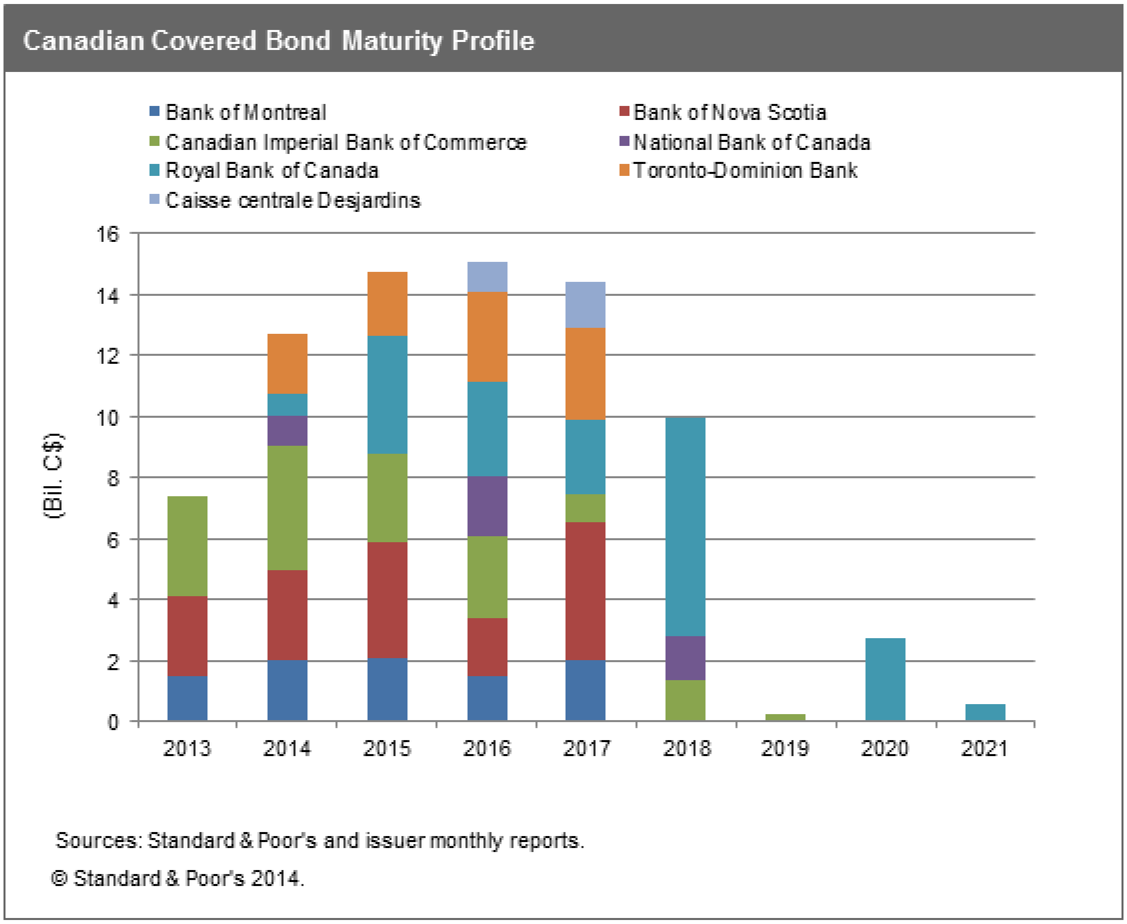
Several Canadian issuers returned to the covered bond market in July 2013, after registering with CMHC under the dedicated covered bond legislation that went into effect on June 29, 2012. CMHC also defined additional guidelines for issuers, which were last updated on June 27, 2013. To date, Canadian Imperial Bank of Commerce, Royal Bank of Canada, Bank of Nova Scotia, National Bank of Canada, and La Caisse centrale Desjardins du Quebec have registered. Total covered bond issuance was C$13.3 billion in 2013, down from C$17.0 billion in 2012 (see chart 12). One notable difference from prior years was the shift from U.S. dollar- to euro-denominated funding; last year we saw the first euro issuances since 2008, which represented 58% of the total issuance in 2013.

**Chart 12**




Following a significant number of three-year deals issued in 2011, C$12.7 billion of covered bonds are now scheduled to mature this year, which will likely benefit new issuance volumes in 2014 (see chart 13).

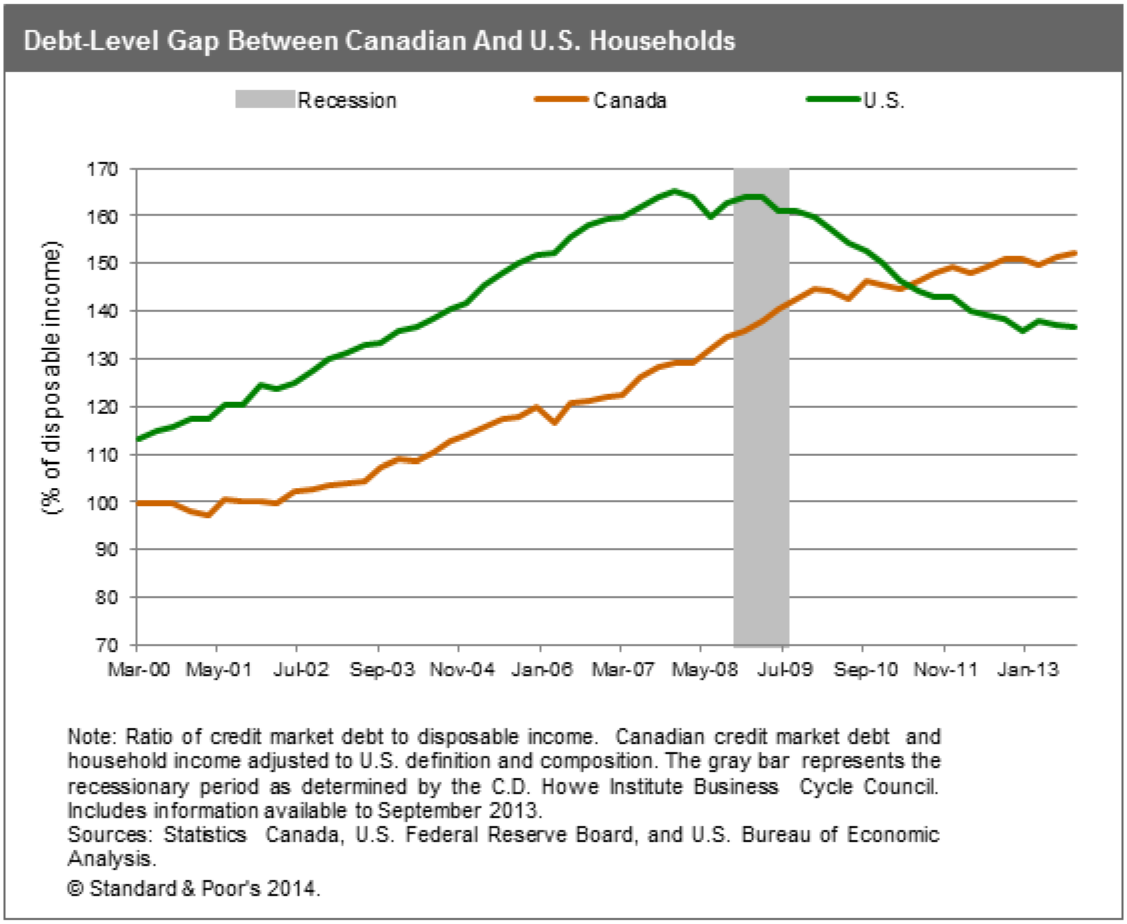
**Chart 13**




## It's Last Call For Canada's Household Credit Party, And The U.S. Will Be The Economy's Designated (Growth) Driver

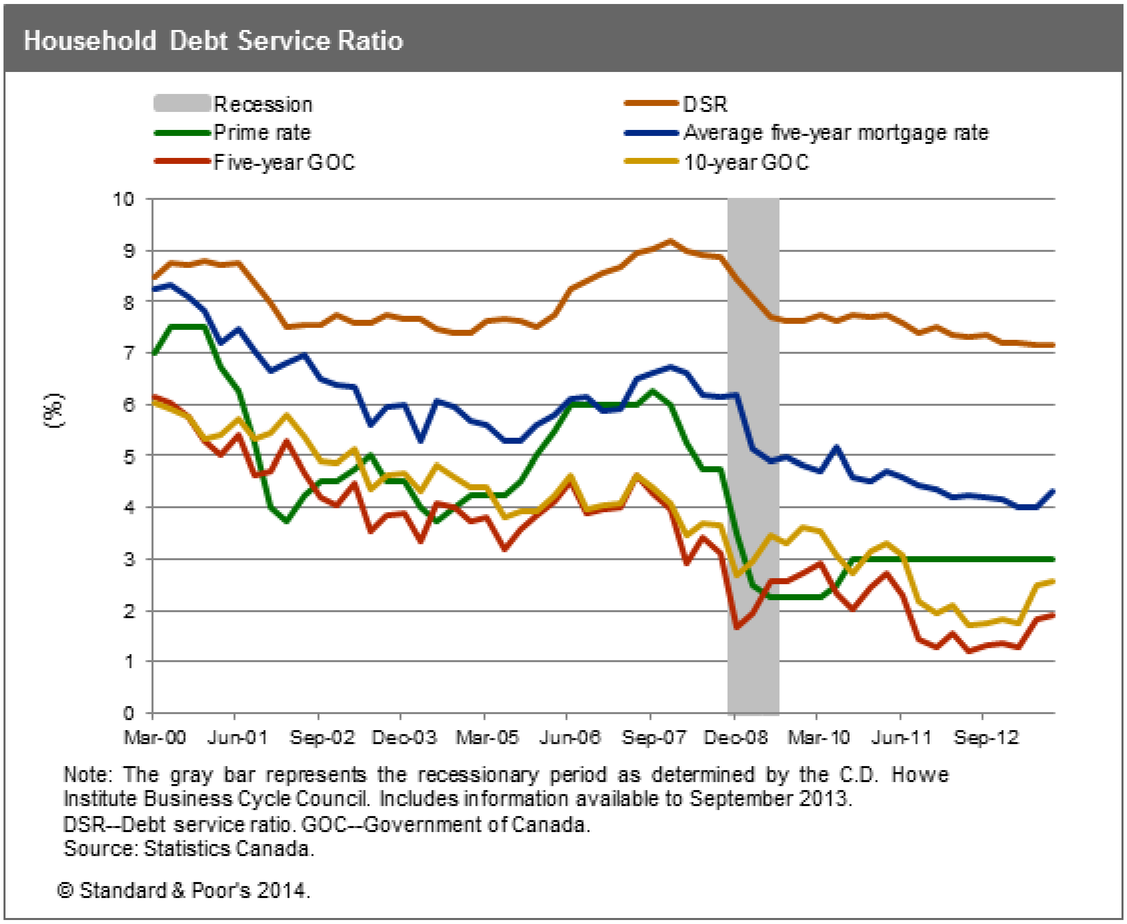
Consumer spending financed with record amounts of household credit (including residential mortgage credit) supported Canada's relatively quick rebound from the 2008-2009 recession. In third-quarter 2013, Canadian household debt reached a new high of 152.0% of disposable income (after adjusting Statistics Canada's data comparably to U.S. data), versus 129.1% at the end of 2007. In contrast, U.S. households have generally been reducing their financial leverage since 2009, and their indebtedness has declined to 136.6% of disposable income in third-quarter 2013 from a high of 165.1% at the end of 2007 (see chart 14).

**Chart 14**



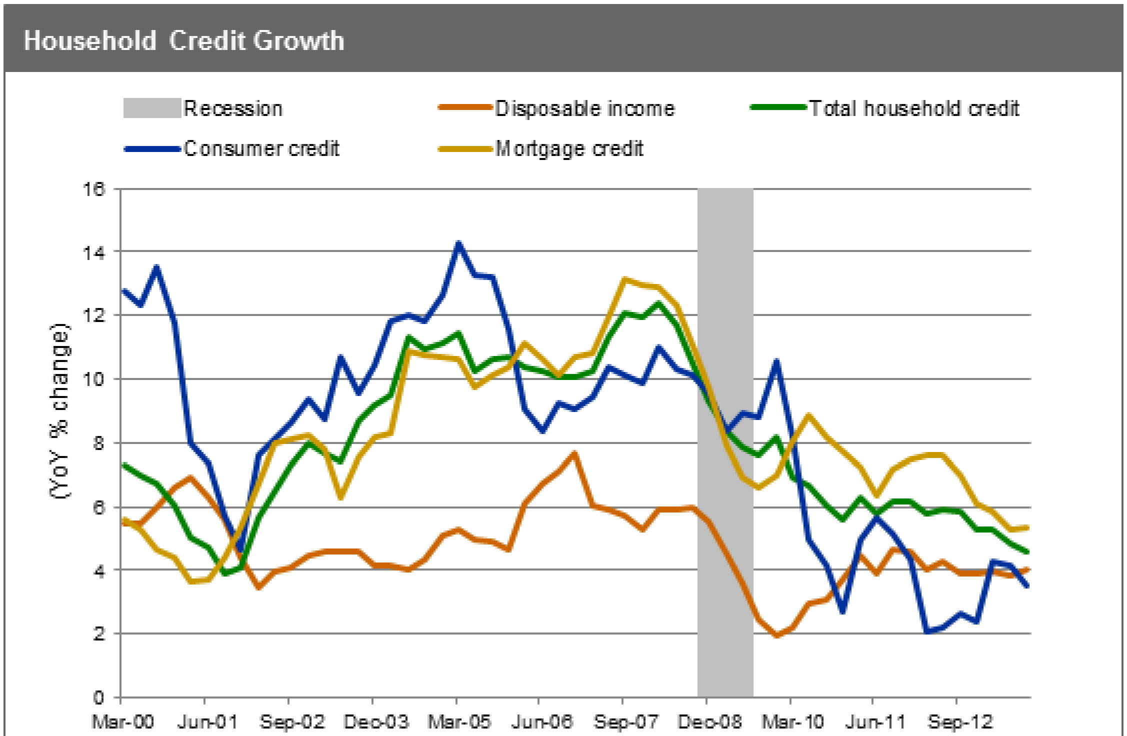

Although household debt burdens are at record highs, prevailing low interest rates have kept the debt service ratio (DSR) at historical lows (see chart 15). We believe one of the largest risks to consumer ABS collateral performance is the effect of interest rate increases on households with untested amounts of leverage. The five- and 10-year Canadian government benchmark yields, which generally set prices for consumer credit, started to increase in 2013, and we believe they'll begin to test household budgets in 2014 as debt service costs climb.

**Chart 15**




Consumer attitudes towards debt are shifting, and the pace of household debt accumulation in Canada has been slowing, although it still remains faster than disposable income growth (see chart 16). We expect Canadian consumers to focus on reducing debt in 2014, which could constrain the economy's growth potential. However, improved household balance sheets in the U.S. have provided greater headroom for a pick-up in consumer borrowing there, which is supporting the growth prospects for Canada's largest trading partner. This, coupled with the recent depreciation in the Canadian dollar, could give Canadian GDP a lift from a pick-up in exports.

**Chart 16**




YoY--Year-over-year. The gray bar represents the recessionary period as determined by the C.D. Howe Institute Business Cycle Council. Includes information available to September 2013.
Source: Statistics Canada.


Over the next two years, we expect Canada will underperform the U.S., and real GDP growth will remain below 3% (see table 1). Against this backdrop, we believe further improvements in the labor market will continue to be slow: The unemployment rate was flat year-over-year at 7.2% in December 2013, and our baseline forecast is for a decline to 6.6% by 2015. In comparison, we forecast the U.S. unemployment rate will fall to 5.8% over the same period. Given the slack labor market, Canada's domestic inflation forecast remains in line with the Bank of Canada's 1%-3% consumer price index target range, so we don't expect inflationary pressures will push short-term rates up in the near term. In our base-case scenario, we don't expect the Bank of Canada to hike its policy rate until 2015. Finally, we believe the relative price differences between the Canadian and U.S. housing markets will begin to converge: Canada's Teranet-National Bank Home Price index is forecast to decline up to 5% in 2014, versus a 6% increase year-over-year in the 20-city Standard & Poor's/Case-Shiller Home Price Index.

**Table 1**

**Standard & Poor's Baseline Economic Outlook**

| | 2009 | 2010 | 2011 | 2012 | 2013e | 2014e | 2015e |
|---|---|---|---|---|---|---|---|
| **Annual real GDP growth (%)** | | | | | | | |
| Canada | -2.7 | 3.4 | 2.5 | 1.7 | 1.7 | 2.5 | 2.9 |
| U.S. | -2.8 | 2.5 | 1.9 | 2.8 | 1.9 | 2.8 | 3.3 |

**Table 1**

| Standard & Poor's Baseline Economic Outlook (cont.) | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Unemployment rate (%)** | | | | | | | |
| Canada | 8.3 | 8.0 | 7.5 | 7.3 | 7.1 | 7.0 | 6.6 |
| U.S. | 9.3 | 9.6 | 8.9 | 8.1 | 7.4 | 6.5 | 5.8 |
| **Annual CPI inflation (%)** | | | | | | | |
| Canada | 0.3 | 1.8 | 2.9 | 1.5 | 1.1 | 1.8 | 2.0 |
| U.S. | -0.3 | 1.6 | 3.1 | 2.1 | 1.5 | 1.4 | 1.8 |
| **Short-term annual interest rate (three-month government bond yield) (%)** | | | | | | | |
| Canada | 0.3 | 0.6 | 0.9 | 1.0 | 1.0 | 1.1 | 2.1 |
| U.S. | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.3 |
| **Long-term annual interest rate (10-year government bond yield) (%)** | | | | | | | |
| Canada | 3.3 | 3.2 | 2.8 | 1.9 | 2.3 | 2.7 | 3.3 |
| U.S. | 3.3 | 3.2 | 2.8 | 1.8 | 2.3 | 3.0 | 3.3 |

e-Estimate. CPI--Consumer price index.

Canadian employment remains above prerecession levels, but businesses are still cautious about hiring, and the economy shed 46,000 jobs in December 2013. Overall job creation slowed to 102,000 in 2013 versus 310,000 a year earlier. We've also observed a shift in hiring practices, with more growth in part-time work at the expense of full-time employment. We don't think there will be a significant near-term improvement in the labor market and expect Canada's unemployment rate to average 7.0% in 2014, little improved from 2013 and well above prerecession lows of about 6.0%.

Although the three-month average unemployment rate declined to 7.1% in third-quarter 2013 from 7.3% in third-quarter 2012, the number of consumer insolvencies increased over the same period (see table 2). In particular, an increase last year in consumer proposals, where consumers request debt relief or extended payment terms, could suggest that debt burdens are becoming unmanageable for highly leveraged consumers. However, one advantage of proposals for unsecured lenders is that they typically experience higher recoveries than bankruptcy filings. We've observed an increasing percentage of consumer proposals since September 2009, when the debt limit (excluding mortgages) rose to $250,000 from $75,000.

**Table 2**

**Consumer Insolvencies And Unemployment Rates**

| | Q3 2013 | Q3 2012 | Q3 2011 | Q3 2010 | Q3 2009 |
|---|---|---|---|---|---|
| **Canada** | | | | | |
| Unemployment rate (%)(i) | 7.1 | 7.3 | 7.2 | 8.0 | 8.5 |
| Bankruptcies | 17,107 | 17,056 | 18,611 | 22,078 | 32,138 |
| Proposals | 12,082 | 10,994 | 10,689 | 10,254 | 8,451 |
| Total consumer insolvencies | 29,189 | 28,050 | 29,300 | 32,332 | 40,589 |
| Proposals (%) | 41.4 | 39.2 | 36.5 | 31.7 | 20.8 |

(i)Three-month average as of Sept. 30, each year. Sources: Office of the Superintendent of Bankruptcy Canada and Statistics Canada.

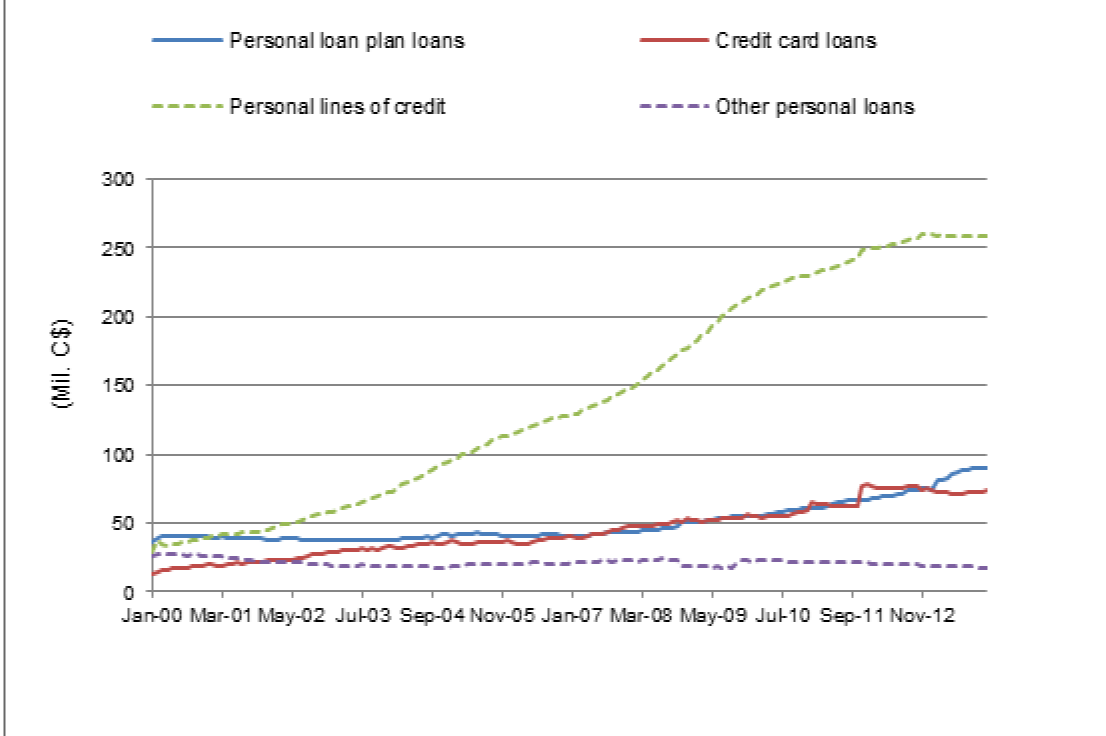
(For further information, see "Economic Research: Canada’s Economic Recovery Is Likely To Keep Sputtering In 2014," published Sept. 26, 2013, "Credit Conditions: North America's Credit Conditions Remain Favorable Despite The U.S. Government Shutdown," published Dec. 9, 2013, "U.S. State And Local Government Credit Conditions Forecast: 2014 Will Be A Balancing Act," published Dec. 17, 2013, and "U.S. Forecast Update: Ringing In An Improving New Year," published Jan. 3, 2014).

## Consumer Credit Trends: This Round Was On The House

Canada's chartered banks have a relatively low-risk consumer credit culture, with limited, targeted high-risk lending, which the composition of consumer credit outstanding reflects. While total credit outstanding has increased, most of the growth has come in the personal lines of credit category, which includes HELOCs (see chart 17). Borrowers have been able to obtain additional credit at favorable rates by offering their homes as security, which has helped to keep the DSRs manageable, notwithstanding significantly higher debt loads. Meanwhile, lenders have mitigated the increased consumer debt levels through higher expected recoveries on secured credit.

**Chart 17**

Canadian Chartered Bank Consumer Credit Composition




Source: Statistics Canada.

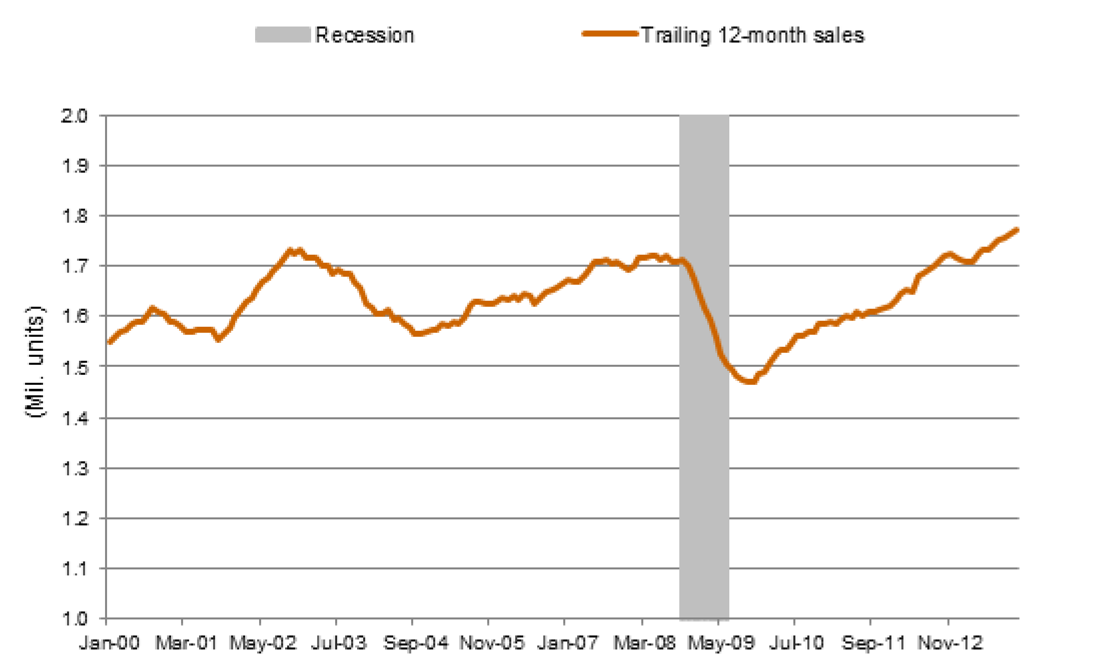


While total consumer credit at chartered banks continued to increase year-over-year, the amount of credit card debt outstanding has been declining. We believe originators will continue to focus on growing their convenience-user portfolios, in which the majority of cardholders accumulate rewards points and pay off their balance each month, as opposed to revolving cardholders who use their cards for financing purposes. TD Bank N.A.'s recent purchase of the Aeroplan portfolio from Canadian Imperial Bank of Commerce is one example of this effort.

Meanwhile, new-vehicle sales reached a record high in 2013 (see chart 18), and average prices have been climbing steadily since the 2008-2009 recession (see chart 19), fueled by a combination of low interest rates and a significant increase in average loan terms. According to J.D. Power and Associates, the percent of new-vehicle loans with a 72-month or greater loan term now represents approximately 67% of new vehicle purchases, up from just 15% in 2007. Lenders have generally set higher credit score requirements for these extended-term products to mitigate the additional risk, but the percentage of borrowers in a negative-equity position for a longer duration is increasing. That said, default frequencies remain low in prime auto loan ABS, and we believe the ratings impact of extended-term loans will be limited, as originators have yet to include a significant concentration of these loans in their securitized pools.

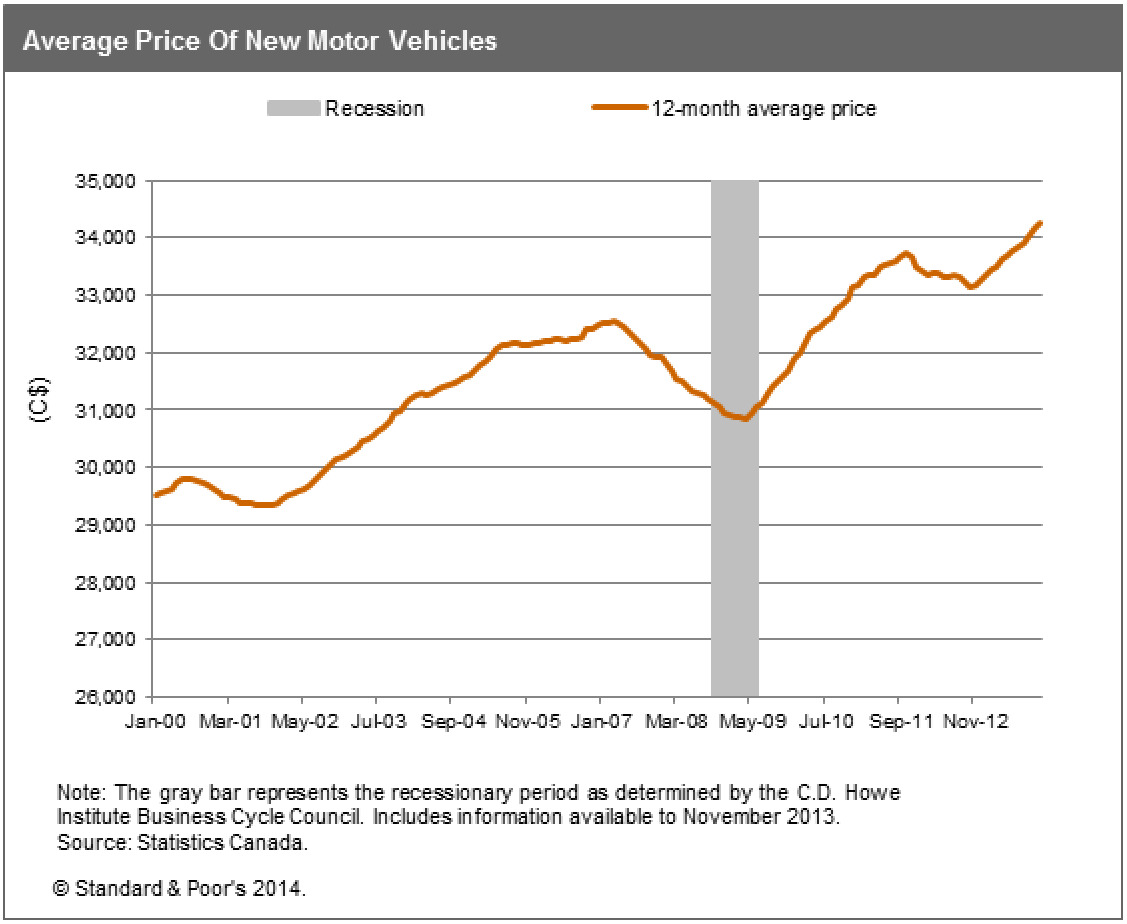
**Chart 18**

**Trailing 12-Month New Motor Vehicle Sales**



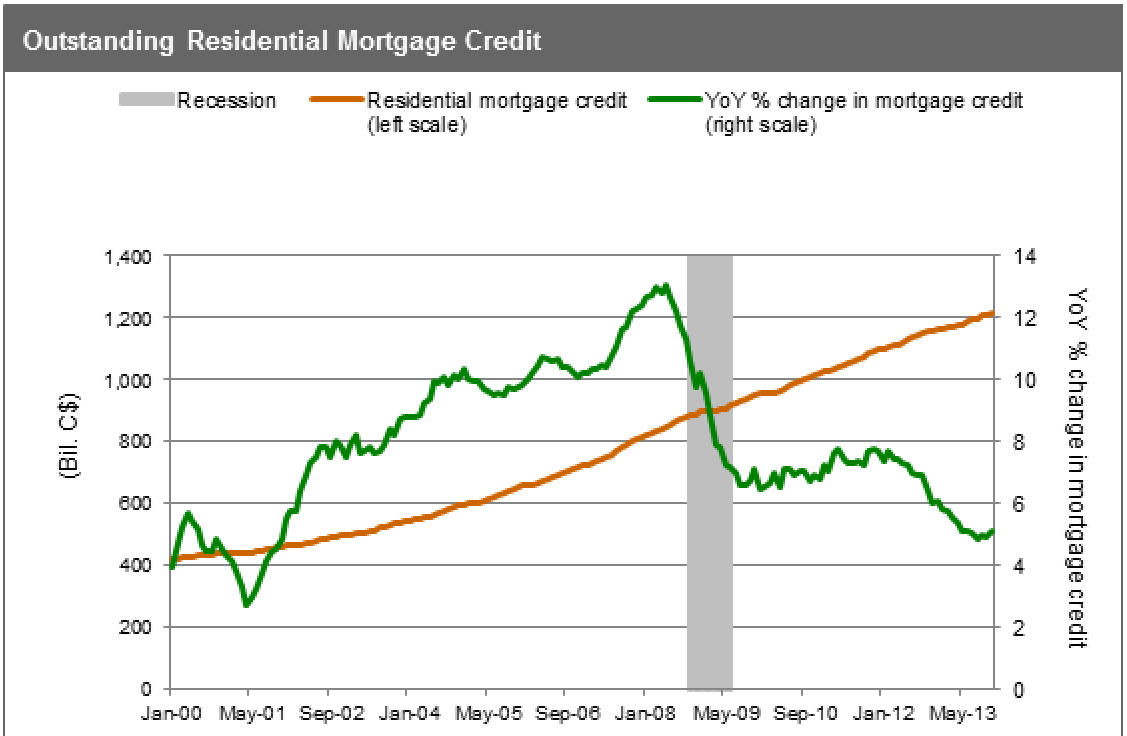

Note: The gray bar represents the recessionary period as determined by the C.D. Howe Institute Business Cycle Council. Includes information available to November 2013.
Source: Statistics Canada.

**Chart 19**




Canada's residential real estate market is a continuing source of economic vulnerability, and the country's housing market is among the most overvalued globally, based on price-to-rent and price-to-income ratios. Strong property price appreciation has pushed outstanding residential mortgage credit to record levels (see chart 20), although the growth rate slowed in 2013 as property price appreciation decelerated. Still, mortgage growth continues to exceed personal income growth (see chart 16).

**Chart 20**




Note: The gray bar represents the recessionary period as determined by the C.D. Howe Institute Business Cycle Council. Includes information available to November 2013; excludes amounts owed under HELOCs. YoY--Year-over-year. HELOCs--Home equity lines of credit.
Sources: Standard & Poor's and Statistics Canada.


We believe the combination of low interest rates and the availability of amortization terms exceeding the typical 25 years helped to fuel home price appreciation. Based on a 39% maximum gross DSR, a household with a $75,000 gross income and 5% down payment could have qualified to purchase a home valued at $440,000, assuming a 4% qualifying interest rate and 30-year amortization term (see table 3). Following changes to the high-ratio mortgage (i.e., loan-to-value greater than 80%) insurance guidelines in July 2012, which limited the maximum amortization term to 25 years for insured high-ratio mortgages, the same household would only qualify for a $397,700 home. If the interest rate were to increase to 7% (which could result not only from a Bank of Canada action but also from the higher funding costs lenders are facing), the household would only qualify for a home valued at $298,700--approximately 32% less than in the first scenario. We view the cumulative buildup in broad housing prices and affordability to be a negative trend, and forecast that house prices may decline up to 5% in 2014.

**Table 3**

**Maximum Qualifying Home Price(i)**

| | Amortization period (C$) | |
|---|---|---|
| Qualifying mortgage rate (%) | 25 years | 30 years |
| 4.00 | 397,700 | 440,000 |
| 5.00 | 359,700 | 392,000 |

**Table 3**

| Maximum Qualifying Home Price(i) (cont.) | | |
|---|---|---|
| 6.00 | 327,000 | 351,700 |
| 7.00 | 298,700 | 317,700 |

(i)Assumes $75,000 gross household income, $3,000 in annual taxes, $200 in monthly heating expenses, a 5% down payment, and a 39% maximum qualifying gross DSR. DSR--Debt service ratio.

## Commercial Credit Trends: Commercial Property Still Going Strong

Canadian commercial property markets continue to demonstrate strong property fundamentals and collateral performance. Both the office and industrial sectors are among the strongest globally and are enjoying relatively low vacancy rates. Multifamily has also remained strong, reflecting both favorable demographics and investment demand, while retail has posted strong sales per square foot, attracting large foreign retailers.

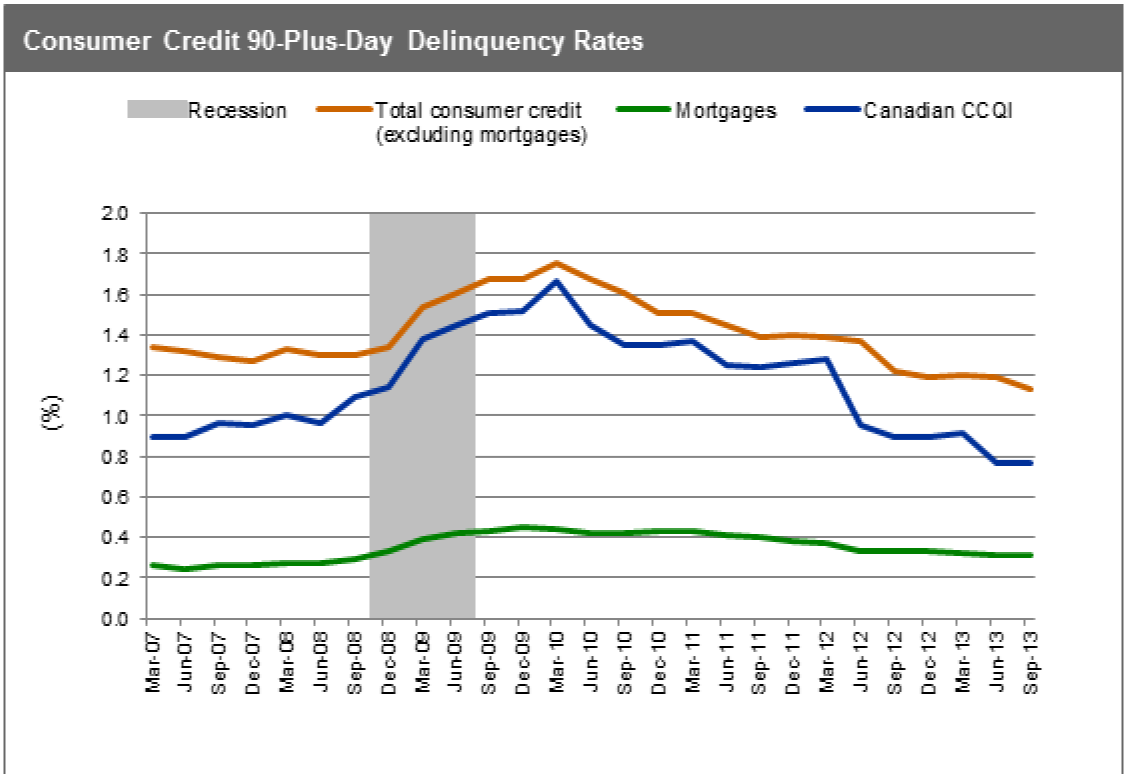
The Canadian CMBS delinquency rate was 0.05% as of Dec. 31, 2013, a mere fraction of the 7.92% U.S CMBS delinquency rate. We believe that the strong property markets, coupled with Canadian mortgage loan financing, which usually provides the lender with recourse to a guarantor with tangible assets, support collateral performance. It is our view that this provides a strong incentive for borrowers to avoid loan defaults.

There could be some negative pressure in both demand (from economic developments) and supply (reflecting increased development) in the office and industrial sectors. We expect the multifamily segment to stay healthy as vacancy rates remain low, though increasing home ownership is an obstacle. Lastly, we continue to have a generally stable outlook on the Canadian corporate retail sector, although mergers and acquisitions activity and real estate spin-outs picked up in the last half of 2103 as domestic retailers made strategic changes to their businesses to counter-punch new competitors that have been taking marginal sales growth. The three notable transactions were Sobeys Inc.'s acquisition of Safeway Canada Ltd., Loblaw Cos. Ltd.'s purchase of Shoppers Drug Mart Corp., and Hudson's Bay Co.'s acquisition of Saks Inc. (see "Top 10 Investor Questions For 2014: Canadian Corporates," published Jan. 9, 2014). In addition, retail will continue to compete with online sales, and Target's entrance will also test the market after opening more than 100 stores in Canada.

## Performance Outlook: Collateral Quality May Be Shaken, But ABS Ratings Not Likely To Be Stirred

Consumer default and charge-off rates have been trending down since early 2009, and delinquencies currently reflect low stress levels (see chart 21). However, the household sector is substantially indebted, making it a principal area to watch and a latent source of credit risk in the event of an adverse shock to Canadian household income or wealth. We also believe that Canadian financial institutions' risk appetite may increase to compensate for lower profitability, leading to more aggressive lending in higher-yielding segments, such as credit cards and auto loans. Given this outlook, we expect a modest decrease in collateral quality in 2014.

**Chart 21**




Note: The gray bar represents the recessionary period as determined by the C.D. Howe Institute Business Cycle Council. CCQI-Credit Card Quality Index. Sources: Equifax Canada, Canadian Bankers Association, and Standard & Poor's.



While in our opinion some consumer asset classes will likely see erosion in collateral performance in 2014, our forward-looking base-case assumptions and the robust structural protections available in ABS point to overall stable ratings on Canadian ABS this year. We do not believe that ratings on 'AAA (sf)' rated notes would be vulnerable to a downgrade of more than one category based on our rating stability definition, even if collateral performance deteriorates to a 'BBB' level of moderate economic stress.

## Related Criteria And Research

### Related Criteria

- Methodology: Credit Stability Criteria, May 3, 2010

### Related Research

- Top 10 Investor Questions For 2014: Canadian Corporates, Jan. 9, 2014
- Top 10 Global Investor Questions For 2014: Transportation Sector, Jan. 9, 2014
- U.S. Forecast Update: Ringing In An Improving New Year, Jan. 3, 2014
- Heading Into Extra Innings, U.S. ABCP Conduit Sponsors Declare It Ain't Over Till It's Over, Dec. 23, 2013
- U.S. State And Local Government Credit Conditions Forecast: 2014 Will Be A Balancing Act, Dec. 17, 2013
- Credit Conditions: North America's Credit Conditions Remain Favorable Despite The U.S. Government Shutdown,

Dec. 9, 2013

- Economic Research: Canada's Economic Recovery Is Likely To Keep Sputtering In 2014, Sept. 26, 2013