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Australian RMBS Sponsored By Nonbanks: Stable Performance Supports Rating Stability

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Table Of Contents

Portfolio Characteristics

Nonbank Arrears Performance Most Improved Since The Financial Crisis

Credit Enhancement

Outlook

Australian RMBS Sponsored By Nonbanks: Stable Performance Supports Rating Stability

Nonbank originators are a significant part of the Australian residential mortgage-backed securities (RMBS) landscape. Issuance by the sector made up around 17% of total RMBS new issuance before 2008, but new issuance by nonbanks declined in the aftermath of the financial crisis. The sector has since regained momentum, and its issuance hit a high of 44% of total RMBS issuance in 2016.

The composition of the nonbank sector has changed since the crisis, with some players exiting the market. It also has experienced the greatest improvement in mortgage arrears compared with all other sectors, with a decline of more than 60% in the past five years. The other sectors are major banks, nonbank financial institutions, other banks, and regional banks.

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

Portfolio Characteristics

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

- The portfolio collateral quality in the nonbanks sector remains strong, as evidenced by loan-to-value (LTV) ratios of around 61% and the highest seasoning of all originator types, at more than 102 months.
- Prepayment rates for nonbank portfolios are typically lower than for other originator categories. This could reflect the nature of their borrowers and those borrowers' potential refinancing prospects, particularly in an environment of tightened lending conditions. It also could reflect the higher proportion of interest-only loans in nonbank portfolios.
- The nonbank sector has a higher exposure to low-documentation loans, at around 15% compared with the prime RMBS average of 1.05%. The figure for the nonbank sector is down from around 21% in 2009.

Table 1

RMBS Prime Portfolio Characteristics Overview

Category	Current loan balance (A$)	Total closing loan balance (%)	Weighted-average loan-to-value (LTV) ratio (%)	LTV ratio above 75% (%)	Prepayment rate (%)	Weighted-average seasoning (months)	Income partially verified (%)
Major banks	62,086,521,875	49.89	59.48	27.01	19.73	68.5	1.58
Nonbank financial institutions	3,427,587,089	2.75	55.93	16.99	17.35	73.9	0.82
Nonbank originators	13,242,721,546	10.64	60.43	28.14	15.64	103.4	14.82
Other banks	30,402,082,269	24.43	61.71	29.48	24.46	73.6	0.79

Table 1

RMBS Prime Portfolio Characteristics Overview (cont.)

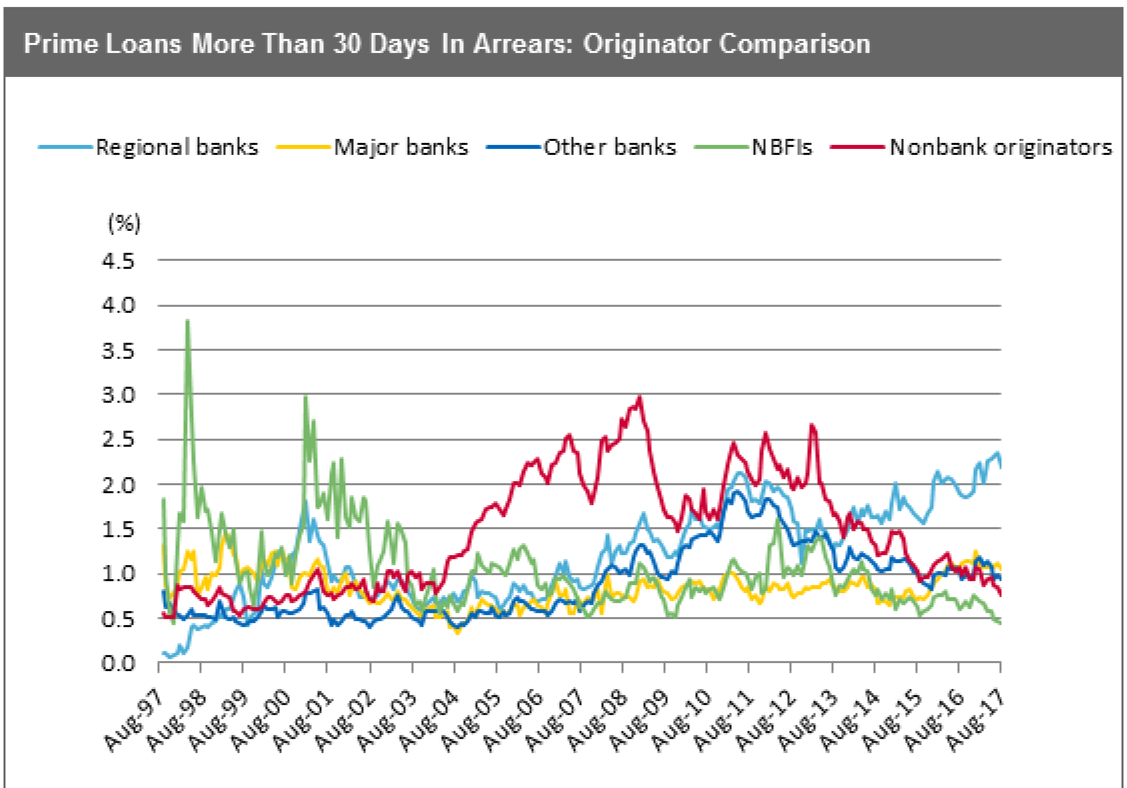
Category	Current loan balance (A$)	Total closing loan balance (%)	Weighted-average loan-to-value (LTV) ratio (%)	LTV ratio above 75% (%)	Prepayment rate (%)	Weighted-average seasoning (months)	Income partially verified (%)
Regional banks	15,288,225,609	12.28	54.53	18.60	18.28	91.0	0.84

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

Nonbank Arrears Performance Most Improved Since The Financial Crisis

A total of 0.76% of loans in nonbank prime RMBS transactions are more than 30 days in arrears (chart 1). This is the second lowest among all originator categories. About 50% of the loans in arrears are more than 90 days past due, and have ranged between 45% and 55% since 2008.

Chart 1



Data as of August 2017. Source: S&P Global Ratings.

Loans more than 30 days in arrears in nonbank prime RMBS transactions peaked in January 2009 at 2.99%--the highest level among all prime RMBS transactions. Arrears in nonbank-originated loans have since fallen at a faster rate than all other originator categories. Until recently, this was occurring against a backdrop of declining loan balances. Some of the possible reasons for this are discussed below.

Reduced low-documentation loan exposure

The exposure to low-documentation loans across nonbank originator prime portfolios has declined from around 21% in 2009 to around 15% as of June 2017. Arrears on low-documentation loans generally have been higher than those on full-documentation loans. This differential historically has widened during periods of economic stress.

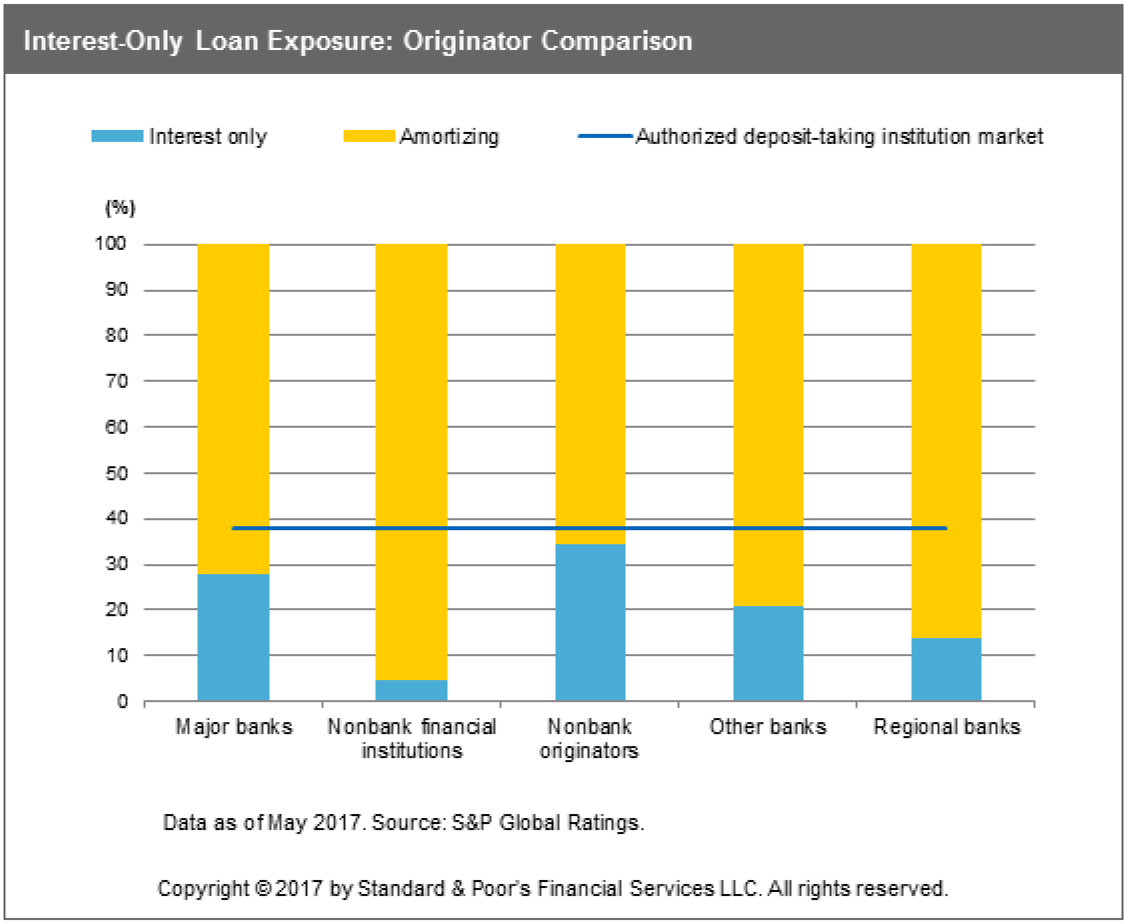
Some lenders historically required only a signed statement from the borrower, stating that the borrower could afford the loan repayments. More recently, however, changes to the Responsible Lending Conduct Obligations of the National Consumer Credit Protection Act require credit providers to make reasonable inquiries and take reasonable steps to verify information. They must also assess whether the consumer can repay the loan without experiencing financial hardship. Standards for verifying information and assessing borrower capacity generally have tightened for low-documentation loans.

Low-documentation loans traditionally have been more common for self-employed borrowers, who often have more variable cash flows. Self-employed borrowers make up about 36% of the nonbank originator prime transactions reviewed in this analysis. Not all loans to self-employed borrowers are classified as low documentation if the income verification provided by the borrower meets requirements. While the income-verification requirements for self-employed borrowers generally is higher since the 2008 financial crisis, the variability of their cash flows makes them more vulnerable to economic downturns and rising interest rates. We make adjustments to the default frequency for self-employed borrowers, depending on the tenor of self-employed borrowers--most business failures tend to be concentrated in the early years of operation--and the level of income verification provided.

Interest-only loan exposure

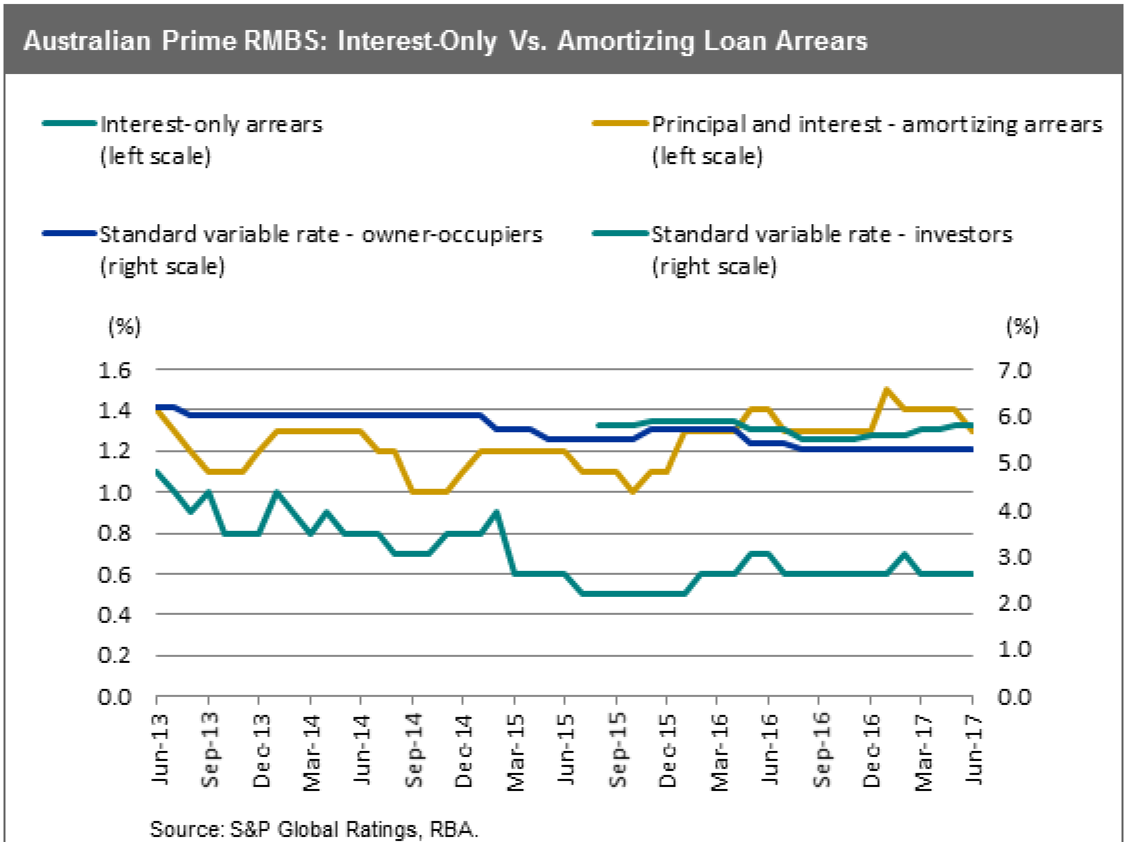
Nonbank originators typically have had a higher exposure to interest-only loans among all Australian securitization originators. However, these exposures have been relatively constant during the past four years (chart 2) compared with other originators, which have recorded a more marked increase in their exposure to interest-only loans.

Chart 2



A prolonged period of low interest rates has enabled many borrowers to stay on top of their mortgage repayments. This can be seen in the relatively low levels of arrears for most prime RMBS transactions. This benefit has been more pronounced for interest-only loans (chart 3).

Chart 3



Nonbank originator prime portfolios' higher exposure to interest-only loans could account for some of the sector's stronger arrears performance in recent years. However, the lower loan arrears for interest-only loans might mask mortgage affordability pressures in the current low interest-rate environment.

Investors generally favor interest-only loans to maximize leverage, given the tax deductibility status of debt repayments. Investors often are in higher income or net wealth quintiles, which can help them to absorb higher repayment costs.

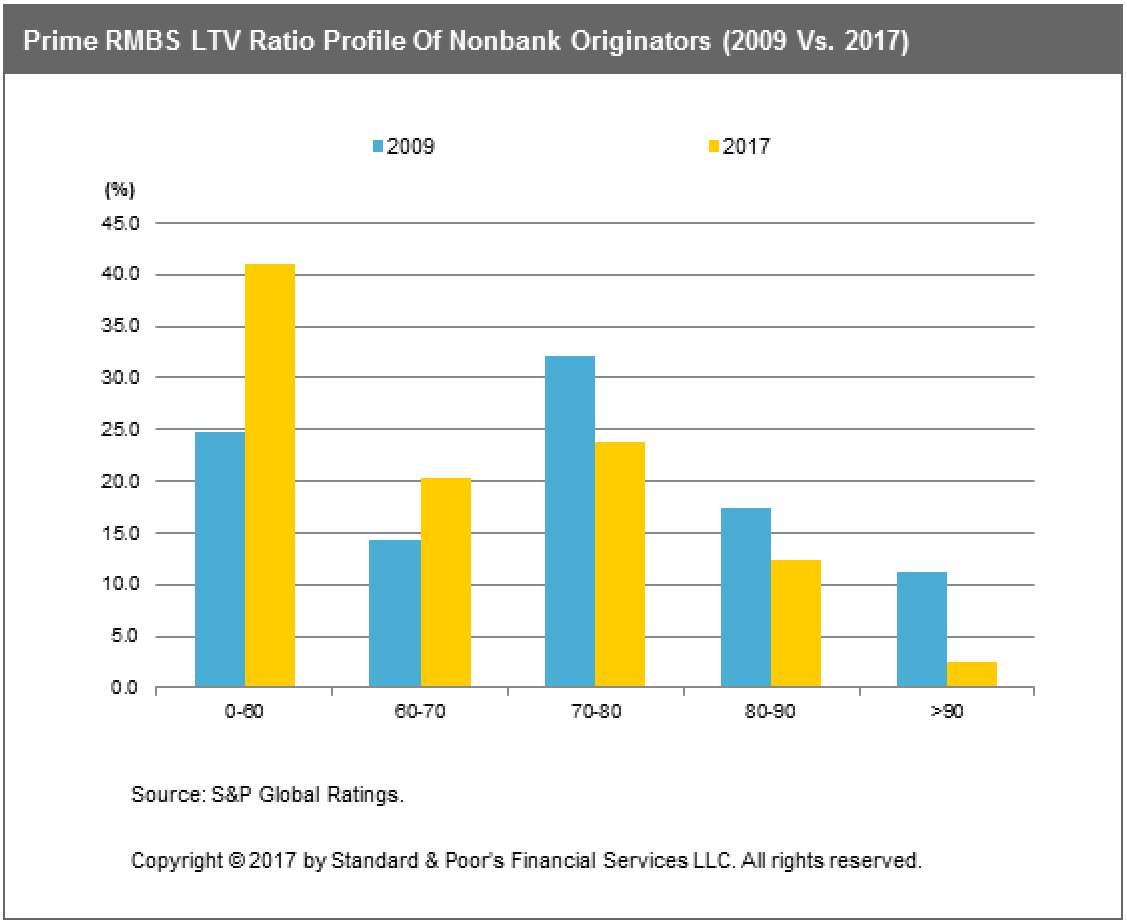
Under our criteria, we look for higher levels of loss protection for nonamortizing or partially amortizing loans, given the risk of repayment shock inherent in these products. The amount of adjustment depends on the degree of payment shock. Loans with longer interest-only period could have a higher probability of default due to their dependence on refinancing or a limited repayment period. We also apply additional adjustment factors to investor loans in our credit analysis, given the more speculative nature of this investment and global default experience on second homes during periods of economic stress.

Changing LTV ratio profiles

LTV ratios historically have been a key predictor of default on residential mortgage loans, and they are a main determinant of credit risk in RMBS transactions. Extensive data relating to the Australian residential loan markets demonstrate a direct correlation. As LTV ratios rise, the probability of default increases exponentially.

The general LTV ratio profile of the nonbank originator prime portfolios has tightened since the financial crisis (chart 4).

Chart 4

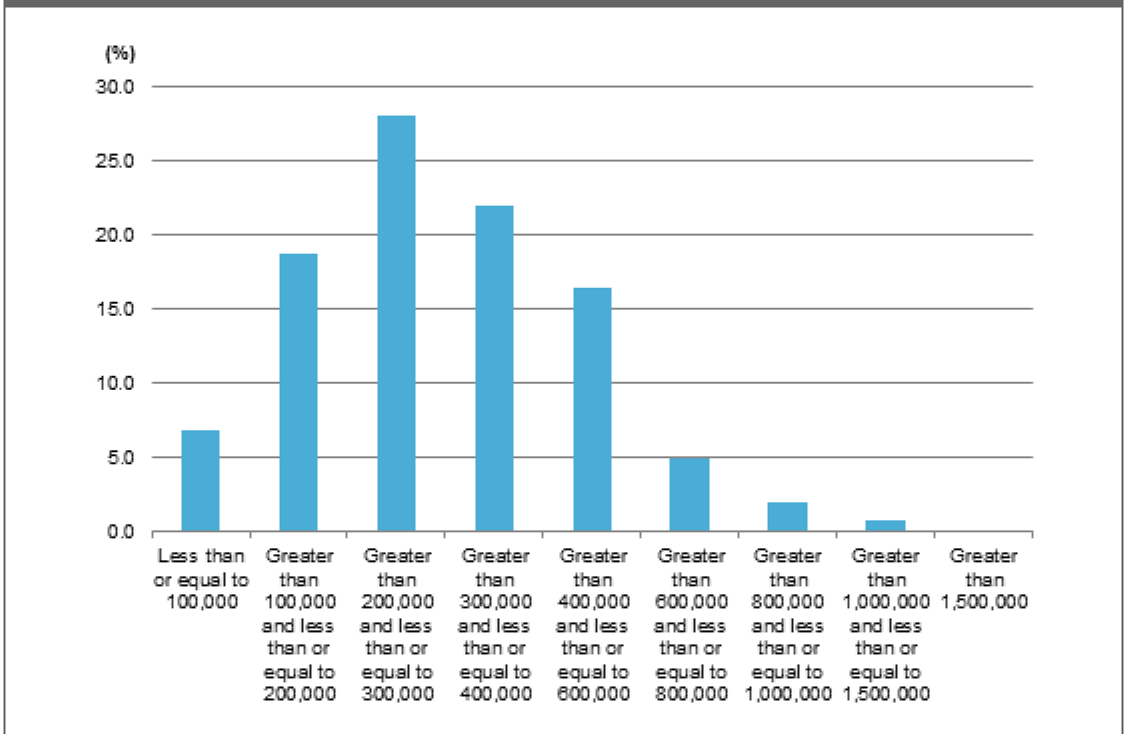


In 2009, around 28% of securitized loans in prime nonbank originator RMBS transactions had an LTV ratio in excess of 80%. In June 2017, it was 15%. The decline partly reflects the higher seasoning of the portfolio now; issuance by nonbank originators was more constrained in some of the intervening years.

Across the broader prime RMBS portfolio, the exposure to high LTV loans (i.e., greater than 80%) is approximately 17% versus 15% for prime nonbank originator portfolios. The slightly lower exposure to high LTV loans in the nonbank originator sector reflects the higher seasoning of this portfolio and the potentially higher exposure to investor loans versus owner-occupier loans. Investor loans are typically underwritten at more conservative LTV ratios, given the more speculative motivations of an investor compared with an owner occupier.

When looking at LTV ratios, it is also important to consider loan size distributions; a modest LTV ratio driven by strong growth in property prices could mask debt-serviceability pressures if debt size relative to borrower income is large. Across the nonbank originator prime portfolios reviewed in this analysis, the average loan size on a consolidated loan basis is approximately A$215,000. The distribution of loan sizes across nonbank originator transactions reviewed in this analysis is shown in chart 5.

Chart 5



Nonbank Prime RMBS Loan Size Distribution

Note: As of June 2017. Source: S&P Global Ratings.

The higher proportion (75%) of loan sizes less than A$400,000 partly reflects the high seasoning of this sector (in excess of 100 months), which has enabled many borrowers to pay down their loans, particularly in an era of low interest rates.

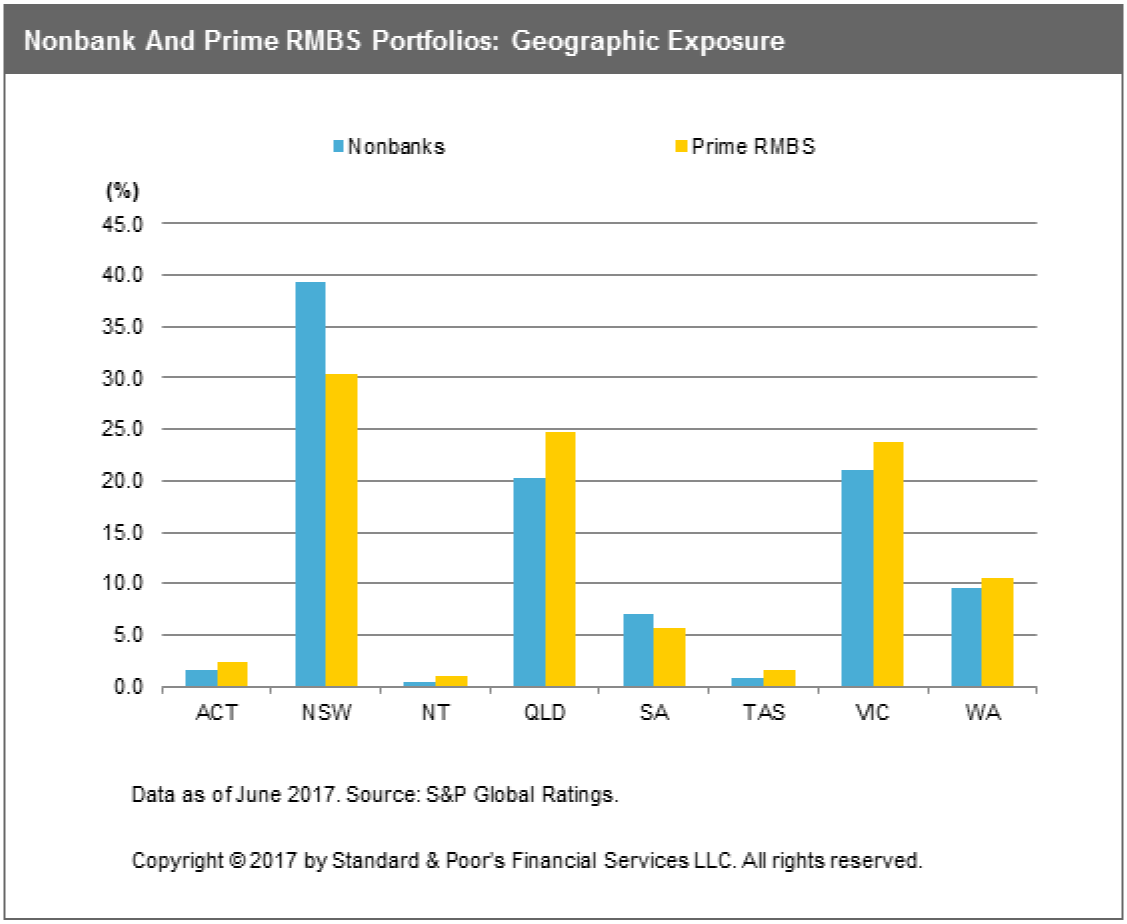
Higher exposure to New South Wales

Arrears for RMBS transactions in New South Wales are the second lowest nationwide (the Australian Capital Territory generally has recorded the lowest arrears). The state's generally good economic health has supported its strong arrears performance. Strong property price growth, low unemployment, and jobs growth have contributed to the state's solid economic performance. Nonbank originators have a higher exposure to New South Wales than the broader prime portfolio (chart 7). This also would have influenced the sector's stronger arrears performance.

Geographic exposure

Nonbank originator prime transactions' exposure to New South Wales is higher than the broader prime portfolio, at 39.39% (chart 6).

Chart 6



We classify about 70% of the state's loans in the nonbank prime RMBS transactions in this analysis as metropolitan (largely Sydney based). Sydney has experienced significant property price appreciation in the past five years, with annual growth above 14% as of June 2017. For seasoned loans, this translates into a positive LTV ratio benefit that enhances borrowers' refinancing prospects. This is a common way for many borrowers to self-manage their way out of arrears.

The state's metropolitan-area loans in the nonbank prime RMBS transactions reviewed in this analysis have a weighted-average seasoning of 91 months and weighted-average LTV ratio of 55%. The relatively high seasoning and modest LTV ratios in this subset of loans provides a buffer against a moderate deterioration in property prices, in our opinion.

Affordability pressure is high in Sydney and Melbourne. The higher property prices in these cities make recent purchasers more vulnerable to interest-rate rises. The risk is more pronounced in new RMBS transactions with lower seasoning levels. The increased focus on underwriting standards has raised the bar, but a rise in interest rates in an economic climate of high household indebtedness and low wage growth will put lending standards to the test, in our opinion. Stable employment conditions and the pace and quantum of future rate rises will be key to how well borrowers can meet this challenge.

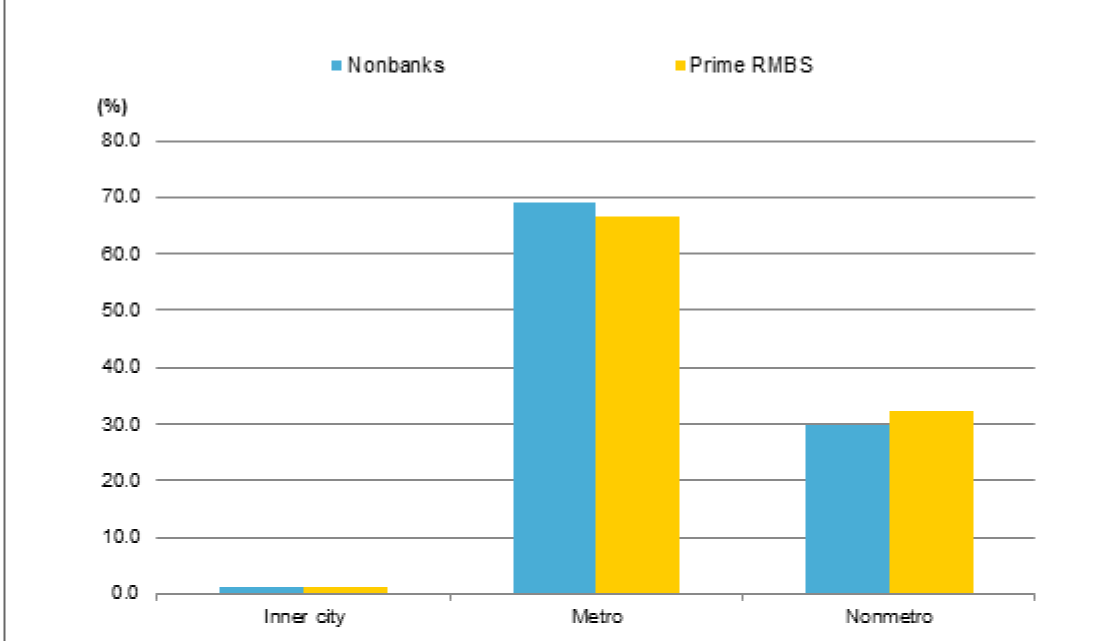
Inner-city exposure is higher than the wider prime RMBS portfolio but nonmetropolitan exposure is lower

Nonbank originators' prime RMBS exposure to inner-city areas is 1.14%, compared with the prime RMBS portfolio average of 1.08% (chart 7). Inner-city areas often have a larger number of high-rise housing developments, which tend to experience greater price volatility.

The exposure of nonbank prime RMBS transactions to loans in nonmetropolitan areas is 29.7%, compared with 32.2% for the broader RMBS portfolio. Arrears performance in metropolitan areas has continued to diverge from that of regional areas, some of which are feeling the effects of the downturn in mining investment and manufacturing operations.

Chart 7

Nonbank And Prime RMBS Portfolios: Metropolitan, Nonmetropolitan, And Inner-City Area Exposure



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

Credit Enhancement

S&P Global Ratings has not lowered its 'AAA (sf)' ratings on any senior tranches of notes issued by transactions from nonbank prime originators. Rating movements for non-'AAA (sf)' rated tranches have been driven largely by changes to our ratings on 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
2010	24.72	3.25	16.97	5.22
2011	32.74	2.54	9.75	3.85
2012	25.31	2.03	14.12	6.95
2013	31.35	2.33	21.66	9.29
2014	45.86	2.64	17.73	6.71
2015	60.30	4.11	16.94	4.12

Note: Credit analysis was undertaken based on data as of June 2017. Average coverage is calculated by dividing the average credit support provided by the average credit support required. LMI--Lenders' mortgage insurance.

The required post-LMI credit support has decreased since transaction close for most vintages in this sector. 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 predominantly have covered any losses. There has been no charge-off to any rated notes in the Australian RMBS market to date.

S&P Global Ratings has raised its ratings on several subordinated tranches of notes issued by prime RMBS transactions this year. In many of these transactions, structural features such as a nonamortizing unrated note, has resulted in a buildup of credit enhancement available to subordinated rated notes that is commensurate with the higher rating levels (and associated stresses) assigned.

We have lowered our ratings on several subordinated tranches of notes in the nonbank originator prime RMBS sector. In many of these instances, the transaction has not been called because the originator has exited the mortgage origination business. In these transactions, the smaller size of the pools means they have higher concentration and tail-end risks. In addition, the subordinated tranches do not benefit from any hard note subordination; only excess spread.

Lenders' mortgage insurance exposure

Lenders' mortgage insurance cover has declined for RMBS in recent years. Across prime nonbank originator portfolios, the proportion of insured loans is approximately 85% as of June 2017. This is higher than other originator types such as major bank RMBS portfolios, in which 30% of loans are insured.

We expect this trend to continue as the market shifts mortgage lending away from higher LTV loans, for which lenders have traditionally obtained mortgage insurance protection. Additionally, it reflects issuers reducing transactions' ratings-risk levels linked to LMI exposure.

We believe mortgage originators' underwriting skills and awareness of LMI underwriting policy standards are reasonably high. Mortgage originators have a long history of managing claims, though claims levels remain fairly low by global standards due to the ongoing good performance of the underlying RMBS assets.

Outlook

The outlook is stable for the nonbank originator prime RMBS category. We expect ratings performance to remain stable as credit enhancement continues to build for seasoned transactions. Improving employment conditions and continued jobs growth will continue to support stable collateral performance.

Table 3

Risk Factors For Nonbanks Originators

Economic risk	Risk exposure across nonbank RMBS transactions
Property price risk: Moderate	
	Modest LTV ratios for most loans provide a buffer against a moderate decline in property prices
	Recently originated loans with higher LTV ratios are more exposed to a decline in property prices
	Reasonable geographic diversity in most transactions
High household indebtedness Moderate	
	Seasoning in excess of 100 months for pre-2016 transactions means most borrowers have a track record of repayment. Our loss curve assumes most losses are realized within the first 60 months from loan origination. Less-seasoned loans are more vulnerable to changing economic conditions.
Interest-only exposure risk: Moderate	
	Nonbank transactions have a higher exposure to interest-only loans, relative to most other originator categories
	Risk of repayment shock is partially offset by a 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 after greater regulatory scrutiny, should help to mitigate this risk
	Seasoning in excess of 100 months for pre-2016 transactions demonstrates a record of repayment for most borrowers. Less-seasoned loans are more exposed to this risk in an environment of lower wage growth and higher household indebtedness.

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 stable 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 are 2.83% for GDP and 5.64% for unemployment in Australia in 2018 (see "Asia-Pacific Credit Conditions September 2017: Trends Are Improving Slightly But Risks Are Escalating," Sept. 26, 2017), suggesting ratings performance should be stable in next 12-18 months.

We carry out regular surveillance on all of the prime and nonconforming RMBS transactions 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.