



Chris Dalton, Chief Executive Officer
Australian Securitisation Forum
3 Spring Street
SYDNEY NSW 2000
(t) 02 8243 3906
(m) 0403 584 600
(e) cdalton@securitisation.com.au

31 March 2014

The Chairman
Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

Dear Mr Murray

SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

Attached is the Australian Securitisation Forum's ("ASF") submission to the Financial System Inquiry on matters relevant to securitisation's role in the future of the Australian financial system. The submission is structured as follows:

- Executive Summary – sets out the ASF's key recommendations;
- Section A – provides an overview of the Australian securitisation market and its key challenges;
- Section B – sets out the role that securitisation can play in funding the Australian economy and future economic growth;
- Section C – sets out the contribution securitisation can make to a competitive financial system;
- Section D – sets out the ASF's views on how securitisation should be regulated; and
- Section E – reiterates the key recommendations.

The ASF is the industry body representing participants in Australia's securitisation and covered bond markets. Our members include financial institutions regulated by the Australian Prudential Regulation Authority ("APRA"), credit providers regulated by the Australian Securities and Investments Commission ("ASIC"), domestic fixed income investors, and arrangers, advisors and service providers to the securitisation and covered bond markets.

This submission was prepared by the ASF's Government & Industry Liaison sub-committee.

We would welcome an opportunity to discuss the matters arising in this submission.

Yours sincerely

CHRIS DALTON



Australian Securitisation Forum

SUBMISSION TO THE

AUSTRALIAN GOVERNMENT'S

FINANCIAL SYSTEM INQUIRY 2014

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Executive Summary

The ASF's submission to the Financial System Inquiry focuses on the importance and benefits that securitisation provides to the financial system and initiatives that the ASF believe will continue to build the market. Securitisation is an important funding tool for a wide range of financial institutions and helps to fund a wide range of asset classes, particularly lending to retail borrowers and small and medium sized enterprises. By adopting the recommendations noted below it is the ASF's belief that this will help to increase the capacity of financial institutions to lend to these sectors as well as other sectors critical to the growth of the Australian economy such as infrastructure financing whilst also fostering a stable and efficient financial system.

Our recommendations fall under three themes:

1. Regulation

- a. Amend the current APRA Prudential Standard for securitisation ("APS120") to increase the structural flexibility for Australian Deposit-taking Institution ("ADI") issuers to enable them to attract the deepest investor base domestically and offshore, and remove unnecessary restrictions on funding only transactions. Specifically, APS120 should:
 - i. allow master trusts;
 - ii. allow features that enhance the current stand-alone structures such as date based calls;
 - iii. abolish the '20% rule' that prohibits an issuer to hold more than 20% of any given securitisation notes; and
 - iv. afford capital relief proportionate to the amount of risk transferred (and added, if any); and
 - v. not increase risk weights for ADIs investing in securitisations notes.
- b. Regulation should be harmonised with offshore regulation, and should not extend into unregulated areas where there is effective industry self-regulation/market-imposed discipline.
- c. Regulation should minimise, as far as possible, the costs and uncertainty associated with holding and issuing securitisations, including use of warehouse facilities. This includes timely introduction of clear and consistently applied

regulation – especially prudential standards.

2. Liquidity

- a. Press through Australia's Group of Twenty ("G20") presidency reciprocity among central banks' repo frameworks. Specifically, to permit Australian securitisation notes and covered bonds denominated in the relevant local currency to be repo eligible at the US Federal Reserve, European Central Bank, and Bank of England. This would deepen international investor demand and reduce the liquidity premium presently charged by investors for Australian collateral not being repo eligible.
 - b. Provide APRA with a cost-benefit framework that gives rise to a re-interpretation of Basel III liquidity standards such that it reverses its decision not to grant Residential Mortgage Backed Securities ("RMBS") and Asset Backed Securities ("ABS") High Quality Liquid Assets ("HQLA") Level 2 status.
 - c. Maintain a mandate for the Australian Office of Financial Management ("AOFM") to invest in securitisation notes, particularly in the secondary market, so as to foster liquidity.
 - d. An optional exchange facility should be available, for a fee, to superannuation funds and Australian domiciled managed funds. The facility would be available during market disruptions (to be defined) to allow discounted RMBS and ABS (that satisfy the eligibility criteria of the Reserve Bank of Australia ("RBA")) to be exchanged for Commonwealth Government Securities ("CGS") of similar tenor. This would assist domestically based non-ADI investors to liquefy part of their portfolios when liquidity is needed whilst the secondary market is not functioning.
3. Implement measures that encourage increased allocation to fixed income by Australian investors and create a level playing field between fixed income and equity investments.

Section A – Overview of the Australian securitisation market

Key points

- Securitisation can provide a number of benefits to the Australian financial system
- However, the Global Financial Crisis (“GFC”) caused a retraction in securitisation volumes
- While the market is rebuilding more could be done to help the market grow further
- Key challenges include restoring the market’s reputation, managing regulatory change and expanding the investor base

Background

In 1997, the Wallis Inquiry recognised the growing importance of securitisation:

“Markets are increasingly challenging intermediaries for the provision of finance and the management of risk. Large corporations have had access to financial markets for some time, but developments in securitisation now allow markets to provide finance to retail borrowers. An increasing range of risks can be managed through an array of market based instruments, while the needs of savers are also increasingly being met through financial market products.”¹

Since that time, Australia’s securitisation capital markets have in fact evolved to provide efficient and competitive financing for a range of retail and commercial finance, most notably residential mortgage lending. In 1997, securitisation capital markets financed around 5%² of Australian residential mortgages. By mid-2007 this had increased to almost 25%² and supported a competitive mortgage market for a broad range of ADI and non-bank lenders. In offshore markets securitisation techniques finance a much broader range of activities including consumer and small and medium enterprise (“SME”) motor vehicle & equipment finance, financing of public utilities and infrastructure assets, corporate loans, student loans and credit cards.

The largest single event to shape Australia’s securitisation markets since 1997 has been the well-documented events of the GFC³. This event highlighted that in many international

¹ Page 138, Financial System Inquiry Final Report, March 1997

² RBA statistics

³ A useful summary of the GFC impact on Australian securitisation markets can be found in a speech “Wither Securitisation?” by Guy Debelle, Assistant Governor, RBA, 18 November 2007

markets securitisation had facilitated poor business and market practices. Australian securitisation markets were severely impacted by dislocations in offshore markets despite not bearing any of the hallmarks of North Atlantic markets' excess and misuse.

The prior Government's AOFM RMBS Investment Program between 2008 and 2013 supported a swift recovery of Australia's RMBS market. Vivally, it also preserved small and medium-sized mortgage lenders' resources (systems, brand, skills, etc.) who were more reliant on securitisation funding as a means to contest the mortgage market. At a banking system level, approximately 5% of ADI funding is sourced from securitisation but this proportion is greater for non-banks (~100%) and non-Major ADIs such as regional ADIs and mutuals (0-25%). This emphasises our subsequent evidence about the disproportionate importance of securitisation to those lenders contesting residential mortgage and other loan markets.

Since the GFC, international and domestic regulators have pursued an extensive range of regulation designed to improve practices, and restore investor confidence, in securitisation markets. The ASF and industry participants acknowledge the importance of these measures and continue to work closely with regulators to implement them.

Importance of Securitisation

Securitisation will be an important part of Australia's financial landscape in the future. The ASF submission highlights the important role of securitisation in the following key areas:

1. Securitisation technology is an important tool for transforming pools of relatively illiquid assets into more liquid investible securities, including residential mortgages and infrastructure assets;
2. Securitisation forms an essential funding source for smaller lenders, particularly non-ADI lenders, and therefore is important for competition; and
3. Securitisation efficiently generates high quality and safe securities, providing a key source of fixed income investment products suitable for superannuation and retirement income sectors as well as liquidity to the banking system (via the Committed Liquidity Facility ("CLF") provided by the RBA).

Key challenges

The key challenges for the securitisation industry in the near-medium term are:

1. Restore reputation as a safe and transparent investment

Post GFC, global securitisation markets continue to rebuild their somewhat tarnished image. Although Australian securitised product was relatively less affected, local and international industry and regulators continue to work toward this objective.

2. Regulatory change

Since the GFC in particular, securitisation markets continue to be subject to a broad range of direct and indirect regulation. While such measures are broadly welcomed by market participants to increase investor confidence, encourage appropriate risk management and financial stability, poorly designed and/or implemented regulations can intentionally or unintentionally reduce market efficiency, flexibility and innovation, ultimately to the detriment of the broader financial system and economy. In Australia, the Basel III liquidity standards, as implemented by APRA, RMBS is not eligible as HQLA Level 2. This limits the investment limits of ADIs for RMBS. In offshore jurisdictions, RMBS is eligible as HQLA. This encourages ADIs to hold RMBS in order to satisfy their Basel III liquidity requirements and is consistent with the fact that such RMBS is repo eligible for cash liquidity at the central banks.

3. Expanding the investor base

Notwithstanding pre-eminent AAA-rated creditworthiness, securitisation notes are less liquid in the secondary market relative to other securities. Accordingly, RMBS has benefited from measures to improve its liquidity through central bank liquidity facilities. Further steps to broaden the appeal and therefore investor base would be welcomed, especially for superannuation funds and annuity products that require income, credit worthiness and tenor, all of which are consistent with securitised product.

Section B – Securitisation’s role in funding the economy and future economic growth

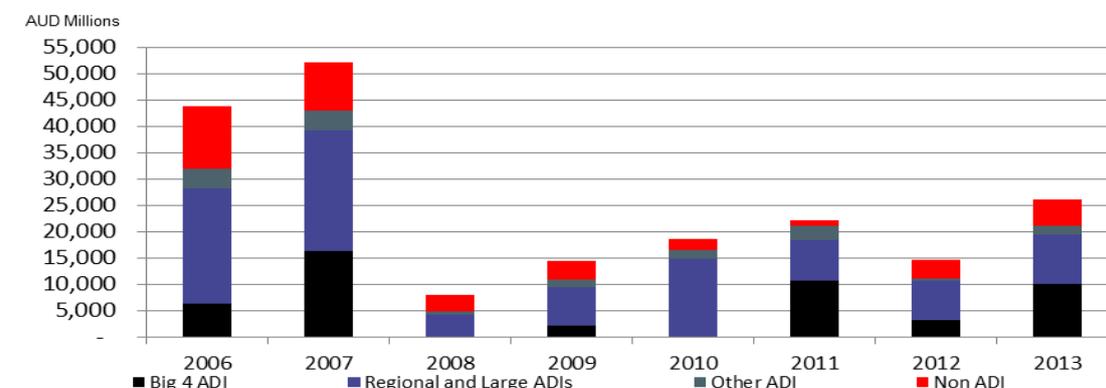
Key Points

- A well-functioning securitisation market is an effective mechanism for funding home ownership
- Securitisation can reduce reliance on the four major ADIs for funding the Australian economy and allows lenders to access a more diversified and stable investor base
- Offshore investors are interested in buying Australian securitisation and changes, in particular with respect to regulation, could increase demand
- Securitisation also has the potential to finance a wider array of assets beyond residential mortgages including lending to small and medium enterprises and infrastructure assets
- Adopting the recommendations in this submission will increase the capacity of the financial system to lend to key sectors and help generate economic growth

Financing home ownership

Demand for Australian property has remained high driven by a growing population and net migration. Home ownership is important to many Australians and is reflected in the high rate of home ownership. The availability of credit is paramount to funding the increased demand for property. While ADIs are the main providers of housing-loan finance to individuals in the Australian market, securitisation has allowed smaller non-ADI lenders to fund at similar levels to larger institutions, adding to competition and choice for home owners.

Chart 1 – Australian RMBS issuance by year by issuer type



Source: NAB and Bloomberg

Reducing reliance on major ADIs as the source of funding Australia

Securitisation reduces the reliance on the four major ADIs to fund part of Australia's economy by allowing lenders of all sizes and credit worthiness to access the capital markets and removes the constraints of market segmentation. It allows non-ADI mortgage providers who do not have access to retail deposits to participate in market segments such as the mortgage market. It has allowed regional ADIs and building societies to compete on a national basis by obtaining low cost funding to supplement their deposit bases and make – through diversity – their funding bases more resilient. These issuers can access the securitisation markets at a similar price level to wholesale funding of the major ADIs due to the pricing of RMBS and ABS notes reflecting the quality of the underlying assets in the pools as opposed to the issuer's rating. Consequently this allows non-investment grade lenders to access the capital markets with investment grade pricing, which in turn has a long term benefit of strengthening the institution's funding profile.

Access to a more diversified and stable funding base

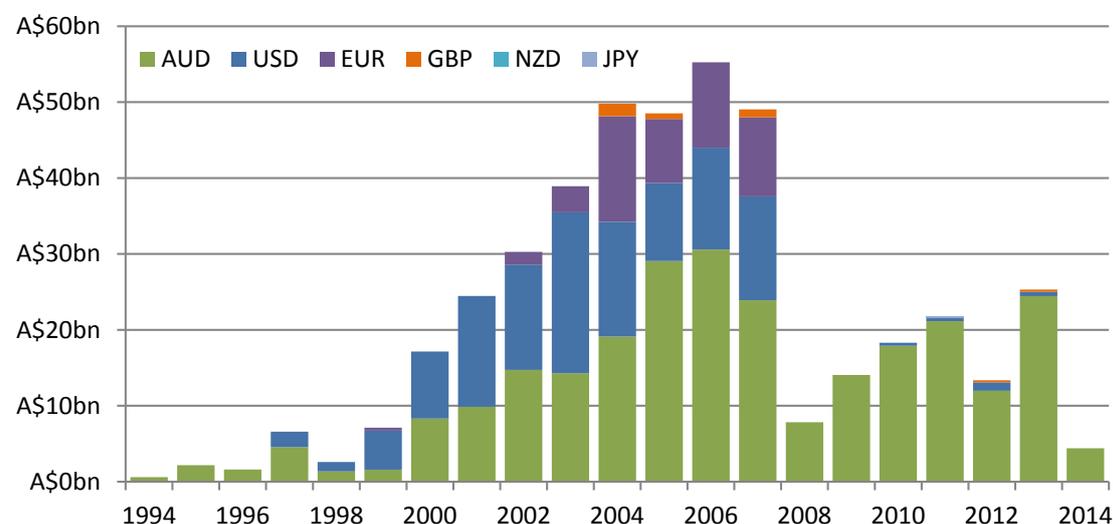
Securitisation has been used as a funding technique by ADIs and non-ADI lenders, providing them with access to a broader debt market and the ability to efficiently recycle credit. Securitisation allows ADIs to issue secured debt, as an alternative to unsecured wholesale funding, and so access a broader pool of investors and generate potential capital and funding benefits. This frees up ADIs' balance sheets to support other borrowers who are unable to access the capital markets, particularly small business.

Access to offshore investors

Pre-crisis, offshore investor appetite for Australian RMBS was a significant factor contributing to the growth of the securitisation market and the contraction in issuance spreads over time. As offshore demand increased, spreads were driven down by the forces of supply and demand. In addition, the emergence of offshore investors allowed greater volumes of RMBS to be issued since the domestic market could not absorb those volumes alone. The GFC led to a number of structured investment vehicles ("SIVs") unwinding their RMBS investments. More broadly, many offshore investors elected to reduce their exposure to securitised products and, as such, these investors were net sellers of Australian RMBS. The level of offshore participation in RMBS transactions is now significantly lower than it was prior to the GFC and is mainly denominated in Australian Dollars. Domestically, a large

portion of the investors are represented by liquidity books of the ADIs. The remaining domestic investors are real money accounts.

Chart 2: Australian RMBS issuance by currency



Source: Macquarie Debt Markets Analysis

We are beginning to see the re-emergence of offshore investors; however, the proportion of investors from offshore remains relatively small. There are a number of factors that are limiting investment from offshore in Australian RMBS (discussed in detail later), including:

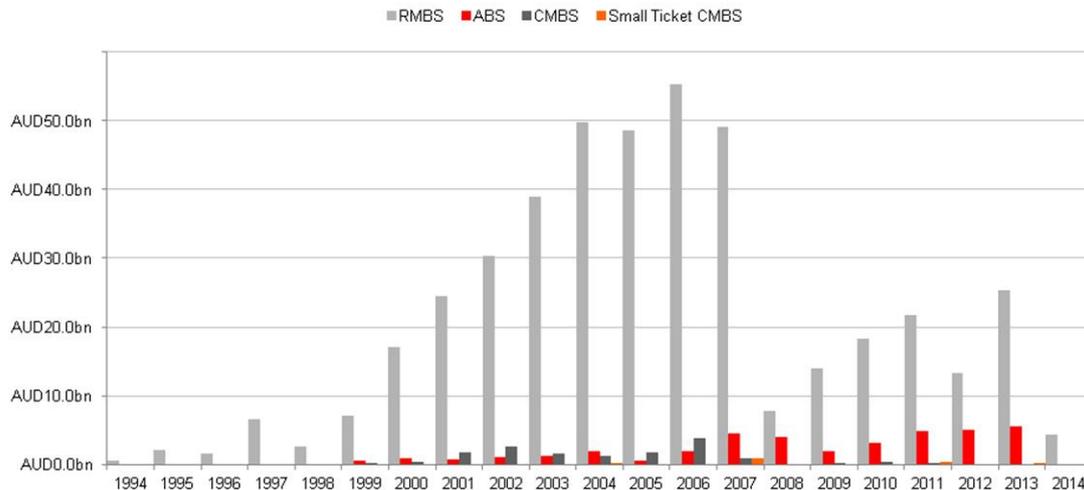
- The absence of master trusts in Australia (due to the current regulatory environment);
- The cost of cross currency swaps (due to ratings agency and regulatory changes) adding significantly to the landed cost, restricting issuing of foreign currency denominated tranches;
- Lack of investor education – lack of supply of foreign currency Australian RMBS tranches results in offshore investors being less familiar with the Australian structures/economy/performance; and
- A lack of primary market supply and poor secondary market liquidity.

Financing assets other than residential mortgages

While residential mortgages have been the largest asset class funded by securitisation, Australian has had a small but resilient ABS market that has funded a variety of non-mortgage receivables such as auto loans, auto leases, agricultural and construction loans as

well as office equipment loans. In the 1990s, this sector also financed credit card receivables and utility company receivables. Chart 3 demonstrates that the volume of non-RMBS issuance has been relatively low, never exceeding A\$6 billion of issuance in a calendar year, even pre-GFC.

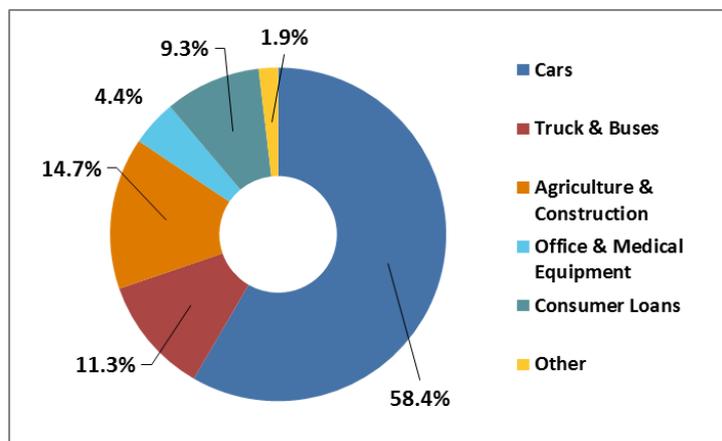
Chart 3 – Annual securitised issuance by type



Source: Macquarie Debt Markets Analysis

Chart 4 below illustrates the variety of assets financed through the issuance of ABS in 2013. It demonstrates the wide variety of asset classes that can be funded through securitisation, in particular it should be noted the ability of securitisation to be able to fund asset classes that help fund small- and medium-sized enterprises (e.g. vehicle and equipment finance) as well as the agriculture and construction industries.

Chart 4 – 2013 ABS asset class breakdown



Source: ANZ Capital Markets, Fitch, Moody's, Perpetual ABS and S&P

In addition to the sectors set out in Chart 3, securitisation has previously been used to fund infrastructure projects and commercial real estate (the latter via Commercial Mortgage Backed Securities (“CMBS”)) and has the potential to fund these types of assets going forward. It has also been used as a potential financing tool to help sectors that have suffered a withdrawal of funding, such as the OzCar scheme that was put in place by the Australian Government in early 2009 to help fund car dealerships following the withdrawal of major funders to that sector.

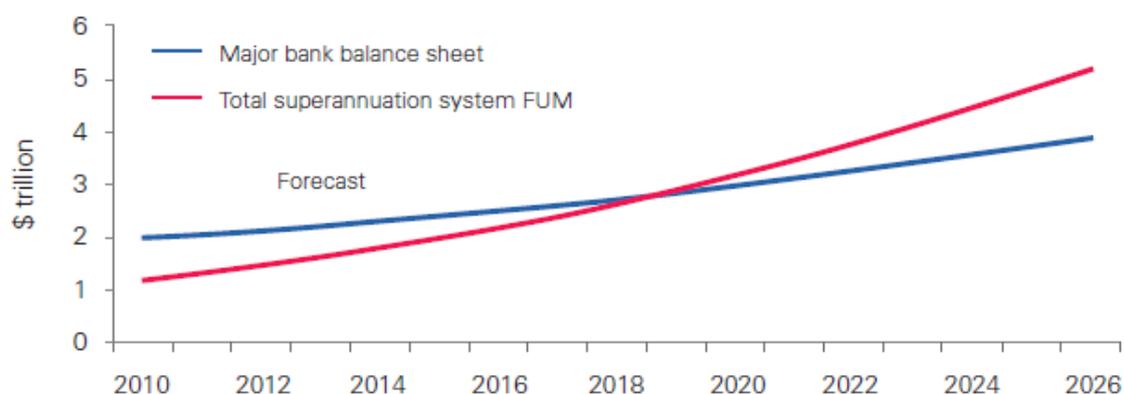
Adopting the recommendations set out in this submission will, amongst other things, increase the capacity of the financial system to lend to sectors important to Australia’s growth prospects which will help generate economic growth in the future.

Securitisation and the importance of a deep and broad-based fixed income market

The capacity of the superannuation system to fruitfully, prudently invest in fixed income ought to be exploited in a mutually beneficial way. Plainly, forecasts (see Chart 5) that the superannuation sector is poised to eclipse the banking sector means harnessing those flows is critical to ensuring a sustainable equilibrium between fund inflows and corresponding investments.

In part, this is about ensuring the infrastructure and incentives are in place to support the impending dominance of the superannuation sector. Unless we do this, our banking sector will be over relied upon, rendering it and the broader economy more vulnerable to shocks. It is also likely to constrain funding capacity for the Australian economy given the post-GFC limitations facing ADI balance sheets.

Chart 5 – Projection of Major ADIs’ balance sheets and superannuation pool



Source: Banks’ balance sheet growth (UBS Research Feb 2012).
 Superannuation FUM: Rice Warner Projections 2011

ASF has consistently advocated for two things that harness this new reality:

1. Promotion of higher fixed income allocations in investment portfolios because they offer capital stability and income predictability. This makes them an important cornerstone of any investor's portfolio, especially pre- and post-retirement products for a population that is growing in size and life expectancy; and
2. Funding Australia's future demands that more 'patient capital' exist in the form of funding rather than equity instruments.

In summary, the present bias to equities is inconsistent with reducing volatility and optimising returns at the micro superannuation account level and a drag on economic growth and stability at the macro level.

In our Deloitte Access Economics-commissioned research report⁴, we identify the forces for change (being, longevity risk; sequence risk; exposure to global financial markets; demographic change; government finances; and regulatory change) and options for policy intervention (being, restoring competitive neutrality; improving access and infrastructure; financial education; and encouraging development of new and niche products).

Liquidity as a significant impediment

An issue frequently raised by Australian fund managers as inhibiting them from investing directly in domestic fixed income securities is the lack of secondary market liquidity.

No new distortions should be entertained. For example, while infrastructure assets are increasingly in demand we note that some forms of public policy to support that sector could in relative terms undermine other asset classes, such as securitisation, just as the government guarantee has done with retail deposits.

We recommend below establishment of a liquidity backstop mechanism for certain illiquid securities. In times of economic shock or dysfunctional financial markets, secondary market liquidity evaporates for all debt securities other than Government securities. A liquidity backstop would assist the superannuation and funds management sectors of the financial system participate more substantially.

⁴ http://www.securitisation.com.au/Conference/2012/DAE-ASF_231012.pdf

Section C – Securitisation’s role in system competition

Key Points

- Securitisation allows small ADIs and non-ADI lenders to fund through capital markets to compete in market segments such as residential mortgages, auto finance and equipment finance
- Securitisation has driven innovation in residential mortgage markets since 1997 and has provided consumers with a wider choice of lenders and products

Background

Prior to the GFC, the funding profile of a typical small ADI was split roughly evenly between deposits and securitisation, and non-ADIs relied, often exclusively, on securitisation. The Australian mortgage loan market was characterized by a high level of competition, contracting lending margins, product innovation, and a low level of arrears. Much of this was driven by the strength of securitisation markets at the time.

There are significant differences between the business models and cost structures of ADI and non-ADI lenders. ADIs can be characterised as having lower average funding costs and higher fixed costs because of their deposit base and branch structure. The non-ADI lending model is entirely dependent on capital markets for funding and relies on the efficiency of service providers to competitively originate and service loans. As a consequence, value propositions offered to consumers by the two models differ: ADIs leverage their brand and geographic scope; non-ADIs seek the scale they require by undercutting their competitors on price. This provides an important competitive dynamic to the home loan market.

Securitisation had a particularly important role driving competition in the mortgage market from 1994 until the GFC in 2008.

Prior to 1990 the margin between the mortgage rate and the bank bill rate was often negative so there was little or no room for housing lending on any scale for anyone other than ADIs. In the early 1990s a combination of financial deregulation and lower inflation substantially reduced the gap between the bill rate and the deposit rate allowing a new class of lenders, the non-ADI mortgage providers, to enter the market.

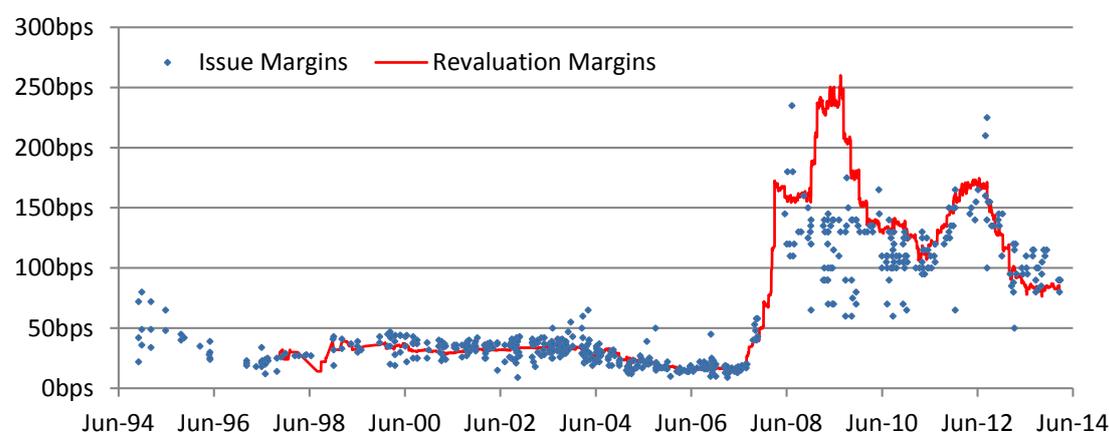
Because ADIs had far larger mortgage books than the mortgage managers and wanted to maintain their average margins, the mortgage managers were able to borrow at the bill rate and undercut the ADI’s mortgage lending rates. In 1994, with the cash rate rising by 2.75%

over a period of four months, the competition between non-ADI mortgage providers and ADIs intensified providing a major benefit to home buyers in the form of a significant reduction in the margin between mortgage lending rates and the official cash rate⁵.

By offering lower mortgage rates than the ADIs the non-ADIs were able to increase their market share of housing lending very quickly from around 2% to 8% of approvals. ADIs reduced their lending rates to meet competition from non-ADIs. This produced a major discontinuity by reducing the margin on mortgage lending over the cash rate by more than 2% to less than 2%. Sub 2% became a new benchmark for the spread on the standard variable rate over the cash rate for the next 14 years until the GFC, and represents the largest reduction in margin received by consumers as a result of competition since deregulation of the financial system in the early 1980s.

The competitive dynamic between ADI and non-ADI lending was disrupted by the freezing of the mortgage securitisation market during the GFC. All funding costs rose, and securitisation funding costs suffered significantly, with both new issue margins and secondary market revaluations increasing substantially.

Chart 6: Australian RMBS new issue and revaluation margins



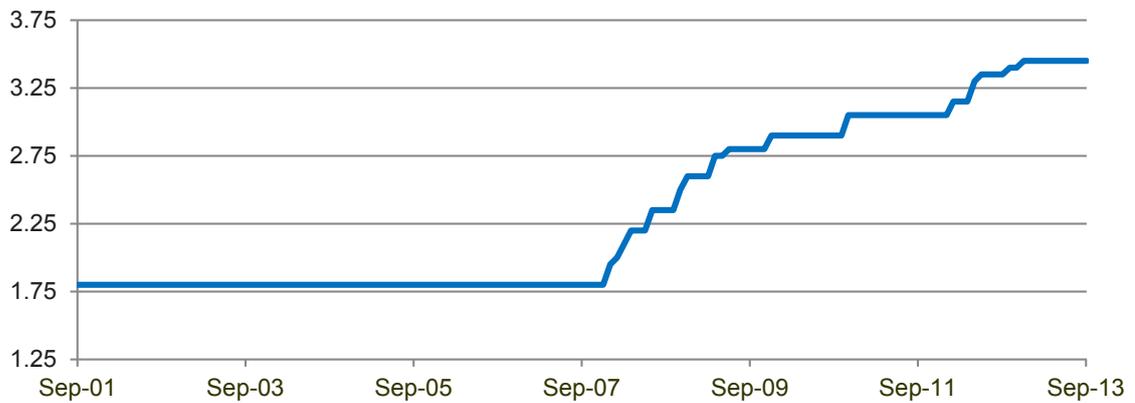
Source: Macquarie Debt Markets Analysis

All lenders had to increase lending margins to meet the higher cost of funds. Spreads on standard variable mortgage rates over the cash rate increased from less than 2% to almost 3.5%, albeit the rate paid by borrowers decreased as the RBA reduced the Cash Rate significantly. In the Australian context this increased margin reflected funding disruptions

⁵ This is discussed in the Reserve Bank of Australia Bulletin, June 1996, Evolution of the housing loan market in Australia, pages 1-5.

not credit performance of the underlying assets, which have remained exemplary. In addition to higher funding costs, the closure of securitisation markets meant that entities solely or heavily-reliant on this form of funding were not able to compete.

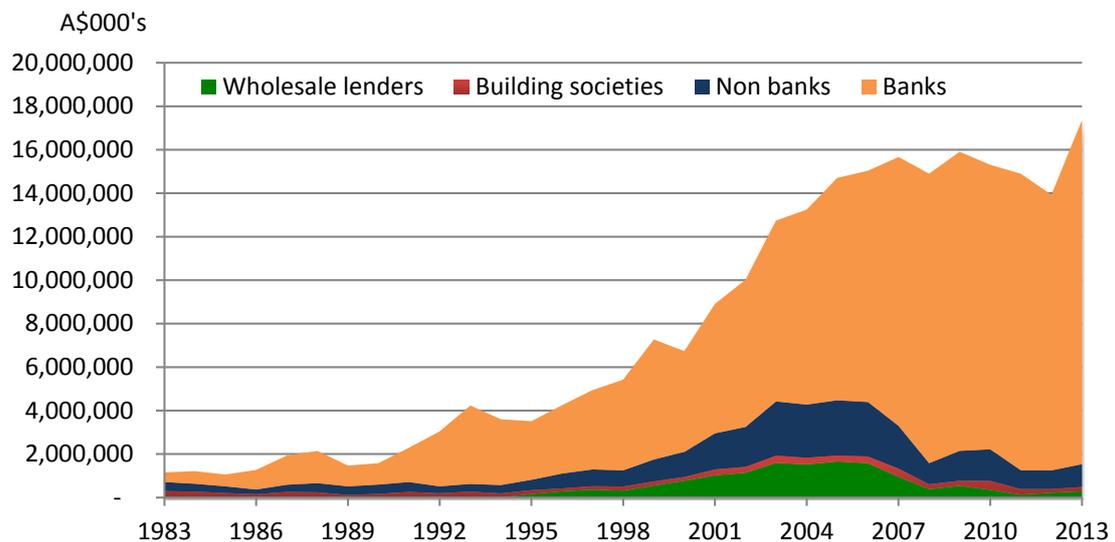
Chart 7: Bank spread on housing finance over Cash Rate (%)



Source: RBA and Bloomberg

RMBS issuance dropped substantially after 2008 and as a result we saw some lenders that were highly dependent on securitisation significantly reduce origination volumes.

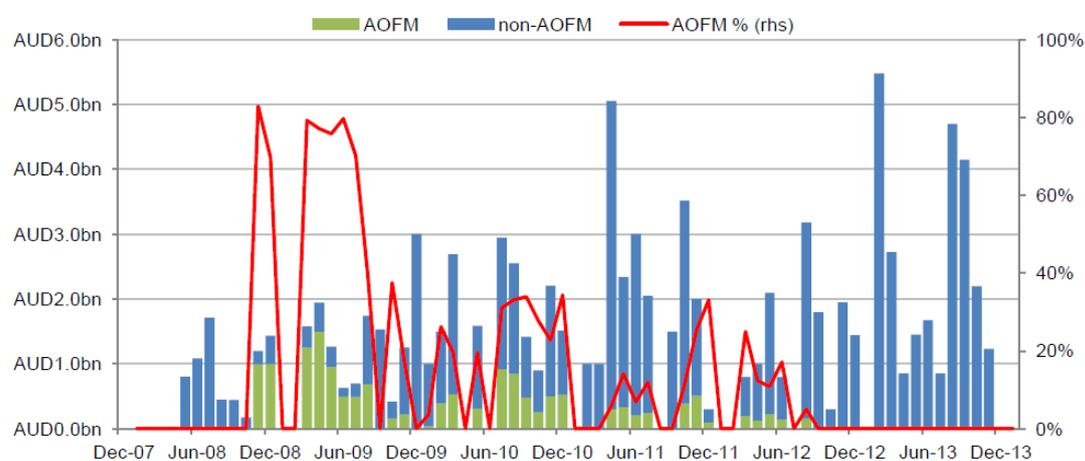
Chart 8: Value of housing loans advanced by lender



Source: Australian Bureau of Statistics

Had it not been for government intervention through the AOFM RMBS⁶ program and self-securitisation by ADIs the Australian securitisation market would have closed for new issuance in the wake of the financial crisis.

Chart 9 – AOFM investment in Australian RMBS



Source: Macquarie Debt Markets Analysis

The Australian securitisation market has recovered more quickly than other jurisdictions. It has re-emerged as a viable funding option for both ADIs and non-bank mortgage originators. This has encouraged a more competitive landscape in the mortgage market, and Australia is now seen as a market leader in the RMBS space in terms of issuance and performance. Much larger use of securitisation by small ADIs and non-ADIs for prime and non-conforming mortgage lending has the potential to safely and efficiently increase the availability of finance for borrowers and drive competition, as it did from 1994 until the GFC.

The increase in competition in the mortgage market benefits the consumer by providing them with access to a wider range of mortgage providers and can increase the availability of finance for all borrowers, including first home buyers and other non-conforming borrowers who do not meet the ADI’s traditional lending criteria.

Another important component of this competitive dynamic has been contribution non-ADI lenders have brought to the home mortgage market with product innovation including low documentation loans, higher loan-to-valuation (“LVR”) loans, interest-only loans, home-equity loans, and reverse mortgages.

⁶ The AOFM RMBS programme was only available to the non-Major ADIs and non-bank financial institutions.

Section D – How securitisation should be regulated

Key points

- Regulation of securitisation can be simplified and there should be a reduction in the amount of regulatory change
- Regulation is limiting the ability of the securitisation market to innovate and grow and changes can be made that whilst still ensuring a stable financial system would enable further growth in the market

Frequency of regulatory change

Regulation is becoming increasingly extensive and complex. Since the beginning of the GFC the securitisation industry has had to deal with a raft of ever changing domestic and offshore regulation. This has resulted in significant compliance costs for industry participants at a time when the securitisation market was recovering from GFC market conditions. The regulatory changes since the beginning of the GFC have been far reaching and include in particular the introduction and/or amendment of the following legislation:

- Multiple versions of APS120 and related guidance from APRA
- National Consumer Credit Protection Act including the National Credit Codeⁱ
- Unfair Terms Legislation (Trade Practices Amendment (Australian Consumer Law) Act (No.1) 2010, which amended the Australian Securities and Investments Commission Act 2001)ⁱⁱ
- Personal Property Securities Act 2009ⁱⁱⁱ
- Privacy Laws (Privacy Amendment (Enhancing Privacy Protection) Act 2012 Cth.^{iv}
- RBA repo eligibility reporting criteria introduced for RMBS, CMBS and ABS^v
- European^{vi} and US^{vii} securitisation risk retention requirements
- Basel III and its implementation in Australia
- Over-The-Counter derivatives market regulation global reform and its implementation in Australia^{viii}
- Dodd-Frank Act^{ix}
- FATCA (U.S. Foreign Account Tax Compliance Act of 2009)^x
- SEC Rule 17g-5^{xi}

Simple, clear and consistently applied regulation

The ASF advocates a simplified and clear and consistently applied regulatory framework for securitisation, particularly in the case of proposed amendments to APS120. In the case of APS120, ASF members would like to see a simple, principles based approach implemented with unnecessary detailed restrictions removed. This is particularly true in respect of

securitisation transactions where no capital relief is being sought (i.e. funding only securitisations). Current restrictions in APS120 should be removed so that in respect of funding only transactions, the 20% limit on holding of securities by the sponsor ADI is removed, date-based calls are permitted, and the securities issued by the funding-only securitisation vehicle can be tranching as desired by investors and sponsor.

APRA has stated that it prefers a principles-based approach to regulation. Proposed amendments to APS120 are expected to move away from the detailed rules of current and past versions of APS120. APRA has expressed a concern that in the past industry has developed structures that might technically comply with the letter but not necessarily the spirit of the relevant APRA standard. This concern however needs to be balanced with a need for clear regulation, particularly where there may be penalties for non-compliance. Furthermore, it is important that regulation is applied in a clear and consistent manner because this promotes a level playing field among industry participants and reduces execution and funding risk through predictability. Principles-based regulation is a worthy goal as long as it is consistently applied with as few regulatory restrictions as necessary.

Regulation should not limit innovation and growth in the securitisation market

Offshore issuance has been an important part of the recovery for some issuers, with ADIs and non-banks issuing in to U.S. and Europe markets in recent years. Regulation should not limit the international competitiveness of Australian issuers and regulators should take this into consideration.

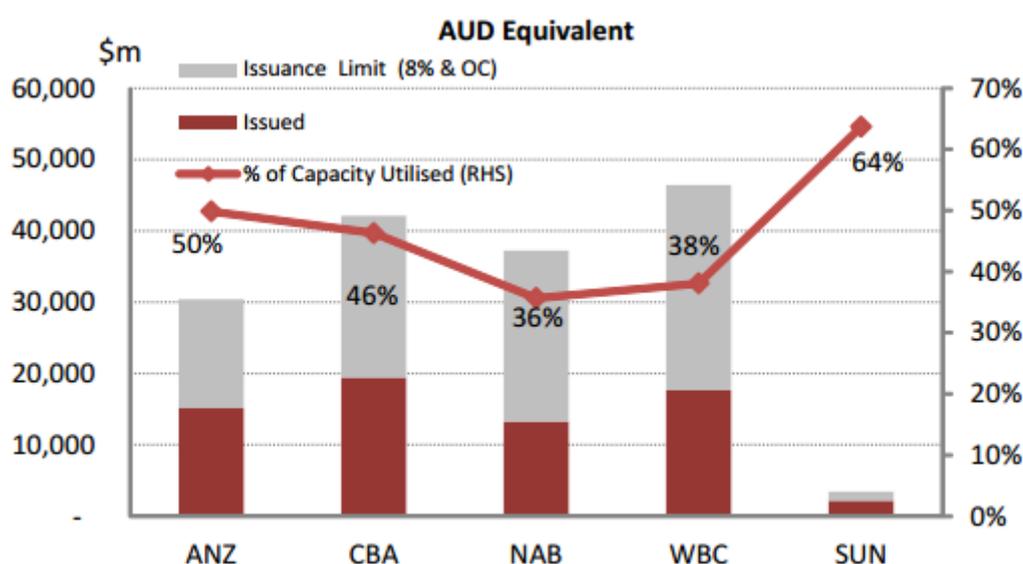
An example of regulation impacting innovation and growth, are the restrictions in APRA's prudential standard APS120 which prevent the issuance of securitised notes from master trusts. A well-established funding tool offshore, industry has been advocating removal of this restriction on the grounds that it would:

- Enhance access to offshore investors and may reduce issuance costs (through management of swap maturities and efficiency in issuance); and
- Realise value in collateral types not presently securitised (e.g. credit cards and small business loans).

Industry has sought to address APRA's concerns regarding master trust structures (including making concessions with respect to a typical master trust structure). Issuers and investors are keen to see a timely removal by APRA of the restrictions on master trust issuance.

The introduction of covered bond legislation and the removal of restrictions on covered bond issuance in APS120 (together with the introduction of APRA Prudential Standard APS121 for covered bonds (“ASP121”)) was one of the successes of the Australian government’s December 2010 reform package. As illustrated in the disaggregated table below, over A\$157 billion in covered bonds have been issued by Australian ADIs – predominantly in offshore markets – enabling ADIs to diversify their investor base and reduce funding risk (with covered bonds historically being less sensitive to global risk events than unsecured funding). In addition, the issuance of covered bonds has assisted ADIs retire their government guaranteed wholesale funding, offering as it did a suitable substitute.

Chart 10 – Australian covered bond issuance



Source: Westpac, Bloomberg, and Company Reports

Harmonisation with offshore regulation

The Australian securitisation market has the opportunity to capitalise upon offshore investment funds seeking high-quality, highly-rated securities. Cross-border issuance is therefore integral to a sustainable and resilient securitisation market. Differences in regulatory approach between jurisdictions are inevitable but in certain areas the efficiencies to be gained through harmonisation would outweigh the effort required to achieve it. Where appropriate, domestic regulation should harmonise with regulation in key offshore markets for Australian securitisation issuers (i.e. Europe and the U.S.) with regulations not making it difficult to comply with offshore regulation in these key markets.

Passporting or mutual recognition between jurisdictions can often be a means of achieving the necessary degree of harmonisation.

Continued regulator and industry consultation

The ASF recognises that regulation can support a sustainable and orderly securitisation market and that often industry consultation has been effective at achieving sensible outcomes.

An example of successful industry consultation has been the work undertaken by the ASF with the RBA in developing reporting requirements for repo eligible securities. In developing these requirements – which will apply to RBA open market operations as well as its CLF – the RBA took into consideration submissions from industry regarding reporting templates and content as well as concerns about privacy law compliance. The final requirements are broadly consistent with the transparency and standardised disclosure initiatives for securitisation markets of the International Organization of Securities Commissions (“IOSCO”) and other central banks, including the European Central Bank and the Bank of England.

Similarly, the ASF has participated in regulatory consultations to represent the views of the Australian securitisation industry in the international regulatory forum, such as the IOSCO consultation on Global Developments in Securitisation in the context of risk retention. The ASF and ASIC continue to have ongoing dialogue regarding the establishment of a risk retention framework that satisfies IOSCO’s objective of consistency in regulatory outcomes.

Section E – Recommendations

Initiatives to develop the securitisation market are set out below:

1. Regulation

- a. Amend the current APS120 to increase the structural flexibility for ADI issuers to enable them to attract the deepest investor base domestically and offshore, and remove unnecessary restrictions on funding only transactions. Specific amendments to APS120 that should be contemplated include:
 - allowing master trusts so that notes – with features such as soft bullets and scheduled amortisation notes – can be issued, which may serve to reduce issuance costs and allow issuers to better accommodate investor preferences;
 - allowing issuers to enhance the current stand-alone securitisation structures by adding features such as date based calls should make those standalone structures more cost efficient and appealing to the broader investor base;
 - abolishing the ‘20% rule’ that prohibits an issuer to hold more than 20% of any given securitisation notes; and
 - issuers should still be allowed to obtain capital relief commensurate with the amount of risk shifted obtained. APRA’s standards encourage funding only securitisation and the ADIs’ ability to achieve regulatory capital relief is restricted by APRA standards in comparison to offshore jurisdictions, without sustainable justification.
- b. Regulation should not unjustifiably limit innovation and growth in the securitisation market and where possible:
 - regulation should be harmonised with offshore regulation and the costs of super-equivalence in particular need to be measured on an informed basis;
 - unintended consequences of regulation on the securitisation market should be properly considered and addressed prior to introduction;
 - regulation should not extend into unregulated areas where there is effective industry self-regulation/self-discipline;
 - regulation (and supervision) should be predictable, clear and consistently applied between institutions and products; and
 - regulators and industry should consult meaningfully on new regulation.

2. Liquidity

- a. Despite RMBS/ABS being a very attractive investment product from a credit perspective, its attractiveness is significantly diminished because of the lack of liquidity in the product. The ASF welcome the fact that RMBS and ABS are eligible for the CLF which resulted in the liquidity books of the ADIs being significant buyers of Australian RMBS. However, Australian RMBS and ABS are not repo-eligible at the Federal Reserve, European Central Bank and Bank of England (whereas international issuers are repo-eligible at the RBA). Australia should press for this to be changed to increase international investor demand.
- b. Provide APRA with a cost-benefit framework that gives rise to a re-interpretation of Basel III liquidity standards such that it reverses its decision not to grant RMBS and ABS HQLA Level 2 status. Not only does this presently serve to shrink securitisation investment limits for ADIs it conflicts with other jurisdictions that rightly recognise that where RMBS is eligible for central bank cash liquidity, it should enjoy HQLA value similar to the amount that the central bank has – in Australia’s case, under the RBA’s CLF – contractually agreed to provide.
- c. The AOFM successfully supported the securitisation sector during a time when a large part of the domestic and global investor base had lost faith in the product. The AOFM investments have performed extremely well. We recommend having AOFM continue its investment in RMBS, albeit on a smaller scale, to:
 - i. further increase the RMBS investor base;
 - ii. allow the AOFM to invest in high yielding, AAA-rated assets; and
 - iii. allow the AOFM to maintain its infrastructure to resume its support role, should another temporary market disruption occur.
- d. Establishment of a liquidity backstop mechanism for certain illiquid securities. In times of economic shock or dysfunctional financial markets, secondary market liquidity evaporates for all debt securities other than Government securities. To assist the superannuation and funds management sectors of the Australian financial system play their role in the future it is recommended a backstop liquidity facility for “illiquid” securities be established by AOFM. This optional exchange facility should be available, for a fee, to superannuation funds and

Australian domiciled managed funds. The facility would be available during market disruptions (to be defined) to allow discounted RMBS and ABS (that mirror the RBA's eligibility criteria) to be exchanged for CGS of similar tenor. This would assist domestically based non-ADI investors to liquefy part of their portfolios when liquidity is needed whilst the secondary market is illiquid. A manager could exchange RMBS or ABS to get CGS that could be sold in the market. An exchange mechanism rather than a repo arrangement is recommended to all funds to continue to comply with their leverage restrictions. This could be modelled of the existing RBA repo eligibility rules or AOFM criteria for investment. In times of economic shock or dysfunctional financial markets, secondary market liquidity is evaporates for all debt securities other than Government securities.

3. Encourage an increased allocation to fixed income
 - a. Remove distortions that disadvantage fixed income from other investment options (e.g. cash and equities), such as:
 - i. Taxation – imputation and capital gains tax discounts; and
 - ii. Government guarantee of retail deposits; and
 - b. Avoid introducing new distortions by preferring certain securities, such as infrastructure assets.

GLOSSARY

ASF	Australian Securitisation Forum
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
APS120	APRA Prudential Standard for securitisation
ADI	Australian Deposit-taking Institution
RMBS	Residential Mortgage Backed Securities
ABS	Asset Backed Securities
HQLA	High Quality Liquid Assets
AOFM	Australian Office of Financial Management
RBA	Reserve Bank of Australia
CGS	Commonwealth Government Securities
G20	Group of Twenty
GFC	Global Financial Crisis
SME	Small and medium enterprise
CLF	Committed Liquidity Facility
SIV	Structured investment vehicles
CMBS	Commercial Mortgage Backed Securities
LVR	Loan-to-valuation ratio
APS121	APRA Prudential Standard for covered bonds
IOSCO	International Organization of Securities Commissions

ⁱ Commenced 1 July 2010. This legislation imposes licencing, disclosure and conduct obligations on persons engaging in a credit activity and may impact the enforceability of securitised consumer receivables. Non-compliance may result in civil and/or criminal penalties.

ⁱⁱ Commenced 1 July 2010. This legislation introduces a national unfair terms regime whereby a term of a standard-form consumer contract may be found to be unfair, and therefore void.

ⁱⁱⁱ Commenced 30 January 2012. The PPSA introduced new rules for the creation, priority and enforcement of security interests in personal property which now includes security interests not previously classified as securities (for example, hire purchase agreements, finance leases, assignment of receivables to a securitisation vehicle and certain leases of goods). A failure to register (or otherwise perfect) a security interest may lead to loss of priority or interest in the secured assets.

^{iv} To commence in March 2014. Replacing National Privacy Principles with new principles introducing a more comprehensive credit reporting system requiring review and possible amendment of a wide range of credit documents, systems and procedures in relation to the management of personal information.

^v Applies to RMBS from 31 December 2014 and for CMBS and ABS from 30 June 2015.

^{vi} Commenced in 31 December 2010 in Europe under Article 122a of European Union Directive 2006/48/EC (as implemented by the Member States of the European Economic Area); now replaced by Articles 404 – 410 (inclusive) of Regulation (EU) No 575/2013 (as amended by corrigendum) of the European Parliament and Council (as implemented by the Member States of the European Economic Area) which came into force on 1 January 2014. Section 5 of Chapter III of the Regulation implementing the EU Alternative Investment Managers Directive also introduced. Certain European financial institutions are restricted from investing in a securitisation unless the originator, sponsor or original lender has retained specified credit risk.

^{vii} US requirements are still being developed through implementation of the Dodd Frank Act.

^{viii} ASIC expects reporting requirements to apply to derivative transactions entered into in relation to a securitisation. Other aspects of the international reform agenda involve margining and mandatory clearing requirements are to be implemented in Australia between December 2015 and December 2019 and are expected to impact securitisation transactions.

^{ix} Signed into law on 21 July 2010. The Dodd-Frank Act contains a wide range of provisions that will affect financial institutions operating in the US, including ADIs. Many of the provisions of the Dodd-Frank Act require extensive rulemaking by US regulatory agencies before the provisions become effective. Significant investment in compliance and reporting programs and changes to business activities may be required for institutions accessing the US market.

^x ASF has been liaising with the Australian Treasury in relation to an Australian FATCA inter-governmental agreement (IGA) in relation to its impact on securitisation vehicles. The IGA will require due diligence and reporting obligations to be complied with in order for financial institutions to be deemed compliant for FATCA purposes and to avoid FATCA withholding on US source income or foreign passthrough payments.

^{xi} Requires the posting of information provided to US rating agencies rating a securitisation transaction on a password-protected website to be made available to non-hired rating agencies.