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Australian RMBS Originated By Other Banks: Strong Collateral Quality Supports Rating Stability

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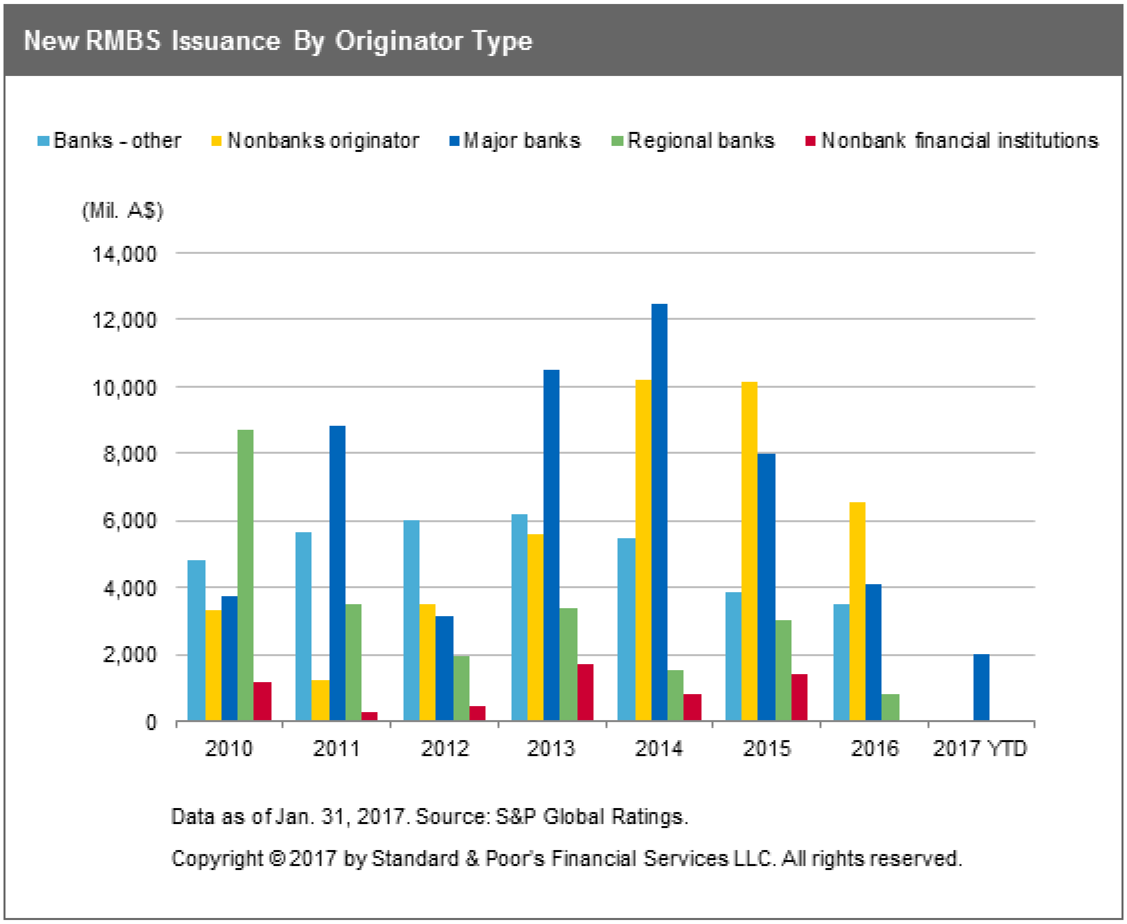
The other banks sector is a staple of the Australian residential mortgage-backed securities (RMBS) landscape. It's a fairly diverse group of lenders, consisting of 12 banks that fall outside the major banks category but have more geographically diverse loan portfolios than regional banks. Issuance from other banks has declined during the past two years, but has averaged around $A5.5 billion during the past five years (chart 1).

S&P Global Ratings has conducted an in-depth analysis of the other banks sector, looking at the key portfolio characteristics, arrears performance, interest-only exposures, and credit support coverage of rated transactions.

Overview

- Portfolio collateral quality for the other banks sector is solid, as evidenced by modest loan-to-value ratios of around 61% and high seasoning levels of about 80 months.
- High prepayment rates of around 23% have contributed to a strong build up in credit support. The credit support provided to most senior tranches of notes issued exceeds seven times current requirements.
- Interest-only exposure in the other banks' loan portfolios is around 20%. We believe the risk of repayment shock is offset by most borrowers' strong repayment history.
- At 42%, exposure to nonmetropolitan areas is higher than the broader prime RMBS portfolio. We believe the risk is offset by most portfolios' modest LTV ratios, which provide a degree of insulation against property price declines.
- Arrears performance for this sector is relatively stable. With more than 90% of underlying mortgages being variable rate, arrears performance is highly sensitive to interest-rate movements. However, the weighted-average seasoning exceeds 80 months, and most borrowers have a demonstrated repayment history.

Chart 1



Portfolio Characteristics

By analyzing each originator type (table 1), we identified the following characteristics of other bank-originated loans that underlie RMBS transactions:

- The loan-to-value (LTV) ratio is slightly higher than most other originator types, but remains relatively modest. There is still a reasonable level of equity buffer to withstand a moderate decline in property prices. At 61.1%, the LTV ratio is quite conservative, given the high seasoning of 80 months. It is based on property valuation at loan origination, and many properties in underlying portfolios would have appreciated in value during this period.
- High seasoning demonstrates strong repayment history. Based on our observations, most borrower defaults occur within five years of loan origination. Most defaults are likely to have occurred by the 80-month mark.
- Other banks' exposure to loans with an LTV ratio greater than 80% is slightly more than 8%. This is higher than other originator categories, but we believe it does not present a rating risk because there is a high level of credit enhancement available to senior notes.
- Other banks' exposure in securitization structures to low-documentation loans is insignificant. At 0.8%, the other banks have among the lowest exposure to low-documentation loans out of all the originator categories. A softening of economic conditions can precipitate a tightening in lending standards for low-documentation loans, restricting borrowers' access to refinancing opportunities and making it more difficult for them to manage their way out of

financial difficulties.

- Average loan balances are quite low. Given the high seasoning of this portfolio, the average loan balance is just below A$149,000. A lower outstanding loan balance improves refinancing prospects if borrowers need to manage their way out of financial difficulty.
- Prepayment rates are relatively high. High prepayment rates generally indicate that the borrowers of the underlying loans have stronger refinancing prospects. This allows most borrowers to stay on top of their mortgage repayments.

Table 1

Portfolio Characteristics Overview

	Weighted average loan-to-value (LTV) ratio (%)	Percentage above 80% LTV ratio (%)	Prepayment rate (%)	Average loan balance (A$)	Weighted-average seasoning (months)	Income partially verified (%)
Other banks	61.09	8.06	23.06	148,558.75	80	0.75
Nonbank originators	61.39	9.31	20.54	144,769.78	100	14.97
Major banks	57.91	7.56	22.54	201,147.00	62	1.53
Regional banks	53.68	4.92	19.75	151,987.80	99	1.87
Nonbank financial institutions	54.68	3.76	17.08	145,482.60	76	0.85

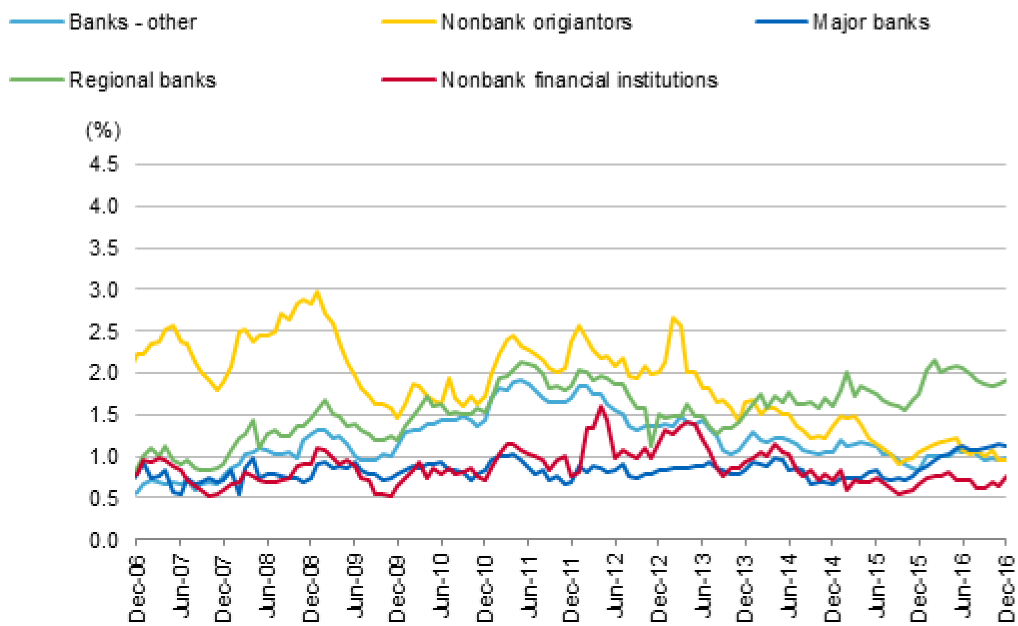
Source: S&P Global Ratings.

Arrears Performance Is Solid And Steady

Like most originator types, arrears levels have improved for other banks since their post-financial crisis highs. They are currently at 0.98%, the third lowest of all originator categories as of December 2016 (chart 2). More than 90% of the loans underlying the other bank portfolios are variable-rate mortgages, and the low interest-rate environment has undoubtedly contributed to the strong arrears performance.

Chart 2

30-Plus Days Arrears Performance Across Originator Types



Source: S&P Global Ratings.

Interest-only exposure

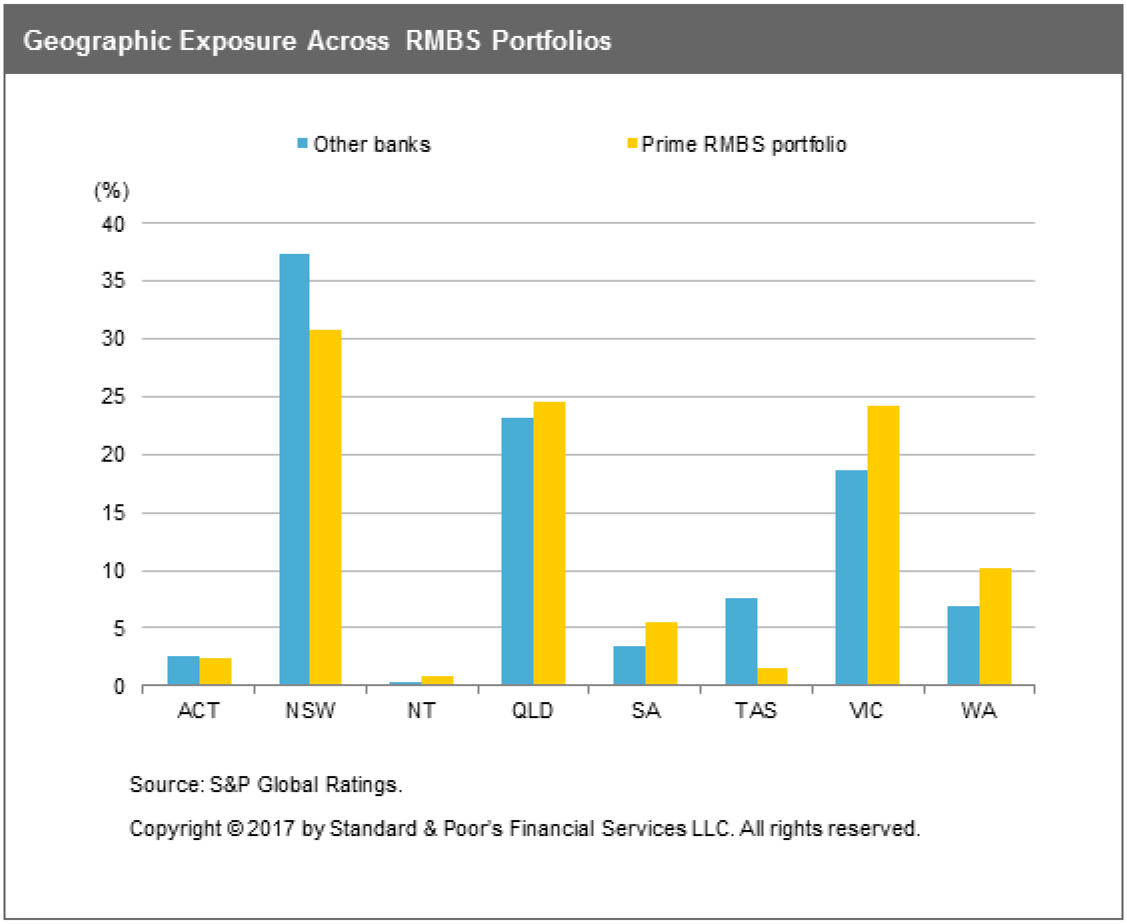
A low interest-rate environment can mask mortgage stress, particularly for interest-only loans. More than 20% of the loans in the other banks' portfolios have an interest-only period. Given the high seasoning of the other banks' portfolios and the modest LTV ratios, however, we do not believe this sector is vulnerable to repayment shock; most borrowers have a demonstrated payment history and have built up a reasonable level of equity in their home loans.

Regulators have increased their scrutiny of debt serviceability assessments and many lenders responded by tightening their lending criteria, particularly for interest-only loans. If an economy weakens to the point that people start losing their jobs, debt serviceability can be affected. If property prices fall at the same time, then borrowers who are unable to service their mortgages could be forced to sell their properties at a loss and could face refinancing difficulties if lenders tighten their lending criteria or if the borrowers' new circumstances mean they no longer meet eligibility criteria. Relatively modest LTV ratios increase a borrower's refinancing prospects and minimize the risk of a loss if a borrower defaults.

Geographic Exposure: Diversity Protects Against Property Price Risk

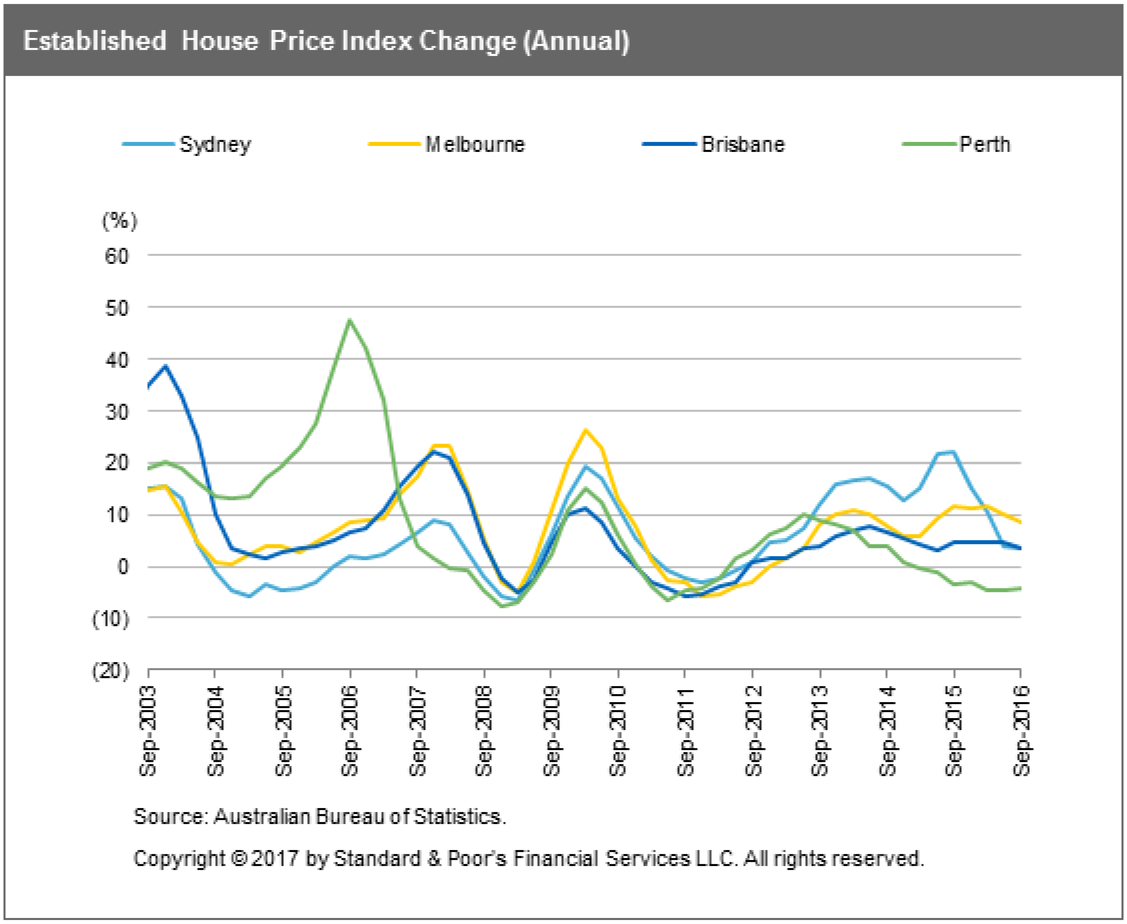
The other banks have a large exposure to New South Wales, Queensland, and Victoria, and a lower exposure to Western Australia than the broader prime RMBS portfolio (chart 3).

Chart 3



The more populous states of New South Wales and Victoria have recorded stronger property price growth in recent years than states such as Western Australia, which has been affected by a downturn in mining investment (chart 4). Strong growth in property prices has contributed to high levels of household debt, but it has also enabled many borrowers to build up equity in their properties, particularly for those with well-seasoned loans. This provides a buffer against any downturn in property prices.

Chart 4



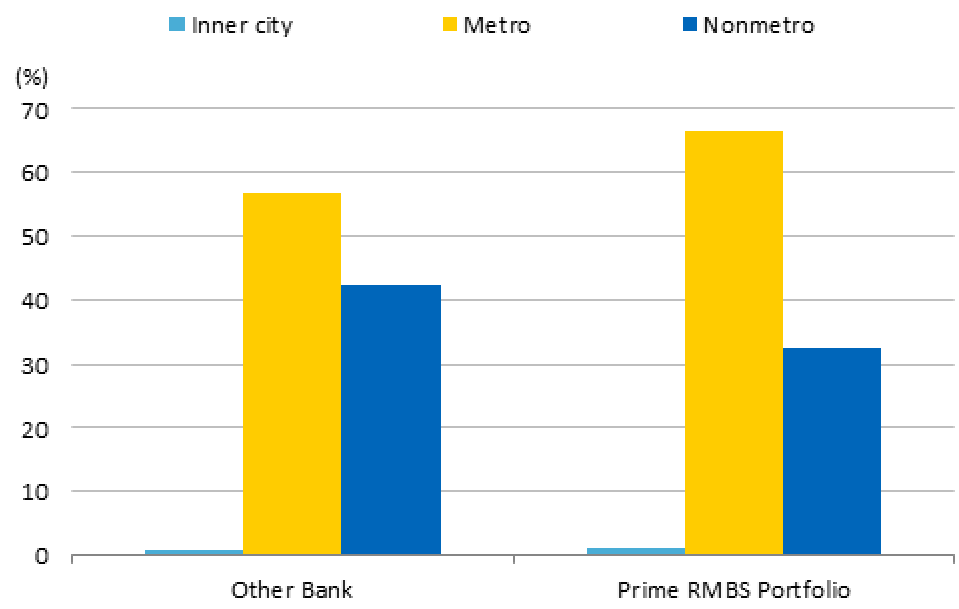
The reasonable level of geographic diversity in the other banks' portfolios provides some protection against a localized property downturn because each state and territory is subject to different property market dynamics.

Inner-city exposure low; nonmetropolitan exposure higher than wider prime RMBS portfolio

Other banks' exposure to inner-city areas is insignificant, at less than 1.0% (chart 5). Inner-city areas often have a larger number of high-rise housing developments, which tend to experience greater price volatility.

Chart 5

Metropolitan, Nonmetropolitan, And Inner-City Exposure Across RMBS Portfolios

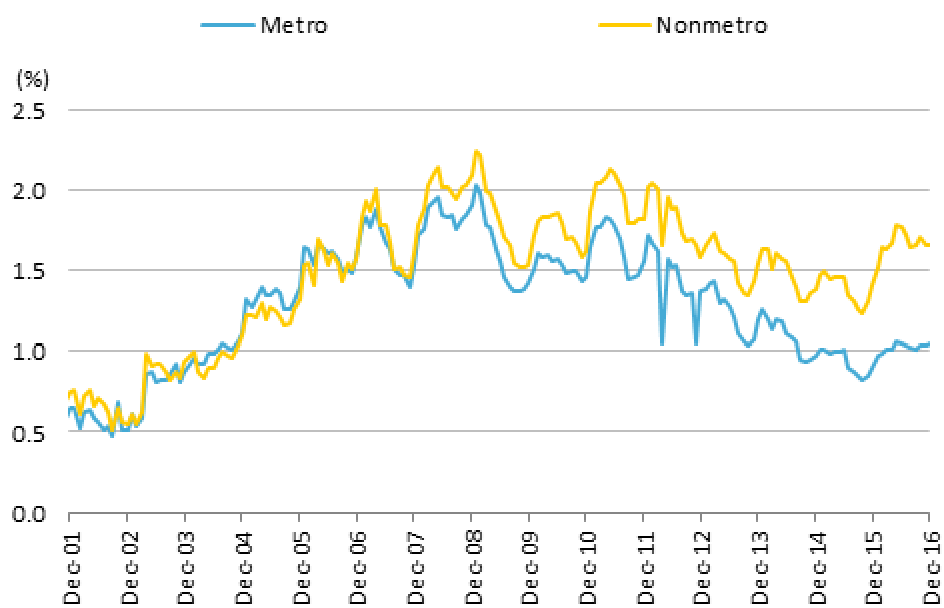


Source: S&P Global Ratings.

The other banks are more exposed to nonmetropolitan areas, at slightly more than 42%, than the broader prime RMBS portfolio (chart 5). Regional areas typically have fewer employment opportunities and higher mortgage arrears than metropolitan areas, and this gap has widened in the past 12 months (chart 6). Properties in nonmetropolitan areas often take longer to sell and can therefore be subject to greater falls in market value. Despite their higher exposure to nonmetropolitan areas, the arrears performance of the other banks' portfolios has been fairly stable.

Chart 6

30-Plus Days Arrears Performance: Metropolitan Versus Nonmetropolitan Areas

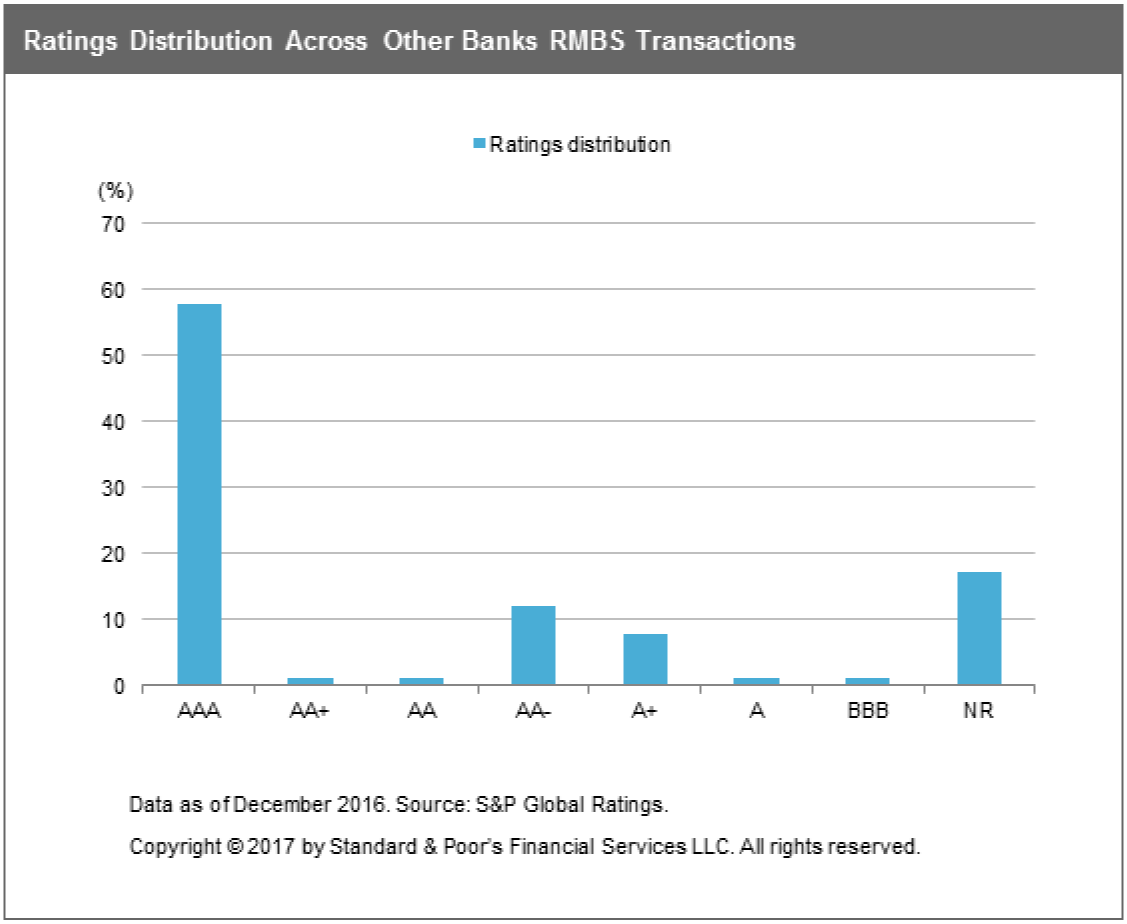


Source: S&P Global Ratings.

Credit Enhancement

The current ratings distribution for notes issued by a securitization sponsored by the other banks category is largely 'AAA (sf)' rated (chart 7).

Chart 7



S&P Global Ratings has not lowered its 'AAA (sf)' rating on any senior tranches of notes issued by transactions from other bank originators. Rating movements for non-'AAA (sf)' rated tranches have been driven largely by changes to our ratings on lenders' mortgage insurance (LMI) providers.

The credit enhancement available to the 'AAA (sf)' rated tranches in this category exceeds the post-LMI credit support requirements for all vintages (table 2).

Table 2

Credit Enhancement Coverage - 'AAA' Rated Tranches

Vintage	Average pool factor (%)	Average credit support required post-LMI (HPI adjusted) (%)	Average credit support provided (%)*	Average coverage (x)*	LMI coverage (%)
2009	20.11	4.39	13.90	3.17	100.00
2010	19.84	2.74	12.90	4.71	100.00
2011	21.85	2.02	14.39	7.13	99.97
2012	26.89	2.05	14.77	7.20	99.94
2013	34.17	2.10	11.74	5.59	92.53
2014	49.50	2.30	11.24	4.88	91.16

Table 2

Credit Enhancement Coverage - 'AAA' Rated Tranches (cont.)

Vintage	Average pool factor (%)	Average credit support required post-LMI (HPI adjusted) (%)	Average credit support provided (%)*	Average coverage (x)*	LMI coverage (%)
2015	66.05	2.61	8.80	3.37	72.45

LMI--Lenders' mortage insurance. HPI--House Price Index. Note: Average coverage = credit support required post-LMI/credit support provided. 2009* - Only one transaction in this vintage for the other banks category. Credit support and credit required based on November 2016 data. *Credit support provided based on note subordination. Source: S&P Global Ratings.

The credit enhancement available to the most senior tranches of transactions sponsored by other bank originators is more than seven times that of current post-LMI credit support requirements (table 3). This reflects the segment's strong prepayment profile and largely sequential pay structures (pro rata triggers are common, but most do not apply until two years into the transaction and until credit enhancement has built up to a predefined level).

Table 3

Credit Enhancement Coverage - Most Senior Tranche Outstanding (All Vintages)

Average pool factor (%)	Average credit support required post-LMI (HPI adjusted) (%)	Average credit support provided (%)*	Average coverage (x)
35.27	2.31	16.51	7.15

LMI--lenders' mortgage insurance. HPI--House Price Index. Note: Credit support and credit required based on November 2016 data. *Credit support provided based on note subordination. Source: S&P Global Ratings.

For most vintages within this sector, the required post-LMI credit support has decreased since transaction close and in many instances is at the credit-enhancement floor. We expect a gradual reduction in credit support requirements over time for the prime RMBS portfolio. Arrears performance could deteriorate from transaction close, but this is generally offset by an improvement in LTV ratios and seasoning.

Lenders' mortgage insurance exposure

Lenders' mortgage insurance cover has declined for RMBS in recent years. The 2015 vintage recorded an average LMI coverage of 72% compared with more than 91% for all other vintages (table 2). We expect this trend to continue as issuers move to reduce transactions' ratings risk levels caused by LMI exposure. It also reflects a general shift in mortgage lending away from higher LTV loans, for which lenders have traditionally obtained mortgage insurance protection.

The strong levels of credit enhancement available to the 'AAA' rated tranches originated by the other banks category provides a good buffer against any deterioration in broader economic conditions. The subordinated tranches of earlier vintages are more vulnerable to tail risk, including borrower concentrations, because they form a larger part of the capital structure as transactions amortize. This risk is elevated if the deals are unlikely to be called as loan portfolios become more concentrated as pool factors decline.

Subordinated tranches, particularly those of earlier vintages, are largely reliant on LMI and, to a lesser extent, excess spread to cover any losses in the event of a borrower default. The Australian RMBS sector has a relatively high LMI claims-payout record, with claims adjustments historically around 10%. We have not observed an increase in claims adjustments for small or concentrated portfolios. The longer a transaction is outstanding, the longer it is exposed to economic cycles and related stresses. Current macroeconomic conditions are relatively benign, however, and we do not anticipate any rise in claims adjustments. We monitor this risk through regular reviews of originators' claims-adjustment assessments.

Outlook

The outlook is stable for the other banks RMBS category. We expect ratings performance to remain stable as credit enhancement continues to build for seasoned tranches. Relatively stable employment conditions will continue to support strong collateral performance.

Table 4

Risk Factors For Other Banks

Economic risk	Risk exposure
Property price risk: Low to moderate	
	Modest LTV ratios provide a buffer against a moderate decline in property prices
	Low exposure to WA, which has experienced greater property price volatility
	High nonmetropolitan exposure, but modest LTV ratios and strong credit enhancement, offset this risk
	Reasonable geographic diversity in most transactions
	Strong credit enhancement to absorb potential losses
Subdued wage growth risk: Low to moderate	
	High seasoning demonstrates strong repayment history
	Modest LTV ratios provide a degree of buffer against any deterioration in economic conditions and improve refinancing prospects
	Higher nonmetropolitan exposure means portfolios are more exposed to a regional economic downturn. This is offset by a demonstrated repayment history for most borrowers. High seasoning of 80 months suggests most borrower defaults are likely to have occurred.
Interest-only exposure risk: Moderate	
	High seasoning suggests majority of interest-only loan periods would be near their expiry period
	High seasoning and relatively high prepayment rates reflect strong repayment behavior, which offsets the risk of repayment shock
	High credit enhancement levels provide a degree of buffer to offset this risk
Increase in interest rates risk: Low	
	High variable-rate exposure means the underlying loans are more sensitive to interest-rate movements
	Incorporation of interest-rate buffers into serviceability assessments, particularly for more recent vintages, should help to mitigate this risk
	High credit enhancement levels provide a degree of buffer to offset this risk

Australia's residential mortgage-backed securities (RMBS) sector has maintained strong ratings and collateral performance. The nation's relatively stable economic condition has underpinned the low levels of losses and defaults in most transactions, and structural enhancements have contributed to a build-up in credit enhancement for senior tranches of notes. S&P Global Ratings expects economic tailwinds such as rising interest rates and subdued wage growth to generate mortgage stress for certain borrowers, but relatively stable employment conditions should continue to support the strong collateral performance of most transactions. Economic growth and relatively stable employment levels are key supporting factors in the credit outlook, and material moves in these variables could be drivers for ratings performance. S&P Global Ratings' current forecasts for GDP and unemployment in Australia in 2017 and 2018 are both 3% (see "APAC Economic Snapshots: Macroeconomic Indicators Showing Resilience," Feb. 21, 2017), suggesting ratings performance should be stable in the medium term.

We carry out regular surveillance on all of the prime and nonconforming RMBS that we rate. This article is part of a series in which we provide an overview of each RMBS originator type and highlight key portfolio characteristics, arrears performance, and credit enhancement data.