NONBANKS' LOCAL BUY-IN

Support from debt investors is a critical component of Australian nonbank lenders' business models, and the major nonbanks have investor relations high on their priority lists. These issuers have been able to fund their businesses through the credit cycle, and domestic fund managers say they see the appeal of the nonbank value proposition – with appropriately detailed credit work.

BY LAURENCE DAVISON

Finding willing buyers for their securitisation transactions has become more important for nonbanks in recent years, as regulation of the bank sector has positive and negative consequences.

The nonbanks are seeking to fund growth in their lending books while managing the changing cost-effectiveness of their other primary means of funding – bank warehouses.

The success of these issuers in continuing to find homes for their local-currency securitisation is shown by the accelerating pace of issuance in the past half-decade. Following the maintenance mode of the immediate post-crisis years, nonbank securitisation in Australian dollars picked up in 2013 before hitting a new record level in 2016 and again this year (see chart on p19). The four biggest nonbank names continue to account for around two-thirds of the total volume.

Domestic investors remain critical to this growth. The largest nonbank issuers see international buyers as their main funding growth driver, but to date issuance in foreign currencies has provided only a small component of total securitisation issuance since the financial crisis. Offshore buyers are taking a bigger share of nonbank-originated paper denominated in Australian dollars, but the domestic component is still dominant.

Nonbank securitisation offers investors an interesting value proposition. The product is diverse in credit profile. Residential mortgage-backed securities (RMBS) based on pools exclusively or partly comprising nonconforming loans are arguably the sector's stock in trade. But nonbanks also offer consistent supply of prime RMBS as well as asset-backed securities (ABS) comprising consumer, auto and equipment or SME loans, and occasionally commercial mortgage-backed securities.

This degree of diversity is part of the appeal to sophisticated credit investors. Fund managers willing to back their credit analysis say they can find value in different collateral and throughout the securitisation capital stack.

On the other hand, perhaps the biggest question for potential investors in nonbank securitisation is whether the investment in detailed credit analysis they have to make in order to gain sufficient understanding of nonbank pools and issuers can be rewarded in scaleable investments. This is more than just deal-by-deal analysis, too.

With nonbanks not having access to deposit bases or – in most cases – alternative forms of wholesale funding, fund managers say being satisfied with the sustainability of these issuers' business models is almost as important to the credit process as detailed analysis of specific securitisation pools.

KangaNews speaks to a clutch of Australian institutional investors that have developed comfort with at least some of the local nonbank sector's issuers and securitisation product.

"Fortunately for us, the major lenders in the nonbank space have come through the financial crisis with their business models intact. Once we have reviewed the players in the sector it becomes easier to keep up to date with the credit profiles of their specific lending."

DYLAN BOURKE KAPSTREAM CAPITAL

FEATURE

INTRODUCING ***THE INVESTORS***

KangaNews speaks to four Australian fund managers with a track record of investment in nonbank securitisation. The firms are diverse, as are the factors attracting them to the nonbank sector. The common factor is a similar view of the positive risk-reward equation these issuers can offer.

Challenger Investment Partners (Challenger) manages A$15.9 billion (US$12.5 billion) across fixed income and real estate globally. Of this, around A$4.5 billion is invested in securitisation markets in Australia and offshore according to portfolio manager, Steve Martin.

Challenger is a relative-value investor. It was one of the largest nonbank issuers of RMBS from 2004-07, and therefore has a long history of participation in Australian securitisation markets. Today, Challenger ranks as one of the largest institutional investors in the sector.

IFM Investors (IFM) manages A$98 billion with debt comprising a third of the total. Scott Barker, the firm's regional head, Asia Pacific, says it tends to focus on credit and often what might be regarded as "non-mainstream credit". Since 1999, Barker says, IFM has "sought to find value for our investors that perhaps isn't as obvious to mainstream fixed-income investors".

This has included securitisation for many years. Here, Barker says IFM is in fact most active outside the major-bank sector including nonbanks. The firm also has a long track record as a buyer of middle-to-lower rated tranches in securitisation deals.

Kapstream Capital (Kapstream) is a debt-specialist fund manager with more than A$11 billion under management. It is "pretty constructive" on structured finance, according to portfolio manager, Dylan Bourke, and the asset class comprises around 10 per cent of Kapstream's portfolio in Q3 2017.

Bourke continues: "Nonbanks make up a substantial portion of our structured-finance exposure at present. It makes sense to us to pick up some spread in an asset class we view as being slightly less liquid in general, provided this spread comes from what we consider to be high-quality collateral – which it does."

Realm Investment House (Realm) is a boutique fund manager that invests across the fixed-income landscape – including rates and credit product – but has a notable affinity with structured finance.

Rob Camilleri, investment manager at Realm, says the firm has a long-term strategic asset allocation of around 30 per cent to the securitisation asset class. However, it is currently somewhat below this level, at around 18 per cent, based on a relative-value view and Realm's cyclical outlook.

PRODUCT NATURE

Fund managers say even analysis of assets being securitised on a standalone basis requires some degree of understanding of the originator. However, those most engaged with the nonbank sector say this is because of the diversity of the Australian securitisation-originator landscape rather than because nonbank collateral inherently demands additional scrutiny.

"When it comes to the specific loan pool, the analysis and stress-testing we do is virtually identical for bank and nonbank RMBS issuers," says Steve Martin, portfolio manager at Challenger Investment Partners (Challenger) in Sydney. "We focus on maintaining consistency in our credit process in this respect and not automatically assuming a loan written by a major bank is of better credit quality than a loan written by a nonbank. Each should be judged on its merits."

Rob Camilleri, Melbourne-based investment manager at Realm Investment House (Realm), adds: "We don't discriminate between prime and nonconforming mortgages or between major bank, regional bank and nonbank originators. Everything is processed through a risk-for-value model and we assess each pool on its own merits."

Investors refer to two important considerations when it comes to nonbank mortgage collateral. The first is that not all nonbank mortgages are nonconforming. Firstmac alone issued nearly A$4.5 billion (US$3.5 billion) of prime RMBS between the start of 2016 and the end of Q3 2017. Fund managers are also keen to counter any stigma about nonconforming product. Taken on its own merits – with appropriate credit analysis and pricing for risk – the Australian nonconforming mortgage can be an appealing investment choice.

"It's important to be clear about what nonconforming means in an Australian context, because we aren't talking about US subprime or 'liar loans'," comments Scott Barker, regional head, Asia Pacific at IFM Investors (IFM) in Melbourne. "There is a lot of lending that doesn't meet the traditional underwriting standards for lenders' mortgage insurance – which tends to be what the major banks are originating – but is still perfectly mainstream mortgage product."

The post-crisis regulatory process has provided a catalyst for increased prominence of 'near-prime' mortgage assets in Australia. With capital deployment at a premium in the bank sector, certain types of lending – for instance to self-employed borrowers – has become less appealing to banks and therefore made them less willing to chase this market segment via aggressive pricing regimes.

Dylan Bourke, Sydney-based portfolio manager at Kapstream Capital (Kapstream), says tighter lenders' mortgage insurance criteria and the Australian Prudential Regulation Authority's desire to manage house-price inflation and financial-system risk have significantly expanded the pool of technically nonconforming loans that have a performance profile very close to prime.

"We are pretty constructive on nonconforming assets at present," Bourke confirms. "Partly this is simply because collateral performance has been consistently good since the introduction of the National Consumer Credit Protection Act in 2010. This applies to all mortgage collateral, but nonconforming in particular has done exceptionally well. We are seeing arrears typically in the 3-5 per cent range where pre-crisis they might have been close to double-digit levels at some points."

ANALYSIS APPROACH

Nonconforming RMBS does require a degree of intensity in the credit analysis, investors say – the point is simply that buyers do not start from a perspective of assuming all nonconforming pools must inherently comprise bad credit. In fact, the range of considerations relating to any securitisation pool can appear dizzyingly broad, and doubly so when it comes to the inherently diverse nonconforming product.

Martin explains: "It's not totally unreasonable to say a lot of prime loans are competing in a similar space – their customers are seeing a range of similar loans and selecting based on a relatively limited group of criteria. By contrast, the reasons why a borrower ends up in a nonconforming portfolio can be extremely varied. On a nonconforming deal it's vital to understand exactly what type of portfolio we are looking at, and to arrive at an assessment of default and recovery based on bottom-up, loan-level analysis."

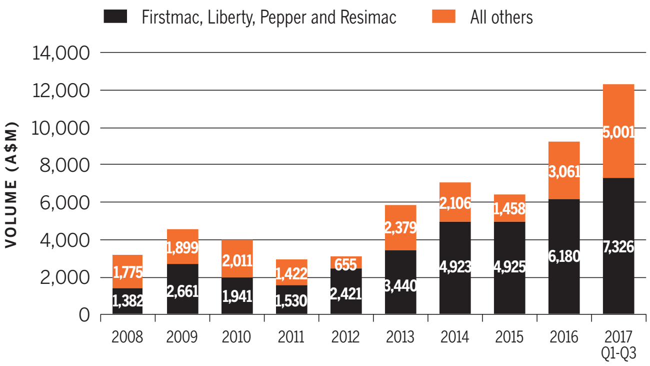
The starting point for many investors is establishing exactly how and why nonconforming loans in any RMBS pool do not qualify as prime and thus what market sector the originator is targeting. From there, the fund manager conducts in-depth, loan-level analysis of each pool.

For some deals, the gap between prime and nonconforming – and bank and nonbank – can be relatively small. "The heterogeneity of nonconforming pools means we need to continue to check the makeup and credit characteristics in depth on every occasion. We run the same process for prime pools but they tend to be quite highly correlated with each other, aside from regional concentrations which we generally prefer to avoid," Martin tells *KangaNews*.

Bourke agrees specific credit work around the nature of nonconforming assets is crucial. In this respect, he draws comfort from two developments in particular. One is the evolution of deal structures in the past decade. Coming out of the financial crisis, investors were highly cautious around securitisation in general and nonconforming assets in particular.

Structures have had to change to woo the buy side back into the fold, Bourke says – and by doing so they have become

NONBANK ISSUER AUSTRALIAN DOLLAR SECURITISATION*



* Includes all issuers and collateral types.

SOURCE: KANGANEWS 9 OCTOBER 2017

much more robust. He points to such factors as initial credit enhancement that is often 30-40 per cent for the top tranches of sequentially paying nonconforming deals, and the fact that these transactions tend to have significantly larger liquidity pools than bank RMBS. This could mean a 3-6 month liquidity pool.

Features like this afford significant investor protection against issuer failure or asset underperformance, Bourke says – especially given the asset quality that often underlies such RMBS offerings.

Martin suggests nonbank securitisation structures can often be better calibrated with investor preferences. For instance, although he says major-bank RMBS may feature a notional coupon step-up if not called this is often only available on the senior notes – which he tends not to regard as a genuine economic alignment between investor and issuer in the event of changed market conditions at call date.

By contrast, Martin says nonconforming, nonbank RMBS will be more likely to offer excess spread diversion post-call, more punitive step ups and other structural features giving investors more comfort around alignment of interest with the originator.

The other factor Bourke points to is the resilient business performance of the bulk of securitisation-originating nonbank lenders in Australia. He explains: "Fortunately for us, the major lenders in the nonbank space have come through the financial crisis with their business models intact. Once we have reviewed the players in the sector it becomes easier to keep up to date with the credit profiles of their specific lending."

Barker says IFM strives to be sure a mortgage originator or servicer is set up to handle the nonstandard characteristics of its

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STEPHEN MARTIN CHALLENGER INVESTMENT PARTNERS

WATCHING THE ***WATCHMEN***

Australian fund managers confirm the nature and extent of regulatory oversight of the local nonbank sector is front of mind. They are comfortable with the concept of regulation but say the devil is in the detail.

Australia's federal budget, delivered in April 2017, included a clutch of measures giving the Australian Prudential Regulation Authority (APRA) enhanced oversight over nonbank lenders. Specifically, proposed law changes will compel nonbanks to register under the Financial Sector (Collection of Data) Act and to provide additional lending data to the regulator. APRA will also have new powers to introduce and enforce rules on the nonbank sector in the interest of financial-system stability.

The purpose of these measures is to ensure nonbanks do not simply replace types of lending APRA believes endanger financial-system security and on which it has already placed restrictions when originated by authorised deposit-taking institutions.

Both federal treasurer, Scott Morrison, and APRA's chairman, Wayne Byres, have emphasised that they see the new powers purely as a failsafe. In fact, some securitisation market sources suggest the policy move is more to do with Australian alignment with international regulatory standards than a specific local concern about the nonbank sector.

"I would seek to reassure those [nonbank] organisations – which in their own way also provide greater choice options and competitiveness in the system, and we welcome that – it is very much a reserve power, to be used solely at the discretion of the regulator, and people got a pretty clear signal from [Byres] that he sees it like that," Morrison said.

Even so, nonbanks themselves have expressed concern at the vague nature of the proposed regulatory changes, suggesting they are prone to overreach – especially given the relatively small lending market share the sector accounts for.

Investor views

Investors in Australian nonbanks universally say they are monitoring developments in the regulatory arena as part of their ongoing due diligence of the sector.

Their biggest concern is that if a regulatory impost came in that made an issuer's business unviable it would be a major risk for securitisation holders, so they say it is critical to stay on top of regulatory developments. Fund managers insist they are not opposed to regulation *per se* but agree the potential for overreach is concerning.

"Regulatory oversight of responsible lending and regulation that promotes a sustainable financial system are good things," says Scott Barker, regional head, Asia Pacific at IFM Investors. "The challenge is getting the balance right. It's also not productive to create a system that participants want to game – to stick to the letter rather than the spirit of the law."

Rob Camilleri, investment manager at Realm Investment House, agrees that a regulatory regime that promotes a strong financial system is positive – especially given the dominance of Australia's big-four banks. He also agrees with APRA's desire not to see excessive liquidity flowing into lending areas the regulator wants to restrict.

But he notes provision of credit to individuals and entities that fall outside the banks' sweet spot is an economic good. "Where I would get worried about regulation is if and when it reaches the point of restricting the business these lenders can write," Camilleri tells *KangaNews*. "This could put us back to the situation we had in 2009-10 when – at Commonwealth Treasury's direction – the Australian Office of Financial Management was underwriting the securitisation market and lenders were only writing the most vanilla business as a result."

Reasons for optimism

While they continue to monitor the issue closely, investors say they are hopeful of a rational landing point for the regulatory process even as they await further information and a clear perspective on market consequences.

"My suspicion is that if the regulatory oversight of nonbanks is limited to a requirement to provide additional reporting it will probably have only a very limited market impact," argues Dylan Bourke, portfolio manager at Kapstream Capital.

Investors speaking to *KangaNews* say they have a degree of confidence that, in the end, the Australian government and regulator will likely not want to constrain the nonbank sector excessively given the wider backdrop of desire to promote competition in the local financial system.

In this context, they point to the volume of public and media talk about the need for competition in the financial sector and ask what the purpose would be of snuffing out a sector that has very small overall share of the lending market but also provides genuine competition to the major banks within its market segment.

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SCOTT BARKER IFM INVESTORS

loans. For this reason, his firm also reviews mortgage originators' standards and systems, including site tours and management meetings, to help it develop appropriate understanding of underwriting processes in detail.

BUSINESS PERFORMANCE

Taking a credit view on nonbanks as corporate entities and having a clear picture of their business models is vital, investors say, even though the assets they are buying are standalone securitisations issued by special-purpose vehicles – and therefore remote from the originator of the underlying loans.

The issue is the potential for securitisation pools to be orphaned by originator failure. Investors want to be confident issuers will call securities voluntarily and that extension risk is minimised. In the worst-case scenario, a missed RMBS interest payment is an event of technical default – though the liquidity pools Bourke mentions insulate against this risk to some extent.

Regardless, fund managers say issuer creditworthiness and funding behaviour is critical even in the securitisation space. In this respect, the nature of nonbank lenders means additional scrutiny is required – including keeping a keen eye on the developing regulatory picture (see box on facing page).

Realm's Camilleri explains: "We model the balance sheets of the main nonbank securitisers and assign an internal credit rating to them. When we invest in RMBS we take mortgage assets that are held in trust, but there is also always the additional factor of refinancing or call risk. This is inevitably greater in the nonbank sector, simply because these issuers don't generally have access to a diverse range of funding options."

Although most of Australia's nonbanks are not rated in their own names – with the exception of Liberty Financial, which holds a BBB- rating from S&P Global Ratings and has twice issued senior-unsecured bonds – investors say the credit process they conduct on nonbanks is similar to what they would deploy on a rated, own-name bond issuer.

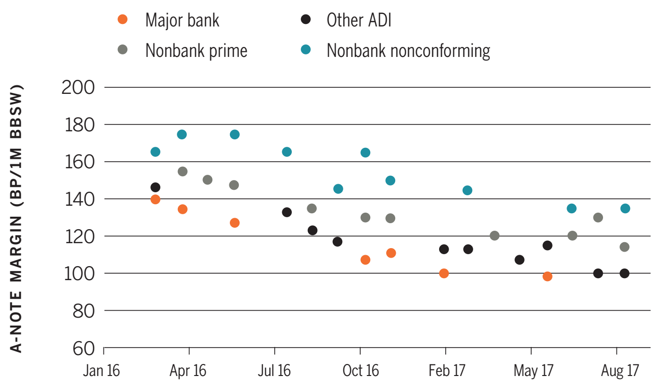
In this sense, success is its own reward – because Australian fund managers say they look most favourably on the nonbanks that have established a track record of resilience and positive investor relations over time. Good assets have survived in Australia even when their originators have not, but the issuer-investor relationship runs deeper than this.

Camilleri notes: "A lot of Australia's nonbanks have been around for a long time and have some very smart, strategic thinkers involved in running them. It's not all about taking the cheapest funding available at any given moment for them – they are clear about wanting to have a strong, stable investor base that is supportive through the cycle."

PRICING DECISIONS

While investors acknowledge the nonbank sector brings special considerations around the nature of the loans its constituents write and their ongoing business prospects, their main message is that none of these make the sector uninvestable. As ever, the question is whether the buy side believes it is being adequately compensated in a holistic sense – from risk profile, to the credit work required to reach an informed view, to liquidity and consistency of supply.

AUSTRALIAN DOLLAR RMBS PRICING BY ISSUER AND DEAL TYPE



SOURCE: KANGANEWS 9 OCTOBER 2017

Martin says Challenger takes a more nuanced view than a blanket yes or no on nonbank names or adding a standard spread increment to reflect additional risk in these issuers' business models. However, there are "red flags" that would lead the firm away from participating in a specific issuer's transactions and cannot be solved by price. These could be related to structural features of deals, market segment or reputation, and Martin says they are "non-negotiable". But in general the discussion is about appropriate pricing.

Unsurprisingly, nonbank securitisation traditionally comes to market in Australia with a small but significant margin premium attached – typically in the range 10-25 basis points above bank deals for prime mortgages (see chart on this page). Bourke says this range is relatively well established, and where relative pricing sits at any specific point in time is a major component of Kapstream's view on the sector.

He comments: "In my view, we are being adequately compensated for the fact that nonbanks may have to keep issuing during sell-offs and their spreads are therefore at risk of blowing out. Nonbanks offer extremely high credit enhancement relative to bank deals, so we're covered from a default perspective. They also add a pickup of around 15 basis points of credit spread on their most senior notes and attractive investment opportunities throughout deal structures." •

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ROB CAMILLERI REALM INVESTMENT HOUSE