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3 September 2012

The Secretary
Senate Economics References Committee
Suite SG.64
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Tim

At our meeting with members of the Senate Economics Reference Committee at Parliament House on 16th August 2012 we undertook to provide the Committee with further comments on low documentation ("low-doc") loans secured by mortgages over residential property.

1. Low-Doc Loans

The provision of finance via low-doc loans secured by a residential property is a minor but important source of finance for the Australian economy. Low-doc lending had its origin in bank manager relationships with local customers. Banks, on occasions, would lend on "not fully documented terms" due to the managers understanding of the borrower's business.

Low-doc lending today is commonly defined as finance provided to borrowers who are not able to provide a continuous pattern of income through traditional forms of evidence to demonstrate a capacity to service the loan being sought. This situation typically arises where the borrower is either self-employed or a small business owner who is seeking finance using the collateral of a residential property.

Low-doc lending has developed in Australia largely as a way for borrowers to obtain finance not ordinarily available through traditional sources that usually required evidence of a borrower's capacity to pay through providing PAYG salary or wage documentation. A low-doc loan secured by residential property is a legitimate lending product in the Australian market and has been and remains an important source of funding for the small business sector. This business sector is typified by variable annual cash flows making it difficult to verify income at a particular point of time in contrast with the consistent income flow enjoyed by PAYG employees. Small businesses provided employment for almost half of total industry employment in 2009–10, which equates to almost 4.8 million people.[1]

The current practice of Lenders who provide low-doc loans is to seek alternate income verification through documents such as tax returns, accountant statements or business activity statements to establish evidence of capacity to service and repay the loan.

[1] ABS Cat. No. 8155.0

Typically lenders also compensate for the reduced amount of documentation by lending to a lower loan-to-value (LTV) ratio than for a borrower who made an application with full documentary evidence of income. The lower LTV provides the lender a greater buffer to mitigate loss should a borrower default.

2. Additional Loan Validation through Securitisation

The securitisation of residential mortgages, including low doc loans, provides additional filters of scrutiny to their veracity.

Banks that securitise residential mortgages from their balance sheet go through a selection and verification process to provide certification to back the representations and warranties they provide in the transaction documents. Non-banks typically securitise mortgages financed through a warehouse facility provided by a major bank. The providers of warehouse facilities put in place checks and balances to ensure their funds are only used for eligible assets as clearly defined in the facility agreements. In both bank and non-bank securitisations the process introduces additional validation of loan data that may not be the case for loans held on-balance sheet by financial institutions.

Additionally loans in RMBS are subject to independent scrutiny by auditors. A long standing practice in the Australian market has been for issuers and lead underwriters of RMBS to commission file audits to be completed by external audit firms prior to issuance. The process of securitisation also includes scrutiny by credit ratings agencies, and in many cases insurers who provide mortgage lenders mortgage in addition to the lenders own scrutiny. Once securitised the collateral is subject to the scrutiny of the investor community, in particular their arrears performance. On this measure, Australian RMBS is an outstanding performer in relation to arrears statistics.

3. Prevalence of Low-Doc Loans

Low-doc loans have and continue to represent a minor part of all finance provided through loans secured by residential property.

Using the major banks as a proxy for the overall market we estimate low doc loans represent up to 5% of all residential mortgage lending. The following table summarises the amount of low doc loans reported by the four major banks.

Table 1

	ANZ	Westpac	NAB	CBA
Reported to	to March 2012	to March 2012	to March 2012	to December 2011
Total Portfolio	178.0bn	310.1bn	213bn	343.0bn
Owner Occupied	63.0%	48.5%	70.8%	57.0%
Investment & LOC	37.0%	51.5 % (40.5%/11.0%)[1]	29.2%	43.0% (33.0%/10.0%)[1]
Loan Characteristics	**ANZ**	**Westpac**	**NAB**	**CBA**
Average Loan Size	209,000[2]	214, 000	258,400	223,000
Variable Rate	-	88.0%	-	86%
Fixed Rate	-	12.0%	-	-
Low Doc	-	6.2%	2.4%	2.9%
First Home Buyer	9.0%	12.3%	9.0%	15.0%
Portfolio insured by LMI	-	25.9%	14.7%	26.0%

Source: bank reports

As at 31 March 2012 Standard & Poor's ("S&P") reported total outstanding low-doc loans in securitised pools of $6.0 billion. This represents 5.21% of all mortgages backing outstanding Australian RMBS. Excluding the value of low-doc loans in "self-securitisations" by banks, we believe the value of low-doc loans in public RMBS pools is around $4.7 billion. We expect the percentage will decline further with the more stringent obligation under the NCCP that lenders be satisfied of a borrower's ability to service and repay the debt.

4. Performance of Low-Doc Loans

It has been put to the Committee that there have been widespread problems with low-doc loans originated prior to 2008. The ASF finds these assertions lack credibility based on the absence of significant defaults arising from such loans. Any such loans would now have been on foot for more than four years. For loans included in securitisations, performance issues relating to a borrower's inability to service the loans would now be evident through the monthly reporting of arrears and defaults that is provided to investors in RMBS issues.

As a general statement, fraudulently originated loans typically exhibit early term delinquency, usually within the first six months of their life. There is no evidence of the occurrence of systemic fraud in relation to low-doc lending despite the product being generally available for in excess of a decade, aside from the allegations that have now surfaced.

S&P produces a quarterly report of the performance of all pools of securitised residential mortgages, both full and low-doc. The most recent S&P report for the quarter ending 31 March 2012 indicates only 3.28% of low-doc loans are 90+ days in arrears. This is a small percentage of all low-doc loans. To put this into perspective, low-doc loans that are 90+ days in arrears represent only around 0.2% of the total residential mortgage loans in the financial system.

It is also noteworthy that the loss rates on residential mortgages in Australian RMBS before claims under mortgage insurance are less than 0.22% and there has been zero historical losses or charge-offs against any Australian Issued prime RMBS.

If there were widespread problems with low-doc loans you would have expected to complaints to the ombudsmen would have evidenced such problems. We understand that complaints to Credit Ombudsmen Service Limited (COSL), which handles disputes arising from the non-bank sector, relating to low-doc loans have been modest. As few as 13 complaints about "low doc fraud" were received in 2009/2010 and 49 complaints in 2010/2011. However, with the recent media coverage on the issue, COSL has received more complaints about this issue in recent months. It is our understanding almost all the complaints received relate to loans which were entered into before the responsible lending provisions commenced.

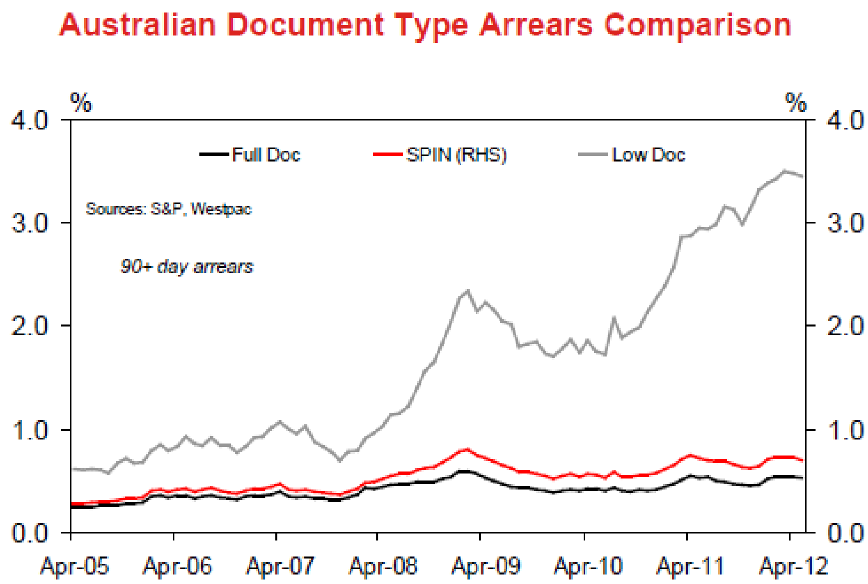
The following chart illustrates the trend of arrears of full and low documentation loans against the S&P index of all securitised loans ("SPIN"). It illustrates that low-doc loans have always exhibited higher arrears rates than full doc loans possibly due to the variability of the income of self-employed and small business people compared to PAYG employees.

While the trend of arrears in low-doc loans has increased in the last four years this could be the result of a number of factors including:

- pre-2008 underwriting standards which have now be strengthened following the introduction of the NCCP;
- the decrease in the number of low-doc loans in the S&P reference pool due to fewer low-doc loans now being orientated and the 20% prepayment rate of pre-2008 originated loans; and
- a reflection of the tougher business environment faced by the self-employed and small businesses not benefiting directly from the mining boom.

Considering these points we do not see any evidence systematic problems with these types of loans.

Chart 1



Finally, the residential mortgages contained within pools in which the AOFM has invested have even lower rates of arrears than those outlined above. This is as a result of the AOFM investing in well-seasoned pools of mortgages, pools that have been subjected to multiple filters or layers of scrutiny as outlined above, together with pre-established minimum mortgage criteria. The AOFM security position benefits from subordinated tranches and in many cases mortgage insurance.

We hope this information is useful to the Committee and we would be happy to discuss this matter further with the Committee if they so wish. You can contact me on or

Yours sincerely

Chris Dalton