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# COVID-19 impact on RMBS pool a complex assessment

Primary deals are now possible in the Australian securitisation market as a result of government support. Attention is turning to what effect the COVID-19 fallout might have on new and existing residential mortgage-backed securities (RMBS) pools.

The easiest conclusion to draw is that the measures put in place to deal with COVID-19 will cause unemployment to rise precipitously. Anticipating this, lenders have already begun offering loan payment holidays and other types of forbearance.

Loans to borrowers on payment holidays would typically fall into arrears. If a lender has many loans fall into this category at once it could lead to cashflow problems in RMBS structures.

New government policy has been filtering through consistently to counter this. Welfare and support measures for employers and employees have been ramped up to try to build the bridge to the other side of the economic crisis.

The fiscal package announced on 30 March aims to enable businesses to keep staff on payroll by subsidising wages up to A$1,500 (US$924.40) per fortnight. This could put a ceiling on the unemployment rate. However, many people are still not going to be able to maintain mortgage repayments, with a potential impact on standalone RMBS trusts.

## Government support

There may be regulatory respite for banks. The Australian Prudential Regulation Authority (APRA) announced on 23 March that for borrowers using payment holidays as a result of COVID-19, "the bank need not treat the period of the repayment holiday as a period of arrears".

Martin Jacques, Sydney-based head of securitisation and covered bond strategy at Westpac Institutional Bank, wrote in a research note on 24 March that if banks follow this guidance, "there is less chance that transactions will fail stepdown conditions".

While nonbanks are not mentioned in APRA's announcement, a Moody's Investors Service report published on 31 March suggests some nonbank lenders could also choose to follow the guidance. It adds that the emergence of an industry standard will be key to understanding the credit impact on senior and junior noteholders.

Direct government support for RMBS is also falling into place. Fiscal measures support borrowers while, at the primary transaction level, there is the Australian Office of Financial Management (AOFM)'s A$15 billion structured finance support fund (SFSF), which is targeted mainly at nonbanks and small banks.

Firstmac was the first beneficiary of this, as the AOFM purchased A$189.14 million of the nonbank issuer's A$1 billion RMBS deal on 27 March. AOFM participation was across the structure alongside third-party investors, while the government debt-management agency took all the A2 notes and tightened pricing to 75 basis points over one-month bank bills (BBSW) from 225 basis points area over BBSW at launch.

By tightening the margin on these notes, the AOFM gives investors in other tranches a buffer against the expected increase in mortgage arrears resulting from COVID-19.

This should provide investors with a degree of confidence in primary market transactions, but it does not resolve any secondary market liquidity issues. Mortgage hardship will probably exacerbate these as it affects existing structures in the coming months.

Campbell Smyth, chief executive at Bluestone Group in Sydney, tells *KangaNews* it would make sense for the AOFM's SFSF programme to be extended to provide liquidity support to existing RMBS and warehouse structures, particularly given the pressure on, and desire of, lenders to provide payment holiday support to customers.

> "If a borrower cannot be kept employed they are now entitled to twice as much welfare as they would have been in the past. At the same time, expenditure is substantially down due to the containment measures in place. Borrower balance sheets and cashflow positions are changing and are dramatically different from in previous economic downturns."
>
> **ROB CAMILLERI** REALM INVESTMENT HOUSE

## Measures already in place

There are existing provisions in securitisation structures designed to mitigate cashflow risk.

Prepayment rates in Australian RMBS have historically been high, meaning most securitisation trusts have principal they can draw on to maintain interest cash flows. In addition, they also have liquidity facilities or reserves available to pay interest if principal is exhausted. These have a cost to draw but give a further buffer to cashflow issues.

David Carroll, treasurer at Columbus Capital in Sydney, says these mechanisms to protect noteholders should provide some headroom, even though prepayment rates are expected to decline in coming months.

An S&P Global Ratings (S&P) research note published on 25 March estimates buffers are typically sufficient in prime structures to "cover around nine months of senior expenses and note coupons at current interest rates, even if cash inflow to the transaction falls to zero – a scenario which remains unlikely". For nonconforming structures, S&P estimates about 11 months of coverage.

## Indiscriminate impact

These buffer facilities were designed and implemented with stress events such as recessions and rising unemployment in mind. In a typical recession, however, unemployment would rise gradually and the effect on RMBS pools would play out over years. The fallout from COVID-19 will be much sharper, as hundreds of thousands or even millions that were able to pay their mortgage a month ago will become unable to do so now.

The 31 March Moody's note states measures being implemented to mitigate job losses will likely prevent some loan delinquencies and defaults that would otherwise have occurred. However, the effectiveness of the policies in what looks to be an unprecedented downturn remains to be seen.

The unusual data on who exactly becomes unemployed in this crisis makes assessing the effect on securitisation structures even more complex.

Typically, a securitisation of prime mortgages could be assumed to have lower borrower risk in a recession than one of nonconforming mortgages. However, government-mandated and other COVID-19 related shutdowns and layoffs do not necessarily discriminate between prime and nonconforming borrowers.

In fact, Smyth states, trusts with greater excess spread – typically those for nonconforming mortgages – may have better ability to withstand cashflow reductions.

A trust with an average interest rate for borrowers of 5 per cent and funding or trust cost of 2.5 per cent could theoretically withstand half of its borrowers ceasing payments before cash flow became insufficient for noteholders, Smyth says. A trust with a lower average rate for borrowers may have less headroom to withstand borrowers ceasing payments.

"Bluestone has a book of prime and nonconforming borrowers and is monitoring borrower payment trends closely to see how the various categories perform," Smyth comments.

The ever-changing fiscal support landscape compounds the difficulty in assessing the impact on RMBS structures. As recently as mid-March, investors may have been running models based on the amount of people expected to be applying for welfare through Centrelink. As of 30 March, that number has changed. The government's new fiscal package is applicable to anyone out of a job from the beginning of the month and now potentially provides greater support for ongoing mortgage payments.

Rob Camilleri, investment manager at Realm Investment House in Melbourne, says the unprecedented welfare measures need to be considered – but so does the change in people's expenditure.

"If a borrower cannot be kept employed they are now entitled to twice as much welfare as they would have been in the past," Camilleri notes. "At the same time, expenditure is substantially down due to the containment measures in place. Borrower balance sheets and cashflow positions are changing and are dramatically different from in previous economic downturns."

S&P expects self-employed borrowers to be the hardest hit, given the exposure of small businesses to forced closures. Self-employed borrowers account for about 15 per cent of prime RMBS borrowing and 45 per cent of nonconforming, the rating agency reveals.

> “We are waiting to see if the rating agencies require any additional overlays in their processes and what impact this may have on existing deals. This will depend on where a deal is in its life cycle. If it is a mature deal that has built up a lot of credit enhancement, [the crisis] may have relatively little impact compared with a newer deal.”
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> **DAVID CARROLL** *COLUMBUS CAPITAL*

## Rating challenge

Lenders, investors and rating agencies all rely on granular data to assess securitisation pools. However, the sharp and sudden nature of the COVID-19 crisis means reliable data on changes to cash flow will not be available for months.

Columbus’s Carroll tells *KangaNews* it will be mid-May, when data for April is available, before arrears begin to reflect reality. He adds: “We are waiting to see if the rating agencies require any additional overlays in their processes and what impact this may have on existing deals. This will depend on where a deal is in its life cycle. If it is a mature deal that has built up a lot of credit enhancement, [the crisis] may have relatively little impact compared with a newer deal.”

How the rating agencies assess the effects of mortgage relief and welfare measures on RMBS pools in the coming months will be important for the ongoing function of the market, Camilleri says. If some of the speculation on unemployment figures proves correct, he adds, there could be severe downgrades of triple-A notes, potentially down to triple-B level.

“We know the government and lenders are trying to ensure borrowers are in a position where they can start paying their mortgage again in three or six months, Camilleri comments. “A lot of the arrears from this period will cure over time so rating agencies need to be aware of what is happening in securitisation pools and with borrowers.”

*KangaNews is your source for the latest on the COVID-19 pandemic’s impact on Australasian debt capital markets.* ***For complete coverage, click here****.*

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