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Softening Macroeconomic Conditions Will Test Australian RMBS

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Key Takeaways

- Softening economic conditions are likely to put pressure on mortgage arrears and prepayment rates in the next 12 months.
- Advanced arrears are likely to remain elevated as high household leverage and subdued wage growth constrain some borrowers' ability to adjust to changing economic conditions and rising interest rates.
- Stable employment conditions are fundamental to ratings stability, despite some collateral performance deterioration.
- Structural enhancement, including available credit support within most transactions, will help to cushion the effects of softening economic conditions.

Falling property prices and reduced access to credit have created refinancing pressure for some borrowers. Most Australian residential mortgage backed securities (RMBS) have been largely resilient to these economic headwinds to date, buttressed by stable employment conditions and low interest rates. However, a softening in broader macroeconomic conditions could lead to some deterioration in asset performance as the confluence of lackluster wage growth and tightened lending conditions weighs on borrowers' debt serviceability.

Some of the key risks that are likely to influence asset performance include falling property prices, interest-only rollover risk, lower seasoning, and rising arrears.

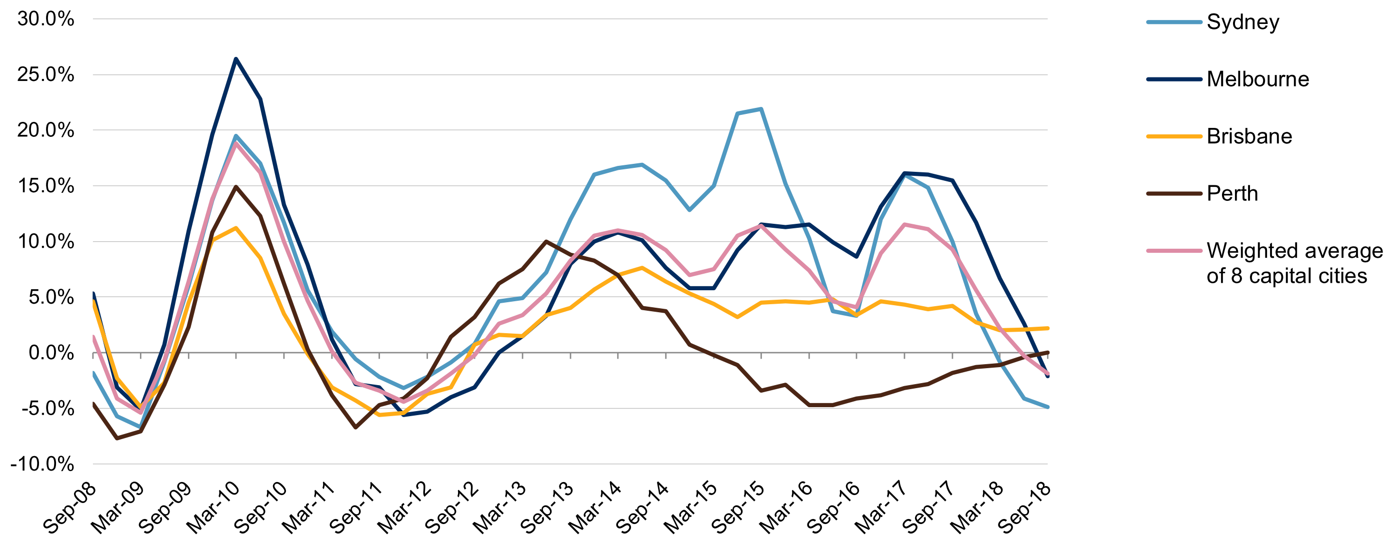
Falling Property Prices Pose More Of A Risk For Lower-Rated Tranches

Property prices have continued to fall in 2019. National property prices declined 1.5% in the third quarter of 2018, with the largest declines in Sydney, Darwin, and Melbourne, according to Australian Bureau of Statistics data (see chart 1).

Chart 1

Annual Property Price Movements

Annual changes in property prices in major capital cities



Source: Australian Bureau of Statistics.

Slowing credit growth continues to influence the pace of property price declines, particularly for investor loans. A decline in domestic and foreign investment and increased housing supply, particularly in Sydney, has compounded the effect. Markets such as Sydney have been technically undersupplied in housing stock for a number of years, and its increased housing supply is a response to this trend.

There is little sign of any stabilization in the housing market, and this could continue to affect consumption, even as a tight labor market increases wage growth (see "APAC Economic Snapshots," Feb. 26, 2019). Strong population growth provides a natural floor to a sharp downturn in property prices, though it is slowing.

Declining property prices pose more of a risk for junior tranches of RMBS transactions and loans with a lower seasoning, such as those underwritten in the past 12-18 months at higher loan-to-value (LTV) ratios. The borrowers of such loans have built up less equity and could face more diminished refinancing prospects in the current lending environment. The lower-rated tranches of some recent vintages with lower seasoning levels are more exposed to this risk, given tranche sizes at this position in the capital structure are quite thin.

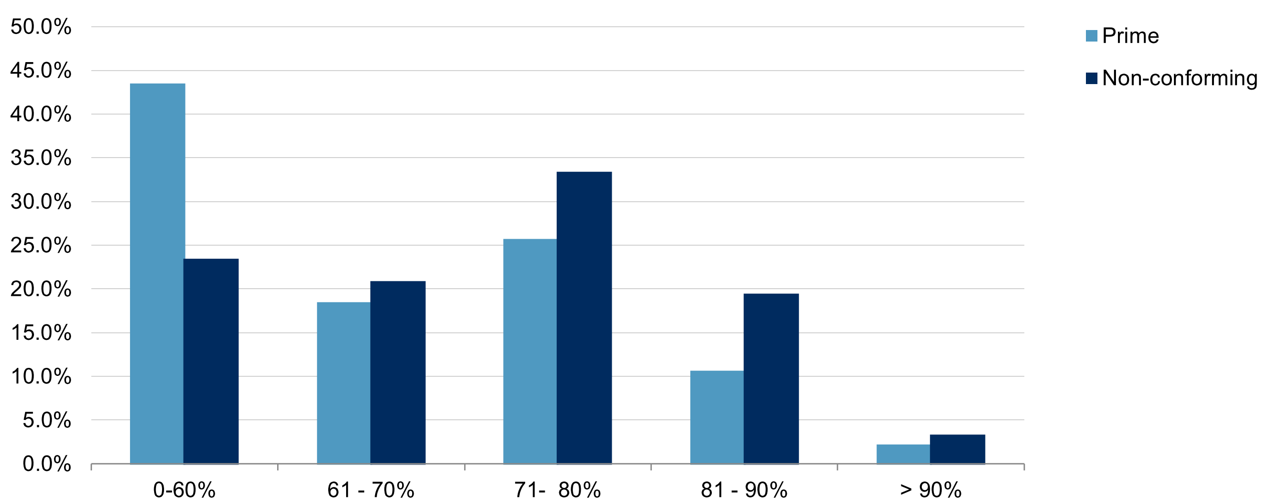
The collateral quality of most Australian RMBS portfolios nevertheless will provide insulation against further property price declines. The credit attributes of most Australian RMBS portfolios include:

- Modest loan-to value (LTV) ratio exposures. Weighted-average LTV ratios in the sector are 60%, which provides a degree of insulation against further property price declines.

- Geographic diversification. Property markets nationwide have their own dynamics and generally do not experience the same magnitude of movements at the same time.
- A low exposure to high LTV ratio loans. Around 13% of total RMBS loans outstanding have an LTV ratio in excess of 80%.
- Minimal exposure to inner-city locations, at slightly more than 1.0%. Inner-city locations are the site of many high-density unit developments.
- A higher exposure to metropolitan areas. Around 68% of loan exposures are in metropolitan locations. Property price declines in metropolitan areas historically have been lower than in nonmetropolitan areas, given the greater job diversity in larger cities.
- The high weighted-average of seasoning of 60 months. Loans with a higher seasoning, particularly those in Sydney and Melbourne, have benefited from many years of strong property price growth, which has enabled borrowers to build a significant level of equity in their properties.
- Senior tranches benefitting from a strong build-up in credit support due to the relatively high prepayment rates in this sector.

Chart 2

LTV Profile Of Australian RMBS Sector



Source: S&P Global Ratings.

Arrears Are Likely To Remain Elevated While Wage Growth Is Flat And Household Leverage High

Loans more than 90 days in arrears reached a record high of 0.75% in December 2018. Most major and regional banks reported in their first-quarter trading updates year-on-year increases in loans more than 90 days in arrears and impaired loans. The proportion of loans in this more advanced stage of arrears has been rising for the past five years. More than 55% of total loans now in arrears are more than 90 days past due, up from 40% five years ago.

Loans in the advanced stage of arrears have continued to rise, despite improving employment conditions and low interest rates. Some of the key drivers for this increase are geography, reporting adjustments, and leverage.

Geography

Loans collateralized by properties in Western Australia and Queensland form a disproportionate share of loans that are more than 90 days in arrears. Exposure to Western Australia in Australian RMBS portfolios is about 11%. But loans more than 90 days in arrears in the state make up more than 22% of total 90-plus days arrears, up from 11% five years ago. The downturn in the mining sector and its protracted downstream effect on property markets and local economic conditions has kept arrears high in this part of the country for some time. While property price declines appear to have slowed in Western Australia, the state's peak-to-trough property price falls are some of the highest in the country, exacerbating refinancing pressures in a tightened lending environment. Mining- and drought-affected areas in regional Queensland have suffered a similar fate to Western Australia, but the greater diversity of employment opportunities in Queensland have offset some of these pressures. These loans are unlikely to cure in an environment of tightened lending conditions.

Reporting adjustments

The inclusion of reporting on loans in arrears that are under hardship arrangements has resulted in some pronounced movements in the 90-plus days arrears category in recent years. 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.

The Australian Prudential Regulation Authority expects that authorized deposit-taking institutions will not freeze or stop the arrears clock for loans for which hardship or other similar payment concessions have been granted, as outlined in "Prudential Practice Guide 223 – Residential Mortgage Lending." These adjustments are intended to reveal the true state of arrears among lenders. The treatment of loans in hardship from an arrears-reporting perspective was not consistent among originators before 2016. In recent years, many lenders have adjusted their arrears reporting to include hardship loans. This alignment in reporting standards accounts for some of the more pronounced movements in 90-plus days arrears in recent years.

Leverage

While changes in reporting methodology have resulted in some large spikes in advanced arrears, albeit off low bases, advanced arrears have been rising for a number of years. At the macroeconomic level, this trend reflects increasing household leverage. Australia's household indebtedness is around 188%, according to Reserve Bank of Australia statistics. In an environment of subdued wage growth and tightened lending conditions, households are more vulnerable to interest-rate rises and deterioration in economic conditions. Stable employment conditions have enabled most borrowers to stay on top of their mortgage repayments to date, but high household leverage diminishes borrowers' resilience to financial pressures and will continue to weigh on arrears, particularly in an environment of tightened lending conditions.

An economic downturn similar to that of the early 1990s would likely place households under more financial stress than it did at the time, given household leverage has more than doubled. The degree of severity would depend on the speed and depth of any such downturn.

While 90-plus days arrears are likely to remain elevated in the medium term, cumulative gross losses in the Australian RMBS sector are low. Lenders' mortgage insurance (LMI) claims adjustment rates--the difference between a claim made and the claim payout--for loans underlying Australian RMBS transactions are low. This partly reflects the relatively modest LTV ratios in the Australian RMBS sector and the reduced appetite for higher LTV ratio lending in the broader mortgage market. It is also due to a prolonged period of relatively benign economic conditions and, until recently, strong property price appreciation.

The strong property price appreciation in recent years, coupled with the high seasoning of many loans, has improved many borrowers' LTV profiles, particularly for earlier loan origination vintages, thereby decreasing potential loss severity.

Weak income growth will put pressure on borrowers' ability to service debt. Flat projections of income growth are likely to lead to weaker consumption growth and weigh on borrowers' ability to service their debt. This could mean arrears remain elevated for longer periods because borrowers have less of a financial buffer to adjust to changing economic conditions.

Lower Seasoning Risk More Prevalent Across Non-Bank Portfolios

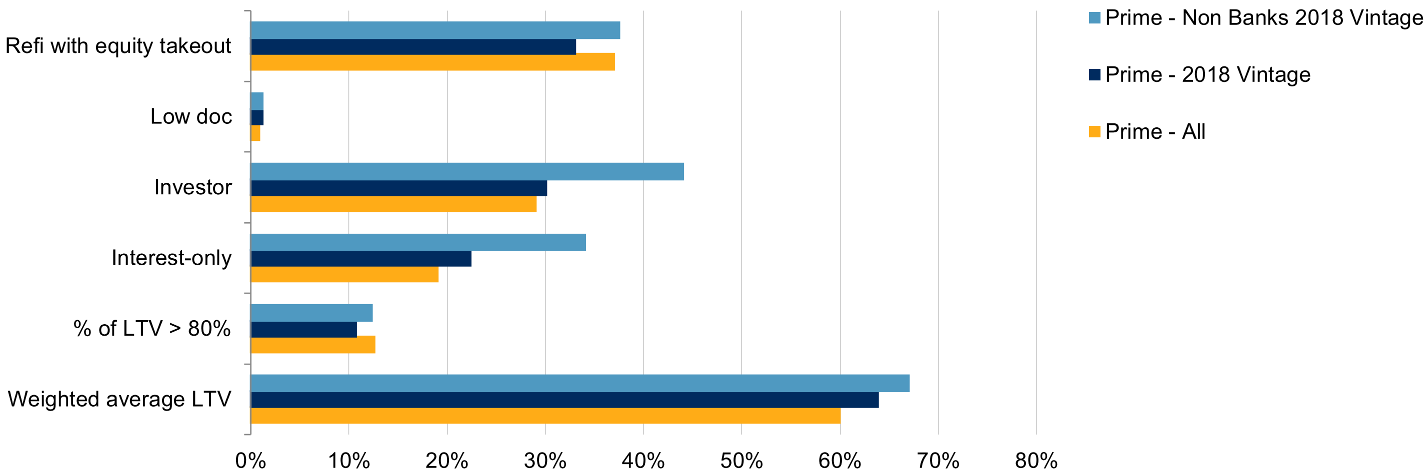
The nonbank sector's strong issuance in 2018 has led to a marked contraction in loan seasoning in nonbank-originated deals. Lower seasoning can carry inherent risks. A borrower of a seasoned loan has a demonstrated track record of repayment behavior. Less-seasoned loans do not have this track record and can be more susceptible to arrears if economic conditions change. The more-heightened focus on debt-serviceability standards helps to mitigate this risk because loans underwritten in the past 12 months have been subject to more stringent underwriting standards and should be better able to absorb interest-rate rises.

Less-seasoned high LTV loans backed by properties purchased or valued at the peak of the property cycle could see an increase in their LTV ratios, affecting refinancing prospects in the current environment for stressed borrowers.

Despite the contraction in seasoning, overall exposure to loan products with a higher credit risk has not increased materially, except for investment and interest-only loans in nonbank portfolios. We can see this by comparing the exposure to higher-risk loan products in the 2018 vintage with the broader prime RMBS sector (chart 3).

Chart 3

Credit Characteristics Of 2018 Vintage
Comparing 2018 vintage to broader prime sector



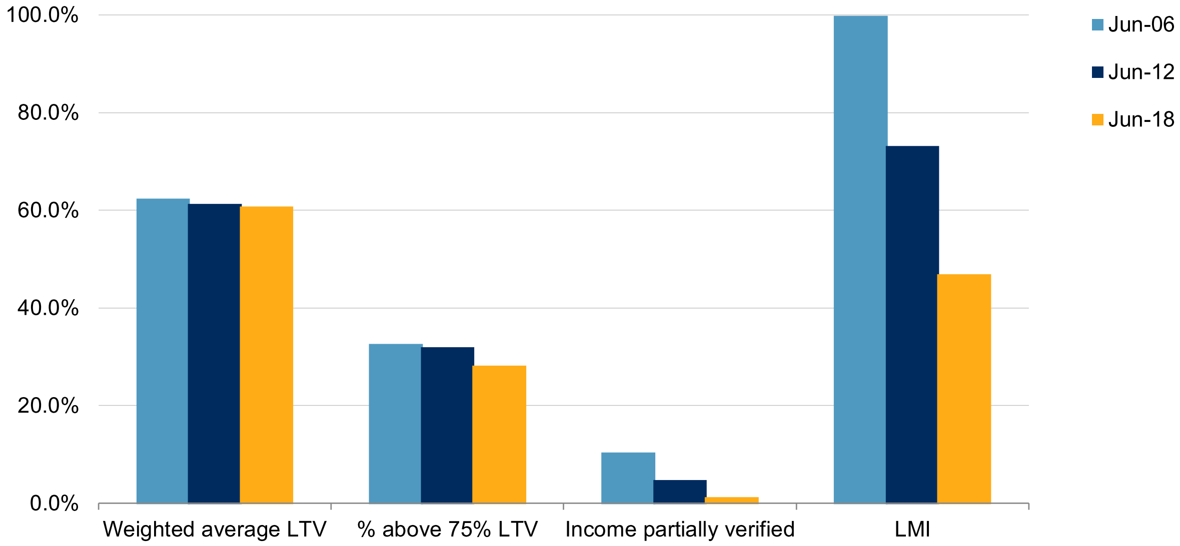
LTV--loan-to-value. Source: S&P Global Ratings.

Nonbank portfolios traditionally have been more exposed to investment and interest-only loans. Interest-only and investment loans attract a higher default multiple in our credit analysis.

Collateral quality in the broader RMBS sector generally has improved during the past five years (chart 4). We can see this in the contraction in high LTV lending and fewer low-documentation loans. This reflects a trend in the broader mortgage market in response to regulatory expectations of prudent lending. We have observed since 2014 a general convergence in lending standards in bank and nonbank portfolios in line with regulatory expectations. This will continue in the wake of the Royal Commission. We expect lenders to continue to bed down their debt-serviceability assessments and expenditure verification processes.

Chart 4

Credit Collateral Quality Over Time
Prime RMBS portfolio



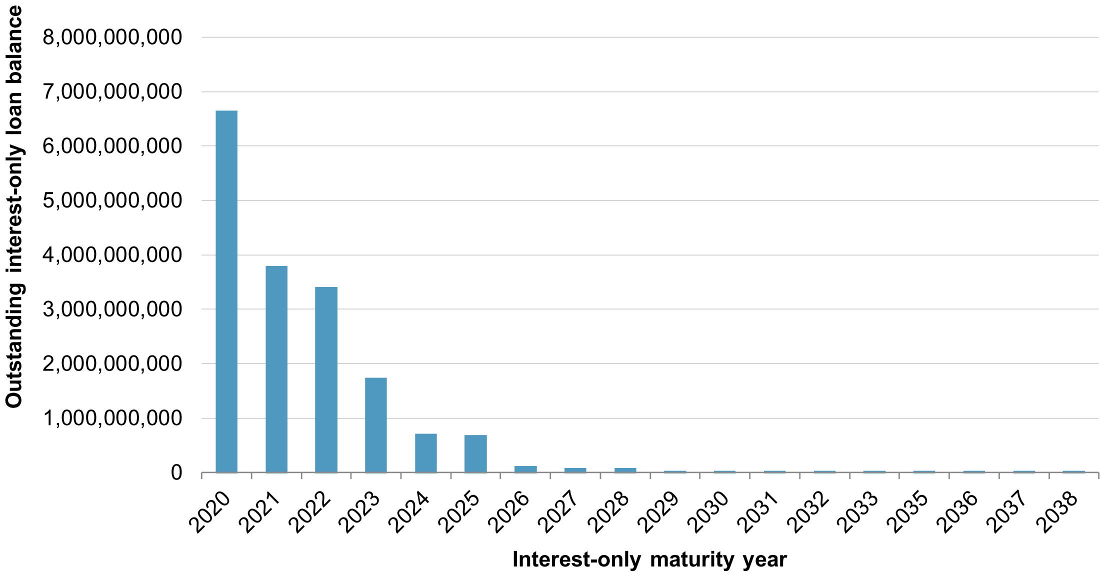
RMBS--residential mortgage-backed securities. LTV--loan-to-value. LMI--Lenders mortgage insurance. Source: S&P Global Ratings.

Interest-Only Rollover Risk Has Put Pressure On Arrears

About 19% of total prime RMBS portfolios are interest-only loans. The number is about 26% for nonconforming portfolios and 27% for the broader bank sector. Most interest-only exposures are for investor loans. About 10% of owner-occupier loans have an interest-only period in Australian RMBS portfolios. For investor loans, the exposure to interest-only loans is 41%. This reflects the tax incentives for investors of interest-only repayment structures.

Chart 5

Interest-Only Exposures By Maturity Date
Current balance of outstanding interest-only loans



Source: S&P Global Ratings.

Around 56% of outstanding interest-only loans in Australian RMBS portfolios are due to reach their interest-only maturity date by the end of 2020 (chart 5). Interest-only loans in RMBS loan portfolios are routinely transitioning to principal and interest payment loans. In 2018, for example, around 22% of then-outstanding interest-only loans converted to amortizing loans.

We have not observed a material increase in arrears as a result of this transition. However, arrears levels for investor loans increased to 1.27% as of Dec. 31, 2018, from around 1.03% in December 2013. Some of this increase reflects repayment rollover risk and the raising of interest-rates on investor loans in recent years in response to regulatory investor lending limits. Interest-only loans carry an inherent risk of repayment shock. Some of the specific risks we are monitoring in relation to this cohort of loans include:

- Loan underwriting year. Interest-only loans underwritten before 2015 were subject to less-stringent lending standards. Exposure is declining, however, because such loans commonly have an interest-only period of up to five years.
- Investor versus owner-occupier loan purpose. Investors typically take out interest-only loans for tax purposes; unlike owner-occupiers, they are incentivized to maintain higher leverage levels. Investors typically have other assets and could be in a better financial position to absorb the higher repayment costs. Investor mortgage arrears have followed this trend, albeit during a period of benign economic conditions, and have outperformed owner-occupier arrears since August 2012.
- Refinancing risk. These loans do not build up equity during the interest-only period. This means

that interest-only loans' LTV ratios might not be as favorable as those of amortizing loans at the end of the interest-only period. In the current lending environment, this could impede interest-only borrowers' refinancing prospects if they try to extend their interest-only period. This could put some pressure on arrears.

Improving Employment Conditions Are Fundamental To Our Stable Outlook

While risks are elevated and the performance of prepayment rates and mortgage arrears are likely to deteriorate in 2019, we do not expect this to cause any ratings pressure for most RMBS transactions. Most Australian RMBS transactions continue to benefit from structural enhancement, including a strong build-up in credit support to senior tranches that provides an additional buffer to economic headwinds.

Stable to improving employment conditions are fundamental to our stable credit outlook for the Australian structured finance sector. Defaults in Australia tend to be influenced by triggers such as unemployment, divorce, and health-related issues. We would not expect a borrower in Australia, particularly an owner-occupier, to default if the outstanding mortgage debt be greater than the market value of his or her property, due to the strong recourse nature of lending. The current magnitude of property market value declines is unlikely to lead to an increase in borrower defaults.

Risk are elevated in Australian RMBS in 2019 and asset performance is likely to deteriorate, but ratings in the main should remain stable.