Securitisation industry readies for touchdown with hopes for soft landing

Participants in the Australasian securitisation industry are realistic about the forthcoming impact of rate rises. But credit fundamentals that have so far surprised on the upside and a functional if challenging funding market give hope that the next phase will be manageable. Meanwhile, upheaval in the UK investor sector could pave the way for an enhanced global bid for Australian product in the medium term.

BY LAURENCE DAVISON

The Australian and New Zealand securitisation market came together in Sydney on 30 November for the first day of the Australian Securitisation Forum (ASF)'s annual conference, held in person for the first time since 2019. Discussions on day one acknowledged the gradual feed-through of rapid rate rises, with the consensus being that the epicentre of their impact on borrower balance sheets is only likely to be reached in the new year.

The good news is that higher interest rates – the Reserve Bank of Australia (RBA) hiked by 3 per cent between May and December, and the Reserve Bank of New Zealand by 4 per cent between October 2021 and November – have yet to feed through into notably higher loan arrears.

Mortgage House's head of finance and capital markets, Ed Freilikh, echoed what many lenders have been reporting: that there has been little or no change in the arrears profile of a predominantly prime lending book. An uptick in 30-day arrears is primarily the result of borrowers forgetting to increase their standing payments, Freilikh explained, while 90-day-plus arrears and requests for hardship arrangements have actually fallen.

"We will be watching the post-Christmas period, when arrears generally tick up. But we have actually seen the level of redraw available to mortgage holders increase in the past three months – it seems borrowers want to get ahead of higher interest payments," Freilikh revealed.

It is a similar story in New Zealand despite its central bank being even more aggressive. Caroline Dunlop, head of funding and acting group treasurer at Avanti Finance, said: "We are seeing some signs of stress but nothing like as much as we would have expected after rate hikes of this scale… The fact is, households still have strong balance sheets and unemployment is at a record low. People are still servicing debt."

However, ongoing borrower resilience to higher rates has not made lenders conclude that they are out of the woods. Rather, the base case appears to be that cash rate hikes were, as of November 2022, still in the process of feeding through to the household bottom line. As a result, the real impact may be yet to come.

"It will be very interesting to see how the start of 2023 plays out," said Stephen Martin, head of domestic ABS at CIP Investment Management. In particular, he suggested greater borrower stress might "separate the wheat from the chaff" among the proliferation of new lenders that have entered the market in recent years.

Andrew Chepul, chief executive at Columbus Capital, said the canary in the coal mine will inevitably be borrowers who took out loans at the cyclical low pricing point and have not been able to build up significant equity positions. Specifically, he said he is "a little concerned about the period after Christmas"

"We will be watching the post-Christmas period, when arrears generally tick up. But we have actually seen the level of redraw available to mortgage holders increase in the past three months – it seems borrowers want to get ahead of higher interest payments."

ED FREILIKH MORTGAGE HOUSE

> "Overall, investor interest in the asset class is not in question – the issue is market volatility. We are aiming for a similar level of market activity in 2023 as we did this year, but to achieve it will need flexibility and quickness as well as ongoing contact with investors."
>
> **MILES DRURY** PLENTI

for borrowers in the high loan-to-value ratio cohort – especially first-home buyers, who may struggle with loan serviceability under much higher rates.

On the other hand, the books of lenders with most reliance on securitisation funding – nonbank financial institutions – may be shielded against the worst of the lagging impact of rate hikes. While Australian nonbanks carry a lot of the weight of lending to self-employed and other nonconforming borrowers, their exposure to fixed-rate loans written during the ultra-low rates period of 2020-21 is much smaller.

Simon Petris, executive director and senior portfolio manager at Revolution Asset Management, pointed out that 25 per cent of Australian fixed-rate loans expire in the next year and will have to be refinanced at higher rates, meaning the impact of costlier debt on marginal borrowers "will play out in 2023". But he added: "There are not many of these loans in the nonbank sector – they were mostly issued by banks using TFF [term funding facility] funds."

There is little sign of relief from global headwinds, though. Neil Calder, head of investments, credit at European Bank for Reconstruction and Development, pointed out that the expected recession in Europe and the US will inevitably feed into other markets. "I expect Australian securitisation will be a functioning, good market in 2023 – but this has to be set against the backdrop of a weaker global economy," Calder concluded.

FUNDING IMPLICATIONS

The potential for weaker credit quality is looming in an environment in which lenders have been finding securitisation funding more difficult. Issuers speaking at the ASF conference highlighted the more challenging capital market conditions of 2022 compared with the previous two years. But they were also quick to point out that a more difficult market is not the same as a dysfunctional one.

For instance, Chepul acknowledged that it has become harder to find a bid for the mezzanine part of the capital structure. On the other hand, he also said investors have gradually been coming back to senior notes, including support from Asian accounts if an issuer is prepared to take its time over a transaction. European buyers have also remained active, Chepul added, albeit they are "less prominent".

Deal execution has had to be more measured to accommodate the absence of easy liquidity. This has not just been reflected in price but in market access practice.

Stephen Magan, executive director, securitised products group at J.P. Morgan, described the contrast. A deal executed in the fair weather of 2021 might have involved wall-crossing 3-5 investors on the senior notes with the goal of having one-third to one-half of this component placed pre-launch, and mezzanine tranches could often all be sold after launch. In 2022, 5-10 – or even more – investors have often been wall-crossed ahead of launch with the goal of securing pre-placement for the "vast majority" of senior notes and whole mezzanine tranches.

Miles Drury, chief financial officer at Plenti, commented: "Overall, investor interest in the asset class is not in question – the issue is market volatility. We are aiming for a similar level of market activity in 2023 as we did this year, but to achieve it will need flexibility and quickness as well as ongoing contact with investors."

Lisa Hood, financial controller at RedZed, shared a similar perspective. She said she is relatively hopeful that the interest rate peak is approaching and, with it, a calmer market environment. Nonetheless, issuance in 2023 will likely "still be hard work".

UK INVESTORS ALERT

Meanwhile, the forced sale of a substantial volume of Australian securitisation assets as a sector of UK investors scrambled to raise liquidity after the

> "I have taken calls subsequently from investors – including large UK fund managers – seeking to come back into the Australian market. Australian product used to have a really bad rap when it came to liquidity, but what we have just seen provided very good proof of the strength of this market, and has really re-energised it."
>
> **JOHN O'CONNELL** DEUTSCHE BANK

“Spreads are wide but we are going into a period of macro weakness so there is scope for further widening – though this is likely to be tiered, based on issuer, collateral and rating level. Triple-A notes in the UK and Australian markets look like fundamentally strong credit.”

IMRAN SHAFFI STATE STREET GLOBAL ADVISORS

country’s catastrophic mini-budget could increase demand in the longer term.

European market participants speaking at the ASF conference say the sell-off demonstrated liquidity many global investors did not believe the Australian asset class possessed and new buyers are emerging as a result.

The UK’s September mini budget sparked an immediate and dramatic spike in local yield, which in turn forced local liability-driven investment (LDI) funds to raise cash to meet margin calls on derivatives used to insulate these investors against rate rises. Andrew Hauser, executive director, markets at the Bank of England, subsequently described the sell-off to the UK parliament as a “full-scale liquidation event”.

LDI funds were forced to sell a raft of assets, with UK Gilts among the most affected. Various speakers at the ASF conference estimated the sell-off included in the region of €10-15 billion (US$12-17.9 billion) of structured finance securities.

Calder suggested the largest component of the structured finance divestment was UK residential mortgage-backed securities (RMBS), at about 40 per cent of the total, with another third being US and European collateralised loan obligations (CLOs). Australian securitisation accounted for an estimated €1.5 billion equivalent – significant volume for an asset class considered to be illiquid.

The impact on spreads and near-term new-issuance prospects was dramatic, but Calder says the supply was absorbed relatively easily. Bids wanted in competition lists included multiple issuer names with substantial tickets on the offer line, but Calder said at the ASF conference: “It all cleared immediately, mostly into Asia and Australia. It was a positive story and a turning point: this was a UK-specific issue and other investors were able and willing to take advantage.”

Deutsche Bank’s head of global credit trading syndicate, John O’Connell, noted that Australian product not only cleared quickly but also outperformed other securitised assets the LDI funds were divesting. For instance, it typically produced a better cash price for sellers than CLOs.

This has not gone unnoticed in the wider investment community, including among accounts that have not been active in Australian product. O’Connell said: “I have taken calls subsequently from investors – including large UK fund managers – seeking to come back into the Australian market. Australian product used to have a really bad rap when it came to liquidity, but what we have just seen provided very good proof of the strength of this market, and has really re-energised it.”

O’Connell acknowledged that it will likely “take a while for normal service to resume” as the sell-off was a major negative for investors and also had a wider pricing impact that the primary market will have to adapt to. But he pointed out that it was in essence a technical event, adding that some LDI investors have already started buying again.

When the dust settles, a more positive environment for Australian issuance should remain. “It has undoubtedly created a new, more positive perception of Australian liquidity,” O’Connell concluded.

Australian collateral has always tended to be well regarded by global investors and liquidity was one of the main factors limiting exposures to the asset class. Even if these concerns abate to some extent, however, a more general tone of caution is likely to remain in place across the global buy side moving into 2023.

Imran Shaffi, managing director, head of investment credit and senior portfolio manager at State Street Global Advisors, said at the ASF conference: “Spreads are wide but we are going into a period of macro weakness so there is scope for further widening – though this is likely to be tiered, based on issuer, collateral and rating level. Triple-A notes in the UK and Australian markets look like fundamentally strong credit. Do they look cheap? It is hard to say – I might suggest they look ‘interesting’.” •

“We are seeing some signs of stress but nothing like as much as we would have expected after rate hikes of this scale... The fact is, households still have strong balance sheets and unemployment is at a record low. People are still servicing debt.”

CAROLINE DUNLOP AVANTI FINANCE