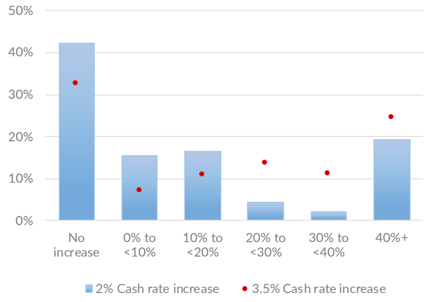
Still No Payment Shock — even if mortgage interest rates increase by 3.5%

SEPTEMBER 2022

PRIOR TO THE RBA raising interest rates in May, Gryphon conducted stress tests examining the impact of a 2% rise in interest rates on the underlying borrowers in the GCI portfolio. We published the No Payment Shock study back in May 2022. Since then, as expected, the RBA has continued to increase rates and there is a lot of discussion in the press about the impact of rising rates on borrowers' capacity to continue to make their mortgage payments. Accordingly, we have updated our analysis of borrowers' ability to withstand higher payments to reflect the risk of rates rising by 3.5%. Essentially, we did the same analysis, but assumed a 3.5% increase instead of the 2% increase used in May.

While the impact on borrowers is greater (unsurprisingly), importantly, our conclusion remains the same — the analysis continues to give us '... confidence that the majority of borrowers are well placed to manage the expected higher mortgage rates ...'.

Increase in borrower payments — 2% versus 3.5% increase in cash rate



Changes required to actual repayment patterns in response to increase in mortgage rates for variable rate, owner occupied home loans which have a 12-month payment history in the GCI RMBS investment portfolio.

Source: *Gryphon Capital*

There are multiple interconnected factors that all support our conclusion that borrowers are well placed to manage higher loan repayments — four key factors include:

1. Elevated Savings

Since the start of the pandemic, Australian households have saved over $412 billion, an extraordinary amount, giving households a significant liquidity buffer or "margin of safety" against higher rates and indeed other economic shocks.

Some of these savings are in the form of offset accounts or early principal repayments on mortgages, meaning borrowers are currently significantly ahead of their repayment schedules. For the GCI portfolio, the average borrower is 20 months ahead of minimum payments, providing another margin of safety against rising interest rates.

2. Strong Employment

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 borrower's capacity to pay their mortgage is underpinned by the lowest unemployment rate for nearly 50 years, coupled with continued high savings rates.

The expectation is that higher interest rates will be accompanied by wage growth and a strong labour market, ensuring the risk of incidences due to financial stress remains low.

3. Historical Mortgage Rates

Historically, irrespective of the prevailing mortgage rate, Australians have always paid their mortgage. It is important to remember that it was not that long ago (October 2018) that the mortgage rates were greater than 5% and yet borrowers paid their mortgage at these higher rates.

While we are expecting an increase in early-stage arrears and some borrowers will clearly experience financial pressure, we are not currently witnessing stress in the borrower's payment habits. In fact, quite the opposite — 90+ Days arrears have fallen from 37bps at the start of the year to a very low 23bps as at August. The strong arrears performance of the GCI portfolio is consistent with S&P's findings in their June SPIN reports (these detail RMBS arrears performance), which state that the arrears of Australian borrowers has made "new post GFC lows".

4. Serviceability Buffers

Since 2014, APRA has determined the "serviceability buffers" or 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 can afford higher interest rates through the term of the loan.

In October 2021, APRA increased the buffer to at least 3.0% from a previous 2.5% — providing a higher margin of safety in ensuring new borrowers can afford higher interest rates.

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 — meaning borrowers could afford higher interest rates.

Gryphon's 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.

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Gryphon's proprietary database enables us to determine the "risk" of these loans by drilling down into many variables including, among others:

- historical payment habits (i.e. have they been previously in arrears?)
- how long have they have been paying their mortgage (i.e. often referred to as a loan "seasoning")
- their savings rate or payment buffers (i.e. how many months ahead of schedule they are in their mortgage repayments)
- how much "equity" they had in their home at origination, and
- how much house price appreciation they have experienced since taking out the loan.

For the borrowers most impacted by rising rates in the GCI portfolio — that is those **borrowers whose repayments increase by greater than 40%** — our updated analysis assuming a 3.5% increase in the cash rate concludes that the risks continue to be very manageable.

For the most impacted borrower cohort — representing circa 25% of the GCI portfolio (an increase from 19% per the original analysis) — several factors give us confidence in our findings:

1. The "habit" of paying your monthly mortgage is an important risk mitigant. Once a borrower is in the habit of paying, they are less likely to stop paying. For the GCI portfolio the weighted average seasoning is 25 months, whereas for the most impacted borrowers, it is even longer at 54 months (4.5 years).
2. The Original LVR of the most impacted borrower cohort is 69% comparable to the GCI portfolio average LVR of 65%. However, the most at risk cohort have benefited over the last 4.5 years from strong growth in housing prices with the weighted average indexed LVR at just 46%, providing the most at risk borrowers with:
   a. a substantial buildup of borrower's equity in their home, and
   b. a massive incentive for any borrower experiencing financial pressure to self-manage through selling their home to repay their debt.
3. Finally, the most impacted borrowers also have on average, substantial savings providing payment buffers against higher interest rates.

No Shock

This level of detail (unique to Gryphon) gives us a great deal of confidence that the vast majority of borrowers are well placed to manage further substantial increases in interest rates. 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 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

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