Emerging mortgage markets

Securitisation in Asia: it's worth the effort

Securitisation has transformed the Australian mortgage lending industry. BRENDAN O'CONNELL and BILL LEUNG point out that despite environmental and legal impediments, securitisation is poised to take off in Asian economies – and Australian market participants should be ready to play a role.

The dramatic growth of the Australian securitisation market in recent years has prompted a number of Australian market participants to explore opportunities in the emerging Asian financial markets. Potential exists in these markets for experienced securitisation practitioners to fulfil a number of roles including the supply of advisory services to new securitisation structures and the provision of credit enhancement and other support to new issues.

Successful securitisation transactions have been carried out in countries as diverse as Hong Kong, Indonesia and Thailand. Despite different legal, economic, cultural, and environmental factors, which must be analysed in-depth before transactions can be successfully completed, strong potential clearly exists for the growth of securitisation in Asia.

Given the great differences between markets, this paper will not attempt to study potential markets individually. Rather, it addresses the main issues that are likely to arise in emerging markets, with special reference to the experience of the Australian securitisation market and with an emphasis on mortgage securitisation.

KEY FACTORS FOR SECURITISATION TO DEVELOP

A number of key indicators of potential for the development of securitisation can help in identifying appropriate target markets.

Capital shortages

An examination of well-developed securitisation markets such as the US indicates that where financial institutions experience capital shortages, there is a strong incentive for securitisation to develop. If financial institutions in a market appear to be becoming more reliant on wholesale funding relative to retail deposits, or their capital bases appear low by international standards, then the all-up costs of securitisation are more likely to be competitive with those of traditional funding options. Conversely, if financial institutions in a market possess large capital bases and have access to abundant low-cost retail funding, then it is less probable that securitisation will prove to be attractive.

New mortgage providers

The experience of the UK (and more recently Australian) mortgage market is that securitisation has been most readily adopted by organisations which previ-
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Favourable macroeconomic conditions

Given that the steady growth of securitisation is dependent on a ready supply of newly originated loans, it is likely that growth in adoption of the process will be encouraged in an environment of strong economic growth, rising levels of consumer affluence, ready affordability of housing and increasing demand for housing stock. Many of the growing Asian economies appear to possess favourable macroeconomic conditions for securitisation to develop.

Well developed capital markets

Capital markets in countries where securitisation has become established, such as the US, the UK and Australia, generally have sophisticated investors trading in large quantities of high-quality securities. In many emerging markets, particularly in Asia, this important ingredient is missing.

However, the lack of a well developed capital market in itself is not an impossible barrier for a transaction arranger to overcome. The transaction arranger can seek to place the mortgage-backed securities privately with local investors. Alternatively, securities (backed by the mortgage collateral sourced from the emerging market) can be issued into more developed offshore capital markets.

Government support

A major catalyst for the development of the US mortgage securitisation market was the formation of government agencies charged with a mandate to foster a secondary mortgage market. Other markets, such as Australia’s, have developed without high levels of explicit government support.

However, government support goes beyond merely providing specific guarantees or other forms of financial assistance. It extends to providing a regulatory framework conducive to securitisation.

The Australian experience has been that existing legal frameworks do not readily lend themselves to securitisation structures, having been designed long before securitisation itself. In many new markets, obtaining the necessary changes to these legal frameworks in order to encourage securitisation has been difficult to initiate and slow to accomplish. This is despite the absence of any “official” resistance to securitisation.

Primary mortgage market inefficiencies

Any evidence of major inefficiencies in a nation’s primary mortgage market will suggest potential for securitisation to develop. For example, if financial institutions appear to have geographically concentrated asset portfolios, this may imply that there are regional imbalances in the supply and/or demand for mortgage funds. In such circumstances, the adoption of securitisation would help alleviate these imbalances.

Added value

The final key factor, and perhaps the most important, is that the process must be seen by local institutions to “add value”. This does not merely mean that a short-term strategic benefit accrues in a particular situation, but from a wider perspective, securitisation must enable firms to better exploit an area of competitive advantage.

For example, if a market is characterised by firms with strong originating and servicing abilities but comparatively high costs of funds, then there is likely to be a strong economic incentive for them to securitise.

ISSUES IN EMERGING ASIAN MARKETS

Originator/investor education

Investment bankers with the competence to structure securitisation transactions can be readily imported into emerging markets. However, there is likely to be a shortage of people in the originating institutions who possess sufficient skills to work with them. Even where there are skilled people available, it may take well over a year for the various parties involved — investment bankers, lawyers, accountants, originators — to bring a new, sophisticated financing to the point where it can be placed.

A significant learning-curve effect is also likely to exist for market regulators, credit rating agencies and potential credit enhancers. Further, the long lead times in arranging new transactions are likely to discourage investment bankers from entering a market in the first place.

Nevertheless, history suggests that those players who are first to establish themselves in an emerging market are likely to capture a dominant market share. Hence, the frustrations of being involved in pioneering transactions in new markets may prove to be well worthwhile in the longer term.
Regulatory, legal and tax constraints
As previously noted, existing regulatory, legal and tax frameworks in emerging markets may not readily lend themselves to securitisation transactions. An assessment needs to be made of whether these barriers are insurmountable or whether they can be overcome through interaction with local regulatory bodies.

In markets such as Australia, industry lobby groups such as the Australian Securitisation Forum appear to have been successful in achieving the legislative and other changes necessary to facilitate transactions.

In assessing the level of regulatory and legal constraints to securitisation in a new market, the following questions need to be addressed:

• Are regulations generally designed for particular, discrete industries but not others? If so, this may impede transaction structuring as regulation by function rather than by industry is more likely to provide a legal framework conducive to securitisation. An example of this has been Japan, where legislation relating to banks has historically restricted them from being able to originate and underwrite securities. Market participants have suggested that this has restricted the development of that particular market in spite of the large volumes of securitisable assets available to them.

• Is there evidence of inconsistent legal approaches to the mortgage industry within national boundaries? If an asset pool is likely to be fragmented between different legal jurisdictions then this may create numerous problems, not only in structuring transactions, but also during the life of the pool, eg, different legal approaches in enforcing mortgage security. In Australia, for example, different state legislation governing mortgages has clearly inhibited the market’s development.

• Is there evidence of significant changeover costs for mortgage customers due to legal or tax requirements? If the costs of transferring title on mortgage loans is comparatively high, this will deter new transactions (unless exemptions are granted for securitisation transactions) as well as discourage customers from shopping around for the best deal (this extra competition tends to favour non-bank lenders who are more likely to utilise securitisation). For example, the relatively high rate of stamp duty on mortgage transfers in Australia is generally thought to have discouraged greater use of securitisation.

• Is the trust concept duly recognised by law in the market? If the trust concept is not recognised in a particular jurisdiction (which is the case in a number of countries throughout Europe and Asia) then this will create significant problems in structuring securitisation transactions to the satisfaction of the various parties involved, given the prominent role of trustees in securitisation transactions.

• What are the likely approaches within a particular legal jurisdiction to the bankruptcy remoteness of special-purpose vehicles? If there appears to be a possibility that a legal challenge against the sale of assets to a special-purpose vehicle will be successful in an emerging market, then this will not only destroy an otherwise soundly structured deal, but will deter future transactions. The legal approach to dealing with asset transfers prior to company insolvency can differ markedly from one jurisdiction to another.

• What are the legal requirements concerning issues of mortgage-backed securities? If a prospectus is required to be registered in order to issue mortgage-backed securities to investors in a market, this will act as a significant inhibiting factor to transactions. Attention should be drawn to examining circumstances under which onerous disclosure requirements for issuance of new securities may be avoided.

Local mortgage originating standards
A careful assessment needs to be made of such factors as the mortgage underwriting criteria adopted by originators, documentation standards, the quality of originating organisations and their staff, and the level of servicing of mortgages. In many emerging markets, there is an absence of standardisation of mortgage underwriting and documentation. Further, even where a pool of mortgages appears to meet set criteria, this perception may be misleading because of inadequate systems and procedures. Inadequacies in default and foreclosure policy, or problem detection generally, may lead to high losses in mortgage pools.

It is of paramount importance in emerging markets to carry out an in-depth due diligence study of all mortgage pools being considered for participation in a securitisation program. It is also crucial to conduct regular audits of the performance of mortgage collateral, rather than to rely on statistics prepared by the originator/servicer.

Conclusions
There is little doubt that securitisation is currently playing a significant role in facilitating the restructuring of the Australian mortgage lending industry. Although the rate of adoption of securitisation in the Asian markets is inhibited by various regulatory, institutional and other barriers, the experience of countries such as Australia indicates that securitisation will play an increasing role in these countries as well.

In fact, it was not long ago that sceptics suggested securitisation would never take hold in Australia. It follows that Australian market participants, looking to expand their opportunities, would ignore these emerging markets at their own peril.