The Australian securitisation market has developed significantly since the late 1980s and has now entered a more mature phase. Nevertheless, many organisations view securitisation as a niche market and see the process as more expensive than other funding options.

Brendan O'Connell examines this challenge for industry participants.

Over the past 25 years, financial innovation has precipitated revolutionary changes in financial instruments and processes. One of the more significant of these innovations has been the securitisation of financial assets.

Put simply, securitisation is the process by which a pool of illiquid, relatively homogeneous financial assets are converted into tradeable financial instruments (Borzi 1990, p. 7). These financial instruments are generally referred to as mortgage-backed securities (MBS) when pools of commercial and residential mortgages are involved, and asset-backed securities (ABS) when other financial assets, such as credit card receivables and trade debtors, are involved.

Securitisation came to prominence in 1970 in the United States and has developed there at a phenomenal rate. Outstanding issues in the United States are estimated at $US1.600 billion. In contrast, the Australian securitisation market started only in the late 1980s, but it has developed at a steady rate with outstanding issues estimated at $5.8 billion.

The study reported in this paper was undertaken between November 1993 and February 1994. Market participants were asked a series of open-ended questions concerning specific transactions in which they had been involved, as well as issues relating to the market in general. Study participants (Table 1) represented 27 Australian organisations — licensed trading banks, registered building societies and industrial and mining companies.

Since securitisation transactions tend...
to be sizeable (public issues in Australia are rarely less than $25 million and usually $100 million or more), the organisations were generally very large. Suitable organisations were identified from industry surveys, the reports of credit-rating agencies, and by direct contact with senior finance executives of entities likely to have sufficient volumes of assets suitable for securitisation. It was apparent from these direct approaches that most major financial institutions and companies in Australia had been previously approached by securitisation specialists.

Organisations classified as "originators" were those that had successfully securitised assets in the past. The study also included a group classified as "potential originators" who had considered securitisation of their financial assets but, for various reasons, had not proceeded. This group was included to provide a balanced view of the market's development.

The "issuers/arrangers" category consisted of financial institutions which are actively involved in promoting established securitisation structures and the market generally. A credit-enhancement provider and a credit-rating agency were included in the study because of their knowledge of the Australian market and the role they play in facilitating transactions.

### Table 2

<table>
<thead>
<tr>
<th>Major driving forces for securitisation in Australia</th>
<th>Originators/potential originators</th>
<th>Issuers/arrangers*</th>
<th>Companies#</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Strong investor demand for MBS and ABS.</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>12</td>
</tr>
<tr>
<td>2. Increasing understanding of the concept by potential issuers and investors.</td>
<td>2</td>
<td>5</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>3. Reallocation of private savings away from financial institutions towards pooled funds.</td>
<td>3</td>
<td>4</td>
<td>-</td>
<td>7</td>
</tr>
<tr>
<td>4. Declining establishment costs as more transactions are completed.</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>5. Improving structuring expertise of issuers/arrangers.</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>6. Improving domestic economic environment.</td>
<td>-</td>
<td>4</td>
<td>-</td>
<td>4</td>
</tr>
</tbody>
</table>

* Includes the responses of the credit enhancer interviewed. # Includes the responses of the credit ratings agency interviewed.

Note: Many of the participants identified a number of driving forces and impediments of which only the most popular six responses overall have been reported.

### Driving forces and impediments

Participants were asked what they saw as the driving forces and impediments to further development in the Australian securitisation market. The most common responses, ranked in order of frequency, are summarised in Tables 2 and 3.

The responses in Table 2 reflect the general optimism of Australian market participants about the future of securitisation. Nevertheless, a number of respondents felt that securitisation would remain as a niche market rather than developing into a significant source of funding for large companies and financial institutions. For example, one respondent commented: "You see big licks every now and again ... but I am not sure you will see large numbers of average corporations doing it on an ongoing basis."

The main driving force identified was the strength of investor demand for MBS and ABS. Respondents felt that the recent low levels of interest rates had encouraged investor interest in these securities, which were seen to be offering attractive yields in comparison with other highly rated securities. Increasing understanding and awareness of securitisation as a funding option for organisations was also cited. Related to this factor was the perceived improvement in investor understanding of the unique risks inherent in purchasing MBS and ABS.

The trend of private savings away from traditional bank deposit accounts and into pooled funds, such as industry superannuation schemes, was also seen by financial institutions as a significant force. With funds under management increasing, the growing demand for MBS and ABS was generally regarded as likely to continue.

The apparent decline in set-up costs reflected the saving achievable by the use of "off the shelf" documentation from previous transactions as well as the amortisation of establishment costs over a rising volume of new issues.

Participants also commented on the improving expertise of issuers/arrangers in arranging transactions. They felt these enhanced skills resulted in structures which better satisfied the needs of originators and investors.

Finally, the improving economy was cited by issuers and arrangers as a positive force in encouraging expanding organisations to seek alternative funding sources such as securitisation.

Table 3 shows that study participants more readily identified impediments than driving forces in the development...
of the market. Two of the six major impediments identified (numbers one and four) related to the cost of the process. This is consistent with statements made by the "potential originator" group which generally cited excessive cost as being the main reason for not securitising. The issuer/arranger group also commonly recognised this as an impediment.

While securitisation was often perceived as more expensive than alternatives, discussions with study participants indicated that this margin had narrowed greatly in the past two years. This declining margin was attributed to increased investor demand for MBS and ABS, more cost-efficient structures and strong competition between issuers/arrangers.

Respondents also mentioned the excess liquidity of potential originators in the present economic climate. Many organisations which had reduced debt in recent years now had significant borrowing capacity available from existing funding facilities. This, combined with competition among financial institutions to lend to high-credit-quality entities, often resulted in securitisation being dismissed as a funding option. For example, one potential originator remarked: "We looked at this [securitisation] because it was new, it was interesting, it could replace other lines, but ... in hindsight, it was never attractive while we were reducing debt. The main thing holding it back in Australia is cost."

Perceptions of unfavourable treatment of securitisation by the Reserve Bank of Australia (RBA) were also considered a significant barrier. Currently, a licensed trading bank wishing to achieve off-balance-sheet treatment for regulatory purposes must first convince the RBA that the assets are sold in a legal sense. However, they must also convince the RBA that there is no "moral recourse" on the part of the seller to bondholders in the event that the assets securitised begin to default, thus jeopardising the payments on the bonds. Given that off-balance-sheet treatment is generally perceived as a major benefit of securitisation, the RBA's approach evidently discourages banks from using securitisation.

Another concern cited by market participants was that MBS attract a 100 per cent risk weighting by the RBA for capital-adequacy purposes. They pointed out that because a residential mortgage carries only a 50% risk weighting, the RBA was effectively discouraging banks from investing in MBS.

Both companies and financial institutions referred to the lack of involvement in the securitisation market by big institutions (particularly the four major trading banks), suggesting that potential originators were looking to the major banks to give impetus to the market before they would commit themselves.

Evolving structures
Survey participants suggested that the Australian market has moved into a more mature phase. The market's embryonic phase of the late 1980s was described as being characterised by transactions involving substantial external-party credit enhancements, a predominance of government-sponsored schemes involving the securitisation of residential mortgages of low-income earners, and a significant risk premium attached by investors to the purchasing yield of these securities. This phase was also notable for the absence of companies seeking to securitise non-mortgage assets.

TABLE 3

<table>
<thead>
<tr>
<th>Major impediments to securitisation in Australia</th>
<th>Financial institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Originators/ potential originators</td>
</tr>
<tr>
<td>1. Large establishment costs for transactions.</td>
<td>3</td>
</tr>
<tr>
<td>2. Excess liquidity of potential originators.</td>
<td>3</td>
</tr>
<tr>
<td>3. Unfavourable treatment of the process by the Reserve Bank of Australia.</td>
<td>4</td>
</tr>
<tr>
<td>4. Excessive cost involved/not competitive.</td>
<td>2</td>
</tr>
<tr>
<td>5. Lack of involvement in the market to date by major financial institutions.</td>
<td>2</td>
</tr>
<tr>
<td>6. Unfavourable regulatory environment.</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>16</td>
</tr>
</tbody>
</table>

* Includes the responses of the credit enhancer interviewed. # Includes the responses of the credit ratings agency interviewed.

Note: Many of the participants identified a number of driving forces and impediments of which only the most popular six responses overall have been reported.
The market appears to have entered a new phase in the past two or three years, as is evidenced by several factors. First, the assets securitised have diversified; for example, consumer charge cards, trade receivables and employee share loan receivables were securitised in 1993. Second, the costs of securitisation have declined, compared with other funding options for companies and financial institutions.

A third factor is the replacement of external credit enhancement techniques such as so-called "wrap-around" guarantees by third parties with the issue of both senior and subordinated securities. In such structures, the subordinated tranche is junior in payment priority and generally has a longer maturity, a more uncertain duration and a lower credit rating. Consequently, the presence of this subordinated tranche renders a great deal of comfort to senior bondholders.

The development of this third factor was generally attributed to the perceived high costs of external-party credit enhancements, a lack of highly rated providers of such guarantees in the Australian market, and growing acceptance by investors of subordinated securities.

Further, this third factor was generally viewed by respondents as a particularly positive development for the Australian market. It was seen to demonstrate the capacity of market participants to innovate effectively. It was also seen as resulting in more transparent securitisation structures, as investors focus on the quality of the underlying collateral rather than that of the external credit enhancers.

**Warning for originators**

The study highlighted two concerns for potential originators: the information system governing the assets and the benchmark against which the process is assessed.

**Information system:** The first area of concern was the critical role played by the information system governing the securitised assets. It was clear that a number of originators did not have information systems capable of providing interested external parties such as credit rating agencies with the detailed information necessary to evaluate the quality of the assets being considered for securitisation. Further, the information systems often failed to satisfy the stringent ongoing reporting requirements of these parties. Market participants suggested that information systems must be able to:

- separate securitised assets from the balance of an organisation's assets;
- promptly identify and report changes in the level of delinquencies;
- provide regular updates on the amortisation of outstanding balances;
- provide a performance history of the assets concerned (preferably up to six years); and
- provide a geographic and asset-size distribution of the securitised assets.

A number of originators belatedly discovered that their information systems were not able to provide this information to the satisfaction of external parties and were obliged to make costly alterations to their systems. Said one originator:

"Significant time and effort was required to get the system together. It cost a six-figure amount and the first number is not 1."

**Benchmarks:** The second area of concern was the divergence of benchmarks against which the cost of securitisation was assessed by originators. The differences were most apparent in transactions involving asset-backed facilities in which the originator periodically sold short-term assets such as trade receivables into a structure which then issued short-dated ABS.

Some respondents felt that this type of securitisation transaction should be measured against a committed funding facility. Others felt it should be compared against an uncommitted funding facility. The dilemma is summed up in this comment by one potential originator: "It is effectively somewhere between a committed and uncommitted line as there is a fair amount of protection for a borrower [originator] as the investors have the assets to fall back on and provided the quality of the assets doesn't fall, what happens to you as a company [e.g., a credit-rating downgrade] is not highly relevant... nevertheless, nowhere in the documentation did it say it [the facility] was committed."

One lesson from this apparent divergence is the importance of carefully examining the documentation of such transactions to assess the level of commitment provided (if any), and to assess the potential impact of a credit-rating downgrade of the originator on its ability to continue to issue through the facility. If issuing is subject to any degree of market risk, then the facility is not "committed" in the true sense of the word.

Nevertheless, most asset-backed commercial paper programs in Australia and overseas incorporate a liquidity-support facility to guard against short-term market failures. This type of facility is generally provided by a highly rated external party. Accordingly, some degree of commitment does seem to exist in these structures, although it is generally limited to less than one year.

The importance of selecting an appropriate benchmark is highlighted by the difference in cost between a committed and an uncommitted facility. One Australian market participant suggests that three-year standby support for commercial paper issued by a highly rated corporate is likely to cost around 45 basis points over the bank bill rate (including line fees and drawdowns). The same company is likely to be able to issue on an uncommitted basis at around 5-10 basis points over the bank bill rate.

**NOTES**

1. For a more comprehensive definition of securitisation which also incorporates the dynamics of the process itself, refer to Shenker and Colletta (1991, pp. 1374-5).
2. A perceived shortage of affordable housing finance in the United States motivated the formation of a government-sponsored organisation, the Government National Mortgage Association (GNMA, often referred to as "Ginnie Mae"). This development precipitated the issue of the first traded MBS.
5. The results reported here mainly relate to the latter group of questions. Study participants were also asked to complete a survey questionnaire. The results of that survey are not reported here.
6. Senior/subordinated structures have been popular in overseas securitisation markets such as the United States for some time. For further discussion of this point, refer to Tierney et al. (1994 p. 32).

**REFERENCES**


