FEATURE

NONBANK MOMENTUM BUILDS

The opportunity set for Australia's nonbank lenders is arguably as positive as it has been for well over a decade. The sector's main players are deploying a variety of business models across a raft of target markets, though all are built around the common themes of nimbleness, high-quality service and specialised risk management.

BY LAURENCE DAVISON

The Australian nonbank sector took a battering in the financial crisis as its main source of funding – securitisation, both through bank facilities and in capital markets – dried up. The players that have emerged on the other side in good shape, without being subsumed by larger banks or abandoning balance-sheet loan origination entirely, say the environment is finally favourable to their business models once more.

Nonbanks' share of the Australian mortgage market reached a peak in the years leading up to the crisis. They commanded nearly 25 per cent market share in owner-occupier loans alone by 2002 (see chart on this page). The last decade has been less kind and has seen significant consolidation, but the remaining players say the outlook is changing.

NONBANK SHARE OF AUSTRALIAN OWNER-OCCUPIER MORTGAGE LENDING (TREND DATA)

SOURCE: AUSTRALIAN BUREAU OF STATISTICS OCTOBER 10 2016

The contemporary landscape for nonbanks once again proves the maxim 'whatever doesn't kill you makes you stronger'. The crisis, which caused so much stress, has also created the circumstances for today's nonbanks to flourish.

An enhanced regulatory regime in the bank sector is helping level the playing field for lenders outside the Australian Prudential Regulation Authority (APRA)'s purview, especially in speciality-finance sectors where some nonbanks believe they have a loan-pricing edge.

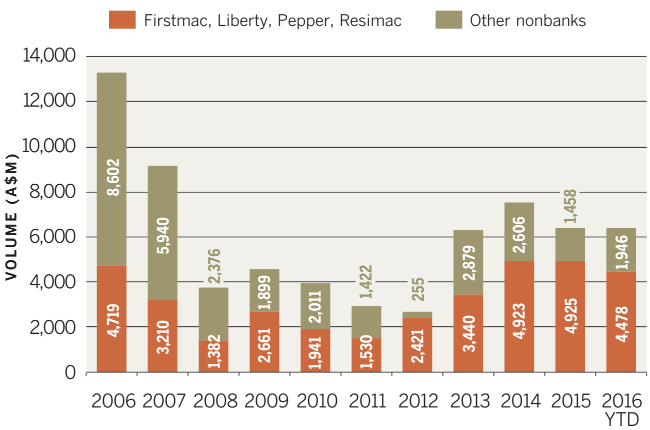
Even in the mainstream mortgage space, the matrix of funding and lending costs has swung back in favour of nonbank lenders. The margin banks can make on retail deposits has been eroded to the point that some securitisation-funded nonbanks are making headway in prime mortgages.

Bank pricing is the main factor driving consumers to explore borrowing options from a wider range of providers. But when they do so – for instance by sourcing loans via brokers – it becomes easier for nonbanks to demonstrate the value of their offering.

At the same time, nonbanks say they are well placed to take advantage of developments in the fintech space. The common theme is that not being burdened by the extensive infrastructure most banks have built over time frees nonbank lenders to exploit opportunities in areas like sophisticated pricing for risk and online product distribution.

However, strategies vary. Firstmac, for instance, is focusing much of its attention on online distribution. This is based on the

AUSTRALIAN DOLLAR SECURITISATION BY NONBANK ISSUERS



SOURCE: KANGANEWS OCTOBER 14 2016

view that the more cost efficiencies it can leverage the better its value proposition versus the big banks in the highly competitive prime home-loans sector. Many of the other nonbanks, while agreeing that online will grow as a distribution method, believe their speciality-finance offerings are at present still best served through the more tailored service offered by brokers.

The funding side of the nonbank business is perhaps the sector's biggest challenge, at least in the sense of the investor outreach and engagement required to fund growth ambitions. Nonbanks themselves say explaining their story – including a sustained myth-busting process – to on- and offshore investors is a key plank of their growth strategies.

COMPETITIVE LANDSCAPE

Front and centre in the competition picture is increased regulatory scrutiny of the banking sector. This is placing pressure on bank lending margins, causing authorised deposit-taking institutions (ADIs) to reprice or even abandon some market sectors. The key regulatory developments are higher risk weights for residential mortgages written by Australia's largest banks and enhanced regulatory oversight of loans to property investors (see box on p8).

Mary Ploughman, Sydney-based joint chief executive at Resimac, says the expectation of increased mortgage risk weights for ADIs has been a major change driver at Resimac over the past half decade. "We knew from the outset that this was going to put us on a much more level playing field from a cost-of-funds perspective and therefore allow us to compete more directly with the banks," she explains.

The same goes for the crackdown on banks' investor lending. Martin Barry, chief corporate treasurer at La Trobe Financial in Sydney, says the macroprudential measures APRA has introduced over the past 18 months aimed at reducing higher-risk mortgage lending have created opportunities in specific market sectors previously served by banks.

Regulation in and of itself goes hand in hand with what the nonbanks report as changing consumer behaviour – specifically, growing willingness to explore alternatives to the major ADIs when seeking financing. Peter Riedel, chief financial officer at Liberty Financial (Liberty) in Melbourne, suggests that mortgage brokers – the traditional, though far from exclusive, source of business for nonbank lenders – have seen their share of mortgage origination grow to 60 per cent from 45 per cent in recent years.

The major banks originate a sizeable proportion of their loans through brokers, too. But customers coming to lenders via brokers are not a captive audience to a single ADI, and are also less likely to be brand focused.

"The regulatory evolution in the banking industry that has gathered pace over the last 12 months, but that has been quite prevalent over the last 36 months, has created lots of opportunities for Liberty and the broader nonbank sector," Riedel says. "These changes have increased our share of broker-originated loans as consumers have sought advice and support for their needs rather than going directly to the banks as they have done in the past."

LENDING MODELS

The opportunities being spun out of the ADI market by regulatory scrutiny of average mortgage risk weights and lending perceived as riskier tend to predominate at the margin of the banks' traditional strength of prime mortgages. But there is room for individual nonbanks to put different business models into play in the pursuit of various target markets.

There is notable disparity even among the 'big four' nonbanks. Liberty's focus in the residential space spans prime, near-prime and custom, supplemented by other significant asset classes including self-managed superannuation loans, SME commercial mortgages and auto and personal loans. Resimac is mortgage focused but with a hybrid book of prime and nonconforming assets. Firstmac's sole focus is on the prime space. Pepper Group (Pepper) is a traditional nonconforming player with new ambitions in global markets.

The playing field is also green enough that a clutch of new and returning lenders have developed sufficient scale to justify a capital-markets presence. La Trobe, for instance, debuted in the securitisation market in 2014 – as did Thinktank Commercial Property Finance, a specialist commercial-mortgage lender.

Domestic securitisation issuance from the nonbank sector has rebounded from 2013 (see chart on this page). Indeed, the consistent level of issuance by the four biggest players – A$4-5 billion (US$3-3.8 billion) a year for the past three years – backs their belief that their growth is testing true domestic wholesale-funding capacity.

What is clear is that the contemporary opportunity set offers openings to all players. Pepper, for instance, might be regarded as having the 'classic' nonbank business model. Pepper historically focused on nonconforming lending, backing its ability to price risk for borrowers who could not obtain cost-effective loans from the ADI sector. Patrick Tuttle, Pepper's Sydney-based co-group chief executive officer, says recent developments have made the company more competitive higher up the credit chain.

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BANK REGULATORY PRIMER: OPPORTUNITY DRIVER

Regulatory developments have changed the dynamics of price competition in Australia's lending market. Higher mortgage risk weights and increased scrutiny on investor loans are the two crucial market-moving events.

The Australian Prudential Regulation Authority (APRA) increased the amount of capital required for Australian residential mortgage loans written by authorised deposit-taking institutions (ADIs) which use the internal ratings-based (IRB) approach, from July 1 2016.

The change, announced in July 2015, affects Australia's big-four banks and Macquarie Bank. It has no impact on the rest of the country's authorised-deposit taking institutions (ADIs) – all of which use the simpler standardised approach.

Specifically, APRA wants to increase the average risk weight on Australian residential mortgage exposures, measured across all IRB ADIs, to an average of at least 25 per cent from approximately 16 per cent. The big four have been forced to increase their capitalisation to respond to the change. All the major banks have conducted multibillion dollar capital-raising exercises since APRA's announcement and implementation.

Crucially, though, some analysts argue that the revised risk-weight regime will in fact only bring major banks' loan-pricing economics closer to a level commensurate with actual lending risk.

A Moody's Investors Service report from July 2015 says: "The additional capital that will be required to be held against residential mortgages will better align the banks' capital positions with the growing tail risks arising from their residential mortgage exposures during a period of high investor demand and an associated rapid acceleration in house prices in Sydney and Melbourne."

Investor lending

The other move APRA has made with significant direct consequences for lending-market competition is its enhanced oversight of mortgage lending it perceives to be of higher risk.

In December 2014, APRA wrote a letter to all ADIs. The letter says the regulator "will be paying particular attention to specific areas of prudential concern". Three are named: "higher-risk mortgage lending" including high loan-to-value ratio and interest-only loans, "strong growth in lending to property investors", and loan-affordability tests for new borrowers.

APRA did not introduce any new rules or hard limits. However, it did say: "Annual investor credit growth materially above a benchmark of 10 per cent will be an important risk indicator that supervisors will take into account when reviewing ADIs' residential mortgage risk profile and considering supervisory actions."

Again, from the perspective of the nonbank sector the opportunity created comes down to the removal of some perceived mispricing.

While it did not uncover any systemic issues, a 2015 APRA study of banks' lending practices – banks submitted serviceability assessments for four hypothetical borrowers, being two owner occupiers and two property investors – suggested there was a need to rein in lending standards.

In a May 2015 speech, APRA's chairman, Wayne Byers, said: "The outcomes for these hypothetical borrowers helped to put the spotlight on differences in credit assessments and lending standards. The outcomes were quite enlightening for us – and, to be frank, a little disconcerting in places."

"The opportunity for Pepper is that we are able to segment our risk appetite much more clearly between prime, near prime and nonconforming," he explains. "This enables us to be a far broader mortgage lender than was perhaps the case five years ago. It is why we are growing, year on year, well and truly above what the banks describe as system growth."

Tuttle also highlights another headwind for bank lenders – the tighter standards applied by lenders' mortgage insurance (LMI) providers in the past few years. Most ADIs use external LMI for loans with, for instance, high loan-to-value ratios. Lenders like Pepper have been able to take advantage of the fact that some otherwise prime borrowers are being squeezed out of the bank market.

"Our prime customers are exactly the same as the traditional bank market, with the only difference at Pepper being that we self-insure mortgages – we don't use LMI as an effective secondary underwrite of underlying credit risk," Tuttle explains.

Factoring in the growth in the near-prime customer base, Tuttle adds: "A lot of consumers are falling just outside the traditional credit-scoring models used by the banks. Again, this has created quite a large opportunity for Pepper – being a more broad-based lender – to lend to these customers on a price-for-risk basis. As you can imagine, we charge a slightly higher interest rate to these customers, though how near they are to prime can vary quite a lot."

Firstmac believes the opportunity set is large enough even purely at the prime level – the firm only lends to prime borrowers. Its Brisbane-based chief financial officer, James Austin, explains that funding dynamics have also swung back in favour of a nonbank lender even in this space. As a fully wholesale-funded entity off a bank bill swap rate (BBSW) base, Firstmac has an advantage over ADIs in a low-rates environment as it is not anchored to an increasingly expensive deposit base.

"The biggest opportunity for us, and it is probably a once-in-a-decade opportunity, is that with interest rates going towards zero banks have reached a floor in their ability to cut mortgage rates," Austin comments. "We expect the cash rate will continue to be cut, towards zero. As this happens, the net-interest margin for a nonbank that is 100 per cent funded over BBSW will continue to widen while banks' margins will continue to be squeezed. The competitive position of a nonbank in a low-interest-rate environment has never been better."

ASSET QUALITY

Whatever sector or sectors form the focus for specific nonbanks, all the sector's lenders are quick to point out that just because some of the borrowers coming to them might previously have been funded by the banks does not mean they are writing poor-quality credit.

The response is straightforward for a lender like Firstmac, given its concentration in the prime space. Austin says Firstmac's offering has simply become more price competitive, because of the changes in the firm's funding dynamics versus deposit-heavy banks and the efficiencies of its online distribution platform. "It is a common misconception, based on lazy thinking, that nonbanks are around to 'pick up the leftovers'," Austin claims. "In fact there are very few lenders in Australia that have better credit quality than Firstmac today. This is borne out by our arrears, which are among the lowest in the country."

Austin adds that Firstmac does not lend to property buyers from overseas – other than Australian and New Zealand citizens living offshore – and does not write investment loans against high-rise developments. It will lend to high-rise owner-occupiers but will not accept rental income in loan applications.

Ploughman also points to the performance of Resimac's prime-mortgage programme – Premier – which she says is equal to or better than that of some major banks. "It is not that nonbanks are lending in areas in which the banks do not want to, but more that nonbanks can play in more diversified areas because they have a more flexible funding model," she adds.

The same message comes from lenders across the nonbank sector. For one thing, the new opportunity set is offering market growth outside the nonconforming space. Pepper's Tuttle explains: "I think it's fair to say our growth is often misconstrued as being purely a product of going further and further down the credit curve. In fact it's the absolute opposite – our growth in the past three years has come predominantly from the near-prime sector."

Riedel at Liberty also emphasises the fact that even fully nonconforming loans can have perfectly acceptable credit characteristics when their risk is appropriately priced. He says: "Nonconforming doesn't mean bad credit. First and foremost we are risk managers and, irrespective of our status as a nonbank, we are managing and operating in the same environment as banks. This means none of us can be blindly writing loans in areas from which others may be stepping away – because they are probably doing so for very good reason."

Riedel emphasises the fact that Liberty pioneered risk-based pricing and continues to set loan costs with which the firm is comfortable on a risk-adjusted basis. Nonbank lenders like Liberty have become more competitive in some sectors as other players change their approaches, but Riedel insists that it is not the case that Liberty is aggressively repricing its offering to pursue business.

"A good example of this is the fact that banks' change in margins due to the developing risk-weighted-assets environment has enabled Liberty to become competitive in the investment-loans space," he continues. "What we have definitely not done is stepped into riskier investment loans, like lending to offshore buyers or providing loans secured against high-rise inner-city apartments. We always look to support our customers but only if the risk-adjusted return profile is suitable for our business."

INSTITUTIONAL STRENGTH

Another misconception nonbanks are keen to counter is the idea that, because they are not ADIs with strict capital rules in place, they are inevitably thinly capitalised and thus inherently insecure institutions. Liberty in particular places capital at the heart of its value proposition to investors.

Riedel explains that having a capital base of more than A$400 million and an investment-grade rating is integral to Liberty's diversification strategy and its ability to establish businesses from the ground up. The firm has for many years measured its own capital based on prudential standards – initially on APRA standards and nowadays against S&P Global Ratings' risk-adjusted capital framework.

"In many ways we have more skin in the game than our peers and are much more like a bank in this respect. We are investment-grade rated and there is generally more scrutiny on us to the extent that we have very discrete approaches to risk-adjusted return hurdles," Riedel adds.

All the main nonbanks say capital is important even to firms sourcing most of their funding via securitisation, with its arms-length special-purpose-vehicle methodology. "Prior to the financial crisis, I don't think capitalisation came up as much as it should have done," Tuttle acknowledges. "A lot of nonbank originators were thinly capitalised – including ourselves, to be frank – and only some got away with it. But those days are over."

The reason why is straightforward, Tuttle explains. "Capitalisation speaks to the long-term credibility of our business model. If a securitisation investor is thinking about buying A$100 million of triple-A rated, Pepper-originated securities they will want to know that Pepper will be around for the long term as a servicer – collecting money and ensuring good performance of the underlying portfolio."

The nonbanks are not universally trying to mirror the ADI model, however. As Austin points out, it can be a point of advantage for the nonbanks that they do not have the same cost of capital as banks. What most nonbank players are aiming to do is have sufficient capital to secure investor confidence without eroding the inherent advantages of falling outside the ADI regime.

"Our experience is also that, since the financial crisis, it is very important to show evidence of skin in the game and that an issuer is continuing to build and apply capital to all the loans it writes," Austin comments. "We do not measure capital in a Basel-style way – rather we look at the capital applied to each discrete pool, including warehouses." •