Does The Declining Use Of Lenders' Mortgage Insurance Make Australian RMBS "Less Prime"?

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Key Takeaways

- The definition of prime residential mortgage-backed securities (RMBS) has lost some of its relevance with the decline in usage of lenders' mortgage insurance. The collateral quality of Australian RMBS transactions meanwhile has generally improved since the 2008 financial crisis.
- The nonconforming universe has widened since the financial crisis, alongside a general tightening in lending conditions that has resulted in more "mixed" pools.
- Shifting stakeholder expectations throughout a credit cycle influence the credit profile of RMBS transactions. The credit analysis remains fundamentally the same, however, and the changing profiles of RMBS transactions over time ultimately will be reflected in their respective credit enhancement levels.

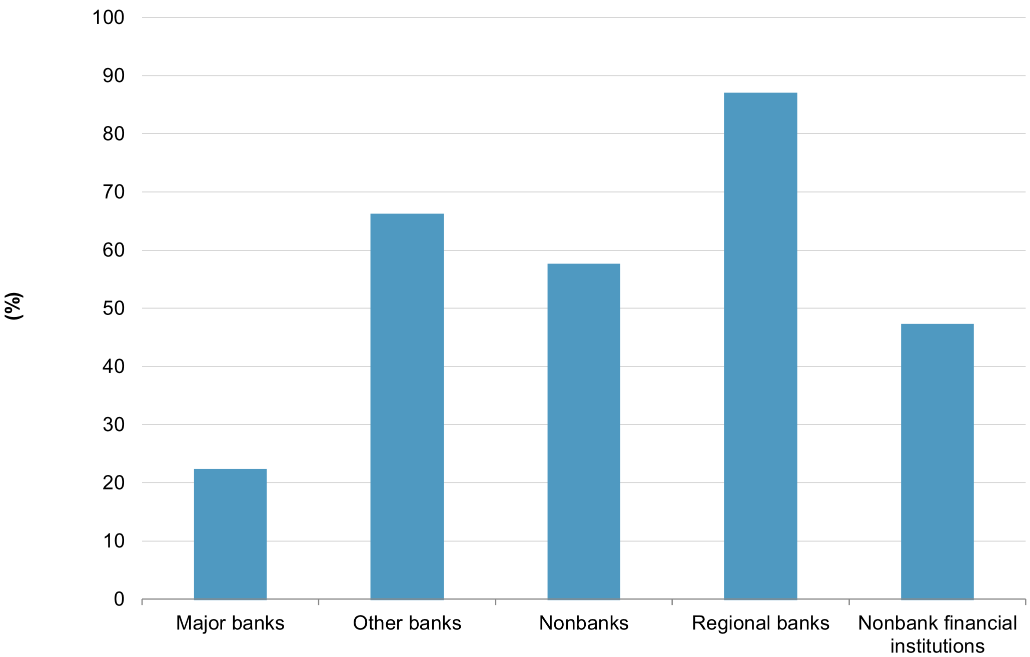
The use of lenders' mortgage insurance in Australian residential mortgage-backed securities (RMBS) has declined, bringing with it a change in the way the market defines prime and nonconforming loans. Mortgage insurers' underwriting standards historically have had a strong bearing on lenders' underwriting policies, but this, too, is changing. A heightened regulatory focus on lending standards is now the dominant factor shaping underwriting policies. But while shifting stakeholder expectations will continue to influence the credit profiles of Australian RMBS transactions, the fundamental credit analysis S&P Global Ratings uses to analyze credit risk remains relatively unchanged.

What Is A Prime Loan?

Prime loans usually are made to borrowers with a clean credit history. Before the financial crisis we generally defined prime loans as those made by traditional residential mortgage lenders, usually eligible for lenders' mortgage insurance (LMI) from a nonassociated and rated mortgage insurer. With the declining use of LMI in the RMBS sector, however, the traditional definition of prime loans has become less relevant (chart 1).

Chart 1

LMI Usage Is Declining
Percentage Of LMI Exposure By Current Balance



Note: Data as of June 2018. Source: S&P Global Ratings. Source: S&P Global Ratings.

The decline in LMI utilization reflects the reduced appetite for high-loan-to-value (LTV) ratio lending, which has slowed in response to regulatory requirements such as higher risk weightings for high-LTV ratio loans. The contraction in LMI usage is not a reflection of RMBS transactions becoming "less prime"; the collateral quality of prime portfolios has generally improved since the financial crisis. So while the traditional definition of prime loans has become less relevant, the underlying credit profile and collateral mix in prime RMBS has not changed markedly in the past decade.

Nonconforming: A Broad Definition

Nonconforming loans generally are made to borrowers who do not qualify for a residential mortgage from a traditional prime lender. The loans generally are ineligible for LMI coverage from a nonassociated mortgage insurer. They can include low-documentation and subprime loans. Subprime loans typically are made to borrowers with adverse credit histories.

The term "nonconforming" came into more widespread use after the financial crisis, when LMI and bank lending guidelines tightened. Nonconforming came to be used as a catch-all description for loans that were not considered prime under the tightened lending and LMI guidelines after the financial crisis. This definition encompasses near-prime loans and traditional subprime loans.

Lenders often differentiate nonconforming lending into near-prime and specialist lending.

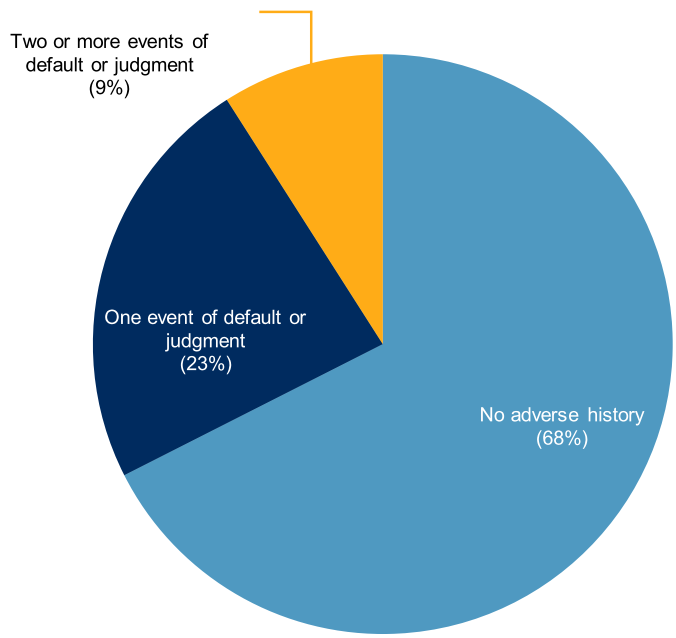
Near-prime lending can be made to borrowers who fail to qualify for a major bank loan due to minor issues such as having irregular savings, employment, payment, or credit histories. Specialist lending is similar to traditional subprime lending, and can include lending to borrowers with a limited history of self-employment. Lenders use these distinctions to price credit risk.

What Distinguishes A Prime From A Nonconforming Transaction?

The key factor that distinguishes a prime RMBS transaction from a nonconforming transaction is exposure to credit-impaired borrowers. All nonconforming transactions have some exposure to borrowers with a negative credit history (chart 2). Prime portfolios are made up of loans to borrowers who have clear credit histories, with no defaults, judgements, or other adverse listings, even though some pools can include a small percentage of loans of a minor nonconforming nature.

Chart 2

Nonconforming Transactions Are Exposed To Borrowers With Negative Credit Histories



Source: S&P Global Ratings.

S&P Global Ratings uses these distinctions to determine which transactions to include in the Standard & Poor's Performance Index (SPIN) for Australian prime and nonconforming mortgages. We do not classify a transaction as prime or nonconforming based on its exposure to loan products that have a higher credit risk, such as interest-only loans, investment loans, high LTV loans, and low-documentation loans. There are loan products with a higher probability of default in both prime and nonconforming transactions. The inclusion of riskier loan products in a transaction will alter its overall credit risk profile, and this will be reflected in its credit-enhancement levels.

We would not reclassify a prime transaction with a lower proportion of loans covered by LMI as nonconforming, for example, if its exposure to credit-impaired borrowers--the fundamental distinction--remained unchanged.

How Do These Definitions Affect Our Credit Analysis?

S&P Global Ratings conducts its credit analysis of Australian RMBS transactions at the loan level. The starting point of our collateral credit risk analysis is the archetypical loan (see Appendix 1 for the pool characteristics of the archetypical residential mortgage loan pool for Australian RMBS). Based on our criteria, we adjust the credit enhancement as the loan or pool characteristics vary from the archetypical loan or pool characteristics. This is the case for prime and nonconforming transactions. We can make further revisions to the credit enhancement in response to product-specific features and originator and servicer practices.

For nonconforming transactions, our criteria adjust the credit-enhancement levels for any loan to a borrower with an impaired credit history that includes at least one "credit event" in the past five years to reflect a higher likelihood of default. We consider a credit event to be an occurrence in a borrower's life, such as ill health or the loss of employment, that could trigger other events that result in a borrower being unable to meet payment obligations.

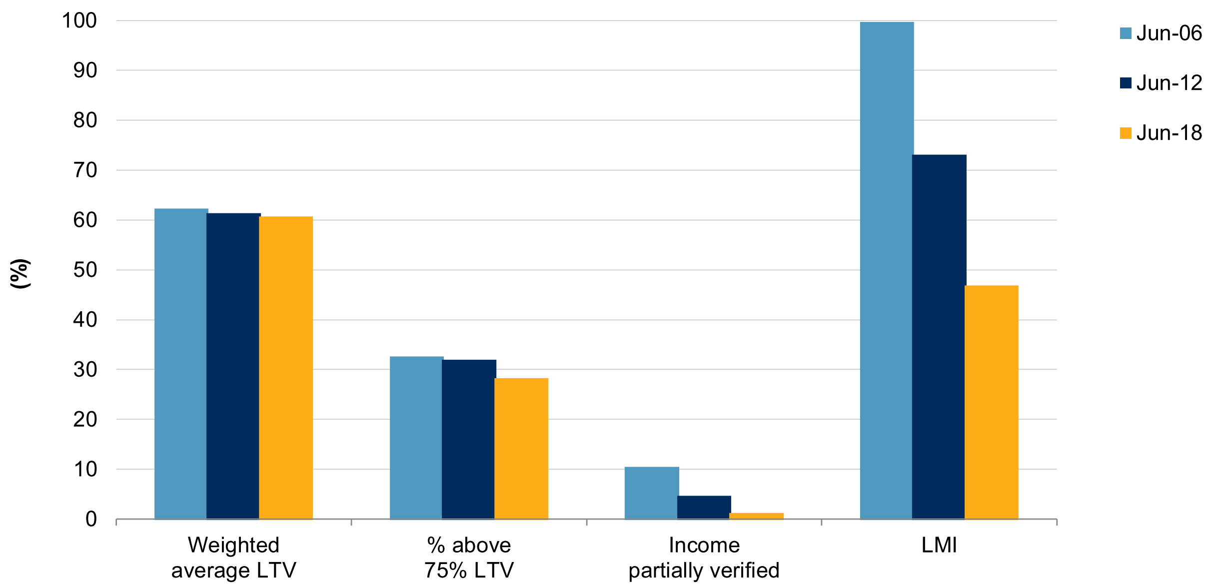
This is different to the U.S., where FICO scores are used as a key measure of borrower credit quality. Until recently, credit reports were not available in Australia to differentiate among the credit quality of borrowers if there had not been any adverse credit events. To supplement collateral risk analysis, we use in Australia borrower profile information that can affect borrowers' income and cash-flow stability as well as their potential mortgage payment behavior. We use the same analysis for prime and nonconforming transactions.

Portfolio Composition Before And After The Financial Crisis

The credit quality of Australian prime and nonconforming RMBS portfolios has improved since the financial crisis (chart 3 and chart 4).

Chart 3

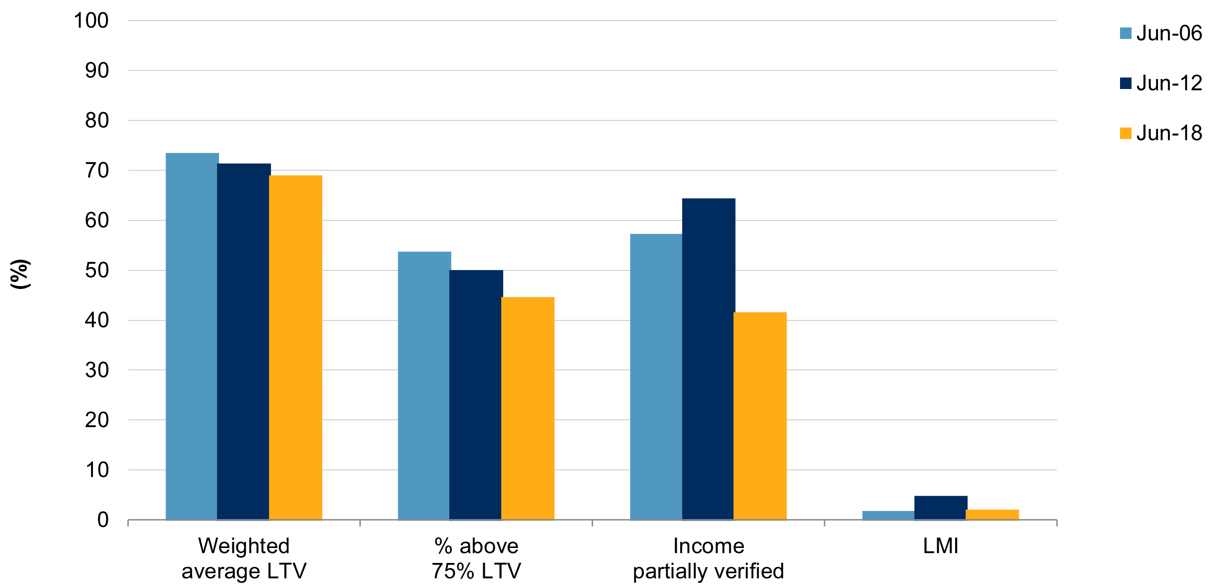
Australian Prime RMBS Portfolios' Credit Quality Has Improved Since The Financial Crisis



Source: S&P Global Ratings.

Chart 4

Australian Nonconforming RMBS Portfolios' Credit Quality Has Improved Since The Financial Crisis



Source: S&P Global Ratings.

We can see the improvements in credit quality by observing:

- The contraction in weighted-average LTV ratios.
- The contraction in portfolios' exposure to mortgages with LTV ratios exceeding 75%.
- The contraction in portfolios' exposure to borrowers whose income has been only partially verified.

The improvement in credit quality reflects the general tightening in lending standards since the financial crisis and, in more recent years, Australian regulators' greater scrutiny of the lending sector amid high household debt, elevated property prices, low interest rates, and low wage growth.

What About Debt-Serviceability Standards?

Australian household debt relative to income has increased, driven by strong property price growth and low interest rates. This has prompted increased regulatory attention on lending standards in recent years. S&P Global ratings has observed a general convergence in lending standards in the RMBS sector in line with the Australian Prudential Regulation Authority (APRA)'s expectations, as articulated in Prudential Practice Guide 223. This has occurred in the bank and nonbank sectors, and in prime and nonconforming transactions.

APRA's guidelines have become more prescriptive in recent years, resulting in greater consistency in lending standards in some areas. Most notable are the inclusion of interest-rates buffers and floors in debt-serviceability calculations and the calculation of principal-and-interest repayment amounts after an interest-only period ends.

We expect to see an increased regulatory focus on the verification processes that lenders use to determine borrowers' expenses. The growth in third-party-originated lending is also an area of potential risk. Third-party originated loans were a common origination channel before the financial crisis. Their share of new lending declined to 36% after the financial crisis in the authorized deposit-taking institutions sector. By June 2018, it had increased to 50% of new lending, according to APRA statistics. The involvement of brokers and third-party originators in the RMBS sector is limited to the referral of borrowers to lenders, with brokers performing more of an intermediary role between the lender and borrower. Credit decisions generally are made centrally, and third parties are not involved. 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.

Some lenders have processes in place to verify the information they receive from brokers, but practices vary. With the growing reliance on this origination channel to expand market share, this will be an area of increased regulatory focus.

S&P Global Ratings believes debt-serviceability standards have increased in line with regulatory expectations, but there is always room for improvement.

Could A Decline In LMI Usage Lead To A Deterioration in Lending Standards?

We are often asked whether the decline in LMI usage could lead to deterioration in lending standards. This is a valid concern because LMI providers often act as a second set of eyes in the underwriting process, given the close alignment between lenders' underwriting policies and LMI guidelines. We believe there are a number of factors that help to address this risk.

Regulatory authorities such as APRA will continue to monitor lending standards. There has been a general tightening in lending standards since late 2014, and this will continue, particularly in the wake of the Banking Royal Commission. We have observed a general convergence in lending standards at bank and nonbank lenders, in line with regulatory expectations. In addition, investor preferences will continue to influence the prevalence of LMI coverage in transactions.

Stakeholder Expectations Have Shifted

Stakeholder expectations have an influence on the composition of RMBS loan portfolios. The Reserve Bank of Australia's repo-eligibility requirements, the Australian Prudential Regulation Authority's mortgage-lending guidelines, LMI guidelines, and investor preferences, for example, at various points have all influenced the credit profile of many prime transactions since the financial crisis.

Greater regulatory scrutiny of the banking sector will continue to affect the collateral profile of bank-originated RMBS portfolios. Restrictions on investment and interest-only lending will reduce these exposures in bank-originated RMBS portfolios. The more recent vintages of nonbank RMBS portfolios meanwhile are likely to have a higher exposure to investment and interest-only loans as nonbank lenders capitalize on lending opportunities in this space. This trend is also playing out with self-managed super fund loans and loans to nonresidents.

Is The Definition Of Prime Loans Still Relevant?

We believe the definition of prime loans remains relevant for the time being. Around 89% of the total number of prime RMBS transactions outstanding have some level of LMI exposure. While LMI utilization is declining, it has been gradual and we do not expect LMI exposure to be completely removed from Australian RMBS portfolios in the short term. Given the LMI exposure is still significant across RMBS transactions, lenders' credit policies, and underwriting decisions will continue to be informed by LMI policies and guidelines in the short to medium term.

What's In A Name?

Shifting stakeholder expectations and evolving credit market dynamics, including declining usage of LMI, have altered the traditional definitions of prime and nonconforming loans. While these forces will alter the credit risk profiles of prime and nonconforming portfolios at different points in the credit cycle, our fundamental credit analysis remains the same, with marked deviations from the archetypical loan profile reflected in higher credit-enhancement levels.

Appendix

Table 1

Pool Characteristics Of Archetypical Residential Mortgage Loan Pool For Australia RMBS

At least 250 consolidated mortgage loans	
Borrower characteristics	
	Pay-as-you-go (PAYG) employees
	Credit check obtained and borrower has a clear credit history
	Loan is currently performing and not delinquent
	Australian resident
	Borrower is not a first-time buyer
	Owner-occupier
Loan characteristics	
	First-registered mortgage over freehold land or crown leaseholds with a lease term of at least 15 years longer than the loan term
	75% loan-to-value (LTV) ratio
	Income and affordability fully verified (Full Doc)
	Borrower's deposit money (or savings history) are verified
	Standard discretionary variable rate (without interest-only period)
	Fully amortizing 30-year loan with even and regular loan installments
	Greater than 12 months* seasoned and less than 5 years seasoned
Security property characteristics	
	Geographical diversity, such as state, region, nonmetropolitan, and postcode

Table 1

Pool Characteristics Of Archetypical Residential Mortgage Loan Pool For Australia RMBS (cont.)

	Full general insurance over security property, including appropriate cover for geographically specific risks, such as earthquakes
	Residential property: detached, semidetached, townhouses, strata-title flats, apartments, and units (excluding high-density apartments and hobby farms)
	Full valuation (or appraisal) of security property at time of approval
	Maximum property value A$1,000,000
Geographic concentration limits	
	New South Wales <=60%
	Victoria <=50%
	Queensland <=40%
	Western Australia <=25%
	South Australia <=25%
	Australian Capital Territory <=5%
	Tasmania <=5%
	Northern Territory <=5%
	Maximum nonmetropolitan exposure <=10%
	Maximum postcode exposure <=2%
	Maximum inner city exposure 0%

*The minimum 12-months seasoning does not apply to issuers of RMBS that have at least five years of stable loan performance data at least in line with the industry performance from RMBS issued to-date.

Related Research

- Australia's Property Price Slowdown Eases Risks Across Sectors, Report Says, Aug. 13, 2018
- Why Australian RMBS Ratings Are Less Reliant On Lenders' Mortgage Insurance, June 13, 2018
- Asia-Pacific RMBS In The Spotlight: Strong Collateral Performance Underpins Credit Quality, April 30, 2018
- Australian RMBS Sponsored By Nonbanks: Stable Performance Supports Rating Stability, Nov. 2, 2017
- Australian RMBS Sponsored By Regional Banks: Stable Performance Supports Rating Stability, Aug. 1, 2017
- An Overview Of Australia's Housing Market And Residential Mortgage-Backed Securities, July 31, 2017
- Australian RMBS Sponsored By Major Banks: Stable Performance Supports Rating Stability, June 5, 2017
- Australian RMBS Originated By Other Banks: Strong Collateral Quality Supports Rating Stability, March 19, 2017

- RMBS Performance Watch: Australia, published quarterly
- RMBS Arrears Statistics: Australia published monthly

This report does not constitute a rating action.