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Australian Business Securitisation Fund Review

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Summary

Background

The *Australian Business Securitisation Fund Act 2019* (the ABSF Act) established the Australian Business Securitisation Fund (ABSF) "*to increase the availability, and reduce the cost, of credit provided to small and medium enterprises (SMEs) by the Commonwealth investing in debt securities in accordance with this Act*".

Debt finance is often important for SMEs to run their operations and to fund growth, but access can be difficult and costly. Some types of lending to SMEs are well provided by the market, such as lending secured by residential or commercial property, but large gaps exist particularly in the provision of unsecured lending. As a result, the cost of such lending can be prohibitively high.

Issues in SME finance have been exacerbated by a shift among traditional SME lenders, such as banks, to focus more on residential rather than SME lending. Smaller bank and non-bank SME lenders have been increasing market share, but their ability to grow and compete is hampered in part by a lack of competitive wholesale funding options.

The ABSF is designed to improve lending market conditions for SMEs by facilitating the development of the securitisation market for SME lenders. By improving funding market conditions for SME lenders, the ABSF aims to pass on cost benefits to SMEs and expand their lending.

The SME securitisation market is relatively underdeveloped as traditional lenders to the SME sector have not needed to fund their SME lending in this way. The development of SME securitisation as a funding source is therefore important to enable non-bank lenders and smaller banks access to a more competitive cost of funds.

Securitisation is a cost-effective way for lenders, particularly smaller and non-bank lenders, to raise funds. However, banks and other investors typically require evidence of strong loan performance over multiple years, as well as sufficient scale, before they are willing to provide funding via securitisation transactions.

The SME securitisation market is on a path of development toward maturity. However, barriers exist to the development of the market, such as a lack of track record in lending and securitisation. This means SME lenders may be subject to a ratings cap from credit rating agencies which ultimately constrains the universe of investors that might consider a transaction. Further, the diversity of the SME lending market makes it more difficult and costly for potential investors and credit rating agencies to assess transactions based on their consistency and comparability.

The ABSF is administered by the Australian Office of Financial Management (AOFM). According to the ABSF investment mandate, the AOFM must prioritise investments in underdeveloped sectors of the SME securitisation market, assist the long-term development of the market, encourage investment in the SME securitisation market by the private sector, promote competition in the SME lending sector and invest in securities that do not wholly or predominantly relate to credit provided for financial assets or residential property.

The AOFM must also consider decision-making and risk and return criteria in the ABSF investment mandate, including the potential of the investment to affect other market participants, the rate of return on the investment and the ability of the ABSF to exit the market in the long term without causing significant market dysfunction.

To further guide ABSF investments, the AOFM has also published investment principles related to its market impact and risk management, including consideration of a proposed investment in terms of its sustainable impact and whether it is crowding in non-ABSF investment rather than crowding out.

ABSF Review

The ABSF Act requires Treasury to undertake a review of the ABSF Act as soon as practicable two years and five years after commencement of the ABSF Act to assess its effectiveness in meeting its objectives. From 20 December 2021 – 4 February 2022 Treasury sought written submissions and undertook targeted consultation with industry stakeholders, including SME lenders, banks, investors, industry groups and others.

Treasury received eight written submissions, seven non-confidential and one confidential. Treasury also held three roundtables with industry bodies and relevant parties, as well as several bilateral stakeholder meetings.

In line with the ABSF Act, the Government has made available $1 billion for ABSF investments with further instalments of $500 million to be made available on 1 July 2022 and 1 July 2023. To 18 March 2022, the ABSF has announced three investments, with details available on the AOFM website.

For much of 2020, ABSF activities were paused because of the impacts of the COVID-19 pandemic and the rollout of related economic support measures such as the Structured Finance Support Fund (SFSF), also administered by the AOFM. The SFSF and other economic support measures, such as the Reserve Bank of Australia's term funding facility and record low cash rate, as well as the SME Guarantee and SME Recovery Loan schemes, have had significant impact on the securitisation and lending markets, making it difficult to isolate the ABSF's impact.

Treasury notes that during consultation several stakeholders provided feedback on the SFSF, including on its ongoing role in the securitisation market. While the SFSF is outside the scope of this review, this feedback will be considered in any future Government decisions related to the SFSF.

Despite these complicating factors, Treasury's industry consultation broadly found that the ABSF is making progress toward meeting its objectives. Further, there is broad industry support for the continuation of the ABSF based on its progress in facilitating market development.

In particular, industry participants are supportive of the ABSF's encouragement of standardised data reporting and of the ABSF moving into segments of the market that have less funding support from banks and other investors.

Some market participants expressed concerns around crowding out of investment and perceptions that funding is provided at a subsidised rate. Treasury considers the processes the AOFM has in place are appropriate to minimise the risk of these adverse outcomes. Some market participants also expressed a desire for more transparent communication from the AOFM regarding ABSF investments. Treasury notes that the AOFM's new ABSF investment proposal process should help to address these concerns.

Going forward, assessing the impact of the ABSF based on the objectives in the ABSF Act – increasing access and reducing cost of SME finance – will remain difficult due to an abundance of factors that can influence these outcomes. While these outcomes should remain the overall objective of the ABSF Act, the development of the SME securitisation market is the means by which they will be achieved.

Therefore, securitisation market outcomes, such as the emergence of a public term market with frequent issuance and the achievement of triple-A credit ratings for SME lenders, should be the ultimate aim of the ABSF over the medium to longer term and a primary focus of the five-year review.

Securitisation market development

Direct effects

The ABSF aims to develop the SME securitisation market by investing in transactions backed by SME collateral types that to date have been uncommon in the securitisation market. The ABSF also seeks to invest in parts of securitisation structures where other investors are rare or cannot be found.

Consistent with the ABSF investment mandate and investment principles, the AOFM aims to sustainably achieve these outcomes over the longer term by crowding in investors to SME securitisation structures. By doing this, the ABSF can have a multiplier effect in the volume of overall investment it facilitates.

In Treasury's industry consultation, participants noted that investor demand for securitisation warehouses backed by SME collateral has been growing. While the high risk-adjusted returns for the asset class was consistently identified as the key driver for this demand, industry participants are confident that support will remain even as returns on other fixed-interest asset classes potentially rise over the short to medium term.

Even so, industry participants expressed the view that substantial gaps remain in parts of the market, particularly in the more niche areas of SME finance. This suggests the industry would benefit from a further crowding in of investors.

Two of the three lenders which have been approved for ABSF investment – Judo Bank and Shift – stated in submissions that ABSF investments have helped to crowd in investors. Specifically, for Judo ABSF investment *"provided meaningful support in onboarding a global banking partner to provide warehouse funding"*.

Meanwhile for Shift the ABSF resulted in a *"new European investor as a funder that we may not have achieved otherwise"*.

Some lenders and other stakeholders that Treasury consulted held the view that there is no problem finding capital to support SME lenders, expressing that they have been able to secure institutional funding arrangements without the support of the ABSF in recent months and years. However, this view was held by a minority.

Further, the ability of some lenders to attract the funding they require is not necessarily evidence that the funding market for SME lenders is mature. Most SME lenders agreed that competition for funding is not yet sufficient to materially impact overall cost of funds even in some asset classes that are relatively well catered for. Feedback indicated that the cost of funds in more niche asset classes also remains at levels that cannot be justified by the associated risk.

These comments are not unexpected given the early stage of the ABSF's implementation and support a view that the SME securitisation market requires more investors to provide competitive pressure on funding rates.

Some investors raised concerns around potential crowding out of transactions in which they might otherwise have invested. A key part of the ABSF investment mandate is the consideration of whether the investment is encouraging private sector investment. As such, crowding out private investors would be contrary to the aims of the ABSF Act. To mitigate this risk, the AOFM has in place policies to test whether an ABSF investment will be incremental.

It is possible that some investors might have considered participating in investments that the ABSF has made. However, given the relatively small volume of ABSF funds that has been invested to date, and the relatively small volume of the ABSF in the context of the broader market, the possibility of ABSF investments having a material crowding out effect are likely to be limited at this time.

The development of a public term securitisation market was stated as an ideal end goal for the ABSF by multiple stakeholders. To date, there has been just one public securitisation transaction backed by SME loans in the Australian market. This deal, executed by Prospa in September 2021, was subject to a ratings cap.

Market participants also suggested that public deals may be where ABSF investments are most needed to fill gaps in the securitisation structure. Stakeholders noted the example of the AOFM's involvement in public term deals through the SFSF, where it provided a bid but exited if the transaction gained enough support from other investors, as a template for how the ABSF could support the public SME securitisation market as it emerges.

Indirect effects

Along with the direct market impacts expected from ABSF investment, Government investment can potentially have a greater impact on the market via indirect means.

A key benefit of the ABSF recognised by most lenders – including many that have not received ABSF investment – is the focus Government involvement has brought to the SME lending sector. This signalling effect was often acknowledged in conjunction with the Government's broader package of support programs for SMEs rolled out during the COVID-19 pandemic.

Stakeholder feedback highlighted that the establishment of the ABSF provided a signal to the financial services industry that the Government was strongly committed to the establishment of the SME loans-backed securitisation market, thereby enhancing access for SME lenders to a broader range of funding sources. Further, the establishment of the ABSF and wide industry engagement has drawn the market's attention to issues in the sector, such as the financing gap and lack of institutional funding support for SME lenders.

This increased focus on the SME sector helps to crowd in investors and potentially assists with developing the long-term sustainability of the sector.

Another key development for the SME securitisation market being encouraged by ABSF investment is the uptake by SME lenders of a standardised data reporting template.

The comparability, consistency and availability of residential mortgage data is one reason for the strength of the Australian residential mortgage-backed securities market. It allows not only for investors to assess the attributes of loan pools more easily but also for credit rating agencies to assess the creditworthiness of newer lenders based on the historical record of similar lending. Until recently, no such consistent reporting standard has existed for SME loans.

An SME data reporting template has been developed by industry in conjunction with the Australian Securitisation Forum (ASF) and with input from the AOFM. The AOFM requires ABSF proponents to commit to reporting in line with the standardised data template. By encouraging the industry to use the template, the ABSF can potentially have a much wider impact than by just investing the funds available to it.

The ASF's written submission says the template *"is seen as critical so that transparency and confidence in data capture and reporting will build confidence in SME receivables portfolios amongst institutional investors and credit rating agencies*".

Meanwhile, the Productivity Commission notes in its submission that given there is currently a glut of capital in global markets, the ABSF can best develop the SME securitisation market by addressing market imperfections such as a lack of information. In the Productivity Commission's view, encouraging the standardised reporting of data is one way to directly address this.

Treasury found broad industry support for standardised data reporting among lenders. In consultation, feedback from lenders, including some which have not received ABSF investment, was that the focus on data reporting is among the most significant benefits of the ABSF and eventually could assist with removing ratings caps and expanding the product base for SME securitisation.

Shift, which has implemented the new data reporting template, says in its written submission that the template has streamlined its process of reporting data to investors and rating agencies. Further, the submission states: *"Assuming most issuers take up standardised reporting, it will have a considerable impact on the SME securitisation market, giving investors more confidence in understanding the non-homogenous receivables of the sector."*

A minority of lenders Treasury consulted expressed that it should not be the role of the Government to set reporting standards. This was based on the view that the market will eventually coalesce around data reporting requirements as lenders with good data reporting standards are rewarded by investors.

The AOFM advises Treasury that considerations of this nature were behind its encouragement of the ASF to convene a working group of market participants to agree upon a standard, rather than seeking to set one itself. Since its publication, the AOFM has sought to encourage adoption of the template by lenders which have been successful in receiving ABSF investment, to assist the data reporting template in achieving critical mass.

Some lenders, while in favour of standardised reporting, noted there is potentially significant cost to a lender in implementing the data reporting template. The AOFM asks ABSF investment proponents to give an estimate of this cost when submitting a proposal. The AOFM considers offsetting the costs of implementation to currently provide the strongest case to offer funding at below market rates.

Investors were generally favourable of the ABSF being used to encourage greater data reporting standards in the industry. They stressed that comparing SME lenders is difficult due to the wide variation in business and lending models. Investors will likely maintain their own data reporting requirements. However, the utility of the data reporting template, particularly the optionality of the fields and the potential to drive consistency in the industry, was acknowledged.

Meanwhile, banks and other stakeholders that participated in the consultation also see the data reporting template as a positive development, recognising the potential to expedite the removal of ratings caps on the sector and achieve triple-A ratings, as well as the benefits of standardisation for new investors in the sector, particularly those from offshore.

It may be possible for the ABSF to encourage further market developments outside of the transactions it supports, as it has with the standardised data reporting template. One lender that Treasury consulted said that increasing investors' understanding of underlying borrowers in transactions is the next challenge, which if overcome could help investors to better understand the risk of a transaction.

Conclusion

The combination of direct and indirect effects of ABSF investment on the SME securitisation market has the potential to accelerate the development of the market and eventually contribute to better funding outcomes for SME lenders.

While some market participants see little need for Government intervention in the funding of SME lenders, these views were held by a minority. Further, most stakeholders have the view that significant gaps remain in the funding market for SME lenders and that lending in those products remains either scarce or expensive.

Overall, while noting that the concerns expressed by industry participants should continue to be considered in the assessment of ABSF proposals, feedback including formal submissions generally supports that ABSF investment has been successful in crowding in investment to SME securitisation structures.

ABSF investment has also been successful in bringing greater attention to the sector, and the encouragement of standardised data reporting has the potential to create outcomes for SME securitisation far greater than would be possible through distribution of the ABSF funds alone.

Feedback also suggests that much more investment is required to achieve competitive funding rates and eventually to close the SME funding gap. It is therefore likely that the ABSF can continue to play a role in developing the SME securitisation market via the transactions it supports as well as by indirect means.

As such, Treasury recommends that the AOFM continue to implement the ABSF with an emphasis on underserved parts of the SME funding market and with an end point of broad term securitisation market access for SME lenders in mind.

ABSF investments – whether in warehouse or public term deals – should continue to consider the contribution investment will make to development of the overall market while balancing the potential for investment to favour the recipient over its competitors.

To achieve a broad public SME securitisation market, it is also likely that the sector's track record and reporting will need to be sufficient for ratings caps to be removed by credit ratings agencies. To the extent that standardised data reporting helps to expedite this process, the ABSF should continue to encourage its use by proponents.

The AOFM should remain open to engaging with the industry and supporting market developments outside of transactions it directly supports through the ABSF. However, like the data reporting template, it likely is more appropriate and will have more chance of success if such developments are driven by industry, with a view to the ABSF playing a supporting role.

Access and cost of SME finance

The objectives of the ABSF Act are to increase access and reduce cost of finance for SMEs. Most industry participants that Treasury consulted considered that it is too early in the ABSF's implementation to discern whether it is achieving these objectives, particularly given the scale of the industry and the relatively small volume of funds so far deployed.

The impact of the pandemic, as well as the various Government responses, are further confounding factors in assessing the ABSF's effectiveness in achieving the objectives of the ABSF Act.

The Productivity Commission, which in its 2021 report, *Small business access to finance: The evolving lending market*, identified unsecured loans of more than $250,000 as being particularly difficult and expensive for SMEs to obtain[1], made the following comment in its written submission to the ABSF review:

"The pandemic and resulting shocks may have slowed the development of the SME credit market; while overall lending to SMEs remained stable (RBA 2021), lenders informed the Commission that unsecured loans of up to $500,000 – which were available prior to the pandemic – are harder to obtain now… a number of other government initiatives have impacted interest rates and credit availability over recent years: the Structured Finance Support Fund (SFSF), the RBA's historically low cash rate, and the SME loan guarantee scheme."

1 Productivity Commission, *Small business access to finance: The evolving lending market* research paper, available at: Small business access to finance: The evolving lending market – Commission Research Paper (pc.gov.au)

Despite these factors, most stakeholders see the ABSF as being on the right trajectory to contribute to the SME lending industry's provision of greater access and lower cost finance. Stakeholders considered that over coming years as the SME securitisation market continues to develop, the benefits of lower funding costs should start to become evident in lending rates.

While the impact on lending rates may not currently be discernible, the two recipients of ABSF investment that made written submissions stated that it has allowed for the expansion of their funding and therefore supported their provision of lending to SMEs.

Judo Bank, which was the first recipient of ABSF funds, provides an example of how the funding can lead to greater outcomes for both the lender and SMEs: *"Following the execution of the ABSF funded warehouse, Judo has established a SME self-securitisation, providing access to the term funding facility. It has also achieved an investment grade credit rating. These milestones have facilitated greater funding diversity and capacity, further enhancing the Bank's ability to provide lending to SMEs."*

Aside from the minority of stakeholders which expressed doubts on the overall need for the ABSF, market participants generally agree that the ABSF can have a positive impact in developing the securitisation market for SME lenders and eventually lead to more capital being available in the sector. Competition among investors theoretically should then push down the lenders' cost of funds and allow for the pass-through of cheaper funding to SMEs.

However, this development cannot be achieved quickly if it is to be sustainable and allow for the eventual exit of the ABSF from the market. In line with the ABSF investment mandate requirement to promote competition in SME lending, the AOFM has been explicit in its communication to market participants that it is wary of providing funding which rapidly develops a specific lender to the detriment of its competitors.

As such, rather than distributing ABSF investment based on a lender's need for funding or overall cost of funds, the focus of ABSF investment criteria is on other factors such as the crowding in of other investors.

Some market participants have the perception that the ABSF is seeking to achieve its objectives by providing funding to lenders at a discount to market rates. The ABSF investment mandate does not prohibit investment at a rate of return below the market rate if it can be justified as reasonably required to satisfy other ABSF investment strategies and policies.

However, the AOFM's policy is for ABSF investments to begin with a rate of return at market rate. A subsidy can then be considered to account for the costs of a lender implementing the standardised data reporting template. The AOFM may provide subsidy to defray other transition costs in future, particularly where there are likely to be broader market development benefits from doing so.

Market rates are based on consultation with the ABSF investment manager and augmented with market intelligence gained via the positions AOFM holds or has sold through the SFSF. Shift, in its written submission, is of the view that the ABSF warehouse investment it received is at market rate.

Some market participants said the ABSF investments announced to date have been for lending types that are already well provided in the market, rather than in lending types where access is difficult and costs high. These market participants expressed a desire for the AOFM to focus more on underserved parts of the market.

In its written submission, the ASF raised this concern, stating: *"Not all outcomes are meeting the guiding principles and objectives of the ABSF. Specifically, ABSF investments to date have been deployed to those lenders who, due to their size and scale, could arguably already source funding from the market but rather have benefitted from more favourable pricing from ABSF investment."*

Conversely, the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) says in its written submission: *"While there has only been a limited number of successful applications to date, it* *is encouraging that ABSF participants are notably some of the new and emerging institutions with innovative and responsive products aimed at better meeting SME financing needs."*

To avoid market distortions, the AOFM's strategy for ABSF investment was initially to begin investing in parts of the market backed by collateral that is more secured, and thus in close proximity to the collateral sitting behind existing, developed securitisation markets. Moreover, to the extent that its initial investment distorted the competitive landscape, the risk of causing lasting damage to fragile, below scale lenders operating in close proximity was considered remote.

However, the AOFM has more recently communicated to the market that its SFSF investments, which included several lenders in underdeveloped segments, have necessitated an acceleration of ABSF investment in these parts of the market so as to reduce any distortion to the competitive landscape created by SFSF investments in this segment of the market.

The AOFM has communicated to Treasury that its focus is on underdeveloped sectors such as unsecured and working capital finance, as well as in more niche areas of secured finance. However, not all SME asset types will be suitable for securitisation structures.

Conclusion

The overarching objectives of the ABSF Act – increasing access and lowering cost of SME finance – should remain a focus in the implementation of the ABSF. However, due to the abundance of factors that influence lending rates and provision, assessing the impact of the ABSF according to these objectives will likely always be difficult.

Some stakeholders, including the ASBFEO in its written submission, suggested the implementation of targets to measure the performance of the ABSF in the five-year review.

It may be possible to set targets in terms of deployment of funds or achievement of the objectives of the ABSF Act. However, doing so also carries risks, such as incentivising the deployment of funding at below market rate which, as outlined above, potentially would work against the sustainable development of the SME securitisation market.

The means by which the objectives of the ABSF Act are achieved should continue to be through sustainable development of the SME securitisation market rather than by wide provision of subsidised funding in underdeveloped asset classes.

A public securitisation market with frequent issuance from a variety of lenders backed by a range of SME collateral is the end point that many stakeholders identified during consultation and as such this is likely a more appropriate measure of success for the ABSF than the provision or cost of SME loans.

Mandate and settings

Treasury consulted with industry on whether the legislative settings and investment mandate of the ABSF Act remain appropriate for the ABSF to achieve the objectives of the ABSF Act. Treasury also asked industry participants whether the ABSF investment principles established by the AOFM to guide its investments are appropriate and being abided by.

Broadly, market participants either had no comments or were supportive of the settings in place. Some industry participants, including the ASF and AFIA in written submissions, raised the prospect of providing the AOFM with more resources to help guide ABSF investment decisions.

A minority of stakeholders also raised concerns around the independence of the ABSF's appointed counterparties. AFIA's written submission states that *"additional resources would assist in managing or avoiding the potential conflicts of interest some members perceived existed with the use of market participants as expert advisers"*.

Treasury notes there is a risk of perceived conflict of interest. However, in practice the AOFM has policies and procedures in place to manage risks related to the outsourcing of some ABSF functions. Further, the relationship the ABSF has with its contractors tends to be either administrative or advisory, with all final decisions on investments made by the AOFM.

The most common reflection from lenders more broadly on the processes of the ABSF was that they are eager to have greater communication from the AOFM on why investments may or may not meet ABSF investment criteria as well as a simplified application process. Most stakeholders that shared these views acknowledged however that the AOFM's new process for receiving proposals would help achieve both.

The new process, announced in November 2021, allows for proposals to be received on a rolling basis rather than through time-limited investment rounds. This allows for greater flexibility for the proponent in the application process and also the AOFM in giving feedback on whether and why a proposal is likely or not to succeed in advance of the application being made.

The AOFM has informed Treasury it will continue to communicate with the market in relation to the ABSF, including through industry forums when appropriate.

Conclusion

The majority of stakeholders Treasury consulted in the ABSF review were supportive of the ABSF and its potential to foster development of the SME securitisation market, and eventually achieve the objectives of the ABSF Act.

Overall, based on stakeholder feedback, Treasury considers that the settings and investment mandate of the ABSF Act, as well as the ABSF investment principles, remain appropriate. Specifically, the AOFM's new process for receiving investment proposals assuages some concerns around the investment process and allows for greater levels of communication between the AOFM and investment proponents.