Chapter 13

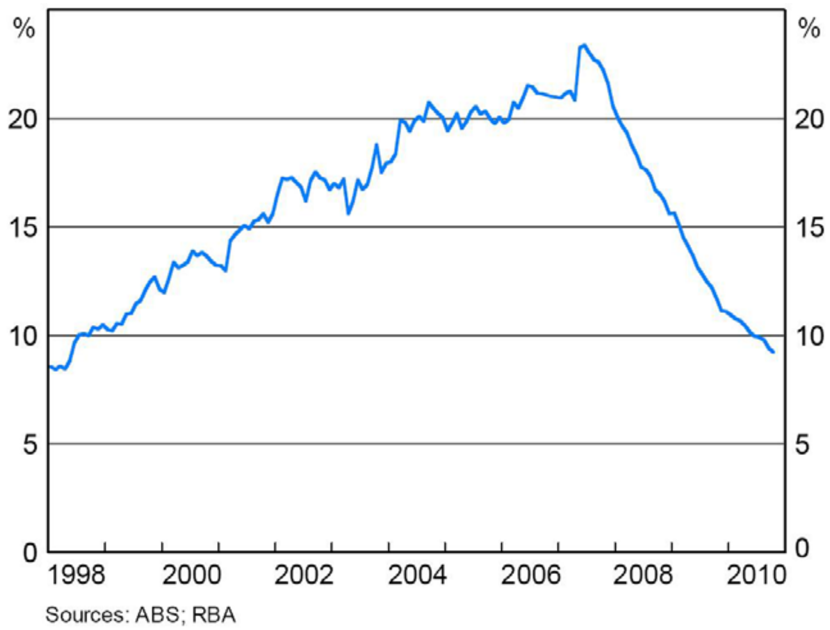
Bonds: a key funding source

13.1 While the traditional source of funds for banks is deposits, in Australia a significant amount of funds have been raised by banks issuing bonds. From the 1990s these bonds have been supplemented by a new class of bonds issued by some non-bank lenders who essentially fund new loans by selling off old ones. The loans are bundled up and bonds giving a claim on the cash flows from them are sold. The process is known as 'securitisation' and the resulting bonds are known as 'asset backed securities' (ABS). In Australia this process has predominantly been applied to home loans with the resultant securities being known as 'residential mortgage backed securities' (RMBS). This technique allows a financial institution to expand its lending much faster than would be possible were it relying on setting up a branch network to raise retail deposits. In the 1990s new organisations which utilised wholesale funding by securitisation such as Aussie Home Loans, RAMS and Wizard quickly became household names. Some non-bank ADIs also tapped this new funding source to expand their lending. This increased the competition in the housing loan market markedly.

Securitisation

13.2 Banks, and even more particularly non-bank mortgage originators, made increasing use of securitisation prior to the GFC. At its peak in 2007, securitisation accounted for over a fifth of new housing loans (Chart 13.1).

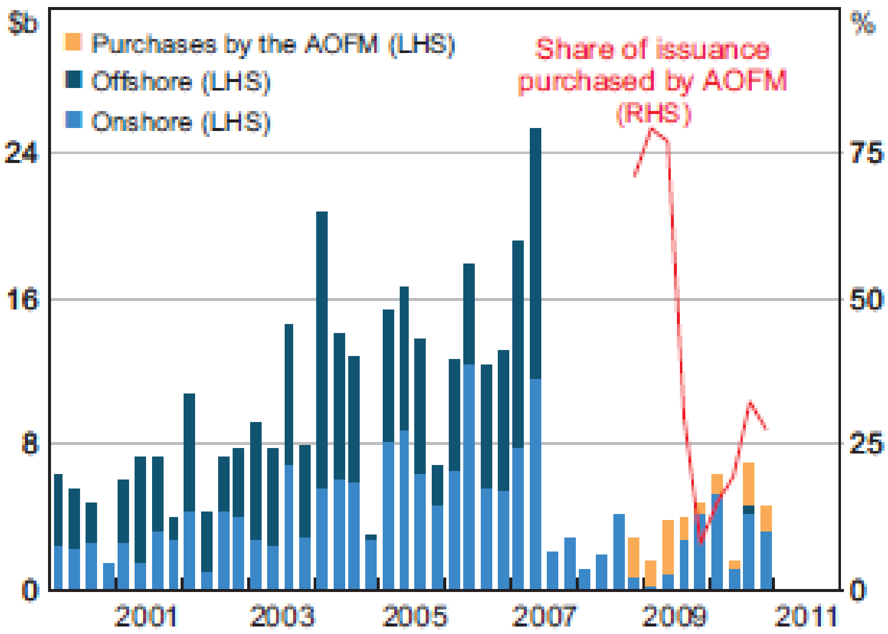
Chart 13.1: Share of housing credit funded by securitisation (monthly)



Source: Reserve Bank of Australia, *Submission 41*, p 3.

13.3 The expansion in securitisation in Australia was part of a global phenomenon. By 2006 the value of asset-backed securities issued in the US and Europe had reached $4 trillion, comparable to that of all corporate bonds. The GFC saw a collapse in the securitisation market, with issuance down to $1 trillion in 2009 and 'securitisation and the new intermediation model blamed for financial instability'.[1] The subsequent collapse in the Australian market for residential mortgage-backed securities (RMBS) is illustrated by Charts 13.1 and 13.2.

Chart 13.2: Australian RMBS issuance



Source: Reserve Bank of Australia, *Statement on Monetary Policy*, February 2011, p 48. (Update of chart included in Heritage Building Society, *Submission 113*, p 3)

13.4 The Reserve Bank described the collapse and why they think it is unlikely it will be (entirely) reversed:

> The securitisation market was particularly adversely affected by the financial crisis. The contraction in securitisation markets was not unique to Australia, but was a world-wide trend driven by changes in global markets. The business models of some of the Australian lenders reliant on it were no longer viable and they either ceased lending or were bought by a larger institution.[2]
>
> …a large part—probably half—of the flow of investment prior to the crisis was by foreign investors, many of whom were SIVs[3] and conduits and so

1 Albertazzi et al (2011, p 1).

2 Reserve Bank of Australia, *Submission 41*, p 4.

3 Structured investment vehicles. Laminar Group also suggests SIVs bought about half the RMBS; *Submission 34*, p 8.

> on. Those people actually had a very risky business model, which we all know now. Those people are not coming back, so we are not going to see that sort of investor demand from offshore again virtually at any price, I would say.[4]

13.5 The Reserve Bank believes that the securitisation market is now close to its 'normal' size. This differs from some submitters who call for support 'until normality returns to the securitisation market'.[5]

13.6 Some other participants concurred with the Reserve Bank:

> …vehicles such as the structured investment vehicles, SIVs, and some of the hedge funds are probably unlikely to come back. Certainly the SIV is a not a business model that is sustainable post-crisis.[6]

> …the securitisation market is unlikely to return in either volume or pricing to where it was pre-GFC.[7]

13.7 A more critical note was sounded by a bank analyst:

> …many organisations' business models came under intense pressure when the securitisation market froze in 2007. It could be argued that many of these business models were flawed as they were too heavily reliant on a single source of funding which was only available at economic levels during a boom or a bull market.[8]

13.8 Yellow Brick Road were a bit more optimistic, suggesting that some of the overseas investors had 'gone into hibernation' with the implication they will in time wake up.[9]

13.9 There were also those somewhat agnostic about the prospects of a return to pre-GFC securitisation levels:

> …financial experts are not predicting an early end to the effects of the GFC on global markets and economies, with some analysts suggesting it will take another two years to see market conditions stabilise. Furthermore, there is still uncertainty over whether or not funding costs will then return to the lower levels seen in the years preceding the GFC.[10]

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4 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, pp 3-4.

5 Australian Chamber of Commerce and Industry, *Submission 37*, p v.

6 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 18.

7 Heritage Building Society, *Submission 113*, p 6.

8 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

9 Mr Owen Williams, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 102.

10 Australian Bankers' Association, *Submission 76*, p 66.

13.10 It has been noted that the whole RMBS market has been tarred by the excesses overseas and their reputation damaged:

> …as an asset class globally, mortgage backed securities have had a severe reputational hit. It is certainly true that the ones sold in this country are of fabulous quality but, as an asset class as a whole, unfortunately, there has been a reputational hit which will take time to be worked off.[11]
>
> Our assessment of the reason that there is not sufficient liquidity today in the RMBS market is more about market perception of asset qualities and liquidity.[12]

13.11 The Australian Office of Financial Management (AOFM) was questioned about the basis for securitisation:

> Senator PRATT—I want to ask from the perspective of our financial system as a whole rather than from the point of view of individual issuers what the advantage is of having financial intermediators securitising mortgages rather than issuing bonds to fund mortgage lending which remains on balance sheets?
>
> Mr Bath—It tends to be more cost-effective. Because mortgages are such a safe investment, by issuing debt that is backed by those mortgages the overall cost of funds for a financial intermediary can be reduced significantly.[13]

13.12 There are flaws, however, in the securitisation market, which have led regulators in some countries to rethink whether it is desirable for there to be no recourse to lenders once they have securitised loans :

> The RMBS market is resource dependent, overly complex and creates an ongoing operational burden for issuers due to the requirements created by external stakeholders such as credit rating agencies. In addition, changes in external stakeholder views or a shift in risk appetite, as well as the punitive regulatory changes insisted on by APRA (often applied retrospectively), reduce the efficiency of this channel from a capital and operational perspective. …there is an over-reliance on mortgage insurers (another oligopoly within Australia) to support RMBS structures…[14]
>
> In theory, securitisation should result in risk being passed to those agents best placed/most willing to manage it. However, the global financial crisis has showed that, because of the complexity and opacity of securitised products, investors did not understand the risk they were bearing and,

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11 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 4.

12 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 97.

13 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 106.

14 Heritage Building Society, *Submission 113*, p 5.

> hence, credit was misallocated. As a result, global regulators are proposing that banks retain 'skin in the game': that is, retain an exposure to the underlying assets within the securitisation pool and hence to the quality of their original credit assessment. These proposals are yet to be fully developed but capital requirements will inevitably reflect the residual risk that an ADI retains.[15]
>
> The basic issue with securitization is the role of asymmetric information. In particular, banks rely on soft information to grant and manage loans. Since this information cannot be credibly transmitted to the market when loans are securitized, banks might lack incentives to screen borrowers at origination or to keep monitoring them once the lending has been securitised... The evidence on the whole supports the thesis that the rise of subprime mortgages was accompanied by a decline in lending standards.[16]
>
> …mortgage originators in some countries failed to exercise appropriate diligence in undertaking credit assessments. Asset retention policies are one way in which other countries have sought to address this issue. By requiring issuers to retain some 'skin in the game', these policies are intended to incentivise mortgage originators to maintain appropriate underwriting standards.[17]

13.13 The UK experience was cited as a cautionary tale of how securitisation can lead to problems:

> …in the UK, with the Northern Rock example, such steady, available and cheap funds through the securitisation market meant that they had an unstable model and they fell over.[18]
>
> Between 1919 and 2000 the five (then four) UK major clearing banks controlled ~85% of the deposit market. However, following the Cruickshank Report into bank competition in 2000 and the substantial increase in funding availability that coincided (via securitisation) the UK banking environment changed substantially. Lending underwriting standards were loosened by newcomers, first in mortgages then in commercial property, leverage increased and asset prices rose sharply. Eventually the large banks followed to protect their position. Then the Global Financial Crisis (GFC) hit. We believe the short-term gains consumers enjoyed from competition appear more than offset by tax payer bail-outs and the recession.[19]

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15 Australian Prudential Regulation Authority, *Responses to questions on notice*, *no 6*, 31 January 2011, pp 3-4.

16 Albertazzi et al (2011, pp 2-3). Their own study casts some doubt on this for the case of Italian banks.

17 Department of the Treasury, *Responses to questions on notice*, *no 14*, 4 February 2011, p 2.

18 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 97.

19 Mr Jonathan Mott, Analyst, UBS, *Tabled document no. 5*, 14 December 2010, p 1.

13.14 As discussed further below, the Government provided some temporary support to the securitisation market during and just after the GFC. The ABA called for more work to identify other means to rebuild the securitisation market:

> Government should establish a working group with banking industry experts to explore options, identify strategies and agree actions to be taken to rebuild the securitisation market in Australia.[20]

13.15 There is a concern that, as a result of the flaws in the securitisation market having been exposed, it is unlikely ever to regain its former size. Arguments that the government should support the market until this happens may therefore effectively be calls for the government to prop up the market indefinitely. The Governor of the Reserve Bank warned that:

> …the taxpayer is being asked to shoulder more risk, one way or another, in order to facilitate the provision of private finance.[21]

13.16 Specifically addressing support for the RMBS market, the Governor counselled caution:

> One idea that one sees around is the extension of guarantees for mortgage-backed securities by the government, which is done in some other countries. Various people put forward arguments why that may be a good idea, and it may be. But if one were inclined to go down that track one would want to do it with great care because, when you think about extensive public intervention in housing markets, we do not need to look any further than the United States of America to see that that can go wrong if you are not very careful about the way incentives are designed.[22]

13.17 Treasury was among other witnesses who sympathised with the Governor's view:

> …caution as to how far governments should get involved in private market practices. Treasury is very much in agreement with the governor on that…[23]
>
> I become concerned when taxpayer money is used to artificially support markets and results in a risk transfer from the private sector to the taxpayer.[24]

13.18 While supportive of measures to invigorate the securitisation market, even the Australian Bankers' Association was hesitant about permanent support:

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20 Australian Bankers' Association, *Submission 76*, p 56.

21 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 2. He elaborated somewhat on p 6.

22 Mr Glenn Stevens, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 6.

23 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 36.

24 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

> A countervailing argument and one of importance is that we also do not want to create a situation where certain markets or certain participants require permanent government support, because that situation would be a problem if it arose.[25]

13.19 One alternative suggested that the cost of supporting the RMBS market be borne by the banks:

> We do not expect the government to fund this sort of initiative. We do submit that if it cannot be funded through consolidated revenue that a social licence fee on major banks, subject to conditions including capacity and other things, be used as a levy to fund the initiative in the early stages.[26]
>
> …by introducing a fee-based facility for offering Government support for the payment of principal and interest on the securities, this reform could provide an opportunity for improving liquidity in the secondary market, but also encourage investment in primary issuance.[27]

Committee view

13.20 The Committee notes the important role the securitisation market played in injecting competitive vigour into the home loan market (and lending markets more broadly) before the GFC. It hopes that such vigour can be regained. It accepts that the taxpayer should not be expected to underwrite the market indefinitely as this is likely to delay restructuring of the market and discourage innovation. But it calls for support for the rebuilding of the securitisation market.

Bullet bonds

13.21 A 'bullet' RMBS returns the principal to the investor in a single lump sum upon maturity, with regular interest payments over the term of the security. This contrasts with traditional RMBS where the principal is repaid progressively over the term of the security.

13.22 One attraction of bullet bonds is that they may be eligible for inclusion in bond market indices. As many institutional investors try to replicate such indices, this increases demand for the bonds.[28]

13.23 The AOFM has facilitated issue of a bullet bond by a smaller bank and the Government is encouraging Treasury and AOFM to accelerate this work.[29]

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25 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 14 December 2010, p 104.

26 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 98.

27 Australian Bankers' Association, *Submission 76*, p 57.

28 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 21.

29 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 21.

13.24 The Australian Securitisation Forum commented:

> We are particularly supportive of and encouraged by the interest of the government in promoting and facilitating the evolution of bullet style residential mortgage backed securities.[30]

13.25 They explained the attractions as follows:

> …those that are less sophisticated in evaluating prepayment speeds and the pass-through principle that is a characteristic of RMBS might be attracted to buy a bullet security where they know they can invest in $10 million today and get $10 million back in three years time and treat it more like a standard bond…bullet style of RMBS will help the market go back to the international community because they will be able to source a currency swap at a cheaper price than they would if they had to put in place a specialised or tailored currency swap to account for the prepayments of principle that you can expect comes through on the underlying portfolio of assets.[31]

13.26 Others added about the attraction of bullet bonds:

> There are coupon or interest payments over the life of the transaction and then at what we call maturity you get back all of your principle and the final coupon. Mortgage backed securities that we have been investing in by and large until recently…have been amortising pass through structures. These are less attractive to investors because not only do they get their principle back in dribs and drabs over time but they also do not know exactly when they will get it back. There are two types of risk—or features that investors are not particularly attracted to—that the bullet structure removes. One is the long-term dribs and drabs return of their capital and one is the unknown rate at which the capital will come back. So the bullet structure is attractive to investors.[32]

> …a bullet bond structure is something we do support. It is something that makes a currency swap cheaper and more efficient to be able to raise those funds.[33]

> We therefore welcome the support for the development of bullet RMBS securities as a step toward satisfying the requirements of the broader fixed interest market…[it would] facilitate superannuation fund investment through incorporation in the fixed income index.[34]

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30 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 16.

31 Mr Dalton, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 19.

32 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 96.

33 Mr James Austin, Chief Financial Officer, FirstMac Group, *Proof Committee Hansard*, 4 March 2011, p 20.

34 Mortgage House of Australia, *Submission 115*, p 2. See also FirstMac Group, *Submission 26*, p 5 and Australian Bankers' Association, *Submission 76*, p 58.

13.27 The Australian Securitisation Forum suggested:

> …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.[35]

Committee view

13.28 The Committee is keen to encourage the securitisation market as a means of promoting competition. Facilitating the issuance of bullet bonds would make a contribution to this.

Recommendation 22

13.29 The Committee recommends that the Government ask the Australian Prudential Regulation Authority to review aspects of its prudential framework to ensure that there are no inadvertent impediments to the issuance and trading of bullet bonds.

Treatment of securitisation

13.30 As noted above, views differ about whether it is desirable for securitisation to remove totally the risk exposure from the originating lender, or whether they should retain some exposure; some 'skin in the game' as it is known.

13.31 The International Organization of Securities Commissions (of which ASIC is a member) issued a report in 2009 which recommended the following regulatory responses to the problems that had arisen due to securitisation:

> 1. Consider requiring originators and/or sponsors to retain a long-term economic exposure to the securitisation in order to appropriately align interests in the securitisation value chain;
>
> 2. Require enhanced transparency through disclosure by issuers to investors of all verification and risk assurance practices that have been performed or undertaken by the underwriter, sponsor, and/or originator;
>
> 3. Require independence of service providers engaged by, or on behalf of, an issuer, where an opinion or service provided by a service provider may influence an investor's decision to acquire a securitised product; and

35 Australian Securitisation Forum, *Submission 122*, p 15.

4. Require service providers to issuers to maintain the currency of reports, where appropriate, over the life of the securitised product.[36]

13.32 The Australian Securitisation Forum commented:

> …the securitiser, whether that is the seller of the assets or the originator of the assets, should retain an interest that reflects the level of risk in the underlying assets…something modest for prime pristine pools of mortgages or it could be something higher for non-conforming mortgages, equipment leases or credit card receivables…[37]

13.33 The Reserve Bank Governor stressed the need to maintain the quality of RMBS:

> …underwriting standards in Australia remain pretty good. You have to keep that, obviously, for the quality of the securities to remain high. In fact, one of the thrusts of the global regulatory work that people are working on has been how to restart securitisation globally but on a basis which keeps the standards up, which keeps the incentives of the underwriters correctly aligned, and that is not easy to do. But that is the key thing: to keep the underwriting standards high. Most people seem to feel that one component of doing that is for the originator to keep a stake in the outcome rather than being able to shift all the risk away to the end investor, because if they are able to totally shift the risk then their incentive to keep the standards up is obviously weakened…we probably will be, over time, heading to a world in the global regulatory architecture where it will be expected that the originating lender retains some so-called 'skin in the game' as a way of keeping the incentives correct.[38]

13.34 Some other witnesses shared this view:

> …it is very important that we look at the recourse of a mortgage origination and that we do not move to an originate-to-sell model, which was one of the primary causes of the US subprime crisis. If we learn one thing from the GFC, it is that the writer of the loan must retain the majority of the risk; otherwise, bad lending practices will develop.[39]

> …there is a need for some degree of skin in the game…[40]

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36 International Organization of Securities Commissions, *Unregulated Financial Markets and Products: Final Report*, September 2009, p 21.

37 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 21.

38 Mr Glenn Stevens, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 7.

39 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

40 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 106.

13.35 While supportive of the approach, one of the world's leading authorities on financial supervision, Professor Charles Goodhart, warned it may constrain the revival of the securitisation market:

> ...[securitisation] largely depended on trust that credit qualities were guaranteed by the ratings agencies, by due diligence undertaken by the originators and by the liquidity enhancement and support of the parent bank. Without that trust, the duplication of information can be horrendously expensive. The attempt to restore trust…by requiring banks to hold a share of all tranches in a securitized product can make the whole exercise less attractive to potential originators. So, the market for securitization remains becalmed.[41]

13.36 Mr Mark Bouris, an active participant in the RMBS market through his former organisation Wizard and now with Yellow Brick Road, also supported the idea of originators maintaining a stake:

> …we are requiring issuers to put equity into the particular issues—which is somewhat similar to the Canadian model, which shows that they are not just buying their assets or originating assets and then loading the risk off to somebody else—that they maintain equity in there; that there are minimum standards of quality in relation to not only the performance of the pool but how the pool is created; there is credit scoring and transparency; and that they have capped LVRs.[42]

13.37 APRA's regulation APS120 requires an ADI, if they are to get capital relief, to satisfy APRA that there has been absolute transfer of the credit risk to third-party investors. If ADIs are required to retain some 'skin in the game', either by allowing some recourse from buyers of the ABS or more simply by just holding some of the ABS on their balance sheet, they will therefore have to hold additional capital consistent with the additional risk to which they will be exposed. This will, of course, make securitisation somewhat less attractive as holding additional capital represents an increased cost. It may be more of an issue for small lenders with small capital bases who rely on securitisation to enable them to originate more mortgages than they could support on their balance sheet.

Recommendation 23

13.38 The Committee recommends that, in order to retain incentives for careful credit assessment, an authorised deposit-taking institution which securitises a loan portfolio be required to keep a proportion of the resultant asset-backed securities on its balance sheet and hold appropriate levels of capital. The proportion should be set by the Australian Prudential Regulation Authority in consultation with the Australian Securities and Investments Commission to

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41 Goodhart (2010, p 165).

42 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 97.

balance incentives to maintain credit standards with the desirability of encouraging the recovery of the securitisation market.

The Reserve Bank's repo operations

13.39 Another area where smaller ADIs are, perhaps inadvertently, disadvantaged arises from the Reserve Bank's rules on what securities they accept in their repurchase arrangements:

> The RBA's definition of eligibility for repurchase agreements… unreservedly favour the major banks, in that the existing definition only provides 'repo' eligibility for long term debt issued by ADIs that are rated above A.[43]

13.40 A change is suggested:

> …the current RBA definition relies too heavily on credit rating opinions and does not give weight to the strong regulatory environment under which all ADIs operate. A relaxation of the RBA definition to incorporate all investment grade issuance would enhance the market for senior debt issuance for smaller ADIs by providing access to a more diversified investor base and reduce the need for smaller ADIs to rely predominantly on securitisation.[44]
>
> RBA repo eligibility criteria should be adjusted to include all ADIs regardless of their rating (including unrated entities) and RMBS.[45]

13.41 Concerns about the reliability of credit ratings have been noted in Chapter 9.

Recommendation 24

13.42 The Committee, having more confidence in the Australian Prudential Regulation Authority's oversight than in the opinions of credit rating agencies, recommends that the Reserve Bank accept as eligible paper for repurchase agreements long term debt issued by any authorised deposit-taking institution rather than just those rated above A.

The Australian Office of Financial Management programme

13.43 The Government has supported smaller lenders by instructing the AOFM to purchase AAA-rated RMBS. The measure had bipartisan support—indeed it was argued whether the idea had first been proposed by the Government or the Opposition.

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43 Heritage Building Society, *Submission 113*, p 7.

44 Heritage Building Society, *Submission 113*, p 8.

45 Bendigo and Adelaide Bank, *Submission 58*, p 6.

13.44 The programme had three phases; $8 billion just after the GFC in September 2008, a further $8 billion in October 2009 and the Government foreshadowed a further $4 billion in its December 2010 statement which it initiated in April 2010.[46]

13.45 The Australian Securitisation Forum views the three phases as having differing natures:

> The first $8 billion was probably almost a lifeline to keep the sector going and particularly to provide funding to the smaller institutions…The second tranche I think the AOFM played a more expanding role to encourage investment by buying into the longer-dated tranches in the transactions. …With the last phase of the $4 billion there is the preparedness for it to be used in ways that could aid, for example, the evolution of the bullet-style residential mortgage backed securities.[47]

13.46 The Reserve Bank pointed to a number of advantages of the programme relative to alternatives:

> …it can be directly tailored to help specific types of institutions; the support 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 the support.[48]

13.47 The Governor added at the hearing:

> The taxpayer takes on some risk. Doing it this way it is confined, the securities are being managed by people who have got expertise, so I do not have a problem with that; I think it was a sensible trade-off.[49]

13.48 Treasury believe the AOFM programme has been effective:

> It has been significant and, realistically, it has kept some of the smaller players in the game.[50]

13.49 The Government asserts:

> The Government's $16 billion RMBS investment continues to put downward pressure on borrowing costs for households and small business.[51]

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46 Australian Government, *Competitive and Sustainable Banking System*, December 2010, pp 19-20; 'More support for a competitive lending market', *Treasurer's media release* no 031, 8 April 2011.

47 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 24.

48 Reserve Bank of Australia, *Submission 41*, p 6.

49 Mr Glenn Stevens, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 18.

50 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 43.

51 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 19.

13.50 As argued in Chapter 5, with borrowing costs effectively determined by the Reserve Bank, any impact is likely to be marginal. It may have increased the supply of credit to some borrowers. The AOFM estimates that about a tenth of funds have been lent to small business.[52]

13.51 The AOFM programme is also supported by a number of market players:

> We also welcome the government's announcement of a further tranche of AOFM's RMBS investments because the recovery of the securitisation market and better pricing for smaller banking institutions will help regional banks, us and non-bank lenders to deliver tighter pricing and put more competitive pressure on the banks.[53]
>
> …the AOFM has played an important role in both fundamentally sustaining the businesses of some of the smaller players through the worst aspects of the crisis and providing important signals to the investment markets that the government sees that securitisation is an important sector of the financing of the Australian economy and that the government has an interest in seeing that the sector recovers. [54]
>
> The government support for securitisation through the AOFM has been vital to rebuilding confidence in that market.[55]
>
> …of the 13 Western economies and banking systems considered by the KPMG review…in 2008 only two, Australia and the UK, had no government involvement in the mortgage market.[56]

13.52 Associate Professor Zumbo, bringing the perspective of a competition policy academic rather than a financier, also called for some government support:

> There needs to be a role for government to promote that confidence in that securitisation market.[57]

13.53 But some thought it did not go far enough, either in the amount of funding or in being restricted to higher-rated bonds or in its focus on residential loans:

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52 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 19.

53 Ms Louise Petschler, Chief Executive Officer, Abacus, *Committee Hansard*, 13 December 2010, p 84.

54 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 17.

55 Mr Steven Münchenberg, Chief Executive Officer, Australian Bankers' Association, *Proof Committee Hansard*, 14 December 2010, p 79. See also Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2; Members Equity Bank, *Submission 77*, p 2; and ING Bank, *Submission 35*, p 2.

56 Mr Phillip Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 14 December 2010, p 67.

57 Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, p 54.

> … the injection of $16 billion of funds through the AOFM and the promise of another $4 billion in the banking reform package. While that is welcomed, it will not be sufficient to revive the securitisation market….[58]

> It will not hit the sides…that [additional $4 billion] is two days of funding…Chickenfeed… If the government want to make a difference and promote competition, they would have to invest at least $30 billion to $40 billion a year, and that is only a small amount.[59]

> …support has been restricted due to the AOFM's current investment mandate that only allows it to invest in A rated notes. While investors have been returning to the higher rated notes, lower rated notes in securitisation issues remain difficult to sell at reasonable margins and it would greatly assist if the investment mandate was expanded to provide the AOFM with the ability to invest in these notes.[60]

> The AOFM mandate should be expanded to permit the purchase of these lower [class B] subordinated tranches….[61]

> 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…[62]

> …housing loans in Australia are $1 trillion. So even a below average growth rate of, say, seven per cent will require $70 billion in funding. So doubling the RMBS investment by another $16 billion would be meaningful to competition.[63]

13.54 Others cautioned about taking it further:

> Substantial amounts of taxpayer money are now being used to artificially stimulate these markets. At present, the risks taken are low, given taxpayer money is only invested in the AAA tranches of RMBS. However, I would be very cautious over any moves to use taxpayer money to go further down the capital structure of RMBS to the subordinated tranches such as BBB or

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58 Mr Phillip Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 14 December 2010, p 66.

59 Mr John Symond, Executive Chairman, Aussie Home Loans, *Committee Hansard*, 14 December 2010, pp 117-8.

60 Credit Union Australia, *Submission 85*, p 8. At the hearing CUA's CEO added that the amount 'is unlikely to be sufficient to support anticipated demand from the credit unions and building societies movement if competition in banking is indeed to increase to meaningful levels'; Mr Chris Whitehead, *Committee Hansard*, 25 January 2011, p 82. See also Abacus, *Submission 53*, p 16.

61 Members Equity Bank, *Submission 77*, p 3. See also Think Tank Property Finance, *Submission 61*, p 5.

62 Australian Securitisation Forum, *Submission 74*, p 12.

63 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 16.

> equity or any proposals to have a government guarantee on those issues. This would lead to a material risk transfer from the originator of the mortgages to the taxpayer, especially at a time when household leverage in Australia is the highest in the world and everyone acknowledges that housing is unaffordable.[64]

13.55 The purpose of the programme is to support smaller lenders who would otherwise have difficulty attracting funding. For this reason the AOFM has not bought bonds issued by the major banks. It has also not bought bonds issued by entities in which the major banks have large stakes, as these would presumably be more able to attract funds from the major banks themselves.

13.56 This proved controversial in the case of Aussie, which is 33 per cent owned by the Commonwealth Bank, but regards itself as acting independently.[65]

Committee view

13.57 The Committee welcomes the programme of AOFM purchases of RMBS, which it would like to see continue. While the initial motivation was preventing the Australian financial system seizing up during the global financial crisis, the focus now should be on helping smaller lenders attract the funding they need to compete in the market with the four major banks. With this new focus on competition, the AOFM should now be allowed to invest in a wider range of securities.

Recommendation 25

13.58 The Committee recommends that the Australian Office of Financial Management programme be expanded to include asset-backed securities based on assets other than home mortgages and to include securities rated AA or A (rather than just AAA) or issued by a financial intermediary supervised by the Australian Prudential Regulation Authority.

Recommendation 26

13.59 The Committee recommends that the Australian Office of Financial Management be given the discretion to purchase residential mortgage-backed securities issued by entities with a substantial bank shareholding where it judges this would promote a more competitive market.

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64 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

65 *Proof Committee Hansards*, 14 December 2010, pp 114-6; 15 December 2010, pp 58-59, 97-103; and 9 March 2011, p 15.

Other proposals for government support of securitisation

13.60 Mr Bouris believes areas where government support may be needed initially is in establishing a secondary market for trading RMBS so that they have the liquidity needed to give investors (in particular Australian superannuation funds) confidence in holding them. This suggestion did not appeal to the banks:

> The ABA does not believe that the establishment of an exchange would be of benefit to the securitisation market, and by itself would not create or enhance liquidity. We consider that the additional transaction costs associated with pre and post-trade infrastructure would likely have an adverse impact on the desirability of securitised products.[66]

13.61 Mr Bouris also suggested conducting a survey of potential demand for types of RMBS. The Australian Securitisation Forum described this proposal as:

> …a useful thing for us to consider. [67]

13.62 Mr Bouris would also like RMBS to be based on specific classes of mortgages. For example:

> 'Australian backed mortgages which have this credit score and have been rated by their agency, and lend money to everyone in Sydney who is earning over $70,000,' or something like that.[68]

13.63 He recommended various forms of standardisation:

> …to support securitisation the Government should sponsor the establishment of an industry standard for disclosure of information concerning marketable pools of Australian mortgages…[and] for credit scoring of applications for Australian mortgages, and require disclosure of the distribution of such credit scores within each Standardised Australian Mortgage Securities.[69]

13.64 The banks were not attracted to this idea:

> The ABA believes that independent benchmarks might stifle innovation.[70]

13.65 Mr Bouris' concept is somewhat similar to the new category of preferred securities being proposed in the US. The Committee acknowledges that such well defined securities that have characteristics meeting certain parameters will make investment in such products more attractive, but would correspondingly, render all

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66 Australian Bankers' Association, *Responses to questions on notice, no 15,* 8 February 2011, p 3.

67 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 19.

68 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 99. This is elaborated in *Submission 101*, p 10.

69 Yellow Brick Road, *Submission 101*, pp 11-13.

70 Australian Bankers' Association, *Responses to questions on notice, no 15,* 8 February 2011, p 3.

other securities less attractive, as well as lower the average quality of those securities not meeting the defined parameters. As such, in a market such as Australia's, which does have some activity, it could limit the market as much as improve it.

13.66 Abacus called for a government repurchase programme to improve liquidity:

> Currently some investors are unwilling to invest in Australian RMBS because of doubts about the ability to resell that investment before the expiry of the investment term. The presence of the Government as a repurchaser (in circumstances to be controlled and prescribed) would provide greater certainty to investors thus stimulating demand in the market.[71]

13.67 The ABA thought liquidity support could be restricted to certain types of RMBS:

> Furthermore, this reform could restructure the securitisation market and achieve broader regulatory objectives by identifying those securities that qualify for liquidity support. For example, certain market attributes and credit quality standards could include setting minimum loan-to-value ratios, imposing loan servicing criteria, improving transparency of data about issuances/tranches, imposing a retention (or capital) requirement, requiring credit quality enhancements or insurance, and establishing origination standards by requiring APRA licensing.[72]

13.68 One market player felt the regulation of the securitisation market needs to be improved:

> There is a pressing need for improved alignment and dialogue between policy makers (Treasury), regulators (APRA/RBA) and industry to ensure that the policy objectives of improved competition (via securitisation) is not frustrated by unnecessary or unintended regulatory conduct. Measures to improve the quality, efficacy, and coordination of engagement between relevant parties would be of material assistance in improving policy outcomes.[73]

The Canadian model

13.69 A number of submissions referred to the Canada Mortgage Bond programme which was introduced there in 2001. The AOFM provided the Committee with a description of the Canadian model:

> …the Canadian model has two components to it. One is a government intervention in what I would call the lenders mortgage insurance market, so it guarantees credit performance…on the underlying mortgages…In Australia in the 1960s or 1970s, the Australian government had a mortgage

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71 Abacus, *Submission 53*, p 17.

72 Australian Bankers' Association, *Submission 76*, p 57.

73 Members Equity Bank, *Submission 77*, p 4.

> insurer. However, as the market was opened up to the private sector and competition, the government of the day stood back and now there are private sector providers of lenders mortgage insurance…The other aspect of it is that you have a facility that essentially guarantees the creation of a bullet structure…There are coupon or interest payments over the life of the transaction and then at what we call maturity you get back all of your principle and the final coupon.[74]

13.70 The Canadian programme is widely used there:

> …the large Canadian lenders all access the CMB program. In fact, 83 per cent of all issuances come from them. There is a good reason for that: pre-GFC the funding cost advantage of a Canadian mortgage bond versus the next cheapest alternative source of funding was 23 basis points. In early 2008, when the impact of the GFC had hit, the cost advantage was 105 basis points.[75]
>
> If you look at the Canadian model, 30 per cent of all their mortgages are securitised through the national scheme.[76]

13.71 Some witnesses regarded the Canadian Mortgage Bonds Program as a model which could be adopted here:

> …what was needed was not a temporary or a bandaid fix but a permanent system whereby lenders could be assured of access to funds, irrespective of the economic environment. We pointed to the Canadian model of a good example of what can be achieved by a government.[77]
>
> …the government should look at a system similar to the Canadian system, where the government—with a similar population— over five years have stood behind $300 billion in mortgage backed securities.[78]
>
> …that [Canadian mortgage] model has proven to be very resilient during the global financial crisis. You would think if anyone was going to be impacted by issues around securitisation it would have been Canada because they are right next door to where the major securitisation issues were. Yet it got through that period very well and continues to do well.[79]

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74 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 96.

75 Mr Phillip Naylor, Chief Executive Officer, Mortgage and Finance Association of Australia, *Committee Hansard*, 14 December 2010, p 67.

76 Mr Phillip Naylor, MFAA, *Proof Committee Hansard*, 14 December 2010, p 73.

77 Mr Phillip Naylor, MFAA, *Proof Committee Hansard*, 14 December 2010, p 67.

78 Mr John Symond, Executive Chairman, Aussie Home Loans, *Committee Hansard*, 14 December 2010, p 111.

79 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, pp 86-87. See also Virgin Money Australia, *Submission 62*, p 4 and Associate Professor Frank Zumbo, *Submission 56*, p 10.

> One option, similar to that in the Canadian system, would be to enable banks to access government guarantee for RMBS issuance for a fee, effectively creating a new class of security which would be seen by investors as an Aussie government guaranteed mortgage bond.[80]

13.72 It could be argued, however, that the Canadian model is popular there because it addresses problems that had arisen in North America but these problems have not arisen in Australia:

> Do you set up a permanent institution to guarantee credit performance? Arguably, credit has not ever been an issue on mortgage backed securities that have been issued in Australia. There has never been a credit loss on a rated mortgage backed security in Australia, so why do you need the government to guarantee something that does not need a guarantee?... The other aspect of it is: do you want to set up a permanent institution that will enable the ratio of bullet securities to the total amount of mortgages being financed to be increased further? That is a separate question to whether a government should be guaranteeing mortgage backed securities.[81]

13.73 Some supporters of the AOFM programme do not want a permanent government agency:

> The Agency model is the securitisation of mortgage backed securities by Government agencies…ME Bank does not support the agency model as it does not result in a market led approach, instead relying upon a Government intermediary interposing with the market, restricting investor choice. This also disconnects each issuer from a direct relationship with investors creating concentration risk.[82]

13.74 When Treasury was asked for their opinion, they referred the Committee to their submission to an earlier inquiry. The submission concluded:

> A Canadian-style program of support to the RMBS market, under which the Government guaranteed RMBS issued by lenders or purchased such RMBS outright using proceeds from the issuance of government-backed debt securities, could potentially enhance smaller lenders' access to funds. However, it is not clear that such an intervention would necessarily result in substantially greater choice and lower interest rates for mortgage borrowers,

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80 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2. See also Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 16.

81 Mr Michael Bath, Acting Chief Executive Officer, Australian Office of Financial Management, *Committee Hansard*, 15 December 2010, p 97.

82 Members Equity Bank, *Submission 77*, p 3.

or that the benefits of the proposal would outweigh the associated risks and costs.[83]

Committee comment

13.75 The Committee believes that enhancing the securitisation market would facilitate smaller organisations providing competitive pressure to the major banks. It therefore believes that proposals suggested by market players should at the least be investigated further. It does not at this time favour the introduction of a programme of government support such as that in Canada. It would, however, like to see some more research done into how the Canadian model could be applied in Australia so that a scheme is in the 'bottom drawer' of the authorities ready to be implemented quickly if circumstances warrant it.

Recommendation 27

13.76 The Committee recommends that the Government commission a survey of potential demand for types of asset backed securities.

Recommendation 28

13.77 The Committee recommends that the broader inquiry into the financial system investigate ideas that may further the participation of smaller lenders in the securitisation market, such as greater standardisation and disclosure, liquidity support for securities issued by mutual ADIs meeting certain quality standards and better co-ordination between regulators.

Recommendation 29

13.78 The Committee recommends that Treasury develop a plan to introduce a support programme for RMBS similar to that operating in Canada in case a future deterioration in the securitisation market requires its introduction.

Covered bonds

13.79 The Government announced in its December 2010 package that it will amend the *Banking Act 1959* to allow Australian ADIs to issue covered bonds.[84] These are

83 Treasury, *Submission 167* to House of Representatives Standing Committee on Infrastructure, Transport, Regional Development and Local Government for its 2009 inquiry into the impact of the global financial crisis on regional Australia, cited in Treasury, *Responses to questions on notice*, *no 14*, 4 February 2011, pp 3-4.

bonds giving the holder a preferred claim on a specific group of assets on a bank's balance sheet. They differ from RMBS in that the assets stay on the banks' balance sheet but are 'ring-fenced' to give investors priority over depositors and other creditors in the event of the issuer going bankrupt.

13.80 Covered bonds offer 'dual recourse' as:

> If the cover assets are not sufficient to meet the bond payments in full, covered bondholders also have an unsecured claim on the issuer to recover any shortfall. In that case they would stand on an equal footing with the issuer's other unsecured creditors.[85]

13.81 Treasury comment:

> This initiative is designed to strengthen and diversify the financial system's access to cheaper, more stable and longer duration funding in domestic and offshore wholesale capital markets.[86]

13.82 The attraction of covered bonds for the issuer is that they should be able to be issued with a lower interest rate:

> It will be cheaper because our wholesale funding is AA rated and covered bonds are typically AAA rated.[87]
>
> ING Direct, for example, has a long term rating of A+ from Standard and Poor's but could issue a covered bond with a AAA rating.[88]

13.83 One caveat on this is that, as described in Chapter 12, government-guaranteed bonds were also expected to be issued at lower yields but, for reasons still not clear, the market priced them instead at the issuer's rating.

13.84 Proposals to allow the issuance of covered bonds are welcomed by a number of submitters:

> …it is another important step in diversifying funding and we would like to take advantage of it.[89]
>
> …covered bonds have a role in expanding and widening the investor base and in diversifying the funding base of ADIs.[90]

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84 As part of this commitment, on 24 March 2011 Treasury released an exposure draft of the Banking Amendment (Covered Bonds) Bill (No.1) 2011 for consultation.

85 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 17.

86 Department of the Treasury, *Submission 102*, p 30.

87 Mr Mark Joiner, Executive Director, Finance, National Australia Bank, *Committee Hansard*, 13 December 2010, p 64.

88 ING Bank, *Submission 35*, p 2.

89 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 64.

> I believe that covered bonds are a good move. That will improve the funding position of all the players.[91]
>
> …covered bonds are priced considerably cheaper than the bank can borrow funds in its own name, and that will have a benefit for us in terms of reducing the overall cost of funding to the industry.[92]

13.85 Covered bonds are commonly used in a number of countries:

> …they have been around in Germany, for instance, for about 150 years. The structure is fairly well established as to how they work…[93]
>
> They are used in many other markets. We [NAB] have issued them ourselves out of our New Zealand bank.[94]
>
> The covered bond market is large, with a total global amount outstanding of about €2.2 trillion in 2010. Around 300 institutions in over 30 countries have issued covered bonds. The bulk of covered bonds, around 90 per cent, have been issued by countries in the euro area…[95]
>
> In more than twenty nations, covered bonds perform a critical role on the liability and asset sides of bank balance sheets.[96]

13.86 Australia's depositor protection arranged had prevented their issue here:

> Under the *Banking Act 1959*…depositors must stand first in the queue in the event that a bank or deposit-taking institution is put into liquidation. That section in the *Banking Act* has always precluded the introduction of covered bonds in Australia.[97]

13.87 This has changed with the introduction of new arrangements for depositor protection:

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90 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 16.

91 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 35.

92 Mr Philip Coffey, Chief Financial Officer, Westpac, *Committee Hansard*, 21 January 2011, p 94.

93 Dr Guy Debelle, Assistant Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 8.

94 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 64.

95 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 17.

96 Australian Securitisation Forum, *Submission 122*, p 15. The countries are 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.

97 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 2. See also Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 17.

> The Government's position is that the introduction of the Financial Claims Scheme has opened the door for Australian institutions to have covered bonds.[98]

13.88 It seems to be generally accepted that, at least initially, covered bonds will help the major banks but may be of limited use for smaller competitors such as the mutuals:

> Abacus strongly rejects however the notion that covered bonds are pro-competitive. There is little doubt that the major banks will be able to source additional lower cost funding through covered bonds, however it is unlikely that many smaller regional banks, credit unions or building societies would be able to access funding through such an instrument.[99]
>
> …covered bonds. I think that is an obvious help to the major banks.[100]
>
> …covered bond market…will not be an option for any bank under an AA rating in the short term (ie. it will only provide a benefit to the major banks).[101]

13.89 The main reason is that it is generally regarded that the minimum viable size for an issue of covered bonds is a few hundred million dollars.[102]

13.90 The major banks suggested the smaller lenders could issue covered bonds by pooling their operations:

> …if there are willing issuers and there are buyers out there the market will find a way to package or structure that so that the smaller banks can benefit from that market. I have no doubt that will happen.[103]

13.91 A warning was sounded by one submitter:

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98 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 36.

99 Abacus, *Submission 53*, p 17. See also Mr John Minz, Chief Executive Officer, Heritage Building Society, *Committee Hansard*, 4 March 2011, p 15.

100 Mr Jonathan Mott, Banking Analyst, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 149. See also Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 36; Associate Professor Frank Zumbo, *Committee Hansard*, 14 December 2010, pp 55-56; and Dr Evan Jones, *Submission 81*, p 6.

101 Bank of Queensland, *Submission 44*, p 4. See also Bendigo and Adelaide Bank, *Submission 58*, p 5; Heritage Building Society, *Submission 113*, p 7; Mr David Foster, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2;

102 Mr Jonathan Mott, Banking Analyst, UBS Securities Australia, *Proof Committee Hansard*, 14 December 2010, p 150. A survey by the Australian Securitisation Forum suggests there is some investor interest in smaller issuance sizes of $100 million to $200 million; see their *Submission 74*, p 16.

103 Mr Graham Hodges, Deputy Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 125. A similar view was put by Mr Philip Coffey, Chief Financial Officer, Westpac, *Committee Hansard*, 21 January 2011, pp 70-71.

> The impression their backers give is that they minimise risk. In reality they simply redistribute risk, so that the bond holders are exposed to less risk and the depositors, including the “mums and dads”, are exposed to more risk then they would otherwise be.[104]

13.92 One way of limiting this problem is the common international practice of capping the amount of covered bonds that can be issued to around 5 per cent of the loans.[105] As the Reserve Bank describe:

> Countries that have only recently begun to permit covered bonds have tended to manage the subordination of depositors and other creditors by setting limits on the issuance of covered bonds. Regulations in Canada and rules proposed in the US Covered Bond Act limit covered bond issuance to 4 per cent of a deposit-taker’s assets (in Canada) or liabilities (in the United States).[106]

13.93 This has also been suggested as a response to concerns here:

> …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 insolvency.[107]

13.94 Especially given the strong capitalisation of Australian banks and the very low chance of one defaulting, this would ensure that the issue of covered bonds does not pose any risk to depositors, or the taxpayers guaranteeing them.

13.95 The covered bond market proved more resilient than did that for RMBS during the GFC, although the Reserve Bank caution that:

> …despite providing more safety to investors, covered bond issuers’ access to debt markets became seriously disrupted during the crisis, suggesting that the robustness of covered bonds should not be overstated.[108]

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104 Mr George Ivanov, *Submission 124*, p 6.

105 Mr Jonathan Mott, Banking Analyst, UBS Securities Australia, *Proof Committee Hansard*, 14 December 2010, p 151.

106 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 18.

107 Australian Securitisation Forum, *Submission 74*, p 17.

108 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 18.

Fixed interest markets more generally

13.96 The weakness in the RMBS market is viewed by some as part of a generally underdeveloped market for fixed interest securities:

> …we do need a big increase in domestic appetite for fixed interest. Our fixed interest market relative to our equity market is quite small on international standards. That is the case even though we have got a terrific savings pool in superannuation. Unless we can get a domestic fixed interest market of substance up and running, we are going to remain hostage to offshore investors, we are going to be reasonably inefficient as an economy because there will be more going into equity and we will not be leveraging to the appropriate amount we should, and there will be some restriction on funding for lower rated institutions...[109]

13.97 The Government aims to boost the vibrancy of bond markets by further streamlining disclosure requirements and prospectus liability regulations, and facilitating the trading of government bonds on securities exchanges to provide a more visible benchmark yield.[110]

Tapping superannuation

13.98 As noted above, the Government links the issue of covered bonds to accessing funds in superannuation:

> A deep and liquid covered bond market will help to channel Australia's national superannuation through the financial system into productive investment in all sectors of our economy.[111]

13.99 Some submitters want superannuation funds to be encouraged or required to provide more funding to ADIs.[112]

> …the Government needs to clearly investigate if the funds invested in Superannuation can be diversified in such a way that it could assist with funding of the banking system… There is a need to bridge the gap between superannuation funds sending much of their funds offshore and the needs of the Australian community, which is made up of the members they serve. Legislation could easily be drafted to support this public interest…Leaving the superannuation funds (and other institutional investors) to direct

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109 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 82.

110 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 24.

111 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 23.

112 Mr Rob Paton and Mr Ismar Tuzovic, *Submission 13*.

investment according to the market system contributed to the global financial crisis.[113]

No fund manager will look at a BBB ADI but (they) are happy to invest 20 per cent of their portfolios in offshore or emerging markets equities. This is not sensible for banking competition…If the Government wants to promote RMBS, the market needs to develop a link to a more significant investor base, i.e. the Australian superannuation funding pool.[114]

…investment and superannuation funds (both wholesale and retail) have an asset allocation that is over-weight equities and under-weight fixed income securities.[115]

…there are also some other opportunities to support competition…via further superannuation reform to encourage a greater proportion of fixed interest investments by superannuation funds…[116]

13.100 The ABA suggested:

The Federal Government should establish a working group with banking industry experts to explore options, identify strategies and agree actions to be taken to promote investment in deposits and fixed income assets within superannuation and retirement income products.[117]

…the Federal Government, in partnership with the banking industry, should conduct…a research exercise as part of responding to the 'Cooper Review' should look at conducting thorough analysis of the drivers and barriers for saving, thereby identifying how best to target savings messages. Understanding the factors that influence individuals' decisions about money, savings, investment, superannuation, debt and lifestyle choices will be important for determining how best to encourage greater personal superannuation contributions and private savings.[118]

13.101 The ABA, clarified, however, that they are not looking for regulations:

Prescribing investment options or mandating asset allocations is likely to have unintended and adverse consequences for superannuation fund trustees acting in the best interests of all members in their fund.[119]

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113 ING Bank, *Submission 35*, p 3.

114 A mutual ADI, cited by Abacus, *Submission 53*, p 14.

115 Australian Securitisation Forum, *Submission 74*, p 18.

116 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 2. See also Bendigo and Adelaide Bank, *Submission 58*, p 6; Mr Michael Murphy, Chief Executive Officer, Queensland Teachers Credit Union, *Proof Committee Hansard*, 4 March 2011 and Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 80.

117 Australian Bankers' Association, *Submission 76*, p 58.

118 Australian Bankers' Association, *Submission 76*, p 59.

119 Australian Bankers' Association, *Submission 76*, p 59.

13.102 One argument is that this would just be restoring the ability of banks to fund their lending from deposits to the situation prevailing before superannuation funds gained more favourable tax treatment:

> It wasn't until the early 1990s when the Hawke/Keating Government introduced compulsory superannuation laws and tax incentives for voluntary superannuation contributions, that a gap emerged between the level of deposits and the funding needed for loan growth. Compulsory superannuation drew deposits away from banks and into superannuation trusts.[120]

13.103 The superannuation funds themselves, however, reject the approach of requiring them to direct funds to the banks:

> Changing the allocation of superannuation investments through government intervention would move funds away from the optimal allocation determined by trustees. The net result of such action would be to reduce superannuation fund returns and ultimately deliver lower retirement incomes.[121]
>
> …we strongly oppose any suggestion that the superannuation sector should in fact be treated as a cash cow for the ADI sector.[122]

13.104 The superannuation funds cite the recent Superannuation Review's recommendation that:

> …government should not mandate that superannuation fund trustees participate in any particular investment class or vehicle.[123]

13.105 Professor Valentine also opposes the suggestion:

> …superannuation funds through the last 10 years have made a deplorable return, and to compel them to hold low-yielding assets so people can have low-yielding mortgages would mean that they would make an even lower return. That is not a particularly desirable result.[124]

Committee comment

13.106 The Committee believes that superannuation trustees should continue to have the sole purpose of maximising the (risk-adjusted) returns to their members. It does not favour measures to direct them to invest in bank securities or any other asset class. The Committee does support, however, removing any artificial barriers or

120 Australian Bankers' Association, *Submission 76*, p 58.

121 Financial Services Council, *Submission 121*, p 3. The FSC argues that population aging will lead to greater amounts invested in fixed income securities without any intervention.

122 Mr John Brogden, Chief Executive Officer, Financial Services Council, *Committee Hansard*, 21 January 2011, p 18.

123 Cited in Financial Services Council, *Submission 121*, p 3.

124 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 62.

discouragements to superannuation funds investing in securities such as ABS or covered bonds issued by banks.

Recommendation 30

13.107 The Committee recommends that the Government establish a working group with an independent chair, representatives from Treasury, the Australian Prudential Regulation Authority, the Reserve Bank, and the banking and superannuation industries, and also including academic experts, to explore and assess options that could promote investment in deposits and fixed income assets by superannuation funds and other funds managers.