Australian Securitisation Forum

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The Chairman
Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Dear Mr Murray

RESPONSE TO THE INTERIM REPORT OF THE FINANCIAL SYSTEM INQUIRY

The Australian Securitisation Forum (ASF) appreciates the opportunity to respond to the observations relating to the Australian securitisation market contained in the Interim Report of the Financial System Inquiry (the Inquiry) dated July 2014.

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), non-ADIs regulated by the Australian Securities and Investments Commission (ASIC), domestic fixed income investors, arrangers, advisors and service providers to the securitisation and covered bond markets.

We would welcome an opportunity to meet with the Committee and elaborate on the matters outlined in this response.

Yours sincerely

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The ASF believes the key recommendations of the Inquiry should focus on measures to enhance the resilience, competition and innovation of the Australian financial system whilst mitigating the risks and vulnerabilities associated with Australia's dependency on international capital markets. Securitisation markets have seen significant positive reforms in recent years and are now even better positioned to contribute to achieving these strategic outcomes.

A larger and more diversified securitisation market can provide the financial system with:

- greater access to funding that matches the asset-liability profile of lenders;
- access to funding from a wider array of domestic and global investors;
- the potential to fund a more diverse array of financial assets; and
- capacity for ADIs to manage their exposure to the residential property market by capping or transferring property risk to investors outside the banking system.

The ASF submits the following comments on four key aspects of the Interim Report relevant to securitisation.

A. Residential mortgage and asset-backed securities

The Inquiry seeks views on various policy options with respect to the residential mortgage-backed securities (RMBS) market (pages 2-15 and 2-16). The ASF makes the following comments:

1. The ASF suggests the Inquiry should encourage Government support of securitisation markets. This could include a policy to maintain the current direct investment capabilities within the Australian Office of Financial Management (AOFM) by it maintaining its RMBS investment portfolio and/or providing additional market liquidity through open market activities.

   The key benefits of such a policy are:

   - to give Government greater flexibility and capacity to respond in the future to periods of market disruption, as it did in 2008 – 2013; and
   - to assist in maintaining confidence in securitisation markets.

2. The ASF supports the inclusion of RMBS as a high quality liquid asset (HQLA) for the purpose of the liquidity coverage ratio under APRA's prudential standard, APS 210. Additionally, we submit that asset-backed securities (ABS) should also be included as a HQLA, as Australia's relatively underdeveloped ABS markets are now growing at a faster pace and provide an important alternate source of financing for small businesses.

   The key benefits of such a policy are:

   - the creation of greater liquidity in primary and secondary RMBS and ABS markets. RMBS and ABS are already repo eligible securities with the Reserve Bank of Australia (RBA) for repurchase facilities and the Committed Liquidity Facility (CLF) and, therefore, both already form part of an ADI's core liquidity holdings (with the exception of smaller ADIs that apply the minimum liquidity holdings (MLH) approach). The ASF believes that any asset that is repo eligible with the RBA should be at least a Level 2 HQLA to the extent it is not already a HQLA. APRA should also consider allowing ADIs that apply the MLH approach to liquidity requirements, to include RMBS and ABS as liquid assets to further increase the investor base for these asset classes. The ASF understands that some regional and smaller ADIs already buy RMBS (and can have access to the CLF); and

- aligning Australia's liquidity standards with other jurisdictions. Inclusion of RMBS and ABS as HQLA would go some way towards harmonising the Australian regulations to those of other key jurisdictions. For instance, the current draft European Central Bank (ECB) standard includes RMBS and ABS as eligible for Level 2B HQLA.

3. APRA is currently reviewing the prudential framework for securitisation and recently sought industry feedback in response to its April 2014 Discussion Paper titled "Simplifying the prudential approach to securitisation". The ASF has provided detailed technical recommendations in its response to the Discussion Paper.

   In summary, the ASF recommends a prudential approach that includes the following key measures[1]:

   - date-based calls – these calls, exercisable only at the borrower's option, enhance the flexibility and efficiency of securitisation funding structures. Any date-based call option would be included in an ADI's liquidity modelling;
   - master trust issuance structures – such structures increase an ADI's access to diversified term domestic and global investor markets across a greater variety of asset classes other than residential mortgages; and
   - warehouse arrangements – securitisation warehouse facilities provide efficient and cost effective access to funding for both small ADIs and non-ADIs, and accordingly are vital to competition. Such facilities are important for competition in the residential mortgage lending and small and medium sized enterprise financing sectors.

4. The ASF does not support the establishment of a public-private funding vehicle to purchase housing loans from small lenders and issue RMBS to fund the loans. Such measures have been used previously and in international markets with varying degrees of success, the largest of which has been the Fannie Mae and Freddie Mac style programs in North America. The recent failures and cost to taxpayers of these US entities has been well documented and their role is currently being downsized or dismantled. If not implemented and managed well, the establishment of a centralised RMBS funding vehicle could pose a significant contingent risk to Government with little benefit to consumers.

   Instead, the ASF advocates any Government intervention should be by way of the ongoing participation by the AOFM as a third party investor in the RMBS market. Such participation would be expected to be minimal in normal market conditions but could be

[1] The ASF would be pleased to provide a copy of its detailed submission to the FSI if required.

scaled up, if required, in times of extraordinary stress such as was experienced in the 2008 – 2013 period. In our original submission to the Inquiry the ASF set out a mechanism for secondary market liquidity mechanism involving the swapping of eligible RMBS with discounted Government bonds through a Government agency such as the AOFM.

B. Lenders Mortgage Insurance

The Inquiry made observations on pages 2-21 to 2-23 on the role of lenders mortgage insurance (LMI) in the mortgage lending market. The ASF supports consideration of policy changes to acknowledge the beneficial role LMI can play in the mortgage lending market. The involvement of LMI providers in the provision of finance to home loan borrowers provides additional discipline to the credit standards applied by lenders and mitigates some systemic risk arising from the exposure of ADIs to the housing market.

Lenders using the advanced methodology for calculating capital requirements for credit risk receive no capital benefit for the use of LMI, despite the fact that the LMI providers are required to hold significant capital for the risk that was transferred. The ASF believes risk weights given to loans subject to LMI should be recalibrated to recognise the additional capital LMI providers introduce to the system and the qualitative benefits of secondary underwriting of loans by LMI providers.

C. Lending to Small Business

The Inquiry has made some observations on page 2-68 regarding financing small and medium sized enterprises (SMEs). Securitisation currently provides some funding to SMEs through both the RMBS and ABS market. A number of specialist lenders provide finance to the self-employed and SMEs by providing loans secured by residential property. Such specialist lenders include IMB, Liberty, Pepper and Resimac. The ABS market also provides finance to SMEs through loans secured by motor vehicles, agricultural equipment and office equipment. While this market is relatively underdeveloped in Australia, based on international experience it does have the potential to provide a greater volume of finance to the self-employed and SME sector, particularly if the ASF's recommendations outlined in Section A above are implemented.

The Inquiry highlights the development of a SME finance database as an option to reduce information asymmetries. The ASF supports this suggestion. Akin to the RBA's recent measures, working with the ASF and other market participants to implement industry consistent data reporting templates for repo eligible RMBS, ABS and commercial mortgage-backed securities (CMBS), a Treasury sponsored industry working group could be established to scope out the type and form of SME finance information that could be collected to benefit both borrowers and lenders.

The ASF believes an industry working group could consider the current challenges to securitising SME loans which include, amongst other matters, the lack of standardised loan agreements and historical credit performance data.

D. Competition

The Inquiry observed in the Interim Report that the banking sector is competitive, albeit concentrated. The Interim Report also notes there could be some advantage to larger institutions in the mortgage lending market. The initiatives the ASF has proposed would also assist with reducing concentration and therefore foster even further competition.

The number of participants and competition in the Australian mortgage lending market escalated in the 1990's due to the growth of securitisation funded lenders. This was evidenced by the material reduction in residential mortgage margins during this period. A number of participants present in today's industry owe their strength to securitisation markets which provides a level playing field between large, small, and non-ADIs alike. In recognition of the importance of securitisation markets to competition for mortgage lending, the Government supported securitisation markets via the AOFM direct investment program during the global financial crisis.

The ASF submits that support for ongoing competition within the banking sector will be enhanced by an open and growing securitisation market. The ASF urges the Inquiry to make recommendations supportive of securitisation due to the demonstrated positive impact securitisation has brought and continues to bring to the wider economy.

Conclusion

In conclusion, we ask the Inquiry to endorse the importance and future potential of the securitisation market to add to the resilience, competition and innovation of the financial system. We endorse the inclusion by APRA of RMBS and ABS as Level 2 HQLA consistent with the Bank of England (BOE) and the ECB. We also ask that the Inquiry endorse prudential regulation that accommodates a growing and diverse securitisation market that will benefit the funding profiles of large and small ADIs and non-bank securitisation issuers. We believe adoption of the ASF's proposed Australian master trust model, date-based calls and warehouses will be vital in allowing securitisation to deliver its full potential. The Inquiry should protect the important role lenders mortgage insurance has played in the mortgage market and the additional discipline and capital it delivers to the system. Finally, the ASF suggests the Inquiry should recommend a cross-industry and Government working group be established to consider measures that could improve access to finance by the SME sector.