Australian Royal Commission Final Report Will Have Limited Effect On Most Structured Finance Ratings

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The final report from the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry is likely to have a limited effect on rated securitizations. The recommendations outlined in the final report will likely have more influence on prepayment rates and could alter some business models within the mortgage market, particularly for mortgage brokers.

In this analysis, we consider how these Recommendations are likely to impact structured finance transactions and collateral performance more broadly.

KEY TAKEAWAYS

- The recommendations in the Royal Commission's final report will have a limited impact on most Australian structured finance transactions.
- Prepayment rates will likely slow in line with tightening lending conditions.
- Changes to remuneration structures for mortgage brokers would affect many business models, increasing refinancing pressures and weighing on prepayment rates.

National Consumer Credit Protection Act Unlikely To Be Altered

The Royal Commission highlighted deficiencies in lenders' debt-serviceability assessments, particularly around their overreliance on the use of the Household Expenditure Measure. Lenders have tightened their debt-serviceability calculations in response to these concerns and expanded the number of expense categories to better reflect borrowers' true expenditure patterns.

Lenders have increased their scrutiny of borrowers' expenses and the progressive tightening in lending standards has affected credit growth. While the recommendation in the final report to not alter the National Consumer Credit Protection (NCCP) Act will negate the need for further tightening, credit growth is likely to remain subdued in the short to medium term as banks continue to bed down more rigorous credit application processes, with a heightened focus on expense calculations. We also expect stronger regulatory enforcement to reinforce these trends.

Initiatives such as comprehensive credit reporting and open banking will give lenders access to more financial data on borrowers in real time, reducing lenders' reliance on manual checks and processes. In the interim, however, we expect credit conditions to remain subdued and refinancing to become more difficult. Prepayment rates are likely to reflect this, and it could flow through to higher arrears in certain borrower segments.

Mortgage Broker Remuneration Changes Could Lead To Sector Consolidation

Recommended changes to broker remuneration structures include the removal of trail commissions and the shifting of payment of mortgage broker fees from the lender to the borrower.

The use of mortgage brokers is common among banks and nonbanks involved in structured finance lending. This is not unique to structured finance; third-party originations make up more than half of new loan originations in the broader bank sector. The prevalence of these origination channels is partly because they are more cost effective than branch networks.

Involving third parties in lending origination carries an inherent credit risk. This is because the information third parties provide can be falsified. The involvement of brokers and third-party originators in the Australian residential mortgage-backed securities (RMBS) sector is limited to the referral of borrowers to lenders, with brokers performing more of a distribution role between the lender and borrower. Credit decisions generally are made centrally, and third parties are not involved. As the Royal Commission findings have shown, however, third parties can provide borrower information to lenders, leading to a risk of broker fraud if appropriate procedures are not in place to verify the accuracy and completeness of the information provided.

If the recommendations are implemented, it would likely to lead to consolidation in the mortgage broker sector. Broker-sourced origination fell in the years following the 2008 financial crisis as a result of credit rationing by lenders. Changes were also instigated at the time in response to concerns over imprudent behavior, but the regulatory weight of the Royal Commission recommendations will have more far-reaching effects if they are implemented in their current form.

Many smaller lenders are reliant on this origination channel and this could raise competition issues. If the market moves to a borrower pays model, then borrowers are likely to refinance less frequently in the medium term and the mortgage broking industry would shrink and consolidate. This would be reflected in slowing prepayment rates. These changes would affect RMBS issuers across the board because all issuer groups—authorized deposit-taking institutes (ADIs) and non-ADIs--use mortgage brokers.

We expect online lending to form a larger share of lenders' origination channels, with increasing competition from financial technology and digital disruption altering the way credit decisions are made. The Royal Commission's recommendations could expedite some of these changes.

The proposed changes to mortgage broker remuneration structures will likely require careful consideration and widespread consultation. Key considerations include competition in the home-lending sector as well accessibility and affordability for borrowers. Changes are likely to be implemented with the aim of minimizing any potential market disruption.

Retail Dealers Could Lose NCCP Provision Exemptions

Under the proposed recommendations, retail dealers will no longer be exempt from the operation of the NCCP. In securitization transactions for which the loan-origination sources include retail dealers, the dealers at present generally perform roles akin to a broker or introducer, in that they collate information from borrowers and send this through to credit departments where credit decisions are made centrally.

If this recommendation is adopted, access to auto finance could slow because retail dealers would have to adjust their verification and credit-checking processes to comply with the provisions of the NCCP.

Small Business Exemption From NCCP Provisions Would Ease Access To Credit

The recommended exemption of small businesses from NCCP provisions will alleviate investors' concerns over the potential impact on small businesses' ability to access credit. It's often hard for small businesses to access finance, particularly without providing real estate as security. The proposed exemption from the NCCP provisions will not further restrict this market's access to credit.

Securitization issuance collateralized by loans to small to medium-size enterprises has been limited in Australia because lending volumes for this loan type historically have been quite small.

The Australian government announced in November 2018 that it would establish a fund that will invest in the securitization market to provide funding to smaller banks and nonbank lenders to "on-lend to smaller businesses on more competitive terms." This could address some of the difficulties that small businesses face in accessing finance. Prospective issuers' data history and performance track record could constrain their ability to head down the securitization path in the short term, but the market will continue to evolve.

Royal Commission Recommendations Could Affect Prepayment Rates And Mortgage Arrears

Prepayment rates

Lending conditions are likely to remain tight while lenders continue refining their loan-application processes to address concerns raised in the Royal Commission and regulatory expectations. This will affect refinancing conditions and prepayment rates because refinancing is a common way for borrowers to voluntarily manage their way out of financial stress. Compounding this will be the potential impact of changes to the mortgage broker model because proposed changes to remuneration structures could result in increased consolidation in the sector and further restrict refinance prospects for some borrowers.

Mortgage arrears

Mortgage arrears could rise as a result of restricted financing conditions though we expect any increase to be modest while employment conditions are stable and interest rates relatively low. Borrowers with high loan-to-value ratio loans; interest-only periods; or loans for which the purpose is of a higher credit risk, such as refinance with equity take out loans, are more susceptible to risk.

Ratings

Our ratings on structured finance transactions are unlikely to be affected by the proposed recommendations, given the strong collateral quality of most loan portfolios and the buildup in available credit enhancement.

RMBS Portfolios' Collateral Quality Should Continue To Improve

The collateral quality of most RMBS portfolios has improved in the past five years, as evidenced by a contraction in loan-to-value ratios and fewer low-documentation loans. We expect this trend to continue as lenders continue to apply greater scrutiny in their credit decision making. Banks' retreat from higher-risk segments such as interest-only and investment loans has created lending opportunities in the nonbank sector, which has been quick to capitalize on the newly vacated space. More recent transactions from the nonbank sector have a higher exposure to these types of loan products. This is likely to continue in the current environment.

This report does not constitute a rating action.