NONBANKS RELISH THE PRESENT AND EMBRACE THE FUTURE

K*angaNews* brought together representatives of Australia's leading nonbank lenders to hear their views on the sector now and in the years ahead. Their insights reveal a degree of optimism about the role of nonbank lenders in the local market and beyond.

PARTICIPANTS

- **James Austin** Chief Financial Officer FIRSTMAC
- **Martin Barry** Chief Corporate Treasurer LA TROBE FINANCIAL
- **Paul Eagar** Director, Securitisation FIRSTMAC
- **Andrew Marsden** Director, Capital Markets RESIMAC
- **Mary Ploughman** Joint Chief Executive RESIMAC
- **Peter Riedel** Chief Financial Officer LIBERTY FINANCIAL
- **Patrick Tuttle** Co-Group Chief Executive Officer PEPPER GROUP

MODERATORS

- **Helen Craig** Deputy Editor KANGANEWS
- **Laurence Davison** Managing Editor KANGANEWS

SECTOR OPPORTUNITIES

Craig When we talk about opportunities spun out of the bank sector, to what extent do these come through in the form of the ability to grow market share organically and to what extent are they whole-business acquisition opportunities? There has certainly been no shortage of acquisition activity.

PLOUGHMAN Our focus has all been around organic growth. Resimac has, of course, made several acquisitions over the years, both high-profile and smaller transactions, but these have all been very opportunistic. The Resimac business does not actively seek out acquisition opportunities around the world. Our focus is on owning our own distribution and developing growth organically, and building and diversifying our global investor base to fund this. This is where we have been investing our resources, and will continue to do so.

AUSTIN Although our business is quite different the story on organic growth is quite similar for Firstmac. In our case business growth also is and will be entirely organic. We will not be engaging in acquisitions. Our market share is growing – and with it the online share of the mortgage market as a whole – because we offer a predominantly online retail service and the rates we are able to offer are so much better priced than banks can currently offer.

TUTTLE Pepper Group (Pepper) has been quite acquisitive globally but in our Australian lending business the focus is also now all on organic growth. We are not seeing the same opportunities to buy portfolios of residential mortgages as we did even a couple of years ago, so our growth is coming from the increased breadth of our product suite and through driving distribution via a diversified network. In fact, we see whole-loan transactions more as a funding diversification tool – selling rather than buying, in other words.

RIEDEL It has always been our preference for our growth strategy to be organic. We believe we have the right price settings, technologies and operational processes to be able to build new products and services from scratch very profitably and in a measured way.

We are always open and ready to respond to organic growth opportunities. For example, we leveraged changed regulatory settings over the past 12-18 months by having scale in our product value proposition, risk- and loan-fulfilment systems and human resources.

We consider domestic acquisitions from time to time, with these coming principally in the form of loan-book acquisitions. But we only do so to the extent that it makes sense for us operationally and financially.

BARRY We also see the best opportunities occurring through the type of responsible, organic, loan-by-loan origination growth that allowed us to originate more than A$3.5 billion (US$2.6 billion) in financial year 2016.

Davison To what extent can nonbanks' own business practices in areas like cost management, servicing and sophisticated risk pricing allow them to compete with established banks when it comes to loan pricing? The banks of course have an inherent advantage, at least in theory, given their general access to a broader range of competitive funding sources.

BARRY We have never positioned ourselves to compete against the established banks based on price, for precisely the reasons you mention. We believe operators in this sector that do so run the risk of being squeezed by the larger banks.

We position ourselves as a viable alternative credit provider for borrowers seeking a higher level of personal service, faster response times, better communication, or a simpler product set.

As we don't compete on price, our recognition that all our borrowers have different needs and our ability to individually meet these needs quickly is what will enable us to continue settling good volumes in the future.

AUSTIN Our view is that the landscape is changing. It's true that, historically, banks' competitive advantage has been their ability to raise funding at a cheaper rate than nonbanks. The nonbank advantage has been superior cost efficiency in everything we do.

This isn't just a coincidence: by nature of the authorised deposit-taking institution (ADI) licence banks have bloated bureaucracies, which cost a lot of money. This has always been balanced by the banks' funding advantage, creating something of a level playing field. But as the banks' funding-cost advantage diminishes due to the relative deposit-cost increase, the cost efficiency we have with our expense base increasingly becomes an advantage to us.

Putting some numbers on it, when banks have zero-rate deposits and are earning, say, 8 per cent on a mortgage they have plenty of coverage for the cost base. This advantage is no longer evident when the cash rate goes down and the mortgage rate with it. This is the key factor tipping the scales in favour of the nonbanks.

As a nonbank is able to become more and more efficient in its lending origination, including economies of scale in the volume it is processing, ultimately its profits and market share will grow.

RIEDEL It is certainly true that bank pricing has moved towards the nonbank model. In our view, we are competitive on price and superior on service. Liberty Financial (Liberty) pioneered risk-based pricing and the nonbank sector followed – to varying degrees. We have since seen the banks follow the nonbanks' lead as well. The banks are now differentiating their pricing based on loan purpose and repayment profile, and some of them are even increasing rates based on loan-to-value ratio.

There is another aspect, though, which cannot be underplayed in competing with the banks: that of service and certainty. Consumers nowadays appear to be frustrated by the lack of certainty from banks. There is a growing group of borrowers that has either been declined or been offered less competitive terms than expected. Customers have turned to mortgage brokers for guidance as a consequence.

Liberty, given its strong relationships with the broker network, has benefited from customers seeking options and alternatives. Demand for Liberty's product has stemmed partly from price, but more important has been our ability to communicate a clear and compelling consumer value proposition via brokers.

PLOUGHMAN Peter Riedel is right that price is not the only factor. We see our main value proposition as speed to market. We are a small and nimble operation that is able to respond to changes in the risk environment using very sophisticated tools. We can create new products and get these into the market very quickly. Also, because we are not a large organisation – at least relative to the bigger ADIs – our turnaround time and response framework for business is much shorter.

All this applies on both sides of the business – by which I mean the issues are relevant to Resimac both as a borrower and as a lender.

TUTTLE Actually we don't see the major banks as our main competitor – and I doubt they view us as such, either. In fact we are providing a service to segments of the markets that the majors are no longer chasing. The scale of business the major banks are writing means they need to have a highly standardised, 'cookie-cutter' process.

It's not that we don't have a lot of automation in our business – in fact we are increasingly digitising in order to write loans more rapidly. But the truth is that the banks aren't targeting some of the niche sectors we focus on because they have enough to do in the standard, prime mortgage space. They also don't have the expertise we have when it comes to the

> "There is a growing group of borrowers that has either been declined or been offered less competitive terms than expected. Customers have turned to mortgage brokers for guidance as a consequence."
>
> **PETER RIEDEL** LIBERTY FINANCIAL

READING THE *CRYSTAL BALL*

The environment for nonbanks is positive in late 2016 but it has certainly had ups and downs in recent years. What happens next will be fascinating.

CRAIG Where will Australia's nonbank sector be in five and 10 years' time?

MARSDEN If you look at the major nonbanks, Resimac and Firstmac have been operating for more than 30 years, and Pepper and Liberty for around 20 years. The nonbanks are very much an entrenched part of the overall mortgage market. Our sector is also evolving its business models and becoming much more sophisticated.

Pepper is listed and Resimac will soon be listed. The capital models the major nonbanks run are not only a lot deeper and much more advanced than they have been in the past but are also definitely here to stay. The opportunities we see are to pursue consumer-lending prospects in the marketplace over time, using our sector's flexible business models.

BARRY I agree that the nonbanks have a long history and are an entrenched part of the overall mortgage market. This puts us all in a very good position over the next 5-10 years. La Trobe Financial is a new participant in the debt capital markets but we have a track record of mortgage and investment management going back to 1952.

AUSTIN In our case the online market will continue to grow. This is unstoppable – it is the future of lending. Bricks-and-mortar branches and, to a lesser extent, brokers are yesterday's hero. Online will overtake just as it has in every industry, and we believe we will be very well placed in five and in 10 years' time.

PLOUGHMAN We also foresee a move to online business and away from the existing strong oligopoly in the lending market. The oligopoly continues to be entrenched as things stand, but it remains so almost entirely because of regulation.

RIEDEL If we are thinking about 10 years' time, I agree that online engagement will be the big change. To date, customers making big financial decisions – like buying a home – like to feel, touch, talk and engage face to face. But we think in 10 years' time this is likely to change, and people are more likely to be comfortable transacting digitally even for major life decisions like home loans. The prevalence of direct-to-market product will certainly be a much larger proportion of the market than exists today.

This change will be driven by technology, and specifically how all stakeholders absorb and use technology. The tools that are available today – such as web chat and video link – will likely be dinosaurs in 3-5 years' time. The speed of technological development so far has been incredible and one would expect this rapid change to continue, providing ways to engage digitally that we can't even foresee today.

Taking the lead from the last two decades, the nonbanks have been primarily responsible for innovation and competition in the lending market. Liberty Financial is very focused on continuing this and thus I believe the trend of market-share growth will continue. This is in part because of the solutions we are providing and also because we believe the broker market will continue to grow.

TUTTLE Over the next decade I see an incremental increase in Australian market share for the nonbanks, driven by the capital pressure on banks. But it won't be life changing of itself. I'm talking about nonbank mortgage-market share growing to something like 10 per cent in five years' time and 15 per cent in 10 years' time, from 5 per cent

"WE FORESEE A MOVE TO ONLINE BUSINESS AND AWAY FROM THE EXISTING STRONG OLIGOPOLY IN THE LENDING MARKET. THE OLIGOPOLY CONTINUES TO BE ENTRENCHED AS THINGS STAND, BUT IT REMAINS SO ALMOST ENTIRELY BECAUSE OF REGULATION."

MARY PLOUGHMAN RESIMAC

pricing-for-risk methodology we use across the three mortgage segments we underwrite.

If anything, we supplement the major banks in the mortgage market. There is overlap, of course, but in the main we take over where they stop. This suits us, because our cost of funds as a nonbank – without access to deposit or senior-unsecured wholesale funds – is materially higher.

Davison Speaking of nonmortgage asset classes, while there is a lot of talk about constraints on bank mortgage lending the reality is that Australian ADIs have if anything further concentrated their books in the residential space. Is the opportunity set for the nonbanks just as large, if not even larger, in other lending-market sectors as it is in residential mortgages?

TUTTLE Taking this a step further, we see ourselves as a 'challenger brand' to the banks. In prime mortgages, as others have mentioned, this comes purely from our faster turnaround time and our service levels in the broker channel. We are going head to head with the banks in this sector, because they also generate up to half their mortgage origination through brokers. I see our value proposition in this area being the fact that we can be more nimble and that we can tell brokers "yes" more often – because we have a broader appetite.

The fact that we don't use external lenders' mortgage insurance (LMI) also supports faster turnaround times, because today. These are guesses not accurate estimates, of course.

For Pepper Group (Pepper), I think the picture will vary across the markets in which we operate. I don't see any nonbank lender becoming the 'fifth pillar' in Australia – I'm sure there will continue to be political rhetoric around the continuing dominance of the local major banks but actually I think the strength of the majors is a good thing for the local market. We benefit from this strength, in fact, because the banks are huge partners to businesses like Pepper through the provision of warehouse facilities.

This isn't to say competition is a bad thing – clearly it is positive, and we will drive it as will the peer-to-peer lenders. This will be of benefit to the end consumer, but it won't change the fact that banks are successful businesses due to their stable funding profiles.

■ DAVISON What do you see as nonbanks' greatest challenges ahead?

BARRY The greatest challenge is to maintain funding lines that enable us to take advantage of the opportunities and write credit assets at a level that is sustainable now and in the future. It would be very easy to grow our portfolios and substantially weight them to specific sectors abandoned by the banks. But without the support of the investor community this is not sustainable and could potentially place funding lines at risk.

On our estimates, the nonbank market is now worth at least A$30 billion (US$22.6 billion) a year – a material increase due to the reasons discussed – so the challenge is significant if industry participants wish to pursue it.

AUSTIN I agree that the biggest challenge will be for us to access incremental senior funding over and above what we are able to achieve in the domestic securitisation market. If the senior funding is there to allow us to grow to our potential, we could become quite a significant participant in terms of percentage market share.

TUTTLE Scale is a focus across our whole business – not just the funding aspect. I wouldn't say we worry about it, but as a fast-growing nonbank we certainly have to ensure we continue to broaden our debt investor base as we grow.

The pace of our growth, and the number of jurisdictions in which it is happening, also means we have to have a continual focus on 'right sizing' our infrastructure, particularly around risk management. This will help to ensure we don't outpace our natural strength and capacity.

We have to maintain adequate bandwidth as a management team to handle growth. It's certainly not the scale of opportunity that concerns us – the opportunity is enormous. For us it's about making sure we maintain management structures sufficient to support the growth. But it's a high-quality problem.

The barriers to entry for new nonbanks are also higher now than they have been, because of the need for warehouse funding. Banks in the contemporary environment won't support thinly capitalised or inexperienced originators in the long term. So if you don't have a strong track record and good capitalisation it's virtually impossible to get access to warehouse capacity sufficient to support growth in your business.

PLOUGHMAN The challenges are always around the fact that this is a volume business. So small and nimble can work well. But, at the end of the day, to make money you need to issue volume. This is where factors such as capital constraints become an issue and where the funding side of the nonbanks' businesses are critical. This means it is more important than ever for the nonbanks to strike the right balance.

RIEDEL The global economic environment and capital markets are constantly evolving. Elections, stimulus management and Brexit are topical now, but before long it will be something else. Managing through turbulence in a low-growth, uncertain global economic environment is the key. As a speciality lender with nearly 20 years behind us, we feel well positioned to take advantage of opportunities, while managing the threats, as they emerge.

> "CHANGE WILL BE DRIVEN BY TECHNOLOGY, AND SPECIFICALLY HOW ALL STAKEHOLDERS ABSORB AND USE TECHNOLOGY. THE TOOLS THAT ARE AVAILABLE TODAY – SUCH AS WEB CHAT AND VIDEO LINK – WILL LIKELY BE DINOSAURS IN 3-5 YEARS' TIME."
>
> **PETER RIEDEL** LIBERTY FINANCIAL

we do all our prime-mortgage underwriting ourselves and don't have to defer to LMI providers.

I also believe we are a challenger brand more broadly – for instance in the consumer-auto sector. There has been a lot of consolidation in consumer auto over the past five years, leading to dominance by a small handful of large ADI lenders. We are positioning ourselves through our distribution network – auto- and consumer-finance brokers and, to a lesser extent, car dealers – as a challenger to the bigger players.

We have a broader credit appetite in autos in the same way as we have in the residential sector. We will lend for anything from brand-new vehicles from dealers to used cars both from dealerships and in the private-sales market. Brokers and dealers are often concerned about too much concentration in the funding space, so positioning ourselves as an alternative has a lot of potential.

We are now writing A$60-70 million a month in auto and equipment finance, from a standing start 18 months ago. We expect to have a book of A$1 billion in receivables outstanding at some point in Q1 2017.

■ RIEDEL Absolutely there are opportunities in the market beyond residential lending, which is why Liberty started its product-diversification journey more than 15 years ago. We provide products and services related to motor finance, SME lending, self-managed superannuation fund lending, personal loans, consumer-credit insurance and investment products.

Some of these other products are higher risk, so to take advantage of the opportunities we need to ensure we have the

"As the banks funding-cost advantage diminishes due to the relative cost increase of deposits to banks, the cost efficiency we have with our expense base increasingly becomes an advantage to us."

JAMES AUSTIN FIRSTMAC

appropriate risk-management practices in place and sufficient capital to establish and support these businesses.

Liberty has the benefit of both capital and significant risk-management capability. We have also been effective at leveraging cross-sale opportunities. For example, we have achieved significant distribution synergies by offering multiple products.

■ **PLOUGHMAN** For Resimac, nonresidential has always been a major part of our lending business and it continues to be so. Meanwhile, a sizeable part of our nonconforming business is SME lending. The 'low doc' or 'alt doc' business is where we lend to small businesses via first-registered mortgage security. Because we use bespoke underwriting we understand the sector's risks.

■ **BARRY** It's true that there also appear to be opportunities in the business-, SME- and other household-lending sectors, all of which are under increasing competitive pressures in the contemporary market environment. However, at La Trobe Financial we will continue to focus solely on granular, property-backed credit. We are not sure the banks would ever let large sections of the nonresidential funding market be controlled by nonbanks.

We have some experience here, with our A$1.2 billion retail credit fund providing diversity in funding. This fund enables us to write high-quality, specialist, property-backed loans to individuals and SMEs. We will continue to be active in this market on a selective basis.

■ **AUSTIN** It's a slightly different story for us, as we are more focused on growing market share in our core product than adding more. The opportunity set for Firstmac is the growing role played by online distribution. Online is currently 3 per cent of the Australian mortgage market but it is growing all the time. This is our main focus and where we expect our growth to come from.

FUNDING MATTERS

Davison One of the main headwinds for nonbanks is that the capital constraints on ADIs' own lending also apply to warehouse facilities. How is the funding landscape changing for nonbanks, and to what extent do issuers expect the role of capital markets to grow?

■ **PLOUGHMAN** The nonbank sector as a whole is working together to respond proactively to this evolving situation. The nonbanks are very close to the investor market, and a number of investors have responded by trying to help fill the gaps created through changes in warehousing rules. This aspect of our market is changing but, because we have strong relationships, we believe Resimac will be able to respond accordingly. The fact that we are a nimble organisation means we can adjust as we need to.

It will be interesting to see how the situation plays out and what is passed on by the banks in cost terms. At the end of the day this is a commoditised part of the market and if a lender cannot compete it will not be selling mortgages in future.

From our perspective, we will raise money and price mortgages. However, if it turns out that our strategy differs from the banks in this respect it doesn't mean it isn't competitive – it just means they have come to one conclusion and us to another.

■ **RIEDEL** It's worth noting that things really haven't changed structurally so far, and nor do we expect them to. The

"We don't see the major banks as our main competitor – and I doubt they view us as such, either. In fact we are providing a service to segments of the markets that the majors are no longer chasing."

PATRICK TUTTLE PEPPER GROUP

“The challenge for the sector in re-engaging the real-money investor base since the financial crisis has been the fact that the global regulatory environment has made international issuance so lacklustre that a number of investors have not come back to the market.”

MARY PLOUGHMAN RESIMAC

consequences of the capital changes will therefore be principally on our cost of funding.

Maintaining a flexible, durable and diversified funding programme is key to our strategy as we manage through these regulatory changes. We have more than A$400 million of equity, in excess of A$3 billion of wholesale funding, a A$600 million commercial-paper programme and a senior-unsecured funding programme – the last two being unique to a nonbank. Of course we also regularly access term-securitisation markets. This durable and diversified funding programme allows us great flexibility to support our customers sustainably.

■ **TUTTLE** We are highly focused on warehouse capacity – and funding capacity overall, of course – given the scale of our organic growth in Australia. There has been spread widening in debt capital markets as a whole since late 2015, and it’s fair to say this has transferred through to warehouse pricing margins.

Because we are such a large mortgage lender we use a multitude of warehouses. For example, we have three nonconforming and two prime mortgage warehouses, as well as two – soon to be three – auto warehouses. They all have different tenors, generally of one, two or three years, and as roll dates came up during 2016 we have certainly seen an increase in their funding margins – commensurate with what’s happened in the public securitisation market.

There is another factor at play. As APS 120 works its way through the institutional banking system we expect there will be a further increase in warehouse margins over time. As the banks have to set aside more capital against warehouses obviously it will cost the banks, and therefore us, more to provide them.

We are factoring this expectation into our thinking on front-end mortgage pricing. This year we have seen 50 basis points of cash-rate cuts in Australia, but we have not passed on all these cuts to our customers. We need to hold some of the pricing reduction back to prepare for a slight widening in our cost of funding as warehouses reprice or RMBS markets get more expensive.

In other words, it is swings and roundabouts in the capital markets. But capital constraints for the banks are gradually increasing – a trend line we don’t expect to see reversing. The good news for us is that, as a market leader in Australian near-prime and nonconforming, we have a considerable amount of pricing power relative to our peers. Obviously we have competitors so I’d caveat this by saying ‘within reason’. But we can calibrate our pricing to meet cost-of-funds issues much more closely than we can in the prime space.

■ **BARRY** I agree with the idea that the broad role of capital in banks and for nonbank warehouses and RMBS is still evolving in the wake of the financial crisis, and is subject to the finalisation of the new regulatory standard, APS 120.

Our view is that capital markets have the potential to play an increased role in our business, complementing our institutional-investor and retail-credit-fund money inflows. However, capital-markets funding could be thwarted by the unintended consequences of APS 120 around capital constraints on ADIs, which are passed through to nonbank pricing and capital minima or restrict the ability to invest across multiple tranches in the RMBS capital structure. Some of these requirements are above and beyond international standards.

This is not a market for the faint hearted, and the A$113 million of equity in our business holds us in the top three nonbanks operating in the country.

■ **AUSTIN** We have rapidly grown our market share but our ability to make further gains is capped by the level of senior funding we are able to raise. At the moment this appears to be roughly A$2 billion in a calendar year, which means A$2 billion is what we can originate through our online channel. The success we are having with our retail lending means we can certainly grow beyond this level of origination, and accessing further senior funding will determine the level of growth we can achieve.

Craig Speaking of which, what is the nonbanks’ read on Australian dollar securitisation capacity? How hopeful are they that the domestic market will be able to meet the requirements of the nonbank sector and its individual issuers, expecially if they achieve their growth targets?

■ **TUTTLE** We aren’t currently concerned about securitisation capacity, though this is because we are actively seeking to maximise it. The first way we are doing so is via securitisation deal structures.

For example, Pepper Residential Securities Trust No.16 was at the time a record volume for an Australian nonconforming deal – A$700 million – and it included a US dollar 2a7 tranche.

GLOBAL STRATEGY VARIETY

Some nonbank lenders have focused their growth plans on domestic lending while others have been much more active globally – particularly via acquisition.

DAVISON What is the rationale behind specific global strategies?

PLOUGHMAN One of the things we recognise is that Australia is a very concentrated market and the banking sector in particular is an oligopoly. This means the ability of the nonbanks to grow market share is limited to a certain extent. Therefore breaking into more diversified markets, like the UK, provides us with a greater ability to gain market share.

However, it's important to be clear that our diversification into offshore markets has been more about taking advantage of opportunities rather than being part of a strategic plan to change business direction.

TUTTLE We believe the opportunity set can be and is different in specific overseas markets from what it is in Australia. Picking up on Mary Ploughman's point about concentration, the political drive for broader competition in the UK banking sector, for instance, is already tangible. The number of licensed challenger banks that has emerged in the UK in the last five years is significant, even if market share is not yet huge.

In time, we might consider applying for a UK banking licence. The government is making it politically attractive and it is easier from a regulatory standpoint than it was just a few years ago.

We believe our global strategy is a key differentiator of Pepper Group versus our Australian peers. The ability to go offshore is largely based on having a global management team. We don't attempt to control or micromanage all our global businesses from Australia.

AUSTIN No two nonbanks are alike. Even though they are all carry the same 'tag' they are very diverse and different businesses. Our business model is relatively unusual in that we focus on competing in the prime residential-mortgage space with the major banks. We have 1 per cent of the market today, but it is only 1 per cent. So far as we're concerned, this means we have a very big playing field in which we can compete and grow market share.

A nonbank that is competing in the nonconforming space will already have a large share of that market and therefore need to look for playing fields elsewhere, for instance in other countries.

EAGAR This isn't to say other business models aren't equally valid – the point is just that we're doing different things. Other nonbanks have their own intellectual property and business models that they have finessed over a number of years. They can take these to offshore markets that may not be as developed as the market here in Australia and add value.

RIEDEL Our loan book is quite different from Firstmac's, but for Liberty Financial the strategy is also largely driven by the significant opportunities domestically, and of course in New Zealand, into the medium term. There are similar regulatory hurdles for the New Zealand banks that enable us to take advantage of the home-loan market there in a similar way to what we are doing in Australia.

The ability for us to grow organically by expanding our products and taking market share is tremendous. The risks involved in achieving acceptable returns when extending a business model across borders are greatly amplified. For this reason, we are confident we can earn superior risk-adjusted returns by continuing to concentrate locally and leave the global expansion to others.

BARRY Each business has its own unique set of shareholders and targeted risk-return appetite. La Trobe Financial, after 60 years, enjoys an enviable reputation for solid risk management – having prudently originated and serviced more than A$12 billion (US$9.1 billion) of investments covering 128,000 individual mortgages without loss of capital or interest to any of our institutional investors.

Our overseas office in Shanghai has been in operation since 2009 but only as an inbound source of retail-investor funding. Our loan book is composed entirely of domestic Australian real-property mortgages and is an asset with a solid investment-grade track record.

This is a short-dated, senior tranche designed to attract some of what is a very large pool of US money-market investors.

Pepper Residential Securities Trust No.17 changed the US dollar component, to include two amortising notes at the top of the structure with weighted-average lives of 1.3 years and 3.8 years. The latter clearly attracts a type of investor looking for longer-dated securities – a broader base of more traditional, life-insurance and funds-management buyers.

Having the flexibility to offer different deal structures allows us to respond to the shape of demand at any point in time. This is helpful, because we are seeing more diverse demand geographically – including out of Europe and Asia – than ever.

Geographic investor diversification is a very important aspect of realising our ambitions. If we were solely reliant on domestic fixed-income investors I think we would be concerned. Our growth rate is likely greater than the domestic market would be able to sustain, so our challenge is to continue diversifying our offshore investor base. Since 2009, we have done so in the US in particular, with the UK, Europe and Asia now following.

RIEDEL We are also comfortable with domestic market capacity, and recent deal flow has served as testament to this. Demand was a little shallow earlier this year but has really picked up over the past few months. Provided collateral and trust performance is good and the margins are fair value the domestic bid remains solid.

Liberty has not yet issued offshore but we are certainly willing and able do so. We could, for instance, issue a CRD

> "Capital-markets funding could be thwarted by the unintended consequences of APS 120 around capital constraints on ADIs, which are passed through to nonbank pricing and capital minima or restrict the ability to invest across multiple tranches in RMBS."
>
> **MARTIN BARRY** LA TROBE FINANCIAL

IV-compliant transaction into a European market that is as yet relatively untapped. Relative value is currently such that Europeans don't see allocating to Australia making sense, though. As European capital markets improve over the longer term we think investors will in time look to Australia.

In summary, we are confident that the domestic market continues to be there for us but we continually look for opportunities to diversify our funding sources. These opportunities include a deposit-taking business in New Zealand and managed-investment schemes in Australia. These are both small in the context of other funding sources but equally as important for our business.

Specifically on securitisation, because we originate a diversified product set our issuance method of choice is to offer 3-4 deals to investors each year across RMBS, SME and auto-loan format. There is some crossover in our investor base but some buyers like specific assets and therefore it is important to access the market across programmes with relative frequency in order to support these investors.

■ **AUSTIN** We like to issue foreign-currency deals but the currency swap has not worked for the last couple of years. Ahead of every issue we do we look at and assess the economics of offshore funding. Our sense is that offshore pricing really goes to the measure of the economic health of the jurisdictions we are looking at. For example, euros remain very wide – which we believe reflects the state of Europe's economic health.

■ **MARSDEN** We believe we place fairly conservative estimates on individual markets' capacity. Our own baseline views on domestic capacity have caused us to seek diversity through offshore markets. We had a large offshore programme pre-crisis which served us very well. It is just naturally how the Australian capital markets work that there will always be a level of reliance on offshore funding.

■ **PLOUGHMAN** Securitisation volume in 2016 is down on previous years. However, echoing Peter Riedel's point, we have executed two transactions during the current financial year and they have both been among the largest deals we have placed in the post-financial-crisis era.

The reason Resimac commenced a US dollar funding programme in 2012 was to ease potential concerns around domestic market capacity, but actually we have not seen any evidence of local capacity constraints to date. We spend time with our investors to determine capacity and do business accordingly, rather than writing as much business as we can and then working out how we're going to fund it. There is most certainly a limit to domestic capacity but we do not believe we have reached it yet.

■ **BARRY** It is clear the domestic Australian dollar securitisation market is supported by a small group of regular investors. This support is appreciated, but we will also continue to encourage new investors to consider the asset class as a high-quality relative-value credit opportunity.

Turning to the international Australian dollar market, we have already seen several of our nonbank peers accessing international markets successfully. We believe these jurisdictions will be critically important going forward given the asset-origination opportunities discussed previously.

At La Trobe Financial, we will continue to work with investors to explain the evolving nature of our high-quality lending opportunities. Our long-term goal is to diversify our investor base.

Craig It still seems that one of the Australian securitisation market's main aims is to replace the investors that left the market following the financial crisis. Are more buyers required?

■ **AUSTIN** We have a very tidy and profitable business writing A$150 million in loans each month, which is sustainable and able to meet its funding requirements in the domestic market. What we would like to do is continue to grow the business's success. To this end the offshore markets are necessary.

■ **EAGAR** There does seem to be finite capacity in the domestic market, and this is a limitation on our growth. Real-money investors have not come back into our market in large numbers, so there is still a great deal of dependence on balance-sheet investment.

Demand from the large balance-sheet investors, such as the major banks, can also be variable. For example, the reduction in committed-liquidity facility requirements imposed upon the banks has had a considerable dampening effect on RMBS demand from the majors – this year is certainly down on 2015 as a result.

■ **PLOUGHMAN** The challenge for the sector in re-engaging the real-money investor base since the financial crisis has been

FUNDING DIVERSITY ON THE AGENDA

Nonbank issuers have traditionally relied on securitisation for the bulk of their funding. As the sector and its individual members focus on growth, many are looking to broaden their funding mix.

CRAIG Are issuers looking at other opportunities to supplement securitisation? If so, through what other means are they attracting capital-markets funding and what role will alternative routes to market play?

RIEDEL Alternative funding options fulfil many roles including diversifying our funding sources. We have raised A$100 million (US$75.5 million) in vanilla-bond financing to date and going forward we intend to have two or three similarly sized deals outstanding at any one time.

This is a small portion on the liability side when set against our A$5 billion of assets. But given it is unsecured it provides us with flexibility.

AUSTIN We will certainly look for other incremental ways to raise funding over and above what we can issue in securitisation markets. This may be in the form of whole-loan sales, servicing or retained financing.

We place a big focus on accessing offshore markets and foreign investors. We are also very keen on master trusts, which we believe will help us access the incremental investor that cannot buy pass-through securities. We are monitoring the use of master-trust structures closely and we hope they will be of material benefit for us into the future.

PLOUGHMAN We are in a similar position in the sense that we have been seeking funding options to complement securitisation for the past nine years. But at the end of the day we have to make our products competitive and we can only operate if they can also be funded competitively.

We would very much like to have alternative funding sources available to us. But as we sit here now the only funding tool that allows us to compete directly with the banks on the lending products we offer is securitisation.

BARRY La Trobe Financial was a very late entrant to the securitisation capital markets, and for a good reason. We operated through institutional-investor long-term debt facilities, institutional investment mandates and our retail credit fund successfully for many years without capital-markets issuance.

The financial crisis taught all participants a valuable lesson about having all your eggs in one basket, though. We first accessed the debt capital markets in 2014 with the goal of broadening our funding capabilities via a residential mortgage-backed securities (RMBS) programme as one component of the group's overall funding strategy.

Such RMBS alternative funding plays an extremely important role in our core belief that we should always maintain a diversified borrowing programme and never be reliant upon one source of funds.

La Trobe Financial now has perhaps the most diversified capital-raising programme of all nonbanks operating in Australia. It incorporates large term-debt facilities from local and international banks, a A$1.2 billion retail credit fund – with its 12-month term account and independently rated peer-to-

> "WE PLACE A BIG FOCUS ON ACCESSING OFFSHORE MARKETS AND FOREIGN INVESTORS. WE ARE ALSO VERY KEEN ON MASTER TRUSTS, WHICH WE BELIEVE WILL HELP US ACCESS THE INCREMENTAL INVESTOR THAT CANNOT BUY PASS-THROUGH SECURITIES."
>
> **JAMES AUSTIN** FIRSTMAC

the fact that the global regulatory environment has made international issuance so lacklustre that a number of investors have not come back to the market simply because of lack of supply. This is disappointing.

European investors in particular are incredibly frustrated at the lack of issuance out of their domestic market. The US is much better and operates more effectively, but it has its own issues around local mortgage issuance.

Investors around the world have money to put to work, and particularly in a negative interest-rate environment they are looking for yield. So our read is that if they can understand the product they will invest.

Craig What is the answer for getting real-money investors back in greater numbers than has been the case of late?

EAGAR We see a considerable number of RMBS investors that currently choose not to invest in nonbank issuance. If these investors could be induced to look more closely at our transactions they would see a great relative-value argument, margin pick-up on both sides, twice the market norm of credit enhancement, quality collateral and a superior level of performance over major and regional banks. This isn't just our view – it is recognised in performance figures from S&P Global Ratings.

Craig What do you see as the biggest issue when it comes to domestic real-money-investor engagement? Specifically, what would you like to see Australian funds do differently when it comes to engaging with nonbank issuers?

peer investments – and the complementary RMBS capital-markets programme.

We see continued growth opportunities for our retail credit fund, while exploring other funding alternatives to continue diversifying our lending objectives.

■ DAVISON Patrick Tuttle, you have mentioned the fact that Pepper Group (Pepper) has conducted some loan-portfolio sales. How do these contribute to the firm's overall funding mix?

TUTTLE As I have mentioned, this year we have packaged up some mortgage portfolios and – as an alternative to a public RMBS transaction – entered into bilateral, private sales of the beneficial interest of Pepper-originated mortgages. We continue to service the loan portfolio, but on behalf of a third-party buyer.

The buyers are typically doing so to bolster their own portfolio growth or their net-interest margins. From our perspective, it's an opportunistic way of capturing what we see as better pricing than we would have achieved in a public securitisation deal at the same point in time. We will of course continue to execute public RMBS as well.

■ DAVISON What about Pepper's global footprint – does this also open the door to alternative funding options?

TUTTLE A further way in which we diversify our funding is through our bank operations. Our South Korean business is a licensed bank, and all our funding in that market comes from retail deposits. We also use wholesale funding in Hong Kong.

We are not ruling out seeking banking licences in some European markets in future – if we view the securitisation market as not offering sufficient liquidity, in the long term, to support our local growth ambitions.

In Spain, for example, we have recently entered into a joint venture with the fifth-largest local bank, Banco Popular, essentially to combine our point-of-sale finance and personal-loan businesses. In the longer term it probably makes more sense for us to apply for a banking licence for this business to provide the most efficient funding we can get in wholesale markets.

■ **EAGAR** From our perspective, it would be good if investors could look beneath the surface of what they are looking to invest in – namely the collateral. As I have just said, Firstmac's portfolio performance is demonstrably and verifiably better than the major and regional banks.

The concern for us is that too many investors have lazy mandates to invest in ADIs, or alternatively they have come to a policy decision only to invest in ADIs and not make the effort to understand the asset mix and performance of a nonbank. In our space, investors would achieve a better margin pickup investing in Firstmac senior RMBS paper.

There will of course inevitably be a natural ceiling to domestic capacity but, frankly, it is a source of frustration to us that the extent to which we could grow our business domestically has not been exhausted. It just seems to be a battle that goes on and on.

Craig Is the issue as far as Firstmac sees it that some investors won't look at nonbank securitisation specifically or that they aren't looking at securitisation in general, and thus of course don't invest in nonbank paper as well?

■ **EAGAR** There are real-money investors that we do not get the opportunity to engage with. The response is that these investors invest in ADIs only, and not in nonbanks. So to what extent they are investing in ADI issuance I can't say – simply because we are not offered any level of engagement at all.

Craig Is this view replicated among offshore investors?

■ **AUSTIN** Not to the same extent. Certainly some investor groups, such as Japanese banks, are selective and technically will only invest in major Australian banks. But I find that real money offshore is less concerned about ADI versus non-ADI. The distinction is much greater here in Australia.

TECHNOLOGY, DISRUPTION AND INNOVATION

Davison Notwithstanding their small market share to date, is the emergence of fintech-based disruptors in the lending market a risk factor or an opportunity for established nonbanks?

■ **AUSTIN** A key point as far as online is concerned is that it demands such cost efficiency that a middle person cannot be involved. The new disruptors and startups do not have funding capability: they are originating loans as brokers rather than lenders. But there is no room for a middle person in this market: if you are not the direct funder to the consumer you cannot compete. So as far as we are concerned disruptors are effectively nonexistent.

We are not concerned about startups, because they have no funding capability. We are a product manufacturer and are able to deliver product with the cost efficiencies that it demands. With no capital to apply, startups cannot deliver a product.

■ **EAGAR** ADIs generally are moving increasingly to third-party distribution via brokers, and this has historically been the way the nonbanks have distributed. Some of our peers still do this. But we have become a disruptor in our own market – because we have strategically decided to do business differently. Pursuing the online model is creating real business growth opportunities for Firstmac, well and truly above where we were two years ago.

■ **RIEDEL** The opportunity right now is taking advantage of emerging technologies. This might be done by embedding them into operational processes to improve efficiencies, by applying them to decisions to improve risk management, or simply using them to enhance the customer experience that is vital for any lending business.

We are very focused on emerging technology developments and on applying them to our business. Technology is one of our core competencies, in that we have always developed all our technology in-house. This is another example of Liberty continuing to innovate.

We did this when we launched our personal-loan product. The ability to access new and emerging technologies is allowing, for instance, our customers to apply for a product and receive money in their account within hours. Our view is that it is the specific disruption that is the relevant part of new technology – not the players deploying it.

■ **MARSDEN** We have always embraced technology, particularly in our origination and servicing platforms, and therefore we like to think we can be nimble to market. A good example of this is our online presence, into which we made our first investment in 2010.

■ **BARRY** The emergence of disruptors in the lending market is a plus for us and for other nonbank lenders. In essence, nonbank lenders have been non-technology disruptors in the banking sector for many years, having helped drive product innovation and competition and offered a real alternative for borrowers. We have been disrupting for six decades and now operate Australia's largest peer-to-peer mortgage-loan operation.

■ **PLOUGHMAN** This is true – and it raises an important point about the role played by the nonbank sector as a whole. Back in the mid-to-late 1990s I would say the original nonbank story was disruptive. Certainly the government sees us now as being an important contributor, because we provide competition to a market that otherwise continues to be a comprehensive oligopoly.

■ **BARRY** The disruptors nowadays are bringing new and faster peer-to-peer technological advancements that assist the way we collect and analyse data, to enable a continued customer-centric focus and reduce the cost of broadening distribution channels. We are also seeing greater interest from a number of investors that have not previously supported this market, as a result of the technology disruptors.

■ **TUTTLE** It's also true that, to some extent, the status of peer-to-peer has been overstated in Australia – at least when it comes to lending volume. Where these players are disruptive is in the technology realm. But we are starting to apply some of the more recent technological developments to our own business, and in this respect I think we actually have an edge over peer-to-peer lenders – because we have a 20-year track record as an underwriter of consumer credit on a risk-adjusted basis.

I tend to feel that a number of peer-to-peer lenders are more what I would describe as 'tech-fins' than they are fintechs. What I mean by this is that they are technology-led but they don't necessarily have 'DNA' in consumer-credit underwriting. The opposite is true at Pepper: we are founded in and based on risk-adjusted credit pricing, and what we are now doing is applying technology lessons being forged in the peer-to-peer sector.

■ **BARRY** I agree that the impact of peer-to-peer has been overstated in Australia when it comes to lending volume. However, there are some exceptions. La Trobe Financial has been operating a peer-to-peer platform since 1992 via our credit fund and we currently manage A$320 million, making us the largest peer-to-peer lender in the country.

■ **RIEDEL** Picking up on Patrick Tuttle's other point, it's the same for Liberty. We see ourselves as a 'mature fintech' because we are adopting the same emerging technologies into our business as some of the startups, but we have 20 years of data that allow us to make better-informed risk decisions compared with some of the newer entrants. Leveraging our experience and combining this with new technology is the opportunity.

■ **TUTTLE** An example of what I'm talking about is our personal-lending business, which aims to cross-sell to existing customers. We have built a front-end online origination platform for this business, which frankly I would argue is the best in the Australian market. Customers can apply online and do the entire process without speaking to a human, including using DocuSign for documentation and fully online ID verification, and have the loan funded into their bank account within 48 hours.

What we are doing here is building a cloud-lending-based platform through technology such as Salesforce and that provided by Cloud Lending Solutions out of Palo Alto. This company has built peer-to-peer platforms for about 50 global entities. We have been able to combine this technology with our credit IP to establish a consumer-loan business in Australia in a six-month period. I believe this will be a significant contributor to our lending book within the next two years – and disruptive technology will be a large part of the reason this is the case.

> "Our baseline views on domestic capacity are what have caused us to seek diversity through offshore markets. It is just naturally how the Australian capital markets work that there will always be a level of reliance on offshore funding."
>
> **ANDREW MARSDEN** RESIMAC

Craig By the same token, as even the largest lenders start to seriously engage with technology-driven developments that in some ways bring them closer to the nonbank model – for instance reduced branch infrastructure and greater online engagement – how will established nonbanks keep their own business models ahead of the curve? Is there a 'risk from above' as well as from new market entrants?

> "We are concerned that some investors seem to have lazy mandates targeting ADI issuance only and have no appetite to better understand the relative value associated with nonbanks."
>
> **PAUL EAGAR** FIRSTMAC

■ **RIEDEL** We will stay ahead by seeking to improve and enhance our customers' experiences. We are at a competitive advantage relative to the banks because we are small and agile, all our systems are in-house and they all talk to each other. This is how we have established ourselves and operated since day one.

We believe our competitive advantage includes our ability to adapt to new technologies faster and with greater certainty about the customer experience, because we are talking to brokers and customers every day. We think we will be able to stay ahead of the pack in this respect.

■ **BARRY** I agree that nonbanks have to maintain a high degree of flexibility but, due to their size, also have a much greater ability to adopt opportunities earlier. The key to staying ahead of the curve is working with our brokers and borrowers to understand their needs and then deliver innovative solutions.

■ **AUSTIN** Our main competitor today is National Australia Bank (NAB)'s UBank, and the genuine threat to us will be the large ADIs when, eventually and inevitably, they come to offer distribution online. This is undoubtedly the future of the market. For us the response is about continually evolving all parts of the chain: online distribution, how we source these customers and how efficiently we do so, and the conversion of these customers through to settlement. Online marketing is just one step in the process – the actual conversion is the greatest challenge and the greatest skill set.

■ **EAGAR** The main positive for Firstmac is that even if a number of new entrants target the space in which we are playing we are essentially operating in an area that is, as yet, nowhere near its peak. Just as online purchasing in the early days was hardly a ripple to bricks-and-mortar retailers, I am sure we will see significant growth in the market share of people prepared to take out a home loan online.

Some lenders will probably not enter this market until its scale can't be ignored. So far, outside of NAB with UBank, the major banks and second-tier ADIs appear to be almost entirely focused on broadening their broker channels. The competition will increase, but my view is that it will do so hand in hand with the expansion of the online share of the home-loan market overall.

Barriers to entry will continue to be considerable and incumbents will have an advantage simply because of their well-established systems, intellectual property and their overall market savviness. We believe the real competitive threat to our online business model remains some years off.

■ **MARSDEN** Something we identified when we started pursuing our online channel was that the major banks in particular would also eventually start to pursue this. We have started to see this now with UBank. So having spotted the opportunity we knew we had it to ourselves only for a limited amount of time. We believe our business is now at a point where we have successfully established an online brand, in the specific sense that it has found its feet in terms of asset production and origination profile.

We are far more aware of how lenders need to be pooled to be successful in the online space – and surprisingly it is not all about price, even though this was an initial assumption we made five or six years ago. There has also been a learning curve through this channel, and we are applying what we have learned to make this business even more successful than it has been historically.

■ **TUTTLE** The key success factor for us is and remains nimbleness. Our whole infrastructure is built around rapid rollout of technology, system and product change – including new products. What this means is that we can get new and changed products to market very rapidly, which I believe gives us a genuine edge over banks – much as some of them are investing heavily in technology.

To be frank, I think some of the banks are playing more of a marketing game around technology. Some have real ambitions, but even with these players the scale of their legacy issues makes it much harder for them to move as quickly as we can. This might not be an enduring advantage for a company like Pepper, but I think it will be a genuine competitive edge over the next 3-5 years in the areas where our credit-underwriting capabilities are strong.

All today's market players – banks and nonbanks – are trying to operate in the same ways. We want to develop customer-focused products and bring them to market quickly and, to be honest, move on just as quickly if they fail. We all want to move on from the old approach of developing systems and products that take two years before we realise whether or not they are working. But I think we have an edge in nimbleness at this stage. •