Credit Snapshots – November 2018

The Australian Business Securitisation Fund

The announcement of the Australian Business Securitisation Fund (ABSF) this month has been derided as a political stunt by a few observers. However, if managed correctly it could (i) reduce the cost of borrowing for small and medium businesses and (ii) earn the Federal Government a decent return on its capital. I'll leave the argument about whether the government should be intervening in the market to the politicians, but note that the lessons from Fannie Mae and Freddie Mac must be heeded to ensure that the government isn't lumped with losses. Ensuring that loans are made to borrowers that have a very good prospect of repaying them is a non-negotiable consideration.

The Australian small business lending market isn't broken, but if funded better it would function better. Traditionally there has been limited debt funding available to small and medium businesses that didn't have property or vehicles to put up as collateral. This is rapidly changing as older generation non-bank lenders expand their product range and as new generation fintech lenders enter. The key stepping stone for lenders is moving from being primarily equity funded to being primarily debt funded. This happens as the size of their loan books and history of operations is sufficient to attract interest from banks for warehouse funding and securitisation markets for term-out funding.

This is where the ABSF could make a real difference to the development of and cost of funding for lenders. By having a ready and willing buyer for senior tranches, emerging non-bank lenders will have a clearer pathway to reach sufficient scale. Lenders such as Liberty and Thinktank have already crossed this threshold for property secured business lending. There's a much larger group of lenders for business equipment, vehicles, invoice backed and unsecured lending that have yet to reach this stage of development. Helping this group of lenders lower their cost of funding will help well managed and well capitalised small and medium businesses receive a lower cost of funding.

Christopher Joye on Securitisation

Over the last few months Christopher Joye has written several articles in the Australian Financial Review calling out the risks for securitised debt now that Australian property prices have started to fall. As I've been a long term investor in securitised debt I've been asked several times to respond to the issues raised. Christopher's criticisms can be described as partly right and partly incomplete. His main concern is that subordinated securitisation tranches could be downgraded as property prices fall. Rating agencies may adjust their criteria, adopting more punitive treatment of new and existing transactions. These changes could result in higher spreads, lower demand and lower prices.

Since the inception of Narrow Road in 2012 I've warned clients to stay away from securitisation transactions reliant upon lenders mortgage insurance (LMI). LMI has a history in the UK and US of failing to pay claims promptly and in full during their property price corrections. It is entirely reasonable to be concerned that the same thing could happen in Australia to transactions and lenders that rely upon LMI for their credit ratings.

Where Christopher's arguments are incomplete is (a) for non-LMI securitisation and (b) in relation to bank subordinated capital. Securitised deals that don't use LMI have several mechanisms that lead them to become stronger over time. Unless property prices fall much further than they have and unemployment spikes well beyond where it is, non-LMI deals will continue to see rating upgrades over time. Seasoned non-LMI deals have built substantial buffer against property price falls through higher subordination and the previous run-up in property prices.

Christopher also fails to mention that the risks from falling property prices apply to banks as well. The majority of loans by the major Australian banks are secured by residential or commercial property, making their loan books little different from the loan books of the major securitisation issuers. If one group is seeing losses on property lending, the

other group will be impacted as well. In almost all cases, non-bank originators have been well ahead of the banks in curbing riskier loans, moving before APRA and ASIC issued guidance on responsible lending. This leaves these lenders better placed from a solvency perspective.

ARPA Finally Moves on TLAC

To the surprise of some Australia's bank regulator, APRA, announced that it would require the four major Australian banks to substantially lift their capital levels in its consultation paper on total loss absorbing capital (TLAC). This shouldn't have been a surprise, APRA had fallen well behind bank regulators in Europe and Canada. In August 2016, I published "Why Banks Fail: The Definitive Guide to Solvency, Liquidity and Ratios". This article recommended what APRA is now proposing. It laid out how APRA should follow the example of Switzerland in strengthening its banks.

What stunned many was that APRA has recommended a substantial increase in tier 2 capital (subordinated debt) rather than a mix of tier 2 and tier 3 (senior subordinated debt) capital. Again, this shouldn't have been a surprise as APRA has consistently said it doesn't see the need to increase complexity with another layer of capital. I'm with APRA on this argument.

Tier 3 debt is like a wolf in sheep's clothing. It may seem more innocuous than tier 2 debt, but if a bank gets into trouble it will have a very similar outcome to tier 2 debt. Tier 3 debt can have a shorter maturity period than tier 2 debt, but it is subject to the same regulatory approval for principal and interest payments. If a bank is looking shaky, a regulator can lock-up its tier 2 and tier 3 debt, delivering the same outcome to holders of both. If a bank becomes insolvent both tiers are likely to be facing haircuts or wipe-out, though tier 3 may receive a better recovery rate.

The main concern raised by proponents of tier 3 debt is that they don't believe capital markets can digest the increase in tier 2 debt that is implied by APRA's discussion paper. Estimates are that the four major banks will, as a group, need to issue $20-30 billion of tier 2 debt per annum. I think markets will handle this well for several reasons.

First, as spreads are now a little higher the incentive to switch from senior to subordinated debt has been sweetened. Second, investors will recognise over time that Australian tier 2 debt represents very good value as it has substantial equity and preference share capital providing protection and doesn't have tier 3 debt diluting its position. Third, capital markets have a long history of finding solutions to business capital requirements. If the price is right, the demand will be there for it.

Deutsche Bank's Ongoing Woes

Deutsche Bank appears to be caught in a slow downward spiral. Its cost of funding is rising, it consistently struggles to make a decent profit, there's never ending waves of restructuring, its best employees are regularly picked off by competitors that pay material bonuses and its share price is hitting record lows again. This month brought the news that it handled $150 billion of suspicious transactions from Danske Bank. If it takes a material provision for this, it could be the fourth year in a row that the bank records a loss.

As well as losing good employees, Deutsche Bank is now losing corporate clients from its core customer base in Germany. The rising cost of funds as well as the reduced international operations means some clients are finding that they can receive cheaper loans and better service elsewhere. Despite changing CEOs and strategies regularly, the bank still struggles to lift its abysmal return on equity. Without recording decent profits, the bank will remain undercapitalised on a total leverage basis, leaving it at risk of failing if there is another credit crunch.

Written by Jonathan Rochford for Narrow Road Capital on November 28, 2018. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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