New Zealand Market

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By email

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Wholesale-funded Non-Bank Lenders – COVID-19 issues and responses

We write to you on behalf of wholesale-funded non-bank lenders (**NBLIs**) about initiatives to support our customers, investors, and the regular functioning of the New Zealand securitisation market, from the immediate and longer run economic impacts of the COVID-19 pandemic.

The nature of the economic impacts of COVID creates particular challenges for NBLIs in implementing the initiatives and achieving the goals just mentioned. For the reasons given below, we believe the most immediate priority is to implement in New Zealand a liquidity facility for securitisation structures similar to the Australian Office of Financial Management (AOFM) proposal announced in Australia last week (briefly outlined in Appendix 2 below).

The COVID-related need
The COVID-19 outbreak has already resulted in, and will almost certainly continue to cause, significant adverse economic effects. This will almost inevitably impair retail borrowers' abilities to service mortgages and other loans.

The Government and banks have announced six month mortgage repayment suspensions will be available to borrowers whose income has been affected by COVID. A large number of New Zealanders have chosen to have their mortgages with non-bank lenders, along with other lending such as personal, auto loans, and credit cards. This includes a relatively high proportion of self-employed, who in the short run are expected to feel disproportionate impacts from the COVID economic fallout.

We want to be able to offer repayment holidays and other hardship accommodation to our customers, but – as noted further below – this has implications for our funding structures that differ from those applying to banks.

Our priorities, to accord with relevant Government's policy objectives, are to:

- Look after our impacted customers, especially the most vulnerable – including by processing requests for repayment holidays, hardship allowances, and extensions.

- Minimise the direct economic disruption, to prevent as far as possible the health crisis becoming an economic one.

- Assist in rapid economic recovery once the lockdown level is reduced and to be in a position to support our customers in the process of making the investments that will be required once the process for economic normalisation begins (including through infrastructure and other stimulus policies).

Issues for NBLIs in responding to that need
Non-bank lenders face two significant issues in meeting these policy objectives:

- They have fewer liquidity and funding support options than those available to banks, through the Reserve Bank's role in "banking the banks" (as reflected, for example, in recently announced liquidity facilities). This situation has exacerbated as a result of COVID-19 disruption (both leading up to, and whilst being in lockdown), in that the reduction in cashflows (resulting from falling consumers incomes or depressed business activity) has created liquidity pressures in the market generally.

- The securitisation structures that wholesale-funded non-bank lenders use provide a rational structure for managing credit risk and allocating credit losses, but one which – in the unprecedented circumstances associated with the COVID pandemic – will not function as intended with likely large and sudden decreases in expected cashflows for a period, resulting in the opposite of the policy objectives.

Our recommendation: adopt measures based on the Australian AOFM proposal
Internationally, a number of initiatives have been triggered to address these issues. Most relevant is the Australian Government's AOFM initiative in the past week (refer brief outline in Appendix 2 below). While we do not propose the wholesale acquisition of asset backed securities, we do recommend the provision of liquidity support to the sector. Importantly:

- Because it focuses on COVID-affected loans, it is highly targeted on achieving the Government's policy objectives and goes no further than required.

- In part because it is based on measures taken in Australia following the GFC, it is a highly evolved proposal on which the 'heavy lifting' has been done by industry representatives and advisers in Australia, coordinated by ASF and Australian government officials through the AOFM.

- It reflects industry and legal conditions that are very similar to New Zealand's. It can therefore be implemented quickly.

- It enables a consistency of approach across Trans-Tasman regulators and financial markets if it were to be followed here.

- It provides meaningful protections for the Government's requested investment, through access to collateral and a priority position for returns on the loan above those of the lender's owners. The liquidity facility should carry a positive return for the Government and would not be on the basis of a guarantee or grant – the terms of the liquidity support would provide for it to be repaid when cashflows resume.

We note that the AOFM proposal – while a very useful model – is still under discussion as to the details of its design and implementation, and may feature some complexity relating to AOFM-specific matters and, as such, would not be necessary in a New Zealand facility. In this letter, we have focused on higher level policy issues and would welcome the opportunity to talk to you further about important details, including our modelling of the quantum for the liquidity that would be required under a range of predicted scenarios.

Further considerations
There are broader matters relevant to the matters addressed in this note include:

- The Government has identified that the economic impact of the virus is going to be large and we are highlighting one of the repercussions. Rating agencies agree with this assessment and its impact on the non-bank lending sector,[1] predicting the increases in arrears to be higher, and arise sooner, than in the GFC – with the big difference being the sudden impact on business. We have close access to data on these impacts as it affects our customers, and wish to work with the Government and officials on an ongoing basis to assess and address those impacts.

- It is important to note that the quality of credit analysis/underwriting is not the reason for the request for liquidity support. The loans/leases in question and the structures funding them would have likely have performed as expected, were it not for Covid-19 and associated the requirement to self-isolate. As noted by rating agency S&P in its assessment of the economic impacts of the COVID pandemic, a factor that counterbalances the immediate liquidity impacts is that collateral quality is much higher than in the GFC, primarily from higher underwriting and lending standards (judged primarily against the situation in the US subprime market).

- The securitisation market forms an important part of New Zealand's domestic debt capital markets. Total securitisation capital markets issuance in New Zealand for calendar year 2019 was $1.43bn – not far behind the total corporate issuance. In this regard, we note that the purchasers of securitisation notes are fund managers, superannuation managers, and local sovereign wealth funds. The product creates an efficient medium for New Zealanders retirement savings to be invested in a sector providing finance to fellow New Zealanders.

- Securitisation also forms an important part of current and upcoming financial stability frameworks in New Zealand. For example, it underpins banks' covered bond and internal RMBS programmes, an important part of their funding profile, particularly in times of general economic stress. It is also the basis for the Reserve Bank's RMO programme, designed to augment those facilities in future.

- Timely response at this stage will help to mitigate multiplier effects and contagion, giving breathing room to adjust to deeper challenges as they arise (e.g. the increased potential for credit or sovereign debt crises).

As such, there are broader benefits from acting to address the immediate liquidity impacts of the COVID pandemic by implementing a proposal similar to the AOFM facility.

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1 Refer for example S&P Ratings Global "How Will COVID-19 Affect Australian Structured Finance?" (25 March 2020) and Fitch Ratings "What Investors Want to Know: Coronavirus Impact on Structured Finance in Asia-Pacific" (March 2020).

We look forward to engaging further with the Minister of Finance and Reserve Bank, and relevant officials, collectively and therefore please let us know how we may further assist.

Yours sincerely,

Chris Dalton
Chief Executive Officer
Australian Securitisation Forum

Simon O'Connell
Director - Structured Finance, Westpac
ASF New Zealand Market sub-committee chair

Additional information
We have also set out below more details on the following matters:

- **Appendix 1**: More information about the NBLI sector.
- **Appendix 2**: Brief summary of the AOFM liquidity facility.
- **Appendix 3**: What the non-bank and securitisation industries in New Zealand and Australia are doing to respond to the immediate and coming COVID challenges.

Our working group
We are happy for you to be in touch with the signatories and with any of the other members of the working group which has been considering these matters, details below:

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Appendix 1 – Who we are

ASF and the ASF New Zealand subcommittee

The Australian Securitisation Forum (the **ASF**) is the leading industry body representing participants in the securitisation and covered bond market in Australia and New Zealand. The ASF has representation from across the securitisation and structured finance industry including issuers, investors, banks and service providers such as lawyers and trustees, with a dedicated New Zealand subcommittee comprised of local market professionals. Our aim is to promote, protect and strengthen the Australian and New Zealand market, to build investor confidence and drive sustainable growth for our members.

The non-bank lending industry and Financial Services Federation

The group represented by ASF is of non-bank lenders, which are funded in the wholesale debt market, primarily through securitisation (refer below). We form part of the broader non-bank financial industry, with the remainder primarily comprising credit unions, building societies and other finance companies which accept retail deposits and therefore are licensed and supervised under the Non-Bank Deposit Takers Act 2013 (**NBDTs**). Membership also includes banks which provide warehouse securitisation facilities (Westpac, ANZ and BNZ), and other smaller banks which employ securitisation as part of their funding, including SBS, Co-operative and Heartland. We will use the term **NBLIs** to refer to non-bank lenders which are wholesale-funded.

We provide funding to New Zealand individuals and businesses in the following areas:

- Vehicle fleet leasing and floor plan financing.
- Consumer and commercial lease and vendor financing.
- Personal and consumer finance, including motor vehicle financing and credit or store cards.
- Home loans.
- Business finance, primarily funding the working capital and investment needs of small to medium sized enterprises (**SMEs**), particularly through equipment and other asset financing.

The **Financial Services Federation (FSF)** comprises 60 members (50 NBLIs and 10 affiliates). The businesses which are NBLIs include the likes of Avanti Finance, FlexiGroup, Pepper Money, Geneva Finance, Resimac, Toyota Finance, MTF, Bluestone Group, Latitude, and a number of brand-linked retail, vehicle and equipment financiers (e.g. The Warehouse Financial Services, Mercedes-Benz Financial and John Deere Financial, and several others). The majority of our members have been in business in New Zealand for at least 10 years and have a long term commitment to this market.

We fill a significant gap in the lending market by providing credit in the areas set out above, where in many cases it would otherwise be unavailable to borrowers. As at September 2019, NBLIs accounted for $14.3b of the lending market (NBDTs comprising $2.7b and non-deposit taking NBLIs comprising $11.6b).[2] Lending is split approximately 55% consumer and 45% business, servicing 1.3m retail customers and over 88,000 businesses. These loans have helped

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[2] Underlying data from the RBNZ Bank Balance Sheet (BBS), RBNZ Standard Statistical Return (SSR), RBNZ Non-Bank Deposit Taker Prudential Return (NBDTPR), Individual Insurer Financial Statements. This does not include UDC, on the basis that it is included on ANZ's balance sheet.

consumers and businesses meet their financial goals, and stimulated downstream economic activity. The NBLI sector itself creates significant economic benefit, providing over 2,500 jobs, as well as creating business for our affiliates including legal and accounting advice, IT support and consultancy services.

The securitisation funding model and COVID impacts

The business model of NBLIs can be broken down in a simplified manner as follows:

1. The originator writes the loans to retail/SME borrowers.

2. The assets (being the above loans) are transferred into a warehouse structure (typically a ring-fenced trust held by a corporate trustee company) and funded by banks under warehouse finance facilities.

3. Once the number of loans in a warehouse reaches a critical mass, the bank-funded warehouse facility is refinanced by selling the loans to a bond trust.

4. In order for the bond trust to finance the purchase of loans, it issues notes to third party investors via the capital markets (e.g. Kiwisaver schemes).

5. These third party investors receive periodic payments of principal and interest, reflective of the principal and interest paid by the underlying borrowers (that is, the returns are a 'pass through' of cashflows from the underlying loan receivables).

While the economic consequences of COVID-19 can have an impact on step 1 – origination of new loans – the focus of this paper is on existing loans, and in particular the ability to support customers with repayment holidays, hardship requests, and extensions. From a broader perspective, the same also results from increasing arrears that are specifically referable to the economic fallout of COVID. The NBLIs can, and do, assess and 'tag' these on their systems as being situations resulting from COVID-related issues, rather than from normal credit issues.

Any of these result in lower cashflows coming into the securitisation trust, and being available to make payments to the senior creditors.

The documentation for securitisation funding transactions, whether of warehouse or term securitisation, makes detailed provision for the consequences of decreased cashflows and increasing arrears, in normal circumstances. Ultimately, where the issues are serious enough, this can result in an 'amortisation event', in which the securitisation goes into rundown – where existing loans are serviced but no more loans can be funded through it. Ultimately, as a result of the 'cashflow waterfall' mechanics, any resulting losses are borne by the sponsor/originator, on a first loss basis, then by any 'mezzanine' (subordinated) investors, and finally by the senior investors.

Appendix 2 – The Australian initiatives in a nutshell

The Australian government and the finance industry, represented by ASF, this week announced that the Australian Office of Financial Management (AOFM)[3] will invest A$15 billion in eligible residential mortgage-backed securities (RMBS) and asset-backed securities, such as consumer, vehicle and equipment loans (ABS).

The Structured Finance Support (Coronavirus Economic Response Package) Act 2020 (*Cth*) was enacted on Tuesday 24 March 2020, establishing the Structured Finance Support (Coronavirus Economic Response) Fund (**SFS Fund**). The SFS Fund supports Australian non-bank lenders and smaller regulated banks (ADIs), which rely on the term and warehouse securitisation market (refer description of these above). This will allow non-bank lenders to provide their customers with COVID-related support (including through repayment holidays and special hardship provisions).

The first investment under the SFS Fund was made in March and it is expected to be used over the coming months to minimise disruption in the securitisation market with a view to supporting the availability of this financing option in the recovery phase and into the future.

The SFS Fund is similar to AOFM facilities made available to assist recovery from the GFC, but on an expanded basis reflecting the nature of the COVID challenge:

- It applies to all securities, not just mortgage-backed. As such, it can also support outstanding personal loans to relieve stress on retail customers, and support asset-backed financing (including vehicle and equipment loans) and SME lending that will be critical in enabling businesses and individuals get back to work.

- It is expanded from the highest rated tranches (AAA) to all securities, other than the 'first loss' that must be retained by the lender's equity owners.

The AOFM facility is available to invest in both term securitisations (i.e. those funded in the capital markets) and in securitisation warehouse facilities offered by banks.

As noted above, the details of the SFS Fund are still being fleshed out, and we would be happy to put you in touch with those involved in that process. We could also discuss with you how this sort of facility could be adapted for New Zealand, particularly because there are some complexities required for the SFS Fund that are specific to the circumstances of AOFM and, as such, would not necessarily be required for a similar New Zealand facility.

[3] The AOFM is an authority that is responsible for managing the Australian government's borrowing needs, performing functions similar to the New Zealand Debt Management Office (a branch of The Treasury).

App 3 – Some of the things the non-bank industry is doing to respond to the COVID challenge

Aside from the issues for all businesses associated with the unprecedented health and logistical challenges presented by COVID and the consequential lockdown.

Contact with customers: The first priority of all our businesses is to deal with the needs of customers, particularly the most vulnerable. In addition to fielding queries, we are getting in touch with as many customers possible to check in on their situation and help they may need.

Switch from origination to servicing: Many of our businesses have seen a large fall-off in new loan inquiries and related credit origination, while others have seen a sharp spike in borrowing need, for example to cover shortfalls being experienced by their own customers (e.g. car dealers experiencing a dramatic decline in business). Subject to the latter cases, financiers are not focused on growing loans, but on assisting with those experiencing difficulties with servicing existing loans, but most particularly with those who are expecting to encounter those difficulties over the coming weeks and months.

Addressing hardship: Many of our customers are anticipating hard times, but in particular are very worried about what their position will be over the coming weeks and months. Subject to the specific funding issues noted above, our policies enable a variety of hardship accommodations and allowances, and more generally contemplate us working with customers who are having difficulty servicing their loans, with enforcement only a last resort. It is very important that hardship claims are tested quickly, but also closely – it is important that hardship allowances go to those who need them, and it also remains important to ensure that borrowers are capable of bearing the loans they are requesting. We are able to 'tag' COVID-related credit problems on our loan systems, and our members are trying as far as possible to do that in a way that does not adversely impact our customers' credit scores and standing.

Working together: Two organisations have had a very active role in helping NBLIs and other non-bank lenders coordinate in responding to the COVID challenge: the ASF, which is presenting this paper, and the FSF, which has also been communicating with Minister Robertson, Governor Orr, and officials. Each of these groups has had frequent group Zoom and Skype meetings to share experiences and ideas, and are keeping in touch with each other's issues and initiatives, through common membership.

Essential service: Finance is included as an "essential service". Members of ASF and FSF are interpreting this according to both its letter and spirit, ensuring that they are serving their customers while keeping them and their staff safe by respecting the Level 4 lockdown, including working remotely.

Talking to Government: As noted, ASF and FSF have been in regular touch with the Government and a range of agencies, to help in meeting the challenges they and their customers face with COVID and in the effort to contain and minimise current economic impacts and the ability to move as quickly as possible to the economic recovery phase. For example, using aggregated data available from the tagging noted above, the FSF is planning to provide data to the Minister of Finance and the Reserve Bank to enable them to track the economic impacts of COVID on an up-to-date basis and see where any stresses or gaps in current support arrangements are arising.