The Future of Securitisation

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This paper addresses the topic *The Future of Securitisation* in the context of the Australian securitisation market while being mindful that securitisation is a global market.

History of the Australian Securitisation Market

In considering the question of the future of the Australian securitisation market, it is useful to reflect on its history. One of the earliest applications of securitisation technology in Australia was by government authorities, namely the State of New South Wales' FANMAC residential mortgage-backed bond program and the State of Victoria's National Mortgage Market Corporation mortgage-backed program. Both programs were established in the 1980's and were mainly directed towards providing finance to borrowers that otherwise were not able to access housing finance through the banking system. At the time banks imposed very restrictive lending criteria for housing finance. Bonds issued under both programs benefited from an explicit guarantee from the respective States. Hence Investors were exposed to the credit risk of the State not the risk of the underlying housing loan.

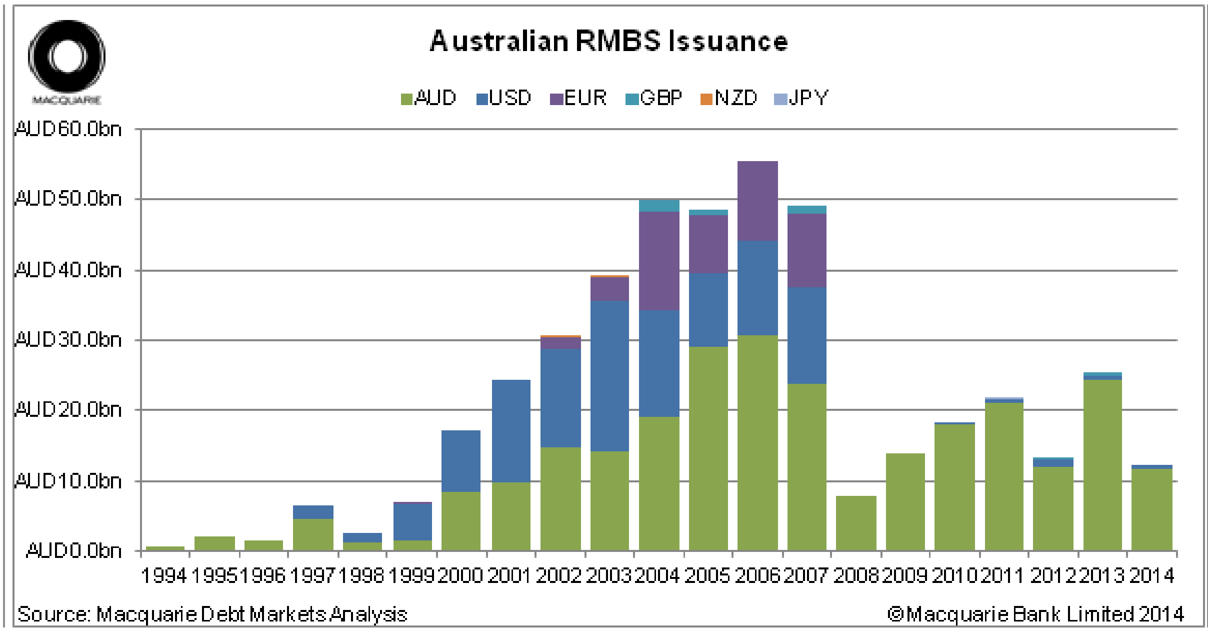
The early 1990's saw the emergence of the private ("non-government") securitisation market with issuance of residential mortgage-backed securities ("RMBS"), asset-backed securities ("ABS") and commercial mortgage-backed securities ("CMBS"). These securities were issued for example by vehicles sponsored by Prudential Bache, Security Pacific National Bank, the Gas & Fuel Corporation of Victoria, and Deutsche Bank's Prime Asset CMBS vehicle. In this paper RMBS, ABS and CMBS will be referenced as asset-backed securities or ABS, unless otherwise noted.

The Australian securitisation market and its principal asset class, RMBS, truly established itself in the mid 1990's, when pass-through RMBS structures gained investor acceptance. At this point, the declining level of Commonwealth Government Securities gave rise to increased investor appetite for securitised debt. Relatively significant volumes of RMBS started to be issued by Macquarie's PUMA program and others such as Interstar Securities. Through the late 1990's and earlier this century, increased Australian and global investor demand drove the growth of Australian securitisation. Authorised deposit-taking institutions ("ADIs") and non-bank issuers entered the market to benefit from this new, diversified and cost effective form of funding.

The growth of the securitisation market in in the early 2000's witnessed global investors becoming very significant buyers of Australian securitised debt, representing up to 50% of the investors in primary RMBS issues. Such investors included the structured investment vehicles ("SIVs") typically based in Europe. The SIVs took advantage of market and regulatory arbitrage opportunities to buy longer dated ABS and fund through short dated asset-backed commercial paper.

The impact of the financial crisis significantly diminished liquidity in the primary RMBS market and especially within the global investor community. Chart 1 illustrates the growth of Australian RMBS up to the crisis, and the slow recovery trend since. Note the decline in 2012 reflects the impact of covered bonds being issued for the first time by Australian banks. Also notable since the 2008 crisis is the absence of significant issues of RMBS in currencies other than Australian dollar.

Chart 1: Issuance of Australian RMBS by Currency



Finally, before turning to a discussion of the future of securitisation, it is worthwhile to define securitisation simply as a form of secured financing. It is not anything extraordinary, neither magical nor dangerous. Securitisation serves as an efficient technique for raising capital and transferring risk from originators of financial assets (which drive growth in the real economy), to the capital markets. Securitisation markets allow originators of credit to consumers and businesses to fund in an efficient and cost-effective manner. A wide range of assets such as auto loans, residential and commercial mortgages, or credit card receivables can collateralise ABS sold to a broad range of domestic and international investors.

Future Role of Securitisation

The role of securitisation in the future Australian financial system is to serve as a compliment to the funding of the economy that is provided through the traditional banking system. Securitisation provides a means to diversifying the funding of a financial institution. It is attractive to smaller ADIs that have limited access to term funding markets. It also provides a potential source of competition in the housing and consumer finance markets, given the highly concentrated nature of the Australian banking system. Securitisation can also provide a means to transfer risk, particularly residential property risk, outside the banking system.

In the future the operation of seamless cross-border securitisation markets will be increasingly important. Australia's major banks are expected to face constraints under Basel III in the amount and type of credit they can supply. The capacity of capital markets to provide an alternative source of financing for consumers and businesses must include both domestic and global investors.

What's the Future?

The future of securitisation in Australia will be determined by four key factors:

1) demand for asset-backed securities;
2) supply of asset-backed securities;
3) market liquidity; and
4) the regulatory framework for securitisation.

While the following points discuss each of the above four factors individually, the reality is that they are interconnected.

1) Demand

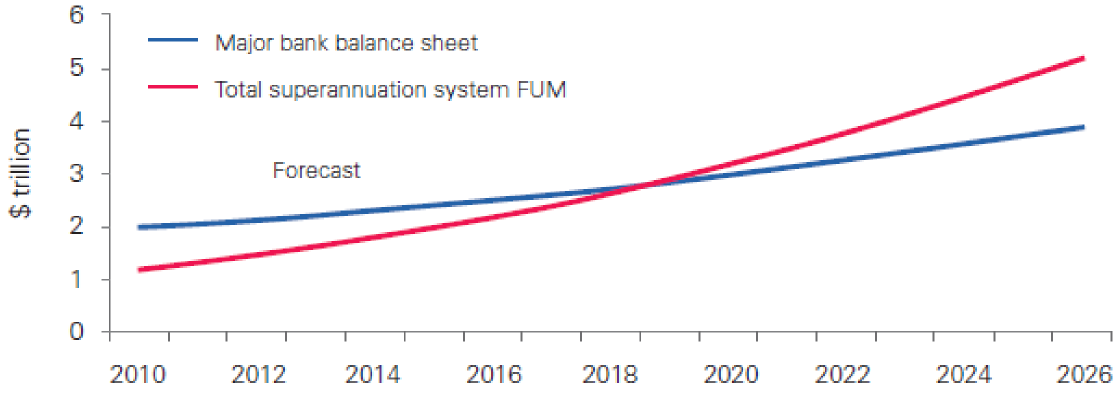
The evolution of the Australian securitisation market to date has demonstrated a sustainable demand base for ABS. The sources of demand can be categorised into three types of investors:

- domestic financial institutions;
- domestic fixed income investors; and
- global investors (financial institutions and bond investors).

Domestic banks have been a large domestic buyer of ABS, primarily RMBS. This is an asset class with which they have great familiarity. Major banks are ABS issuers, investors or providers of warehouse facilities to smaller ADIs and non-banks. Bank buying of RMBS has been spurred by its inclusion as an asset class eligible to be included in the collateral of a bank's Committed Liquidity Facility ("CLF") with the Reserve Bank of Australia. The CLF forms part of Australia's compliance with Basel III's Liquidity Coverage Ratio requirement. This is an example of the interaction of demand and regulation which will jointly determine the future composition and size of the Australian securitisation market.

To date, a great disappointment of the Australian securitisation market has been the tardy growth of investment by fixed income funds and insurance companies, referred to colloquially as "real money" investors. This primarily reflects the constrained investment by Australian investors and institutions in the fixed income asset class, and specifically credit assets such as ABS. Domestic fixed income investors do invest across the credit spectrum of ABS structures including senior, mezzanine and junior notes. A positive feature of the post financial crisis period has been the emergence of new specialist credit funds which have invested in ABS. Many have delivered investors strong returns based on the running yield and the recent rally of valuations of ABS.

The opportunity exists for securitisation to play a larger role in funding Australia's economic growth. The can be realised by repackaging a greater volume and wider array of financial assets into ABS that can be held in portfolio by domestic and global investors. Chart 3 below illustrates the trend over the next 10 years for a greater amount of financial assets to be held within Australia's superannuation industry than within the banking system. Securitisation is an established funding option for high quality assets with predicable credit performance to be repackaged as ABS and held in the superannuation system. This could allow ADIs to use the proceeds from issuing ABS to exploit their credit skills to finance more heterogeneous assets such as small business, construction and infrastructure loans.



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

Global investors based in Europe, the U.S. and Asia have been active buyers in Australian ABS for many years, however they have largely been absent for the immediate period after the 2008 financial crisis. The repricing of risk in global debt markets, the evaporation of market liquidity and the demise of the European SIVs, started a period of abstinence by global investors in Australian ABS. In the aftermath of the crisis, Australian ABS issuers were restricted to fund primarily in Australian dollars. This was due to higher margins and fewer counterparties willing to provide an amortising cross currency swap in the aftermath of the crisis. Since the start of 2013, global investors have returned to participate in new primary issues, in both Australian dollar tranches and a few US dollar tranches issued in recent ABS deals. Macquarie Bank's SMART auto ABS program has been the notable exception, with a number of successful U.S. ABS transactions completed since 2012.

Investment by global investors will be imperative for a future larger and sustainable securitisation market. Issuance in non-Australian dollars will be a necessity, as will an accommodating and predictable regulatory framework. Global investors were dismayed by APRA's reversal of its acceptance of date based calls included in many pre-crisis ABS deals, as this policy reversal created unanticipated extension risk for investors. The importance of a clear and predictable regulatory framework will be discussed later in the paper.

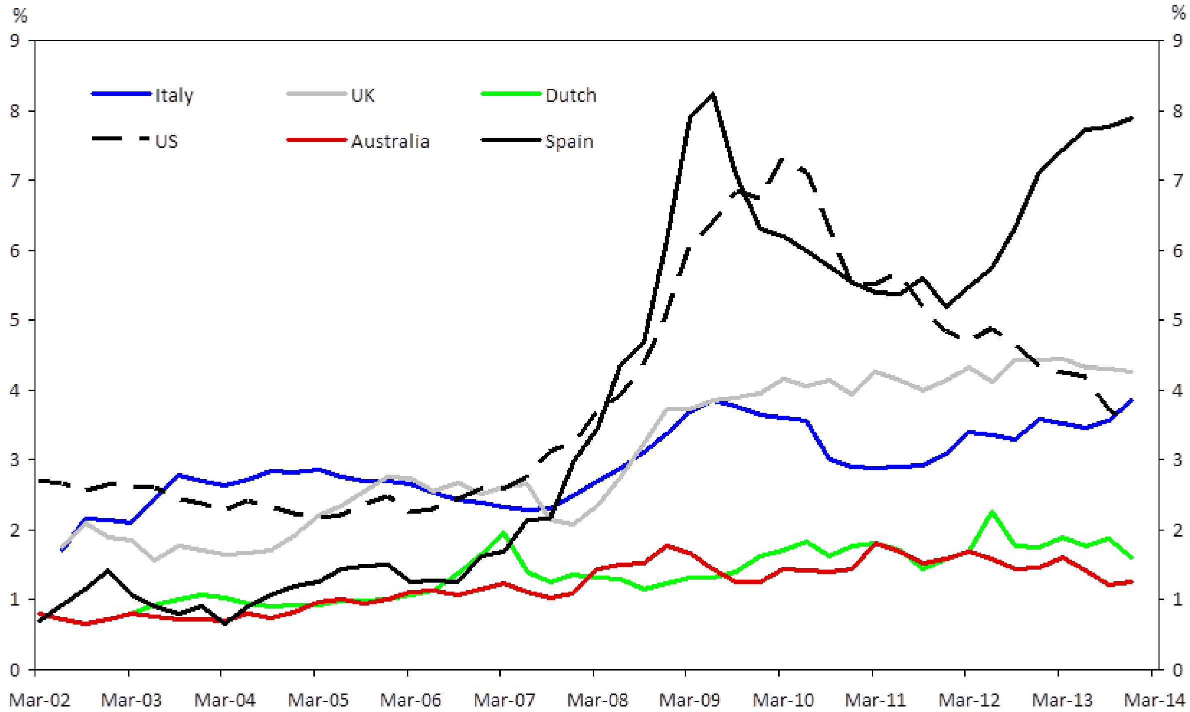
From a demand perspective, it will be important for investors in senior as well as mezzanine and junior tranches of ABS, to be present and active in securitisation markets. A significant focus of policymakers has been placed on making senior ABS notes "super safe" in terms of credit risk. It is vital that a diverse and active investor base for higher risk and higher yielding ABS tranches also remains present in global securitisation markets.

2) Supply

The Australian securitisation market has always been dominated by the RMBS asset class, and this is unlikely to change in the next decade or so. Australian RMBS are backed by pools of high quality mortgage receivables which are originated according to relatively conservative underwriting standards and within a well regulated credit and consumer law environment For example, all mortgage brokers are licensed in Australia, which is still not the case in the U.S.

Australian RMBS has established a pre-eminent track record with investors for its transparency, relative simplicity and credit performance. This credit performance is illustrated in Chart 2 below.

Chart 2 – Comparison of Australian RMBS delinquency rates to other selected OECD countries



Sources: Standard & Poor's, Westpac Research and Bloomberg

While there can be a variety of collateral types backing ABS, it is not necessary for a bank treasurer to issue ABS backed by specific collateral to fund the bank's lending in that asset class. Funding of a bank is fungible, and so it may be best if banks continue to securitise "easy" assets such as residential mortgages. The funds raised by an RMBS issue can then be directed to any part of the bank's activities including small business lending, personal finance, construction loans or even infrastructure finance.

The supply of ABS in the Australian market is potentially quite large, particularly when the value of assets suitable for securitisation on the balance sheets of ADIs is measured. In addition, there are assets originated by non-banks and captive auto finance companies. Assets most suitable for securitisation are consumer and business receivables that have been originated on relatively standard and similar loan contracts and have a predictable cash flow profile based on the payment of principle and interest by the underlying borrower or obligor.

In considering the future supply of assets, there is also the potential for ABS to be collateralised by assets not typically securitised in Australia, as outlined below.

Reverse mortgages – These mortgages are a form of finance that can be used to provide an income stream to senior Australians who may have substantial equity in their primary residence, but prefer not to sell the property to release the equity. According to the Deloitte Reverse Mortgage Market survey[1], as at 31 December 2014 the outstanding balance of reverse mortgages stood at $3.56 billion. There has been some attempt to use securitisation to fund pools of reverse mortgages in Australia, New Zealand, the UK and the US. These types of assets, while potential suitable for securitisation, have to date failed to establish a niche in the ABS market. The ageing Australian population, and the need to create retirement income streams for retiring baby-boomers, may give this asset class another opportunity to use capital markets to meet a financing need in the economy.

Student loans – Australia's recent tertiary education policies have incorporated a user pays model for the provision of courses. This has resulted in a large number of graduates effectively borrowing the cost of their course under the Commonwealth Government's HELP scheme. There are approximately 1.50 million HELP borrowers who owe about $26.5 billion[2]. While these student loans have not been structured on a commercial basis, the outstanding debt could be securitised, should the Government wish to fund the obligation through the ABS markets rather than through its own borrowing program. To achieve such funding the Government would need to impute a market interest rate on the obligations and provide some form of guarantee around the credit risk and timeliness of repayment. The case for securitising the current HELP portfolio is not compelling. Should the Government wish to restructure the program, and base loans on a more commercial basis, with market linked interest rates and specific repayment timetables, then the potential to securitise the debt would be enhanced.

Business loans – There has been, and continues to be, significant discussion around the role of securitisation in improving the availability, and potentially the cost, of business loans to small and medium sized enterprise ("SMEs"). Lending to SMEs has been a topic highlighted in a number of submissions to the 2014 Financial System Inquiry. It is a major topic in Europe, where regulators such as the Bank of England and the European Central Bank, have explicated raised the role of securitisation to provide additional funds to European SMEs[3]. In the U.S., ABS backed by SME loans are guaranteed by the Small Business Loan Administration, which is part of the U.S. Government. The buyers of the ABS view them as Government credit risk rather than being based on the underlying SMEs. The potential for securitisation to provide an additional direct channel to finance to SMEs in Australia is likely to be challenged by a number of factors. These include the fact that financing of SMEs is often relatively complicated, with the borrower requiring several forms of finance and transaction facilities from a financial institution. Also the legal form of financial accommodation to SMEs is not necessarily standardised and can vary between and within lenders. Further, to obtain a credit rating of an ABS backed by SME loans, will require a time series of credit performance. It is unlikely that such a history is currently readily available from bank systems.

Trade receivables – The financing of trade receivables through the issuance of ABS is an underdeveloped component of the Australian securitisation market. The securitisation of trade receivables has been a long standing and successful part of the U.S. securitisation market. In the US many corporates finance their receivables portfolios through Wall Street conduit programs. This is a way of preserving capacity under banking limits for other more medium funding needs. The absence of this sector in the Australian market can possibly be explained by the comprehensive nature of banking relationships that exist between large corporates, who have portfolios of receivables

[1] Deloitte 2014 Reverse Mortgage Report 10 July 2014.
[2] news.com.au "Federal Government Hunts for HECS Debt Dodgers" 21 May 2014.
[3] The case for a better functioning securitisation market in the European Union May 2014.

suitable for securitisation, and their primary banks. Another constraint for the development of this sector is the absence of a data series of credit performance on these types of receivables that can be extracted and provided to credit rating agencies ("CRAs") for their analysis and determination of a credit rating of the ABS.

Credit card receivables – Currently funded through bank balance sheets, this is an asset class that is eminently suitable for financing via securitisation. This asset class has a great degree of homogeneity, and is a large established market in the US securitisation market. A long and rich time series of credit performance is available to rate this type of ABS. The impetus for this form of ABS to emerge in Australia will be the approval of a market-appropriate form of master trust structure under APRA's new securitisation prudential standard, APS120. The balance of credit card receivables on the 8 largest ADIs as at 31 March 2014 was approximately $77 billion[4] and may be up to $100 billion for the entire credit card industry. The possible size of this asset class could be up to $5 billion of issuance per year, based on current outstanding balance. This would add significantly to the size and diversity of the ABS asset class. ABS collateralised by credit card receivables would be an attractive asset class for both local and global investors who are eager to add diversification to their fixed income portfolios.

Infrastructure loans – The 2014 Financial System Inquiry has also galvanised the debate regarding funding infrastructure loans. The Federal and State Governments have been reluctant to take advantage of historic low interest rates to borrow to fund new infrastructure assets. The experiment of the last decade with public private partnerships ("PPP") has had a less than stellar history. There have been a number of failures of such financings in Queensland and New South Wales, and Victorian taxpayers will be burdened for decades by the very expensive PPP financing of its desalination plant. There exists an opportunity for securitisation to play a role in refinancing existing infrastructure assets to free up investment and finance of new infrastructure. Securitisation is ideal to create ABS based on established and predictable cash flows from established infrastructure assets. Such assets may be based on either user pays or government concession infrastructure funding models. Such ABS could easily be placed with superannuation funds that are seeking assets that provide annuity style returns for the growing appetite for retirement income products.

Social benefit bonds – Securitisation technology has also been adapted to the niche funding of social benefit bonds. In 2012, Westpac Institutional Bank and CBA piloted this niche funding market with an inaugural $10 million issue. The proceeds of three tranches of bonds issued by a special purpose vehicle will be drawn down over five years by The Benevolent Society. The funds will be used to provide family preservation services aimed at preventing children from going into foster care. Interest and principal to repay the bonds will come from the NSW Government and is dependent on the performance of The Benevolent Society's program. The Government payment is calculated by the level of savings made by the Government in terms of what it would have required to fund its own programs had the project not achieved its objectives.

[4] Source: APRA APS330 Disclosure

3) Market Liquidity

When discussing the prospects of the Australian securitisation market, it is hard not to move quickly to the discussion of the importance of liquidity, in both the primary and secondary markets.

Liquidity in financial markets is probably best considered as a phenomenon of confidence. Typically it exists in normal or buoyant market conditions and evaporates in uncertain or stressed market conditions. Some experts have defined a liquid market to be one where there is little difference between the transaction price and the fundamental value[5]. Other experts have postulated that market illiquidity is the result of market imperfections[6]. The recent Bank of England and European Central Bank discussion paper "The case for a better functioning securitisation market in the European Union" commented that a liquid market requires well-funded buyers, widely available information on the asset being traded and a mechanism for buyers and sellers to meet and trade in a competitive, low cost environment. It is fair to say that the Australian ABS market only exhibits some of these features, from time to time.

In looking forward, one area that could assist greater secondary market liquidity is improved post-trade reporting of prices. Price reporting could improve the efficiency of the market and potentially marginally reduce costs. FINRA in the US has instigated enhanced reporting of ABS post trade pricing. While there are some issues to be addressed in the Australian market, investors generally see benefit in better transparency of actual trade prices with some additional information about the trade size and type of institutions involved in the trade.

A fundamental ingredient for market liquidity is the presence of banks willing to act as market makers in ABS. This requires banks to hold an inventory of securities to facilitate timing and price mismatches between buyers and sellers at any point in time. Prior to the financial crisis, there were a reasonable number of banks in Australia willing to act as market makers. This allowed buyers and sellers to transact in reasonable time periods (days), with a reasonable bid/offer spread quoted on the securities. Since 2008, the number of market makers in ABS has reduced significantly, and the bid/offer spread has widened considerably. This reflects, in part, the impact of revised capital requirements prescribed by Basle III for the securities held in the trading books of financial institutions.

4) An Accommodating Regulatory Framework

Proposed and actual regulatory changes to securitisation markets have dominated the industry since the financial crisis. Scrutiny has come from global bodies such as the G20, the Basel Committee on Banking Supervision, the International Organization of Securities Commissions ("IOSCO"), as well as local policy markets and regulators.

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[5] Brunnermeier, M.K. and Pedersen, L.H. (2009) 'Market Liquidity and Funding Liquidity', Review of Financial Studies, Vol. 22, Issue 6, pp.2201-2238.

[6] Vayanos, D. and Wang, J. 'Market Liquidity: Theory and Empirical Evidence' in Constantinides, G., Harris, M. and Stulz, R. eds.: Handbook of the Economics of Finance, 2013, Chapter 19.

The current APRA Discussion Paper "Simplifying the prudential approach to securitisation" presents an opportunity to create a sustainable securitisation market. The new prudential standard needs to permit financial institutions to issue ABS, invest in ABS, trade ABS and provide credit and derivative facilities to support securitisation by third parties. Not all financial institutions will wish to conduct activities that span this spectrum although it can be expected that the four major Australian banks will do so.

Securitisation will benefit from a clear prudential approach. Such an approach would recognise securitisation can be undertaken for funding-only purposes or to achieve significant risk transfer, with a commensurate amount of regulatory capital relief. Prudential regulation should focus primarily on the capital and liquidity required to be held by an ADI against securitisation exposures. The regulator should be agnostic to the form of a securitisation, be it an amortising or revolving structure, provided the necessary capital and liquidity buffers are maintained by an ADI. It is advisable for the prudential standard not to be prescriptive about the transaction structures. Such a policy is likely to have disruptive implications in capital markets.

The setting for an appropriate regulatory framework should include a level playing field for various participants. It will be important that distortions and disincentives are not created through regulation that applies inconsistent regulatory capital requirements to the same risk exposures. The current global reconsideration of the risk weightings applied under the Basel III and Solvency II regimes is a welcome and necessary step to facilitate a broadening of the global investor base for ABS.

A key challenge for global regulators will be to find ways to adopt the principles of equivalency and mutual recognition of a number of regionally focused regulations. Recognising the equivalency of varying approaches will enable cross border securitisation markets to function better. A November 2012 report by IOSCO states that, "cross border activity is an important component of global securitization markets, and policy makers and regulators should be conscious of not adding to the cost of cross border activity through requirements that are duplicative of, or inconsistent with, requirements in other jurisdictions."[7] Accordingly, IOSCO's report includes the following recommendation: "Regulators should seek to minimize the potentially adverse effects to cross border securitization transactions resulting from differences in approaches to asset-level disclosure and privacy protections."[8]

Concluding Thoughts

Securitisation is an established and successful part of Australia's financial system. It provides an alternative source of funding for ADIs, introduces an element of competition in certain lending markets, and provides fixed income securities with varying risk and yield attributes to investors.

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[7] International Organization of Securities Commissions, *Global Developments in Securitisation Regulation: Final Report*, at 10 (Nov. 16, 2012), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf (the "IOSCO Final Report"). This report is part of a larger effort by the Financial Stability Board, acting upon the request of the G20, to develop recommendations to strengthen oversight and regulation of the securitization sector.

[8] *Id.* at 49.

The securitisation market can be a large, deep and liquid part of our financial system. To achieve this outcome a number of improvements will need to be achieved including:

- increasing the supply and diversity of ABS through use of efficient master trust structures;
- developing a larger, more diversified and sustainable investor base;
- pursuing improvement to the liquidity of the market; and
- finalising a consistent and pragmatic set of regulatory policies that are equivalent or mutually recognised by global policymakers and regulators.