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Australian RMBS Sponsored By Major Banks: Stable Performance Supports Rating Stability

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The major banks have become a significant part of the Australian residential mortgage-backed securities (RMBS) landscape, particularly since the 2008 financial crisis.

The RMBS transactions originated by the major banks and rated by S&P Global Ratings, including Commonwealth Bank of Australia, National Australia Bank Ltd., and Westpac Banking Corp., have a strong influence on overall mortgage performance in the RMBS sector; together they originated more than 53% of the loans currently underlying Australian prime RMBS transactions.

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

Portfolio Characteristics

S&P Global Ratings has analyzed each originator type (table 1) and identified the following characteristics of major bank-originated loans that underlie RMBS transactions:

- The portfolio collateral quality in the major banks sector remains strong, as evidenced by loan-to-value (LTV) ratios of around 58% and seasoning levels of about 65 months.
- The major banks sector's exposure to loans with an LTV ratio greater than 80% is around 14%. This is lower than the other banks and nonbanks sectors, but higher than the nonbank financial institutions and regional banks, partly reflecting the lower seasoning of major bank portfolios compared with other originator types.
- High prepayment rates of around 22% have contributed to a strong build up in credit support for major bank-sponsored transactions. The credit support available to 'AAA (sf)' rated tranches is 3-7 times higher (earlier vintages have higher coverage levels) than the post-lenders' mortgage insurance (LMI) credit support requirements for the major banks RMBS sector.
- Exposure to low-documentation loans is insignificant, at 1.55%. These are legacy loans originated by Challenger Mortgage Management, which was acquired by National Bank of Australia in 2009. All loans originated in this sector require full documentation.

Table 1

RMBS Prime Portfolio Characteristics Overview

	Current Loan Balance (A$)	Percentage of TCLB	Weighted-average loan-to-value (LTV) ratio (%)	Percentage above 80% LTV ratio (%)	Prepayment rate (%)	Weighted-average seasoning (months)	Income partially verified (%)
Major banks	66,538,706,468.00	53.26	57.49	13.87	21.65	65	1.55
Nonbank financial institutions	2,325,811,439.00	1.86	54.44	6.09	18.35	78	0.85
Nonbank originators	11,724,351,754.00	9.38	61.21	16.09	20.56	100	14.77
Other banks	29,788,007,357.00	23.84	61.27	16.50	23.92	79	0.71

Table 1

RMBS Prime Portfolio Characteristics Overview (cont.)

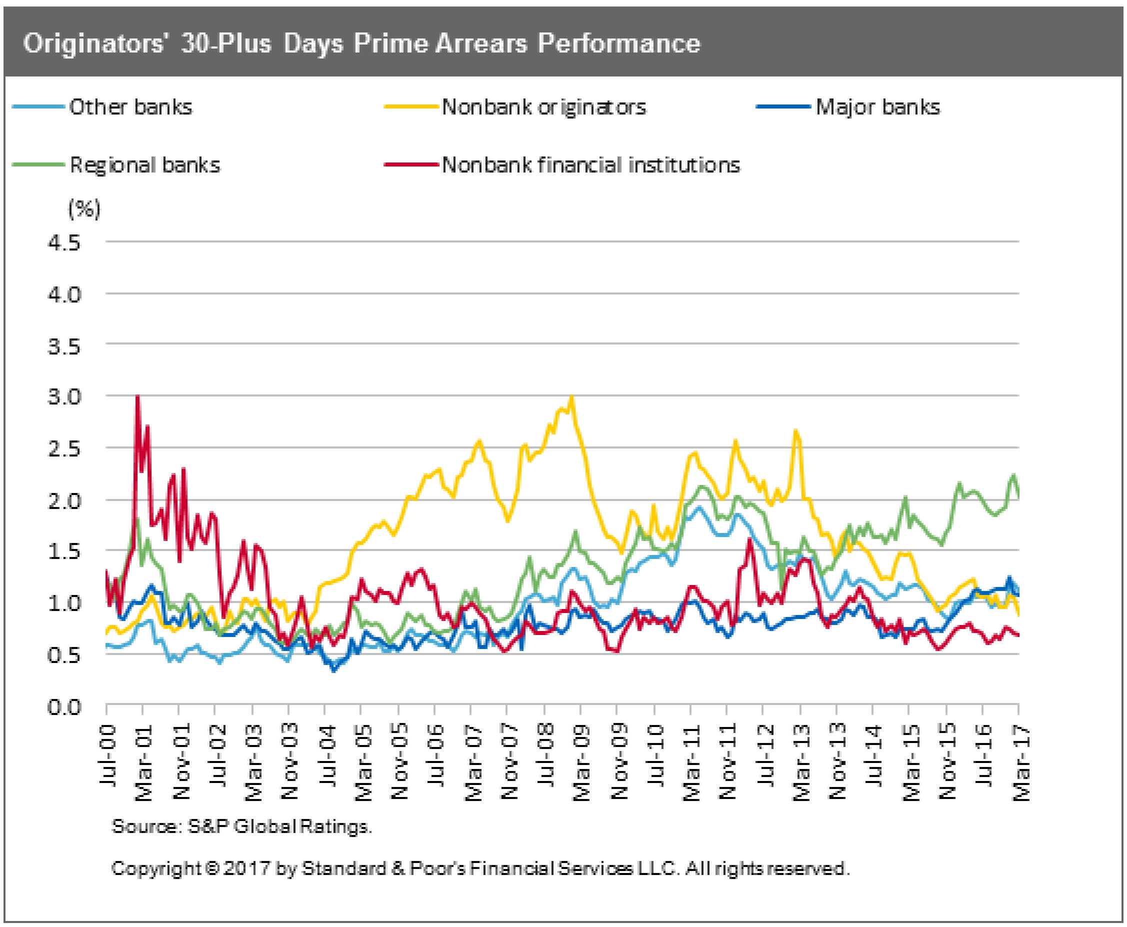
	Current Loan Balance (A$)	Percentage of TCLB	Weighted-average loan-to-value (LTV) ratio (%)	Percentage above 80% LTV ratio (%)	Prepayment rate (%)	Weighted-average seasoning (months)	Income partially verified (%)
Regional banks	14,565,903,442.00	11.66	55.12	9.95	19.81	98	2.36

Source: S&P Global Ratings. Data as of Dec. 31, 2016.

Arrears Performance

The level of loans in arrears by more than 30 days for major bank transactions is relatively low, at 1.08% (chart 1). Around 89% of the loans that underlie major bank transactions are variable-rate mortgages, making arrears performance sensitive to interest-rate movements. This is a common theme throughout the Australian RMBS sector.

Chart 1

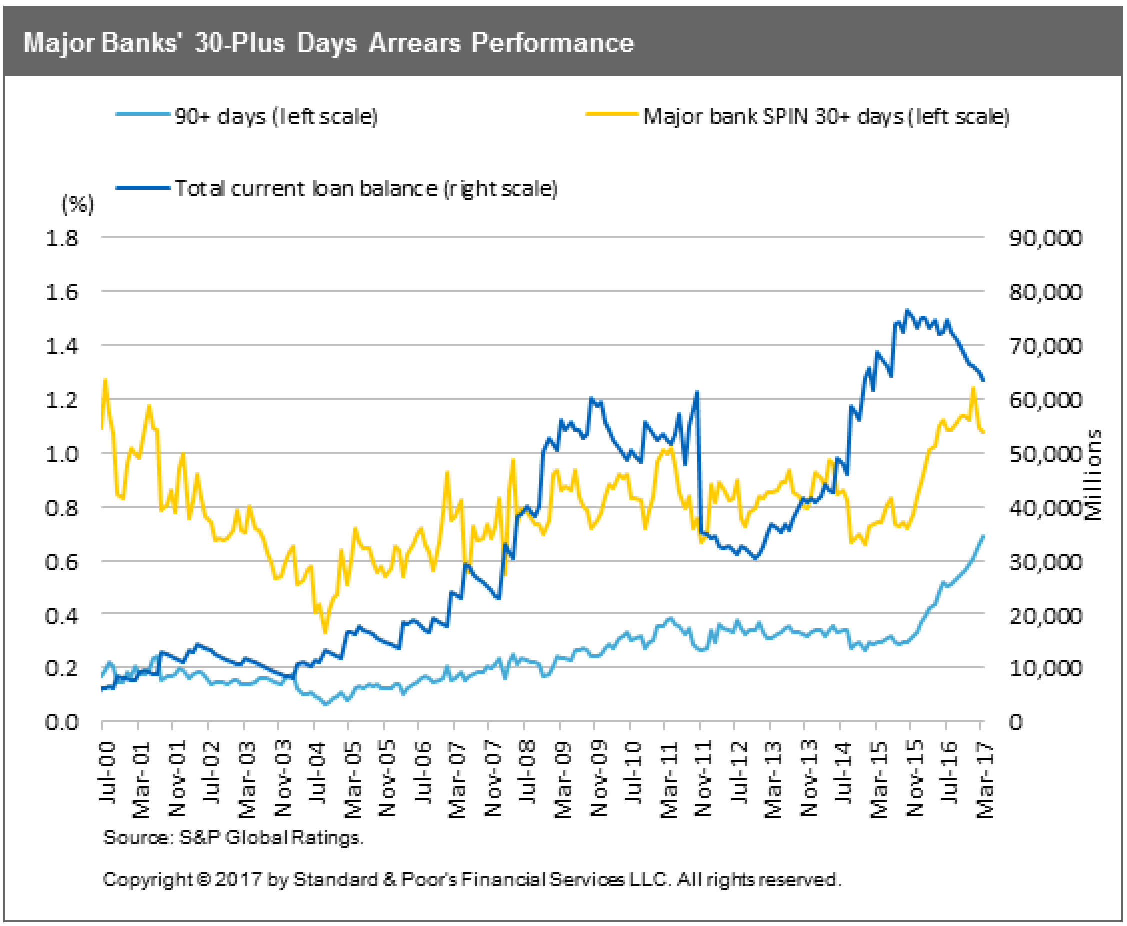


The major banks in the past two years have recorded some of the largest increases in arrears, albeit off low levels, against a backdrop of increasing outstanding loan balances (chart 2). The increase has been most pronounced for loans that are more than 90 days in arrears, which almost doubled in percentage terms and amounts between September 2015 and February 2017. This trend partly reflects a change in the measurement and reporting of hardship accounts to align with regulatory provisions during the period.

Authorized deposit-taking institutions are obliged under consumer laws and banking codes to consider hardship variations to credit contracts for borrowers experiencing temporary financial difficulty. As outlined in "Prudential Practice Guide 223 – Residential Mortgage Lending," February 2017, the Australian Prudential Regulation Authority (APRA) expects that ADIs would not freeze or re-age loans for which hardship or other similar payment concessions have been granted.

The treatment of loans in hardship from an arrears reporting perspective was not consistent among originators before 2016. For all major bank RMBS transactions since 2016, accounts in hardship continue to migrate through delinquency buckets until becoming delinquent for more than 90 days. This alignment in reporting standards accounts for some of the rise in major banks' loans that are more than 90 days in arrears during the past 18 months.

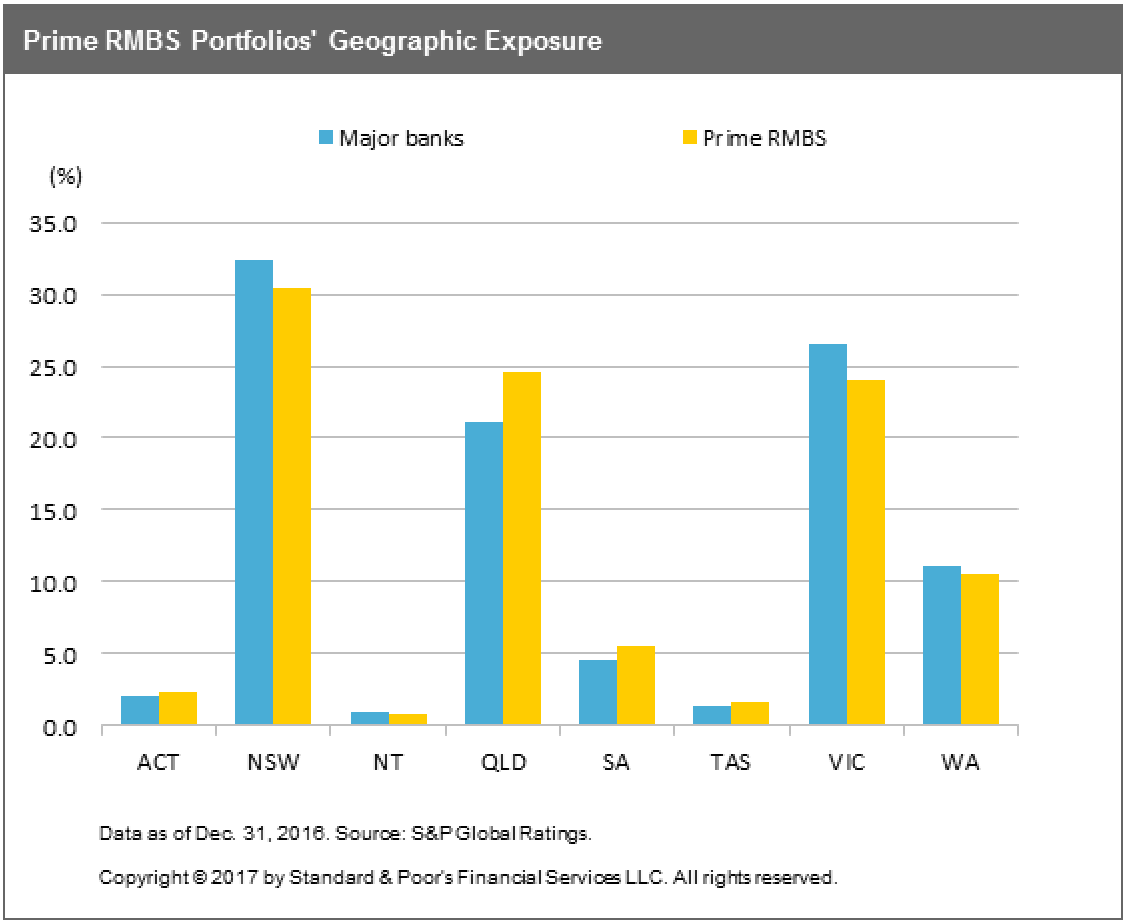
Chart 2



Geographic exposure

The major banks have a large exposure to New South Wales, Queensland, and Victoria, and a lower exposure to Western Australia. This is broadly consistent with the wider RMBS portfolio (chart 3).

Chart 3



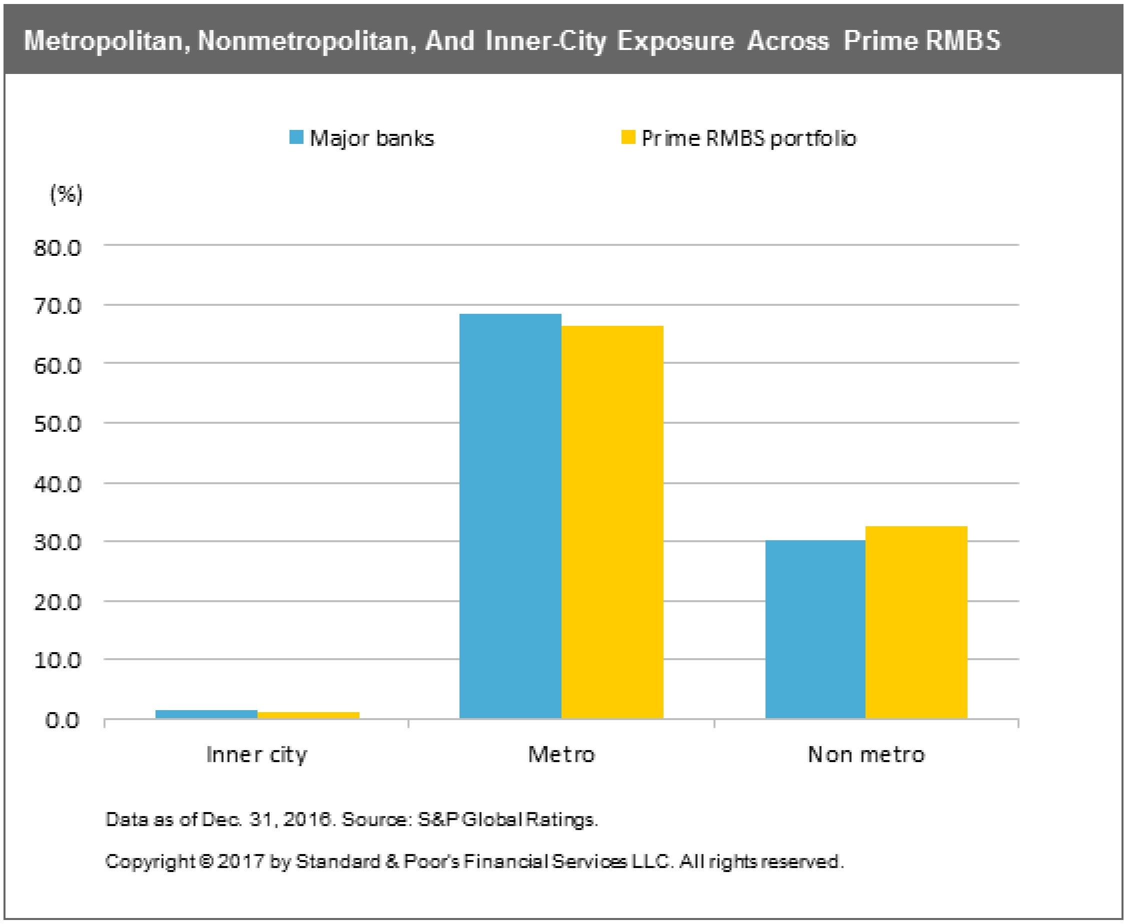
The more populous states of New South Wales and Victoria have recorded stronger property price growth in recent years compared with states such as Western Australia, which has been affected by a downturn in mining investment. Strong growth in property prices has contributed to high levels of household 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.

Inner-city exposure is higher than the wider prime RMBS portfolio but nonmetropolitan exposure is lower

The major banks' exposure to inner-city areas is low, at 1.3% (chart 4), but slightly higher than the wider prime RMBS portfolio. Inner-city areas often have a larger number of high-rise housing developments, which tend to experience greater price volatility.

The exposure of major bank RMBS transactions to loans in nonmetropolitan areas is slightly lower than the broader RMBS portfolio, at 30% versus 32%. Arrears performance in metropolitan areas continues to diverge from that of regional areas, which are feeling the effects of the downturn in mining investment and manufacturing operations.

Chart 4

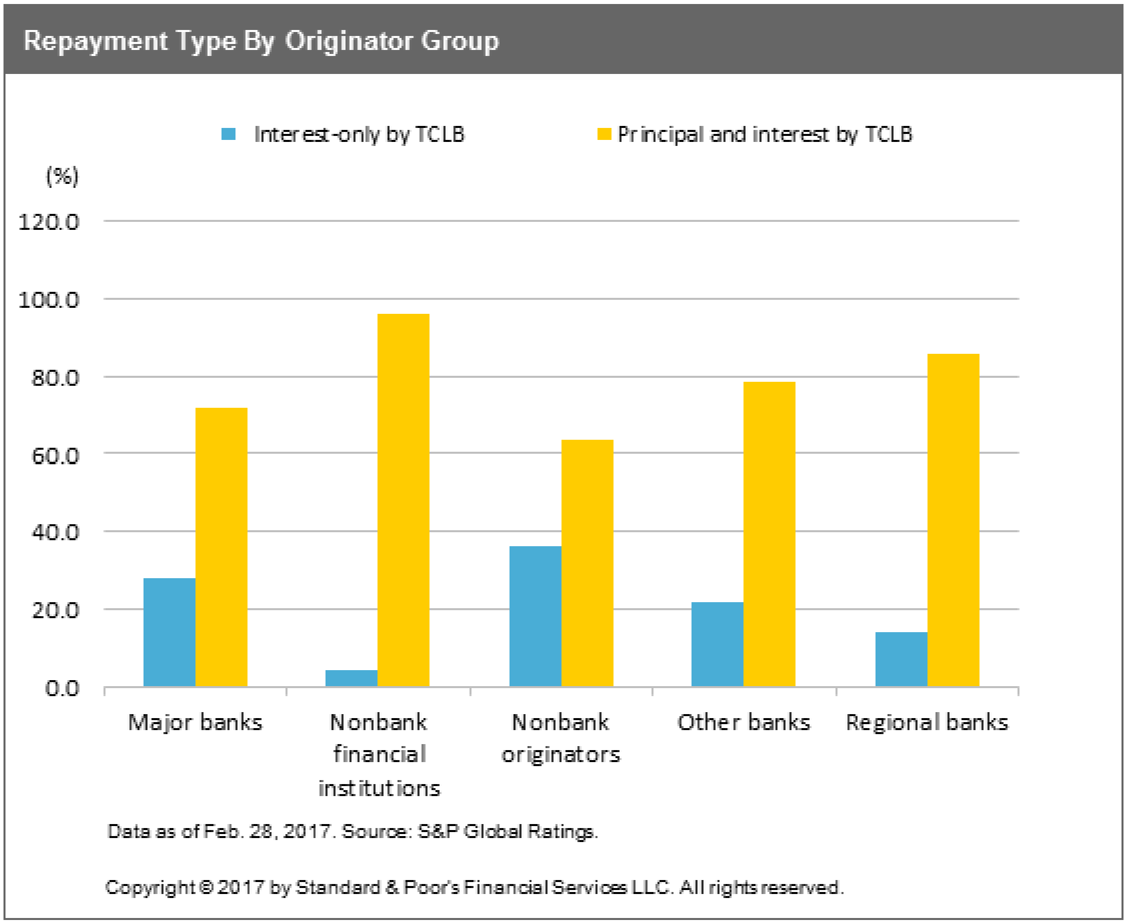


Interest-Only Exposures

A low interest-rate environment can mask mortgage stress, particularly for interest-only loans. More than 28% of the loans that underlie major banks' RMBS transactions have an interest-only period compared with around 25% for the entire prime RMBS portfolio. The interest-only exposure for residential term loans originated by authorized deposit-taking institutions was around 39% as of March 31, 2017, according to APRA statistics.

Among all originator types, the major banks have the second highest exposure to interest-only loans after nonbank originators (chart 5).

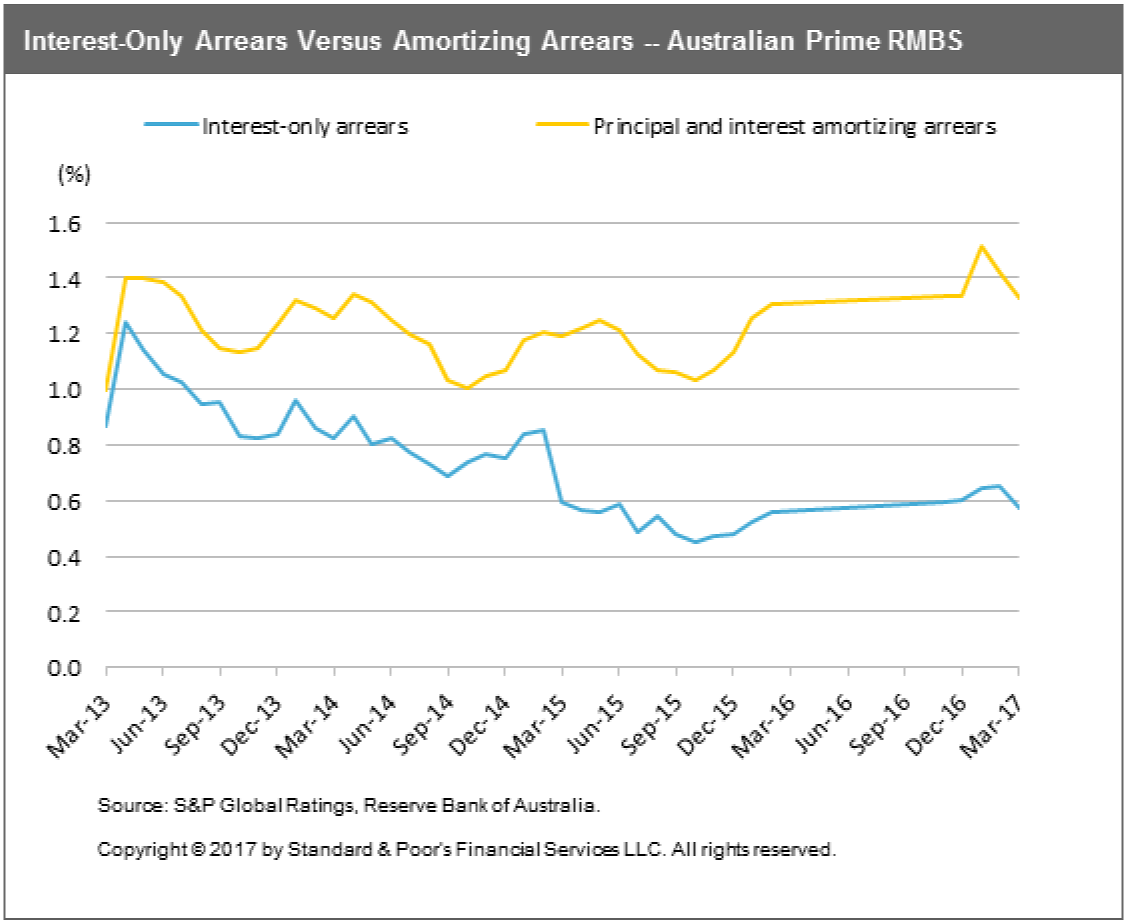
Chart 5



Loans with an interest-only period are more common for investment loans, given the interest on investment loans is tax deductible. The major banks' higher exposure to interest-only loans compared with most other originator types might reflect the relatively lower seasoning of major bank portfolios. Relatively lower seasoning might mean more loans are still within their interest-only period than more seasoned portfolios, in which more interest-only periods might have since expired.

Interest-only loans have inherent credit risks that can be masked during more benign economic periods. Across prime RMBS portfolios, loans with an interest-only period have outperformed principal and interest amortizing loans from an arrears perspective for the past three years, during a period of low interest rates (chart 6).

Chart 6



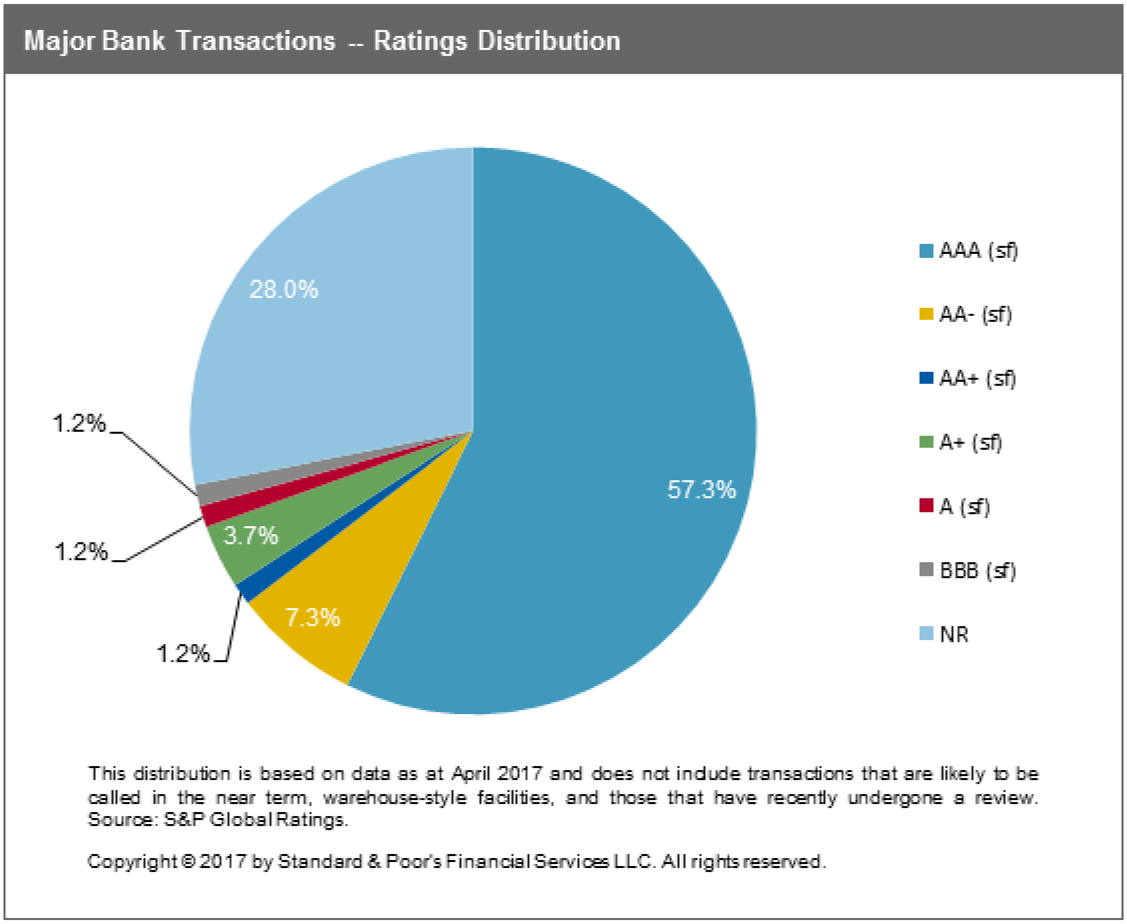
Loans with interest-only periods are more vulnerable to repayment shock. This is why under our criteria we require higher levels of loss protection for nonamortizing and partially amortizing loans. Australian households' high level of indebtedness makes many borrowers vulnerable to rising interest rates and deterioration in economic conditions. Lower wage growth and falling growth in rental incomes have heightened this vulnerability because there is not much of a buffer if economic conditions change.

The longer a loan is outstanding, the longer it is exposed to economic cycles and related stresses. By virtue of their repayment structure, loans with an interest-only period pay down more slowly, particularly during the interest-only period. This leaves borrowers more vulnerable to a decline in property prices or deterioration in economic conditions because their LTV ratios remain at more elevated levels while they are making only interest repayments. Lower equity buildup also exacerbates borrowers' ability to refinance. Amortizing loans meanwhile continue to build up equity after each monthly repayment is made.

Credit Enhancement

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

Chart 7



S&P Global Ratings has not lowered its 'AAA (sf)' ratings on any senior tranches of notes issued by transactions from major 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) (%)	Average credit support provided (%)	Average coverage
2009	17.22	3.96	30.49	7.7
2010	16.70	2.02	12.96	6.4
2011	21.08	3.26	13.02	4.0
2012	30.65	3.32	14.36	4.3
2013	38.29	3.41	15.49	4.5
2014	50.51	3.48	14.27	4.1

Table 2

Credit Enhancement Coverage - 'AAA' Rated Tranches (cont.)				
Vintage	**Average pool factor (%)**	**Average credit support required (post-LMI) (%)**	**Average credit support provided (%)**	**Average coverage**
2015	64.87	3.50	11.34	3.2

Note: Credit analysis based on data as at January 2017. Average coverage is calculated by dividing the average credit support provided by the average credit support required. This distribution does not include transactions that are likely to be called in the near term, warehouse-style facilities, and those that have recently undergone a review. LMI--Lenders' mortgage insurance.

The credit enhancement available to the most senior tranches of transactions sponsored by major bank originators is around five 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 - Senior Tranche				
Most senior tranches	**Average pool factor (%)**	**Average credit support required (post-LMI) (%)**	**Average credit support provided (%)**	**Average coverage**
1	37.57	3.30	16.46	5.0

Note: Credit analysis based on data as at January 2017. Average coverage is calculated by dividing the average credit support provided by the average credit support required. This distribution does not include transactions that are likely to be called in the near term, warehouse-style facilities, and those that have recently undergone a review. LMI--Lenders' mortgage insurance.

For most vintages within this sector, the required post-LMI credit support has decreased since transaction close. 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.

Losses have been low in the prime RMBS portfolio. LMI and excess spread have predominantly covered any losses. To date, there has been no charge off to any rated notes in the Australian RMBS market.

Lenders' mortgage insurance exposure

Lenders' mortgage insurance cover has declined for RMBS in recent years. As observed in the major banks' portfolio, the proportion of insured loans has decreased to 30% as of March 31, 2017, from 39% about three years ago.

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.

Outlook

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

Table 4

Risk Factors For Major Banks

Economic risk	Risk exposure of major bank RMBS transactions
Property price risk: Low to moderate	
	Modest LTV ratios for most loans provide a buffer against a moderate decline in property prices
	Low exposure to Western Australia, which has experienced greater property price volatility
	Reasonable geographic diversity in most transactions
	Strong credit enhancement for 'AAA (sf)' rated tranches in excess of current credit support requirements to absorb potential losses.
High household indebtedness risk: Low to moderate	
	Seasoning in excess of 60 months suggests most borrowers have a track record of repayment because our loss curve assumes most losses are realized within 60 months of loan origination.
	Modest LTV ratios for most loans provide a degree of buffer against deterioration in economic conditions and improve refinancing prospects.
Interest-only exposure risk: Moderate	
	Higher exposure to interest-only loans, particularly for investment loans, across major bank transactions relative to most other originator categories.
	Risk of repayment shock is partially offset by build-up in credit enhancement to senior tranches relative to credit support requirements. Initial credit analysis also assumes a higher default multiple for interest-only loans.
Increase in interest rates risk: Moderate	
	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 following greater regulatory scrutiny, should help to mitigate this risk
	Seasoning of more than 60 months suggests a demonstrated record of repayment for most borrowers

Australia's 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' currently forecasts GDP of 2.9% and unemployment at 5.5% in 2018 (see "APAC Economic Snapshots: May 2017," published May 19, 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.

Only a rating committee may determine a rating action and this report does not constitute a rating action.