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Economics References Committee
Economics Committee
Department of the Senate
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2 December 2010

ASF SUBMISSION: COMPETITION WITHIN THE AUSTRALIAN BANKING SECTOR

Background

The Australian Securitisation Forum (ASF) was formed in 1989 to promote the development of securitisation in Australia. As the peak industry body representing the securitisation market, the ASF performs a pivotal role in the education of government, regulators, the public, investors and others who have an interest or potential interest both in Australia and overseas, regarding the benefits of securitisation in Australia and aspects of the Australian securitisation industry.

The ASF is grateful for the opportunity to make a submission to the Senate Economics References Committee's *Inquiry into Competition within the Australian banking sector* (the 'Inquiry'). As an industry body, the ASF has limited its submission only to those aspects of the *Terms of Reference* for the Inquiry that relate directly to funding. Accordingly, the ASF's submission speaks to:

- (a) how securitisation can assist competition by providing a broader range of funding to a broader range of financiers;
- (b) what the government and regulatory agencies can do to promote confidence in the areas of consistency of regulation within and between government agencies as well as specific policy issues; and
- (c) where the market has and should continue to reform itself.

Background to the securitisation market

Sourced from *Austrade*¹ briefing note

- Australia's financial sector is the largest contributor to the country's national output, generating more than 10 per cent of Australian output. The sector has benefited from almost 20 years of sustained economic growth.
- 97 per cent of Australian Residential Mortgage Backed Securities ('RMBS') are backed by prime mortgages. Only 3 per cent are classified as non-conforming loans.
- Housing loan arrears for Australian RMBS prime mortgages (90+ days past due) peaked at less than 1 per cent in the beginning of 2009 and subsequently reduced. Non-performing housing loans in Australia have been substantially lower than that experienced in the US, UK and Spain (mortgage markets commonly compared to the Australian market).
- Australia's non-conforming loans market is small and mostly distributed by specialist lenders. The structure of these products is also 'less risky' than most of their overseas counter-parts, with lower loan-to-valuation ratios ('LVRs'), and does not generally feature introductory rates.
- Australia's market is characterised by high levels of lender's mortgage insurance ('LMI'). This is an additional charge, borne by the lender and often passed on to the borrower, which serves to meet any shortfall arising between the proceeds from foreclosure on the collateral (e.g. residential property) and the loan amount, which would include missed interest payments and any other claimable fees and expenses.
- There is a strong incentive for borrowers to repay their loans due to the full recourse nature of personal borrowing laws, such that upon default the lender and the LMI provider can pursue the borrower for any monies owed that were not otherwise met from foreclosure. This contrasts with most States in the United States where it is usually the collateral or the borrower's other assets (but not both) that are available to meet any losses.
- The Australian Government remains committed to the industry, having recently increased its direct participation in the industry by way of an additional \$8billion commitment to RMBS investments, bringing the total level of support since the GFC to \$16billion.
- The Reserve Bank of Australia (RBA) remains committed to include RMBS as eligible collateral for its repurchase agreements going forward.
- Residential Mortgage Backed Securities represented 75 per cent of all Australian Asset-Backed Securities on issue at December, 2009. RMBS has become an important source of financing Australian mortgages. Residential mortgages are a significant proportion of the overall domestic credit supply representing 56 per cent (\$1.1 trillion) of Australian credit outstanding as at December, 2009.

¹ Austrade: June 2010 *Securitisation. Australian Residential Mortgage Backed Securities*

Why securitise?²

Diversification of funding sources

Opens up access to new investor bases and funding sources that can provide resilience in times of liquidity crises

Balance sheet management

Can improve return on capital, may achieve off balance sheet funding, may release unproductive capital invested on low margin assets, can facilitate balance sheet restructuring.

Enhance strategic profile

An originator who may want to enhance their profile in the capital markets, often with a view to tapping into the market in their own name at some later stage, may choose to build up recognition and track record through a securitisation program

Reduce cost of funds

For lower rated originators, securitisation can often achieve a lower cost of funds than raising debt in their own name

Enhance liquidity

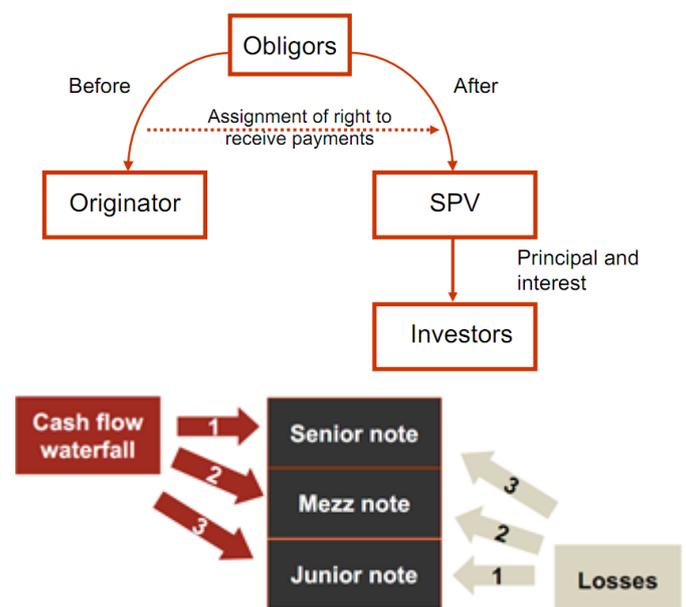
Transforming illiquid asset pools into marketable securities that when transferred into cash, can enhance originator liquidity.

Manage and match asset/liability profile

Securitisation transactions often issue pass-through securities, whose repayment obligations effectively match the repayment characteristics of the underlying asset

Transfer risk and cap the originator's credit risk

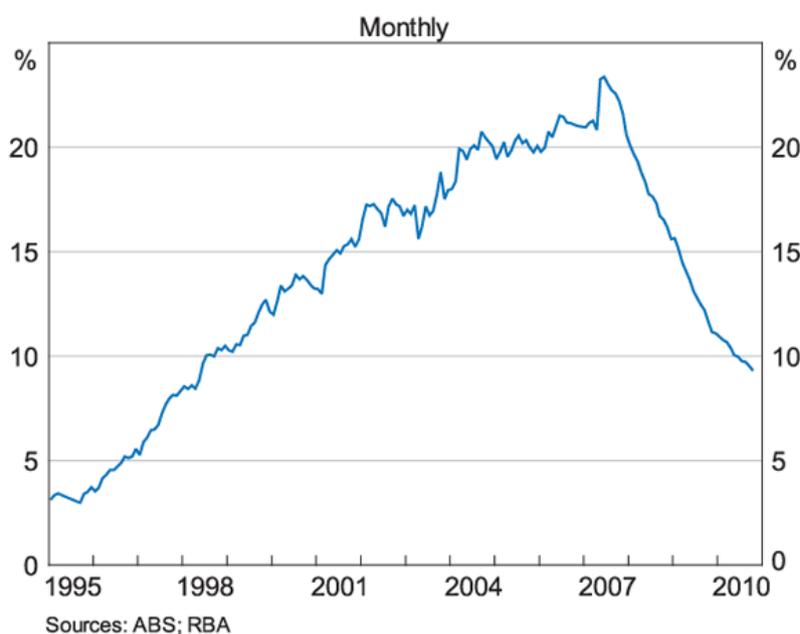
By securitising assets, some or most of the credit risk of those assets can be transferred to investors, with the originator's exposure limited to the portion that it retains as credit enhancement.



² Sourced from *St George Bank* briefing notes by Roger Desmarchelier, Chief Manager, Group Securitisation, St George Bank : May 2007 *Securitisation as an Alternative Funding Tool*

Introduction

The ASF supports market-led solutions that will promote the access of the Australian financial system to wider sources of funding and to reduce the overall cost of funding to the financial system, the providers of funding and ultimately to borrowers. A key part of the ASF's position relates to the reinvigoration of the market for Australian residential mortgage-backed securities ('RMBS') and other asset-backed securities ('ABS'). In order to note the contribution of securitisation to the funding of residential mortgage lending please refer to The Reserve Bank of Australia's graph below, *Share of Housing Credit Funded by Securitisation*.



Key initiatives supported

The ASF supports the following key initiatives, which are discussed in greater detail in the main body of our submission:

Policy and legislative change to develop a market for **covered bonds**, which will assist with reducing the overall cost of funds to issuers and creating greater financial stability for issuers by increasing their funding diversification as well as access facilitating longer tenors for funding (typically in the 5- to 10-year range).

Market and policy measure to **improve secondary market liquidity for RMBS**. Liquidity is one of the key issues faced with the RMBS market; not the credit of the RMBS. Therefore, the ASF will focus on initiatives that seek to improve liquidity.

Initiatives focused on **deepening the investor base** in order to improve liquidity but also to increase the volume of funds that enter the lending system through RMBS. To this end, the ASF recommends initiatives that seek to increase the allocation of superannuation and non-superannuation funds to RMBS.

The ASF has also considered initiatives such as the Government providing a guarantee on RMBS and the Canadian Mortgage Bond model. The ASF does not on balance recommend these initiatives;

- given the Government's stated preference not to distort the market or to remain itself as a permanent fixture in the market;
- as there is no evidence that they would actually reduce the cost of mortgages, judging from RBA data, which observes that *"the increases in variable and fixed mortgage rates in Canada have been similar to those seen in Australia, suggesting that the Canadian housing agencies have not had a significant impact on mortgage rates during the recent capital market turbulence³;"* and,
- because they do not constitute a universal, market-oriented approach

As an industry body, the ASF has consulted widely with its members in formulating its policy initiatives and this submission. However, support across the ASF's members for certain aspects of this submission cannot be said to be universal given its broad membership base of major banks, regional banks, non-banks, credit unions, building societies and investors (see Appendix A for a list of ASF members). The perspective and preferences of each of the ASF's members, in matters of funding and competition, differ occasionally. Where any significant points of difference arise, these are highlighted in the relevant section.

We wish the Inquiry well and look forward to taking your questions at the upcoming hearings.

Yours sincerely

STUART FULLER

Chairman
Australian Securitisation Forum, Inc.

³ p.19, Appendix A – The Canadian Securitisation Market, *RBA SUBMISSION TO THE INQUIRY INTO COMPETITION IN THE BANKING AND NON-BANKING SECTORS*, November 2010



EXECUTIVE SUMMARY

1. **Liquidity and confidence; not credit.** The credit performance of Australian RMBS has proven to be strong throughout its twenty-year history, including during the GFC. While slow to recover, the AOFM's participation has allowed funding to continue in limited volumes. Initiatives to assist with reinvigorating the RMBS market need to focus on improving liquidity. Confidence will come over time given a stable, supportive environment. Government support will contribute to this confidence-building.
2. **Reduced number and depth of investor base.** Initiatives should seek to increase the investor base and/or the amount of funds available for investment in RMBS through measures that incentivise investors towards fixed-income securities generally, including RMBS.
3. **Regulatory barriers.** A sound legislative, regulatory and prudential framework is a fundamental element to market and investor confidence. Consistency in the approach of government and regulators across each of them is crucial. The ASF believes that a coordinated policy framework needs to be developed in order to promote the confidence of investors in the securitisation markets as well as ensuring consistent treatment across the range of financiers and sources of funding.

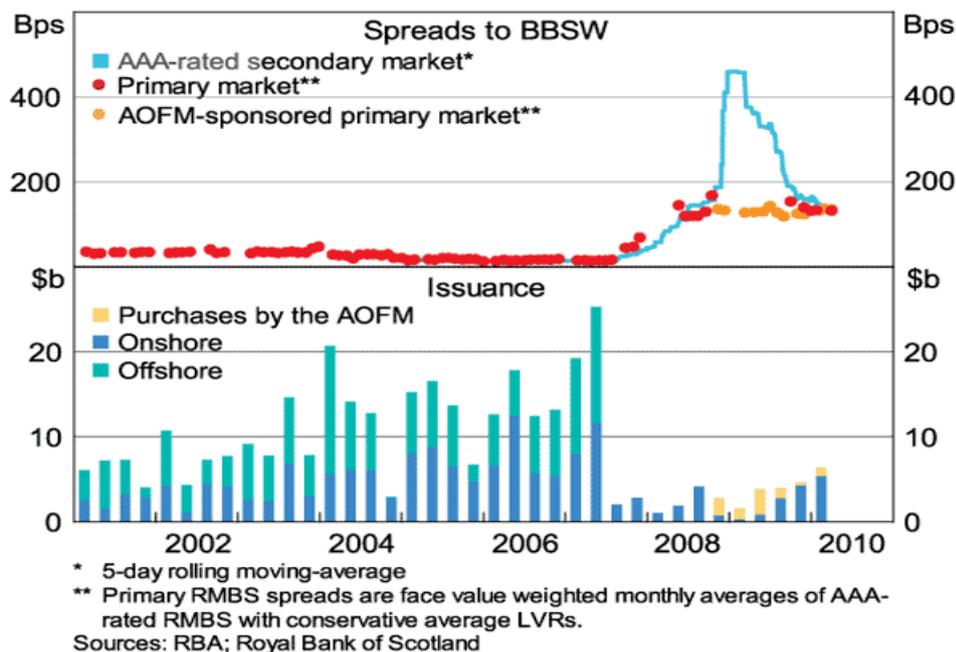
INTRODUCTION

This section of the ASF's submission first provides background information on the securitisation markets that, on balance, make RMBS a class of security worthy of support in order to:

- foster competition;
- price and distribute risk optimally within the financial system and economy; and,
- deliver cheaper funding.

Graph 1 below illustrates why issuance and therefore lending stemming from securitisation funding had a sudden and dramatic fall. Namely, the return (or yield) demanded by investors increased 150 basis points (or 1.5%) for new, 'primary' issuance and 400 basis points (or 4.0%) for existing transactions in the market.⁴ This explains why securitisation funding came to a halt.

Graph 1: Australian RMBS: margins and issuance levels



Securitisation brings a number of advantages to Australia's financial system. It:

- facilitates the funding of 'the Aussie home loan' by accessing the large pools of global capital market investors, which in turn reduces the system's reliance on deposits and other competitive sources of debt funding;

⁴ This 'secondary market overhang' undermined primary market issuance because it was more lucrative for investors to buy in the secondary market (i.e. a 4% return over BBSW rather than a 1.5% return over BBSW).

- diversifies risk away from bank balance sheets and beyond Australian investors;
- by linking directly the performance of the underlying collateral to the RMBS itself, it removes many of the risks and intermediation costs associated with balance sheet lending;
- it enables investors to diversify their investments by gaining access to a low-risk (A, AA and AAA rated) yet relatively high-yielding class of security; and
- provides long term funding that is matched to the term of the underlying assets.

However, the ASF also notes that the use of securitisation raises a number of issues which need to be managed, and many of which have been highlighted by the conduct of offshore markets in the lead up to the global financial crisis. Given these challenges, the market will and indeed already has begun to evolve to meet investors' new preferences, both local and global.

The ASF believes that there is no single solution to the challenges that face the securitisation market and, more broadly, the continued recovery of a broader range of financiers that can provide funds to the Australian economy. This is because the challenges are many; and because the structure of the financial system is made up of different players with different roles and interests, and which face different opportunities and threats.

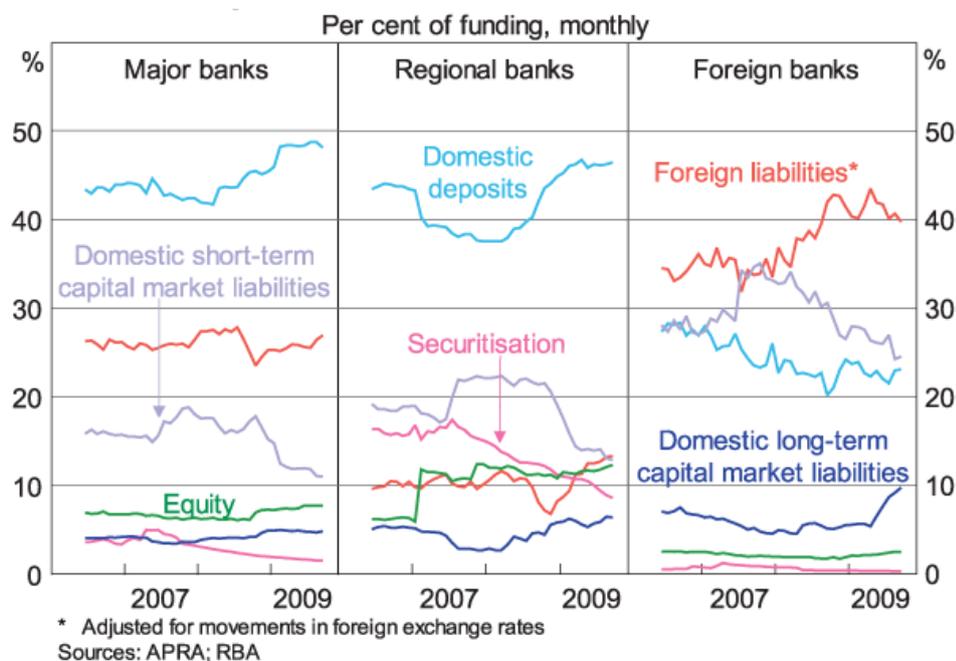
As a result, the ASF believes that the Government needs to support a portfolio of measures that focus on the dominant issue – funding – and that these measures are accessible so all can compete.

The ASF also believes that this is politically and socially prudent, as few measures can claim to meet the various challenges posed by financial stability, competition, and cost of funds.

The ASF acknowledges that securitisation is merely one method of funding. That is why the ASF also promotes the introduction of covered bonds legislation in conjunction with initiatives that support the RMBS market. From a competition perspective, RMBS is more attractive because it ignores the credit rating of the entity that originates the mortgage loans and instead focuses on the credit quality of the mortgage loans themselves. By doing so, securitisation provides a method of funding that provides a consistency of requirements between all financiers, and a greater equality in the cost of funding between those financiers, regardless of their size or rating.

The ASF also promotes a policy and regulatory environment that ultimately promotes the basis for market solutions. In some instances, this may initially require Commonwealth balance sheet support in order to provide the necessary scale and impetus.

Graph 2: Funding composition of Australian banks (excludes non-banks)

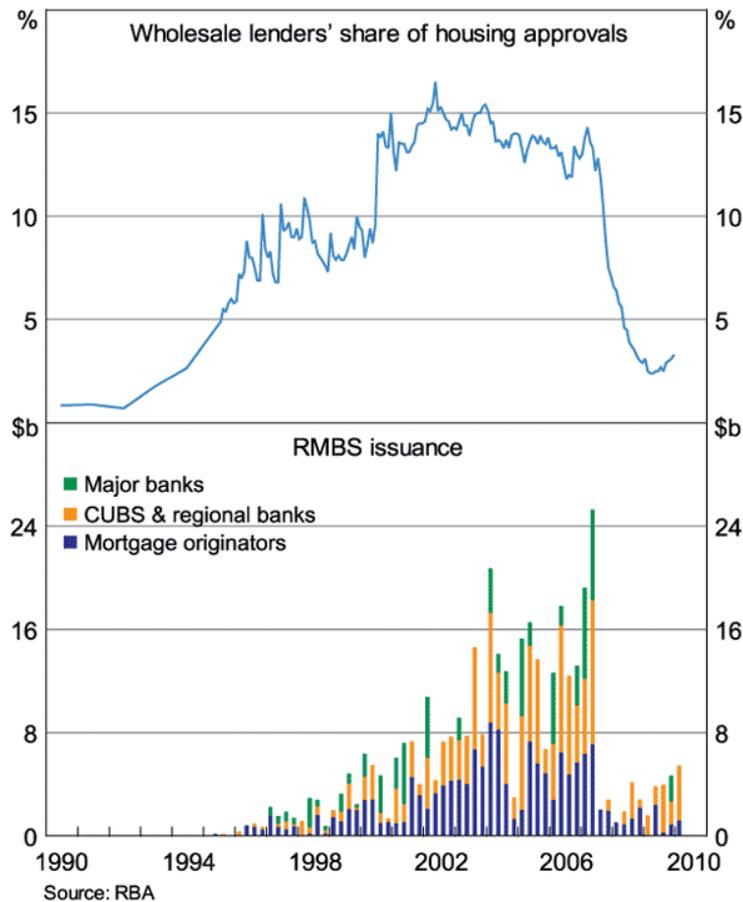


To support the ASF's view that securitisation can be an important source of funding, Graph 2 shows that, before the GFC, almost one-fifth of bank funding was sourced from securitisation markets. Mutuals and non-banks also used securitisation extensively (not reflected in Graph 2) as both a capital management and funding tool, bringing the whole financial system's use of securitisation markets to approximately 25% of the financial system's funding requirements. Graph 3 below illustrates the market share of non-bank/wholesale lenders and their corresponding levels of issuance of RMBS relative to deposit-taking institutions.

KPMG reports⁵ that securitisation receivables have declined 5.8% (to \$6.1bn) for building societies and 3.1% (to \$10.9bn) for credit unions. A tightening of certain prudential requirements, together with the contraction of the securitisation markets, are the principal reasons cited for this reduced use of securitisation.

⁵ KPMG, Building Societies and Credit Unions 2010, Financial Institutions Performance Survey

Graph 3: Wholesale lenders market share and use of securitisation



The Australian securitisation industry, and its industry, benefited from keeping its products relatively simple; it rarely used complicated structures or high-risk assets; and maintained a close relationship with investors. This conservative has continued after the GFC, with the securitisation industry actively working with regulators to develop additional standards that meet the requirements of the G20 and IOSCO initiatives. These relate to consistency, transparency and better alignment of issuer and investor interests. We believe that these measures may assist in removing further obstacles to investment.

Perversely, some measures that have sought to support the Australian financial system have of late undermined the recovery of the securitisation markets. Specifically, the government guarantee of wholesale funding and retail deposits has meant that many investors have preferred simpler and safer – albeit lower yielding – assets issued by the ADIs. At the retail level, it has been difficult to persuade the investment and superannuation funds industry of the advantages of investing in RMBS

when they can lend funds to an ADI or other deposit-taker that has the benefit of a government guarantee in the event of default. The ASF continues to be hopeful that, as the government guarantees fall away, RMBS will have yet another obstacle removed from the path between lenders and borrowers. Introduction of a selective wholesale guarantee or indeed RMBS guarantee for Mutuals would be detrimental to non-bank and second-tier bank RMBS issuers.

There are differences of opinion between the major and the non-major banks as to who were the beneficiaries of government guarantees at both the deposit and wholesale funding level. The majors contend that the flight to quality during the GFC meant that, inevitably, lenders would prefer them over lower-rated, smaller institutions but that the government guarantee particularly of deposits stemmed the extent of this flight to them. There is also evidence to suggest that their substantial need for funding and correspondingly aggressive term and at-call interest rates to attract funding meant that depositors preferred them. They also point to their role in continuing to provide securitisation warehouse facilities⁶ to the rest of the securitisation system. Without being able to fund, the rest of the system would have suffered.

Meanwhile, the non-Majors claim that the government guarantees were priced inequitably and meant that both on a perception (at the retail level) and reality (at the wholesale level) basis the Majors did indeed disproportionately benefit.

SPECIFIC RMBS SUPPORT MEASURES

Getting the issuance environment and regulatory settings optimised and consistent

The proposals set out in this section of the ASF's submission primarily seek to promote liquidity, but also are designed to ensure the continued business operation of certain lenders that cannot, in the short-term, fund themselves without modest government support.

1. AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT RMBS INVESTMENT PROGRAM ('AOFM')

Excellent in keeping alive competition agents; adapt mandate to tackle underlying causes

The first two rounds of investment by the AOFM have been very supportive of certain non-major and non-bank lenders in terms of price and volume of funding.

⁶ These are used extensively by small banks, credit unions and building societies, and the non-banks as a means to fund lending up to the point that a critical mass of mortgages have been written, at which point they 'term out' to the public securitisation bond markets that require a typical minimum of \$200m but which average around \$750m.

a. Continued ‘back-stop’ direct investment in need

The ASF continues to see signs that the degree of reliance on the AOFM is lessening, which is a crucial sign of improvement in the securitisation market. However, whilst issuers have been pleased with the AOFM’s programme and pricing, investors have become increasingly concerned with what they see as the artificially low prices at which the AOFM has been willing to invest. The issue is that this is seen as a manipulation of the market’s natural demand and supply dynamic, which could lead to the investors questioning RMBS as a dependable investment.

b. Investing lower down the capital structure

There is support amongst some (but not all) industry participants for the investment programme of the AOFM to be broadened to include the lower tranches of RMBS as these classes are proving the hardest to sell to investors – whether ‘real money’ investors, or the issuer themselves – for the following reasons:

- mark-to-market (‘MtM’) accounting requirements⁷ amplify the volatility of reported earnings even for an investor that intends to hold to maturity junior RMBS notes;
- where the tranches of RMBS cannot be sold to external investors, the retention of these tranches of RMBS on the issuer’s balance sheet has an adverse regulatory capital treatment under Australian and international standards and which adds to the cost and financial impact of the securitisation transaction;
- most investors are exposed to extension risk (i.e. that repayment of the RMBS will occur at a date later than expected by investors because of slow payment rates from borrowers);
- there is limited depth in the domestic investor for lower tranches of RMBS because the risk is higher and therefore outside of the parameters of existing investment mandates. This is despite the fact that the credit quality of these lower tranches of RMBS is still comparatively high (A and AA rated, typically)

⁷ Securities that qualify as *Hold-to-Maturity* or *Loans & Receivables* can be carried at *Amortised Cost* but *MtM* is more appropriate for investment funds that seek to facilitate redemptions for incoming and outgoing investors. When trying to fair value securities, the current *MtM* guidance requires independent broker quotations even in an illiquid market. As a consequence, we witnessed a downward spiralling of market values as securities were marked to the most recent secondary market sales. Recent IFRS 9 changes will continue to require all investors (including banks) in junior notes – where the credit risk in the tranche held is greater than the portfolio as a whole – to be carried at fair value and marked to market. The reality is that this is unhelpful albeit.

Some participants in the industry advocate a government guarantee of RMBS. The ASF does not endorse this approach. Indeed, the RBA echoes this view:

“In thinking about the AOFM support for the RMBS market, I believe the AOFM program has a number of advantages relative to alternative means of support: it can be easily tailored to help specific types of institutions; it can be phased out easily; the likelihood that the Government loses money on its investment is very small; and there is no ongoing contingent liability to the Government from providing the support. If instead a government guarantee of RMBS were provided, it would be difficult to phase out, creating a commitment that could generate a large contingent liability for the Government.”⁸

c. Develop focus on reaching self-employed and small business segments

The latest round of AOFM direct investment in RMBS sought to target small business owners and self-employed borrowers. The ASF encourages further targeted investment in these types of RMBS by the AOFM by, for example, AOFM investment in RMBS issued by financiers in the specialist mortgage sector, 75% of whose borrowers are self-employed or small business owners. This will require, in part, a change to the AOFM’s current *Minimum Eligibility Requirements* so that it can invest in AAA RMBS regardless of whether the underlying loans are mortgage insurable.

2. PRUDENTIAL REGULATION

a. Allow RMBS and covered bonds to be part of the ‘Australia solution’ to meet Basel III Level 2 liquidity and net stable funding ratio requirements

If the international and Australian prudential standards include covered bonds as an eligible liquid asset¹⁰ for the purpose of Basel III, then the ASF sees no reason why Australian RMBS should be excluded, noting the remarks of the ECB:

“At the moment, it is difficult to quantify the impact on the different market segments [of liquidity changes under Basel III], or to judge whether the adjustment will take time or be abrupt.

⁸ *The State of Play in the Securitisation Market*, Guy DeBelle, Assistant Governor (Financial Markets), *Address to the Australian Securitisation Conference 2010*, Sydney – 30 November 2010

¹⁰ Given that the matter of permitting covered bond issuance (as a liability instrument for funding) is a matter for government rather than APRA, this is discussed under the section on covered bonds.

But it can be expected that the categorisation of assets into certain classes of liquidity will lead to a ‘cliff effect’, by which the regulatory categorisation of assets as either liquid or illiquid plays a crucial role for the future of their market. Moreover, it implies that changes in market conditions, such as a downgrade, can move assets from one category into the other, leading to sudden changes in banks’ fulfilment of the liquidity coverage ratio. This could make their fulfilment somewhat unpredictable.” [\[ECB\]](#) (emphasis added)

b. B Class Notes

Some participants also believe that APRA should review¹¹ practice in the European Union and the USA under which tranches of RMBS which are retained by an issuer should be assessed with detailed regard to how much risk has in practice been transferred (rather than taking the default position that retention means no Significant Risk Transfer has occurred). This position would require a methodology to determine how much risk has (or has not) been retained and therefore what proportionate amount of regulatory capital ought to be held (or which can be released) and recycled for lending purposes.

We note that on 30 November 2010 at The Australian Securitisation Forum conference, APRA announced its intention to write to ADIs advising of its willingness to ease the capital treatment of so-called B Class Notes. The ASF very much welcomes this signal as heading in the right direction and will provide its views to the Inquiry once we have had sight of the detail and consulted with industry members.

c. Facilitate and clarify treatment of master trust structures so that ‘bullet’ RMBS can be issued by ADIs to additional investor bases

Offshore jurisdictions have a regulatory framework that allows the establishment of “master trust” structures (whether used by only one issuer or by multiple issuers) and under which fixed term (or “bullet”) RMBS are issued to a further class of investors. The ASF believes that APRA should be encouraged to introduce a regime that allows these type of “master trust” structures and under which, for example, Mutuals can exploit their aggregate scale and so can also gain access to RMBS funding.

¹¹ For a detailed discussion of this, see ff12 a [report](#) by Sidley Austin LLP. It discusses efforts by FSA, FRBNY/SEC, and EU C-EBS to establish how an originator can still get capital relief on a retained amount. It also discusses how this might be possible as well as meet the otherwise unrelated retention requirements under IOSCO.

The ASF also believes that a more efficient way of achieving a bullet RMBS is to allow for substitution of assets and to permit an ADI to buy-back the performing assets at maturity – this eliminates negative drag and reduces extension risk for investors. However, the ASF notes that the current prudential and regulatory framework does not allow APRA (or any other relevant regulator) to assess and administer such structures in a way that is efficient from a capital and liquidity perspective for an ADI. It requires a more specific direction from Government, from a policy perspective, to allow such structures.

COVERED BONDS

Levelling the playing field globally; accommodating the Basel III liquidity and funding challenges

1. G20 nations permit covered bond issuance by their deposit-taking institutions

In more than twenty nations¹², covered bonds perform a critical role on the liability and asset sides of bank balance sheets. The ASF has consistently recommended their introduction in Australia under an appropriate legislative and prudential framework.

The ASF also notes that the Basel Committee of Banking Supervision ('BCBS'), as part of the G20 reform initiatives, includes covered bonds as a permissible asset for liquidity and funding for banks. In each case, any reduction in security for depositors has been offset by the increased sources of funding and the resulting benefits to the stability of individual issuers and the broader financial system.

2. Issuance would not – in conjunction with RMBS measures – entrench the position of the Majors

Because the relative cost benefits are secondary to the primary prudential benefits of lower overall ADI funding costs and lengthening the funding profile; diversifying the investor type (to 'rates' investors, especially the large European pension funds and insurance companies that buy covered bonds but not RMBS).

¹² Austria, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Luxembourg, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, South Korea, Spain, Sweden, Switzerland, United Kingdom, U.S.A. and Ukraine

The primary advantage of allowing a bank to issue covered bonds is not a lower cost of funding (and therefore it is not chiefly a competitive threat) but, rather, it is the strengthening of a bank's balance sheet and the stability of the broader financial system through:

- lengthening the duration of a bank's debt maturity profile, meaning it is less vulnerable should short-term sources of funding disappear or become expensive;
- lowering wholesale funding costs, which reinforce the capital position and on-going ability to attract capital and funding (indeed, for this reason, credit rating agencies see modest covered bond issuance as pro-prudential)
- diversifying funding sources so that they are able to broaden the number and types of investors that are only interested in so-called 'rates products' (i.e. highly-rated, fixed bullet securities that respond more to interest rate than credit movements)

The potential for investors to accept AA rated covered bonds (which will assist investment grade rated issuers) was assessed by ASF by way of an investor questionnaire. Nineteen of the twenty-two investors polled¹³ said they would invest in A, AA and AAA rated covered bonds, suggesting the non-Majors could access this market. The ASF does acknowledge that there would be a pricing difference between AAA, AA and A rated covered bonds, just as there naturally is for ordinary bank (and corporate) funding at present.

The ASF also notes for instance that, because of dual recourse to the bank balance sheet and the cover pool of collateral, a AA rated covered bond usually prices tighter than AA rated Major bank senior unsecured issuance.

In terms of minimum issuance size, domestic investor feedback indicated interest in smaller issuance sizes (i.e. \$100m - \$200m), suggesting the potential for access by Mutuals and small banks. Furthermore, based on the European experience, the pricing benefit would be disproportionately beneficial to the non-Majors. In doing so, the ASF notes the strong, opposing view from one ADI and one LMI provider as to the pricing benefit and scope for unintended consequences. It should also be noted that whilst all other ADIs are neutral or supportive, there is widespread desire to ensure that RMBS receives support along the lines outlined in the RBMS section above. The rationale is clear: if the major banks are to be the prime beneficiaries from covered bonds, the Regionals and other 'second-tier' ADIs require commensurate support because RMBS is their dominant funding source, after deposits.

¹³ See attachment to this submission for the full survey results, conducted by Barclays Capital and Deutsche Bank on behalf of The Australian Securitisation Forum Covered Bond Working Group.

Multi-issuer covered bond structures that prevail in Europe among medium- and small-sized issuers could also permit access by the non-major ADIs and therefore address the concerns that the Majors ADIs will further entrench their funding advantages. The ASF *Covered Bond Working Group* has been focussing on the following two models:

- *Caisse de Refinancement de l'Habitat* – resilient before, during and after the GFC, with total outstanding funding in France of €41.2bn
- Multi-issuer *Cedulas* – *AyT Cedulas Cajas* which provides covered bond funding for 43 savings banks in Spain. This structure has however not been as resilient during and post financial crisis largely due to sovereign issues.

Prudential issues with respect to the protection of depositors exist but every major jurisdiction has managed to satisfactorily address these. New Zealand and Canada are both poised to introduce legislation to formally introduce and allow covered bond issuance as a part of the architecture of their financial systems. It has long been the ASF's contention that prudential issues can be addressed through an appropriate legislative and prudential regulatory framework together with supervision, under which:

- there is a limit on the proportion of the ADI's assets that can be encumbered for covered bond holders instead of deposit holders, so that the latter still sufficient recourse to an issuer's assets in the event of insolvency¹⁴
- there are prescribed operational and governing principles – so that there is no adverse selection of assets between those left on the balance sheet for deposit holders and those used as collateral in the cover pool
- there is a regulatory limit on the volume of covered bonds that financial institutions may issue, and which would provide greater certainty for issuers, investors and regulators and lead to market confidence
- the covered bonds that are issued will meet Basel III 'Level 2' liquidity eligibility criteria thereby providing

The prohibition on Australian banks against issuance of covered bonds means AUD covered bonds to date have been issued only by offshore banks, with the consequence that Australian funds are being repatriated to fund foreign banks and ultimately foreign mortgages instead of those funds going to work in and for Australia.

¹⁴ By way of example: even if an upper limit of 10% of a bank's total funding were through covered bond issuance, and that 10% were 'over-collateralised' with 15% of its assets, that would still leave 85% of its assets to cover domestic retail deposit holder liabilities, which tend to be in the 40%-60% range.

SUPPORTIVE MEASURES TO ATTRACT INVESTORS

Imperative to create a dynamic under which a greater allocation of Australian investment and superannuation funds are allocated to, and invested in, fixed income securities, including RMBS.

The ASF shares the views of many that investment and superannuation funds (both wholesale and retail) have an asset allocation that is over-weight equities and under-weight fixed income securities. Indeed, the Intergenerational Report 2010, *Australia to 2050: future challenges*, emphasised the need for Australian retirement incomes to have higher weighting to fixed income so as to provide greater certainty of income and less capital volatility.

The following two charts display the monthly rolling annualised returns for domestic bonds and domestic equities, which demonstrate the potential higher returns to equities but at the cost of higher volatility and the risk of significant loss of capital.

Fixed income

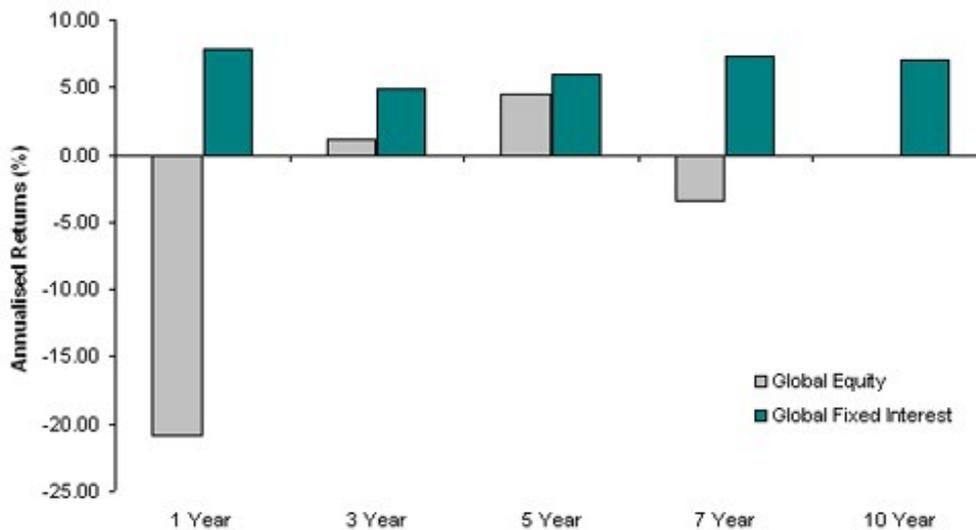


Equities



Source: Bloomberg/PIMCO

The bar chart below further from PIMCO supports this view at the global level, illustrating returns for Global Equity Returns v Global Fixed Interest Returns over a number of different periods.



Investors – ‘real money’ as well as bank balance sheet – say that linking RMBS to a prudential liquidity requirement could have a significant benefit for the asset class as it would rapidly deepen the liquidity of RMBS, making it more attractive to a much larger investor base.

GREATER COORDINATION BETWEEN REGULATORS

As set out above, the ASF and its members have embraced the need for regulatory and other improvements in the “infrastructure” of the market and its effectiveness to promote investor confidence. These include amendments made by APRA to the prudential framework, as well as the initiatives taken by ASIC to introduce specific requirements as a result of the initiatives from G20 and IOSCO. These initiatives include enhanced disclosure and transparency regime for investors, a framework under which an issuer is required to retain a certain economic interest in the assets that are being securitised (“skin-in-the-game”) and other requirements under which a securitisation programme, across issuers, will become more consistent.

The key concern to the ASF is the consistency of the application of these requirements, across different regulators, as well as the coordination of further enhancements to the regulatory and prudential framework. The ASF believes that there is a further role that *The Council of Financial Regulators* (or any other appropriate inter-agency group) can play in meeting this requirement.

Appendix A

List of members of The Australian Securitisation Forum as at November 2010

1. AIG Mortgage Risk Solutions
2. AIMS Home Loans
3. Allen & Overy
4. Allens Arthur Robinson
5. AMAL Asset Management
6. AMP Bank
7. ANZ Banking Group
8. Assured Guaranty
9. Australian Ethical Investments
10. Australian Executor Trustees
11. Bananacoast Community Credit Union
12. Bank of America Merrill Lynch
13. Bank of Queensland
14. Banksia Mortgages
15. Blake Dawson
16. BNY Mellon Australia
17. Calibre Financial Services
18. Challenger Mortgage Management
19. Clayton Utz
20. Collins Securities
21. Columbus Capital
22. Commonwealth Bank
23. Corrs Chambers Westgarth
24. Credit Union Australia
25. Cuscal
26. Deloitte
27. Deutsche Bank
28. Ernst & Young
29. FIIG Securities
30. FirstMac
31. Fitch Ratings
32. Fox Symes Home Loans
33. Freehills
34. Genworth Financial
35. Greater Building Society
36. Henry Davis York
37. Heritage Building Society
38. Hometrack
39. ING Bank
40. IMB (Illawarra Mutual Building Society)
41. Indue
42. Investec
43. JP Morgan
44. Laminar Advisory
45. Liberty Financial
46. Lloyds International
47. Macquarie Bank
48. Mallesons Stephen Jaques
49. Minter Ellison
50. Moody's Investors Service
51. Morgan Stanley
52. Mortgage House of Australia
53. National Australia Bank
54. Norton Rose Australia
55. Pepper Homeloans
56. Perpetual Limited
57. PricewaterhouseCoopers
58. Provident Capital
59. QBE LMI
60. Resimac
61. RHG Home Loans
62. The Royal Bank of Scotland
63. Standard & Poor's
64. Stargate Global Asset Management
65. State Street Capital
66. Suncorp-Metway
67. Trust Co
68. Victorian Mortgage Management Group
69. The Rock Building Society
70. UBS AG, Australia Branch
71. Unicredit Bank AG
72. Westpac Banking Group
73. Wide Bay Australia