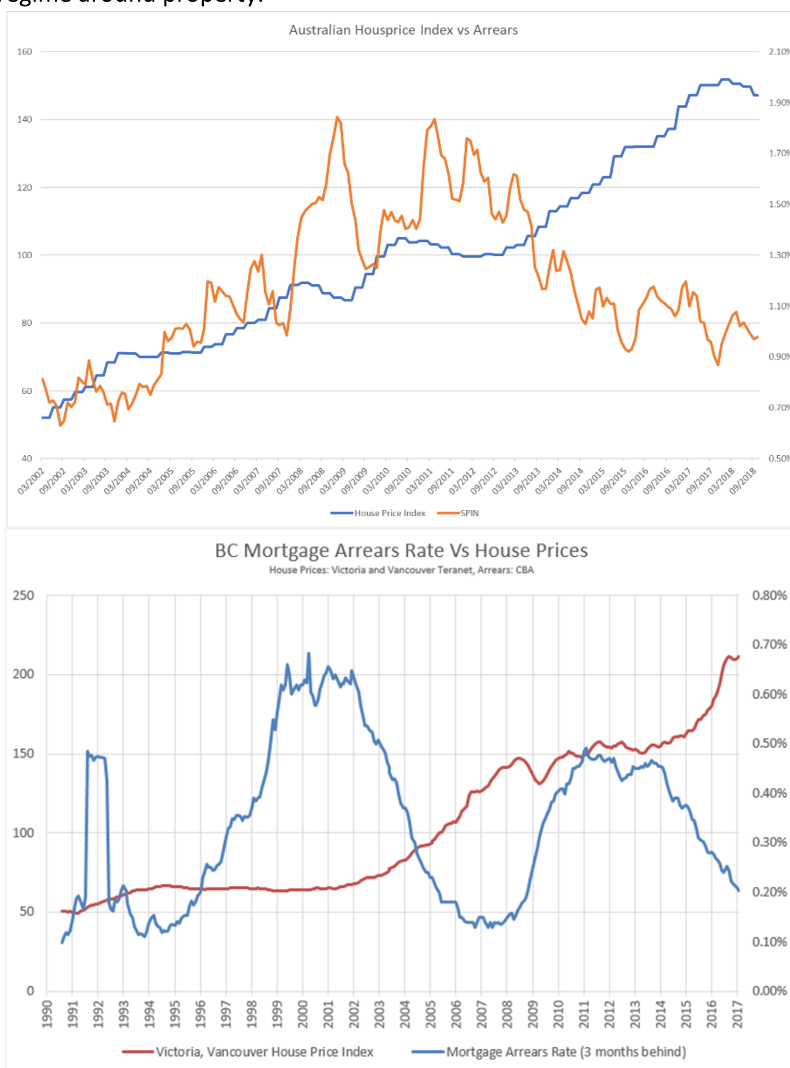
Is RMBS a safe bet in 2019? Jan 2019

Last year was the most dynamic year for the RMBS market I can remember. We had the implementation of APS120, a credit crunch imposed by APRA, a departure of our rate cycles from the US, a turnover in house prices, private equity activity in the non-bank mortgage space, and a re-emergence of competition in syndicated warehouse facilities driven by foreign banks. This year is again set to be challenging. The findings of the Hayne Royal Commission are due, ASIC is increasing its focus on the adherence to the NCCP, recent offshore changes to the regulatory environment is impacting demand for Australia Issuers, APRA's bank capital finalisation appears to encourage more issuance of RMBS by the big four banks and to top it all off we have a potential change of government and with it a threat to a change in the tax regime around property.

Do House Prices Matter to RMBS Performance?



Let's take a step back to and revisit how property prices relate to an RMBS structure. It's the financing of the loans that are made to borrowers, secured by the property via a mortgage as credit enhancement. If the borrower fails to pay that loan, the mortgagee will seize the collateral, being the property, and sell it on the open market to recover the loan. In this case house prices in aggerate will matter, and the loss in the event of default will be a function of the Loan to Value Ratio ("LVR") at the time of sale.

Borrowers default all the time, this is a fact, it's not a perfect world. An RMBS structure is designed to manage this through a macro cycle. The first 12-18 months of any new loan is the ramp up period of pre-payment conditioning. So, if a borrower cannot manage this new loan comitment, they will default, post this period the factors even out, and the dominant feature of why borrowers default becomes the change in their employment status.

There is no evidence of house price declines acting as a leading indicator to higher arrears. In Sep 2018, we undertook a research tour to North America, in which we met, amongst others, the Bank of Canada. We discussed the similarities of both the Australian and the Canadian (British Columbia) economies. Both showed some informative comparisons around the relationships, or lack thereof, of property prices leading arrears. BC property prices have been soft for almost two years now, and while the Canadian central bank is acutely aware of this weakness, that fact of the matter is that it has not driven an increase in arrears. Their views (which we share) is that house price weakness is not causal in this regard. By comparison high arrears are almost always likely to impact house prices, however this is not what drove Canadian or Australian price softness for that matter.

The overarching concern with debt investors at present, is a fear that the retracement in house prices will affect performance of the RMBS asset class. The evidence however suggests houses prices have no direct casual impact to mortgage delinquencies, noted above, through a normal macro cycle. The chart above shows the Australia House Price index vs the total prime arrears for Australia. There was only one period of co-incidence, and that was around the financial crisis, an out of cycle macro event, (*see our research on Demystifying the big short for Australian RMBS*). It's important to note that Australian mortgage losses were inconsequential during this period, even though arrears rose. The weakness in RMBS in this instance was related to general global credit market volatility.

The APRA and Pillar 3 data shows the low loss rate on lending to households over the 2008-13 period on housing loans, which made up around 90 per cent of bank lending to households over this period, averaged 3 basis points per year. Most of the losses on lending to households arose from personal lending (credit card and other personal lending), which was about 4 times as large.

Do newly originated loans in an RMBS pool, increase its risk?

Newer loans are of greater risk of arrears and default, everyone knows this. In times of increased competition between lenders, loan seasoning falls within pools - due to higher refinancing. The mitigating factor to this is that within RMBS pools, the credit enhancement required for a new loan vs a seasoned loan is higher, all other things being equal. The reality is, all borrowers will not default in this ramp up period, as if this was the case, there would be no mortgage market. As such this information is captured and properly accounted for in the system. In our opinion this risk is very often "over-accounted" for, with many issuers using higher seasoning to game other metrics. This however brings a diversity buffer as a benefit with a blend of seasoned loans, and all that a high concentration of new loans does is increase the risk around cashflow modelling, not the risk of loss. In addition, a good portion of the loans that are in arrears, will also cure, be refinanced or be paid out of the pool.

So, putting it in plain English, newer loans are assessed by rating houses as being riskier, which means issuers must keep more capital against them. Known risks do not break a system, but rather it is those risks that are under-accounted for and that change that pose a greater risk. Under-seasoned loans will not break a pool in a normal macro cycle, nor do they constitute a stand-alone large autonomous risk statistically speaking. Rating agencies could increase the factor of risk on a loan considerably basis its seasoning, this is increased further if this new loan belongs to a first home buyer also.

To add substance to the risk trade-off between a newly written loan that defaults within the ramp up period, there is the element of the borrower's equity i.e. deposit, providing the first loss buffer on a mortgagee sale. In the case of higher LVR loans there will often also be Lenders Mortgage Insurance ("LMI") on these same loans.

Upgrades/Downgrades of Australian RMBS Tranches 2018

Sector	Tranche	2013	2014	2015	2016	2017	2018
Big Bank	B	0/0	0/0	0/0	**4**/0	0/0	0/0
Big Bank	C	0/0	0/0	0/0	1/0	0/0	0/0
Big Bank	D	0/0	0/0	0/0	1/0	0/0	0/0
Big Bank	E	0/0	0/0	0/0	1/0	0/0	0/0
Big Bank	F	0/0	0/0	0/0	0/0	0/0	0/0
Sub Total		0/0	0/0	0/0	7/0	0/0	0/0
Regional	B	0/0	3/0	0/0	4/0	0/0	0/0
Regional	C	0/0	1/0	0/0	2/0	0/0	0/0
Regional	D	0/0	0/0	0/0	1/0	0/0	0/0
Regional	E	0/0	0/0	0/0	0/0	0/0	0/0
Regional	F	0/0	0/0	0/0	0/0	0/0	0/0
Sub Total		0/0	4/0	0/0	7/0	0/0	0/0
Non-Bank	B	1/0	0/0	0/0	8/0	0/0	0/0
Non-Bank	C	0/0	1/0	0/0	7/0	0/0	0/0
Non-Bank	D	0/0	0/0	0/0	7/0	0/0	0/0
Non-Bank	E	0/0	0/0	0/0	2/0	0/0	0/0
Non-Bank	F	0/0	0/0	0/0	0/0	0/0	0/0
Sub Total		1/0	1/0	0/0	24/0	0/0	0/0
NB NCM	B	0/0	1/0	0/0	6/0	7/0	1/0
NB NCM	C	1/0	1/0	2/0	8/0	9/0	1/0
NB NCM	D	1/0	1/0	4/0	9/0	6/0	1/0
NB NCM	E	1/0	1/0	4/0	8/0	5/0	1/0
NB NCM	F	1/0	1/0	4/0	4/0	2/0	0/0
Sub Total		4/0	5/0	16/0	35/0	29/0	4/0
All Sectors	*B*	*1/0*	*4/0*	0/0	*22/0*	7/0	1/0
All Sectors	*C*	*1/0*	*3/0*	2/0	*18/0*	9/0	1/0
All Sectors	*D*	*1/0*	*1/0*	4/0	*18/0*	6/0	1/0
All Sectors	*E*	*1/0*	*1/0*	4/0	*11/0*	5/0	1/0
All Sectors	*F*	*1/0*	*1/0*	4/0	*4/0*	2/0	0/0
Total	137/0	5/0	10/0	16/0	73/0	29/0	4/0

So, in a period of falling house prices, this risk of loss has increased on each of these loans but it is buffered by this equity, the LMI and pool diversity. An additional structural feature that considers that new loans have a higher probability of default is that each loan is assessed basis its probability of default at the time of origination, which includes a variety of other factors that are considered, not just its seasoning. Which means as these shorter seasoned loans increase their "seasoning" in the structure, it creates an accelerated over subordination position of the remaining pool. In the case of the short-seasoned loans that do default, if they do in a normal macro cycle, if there are losses, i.e. the owners' equity is lost, they are buffered by LMI, the collateral or excess income, leaving the remaining pool in a better aggregate position.

So how has the recent increase in new seasoned loans impacted the market. In 2018, there were 137 upgrades and zero downgrades of RMBS. The 2016 vintage dominated, with the 2017 vintage a far second, but combined represented close to 75% of the upgrades. There was even a deal issued in 2018 that experienced upgrades across all the rated junior tranches in the same year.

This is evidence that the subordination at issue is delivering solid upgrades in a shorter window of 12 to 24 months. Meaning that subordination is proving to be ample when reconciled against actual arrears and losses. In other words, there is no evidence of a capital shortfall in domestic public RMBS or more importantly there is no evidence of any kind of negative mass ratings migration as some have suggested.

What are the early warning indicators?

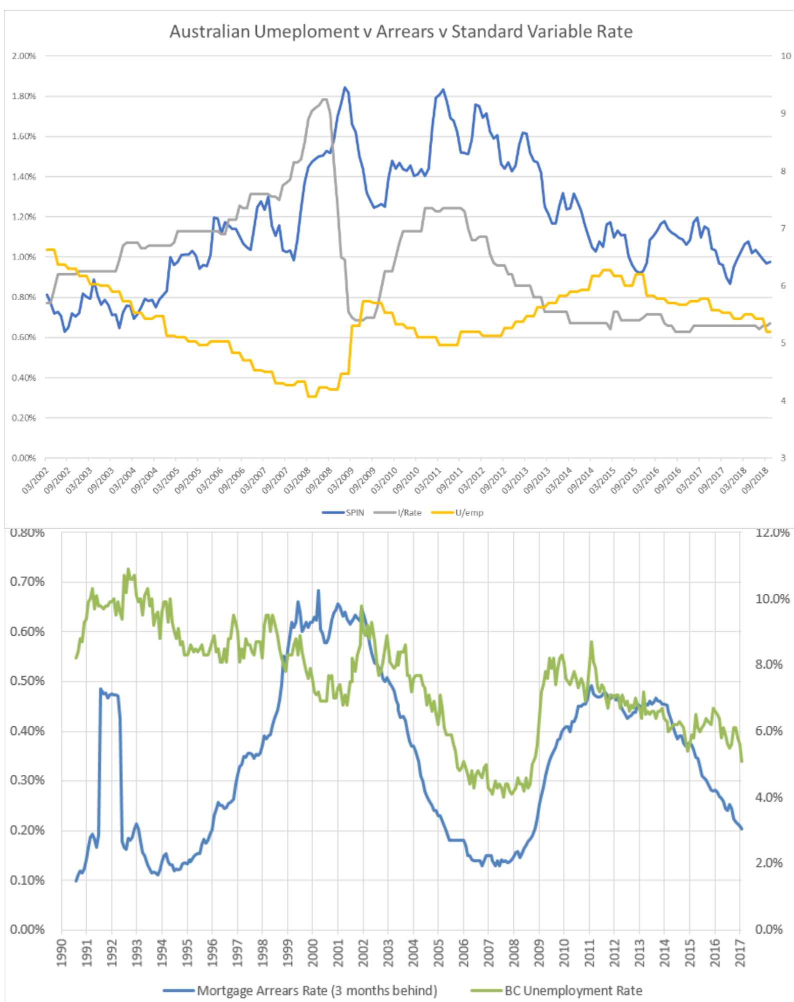
There are many of which I have noted topical ones below;

Reductions in the "aggregate mortgage buffers" – balances in offset accounts. These have been declining as Interest Only lending has reduced. Offset accounts peaked at around 30% in 2015 and are around 15% of outstanding loans now. This represents around two to two and half years of scheduled payments.

Increased costs to service debt i.e. Increased mortgage rates - Ability to Pay Factor. Since 2015, the cost of investor and interest only debt has increased by around 1%, which has reduced Debt Servicing Ratio ("DSR") by 5% only for these borrowers. The data is telling us borrowers have used savings and their offset balances to help manage this decrease in DSR. RBA research indicates that a 1% increase will increase the likelihood of stress by 1.4x each borrowers default probability.

The RBA also has confirmed that they have reliable and relatively timely indicators that point to pockets of household financial stress, but this is not widespread or systemic at present. The DSR is an indicator of household stress, if we focus on lower-income households and a '30%–40%' DSR as a rule, this is always a good leading indicator. Applying this rule using required debt servicing repayments suggests that around 5 per cent of indebted owner-occupier households could be classified as facing housing stress and this is stable over time. Households with high required DSRs only make up a relatively small share of all indebted owner-occupiers, but they represent a more sizable share of those on lower incomes. The latest HILDA survey also reports the share of indebted owner-occupier households with high DSRs that have a large mortgage relative to the property value. Households with a high loan-to-valuation ratio (LVR) have greater risk as they are less likely to be able to pay off their mortgage by selling if property prices fall. The RBA predicts, that Owner-occupier mortgagees in the HILDA survey with a required DSR above 30 per cent are twice as likely as other households to have an LVR above 80 per cent.

Unemployment is a key leading indicator, as it ultimately leads to an increase and an accelerated delinquency, as the financial buffer of the household is destroyed. The observable behaviour of Australian borrowers is that they use savings first, then cut costs out of their cashflows before defaulting and/or selling the house. You can see in both the Australian data and the Canadian data there is a relationship in times of stress, this can be observed in the period between 2008 and 2013. BC arrears fell further in 2018 to 0.15% along with a stronger employment market heading towards full employment (despite persistent house price weakness).



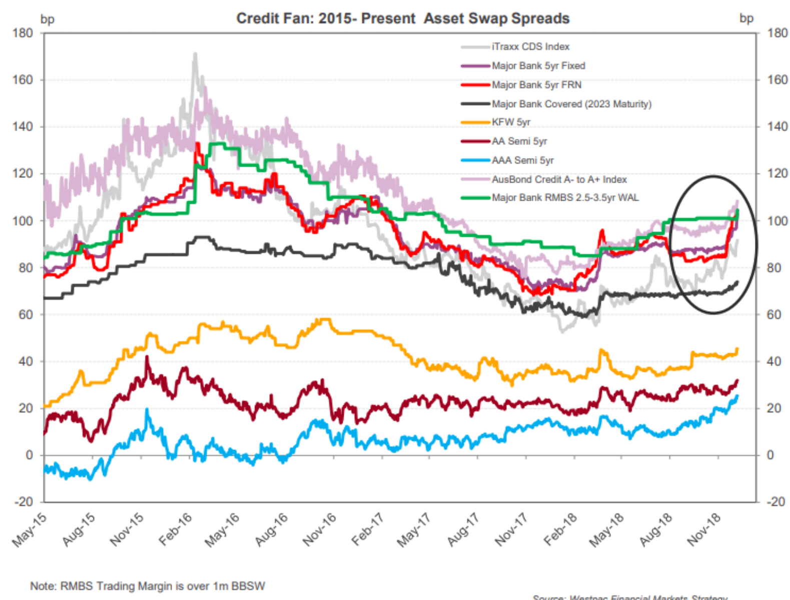
The rating agencies speak to the biggest factor in arrears being a "change" in employment status. Perversely that means that your safer borrowers present the greatest risk, as they are the ones that are under-capitalised by the system, but the ones that do the most harm when their employment status changes. By comparison non-conforming borrowers (casual employment, self-employed), are heavily penalised from a capital perspective meaning the risk is well accounted for by the system, furthermore a negative change in these areas is much less impactful.

Australian 30+ Delinquencies for 2018 have broadly remained around 1%, and the 90+ around 0.50%. Interestingly the owner-occupied vs investor arrears are higher contradicting the regulatory narrative that investor loans are riskier. In the Nonconforming space, it's always a mixed bag, however the flagship issuers had a range of arrears for 30+ from 0.92% to 1.54% and 90+ between 0.34% and 0.71%, which also bucks the notion that the mortgage market is in distress.

What are Credit Spreads telling us?

The retracement in RMBS spreads in 2018 is not being driven by house price declines. Spreads were generally weaker across all debt sectors, and RMBS spreads have retraced broadly to 2016 levels, like all other debt sectors.

Questionable earnings outlooks, political uncertainty and global volatility have driven global funding markets wider in 2018, and RMBS spreads have not been immune to this. What exacerbates the impact on Australian RMBS today versus years gone by is that our larger originators are now regular issuers to overseas markets, meaning that global funding pressures have a greater impact today than in any point in the sectors history.



Realm Strategic Positioning

As you may have read in our monthly commentary, we had reduced our RMBS targeted exposure from approximately 35% to 15% leading into Q2 of 2018. Our view was that the RMBS market had become fully priced on the back of increased foreign investor demand. In addition, we also took the view that technical factors would have a bearing, specifically the new APRA regulatory focus on serviceability and capital would see an increase in issuance, especially out of the non-bank sector as they looked to fund their growth in lending as ADIs became more prudentially regulated. To re-cap, we have been reducing Sub Investment Grade RMBS, over the last couple of years and moving up the capital structure into senior RMBS A tranches (AAA rated), B (AA rated) and C (A rated) notes. At the end of 2018 Q2 we meaningfully reduced this higher rated exposure, as we began to form the view that senior funding spreads across all markets would widen, in addition the sector risk had become expensive on a relative value assessment. Simultaneously, we made a re-allocation to upstream funding in Syndicated Mortgage Warehousing, which we believe exhibits a better risk adjusted return dynamic, for where we are in the cycle.

2019 Realm RMBS Outlook

Supply Side Factors

There has been an increase in issuance since Q3, dominated by the growth in the non-bank sector. This is mainly because ADIs are writing less loans because of regulatory oversight, and a heighted focus on quality at the super prime end of the lending spectrum. In addition, the growth of non-banks is being funded by strong Syndicated Mortgage Warehouse competition from foreign banks, in which they are funding the gap in the Senior Syndicated Mortgage Warehouse funding market, that the major Banks cannot fund, due to accelerated growth in the sector. This has the effect of also increasing the turnover of issuance given the current capacity of the Syndicated Mortgage Warehouse Market.

This rate of growth won't be sustained, and the non-banks know it, they are just trying to fill their boots by winning as much share as they can while the majors are under regulatory siege. The Royal Commission findings are due to be released in early 2019 and coupled with a relaxing of the prudential caps imposed by APRA, loan growth in the non-bank space will begin to abate. We also see with the introduction of the new bank capital rules (*See our T2 capital review Oct 2018*) around total capital being finalised, that the utilisation of RMBS issuance out of the big four banks will increase.

Demand Side Factors

Our market locally experienced investor fatigue to non-bank issuance, also many managers were nearing limits around non-bank exposure given the weight of total issuance in 2017 and 2018, including the increased funding and capital requirements of Syndicated Mortgage Warehousing. Bid cover ratios began to abate, and a final validation of this was the National Australia Bank RMBS deal that could not clear all tranches noting the most junior note received the strong absolute price support, with bids through the guidance range, but actually cleared at the wider end of the guidance, indicating they had to accommodate conditional bidding to cornerstones to clear other tranches that would appear on the face it, priced expensive.

Meanwhile, the recent Bank of England's termination of the Term Funding Scheme ("TFS") has had the effect of reducing demand for Aussie issuers overnight. This TFS allowed banks to put mortgages to a Bank of England, which was essentially killing the supply of British RMBS to the locals, while at the same time ECB asset purchases were soaking up Dutch issuance (the other large issuer in Europe). The result was that UK and European investors went looking for yield elsewhere and more specifically Australia. As ECB asset purchases end and the UK issuers get back on line, we expect to seeing senior funding spreads globally stay anchored

at these already wide spreads to accommodate this issuance. In addition, more specifically to RMBS issuance, the ECB has finalised and implemented Simple Transparent Securitisation rules which effectively precludes Australia issuers from issuing into this market. The issuers are aware of this, so they have turned their attention to sucking up capital from domestic investors that haven't got the memo.

It's early days, but the announcement of the Australian Business Securitisation Fund – of which Realm has been invited into the working group to consult to treasury on the blueprint design is a positive for the sectors underlying loan performance view.

An unknown at this stage is the potential for future tax policy changes that may affect housing as an asset class. Policy is fluid here and not definitive. You may see a change in pool mixes post this potential tax policy change, with less IO and Investor concentrations. The fear that house prices will crash is probably over stating the fear mongering of the politics, however ultimately the laws of capital allocation will prevail, and capital will be directed to where the best risk adjusted returns are expected, and where leverage in this equation will maximise this return expectation. This implies the strong marginal bid, driven by investors who use negative gearing to fund capital growth will abate and the historical strong price gains made in Australian property as an asset class may be a thing of the past.

Should you allocate to RMBS now?

The RMBS market has a way to go before settling. As a benchmark, we see value in the senior RMBS curves a little wider than where they current are trading. In the lower part of the capital structure, we are still cautious of a crowding out and spread pressure of major bank issuance, the recent NAB transaction is evidence of this. Even though this part of the market has been well supported by an increase in the re-emergence of High Yield funds, we saw the coverage ratios decline, indicating that they are reaching limits here. It also appears, LMI use is increasing and that the rating agencies are revisiting this as part of their credit modelling. We are cautious that this, yet again, could spook investors and become a game changer for structures. Having said that, the loans that are getting written under this new regulatory framework are the best the Australian economy have seen for a few decades. We are cautious on the 2016/2017 vintages given the potential for LVR stress, however this is not eventuating, given the strength in the employment market and furthermore these vintages have experienced rating upgrades by rating agencies. On our positioning, we are targeting well-seasoned shorter securities, syndicated warehouse exposures and we are picking the cream out of the junior risk markets as margins drift. We believe the basis between RMBS spreads and other debt assets will widen as these demand and supply issues play out in 2019.

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