

Australian Securitisation Markets: Responding to Change



RESERVE BANK OF AUSTRALIA

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Introduction

It is a pleasure to be here with you at the Australian Securitisation Conference. For many years now the Reserve Bank has been invited to present at this annual event and the securitisation market regularly delivers plenty to discuss.

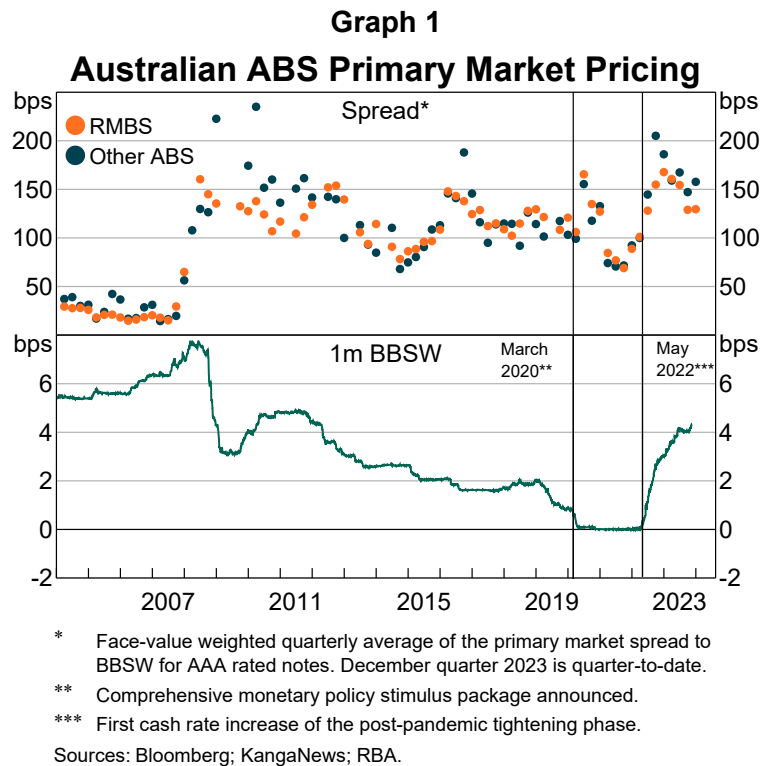
The Australian asset-backed securities (ABS) market is an important source of funding in Australian financial markets, particularly for non-bank lenders and the borrowers they serve.^[1] For investors, it offers exposure to an increasingly diverse pool of issuers and products.

Today I will be mainly talking about how the securitisation market has evolved over recent years. To summarise, securitisation markets have continued to adapt to large changes in financial conditions. While securitisation pricing has responded sharply to tighter monetary policy, and total credit growth in the economy has slowed, overall securitisation issuance has been maintained at high levels. Underpinning the strength in issuance in recent years has been the non-bank sector, which has seen new entrants and existing lenders quick to switch attention to different borrower segments to support lending growth. Against that backdrop, I'll wrap up with thoughts on a few things to watch for the period ahead.

In recent years there have been big swings in ABS pricing along with broader financial conditions

The onset of the pandemic was an anxious time for all, including securitisation markets. But the recovery in sentiment was swift amid comprehensive policy support from governments and others.

Within a year or so of the support measures announced from March 2020 – including the Reserve Bank's comprehensive package^[2] – yield spreads to the bank bill swap rate (BBSW) on AAA-rated ABS deals had halved to reach the lowest levels since the global financial crisis (GFC) (Graph 1). With BBSW at very low levels, these were very low borrowing costs.



By late 2022, however, these ABS yield spreads were back to, or above, their level at the start of the period. Spreads peaked not long after the commencement of the cash rate tightening phase in May 2022, and have moved lower since.

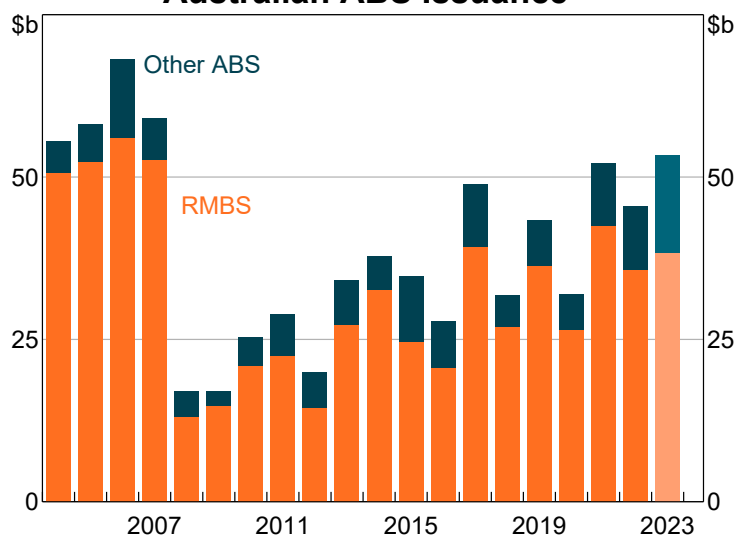
The big swings were evident in the AAA-rated notes of both RMBS and other ABS, and were even larger for lower rated mezzanine debt. Relative to past experience, movements in AAA-rated notes were largely contained to the broad range of post GFC pricing, but the speed of the adjustments was unprecedented in the post-GFC period.

Overall securitisation issuance has been resilient as financial conditions have tightened

Interestingly, at a broad level, issuance has been little changed even with the shift higher in spreads and tighter financial conditions in recent years. Annual issuance has been broadly maintained at around \$50 billion over 2022 and 2023, the same level reached through 2021 (Graph 2). This has occurred even as system credit growth slowed; from around 9 per cent a year ago to around 5 per cent more recently.

Graph 2

Australian ABS Issuance*



* 2023 year-to-date.
Sources: Bloomberg; KangaNews; RBA.

There are two broad shifts underpinning the strength in issuance throughout this period. One is increased issuance by non-banks. And a second, related development, is growth in different types of loans being securitised.

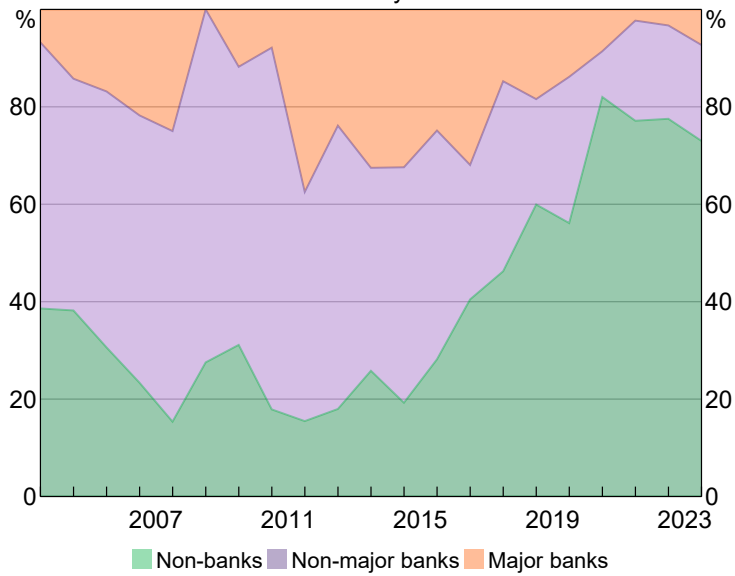
I will talk through these developments in turn.

Issuance in recent years has been underpinned by a further shift to non-banks

Non-bank lenders are the major issuers of ABS in Australia. This is not a recent development, but it has become more pronounced in recent years.

For many years, banks were the main issuers of asset backed securities, so that non-banks accounted for around one-quarter of issuance (Graph 3). This began changing around the mid-2010s. This partly reflected banks reducing issuance as they turned to other lower cost funding markets. And partly non-banks increasing issuance as they grew their lending at above system pace. Non-banks continued to increase their share of issuance through the pandemic period and they now account for around three-quarters of ABS issuance.

Graph 3
ABS Issuance*
 Yearly



* 2023 year-to-date.
 Sources: Bloomberg; KangaNews; RBA.

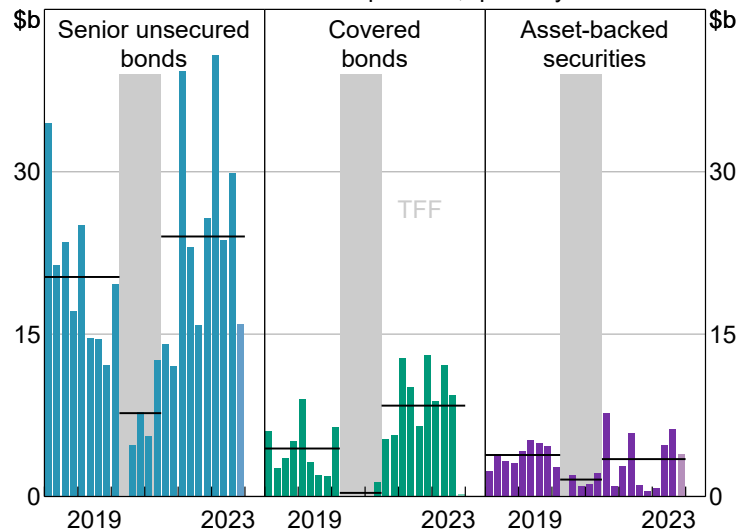
One reason for the further increase in the non-bank share of issuance during the pandemic period was that banks weren't issuing much wholesale debt at all.

The Reserve Bank's package of policy measures was a big factor behind this. In particular, the Term Funding Facility (TFF) offered low-cost three-year funding to banks between April 2020 and June 2021. It ultimately provided \$188 billion in funding to banks.^[3] As intended, this reduced their funding costs and helped to reduce interest rates for borrowers.

Banks' lower funding needs were reflected in their much reduced issuance across senior unsecured debt, covered bonds and ABS (Graph 4).^[4] In particular, there was no issuance of ABS by the major banks during the TFF drawdown period. The relative absence of bank debt across markets was one factor encouraging investors to purchase ABS as an investment with some comparable qualities.

Graph 4 Bank Debt Issuance*

Australian dollar equivalent, quarterly**



* Shaded area represents Term Funding Facility (TFF) drawdown period. December quarter 2023 is quarter-to-date.

** Horizontal lines show average quarterly issuance for different periods.

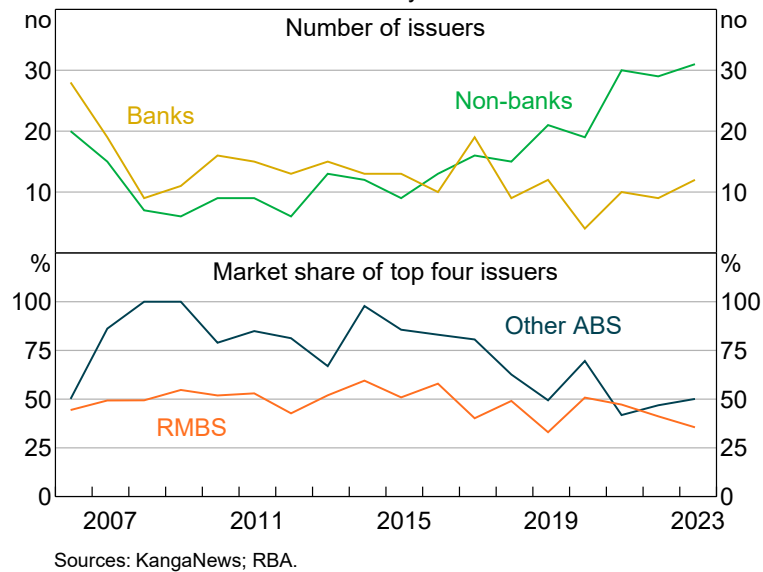
Sources: Bloomberg; RBA.

Once the TFF drawdown period ended in mid-2021, mid-sized and smaller banks increased their issuance of ABS. The major banks, however, have issued very little over much of the past two years. Wider spreads in RMBS markets over the past two years have made RMBS issuance less appealing for banks compared with senior unsecured and covered bond issuance. That said, in recent months we have seen some more activity from larger banks, including a large public deal by one of the major banks, as spreads have narrowed. Given the step up in unsecured and covered bond issuance, diversifying funding through RMBS may also be more attractive at the moment.

A second reason for the increase in non-bank market share has been an increase in the number of non-banks issuing ABS (Graph 5). This year around 30 different non-bank lenders have issued ABS, a three-fold increase from the number about a decade ago. In contrast, the number of banks issuing ABS has declined over the period, with about 10 banks issuing this year.

One consequence of these new entrants and shifting practices is that concentration in the securitisation market has fallen, particularly for non-mortgage ABS. About a decade ago, the top four issuers of non-mortgage ABS accounted for nearly all issuance. Today they represent about half of the issuance. As a result, concentration in the non-mortgage ABS market is now similar to that in the RMBS market after being consistently higher for many years after the GFC.

Graph 5
ABS Market
Yearly



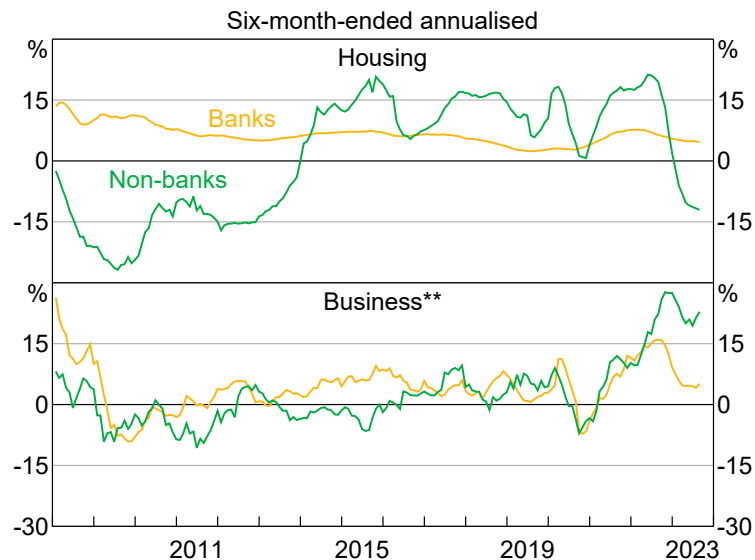
A third reason, as hinted at in the preceding point, is that non-banks have been expanding issuance outside of prime RMBS, to non-prime RMBS and other ABS.

Non-banks have adapted to changing housing finance market conditions with increased non-prime RMBS issuance ...

Favourable funding conditions and a strong housing market during much of the pandemic period supported non-bank lending. Annual system housing credit growth increased from 3 per cent at end 2019 to around 8 per cent by May 2022 and non-banks were able to continue to increase their share of the housing credit market.

As spreads on RMBS narrowed, non-banks were able to be more competitive on loan rates. For prime borrowers, one important feature of non-banks was their fast turnaround times. Amid rising house prices in 2021 and early 2022, borrowers worried about 'missing out' were willing to accept somewhat higher loan rates to secure a faster approval. Reflecting this environment, non-bank housing credit was growing about twice as fast as bank housing credit during those years (Graph 6 – upper panel).

Graph 6 Credit Growth*



* Seasonally adjusted and break-adjusted.

** Excluding credit to the finance industry.

Sources: APRA; RBA.

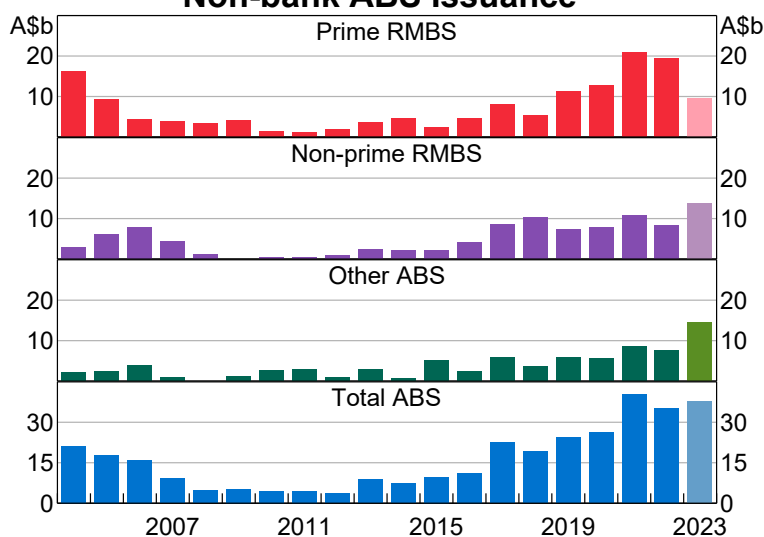
As interest rates started increasing in mid-2022, funding costs for financial institutions increased but by more for non-banks than for banks. While non-banks source most of their funding through ABS in capital markets, banks have access to lower cost deposit funding, which tends to reprice more slowly. This made it more difficult for non-banks to compete on price with banks, with loans from non-banks becoming more expensive.

In this competitive environment, external refinancing increased to record highs, driven by borrowers searching for better deals on offer from a range of lenders. Much of this refinancing activity has flowed to the major banks, consistent with major banks offering rate discounts and cashback offers that non-banks were not able to match. In fact, the interest rate difference for new loans between non-banks and banks widened from approximately 40 basis points during 2021 to around 100 basis points in December 2022.

In addition, the housing market started to cool, meaning that borrowers were less worried about 'missing out' and therefore less willing to pay a premium for fast turnaround times. In this environment, non-bank housing lending slowed and has been contracting since the start of 2023, while bank housing credit has continued to grow.

The decline in mortgage lending by non-bank lenders has naturally resulted in lower RMBS issuance. This has been driven by prime RMBS issuance, which has fallen over 2023 to be, so far, around half the pace of the preceding two years (Graph 7). In contrast, and reflecting the changes in non-banks' lending focus, their non-prime RMBS issuance has increased by about 50 per cent over the same period.

**Graph 7
Non-bank ABS Issuance***



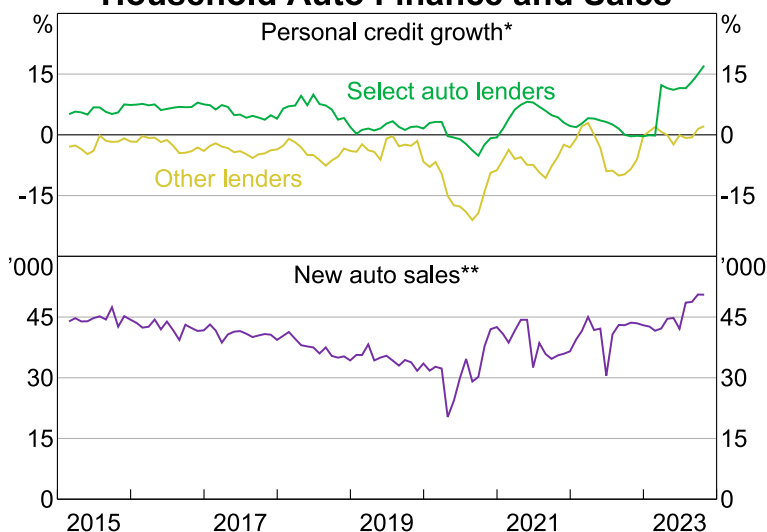
* 2023 year-to-date.
Sources: Bloomberg; KangaNews; RBA.

... and non-banks have expanded personal and business lending and increased issuance of non-housing ABS

One part of the response to these competitive pressures is that some non-bank lenders have focused on personal and business lending, either as a new interest or growing an existing business.

In particular, lenders have identified auto loans, personal loans, self-managed super fund mortgages, and 'specialist' mortgages as growth areas where competition with banks is less intense. Within personal lending, auto loans have certainly been a hot segment of the market (Graph 8). New auto sales have picked up materially since the pandemic and were still growing at around 16 per cent for households in the year to October 2023.

**Graph 8
Household Auto Finance and Sales**



* Six-month-ended annualised. Seasonally adjusted and break-adjusted. Select vehicle lenders includes lenders who primarily provide financing for car loans.

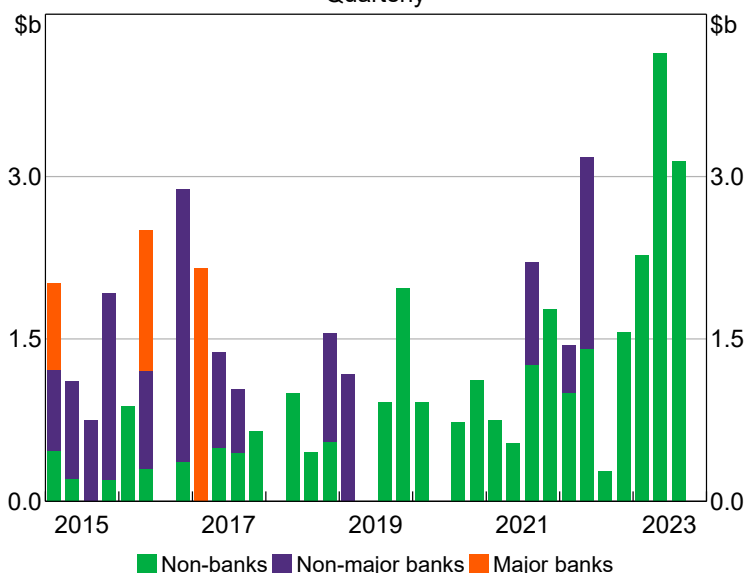
** Monthly, seasonally adjusted.

Sources: APRA; RBA; VFACTS.

In contrast with housing lending, non-bank business lending has continued to grow faster than bank business lending (Graph 6 – lower panel). As a result, non-banks have increased their market share of business lending at a time when business credit growth remains higher than for housing credit. In aggregate, the difference between interest rates that non-banks and banks charge small businesses has not moved as much as for housing. Also, some market participants suggest that tighter financial conditions have pushed more businesses, particularly smaller businesses, outside bank risk tolerances given associated prudential requirements. Some portion of this non-bank business credit is financed through securitisation markets.

Non-bank issuance of auto and equipment (A&E) ABS, the key category of non-mortgage securitisations, has risen to record levels over 2023 (Graph 9).^[5] This is a segment of the market where non-banks have been the key issuers for a number of years. The major banks have not issued, at least publicly, an A&E ABS since 2018 and other banks have not issued since the first half of last year. Despite this, the number of issuers of A&E securitisation has increased steadily over the past few years. Some of the new issuers are non-banks that have entered the market after acquiring lending businesses from banks that have left the market. In 2023, a record 15 lenders have issued A&E ABS, with three being new issuers in this segment of the market.

Graph 9
Auto and Equipment ABS Issuance
Quarterly



Sources: KangaNews; RBA.

So who is buying it?

Of course, high and steady issuance requires willing investors. Available data suggests that the investor base remains spread across foreign investors, banks and, to a lesser extent, super funds and other similar long-term investors. We hear from investors in liaison that they like the increase in the number of issuers and the diversity of ABS collateral types in recent years. Investors also like the diversification associated with having ABS backed by personal and business loans since there are more loans than in a RMBS (due to smaller loan sizes), reducing exposure to individual borrowers.

We also hear in liaison that issuers, and non-banks in particular, have put a lot of effort into expanding their investor base, especially overseas. One example is dual-currency deals, which are designed to appeal to foreign investors that otherwise may not buy Australian paper. The idea here is that some foreign investors may find it difficult to hedge the AUD exposure back to their domestic currency due to prepayment risk, and the foreign

currency tranche removes that barrier for the investor. While the issuer may face a similar challenge with hedging, the issuer knows the asset pool better so arguably it is in a better position to manage the risk than a foreign investor.

Good credit performance to date and a broadly favourable outlook continue to support investor confidence. The sharp increase in ABS spreads during the early phase of tighter monetary policy suggested investor caution, particularly with the potential for rising housing repayments and declining house prices to weigh on housing loan performance. However, to date, unemployment has remained low, house prices have turned around and, in aggregate, housing loan arrears have not increased much from their very low starting point.

Looking ahead

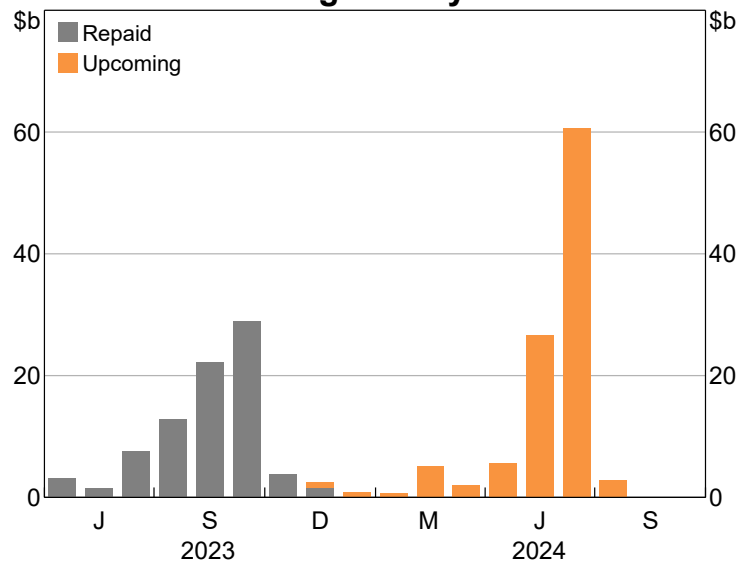
The big swings in economic and financial conditions in recent years are good reason for humility when opining on what might transpire in the period ahead. I'll restrict my crystal-ball gazing to suggesting three areas that might be topical for discussion at this conference next year.

First, developments in credit quality fundamentals. As outlined in the latest *Statement on Monetary Policy*, the Reserve Bank Board's priority is to return inflation to target, but risks on either side remain. Repayments are an increasing share of household income and unemployment is forecast to rise. And the risk characteristics of the ABS market facing that environment have changed. By product, there is less prime RMBS, more non-prime RMBS and non-housing ABS, and by issuer, more non-banks.^[6] The Reserve Bank's latest *Financial Stability Review* concluded that the outlook for non-banks' housing loan quality is more challenging than in recent years because some are relaxing lending standards and have found it difficult to retain more creditworthy borrowers in an environment of heightened competition with the banks.^[7]

A second potential area of interest is funding conditions around the remaining TFF maturities. Around \$80 billion of TFF funding has already matured, with banks repaying \$64 billion of TFF funding in the September quarter 2023. This was the first of two concentrated maturity periods, with the larger \$96 billion maturity scheduled in the June quarter of 2024 (Graph 10). Banks have managed their TFF repayments smoothly to date: as shown earlier, banks have significantly lifted their bond issuance in recent years and, in recent months, increased RMBS issuance too.^[8] Will their funding plans extend to a larger re-entry to the RMBS market? Put another way, while the lack of bank debt issuance when banks were drawing down the TFF provided more room for non-bank ABS issuance, will this work in the other direction when banks are paying back the TFF?

Graph 10

Term Funding Facility Maturities



Source: RBA.

A third area of interest for ABS markets is the evolution of competition in lending markets. A period of intense competition in housing mortgage markets has eased in recent months, with fewer cashbacks on offer for mortgage refinancers and variable housing loan rates for new loans edging higher by more than the cash rate. The banks' funding cost advantage over non-banks has also diminished somewhat with higher deposit rates as customers switch from at call to term deposits, and a narrowing in RMBS spreads. Where to from here? While a number of non-banks have proven very agile in finding markets outside of prime mortgage lending, will they maintain that flexible approach or will they look to consolidate their current market segments?

To conclude, ABS markets have shown considerable dexterity in adjusting to change. While I'm not confident to predict how this will continue to evolve, I confidently predict that we will have plenty to recap this time next year at the ASF's annual conference.

Thanks for your attention and I look forward to your questions.

Endnotes

- [*] Thanks to Shan Jayawardhana, Faye Khammo and Ed Tellez for excellent assistance with this speech.
- [1] The ABS estimates that in June 2023 the outstanding assets of Australian securitisers were \$165 billion.
- [2] See RBA, 'Supporting the Economy and Financial System in Response to COVID-19'.
- [3] Alston M, S Black, B Jackman and C Schwartz (2020), 'The Term Funding Facility', *RBA Bulletin*, December.
- [4] Johnson C (2022), 'Trends in Australian Bank's Bond Issuance', *RBA Bulletin*, September.
- [5] Non-mortgage securitisations cover a wide range of collateral, including auto loans, mixed auto and equipment loans, business loans, commercial mortgage loans, small-to-medium business loans, personal loans, and buy-now-pay-later receivables.
- [6] As my former RBA colleague Jonathan Kearns noted in this forum last year, non-bank RMBS typically have lower average seasoning and higher loan to value ratios than bank RMBS, see Kearns J (2022), 'Securitisation: Past, Present and Future', Address to the Australian Securitisation Conference, Sydney, 30 November.
- [7] RBA (2023), 'Financial Stability Review', October.
- [8] Banks use their Exchange Settlement (ES) balances to repay the TFF. These ES balances qualify as high-quality liquid assets (HQLA) for the purpose of banks' regulatory liquidity ratios. However, most of the collateral that have secured banks' TFF loans are self-securitised assets, which do not qualify as HQLA. Banks can source replacement HQLA if they choose to offset the impact of TFF maturities on their liquidity ratios, which are currently well above regulatory requirements. Bank bond issuance has been above average over 2023 to date, with some of this funding being used to purchase HQLA securities.