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INSIGHT

Credit Insight: Trends in Asset Backed Securities

In this IFM Credit Insight we talk to Andrew Beales about how monetary policy tightening and rising interest rates are impacting asset backed securities markets and the implications for credit portfolios.

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CREDIT INSIGHT

Q Credit portfolios often contain exposure to asset-backed securities (ABS). Can you explain how these instruments work and what role they play within the portfolio structure?

A Asset backed securities are a type of financial instrument within debt markets that enable illiquid financial assets to be grouped together into an investable, yield-producing security. The assets underlying these securities are usually income-producing loans – such as mortgages, car loans and personal loans – which aim to provide a regular and consistent cashflow that translates into a yield for underlying investors.

One of the attractions of ABS is that they are “bankruptcy remote” as the underlying loans are sold to a Special Purpose Vehicle (SPV) financed by marketable securities, so they do not form part of the

insolvency estate of the sponsor. This means that there are protections within the securitisation structure that prevent ABS investors from being affected if the issuer goes bankrupt. If bankruptcy occurs, the securitised loan(s) can be sold to another issuer, or a third party can be used to service the loans, resulting in an orderly unwind of investments, with limited impact on the underlying assets or investors. This is quite different to traditional corporate credit where the bankruptcy risks faced by investors are higher.

The cashflows from the underlying loans flow through to meet the regular principal and interest repayments on the securitised investments. The investments and monthly cashflow repayments are tranching by various levels of seniority, offering investment opportunities in securities with a range of different risk profiles.

These varying risk profiles mean that not all ABS are

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the same from an investment perspective. Principal and interest payments on the investments are typically allocated in order of seniority, so any losses that occur on the loans are applied in reverse order, from the most junior investment to higher ranking exposures. In addition, whilst different loans and borrower profiles have various levels of credit risk, the level of subordination (or loss protection) of an investment is based on the expected loss performance of the loan pool in various stressed economic scenarios. This loss protection is captured in an investment's credit rating, ranging from AAA, which is designed to provide investors protection against an extreme level of economic stress,

down to B which provides protection against a mild economic downturn. Securities with higher risk (lower credit rating) usually offer higher yields (potential for higher returns). So institutional investors can formulate their own view on the expected performance of assets over the investment tenor, balancing their return objectives with their risk tolerance.

From a credit portfolio perspective, ABS usually provide a yield premium over similar quality corporate debt and exposure to consumer demand dynamics within the economy – a key component of developed market economic activity. This segment is typically not as easily accessible through other forms of debt as a first order exposure.

Q Economic conditions have changed significantly over the past 12 months, with rising inflation and higher interest rates causing some deterioration in the growth outlook. What impact could this potentially have on the ABS market?

A Since ABS are usually backed by consumer loans, it is very important for us to monitor any changes in economic conditions that might impact household balance sheets and borrowers' abilities to make loan repayments.

At present, we believe there are several factors negatively impacting household balance sheets:

- The Reserve Bank of Australia (RBA) is tightening monetary policy in response to accelerating inflation and this clearly impacts households via higher mortgage repayments. Estimates suggest that a 100 basis point (bp) rise in mortgage rates (nationally) adds about A\$323 to monthly repayments for loans of around A\$600,000 and a 200bp rise will add around A\$668¹. With more rate rises expected in 2022, mortgage repayments are set to continue to rise in coming months.
- Significant price inflation is occurring across basic items such as food, fuel, utilities and rents. This is crimping household budgets and extinguishing existing repayment headroom and savings.
- Inflation has accelerated faster than wage growth, so real household incomes are under downward pressure.

In addition to the pressures currently being faced by borrowers with variable rate mortgages, borrowers who locked in cheap fixed rate loans during the pandemic may also face serviceability pressures when their

interest rates reset. Fixed rate lending from banks increased significantly during the pandemic due to the cheap funding made available through the RBA's term funding facility. In late 2021, around 40% of lending had fixed rates, with around three quarters of this due to expire by the end of 2023.² This lending was predominately to prime borrowers who satisfied conservative bank underwriting criteria hence they should be well placed to meet the payment increases. However, we still expect this expiry of fixed rate mortgages to impact overall consumer demand and the housing market in the near term. From a Residential Mortgage Backed Security (RMBS) perspective, exposure to upcoming fixed rate maturities in the sector is less than 5%³, so we expect the performance impact to be muted. This is because the RMBS market is weighted towards non-bank originators who did not significantly increase fixed rate lending over the same period.

Given the changing economic environment, we believe that it is crucial to assess the borrower profile and serviceability testing that has been undertaken by the lenders in each individual investment to determine whether there are adequate buffers in place to withstand the additional pressures the economy is facing. Our analysis, presented below in Figure 1, suggests that while there are some serviceability buffers in place, there is still some sensitivity to deteriorating household finances that could lead to higher arrears and loss rates than evidenced over the last two years. It is expected that personal loans, auto loans and some non-conforming mortgages will exhibit the first signs of debt serviceability pressure when the economic environment deteriorates, hence some caution in the sector is warranted.

¹ Source: CoreLogic (<https://www.corelogic.com.au/news-research/news/2022/higher-interest-rates-likely-to-add-further-downwards-pressure-on-housing-growth-rates>)

² <https://www.rba.gov.au/publications/fsr/2022/apr/household-business-finances.html>

³ <https://www.spglobal.com/ratings/en/research/articles/220616-monetary-tightening-to-test-australian-rmbs-12387859>.

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FIGURE 01 CONSUMER LOAN SERVICEABILITY AND BUFFERS

	Auto and Personal Loans	Mortgages
Borrower Profile	Lower minimum gross income requirements given the smaller loan sizes required however borrowers are typically required to have a credit score of greater than 500.	Borrowers have higher income requirements given requirements to fund a deposit, stamp duty and legal fees associated with purchasing a home.
Income	Stable income streams are typically assessed at 100% of their value and variable income streams such as rental income, commissions and bonuses are assessed at 70-80% of value.	
Current Financial Indebtedness	Loans are typically 5-7 year fixed rate loans and are not as directly impacted by rate rises on variable loans. Despite this, a borrower may still be affected if they are a homeowner or have other debts to their name. A borrower's home loan has typically been assessed at its current mortgage rate and credit cards assessed at 3.8% of the limit.	Borrowers' mortgage repayments are typically tested against a minimum interest rate serviceability buffer of 250bps-300bps with full principal and interest payments over the life of the loan. All other financial indebtedness is included, with credit cards assessed at 3.8% of limit and fixed rate loans at their current repayments.
Household Expenditure	Borrowers are required to disclose their current household expenditure across multiple categories. These disclosed expenses are reviewed against a benchmark called the Household Expenditure Measure used by lenders to approximate living expenses based on their household characteristics. The higher of the two is commonly used for calculating serviceability. Given these expenses are assessed at a point in time, investors are required to assess the inflationary pressures on expenses that have occurred since a loan origination and how this may impact a borrower's ability to continue to service the loan.	
Final Serviceability Buffer	Borrowers may be required to prove an additional buffer of \$100 to \$200 a month in additional disposable income, considering the stresses applied above. However, this is not a requirement of all borrowers.	Typically require positive serviceability with buffers sometimes built in depending on loan risk. Caps on debt to income ratios are also used to limit risk.

Source: IFM Investors

Q Given this cautious outlook, are there any mitigating factors that you are including in your analysis?

A We are currently focusing on several mitigating factors that suggest the impact of rising interest rates on ABS may be less than the market is expecting. The primary mitigating factor is the record low unemployment rate, but there is also support from improved household liquidity buffers and the asset inflation evidenced during the pandemic for both housing and cars.

The unemployment rate fell to 3.5% in June 2022⁴, which is its lowest level in 48 years. This is important because the rate of mortgage and other consumer loan

defaults tends to trend lower as the unemployment rate falls, as shown in Figure 2.

The outlook for unemployment remains quite positive, given widespread skill shortages and lower migration rates currently impacting the Australian economy. Given this, it is unlikely that unemployment will rise dramatically in coming months and this should underpin ABS performance.

Aggregate household cash levels are also relatively high in an historic context, largely due to the lockdowns in 2020 and 2021 that reduced household spending and government income support in response to the pandemic. Figure 3 shows that the household savings ratio peaked at 22% in June 2020 and is only now reverting to more normal levels. In addition, households

⁴ Australian Bureau of Statistics

with mortgage debt are, on average, ahead in their mortgage repayments, with buffers in redraw and offset accounts that should help smooth the impact of rising interest rates.

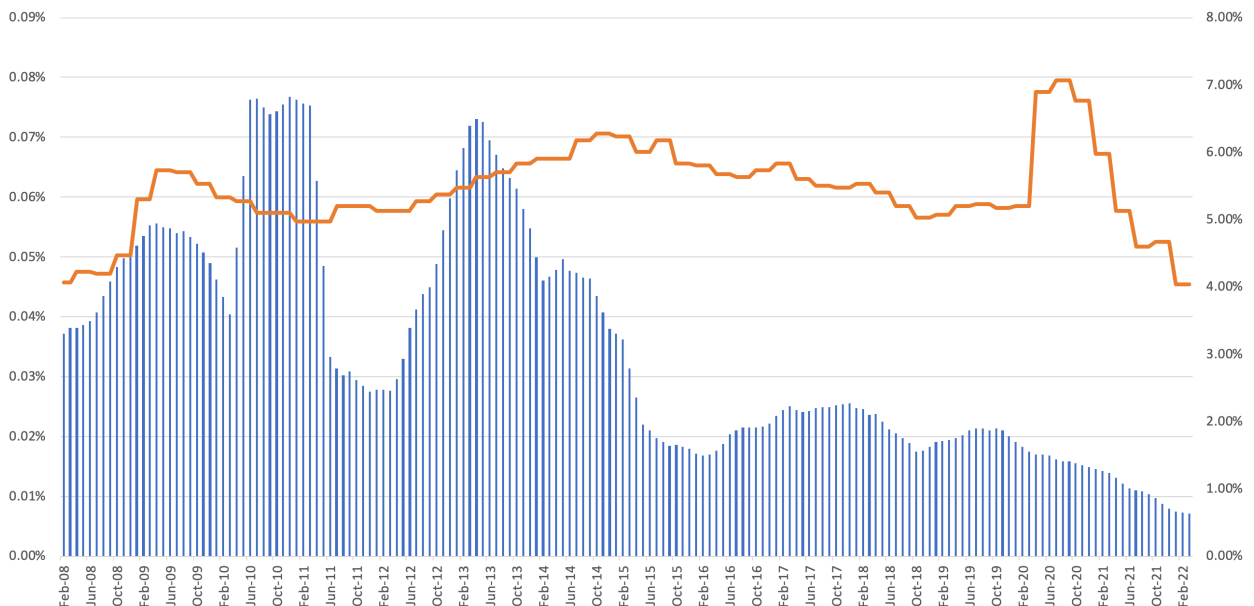
Figure 3 also shows that although Australian households are heavily indebted from a debt-to-income ratio standpoint, this is offset to some degree by increased holdings in assets (partly due to rapid house price growth) and savings of around A\$260bn which have been parked in redraw and offset facilities. RBA securitisation data for February 2022 suggests the median excess payment buffer for owner-occupiers with variable rate home loans was around 21 months' worth of scheduled payments. Taking into consideration these offset facilities, household credit to income ratios have remained largely flat since the Global Financial Crisis. We are mindful however, that these elevated aggregate

household liquidity buffers need to be aligned with those borrowers who are most likely to experience stress in the current rising rate environment. Figure 4 shows that the distribution of liquidity buffers is well matched to the borrowers who require them most, namely the heavily indebted borrowers and low-income borrower cohorts.

We are also cognisant that there may be several borrower profiles within the underlying loan pools that may still experience additional financial stress. This includes:

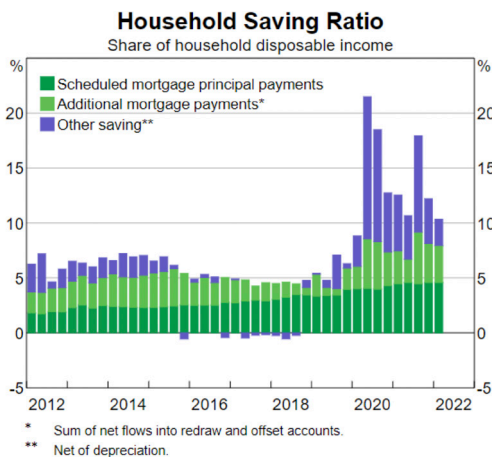
- borrowers within personal loan and auto loan transactions that are unlikely to have the same earning capacity and ability to build up significant savings buffers to offset inflation; and
- highly leveraged mortgage borrowers with loan to value ratios (LVRs) in excess of 80%, such as first home buyers who purchased homes in 2021 and have not had the time to build up repayment buffers.

FIGURE 02 UNEMPLOYMENT AND MORTGAGE ANNUALISED NET LOSS RATE



Source: Fitch Ratings Dinkum ABS Index, Bloomberg

FIGURE 03 AUSTRALIAN HOUSEHOLD BALANCE SHEET



Source: ABS, APRA, RBA

This is why we review the characteristics of each pool closely to better understand how a borrower is likely to perform.

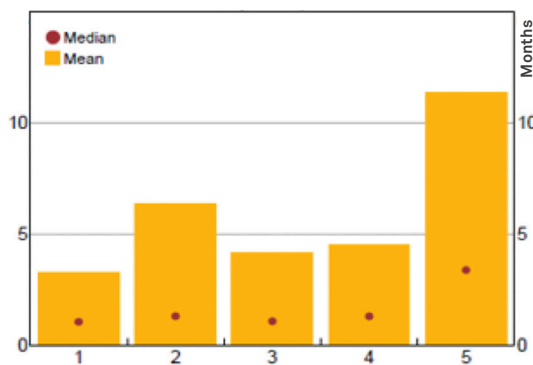
The other mitigant we are focusing on is the rapid increase in house and used car prices evidenced since the pandemic. For auto lending, the Moody's Analytics Used Car Vehicle Price Index increased by 18.4% year-on-year in May 2022 (up 79% since early 2020). Used car prices continue to benefit from semiconductor chip shortages that are constraining new car production and pushing excess demand into the used car market. Whilst semiconductor chip shortages are expected to ease later this year, these huge price rises have made it much easier for loan providers to recoup their money in the event that a borrower defaults. This is evident in Figure 5 which shows that loan recovery rates are still tracking at high levels.

In the housing market, material declines in some areas

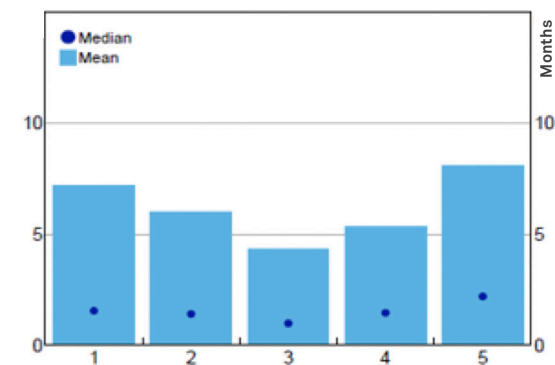
are already evident in response to higher mortgage rates, but it is important to remember that house prices surged in 2021, with the Australian Residential House Price Index up 24% over the year⁵. The RBA's securitisation data also indicates that only around 5% of loans have an LVR greater than 75%, compared to almost 25% at the beginning of 2020, and the share of homes with negative equity is less than 0.25%⁶. This is also providing a significant wealth buffer to consumers, even if house prices were to stall or fall by some degree in 2022. There is still a portion of the population with higher LVRs originated in the last 12 months, at the peak of the property cycle, that have not benefited from the rise in house prices, but this is relatively small. S&P Global estimates that exposures to loans originated in the last 12 months with LVRs greater than 80% is only about 1% across the prime RMBS sector and 6% in the non-conforming sector as of February 2022⁷.

FIGURE 04 CHANGE IN HOUSEHOLD LIQUIDITY BUFFERS

Change in Household Liquidity Buffers
From 2003/04 to 2017/18, by debt quintile, indebted households

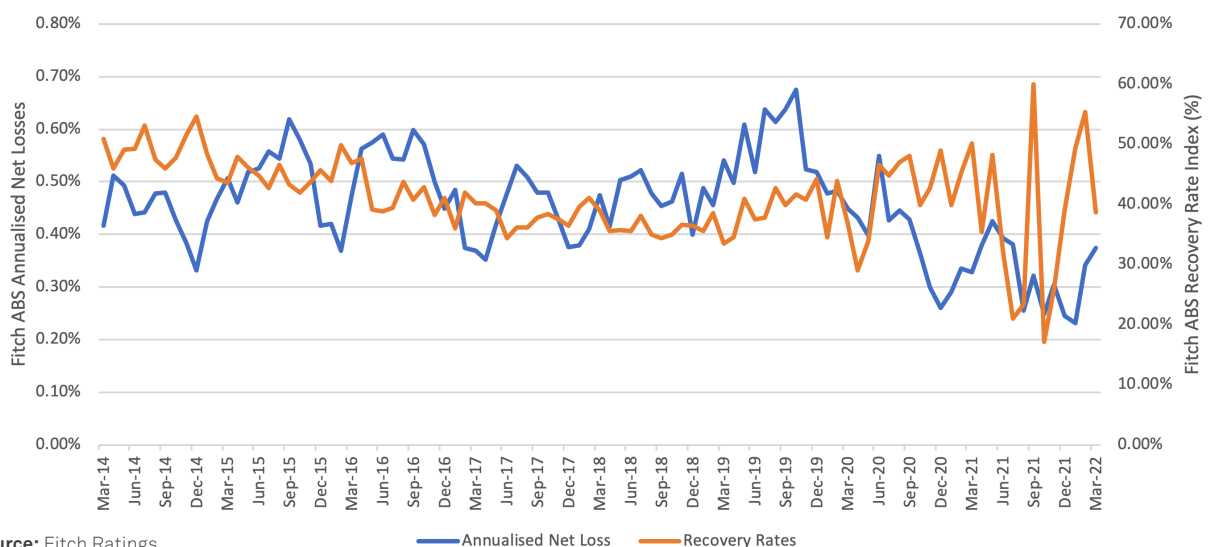


Change in Household Liquidity Buffers
From 2003/04 to 2017/18, by income quintile, indebted households



Source: RBA

FIGURE 05 FITCH NET LOSSES AND RECOVERY RATES



Source: Fitch Ratings

⁵ Australian Bureau of Statistics, Residential Property Price Indices: Eight Capital Cities, December 2021

⁶ <https://www.rba.gov.au/publications/fsr/2022/apr/household-business-finances.html>

⁷ <https://www.spglobal.com/ratings/en/research/articles/220616-monetary-tightening-to-test-australian-rmbs-12387859>

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How have ABS investments performed in recent months?

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To date, we have not seen a deterioration in the ABS sector despite higher inflation, tighter monetary policy and expectations of more rate rises in coming months. We think this is largely due to the mitigants outlined above – the low level of unemployment and high levels of cash on household balance sheets that are providing an income buffer. However, we are mindful that given the liquidity buffers, there may be a lagged effect on performance and we continue to monitor this closely.

Market pricing in the sector has begun to widen from the tight levels experienced in 2021 as shown below in Figures 6 and 7. Whilst spreads are starting to widen, this has not been a uniform move, with some mezzanine tranches being ‘stickier’ compared to the movements witnessed in AAA tranches.

Within our portfolios, we also have the added protection of our thorough due diligence and modelling processes that assist us in targeting attractive opportunities within the sector, whilst also making us more aware of all the potential risks. This includes deep dives into each issuer’s underwriting, servicing, products, pricing, technology and management teams to give us greater awareness of the expected performance of the

loan pool. We also work with issuers to formulate an appropriate credit risk profile in the changing economic environment. This process makes us selective when determining the risks and/or level of risk we are willing to take relative to the protections provided within the transaction structures, and the return on investment.

FIGURE 06 OUTSTANDING LOAN TO VALUE RATIO DISTRIBUTION

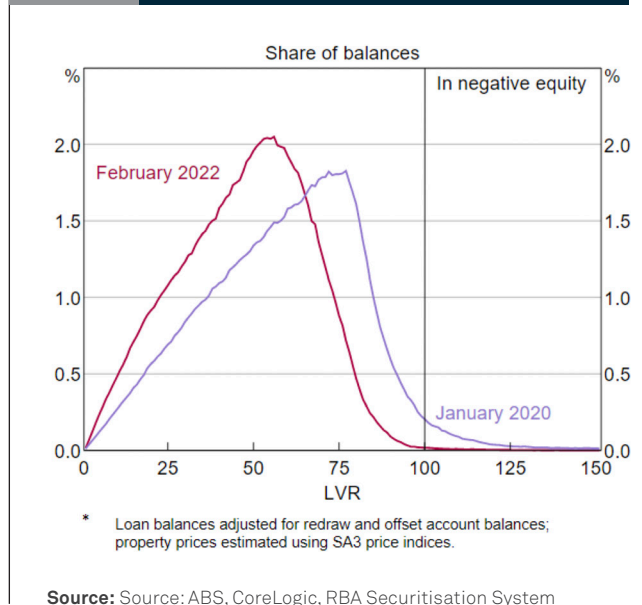
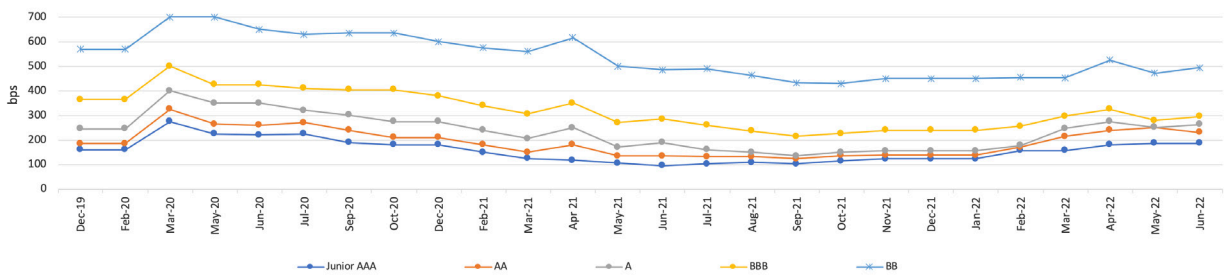
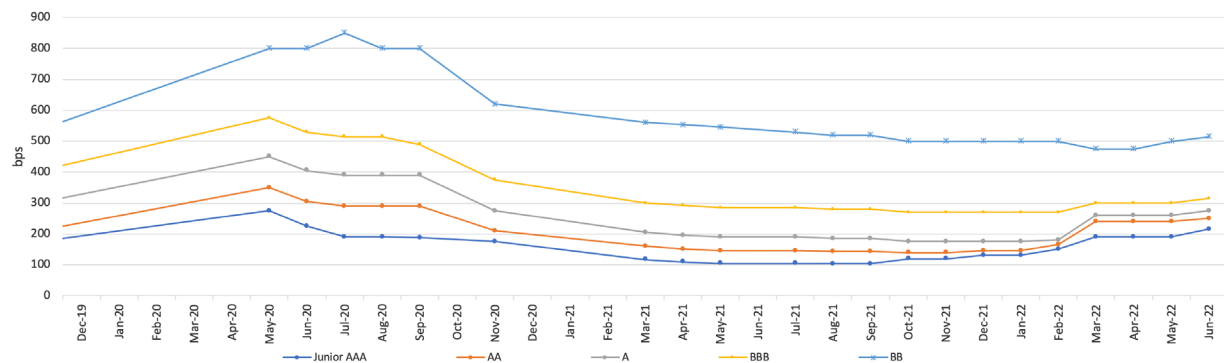


FIGURE 07 RMBS PRICING ACROSS CREDIT RATINGS – NON-CONFORMING PUBLIC PRIMARY



Source: IFM, Bloomberg

FIGURE 08 RMBS PRICING ACROSS CREDIT RATINGS - PRIME



Source: IFM, Bloomberg

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Q What is your outlook for the ABS market over the remainder of 2022?

A Looking forward, despite inflation and rising interest rates, we believe that seasoned consumer loans with established payment histories and larger liquidity buffers will likely continue to perform well in the current environment, particularly as the unemployment rate remains low.

There will still be pockets of stress in particular borrower cohorts that are highly levered or with minimal serviceability buffers going into this environment, but the diversification provided in securitisation pools and elevated recovery rates on seasoned loans will help to ensure that a number of ABS transactions continue to perform well over the near time.

We also expect a more cautious approach from investors in the market, with greater loss protections required in a given transaction and wider pricing for a given level of risk.

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