AOFM to support public ABS/Non-Conforming RMBS issuance 15 Nov. 2018

In 2018 we made a conscious decision to build investment exposure to the Mortgage and asset backed warehouse sector, this decision was based on a view that regulatory changes (more specifically APS 120 capital requirements), would create an attractive investment opportunity for investors.

Our view was that these regulatory dynamics would drive an increase in capital needs approaching $150-$200ml to mature high quality mortgage originators, allowing us to build an allocation on our terms.

Since inception, the opportunity and funding gap has grown to in excess of $500ml as non -bank lending growth has risen materially on the back of the major banks retreating into their shell. This has seen non-banks broaden their addressable market share which in turn has driven a need for them to raise more capital still.

Moving on from that, today's announcement of a new $2bln Securitisation fund by Prime Minister Scott Morrison is unequivocally positive for the opportunity.

What is being proposed seems to imply that the government will buy packages of secured and unsecured SME loans issued by smaller banks and non-bank lenders such as fintechs, boosting funding to these non-big bank lenders to lend to small businesses.

To be more specific this is likely to come in the form of government support for AAA ABS public securities. This will mirror prior government programs. In 2009 the initial commitment of $4 billion grew to a $20bln approval. As such we believe that this current $2bln in the Australian Business Securitisation Fund, has the potential to grow in a similar fashion.

The AOFM (Australian Office of Financial Management) bought almost $16 billion of residential mortgage backed securities (RMBS) to keep alive non-bank home lenders during the liquidity and funding squeeze of 2008-09 at the direction of then treasurer Wayne Swan.

By providing a constant bid in the market the AOFM will essentially provide support to public RMBS/ABS, this will mean that the risk of the public market closing to non-bank lenders has reduced materially on the back of this decision. To be clear we do not think that the government bid will crowd out investor money and drive spreads tighter, far from it, in fact the people who will likely be responsible for the program are seasoned operators who will protect the tax payer by allocating funds in a thoughtful and prudent manner.

That said we do think it is more likely that they will use their capital strategically to allow the non-bank market to sustain itself at these elevated levels, allowing them to continue to strip market share from the majors. This is a big deal.

In terms of the types of loans that get supported, we expect that the preference for rated securities will benefit well scaled mature programs, at the margin we think it will incentivise more banks to support unsecured warehouse lending, however at the same time it will be supportive to the non-conforming RMBS market. A good number of non-conforming borrowers are in fact self-employed people who lack the track record to be banked by a business bank relationship, as a consequence their cost of funding is materially higher to reflect the greater need for lenders to provide more capital under these loans.

The government's decision to provide support in this area will flow through to this part of the market, and perhaps even your professional property investor market who many people forget are also small enterprises that are credit reliant.

It was our opinion during the RC that Hayne gave the non-banks a widish berth, after all the last thing the system needed was to close the non-bank channel as the big four were throwing risk over board. What this does however is it brings into light the fact that government understand the importance of the non-bank and small bank sector in helping businesses run.

Where this could be a game changer is that it hits at the primary and fundamental competitive advantage ADI's have versus non-banks, which is the funding piece.

By providing funding support to non-bank origination, the non-banks and the banks who provide them with warehouse funding can have greater confidence that the government is aware of the fact that this channel is important, and it needs to function properly. We view this as a re-affirmation to what was implicitly said in 2009, which is that the non-bank sector is important for business. If this amount can grow and support the AAA market, it will see this risk get written without the constant fear of how do we fund it if markets turn sour?

For specialist investors in this area this is an unequivocally positive outcome. It will lead to another increase in capital requirements, which will likely see spreads have to widen to accommodate further demand. While the government will fund AAA, mezz investors will still be required to fund between AA and BB, with issuers also likely required to come up with first loss capital to be able to get lending away.

In terms of what we think,

It underpins the opportunity set and allows Realm to grow theme specific strategies without necessarily having a dilutive impact. In addition, the term out of Syndicated Warehouses now will be underpinned by a government bid in the SME area. SME loans include non-confirming loans, which we already fund. Advisers should contact Realm directly for more information if there is interest in the theme.

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