Re-evaluating LMI

AUSTRALIAN RESIDENTIAL MORTGAGE-BACKED SECURITIES (RMBS) HAVE HISTORICALLY BENEFITED FROM THE ADDITIONAL CREDIT SUPPORT OF LENDERS' MORTGAGE INSURANCE (LMI). PROVIDERS EXPLAIN WHY LMI CONTINUES TO PLAY AN IMPORTANT ROLE IN SUPPORTING THE MARKET'S ROBUSTNESS – DESPITE A RE-EXAMINATION OF THE ROLE OF MORTGAGE INSURANCE.

Jenny Boddington, executive general manager, financial institutions at QBE Australia and chief executive of QBE LMI in Sydney, says LMI providers act as a second set of eyes on the market. She comments: "One reason the Australian RMBS market did not experience similar problems to the US was that the prime RMBS market was indirectly regulated by the Australian Prudential Regulation Authority (APRA), through APRA-regulated LMI companies."

A similar message about the role of LMI in the Australian industry comes from Genworth. Its Sydney-based chief financial officer, Georgette Nicholas, explains: "We have a strong impact on providing insight on what is happening in the market."

Current economic and market conditions only enhance this role. "APRA is certainly helping with this, given it is an active regulator overlooking the lenders markets and creating a focus on investment properties by limiting growth to 10 per cent," Nicholas continues. "Given cash rates are dropping, this is an important part of managing risk with the variable nature of the market going forward."

LMI CHALLENGES

LMI is clearly a market shaper in Australia – and is also facing challenges. Most recently, a change in assessment criteria used for LMI by Standard & Poor's Ratings Services (S&P) put the whole industry under the microscope.

The new criteria came into effect on February 2 this year, following a request-for-comment (RFC) period which appeared to result in a shift in Australian issuers' ratings preferences on RMBS deals. Of the two prime RMBS deals which directly followed the RFC announcement, by AMP Bank and Beyond Bank, neither opted for an S&P rating.

The major changes between S&P's RFC proposals and its finalised criteria principally fall under "cancellable policy" and "rating differentiation for assumed claims-adjustment rates".

The first covers S&P criteria for assessing whether credit support is sufficient to cover potential losses after applying a 50 per cent haircut to the mortgage insurance coverage amount for cancellable policies based on two possible outcomes. The second is intended to simplify application and differentiates among claims adjustments by rating categories.

A day after the revised methodology was published, S&P lowered the ratings on 61 tranches of Australian and New Zealand RMBS, and affirmed those on an additional 82 tranches. At the same time, the rating agency lowered its rating on QBE LMI to A+ from AA- with a stable outlook. At the same time, Genworth Financial Mortgage Insurance (GFMI) was affirmed at A+ with a developing outlook.

Meanwhile, as at mid-May 2015 QBE LMI is rated A2 and AA- by Moody's Investors Service and Fitch Ratings (Fitch), while GFMI holds A3 and A+ ratings from the same rating agencies.

However, while market feedback was clouded with uncertainty at the time, since implementation of the new methodology the market has returned to its historical norm – where S&P and at least one other rating agency typically provide ratings to Australian prime RMBS deals.

Boddington says the S&P changes were not unexpected. "The market was aware that S&P had been conducting the methodology review for several months. QBE has not received any negative feedback from clients following the changes," she tells *ASJ*.

But Nicholas points out that alongside the market uncertainty surrounding S&P's review, Genworth's clients are also faced with the challenge of assessing how mortgage lending standards may develop and what impact this might have from a cost perspective. "This depends on the types of tranches and types of notes in the transaction and whether it makes economic sense to include LMI."

MOVING FORWARD

The industry has dealt with issues before. The first major one emerged in the wake of the financial crisis: concerns about the ability of insurers with

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substantial exposure to a single risk factor – in this case, Australian housing – have led to heightened rating-agency scrutiny.

On May 12 this year, Moody's published a report stating that Australian mortgage insurers are well positioned. According to the report, the Australian LMI sector remains financially sound with healthy capital levels, good underlying profitability and solid underwriting practices.

In fact, the challenges the sector faces are mainly on a business level. The rating agency states in the May report: "Recent moves by some Australian banks to diversify their mortgage insurance to more diverse global reinsurers, and the increase in the use of self-insured, low-deposit mortgage products, could over time threaten the lenders' mortgage insurers' future prospects."

Australian LMI providers insist that RMBS issuers continue to be engaged with LMI. The decision to use LMI as a tool for credit enhancement when structuring an RMBS deal will vary for each transaction.

In funding-only transactions, Boddington explains, the issuer tends to retain most of the subordinated notes and therefore does not generally need to rely on LMI as a credit-enhancement tool. There is stronger reliance on LMI for funding and capital relief transactions, in which mezzanine and subordinated notes are typically sold to third-party investors rather than retained by the issuer.

"We anticipate that potential growth opportunities will come from major banks if they start to issue RMBS for both funding and capital purposes," Boddington says.

SMOOTHING EFFECT

The providers remain confident in the value of their product in a downturn. "While Australian mortgages are performing well at the moment, we know that when the market experiences stress – as it undoubtedly will do at some point in the future – we will see a divergence in loan performance. LMI will smooth this for investors," Boddington argues.

Nicholas also points to the importance of investor education in order to actively promote the value of LMI. This is particularly important given the securitisation market seems to be balanced between issuers deciding whether LMI makes sense from an economic standpoint, and investors looking at the market from a yield perspective.

In fact, Nicholas suggests, LMI is an important part of the value chain of Australian mortgage origination. "For Genworth, the challenge is educating investors that we do more than just pay a claim. We are part of quality assurance up front – we work with lenders and do a lot around the underwriting side, to audit and assess underwriting quality across the market," she tells *ASJ*.

LMI providers such as Genworth point out that they also offer support by managing aspects of the arrears segment of the mortgage market, Nicholas explains. "We audit the underwriting quality of a transaction's book before it goes to market. If it goes delinquent, we have a strong arrears-management and loss-mitigation process to go through. There are services, such as this, which we provide which perhaps are not fully appreciated at a time when the market is good, but are important in times of stress."

ISSUER PERSPECTIVE

Issuers themselves appear to continue to value the part LMI plays in Australia's mortgage market, but note that going forward there may be a shift in its usage in RMBS structures.

Peter Casey, deputy treasurer at ING Bank Australia, points out that only one of the bank's eight IDOL Trust RMBS transactions since 2010 has not had all the loans insured. He explains that investors put particular value on insurance of high loan-to-value ratio (LVR) loans. For lower LVR loans they are open to receiving greater credit enhancement through the structure rather than through LMI.

"This trend – prompting issuers to think about whether they get value for insurance – may gather pace, although we haven't seen this happen yet," Casey comments.

But he agrees that LMI providers give investors the added benefit of a third party which has the same interests as them. "The insurer wants those loans underwritten and serviced well, and so do investors. This gives further confidence in the market."

As another regional bank lender, ME's general manager, markets, John Caelli, agrees that LMI has played an important role in the mortgage market historically. But he adds that going forward structures will need to "stand on their own two feet" irrespective of LMI. "Investors are increasingly looking through LMI given recent changes by the rating agencies and the downgrading of the insurers themselves," Caelli comments. "We may see some different types of structures issued, given the changes in rating-agency methodology and in investor appetite for risk."

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