Suncorp mortgage bond failure 'a canary' - The Australian **05.03.2019**

An article written in the Australian on March 5th around the inability of a Suncorp originated Mortgage Bond to repay investors is sensational reporting, misleading and ill-informed.

More specifically the following statement was made in the article;

"Suncorp has unexpectedly declared a residential mortgage bond worth $120 million may not repay all investors after the share of borrowers in arrears rose to a trigger point, putting the distributions in doubt"

What Is Actually Happening?

An RMBS transaction that was issued by Suncorp in 2010, has been amortising as expected since issuance, approximately 12% of the bond is outstanding to be repaid. The transaction will be refinanced by Suncorp when it reaches a balance of 10% of original issuance (clean-up call). This is expected to occur in the current year.

The original size of the transaction was $1bn and contained some 4711 loans. There are now circa 1000 loans left to be repaid, and out of that around 20 are in arrears. Given the small pool balance and the reduced number of loans compared to at issuance, the balances of the 20 odd loans has been large enough to increase the arrears for >60 days to above 3% of the outstanding pool. The loans >60 days in arears by value of loans is currently 4.35% but the >60-day arrears by number of loans is only 2.26%, implying the delinquent loans are relatively few but relate to larger specific loans relative to the rest of the pool. This threshold has hit what is known as an arrears trigger.

What is an arrears trigger?

Mortgage bonds generally maintain an arrears trigger in the documentation. In simple terms if more than a certain percentage of total mortgage value (in this case 3%) are behind for a certain period (in this case over 60 days for an average over 12 months) the structure stops paying down principle for the junior bond-holders. This is a structural feature that looks to maintain subordination ratios and reduces costs within the funding structure. It does not increase the risk by reducing subordination to the senior bond holders but provides comfort for senior bond holders that there is adequate subordination and excess income for the life of the transaction.

Why does an arrears trigger exist?

It is not uncommon for RMBS transactions approaching their 10% clean-up to trigger the sequential pay arrears trigger, in-fact this has occurred on two prior occasions recently (e.g. Torrens 2010-3, SAMT 2011-1, etc.). Structural features, like this Step-Down feature, will switch the Serial principal repayment trigger on and Sequential payments off, can also switch back to Sequential, meaning only the senior bonds receive all the cashflows. This is quite common and a standard feature in RMBS transactions globally. This does not mean the transaction is in default, nor has the bond holders lost any money in such a scenario. All bond holders still receive coupons and principal as allowed under the documentation. When the most senior bonds are repaid, then the next bond in sequential order will receive principal and begin amortising again. In addition, if these arrears are cured, i.e. they fall back to the 30-day bucket or are resolved by Suncorp selling the property and repaying the loans, bringing the 60days arrears back under the 3% covenant for a minimum of 12 months, the Serial trigger may be reinstated and principal will begin to flow to all bonds again, as allowed under the transaction documents.

Understanding the clean up call

Banking institutions, are not allowed to use date-based calls in their RMBS transactions, e.g. nominating a date they refinance the mortgage bonds (unlike non-banks). Essentially, they need to leave the bond outstanding until the pool balance amortises to 10% of its original size. In the case of the Suncorp originated APOLLO 2010-1 the pool started at 1 billion AUD and currently stands at 120 million AUD. As such, borrowers only have to repay or refinance 20 mil for the pool to amortise to this 10% clean up level (100 mil / 1 billion). This should happen later in calendar year 2019.

Law of Large Numbers vs Idiosyncratic Risk

In a big pool you get diversity which delivers a level of risk that is largely reflective of that of the macroeconomic system, however as the pools shrinks, the individual loans become more important on a relative basis. In the case of this pool, if you do get an anomalous concentration of non-performing risk this can occur. Here you have 20 odd loans out of around 1,000 that have fallen behind. This has translated to arrears in the 60+ day bucket of a little over 4% at his time and has persisted for the last 12 months over 3%.

Is there a potential for holders of the bonds in this RMBS transaction to lose money?

Let me fly the flag for a second on this question here – No Australian RMBS transaction has ever defaulted, and all residential mortgage back pools and notes have been repaid in full. Having said that, it does not remove the probability (however remote) that this may happen, however it is extremely unlikely. The probability of such an event occurring in this pool given the mitigants and the likely term to call is, frankly, inconsequential. Ultimately the documentation has acted to delay the paydown for junior noteholders, but there is no loss or charge off.

Borrowers miss payments all the time, it happens. Are these 20 odd borrowers unique? No. Will these loans be resolved? Yes. Will investors lose money if all these 20 odd loans move in mortgage in procession and are sold? – let's explore some facts.

- The Weighted Average LTV on the portfolio is 50.27% (ignoring any property market increase from 2010)
- 100% of the deal has LMI insurance
- Less than 1% of the pool has an LTV >85% and less than 2.5% has an LTV >80% (ignoring property market increases from 2010)
- No LMI claims have been made on any loans over the life of the deal i.e. no loans have suffered a loss post sale of the property and required a mortgage insurance claim

For a note holder to suffer a loss, and we are talking about the most junior note holder here in this transaction, which has approximate 4% balance in the current structure, all of the homes would need to be sold for a substantial loss from their original financing value in 2010, and then the mortgage insurer would have to deny or not pay the claim for losses.

These non-performing assets will be resolved. Given that the loans have been outstanding for more than 8 years, the likelihood is that there is a reasonable buffer in the value of the property.

If the mortgage insurer decided to reject the claim or only partially pay, this would likely be a function of incomplete or inadequate underwriting or servicing performance. If this was the case, it would be a contravention of the reps and warranties made by the bank to the trust, meaning the trust would need to be made good.

As such even in a worst-case scenario where all loans experienced a 100% loss, and this would mean the houses are sold for a $1, the prospect of a loss of capital is as we said earlier, extremely unlikely.

Holders of the junior bonds would be relaxed at present despite the hubbub.

Is this a canary in the coalmine?

The tail of a deal is beset by a whole lot of noise. At this stage idiosyncratic factors can have an upsized impact on a small pool. Nothing in this event would act as a marker for us. In fact, the event is well within the normal range of events.

And The article? - Our comments in red –

Suncorp has unexpectedly declared a residential mortgage bond worth $120 million may not repay (sensationalizing a technical, yet extremely unlikely possibility- while this is technically possible, it is highly improbable) all investors after the share of borrowers in arrears rose to a trigger point, putting the distributions in doubt (overstated, the trigger delays repayment of capital to junior holder by a matter of months and has no impact on the coupons).

The surprise development (only a surprise to people not following this market, elevated arrears in mature pools is normal) may be a sign of further stress in the $1.7 trillion mortgage system (these figures are captured in weighted arrears data). It is also believed to be the first local mortgage bond to encounter difficulty since the global financial crisis (difficulty is a really vague term, its arrears are on the high side of normal, it is not experiencing difficult and will (with a very high probability), be called in the period of the next 6 to 12 months. .

CLSA banking analyst Brian Johnson pointed to a combination of borrowers carrying too much debt and rising arrears rates in states such as Western Australia, where unemployment has increased at the same time house prices have fallen, as a possible reason for the announcement. (There was no cohort concentration based around geography, so this is not correct)

“To get to this point, for a securitisation this old to go bust — that is weird,” Mr Johnson said. (Horrible un-informed comment from someone who is professionally employed to know better. The securitization has not gone bust, I expect this comment to be retracted, Also, hitting an arrears trigger is also not “weird”, see explanation above.

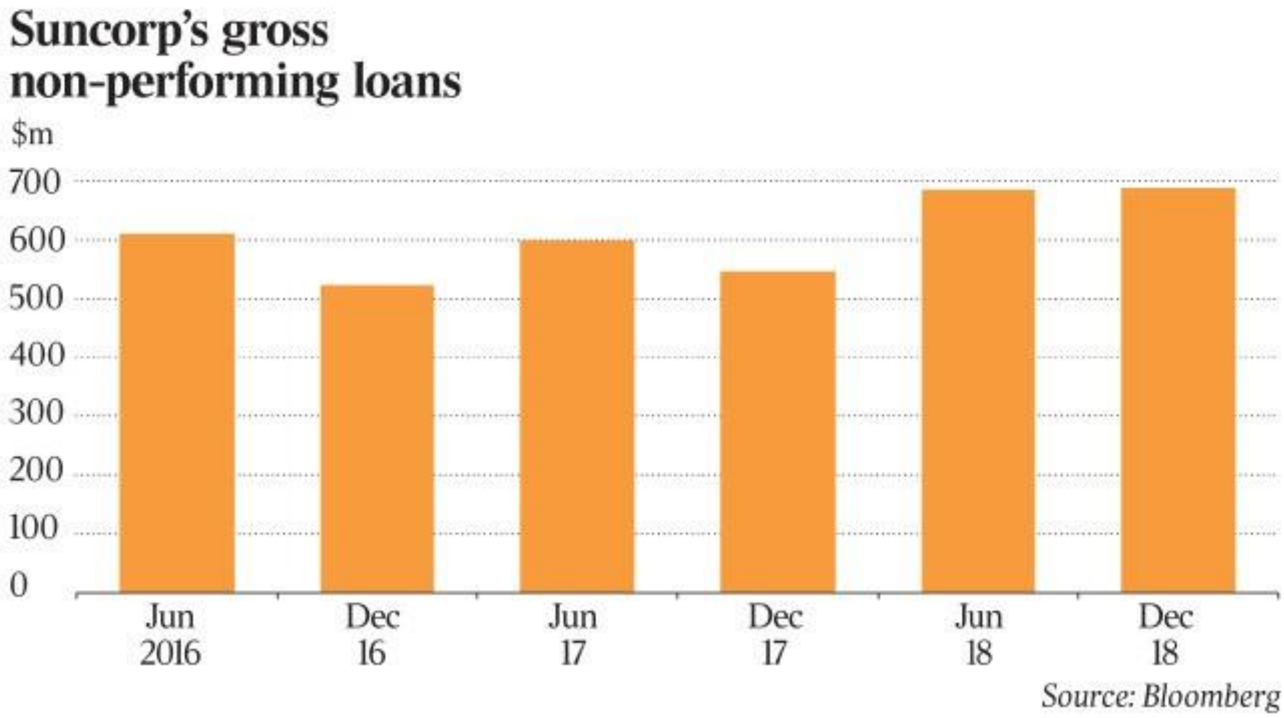
“It certainly is a canary Ummm, a securitization going “bust”, would be, but this isn’t the case… So it’s not… . Perhaps as long as the newer securitisations don’t default then it seems like the securitisation process is working,” Mr Johnson said. Newer securitisations will see arrears trend higher as they mature, at the same time the subordination (capital underneath the deals), increases in relative terms. Arrears are increasing off a low base, however this is expected and well within the normal bounds.

The tranche of mortgages in the Apollo series trust sold in 2010, which has shrunk from its original volume of $1 billion since it was first sold to investors, reached a rate of 3 per cent of borrowers more than 60 days overdue on their mortgage, the Queensland-based bank yesterday said. True

Suncorp said the announcement did not affect other tranches of loans in the Apollo trust. True

While the tranche of mortgages is a small volume of loans, the 3 per cent arrears figure on the group of borrowers is three times the rate of arrears in Suncorp’s broader mortgage portfolio of about 1 per cent. This is correct and a function of pool specific factors – not market factors, which is funnily what the article was asserting. It is also unusual due to the length of time borrowers have been meeting repayments — for almost a decade. Not really it is totally normal and expected that arrears trends higher as the pool matures and gets closer to the 10% cleanup.

According to Standard & Poor’s, the amount of borrowers more than three months behind their mortgage repayments doubled over the last decade, in a sign there has been a “persistent rise” the severity of home loan arrears. Again this is the normal glide path, pools that have been outstanding for close to 10 years will experience a level of arrears of anywhere between 2.5 to 4 times system arrears (currently 1%).



Suncorp said all investors were expected to continue to receive monthly payments on the instalments on interest, but the principal amount on their investment would be diverted from subordinated debt holders to the highest class of shareholders, AAA note holders This is true the documentation allows for this, this is normal and will delay capital return to the mezz.

The distributions will be then staggered according to the class of shareholders until all funds are exhausted. Not accurate. The bank has the right to - and will with a high likelihood - call the deal when the outstanding amount gets to 100 mil from 120 mil, expect this to occur end 2019.

Suncorp also expected the Apollo trust tranche to shrink further over the coming year to meet the 10 per cent threshold which allows the bank to close the trust. Call the trust - correct

The bank said at this point, subject to regulatory approval, it was expected that all holders were expected to receive the full principal amount once the trust was called. - Correct

"In the case of the APOLLO Series 2010-1, this is a very small number of customers going into arrears. As for the broader Suncorp retail portfolio, the total arrears is low at around 1 per cent," a Suncorp spokesman said.

Although the overall rate of borrowers falling behind on mortgage repayments remains low, S&P has warned households could encounter more financial stress if they struggle to refinance their loans if banks overhaul lax lending standards following the royal commission. – This is true, but not significant enough to be systemic.

About 60 per cent of borrowers overdue in repayments are currently overdue by more than three months — this is up from 34 per cent a decade earlier. No real information in this statement, means that some are delaying to resolve, or not resolving.

The economic outlook has been hit by a series of bad events over summer, as falling house prices have taken a toll on consumer confidence, spending and the pace of home building.

GDP figures for the December quarter, which will inform the government's official budget forecasts, will be released this week.

The government was already forced to trim back Treasury forecasts in December's mid-year economic and fiscal outlook as the drought in eastern and southern Australia crimped exports.

Amid the worsening economic outlook, Reserve Bank governor Philip Lowe last month canvassed the possibility of rate cuts for the first time since 2016.

Last week, official figures showed housing credit grew 0.2 per cent in January — the smallest rise in lending since 1984, when credit shrunk 0.4 per cent in a month.

Data from the Australian Bureau of Statistics also revealed an accelerating fall in the rate of housing construction, and a slide in engineering work dampened economic growth towards the end of last year — a slump that could trigger a downgrade to budget forecasts in April.

Analysts are concerned falling house prices could scare consumers into shutting their wallets, which would sap the biggest contributor to economic growth.

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