Reading 35

Moody's Investors Service 2011, International Structured Finance, Sector Comment, *Changing use and dependence of LMI in Australian RMBS*, extracted from *Structured thinking: Asia Pacific*, 20 April.

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SECTOR COMMENT

Changing use and dependence of LMI in Australian RMBS

Extracted from 'Structured Thinking: Asia Pacific', dated April 2011

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» In contrast to typical RMBS deals, more recent deals have cut back on use of LMI.

» This is due to investor preferences and cost benefit analysis on the issuer's behalf.

» Additionally, issuers are choosing not to have junior notes rated and retain the notes themselves.

Some recent Australian prime RMBS deals have cut back on their use of lenders mortgage insurance (LMI). Unlike typical prime deals, these transactions do not have LMI coverage for every loan, but only on those loans with a loan to value ratio (LTV) of 80% or higher. Examples are Citibank's Securitised Australian Mortgage Trust 2011-1, as well as Westpac's Series 2011-1 Trust.

We see two main reasons for this. The preference for investors to have the ratings of the notes detached from that of the providers of LMI and the cost benefit analysis on the issuer's behalf of paying for LMI on loans with less than 80% LTV when junior notes are not rated.

Prior to the global financial crisis (GFC), the Aaa ratings of the senior notes in a prime RMBS deal were typically dependent on both the subordination provided by the junior notes and any benefit of LMI. Senior Aaa notes were structured to withstand a one-to-three notch downgrade of the LMI provider before their ratings were pressured.

Since the crisis, many senior note investors have saught to avoid reliance on LMI and hence the possible rating downgrade of the senior notes due to a downgrade of the LMI provider. Issuers responded by ignoring any benefit provided by LMI and increasing the amount of the junior note to compensate, thus making the senior notes LMI independent. In fact some issuers overcompensated and provided subordination in excess of what Moody's required for Aaa rating.

The second reason why the use of LMI is changing is that issuers who are choosing not to have the junior notes rated and are instead retaining the notes themselves, as was the case with recent Citibank and Westpac deals.

In a typical prime deal, the junior note receives an investment-grade rating, normally commensurate with the rating of the insurer, when all mortgages are covered by LMI. However, obtaining LMI coverage for all mortgages comes at a cost to the issuer for mortgages with an LTV of less than 80%.

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In Australia's mortgage market, all lenders require that prime mortgages with an LTV higher than 80% be covered by LMI. LMI premiums are paid by the borrower with a single upfront payment as part of the loan origination process. When issuers come to market with a portfolio of mortgages for securitization in which every loan is covered by LMI, the lender must pay the LMI premium on mortgages with an LTV of less than 80%.

If issuers want to retain the junior note, obtaining LMI coverage on mortgages with an LTV below 80% could be seen as wasteful expenditure. If more issuers decide to retain the unrated junior note, we may see more deals with portfolios in which only the loans with an LTV higher than 80% are covered by LMI.

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