Credit FAQ:

How Will The Recent Floods Affect Australian RMBS?

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Mortgage arrears are likely to rise in communities on the east coast of Australia affected by recent floods. The government has declared a natural disaster in several areas of New South Wales in response to torrential rains and historic flooding, and flood warnings remain current in Queensland.

In this Credit FAQ, S&P Global Ratings considers the effects of the flooding in the context of Australian residential mortgage-backed securities (RMBS) portfolios.

How Exposed Are RMBS Portfolios To Affected Areas?

Most Australian RMBS portfolios are well diversified geographically. Exposure to nonmetropolitan, or regional, areas outside of capital cities is typically around 30%, though it can be higher in portfolios of loans underwritten by regional lenders with higher concentrations of particular geographic areas. New South Wales, the nation's most populous state, is home to around 30% of loans in Australian RMBS portfolios, and most of these loans are secured by properties in capital cities.

The recent flooding in New South Wales has affected a large area that spans the central and mid-north coast, from Hunter Valley near Sydney to Coffs Harbour. A total of 60 local government areas are eligible for the Australian Government Disaster Recovery Payment and Disaster Recovery Allowance.

We estimate that exposure to areas where floods have been most severe is less than 7% across the broader Australian RMBS sector. This is a conservative estimate based on exposure to local government areas eligible for disaster recovery assistance. Not all locations and properties within these catchment areas will have been directly damaged by flooding.

How Many Portfolios Have High Exposure To The Recent Flooding?

Most Australian RMBS portfolios are geographically well diversified, with higher exposures to the more populous capital cities. Fewer than 10 RMBS transactions out of our rated pool of around 260 have a high exposure to nonmetropolitan areas in New South Wales, where flooding has been more severe.

Under our criteria, we apply geographic-concentration penalties at a nonmetropolitan, postcode, and state level to address geographic-concentration risk. Some regional lenders have a higher exposure to certain geographic areas, which increases their geographic-concentration risk and can make them more vulnerable to higher arrears if, for example, local employment conditions decline due to a downturn in a key industry or a natural disaster strikes creating temporary disruptions in local employment conditions.

How Will Affected Portfolios' Collateral Performance Be Affected?

We expect arrears to increase in the coming months in areas affected by flooding. The disruption to business activity and incomes will have a flow-on effect on local employment conditions. This could lead to debt-serviceability pressures for affected borrowers. Some borrowers could face similar pressure while they wait to access various assistance schemes and property insurance.

Natural disasters historically have had a more pronounced effect on mortgage arrears in areas with higher population densities because more properties are affected.

The full extent of the damage caused by the floods across large parts of New South Wales and, to a lesser extent, Queensland has not yet been determined. It will likely take weeks for many claims to be lodged. Nevertheless, we believe Australia's property/casualty (P/C) insurers are well-placed to assess and meet claims that arise with reinsurance protection, shielding the larger insurers from outsize losses (see "Australia's P/C Insurers Well-Placed To Handle Flood Claims," published March 22, 2021).

Are Financial Hardship Claims Likely To Increase And How Will This Affect Arrears?

Lenders to borrowers in affected areas observed an increase in financial hardship claims during previous periods of natural disasters, such as floods. We expect this to be the case with the recent floods.

Borrowers experiencing financial difficulty can apply for financial hardship provisions under the National Consumer Credit Regime administered by the Australian Securities and Investment Commission. Lenders are obliged under consumer laws and banking codes to consider hardship variations to credit contracts for borrowers experiencing temporary financial difficulty.

Hardship concessions can include a reduction in the interest rate or payment, lengthening of loan maturity, or full or partial deferral of interest for a temporary period. Under the Australian Prudential Regulation Authority's (APRA's) prudential practice guidance, loans under financial hardship arrangements should continue to be reported in arrears, based on the original scheduled payments, until the loan is brought back to performing status.

In the Australian RMBS sector, the inclusion of loans under hardship arrangements in arrears reporting has become more commonplace among lenders, but practices vary. An area of difference is whether the arrears day count continues once the loan is no longer under hardship arrangements. Once the hardship period has ended, bank lenders typically continue to include these loans in their arrears reporting for a further six-month serviceability period, based on APRA's guidelines.

Is There Likely To Be A Material Increase In Loss Severity In Flood-Affected Areas?

Adequate insurance coverage is a key loss-severity risk in flood-affected areas in RMBS portfolios. While property values may be lower due to flood damage and reduced demand for property in affected areas in some individual cases, we expect such instances to be limited. The likelihood of this combining with borrower default--and therefore the possibility of loss to the pool--is limited, given the diversity of most RMBS pools.

Home insurance policies typically cover several water-related events such as storm, cyclone, and rainwater runoff. Flood damage can be excluded if it was due to tidal or wave damage, for example. Also, because insurance is generally taken out when the loan is underwritten, it might not have been kept up to date and could have lapsed. Some lenders maintain blanket insurance policies to cover this risk. In other instances, the amount of insurance cover could be inadequate.

Following a natural peril event, housing prices might drop and the ability to sell property could be adversely affected should the area be deemed less desirable or of higher risk to buyers, as occurred after the recent California wildfires and the flooding of the Brisbane River in Queensland in 2011.

Are Ratings Likely To Be Affected?

We do not expect our ratings on most Australian RMBS to be affected by the recent floods, given the strong geographic diversification in most RMBS portfolios. Furthermore, the credit support buffers available in most transactions should be adequate to absorb an increase in the loss severity for affected loans in flood-affected areas.

We took no rating actions on RMBS when arrears rose in areas affected by previous natural disasters, such as the Black Saturday fires in 2009, floods in 2011, and bushfires in 2019.

How Are ESG Factors Considered In Credit Rating Analysis?

Our credit ratings on structured finance transactions incorporate environmental, social, and governance (ESG) credit factors when we believe they could affect the likelihood of timely payment of interest or ultimate repayment of principal by the legal final maturity date of the securities.

Environmental, social, and governance (ESG) risks and opportunities can affect an obligor's capacity to meet its financial commitments in many ways. However, in most cases, exposure to ESG credit factors in structured finance transactions is indirect or mitigated by legal and structural features already embedded in typical transactions (see "The Role Of Environmental, Social, And Governance Credit Factors In Our Ratings Analysis," published on Sept. 12, 2019).

In the context of RMBS, physical climate risks such as floods, storms, or bushfires could severely damage properties and reduce their value, affecting recoveries if borrowers default. In our view, well-diversified portfolios reduce exposure to extreme weather events.

This report does not constitute a rating action.