AUSTRALIAN SECURITISATION INVESTOR REPORT

Australian Securitisation Forum

Perpetual

THE ASF-PERPETUAL DOMESTIC INVESTOR REPORT

ASF and Perpetual are very pleased to present the 2018 Australian Securitisation Investor Report. ASF and Perpetual have come together to produce this report and provide insights into the dynamics of the securitisation market and Australian based investor preferences.

The report reveals a healthy industry which provides both opportunities and challenges to domestic investors. Supply is increasing, competition is growing and the search for value rolls on.

Investors are a diverse group with each displaying a unique approach to investment yet the focus on quality is universal. Local investors are proud of their legacy and keen to ensure it continues for many years to come.

We hope you enjoy reading the report as much as we have enjoyed compiling it.

Chris Dalton, Chief Executive Officer, Australian Securitisation Forum and Chris Green, Chairman ASF and Group Executive Perpetual Corporate Trust

ABOUT US

AUSTRALIAN SECURITISATION FORUM (ASF)

The ASF was formed in 1989 to promote the development of securitisation in Australia. It is the peak industry body representing participants in the securitisation market, which include major banks, smaller Authorised Deposit-Taking Institutions, non-bank issuers, fixed income investors and service providers to the sector.

The ASF performs a pivotal role in promoting and representing the industry to government, regulators, the public, investors and others who have an interest or potential interest both in Australia and overseas, regarding the benefits of securitisation in Australia and aspects of the securitisation industry.

Membership with the ASF offers a unique opportunity to participate meaningfully in shaping the future of securitisation and enhancing its role as a vital sector of Australia's capital markets.

PERPETUAL CORPORATE TRUST

Perpetual is an ASX-listed, independent and diversified financial services company with a rich history dating back to 1886. Across our three businesses – Perpetual Investments, Perpetual Private and Perpetual Corporate Trust – our people focus on protecting and growing clients' wealth, with a relentless focus on consistent delivery over time.

Perpetual Corporate Trust is a leading provider of corporate fiduciary services to the Australian securitisation industry, administering more than A$640 billion on behalf of our clients (as at 30/12/2017). Our services include trustee, trust management, accounting, document custody, data services and standby servicing.

Having been involved in the Australian securitisation industry since its inception in the 1980s, we play a leading role in growing the industry and managing regulatory and technological change.

ABSPerpetual provides the link between issuers, the Reserve Bank of Australia and the investment community. Today, the new digital platform, ABSPerpetual Business Intelligence, helps financial institutions manage their regulatory reporting obligations and promote a simple, transparent and comparable mortgage market.

Our extensive knowledge of financial markets, our trustee heritage and the expertise and experience of our team ensures we are the trusted partner to our clients throughout the lifecycle of a securitisation program.

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THE STUDY

The study was conducted in two stages. Initially, an extensive online survey captured the opinions of 27 investors across a range of topical issues. This was followed by a series of in-depth interviews with a further 16 investors from 12 organisations to uncover their approach to the market and their views on its health.

The study was generously supported through the participation of investors for which we are very grateful. The responses of investors are anonymous.

In the online survey the vast majority of investors were Portfolio or Investment managers (84%). The in-depth interviews covered a wider spectrum of investors to ensure we included both large and small investors, as well as institutional and independent.

THE KEY THEMES

Demand is high and continues to grow despite tightening of spreads and the perpetual quest for value and performance which are becoming increasingly difficult to find. Competition is more intense with new global and local investors entering the fray.

Investors are focused on quality which drives the widespread desire for quality information and data. They are wary of anything that might interfere with quality issuance.

Issuers are called upon to continue to improve post-deal service. Investors are calling for more dialogue, continuous access to data and greater transparency in pricing secondary market deals.

Lack of a vibrant secondary market frustrates investors who find themselves in a buy and hold cycle that seems impossible to break.

The media driven mortgage market correction is not phasing investors who have confidence in the strong economic fundamentals of population growth, low interest rates and high employment as well as an appreciation of the sound regulatory environment.

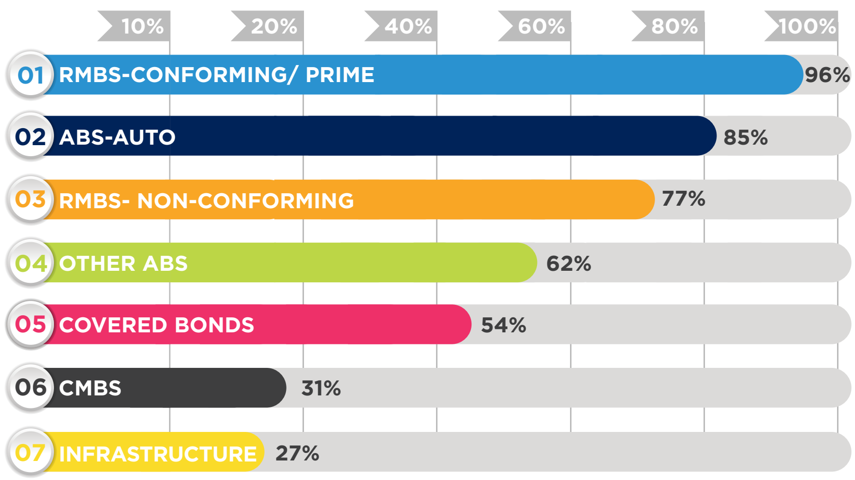
SECURITISATION MARKET ACTIVITY

STRONG AND GROWING DEMAND

The activity across the range of asset classes is constant and investors are keen for more. Several commented on the lack of securitisation opportunities beyond residential mortgage-backed securities (RMBS), flagging unmet demand in the asset-backed market.

Growing global and local competition for assets is fuelling growth in demand and despite a record year for issuance in 2017 local investors have capacity for more RMBS.

ASSET CLASSES INVESTED IN



THE MEDIAN INVESTMENT IN RMBS AND ABS IS $750 MILLION AND INVESTORS ARE HUNGRY FOR MORE.

"I don't think there's been a significant amount of deals, you certainly would not want to set up an exclusive asset backed fund in Australia. I just don't think you're going to get the deal flow."

"Although from an issuer perspective there's a delicate balance, you don't want to print to meet demand, you want a bit of price tension and a bit of secondary market performance, particularly if you are going to be a repeat issuer."

"The issuer's motives are going to be driven by economics as well and the Japanese are willing to price very tight and issuers have to look after them as well right? So, in short, we are getting scaled, some much more savage than others."

"The big banks' ability to make money out of the CLF (Committed Liquidity Facility) which has been a bit of a gripe of mine is diminishing."

"Seasoning is falling. At issue normally it was six, nine months sometimes twelve or even 24. Now I'm seeing issuance under six months. Pretty reasonably they're just originating spitting bonds out. That's the function of the market being open which is great. It used to go through periods post the global financial crisis (GFC) where it was stop-start. And then before that it was just stop."

ALLOCATION TO CAPITAL STRUCTURE AND MORTGAGE TYPE PREFERENCE

Investor activity and demand is strong right through the capital structure with preference driven by mandate or the quest for higher yield. Investors in senior notes are keen to see more deals while investors in the lower tranches would appreciate larger deals or larger allocations.

Almost 60% of the ticket sizes for senior notes are at least $25 million whereas half of the ticket sizes for junior notes are less than $5 million. Investors in the senior tranches are typically from large, conservative organisations. Irrespective of size, investors have capacity for more RMBS.

We also found that even those with restrictive mandates are willing and interested to look further down the capital structure to seek value and those operating in the lower tranches are just as likely to look up.

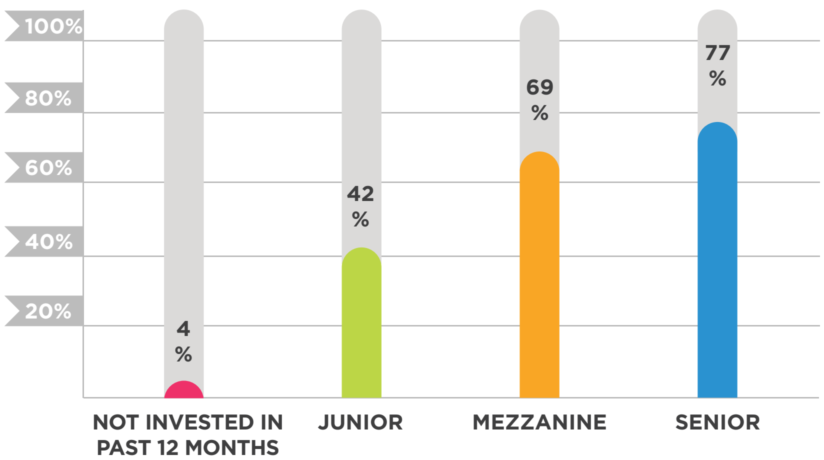
This market has no hard and fast boundaries and there is flexibility for investors to shift with the changing face of the market.

Owner occupied mortgages are the market favourite but this is by no means exclusive. Investors recognise investor loans have performed very well for many years but are quick to point out it doesn't mean their risk profile has changed.

Investors claim lenders' mortgage insurance (LMI) has been a terrific thing for the industry and, more broadly, improvements in the underwriting standards across the market have contributed to favourable conditions for investors and issuers alike. As a group, investors feel quite confident about the stability and security of loans in the lower levels of the capital structure and most don't see this changing in the near future.

However, there are some investors who are cautious about the future performance of the market, particularly in the event of a downturn in property prices and, specifically, the impact that would have on investor loans.

PARTS OF CAPITAL STRUCTURE INVESTED IN PAST 12 MONTHS



"So you've had this influx of money into the high yielding part of fixed income, and then they've gone 'what do I buy?' Spreads have rallied; stuff is tighter, so I've just got to put more money into that mezz part of the market because high yield is really the only last bit of high yield left in Australia."

"They call it reach for yield – that's the classic comment. We've seen this before. You've seen it in 2006, 2007, you've seen it in various parts of the cycle when rates are very low. People reach for yield. It's very late cycle behaviour."

"The influence of home ownership is very important and the fact the thing is recoursed to the individual. I think the Netherlands come just after Australia, and we do have the lowest level of arrears defaults in the world. Home ownership is very important for individuals and people do what they can to pay off their mortgage."

"Now a lot of issuers will tell you that investor loans have done better, and they will actually list all the reasons why, and that's a fair statement, but we've had a chronic undersupply of housing, so that evidence is based on the premise that you'll always have an undersupply of housing and that may remain the case forever, but that doesn't mean an investor loan is a stronger loan than an owner occupier."

"I think you'd be brave to say the RBA and APRA and everybody is barking up the wrong tree, these investor loans are just going to be fine. We haven't had a recession to really test those investor loans."

MAKING INVESTMENT DECISIONS

INVESTORS' STYLE

Our 2016 study of Global Securitisation Investors revealed a diverse group of analytically minded individuals who relish the opportunity to engage with market peers. Domestic investors are very similar.

The majority spend a great deal of time analysing deals and the market and many have created their own models for measuring risk and value.

At the same time they're keen to engage with issuers and peers.

This means that not only do they have significant demands for data, they value ongoing dialogue with issuers and they're choosy about the issuers and originators they prefer to deal with.

> **"For me constantly analysing the market is really just a sleep at night factor. I want to be thorough in my own way."**

FACTORS CONSIDERED

Price and quality are the dominant factors driving investment decisions but perceptions of price and quality differ depending on the investor's mandate.

TOP 5 FACTORS CARRYING MOST WEIGHT WHEN ASSESSING DEALS

While no clear lines exist, investors tend to stick to the parts of the capital structure they specialise in. Simplistically, the institutional investors tend to invest exclusively in senior notes in line with their mandate while the independent investor favours lower parts of the capital structure as they seek the value these provide.

Irrespective of their sphere of operation, many common factors are considered and analysed with the ultimate goal being to price for risk and assess the underlying value of the deal.

Interestingly, each investor has their own unique way of assessing risk and value which is why loan level data is essential. Even investors with restrictive mandates are not prone to rely on ratings data alone.

In complete contrast there are one or two investors who are far more concerned with the quality of the originator than they are with the particular characteristics of a pool.

They contend the originator's ongoing commitment to timely and effective servicing is a far stronger determinant of quality.

"So things like bank originated, fully certified or fully documented loans, there's guidelines around loan to value ratio (LVR) and geographic distribution and all of the things that you would expect that we want the pool to look like before we can sort of tick that off and go ahead."

"We look at the underwriting criteria, so we'll typically visit the issuer at some point and meet their credit team, we'll look at their underwriting guidelines, we will look at the pool of course and look at the characteristics of the pool, the LVR, the loan size, the types of loans, we'll look at the geographic split, we typically like to see the diversity there. We will also look at their risk performance."

"One of the primary issues is the quality of underwriting and the quality of origination. That is people who are providing home loans to the public; if their processes and procedures for giving credit to individuals are good, then obviously that's good for the investment."

"I think we're probably sitting here thinking, have the spreads moved in too fast, too tight, have the quality of the actual underlying assets started to deteriorate a bit by the seasoning...are we seeing some other characteristics in these pools that are becoming more risky, do we think that there could be some sort of a correction coming through. So we're probably sitting here thinking...having more thoughts about potential negative issues rather than you know, oh no we need more, we need more."

APPROACH TO EVALUATING DEALS

The majority of investors conduct deep analysis of new deals they're considering. The extent of their analysis depends to a degree on the size of the deal and the relative weight of RMBS in their portfolio.

Securitisation specialists typically have a standard but rigorous process they follow to assess deals and they commonly use their own models. For most, the demand for detail is intense. Some do an initial screening of the data to establish whether the deal is worth pursuing. Investors will not pursue a deal if the expected size of their allocation is likely to be too small. They'll question the effort required relative to the return.

Investors are comfortable doing the analysis in the relatively short time frames they are given but are becoming a little concerned that new investors are not putting as much work into the analysis and driving prices down without due consideration of the risk.

They are also reluctant to put a lot of effort into their analysis if they believe the outcome might be that they'll be scaled down to a size that doesn't make the deal worth doing.

In some cases, investors work directly with issuers to create bespoke pools to meet pre-defined criteria.

"We do an initial screening looking at the basic parameters of the investment and comparing it to other investments in bonds and then we decide at that point whether to do the work of analysing it in more detail."

"We put in a ratio type bid, so if they are going to scale us back on one side of notes, they'll scale us back on the load."

"We read through the ratings information on each of the deals, in detail. That helps provide us with some questions back to the issuers. We have our own rating on the issuer and how they originate loans; how they deal with arrears; how they've been performing in the past; and also how they've treated us in the past from a relationship basis."

"We look at things the rating agencies don't pick up on such as multiple exposures to single obligor. We've seen in pools exposure as high as 9-10-11 and it's not part of the ratings methodology. We get a strat table on that because that's the spice of where the issuers are trying to hide the risk within the pools. We tax that – we call it taxing in terms of you need to get paid more return for taking that risk. You add in investor composition, interest only composition, multiple obligor, or single obligor multiple loans and then ... geographic dispersion is always an interesting one so you're always looking at the poor performing states. It is part of the cycle."

"We're okay with the credit but we don't agree with where the pricing is, so we might pass on the deal."

"You know broadly what your exposures are, be it geographic or LVR or interest only or whatever, you've got to know what that is and you've got to know whether you're increasing that by taking a particular issue or not."

"We do a lot of work with the actual issuer, the originator to make sure we actually understand and are comfortable with their origination process as well as their servicing."

"So you're actually sort of playing the Australian psyche of owner - occupiers paying down loans and so therefore, that builds up that equity bumper versus that market issue of valuations."

ASSESSING VALUE

When we asked investors what they would choose if forced to choose between better value or more stock in RMBS two thirds chose more stock. When asked to explain this, investors were quick to point out that value is relative and that despite significant tightening of spreads there was still value to be had relative to alternative assets.

They were just as quick to point out the time is near when lack of value will restrict their demand. Already investors are walking away from deals that are too small for the work involved. New entrants in the lower tranches and more active global competitors in the senior tranches are putting pressure on prices.

They say value is in the eye of the beholder and that's definitely true of the securitisation market. The perception of value strongly depends on the goal of the investor so what is value for one may be not worth pursuing for another.

The tightening of spreads is only increasing the scrutiny of investors when assessing deals and, if anything, intensifying their demand for quality. Yet while RMBS continues to offer value relative to alternative assets there'll be no shortage of demand.

Interestingly, the bespoke approach each investor takes to assessing value often makes them feel they enjoy a competitive advantage.

"Even if the collateral starts to get a bit ugly, if the demand is strong enough, I think people will still buy it, they will buy it tight."

"The spreads were pretty wide two years ago and then there was tightening at a federal level in the US and there was tightening in the European markets and that had the impact of leading to narrower spreads in Australia, even though the Australian market wasn't necessarily linked to the European and other global markets."

"I can remember the days when if you got 15 basis points for a Triple-A, you were fist-pumped and that was great, but it has come in a lot."

"A lot of people will say it's always cheap and that's true to a general extent, but you've got to understand how much of that cheapness is liquidity premium and how much of it is not. So how much of it is actually underlying risk in the market or risk in the pool."

"When it comes to the demand for RMBS, well, I don't know if it's global, I don't know who those people are but margins tell you, and just how issues go, you know the issue is announced, the range is given and for the last year or two years they have gone at the bottom of the range, or the range has moved lower and then it's hugely over-subscribed."

"18 months ago, we saw that it was a couple of geopolitical events, Brexit, Trump and we saw some widening then, but that was a bit of an aberration. Since then it's just been one way, just been grinding tighter, tighter, tighter."

THEY SAY VALUE IS IN THE EYE OF THE BEHOLDER AND THAT'S DEFINITELY TRUE OF THE SECURITISATION MARKET

INVESTORS' NEEDS

IMPRESSION OF ISSUERS

Issuers are not all the same. That's the clear message coming from investors. And investors would like that to change in some areas in particular.

The one thing that is universally desired, is the practice of maintaining an ongoing dialogue with investors. Investors feel that they're the ones who often instigate out-of-deal conversation but it rarely goes the other way and it's different when a deal is on the table. Issuers are quick to ensure investors are aware of the deal and provided with all of the information they need to assess its relative value.

Investors are open and they actively engage with the range of issuer types unless their mandate or style means they're more likely to get what they need from one type of issuer or another.

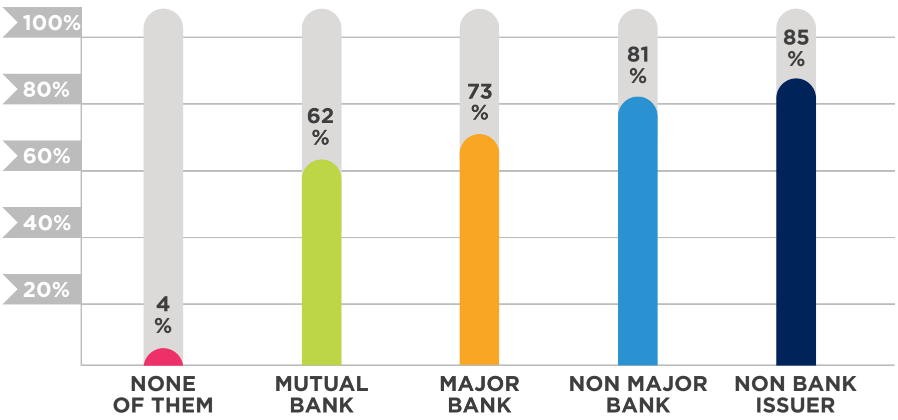
Nothing that investors said indicated they would actively avoid any category of issuer but most did say they'd avoid issuers whose practices indicated they did not have the investor's interests at heart.

When it came to preferences for particular types of issuers there was an overwhelming preference for non-bank issuers.

PREFERRED TYPE OF ISSUER TO DEAL WITH

- NO PREFERENCE - 21%
- NON MAJOR BANK - 4%
- MAJOR BANK - 17%
- MUTUAL - 4%
- NON BANK - 54%

ISSUERS INVESTED WITH PAST 12 MONTHS



There were strong opinions about why this is the case and an almost comprehensive view that non-bank issuers practised the ongoing dialogue they're all looking for including taking the time to visit investors and keep them informed of their plans.

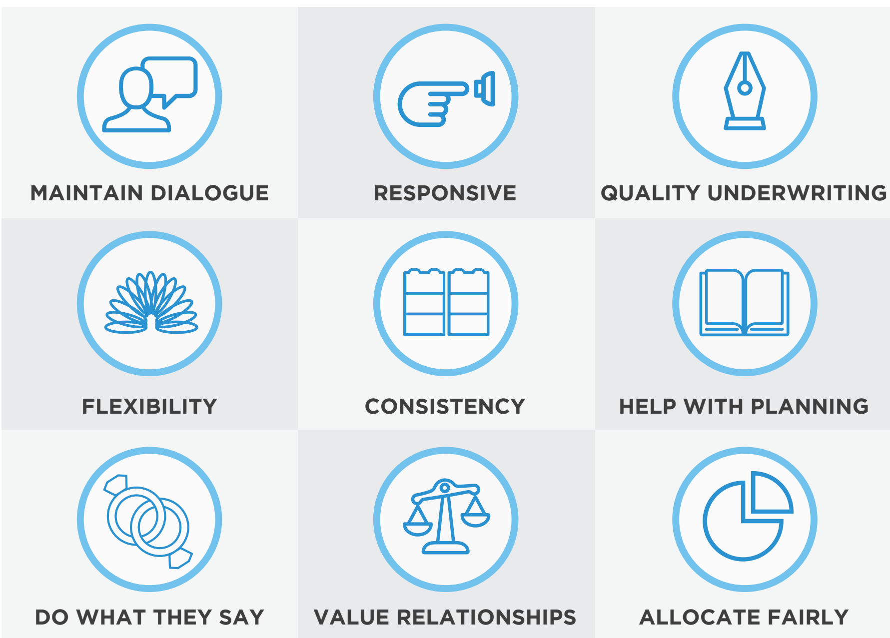
There was a suggestion that non-bank issuers are compelled to offer a high quality service and behave in this way because their business relies on it. However, in a buoyant market in which demand is outstripping supply it would be reasonable to assume non-bank issuers would continue to attract investors whether they delivered quality service or not.

The reality seems to be that they value quality service and they're prepared and willing to offer it as simply good business practice.

Non-bank issuers typically recognise the importance of ongoing dialogue to investors as much as themselves and this has led to the development of some very strong relationships right across the market.

Of course, it's not just about the ongoing dialogue. Some of the other traits of great issuers are shown below.

TRAITS OF GREAT ISSUERS



"They (non-bank issuers) just sort of engage. A lot of them will have a dedicated funding professional who will engage with investors and provide them any sort of information that they require. When you ask the larger institutions for historic data they don't give you anything, or they will give you something from a slide deck, but I want all the data. Non-bank issuers have always been very, very flexible and amenable to those sorts of requests. And they always come around to me whereas the major banks I've maybe only met them once or twice."

"We've been disappointed last year with some of the issuers coming to market only offering the A1 notes as they had placed everything underneath it. Obviously people that are soaking up large tranches of paper sway the market considerably, so it is difficult for middle-sized players like us."

"The ones we don't deal with we dumped ages ago and refuse to deal with them. For example, not calling deals and seemingly putting their own profitability way ahead of everybody else's."

"On the whole the non-bank issuers need to be more flexible or more responsive to the desires of the investor because their funding is from the investor base as opposed to the bank issuers who have not just one source of funding generally and a bigger balance sheet into multiple sources of funding whether its deposits or senior notes and covered bonds or securitisation. So from the non-bank issuers who are a little bit more one trick ponies, so to speak, they're going to be more focused on making sure that that pony is well fed."

"I think the issuers are doing their best, they understand, it's been 10 years but 10 years isn't that long, people still remember what happened when foreign investors pulled out of the market, it's the local investors that funded them up. You needed that local support because you weren't going to find that offshore."

"They (non-bank issuers) also tell you when they are going to bring a deal so you can manage your cash flows much better. They they just do everything to make the investor's life as easy as possible."

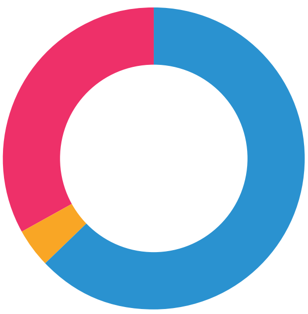
"It's less common to have close relationships with the major banks because they don't have to be as nice."

PREFERENCE FOR VALUE OR STOCK

With investors who are always focused on value and never stop looking for stock it's hard to get them to choose one over the other. The fact that two-thirds chose stock says a lot about demand for RMBS because there is no denying the significant tightening of spreads over the last couple of years.

Despite the tightening, the relative value of RMBS continues to make it an attractive investment so the preference for more stock is not surprising.

WHAT ONE ASPECT WOULD YOU LIKE TO SEE IMPROVED?



- AVAILABILITY OF STOCK - 63%
- EASE OF DOING BUSINESS - 4%
- VALUE - 33%

"Right now it's definitely availability of stock but you also have to take a tactical view. From my perspective, we've seen spreads more than halve over the last 12 to 18 months, but as an instrument, RMBS makes a lot of sense, it's highly defensive, it's very sure, it amortises and the spreads, albeit tighter, are still offering a decent pickup over treasuries."

"Because if you had more stock and there was more churn, you could really test the dealers and see how good they are at providing liquidity and then you could really test the product then that will probably drive more confidence."

"I would certainly like the size of the deals that are coming to be bigger. That doesn't necessarily mean more volume overall, but when they come, the bigger volume because of the inverted nature of the pyramid. We'd prefer it to be one $5 billion deal than five $200 million deals because that's five times the work isn't it?"

LIQUIDITY

Perceptions of liquidity were inextricably linked with the industry wide desire for a vibrant secondary market. There were several comments about expecting a liquidity premium in the price of RMBS because in reality it does not have the liquidity characteristics of cash.

A few mentioned the conundrum whereby banks are lifting the volume of RMBS to meet their CLF requirements, essentially holding RMBS as a liquid asset which in turn limits the supply of RMBS in the broader market.

Fundamentally though, the desire for liquidity is strongly linked to the practice of continually monitoring and reviewing investments and wanting to be in a position to sell tranches that are no longer performing in a way that is consistent with the goals or parameters of their portfolio.

The lack of new deals ready to replace divested loans creates a fear that funds will have to sit in cash for extended periods. Investors like to be fully invested but want the flexibility to switch investments if this gives them an edge.

"People don't want to sell because they can't replace the stock."

"You've got a lot more participants coming into the market so they're improving liquidity."

"The issue with asset backed generally is that the liquidity is not fantastic. And I don't really see that changing a great deal and that's across the rating spectrum. Even the Triple A tranches don't tend to deal actively, so certainly from our perspective, given that's the case, there has to be illiquidity premium in the spread, in its pricing. Such that if you're happy to take the liquidity, you need to be compensated."

"We bring our investors in knowing that they are entering a low liquidity space. It's not by the whole by definition but it's buying with your eyes wide open and we'd probably be holding it."

ASSET-BACKED SECURITIES (ABS)

The single message from investors concerning ABS is 'give me more'. There is a feeling that the range of categories covered by ABS could also improve, with Higher Education Contribution Scheme (HECS) debt being an interesting example given.

Investors are also open to more commercial mortgage-backed securities (CMBS) for the same reasons. They understand securitisation because they've been doing it for many years, they're experts at pricing for risk and it makes sense to get access to assets that can be predictably modelled.

The primary downside to ABS is the size of the tranches available, but for the boutique, value investor this is less of an issue. There is also the suggestion that underwriting standards are not as strong for ABS which makes it less attractive for investors whose focus is primarily on underwriting quality.

"Certainly, in the ABS space we're operating a lot of tranches, just the size of the tranches themselves aren't that big. So for 5 million tranches held by 4, 5 people, that's a million, 1.5 million each. So if someone says they want to sell half a million, quite frankly for the people our size, it's just not worth getting other people. There's too much work involved to buy half a million dollars' worth, it's just not worth it."

"Cars is too small a sector to even build up some speciality in, it's too much about quick finance and low underwriting standards. The Royal Commissioner in his opening statement two days ago said we are going to focus more on motor finance, Latitude, Macquarie, Nissan, Toyota and Mercedes and everyone's going, geez, no one saw that coming, we thought it was a banking thing."

"ABS is a very shallow market because a lot of it is kept on bank balance sheets. It's a very cottage type industry. The asset backed financing market in Australia is not large. You can get more innovative with the way you use securitisation, so you can go on securitised student loans if you wanted to, you can securitise HECS debt, you could securitise anything really. As long as it's got an asset and an income, and it's got predictability of that income, you could securitise it. So we just have got to get more innovative in the way we use securitisation and people are trying to do that and, there will be some good ones, there will be a lot of bad ones but the market in Australia is just not big enough."

DATA

Despite the maturity of the market there is wide variability in the quality of information supplied by issuers. Yet the analytical nature of investors means heavy reliance on data and information.

40% of investors say the quality of information provided by RMBS issuers varies considerably and this rises to 50% for ABS.

Investors are typically satisfied with the information that is provided for new deals and they feel confident issuers will respond quickly to questions but they are not happy with getting the information they need to effectively monitor their investments.

The same applies to information about deals on the secondary market. There is not one reliable source and the sources that are available are often out of date.

Most local investors are keen to have access to loan level data when assessing deals. It is rare for local investors to rely on ratings data which we found satisfied some global investors.

The reason for needing loan level data is that local investors create their own models and have bespoke approaches to analysing pools.

The amount of time investors spend looking at the detail in the data is substantial and there are as many ways of looking at the data as there are investors in the market. For some, summary statistics satisfy their immediate needs but for the majority this is just not enough. They want access to data in a way that allows them to create their own filters and monitor their investments (or parts of the market) through the lens of the filters they create.

"The info we get is at the start of the deal, and we get everything that we need. I'd say it's the follow-up afterwards that's tricky and that's been the case for several years."

"It's the stuff (loans) that was written four or five years ago that you've got to worry about."

"If they don't give us the data we don't deal with them. So tit-for-tat. We've got the money, you've got the data."

"I am analysing all the time, because I try to be active, I get shown pretty much every line in the secondary and also primary, so when I look at that I have to by extension look at, you know, everything."

"I mean it's understanding the way the underlying collateral behaves is the key. So the more information you can get from how the loans are performing, that's what you're looking for and so the more of that you get the more granularity you get the better. Even when deals are being launched, you're getting kind of broad based pool stats, which are great, but it doesn't give you the underlying granularity you might need to see where there might be a skew somewhere."

MONITORING

Local investors monitor their investments frequently, typically monthly. While this regular monitoring might start with basic measures, any anomalies in the composition and performance of pools triggers deeper analysis.

It is less common for local investors to analyse broader market characteristics using market data. It seems their understanding of market characteristics that may impact pool quality are more from observation than formal analysis whereas global investors, without the benefit of local knowledge, were keen for access to industry wide data to monitor regional issues and the like.

However, this may change in the foreseeable future.

DO YOU REQUEST OR REQUIRE RBA MONTHLY LOAN LEVEL DATA?

NO - 32%

NOT AT THIS STAGE BUT WILL IN THE FUTURE - 36%

YES - 32%

Large scale Triple A investors were more likely to have simpler ongoing information needs for monitoring their investments. Some rely primarily on summary data.

Irrespective of their approach, local investors feel the quality of data post-deal is not up to scratch although conceding that it is usually provided when asked for but often not in a format that makes it easy to use.

> **“So we’re looking for arrears, losses, defaults, you know LMI claims. Ideally we’d like to have access to the pool cut to see which loans are not performing and keep track of the LVRs, those sorts of things. But really the key things that we’d be looking at monthly would be the arrears and defaults, the losses.”**

> **“We always get the trust reports every month so you’re always tracking in arrears, but if the arrears did really step up, that would be the trigger to get the loan level data again to really mine it and understand the trend.”**

ATTITUDE TO RISK

Investors are highly conscious of risk and price for it but they have many different ways of assessing risk in the same way as they have many different ways of analysing the market and deals specifically.

Investors have a common goal of measuring quality. This makes investors alert to factors that might indicate any change in quality in the investments they hold or more broadly to changes that might affect the market as a whole.

They have quite a different view of market risk than they do of investment risk. Investors are generally upbeat about the state of the market despite their natural caution. They point to the strong economic fundamentals and see few reasons why these should change in the short to medium term. They also comment positively on the role of the Australian Prudential Regulation Authority (APRA) in contributing to quality underwriting standards in the mortgage market.

In contrast, when it comes to investment risk, they are perpetually vigilant because it is in their nature and because it directly impacts their performance. This means that even when there is little reason to be concerned about the performance of their investments they simply don't take their eyes off them.

Finally, when it comes to the potential impact of external factors some do admit that certain types of events could have some impact on their willingness to invest. For example, the prospect of a geopolitical event is quite real for a small number of investors. Not that they know what that event might be, but experience tells them that events can occur without warning.

" APRA is certainly having a macro impact and an impact in the broader landscape but over the years I can't think of any occasion when issues have been raised from APRA that have not already been addressed by the originators. Now whether that's been of their own volition or because we've (investors) had some discussions about it, such as qualification rates for borrowers."

"You've got to look at where the loan is as well so if the originator is writing loads of investment loans at Docklands versus an investment loan for an apartment in Hawthorn the risk profile is entirely different."

"Everything is tight, equities are so high, I think there are great walls of money that keep coming in and they're not properly assessing risk. It's difficult because we've been holding some fairly conservative views and holding the positions fairly conservative for a while, expecting this modal reversion that we see in credit markets to occur. It's not occurring; they continue to grind in and we're starting to reassess what we've been doing. I personally think that there will be some geopolitical action in the world that is one of the triggers, as we saw in 1987 with the sinking of the oil tanker or aircraft carrier and then very quickly afterwards we saw the triggers that created the October '87 crash. I think we see a similar sort of environment today."

"And I think that's where people get unstuck and I guess that's one of the concerns about the evolution of the market and the range of new investors coming in is how informed are they around the multiple facets of the risk profile and components of the underlying asset pool as opposed to just going oh yeah it's rated A or Triple-A or Triple-B or whatever the rating is."

WHAT DO INVESTORS THINK OF THE MARKET?

ATTRACTIVENESS

Investors are split on whether RMBS retains its attraction. There was much concern over the tightening of spreads in the past couple of years and the impact of increased competition right through the capital structure.

While some viewed this tightening as cyclical and expected, others are questioning RMBS' value relative to other asset classes and in relation to the effort required.

The two primary concerns are relative value and availability of stock. The perception of value changes as you go through the capital spectrum, so the degree of attractiveness depends to an extent on the parts of the capital spectrum the investor operates in.

On balance, despite tightening of spreads, investors continue to feel there is value to be found.

One note of caution though relates to the risk profile of RMBS investments, with at least one investor expressing concern that high household debt makes current pricing less attractive.

Many noted the fact that despite an increase in issuance in the past 12 months, most deals were over-subscribed and there was a bit of concern about new investors having a potentially negative impact on pool quality.

There is also the view that the market being dominated by the large banks means there has to be a question mark over its long-term health as a decline in major bank issuance would leave little for investors to compete for.

IS THE MARKET BECOMING MORE OR LESS ATTRACTIVE TO YOU AS AN INVESTOR?

- THINKING OF NOT INVESTING IN IT - 4%
- GETTING LESS ATTRACTIVE - 12%
- IT'S OKAY - 36%
- CONTINUES TO BE ATTRACTIVE - 36%
- GETTING MORE ATTRACTIVE - 12%

"People are saying it's not attractive because bonds are tighter, but all bonds are tighter that's just the market."

"So demand for fixed income has increased by the virtue of this quantitive easing (QE) phenomena, and demand for RMBS has increased because by the fact that it was almost like the last high yielding, if you want to use the word 'high yielding' very loosely, investment grade type asset class left."

"Our views are that there are certain segments of the market that are attractive, we think that the senior lower rated tranches, the illiquidity premium associated with that is attractive."

"The senior investors are not back; they didn't come back post GFC; they're gone for good at this stage; but some investors who were there in the past have come back. I guess it's one thing that we're conscious of that we've been a consistent player through the ups and downs of the market pre GFC and post GFC and it's relatively less attractive than it was and it's still not unattractive. It's more cautiously attractive I guess."

"I think for us it was just the risk return kind of characteristics of the trade. We are looking at a Triple-A rated amortising security ultimately, that's got a much more attractive pick up than a Triple-A rated government security of equivalent tenor and where the capital regime is such that, that works for us."

"That's a perception depending on how you manage money. When you look at RMBS as one of many asset classes in the fixed income spectrum, it's just the relative value of opinion."

"When you look at RMBS in its own world compared to bank debt, senior sub, corporate, it actually hasn't outperformed in its own right."

"I think it's very attractive. It's cheap compared to other assets. It's getting well supported as a result."

PERCEIVED STRENGTHS

The dominant strengths of the Australian securitisation market are the performance of the collateral and the relative value compared to other asset classes.

Investors attribute collateral quality to strong underwriting and favourable market conditions and a tendency to create higher quality pools. They cite the Australian 'love of property' as a primary incentive for Australians to diligently service their loans despite high debt to income ratios.

The sustained performance of Australian RMBS through difficult cycles gives them confidence and they feel this makes the Australian market attractive to global investors as well. There were a couple of comments about the absence of defaults in the Australian market for over 20 years and it's that track record which they feel sets Australian RMBS apart from other regions.

While not as many chose the regulatory environment and the ease of dealing with issuers as strengths there were plenty who did.

The combination of these factors leads to the generally held view that Australia offers quality RMBS investments in a stable environment where it's easy to do business.

TOP 5 STRENGTHS OF AUSTRALIAN RMBS

"We've had 20 years where nobody has defaulted in the RMBS market, so that speaks for itself."

"Funnily enough, you don't see a lot of apartments in RMBS pools because issuers know that it's not a favoured part of the asset class."

"I think it offers enormous value relative to the low risk that it has. I don't think that low risk is fully appreciated by the market. I still think that, for some reason RMBS has a very negative connotation which dates back a decade now. I don't think people realise that no RMBS has ever lost any money in Australia."

"I think it's a pretty well-developed product now and I think people understand it. I know that certainly the improved uniformity of reporting has helped participants to evaluate the price relativities and so forth a bit more readily, which was always a difficulty in the past."

"The RBA actually even made a comment that the best loans get securitised and that's why they participate. So when you look at what comes to the market, they're actually very, very high quality. So underwriting in the major banks is fine, when you look at regionals it's fine, when you get to the non-banks there's a dispersion of quality there."

"Securitisation in Australia is very strong now, but it goes in waves, so it would be naïve to think it will be strong like this forever. So if you're clearing transactions easily and you're scaling investors, and you see your investment getting scaled then I think that is a strong market."

CHALLENGES

The lack of an active and viable secondary market is the standout challenge investors perceive in the Australian securitisation market. Investors have quite different views of the reason for this lack of a secondary market although many made the observation that everyone they talk to claims to be a buy and hold investor.

Interestingly, global investors also cited the lack of a secondary market as a primary issue for Australia.

Certainly, the demand for RMBS has led to investors being determined to hold on to what they have in fear that trading may mean there will be nothing to replace their investment with in the RMBS space.

A similar challenge that didn't emerge via the online study was the lack of ABS stock which is believed to be due to a combination of banks preferring to hold their non-mortgage or consumer assets on balance sheets and the relatively small size of the deals that are available.

Investors like to constantly refine their portfolio particularly when they are seeking out-performance and they find the lack of opportunity to trade more actively or frequently a hindrance.

The health of the housing market was also cited as a key challenge particularly amongst investors who don't believe the current strong market conditions (high employment, low interest rates, strong economy) are guaranteed to continue. Investors do not believe interest rates are likely to rise to any great degree but they are concerned that a diminishing of the quality of underwriting could threaten the quality of the underlying collateral.

TOP 5 CHALLENGES FOR AUSTRALIAN RMBS

AVAILABILITY OF STOCK | DATA & ANALYTICS | BIDDING PROCESS | ECONOMIC OUTLOOK / HOUSING MARKET | LACK OF SECONDARY MARKET

"I think one of the biggest challenges as an investor, is having a diverse portfolio because you have the same issuers over and over again. We'd like to see more diversity in terms of asset classes. So much of it is focused on residential market lending and it would be good to see more credit card deals, more even CMBS, personal loans, some other asset classes, all those certainly."

"You like to see the market have a little more depth to it, obviously."

"Also fixed on the challenges; one making sure the originators keep their credit standards; they don't just don't try to grow too quickly; that's a critical thing. Another thing that you've got to be careful of is the time for when a new issue comes out to the time they price it. We can't allow that to contract, because at the moment sometimes they will allocate the volumes or the speed with which you get back to them saying that you'll take the deal. All that does is promote people who don't do any work. And then we'll start getting losses and so on and then the whole market will collapse and our business will fall away, not because we've something wrong but because there's too many people who have just not bothered to do the work."

"The competition is mostly local in that junior space, so there's still probably only half a dozen investors but the problem is those tranches are quite small so they tend to be allocated across one or two investors which can make it challenging to actually get hold of the supply."

THE SECONDARY MARKET CONUNDRUM

The reality is the secondary market for RMBS in Australia is not active at all yet there is incredibly strong desire for it. There is little conviction it will ever happen.

This conundrum in regard to the secondary market generates a range of opinions amongst investors with many claiming the majority of their peers are buy-to-hold themselves, effectively limiting supply.

With such high demand for RMBS there is also an underlying fear that selling unwanted tranches will leave them with capital that has no home as there are rarely deals waiting to be picked up. This has led to investors not selling on the secondary market unless there is a ready home for the funds once sold.

Investors also commonly raise concerns over the quality of data available for secondary market deals which in turn makes pricing difficult and creates caution. Pricing transparency appears to be the most significant issue limiting the reality of a healthy and active secondary market.

More than half of the investors claim 'better intermediary support' has the potential to improve the secondary market.

Realistically though, there are investors that claim there really is no secondary market because these securities have never been liquid and that is unlikely to change.

> **"Well the problem is just the lack of issuance. I mean we'd love to see more volume so that there's more money, there's more demand than supply, so that's pushing. I think what the problem is you get your money back, where do you put it? You can't reinvest it."**

> **"But it's never been the case, back in the heyday it was never heavily traded, it was never really liquid. I don't think it's ever been really liquid."**

> **"It's terrible. It's almost non-existent. It doesn't matter whether you're buying or selling. It's non-existent in both directions."**

> **"Very interesting during the ASF conference, a lot of the people in the market talking about lack of secondary opportunities would then turn around and say, "Yes but we're 'hold to maturity' investors", so they never sold. If that's the case, then they can't expect that they're going to have a secondary market if they are constantly holding to maturity and they don't reassess their position."**

> **"Perhaps there's not as much clarity around pricing secondary stuff as there could be."**

> **"Maybe the premium is good enough that people don't want to sell it on the secondary market because the spreads you're getting for those well-seasoned, sort of Triple A rated notes with short duration is actually pretty attractive."**

83% OF INVESTORS SAY THEY ARE ACTIVE IN THE SECONDARY MARKET.

FACTORS THAT MAY IMPACT WILLINGNESS TO INVEST

A range of factors were cited as potentially diminishing willingness to invest but on the whole these were factors based on market events that are largely unpredictable including the continued rising of household debt levels, geopolitical events and RMBS no longer retaining its value relative to other similar investments.

Competition is already having an impact amongst investors focusing on junior and mezzanine with some feeling that deals are not worth pursuing if their allocation falls below acceptable levels.

We asked about a range of factors that might impact willingness to invest in the online survey and captured the results shown in the figure below.

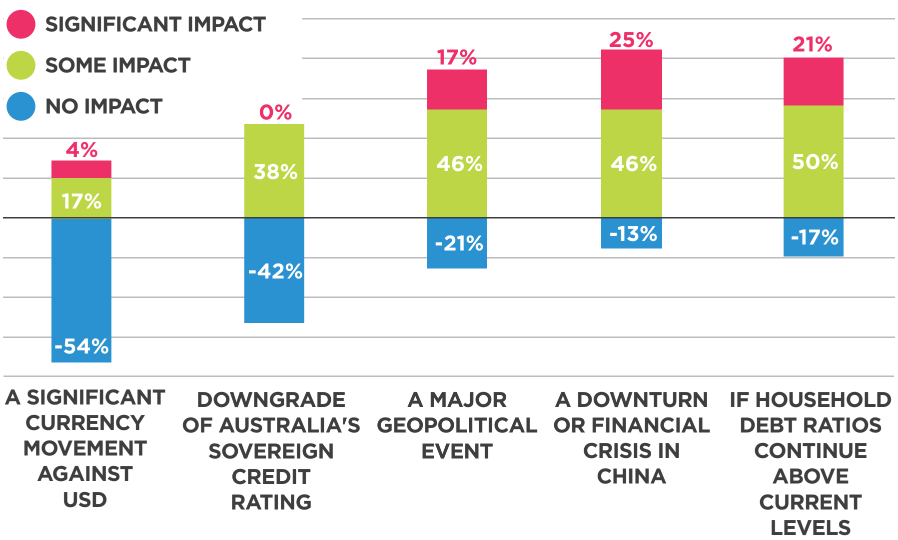
From the chart it is clear that investors feel household debt ratios, the China economy and a major geopolitical event could each have an impact on the local RMBS market. However, a relatively small number feel this impact will be significant.

In contrast, many investors believe significant currency movements against the USD or a downgrade in Australia's sovereign credit rating will have no impact at all.

The factors that might inhibit investment in a specific deal are different to those that might slow RMBS investment across the market.

Investors will resist investing in specific deals for a few key reasons, as shown in the figure at the bottom of the page.

IMPACT OF SPECIFIC EVENTS ON WILLINGNESS TO INVEST*



*Those who answered 'not sure' are not shown in this chart

FACTORS INHIBITING INVESTMENT IN SPECIFIC DEALS

> **"Residential mortgage lending has definitely improved, but I think in Australia it has been pretty well managed, there's a couple of things, the responsible lending standards and then APRA and the RBA and all the banks have been very co-ordinated, moved to rein in some of the excesses of the household lending market, I think that's what worked reasonably well, on the asset backed side, personal loans, credit cards also, stuff like that."**

> **"In the last 12 to 18 months certainly the pricing has dramatically changed."**

> **"I think this is an important thing universally across the Australian market - so we don't look for it per se because it's already there, but I think the absence of it would be a concern, would be the continuity of connections/risk shared by all parts of the value chain."**

> **'If it's a smallish deal when we think it is going to be well sought after, we won't even bother looking at it. We have a sit down and say what's the point of spending a lot of time on it; we'll get $3 million out of a $25 million of mezzanine debt."**

> **"What we saw in 2017 is a real dispersion of poor quality. Things that raised our eyebrows were concentration of IO lending and investor lending."**

> **"But the other clear thing is that we're all in the same boat; if it starts to sink we all go down with it. I think the risk that we run is that in benign economic conditions the originators push the envelope to credit quality down too far and we start giving credit to people who really shouldn't have it. And if that happens we'll start getting losses, and I'm not too sure how the market will handle losses in RMBS or ABS."**

VIEWS ON THE AUSTRALIAN MORTGAGE MARKET

Investors continue to be positive about the Australian mortgage market despite public noise about a housing market crash. Investors simply do not believe a crash is likely for a range of reasons including the quality of underwriting and the regulators efforts to sustain that quality, the favourable economic conditions and the continued use of LMI.

They are realistic about the slowing of the housing market and readily point to pockets that are currently affected including the Sydney and Melbourne apartment markets (and some mention Brisbane) and the sudden loss of value of properties in areas affected by the end of the mining boom.

Whichever way you look at it, investors are not expecting a major correction to housing prices and even with a correction they don't see ability to service loans being compromised. However, they did feel that less activity in the housing market could lead to less issuance.

"You need a massive spike in unemployment to crash the housing market, like we have $80 billion worth of infrastructure projects over the next few years that are going to create jobs."

"If you're not flipping properties and you're not refinancing and it's not driving prepayments, that means your existing bonds are not amortising as quickly, but then that means that there's a need to reissue new bonds, so the new supply could be constrained over the next 12 months, it might be a bit slow."

"Obviously, the personal debt level in Australia is extremely high. I think until one of the rating agencies reflects that against the sovereign rating, there's probably not going to be a lot of shift. The housing data in Australia seems to be a bit more comfortable now than when they were talking about the bursting of the bubble up until October last year."

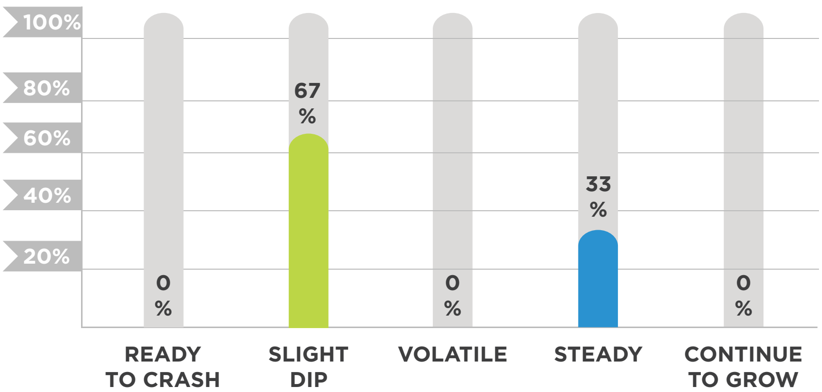
"The environment is quite different today and the lending criteria that even the non-conforming lenders have, is so much better than it was pre GFC."

"I don't imagine that will have a massive decline like we saw in the US and other parts of Europe sort of post crisis, but I do think we'll have more of a correction."

"Sydney goes down 5% Melbourne staggers a little bit and barely moves. We've got good economic conditions, interest rates aren't likely to rise dramatically and we've got population growth. So they give you a pretty strong fundamental suit of what's going to happen."

"Low interest rates really have driven the health of the housing sector, and I think interest rates can't rise with the level of debt that's there. Even if the RBA was hell bent on increasing them it's going to get to a point where it'll cause a problem, then we'll just have to back off because it's too much for the economy to handle."

DIRECTION OF PROPERTY PRICES NEXT 12 - 18 MONTHS



WHAT WOULD MAKE THE MARKET BETTER?

There's no doubt that a healthy, active secondary market and an increase to the volume and range of securitisation opportunities are the primary desires of local RMBS investors.

More activity across the major banks and a consistency with which they participate in the market is also highly desired. Currently they see banks coming in and out or rarely making an appearance at all.

Investors certainly feel that issuers could improve their quality of service to investors. Maintaining ongoing dialogue, providing consistent, high quality data particularly post-deal, better transparency of pricing in the secondary market and a fair approach to scaling are all things investors would like to occur consistently across the market.

"If the ASF was going to do anything that was really valuable it would be to collect data on arrears, losses, loss given default. That would be probably the most useful. That's the one thing that's really very hard to get any data on."

"BBSW (the bank bill swap rate) is fine, I mean that's the rate that banks are willing to fund out to you on a month or three months, that's okay with me."

"Date based calls are pretty favourable because then you've got more confidence in the duration of your bond, you're not reliant on the pre-payment behaviour of the borrower."

"The transparency from a number of the issuers would aid us and consensus… I think it's a well performing market now. I don't have any real issues; it's just some issuers I have issues with but I think it's … you can always find a bed for your bond."

"I think - it's probably an impossible dream - but I think, given our internal process, if we could have greater certainty at the outset about what we are looking at, that what we are looking at is not going to change significantly as the deal is marketed and upsized is something I think that would make it much easier for us."

FOR MORE INFORMATION

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