TREASURY EXECUTIVE MINUTE

10/2632

Minute No. TBA

18 October 2010

Parliamentary Secretary to the Treasurer cc: Deputy Prime Minister and Treasurer
Assistant Treasurer and Minister for Financial Services and Superannuation

MEETING WITH AUSTRALIAN SECURITISATION FORUM (ASF)

Timing: You are meeting with the ASF on Wednesday 20 October 2010 at 12 pm.

Recommendation/Issue:

- That you note this briefing on the outlook for the securitisation market as well as the funding and competition issues relevant to securitisation markets.

Noted Signature: 20/10/2010

KEY POINTS

- You are meeting with the ASF, an industry body that represents the interests of issuers, arrangers, and investors in securitisation markets (Attachment A refers).
- The securitisation market remains dislocated due to the fallout from the global financial crisis, ongoing uncertainty in international credit markets, and uncertainty regarding regulatory changes governing securitisation and Basel III liquid asset rules (Attachment B refers).
- The Government has committed to invest up to $16 billion in residential mortgage-backed securities (RMBS). This policy is designed to provide cost effective wholesale funding for smaller lenders, enabling them to compete with the major banks in the mortgage market.
- The Australian Office of Financial Management (AOFM) has approximately $4.8 billion of funds under its existing mandate. These funds are expected to be invested in the next three to nine months (Attachment C refers).
- Public pressure is mounting to extend the AOFM initiative:
  - The press reports that the regional banks have called for the funds allocated to the AOFM RMBS mandate to be increased (Attachment D refers).
  - The ASF has publicly called for the widening of the AOFM mandate to permit it to invest in the subordinated tranches of RMBS. These B-rated tranches are more risky than the AAA-rated tranches the AOFM is currently permitted to invest in, raising the prospect that the Government may suffer capital losses should it adopt this suggestion.
  - Previously, some members of the ASF have called for the AOFM to purchase short term asset-backed commercial paper to reduce the cost of warehouse financing.

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ATTACHMENT A: MEETING PARTICIPANTS

- The ASF is a broadly based professional forum through which participants in the Australian securitisation markets can advocate their common interests on important legal, regulatory, accounting and market practice issues.

Sub-paragraph 22(1)(a)(ii)
(ie not relevant to request)

ATTACHMENT B: SECURITISATION MARKETS

Securitisation

- Securitisation is a source of funding whereby illiquid assets are aggregated into a pool and transferred to a special purpose vehicle (usually a trust), which issues tradeable securities.

- Securitisation employs credit enhancements so that unrated or lower-rated institutions can issue highly rated securities.

- Securitisation is a form of non-recourse borrowing. Investors in securitisations have recourse to the assets transferred into the special purpose vehicle, but not the company that transferred the assets into the special purpose vehicle.

Competitive impact of securitisation markets

- Securitisation was historically an important driver of competition in Australia's mortgage market. It allowed unrated or lower-rated lenders to issue AAA-rated debt instruments, providing them with a large and relatively inexpensive source of funding that enabled them to compete effectively with the major banks.
  - In particular, the growth in securitisation markets was a key factor driving the reduction in banks' interest margins from as high as around 4 per cent in the early 1990s to around 2 per cent in 2007.

- The rising defaults on subprime mortgages in the US contributed to the global financial crisis. Investment banks had repacked the subordinated tranches of subprime RMBS into collateralised debt obligations (CDO) and the ratings agencies assigned these securities a AAA-rating, despite the questionable underlying collateral. Investors underestimated the risk of these securities and suffered heavy losses on supposedly safe securities. As a result, investors lost confidence in the broader securitisation market and, ultimately, the interbank market.

- Following the onset of the global financial crisis, issuance of Australian RMBS fell from a quarterly average of $17.5 billion in 2006-07 to just $2.5 billion over the following two years. This occurred despite no prime AAA-rated, Australian RMBS suffering any credit losses. With smaller lenders no longer able to access securitisation markets, their ability to compete with the major banks has diminished, contributing to a loss of market share from smaller lenders to the major banks.
  - Non-ADI lenders were most affected by this development as they could not draw upon deposits to supplement their funding needs. Non-ADI lenders' market share fell from around 13 per cent in 2007 to less than 3 per cent currently.

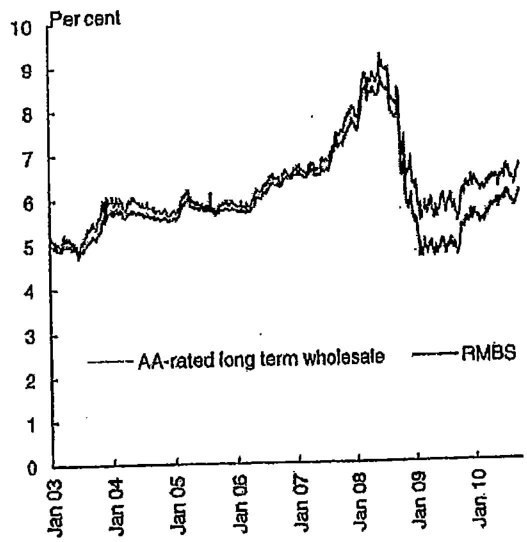
- Given the historic importance of securitisation markets in supporting competition from smaller lenders, the recovery of these markets is thought to be a key mechanism for restoring the competitive dynamics of the mortgage market. For this reason, the Government decided to invest up to $16 billion in RMBS to support competition in the mortgage lending market, of which approximately $4.8 billion is yet to be invested.

Funding with securitisation

- Prior to the GFC, securitisation was an important source of funding for smaller ADIs and non-ADI lenders. In January 2007, securitisation comprised 3 per cent of the major banks' funding, 36 per cent for other Australian banks, 25 per cent for the credit unions and building societies (CUBS), and 100 per cent for non-ADIs. In contrast, in February 2010, securitisation comprised 2.1 per cent of the major banks' funding, 28 per cent for other Australian banks, 17 per cent for the CUBs and 48 per cent for non-ADIs.

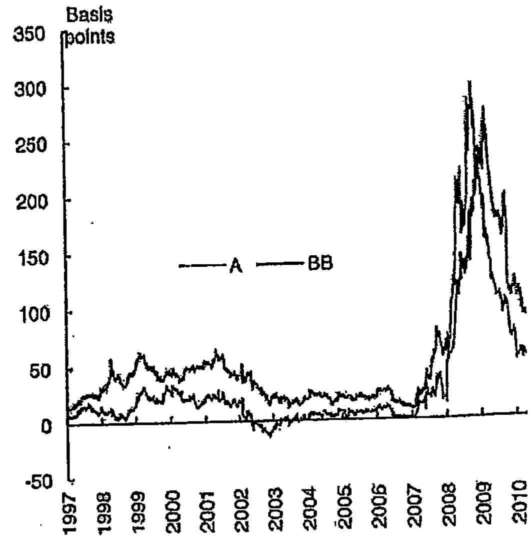
- Nevertheless, over the global financial crisis, securitisation became an important source of wholesale funding for beneficiaries of the AOFM investment program. This occurred because the differential between A and AA rated bonds increased, a factor that gained in importance after the Government guarantee of large deposits and wholesale funds was rescinded in March 2010.

Yields RMBS vs. long term funding



Source: RBA

Spreads on AA-rated corporate



Source: Reuters

- Securitisation remains an attractive source of funding for smaller lenders relative to alternatives. However, the market remains quantity constrained, which limits its effectiveness as a funding source.

Barriers impeding the RMBS market's recovery

- Regulatory risks as well as ongoing investor concerns about RMBS liquidity has resulted in persistent uncertainty over the viability of securitisation.

Liquidity risk

- Prime Australian RMBS have very low credit risk reflecting sound consumer credit legislation, conservative structuring of RMBS, robust underwriting standards, and undersupply in the housing market.

- The main risk of investing in RMBS is market liquidity risk. This is the risk that investors who need to sell their RMBS quickly will have to accept a price beneath that implied by interest rate and credit fundamentals. Many investors in Australian RMBS suffered losses due to market illiquidity during the crisis. Banks have closed their special investment vehicles (SIVs), which were previously a large component of demand for RMBS. They are unlikely to reopen these vehicles.

Regulatory risks

- There are a number of parallel regulatory reforms and changes to credit rating agency models in domestic and international fora which will impact on securitisation markets and may determine the long-term viability of securitisation as a funding source for Australian lenders.

- The Australian Securities and Investments Commission (ASIC) is introducing a risk-based 'skin-in-the-game' regulation, under which issuers will be obliged to retain exposure to their securitised assets proportional to the riskiness of the underlying collateral. This would result in up to 1.5 per cent of the subordinated tranche being retained by the issuer. This rule will make Australian securitisation compliant with the International Organization of Securities Commissions (IOSCO) recommendations and may in the future help Australian entities issue into American and European securitisation markets, where regulatory responses have gone further.

- Simultaneously, Australian Prudential Regulatory Authority (APRA) has clarified its rules regarding capital relief and retained exposure of issuers to their RMBS. Under this rule, if there is an insufficient transfer of credit risk from issuers to investors then issuers are not entitled to claim capital relief. This enables lenders to hold less capital, increasing their return on equity.

- The Basel Committee for Banking Supervision (BCBS) will shortly finalise its minimum global liquidity standard, which is based on banks holding a sufficient pool of high-quality liquid assets (government securities and a limited range of non-financial securities) to meet a 30-day stress scenario. This includes allowing alternative arrangements in the case of countries like Australia where the level of high-quality assets on issue are insufficient for banks to meet the global liquidity standard.

- Finally, Standards & Poors (S&P), a ratings agency, is changing its methodology concerning lenders mortgage insurers' (LMI) independence. LMIs suffered losses in the reinsurance market during the global financial crisis, which threatened their credit ratings, and reduced the value of their insurance products. In response to this uncertainty, new RMBS were issued with a greater level of subordination. This has meant that the AAA-rated tranches would not be downgraded in the event that a LMI's credit rating was reduced. Under S&P's new methodology, the level of subordination to achieve LMI independence would need to increase from about 7 per cent to about 13 per cent of the securitisation.

- The net effect of these changes on the RMBS market is unclear and this uncertainty itself is an impediment to the market's recovery.

ATTACHMENT C: GOVERNMENT INVESTMENT IN RMBS MARKETS

- In November 2009, the Government directed the AOFM to invest up to a further $8.246 billion in RMBS, in addition to the initial $8 billion committed in October and November 2008.
- This policy is designed to enable beneficiaries to maintain competitive interest rates, higher lending volumes and higher market shares than would otherwise be the case; ameliorate the pressure faced by some smaller lenders to withdraw from the market; support the retention of core securitisation market infrastructure during the global financial crisis; and, at the margin, support lending to small business.
  - As at 14 October 2010, this initiative has enabled 17 smaller mortgage lenders to raise almost $24.3 billion in total, to fund new mortgage loans.
  - The private sector's contribution to RMBS transactions supported by the Government increased from 20 per cent towards the end of 2008 to around 80 per cent in the March quarter 2010 and 70 per cent in the September quarter 2010.
  - Based on information provided by lenders to the AOFM, it is expected that around $1.3 billion of the funds raised under the current mandate is being lent to small business.
- Should market conditions improve sufficiently, the Government will assess whether the full $8 billion extension program is required.

Summary table - November 2008 to present			
Total RMBS issued	$m	31,388	100 per cent of total issued
AOFM sponsored	$m	24,255	77 per cent of total issued
Total AOFM purchased	$m	11,225	36 per cent of total issued
Total private purchased	$m	20,163	64 per cent of total issued
Private purchase of AOFM sponsored	$m	13,030	54 per cent of total sponsored
Number of deals	$m	43	
Number AOFM sponsored deals	No.	36	84 per cent of total deals
Number of supported lenders	No.	17	
Total fully private	$m	7,133	35 per cent of private funds invested
Average amount raised	$m	1,427	(in AOFM supported deals)
Amount invested in 2010	$m	3,472	
No of deals AOFM has invested in 2010	No.	16	
No of non-supported deals in 2010	No.	2	

Possibility of extension/broadening of RMBS initiative

- The Government has not made any announcements that it is considering extending the RMBS investment program.
  - Further support would complicate exit arrangements from the emergency actions taken during the crisis.
  - However, the ongoing regulatory uncertainty means that the market is likely to remain subdued until the outcomes of Basel III are announced in December 2010.
- Treasury considered broadening the AOFMs investment to permit it to invest in subordinated debt in October/November 2009. It did not recommend this policy to Government.

- Investing in subordinated debt would materially change the risk profile of the AOFM's portfolio, raising the prospect that the Commonwealth would suffer credit losses.
- High yields on subordinated debt are necessary to attract investors back to this segment. Purchasing subordinated debt at artificially low yields would impede the market's recovery.
- The AOFM can reduce the all-in cost of issuing RMBS without purchasing subordinated debt. It is currently doing so by purchasing tranches that have a long maturity at low yields. This facilitates a larger proportion of private sector investment in shorter tranches that have a lower market price.
- Some RMBS issuers have retained subordinated tranches on their balance sheet or entered into reciprocal arrangements to purchase one another's subordinated debt. APRA recently wrote to these ADIs stating that these arrangements should not qualify for capital relief. Treasury analysed this issue and found it to be a consistent application of prudential regulation.

• Treasury also examined purchasing short term asset-backed commercial paper (ABCP) in October/November 2009. It did not recommend this policy to Government

  - Due to the dislocation of the ABCP market, warehouse providers needed to fund their warehouses on their balance sheets. Much of the increase in cost in warehouse financing reflected this cost.
  - There are few barriers to entry in the warehouse finance market. Over the last 12 months, conditions in warehouse financing have improved and the size of facilities has increased.
  - Treasury did recommend lifting the per deal, low-doc loan cap the AOFM had imposed on deals it supported. This enabled a number of warehouses to reduce the concentration of low-doc loans in their warehouse facilities.

ATTACHEMENT D: PRESS EXTRACTS

Small lenders' securitisation bid, Eric Johnston *October 11, 2010*

REGIONAL banks and other small lenders have begun talks with the Gillard government seeking a third extension to the $16 billion residential mortgage-backed securitisation program, which forms a key funding source for the sector.

The smaller banks are hoping to capitalise on recent concerns raised by Treasurer Wayne Swan about the state of competition in the market, amid speculation that some of the bigger banks could push through an out-of-cycle interest rate rise.

The government has invested in $11.3 billion worth of low-risk mortgage securities and been a cornerstone investor in several major transactions in a bid to boost investor confidence after the securitisation market stalled in 2008.

Securitisations are loans - mostly in the form of mortgages - that have been bundled into bonds and then sold to investors. They represent an important source of funding for smaller lenders.

The initial $8 billion program, launched in late 2008, was extended by a further $8 billion in November last year.

It is understood that several lenders have approached Mr Swan over ongoing support for the program, particularly as a $3.4 billion standing facility to support securitisation issuance from five smaller operators is set to expire on December 15.

The government's funding arm, the Australian Office of Financial Management, has purchased about one-quarter of residential mortgage-backed security issuance this year and its holdings now represent about 15 per cent of the domestic market.

While there are signs that the mortgage-backed securities market is slowly improving, it is still relatively fragile, according to Australian Securitisation Forum chief executive Chris Dalton.

"There needs to be further support," Mr Dalton told BusinessDay.

Mr Dalton has called on the AOFM to also broaden its scope to invest in the so-called "B-class notes", or subordinated debt, which forms part of a securitisation issue. This will avoid crowding out the senior debt, where demand is becoming more robust.

Both Bank of Queensland and ME Bank have recently issued securitisations in excess of $1 billion.

Last week, Mr Swan said he was considering further measures to boost competition in the banking sector, adding that the existing investment program "had been very important to boost lending from smaller lenders, from credit unions and smaller banks".

"One of the sad consequences of the global financial crisis is that it did restrict competition in the banking sector; it did strengthen the big four. So we've been making investments in residential mortgage-backed securities to give the smaller lenders a hand."

Liberty Financial, one of Australia's first mortgage-backed securities issuers, this month entered the retail market with a term investment backed by a range of residential, commercial property, motor vehicle and equipment loans.

Regional banks seek securities extension, Eric Johnston, *October 11, 2010*

REGIONAL banks and other small lenders have begun talks with the Gillard government seeking a third extension to the $16 billion residential mortgage-backed securitisation program that forms a key funding support for the sector.

The smaller banks are hoping to capitalise on recent concerns raised by the Treasurer, Wayne Swan, about the state of competition in the market, amid speculation some of the bigger banks might try an out-of-cycle interest rate rise.

So far the federal government has invested $11.3 billion in low-risk mortgage securities and has been a cornerstone investor in several big transactions in a bid to boost investor confidence after the securitisation market stalled in late 2008.

Securitisations are loans - mostly in the form of mortgages - that have been bundled up into bonds and sold to investors. They are an important source of funding for smaller lenders.

The initial $8 billion program in late 2008 was extended by $8 billion last November.

It is understood several lenders have approached Mr Swan to continue the program, with a $3.4 billion standing facility to support securitisation issuance from five smaller operators due to expire on December 15.

The government's funding arm, the Australian Office of Financial Management, has bought about a quarter of residential mortgage-backed security issuance this year and its holdings represent about 15 per cent of the domestic market.

While there are signs the market for the securities is slowly improving, it is still fragile, says the Australian Securitisation Forum chief executive, Chris Dalton. "There needs to be further support," he said.

Mr Dalton also called on the Office of Financial Management to broaden its scope and invest in the so-called "B-class notes", or subordinated debt, which is part of a securitisation issue. This will avoid crowding out the senior debt where demand is becoming more robust.

The Bank of Queensland and ME Bank have recently made securitisation issues of more than $1 billion.

Small fry seek more AOFM money, *11 October 2010 6:58am*

Several small deposit taking entities approached the Treasurer, Wayne Swan, over an extension to the present program of investment by the Australian government in mortgage-backed securities, The Age reported.

Through the Australian Office of Financial Management the government has invited around $13 billion in support the home loan issuance of small lenders, some of them non bank lenders. Another $3 billion or so remains available for investment.

The Australian Securitisation Forum told the newspaper that it sought further support and called on the AOFM to also invest in subordinated debt of mortgage pools.