Spotlight on GCI and Australian RMBS

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Spotlight GCI and RMBS

Rising unemployment will be a headwind for the residential mortgage-backed securities (RMBS) market as prepayments slow and non-performing loans rise. However, strong fiscal support along with specific hardship provisions and underlying support from the from the Australian Office of Financial Management's (AOFM) Structured Finance Support Fund (SFSF), allotting $15 billion to RMBS and ABS purchases, should see Australian RMBS remain a valuable source of income and spread diversification derived from well positioned managers.

With respect to GCI, the first thing Gryphon Capital Limited (the 'Manager') did in March through to early May was bed down the risk in its portfolio from the perspective of perceived Covid risks to the Australian RMBS (and ABS) sector.

When the Manager was comfortable with the existing portfolio, and as the RMBS market started to re-open liquidity wise in May the Manager then began to reposition the portfolio further with the express purpose in order to generating a higher expected returns portfolio for a givenwith a lower level of risk. The Manager was optimising the GCI portfolios risk adjusted returns.

The sections below are intended to provide both a state of play snapshot of the Australian RMBS market currently and, in that context, the initiatives the Manager has taken to generate a higher level of expected income versus pre Covid.

Government Support for RMBS

While Australian corporate credit has not been included in the local monetary policy QE toolkit, the RMBS market for has had strong support from the AOFM's SFSF, allotting $15 billion to RMBS and ABS purchases.

This is important in a number of regards. First, unlike when the AOFM first entered the Australian RMBS market in 2010, when it only purchased one class of asset, specifically the senior AAA tranche, this time in the the SFSF is mandated to purchase AAA, AA, A, and BBB RMBS tranches, both in relation to new issuance (primary market) and secondary market purchases.

The SFSF was established in mid March and by the end of March had made its first investment, specifically the $189.6m new issuance by FirstMac. Importantly, GCI co-invested with the SFSF in this deal.

Since that time, the SFSF has continued to actively support the Australian RMBS sector via the warehousing segment (funding loans that will serve as collateral in a securitization) and both primary and secondary markets. As at 14 August 2020, the SFSF has invested a total of AUD1.36 billion, split across AUD395 million in primary purchases, AUD967 million in secondary purchases and a further approval of AUD1.9 billion in warehouse facilities. Purchases in the secondary market have strongly favoured non-bank lenders, including prime and non-prime RMBS. We note that the amount spent to date relative to the total budget provides the SFSF with substantial dry powder to continue to support the market.

GCI has both co-invested with, and made secondary sales to the AOFM, both of which have been important in de-risking the portfolio from the prescriptive of potential Covid ramifications. With respect to secondary sales, GCI also sold early, enabling it to not only de-risk early but take advantage of more distressed secondary purchases to improve the overall risk-return profile of the portfolio.

The second thing to draw from this unprecedented action by the Government, at least in the view of the Manager, is it highlights that the Government not only views the non-ADI Australian RMBS sector as integral to the strength of liquidity in the Australian mortgage market but that it reflects its view of the robustness of the asset class. If the US Government's involvement in the CMBS market during the GFC is an indicator, the intention is not just to grease the liquidity wheels but to ultimately provide an appropriate return to taxpayers.

Where is the RMBS Sector Risk Greatest?

In short, with the onset and ramifications of Covid, the risks are greatest in three subsectors:

- **SME Loans** - risks will likely be greatest for deals exposed to SMEs. Most directly, they will impact RMBS portfolios with larger proportion of self-employed borrowers or borrowers employed by SMEs.
- **Investment Loans** - declines in rental income, which are more pronounced in particular areas, could translate to debt serviceability pressures, particularly for more leverage borrowers. Declines in rental income are likely to be more pronounced in inner city areas where rental income is being impacted by rising vacancies due to falling international arrivals, Airbnb declines and higher job losses in cafes and restaurants in these locations (sectors where employees typically rent).
- **Non-conforming RMBS** - Non-conforming RMBS portfolios include loans to borrowers with adverse credit histories, as well as typically high shares of loans to self-employed borrowers. According to Moodys, based on data from lenders, borrowers have deferred payments on around 5%-20% of loans in RMBS portfolios because of Covid disruptions, with prime RMBS typically at the lower end of that range and non-conforming deals at the higher end of the range. Further, in the non-conforming RMBS portfolio rated by Moodys, the share of self-employed borrowers averages 45%, compared with 12% in prime RMBS deals.

GCI Portfolio Positioning

We note that GCI, by way of secondary sales and primary issues, moved the portfolio away from non-conforming RMBS and SME borrowers into Prime RMBS, with Prime loans being predominantly backed by borrowers with high lower risk scores. Since March 2020, the Manager has been able to transact and reinvest around 40% of the total portfolio. In doing so, not only has the Manager de-risked the portfolio but, on account of the dislocation event, garnered a higher portfolio running yield.

The repositioning is evident in the table below.

GCI Portfolio Allocation

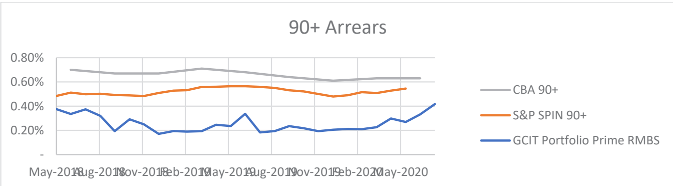
Metric	July 2019	Mar 2020	Jul 2020
Prime RMBS	70%	72%	74%
Non-Conforming RMBS	13%	8%	7%
ABS	14%	16%	15%
No. Underlying Loans	78,407	113,567	114,870
Weighted Average LVR	64%	65%	65%
Weighted Average Seasoning	26 mths	29 mths	30 mths
Weighted Average Interest Rate	4.84%	3.96%	3.67%
Owner Occupied	59%	65%	65%
Interest Only	27%	25%	24%
90+ Days in Arrears (% Loans)	0.38%	0.32%	0.41%
% Loans > $1.5m balance	0.64%	1.09%	0.89%

Source: Gryphon

There is a number of points to focus on in relation to the GCI portfolio in general and in terms of changes over the last 12-months.

- Diversification - First, the portfolio is diversified by number of bondholdings, numbering 91, secured on 114,870 loans as at 31 July 2020, and diversification by maturity bucket. Both serve to insulate the portfolio from market volatility. The relatively tight maturity window of slightly over two years comprises many bond holdings that mature over the next 12-months, which facilitates market confidence in getting their investment back rather than a more extended time frame.'
- +90 Days Arrears - In terms of changes, the most important metric is the +90 days arrears figure. The 90 days arrears figures teases out how many borrowers are in distress. At 0.41% as at 31 July 2020, this compares to 0.38% 12-months prior. This illustrates, that despite the Covid turbulence GCI has not recorded (to date) a material increase in loans with +90 days arrears. To put the 0.41% figure in perspective, the major banks typically have +90 days delinquency rates at around the 80-90 bps level, i.e. GCI is approximately one-half that level.

90+ days Arrears Timeline



Source: Gryphon

- Prime RMBS allocations have increased to 74% and Non-Conforming RMBS declined by nearly one-half to 7%.
- Covid-19 Hardship - In the GCI investment portfolio, about 6.2% of mortgage borrowers have been granted Covid-19 hardship compared to over 10% for the major banks. While this may demonstrate the quality of portfolio holdings, the Manager conducts granular analysis into the likely loss for any of these borrowers who may default (see below). For the COVID hardship borrowers in the GCI portfolio, the average loan balance is approx. $570K with a weighted average indexed LVR of 65% meaning on average the borrower has greater than $300K equity in their home – this equity in the home is the first (of four) protection against loss for bondholders.
- High Risk Loans - The Manager isolates high risk loans using this loan level data stratifying borrowers by attributes including, LVR, arrears, if the loan has Lenders Mortgage Insurance, Large loan, self-employed, interest only, dwelling type (ie house or unit), geographic region (ie non metro, inner city) among others. Rather than work in averages and top down, this granular bottom up stress testing enables the Manager to accurately forecast the most high-risk loans where future losses may arise. As an example of the "higher risk loans" bucket for loans experiencing "COVID hardship", less than 1% is exposed to LVR > 80% with no lender mortgage insurance. That said, there are additional protections against loss if any of these loans roll into default including excess spread in the transactions and bond subordination (see section below entitled 'Liquidity and Bondholder Protections reduce Risk").
- Determinants of Mortgage Defaults - As the Manager notes in its 31 July update, the most recent research released by the RBA in July 2020 1 provides insight into the potential performance for the borrowers impacted by COVID. The RBA research concludes that for a home loan borrower in Australia to default requires both an inability to repay the loan, and (importantly) the home loan to also be in negative equity. The Manager has adopted these conclusions as another stress test to all of our exposures. The GCI portfolio has a very small number of loans in negative equity (approximately 0.1% or approx. 158 loans in total) and only 19 of which have been impacted by COVID. None are in arrears and of the COVID impacted loans 2/3rd have the benefit of mortgage insurance.
- Liquidity stress - As discussed in the "Liquidity and Credit Enhancements reduce Risk" section below, Australian is supported by various in-built liquidity mechanisms to protect bond holders should the interest received on loans in any given RMBS deal be insufficient to pay bond holders. The Manager has stress tested its holding to test downside liquidity. The results being that every deal has 7-10x liquidity over and above the level of hardship currently reflected in each deal. A consistent problem for the market is the under researched nature of Australian RMBS as senior or AAA investors are less detailed which then creates uncertainty. GCI has an information advantage due to extensive research and a proprietary database analytics platform leading to better identification of opportunities. Following the advent of COVID, GCI was able to identify inefficient pricing opportunities.

Liquidity and Bondholder Protections reduce Risk

The economic and labour market downturn triggered by Covid-19 has increased loan delinquency, payment deferral and default risks for Australian RMBS, which is credit negative. However, RMBS deals' liquidity and bondholder protections mitigate in the form of excess spread and note subordination lessen the credit negative effects of these coronavirus disruptions. Based on a recent note from Moody's, we examine these attributes in the current market environment::

A) Liquidity reserves reduce payment deferral risks

Australian RMBS have liquidity reserves or facilities and principal-to-pay-interest mechanisms, which materially reduce the risk that deals will miss note interest payments because of Covid-19-related loan payment deferrals.

Loan payment deferrals, while easing the financial strain on borrowers amid the coronavirus disruptions, reduce RMBS deals' loan repayment collections. Lower loan collections increase the risk that RMBS deals will not have sufficient funds to make note interest payments on time.

However, Moody's notes that the prime and non-conforming Australian RMBS it rates have sufficient liquidity to continue making noteholder interest payments for 10 and 11 months respectively on average, even if they do not receive any loan collections.

Based on data from lenders, borrowers have deferred payments on around 5%-20% of loans in RMBS portfolios because of coronavirus disruptions, with prime RMBS typically at the lower end of that range and non-conforming deals at the higher end of the range.

Borrowers' requests for payment deferrals peaked in late March and early April and have declined significantly since then.

B) Bondholder Protections will Absorb Losses

In the event that delinquent loans do ultimately move into default the following four protections built into Australian RMBS provide protection against losses on any individual defaulting loan: 1. Homeowners deposit or equity; 2. Lenders Mortgage Insurance (LMI); 3. Excess Interest (or spread); 4. Subordination.

As mentioned earlier, if we just look at the COVID hardship loans in the GCI portfolio the average loan balance is ca. $570k, with a weighted average LVR of 65%. This means that on average the borrower equity in these loans is over $300k. In other words, house prices would need to fall by 35% before this first bondholder protection would not be enough to cover the losses in event of an actual default.

The next protection then is the lenders mortgage insurance which pays out in the event that a defaulted loan actually suffers a loss. Mortgage insurers are regulated by APRA and required to hold substantial capital against potential claims.

If the previous two protections are not enough to cover the loss on a loan, then excess spread is used to cover losses.

Excess spread in non-conforming RMBS averaged approximately 2% per annum over the last twelve months. Furthermore, the spread between the interest rate on loans in Australian RMBS portfolios and the benchmark bank bill swap rate has generally increased over the last few months, because many lenders have not passed on recent Reserve Bank of Australia interest rate cuts in full to borrowers.

The excess spread in Australian RMBS will decline over coming months, because of loan payment deferrals. Furthermore, for RMBS that have closed during this period of disruption, the excess spread is slightly lower than in outstanding RMBS, because note margins have increased (partially offset by a decreasing RBA cash rate / BBSW basis). Nevertheless, a level of excess spread will remain, which will mitigate the credit negative effect on RMBS deals if losses rise because of coronavirus disruptions.

The fourth protection, note subordination, protects against losses too.

In addition to the prior three protections, the note subordination in Australian RMBS will protect notes against losses if loan defaults increase. For seasoned Australian RMBS, note subordination has built up during the sequential repayment period. Australian RMBS typically have a minimum period when principal repayments occur sequentially starting with the senior notes. Moody's notes that, on average, the note subordination in senior AAA-rated RMBS notes is 3.9 times the loss expected in a severe recession. Subordination is much lower for junior and mezzanine notes.

C) Performance Triggers less Effective for Senior Notes

Performance triggers — typically based on credit enhancement, losses and delinquency rates — ensure senior Australian RMBS notes receive principal repayments ahead of mezzanine and junior notes when the underlying loans perform poorly.

However, Covid-19-related payment deferrals have made performance triggers based on delinquency rates less effective. Lenders are classifying loans with Covid-19-related payment deferrals as current rather than delinquent, in line with Australian Prudential Regulation Authority guidelines. This means RMBS deals are less likely to breach delinquency rate performance triggers than would otherwise be the case. The result is more pro rata principal repayments among the notes and less credit enhancement available to senior notes, than would otherwise occur. This makes senior notes more vulnerable (to the benefit of junior noteholders) if there is a high level of loans ultimately defaulting following the end of coronavirus-related payment deferral period.

Discount to NTA - Go Figure!

GCI is trading at an 11% discount to NTA as at 17 August 2020. All in the context of:

- There has never been a default in Australian RMBS;
- The Australian RMBS market is currently supported by the AOFM;
- GCI has repositioned portfolio well with respect to Covid-19 risks and opportunities;
- GCI's annualised monthly distribution has increased since April 2020, from 4.04% to 4.33% of NTA in July 2020.
- RMBS safeguards regarding liquidity, subordination, performance triggers;
- Broader market search for yield in low interest rate environment.

Conclusion: Go figure!!

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