The Impact of COVID-19 on Indonesian Residential Mortgage-Backed Securities

Analyst: Hasnalia Hanifah

The COVID-19 pandemic has dramatically affected economic conditions in Indonesia, creating a significant deterioration in revenue and cash flow generation in almost all activities and subsequently the debtors' capabilities in repaying its financial liabilities. For most individuals, residential mortgage is commonly the single largest financial obligation, and typically accounts for a major portion of a bank's loan portfolio. The sizable number as well as amount of loan restructures in the Indonesian mortgage industry indicate that the debtors' loan repayment capacity and the banks' cash flows and profitability have both been severely affected by the COVID-19. Interestingly, however, its impact on the ratings of the mortgage-backed securities has been much more modest due to the inherent structural features of this type of securities.

PEFINDO views that the impact of the pandemic on the credit profile of Residential Mortgage-Backed Securities (RMBS/EBA KPR) to remain manageable. This is because these securities are backed by the availability of structural features that cover for cash flow disruption such as subordination of Class B, reserve funds, and interest excess spread. However, caution should be exercised in view of the high degree of uncertainties the pandemic may entail. As the situation evolves, PEFINDO will continue to be cognizant on the impact of COVID-19 on the underlying mortgage pool, and the possible scenarios in relation to its cash flow as well as gauging the strength of the security's structure to warrant a full and timely payment to the security holders. Below is PEFINDO's methodology on assessment of the structural features and the new additional enhancement to mitigate the heightening risks the industry may encounter in case of the proliferation of COVID-19.

Interest Excess Spread

The excess spread serves as a first line of defense to absorb losses in the event that the reference portfolio underperforms. If individual loans or a portfolio of loans experience delinquency or default, the cash from the excess spread account is used to pay the investor. At the time of the issuance of the EBA KPR, the coupon for the EBA Class A (the Class which has been sold to investors) is calculated to be fulfilled by mortgage interest payment within the portfolio, by setting Class A coupon as low as possible compared to the mortgage interest. We note that natural mismatch exists between mortgage interest rates and Class A coupons, whereby mortgage loans are based on floating rate whereas the RMBS coupons offer fixed rate. To mitigate the mismatch, EBA KPR agreements typically set the interest rate floor for the securitized mortgages with the threshold being higher than the offered Class A coupon. The difference between the offered Class A coupon and the minimum rate will serve as a buffer against possible prepayment and restructuring risks that may materialize either during the pandemic or normal period.

Table 1. Actual Mortgage Interest Rate,
Minimum Rate Requirement, and Class A RMBS Coupon Rate as of Sep 30, 2020

Interest Rate	DBTN-05	SPBMRI-01	SPBTN-02	SPBTN-03	SPBTN-04	SPBTN-05
Weighted Average Mortgage Interest Rate	13.96%	13.25%	13.95%	13.65%	13.44%	13.52%
Minimum Rate Requirement	11.50%	12.75%	12.00%	12.00%	10.00%	11.00%
RMBS coupon rate - Class A1	10.00%	8.60%	8.15%	8.00%	7.00%	8.50%
RMBS coupon rate - Class A2	10.25%	9.10%	8.75%	8.40%	7.50%	8.75%
RMBS coupon rate - Class M	NA	NA	NA	NA	NA	10.40%
Margin - Clas A1	3.71%	4.15%	5.20%	5.25%	5.94%	4.77%
Margin - Clas A2	1.25%	3.65%	3.25%	3.60%	2.50%	2.25%

Source: PEFINDO Data

Reserve Account - Interest and Senior Expense

In RMBS transactions, collections from the underlying mortgage borrowers are the only source of regular cash inflows for the issuer. A suspension of scheduled debt payments would therefore result in a direct reduction in cash flows available to the issuer. At the same time, the issuer remains obliged to make timely interest payments to EBA holders in addition to pay regular costs to keep the transaction current. A significant reduction in collections may therefore lead to a shortfall, rendering the issuer being unable to pay a part or all of the senior costs plus interest. Non-payment of interest on the most senior class of notes would typically lead to an event of default under the transaction documents.

Our rated RMBS are supported by credit support mechanism in the form of reserve account provided by PT Sarana Multigriya Finansial (Persero) with its primary role is to support the development of secondary mortgage transactions. The credit enhancement consists of 3-months interest payment covering coupon payment and senior expenses for the EBA KPR holders. The balance of the reserve fund is periodically adjusted following the actual use of such fund, as in the event of an excess between the existing amount of the reserve fund and the sum of the coupon payment and senior expenses. The excess amount will be returned to credit support provider. We view that the structure and the existing enhancement may act as protections against a liquidity stress. Therefore, it helps cover for the coupon and senior expense payments, especially during the pandemic. In spite of this, a limitation exists since it might not cover the principal portion of the payments to investors in case the RMBS suffers a significant increase in non-performing loan ratio, leaving the reserve account falls short for covering all of the payment obligations. Up to September 30, 2020, the amount of cash inflows obtained from collection efforts exceeded the projected collection amounts for all the pools.

Table 2. Actual to Scheduled Collection as of September 30, 2020

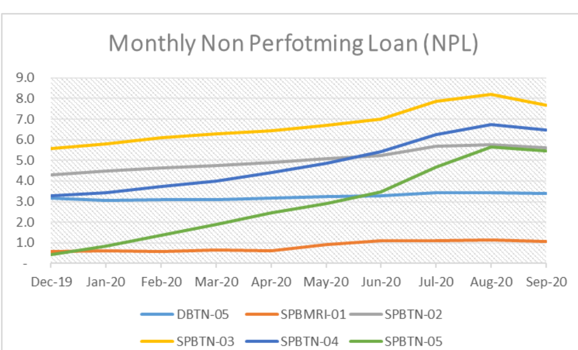
Actual to Scheduled Collection	DBTN-05	SPBMRI-01	SPBTN-02	SPBTN-03	SPBTN-04	SPBTN-05
[%] Actual to Scheduled Principal Collection	117.1	286.4	122.1	157.3	148.4	199.7
[%] Actual to Scheduled Interest Collection	101.0	181.3	98.4	100.6	94.9	94.9
Total Actual-To-Scheduled Ratio	113.2	246.2	113.2	131.4	124.8	131.6

Source: PEFINDO Data

Subordination in the form of Class B

The risk profile of Class A is also supported by Class B of the total securitized assets, which will provide credit enhancement for Class A EBA-SP since no principal payment will be made to Class B until Class A has been fully repaid. This structure is strengthened by a pass-through mechanism to minimize the impact of prepayment. Any principal repayment of the securitized mortgages will be transferred to Class A holders every three months, along with the coupon payment.

Graph 1. Monthly Non Performing Loan (NPL)



Source: PEFINDO Data

We observed a higher non-performing loans (NPL, overdue more than 90 days) at the end of September 2020 compared to the end of February 2020 (before COVID-19) on all our rated RMBS**.** The prolonged economic slowdown has weakened the debtors' repayment capacity. However, this NPL was mitigated by the availability of adequate property collaterals and the existing class B EBA, of which we view it sufficient, and therefore should be able to withstand the potential loss arising from these non-performing mortgages.

Below are the data of NPL compared to Class B amount per September 30, 2020. We notice two pools with high NPL ratios, namely: EBA SP SMF BTN 03 and EBA SP SMF BTN 04. The NPL amount escalated since March 2020 due to high NPL particularly in areas where the economic activities were severely disrupted by COVID-19, such as Batam. However, we also note both some pools with longer seasoning recorded relatively stable NPL ratios and and some pools from the areas less affected by COVID-19.

Table 3. NPL to Class B as of September 30, 2020

	DBTN-05	SPBMRI-01	SPBTN-02	SPBTN-03	SPBTN-04	SPBTN-05
[IDR bn] Original Balance	1,500,000,001,615.0	500,000,134,976.0	1,000,000,000,000.0	1,000,000,000,000.0	2,000,000,000,000.0	2,000,000,000,000.0
[%] SML	19,756,442,654.3	12,945,164,022.0	37,855,111,314.0	46,457,897,681.0	103,964,331,859.1	120,657,235,352.6
[%] NPL	50,698,193,213.0	5,312,633,541.7	56,118,436,456.0	76,624,906,805.4	129,621,295,819.5	109,461,834,780.0
[IDR bn] Class B	129,000,001,615.0	43,500,134,976.0	87,000,000,000.0	87,000,000,000.0	176,000,000,000.0	260,000,000,000.0
[%] SML	1.3	2.6	3.8	4.6	5.2	6.0
[%] NPL	3.4	1.1	5.6	7.7	6.5	5.5
[%] NPL/Class B	39.3	12.2	64.5	88.1	73.6	42.1

Source: PEFINDO Data

Additional Enhancement – Principal Reserve Account

Although the existing enhancements provide adequate cushion to guarantee principal payments to EBA holders, the continued increase in NPL arising from the weakening debtor capacity may exert unsustainable pressure on the cash flow performance of the underlying assets during the pandemic. To mitigate the potential risk resulting from the prolonged pandemic period, SMF as credit enhancer has created an additional enhancement feature in the form of reserve account that would cover in case of a shortfall for full payment of the principal amount of Class A EBA-SP on its payment date. The additional reserve account will be added if the percentage of outstanding NPL of the existing pool has reached 80% of Class B value. Additional reserve funds will be topped up based on a tiering system of 20% up to a maximum of 200% of NPL/Class B. We view that the principal reserve account will strengthen structure protection, particularly in case of prolonged economic downturn.

However this type of enhancement will only apply on EBA SP BTN, while KIK EBA DBTN 05 and EBA SP SMF BMRI 01 are excluded. Despite the absence of the additional enhancement, we consider the latter two instruments to have better risk profile given the longer seasoning and lower NPL compare to the others.

Collateral Performance

We view the performance of mortgages as the underlying assets of the EBA KPR will remain manageable amidst the pandemic. This is supported by the long-seasoned installment period, the relatively conservative loan to value (LTV) ratio, and the debtor profile which is dominated by fixed income employees.

At the time of the issuance, we have established the minimum seasoning benchmark for the securitized mortgage to examine the debtors' track record in honoring its installment obligations. We view the debtors with longer seasoning period are more resilient, due to the higher equity participation in the property. As the LTV becomes lower along with the seasoning, credit risks for the lenders decrease. In addition, another requirement for the transaction is for first time home buyers, as the debtors living in the house will have more willingness to maintain ownership of the property by fulfilling the mortgage obligations.

Table 4. Loan by Loan Analysis as of September 30, 2020

30-Sep-20	DBTN-05	SPBMRI-01	SPBTN-02	SPBTN-03	SPBTN-04	SPBTN-05
Issuance Date	3-Dec-14	27-Aug-16	31-Oct-16	28-Apr-17	28-Feb-18	27-Nov-19
Number of Loans	33,173	3,696	11,280	11,237	18,728	16,476
Current number of loans	12,331	2,538	7,682	7,712	14,221	15,602
Total Current Balance (Rp billion)	202,467,841,582	201,988,850,365	382,346,700,785	479,000,522,889	1,112,271,020,856	1,781,195,653,942
Maximum Current Balance (Rp million)	275,407,151	618,911,316	316,454,659	389,818,208	355,961,719	423,836,697
Average Current Balance (Rp million)	16,419,418	54,650,663	33,895,984	42,627,082	59,390,806	108,108,500
Total Original Balance (Rp billion)	1,500,000,001,615	670,721,539,124	1,370,659,520,471	1,339,890,465,500	2,827,714,512,791	2,587,885,401,303
Maximum Original Balance (Rp million)	500,000,000	1,000,000,000	500,000,000	500,000,000	500,000,000	500,000,000
Average Original Balance (Rp million)	65,900,209	181,472,278	121,512,369	119,239,162	150,988,601	157,070,005
Weighted Average Debt-to-Income Ratio (%)	30.2	27.4	33.7	45.1	35.9	36.5
Weighted Average Current LTV (%)	24.9	40.7	33.5	57.0	41.4	54.5
Weighted Average Original LTV (%)	74.6	78.9	72.8	79.0	71.7	72.9
Weighted Average Original Term (years)	13.5	14.3	13.2	14.8	12.3	14.9
Weighted Average Seasoning (years)	11.4	9.7	9.6	7.6	7.4	6.5
Weighted Average Remaining Term (years)	2.1	4.6	3.6	7.2	4.9	8.3
Average Current Borrower's Age (years)	48.2	43.9	45.2	41.2	44.2	40.6
Weighted Average Mortgage Rate (%)	14.0	13.2	13.9	13.7	13.4	13.5
Minimum mortgage rate (%)	12.5	10.8	12.0	12.0	11.3	10.0
[IDR bn] SML	19,756,442,654.3	13,234,171,710.8	37,855,111,314.0	46,457,897,681.0	103,964,331,859.1	132,997,264,994.6
[IDR bn] NPL	50,698,193,213.0	5,665,887,693.3	56,118,436,456.0	76,624,906,805.4	129,621,295,819.5	113,279,406,133.0
[%] SML	1.3	2.6	3.8	4.6	5.2	6.6
[%] NPL	3.4	1.1	5.6	7.7	6.5	5.7

Source: PEFINDO Data

We also view the collateral performance is supported by its debtor capacity since most debtors hold fixed income jobs either as civil servants, private company employees, state-owned enterprise employees or serving in the armed forces or police officers. Fixed income employments provide higher income stability as against otherwise such as entrepreneurs or professionals, most notably during the current economic recession. Fixed income debtors accounts for more than 90% in our rated EBA KPR and should support the pool cash flow generation amidst the pandemic and serve as a cushion in case of deterioration in asset quality. In spite of this, a prolonged pandemic may also affect the fixed income debtors' repayment capacity in the event that the employers' business performance deteriorates leading to salary cuts or even layoffs. Accordingly, PEFINDO will continue to monitor the impact of COVID-19 on the underlying mortgage pool, including the pool's cash flow quality under different possible scenarios, and ultimately the strength of the security's structure to warrant a full and timely payment to the security holders.

In order to cope with the adverse effect of the pandemic on the domestic economy, especially the financial sector, the authorities have taken a number of measures, among others, POJK No. 11/POJK.03/2020. This measure is intended to address the banking industry intermediary function, stabilise the financial system and support the economic recovery program through providing relieve for the financially distressed debtors affected by the pandemic. The key policies contained in the regulation include assessment of the affected borrowers and banks' asset quality, credit restructuring policy, new loans, and reporting requirements. Following the relaxation of asset quality assessment, banks are allowed to manage their non-performing loans and to provide a stimulus to the affected debtors, including loan restructuring. We view the stimulus will help ease the debtors affected by the pandemic to maintain their obligations to the bank current depending on their payment capacity.