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

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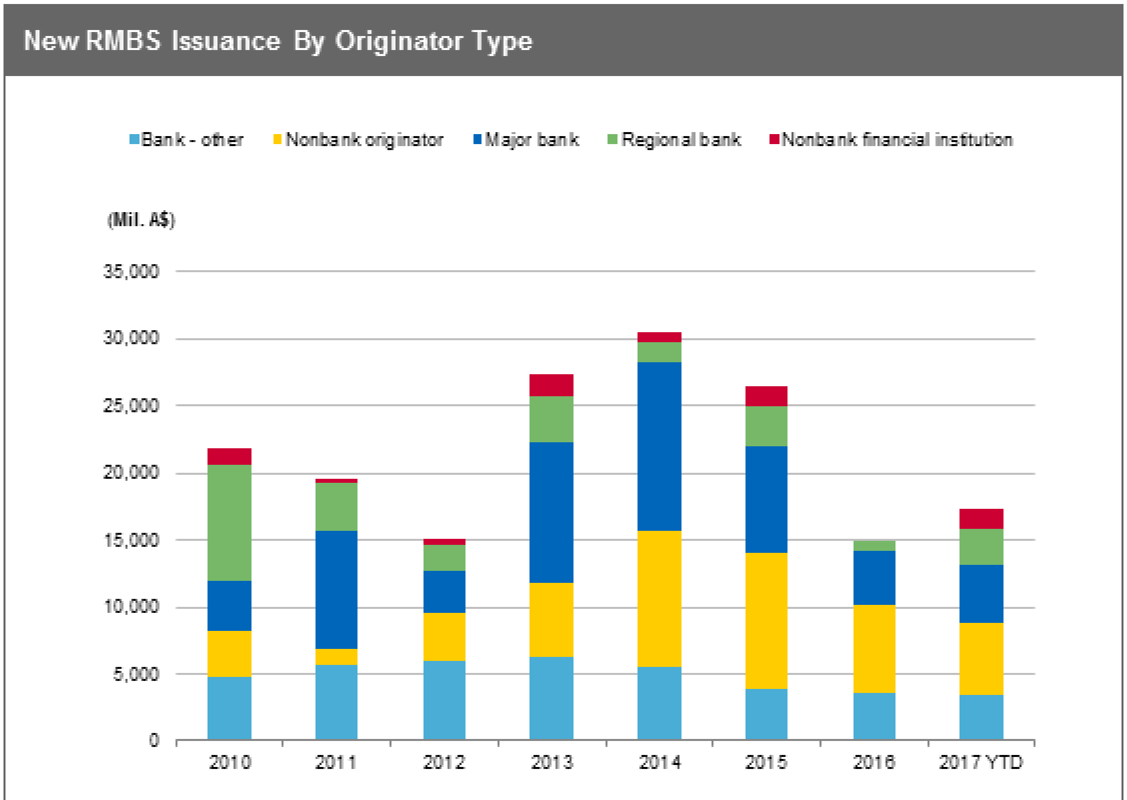
Australia's regional banks were a significant contributor to the residential mortgage-backed securities (RMBS) landscape before the 2008 financial crisis. The sector's issuance volume has since decreased, following industry consolidation and lower utilization of securitization as a funding source (chart 1). Issuance from regional banks has increased in 2017, however, in line with stronger growth in Australian RMBS issuance.

Chart 1



Data as of June 30, 2017. Source: S&P Global Ratings.

The regional banks sector has a higher exposure to nonmetropolitan areas, making it more vulnerable to downturns in regional economies and the flow-on effect on local employment conditions. This is mitigated by the strong credit enhancement available to senior tranches and strong collateral quality, with average seasoning across the portfolio exceeding 100 months.

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

Portfolio Characteristics

In its analysis of originator types, S&P Global Ratings identified the following characteristics of the regional bank-originated loans that underlie RMBS transactions:

- The portfolio collateral quality in the regional banks sector remains strong, as evidenced by weighted-average loan-to-value (LTV) ratios of around 54% and weighted-average seasoning levels of 100 months across the subsector.
- The modest weighted-average LTV ratios and high seasoning of many regional bank-originated RMBS transactions partly reflect the sector's lower levels of new issuance in recent years compared with the major bank and nonbank originators.
- The regional banks sector has an exposure of about 8% to loans with an LTV ratio greater than 80%. This is lower than all originator types except nonbank financial institutions and partly reflects the sector's high seasoning compared with the other originator types.
- The sector's prepayment rates as of March 31, 2017, are the second lowest among all originator categories. However, prepayment levels for this sector have been relatively stable and tend to decline in March of each year.
- The regional banks sector's exposure to low-documentation loans is low, at 1.65% as of March 31, 2017, down from 2.35% in March 2007.

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	63,630,926,088	51.54	57.38	13.60	20.57	67	1.56
Nonbank financial institutions	2,290,037,760	1.85	55.42	7.83	17.69	75	0.80
Nonbank originators	12,988,802,782	10.52	60.78	15.48	15.85	102	14.79
Other banks	28,659,235,506	23.21	60.96	15.61	22.95	81	0.71
Regional banks	15,897,415,609	12.88	53.91	8.11	16.37	100	1.65

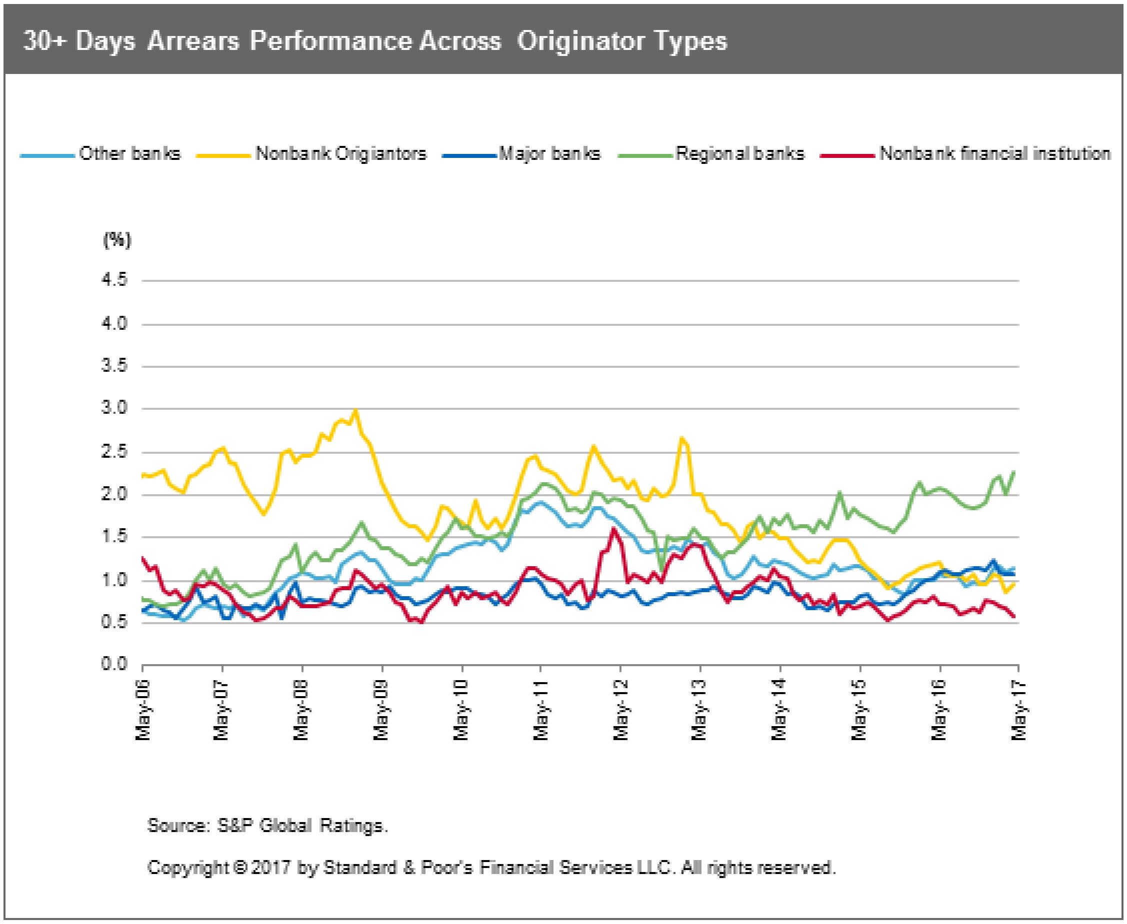
Source: S&P Global Ratings. Data as of March 31, 2017.

Arrears Performance

Mortgage arrears in the regional banks sector have increased to 2.27% in May 2017 from 1.95% in May 2012.

Regional banks' mortgage arrears have surpassed those of all other types in percentage terms since early 2013. They are 2.27% as of May 31, 2017, which is 1.9 times the Standard & Poor's Performance Index (SPIN) for Australian prime mortgages (chart 2). The SPIN is a weighted-average index of all Australian RMBS transactions rated by S&P Global Ratings that are more than 30 days in arrears.

Chart 2

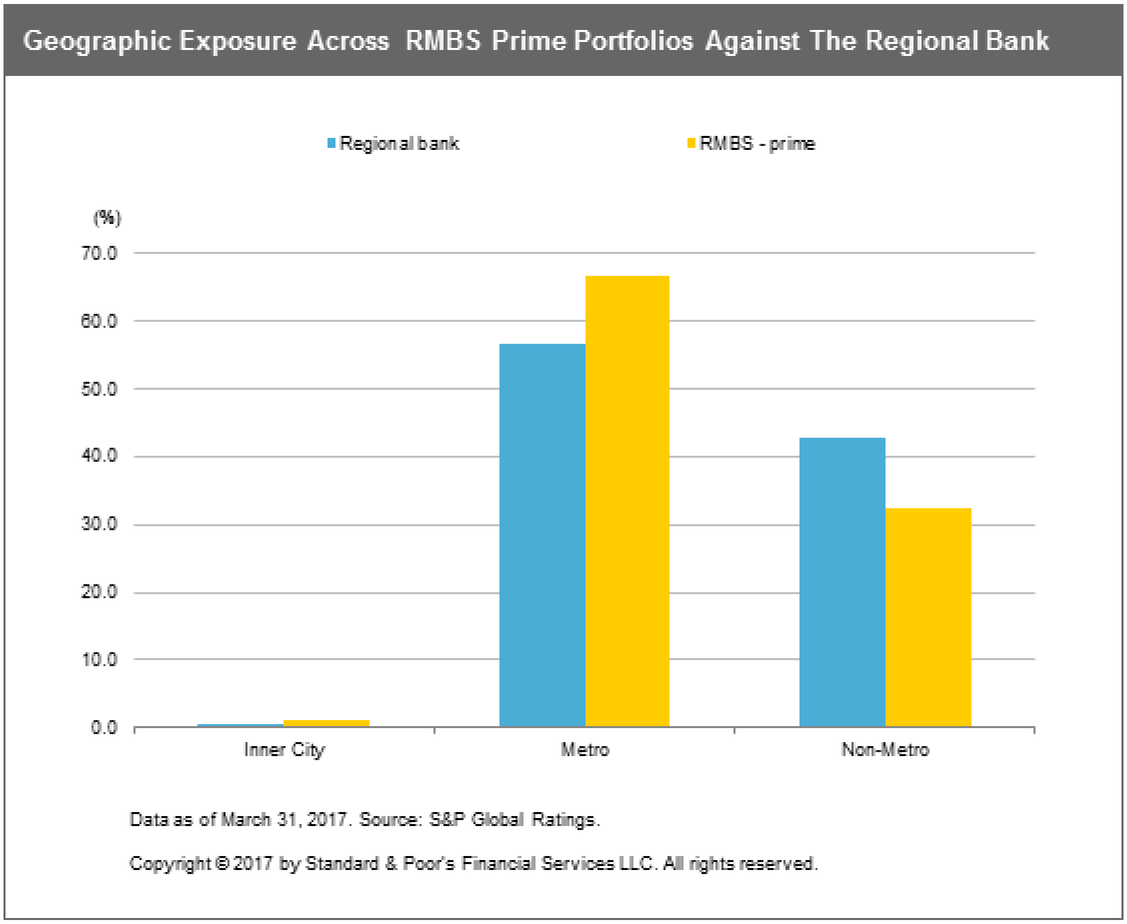


In our opinion, higher arrears in the regional RMBS sector are influenced by a number of factors, but their higher exposure to Queensland, particularly the state's nonmetropolitan areas, has been a key contributing factor. The declining loan balances securitized for the sector have exacerbated the situation; the loans in the more advanced arrears stages will continue to form a larger proportion of declining outstanding loan balances over time.

Higher nonmetropolitan exposure

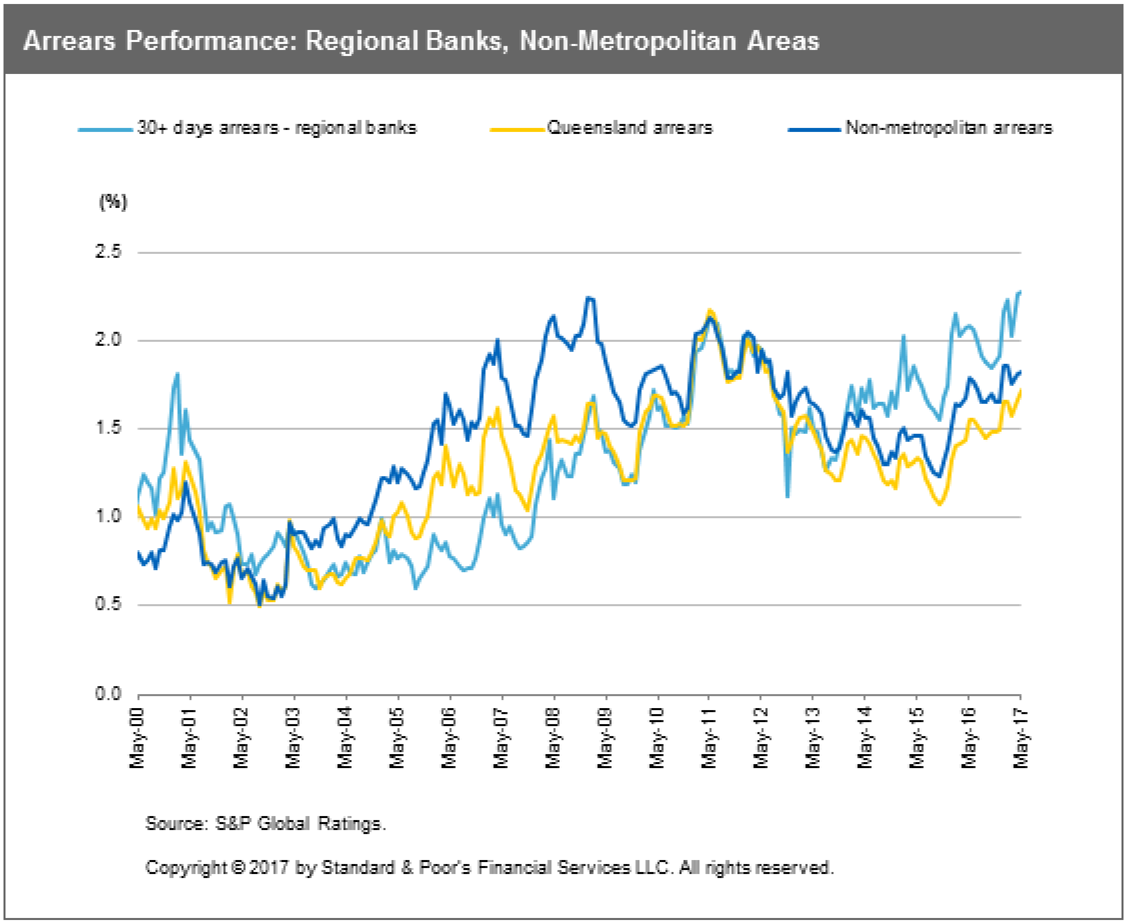
Regional bank RMBS portfolios have a higher exposure to nonmetropolitan areas than the broader prime RMBS portfolio (chart 3).

Chart 3



Mortgage delinquencies in regional areas traditionally have outpaced those in metropolitan areas. This has often been the case because regional centers are more vulnerable to a downturn in a key industry or redundancies by a major employer. Regional banks' RMBS arrears have moved in step with arrears in regional areas (chart 4).

Chart 4



The 20 worst-performing areas for regional bank RMBS portfolios are led by Mandurah in Western Australia and the Barossa - Yorke - Mid-North region in South Australia (table 2).

Table 2

20 Worst-Performing Areas – Regional Bank RMBS Portfolios			
ABS Statistical Area Level 4	**State**	**30+ days in arrears (%)**	**Exposure across regional RMBS sector (%)**
Mandurah	WA	9.31	0.32
Barossa - Yorke - Mid North	SA	7.37	0.11
Queensland - Outback	QLD	5.70	0.38
Far West and Orana	NSW	5.67	0.15
Western Australia - Outback	WA	5.34	0.47
Coffs Harbour - Grafton	NSW	4.54	0.39
South East	TAS	4.39	0.06
Mid North Coast	NSW	4.37	0.23
Perth - North West	WA	4.18	1.80
Perth - North East	WA	4.04	1.29
Logan - Beaudesert	QLD	3.85	1.95
Fitzroy	QLD	3.77	2.68

Table 2

20 Worst-Performing Areas – Regional Bank RMBS Portfolios (cont.)

ABS Statistical Area Level 4	State	30+ days in arrears (%)	Exposure across regional RMBS sector (%)
Hunter Valley (excl. Newcastle)	NSW	3.59	0.53
Mackay	QLD	3.58	1.71
Adelaide - North	SA	3.47	1.01
Mornington Peninsula	VIC	3.41	0.76
Townsville	QLD	3.31	2.95
Melbourne - North East	VIC	3.26	1.43
Wide Bay	QLD	3.24	2.23
Melbourne - South East	VIC	3.21	1.51

Source: S&P Global Ratings. ABS--Australian Bureau of Statistics. Note: The geographical classifications are based on Australian Bureau of Statistics (ABS) definitions. The Statistical Area Level 4 classification used by the ABS reflects one or more whole labor market in the release of its "Labour Force Survey" data. Each SA4 has a population of more than 100,000 people. S&P Global Ratings maps loan-level data at the postcode level to its respective SA4 geographic classification.

The arrears levels in many of the 20 worst-performing areas for regional bank RMBS portfolios exceed the SPIN for prime mortgages; however, the broader regional banks RMBS portfolios' exposure to these areas is not material. This reflects the regional banks sector's reasonable geographic diversity at the more granular Statistical Area Level 4 (SA4) level.

Many of the locations in table 2 are outside of the capital cities, and Queensland is home to the highest number of these locations in the list of the 20 worst-performing areas. We believe loans in arrears in regional areas are less likely to cure, given the higher unemployment that persists in regional Australia and the flow-on effect this has on local property markets and refinancing conditions.

At the state level, regional bank RMBS transactions have a higher exposure to Queensland than the broader prime RMBS portfolio (chart 5). Since late 2015, arrears in Queensland underlying all RMBS transactions have risen more steeply than those in the most populous states of Victoria and New South Wales, reflecting the greater exposure to nonmetropolitan areas in Queensland, given its more decentralized population.

The downturn in mining investment has been more keenly felt in the resource-oriented states of Western Australia and Queensland. This is evidenced by their higher arrears, which have been on a reasonably steep upward trajectory, particularly in Western Australia, since late 2015.

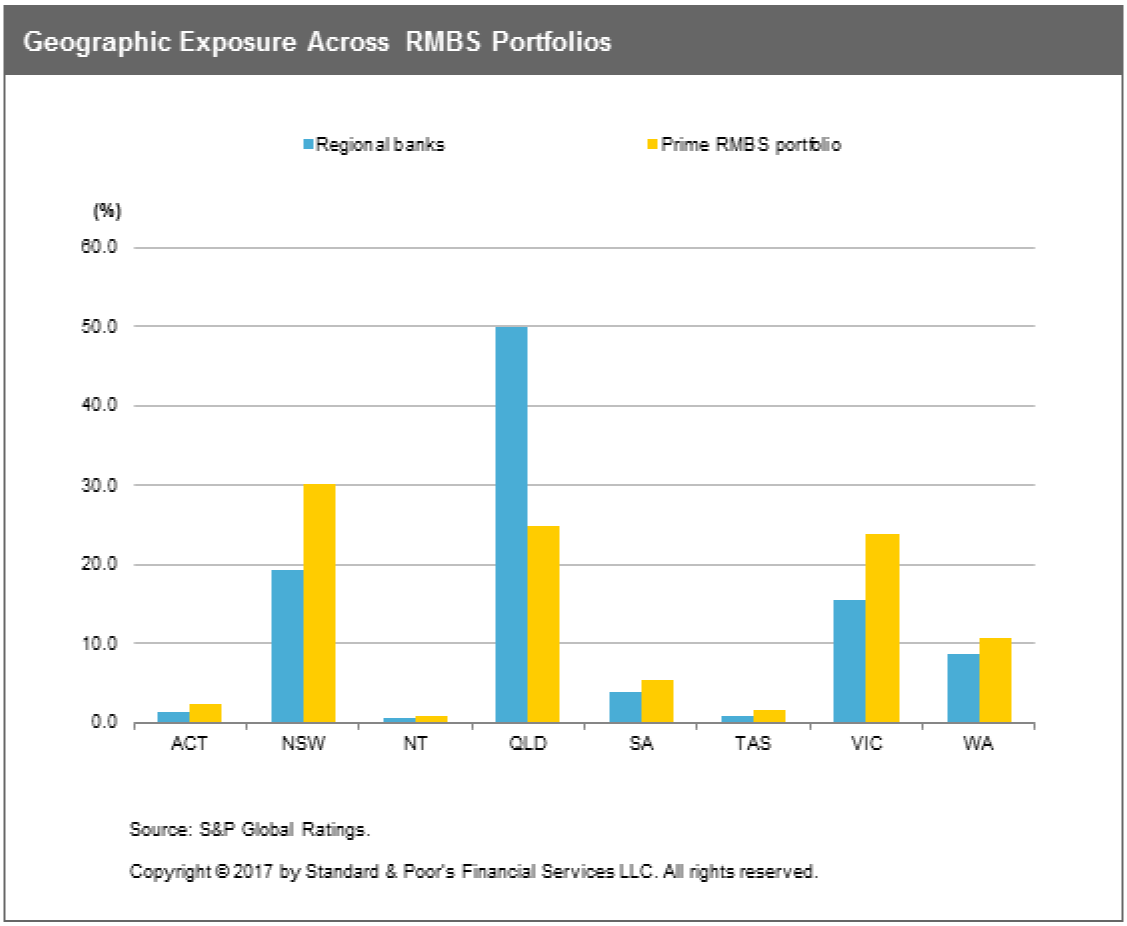
While mining industry jobs make up a small proportion of all jobs in most cities and regions, the growth in such jobs in some areas during the mining boom has had a significant effect. The mining towns that experienced a strong population influx between 2006 and 2011 were in either the Pilbara region of northwest Western Australia or the Bowen Basin in central-eastern Queensland, according to the ABS.

The growth in mining jobs in the Pilbara region and Bowen Basin between 2006 and 2011 was accompanied by jobs growth in the construction industry, which to some extent is an ancillary industry to the mining industry because the construction phase usually precedes the mining phase. The downturn in mining investment and the transition from the construction phase to the mining phase therefore had a flow-on effect on local employment, given the lack of employment diversity outside of the higher-paying mining sector in many of these areas.

Larger urban centers such Perth in Western Australia and Brisbane and Mackay in Queensland also have been affected by the downturn in mining investment. These cities and centers are where "fly-in, fly-out" and "drive-in, drive-out" workers usually reside, and where many of the administrative and white collar jobs in the mining industry are based, according to the ABS.

As the economy continues to transition away from mining toward a more service-oriented economy, we expect arrears to remain elevated in regional Queensland and Western Australia.

Chart 5



Cyclone Debbie, which struck in April 2017, flooded vast areas of Queensland and northern New South Wales. The exposure of regional banks' RMBS transactions to locations that were most affected by Cyclone Debbie, including Mackay and Townsville in Queensland, is around 4.7%. We have not yet observed any material performance issues in RMBS transactions with exposures to these areas.

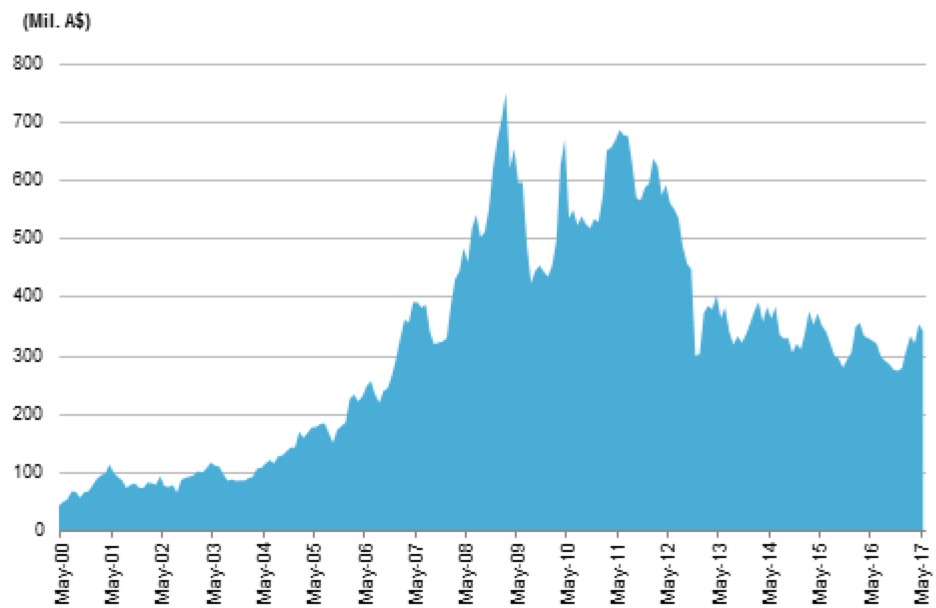
Declining loan balances

Regional bank RMBS transactions have experienced a sharp reduction in loans balances outstanding since the 2008 financial crisis. At its peak, in June 2007, regional banks had the highest balance of outstanding loans for prime RMBS transactions, at more than A$42 billion. By May 2017, the figure had fallen almost 80% to around A$9 billion.

In percentage terms, arrears therefore can be overstated in the context of declining loan balances outstanding. The value of outstanding loan balances in arrears has been relatively stable since mid-2012, with a seasonal peak in March each year (chart 6). In addition, the average cumulative gross loss as a percentage of initial pool balance for the regional banks RMBS sector is around 0.04% as of May 31, 2017.

Chart 6

Amount Of Loans In Arrears – Regional RMBS



Source: S&P Global Ratings.

Recent new issuance by regional banks has helped to offset this effect to some degree, but when measured in percentage terms, arrears for this sector are likely to remain elevated while outstanding loan balances continue to decline.

We do not expect this to increase tail risk for most regional RMBS transactions because most transactions within this sector have been called by the issuer by their respective call dates, thereby mitigating tail risk and borrower concentration risk.

Mitigants to higher exposure to nonmetropolitan areas

Regional banks' RMBS transactions face risk because of their greater exposure to nonmetropolitan areas, but this is mitigated by the following factors:

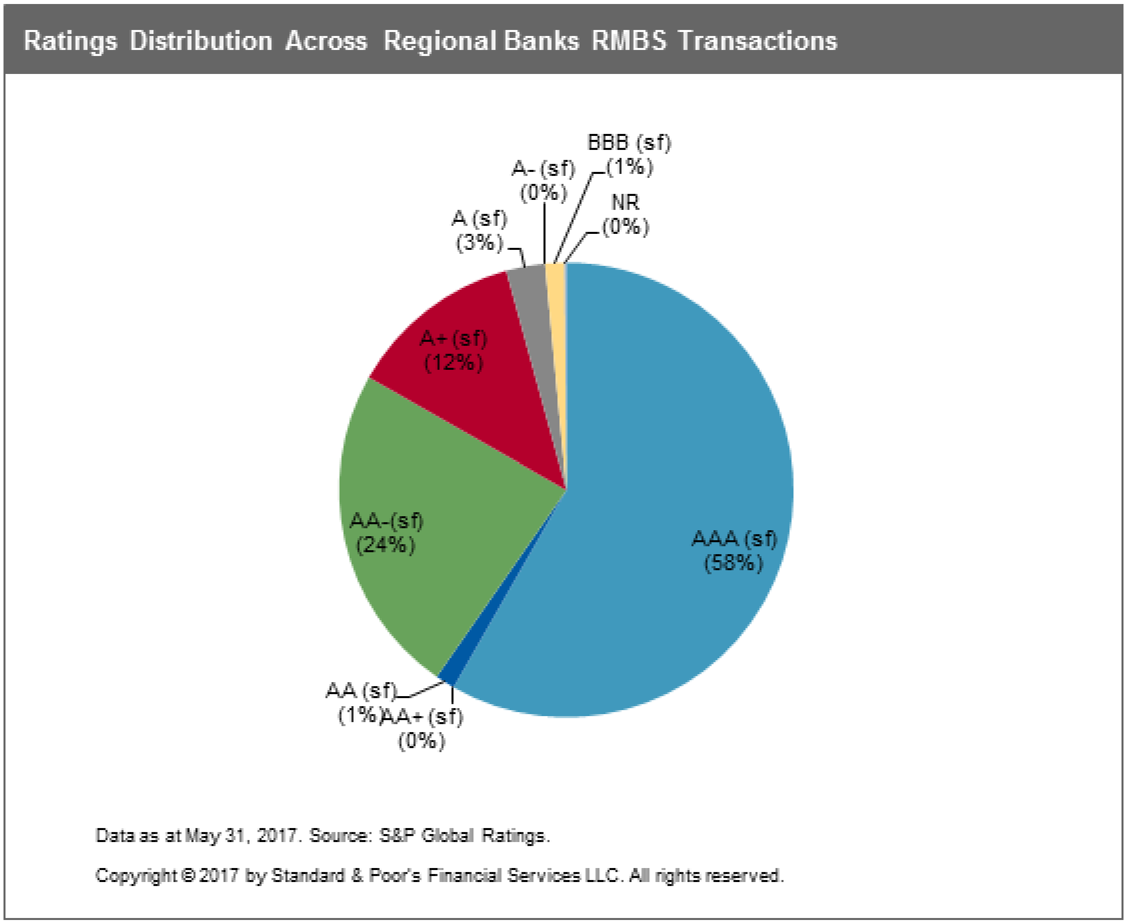
- Foreclosure frequency adjustments. Under our criteria, to factor in the impact of a localized economic downturn on default risk, we make adjustments to estimated losses for excess concentrations in any particular states and territories, nonmetropolitan areas, and particular postcodes compared with their respective limits defined in the archetypical pool.

- Foreclosure period adjustments. Under our criteria, we apply a longer foreclosure period assumption of between 18 months and 24 months for loans in nonmetropolitan areas. This is based on our view that regional housing markets could function less efficiently than metropolitan markets.
- High seasoning indicates demonstrated repayment track record. The high weighted-average seasoning of 100 months for regional banks RMBS transactions suggests that most borrowers have a demonstrated repayment history and the majority of defaults have already occurred. We assume that most defaults have occurred by month 60 for prime transactions.
- Excess credit enhancement. The 'AAA (sf)' rated tranches of all vintages included in our analysis have hard credit support available to them in excess of four times current requirements (table 3). This provides a comfortable buffer to absorb a certain threshold of losses if economic conditions deteriorate.
- Reasonable geographic diversity for most portfolios. While some regional RMBS transactions have a higher state exposure to Queensland, most have reasonable geographic diversity at the more granular SA4 level.
- Relatively stable prepayment rates. Prepayment rates for the regional banks sector have been relatively stable for the past 10 years, averaging around 20%. Prepayment rates for the sector typically decline in March before rising again. A slowdown in prepayment activity can indicate a slowdown in refinance activity, which is a common way for borrowers to manage their way out of financial difficulty.

Credit Enhancement

The current ratings distribution is predominantly 'AAA (sf)' for notes issued by a securitization sponsored by the regional banks sector (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 regional bank originators Rating movements for non-'AAA (sf)' rated tranches largely have been driven 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 3). Post-LMI 'AAA (sf)' credit support requirements for all vintages are now at the floor of our 'AAA (sf)' rating stress.

Table 3

Credit Enhancement Coverage - 'AAA (sf)' Rated Tranches

Vintage	Average pool factor (%)	Average credit support required (post-LMI) (%)	Average credit support provided (%)	Average coverage
2009	16.19	2.02	29.23	14.47
2010	19.37	2.02	8.63	4.27
2011	20.76	2.02	12.06	5.97
2012	32.25	2.02	10.22	5.06
2013	32.56	2.02	9.46	4.68
2014	42.99	2.02	12.09	5.98

Table 3

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

Vintage	Average pool factor (%)	Average credit support required (post-LMI) (%)	Average credit support provided (%)	Average coverage
2015	56.16	2.02	10.09	4.99

Note: S&P Global Ratings carried out credit analyses based on data as of April 2017. We calculated average coverage by dividing the average credit support provided by the average credit support required. LMI--Lenders' mortgage insurance. Regional RMBS transactions excluded from this credit analysis include those that are likely to be called in the near term, warehouse style facilities, and those that have recently undergone a review.

This reflects the segment's high seasoning 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.

For most vintages within this sector, the required post-LMI credit support has decreased since transaction close. We expect a gradual decline 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. There has been no charge-off to date 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 regional banks' portfolio, the proportion of insured loans has decreased to 50% as of March 2017 from 92% 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 regional banks RMBS category. We expect the ratings performance to remain stable as credit enhancement continues to build for seasoned transactions.

Table 4

Risk Factors For Regional Banks

Economic risk	Risk exposure across regional 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
	Greater exposure to nonmetropolitan areas, which normally exhibit greater property price volatility, but this is factored into initial credit support sizing at transaction close
	Reasonable geographic diversity in most transactions, though there is a higher exposure to Queensland
	Reasonable credit enhancement for 'AAA (sf)' rated tranches exceeding current credit support requirements to absorb potential losses

Table 4

Risk Factors For Regional Banks (cont.)	
High household indebtedness risk: Low to moderate	
	Seasoning in excess of 100 months suggests most borrowers have a track record of repayment because our loss curve assumes the majority of losses are realized within the first 60 months from 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: Low	
	Exposure to interest-only loans across regional bank transactions is lower than the industry average, at 14%
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 in excess of 100 months suggests most borrowers have a demonstrated record of repayment

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 high household indebtedness 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. As of June 2017, S&P Global Ratings forecasts GDP of 2.9% and an unemployment rate of 5.5% in Australia in 2018 (see "APAC Economic Snapshots: June 2017," published June 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.