Chris Dalton
Chief Executive Officer

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Economics References Committee
Economics Committee
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Committee Members,

ASF SUBMISSION: SENATE INQUIRY INTO THE POST-GFC BANKING SECTOR

The Australian Securitisation Forum ('ASF') is grateful for the opportunity to provide the following submission addressing the Committee's Terms of Reference for the above inquiry. We thank the Committee for providing an extension of time to accept our submission on this matter.

The ASF was formed in 1989 to promote the development of securitisation in Australia. As the peak industry body representing the securitisation market, the ASF represents and promotes the interest and perspectives of the Australian market to policy makers, regulators and government. It facilitates improvements to market standards and practices and provides a suite of training to increase market participants' professional development.

This submission is made by the ASF's Government & Industry Liaison sub-committee, comprising a cross-section of the securitisation market which includes representatives of banks, non-banks, institutional fixed interest investors, lenders mortgage insurers, investment banks and lawyers.

The membership of the ASF has observed significant changes in the shape, nature and scale of Australia's banking sector post the 2008 financial crisis and are pleased to share these observations with the Committee. Our responses are focused on the Australian securitisation market and its participants, particularly residential mortgage lenders that have been particularly affected by the funding challenges in the wake of the global financial crisis.

Please contact me if you have any questions or wish to discuss our comments in greater detail.

Yours sincerely

CHRIS DALTON

A. The impact of international regulatory changes on the Australian banking sector, particularly including changes to liquidity and capital holding requirements;

Many of the poor business and market practices that existed in many global securitisation markets prior to 2008, and are now sought to be addressed by international regulators, were not prevalent in the Australian securitisation market. However such international regulatory changes have had a direct impact on the Australian securitisation market. Changed regulations attempt to target the following areas:

- capital and liquidity treatment of securitisation within the banking and financial sector (including Basel III);
- investor disclosure and reporting;
- the role and operation of credit rating agencies; and
- the alignment of economic interests of securitisation market participants.

The impact of ongoing international regulatory changes, principally those proposed under Basel III, have contributed to the increased cost of securitisation as a source of funding for banks; reduced the attractiveness of certain higher risk securitisation investments by banks; and, fund managers have become more cautious towards securitisation due to the continuing regulatory uncertainty and change, both within and between jurisdictions.

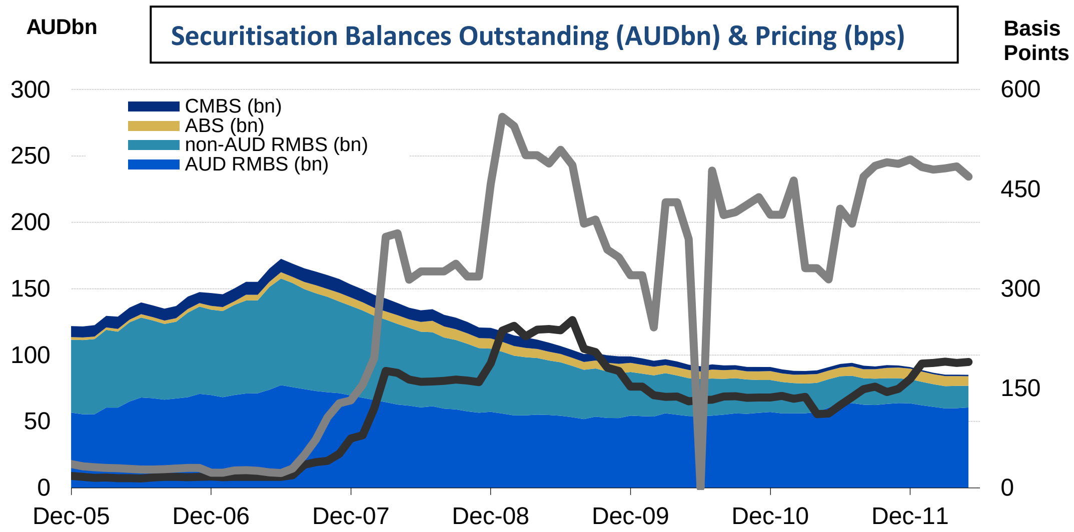
For example, the yet to be resolved rules from the Dodd-Frank Act in the United States – including the controversial Volker Rule – and Solvency II are creating further uncertainty and negatively impacting the Australian securitisation market.

The impact of international regulatory changes in the Australian securitisation market has been evidenced in a number of ways including:

- a decrease in the number of credit providers and the quantity of credit provided;
- an increase in the pricing of and required amount of committed regulatory capital of credit facilities provided to small ADIs and non-bank securitisers under warehouse loans prior to a capital market securitisation issue;
- a decline in the number of banks willing to provide securitisation warehouse facilities to smaller securitiers and uncertainties around the ability to refinance warehouse loans (whether by way of term issuance or warehouse funding from third parties);
- fewer counterparties willing to provide hedging contracts to mitigate interest rate or foreign currency risk in securitisation transactions. This is also due to rating agency actions including downgrades;
- an increase in the costs to provide hedging especially cross-currency swaps to support offshore issuance as a direct result of increased capital costs due to Basel III and rating agency counterparty criteria changes;
- the changes in market conditions and regulatory changes has dramatically increased the risk premium required by investors in both the senior and subordinated tranches of Australian securitisation

The following chart illustrates that since the 2008 financial crisis the balance of securitised debt outstanding has decreased while the pricing of the main asset class, residential mortgage backed securities (RMBS), has increased. The increase in pricing is due to a number of factors including a general re-pricing of risk in global credit markets but does incorporate the cost of financial institutions needing to comply with new and proposed regulations.

Chart 1 – Size of Securitisation Market and Yield on Senior Securities



Source: Macquarie Debt Markets Analysis

B. The impact on the relative shares of specific banking markets;

From the early 1990s to 2007, securitisation markets allowed smaller banks and specialised non-bank mortgage lenders, including well-known brands such as Wizard, Aussie Home Loans, Liberty Financial, and RAMS Home Loans, to become a strong competitive force in residential mortgage lending in Australia. By 2007, these lenders accounted for 23% of new mortgage lending.

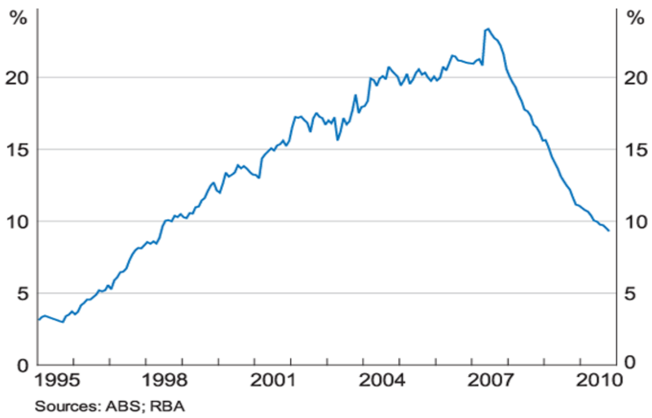
Due to the collapse of international securitisation markets, many of these lenders have been wholly or partially acquired by larger lenders (for example Westpac's acquisition of RAMS Home Loans and merger of St George Bank, CBA of Aussie Home Loans and BankWest, NAB of Challenger Mortgage Management). This has resulted in a greater concentration of mortgage lending by major banks, as evidenced by Reserve Bank of Australia (RBA) and Australian Bureau of Statistics reports.

It is the conclusion of the ASF that the impact of international regulatory changes has, in part, increased the degree of concentration within the Australian banking system. This has come about due to the inability of smaller financial institutions and non-bank securitisers to remain as competitive as the major Australian banks as funding in local and international capital markets has become more difficult and expensive.

The overall decrease in the size of the securitisation market can also be attributed to a smaller number of investors, both domestic and global, who are now investing in new primary market issues of mortgage and asset-backed securities. This again is in part due to changes in regulation and has the effect of constraining the capacity of capital markets to fund financial assets through securitisation. Further, the small investor base has reduced the “price tension” for new primary issues and this translated into increased cost of funds for securitisers.

The following graph illustrates the reduction in the share of the home loan market financed via securitisation.

Chart 2 – Percentage of Australian Residential Mortgages Funded by Securitisation



European regulations such as CRD IV and Solvency II are negatively influencing the interest of European investors in Australian mortgage and asset-backed securities relative to other debt securities such as sovereign bonds and covered bonds.

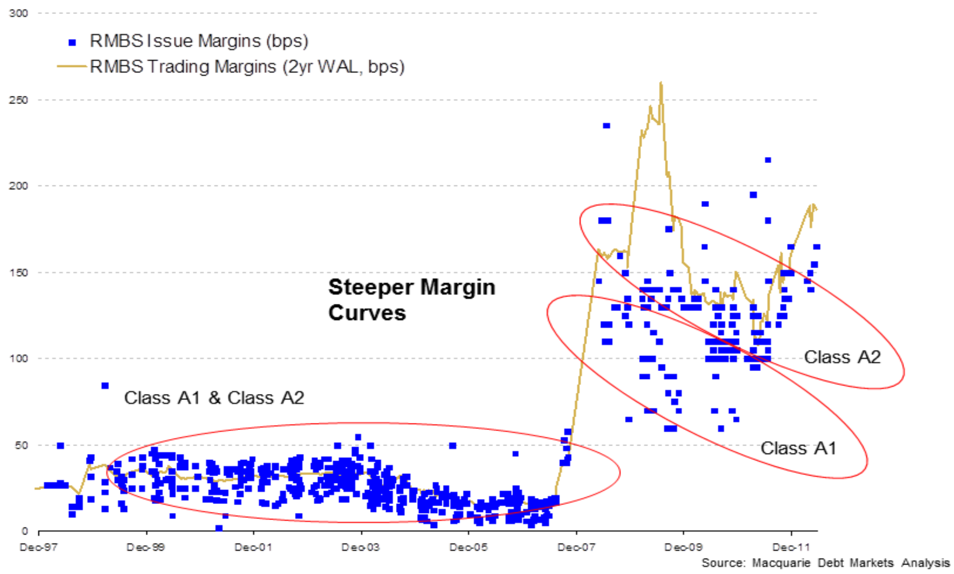
The impact of the consolidation within the Australian banking sector and the absence of international investors in Australian securitisations have reduced the amount of housing finance being provided through non-bank channels and funded via securitisation.

C. The current cost of funds for lending purposes;

The Australian securitisation market is mainly used to fund residential mortgages but also other lending to consumers and small business including auto loans, equipment leases and small commercial properties. The cost of funding through securitisation has increased dramatically since the financial crisis and is likely to remain above pre-crisis levels. This is due to the changed market dynamics of global debt capital markets.

Chart 3 below shows the increase in securitisation funding costs for residential mortgage lenders. This increased cost is passed on directly to the lending interest rate. The chart plots the actual pricing margin of ‘AAA’ rated tranches since 1997. It clearly demonstrates that there have been substantial increases in the prices of highly rated tranches of Australian RMBS securities. A similar shift in the pricing of ABS has occurred for asset-backed securities.

Chart 3 – Change in RMBS Pricing Post-GFC



D. The impact on borrowing and lending practices in the banking sector and since the global financial crisis;

In the sectors of the financial market in which securitisation provides a source of credit (predominately the residential mortgage market) it has been evident that more conservative lending criteria have been applied. Accordingly, since 2008, residential mortgage-backed securities issued have been collateralised by pools of high credit quality features including more seasoned loans and lower loan-to-value (LTV). The implication being that securitisers have generally been more selective and restrictive as to which borrowers they extend credit.

A number of factors have had an impact on the characteristics of the Australian securitisation market today compared to pre-2008. These include:

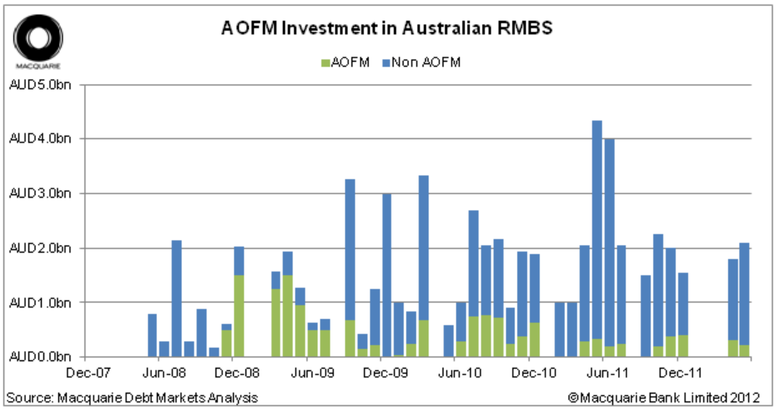
- more conservative risk appetite of investors;
- contraction of lenders mortgage insurance risk appetite amongst investors in RMBS;
- absence of international investors in domestic securitisation transactions (except for a small number of Japanese investors);
- more expensive liquidity and swap facilities especially cross currency swap facilities required to support offshore issuance;
- the more conservative rating criteria adopted by credit rating agencies who rate Australian securitisations which have increased the costs for issuers due to the increased level of credit enhancement required to attain a rating of ‘AAA’.

E. The need for further consideration of the state of the broader finance and banking sector;

The initiative of the Government to support the new RMBS issues by smaller ADIs and non-bank securitisers through the $20 billion RMBS investment program has been vital and successful in maintaining the domestic RMBS market. The program supported a more rapid recovery of Australia's RMBS market than would have been the case without the Government initiative. It has also permitted much of the industry and its infrastructure to remain intact. While the program was intended and expected to be a temporary measure to support the market until market conditions stabilised its continuation has been necessary to support the market through the current Eurozone debt crisis.

Indeed, AOFM has invested a total of $15.3billion in 60 RMBS bonds of which $4.75billion has been to specialised non-bank mortgage lenders. The following graph illustrates the ongoing involvement of the AOFM in new primary issues of 'AAA' rated RMBS. It can be seen that generally AOFM's participation has declined since 2009 but exhibits spikes when global credit markets have become dislocated from time to time as the Eurozone crisis has evolved.

Chart 3 – Investment by AOFM in Australian RMBS



Continuing Eurozone volatility and changes to market dynamics (caused by ongoing regulatory reform and the introduction of covered bonds), have provided good cause for the government to continue this successful initiative. The ASF supports the regular review by Government to ensure that the program parameters result in its objectives being best met in the prevailing market conditions.

The ASF also recommends that Government (and its agencies) aim for:

1. greater and more immediate convergence of the global regulatory reforms. As offshore funding markets are important to the Australian financial system it will benefit from greater convergence of regulatory reforms in the United States and Europe. While Australia may not be able to dictate such convergence it suggested that advocacy of mutual recognition of varying regulatory approaches in aiming for common objectives is recommended;

2. international regulators to adopt a “passport” approach to regulation of mortgage and asset-backed securities through official forums such as G20 and IOSCO. The ASF believes a strategy of “mutual recognition” is a pragmatic solution to meet common regulatory objectives in a timely manner; and

3. investor demand for Australian securitisation could be enhanced if central banks such as the European Central Bank (ECB) would accept Euro denominated bonds collateralised by Australian assets such as residential mortgages for repo by European financial institutions. Such bonds were eligible for repo with the ECB up until 2010 but the ECB now restricts the bonds it accepts for repo to those where the collateral is from the European Economic Area and other countries in the G-8. The ASF recommends that Australia uses international forums in which it participates to press for central banks to accept bonds collateralised by Australian financial assets.

F. Any other relevant matters

The ASF recommends that government and market initiatives need to be considered to further develop the domestic fixed income market. Specifically, we believe that it is desirable to develop a deeper, more diversified and liquid domestic fixed income market that:

1) creates a greater pool of investment funds that can provide an alternative source of debt capital for Australian corporate borrowers, smaller ADIs and securitiers;
2) can provide a larger pool of financial assets to facilitate the build out of Australia’s retirement income sector to match the growing demand for capital stable income producing products for the growing post-retirement segment of Australia’s population;
3) potentially reduces Australia’s overall reliance on offshore debt capital markets for funding a material part of the Australian banking system. A larger and more liquid domestic debt capital market can insulate, to some degree, Australia’s vulnerability to shifts of sentiment amongst offshore investors;
4) can be part of achieving the policy objective of making Australia a financial hub through creating a more active AUD bond market in which international investors participate particularly Asian investors.

It is the intention of the ASF to engage with various constituents of Australia’s financial markets to complete this research including the Finance & Treasury Association and the Australian Superannuation Funds Association. It is anticipated that the research report will be available in the fourth quarter of 2012 and the ASF will forward a copy of the report and recommendations arising from it to the Committee.