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Competition in Australia's Financial System Inquiry
Productivity Commission
GPO Box 1428
Canberra City ACT 2601

Attention: Mr Peter Harris
Presiding Commissioner

By email: financial.system@pc.com.au

Dear Mr Harris

Competition in the Australian Financial System

The Australian Securitisation Forum (ASF) appreciates the opportunity to provide a submission in relation to Draft Recommendation 7.1 and Draft Finding 7.2 of the draft report released by the Productivity Commission in February 2018. The ASF is the peak industry body representing the Australian securitisation and covered bonds markets. The ASF goals are to facilitate the formation of industry positions on policy and market matters, represent the Australian industry to local and global policymakers and regulators and to advance the professional standards of the industry through a comprehensive suite of educational courses and workshops.

In addition to the detailed discussions held with the Productivity Commission on 18 December 2017 and on 22 March 2018, we provide the following responses with contribution from several of our non-bank (NBFI) members:

1. **How material the direct and indirect impacts of changes to APS120 have been for NBFIs, including whether the PC's draft recommendation is timely.**

   The ASF believes APS120 should provide a framework in which both large and small ADIs as well as non-ADIs can use securitisation to access term funding markets and broaden their domestic and global investor bases. When designing the new APRA Prudential Standard for

Securitisation (APS120) which was implemented in January 2018, the ASF understands that APRA aimed to strike a "*balance between financial safety and efficiency, competition, contestability and competitive neutrality*"[1]. These priorities are consistent with the general outlook of global regulators since the Global Financial Crisis (GFC). The resultant APS120 standard and scope of application is generally consistent with the final Basel III global securitisation standards issued by the Basel Committee on Banking Supervision (BCBS) in 2014.

The 2018 changes to APS120 have affected NBFIs because many rely on ADI provided/funded warehouse facilities as part of their broader funding models. It is fair to say that the changes have been material for many of the NBFIs for reasons such as the following:

(a) The additional credit enhancement (CE) in the form of regulatory capital required for warehouse funding of both mortgages and non-mortgage assets (e.g. autos and equipment loans and leases) under APS120 has increased materially. Previously the required CE for mortgages was in the range of approximately 2.00 - 3.00% and this has now increased to 6.25 - 7.00% and much higher for non-mortgage assets.

(b) The increased costs of capital under APS120 has resulted in the need to replace some of the funding previously provided by ADIs with more expensive funding from mezzanine financiers/investors. Given that many NBFIs were in the same position, it created a challenge for NBFIs to find and secure additional mezzanine funding from a relatively small pool of investors, including those investors who were not necessarily natural financiers in a book build or warehouse environment.

(c) Additional finance has also been sought from offshore participants which has created onerous challenges in relation to interest withholding tax obligations and risk retention requirements. Although international institutions can introduce alternative funding solutions to the local banks, the NBFI sector needs to exercise a degree of caution given foreign institutions were the first to retreat from the Australian market during and after the GFC.

(d) The work required to effect the changes took a considerable amount of time and the associated costs (including legal fees) were significant (estimated to be in the order of $2 million for some NBFIs). It is doubtful that NBFIs would be able to fund their warehouse lines in the absence of third party mezzanine investment without

[1] APRA "Response to Submissions – Revisions to the prudential framework for securitisation" dated November 2016, p.8

undertaking fundamental changes to its capital base and further diminishing its competitive effectiveness.

Given that existing NBFIs have already spent time and money negotiating, restructuring and locking in amended warehouse lines with their ADI warehouse providers to ensure compliance with APS120 by the implementation date of 1 January 2018, draft Recommendation 7.1 has less relevance now. However, the ASF believes that future policy and regulation affecting securitisation should give greater consideration to the impact of competition.

It is worth emphasizing that for those NBFIs who utilise warehousing lines as part of their funding arrangements, APS120 has resulted in a direct increase to their cost of funding and to a loss in their funding and competitive efficiency. Any cost impact that applies only to NBFIs does not assist with competition in that sector of the market.

2. **Do NBFIs consider the changes brought about by APS120 to be an '*insurmountable barrier to entry*' for newer or less established players?**

The amount of capital required to establish a "*funded by securitisation*" business model in a post 2018 APS120 environment has increased significantly. It may not necessarily be an "*insurmountable barrier to entry*" but it is certainly more of a hurdle to source and secure the various layers of funding now required as a consequence of the new APS120.

Certainly, the quantum of increased CE required may act as a barrier to entry for many would be new participants reliant on warehouse funding. In the absence of a very substantial capital base, CE would need to be sourced from external investors and this will be difficult to obtain for any entity without a demonstrated track record in mortgage or non-mortgage portfolio performance and ability to access term markets for warehouse refinancing purposes. If available to a new entrant, reflective of perceived risk, this CE would probably be very expensive; therefore, impacting on market competitiveness of the new entrant. The pool of investors willing to invest in warehouses is also relatively small leaving fewer funding options available.

In summary, a new entrant would need to be a significantly well-capitalised entity which might preclude smaller and more innovative organisations, such as fintechs or mortgage managers, from developing their business models to incorporate a securitisable funding capability.

3. **Information on NBFI funding sources (including cost of funds) and LMI:**

(a) key funding sources, the shifts over time between warehouse and mezzanine finance, and the provision of warehouse funding from international institutions

ADIs have available to them various funding alternatives including borrower deposits which have proven to be an attractive funding source during various stages of the economic cycle particularly when market activity was in decline for a period following the GFC. Given that NBFIs are not banks and have limited capital of their own, their

funding is externally sourced for the most part. A key and primary funding source for most NBFIs is secured funding – in the short-term through temporary warehouse facilities and in the longer term through RMBS/ABS issued into the debt capital markets.

Since the early 1990s, NBFIs have played a key role in providing competition in the lending market and also, as a niche lender, NBFIs cater for a broader spectrum of borrower and therefore provide for a more efficient credit flow to the household and business sectors of the economy. To be able to provide competitive lending rates it is pertinent that funding facilities available to NBFIs are as efficient as possible. Post the GFC, following the withdrawal of the international banks from the domestic warehouse funding market, many NBFIs were restricted to establishing warehouse facilities with the Australian major banks. More recently the ADI directed regulation has had some impact on the non-bank sector's ability to be competitive, notably with restrictions on investment and interest only (IO) lending which flow through to the warehouse terms, and the ADI capital changes for securitisation facilities (APS120 changes) (introducing mezzanine financiers).

(b) *industry trends, such as changes in the NBFI sector's market share over time, and the reasons for this change – for example, it was mentioned last week that the NBFI sector's home loan market share has increased from 5% to 8%*

Consolidation and acquisitions in the NBFI sector has created participants of greater scale helping to support their underlying growth. Although the NBFIs are making the most of a favourable market environment in relation to the supply and demand side of originations, whether the rate of growth can be maintained is speculative. In fact, the RBA in its Financial Stability Review released on 13 April 2018 noted that although estimated growth in the NBFI sector picked up materially over the past year, NBFI lenders still only account for around 4% of outstanding residential mortgages, and their contribution to overall housing credit growth remains limited and constrained by their access to wholesale funding.

(c) *the impact (if any) of IO and investor lending caps on NBFIs*

The reduced availability of ADI funding for these types of loans has arguably created opportunities for NBFIs. However, where NBFI funding is dependent on securitisation and the size of the securitisation market, investor limits for these loan types, and warehouse lender appetite all combine to act as a natural cap. ADI provided warehouses have predetermined caps on IO and investor loans which automatically restricts the volume of such loans that NBFIs can originate. APRA expects that the collateral characteristics of the ADI provided warehouses are similar to loans funded on the ADIs' balance sheet. Given the challenges the NBFIs face in funding, it is less likely they will be in a position to seek out IO and investor loans as niche origination opportunities.

(d) *whether there is a natural 'capacity ceiling' for NBFIs in the Australian market and whether this has been reached (as claimed by the RBA). This query arises out of the following general statement made by the RBA "In general, non-major lenders are*

running up against constraints in their capacity to process the increased volume of applications in a timely manner."

It is not clear why the RBA made such a statement or what it is based on. It could possibly relate to non-major ADI processing capability as it is doubtful the RBA would have sufficiently deep insight into the non-bank sector to be commenting on NBFIs. Increased processing times have been reported across the mortgage industry, including the major banks. Although it makes sense for an organisation to have a capacity ceiling after which service levels fall, there is evidence to suggest that NBFIs are consistently providing faster approval times than many ADIs. NBFIs have been able to make better use of technology advances in a timely fashion than many ADIs who may have larger disjointed legacy systems and are, arguably, more nimble in adjusting staffing levels.

The most likely constraints for NBFIs is their ability to tap the term markets multiple times within a year to free up their warehouse lines for new originations. In 2017, some issuers went to market several times but this was notable against a backdrop of considerable demand and liquidity in the financial system. It should also be noted that the regulatory backdrop for ADIs and their willingness and ability to compete in certain pockets of lending will influence NBFI market share.

(e) how the LMI products NBFIs use are priced and which products used are paid for by the consumer

Market norm is that LMI is required to be taken out by a borrower for mortgage loans with >80% LVR to better manage risk exposure; bearing in mind that NBFIs often have origination caps on loans >80% LVR. The associated cost or premium is borne by the borrower generally for loans >80% LVR. LMI pool insurance is also available as a form of first loss credit enhancement (subject to conditions) insuring against losses should there be a shortfall in the recovery process. In this case, the premium for pool cover is borne by the lender.

NBFIs have undertaken 100% pool insured transactions, part non-insured and flow insured transactions, and 100% non-insured transactions. In many cases, investors do not perceive transactions with LMI pool cover more favourably as CE requirements are determined pre-LMI where no benefit is given to LMI. There is greater market acceptance for little or no LMI pool insurance particularly for prime mortgage assets, resulting in no difference between investor deal pricing for LMI and non-LMI transactions.

LMI value is seen as important for risk transference on higher LVR loans which are typically more susceptible to loss and would in many cases probably be the difference between a loan being available or not. The price of LMI is influenced by the level of regulatory capital required to be held by LMI providers by APRA and credit rating agencies to retain investment grade credit ratings.

(f) a comparison between flow pricing and pool insurance – costs, benefits and application

There is little if any difference between flow pricing and pool insurance for a non-bank.

4. Insights from other jurisdictions' approaches to government involvement in the NBFI sector

Australia has been fortunate in that it has been able to maintain an effective and functioning NBFI lending sector whereas other countries have seen their NBFI sectors suffer significantly through and after the GFC. In the ten years since the GFC, the NBFI sector in Australia has continued to service borrowers who may not be serviced by ADIs while maintaining high credit standards and providing competition in the home loan and SME markets.

Offshore financiers have different regulatory considerations and thus they can have a different appetite for certain asset types than local banks. Other factors may also influence their appetite to provide warehousing such as their cost of funding, so it would be difficult to generalise about whether their regulatory landscape is better than ours.

Please do not hesitate to contact us if you would like further clarification on any of the matters raised in this letter.

Yours sincerely

Chris Dalton