ASJ

AUSTRALIAN SECURITISATION JOURNAL

Incorporating Australian and New Zealand Securitisation and Covered Bonds

>> Issue 21 • 2022

Securitisation outlook

After a year of record issuance in Australia and New Zealand, the Australian Securitisation Forum gathered the industry to discuss where the market goes next

Australian Securitisation Forum

ASJ

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Australian Securitisation Forum

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ISSN 1839-9886 *(print)*
ISSN 2207-9025 *(online)*
Printed in Australia by Spotpress.

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It is my pleasure as the new chair of the Australian Securitisation Forum (ASF) to welcome you to the 21st edition of the *ASJ*. I wish to thank the outgoing chair, Sarah Hofman of PwC, for her stewardship of the ASF over the last three years and for more than eight years as a member of the ASF's national committee.

I also wish to thank outgoing national committee members, Eva Zileli and Rob Camilleri, for their contribution to the ASF and the industry over many years. The national committee for 2022 has been refreshed with Richard Lovell of Clean Energy Finance Corporation, James Austin of Firstmac and Michael Heath of Judo Bank joining as new members.

This edition features the highlights of the 2021 Australian Securitisation Conference, which was held virtually in late November. There was strong interest in the conference agenda with more than 1,300 registering and over 900 joining the virtual sessions over the three days of the conference. We thank our 20-plus sponsors, including the headline sponsors Commonwealth Bank of Australia, Moody's and National Australia Bank (NAB).

Australian securitisation had a post-financial-crisis record issuance year in 2021. While there was limited issuance from Australian Prudential Regulation Authority-regulated banks, the market witnessed a steady stream of primary-market issues from nonbanks, including several first-time issuers.

According to NAB's securitisation insights, in 2021 there were 43 new residential mortgage-backed securities (RMBS) issued into the Australian public market with volume totalling an Australian dollar equivalent of US$38.8 billion. This is up 49.5 per cent, or US$12.9 billion, from 2020's US$26 billion of RMBS, issued from 31 public deals. There were 21 asset-backed securities (ABS) issued into the Australian public market for a combined total of US$9.6 billion, up 88 per cent or US$4.5 billion from 2020's US$5.1 billion, which came from 13 deals.

Pleasingly, the New Zealand securitisation market also saw a record year of new issuance. According to Westpac's ABSolute coverage, NZ$2.4 billion (US$1.6 billion) of ABS and RMBS placed from nine separate issuers over the course of 2021. This surpasses prior years and notably featured several first-time issuers in the New Zealand market – such as UDC Finance and Basecorp – as well as a diverse set of asset types.

Demand for Australian and New Zealand securitisation has been strong with margins on primary issues better than any time in recent years. Firstmac, a major nonbank issuer, completed a A$2 billion (US$1.4 billion) deal in the second quarter that was the largest nonbank transaction and enjoyed strong local and international investor support.

Firstmac also privately placed the first entirely 'green' RMBS in Australia. To assist with the growth of this market, the ASF is collaborating with members and industry groups to determine what sort of data and requirements originators should be considering as part of a reporting framework for investment in sustainable lending and environmental, social and governance aligned assets.

On the policy front, we were pleased with the Australian parliament passing legislation to reform the taxation of offshore banking units and the consequential removal of Australia from the Organisation for Economic Co-operation and Development and EU lists of "harmful" tax jurisdictions – thereby removing the need for EU investors to notify national tax authorities of their investment in Australian securitisations.

The ASF is also in the process of finalising its guidelines with respect to fallback language for BBSW-linked securities in response to the Reserve Bank of Australia's September 2021 announcement of changes to its criteria for these to be repo-eligible after December 2022.

The ASF plans to continue running its education programme in both in-person and virtual format in 2022. With the growth of market activity and new entrants in 2021, the demand for ASF education courses remains strong. The ASF has also delivered a number of these courses in-house, tailored to meet specific needs. Details of upcoming courses are available on the ASF's website.

ASF membership continues to broaden. We now have more than 160 Australian and New Zealand market participants constituting our membership. We are delighted to welcome the following new members who have joined the ASF since our last publication: AIA, AltX, Aware Super, Australian Unity Bank, Kooyong Group, Money3 and Vixory Capital.

Please enjoy this 21st edition of the *ASJ* and I wish all market participants a successful 2022.

WILL FARRANT
CHAIR


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SESSION REPORT

Demand drives ESG takeup at front end and in funding

A panel hosted by ***Commonwealth Bank of Australia*** *at the* ***Australian Securitisation Forum Conference 2021*** *discussed evolving investor expectations on environmental, social and governance issues in securitisation – with a particular focus on buy-side preferences.*

PANELLISTS

- **Victoria Gao** Portfolio Manager CIP ASSET MANAGEMENT
- **Jonathan Rochford** Portfolio Manager NARROW ROAD CAPITAL
- **Natasha Feder** Portfolio Manager and Structured Credit Analyst FIRST SENTIER INVESTORS
- **Ben Warren** National Manager, Electrification and Mobility NISSAN MOTOR COMPANY AUSTRALIA

MODERATOR

- **Camille Wynter** Director, Sustainable Finance COMMONWEALTH BANK OF AUSTRALIA

ESG JOURNEY

Wynter *Environmental, social and governance (ESG) factors are a core and growing component of operating requirements that spans fundamental changes to how businesses operate, the products they deliver and, for securitisation, the investment products created. Can each of the panellists share their institutional ESG journeys?*

◆ **WARREN** As an automotive company, we are facing a significant period of transition that is the biggest change since the horse and cart. As the ways our vehicles are powered, driven and integrated into society are evolving, our ESG framework has never been more important and relevant.

Our journey as an automotive company is traditionally quite focused on the E component of ESG – it is a tangible manifestation of decarbonising transport. As we go through this change, however, making this a 'just transition' ties in the S and G components. This means making safer products, and maintaining safe and sustainable work practices in our supply chains.

Sustainability has always been a core theme for us. It started back in 2002 with our Nissan green programme and we launched the first mass market electric vehicle (EV) – the Nissan Leaf – in 2010.

We have strong alignment with the UN's Sustainable Development Goals in our planning and structure, from which stems our carbon neutrality objective for 2050. It covers our operations but also the entire product lifecycle from cradle to grave, which is a significant undertaking.

◆ **FEDER** First Sentier Investors (FSI) has a strong responsible-investment position. It is based on quality, stewardship and engagement, and it is reviewed every three years. At this stage, it includes four key areas: climate change, biodiversity, modern slavery and diversity. We like to play a strong role externally as well as these internal areas of focus.

We are a member of 20 organisations around the world addressing these four areas of focus. For example, we are the chair of Investors Against Slavery and Trafficking in the Asia-Pacific region and president of Eurosif, which is a sustainable investment foundation based in Europe.

Residential mortgage-backed securities (RMBS) is an evolving ESG landscape. To seek to include our four areas, there is a greater focus on the S and the G rather than the E section. We are looking holistically at our investments – that is, the originator and servicer of RMBS and not purely at the assets.

◆ **GAO** Because we have greater access to issuers' information due to the proximity afforded by our private-warehouse funding, we are fortunate to be able to understand issuers' systems and policies quite deeply.

Like FSI, we take a holistic approach to our investments. We consider the ESG adequacy of each transaction and we recognise, given we invest across a number of different asset classes, that certain issuers are more naturally inclined to one or two of the factors.

As an example, on the environmental side, we may look at how many green initiatives are considered and whether green ABS or RMBS is considered now or down the track.

On the social front, we examine whether credit policies and underwriting breaches ethical lending and, on governance, we examine what board and leadership is like and whether there is sufficient training and clear disclosure.


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"AS AN AUTOMOTIVE COMPANY, WE ARE FACING A SIGNIFICANT PERIOD OF TRANSITION THAT IS THE BIGGEST CHANGE SINCE THE HORSE AND CART. AS THE WAYS OUR VEHICLES ARE POWERED, DRIVEN AND INTEGRATED INTO SOCIETY ARE EVOLVING, OUR ESG FRAMEWORK HAS NEVER BEEN MORE IMPORTANT AND RELEVANT."

BEN WARREN NISSAN MOTOR COMPANY

We view ourselves as a funding partner, so where we see areas for improvement we will work with issuers to get them to a point where they are ESG positive.

Wynter *How have family offices approached ESG issues? Has ESG changed the direction of mandates over the last decade?*

◆ **ROCHFORD** Family offices sometimes approach things a little differently. They are often very keen to get to the nub of an issue and deal with it directly – box-ticking exercises do not work for them. The starting point is always that high ESG risk often correlates with high credit risk.

But there is an interesting discussion – which I have had with most of our clients along the way at some point – on the subject of whether funding ESG assets will move the needle. Often the conversation very quickly comes to the conclusion that it will not.

An ESG label may knock off a few basis points from funding cost but is it the best asset for the investor's portfolio? Could they buy something that is not ESG-negative but is not holding itself out as positive, then give away the additional profits made from such an investment to achieve a better outcome?

The vast majority of family-office clients I deal with have foundations and they are generous with their money. Earning a better return, rather than targeting high ESG scoring assets, and then giving that greater return away is something they tangibly can do and have done.

PRODUCT LABELS

Wynter *Even so, ESG labels have become critical in fixed-income investment. What does Nissan think about labelling in product development? Does it envisage this changing as EVs become mainstream?*

◆ **WARREN** Yes, absolutely – EVs are becoming far more relevant as we transition. Product development is a bigger process than just the vehicles, though. Our carbon-neutrality objective, for example, is end-to-end for operations and life cycle.

We know what we need to do product-wise, but the 'how' is very important in the overall picture. It drives the types of investment we make to optimise our ability to hit our goals. Building more factories and more capacity must be done sustainably.

To give an example, Sunderland production facility in the UK – where the Nissan Leaf is produced for Australia – recently announced a £1 billion (US$1.4 billion) partnership with Nissan, our battery partner Envision AESC and the Sunderland City Council to expand the plant by building a new battery giga factory and installing a renewable energy micro grid. This expands the existing solar and wind renewables already on site, moving to 132 megawatts of generation and a significant second-life EV battery storage system to support the production operations of low-emission vehicles moving forward.

Wynter *ESG principles have become an increasingly important distinguishing factor for fixed-income issuers. How do investors think ESG expectations from issuers and themselves will evolve in future?*

◆ **GAO** Investors overall have been proactive in laying out their expectations, which has allowed issuers to put ESG front and foremost. We have seen issuers increase their focus and engagement with us.

For example, issuers come to us to understand what they need to do better on ESG. It is a great market development and demonstrates to us as a funder that ESG is a focus point at leadership level for the issuer.

Investor presentations now include multiple slides on ESG, which demonstrates increased focus. We hope to see more of this.

Wynter *As we were discussing before, the environmental part of ESG gets most of the air time. What is being done to address the social and governance components?*

◆ **FEDER** On the social aspect, there are a couple of metrics we want originators to perform well in. One of them is going above and beyond what is legally required. This means we look at complaints, and not just the numbers of complaints but if there are any trends that could be driven down to the underwriting.

Another aspect is staffing, staff turnover rates, and offshore call and service centres. We ensure staff are adequately compensated and incentivised in line with their Australian

"AN ESG LABEL MAY KNOCK OFF A FEW BASIS POINTS FROM FUNDING COST BUT IS IT THE BEST ASSET FOR THE INVESTOR'S PORTFOLIO? COULD THEY BUY SOMETHING THAT IS NOT ESG-NEGATIVE BUT IS NOT HOLDING ITSELF OUT AS POSITIVE, THEN GIVE AWAY THE ADDITIONAL PROFITS MADE FROM SUCH AN INVESTMENT TO ACHIEVE A BETTER OUTCOME?"

JONATHAN ROCHFORD NARROW ROAD CAPITAL

peers, and also for training provided offshore to be the same as what employees would receive onshore. We are looking for no change or difference in how staff are treated based on their location.

Another feature in mortgage origination is the behaviour of brokers. We look for originators to take the lead by ensuring brokers are doing the right thing. Importantly, we actively try to work those brokers that are not doing so out of the industry completely

On governance, we know a lot of originators are not listed and not required to meet Australian Securities Exchange listing standards. We ask for originators to have independent boards, chairs, and audit and risk committees. Basically, we ask them to raise the standard and to improve everything along the way.

For a lot of the smaller originators – specifically fintechs – their management needs to have more focus on risk and credit. Tech is driving their businesses and growth, but we would also like to see a better spread of management skills across critical areas.

Wynter *How prevalent is greenwashing in the securitisation market and how do investors' clients think about this issue?*

◆ **ROCHFORD** There are only a couple of deals in Australian securitisation that hold themselves up as green, typically involving solar systems, panels and batteries. They are green and that is what the label is for.

In fixed income more generally, there are examples where we scratch our head. If a bank seeks to raise funding for solar panels or wind farms, it will notionally allocate against those projects – but, realistically, we have just funded part of the overall bucket. It is a box-ticking exercise that does not change much.

Another example would be a mining company trying to issue in green format even though it is digging up coal. There are a lot of environmental issues that go with this, and placing a whole bunch of solar panels at a mine site does not move the needle. Ultimately – once again – a labelled bond is just a small part of the borrower's overall funding position.

My family office clients look at these sorts of transactions and laugh. They know they do not change anything. But some investors – the ones that have a dedicated bucket that must be filled – may go ahead funding with some of these transactions to achieve specific targets.

OUTLOOK AND CHALLENGES

Wynter *How will the motor vehicle fleet evolve over the next 5-10 years, specifcally of course in the context of EV uptake?*

◆ **WARREN** There are going to be more EVs, no doubt about it. We are seeing clearer pathways in some major jurisdictions. Europe is leading the charge: about 10 per cent of our volume is in EV format there versus less than 1 per cent here. The rest of the markets are catching up, though. Stronger roadmaps are being implemented.

Markets like Norway are the beacon of light when it comes to EVs: 80-plus per cent of that market is now plug-in cars. But it took 10 years of consolidated policy and market development to get there.

A market like the UK is a little closer to home for us given it is a major right-hand drive jurisdiction. It is moving quickly as well. In 2015, 1 per cent of UK sales were plug-in. In 2016, the country started introducing some policies but progressed to only 3.2 per cent in 2019 – so only moderate growth. It took off in 2020, at nearly 11 per cent.

Markets are moving faster and faster as more products become available and the barriers come down. For Australia, the destination is set for us because we do not make cars here any more. It really comes down to when, rather than if, we see a significant movement and uplift of the trend. It will likely be toward the back end of this decade and into the next.

Wynter *What are the risks of building a debt portfolio of high ESG scoring borrowers?*

◆ **ROCHFORD** There are not a lot of investment opportunities out there that fit into an ESG debt bucket at the moment. There are a lot more opportunities available in equity: investors can very quickly get a portfolio full of solar and wind farms, and similar projects.

As we have seen in recent times, some of these projects have struck issues when they have tried to connect to the grid a long way from the main power lines – they have been told to throttle back on what they are putting into the grid because the system cannot handle it.

We always need to start with a credit-risk lens and not just put something in our portfolio because it has an ESG label. This is because we also want to ensure it will pay the interest and principal on time.

Wynter *Transparency and reporting are generally held to be essential for ESG securitisation. How do investors think about this when managing their portfolios?*

◆ **FEDER** As an industry, I hope – and I am sure I can speak for every investor and originator here – ESG reporting will be a lot easier than RMBS reporting was. The introduction of the latter, and the continuing issues around its transparency, has become quite problematic. I hope the ESG part will become a lot easier for everybody.

In this sense, we are looking for clear and transparent reporting at pool and originator-servicer level. We would like to see reporting that supports a positive outcome and is measurable.

We have all seen ESG reporting full of lovely language but nothing actually tangible. For RMBS, there is certainly a lot we can actually report on that could be tangible. For existing originators, there is diversity, use of paper and net zero. Every listed bank is reporting net-zero commitments. I suggest this is a good place for a nonbank or an unlisted ADI [authorised deposit-taking institution] to start, as well as perhaps investigating whether a power purchase agreement for solar is possible.

I would also point out to originators that there are corporates out there reporting against targets and measurable outcomes – so please go out and do more.

Wynter *What are the biggest barriers in ESG? And which developments in the ESG market would market participants most like to see in future?*

◆ **GAO** Echoing Natasha Feder's points, data consistency and transparency are important for investors. From a pool-specific data standpoint, a consistent reporting framework would be a really good development. At CIP Asset Management, we would like to see quantifiable carbon-emissions data on a loan-by-loan basis in green ABS and RMBS transactions, and clear disclosure of assumptions when there are any.

Our global ABS team overseas has witnessed good development in this respect. In recent UK auto ABS transactions, for example, instead of disclosing just a pool level of emissions data issuers have been able to disclose loan-by-loan emissions. We are beginning to see this in Australia.

The ASF [Australian Securitisation Forum] ESG working group, which has a cross section of market players, is developing a reporting template. A market consensus is important to ensure there is data consistency and market-wide adoption. Again, to Natasha Feder's point, it is important that ESG reporting is not just at pool level but corporate level, and includes disclosure of policies, targets and governance. It must also be easily consumable. It will be very useful to investors.

◆ **FEDER** It would be great, from an Australian securitisation industry point of view, if we could get to this point quickly and easily. It would be a great selling point offshore if we could adopt a consistent data approach.

Audience question *Are investors less willing to buy nongreen tranches in deals that also include green tranches because they are only getting the 'less green' assets? Should we see a more obvious price differential on this basis?*

◆ **GAO** We would look at it from a risk-return perspective. Going back to Jonathan Rochford's point on whether there is lower credit risk and demonstrable better performance, ultimately these factors may lead to a price differential.

We have also seen overseas that regulators have been able to influence pricing. If there were different capital treatment for green, for example, it would generate more demand for ESG product.

◆ **ROCHFORD** Overseas there is certainly a greenium in pricing. Some of the data also indicates ESG product is lower risk. At a very basic credit level, if a company cares about the environment and employees, there is a better chance it will care about its capital structure – ensuring all stakeholders, debt and equity, are happy to be long-term partners.

So far, pricing has been equivalent but if there is enough demand it will certainly move. There will be basis points difference in time – but we are not quite there yet.

In my credit career, those that have done ESG poorly have been far more likely to end up having credit problems. There is a correlation.

"INVESTORS OVERALL HAVE BEEN PROACTIVE IN LAYING OUT THEIR EXPECTATIONS, WHICH HAS ALLOWED ISSUERS TO PUT ESG FRONT AND FOREMOST. WE HAVE SEEN ISSUERS INCREASE THEIR FOCUS AND ENGAGEMENT WITH US."

VICTORIA GAO CIP ASSET MANAGEMENT

Wynter *Investor expectations are evolving rapidly in the fixed-income sector. Are stakeholder expectations also changing? At the same time, how do issuers view stakeholders in product development – whether they be other businesses, customers, regulators or government?*

◆ **WARREN** The pool of stakeholders continues to grow. First and foremost, we think about our customers. Specifically, we think about the products they need, the vehicle line-up and how we electrify it.

As I mentioned before, our development does not necessarily start and end with the car itself. We must think about the ripple effects, upstream and downstream, of our decisions to ensure we use our resources and assets as best we can. We cannot do this on our own. We need strong partnerships and we need to set clear expectations in our supply chain.

For example, one of the critical things with EVs is what to do with old batteries. In 2010, when we launched the Nissan Leaf, we started a joint venture with Sumitomo Corporation called 4R to research second-life batteries. We are now seeing these projects come to life globally.

We are powering streetlights, camper vans, homes, railway crossings and a football stadium in Amsterdam using second-life batteries. When they are finished in the car they can live for another 10 years in a stationary application before we recycle them. Solving these issues before scale is established is a major focus.

The second example is the grid and how it can handle more renewables. We have been leading the way on this. We have vehicle-to-grid projects around the world, including a couple in development in Australia. This means using the car as a battery to power your home: collecting the sun during the day and using it to power your home at night.

This is decarbonising transport and energy while effectively having the world's sexiest home battery sitting in your driveway that is also a brilliant car.

Wynter *Are there any projects, assets or even types of issuers that investors would like to see more of in the context of ESG alignment in the securitisation market?*

◆ **FEDER** From FSI's holistic view of responsible investment, I would love to see unlisted ADIs and listed nonbanks report on ESG issues more. They need to step up their game, find a net-zero emissions commitment and act on it.

◆ **GAO** Because we have constant dialogue with issuers, we know a lot have been taking steps. We recognise it is not going to happen overnight nor will it be exactly what we want.

But we have seen issuers contemplating green ABS where they have not done so before, or come to us asking what we need. This continued willingness to develop is definitely a positive sign.

◆ **ROCHFORD** The biggest concern with ABS and ESG is predatory lending. We always look at transactions and consider whether interest rates are too high for us to be comfortable. If this is the case, we do not fund it.

The key thing for me is that issuers start with not doing the negatives. We have a filter and we have passed on transactions simply because the interest rates on the collateral were too high. We do not think it is an appropriate way to do business.

◆ **FEDER** This is one of the problems we have with some of the personal-loan ABS products out there. Once we dive into the loans line-by-line, they are quite concerning from a social perspective.

Wynter *On the topic of the increasing focus on issuers' entity-level ESG credentials rather than labels on tranches, are securitisation issuers keeping pace with what investors see in the wider corporate debt market?*

◆ **FEDER** A lot of issuers in the securitisation sector are private and also unregulated beyond a brief touch by the Australian Prudential Regulation Authority and Australian Securities and Investments Commission. Some of these are doing well on ESG but others are behind. Some are small and emerging, and trying to grow a business. ESG reporting is still quite intangible for them.

One originator said to me that a lot of investors ask but very few investors can enunciate exactly what they are looking for. This is possibly an area where the ASF ESG working committee – that Victoria Gao and I sit on – could provide assistance to smaller originators about how to improve their standards and do better in a corporate sense. It is a long journey but hopefully we will get there. ■

"EVERY LISTED BANK IS REPORTING NET-ZERO COMMITMENTS. I SUGGEST THIS IS A GOOD PLACE FOR A NONBANK OR UNNLISTED ADI TO START. I WOULD ALSO POINT OUT TO ORIGINATORS THAT THERE ARE CORPORATES OUT THERE REPORTING AGAINST TARGETS AND MEASURABLE OUTCOMES – SO PLEASE GO OUT AND DO MORE."

NATASHA FEDER FIRST SENTIER INVESTORS

ESG investing and building scale on the asset side

In the second session of the ***Australian Securitisation Forum Conference 2021*** *that focused on environmental, social and governance issues in securitisation,* ***Moody's*** *hosted a group of market experts to focus on the asset side of the ledger. Electric vehicle uptake was a major topic of conversation, as was collecting, collating and delivering market-ready data.*

PARTICIPANTS

- **Dom Di Gori** Treasurer ECLIPX
- **Jennifer Hellerud** Head of Securitisation RBC CAPITAL MARKETS
- **Ben Milsom** Co-Founder and Chief Commercial Officer PLENTI
- **Grace Tam** Director, Debt Markets CLEAN ENERGY FINANCE CORPORATION

MODERATOR

- **Marc Levine** Managing Director, Issuer Solutions MOODY'S ANALYTICS

ASSET GROWTH

Levine *When leaders from across the world gathered at COP26 in Glasgow to discuss and commit to climate-related initiatives, the role of finance – in particular, what will be needed from financial institutions – was highlighted. There is no doubt we all have a key role to play.*

This panel will explore some very interesting topics related to ESG [environmental, social, and governance] considerations and securitisation, such as the demand for asset-level ESG data disclosure in the structured-finance market.

By definition, a securitisation is a bankruptcy-remote special-purpose vehicle (SPV). While many companies already provide certain disclosures related to their ESG practices, very little disclosure happens with respect to securitisation transactions and their underlying collateral.

Whether we are talking about Australia, New Zealand, Europe, the UK or the US, the fact is there is no global standard for reporting in securitisation – and not even regional standards.

I believe this will change in the not-too-distant future. I know conversations are going on across industry groups regarding what such a framework might look like. But there is a lot of work to be done and a lot of questions to be answered.

As for Australia, let us start by talking about the growth of volume in ESG-aligned assets. How are market participants helping promote the origination of green credit?

TAM The CEFC [Clean Energy Finance Corporation] has a unique mission to accelerate Australia's transition to net zero emissions. We try to create a workable example others can follow.

When we look at green securitisation, we see a need to design the green assets themselves in order to feed into a green securitisation programme as a final product.

As we think about creating green home loans, car loans and personal loans, we work with lenders' operational teams and customers. The idea is that green consumer loans have been designed from day one to be eligible for future green securitisation, with all the associated data collection and consumer outcomes clearly evidenced on the issuer's systems.

In our experience, issuers that have the support of their management for the creation of a green programme tend to have more success in establishing a green consumer loan product and funding programme. Senior management

"ISSUERS THAT HAVE THE SUPPORT OF THEIR MANAGEMENT FOR THE CREATION OF A GREEN PROGRAMME TEND TO HAVE MORE SUCCESS IN ESTABLISHING A GREEN CONSUMER LOAN PRODUCT AND FUNDING PROGRAMME. SENIOR MANAGEMENT PROVIDES THE ORGANISATIONAL FOCUS AND SUPPORT THAT HELPS OVERCOME ANY ROADBLOCKS."

GRACE TAM CLEAN ENERGY FINANCE CORPORATION

"THERE IS STILL A GREAT DEAL OF NUANCE IN THE MARKET, WHETHER IT IS ALIGNING TO PRINCIPLES OR PRESCRIPTIVE MEASURES OR MORE PRECEDENT-BASED. WHERE THE MARKET WILL ULTIMATELY GO IS AN ALIGNMENT WITH PRINCIPLES SUPPORTED BY SECOND-PARTY OPINION."
JENNIFER HELLERUD RBC CAPITAL MARKETS

provides the organisational focus and support, internally and externally, that helps overcome any roadblocks along the way.

It is very important for a green securitisation to be able to stand up to scrutiny in the green fixed-income market. We consider what disclosure will be required for fixed-income investors. This includes ensuring green consumer products are aligned with global taxonomies.

In this area, we think the EU taxonomy is likely going to become the global benchmark. For example, a new home is considered green under the EU taxonomy if it has been built to an energy efficiency rating above the current building-code requirements or, if renovating an existing home, that the renovation leads to a 30 per cent reduction in energy demand.

We have supported two green home loan programmes to date. The first is with Bank Australia, the loans from which are eligible for its sustainability-bond programme. The second is with Firstmac, which undertook a 100 per cent green RMBS [residential mortgage-backed securities] transaction in 2021.

For new homes, we have defined the Australian green home loan specification as being rated at least one star above the national energy efficiency rating required for new homes. We leverage the home energy rating certificate that is already part of the paperwork for new constructions as the evidence for the home meeting the green specification.

From a process point of view, the lender's operational team needs to market the energy rating requirements clearly and collect the energy rating certificate as part of the loan application documentation process. This home energy rating score then needs to be recorded in the originator's IT system so it can be reported as part of green RMBS issuance.

We think ESG disclosures will continue to evolve over time and recommend issuers collect data they think might be useful in the future, such as any additional green features of the home – including rooftop solar, batteries and solar hot water systems.

The issuer should also follow global best practices for green-bond issuance. This includes creating a green-bond framework that aligns with the International Capital Market Association's Green Bond Principles.

When an issuer engages with investors about raising green funding in the market, it needs to be able to communicate its corporate ESG strategy. An issuer should therefore also be prepared for investor questions, for example: what are its issuance plans? What makes it green? How do the carbon or energy intensities differ from the issuer's nongreen issuance?

While there is a lot of additional upfront work to be completed to establish a green-bond programme, it is worth the effort. We have seen the benefits of increased customer engagement as well as increased investor demand and engagement.

We expect the pool of ESG investors to continue to grow rapidly in future. For example, we heard at COP26 that the Glasgow Financial Alliance for Net-Zero consists of banks, insurers and investors with US$130 trillion of private capital pledged to invest in assets that combat climate change. By creating green products in the fixed-income market, issuers can tap into this growing investor base.

◆ **HELLERUD** It is certainly true that ESG is very high on the corporate agenda for issuers, investors and intermediaries alike. As an example, RBC [Royal Bank of Canada] is committed to providing C$500 billion (US$391 billion) of ESG funding by 2025. We are also working with and observing companies around the globe that are developing really comprehensive ESG policies.

As a result, we are starting to see increased warehousing and capital-market issuance that dovetails with corporate ESG policies, particularly in addressing the 'E' and the 'S'.

When it comes to term securitisation issuance and RBC Capital Markets (RBCCM)'s own warehousing, we have been involved in funding a variety of asset types, predominately offshore. But I want to mention three developments for the purpose of this discussion.

On the 'E' side of things, we are seeing a lot of development in the EV [electric vehicle] space including green ABS [asset-backed securities], as OEMs [original equipment manufacturers] increase their production of EVs. As a result, our warehousing portfolios are commonly collateralised by comingled EVs and internal combustion engine (ICE) vehicles. EVs are slowly increasing as a percentage of the portfolio, in line with the growth in our clients' EV sales.

As it relates to ABS, Toyota is the most active issuer in the green ABS market. What is particularly interesting about its transactions is they are not exclusively collateralised by EVs. They use deal proceeds to finance future hybrid and EV originations that meet the eligibility criteria outlined in Toyota's green-bond framework.

"GOVERNMENT COULD BE DOING A LOT MORE WITH ITS SETTINGS, BUT STATE GOVERNMENTS ARE DOING WHAT THEY CAN – PARTICULARLY IN THE ASSET ORIGINATION SIDE FOR SOLAR AND EVs. THE DATA COLLECTION PIECE COULD CERTAINLY BE STANDARDISED AND THE AMBIGUITY REMOVED, THOUGH."

BEN MILSOM PLENTI

Elsewhere, we have seen Hertz's announcement that it will include Tesla vehicles in its global rental fleet. We will start to see our rental fleet warehouses, as well as future ABS issuance from Hertz, being collateralised by Tesla EVs. I believe this is very positive, particularly given the nascent supply of EVs in Australia. We will start to see good quality EVs in the secondary market as Hertz turns over its fleet.

Second, we are increasingly incorporating corporate entities' ESG commitments in warehouse terms and conditions. Pricing on the warehouse adjusts in line with how the client performs against its ESG KPIs.

The third topic I want to mention – and this is more on the social side of things – is that RBC has acted as DE&I [diversity, equity and inclusion] coordinator on other ABS transactions including for Horizon and CNH Capital. Through their ESG policies, these clients are very much committed to fostering DE&I among employees and suppliers, and we have extended the application of this to the way their bonds are placed in capital markets.

The way it works is the issuer, with RBCCM, has developed new sets of syndicate protocols to help support DE&I objectives by appointing diversity minority owned firms to act as co-manager on these trades. The idea is that, by being appointed as dealer brokers, these firms can participate in trades and place bonds with their investor bases where they may not have otherwise had the opportunity to do so. This creates social equity in capital markets while expanding the investor base.

In each case, where RBC is providing ESG to funding as an absolute baseline, we assess the transactions against relevant ICMA (International Capital Market Association) principles, whether it is the Green Bond Principles or the Sustainability-Linked Bond Principles.

The information required is different depending on the transaction. It can be relatively straightforward, such as tailpipe emission standards for vehicles. For use of proceeds (UOP) transactions, we want to see how the proceeds are being applied in accordance with the asset evaluation and selection criteria.

For sustainability-linked financing, the issuer needs to be very clear about its KPIs and sustainability performance targets. It therefore needs to be able to measure and report on the environmental or social impact of the KPIs.

There is a great deal of nuance in the market, whether it is aligning to principles or prescriptive measures, or more precedent-based. Where the market will ultimately go is an alignment with principles supported by second-party opinion. What is important to the market is consistency and comparability of data, and reporting based on the type of ESG transaction.

Levine *The EV market is in the early stages of adoption in Australia. I am curious about what Eclipx is seeing in the fleet segment, including what its customers are thinking about regarding emissions when they come to Eclipx with a new order.*

◆ **DI GORI** It is best described as a gradual transition. In Australia, pure EVs make up less than 1 per cent of our overall fleet exposure. It is a little higher in New Zealand due to a consistent and strong government response.

Fleet emissions have been part of our customer dialogue for years. It started when we first saw hybrids come into the country. The conversation, as well as the analysis, is getting more robust and deeper. We have constant discussions with our larger clients about their fleet emissions and these conversations are getting better as they consider pure EV options.

When it comes to EVs, we need to consider demand, supply and the policy settings. On the demand side, we are seeing a clear desire from company boards to apply ESG settings to procurement decisions. But, of course, there are also operational expenses to manage. Only when we see clear guidance from boards across Australia will procurement departments feel empowered and mandated to look at these options.

In our conversations with CFOs and procurement teams across the country, we spend a lot of time talking about the whole-of-life cost of the vehicle. While EVs are more expensive on day one, there is also the ongoing cost to compare. It is encouraging that we are experiencing more dialogue about this. Meanwhile, a growing number of larger companies are looking at pure EVs more seriously as whole-of-life cost analysis shows we are getting closer to parity with ICE vehicles.

The necessary conversation then goes to the supply-side dynamics. We are faced with issues in this area. Globally, there

"WHILE EVs ARE MORE EXPENSIVE ON DAY ONE, THERE IS ALSO THE ONGOING COST TO COMPARE. MEANWHILE, A GROWING NUMBER OF LARGER COMPANIES ARE LOOKING AT PURE EVs MORE SERIOUSLY AS WHOLE-OF-LIFE COST ANALYSIS SHOWS WE ARE GETTING CLOSER TO PARITY WITH ICE VEHICLES."
DOM DI GORI ECLIPX

are something like 300-400 EV makes and models. In Australia, we only have around 30 models available. In the fleet space, when we consider what is fit for purpose, this goes down to high single digits to low double digits. This means customers have limited options available.

It is also common in the fleet space to have 40-50 per cent light- and heavy-commercial vehicles because these are tools of trade. As we sit here today, there is not a viable EV alternative – so buyers are limited to only a subset of their fleet when considering electric options.

We need a supply-side response, particularly in Australia. We are seeing it in New Zealand. Government policy settings were reaffirmed earlier this year and will get stronger even in the short term. We have also seen OEMs react positively, by indicating they will bring more makes and models to the New Zealand market. Once we get this supply-side response, a larger component of the fleet can potentially transition to electric.

The missing link – particularly in Australia – is government policy settings. It is a mixed bag in which different states are doing different things. I would describe policy settings in New South Wales as more advanced. The state government is looking at rebates and stamp duty offsets, and it has made an announcement about potential subsidies to fleet users as well as organisations such as ourselves.

However, Australia is a very large country and states are on different journeys – for example, some states are looking at road-user charges to offset reduction in fuel excise. Procurement managers or CFOs making decisions about a national fleet find it difficult to do so under the current policy settings.

When they look at whole-of-life costs for vehicles they need to consider the different options available by state. We need a homogeneous policy setting across Australia. We have seen positive momentum in New Zealand because of this and I have the strong view that once we have this setting we will see a strong supply-side response.

In the wider context, this is important because fleet-management companies make up 50 per cent of new car sales and we supply a steady set of used cars to the market. We need supportive policy settings in place to allow these vehicles to go into fleets across Australia.

This will lead to a supply of used cars, creating an ecosystem for electric vehicles. When we have a solid ecosystem, like we do today for ICE vehicles, it is a snowball effect. There is a consumer response – with those who cannot afford to buy a new EV able to do so when more are available in the used-car market. With strong policy and supply-side responses, we will see further growth in EVs in Australia.

Audience question *Should regulators create incentives – and, if so, should they be for issuers, investors or both?*

◆ **TAM** Yes, and this is already happening overseas. The European Energy Efficiency Initiative invites European banks to sign up to their green home loans label and definition, with a view to collecting sufficient data to demonstrate to regulators that green consumer home loans have better credit performance. If this proves to be the case, the initiative will advocate for better regulatory capital treatment for European green home loans.

We are already seeing a 5 basis point premium for green bonds in the corporate market. With or without regulatory support, issuers should be able to see that, if they issue green, they will be able to tap into an additional investor group and potentially benefit from a 'greenium'.

◆ **HELLERUD** I agree. Market forces will ultimately take care of this. If it is not a greenium we start to see emerging, there will certainly be a 'brownium': issuers will be penalised for not having appropriate ESG policies or not working toward their own decarbonisation or social objectives and appropriate governance standards.

◆ **MILSOM** As a private company, we are always in favour of incentives and grants to help us 'grease the skids'. But Australia already has some reasonably progressive thinkers. Entities like the CEFC are already intervening in the space.

Government could be doing a lot more with its settings, but state governments are doing what they can – particularly in the asset origination side for solar and EVs. The data collection piece could certainly be standardised and the ambiguity removed, though.

◆ **DI GORI** I agree with all these comments. When we get a consistent government response for EVs, we will see natural growth in the asset class. On the capital markets pricing side, market forces will dictate it and regulators do not need to intervene. Capital markets are fairly efficient and there is a lot of money to put to work in ESG. This will have pricing implications. I am in favour of letting capital market forces dictate the result.

DATA DELIVERY

Levine *What type of diligence does a lender like Plenti do to describe a loan as green?*

◆ **MILSOM** I certainly agree there is not a clear standard and there are lots of views about what constitutes a green loan. We have been steered by some of our funders and investors, while the CEFC – with which we have a long partnership – has been instrumental.

At Plenti, we fund loans for what we call 'core-green assets' for domestic SMEs, for both interest-bearing and interest-free buy-now, pay-later (BNPL) loans. These fall into two categories, reflected in broader bank and sectoral eligibility criteria.

Solar panels, battery storage and heat pumps are all obviously carbon-reducing so it is a no-brainer that these tick the Paris Accord boxes. There are some sub-eligibility criteria, mostly relating to quality and safety overlays – such as the panels needing to be installed by accredited installers.

There are also safety issues covering various assurances the products need. They do not speak to impact or green credentials. It is about whether something can produce carbon-free electricity. Again, though, this is an easy one when we are considering eligibility.

We can also fund more exotic things, like power-factor correction, variable-speed drives and low-emission lighting. These can be harder to quantify, particularly because we want to do so at scale; we typically write smaller-ticket loans but in a large quantity.

In some areas we get assistance – for example, in air conditioning we have the energy efficiency star rating system, which means we can determine eligibility. When nothing like this is available, we must restrict our assessment to new installations or use third-party verification. Obviously this brings an increase in cost, which is challenging for SMEs and small-scale installations.

We use three approaches to the required diligence. The first is a documentary-based approach, which includes getting invoices and copies of small-scale technology certificates. All this documentation is collected at the time the loan is funded to ensure we are only funding eligible assets.

In some cases, we also rely on accreditation and installation by a third party. Increasingly, with some of our retailer and government partnerships, we are working on creating menus of previous adoptions and taking an active hand in managing that list.

For example, a solar installer or supplier might come to us and say they want to do a large programme but they want to reduce the documentation required. We will then provide a list of eligible goods and say we can fund anything – as long as it is on this list and we receive data on the installation so we can ensure it is a green asset. In saying this, for some products – such as solar panels – it is easy to tick the green box as long as they are safe and produce energy from the sun.

Disclosure is an interesting question because it is quite nascent. We are working toward green-bond certification under the Climate Bonds Initiative, but most of our green funding is currently in warehouses.

Nonetheless, we provide a high degree of transparency. For example, when we fund solar panels and batteries we provide data on the solar system size, panel type, battery capacity and manufacturer. We also track data on suppliers and installers, including what accreditations they hold. This gives us information on whether some installations are better quality or likely to last for longer – and we give this to our funders.

Levine *Is it a different situation when there is government involvement, for instance a scheme subsidy?*

◆ **MILSOM** We provide even more transparency on the ecosystem for some of the government schemes we are involved in. This includes things like whether the installation system is connected to a virtual power plant or whether the devices are network connected.

This gives us an indication of whether the assets are standalone or capable of being part of a wider demand-response system. We think this will grow in importance in future as we move from static to behavioural-based assessment – in other words, asking whether owners are using the assets in a green way and whether they are saving energy relative to their traditional usage.

Levine *What is the next stage of development for data capture and usage in the ESG space?*

◆ **MILSON** We must balance data collection with what consumers are comfortable providing. We also need to ensure the data are not burdensome to collect. In saying this, we are a technology-driven lender. Our customer journeys are entirely online and the data exchange we have with suppliers and installers is all electronic. Our ability to collect a lot of data seamlessly – either for now or for future analysis – is high.

An innovation in Australia is the development of an industry code of conduct that requires solar-panel and battery installers to make an estimate of energy savings and usage. We might be capturing this information for compliance purposes, but the question is whether we can demonstrate it to investors and whether – if our products are typically more energy efficient than others – we can get a greater greenium if we can demonstrate this level of activity.

We are also seeing greater involvement from energy suppliers in the distributed energy market. They have huge amounts of usage data, which can flow through to financiers to be provided to investors. ■

Delivering on collateral diversity's potential

The Australian dollar securitisation market has started to deliver on longstanding hopes for a wider range of collateral being made available. Deals based on consumer and SME assets have started to emerge consistently and win investor support. ***National Australia Bank*** *hosted a panel of sector experts at the* ***Australian Securitisation Forum Conference 2021*** *to discuss market evolution.*

PARTICIPANTS

- **Beau Bertoli** Co-founder and Chief Revenue Officer PROSPA
- **Anthony Moir** Treasurer PEPPER MONEY
- **Bianca Spata** Treasurer HUMM GROUP
- **Irene Kleyman** Vice President and Senior Credit Officer, Structured Finance MOODY'S INVESTORS SERVICE

MODERATOR

- **Stephen McCabe** Director, Securitisation NATIONAL AUSTRALIA BANK

ESTABLISHED ISSUERS

McCabe *Back in 2004, most deals in Australia were simple lenders' mortgage insurance-covered mortgage collateral, often with just two tranches and no cash flow modelling. There was hardly any nonmortgage asset-backed securities (ABS) issuance.*

ABS issuance was north of A$7 billion (US$5 billion) in 2021, about 17 per cent of market share by volume and 30 per cent by deal number. Nonbank issuers have dominated the issuance pipeline, including all the way down the capital structure; in some cases to unrated tranches sold to third-party investors.

We are going to drill down into the different collateral types we see in the residential mortgage-backed securities (RMBS) and ABS markets, starting with mortgages. How is the market responding to prime and nonconforming collateral from an issuer like Pepper Money?

◆ **MOIR** We have been a very active issuer this year, completing five public transactions and we are in the market with our sixth. We issue across the prime and nonconforming residential mortgage space, as well as an asset-backed programme called Sparkz. We issue on our prime platform under the iPrime programme while our nonconforming programme is PRS.

Markets have been very accommodating to all our issuance in 2021. The strength of our investor relationships and the frequency with which we can come to market shows how valued we are.

On the key question of whether we still see much difference between our prime and nonconforming portfolios – at a high level, the answer is 'yes'. A larger number of investors participate in our prime programme, mainly due to buyers from the bank sector. Some bank investors have no appetite for nonconforming mortgages.

On the other hand, we do not see any differentiation when it comes to real-money accounts. They are indifferent across both programmes other than charging a premium on the nonconforming transactions.

McCabe *We typically think of collateral diversity primarily as more ABS and, in particular, new collateral types coming to market. But we have seen a wider range of products even in the mortgage space in 2021, in the form of products like self-managed superannuation fund loans and nonresident lending. What is the impact of these newer assets for a more traditional mortgage lender?*

◆ **MOIR** It is generally a positive thing. It attracts new investors to the sector and gives them more opportunities. For us, it offers the chance to differentiate our programme by comparison on collateral quality compared with the newer issuers and asset classes.

There are times when investors are most keen on higher-yielding assets than our programme offers, and this affects demand. We expect competition will continue but there is undoubtedly a greater pool of money out there as well as additional competition for it.

McCabe *The other thing that is relevant for Pepper is its auto programme. While there has been a big increase in nontraditional ABS asset classes – such as consumer and SME loans – there has also been a drop-off in issuance from the traditional auto space. However, this comes in the context of several of the big, historical players potentially looking to get rid of their books.*

◆ **MOIR** There has certainly been a lot of change in the sector. But I think the market will grow significantly next year.

"THERE ARE TIMES WHEN INVESTORS ARE MOST KEEN ON HIGHER-YIELDING ASSETS THAN OUR PROGRAMME OFFERS, AND THIS AFFECTS DEMAND. WE EXPECT COMPETITION WILL CONTINUE BUT THERE IS UNDOUBTEDLY A GREATER POOL OF MONEY OUT THERE AS WELL AS ADDITIONAL COMPETITION FOR IT."

ANTHONY MOIR PEPPER MONEY

McCabe *Hummgroup would be considered one of the more seasoned issuers in the ABS space. What do new market entrants mean for an issuer like humm? Is it a positive development because more investors become familiar with unsecured consumer lending collateral and the less traditional products, such as buy-now, pay-later (BNPL), or is it more difficult because there are more mouths to feed?*

◆ **SPATA** Like Pepper, we had an active year – clocking up more than A$1.4 billion in issuance, which is very material for us. This is across three portfolios, including our credit card book in New Zealand and, in Australia, across our BNPL and commercial books.

With our BNPL issuance, since 2011 we have built up a strong investor base that is familiar with how our product works. The interest in this market has really ramped up since 2017. There have been a lot of new entrants, largely in the nonbank sector. There are also banks pushing into this market as consumer behaviour shifts away from more traditional credit. We will continue to see the expansion of the BNPL market in Australia and offshore.

Australia is leading the charge on the investor side. Australian investors are very familiar with BNPL and understand the product well. The conversations we have with investors tend to focus on the nuances between the different products in the market.

Sometimes there is more education required from an offshore investor perspective as these markets are less mature. However, I see this changing quickly. Investor discussions are getting easier as the asset class builds out and we are certainly a long way from any market saturation from an issuance perspective.

McCabe *How has investor engagement with nontraditional asset classes evolved?*

◆ **SPATA** Most issuers would agree that investors normally start their journey with secured lending, typically looking at mortgage deals. However, I think the transition to the unsecured space is getting easier – whether it be personal-loan transactions, investments in credit cards or BNPL.

We have seen our investor books build out in Australia and New Zealand. We meet new investors to the sector on every transaction, whether or not they invest in the first deal they engage with.

To my mind, a couple of things will support continued growth in unsecured lending. The first is more collateral in the market. The ABS sector continues to build out and there is greater opportunity for investors to assess the merits of this sector and also understand the relevant approach and analysis from rating agencies.

The second is continued improvements in credit. The sophistication in credit and fraud tools originators are deploying – as well as comprehensive data – supports informed credit decisions and performance. These factors, together with the performance we have seen in the market, bode well for the future of unsecured lending.

McCabe *With unsecured products, the typical loan to a borrower is a small dollar value – which is reflected in ABS deal sizes, many of which are in the A$200 million area. Does this create pushback from investors from a liquidity perspective?*

◆ **SPATA** The transactions are definitely smaller than RMBS and my view is we will continue to see this for any new assets in the market. Our deals are typically in the A$250-300 million range. But we do not see push back per se in the sense of liquidity constraints.

Most investors we speak to buy to hold. The key difference between a humm transaction and a larger RMBS transaction is we do not see the really large investors that need substantial minimum parcels in order to participate. From my perspective, this means smaller deals can actually lend themselves to very well diversified books.

McCabe *Outside the consumer space, humm recently issued the fourth transaction from its commercial book: ABS Trust 2021-2. Was there any differentiation on the investor side in the sense of a preference between consumer or commercial assets?*

◆ **SPATA** Bringing the flexicommercial book back to market was a huge achievement. We had been out of market for six years and the business had changed a lot during that time. For us, given the changing strategy – from what was a very

multifaceted business to a simplified offering – meant we wanted to wait before bringing the book back to market.

A few key things fed into investor appetite. Having been out of the market, it felt like an inaugural transaction in many respects. Our focus was on how we engage our investor base early and ensure these investors were clear on how the business had evolved. We invested a lot of time upfront with the buy side and also the rating agencies.

The other key point – particularly for the SME sector – was navigating the pandemic. The timing of the deal was really critical and ultimately led to a delay in execution, to 2021 from an original target of 2020.

Finally, again in the SME space, we needed to ensure the deal had all the appropriate investor protections considering the market and economic conditions.

We were pleased to get our first deal done in March 2021 then a second in October. This validated the conversations with investors, which focused on humm becoming a programmatic issuer in this space.

We have noticed some investors are not interested in SME loans, or they prefer consumer assets as they consider them to be more vanilla. In saying this, we have seen really strong investor numbers across both flexicommercial deals this year – including a number of new investors to the programme, which is promising.

With any collateral class, it comes down to whether investors can get their heads around the product and the credit and, from there, relative value.

SME ISSUERS

McCabe *Prospa has been originating credit to Australasian SMEs since 2012. What types of loans are common in this space?*

◆ **BERTOLI** The SME space is definitely becoming more active. Prospa has been originating small business loans – fixed-term loans and revolving lines of credit – for the better part of nine years. It has been remarkable to watch the evolution of the asset class, from us having effectively to do the lending with our own equity and cash to more recently having built warehouses and completed inaugural ABS issuance.

The consumer space is very well understood by all participants in the market, while the commercial space is only understood in certain asset categories – such as equipment and vehicle finance.

There is a whole market out there and huge demand for products that are not necessarily secured. The space we operate in is working capital across Australia and New Zealand.

McCabe *Prospa priced its first term ABS transaction in October 2021. This was also the first unsecured SME transaction in Australia. What was the issuer's experience of the deal process and were there any notable challenges?*

◆ **BERTOLI** It is a new market in regard to public transactions but it is not a new asset. We have been writing these products for some time – and so have banks.

From a process perspective, we started in 2020 – which coincided with COVID-19, so we decided to wait while things settled down. Pleasingly, the resilience of the small business economy was obvious during this time.

From a data perspective, we can now see what happens when small businesses are under pressure. While we had witnessed it in certain geographic pockets, it had never been experienced at a system-wide level. We are delighted to be able to say small business owners find ways to keep trading and operating even in extraordinary circumstances.

We were very pleased with the level of demand when we brought our debut deal to market, especially as it was the first of its kind in Australia. There were a few things to overcome, including awareness of the category. It is not well understood but hopefully we have started the journey of education. I think awareness will build across the industry.

We expect to be a regular issuer. When we think about the category, we see huge growth potential in this market. There are not a lot of places in the world where there is unmet demand for credit but we have estimated the small business space to be around A$20 billion per annum. Our A$200 million deal is only 1 per cent of the way to where we expect this market to be.

We believe a lot of others will eventually bring these assets to market. It is also a wonderful thing for the community. When we fund a small business, the economic impact and effect on job creation are phenomenal. It is very satisfying to be a part of all these stories of small businesses across the country, which are driving Australia forward.

"SOMETIMES THERE IS MORE EDUCATION REQUIRED FROM AN OFFSHORE INVESTOR PERSPECTIVE AS THESE MARKETS ARE LESS MATURE. HOWEVER, I SEE THIS CHANGING QUICKLY. INVESTOR DISCUSSIONS ARE GETTING EASIER AS THE ASSET CLASS BUILDS OUT AND WE ARE CERTAINLY A LONG WAY FROM ANY MARKET SATURATION."

BIANCA SPATA HUMM GROUP

McCabe *SME loans are very short term compared with auto and mortgage loans. What challenges did collateral duration provide when it came to Prospa's term deal and transitioning from a warehouse environment, where maturity is easy to deal with?*

◆ **BERTOLI** Typically, our loans are written over a 1-3 year term and our revolving round of credit products are two years. This is where the short-term nature comes from.

The main questions from investors were whether there would be enough income and whether this would actually work as an investment. This is where we had to bring some innovation into the structure. We had to think about how we could create a product that works, based on the fact we know the credit and the asset class really well.

We included things like a revolving substitution period and an ability to include liquidity in the revolving line of credit drawing for our customers. It was about providing our investors and our customers with the right solutions.

There was a little back and forth as we worked it out, including input from the rating agencies. But in the end we came to market with something not quite vanilla but which works really well for all parties involved.

MARKET ACCESS

McCabe *Another thing Prospa had to deal with, that established issuers do not, was a Moody's Investors Service-imposed rating cap on the transaction. How did this affect the process?*

◆ **BERTOLI** It made sense, being a new asset category. It was the first time in Australia that this type of asset had been brought to market. It did not slow down the process – we just had to explain to investors why it was happening.

It is also worth noting that the risk profile of small-business unsecured lending is very diversified. Our business writes loans from A$5,000 to A$500,000 with the average being A$30,000-40,000. We are dealing with a lot of businesses in different industries, spread across Australia. The risk is very diversified in these asset categories.

A rating cap was required to start the process, but this will evolve as more assets come to market and provide more performance data.

McCabe *How does Moody's look at new asset classes in general?*

◆ **KLEYMAN** It is a very topical question. I believe it has been a record year for new securitisation issuers. In the last 12-15 months, we rated nearly a dozen deals from new ABS issuers, including quite diversified assets such as personal, auto and SME loans.

The challenge for new issuers is their asset performance and operational track record are reasonably short. Our credit assessment places significant emphasis on qualitative considerations. Operational track record to date is very important and we look at things like operations checks and balances, and origination and underwriting policies – how they have evolved over time – governance, third-party oversight, what technology originators are using to reduce risk and any securitisation experience to date – such as through warehousing.

If issuers have relatively little historical performance data, it helps from a qualitative perspective if it is an established asset class. It also helps if there are other issuers with performance data to compare for benchmarking purposes.

Obviously, it is not as simple as using someone else's data. We still need to understand the type of borrower the originator lends to. Is it the average borrower looking for an alternative to a bank loan or are they at the higher end of the risk spectrum?

Ultimately, even if it is an established asset class, for issuers with limited historical data we account for additional stresses in our analysis. This is to cover any greater variability in performance than the historical data indicate.

New asset classes are more challenging because there are no established performance benchmarks. As well as the additional stress-test assumptions, we need to consider what would be the maximum achievable rating, as was the case for Prospa.

It is about recognising performance variability in a very stressed economic scenario that might be even more unknown. There are other nuances when it comes to new issuers and asset classes, but this is our approach in a nutshell.

McCabe *What are the 'must haves' for new issuers?*

◆ **KLEYMAN** Having a consistent track record helps, as well as detailed loan-by-loan data to provide an understanding of the

"WE WERE VERY PLEASED WITH THE LEVEL OF DEMAND WHEN WE BROUGHT OUR DEBUT DEAL TO MARKET. THERE WERE A FEW THINGS TO OVERCOME, INCLUDING AWARENESS OF THE CATEGORY. IT IS NOT WELL UNDERSTOOD BUT HOPEFULLY WE HAVE STARTED THE JOURNEY OF EDUCATION."

BEAU BERTOLI PROSPA

"ULTIMATELY, THE ABS MARKET IS PREDOMINATELY FIXED-RATE LOANS, WITH THE RATE LOCKED IN FOR PERHAPS FIVE OR SEVEN YEARS – THOUGH BNPL MAY BE A SLIGHTLY SHORTER TENOR. HAVING A FIXED RATE HELPS. THEY ARE ALSO MUCH SMALLER AMOUNTS THAN MORTGAGES, WHICH MITIGATE THE RISK."

IRENE KLEYMAN MOODY'S INVESTORS SERVICE

borrower demographic. It is also important for new issuers to be able to demonstrate the quality of the data underpinning the analysis.

McCabe *How often does Moody's use its global network for comparison purposes?*

◆ **KLEYMAN** We use the global network when appropriate. It can help from a benchmarking perspective, or we might be able to look at how an asset class performs through a stress cycle to see performance variability.

It is good for benchmarking but we cannot just take performance data and apply them to Australia. Interestingly, as Bianca Spata mentioned, in asset classes like BNPL Australia is at the forefront so we are setting a global standard here.

McCabe *What sorts of asset classes might we see securitised in Australia in future? Where will there be growth and where will there be a decline?*

◆ **MOIR** We are pleased to see the growth in the New Zealand market and we would like to see it continue across asset classes. As I mentioned earlier, the auto space is going to take off next year with what we are seeing from an origination perspective.

The question is whether we will continue to see the same level of growth in traditional RMBS. Will the property market start to slow down when we see rates finally start to increase?

◆ **SPATA** We will continue to see nonbanks ramp up issuance across the consumer and commercial space. We will also continue to see new entrants.

For me, the biggest growth sector feels like the SME market. We have continued to see the banks pull out of the space and there are gaps in the sector that need to be addressed. Nonbanks will step in and take these opportunities. We will see growth not just in more traditional secured lending products but also less mainstream products in the unsecured space such as BNPL offerings to small business.

I also see consumer finance continuing to grow, again in the unsecured space. We will continue to see a shift in consumer expectations and their approach to more traditional credit.

◆ **BERTOLI** New Zealand SME in particular holds a lot of opportunity. There is almost no funding over there, especially in the unsecured space. This is a area in which I would definitely like to see new entrants and activity.

The other relevant thing is the way COVID-19 has brought up the importance of revolving products for small businesses – including lines of credit and overdrafts. I think we will see a lot more of these products come to market, and the capital markets have a large role to play in enabling them.

We have shown there is opportunity to create good risk outcomes and performance in the unsecured SME space, so it is now about product diversification and evolution.

◆ **KLEYMAN** I agree with everything that has been said. I expect further growth and diversity in ABS.

McCabe *How close is the Australian market to being tapped out in the volume of issuance and number of issuers in nonmortgage ABS?*

◆ **SPATA** I do not think we are tapped out just yet, and I say this from a market lens considering the deal flow and coverage levels we continue to see across all transactions in the ABS space – from the senior level down.

There is a lot of appetite to absorb additional ABS deals at the moment and I think the diversification ABS brings is valued – so I would like to think this appetite continues to increase over time.

McCabe *How does Moody's see collateral quality outside the mortgage sector performing as interest rates go up? Things like BNPL and house prices very much surprised on the up side during the pandemic, but how will they cope with higher interest rates?*

◆ **KLEYMAN** We have started thinking about this already: with fixed-rate mortgages beginning to increase we might expect this to come through in the ABS market as well.

Ultimately, the ABS market is predominately fixed-rate loans, with the rate locked in for perhaps five or seven years – though BNPL may be a slightly shorter tenor. Having a fixed rate helps.

They are also much smaller amounts than mortgages, which mitigate the risk. For example, during the pandemic consumer ABS performed well because there was a lot of liquidity in the market and borrowers were able to support the size of their payments. ■

SECURITISATION INDUSTRY CHARGES AHEAD

For the second year running, the ***Australian Securitisation Forum*** *held its annual conference virtually in November 2021, bringing together industry leaders for a range of informative sessions tackling a diverse set of topics. After a record issuance year, speakers discussed where securitisation is headed, developments in green-led deals, technology and regulation.*

MARION KOHLER RESERVE BANK OF AUSTRALIA

When financial markets do not function well it has real effects for employment and activity. It is therefore important that the policy response is sizeable but coordinated and quick to shore up confidence.

JAMES AUSTIN FIRSTMAC

We cannot underestimate the importance of ESG for offshore markets and it is fair to say Australia is lagging. We are evolving, including through ASF subcommittees and looking at standard templates.

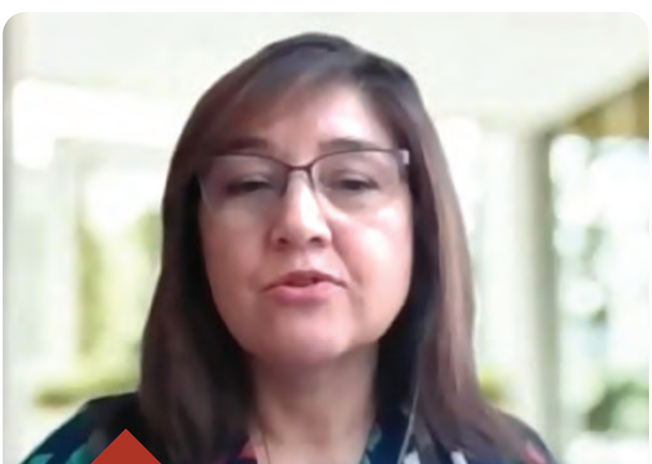
NATASHA VOJVODIC FITCH RATINGS

There has been no material impact on RMBS or ABS performance from pandemic-containment measures this year or last, owing to payment deferrals and government support. Historically, interest-rate movements have had an impact on performance – it is the speed and magnitude of future interest-rate rises that will be key.

If interest-rate rises are incremental, borrowers can adapt. Any additional buffer will help loan serviceability but we already consider the interest-rate floor applied by lenders as close to a 3 per cent debt buffer for some mortgage holders.

FABRICE GUESDE NATIXIS

We are going back to the pre-COVID-19 environment with a range of securitisation issuers that are in significantly better shape. They have benefited from strong performance and management of their assets, very attractive pricing for their public deals, ample offers on the warehousing side with many banks returning and increasing the size of their facilities, and a repricing of warehouses.



LILLIAN NUNEZ IFM INVESTORS

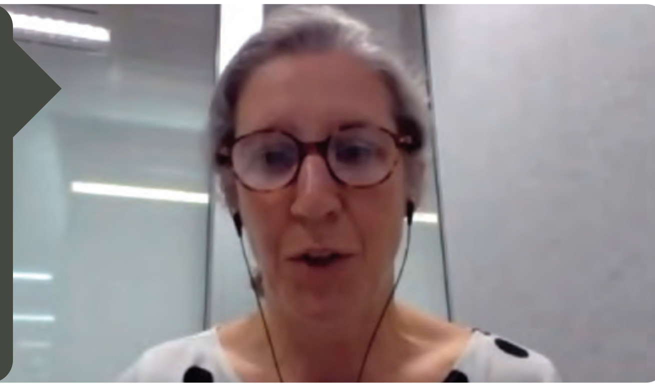
We expect some investors may move away from securitisation as bank issuance returns and business confidence lifts leading to an increase in corporate bond issuance. That said, a significant level of liquidity remains and banks are still cashed up.

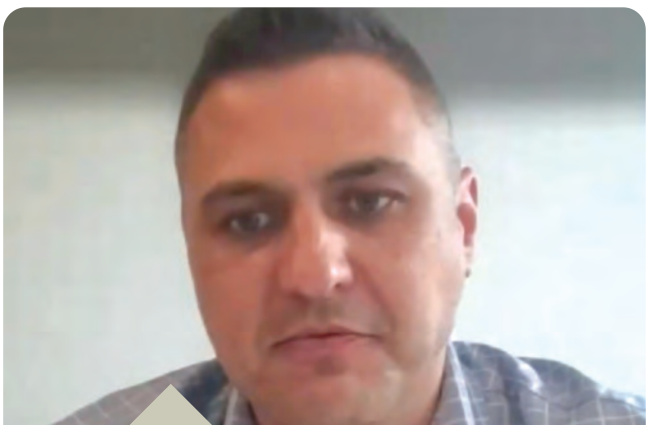
GUY VOLPICELLA WESTPAC BANKING CORPORATION

In addition to our usual focus on diversifying our investor base, in 2022 a key focus will also be diversification in tenor. As we manage some of the concentration of funding resulting from accessing the RBA's TFF, we will need to be more selective when it comes to issuance tenor.

CATHERINE DE FONTENAY PRODUCTIVITY COMMISSION

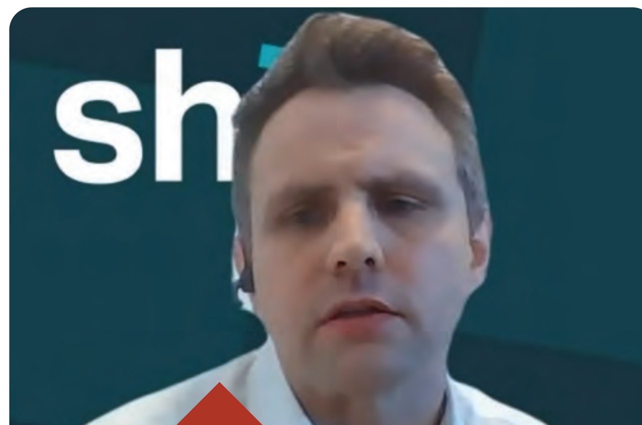
There do not seem to be any major legislative barriers to new entrants, meaning regulation is not the cause of credit only gradually becoming available to more SMEs. Australia is relatively small in a global context and it could be the scale of our market that precludes new entrants.





MICHAEL HEATH JUDO BANK

Almost all our affected customers have returned from COVID-19 hardship and our book has performed very well. This underlines the strength of the SME asset class – it is very resilient.



JAMES DONOVAN SHIFT

During the first lockdown, 15 per cent of Shift's borrowers applied for for COVID-19-related hardship. The second time around, our borrowers had a better idea of how to manage through a lockdown period and therefore only 2 per cent of Shift's book applied for COVID-19 hardship.

ANDREA BRISCHETTO RESERVE BANK OF AUSTRALIA

The RBA's new eligibility criteria for securities to be accepted as collateral in its market operations are being introduced in support of global reforms to strengthen financial benchmarks and ensure they are being used appropriately.

From December 2022, new securities referencing BBSW must have at least one robust, reasonable and fair fallback for BBSW in the event that it permanently ceases to exist. The fallback needs a clearly defined interest-calculation method and a clear and unambiguous trigger event. We also require a robust fallback in the case of a temporary cessation of BBSW.

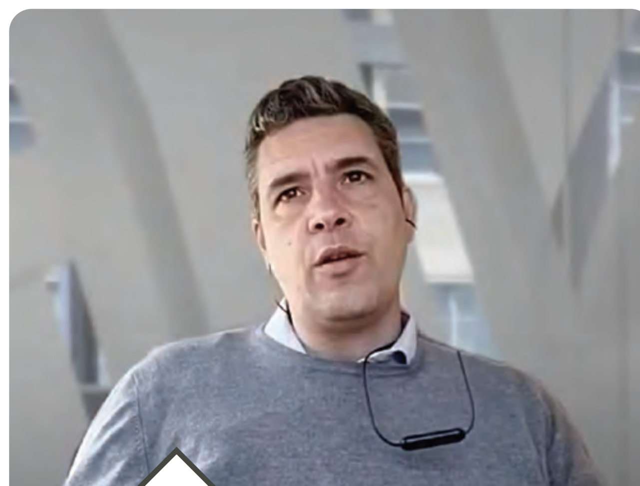
KRISTYE VAN DE GEER ASX

With the introduction of the enhanced methodology and the widening of the maturity pool, we have seen an increase in tenor formation specifically in one-month BBSW. In July 2020, six months before the methodology change, one-month BBSW was published 18 per cent of the time using the transaction layer, relative to 33 per cent on average since and 40-50 per cent most recently.

This year we have been working closely with ASIC on the development of the benchmark cessation should we see evidence a BBSW tenor is no longer representative of the underlying asset it is there to measure.

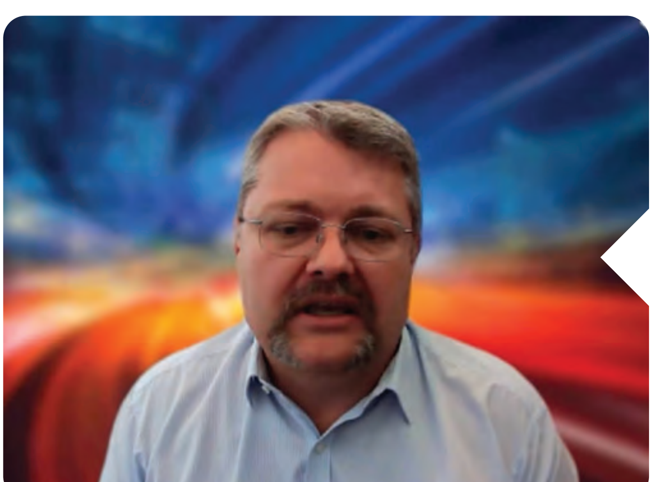
PAULINA TING CIP ASSET MANAGEMENT

The SME lending market is evolving including new entrants offering innovative products. These lenders are catering for a wider range of SMEs not traditionally serviced by the major banks but which need access to cost-effective funding.



ALEX ORGAZ-BARNIER
AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

The concepts of precessation and representativeness are not explicitly referenced in the benchmark's regulatory framework, but we understand they may be useful milestones in an orderly transition. ASIC's role includes providing additional confirmation and clarity to the market.

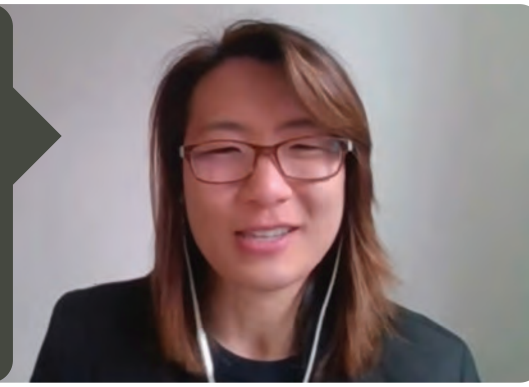


DAVID ZIEGLER MACQUARIE GROUP

We have talked about the evolution of fallbacks and an array of calculation conventions, we have seen markets grapple with the robustness of new and credit-sensitive alternative rates and we have witnessed the implementation of a range of legislative and regulatory solutions.

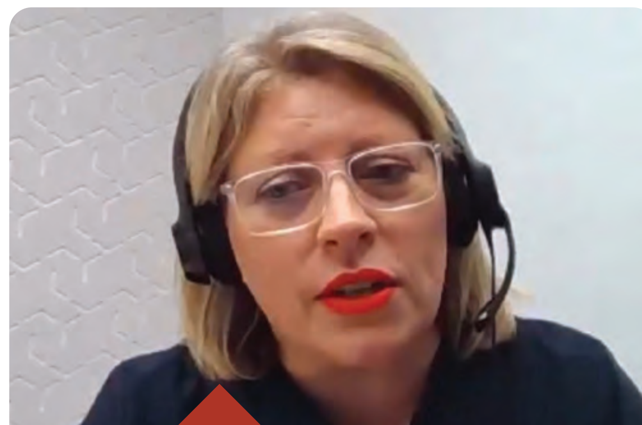
BELINDA CHEUNG AWARE SUPER

Australia is not alone in its high level of household indebtedness. If not carefully managed, this may result in central banks exercising more caution in their rate-hike approaches. Households and businesses adjusting to hikes rapidly might lead to challenges.



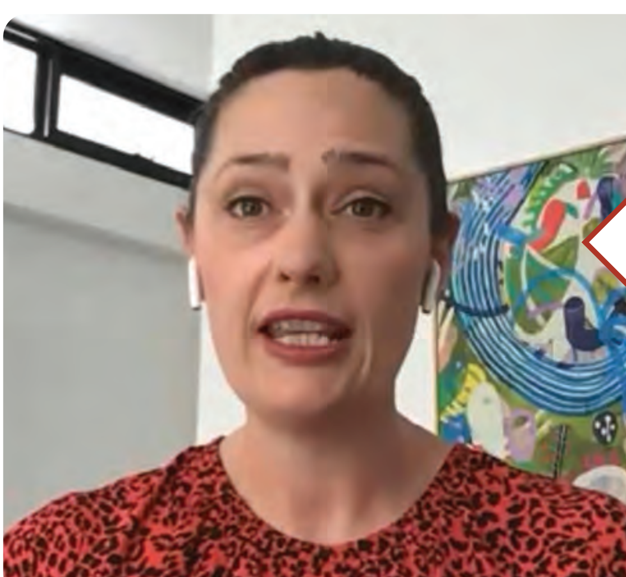
SKYE MASTERS NATIONAL AUSTRALIA BANK

The shift in central bank commentary and policy is upon us as the macroeconomic backdrop no longer points to the need for ultra-easy policy. But the outlook remains uncertain and this will likely be reflected in ongoing rates-market uncertainty.



CHERELLE MURPHY AUSTRADE

With limited competition in the global shipping industry there is a concern that high cost will persist for the foreseeable future even if some of the demand and supply imbalances causing the most immediate price rises start to fall away.



BELINDA ALLEN COMMONWEALTH BANK OF AUSTRALIA

We still need COVID-19 on the list of risks. We were initially worried that the adjustment period out of lockdowns would be too long but with the easing of restrictions we have seen more of a pickup in consumer spending than we expected.

The RBA had the opportunity to reflect on the Australian economic outlook. It raised its forecast in line with recent prints and made policy changes, including abandoning the yield-curve target. But there is still no change in view on how quickly inflation and wage growth will emerge.

PAUL GRUENWALD S&P GLOBAL RATINGS

Inflation is running higher than target in almost every economy. We have seen a slew of emerging-market central banks bring steep increases in the policy rate and some mid-size economies, including Australia, starting to tighten monetary conditions.

SENATOR ANDREW BRAGG

One of the biggest economic levers over the next generation will be a policy on payments and digital assets. If Australia does not have a strong policy in this regard, we risk ceding ground to Silicon Valley.

We have tried to deal with tax issues by recommending a change to the law such that only gains or losses that are demonstrable are captured and to seek to address the crippling phenomenon whereby Australians with exposure to cryptocurrency are being readily 'de-banked' by ADIs.

BRAD SCHWARZ WESTPAC INSTITUTIONAL BANK

The Australian securitisation market is on track to exceed the post-financial-crisis record from 2019 with Q3 2021 the busiest issuance period since Q2 2007 and more than A$44 billion of volume raised in the year to date.

AMANDA BAKER MAYER BROWN

It definitely feels that market activity is at a level we last saw before the global financial crisis, and we are already seeing deals coming in for 2022. It does not seem likely that the market is slowing down any time soon.

THE ASF WOULD LIKE TO THANK ALL SPONSORS FOR THEIR SUPPORT OF THE 2021 CONFERENCE

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COPUBLISHED FEATURE

MOODY'S MOVES INTO THE FUTURE WITH NEXT-GEN ABS SUITE PLUS

***Moody's Analytics** has been beefing up its administration, reporting and analytics solutions to offer clients greater flexibility, control and optimisation when managing term, warehouse and covered-bond transactions. The platform automates a labour-intensive process and removes the guesswork of choosing an optimal pool of assets.*

Australian securitisation broke records in 2021, with A$47.3 billion (US$33.9 billion) raised in 66 deals, an improvement on 2017's A$46.6 billion (see chart). New entrants from the nonbank sector were notable in the flow of issuance, as a growing group of new names reached the stage of business development where public term funding became relevant.

Moody's Analytics says new entrants are prime candidates for a platform such as ABS Suite Plus, which automates and streamlines onerous investor and regulatory reporting. Issuers and trustees use the software platform for the administration of securitisation programmes, supporting diverse underlying assets that can range from credit cards, mortgages and consumer loans to auto loans, leases and mobile-device payment plans.

"The solution is designed fully to automate and provide infrastructure for a structured-finance issuance programme, be it securitisation, covered bond or any type of asset or mortgage-backed securities," says Marc Levine, managing director, issuer solutions at Moody's in Boston.

"When an issuer comes to market, it is faced with all sorts of challenges regarding daily and monthly reporting requirements. Our system takes data from the issuer's source systems, automates all the calculations required at the loan level, then aggregates it."

In addition, all the logic related to the deal's capital structure lies within ABS Suite Plus, as well as functionality that allows for an optimised selection of assets for inclusion in securitisations or warehouses, while automating reporting, accounting and cash flows. "In Australia, RBA [Reserve Bank of Australia] reporting can also be automated through the platform and payment instructions produced," Levine adds.

More than 150 issuers and trustees globally take advantage of the Moody's offering, making it the most widely used structured-finance platform in the world. In 2021 alone, Moody's implemented a record number of new clients as organisations further recognised the importance and value of the functionality as well as the unique expertise, investment, commitment and experience it offers.

According to Moody's, platform users have noted an 80 per cent efficiency gain and significant reduction in keystroke error. "When firms generate these critical reports, there are sometimes no controls and no reviewer who understands all the complex calculations going on in the spreadsheet," Levine explains.

"This is a huge key person and control risk, particularly considering the size of many of these transactions. Our system solves these challenges and does so in a way that provides a significant improvement on the time and effort it takes to generate the reports, accounting entries and other downstream obligations."

Without the system, Levine continues, the whole process tends to be manual – people pulling data off servicing systems, entering it into spreadsheets and calculating offline. A typical month could include multiple days with multiple people working on reporting. The Moody's platform takes the entire manual process and fully automates it, Levine says.

ISSUER SPEED

Six debut issuers tapped the Australian market in 2021, with deals totalling A$1.6 billion. All came from the nonbank

"We have built and modernised an unmatched set of configurable functionality and we are able to leverage it in Australia and the rest of the world. The flexibility to handle any complexity a deal may contain, either on the collateral or structure side, is the single most important thing to consider when investing in a system."

MARC LEVINE MOODY'S ANALYTICS

T-Mobile notes efficiency gain with ABS Suite data management

MOODY'S ANALYTICS' ABS SUITE HELPED T-MOBILE PREPARE ITS DATA FOR SECURITISATION – A SUBSTANTIAL TASK FOR ONE OF THE WORLD'S LARGEST TELECOMMUNICATION COMPANIES. THE ISSUER SAYS THE PLATFORM PROVIDED CLEAN DATA FOR ITS TWO ASSET TYPES, READYING SECURITISATIONS FOR PRIVATE ISSUANCE.

The underlying mobile contracts backing T-Mobile's securitisations are small in dollar value but massive in number. The issuer maintains two privately placed revolving securitisations totalling about US$1 billion apiece, even though the nature of its mobile phone contracts is constantly changing in line with marketing campaigns.

"We like to do creative and exciting things, and ABS Suite has been able to keep up with all of them," says Amber Carrasco, Seattle-based director, financial services at T-Mobile.

The borrower has been using ABS Suite since 2015. Carrasco says its ability to adapt to T-Mobile's specialised needs was impressive. "We often work with IT partners with which it is difficult to get on the same page – but Moody's knew exactly what we were trying to accomplish," she tells *ASJ*.

Extracting and sorting through data from multiple sources then getting it into a format useful for investors was T-Mobile's first challenge. "We have separate billing and loan-and-lease systems, but we need to pull data from both to calculate the outstanding balance," Carrasco explains. "It does not sound complicated but the challenge is making sure we are capturing everything."

She says ABS Suite helped set up the deals and get the data in. "We could easily see what we had available to sell that day," she adds. "[ABS Suite] was able to work through the very complicated logic and the efficiencies gained were on the time we would have spent trying to figure this out manually. If we built this internally, it would take a couple of years."

An in-house solution may have proved difficult to deliver during the pandemic, when regulatory changes meant T-Mobile needed to adapt its systems quickly. "We had to put collections on hold for some customers," Carrasco explains.

It then became a case of working out how to identify these accounts within the system. "Moody's helped us to get this up and running quickly and we were able to report on it within the first month," she explains. "The response time was incredible, especially for something so urgent."

sector. Securitisation has historically been the primary means of funding for these issuers as structured finance gives them access to institutional debt finance at a price that typically helps them compete with authorised deposit-taking institutions (ADIs).

Levine says the time it takes to set up a new deal is an important consideration for issuers and trustees focused on efficiency. "Without the right system, setting up new deals can be extremely arduous. But if a tool has the right features issuers can leverage existing deals and reduce operational overhead while having all the necessary controls in place," he adds.

Enhancements to the platform have also made selecting assets from warehouses and adding them to term deals simpler, optimising the funding process.

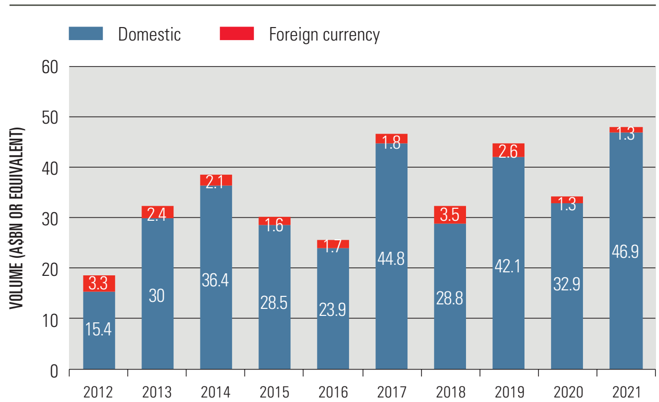
Levine comments: "We have integrated a mixed-integer solver, making it easier for clients with warehouses to take loans out and put them into a securitisation. It is a complicated process with a lot of moving parts as issuers are trying to select a pool of assets for a term deal, which has a set of eligibility and compliance rules, while at the same time keeping their warehouses in compliance with covenants. ABS Suite Plus can do it in a single automated process."

To accomplish this, a series of optimisation routines – which consider all eligibility and compliance rules of the term deal and warehouses – are run against the assets to help select an optimal collateral pool for the securitisation and what to leave in the warehouse.

BESPOKE CONFIGURATION

Australian mortgages do not necessarily behave like those found in other parts of the world. For instance, split home loans that divide the mortgage into fixed- and variable-interest

AUSTRALIAN SECURITISATION ISSUANCE



SOURCE: KANGANEWS 20 JANUARY 2022

Suncorp finds edge with ABS Suite's data management

WHEN COVID-19 STRUCK, THE ABILITY OF AUSTRALIAN MORTGAGE HOLDERS TO MAKE PAYMENTS WAS NEGATIVELY AFFECTED, PARTICULARLY THOSE IN THE SERVICE SECTOR.

The banking industry was swift to offer support, giving customers the option of repayment deferrals in the hope they would recover and meet mortgage obligations once the pandemic was brought under control.

While the turmoil was at its peak, the Australian Prudential Regulation Authority (APRA) also issued guidance designed to support issuers of affected securitisations, specifically residential mortgage-backed securities.

"When the pandemic hit, APRA requested the banks increase their self-securitisation for liquidity purposes," Maddalena Gowing, manager, securitisation and covered bonds at Suncorp Bank in Brisbane, explains. "We were the first bank to do it successfully – and that is because we used ABS Suite. We wanted to get on the front foot, and not get caught in a bottleneck with the rating agencies, and there was no way we could have done so without ABS Suite."

Following APRA's call, Suncorp was able to double its on-balance sheet trust – or its internal securitisation – to A$12 billion (US$8.6 billion).

"As we had everything formulated, coded and in the system the speed with which we worked was so much faster," Gowing tells *ASJ*. "We received positive feedback from APRA and we provided a timeline on how we managed to get the increase done so quickly."

She notes the financial crisis presented a similar situation but Suncorp did not have access to ABS Suite at the time. "ABS Suite gives us an edge at critical times and it is good to have a standalone system we can control with all the information we need."

When the Reserve Bank of Australia (RBA) asked for an extra line of data within its mandatory reporting regime to ensure securitisations kept their repo-eligibility status in 2015, Suncorp was able to customise its ABS Suite platform quickly to meet the demands.

Gowing comments: "We had only just started using the system, but we were able to design it to import all the necessary information that we needed to meet the additional reporting requirements. We were the first bank to pass the level two RBA reporting requirements when it became mandatory."

She says having a standalone, customisable system is important. "We were using Excel spreadsheets before, with a lot of manual entry and controls such as segregation of duty. With ABS Suite we have set up different permissions internally on a team-by-team basis, and we are pleased with how well this setup is working for the bank."

payments are not typically available in markets like the US. The RBA also demands slightly different data points for regulatory reporting than global counterparts.

Moody's has spent years enhancing its offering to cater to local markets. But the configurable nature of its platform made this an easier task, according to Levine.

He comments: "The way our platform is built, and the level of investment we have made, makes it capable of handling complex structures – including, but certainly not limited to, revolvers and master trusts. This is something difficult for a system without years of development and significant investment to do.

"In fact, over the past three-plus decades, we have built and modernised an unmatched set of configurable functionality and we are able to leverage it in Australia and the rest of the world," Levine continues. "The flexibility to handle any complexity a deal may contain, either on the collateral or structure side, is the single most important thing to consider when investing in a system."

He suggests the true value of ABS Suite Plus lies in its ability to offer flexible setup: in fact, all its core capabilities are available to configure. If a user has a different product type or structure, the system can be configured based on the bespoke nature of the deal and issuer.

Levine adds ABS Suite Plus is capable of tracking different data elements and can process multiple inputs from multiple systems. "Our system handles so many complexities but the biggest one is the ability to manage all the possible permutations of how a capital structure or waterfall works. When building a modelling tool, unless you have tested the system on all sorts of different structures across multiple different asset classes – with different credit support and credit enhancement types – you really do not know until you get into the details of the specific deal that you have a system that can handle it."

Levine says, with ABS Suite Plus, Moody's is not customising but rather configuring what is already there for the client – or the user can do it themselves.

THE FUTURE

Moody's purchased ABS Suite from Deloitte in late 2019, and has been improving the platform and combining it with

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Latitude extends ABS Suite use, noting efficiency gains

LATITUDE FINANCIAL SERVICES INCORPORATED MOODY'S ANALYTICS ABS SUITE IN 2020, STARTING WITH ITS SALES FINANCE AND CREDIT CARD SECURITISATIONS BEFORE ROLLING OUT TO ITS OTHER PROGRAMMES. *ASJ* DISCUSSES THE SOFTWARE'S BENEFITS WITH OGGY LI, SENIOR MANAGER, TREASURY OPERATIONS, AND MICHAEL DONOHUE, ASSISTANT TREASURER, AT LATITUDE IN MELBOURNE.

What was onboarding ABS Suite like? How was the integration?

◆ **LI** We had regular catch ups with the Moody's teams in the US and Australia, and then held workshops to map out the data elements from our source system into ABS [asset-backed securities] tables. We then designed our logic to sell assets into the asset classes in the trust on a daily basis.

On the liability side, we started working on reporting and capturing the different structures and setting up calculations for the trust waterfalls that included different interest and fee calculations. We went live with our credit cards ABS deal in Q4 2020. We maintained a parallel-run process for a few months before we turned off the old system.

What did you gain from switching to ABS Suite?

◆ **DONOHUE** We have seen efficiency gains in the way we manage data and turn it into daily and monthly investor reports. We have a lot of data, given we issue credit cards to millions of customers. In the past, accounting and aggregating the data to determine our asset position and collections number was onerous.

◆ **LI** Moody's streamlined this by having a control process to sub-run the summary of the information. We also have the system integrated with our treasury management system. Once things are calculated, we push it to our other systems to settle payments and post into the general ledger.

Previously, all the reporting was based in Excel and was open to human error and operational risk. With ABS Suite, everything is locked in with a set of logic programmed into the back end. It is more reliable.

What customisations did Moody's make to fit the program into Latitude's various issuance programmes?

◆ **LI** The system itself is quite flexible to customise different kinds of waterfall logic. We have two types of trust for credit cards. One is like a warehouse that supports our daily growth in the asset class. We also have a master trust, like a term deal. The two have very different cash-flow allocation requirements based on the legal documents.

ABS Suite can be customised in a way that models the logic based on the requirements in the legal document for the cash flow. It is all driven by diagrams at the back end that act like flowcharts.

It is quite easy to program to meet the requirements for the cash flow and it is easy to clone from an existing trust.

Does ABS Suite accelerate the pace of issuance?

◆ **LI** We get to market much quicker. For some of the recent deals we have closed, we realised just how much faster the turnaround is, particularly when dealing with the rating agencies' requests for certain information or pool cuts.

We were able to turn around these requests within an hour. Everything is just a click away to generate all charts and certifications to share externally.

◆ **DONOHUE** We see a material benefit on the data side, such as collateral information we need to provide to investors and all other parties related to a transaction. The turnaround time for this has materially improved.

Lead times for a transaction and marketing to investors has its own nuances depending on markets. But we have taken out the risk, or the delays, as they relate to the provision of the data.

features from its other legacy platforms ever since. It is also exploring ways to leverage and integrate other analytical capabilities, such as credit models, that exist across the firm.

Moody's considers the platform as part of a larger structured-finance ecosystem. It is building tools that can connect it to other platforms it offers to warehouse lenders, investors and others with a vision of interoperability and connectivity that it believes will further enhance its value.

Levine comments: "In addition to our ABS Suite Plus platform, we also have a system that captures data on securitisations across the world. Furthermore, we have clients providing warehouse lending that are using another one of our applications, and we are focused on providing interoperability and connectivity between the different platforms."

For example, in future users will be able to generate reports out of the platform and make the data available to lenders and investors immediately. "We are also working on other types of cashflow analytics within the platform that will incorporate credit models," Levine adds. "When this is in place, rather than a user inputting assumptions, it will leverage the credit models that include much broader and more sophisticated capabilities." ■

BEEFED UP COMPLIANCE REQUIREMENTS CREATE OPPORTUNITY FOR AVANTI

***Avanti Finance** is maintaining its competitive advantage despite changes to the funding and lending landscape in New Zealand. Though new regulation challenges the bank and nonbank sectors alike, the lender believes its new origination platform places it ahead of the competition, turning a potential negative into a growth opportunity.*

The New Zealand securitisation market printed a record NZ$2.7 billion (US$1.8 billion) in 2021 (see chart), almost double the previous record – set in 2019 – and marking what many market participants believe is a step up in scale and consistency for the asset class.

Improved appetite for securitisation, particularly from new investors to the product in New Zealand, alongside eased uncertainty about the economic impact of COVID-19 and associated lockdowns is pushing the market to achieve the potential its advocates have long suggested it had.

But the record year of securitisation issuance is not matched by a similar explosion in lending market share for the New Zealand nonbank sector.

In part, this is because the pandemic continues to disrupt credit growth across the board. Expansion of gross loans and advances for the nonbank sector slowed to 0.6 per cent in 2021, compared with 14.2 per cent in 2018, 12.5 per cent in 2019 and 3.2 per cent in 2020, according to KPMG's *Nonbank financial institutions performance survey – review of 2021*.

Avanti, however, was able to buck the slowdown trend, growing its balance sheet by 26.7 per cent and moving up a place to become the second-biggest New Zealand nonbank by balance sheet, according to KPMG's survey.

LENDING CHANGES

The local lending landscape is also shifting – and in way that may pose challenges for nonbanks. On 1 December 2021, changes to the *Credit contracts and consumer finance act* (CCCFA) came into effect that place greater compliance requirements on New Zealand lenders.

The changes set minimum requirements that lenders must apply to borrowers to be satisfied they can repay loans without substantial hardship and that the debt is likely to meet the borrower's needs. Previously, lenders were required only to make "reasonable enquiries". They now need to keep detailed records of the enquiries made and the process used to show loans are affordable and suitable.

The new law also introduces additional duties on directors and senior managers, responsible advertising standards, and greater transparency and access to redress before debt collection starts. An update to the responsible lending code complements the requirements.

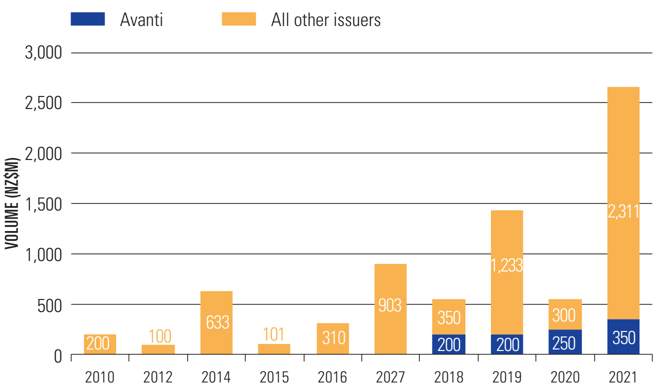
The concern is that the updated lending regime may hinder nonbanks' progress in New Zealand by adding compliance burdens that slow these lenders' traditional nimbleness and highly valued service offering.

Survey respondents in KPMG's report fear the changes will lead to a more cautious approach among nonbank lenders. The report states: "Some cited the possibility of as many as one in five loans being turned down along with the time taken to approve loans increasing by 25-50 per cent. The additional processing time along with a requirement for increased documentation may cause friction where customers are unprepared for the changes."

"We have printed larger RMBS transactions over each of the past two years but we are considering issuing twice a year as the way to fund loan volume that we forecast to continue to increase."

PAUL JAMIESON AVANTI FINANCE

NEW ZEALAND DOLLAR SECURITISATION ISSUANCE



SOURCE: KANGANEWS 15 DECEMBER 2021

AVANTI ADVANCES

Having started out as a personal lender to borrowers unable to access bank loans, Avanti is now focused primarily on auto and mortgage lending. More recently, offering long-term mortgages and competing for prime borrowers has led to a diversification of its product set.

The unique selling points of the nonbank sector are its focus on borrowers that do not fit neatly into bank criteria and its ability to process loan applications quicker than banks. Paul Jamieson, Auckland-based group treasurer at Avanti, says banks have typically taken 2-3 weeks to approve a loan in recent times whereas Avanti usually processes borrowers' applications in one week or less.

Jamieson says Avanti's new technology platform – launched in November 2021 with the new CCCFA requirements embedded from day one – will further improve its service proposition to customers despite the compliance requirements, helping grow its market share.

Borrowers with clean credit profiles will find the loan application process quicker than it previously was, allowing Avanti to write more prime loans, Jamieson adds.

Once mortgage brokers have entered a customer's details the automated platform performs all the necessary credit and other checks, Jamieson explains. "The platform performs the tasks that had previously been performed manually by a lender, so it speeds up the process and allows the lenders to make a lending decision faster."

Another dynamic playing out in the New Zealand lending landscape that could provide a tailwind for Avanti is the potential for borrowers to switch to floating-rate mortgages in a rising rates environment.

New Zealand mortgages have in recent times been heavily weighted toward fixed-rate format – a harder market in which for nonbanks to compete against the major banks on price. Around 90 per cent of New Zealand mortgages are fixed rate – a proportion that has been stable for some years.

Throughout the pandemic, banks enticed many borrowers to lock in record low one-year fixed-rate mortgages. But these will roll off in the next 6-12 months – in a higher interest-rate environment.

Jamieson says Avanti has typically offered floating-rate mortgages that start approximately 150 basis points higher than the major banks' one-year fixed-rate mortgages. "What has happened more recently is that fixed rates offered by banks have come up significantly and our floating-rate offer has only increased a little, so the differential between the two is smaller now," he says.

As borrowers roll off one-year fixed mortgages, a portion of them are likely to explore the value of an Avanti mortgage, Jamieson believes. As the rate differential between the bank fixed rates and Avanti's floating rates is now smaller, there is less incentive for existing customers to switch from Avanti as well. Jamieson notes the nonbank traditionally loses customers to the major banks when they refinance – enticed by the cheaper rates offered by banks.

FUNDING LANDSCAPE EVOLUTION

In the securitisation market, Avanti printed a NZ$350 million residential mortgage-backed securities (RMBS) transaction on 11 August 2021 – its biggest deal to date – taking its total funding completed in the market to NZ$1 billion. Jamieson says the issuer intends to bring NZ$400-500 million of issuance in 2022, most likely across two transactions rather than one.

The signs are positive for market capacity. UDC Finance priced a NZ$400 million transaction in September 2021 – the largest-ever securitisation deal in New Zealand – and Avanti's deal the same year was twice oversubscribed. However, Jamieson says Avanti is conscious of the market's ability to absorb transactions of similar or greater size on a regular basis, or from multiple issuers, at this stage in its evolution.

"We have printed larger RMBS transactions over each of the past two years but we are considering issuing twice a year as the way to fund loan volume that we forecast to continue to increase," Jamieson concludes.

He adds Avanti will continue to issue out of its Australian dollar medium-term note programme in 2022, having priced two deals over the past 18 months, as well as exploring a debut auto asset-backed securities transaction in the New Zealand or Australian market. Avanti lends to prime borrowers in this space under the Branded Financial Services name.

Overall, and with the groundwork now in place after a bumper year, Jamieson has little concern demand for securitisation will dissipate anytime soon. He says the managed funds industry in New Zealand – driven by KiwiSaver – is growing at a significant pace. In combination with historically low interest rates, a number of fund managers are investing in securitisation for the first time.

This includes new investors participating in Avanti deals over the past few years, with its most recent transaction including two new investors. ■

DELIVERING ON THE DIGITAL PROMISE

With a focus on operational efficiencies and regulatory compliance obligations, **TAO Solutions** *has continued to demonstrate a keen awareness of establishing best practices throughout the value chain, enabling agility and precision in structured credit funding activities.* ***Jim Metaxas****, Sydney-based head of Asia Pacific, and* ***Aaron Seaton****, Toronto-based chief executive officer, at TAO Solutions discuss the firm's evolution, key market developments and their 2022 outlook.*

What makes TAO Solutions unique?

◆ **METAXAS** TAO Solutions is a world leader in automated, end-to-end cloud-hosted securitisation software solutions for all asset classes and transaction types. The company is headquartered in Toronto and nine out of the top 10 banks use its software, with more than C$1 trillion (US$781.7 billion) in assets administered. As a boutique, our customer base includes issuers, lenders – as warehouse and asset-backed commercial paper conduit providers – investors in private transactions, trustees and trust managers, and regulators.

Our international offices are in Sydney and San Diego, and we also have representation in the UK, Europe and Singapore. We consider ourselves unique in that we believe we have been able to provide the securitisation industry with a market leading tier-one bank-class hosted solution for all market participants.

What were the highlights of 2021?

◆ **SEATON** Regarding our geographical coverage, we are very pleased to have significantly expanded our Asia Pacific customer base to include tier one and two banks, major nonbank originators and service providers to the securitisation industry. We now service all the major asset classes – mortgages, auto and equipment finance – and are able to provide a level of end-to-end automation that has excited several major industry participants and demonstrated our leadership position.

◆ **METAXAS** Our work in Australia and New Zealand has redefined our market positioning. We identified early on that software implementations in this region rely too much on rigid vendor-driven operational processes and substandard tooling – modelling – methods. In fact, the customer requires operational flexibility and a consultative implementation approach with a focus on industry best practices in respect of operational and reporting requirements.

With this approach, we can introduce a turnkey, cost-effective software solution that has caused many industry participants to re-evaluate the status quo and set their aims higher.

Why is flexibility and a consultative approach important?

◆ **METAXAS** TAO Solutions provides securitisation software and administration services to nearly 50 customers. This includes the largest banks and financial institutions in the world as well as the next generation of fintech lenders. Each lender has its own nuances surrounding data, and preferred operational funding, pooling and reporting needs. Our software is highly configurable to address these.

In respect of reporting, we generally find legal documents do not reflect what has been historically modelled and, by using a blank canvas approach, we have been able to streamline modelling and reporting – both management and investor – to add material value for existing and future funding activities.

◆ **SEATON** Securitisation software solutions continue to evolve, and each vendor is taking its own approach to data usage, functionality, modelling, analytics and reporting. It became apparent that subject matter expertise throughout the sales process and implementation exercise was needed to ensure we could provide industry best practices at go-live.

To do this, we have brought on experienced personnel who are

"Reverse enquiries from major industry participants and issuers are helping drive our ESG securitisation credentials. Over time, we believe ESG and climate risk-related assessments will become part of the standard reporting activities required by the industry and via our embedded BI tool and flexible reporting engines."

AARON SEATON TAO SOLUTIONS

"Our securitisation software already easily supports the ingestion of third-party data feeds and the relevant data points required for ESG assessments and reporting. In fact, with our existing regulatory reporting credentials, we believe we are in a strong position to assist our customers with ESG activities by providing the required data repository for treasury related activities."

JIM METAXAS TAO SOLUTIONS

familiar with local issuer, rating agency and investor requirements. This has significantly streamlined our implementation efforts whereby we can recommend various options and best practices that enable our customers to obtain material benefits to their business operations.

How does TAO Solutions operate in the environmental, social and governance (ESG) space?

◆ **SEATON** It is no surprise that ESG-related activities have taken centre stage. In fact, reverse enquiries from major industry participants and issuers are helping drive our ESG securitisation credentials.

Over time, we believe ESG and climate-risk-related assessments will become part of the standard reporting activities required by the industry, and via our embedded business intelligence tool and flexible reporting engines.

We have something easily configurable by end-users that will cater for industry requirements. While these are still early days – and much work by the industry and jurisdictional regulators remains to be done – TAO Solutions has already identified several key areas of enhancement it can add to speed the pace of adoption while easing the pain and cost of implementation.

◆ **METAXAS** Our securitisation software already has embedded normalised table structures that easily support the ingestion of third-party data feeds and the relevant ESG-related data points required for ESG assessments and reporting. In fact, with our existing regulatory reporting credentials, we believe we are in a strong position to assist our customers with ESG activities by providing the required data repository for treasury-related activities.

How is TAO Solutions supporting nonbank issuer momentum?

◆ **SEATON** We picked up on the nonbank segment early in the North American market as it required significant workflow automation. Fundamentally, nonbank issuers differentiate themselves through their agility and lack of legacy systems and processes that hold them back from providing the best customer experience possible.

With this in mind, about five years ago we set ourselves on a journey to address workflow automation and speed of execution – in securitisation and other aspects of the value chain. Examples include booking and servicing that feeds into securitisation funding. This enables originators to automate the flow from booking to securitisation funding to loan servicing.

We are now seeing interest in this holistic approach in Australia and New Zealand's nonbank issuer segment, where TAO Solutions can provide a hosted solution that supports back-end processing and treasury needs via application programming interfaces.

◆ **METAXAS** The importance of the nonbank issuer segment has increased in recent times, exacerbated by the retail segment's need to obtain alternative forms of funding. The broad willingness of lenders to provide warehouse funding to all types or originators has enabled TAO Solutions to support originators using bulk sale, manual allocations and funding-based predetermined warehouse compliance assessments.

Given our ability to serve both sides of the market – warehouse lenders and borrowers alike – we think we can be an instrumental part of growing the nonbank segment to the ultimate benefit of retail and commercial borrowers, with the ancillary gains extended to the regional economy at large.

What are your predictions for 2022?

◆ **METAXAS** With a strong implementation pipeline and prospect list, our unique, cloud-hosted issuer securitisation software solution will continue to demonstrate its value across all segments, irrespective of the size of the underlying programme. Furthermore, we are also seeing automation across user groups that includes our ability to scrape data from reports and use this for downstream calculations.

◆ **SEATON** Oceania and Asia Pacific have become a major growth segment and we have invested considerably in local resourcing and IT infrastructure. We see this level of investment continuing as our products mature and our regional coverage expands into more specialised markets and alternative asset classes.

With the expansion of credit in the post-COVID-19 world, coupled with the guardrails put in place after the financial crisis, we expect structured finance in fixed-income markets will be more widely accepted than ever before by treasurers and investors.

With this in mind, we believe our company and products are perfectly aligned to match the needs of the new reality and we intend to assist our current and future clients to be at the forefront of market evolution. ■

LEVERAGE, LENDING STANDARDS AND HOUSEHOLD INDEBTEDNESS

The three perennial themes of the Australian residential mortgage story – leverage, lending standards and household indebtedness – are back in focus, thanks to an acceleration in house prices and credit growth. ***Erin Kitson****, director, structured finance at* ***S&P Global Ratings*** *in Melbourne, explores how these factors are influencing the residential mortgage-backed securities market.*

Debt serviceability has remained stable for most borrowers throughout Australia's property price cycles, thanks to relatively benign economic conditions and prudent lending standards.

The fundamentals underpinning stable residential mortgage-backed securities (RMBS) performance and debt serviceability also remain sound, despite an increasing risk environment. But in an era of high household indebtedness, regulatory fine tuning has become a prerequisite in the pursuit of financial stability and maintaining equilibrium in this delicate ecosystem.

POST-PANDEMIC LEVERAGE

In the wake of the pandemic, leverage is a tale of two borrowers. Low interest rates, higher household savings and boosts to household income from government stimulus measures have enabled many existing borrowers to build repayment buffers. This has enhanced households' financial resilience to income shocks, keeping arrears low on average across the sector.

For new borrowers, rising house prices have increased high debt-to-income (DTI) lending as low interest rates have facilitated greater debt. This increases borrowers' sensitivity to household income deterioration and interest-rate rises.

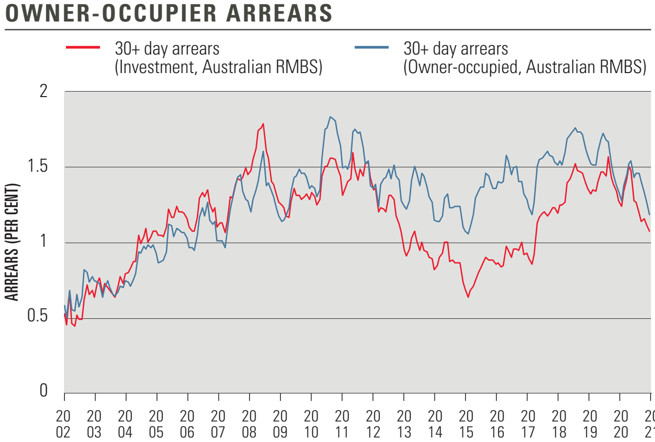
Australian residential mortgagees are among the most indebted in the world as housing debt as a proportion of total household debt has grown in step with property prices since financial deregulation began in the 1990s. The household sector's greater ownership of rental stock and the debt used to fund it have contributed to this indebtedness. In most other countries, the government and corporate sectors hold a significant share of rental properties and the associated debt.

While high DTI loans carry inherent risks, who owns the debt is important from a system-wide perspective. Investors tend to be more highly indebted than owner-occupiers because they have multiple loans for different properties and a tax incentive to maintain higher loan balances. But they also tend to have larger liquidity buffers than borrowers with lower DTI ratios. The arrears performance of investor loans in Australian RMBS transactions has been stronger than owner-occupier loans (see chart), in part reflecting the higher debt serviceability propensity of investors.

While investors may be in a better position financially to service their mortgages, a build-up of these loans in the financial system can increase systemic risks as well as amplify economic downturns and property price corrections.

Investors account for around 30 per cent of loans underlying Australian RMBS transactions. This exposure is higher for some originator types, particularly nonbanks. The Australian RMBS average is broadly consistent with the overall residential mortgage sector's exposure to investor loans.

INVESTOR ARREARS TYPICALLY OUTPERFORM OWNER-OCCUPIER ARREARS



SOURCE: S&P GLOBAL RATINGS DECEMBER 2021

LENDING STANDARDS

Arrears performance has remained relatively stable in the Australian RMBS sector. Higher arrears to date have been confined to specific geographic areas, such as Western Australia in the wake of a downturn in mining investment. The stability of arrears reflects a prolonged period of relatively benign economic conditions and prudent lending standards.

The lending standards of banks and nonbank lenders in the Australian RMBS sector remain comparable. Regulatory guidance on residential mortgage

lending standards has become more prescriptive in recent years, resulting in a greater level of consistency. We conclude that there are some areas with a high level of uniformity among lenders and others with greater variations in standards (see table).

The prevalence of lender's mortgage insurance (LMI) historically meant there was a good level of consistency among prime lenders. LMI is now less prevalent in securitisation but remains a key factor in underwriting and a second underwrite for a material part of residential lending. This has been enhanced in recent years by increased regulation.

Macroprudential tools maintain financial stability and are deployed to curtail build-up in system-wide risk. They can be used to target specific loan segments and are useful in fine tuning the residential mortgage market to maintain financial stability.

The tools can have unintended spill over effects. After investor and interest-only lending limits were deployed in 2015 and 2017, for example, banks retreated from these loan segments and nonbanks capitalised on the opportunities. Maintaining underwriting standards during growth periods is key to avoiding increasing credit risks.

KEY FEATURES OF AUSTRALIAN PRIME RMBS LENDERS' UNDERWRITING STANDARDS

UNIFORMITY	LENDING STANDARD
HIGH	
	Interest-rate buffers used in debt-serviceability calculations. (Previously 2.5 per cent but since raised to 3 per cent).
	Interest-only loans assessed on a principal-and-interest basis over the residual term of the loan.
	Debt-service commitments calculated on the higher of defined interest-rate floor and actual loan rate plus buffer.
	Expenses based on the higher of a benchmark living expense (typically the household expenditure measure (HEM)) or borrowers' declared living expenses.
	No involvement of mortgage brokers in credit decision making or income-verification processes.
	Minimum net-income surplus income ratio of 1:1 applied in debt-serviceability calculations.
	Existing and new debt commitments included in debt-serviceability calculations.
	Alignment to lender's mortgage insurance underwriting standards if it is used.
MODERATE	
	Income shading: banks typically apply a haircut of 20 per cent to variable income sources. Nonbanks typically apply lower haircuts to these income sources, provided the borrower can demonstrate they are regular and ongoing or provide a payment history.
	Rental income: a haircut of 20 per cent is normally applied to rental income. Some lenders apply further haircuts to rental income from high-density apartments.
	Use of HEM as a benchmark index.
	Increase in the number of expense categories in loan systems to provide more granular breakdown of borrower expenses.
	Property valuation types: some lenders only use full valuations while others use a mixture based on a risk-based approach that is lender specific regarding the loan-to-value ratio (LVR) and location of the loan, among other factors.
LOW	
	Floor lending rates used in debt-serviceability calculations.
	Use of auto credit-decisioning tools in lending process.
	Override exception limits/tolerances. These are very lender specific.
	Use of DTI limits in debt-serviceability standards. More common across banks, but the maximum DTI limits applied vary.
	LVR cap restrictions. Criteria covering LVR restrictions vary by lender, but typically depend on property type, size and postcode, and loan size.
	Types of "reasonableness" tests employed to check or verify borrowers' declared living expenses.
	Use of comprehensive credit reporting to verify borrowers' existing financial commitments.

Note: This information is based on our operational review assessments that include a review of lending processes and credit policies.

SOURCE: S&P GLOBAL RATINGS DECEMBER 2021

Nonbanks are not beyond regulatory oversight: The Australian Prudential Regulation Authority's reserve powers allow it to regulate nonbanks' lending if they become large enough to pose a material risk to the financial system.

AUSTRALIAN FUNDAMENTALS

Despite high household indebtedness, the Australian mortgage and RMBS markets have been relatively resilient to economic downturns. This reflects a number of key features.

Most housing loans are based on discretionary variable-rate loans, which can subject borrowers to payment shocks should interest rates increase rapidly. As such, borrowers generally prefer to repay home loans as fast as possible to reduce the potential exposure. The build-up in repayment buffers during the pandemic is evidence of this.

All mortgages are full recourse. In some other jurisdictions – in practice or by law – lending is limited recourse, whereby lenders predominantly rely on the mortgaged property as collateral to repay the loan in the event of a borrower default. As a result, borrowers may be less incentivised to maintain mortgage payments when house prices decline. We have observed this has a significant effect on borrower behaviour compared with full-recourse markets such as Australia.

Loans to owner-occupiers, who account for about 70 per cent of total residential mortgages, do not benefit from tax deductions to offset interest payments on their mortgage loans. As a result, owner-occupiers have an incentive to pay down their loans rapidly, creating further borrower equity in the security properties.

There is a strong social stigma attached to default and limited options for credit-impaired borrowers. Regulators continue to reinforce prudent lending standards.

These features support the Australian RMBS sector's strong collateral performance. They must be preserved through prudent lending standards and macroprudential fine tuning to limit the build-up of systemic risk. ■

ANZ

ADI-SPONSORED SECURITISATIONS AND THE ROAD FORWARD

While nonbanks were issuing large volumes of residential mortgage-backed securities and an increasingly diverse array of asset-backed securitisations in 2021, public issuance from authorised deposit-taking institutions was a different tale. Of the A$48.7 billion of securitised paper offered last year, only A$11 billion came from bank-sponsored trusts. ***Graham Metcalf****, head of structured capital markets at* ***ANZ*** *in Sydney, explores where next for ADI-sponsored securitisation.*

In percentage terms, nonbanks now account for more than three-quarters of market volume, up from around half in 2019.

Authorised deposit-taking institutions (ADIs), meanwhile, act as both issuers and holders of securitisations, with A$727 billion (US$521 billion) of securitised assets on balance sheet or 15 per cent of total resident assets across the ADIs. This is material, according to the Australian Prudential Regulation Authority (APRA)'s banking stats from 31 October 2021.

However, only 50 of the 125 banks, credit unions and building societies included in APRA's monthly banking statistics have securitised assets on their books, while just nine of these ADIs used the public capital market for securitisation in 2021.

CLF AND SELF-SECURITISATION

Most of the A$727 billion of securitised assets are self-securitisations – asset-backed securities (ABS) issued by ADIs solely to access liquidity from the Reserve Bank of Australia (RBA).

These programmes are useful for ADI treasurers in normal times, such as banks using notes issued under the self-securitisation programmes as collateral to access the committed liquidity facility (CLF). The CLF enables certain ADIs to use a contractual liquidity commitment from the RBA toward meeting their liquidity coverage ratio (LCR).

At 31 December 2019, the aggregate CLF was A$239 billion. This reduced to A$136 billion by December 2021, while APRA expects ADIs to reduce their usage of the facility to zero by the end of this year. However, the fact CLF usage had already reduced by A$100 billion prior to APRA's September closure announcement was overlooked in recent commentary.

CLF reduction affects ADI securitisation in two ways. First, it is expected to reduce self-securitisation for CLF purposes. However, there is a new requirement on ADIs to hold contingent liquidity to cover potential future stresses over and above the liquidity requirements to meet LCR needs. APRA issued final guidance on 18 November 2021, requiring ADIs to prepare repo-eligible securities – mainly in the form of self-securitisation – that can be provided as collateral to the RBA if needed.

Second, some ADIs own publicly issued senior notes dealt by external securitisation trusts on their own balance sheets, again as collateral for the CLF to ensure it is sufficiently diversified to meet RBA requirements. The four Australian major banks collectively hold about A$22 billion of these securities (pillar three as at 30 September 2021). This has been falling over time from a recent high of about A$30 billion at the start of 2019. In the later stages of 2021, following the CLF announcement, lower demand from balance sheets appeared to come through making execution of some large-volume transactions more challenging.

ANZ expects 2022 will see this changing dynamic produce some reduction in the large issue sizes prevalent in 2021. It should be noted 2021 was a year of record volume and post-financial-crisis tight pricing for many nonbank issuers, so reduced deal size would be a reversion to more normal conditions.

LIQUIDITY DEVELOPMENTS

Since 2015, those ADIs to which APRA applies the Basel III liquidity standards have been required to hold high-quality liquid assets (HQLAs) sufficient to withstand a 30-day period of stress under the LCR requirement. In the Australian dollar securities market, APRA has only assessed Australian Commonwealth government securities and those issued by the borrowing authorities of the states and territories as meeting the Basel criteria for HQLA. Publicly issued RMBS or ABS do not qualify.

Recently, more complex ADIs operating their balance sheets under the LCR regime and less complex ADIs operating under the minimum liquidity holding (MLH) regime have had no shortage of liquidity. Resident deposits for ADIs were A$2 trillion in March 2019 and in October 2021 they stood at A$2.6 trillion. Additional deposits have unexpectedly swollen the balance sheets of the ADIs by about A$500 billion in a relatively short timeframe.

COPUBLISHED COLUMN

"ADIs will continue to see value for diversification of funding, duration matching and capital relief. For the major banks, the approach may vary as it did in 2021. The majors may move back to a more normal wholesale funding mix in 2022 or choose to prioritise senior-unsecured markets domestically or offshore."

GRAHAM METCALF ANZ

In addition, the term funding facility (TFF) – announced 19 March 2020 and increased 1 September 2020 – provided A$188 billion of funding, equivalent to 4 per cent of banks' non-equity funding. Introduced prudently at the start of the pandemic to ensure liquidity in the financial system, the addition of this funding sees ADIs using it heading into 2022 with a considerable challenge.

ASSET GROWTH AND FUNDING

Housing dominates Australian ADIs' use of funds, with owner occupier and investor home loans totalling A$1.9 billion, up from A$1.7 billion in March 2019. Despite the highly publicised rampant house price gains, only A$200 billion of the A$700 billion of additional deposits and TFF have been allocated to housing finance. In the month of October 2021, total new housing loan commitments in Australia excluding refinancing were A$29.5 billion, compared with A$16.5 billion in March 2019 – an unprecedented spike in housing loan commitments.

Predictions for property price performance in 2022 and beyond vary widely and sentiment will affect demand for housing credit. It is conceivable that the very recent downturn in loan commitments will presage a reversion to a lower level in 2022 if steam comes out of the Australian housing market.

The additional available liquidity has not been absorbed through lending to sectors other than housing: for these ADIs total resident loans and finance leases, including the extra A$200 billion of housing, increased by only A$230 billion to A$3 trillion in October 2021 from A$2.8 trillion in March 2019.

It seems unlikely the ADIs will grow strongly in non-housing securitised assets – including consumer credit, auto and equipment – as lending in many of these is transitioning from ADIs to nonbanks.

For those charged with funding these ADIs, the issues are not about sourcing liquidity but managing their overfunded positions with an eye to the future. There is recognition that relationships and lines with depositors, short- and long-term wholesale investors and structured-funding investors must be maintained.

One significant unknown is what happens to higher deposit balances: are they maintained, withdrawn and invested in other asset classes, used to pay down debt or withdrawn and spent? Further, how does their composition change – that is, where does excess cash end up as it moves through the economy? Where the cash ends up with retail customers, SMEs, funds and larger institutional customers is an interesting issue for ADIs. They must evaluate this imprecise equation to explore their future funding requirements.

Regarding securitisation funding requirements, ANZ expects ADIs will continue to see value for diversification of funding, duration matching and capital relief. For the major banks, the approach may vary – as it did in 2021, with only Westpac Banking Corporation issuing the A$1.2 billion WST 2021-1. The majors may move back to a more normal wholesale funding mix in 2022 or choose to prioritise senior-unsecured markets domestically or offshore.

Similarly, the large ADIs have more than enough flexibility and options. Generally, their deposit-to-loan ratios are currently in the vicinity of 85 per cent, which is in the order of 10-15 per cent higher than usual.

For these ADIs, if deposits were to reduce over time, and as TFF funding rolls off, the logical course includes returning to short- and medium-term wholesale funding markets in greater volume. Large ADIs also have active programmes at their disposal with plenty of collateral for covered-bond issuance, particularly in times of high volatility. They remain conscious of the desirability of staying current with institutional investors and will balance this with other considerations.

The equation is similar but slightly different for smaller banks and credit unions. Many of these entities have deposit-to-loan ratios over 100 per cent but less access to wholesale-funding markets than larger ADIs. Traditionally, they may have implemented self-securitisation and turned to external securitisation for about 20 per cent of their total liquidity needs. Using private warehouses to diversify their funding away from deposits and accessing the public residential mortgage-backed securities market infrequently when issuing conditions are favourable has worked well for these institutions.

ANZ expects this to continue. We also expect growing interest in capital relief warehouses from smaller ADIs flush with liquidity, but in need of expansion capital, to increase scale and potentially consolidate with other small ADIs. We expect institutional investors to value new ADI-sponsored issues in part for their rarity among the greater flow from the nonbank issuers driven by their strong asset growth. ■

STRUCTURED FINANCE HEADS INTO A YEAR OF CHANGE AND INNOVATION

*The structured-finance market remains strong going into 2022, even if it might not hit the heights of 2021. **Westpac Institutional Bank** explores some of the key elements predicted to drive the market in 2022.*

BY CHRISTOPHER NIESCHE FOR WESTPAC INSTITUTIONAL BANK

The new year will start strongly for the structured-finance sector as investor demand and the housing market remain robust, according to experts at Westpac Institutional Bank. The pandemic continued but failed to slow the market in 2021, with just less than A$49 billion (US$35 billion) in structured finance bonds issued publicly – the highest since the financial crisis.

In New Zealand, about NZ$2.4 billion (US$1.6 billion) of residential mortgage-backed securities (RMBS) was issued. While this amount pales in comparison with Australian issuance, it is much higher than the typical annual issuance of less than NZ$1 billion. The market may grow further, as the Reserve Bank of New Zealand places additional macroprudential controls on the banking sector, paving the way for nonbanks to issue more home loans.

In Australia, nonbank financial institutions increased their share of the RMBS market – for several reasons. In part, they are nimbler than the major banks that are hindered to some extent by legacy IT systems and are thus slower to approve home loans.

Craig Parker, head of structured finance at Westpac in Sydney, expects the nonbanks to continue growing their RMBS issuance. The rate of growth will slow, however, as the housing market cools in the second half of 2022 and major banks improve their home loan approval times.

Nonbanks also increased their share of the issuance market as banks accessed other cheap funding, such as consumer deposits and the Reserve Bank of Australia (RBA)'s term funding facility (TFF) provided during the pandemic. At the same time, nonbanks are pushing into other sectors of the asset-backed securities (ABS) market.

In December, Westpac helped specialist lender Think Tank originate a A$750 million bond, after increasing the original target from A$500 million when investor demand proved strong.

"This is a type of transaction we expect to see more of," Parker says. "I think we will see other relatively new clients issuing structured finance. There will be growing demand for ABS product, such as small-ticket commercial mortgages, personal loans and auto loans."

IMPACT OF CLF WITHDRAWAL

A significant development in the ABS market for 2022 will be the withdrawal of the government's committed liquidity facility (CLF), which the RBA provided to allow banks to meet their capital adequacy requirements in times of low bond market liquidity because of the low level of government debt on issue pre-COVID-19. The reserve bank allowed banks to invest in RMBS issued by other banks and use them as collateral.

Parker says the withdrawal of the CLF means big-bank demand for RMBS could fall. However, the banks did not typically buy nonbank RMBS so the overall effect may not be great.

"I expect the demand for ABS or RMBS from the big banks will reduce somewhat because of the CLF. But I do not think it is going to be as material in the nonbank space as it would otherwise have been in the authorised deposit-taking institution [ADI] space," Parker adds.

"I think we will see other relatively new clients issuing into the structured finance. There will be growing demand for ABS product, such as small-ticket commercial mortgages, personal loans and auto loans."

CRAIG PARKER WESTPAC INSTITUTIONAL BANK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Demand from investors for RMBS and other structured-finance products remains strong because of their relatively high yield. Parker explains: "Investors seeking a balanced investment portfolio need to have some amount of fixed interest. Within the fixed-interest asset allocation, structured-finance products offer better value than straight bonds."

Securitisation will have to compete with more alternative credit supply in 2022, however. The end of the TFF means the major banks need to issue around A$140 billion in bonds to meet their funding requirements, which is putting pressure on the RMBS market.

Hugh Norton, credit trader at Westpac in Sydney, says spreads on ADI RMBS widened about 20 basis points between the announcement of the CLF closure in September 2021 and year-end, but appeared to have found a clearing level. The return of major banks to senior-unsecured issuance could cannibalise some demand for highly rated Australian dollar paper, Norton says.

The trend will likely continue, says Martin Jacques, head of ABS research at Westpac in Sydney. While demand is likely to ease as capital market supply normalises, there is a strong expectation many of the investors that previously only considered ADI issuance will be sticky, having done the diligence to become comfortable with more securitisation issuers, Jacques says.

Nonbanks remain highly reliant on RMBS and might have to look for investors offshore if the local market is tapped out by the banks, despite the additional cost.

STRENGTHS AND WEAKNESSES

Consumers come into 2022 in a strong position and their continued ability to make mortgage payments will support asset quality in the RMBS sector, according to Sydney-based Westpac senior economist, Matt Hassan.

They have accumulated savings through COVID-19 lockdowns and their employment prospects are strong thanks to the tightening labour market. While supply-chain constraints and the labour shortage will stoke inflationary pressure, the RBA has committed to leaving rates unchanged until its inflation and unemployment targets are met and wages growth shows convincing evidence of a sustained lift.

"Westpac expects this to happen sooner than the RBA's recent guidance of '2023 at the earliest' with the cash rate forecast to begin rising from August. That said, unless something comes out of left field, it is looking like a bit of a Goldilocks year for the consumer – not too hot but not too cold – with housing markets continuing to perform, the economy posting strong gains and the RBA taking a gentle approach to interest rate increases," Hassan says.

On the other hand, 2022 is clearly not shaping as a very strong year for the housing market. Affordability is already a significant headwind in many locations and, with rising fixed-rates and macroprudential tightening measures also in the mix, a moderation already looks to be coming through. That will clearly intensify as official interest rates start to move higher in the second half of the year.

Pertinently for RMBS, the number of home sales looks set to decline. Fewer consumers believe now is a good time to buy a home, according to the Westpac Consumer Sentiment Index – and a drop often presages a housing market turning point.

One open question is the extent to which somewhat dormant property investors re-enter the market in 2022. While investors' ability to repay remains strong, any fall in house prices will prompt a more granular examination of the pool of assets collateralising the loans, particularly for those backed by houses bought at the top of the market.

APPETITES PIQUED FOR GREEN

Another feature of 2022 is likely to be a further increase in investor focus on green ABS, says Charlotte Plaisant Millecamps, director, sustainable capital markets at Westpac in Sydney.

There are three ways of considering the green credentials of ABS: the sustainability approach of the institution issuing the products, what the proceeds will be used for – such as funding residential rooftop solar panels – and the sustainability profile of the collateral, for instance energy-efficient homes.

"We foresee investor demand increasing," says Plaisant Millecamps. "The buy side is really trying to understand the story, so it is important for issuers to be able to tell it, be genuine and show where they are on their journey."

Regarding green mortgages, a difficulty for investors is understanding the underlying data to ensure the mortgage is as advertised. There are other complications, such as if a homeowner with a green mortgage renovates their home and by doing so changes its profile. Plaisant Millecamps points out this is a developing market where technology and data will play a key role in future.

Westpac provides a full suite of services to the ADI and nonbank sectors. The bank finances large finance receivable portfolios for ADIs, including smaller financial institutions, as well as nonbanks across a range of asset classes, among them prime and nonconforming residential mortgages, and personal, auto and commercial loans.

Westpac provides short-term warehouse facilities, where assets are funded for a period until they are used to collateralise an ABS, along with arranging and lead-managing bond issues accessing the domestic and international capital markets for clients. Longer-term financing is also available to clients that require it.

The bank offers all financial services needed to manage bonds, including transactional banking services for the collection of money from the underlying mortgages or loans. Other services include fixed-floating rate swaps, to allow clients to hedge their risk, and liquidity support facilities to enable payment of required trust expenses. ■

HAS AUSTRALIAN HOUSE PRICE GROWTH PEAKED?

The outlook for Australian house prices is one of the easiest macro questions to answer on a six-month horizon but one of the hardest to get right on a longer timeframe. History shows Australian housing sentiment can prove just as fickle as its fundamentals are strong. ***Phil O'Donoghue****, chief economist, Australia and New Zealand at* ***Deutsche Bank*** *in Sydney, looks at three recent developments that could indicate the peak might be in – or at least getting close – for house price growth.*

First, auction clearance rates in Sydney and Melbourne have turned lower. Data compiled by domain.com.au show clearance rates – meaning sales as a per cent of auctions held – in Sydney and Melbourne fell by more than 15 per cent between early October and late 2021.

From an 86 per cent clearance rate on Saturday 9 October, Sydney clearances on Saturday 11 December had fallen back to 63 per cent. In Melbourne, clearances spiked to 81 per cent on 2 October but dropped back to 65 per cent by 11 December.

Auction clearance rates are one of the most reliable leading indicators for house prices. For Sydney and Melbourne, the correlation between auction clearance rates and year-end dwelling price growth within a six-month timeframe has been tight since the 1990s.

The current level of auction clearances suggests house price growth in Sydney could slow from around 25 per cent over the year to Q3 2021 to the low teens by the middle of 2022, while Melbourne growth could slow from around 20 per cent to single-digit growth over the same timeframe.

Second, the timing of the decline in clearance rates coincides remarkably well with APRA's 6 October announcement that it would "increase the minimum interest rate buffer it expects banks to use when assessing the serviceability of home loan applications" from 2.5 per cent to 3 per cent. Having been stable for three months in Sydney, and – ignoring COVID-19 lockdown disruptions – for about six months in Melbourne, auction clearance rates turned noticeably lower within days of the APRA announcement.

Although a relatively recent development – and only used sparingly – macroprudential measures have been associated with slowing house price growth before. One difference this time is that, unlike previous macroprudential tightening measures, APRA's October announcement was not targeted specifically at investor lending. Nonetheless, the timing follows a sharp increase in investor activity in 2021 – and this hardly looks coincidental.

Investors have indeed proved to be the canary in the coal mine for the house price cycle before.

A remarkable regularity in the flow of Australian housing finance is that about half of total housing-finance credit in any given month is extended to existing owner-occupiers. Since 2002, the average amount of new housing credit extended to this cohort in any given month is 48 per cent, within a range of 40-54 per cent.

The other half is a perennial battle for market share between investors and first home owner-occupiers. Recent dynamics are notable: having steadily increased from 11 per cent of new housing finance in early 2017 – a near-record low share – the share of new housing finance extended to first home buyers lifted to 25 per cent by early 2021, just below the record high of 30 per cent reached in 2009.

Since then, investor finance has surged, crowding out first home buyers,

"While it remains too early to tell whether APRA's October announcement alone will bring about a downturn in the price cycle, the evidence that macroprudential measures in general can influence the house price cycle is clear."

PHIL O'DONOGHUE DEUTSCHE BANK

Deutsche Bank

> *"2022 is shaping up as a much softer year for house price growth than 2021. Nonetheless, Deutsche Bank's strong view is that house prices will not collapse: we expect the circularity of monetary policy, coupled with the demonstrated effectiveness of macroprudential policy, to circumvent any scenario that delivers sharp price declines."*
>
> **PHIL O'DONOGHUE** DEUTSCHE BANK

and is now at a level that previously prompted macroprudential restrictions on investor activity. While it remains too early to tell whether APRA's October announcement alone will bring about a downturn in the price cycle, the evidence that macroprudential measures in general can influence the house price cycle is clear.

House prices kept rising after APRA's first foray into macroprudential policy tightening in December 2014, before a pause about nine months later as investor finance reached a cyclical trough. After investor finance began to strengthen again, however, APRA tightened policy further in March 2017, which led prices – and investor finance – to steadily fall for about two years, through to January 2019. At this point APRA eased macroprudential policy.

The third factor pointing to a peak in house price growth is that fixed-term mortgage interest rates are rising. This matters more now than historically.

The Reserve Bank of Australia (RBA)'s housing lending interest rate database shows the average interest rate on new owner-occupier housing loans with a fixed term of three years or more reached a low point of 1.99 per cent in February 2021. It had risen 45 basis points by October. Fixed interest rates for less than three years have also risen, albeit by less: they were up by 5 basis points in the October data release from the low point in May.

Variable rates have continued to trend lower, but the turn higher in fixed-rate loans will have a more significant impact on demand than usual. This is because the proportion of new housing finance extended to borrowers on fixed-rate terms, rather than variable rates, is at a record high. Since the RBA shifted to an ultra-easy monetary policy stance in the COVID-19 era, the flow of fixed-rate borrowing had surged to about 40 per cent of new mortgage borrowing by October 2021, surpassing the previous peak of 30 per cent from 2008.

Take these three factors together and 2022 is shaping up as a much softer year for house price growth than 2021. Nonetheless, Deutsche Bank's strong view is that house prices will not collapse: we expect the circularity of monetary policy, coupled with the demonstrated effectiveness of macroprudential policy, to circumvent any scenario that delivers sharp price declines.

Our baseline forecast for the end of 2022 is that house prices will still be about 5 per cent higher than their current level. This might sound upbeat, but it represents a sharp slowdown in growth from the current 20 per cent year-on-year pace. The most identifiable risk to our forecast is a sharper-than-expected rise in interest rates. ■

Capital Markets

COPUBLISHED FEATURE

HOW SECURITISATION IS RISING TO THE ESG CHALLENGE

Soaring investment linked to environmental, social and governance criteria has put sustainability high on the structured finance agenda. ***RBC Capital Markets*** *explores how the ESG securitisation market will develop rapidly in the coming years despite challenges, as the industry responds to investor and consumer expectations.*

While securitisation comprised a sliver of the US$1.7 trillion global sustainable debt market in 2020, it is expected to play a bigger role in future given the asset class finances a range of collateral that apply ESG objectives. Stronger commitments from companies and policymakers toward sustainability goals is driving momentum as investors take more interest in climate change, human rights and social development.

"It is notable just how high on the agenda it is for issuers really to spend time on developing their ESG policies," says Jennifer Hellerud, head of securitisation, Australia at RBC Capital Markets (RBCCM) in Sydney. "Investors are starting to ask questions about ESG policies and there may come a time when investors will not buy bonds from issuers if they do not at least have appropriate corporate ESG policies in place."

A vast majority of securitisation market participants – 86 per cent – had ESG programmes at enterprise level by the end of 2020, while nearly half had one at the structured finance level, according to the Structured Finance Association's ESG Industry Engagement Survey from 2020. While only 13 per cent of respondents had sponsored an ESG-focused securitisation programme, nearly half indicated they were developing one.

The growing interest has spurred a flurry of ESG securitisations over the last two years across a wide spectrum of sustainability concerns. One of the standouts was Toyota Financial Services' US$1.6 billion asset-backed green bond issued mid-year to finance the sale of hybrid, fully electric and late-model vehicles that meet emissions standards. The proceeds are aimed at future hybrid and electric vehicle (EV) originations that meet green eligibility criteria.

PRIVATE SECTOR LEADS

While the northern hemisphere has led the market for ESG securitisation, Australia is moving forward despite challenges of scale and relatively few incentives from policymakers. Nonbank lender and payments company hummgroup became the first Australian company to issue a green asset-backed securities (ABS) deal, in 2016, to fund its solar panel installation financing.

There have been a slew of landmark deals since, including nonbank lender Firstmac's A$750 million (US$538 million) residential mortgage-backed securities (RMBS) issue in June 2021, Australia's first RMBS to comprise exclusively green tranches. The deal provides finance for homes that meet efficiency criteria in the Nationwide House Energy Rating Scheme.

Australia, however, has yet to catch up with Europe in policy and tax incentives to drive capital into ESG investments. Scale also remains a hurdle for certain assets. While the country leads the world in solar photovoltaic capacity per capita, EV uptake remains low compared with developed world peers due to a lack of incentives, infrastructure and limited availability of models. Low levels of EV collateral in warehouse facilities are still an obstacle to ESG-focused auto ABS securitisation – but the landscape is expected to shift rapidly over coming years as sales eclipse internal combustion engine (ICE) vehicle sales.

Hellerud comments: "As supply becomes available and the entry price for EVs drops, we expect to see a marked increase in finance applications. Government initiatives should drive consumer uptake even higher. We are in the last decade in which ICE cars outsell EVs, and every manufacturer is looking at EV options."

While industry and tax incentives are the missing piece in Australia, the private sector continues to power ahead. "Companies have an ESG consciousness that they are seeking to incorporate formally," Hellerud adds. "Similarly, investors want to make sure they are investing in companies and securities that have a base level of ESG accountability."

While ESG securitisation has so far largely focused on environmental and sustainability criteria, there is growing interest and activity on the social component. The COVID-19 pandemic has focused the minds of policymakers, regulators and investors on the importance of diversity, equity and inclusion in investment decisions. RBCCM has recently been

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JENNIFER HELLERUD RBC CAPITAL MARKETS

active in social-focused securitisation as sole structurer, joint bookrunner, and diversity and inclusion coordinator for Verizon's US$1.7 billion ABS issue in May 2021. RBCCM and Verizon developed a syndication structure that provided diverse-owned firms with enhanced transaction economics and equality of opportunity to place ABS securities with investors.

"The transaction underlined how corporate borrowers are trying to include more social equity in their capital market transactions," Hellerud explains. "It also provides means for them to expand their investor base through the investor relationships diverse-owned dealer-brokers have."

CLEARER STANDARDS

While interest in ESG securitisation is growing, a lack of clear and unified standards remains a challenge. The market continues to debate how to define green and social, what metrics should be used to measure performance and how to penalise noncompliance. The opacity has left companies setting their own definitions and benchmarks, raising concerns about greenwashing.

Some jurisdictions are moving faster than others in producing policy frameworks to guide market participants. The EU has made strides in formulating a detailed classification system through its taxonomy regulation, which will help provide clarity on what economic activities can be classed as sustainable. The EU's green bonds standard is also offering a unified standard for the green-bond market.

With Australia trailing the EU in setting standards, there is still considerable nuance in the classification of ESG transactions. To date, the most common approach involves issuer adherence to the International Capital Market Association (ICMA) principles. These include the Green Bond Principles, which outline best practice when issuing green bonds and ultimately help promote transparency and disclosure.

Hellerud says: "A common global approach to defining sustainable transactions would make life a lot easier for everyone and would certainly assist with mitigating problems like greenwashing."

More work needs to be done to produce agreed frameworks for measuring and reporting the impact of investments. As a minimum, participants must be able to demonstrate they can capture and report the data underpinning ESG metrics. This can be straightforward for certain assets but is complex for others.

With portfolios of vehicles, for example, capturing tailpipe emissions and other energy-efficiency indicators is common. National energy benchmarks and ratings systems could anchor RMBS issuance for housing. However, verifying long-term impacts of investments, whether through decarbonisation or improved social equity, will inevitably require more sophistication. Industry will need to collaborate to agree on reasonable and robust standards that can be applied broadly and regulated effectively.

"Investors will certainly play a part in this," Hellerud notes. "They will be in a position to dictate what it is they need to classify a transaction as ESG aligned."

In corporate ESG issuance, investors are seeing 'greeniums' – premiums for green transactions – of about 5 basis points for ESG-compliant deals versus noncompliant ones. ESG securitisations are likely to see a similar greenium emerge over time. "There is not quite enough volume of transactions in the space yet to determine whether the greenium exists. But I think ultimately it will emerge with volume," Hellerud says.

Industry has rarely failed to innovate when presented with opportunity, and the securitisation sector will be no different as it meets growing demand from investors and consumers for products that deliver a sustainability dividend. Industry participants who commit early to ESG will be well-positioned as new policy incentives come online and standards become clearer.

Royal Bank of Canada is committed to mobilising C$500 billion (US$391 billion) in sustainable finance by 2025 and achieving net-zero emissions in lending by 2050. RBCCM's dedicated sustainable finance group works with clients on their sustainability journeys, partnering across the capital markets platform to deliver advice and solutions that also aim to have a positive impact on the world.

"The investment community is a lot more socially and environmentally conscious now," Hellerud points out. "It is important not to be left behind, which means companies have got to be on board with their policies and how they will achieve their ESG objectives." ■

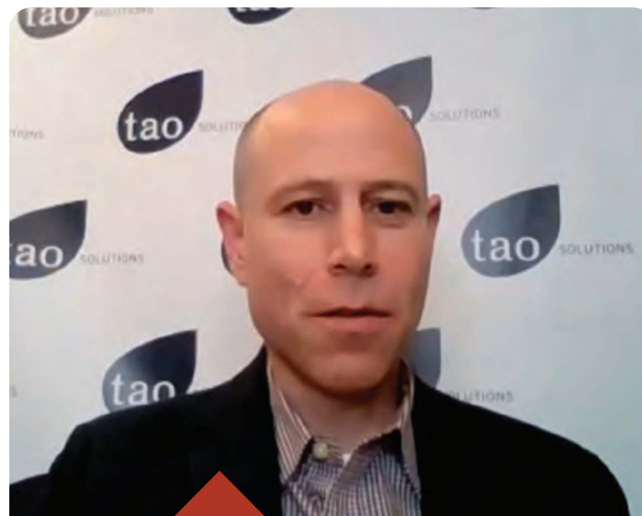
EVENT REPORT

SECURITISATION INDUSTRY CHARGES AHEAD — PART TWO

Continuing coverage of all the perspectives from the ***Australian Securitisation Forum Conference 2021***.

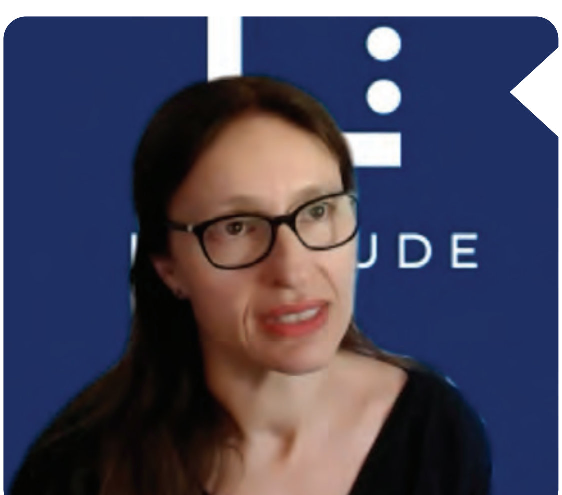
RICHARD MCCARTHY PERPETUAL CORPORATE TRUST

The first challenge with a new system is to understand it, embed it and use it effectively. Using digital solutions with a structured workflow across the end-to-end process enables efficiencies, automation and scalability, while mitigating cyber security risks and maintaining compliance.



AARON SEATON TAO SOLUTIONS

By introducing more technology, we will see greater efficiency regarding the types of products offered to investors and the data available to them. The tech dividend will produce more issuers and a more competitive market landscape.



EVA ZILELI LATITUDE FINANCIAL

Initially my expectation was our latest digital evolution would be 'the solution'. But it has become obvious that while it takes us a large step of the way we will continue to consider other solutions to bring us to what I view as the nirvana – which for me is end-to-end digitalisation that minimises manual intervention.

The aspiration is to move the effort from processing to analysis and value-add, providing the level of detail investors want to see and contributing to agility and nimbleness.

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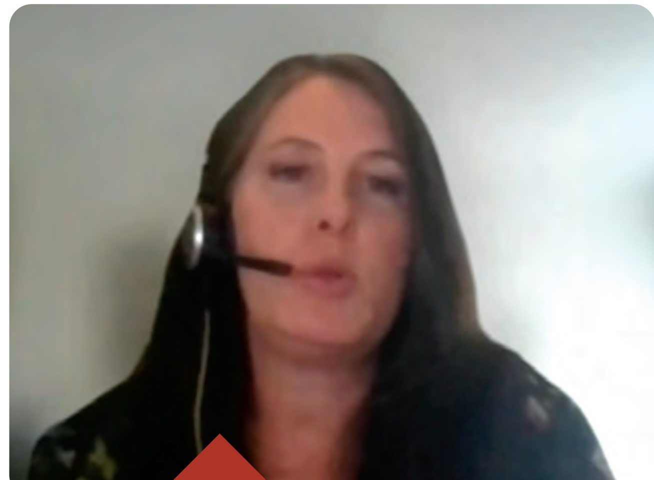
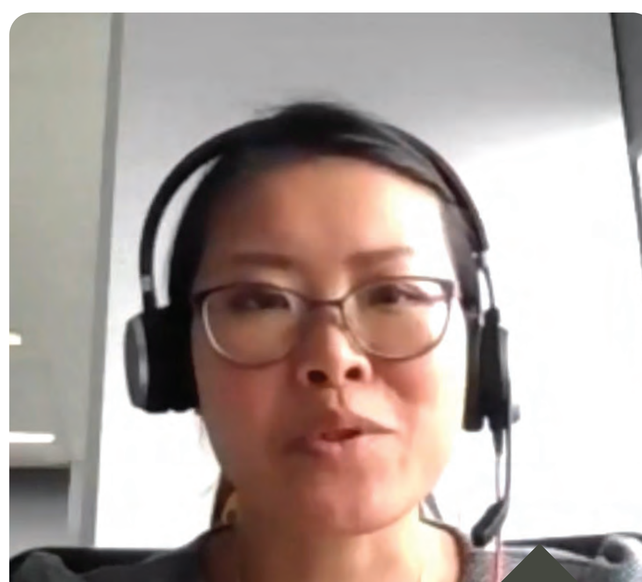
MEGAN BRENNAN PEPPER
Technology is enabling the next phase of insight into data so we can gain better insights into available assets and give our investors confidence about what the data tell us. Investors can then satisfy their own opportunities and obligations in this regard.



CAROL LYDFORD TOYOTA FINANCIAL SERVICES
We all know the saying 'you can't be what you can't see'. Through the increased focus on diversity and inclusion within the finance and securitisation industry at forums like this, young talent – particularly female talent – will be more confident that they too can be a speaker and be heard.

SARAH SAMSON NATIONAL AUSTRALIA BANK
The fight for talent and diversity is real. While on one hand it is a good thing, securitisation needs to ensure we are at the forefront of talent attraction, known as a great industry in which to work, and comprised of companies that embrace champions, diversity and inclusion.



AMY KOK ASF FUTURE LEADERS AND YOUNG PROFESSIONALS
Perceptions that the securitisation industry is too bespoke and complex to understand are a barrier to attracting talent. FLYP addresses this through a range of initiatives including university outreach.

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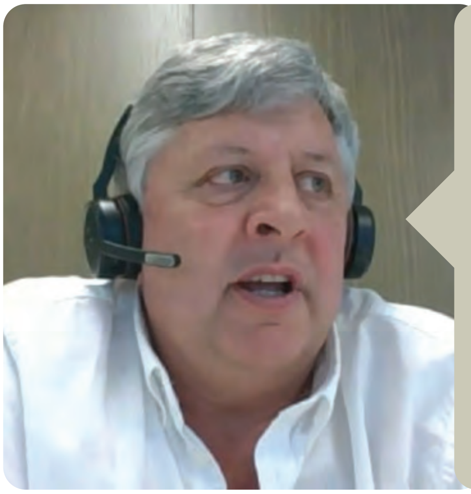


MARK DE REE UDC FINANCE

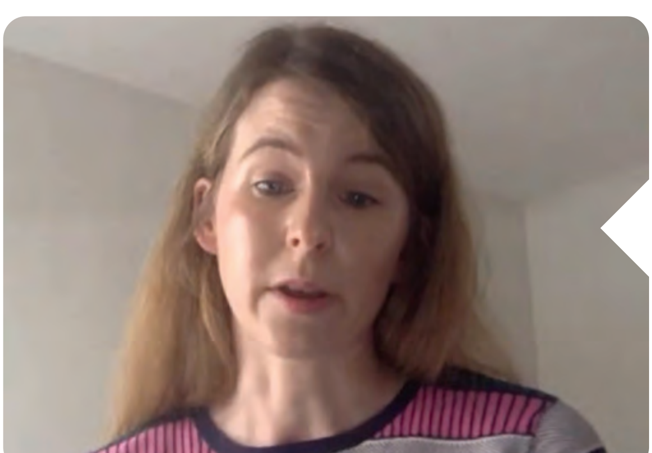
Ultimately, it is about engaging with potential investors – and not just when issuers want to do transactions. The investor base has a multitude of options so from our perspective there is an ongoing obligation to keep talking to the market.

MARK SMITH ASB BANK

Since COVID-19, house prices have increased by 40 per cent in Auckland and 45 per cent in the rest of the country. The New Zealand economy has proved to be more resilient than initially feared and people have recently been turning away from services.

SIMON O'CONNELL WESTPAC

We are seeing a growing number of New Zealand investors building securitisation into mandates. The KiwiSaver scheme has reached a level of maturity and size, so including securitisation does not overweight investors' mandates in a slightly esoteric asset.



MIA PRKUSIC ANZ INVESTMENTS

The credit we could find became extremely expensive while spreads on securitised product were at more enticing levels. The fact there was little other issuance meant investors with the in-house capability to look at these deals had the time to do the required due diligence.

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Compare a deal's historical performance to related cohorts. Reference an index composed of all issuance from a given collateral type, issuer, collateral manager or vintage. Custom indexes can be created and shared for additional comparisons.

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License Intex's structuring tool, *INTEX DealMaker*, used by Intex and leading Arrangers globally to create private cashflow models. Permission the models to be analysed by selected Intex clients. The analysis leverages Intex's cashflow engine before deals have priced to make superior purchasing decisions and provide valuable feedback during the marketing phase.

Secondary Market Modeling

Intex models and calibrates to the final legal deal documents, independent of the Arrangers' models. The cashflow models are promptly updated per the Trustee documents and loan-level data files.

INTEX

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Intex Solutions, Inc.

JOHN O'CONNELL DEUTSCHE BANK

In a situation where investors might have three or four deals in front of them, we want to get to the top of the pile. We do so by bringing robust structures and solid collateral pools, and by demonstrating relative value. Maintainting a strong relationship with the global investor base is also paramount.

ADAM PARRY SUNCORP

We would like to return Suncorp's funding profile to the pre-COVID-19 style and it should look broadly similar by the time we get through the refinance of the TFF. This could include covered, senior domestic and US 144A bonds, and the use of a reinvigorated Apollo RMBS programme in 2022 as a capital and funding tool.

FIONA GAAL ANZ

The last two years have seen an unprecedented period of change for ADIs, including changes driven by the royal commission, COVID-19, the impact of government support and TFF, and changing economic headwinds. The sense at the end of 2021, though, is that bank balance sheets are going back to the future.

SCOTT GIFFORD ANZ

We have four SDG bonds outstanding and investors trusted us with a 5 basis points greenium on our most recent. Our commitment is not to profit from this but it does support lower transfer pricing to assets in our use-of-proceeds bonds, enabling us to pass on the greenium and drive more positive impact in the Australian economy.

Ongoing deposit growth and increased levels of liquidity allowed ANZ last year to reduce its CLF by A$25 billion to A$10.7 billion. The CLF fee was 20 basis points and we could raise liquidity at less than that, so it was economically rational for us to do so.


ASJ
AUSTRALIAN SECURITISATION JOURNAL
Incorporating Australian and New Zealand Securitisation and Covered Bonds
>> Issue 21 • 2022
Securitisation outlook
After a year of record issuance in Australia and New Zealand, the Australian Securitisation Forum gathered the industry to discuss where the market goes next
2025
2024
2023
2022

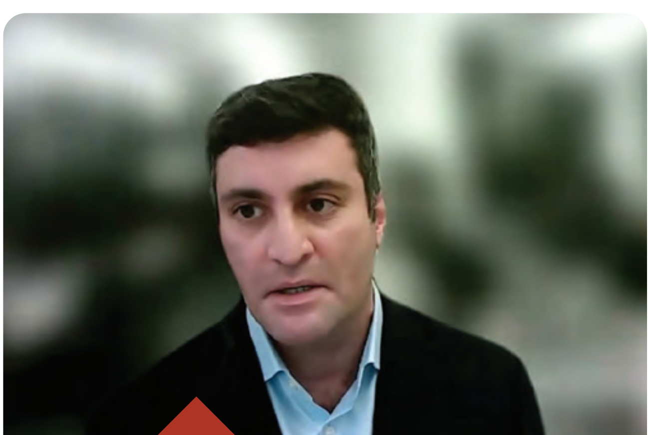
ANDREW MARSDEN RESIMAC

Over the last 12-15 months, markets have been very conducive to Australian issuers' funding task, with the extent of the liquidity in various financial systems driving the supply dynamic. While there are headwinds, we believe markets are accommodative to issuers' needs going into 2022.

CEDRIC TCHABAN HSBC GLOBAL ASSET MANAGEMENT

The fact Australia was removed from the annex to the OECD list was incredibly positive as it makes market access easier. When it comes to EU and UK risk-retention, these are the regulations and we have to adhere to them. There really isn't any other way around it.

There are only a few attractive asset classes left and yields on those are tightening. When Australian issuers were issuing euro tranches we participated in those deals and when they issue US dollar trades it is something that comes up. Diversification of funding is important across functional currencies.



IMRAN SHAFFI STATE STREET GLOBAL ADVISORS

There is no doubt the recovery theme continues across several market-related metrics. This has been reflected in some credit fundamentals and spreads, so when we compare 2021 with 2020 the growth trend is improving, even if it has been a bit more zig-zag.

JEN DALITZ WOMEN IN BANKING AND FINANCE

It is not necessarily 'flexible' to be told you must work from home. Meanwhile, for many people home working introduced a new kind of status to do with the hierarchy of the home office. To work from home is easier for some than others.

CHRISTINA TONKIN ANZ

With a largely external-facing team, I am finding people are eager to return as we reopen offices and facilities, and customers do likewise – to do things like co-creating new types of deal opportunities. But it is going to be a journey in 2022 and beyond for a team like ours, to ascertain the best working arrangements that meet the needs of the team as well as the requirements of the customer and shareholder.

LEONORA RISSE RMIT

We know from research on unconscious bias that if you are not there in person you are less likely to form affinities with your colleagues. There are disadvantages when it comes to who gets promoted or is front of mind for a project.

If you don't have strategies that are intentionally inclusive, you will end up with a workplace that is unintentionally exclusive. It is the responsibility of employers and managers to build in systems that ensure they are fully inclusive of workers at home, whatever arrangements transpire.

ALICE DREW LENDLEASE

The biggest thing we need to work on now is making sure we revive the cultures of our workplaces, organisations and cities. This will help re-energise people toward better wellbeing and refreshed community spirit, after so long working from home.

READY FOR THE CHANGE REQUIRED?

As financial services regulation gets more complex, customer expectations increase, the battle for talent gets fiercer and competition bites into margin. Executives are feeling the challenge and, as a result, digitisation is on everyone's lips – and, increasingly, in everyone's budget. ***Perpetual Corporate Trust*** *explores how financial services firms are stepping up to tackle digitisation.*

All types of financial services firms are trying to navigate the risk and opportunities of digitisation. Research from Gartner highlights the importance of tech issues for financial services leaders, with its 2021 *CEO and senior business executive survey: financial services* report identifying tech-related priorities as one of the biggest concerns – second only to growth. For the second straight year, digitisation ranks as the most important priority within the tech space.

What is driving the change? Gartner survey respondents say the demand for better digital technologies and more digital channel flexibility were the biggest shifts in customer behaviour in 2021-22. It is no surprise that an overwhelming 92 per cent of the firms surveyed by Gartner were increasing their spend on digital capabilities.

For many financial services businesses, tech offers an efficiency dividend – notably for smaller banks, where 78 per cent cite gaining efficiency through technology as a key priority in the *Bank director 2021 tech survey*.

Conversely – and especially for larger players – legacy technology represents an ongoing cost and a growing risk, including high maintenance and management costs, a constant drain on project and technology teams, and all the additional resources required to remediate errors.

There is also a substantial opportunity cost, with customers suffering suboptimal experiences and management flying blind due to insufficient data and outdated management information systems. The longer this reliance on legacy technology continues, the more expensive and riskier replacing it becomes.

FUNDING ISSUE CASE STUDY

Funding processes provide examples of these issues. Securitisations are inherently complex and the number of parties involved – including law firms, rating agencies, lead managers and investors – amplify the complexity.

At its core is the loan allocation and pool selection process, which seeks to find the right-sized pool of eligible loans with the right portfolio profile and suitable risk concentrations, while making sure loan allocations optimise the cost of funds, margins and compliance is maintained across their funding structures.

Managing the data, transactions, pool profiles, expenses and reporting between these parties is a manual process based mainly on spreadsheets and email. These outdated methods make the entire operation ineffective, a drain on key resources, inefficient or not scalable to support business growth.

In securitisation, it is important firms have visibility of the entire portfolio to derive timely data-driven insights that inform strategic decisions. Perhaps more critical is the firm's ability to ensure the investor experience is maintained or improved. New technology is the obvious business solution – but this throws up another set of challenges and risks.

Developing technology to optimise funding operations means investing time, money and people not only into the initial development but ongoing improvement and limiting the tech debt that can quickly erode the performance of any application over time.

Such a project can quickly become high risk and take a significant toll on the tech resources of any business. It also moves crucial management focus away from sales strategies,

"The funding optimisation module will bring issuers and lead managers closer to investors and improve their experience. We are focused on developing the types of digital solutions we think can help across the entire securitisation ecosystem."

MATTHEW NEECE PERPETUAL CORPORATE TRUST

COPUBLISHED FEATURE

Perpetual

"We see ourselves as enablers – it is our job to bring all parties in the securitisation sector seamlessly into the ecosystem and then develop end-to-end technology capability that keeps up with their changing business needs, whether they are financial, risk, regulatory or funding."

RICHARD MCCARTHY PERPETUAL CORPORATE TRUST

customer relationships and growth, and refocuses it internally on technology development and testing.

Businesses using securitisation want high-powered tech solutions to solve specialist problems without taking on the risk of in-house development. Most companies are also deeply aware of the cost and risk of managing key business processes on spreadsheets. Companies do not typically entrust an external business to develop technology solutions without proven credentials. These third parties need a track record in the development of effective, user-friendly solutions.

According to Karl Sick, chief operating officer at BC Investment Management (BC Invest) in Sydney, finding ways to move away from multiple spreadsheets is important. "We needed funding optimisation technology to integrate all our information so we can move fast," he says.

BC Invest – a diversified business specialising in mortgage lending and asset management – chose the funding optimisation module within the Perpetual Intelligence platform to drive efficiency and scale. By deploying the module, the company obtained a complete view of the total balance sheet when making funding decisions. "This visibility means we can better understand and manage liquidity and have a better idea of where opportunity and risk lie," Sick notes.

Visibility is important for investors too. "Operating within the Perpetual Intelligence platform means investors can use it to get a view of the facility and the underlying collateral – they are not stuck waiting for a PDF report to drop into their inbox," Sick adds.

For BC Invest – a fast-growing business where scalability matters – a partner with deep experience was necessary. According to Richard McCarthy, group executive at Perpetual in Sydney, the partnership with BC Invest and companies like it reflects an effort that has evolved over decades.

"We have supported the securitisation industry and adapted to client challenges for more than 30 years," McCarthy notes. "Perpetual Digital was established to help financial service firms meet these challenges and enable their success in a constantly changing regulatory, technological and economic environment."

TRUSTING THIRD PARTIES

The development of Perpetual Intelligence's funding optimisation module exemplifies the firm's commitment to helping its clients meet their challenges. "It started with taking a holistic view of the securitisation market," says Matt Neece, head of product at Perpetual in Sydney. "We wanted to be clear about how our clients could use technology to optimise their portfolio and processes when they came to do a transaction."

The new module allows firms to use multiple warehouses, loans and specific characteristics to comply with investor requirements. "It will bring issuers and lead managers closer to investors and improve their experience," says Neece. "We are focused on developing the types of digital solutions we think can help across the entire securitisation ecosystem."

The separate Perpetual Digital business has more than 50 staff including 15 dedicated developers combined with internal and specialist external business partners. This emphasises the resources, specialisation and focus required to deliver tested, robust technologies into the securitisation market. It takes time, development experience and expertise to be successful in supporting digitisation.

The funding optimisation module is one example of that development. With a fully integrated and automated IFRS9 loss provisioning solution, the new module helps increase business scalability, capture insights and enhance compliance. It is designed to create efficiency, improve cyber security, reduce enterprise risk, enhance the investor experience and help deliver a firm's strategic goals by freeing resources that could be tied up in development.

As financial services strategists react to mounting regulatory and technological pressures, experts note it is important to take a wider view.

PwC's *Financial services technology 2020 and beyond: embracing disruption* report says: "Most financial institutions are currently focusing much of their IT attention on the short term. We understand this: on any given day, there are fires to fight, with regulatory fixes, fraud attempts, budget discussions and so on." But to get ahead of the curve on these issues, firms need a flexible, adaptive mindset – and trusted partners.

"We see ourselves as enablers – it is our job to bring all parties in the securitisation sector seamlessly into the ecosystem and then develop end-to-end technology capability that keeps up with their changing business needs, whether they are financial, risk, regulatory or funding," McCarthy explains. "We have built a unique development skill set and know-how in delivering ever-green digital solutions to meet our clients' needs today and the future, while making the market more efficient." ■

FitchRatings

WHAT COULD THE FUTURE HOLD FOR AUSTRALIAN COVERED BONDS?

Since its inception in November 2011, the Australian covered-bond market has matured and diversified, with a total of eight issuing banks and A$89.5 billion outstanding at the end of November 2021. ***Fitch Ratings*** *discusses the state of the market in 2022 and explores where it might go next.*

Covered bonds were first introduced so authorised deposit-taking institutions (ADIs) could diversify funding, providing a reliable source of contingent financing in periods of stress when other markets become constrained. In the beginning, the four major banks issued hard-bullet covered bonds. Over time, this expanded to a total of eight banks issuing notes with maturity extensions, either soft-bullet or pass-through, with a focus on offshore funding. During this period, more than A$174 billion (US$125 billion) of covered bonds has been issued and rated AAA stable by Fitch.

COVERED-BOND ISSUANCE TO INCREASE IN 2022

With the end of the term funding facility (TFF), Fitch expects ADI funding plans to normalise over 2022. How quickly this happens depends on the balance-sheet mix. The funding gap between deposits and loans will influence the need for ADIs to tap the wholesale funding markets. Certain ADIs will also need to cover the funding gap left by the wind-down of the committed liquidity facility through other funding options and address maturity duration.

Covered bonds are well placed to plug the funding gap alongside senior-unsecured funding. This is due to increased capacity as maturities rolled off and were not replaced during the pandemic period, thanks to the high level of liquidity available. Fitch believes covered-bond issuance will increase in 2022 in line with the longer-duration funding needs of issuing ADIs. This will be a focus for these institutions as they pre-fund TFF maturities due in 2023 and 2024.

EU COVERED-BOND DIRECTIVE RECOGNITION

Australian covered bonds have enjoyed some regulatory recognition in certain countries, such as eligibility for level two high-quality liquid asset (HQLA) treatment in Europe. But they have not benefited from specific risk weights among European investing banks, which form the largest cohort of covered-bond investors globally.

Nevertheless, this has not dampened interest from investors, with about 57 per cent of Australian covered bonds issued in euros at the end of November 2021 and US dollar issuance coming in second at 16 per cent.

In 2020, Europe moved to harmonise its covered-bond framework under the EU covered-bond directive 2019/2162. This provides a consistent framework across countries and a clear definition of what qualifies for preferential regulatory treatment under the Capital Requirement Regulation.

A small number of EU countries have transposed the directive into their national covered-bond frameworks as the deadline for implementation is 8 July 2022. Third-country recognition of covered-bond framework standards outside the EU is provided for under the directive and a proposal for it will be presented within two years of implementation, expected to be before 8 July 2024.

Australian regulatory recognition in Europe will ultimately depend on the European Banking Authority, EU Parliament and EU Council determining that the Australian framework is equivalent to the EU directive. Some notable features will need to be addressed if the Australian market wants preferred treatment under the directive. These include minimum overcollateralisation coverage requirements, harmonised investor reporting, conditions for extendable maturity provisions and a liquidity buffer.

The most significant of these is the requirement for programmes to maintain liquid assets or cash covering at least 180 days of net outflows. There is national discretion on whether the net outflows should be calculated based on the bonds' expected or extended due payment date, which would provide less protection for programmes with a 12-month extension period in the absence of any other mitigant for interest payments.

While legislation, or the associated Australian Prudential Regulatory Authority regulation APS 121, for covered bonds in Australia does not require liquidity reserves, the programmes include these on a contractual basis: three months coverage of interest and senior expenses. These provisions currently fall short of the requirements under the EU directive.

Second, the EU directive specifies the legal framework may allow for the issuance of covered bonds with extendable terms, in which case their maturity can only be extended subject to objective triggers specified in the national law.

In Australia, this is handled through contractual provisions specific to each programme. One of the difficulties with incorporating this change experienced in Europe is whether the legal provision would apply retrospectively to existing securities – in particular hard-bullet covered bonds – or only to new covered bonds issued after an effective date. If the latter, this may require the setup of a cover pool to secure bonds issued under the new regime.

If the provisions were applied to existing covered bonds it could create the need to seek investor consent to adjust the terms and conditions of existing bonds to comply with the framework. Both approaches have drawbacks for issuers that may make it unfeasible to execute in cost and complexity.

Even if expectations under the EU directive are met, the impact to Fitch's covered-bond rating analysis would be minimal, if any. This is because Australian covered bonds already benefit from the maximum uplift under the rating agency's payment continuity analysis: six notches for soft-bullet bonds with a 12-month extension period and eight notches for conditional pass-through covered bonds.

While Fitch's analysis focuses on liquidity gap mitigation as the primary driver of rating uplift, it also looks at what triggers an extension event for a soft-bullet covered bond and whether this sets off a permanent switch in recourse to the cover pool. Changes stemming from the EU directive would also need regulatory input from APRA, though.

Such provisions could be incorporated into the regulatory framework to achieve equivalence. But they may also require a legislative amendment if they cannot be fully addressed under APS 121.

GREEN AND SOCIAL COVERED BONDS

Investor mandates have been shifting toward greater emphasis on the environmental, social and governance (ESG) market. There has been some issuance of green and social covered bonds, mainly from Europe and Korea. But globally this only accounts for about 3 per cent of outstanding ESG bond issuance across all instruments. Australia has only recently begun considering ESG investments, but it is becoming a focus for ADIs when planning their future funding commitments.

With climate change at the forefront of ESG funding, green collateral – such as energy-efficient properties – still dominates, including for covered bonds. Social collateral, however, is growing fast. Green mortgages are not yet a prominent feature of the Australian mortgage market, plus a definition of the guidelines buildings need to meet is not readily available.

Even in the EU, where a taxonomy is in place, there is still a shortgage of green assets as about 75 per cent of the building stock has been deemed largely energy inefficient by the European Commission – mostly because it was built before the 1990s. This calls for a push toward renovation.

In Australia, ADIs are providing incentives to borrowers to encourage green renovation of existing buildings, such as cash incentives to fund solar panel installation. However, as in Europe, it would be useful for common standards to be implemented and data collected.

Due to the lack of common definitions, it is hard to see green mortgage assets being identified and used in cover pools in the short-to-medium term. However, as this segment develops in Australia, we could see future regulations mandating that a proportion of cover assets be green mortgages or the creation of a separate green cover pool to secure bonds.

Notwithstanding the current limitations, ADIs can today issue covered bonds and use the proceeds for green financing purposes. Affordable housing initiatives in Australia could also be funded through social covered bonds in the same manner.

Proceeds from a limited quantity of senior-unsecured debt is already being used for sustainable green purposes and we expect in time Australian covered bonds will be used in a similar way, bolstering ESG financing needs and meeting investor demand.

NONTRADITIONAL ASSETS SECURED BY COVERED BONDS

Covered bonds are no longer just the domain of mortgage and public-sector assets. In 2021, the first European auto-backed pass-through covered bond was issued by a nonbank financial institution AMAG Leasing in Switzerland. The trasaction is rated AAA stable by Fitch.

Historically, the issuer made use of securitisation but it added covered bonds to expand its pool of investors. Nonbanks in Asian markets are considering covered bonds to fund nontraditional cover assets, but this effort has stalled either through regulatory restrictions or rating limitations.

In Australia, nonbanks' market share continues to grow and their product offerings are becoming more diverse at the same time. Therefore, Fitch expects nonbanks eventually to look beyond securitisation to fund these assets. Contractual covered bonds issued by Australian nonbanks will not benefit from any legislative recognition but the product can provide pricing, cost and duration benefits to their current funding mix.

Under Fitch's criteria, pass-through covered bonds issued by nonbanks can achieve up to 10 notches of total uplift above the issuer default rating, so the covered bond of a BB+ rated nonbank could be rated at AAA. In Fitch's view, the Australian covered-bond market is well-placed to grow and evolve, influenced by offshore market developments and investor demand. ■

COPUBLISHED COLUMN

NATIXIS

WHY FOREIGN-CURRENCY DENOMINATED STRATEGIES SHOULD PREVAIL

Market dynamics provided a compelling case for issuers to consider foreign-currency residential mortgage-backed securities issuance in 2021. The trend looks set to develop further this year, including the yen market providing attractive dynamics for issuers to diversify. ***Fabrice Guesde****, head of credit markets and global structured credit solutions, Asia Pacific at* ***Natixis*** *in Hong Kong, explores the factors set to influence the offshore funding market this year.*

Non-Australian dollar denominated issuance comprised about half of public Australian residential mortgage-backed securities (RMBS) volume from the year 2000 until the financial crisis, before falling to zero in the immediate aftermath. Since then, however, domestic Australian dollar denominated RMBS volumes have grown steadily, surpassing pre-crisis volume while non-Australian dollar denominated issuance has lagged.

Even during a turbulent 2020 and 2021 for markets generally, Australian issuers focused on local-currency deals with non-Australian dollar volume significantly below prior years. Much of this was due to the COVID-19 measures from the Reserve Bank of Australia (RBA) driving spreads into decade-tight levels across all asset-backed securities (ABS) asset classes through the first half 2021.

The second half of 2021 saw a slight widening in spreads as the term-funding facility was closed to new drawdowns from 30 June. As spreads have begun to widen again, some select nonbank issuers have looked to re-engage with their offshore investor base by issuing foreign-currency tranches.

Natixis expects this trend to continue and accelerate into 2022, as issuers resume focus on diversifying funding sources with the addition of foreign-currency tranches to attract a new and diverse source of investors and provide best execution. Continued diversification into the offshore investor base is critical to ensure issuers are not overly reliant on traditionally domestic investors who may already be full on Australian dollars and tempted to force a wider reprice. The market is expecting the continued widening of triple-A tranches of 20-40 basis points, further adding to the offshore investor appeal of Australian ABS.

A foreign-currency tranche coupled with green or environmental, social and governance (ESG) accreditation will also add to the appeal for offshore investors who may have a mandate for these bonds but do not have a mandate to invest in Australian dollars. This gives issuers with an increased funding task over the coming years an opportunity to continue expanding their investor base into offshore markets.

As spreads continue to widen, the relative attractiveness of Australian ABS has continued to improve when compared with European peers. The European Central Bank (ECB) has continued its regime of purchasing bonds from British issuers, which ultimately means these bonds are not pricing at a true market spread.

Since the financial crisis, non-Australian dollar denominated primary issuance has overwhelmingly comprised US dollar transactions, totalling about US$9.9 billion, with smaller amounts issued in euros, yen and sterling. Only a small portion of the non-Australian dollar issuance to date appears to have been opportunistic with programmatic issuers responsible for the bulk of the nonbank issuance.

COVID-19-related disruption saw issuers focus on the domestic market through 2020 and 2021, with only a minimal volume of US dollar-denominated notes issued via a couple of transactions. Despite the challenging environment in 2020, though, the market showed signs of innovation including three yen tranches issued by Liberty Financial, Firstmac and Resimac.

This continued to develop in 2021 and we view the yen market as a prime target for Australian issuers in 2022, to broaden and diversify their funding through attracting new investors to their programmes. The yen to Australian dollar basis market also continues to be the most attractive and stable for issuers as investors are more likely to hold firm levels regardless of market idiosyncrasies.

We expect basis volatility will continue to be a key theme throughout 2022, again boosting the attractiveness of foreign-currency bonds for offshore investors. This will decrease the burden for offshore investors when managing foreign-currency exposures and will lead to a more marketable bond than the Australian dollar equivalent.

The pace of growth in the nonbank residential mortgage loan sector naturally places a greater emphasis on lenders' ability to source term funding,


More than
developing business,
together we build a
long-term partnership
to support your strategic
decisions

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"A foreign-currency tranche coupled with a green or ESG accreditation will also add to the appeal for offshore investors who may have a mandate for these bonds but do not have a mandate to invest in Australian dollars This gives issuers an opportunity to continue expanding their investor base into offshore markets."

FABRICE GUESDE NATIXIS

as the task grows year on year. With the primary market experiencing compression in senior triple-A margins almost to pre-COVID-19 levels, the current supply-demand dynamics driven by lower levels of authorised deposit-taking institution (ADI) RMBS issuance and the relative-value appeal of Australian RMBS for investors globally are positive for nonbank issuers.

With the aim of further diversifying their funding platforms, issuers should, however, consider developing their non-Australian dollar denominated strategies over the short-to-medium term.

DEAL STRUCTURE

Foreign-currency tranches issued by nonbank issuers have typically followed investor preferences regarding repayment structures, with US dollar notes adopting bullet, scheduled amortisation or soft-bullet formats. Euro-denominated issuance to date, though, has been on a pass-through basis, while yen issuance has seen a mix of pass-through, scheduled amortisation and a longer weighted average life soft-bullet structure.

Note proceeds, as well as any ongoing prepayments to maturity, are then hedged via a structured cross-currency swap. Other than the cross-currency basis, the total swap cost factors in the expected duration of the swap period as well as the predictability of foreign-currency cash flows.

While management mechanisms employed in scheduled amortisation or hard-bullet tranches increase the predictability of future cash flows and potentially reduce the cost of the cross-currency hedge, they have a direct cost impact on the structure. In addition, such an approach might entail employing two funders' balance sheets – thus eating up funding capacity.

Where investor appetite allows, a balance-guaranteed swap that fully hedges pass-through risk is likely to be a more efficient solution with one swap counterparty taking the full prepayment risk.

Non-Australian dollar issuance is best undertaken as part of a committed diversification strategy, as foreign-currency investors expect a commitment to the currency programme.

Over time, repeat issuance should also lead to compression in the new-issue concession, allowing a pricing curve to be established, and will see economies of scale extracted from the upfront resource commitment and cost. Building a sufficient stock of bonds in the target currency will also serve to bring in additional investors and facilitate liquidity in secondary trading – especially where investors tend to have more of a buy-to-hold mindset.

In a lower-for-longer environment, where core asset returns have seen compression driven by a continuation and in some cases broadening of central bank purchase programmes, global investors continue to search for risk-reward relativities.

Last year, like 2020, saw offshore investors across the senior and junior space continue to enter the market. Such sentiment can be expected to support issuers seeking to build out a non-Australian dollar profile.

The relatively positive reaction of the Australian economy to policy stimulus is an additional factor contributing to improved sentiment while, at the same time, the attractiveness of investing in Australian bonds has also increased among Japanese investors. With the yield on Australian government bonds above or in line with US Treasuries since 2020, the net purchase of Australian sovereign bonds by Japanese investors rose to its highest-ever level in 2020. A positive inflow into the Australian market should continue.

As outlined, the opportunity for Australian issuers to add resilience to their funding platforms via diversification in 2022 is considerable as the broad themes driving the environment of greater nonbank issuance requirements, as well as a potential return to rising interest rate levels in the latter half of 2022, continue and basis volatility increases after historically low cross-currency basis swap rates in 2020 and the first half of 2021.

Issuers with established foreign-currency profiles should be able to, as some already have, leverage the infrastructure already in place to take advantage of the market environment, enabling them to deliver compelling returns to the offshore investors who have supported them. Further, they may also improve their overall funding costs to levels which at prevailing levels might compete with those achievable in Australian dollars.

Issuers that have not yet put in place a non-Australian dollar strategy may also find it a compelling time to broaden their investor base and offset some of the new-issue congestion that is likely to persist in the Australian dollar market over the next 12-18 months. In doing so, they could continue to diversify their investor base and build out an issuance curve, which should compress over time as they return to those markets. ■

MAYER | BROWN

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MARKET BRACES FOR TRANSITION AS LIBOR PHASE OUT BEGINS

Financial institutions in Australia, the US and Europe have for years used LIBOR as a common benchmark for various adjustable-rate loan products. This is set to change in 2022 as LIBOR is effectively phased out. ***Mayer Brown*** *partners* ***Amanda Baker***, ***Stuart Litwin*** *and* ***Jon Van Gorp*** *explore preparedness for the transition.*

On 27 July 2017, and in a subsequent speech by its chief executive on 12 July 2018, the UK Financial Conduct Authority (FCA), which regulates LIBOR, confirmed it would no longer persuade or compel banks to submit rates for the calculation of the benchmark after 2021. As a result, the FCA warned there could be no guarantee LIBOR would be determined after 2021.

With the transition underway and less than two years to go until LIBOR is no longer quoted, the final phase-out of LIBOR as a quoted benchmark is looming.

Transition preparedness will be an increasing area of supervisory focus and review in the market and, on a more granular level, in new transactions.

On 20 October 2021, in a joint statement on managing the LIBOR transition, the board of governors of the US Federal Reserve System, Consumer Financial Protection Bureau (CFPB), Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency and state bank and credit union regulators emphasised their expectations that supervised institutions in the US will transition away from LIBOR in an orderly fashion by the end of 2021.

TRANSITION PROGRESS SO FAR

The US regulators summarised prior guidance then clarified several key supervisory considerations, including the following:

- Entering new financial contracts, including derivatives, that use LIBOR as a reference rate after 31 December 2021 would create safety and soundness risks. Importantly, for this purpose, "new contract" includes an agreement that: (a) creates additional LIBOR exposure for a supervised institution (with limited defined exceptions) or (b) extends the term of an existing LIBOR contract. A draw on an existing enforceable agreement will not be viewed as a new contract in this context.

However, other types of contract changes are not as clearly delineated and remain open to interpretation and uncertainty. For example, if an amendment increases the contractual spread, either directly or by the operation of a specified financial matrix, there is an open question regarding whether this creates additional LIBOR exposure and, as a result, constitutes a new contract.

Similarly, other amendments to existing contracts might be deemed by an applicable regulator to constitute such additional LIBOR exposure and be a new contract for purposes of LIBOR transition.

- Contracts executed on or before 31 December 2021 should use a reference rate other than LIBOR or incorporate LIBOR fallback language that refers to a strong and clearly defined alternative reference rate (ARR). Thus far, market participants appear to be tepidly embracing variations of the SOFR benchmark.
- Supervised institutions should ensure alternative rate selections are appropriate for their "products, risk profile, risk management capabilities, customer and funding needs, and operational capabilities," and understand "any fragilities associated with that rate and the markets that underlie it".

"AS OF 1 JANUARY 2022 THE FCA WILL NO LONGER COMPEL BANKS TO QUOTE LIBOR AND ITS VARIATIONS AS A BENCHMARK LENDING RATE. THE REQUIRED TRANSITION IS SHAPING UP TO BE ONE OF THE MOST FUNDAMENTAL CHANGES TO THE FINANCIAL SERVICES INDUSTRY IN RECENT TIMES."

Over the past couple of years, large financial institutions have started developing model LIBOR fallback language. However, the provisions tend to be highly negotiated as the market is currently struggling to swallow and adjust to the new backward-looking SOFR rate, which is a departure from LIBOR.

- Supervised institutions should identify all LIBOR-referencing contracts that mature after the relevant tenor ceases and fail to include adequate fallback language. It is worth noting that this trend has generally been the case in private transactions as well as in the capital market.
- All new and updated financial contracts should include fallback language that refers to a strong and clearly defined ARR that can be used if the initial reference rate is discontinued.
- Supervised institutions are encouraged to communicate their transition plans to appropriate parties – including customers, clients and counterparties – and should ensure systems and operational capabilities are in place and ready for transition. While the market has not necessarily fully embraced SOFR, participants are moving toward this aim.

In connection with the foregoing, on 7 December 2021 the CFPB issued a final rule to facilitate LIBOR transition via amendments to Regulation Z. The amendments take effect on 1 April 2022 and compliance becomes mandatory on 1 October 2022.

The final rule makes numerous related amendments. In doing so, while it does not require institutions to adopt particular replacement indices in place of LIBOR, broadly speaking, the final rule outlines the standards replacement indices are expected to meet and provides examples to help ensure creditors are able to meet the revised index standards.

With respect to closed-end credit, the rule identifies SOFR-based spread-adjusted indices recommended by the Alternative Reference Rates Committee (ARRC) as an example of a "comparable index" for the LIBOR indices they are intended to replace.

The commentary lists factors – such as whether identified aspects of the two indices are comparable and whether the new index is publicly available – to assist in determining whether a replacement index meets Regulation Z standards.

With respect to open-end credit, the final rule provides guidance on transitioning away from a LIBOR index on a home equity line of credit. It also identifies examples of replacement indices, which include the prime rate published by the *Wall Street Journal* and the SOFR-based spread-adjusted indices recommended by the ARRC.

What the final rule does not do is include reference to a one-year US dollar LIBOR index or its specific replacement. The CFPB reserved judgment on this issue until it reviews the index recommended by the ARRC and measures it against other open-end credit rate requirements.

In a further related development, also on 7 December 2021, the *Adjustable Interest Rate (LIBOR) Act 2021* was reported in the US House of Representatives by the Committee on Financial Services and placed on the union calendar. The proposed *LIBOR Act* would mandate a statutory benchmark replacement, spread adjustment and one-year transition period for consumer loans – as defined in the *Truth in Lending Act* or Regulation Z – that mirror the ARRC recommendations and are incorporated into the final rule.

"IT IS ESTIMATED THAT THERE ARE MORE THAN US$300 TRILLION OF LIBOR-REFERENCING MORTGAGES, COMMERCIAL LOANS, BONDS AND DERIVATIVES. THE PROBLEM IS GLOBAL, COMPLEX AND IS NOT GOING AWAY. AFFECTED BANKS, INSURERS AND OTHER FINANCIAL MARKET PARTICIPANTS NEED TO ACT QUICKLY, AND EFFECTIVELY, TO RESOLVE IT."

Finally, it should be emphasised that as of 1 January 2022 the FCA will no longer compel banks to quote LIBOR and its variations as a benchmark rate.

MARKET GUIDANCE

The required transition is shaping up to be one of the most fundamental changes to the financial services industry in recent times. While it is not necessarily yet fully embraced by industry participants, regulators in the US and UK are making it abundantly clear that transactions and market participants will have no choice but to comply with the transition away from LIBOR.

It is estimated that there is more than US$300 trillion of LIBOR-referencing mortgages, commercial loans, bonds and derivatives in the market today. It is clear that the problem is global, complex and not going away. Banks, insurers and other financial market participants need to act quickly and effectively to resolve it.

While the global markets may not yet have fully embraced SOFR, most transactions use a formulation of SOFR as a fallback for the LIBOR benchmark. We are also starting to see floating-rate tranches in transactions using variations of SOFR as the benchmark.

While this trend was slow to materialise, it had started to take hold by late 2021. As market participants have justifiably been hesitant to consent to changes without robust LIBOR replacement mechanics, we expect to see many more transactions start to embrace SOFR at the inception of the transaction or at least as the clear fallback when LIBOR is no longer available. ■

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