The history of the Australian securitisation market

The future of securitisation

This paper examines the future of the Australian securitisation market while recognising that securitisation takes place within a global market. The paper highlights the key issues that will need to be addressed to ensure the securitisation market becomes a large, deep and liquid part of our financial system, and plays a larger role in funding Australia’s economic growth.

History of the Australian securitisation market

In considering the future of the Australian securitisation market, it is useful to reflect on its history. One of the earliest applications of securitisation technology in Australia was by government authorities, namely the State of New South Wales’ FANMAC residential mortgage-backed bond program and the State of Victoria’s National Mortgage Market Corporation mortgage-backed program. Both programs were established in the 1980s and were mainly directed towards providing finance to borrowers that otherwise were not able to access housing finance through the banking system. At the time, banks maintained very restrictive lending criteria for housing finance. Bonds issued under both programs benefited from an explicit guarantee from the respective states. Hence investors were exposed to the credit risk of the state not the risk of the underlying housing loan.

The early 1990s saw the emergence of the private (non-government) securitisation market with issuance of residential mortgage-backed securities (RMBS), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS). These securities were issued, for example, by vehicles sponsored by Prudential Bache, Security Pacific National Bank, the Gas & Fuel Corporation of Victoria, and Deutsche Bank’s Prime Asset CMBS vehicle. In this paper, RMBS, ABS and CMBS will be referred to as asset-backed securities or ABS, unless otherwise noted.

The Australian securitisation market and its principal asset class, RMBS, truly established itself in the mid 1990s, when pass-through RMBS structures gained investor acceptance. At this point, the declining level of Commonwealth Government Securities gave rise to increased investor appetite for securitised debt. Relatively significant volumes of RMBS started to be issued by Macquarie’s PUMA program and others such as Interstar Securities. Through the late 1990s and earlier this century, increased Australian and global investor demand drove the growth of the Australian securitisation market. Authorised deposit-taking institutions (ADIs) and non-bank issuers entered the market to benefit from this new, diversified and cost-effective form of funding.

The growth of the securitisation market in the early 2000s witnessed global investors becoming very significant buyers of Australian securitised debt, representing up to 50 per cent of the investors in primary RMBS issues. Such investors included the structured investment vehicles (SIVs) typically based in Europe. The SIVs took advantage of market and regulatory arbitrage opportunities to buy longer dated ABS and fund through short-dated asset-backed commercial paper.

The impact of the financial crisis significantly diminished liquidity in the primary RMBS market and especially within the global investor community. Figure 1 illustrates the growth of Australian RMBS market prior to the crisis, and the slow recovery trend since then. Note the decline in 2012 reflects the impact of covered bonds being issued for the first time by Australian banks. Also notable since the 2008 crisis is the absence of significant issues of RMBS in currencies other than in Australian dollars.
Before turning to a discussion of the future of securitisation, it is also worth noting that we define securitisation simply as a form of secured financing. It is not anything extraordinary or dangerous. Securitisation serves as an efficient technique for raising capital and transferring risk from originators of financial assets (which drive growth in the real economy) to the capital markets. Securitisation markets allow originators of credit to provide funds to consumers and businesses in an efficient and cost-effective manner. A wide range of assets such as auto loans, residential and commercial mortgages, or credit card receivables can collateralise ABS sold to a broad range of domestic and international investors.

Future role of securitisation
The role of securitisation in the future Australian financial system is to complement the funding of the economy that is provided through the traditional banking system. Securitisation provides a means of diversifying the funding of a financial institution. It is attractive to smaller ADIs that have limited access to term funding markets. It also provides a potential source of competition in the housing and consumer finance markets, given the highly concentrated nature of the Australian banking system. Securitisation can also provide a means of transferring risk, particularly residential property risk, outside the banking system.

In the future, the operation of seamless cross-border securitisation markets will be increasingly important. Australia’s major banks are expected to face constraints, as part of the Basel III capital requirements, in terms of the amount and type of credit they can supply. For capital markets to provide a strong alternative source of financing for consumers and businesses, it is important to ensure participation by both domestic and global investors.

What will determine the future?
The future of securitisation in Australia will be determined by four key factors:

> demand for asset-backed securities
> supply of asset-backed securities
> market liquidity
> the regulatory framework for securitisation.
While the following points discuss each of the above four factors individually, in reality they are interconnected.

1) Demand
The evolution of the Australian securitisation market to date has demonstrated a sustainable demand base for ABS. The sources of demand can be categorised into three types of investors:

> domestic financial institutions
> domestic fixed income investors
> global investors (financial institutions and bond investors).

Domestic banks have been a large domestic buyer of ABS, primarily RMBS. This is an asset class with which they have great familiarity. Major banks are ABS issuers, investors or providers of warehouse facilities to smaller ADIs and non-banks. Bank buying of RMBS has been spurred by its inclusion as an asset class eligible to be included in the collateral of a bank’s Committed Liquidity Facility (CLF) with the Reserve Bank of Australia. The CLF forms part of Australia’s compliance with Basel III’s Liquidity Coverage Ratio requirement. This is an example of the interaction of demand and regulation which will jointly determine the future composition and size of the Australian securitisation market.

To date, a key disappointment in relation to the Australian securitisation market has been the tardy growth of investment by fixed income funds and insurance companies, referred to colloquially as ‘real money’ investors. This primarily reflects the constrained investment by Australian investors and institutions in the fixed income asset class, and specifically credit assets such as ABS. Domestic fixed income investors do invest across the credit spectrum of ABS structures including senior, mezzanine and junior notes. A positive feature of the post financial crisis period has been the emergence of new specialist credit funds which have invested in ABS. Many have delivered investors strong returns based on the running yield and the recent rally of valuations of ABS.

The opportunity exists for securitisation to play a larger role in funding Australia’s economic growth. This can be realised by repackaging a greater volume and wider array of financial assets into ABS that can be held in portfolio by domestic and global investors. Securitisation is an established funding option for high-quality assets with predicable credit performance to be repackaged as ABS and held in the superannuation system. This could allow ADIs to use the proceeds from issuing ABS to exploit their credit skills to finance more heterogeneous assets such as small business, construction and infrastructure loans.

Global investors based in Europe, the US and Asia have been active buyers in Australian ABS for many years, however, they were largely been absent for the period immediately after the 2008 financial crisis. The repricing of risk in global debt markets, the evaporation of market liquidity and the demise of the European SIVs, started a period of abstinence by global investors in Australian ABS. In the aftermath of the crisis, Australian ABS issuers were restricted to fund primarily in Australian dollars. This was due to higher margins and fewer counterparties willing to provide an amortising cross currency swap in the aftermath of the crisis. Since the start of 2013, global investors have returned to participate in new primary issues, in both Australian dollar tranches and a few US dollar tranches issued in recent ABS deals. Macquarie Bank’s SMART auto ABS program has been the notable exception, with a number of successful US ABS transactions completed since 2012.

Investment by global investors will be imperative for a larger and sustainable securitisation market in the future. Issuance in non-Australian dollars will be a necessity, as will an accommodating and predictable regulatory framework. Global investors were dismayed by APRA’s reversal of its acceptance of date-based calls included in many pre-crisis ABS deals, as this policy reversal created unanticipated extension risk for investors. The importance of a clear and predictable regulatory framework will be discussed later in the paper.

From a demand perspective, it will be important for investors to be present and active both in senior tranches of ABS, as well as mezzanine and junior tranches. A significant focus of policy makers has been on making senior ABS notes ‘super safe’ in terms of credit risk. It is vital that a diverse and active investor base for higher risk and higher yielding ABS tranches also remains present in global securitisation markets.
2) Supply
The Australian securitisation market has always been dominated by the RMBS asset class, and
this is unlikely to change in the next decade or so. Australian RMBS are backed by pools of
high-quality mortgage receivables which are originated according to relatively conservative
underwriting standards and within a well-regulated credit and consumer law environment. For
example, all mortgage brokers are licensed in Australia, which is still not the case in the US.
Australian RMBS has established an excellent track record with investors for its transparency,
relative simplicity and credit performance. This credit performance is illustrated in Figure 2.

FIGURE 2 — Comparison of Australian RMBS delinquency rates to other selected
OECD countries

While there can be a variety of collateral types backing ABS, it is not necessary for a bank
treasurer to issue ABS backed by specific collateral to fund the bank’s lending in that asset class.
Funding of a bank is fungible, and so it may be best if banks continue to securitise ‘easy’ assets
such as residential mortgages. The funds raised by an RMBS issue can then be directed to any
part of the bank’s activities including small business lending, personal finance, construction loans
or even infrastructure finance.

The supply of ABS in the Australian market is potentially quite large, particularly when the value
of assets suitable for securitisation on the balance sheets of ADIs is measured. In addition, there
are assets originated by non-banks and captive auto finance companies. Assets most suitable
for securitisation are consumer and business receivables that have been originated on relatively
standard and similar loan contracts and have a predictable cash flow profile based on the
payment of principle and interest by the underlying borrower or obligor.

In considering the future supply of assets, there is also the potential for ABS to be collateralised
by assets not typically securitised in Australia, as outlined as follows.

Reverse mortgages — These mortgages are a form of finance that can be used to provide an
income stream to senior Australians who may have substantial equity in their primary residence,
but prefer not to sell the property to release the equity. According to the Deloitte Reverse
Mortgage Report, as at 31 December 2013 the outstanding balance of reverse mortgages stood
at $3.56 billion. There has been some attempt to use securitisation to fund pools of reverse
mortgages in Australia, New Zealand, the UK and the US. To date, while these types of assets
are potentially suitable for securitisation, they have failed to establish a niche in the ABS market.
The ageing Australian population, and the need to create retirement income streams for retiring
baby-boomers, may give this asset class another opportunity to use capital markets to meet a
financing need in the economy.
**Student loans** — Australia’s recent tertiary education policies have incorporated a user pays model for the provision of courses. This has resulted in a large number of graduates effectively borrowing the cost of their course under the Commonwealth Government’s HELP scheme. There are approximately 1.50 million HELP borrowers who owe about $26.5 billion. While these student loans have not been structured on a commercial basis, the outstanding debt could be securitised, should the government wish to fund the obligation through the ABS markets rather than through its own borrowing program. To achieve such funding the government would need to impute a market interest rate on the obligations and provide some form of guarantee around the credit risk and timeliness of repayment. The case for securitising the current HELP portfolio is not compelling. Should the government wish to restructure the program, and base loans on a more commercial basis, with market-linked interest rates and specific repayment timetables, then the potential to securitise the debt would be enhanced.

**Business loans** — There has been, and continues to be, significant discussion around the role of securitisation in improving the availability, and potentially the cost, of business loans to small- and medium-sized enterprise (SMEs). Lending to SMEs has been a topic highlighted in a number of submissions to the 2014 Financial System Inquiry. It is a major topic in Europe, where regulators such as the Bank of England and the European Central Bank, have explicitly identified the role of securitisation in providing additional funds to European SMEs. In the US, ABS backed by SME loans are guaranteed by the Small Business Loan Administration, which is part of the US Government. The buyers of the ABS view them as government credit risk rather than being based on the underlying SMEs. The potential for securitisation to provide an additional direct channel to finance to SMEs in Australia is likely to be challenged by a number of factors. These include the fact that financing of SMEs is often relatively complicated, with the borrower requiring several forms of finance and transaction facilities from a financial institution. Also the legal form of financial accommodation to SMEs is not necessarily standardised and can vary between and within lenders. Further, to obtain a credit rating of an ABS backed by SME loans, will require a time series of credit performance. It is unlikely that such a history is currently readily available from bank systems.

**Trade receivables** — The financing of trade receivables through the issuance of ABS is an underdeveloped component of the Australian securitisation market. The securitisation of trade receivables has been a longstanding and successful part of the US securitisation market. In the US many corporates finance their receivables portfolios through Wall Street conduit programs. This is a way of preserving capacity under banking limits for other more medium funding needs. The absence of this sector in the Australian market can possibly be explained by the comprehensive nature of the banking relationships that exist between large corporates, who have portfolios of receivables suitable for securitisation, and their primary banks. Another constraint for the development of this sector is the absence of a data series of credit performance on these types of receivables that can be extracted and provided to credit rating agencies (CRAs) for their analysis and the determination of a credit rating of the ABS.

**Credit card receivables** — Currently funded through bank balance sheets, this is an asset class that is eminently suitable for financing via securitisation. This asset class has a great degree of homogeneity, and it is a large, established market in the US securitisation market. A long and rich time series of credit performance is available to rate this type of ABS. The impetus for this form of ABS to emerge in Australia will be the approval of a market-appropriate form of master trust structure under APRA’s new securitisation prudential standard, APS120. The balance of credit card receivables on the eight largest ADIs as at 31 March 2014 was approximately $77 billion and it may be up to $100 billion for the entire credit card industry. Based on the current outstanding balance, the potential size of this asset class could be up to $5 billion of issuance per year. This would add significantly to the size and diversity of the ABS asset class. ABS collateralised by credit card receivables would be an attractive asset class for both local and global investors who are eager to add diversification to their fixed income portfolios.

**Infrastructure loans** — The 2014 Financial System Inquiry has also galvanised the debate regarding funding infrastructure loans. The federal and state governments have been reluctant to take advantage of historically low interest rates to borrow to fund new infrastructure assets. The experiment of the past decade with public-private partnerships (PPP) has had a less than stellar history. There have been a number of failures of such financings in Queensland and New
South Wales, and Victorian taxpayers will be burdened for decades by the very expensive PPP financing of its desalination plant. There exists an opportunity for securitisation to play a role in refinancing existing infrastructure assets to free-up investment and finance of new infrastructure. Securitisation is ideal to create ABS based on established and predictable cash flows from established infrastructure assets. Such assets may be based on either user pays or government concession infrastructure funding models. Such ABS could easily be placed with superannuation funds that are seeking assets that provide annuity style returns for the growing appetite for retirement income products.

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Social benefit bonds — Securitisation technology has also been adapted to the niche funding of social benefit bonds. In 2012, Westpac Institutional Bank and CBA piloted this niche funding market with an inaugural $10 million issue. The proceeds of three tranches of bonds issued by a special purpose vehicle will be drawn down over five years by The Benevolent Society. The funds will be used to provide family preservation services aimed at preventing children from going into foster care. Interest and principal to repay the bonds will come from the NSW Government and is dependent on the performance of The Benevolent Society’s program. The government payment is calculated by the level of savings made by the government in terms of what it would have required to fund its own programs had the project not achieved its objectives.

3) Market liquidity
A key issue in any discussion of the prospects of the Australian securitisation market is the importance of liquidity in both the primary and secondary markets.

Liquidity in financial markets is perhaps best considered as an indicator of confidence. Typically it exists in normal or buoyant market conditions and evaporates in uncertain or stressed market conditions. Some experts have defined a liquid market to be one where there is little difference between the transaction price and the fundamental value. Other experts have postulated that market illiquidity is the result of market imperfections. The recent Bank of England and European Central Bank discussion paper, ‘The case for a better functioning securitisation market in the European Union’, commented that a liquid market requires well-funded buyers, widely available information on the asset being traded and a mechanism for buyers and sellers to meet and trade in a competitive, low-cost environment. It is fair to say that the Australian ABS market only exhibits some of these features, from time to time.

In looking forward, one area that could assist the achievement of greater secondary market liquidity is improved post-trade reporting of prices. Price reporting could improve the efficiency of the market and potentially marginally reduce costs. The Financial Industry Regulatory Authority (FINRA) in the US has instigated enhanced reporting of ABS post-trade pricing. While there are some issues to be addressed in the Australian market, investors generally see benefits in better transparency of actual trade prices, along with additional information about the trade size and type of institutions involved in the trade.

A fundamental ingredient for market liquidity is the presence of banks willing to act as market makers in ABS. This requires banks to hold an inventory of securities to facilitate timing and price mismatches between buyers and sellers at any point in time. Prior to the financial crisis, there were quite a few banks in Australia that were willing to act as market makers. This allowed buyers and sellers to transact in reasonable time periods (days), with a reasonable bid/offer spread quoted on the securities. Since 2008, the number of market makers in ABS has reduced significantly, and the bid/offer spread has widened considerably. This reflects, in part, the impact of revised capital requirements prescribed by Basel III for the securities held in the trading books of financial institutions.
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4) An accommodating regulatory framework

Proposed and actual regulatory changes to securitisation markets have dominated the industry since the financial crisis. Scrutiny has come from global bodies such as the G20, the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), as well as local policy makers and regulators.

The current APRA discussion paper ‘Simplifying the prudential approach to securitisation’ presents an opportunity to create a sustainable securitisation market. The new prudential standard needs to permit financial institutions to issue ABS, invest in ABS, trade ABS and provide credit and derivative facilities to support securitisation by third parties. Not all financial institutions will wish to conduct activities that span this spectrum although it can be expected that the four major Australian banks will do so.

Securitisation will benefit from a clear prudential approach. Such an approach would recognise securitisation can be undertaken for funding-only purposes or to achieve significant risk transfer, with a commensurate amount of regulatory capital relief. Prudential regulation should focus primarily on the capital and liquidity required to be held by an ADI against securitisation exposures. The regulator should be agnostic to the form of a securitisation, be it an amortising or revolving structure, provided the necessary capital and liquidity buffers are maintained by an ADI. It is advisable for the prudential standard not to be prescriptive about the transaction structures. Such a policy is likely to have disruptive implications in capital markets.

The setting for an appropriate regulatory framework should include a level playing field for various participants. It will be important that distortions and disincentives are not created through regulation that applies inconsistent regulatory capital requirements to the same risk exposures. The current global reconsideration of the risk weightings applied under the Basel III and Solvency II regimes is a welcome and necessary step to facilitate a broadening of the global investor base for ABS.

A key challenge for global regulators will be to find ways to adopt the principles of equivalency and mutual recognition of a number of regionally focused regulations. Recognising the equivalency of varying approaches will enable cross-border securitisation markets to function better. A November 2012 report by IOSCO states that, ‘cross border activity is an important component of global securitization markets, and policy makers and regulators should be conscious of not adding to the cost of cross border activity through requirements that are duplicative of, or inconsistent with, requirements in other jurisdictions’. Accordingly, IOSCO’s report includes the following recommendation: ‘Regulators should seek to minimize the potentially adverse effects to cross border securitization transactions resulting from differences in approaches to asset-level disclosure and privacy protections’.

Concluding thoughts

Securitisation is an established and successful part of Australia’s financial system. It provides an alternative source of funding for ADIs, introducing an element of competition in certain lending markets, and it provides fixed income securities with varying risk and yield attributes to investors.
The securitisation market can be a large, deep and liquid part of our financial system. To achieve this outcome a number of improvements will need to be achieved including:

- increasing the supply and diversity of ABS through use of efficient master trust structures
- developing a larger, more diversified and sustainable investor base
- pursuing increased liquidity within the market
- finalising a consistent and pragmatic set of regulatory policies that are equivalent or mutually recognised by global policy makers and regulators.

Notes
8. Ibid. p. 49.