No Payment Shock — impact if mortgage interest rates were to increase by 2%

MAY 2022

With inflation mania firmly entrenched in the markets (refer Gryphon Insight on Inflation) and wage growth finally picking up, the RBA at last decided to act and increase the cash rate on 3 May 2022 to 0.35%. The timing and path of rate increases is an ongoing debate with Gryphon's expectation that the RBA will gradually increase the cash rate over the coming years by circa 1.50%–2.00%. In order to understand the impact this will have on RMBS, Gryphon uses its deep lens at an individual loan level to conduct stress testing on the impact of rate rises on borrowers, bondholder protections and ultimately the likely performance of RMBS investments. We have spoken previously about how valuable the "information feedback loop" gained from monitoring loan level data each month is to our stress testing as we seek to validate our forecasts and assumptions. The RBA's April *Financial Stability Review (FSR)* presented analysis around the impact on borrowers of a 2% rise in interest rates. This analysis validates Gryphon's own analysis of the impact of rate rises on Gryphon's RMBS portfolio against the RBA's analysis.

Promisingly, Gryphon's conclusion is that the average borrower in the GCI portfolio is well positioned to manage higher interest rates, something confirmed by the RBA's own analysis: 'Overall, the majority of indebted households are well placed to manage higher minimum loan repayments…'[1] This is also further corroborated by S&P's analysis released immediately after the rate rise in which they state: 'While arrears are set to increase in earlier arrears categories as borrowers adjust to higher mortgage repayments, we don't expect significant increases in the advanced arrears categories, given a strong labor market and the buffers built into serviceability assessments. In addition, many borrowers have benefited from a pandemic build-up in savings and repayment buffers, which will help to absorb higher mortgage repayments.'[2]

Gryphon's analysis includes multiple interconnected factors all supporting the conclusion that borrowers are well placed to manage higher minimum loan repayments, and RMBS will continue to provide stable, regular income for GCI investors.

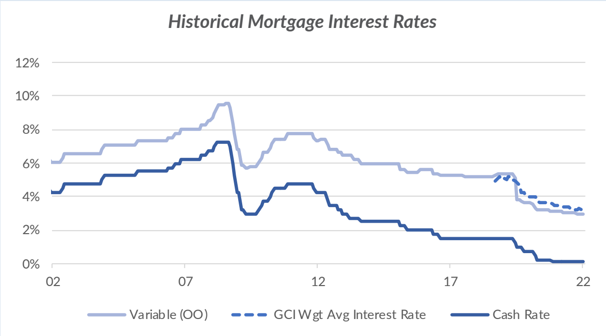
[1] *Financial Stability Review — April 2022*, page 27
[2] S&P May 3, 2022

We discuss some of these factors below:

Historical Mortgage Rates

Historically, irrespective of the prevailing mortgage rate, Australians have always paid their mortgage. While the current weighted average interest rate for the underlying home loans backing the GCI RMBS investments is circa 3.20%, it is important to remember that it was not that long ago (October 2018) that the mortgage rates were ~2% higher at 5.18%.

The performance of the loans underlying GCI RMBS investments (measured as the % of borrowers more than 90 days in arrears) has been very good since the IPO in May 2018. In October 2018, only 0.20% of borrowers were 90+ days past due compared to (an also very low) 0.34% in March 2022 — a different interest rate scenario but consistently good borrower payment performance.



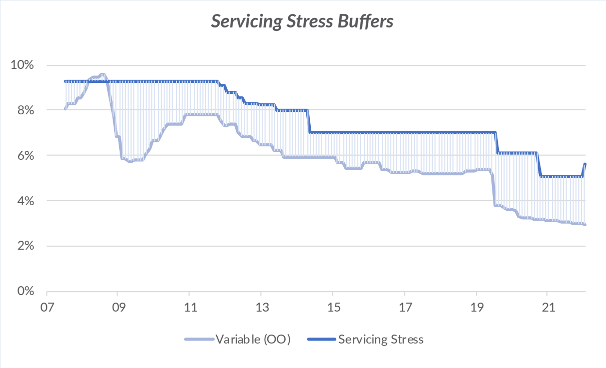
Source: *Standard & Poor's, Gryphon Capital*

Serviceability buffers

Since 2014, APRA has determined the "serviceability buffers" i.e. the minimum mortgage interest rate it expects banks (and indirectly non-banks) to use when assessing serviceability of home loan applications. The serviceability buffers are used as a risk management tool to ensure new borrowers are able to service higher interest rates over the term of their mortgage.

While the methodology for determining the buffers has changed over time, in October 2021, APRA increased the minimum interest rate buffer it expects banks to use when accessing the serviceability of home loan applications to ***at least 3.0%*** above current rates compared to the commonly used 2.5% previously. These buffers provide a significant margin of safety and ensure that even though current variable home loan rates are at historical lows, a mortgage rate above 5% is typically used by lenders to assess whether a new borrower is eligible for a loan (i.e. they are able to afford the higher interest rate).

The average loan in the GCI portfolio was originated more than two years ago when the serviceability buffers meant borrowers were assessed using a 6% — 7% mortgage interest rate.



Source: *Standard & Poor's, Firstmac*

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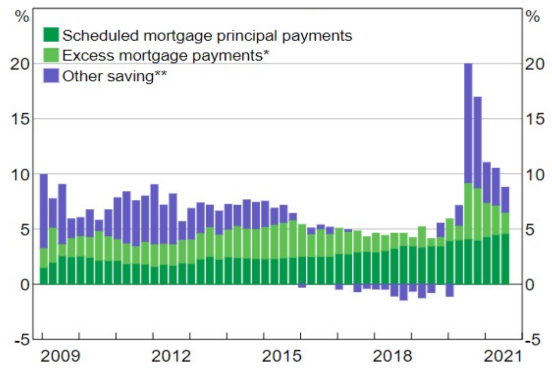
Elevated savings rates

The *FSR – April 2022* report commented that the '...financial resilience of the household sector as a whole has improved since the start of the pandemic...' and high savings rates is a major reason for this improved resilience.

Using their own securitisation data, the RBA commented in the *FSR – April 2022*: '...that the median excess payment buffer for owner-occupiers with a variable-rate loan was equivalent to around 21 months' worth of scheduled payments in February 2022, up from around 10 months' worth at the start of the pandemic...'.

In the GCI portfolio, the average borrower is slightly better, being 24 months ahead of minimum payments, providing another margin of safety against rising interest rates. In current conditions, the average borrower in the GCI portfolio could make literally zero payments on their home loan for a further 24 months before their home loan payments would be in arrears.

Household Saving Ratio
Share of household disposable income



* *Sum of net flows into redraw and offset accounts*
* * *Net of depreciation*

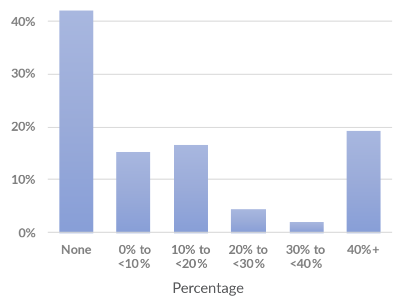
Source: The Rise in Household Liquidity, *RBA 2021*

Employment Growth

Household incomes have been supported by strong employment growth with an unemployment rate of circa 4% — historically an extremely low level. Unemployment is a key driver of a borrower's capacity to make their mortgage payments with a high correlation between borrower arrears and unemployment. The expectation is that higher interest rates will be accompanied by wage growth and a strong employment market ensuring the incidence of financial stress remains low as borrowers are less vulnerable to a sustained fall in income.

Our independent analysis on the impact of variable mortgage rates increasing by 2% is consistent with the RBA's conclusion that the '...the majority of indebted households are well placed to manage higher minimum loan repayments...'.

Repayment increases assuming 2% rate increase



* *Changes required to actual repayment patterns in response to a 2% increase in mortgage rates for variable rate, owner occupied home loans in the GCI RMBS investments.*

Source: *Gryphon Investments*

Gryphons' stress testing focused on most at risk borrowers

Gryphon's stress testing has focused on the borrowers facing the largest increase in their minimum loan repayments and who, therefore, are the most vulnerable to rate rises. In our analysis, 19% of the GCI portfolio are loans whose actual repayments over the past 12 months must increase by greater than 40% in the event that interest rates increase by 2%. Gryphon's proprietary database enables us to determine the "risk" of these loans by drilling down into many variables including historical payment habits (i.e. have they been previously in arrears), how long have they been paying their mortgage (i.e. seasoning), their savings rate or payment buffers (i.e. how many months ahead of schedule are they), how much equity they had in their home (at origination) and indeed how much house price appreciation they have experienced since taking out the loan.

Our risk assessment of this 19% of the GCI portfolio concludes that the risks are very manageable.

For the average loan balance of $235,301, the weighted average seasoning is circa 60 months (i.e. 5 years!) meaning the borrower has benefited from strong growth in housing prices with the weighted average indexed LVR of just 44% (versus an original LVR of circa 69%) — substantial equity built up averaging circa $300,000. Another way of thinking about this is that house prices would need to fall by more than 50% before the average borrower in this group would be in negative equity (remember that we have previously mentioned RBA research that shows that the borrower needs to both be in negative equity AND lose their income before they default). The average borrower also has substantial savings providing payment buffers against higher interest rates — on average, if the borrower continues to make the same mortgage payments as they have done over the past 12 months, then their savings are sufficient to plug the gap to meet the higher mortgage payments resulting from 2% increase

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in interest rates (i.e. in excess of current payments) for about 52 months.

The high level of savings and substantial build up in borrowers' equity will also enable borrowers experiencing financial pressure to voluntarily self-manage their way out of arrears through property sales, unlocking unrealised property gains.

No payment shock

In conclusion, Gryphon's analysis provides us with confidence that the majority of borrowers are well placed to manage the expected higher mortgage rates, entirely consistent with findings by the RBA and S&P. For the cohort of borrowers most exposed to large increases to their mortgage payments, a combination of serviceability buffers, elevated savings rate, over-payment history and strong employment growth provides effective mitigants against financial stress. Additionally, the substantial build up in borrowers' equity will also enable any borrowers experiencing financial pressure to voluntarily self-manage their way out of arrears through property sales. RMBS are well placed to continue to provide the stable and predictable income characteristic of GCI's performance to date.

Gryphon Insights videos

To view Gryphon Insights videos, please go to:

https://gcapinvest.com/news-insights/

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