SUBMISSION 30

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Dear Sir/Madam

INQUIRY INTO COMPETITION IN THE BANKING AND NON-BANKING SECTORS

SUBMISSION BY THE AUSTRALIAN SECURITISATION FORUM

This submission is made by the Australian Securitisation Forum (ASF).

The ASF was formed in 1989 to promote the development of securitisation in Australia. As the peak industry body representing the securitisation market, the ASF performs a pivotal role in the education of government, regulators, the public, investors and others who have an interest or potential interest both in Australia and overseas, regarding the benefits of securitisation in Australia and aspects of the securitisation industry.

The Australian securitisation market enjoyed rapid growth over the last 10 - 12 years, until the global credit crunch struck in mid-2007. The size of the market, based on the values of securities outstanding by Australian securitisation vehicles, has increased from A$10 billion in March 1995 to nearly A$200 billion by the end of 2007.

Consistent with overseas securitisation markets, a large part of the growth of the Australian securitisation market has been the mortgage-backed securities market, which in turn has been driven by the banking and non-banking sectors. The ASF therefore has an interest in the regulation of, and competition in, the bank and non-bank lending sectors.

This submission addresses each of the terms of reference as outlined by the Treasurer, the Honourable Wayne Swan MP, on 3 June 2008.

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Australian Securitisation Forum

Executive Summary

- A healthy securitisation market is good for competition: it allows non-bank mortgage providers who do not have access to a retail deposit base to participate in the mortgage market; has allowed regional banks and building societies to compete on a national basis by obtaining low cost funding to supplement their deposit bases; and provides an additional source of diversified mortgage funding for the major banks.
- Mortgage brokers have played an important role in facilitating competition in the Australian mortgage market. Brokers provide an essential distribution channel for non-bank mortgage lenders, and to a lesser extent, regional banks, building societies and credit unions. The major banks also utilise the broker distribution channel as a means of maintaining their market share.
- Prior to the emergence of the global credit crunch in mid-2007 the Australian securitisation market was a liquid and flourishing market. However since the crisis the global securitisation market has virtually collapsed. The impact is not only fewer deals but deal sizes are significantly smaller and they have been executed at prices significantly more costly to the originator.
- The current liquidity issues in the securitisation market are increasing the Australian bank and non-bank cost of funds, which is driving up mortgage rates, over and above official RBA rate rises. Furthermore, the smaller financial institutions and non-bank lenders, who rely on securitisation for the majority of their funding, are in serious risk of being forced out of the market if the current situation continues, jeopardising competition in the mortgage market.
- The current market situation has highlighted that reliance on wholesale funding has risks. However, a reversion to predominantly balance sheet financing funded from retail deposits would lead to a reconcentration of the lending sector.
- Without intervention, the securitisation market may not recover, which would have a negative impact on competition in the Australian banking and non-banking sectors. The ASF advocates measures to ensure that Australia continues to enjoy a healthy securitisation market. This requires some industry led initiatives but also some government support including:
    - RBA repurchase agreements - has provided short term relief but in its current form is practically inaccessible to non-banks and small financial institutions. Short term liquidity issues may be addressed via expansion of existing arrangements and/or the introduction of a special liquidity scheme.
    - AOFM - has longer term potential to aid competition. Under this proposal, liquidity can be provided to the market as needed, it is quick in implementation, increased return on government funds raised to provide a government benchmark, and balancing the supply and demand in the mortgage-backed securities market at a price that creates a level playing field.
    - Agency model - creates a new investor base for mortgage-backed securities and has limited exposure to mortgage risk for the government.
    - Covered bonds – provides an opportunity to expand the investor base for mortgage-backed securities.
- The ASF is proposing several initiatives to reinvigorate the securitisation market and is working in consultation with the equivalent industry body associations in Europe and the United States.

1(a) Recent developments in relation to products, providers and distribution channels

Recent history of the mortgage market vis a vis banks and non-banks

Prior to the 1990's the mortgage market was dominated by the major banks. However in the early 1990's, a combination of financial deregulation and lower inflation substantially reduced the gap between the bank bill rate and the deposit rate allowing a new class of lenders, non-bank mortgage providers, to enter the market offering home loans at a lower rate of interest.

The non-bank mortgage providers utilised broker networks to originate mortgages and accessed the wholesale capital markets for funding, via securitisation, rather than requiring retail deposits. The emergence of non-bank lenders resulted in increased competition in the mortgage lending market.

Securitisation, combined with the broker distribution model, has also allowed regional banks and building societies to compete on a national basis by obtaining low cost funding to supplement their deposit base, adding to competition in the market.

The growth in mortgage lenders has promoted healthy competition in this market. This has not come by sacrificing the quality of the mortgages being originated which is in stark contrast to the experience in the U.S. mortgage market. The overall quality of mortgage portfolios, both securitised and on-balance sheet, remains high as evidenced by the low arrears levels in the following graph, illustrating both on-balance sheet and securitised loans in arrears[1].

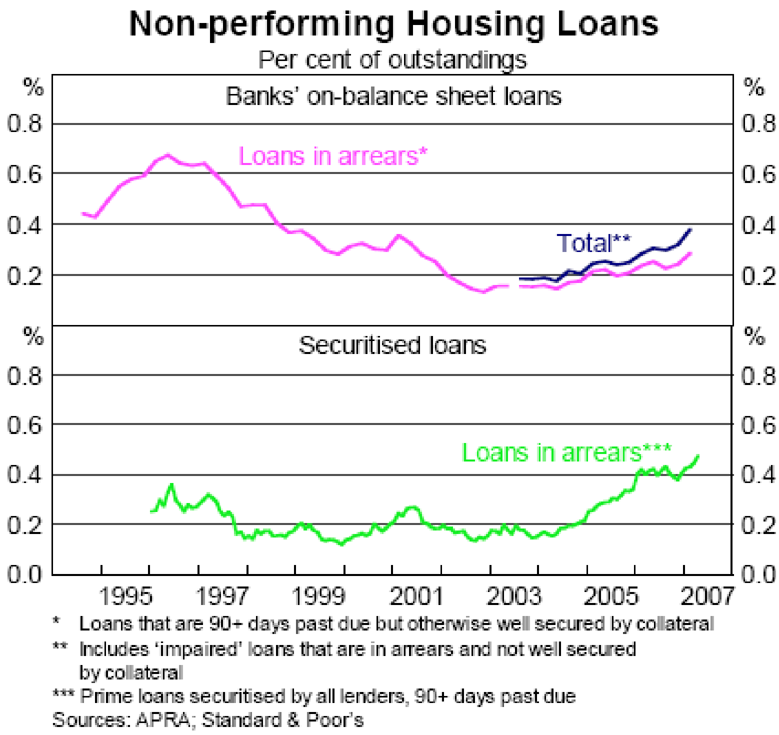

Figure 1 - Non-performing Housing Loans

The greater number of mortgage providers in the market has underpinned the increase in competition. However, there has been a change in the competitive environment since the dislocation of the credit markets in mid-2007. The effect is evident in recent changes in mortgage market shares, with data on housing loan approvals showing that the share of owner-occupier loan approvals by

[1] Joint RBA-APRA Submission into the Inquiry into Home Lending Practices and Processes, August 2007

wholesale lenders (mainly mortgage originators) fell to around 6½% in January 2008, compared with around 12% for the previous few years. Conversely, the share of new loans approved by the five largest banks has risen in the past few months.[2] This is represented in the graph below.

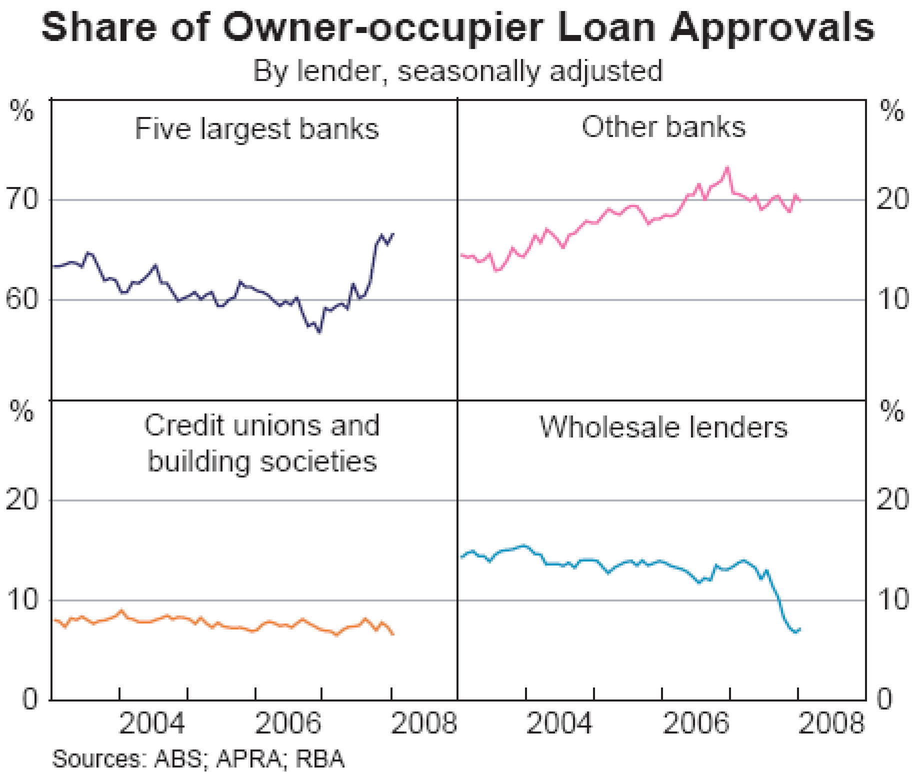

Figure 2 - Share of Owner-occupier Loan Approvals

The Australian credit market today comprises a number of participants including banks (major banks and regional banks), building societies, credit unions, non-bank lenders, mortgage brokers and some international/foreign banks that choose to provide housing and other retail credit in Australia (such as Citigroup and HSBC). Each of these participants provide, in addition to mortgages, a range of other retail and business credit products including credit cards, auto loans, personal loans, small business loans and commercial property loans.

Products, providers and distribution channels

The relationship between mortgage products, providers and distribution channels is interlinked. As discussed above, the growth in providers of finance has led to greater levels of competition in the market. As banks and non-banks compete in core products, new products have been developed. In fact, many mortgage product innovations were first introduced by non-mainstream lenders and are now widely available. Product innovations have taken the form of additional features to existing home loans, e.g. redraw facilities, and new product types, e.g. low-doc loans, home-equity loans, reverse mortgages, higher loan-to-valuation (LVR) loans, interest-only loans and shared-equity loans.

Mortgage brokers have played an important role in facilitating competition in the Australian mortgage market. A healthy broker channel is essential for non-banks, and to a lesser extent, regional banks, building societies and credit unions. The major banks also utilise the broker distribution channel as a means of maintaining their overall market share. It is estimated that brokers accounted for nearly 40%

[2] Financial Stability Review, RBA, March 2008

of the market in 2007, an increase from around 15% when the non-banks first entered the market.[3] This proportion of the market share demonstrates the value brokers provide to consumers in sourcing the most competitive housing loan and has ultimately resulted in a more efficient distribution of product to consumers.

A fundamental difference exists between business models operated by the different mortgage providers. The banks have access to multiple sources of funding (deposits, wholesale finance, securitisation), at variable prices/costs, whereas the non-bank lenders are dependent on the existence of the wholesale credit markets in terms of both supply and price.

The current market situation has highlighted that reliance on wholesale funding has risks. However, wholesale funding has been positive for the mortgage market as it represents an alternative funding source to retail deposits and has allowed for the growth of non-bank lenders which has been good for competition. A reversion to predominantly balance sheet financing funded from retail deposits would lead to a reconcentration of the lending sector, impacting competition.

The ASF advocates that mortgage lenders have access to sustainable long term, capital markets funding and that access to the supply of credit is not cushioned by the dislocation of markets.

Competition benefits the consumer

The increase in competition in the mortgage market over the past 15 years or so has benefitted the consumer in several ways, as identified by a joint RBA-APRA study[4]:

- Lower interest margins
  Interest margins (relative to the cash rate) on prime variable-rate housing loans have fallen from a peak of around 450 basis points in 1993 to bottom out at an average of 120 basis points in August 2007. See the spread over the cash rate in Figure 3 - Housing Loan Variable Interest Rates.

  Since then, interest margins have widened out to 165 basis points as a result of increased funding costs, due to the credit crisis, being passed onto the consumer. This is evident by comparing the target cash rate of 7.25% to the major bank's indicator rate of around 8.90%[5].

- Lower fees
  Establishment fees have fallen or are waived by lenders.

- Product innovations
  In the form of additional features to existing home loans and new product types (as discussed in the previous section).

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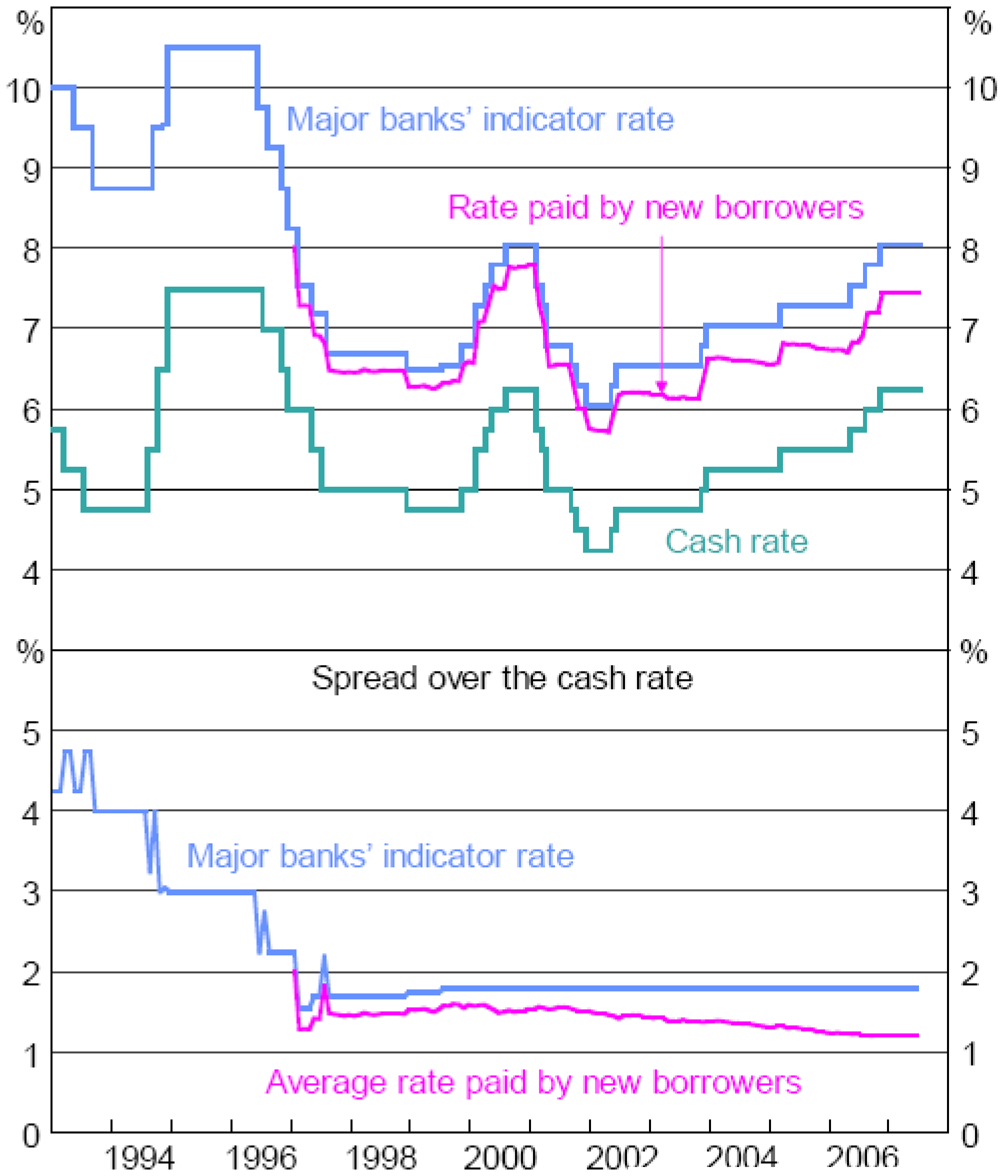
[3] Fujitzu Consulting Estimates

[4] Joint RBA-APRA Submission into the Inquiry into Home Lending Practices and Processes, August 2007

[5] This represents a discount of 0.70% on the premium rate of approximately 9.60% which is widely offered to borrowers



Sources: ABS, RBA

Figure 3 - Housing Loan Variable Interest Rates

Some additional benefits of competition to consumers are:

- Access to competitive finance from a wider range of providers.
- Increased availability of finance for all borrowers including first home buyers and other non-conforming borrowers who do not meet the bank's traditional lending criteria.
- Choice in terms of product and mortgage provider.
- Improved credit approval time.

Role of securitisation and benefits

Securitisation defined

The Australian residential mortgage-backed securities (RMBS) market is an alternative source of capital. Broadly, securitisation involves the conversion of loans, receivables and other forms of usually illiquid, non-traded assets into tradeable securities. These are generally referred to as mortgage or asset-backed securities. The relevant assets are pooled into a special purpose vehicle which issues securities backed by the asset's cash flows.

Securitisation issuance

Securitisation has been utilised as a funding technique by both banks and non-bank lenders, providing them with access to a broader credit market and the ability to efficiently recycle credit.

As can be seen in Figure 4 - RMBS issuance by originator type, the share of RMBS issuance in 2006 was fairly evenly split between major banks, non-bank lenders and regional banks. However, in 2007 and 2008 issuance has been severely impacted by the credit crunch resulting overall reduced issuance levels. It is evident over this period the proportion of issuance has changed with the major bank's share of total issuance increasing from 24% in 2006 to nearly 60% in 2008. Similarly, the non-bank lender's share has decreased from 26% in 2006 to only 4% in 2008. It is important to note that the majority of issuance by the major and regional banks in 2008 is retained issuance, i.e. held on balance sheet for liquidity purposes. This is compared with prior years where there has been very little retained issuance. Issuance to third parties this year has totalled only A$1.9 billion highlighting the impact that the credit crisis has had on the securitisation market.

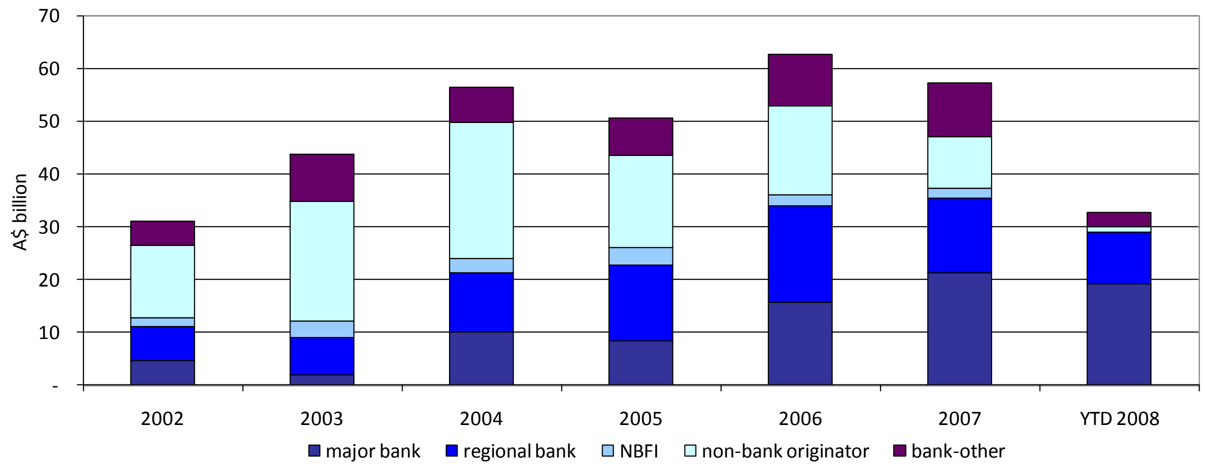


Figure 4 - RMBS issuance by originator type Source: Standard and Poor's

Benefits

Securitisation has helped to increase competition in the Australian lending market by providing a source of funding for non-bank mortgage providers, who do not have access to a retail deposit base, to participate in the mortgage market. It also provides an additional source of diversified mortgage funding for the major banks, and has allowed smaller ADIs such as regional banks, building societies and credit unions to compete on a national basis. For example, through the use of securitisation, St

George rose from being a building society to competing with the big four banks in mortgage lending. There are direct benefits for the lenders who use securitisation as a funding technique, including both banks and non-banks:

- It allows lenders of all sizes and credit to access the capital markets and remove the constraints of market segmentation.
- Enables smaller financial institutions to compete more effectively as they can access the securitisation markets at a similar price level to wholesale funding of the major banks since the pricing reflects the quality of the underlying assets in the pools.
- Allows the process of disintermediation to work and has enabled lenders to increase their lending capacity (and in turn benefitting the consumer).
- Non investment grade lenders are able to access the capital markets with investment grade pricing, which in turn has a long run benefit of strengthening the institution's access to risk capital.

There are also benefits for the broader economy:

- It allows for the reallocation of risk through tranching to the segment of the market most willing and able to manage that risk.
- Provides a source of credit risk diversity for investors. For example, an insurance company normally invests in bonds, bills etc. Securitisation enables it to access other types of assets such as residential mortgages, commercial mortgages and auto loans.

The ASF advocates measures to ensure that Australia continues to enjoy a healthy securitisation market. This requires some industry led initiatives but also some government support. These are discussed in section 2 of the submission.

1(b) The current state of the retail banking and non-banking industries

The current state of the securitisation market

RMBS

Prior to the emergence of the global credit crunch in mid-2007 the Australian securitisation market was a liquid and flourishing market with increasing issuance levels since its beginnings in the mid-1990's. The market enjoyed rapid growth over the last 10 - 12 years. The size of the market, based on the value of RMBS outstanding, increased from A$10 billion in March 1995 to nearly A$200 billion by the end of 2007.

Annual issuance of residential mortgage-backed securities rose to over A$60 billion in 2006. However since the crisis, the securitisation market has virtually collapsed, with only A$6 billion of mortgage-backed securities issued in the second half of 2007, as compared with A$45 billion in the first half of 2007. This trend has continued into 2008 with only four RMBS deals completed to date, totalling A$1.9 billion. The impact is not only fewer deals but deal sizes are significantly smaller and they have been executed at prices significantly more costly to the originator (i.e. mortgage provider).

The most recent prime AAA-rated RMBS issues have taken place at spreads of 110 to 150 basis points over the bank bill swap rate, compared to spreads of around 15 basis points in the first half of 2007. As noted in the RBA's recent Financial Stability Review[6], with the bank bill spread itself having increased

[6] Financial Stability Review, March 2008, RBA

(refer to Figure 5 - 1-month Bank Bills vs. Cash Rate), the interest rate on a new AAA-rated RMBS would be likely to be over 150 basis points above the cash rate (assuming a spread at the tighter end of the recent range of 110 basis points), compared with an average of 25 basis points over recent years.

The graph below indicates the increase in the spread between 1-month Bank Bills and the cash rate. The spread has steadily increased since August 2007 and is currently around 35 basis points. The implications for mortgage lenders is increased funding costs as wholesale funding is priced off the Bank Bills benchmark.

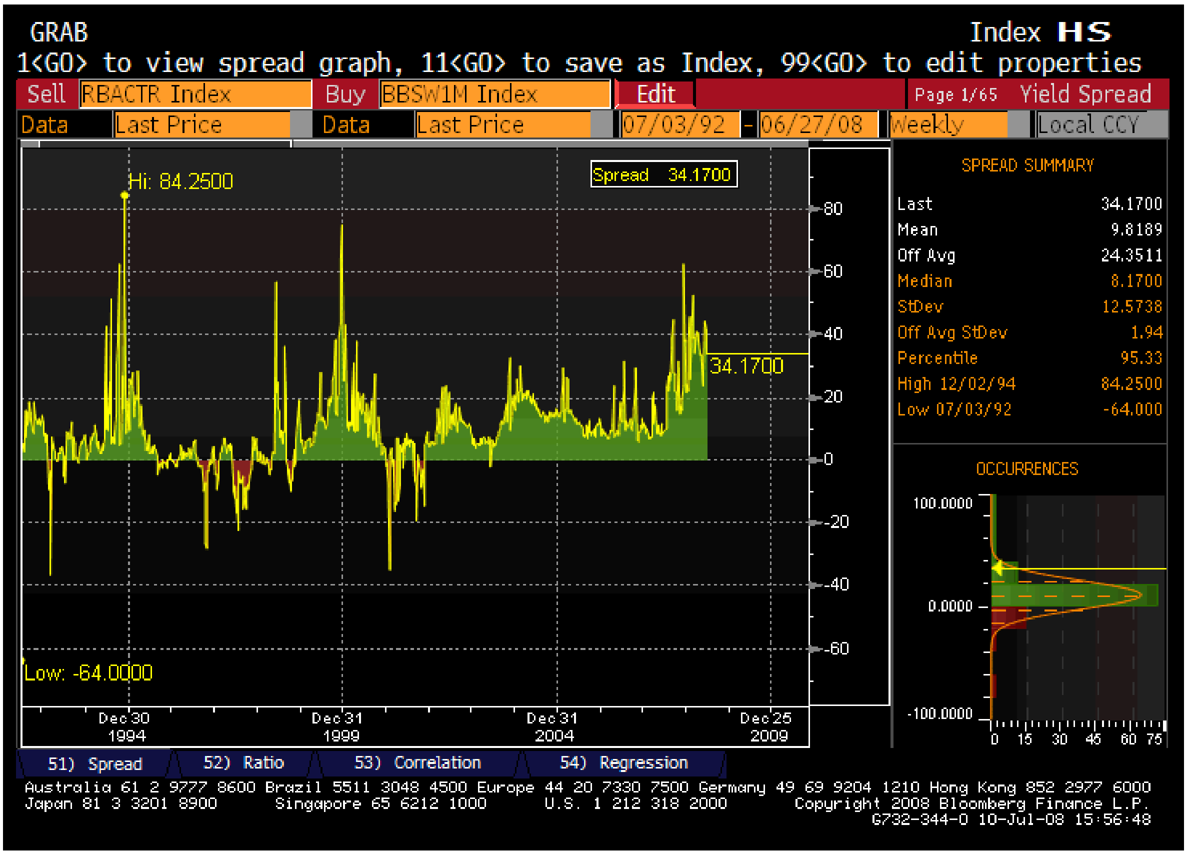


Figure 5 - 1-month Bank Bills vs. Cash Rate

The following graph shows spread levels on prime AAA-rated RMBS have, up until mid-2007, contracted over time from highs of around 40 basis points in 2000, to lows of mid-teens. The second half of 2007 saw spreads significantly increase as a direct result of the credit crisis. This trend has continued into 2008, although not shown on this graph, prime AAA-rated RMBS issuance levels on the few securitisation deals completed have been around 100 – 150 basis points.

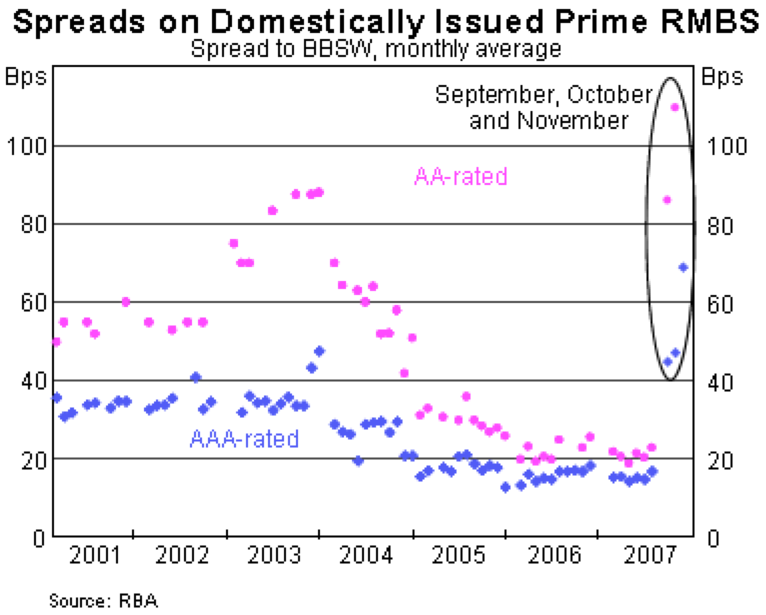


Figure 6 - Spreads on Domestically Issued Prime RMBS

<u>ABCP</u>

The liquidity crisis is having a similar impact on the asset-backed commercial paper (ABCP) market. A large part of the ABCP market is represented by warehouses used by mortgage originators for short term funding prior to completing an RMBS deal in the capital markets.

Total outstanding ABCP issued by Australian entities has fallen by around A$15 billion, or 20%, during the period between July 2007 and January 2008.[7] Spread levels on ABCP have also widened. Prior to July 2007 it was possible to issue ABCP in Australia at a spread of less than 5 basis points over the Bank Bill rate however current spreads are now around 50 - 60 basis points over 30-day Bank Bills.

Arriving at the current state

<u>RMBS</u>

Offshore investor appetite for Australian RMBS has been a significant factor contributing to the growth of the securitisation market in Australia and the contraction in spreads over time. As offshore demand increased, attracting new sources of funds to this asset class, spreads were driven down by the forces of supply and demand. In addition, the emergence of offshore investors allowed increasing volumes of RMBS to be issued since the domestic market could not absorb those volumes alone.

The main categories of investors that have driven the growth in the securitisation market are:

- Bank trading books
- Bank arbitrage vehicles
- Structured Investment Vehicles (SIVs)
- Real money accounts (investment managers, insurance, pension funds)

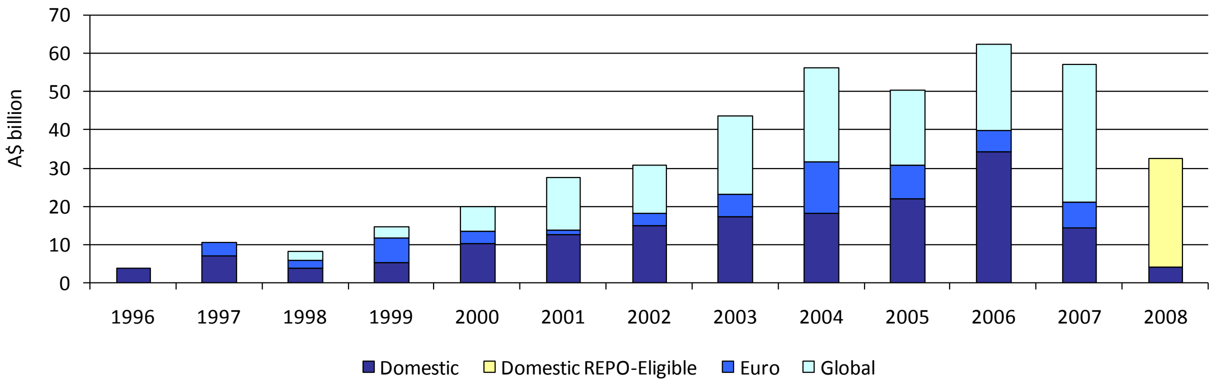
Offshore investor appetite for Australian RMBS has been driven by the good quality and strong historical performance of these securities. Australian RMBS offers offshore investors with diversity of asset type and relative value compared with RMBS issued from other jurisdictions.

[7] Financial Stability Review, March 2008, RBA

Some other reasons why Australian RMBS appeals to offshore investors:

- Stable economy
- Strong regulatory environment
- Full recourse to borrower
- Bankruptcy laws (more stringent than in other jurisdictions such as the U.S.)
- Mortgage insured loans
- Property cycle history

As can be seen in the following two graphs the demand for Australian RMBS by offshore investors has grown over time. Figure 7 - RMBS Issuance by Market of Issuance shows that, prior to this year, the majority of RMBS has been issued in offshore markets in the past five years, with approximately 75% being sold in offshore markets in 2007.



Source: Standard and Poor's

Figure 7 - RMBS Issuance by Market of Issuance

The increasing demand for Australian RMBS by offshore investors is further illustrated in the following graph which shows the total amount of RMBS outstanding.

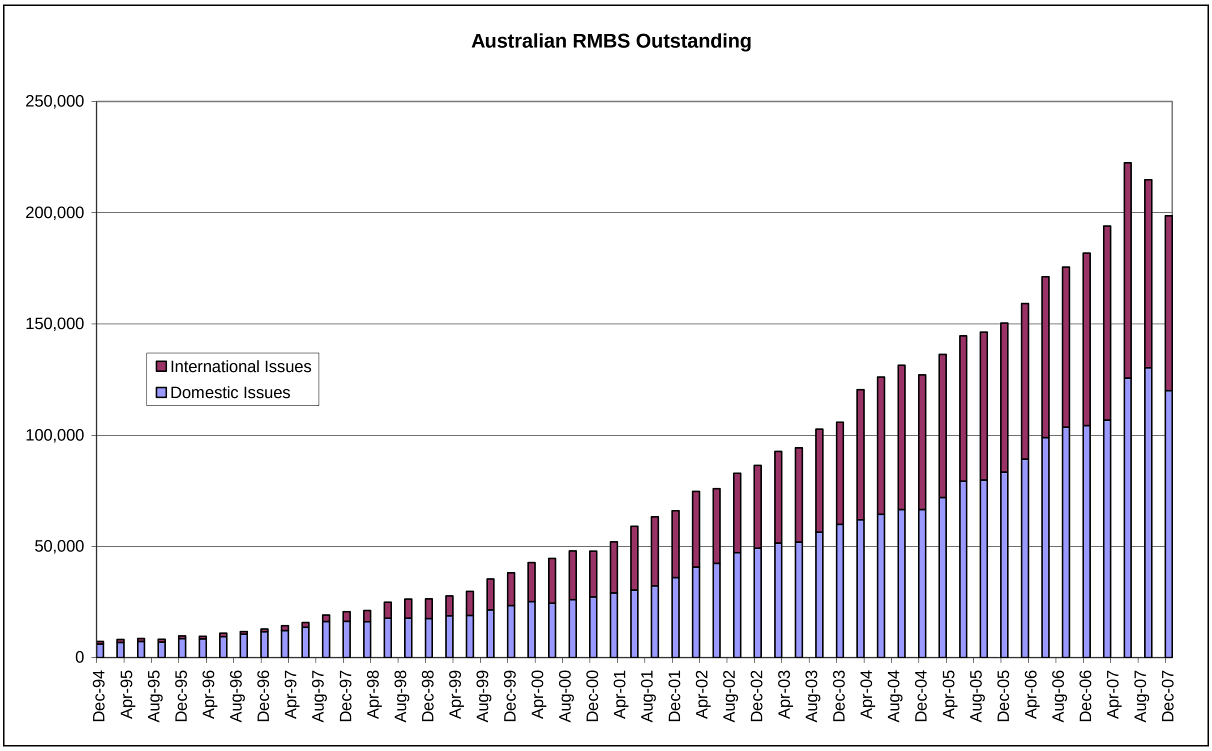


Figure 8 - Australian RMBS Outstanding Source: RBA

As the global liquidity crisis emerged, stemming from issues in the U.S. subprime market, offshore investors have withdrawn from the global market severely impacting the issuance levels and spreads of Australian RMBS.

Figure 9 - Investors in European covered bonds and ABS[8], indicates that the majority of investors in the European asset-backed securities (ABS) market have, up until now, been SIVs. This is relevant anecdotal evidence as Australian RMBS sold into Europe have found similar investor distributions. There is expected to be a shift in RMBS investor distributions going forward which is partly a structural change and partly a cyclical change. From structural perspective, SIVs are not expected to return to the market as it has become evident that the funding model adopted by them was flawed in periods of market illiquidity. At the same time these buyers have also become sellers, flooding the market with secondary supply. This phenomenon will not abate until this supply is diminished or absorbed by the current market participants, however this is expected to be some time away, as we have shown that RMBS issuance has been substantially larger than the domestic market could absorb, unless the size of the investment market increases via a reallocation of domestic investment funds from offshore to onshore. In addition bank arbitrage vehicles are not expected to return to the market due to a tightening of accounting standards and new Bank for International Settlements rules. From a cyclical perspective, more real money investors will most likely re-enter the market when macro-economic conditions look more certain.

[8] The Covered Bond Market, BIS Quarterly, September 2007

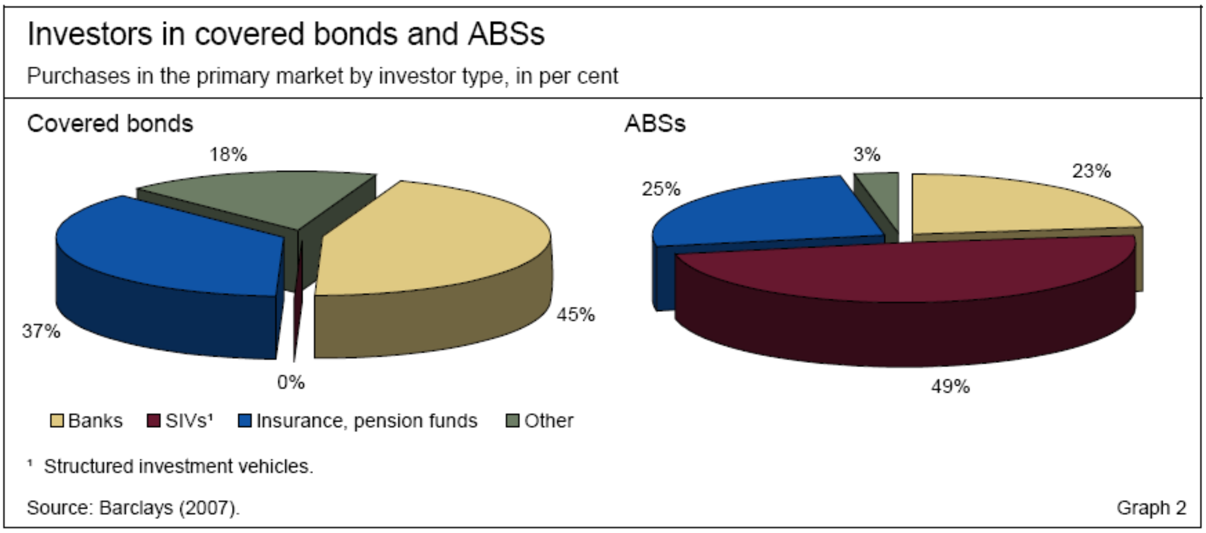


Figure 9 - Investors in European covered bonds and ABS

The result for Australian RMBS is that a significant capacity of investor funds will still have disappeared. The ASF advocates rebuilding the investor base through new sources of investor appetite and to increase existing investor confidence in this asset class through various initiatives discussed later in the paper. Considering this, it is interesting to identify the different investor bases between covered bonds and ABS in Europe in the above graph. Banks are the main investors in covered bonds, accounting for just under half of all issuance in the primary market, whereas SIVs (now disappeared from the market) accounted for the majority of the ABS issuance. It is important to note that banks investing in covered bonds are doing so for liquidity purposes whereas banks investing in ABS were motivated by credit arbitrage. The later type of bank investor has now disappeared. Therefore, accessing a different investor base is one of the motivations for banks to issue covered bonds to finance mortgages. This is discussed later in the paper.

ABCP

Similarly, ABCP had traditionally been funded via a combination of onshore and offshore markets. However since the liquidity crisis began new offshore issuance of ABCP has virtually disappeared. As of January 2008, outstanding ABCP issued by Australian entities to offshore markets was 70% below its peak in May 2007.[9] Although the domestic market has been able to fill some of this reduction, as noted in Figure 10 - Australian ABCP Outstanding below, there has been an overall reduction in outstanding ABCP of around A$15 billion for the seven months to January 2008.

[9] Financial Stability Review, March 2008, RBA

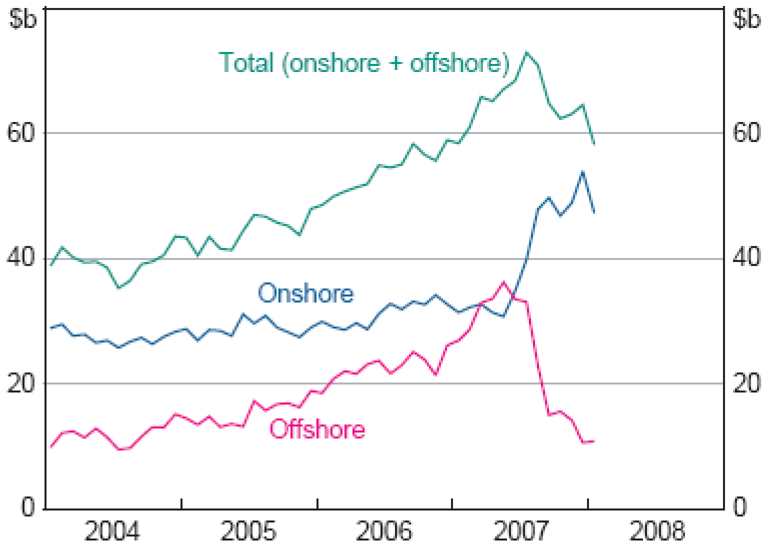


Figure 10 - Australian ABCP Outstanding Source: Standard and Poor's

Impact on the bank and non-bank lending sectors

The current liquidity issues are increasing the Australian bank and non-bank cost of funds, which is driving up mortgage rates over and above official RBA rate rises. The major banks have increased mortgage rates by as much as 55 basis points above moves in the target cash rate by the RBA.

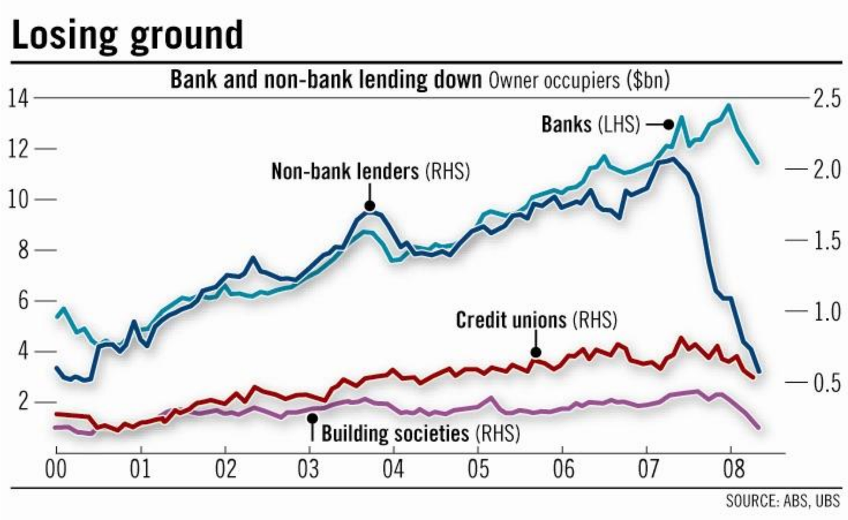
Furthermore, the drying up of the securitisation market is having a significant impact on the smaller financial institutions and non-bank lenders who are under continued funding pressure as they rely on securitisation for a significant portion of their funding needs. It has been reported that many have either had to withdraw from mortgage lending or significantly reduced their lending activities. Several lenders have cut back lending volumes, or exited the business, to preserve funds such as Macquarie Bank, GMAC, Mobius, Bluestone and RAMS. This funding pressure will only increase as existing securitisation deals are due to be refinanced.

The impact of this recent and significant reduction in housing lending from smaller financial institutions and non-bank lenders can be seen in new housing lending statistics. As recently noted by the RBA, new housing lending has been financed largely on the balance sheets of the five largest banks which is partly as a result of an increase in their share of the housing finance market. [10] Housing Finance data released by the ABS has revealed that the bank's share of new owner occupied home loans rose above 90% in May 2008 for the first time since July 1994. This is in stark contrast to their reported market share of 75% of new home loan volumes prior to the liquidity crisis.

The ABS data also indicated that the number of loans to owner occupiers fell to 7.9% in the month of May, the biggest monthly decline in eight years. The total value of housing finance approvals fell 6.9% to A$13.78 billion, the lowest level in three years. Whilst housing lending has declined across all mortgage providers, it is most significant for the non-bank lenders, as illustrated in the following graph[11].

[10] Statement on Monetary Policy, May 2008, RBA

[11] Big banks profit at others' expense, Australian Financial Review, July 12-13, 2008



The reduction in lending by the non-bank lenders, and to a lesser extent, the smaller financial institutions, and has also resulted in significant pressure being placed on mortgage brokers. The major banks have announced cuts in commissions, questioning the viability of many mortgage brokers, who have significantly contributed to competition in the Australian mortgage market.

The U.K. experience

The United Kingdom is also facing serious challenges in their mortgage lending market. The British Bankers Association (BBA) reported that in May 2008 the number of new mortgage approvals for house purchases declined 20% from the previous month. This represented a decline of 56% since May 2007, hitting a record low. The BBA attributed the significant decline to tighter lending criteria and economic pressures on households. As in Australia, U.K. mortgage lenders are experiencing liquidity issues and as a result are tightening lending criteria, in both the prime and non-conforming sectors, in an effort to preserve funds.

The BBA expects that the next few months will remain very weak for house purchase activity due to mortgage lender funding constraints and are waiting to see the impact of the Bank of England's Special Liquidity Scheme (SLS). This was introduced in March 2008 as a government initiative to promote short term liquidity in the wholesale capital markets. A study by JPMorgan[12] indicated that the SLS aims to increase confidence in the wholesale funding markets by alleviating issues with the funding of certain assets that were deemed illiquid. The ASF recommends similar proactive initiatives by the government via expansion of the RBA repurchase arrangements. This is further discussed in section 2.

The U.S. experience

The problems experienced in the U.S. housing market, particularly the subprime market, are specific to factors that exist in that market and bear no resemblance to the Australian mortgage market. Many differences exist between the subprime loan market in the U.S. and the equivalent non-conforming loan market in Australia[13]:

- Subprime loans account for approximately 13% of the mortgage market in the U.S. whereas in Australia the non-conforming market accounted for about 1% of outstanding loans in 2007.

[12] Open Market Operations Mechanisms with the ECB, BOE, FED and RBA, JPMorgan, July 2008

[13] A Comparison of the US and Australian Housing Markets, Guy Debelle Assistant Governor (Financial Markets), May 2008

- Subprime loans were offered by a wide range of financial institutions in the U.S. compared with a few specialist non-bank mortgage lenders who provide the majority of non-conforming loans in Australia.
- The U.S. subprime product features that contributed to the current problems are not present in Australia, e.g. large teaser rates, a marked decline in lending standards, and an origination and distribution model where the lender has a reduced incentive to care about the quality of the loan written.
- Arrears rates are significantly higher in the U.S. at around 15% versus 4.5% for Australian non-conforming loans as at December 2007.

Outlook on the securitisation market

Without intervention the securitisation market may not recover, which would have a negative impact on competition in the Australian banking and non-banking sectors. Although there have been some recent RMBS issues, the volume and price at which they have been issued are not sustainable. As noted by the RBA in the recent Financial Stability Review[14] lenders are clearly reluctant to issue RMBS at current spreads given that doing so would mean that their mortgage business would be unprofitable at existing mortgage rates.

However, many smaller financial institutions and non-banks are required to refinance existing securitisations or warehouse lines within the next 6 to 9 months. These institutions are facing the prospect of undertaking a securitisation issue that, at current market prices, would be uneconomical. The alternative is to raise mortgage interest rates however that would put them at a competitive disadvantage and effectively price them out of the market. The current situation poses a significant risk to smaller financial institutions and non-bank lenders that have supported the Australian marketplace for many years.

A study by Macquarie Private Wealth[15] has estimated the cost of different funding alternatives and, combined with the typical funding mix of different mortgage lenders, how the funding mix can significantly alter the overall average cost of funds for an organisation.

Funding mix	Estimated cost[16]	Non-bank lender	Building society	Regional bank	Major bank
Retail deposits	20-25 basis points		50%	40%	50%
Wholesale markets: short-term long-term	 38 basis points 96 basis points			45%	48%
Securitisation	132 basis points	100%	50%	15%	2%

It is evident that the business model of smaller financial institutions and non-banks are more vulnerable to tighter wholesale credit markets. For non-bank lenders, who do not have a retail deposit base, they are completely exposed to the availability and pricing of credit in the securitisation market.

14 Financial Stability Review, March 2008, RBA

15 As reported in the Australian Financial Review, “Deposit-fat Westpac’s Dragon song is inevitable”, 7th July, 2008

16 As reported in the Australian Financial Review, “Deposit-fat Westpac’s Dragon song is inevitable”, 7th July, 2008 sourcing a study conducted by Macquarie Private Wealth

For smaller financial institutions such as building societies, they are generally reliant on securitisation for about half of their funding needs whilst being able to access retail deposits for the remainder. However, given their size and low (or no) credit rating, they generally do not have access to the cheaper wholesale capital markets for funding as compared with the regional and major banks.

The smaller financial institutions and non-bank lenders, who rely on securitisation for the majority of their funding, are in serious risk of being forced out of the market if the current situation continues. As a result, competition in the mortgage market is at risk of being drastically reduced. The benefits that competition has brought to the market over many years would diminish, to the detriment of the consumer and the overall stability of the Australian credit markets.

The ASF strongly believes that a healthy securitisation market is good for competition and advocates measures to ensure that Australia continues to enjoy a healthy securitisation market. As Sheila Bair, Federal Deposit Insurance Corporation (FDIC) Chair, recently commented, “there is greater risk of not doing something than there is of doing something”. Addressing the current situation requires some industry lead initiatives but also some government support, as discussed in section 2.

1(c) The likely drivers of future change and innovation in the retail banking and non-banking sectors including the continuing impact of technological developments

The main drivers of future change are:

1. Competition within the Australian lending market is in jeopardy if market illiquidity continues. This would result in a smaller number of big players in the Australian credit market. This would be significant for the consumer, impacting the availability, cost and choice of retail credit products and providers.
2. The current market dislocation indicates that change is necessary for the survival of smaller financial institutions and non-bank lenders who rely on the wholesale markets as a source of funding. They require certainty of liquidity, i.e. a source of liquidity that is unchallenged in times of market dislocation such as this one. Government support to ensure sustainable, long term, capital markets funding is required. The ASF recommends that the government adopt mechanisms similar to those implemented in other jurisdictions. This is discussed further in the next section.
3. The role of brokers as an independent distribution channel plays a vital role in the mortgage lending market, facilitating competition and product innovation. Their viability is in doubt due to reduced origination volumes by smaller financial institutions and non-bank lenders, in addition to fees being cut by the major banks. Refer to Annex 1: ASF submission on Financial Services and Credit Reform.

1(d) Comparison with relevant international jurisdictions

Repurchase Arrangements

Background

Broadly, there are three types of liquidity back up schemes used by central banks, as follows.

1. Open Market Operations (OMO): this is an arm of central bank monetary policy that aims to ensure the actual cash rate remains close to the target rate. Liquidity is generally subject to availability and is available for up to 3 months, and more recently, up to 12 months under the RBA

OMO. OMO are operated by the RBA, European Central Bank (ECB), Federal Reserve (Fed) and Bank of England (BOE).

2. Standby Liquidity: this is offered to banks generally on an open basis, as follows:
   - RBA-provides this intra-day or overnight for market disruptions.
   - BOE-has a similar overnight facility.
   - ECB-has a similar overnight facility offered at 1% over the cash rate.
   - Fed-has the discount window which was originally overnight and was extended to 90 days as a result of the credit crisis. The spread was 1% over the Fed cash rate but subsequently reduced to 50bps and then to 25bps over the Fed cash rate.
3. Special Liquidity Facility: offers switching of illiquid mortgage-backed securities for government securities effectively allowing borrowing of government rating for liquidity without affecting the money supply. The borrowing institution then funds itself by using Treasury repo. Refer to section 2 for discussion on the BOE's Special Liquidity Scheme.

Repurchase Arrangements

A comparison of different central bank repurchase arrangements has shown that the RBA is the most conservative. In order to align with arrangements offered by other jurisdictions, and to improve the short term liquidity of ABS securities, the ASF recommends that the RBA expand existing arrangements as discussed further in section 2.

Refer to Annex 2 for a summary comparing the repurchase arrangements of different jurisdictions.

Agency model

Asia

The BIS examined the roles of government-supported housing finance agencies in Asia. They considered five Asian economies: Hong Kong SAR, India, Japan, Korea and Malaysia. The conclusion was that, in many of the cases considered, housing agencies appear to have played a constructive role in the development of residential mortgage bond markets. They have helped eliminate barriers to securitisation, initiated more systematic issuance of mortgage-backed securities, improved access to housing finance for households and provided liquidity to banks[17]. Refer to the complete report: The role of Government supported Finance Agencies in Asia in Annex 3.

Europe

The European Mortgage Finance Agency (EMFA) project commenced in early 2001 to develop a blueprint for a European Government Supported Enterprise (GSE) to be put to the European Union to seek governmental support. One of the objectives of the GSE would be to provide a stable flow of funds to mortgage lenders across the EU through the establishment of a standardised secondary mortgage market[18]. EMFA is now in discussions with a number of governments who have provided positive feedback on the proposal and are currently evaluating it in greater depth.

For further details refer to Annex 4: Creating a government-sponsored enterprise for Europe - the European Mortgage Finance Agency.

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[17] BIS Quarterly Review, December 2006, The role of Government supported Finance Agencies in Asia

[18] Creating a government-sponsored enterprise for Europe - the European Mortgage Finance Agency

United Kingdom

The U.K. has commissioned Sir James Crosby, Deputy Chairman of the Financial Services Authority (FSA) to review the mortgage financing market, including exploring an agency model.

United States

The ASF has promoted discussion on an agency model that is similar to the Canadian MBS program (discussed further in the next section). This model is distinctly different from the government sponsored enterprises (GSE) in the U.S., Fannie Mae and Freddie Mac. There are five main points of difference:

1. The Canadian MBS program provides a full government guarantee and so there is no issue concerning government support. The securities issued by Fannie Mae and Freddie Mac do not explicitly benefit from a statutory government guarantee or protection, however many people believe that these GSEs are too big to fail and so believe that they are implicitly supported.
2. Under the Canadian MBS program mortgage loss risk is covered by mortgage insurance from the private sector whereas Fannie Mae and Freddie Mac take any losses directly.
3. The Canadian MBS program requires mortgage originators to have a minimum net worth of CAD$3 million (A$3.2 million) plus 2% of the aggregate principle amount of securities issued, as well as amounts for any proposed issues, to cover any recourse. There is no such requirement by the U.S. GSEs.
4. There is a limit to the amount of Canadian Mortgage Bonds that can be issued annually whereas securities issued by Fannie Mae and Freddie Mac are unlimited.
5. Canadian MBS are issued by a government agency whereas Fannie Mae and Freddie Mac are private companies.

Covered Bonds

Europe

Covered bonds are a widely used funding mechanism in the U.K. and European markets. In some of those jurisdictions, there are statutory schemes that regulate the issue of covered bonds; in others, the transaction is structured so as to constitute a covered bond.

Volumes

Issuance of covered bonds has grown over the past several years, to €343.8 billion in 2007[19], as can be seen from the graphs[20] below.

[19] European Covered Bond Council
[20] The Covered Bond Market, BIS Quarterly, September 2007

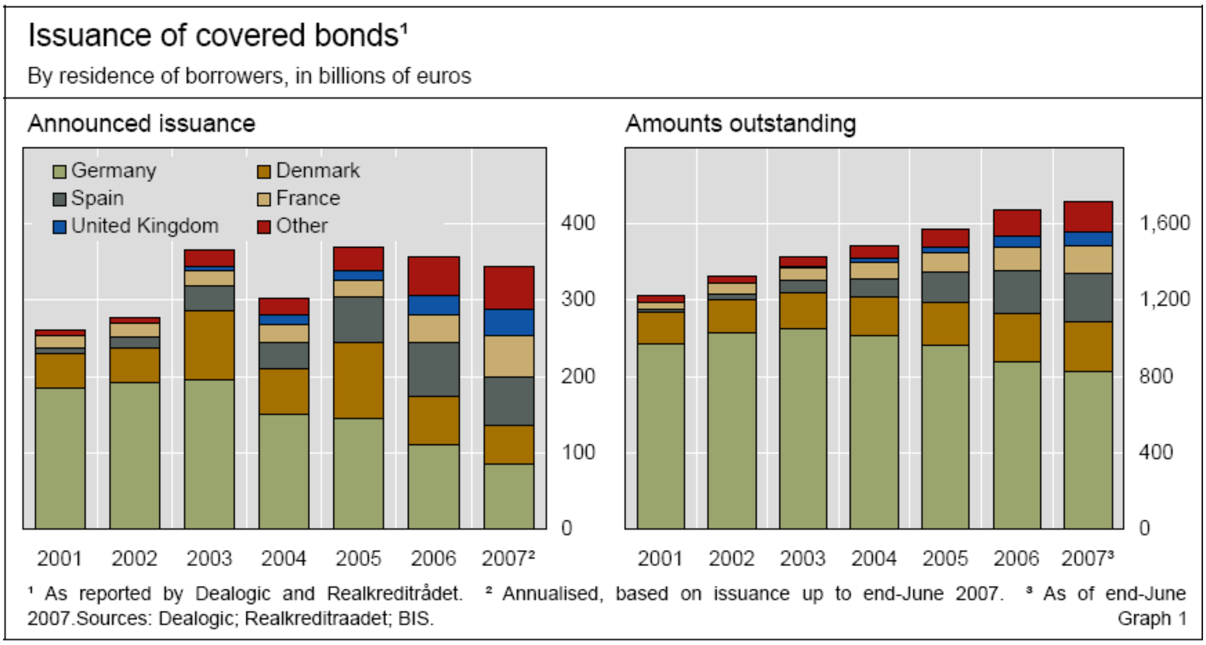

Figure 11 - Issuance of covered bonds

More importantly, healthy issuance levels of covered bonds have continued into 2008, despite the dislocation in the global credit markets, with issuance up 158% in Q2 against Q1[21]. In contrast, RMBS activity has been negligible this year. Some examples of covered bond deals recently completed are:

- On 10th July, U.K.-based Standard Life Bank issued its first covered bond, a £1.5 billion (A$3 billion) deal from a £5 billion (A$10 billion) program.
- On 10th July, Barcap issued inaugural tranches under its covered bond program worth £2billion, backed by £3.58billion collateral, of a new £15billion covered bond programme.
- On 7th July, Dutch SNS Bank issued two new series of notes from its €15 billion (A$23 billion) covered bond program: a €50 million (A$78 million) series 3 and a €535 million (A$837 million) series 4.
- On 24th April Portuguese Banco BPI issued €1.5 billion in covered bonds backed by an €1.7 billion (A$2.6 billion) cover pool of residential mortgages.

The U.K. government has recognised the increasing importance of RMBS covered bonds as a means by which U.K. lenders can finance mortgages. It aims to ensure that there is a continuous flow of secondary market funding, which is important for housing finance, and for the development of the long term fixed-rate mortgage market[22]. To this end, in March 2006 the government introduced a U.K. legislative framework that provides significant benefits for investors and issuers by reducing the amount of regulatory capital investors are required to hold and allowing U.K. issuers access to a larger European investor base.

The U.K. government is announcing a Working Group that will take forward market initiatives to improve liquidity in the mortgage-backed securities market. The Working Group will include the mortgage industry and the investment industry, and also the Treasury, the Bank of England and the FSA.

Refer to Annex 5: Housing Finance Review: analysis and proposals, March 2008, HM Treasury

[21] FT Alphaville, 4th July 2008

[22] Housing Finance Review: analysis and proposals, HM Treasury, March 2008

U.S.

This is a funding technique that is being investigated for use in the U.S. Recent comments from the U.S. Treasury Department suggest that covered bonds may provide a solution to resuscitate weak home buying activity. The Treasury Secretary Henry Paulson said "As Treasury seeks to encourage new sources of mortgage funding in the United States, improve underwriting standards and strengthen financial institutions' balance sheets, covered bonds have the potential to serve these purposes and reduce the costs for first-time home buyers, and for existing homeowners to refinance. We are also looking more broadly for ways to increase the availability and lower the cost of mortgage financing to accelerate the return of normal home buying activity." [23]

Refer to Annex 6: The Covered Bond Market, BIS Quarterly, September 2007.

Refer to Annex 7: Bond Basics: Covered Bonds, PIMCO, December 2006.

2. The Committee will also identify any barriers that may impact on competition in the retail banking and non-banking sectors, and policies to enhance further competition and product choice for consumers

The key barriers that may impact competition:

- Stability of access to market liquidity by mortgage lenders.
- Access to RBA liquidity by non-bank lenders.
- An unhealthy or inactive broker market or one that is over regulated.

Whether or not the illiquidity in the RMBS market is temporary or permanent is besides the point: there is a clear need for government infrastructure that provides liquidity support to mortgage lenders who access the securitisation markets for funding, during times of dislocation in those markets. The regulatory infrastructure needs to accommodate financial innovations such as mortgage-backed securities as an important source of funding for Australian home loans.

The International Monetary Fund conducted a study[24] of major financial crises and concluded that the following key lessons can be learnt:

- Early intervention by central banks is more effective in limiting their spread than later moves.
- It is difficult to tell at the time whether a financial crisis will have broader economic consequences.
- Regulators often cannot keep up with the pace of financial innovation that may trigger a crisis.

The ASF believes that a combination of government policy initiatives and other industry body initiatives are necessary to provide the required short and long term support to the wholesale bond market, hence enhancing competition and product choice for consumers.

We identify four main areas of government policy initiatives and discuss each in turn below:

1. RBA repurchase agreements and/or a special liquidity scheme to address short term liquidity.
2. AOFM to support the short and long term liquidity of the securitisation market.

[23] Wall Street Journal: "Paulson Touts Covered Bonds As Way to Boost Homebuying", 8th July 2008
[24] BBC News: "Financial crises: Lessons from history", 3rd September 2007

3. Agency model: the ASF has promoted discussion on the introduction of an agency model as a step further than the proposed AOFM support to address the stability and availability of long term liquidity.
4. Covered Bonds: provides an opportunity to expand the investor base for mortgage-backed securities.

RBA Repurchase Agreements

The aim of the RBA's open market operations is to ensure that the cash rate remains close to the target cash rate. These operations are conducted on a daily basis and are implemented using repurchase agreements (repos) in eligible domestic securities.

In response to the liquidity crisis, in September 2007, the RBA extended the range of collateral that is eligible for repo to include RMBS and ABCP. The RBA will accept under repo any A$ domestic-issued RMBS with a public rating of AAA or equivalent and A$ domestic-issued ABCP with a public rating of P-1 or equivalent, by any one of the major credit ratings agencies. However, the RBA will only provide value for prime full-doc residential insurable mortgages and similarly qualified low-doc mortgages comprising up to 10 per cent of the value of the security. A further 10% hair cut is added if the RMBS are deemed illiquid.

Whilst the expansion of the repo eligible securities is a positive step in addressing short term liquidity, the ASF recommends that the RBA expand the existing arrangements to address the continued liquidity crisis and to align with other central bank liquidity operations. The recommended proposals are:

- Extension of normal RBA open market operations to issuers own RMBS assets.
- Reduction in haircut amount, which is high compared to other jurisdictions.
- Expansion of eligible collateral.
- Counter party credit risk primarily dealt with by haircut.
- Improve ease of access, i.e. the ability to access deposits is currently dependent on the liquidity needs of the RBA on the day rather than acting as a reliable liquidity backup.

Special Liquidity Scheme

Short term liquidity issues may also be addressed via a special liquidity scheme similar to that introduced by the BOE. This scheme allows 1-3 years, on AAA-rated RMBS with a 12% haircut plus a further 5% haircut for own assets. The fee charged is based on the difference between LIBOR and the Treasury repo rate, thus effectively at LIBOR flat cost. This facility was limited to £50 billion and was used very quickly. The credit risk of the assets pledged remains with the borrowing institution. This is probably the most effective scheme for providing liquidity in disrupted markets.

Australian Office of Financial Management (AOFM)

The ASF proposes the AOFM support the short and long term liquidity of the securitisation market by:

1. Australian Office of Financial Management (AOFM) to purchase ABCP
   The AOFM operates an investment facility in excess of A$2 billion on behalf of the Communications Fund and invests in a variety of short-term Australian dollar denominated debt instruments, including commercial paper. The ASF recommends encouragement of investment in ABCP to assist short term liquidity in the mortgage sector as many smaller

financial institutions and non-banks rely on ABCP to warehouse mortgages prior to securitisation.

2. AOFM to purchase RMBS to support liquidity and competition in disrupted markets
The Government recently announced its intention to increase the issuance of Treasury Bonds as part of its commitment to the effective operation of Australia's financial markets (announced in May 2008). As a result of the increased funds, and to improve the return on the funds invested, the Government will change its investment powers to invest in a wider range of assets than under its current mandate.

   Currently the AOFM invests in term deposits with the RBA and would require any new investments to be low risk. Investment in AAA-rated residential mortgage-backed securities would meet this objective. Targeted investment in RMBS could support liquidity and competition in disrupted markets. It is noted that the AOFM has nominated mortgage-backed securities as eligible investments for the Communications Fund it manages, setting a precedent for investment in this asset class.

The advantages of the proposed AOFM initiatives are that liquidity can be provided to the market as needed, it is quick in implementation, increased return on government funds raised to provide a government benchmark, and balancing the supply and demand in the mortgage-backed securities market at a price that creates a level playing field.

Agency Model

An agency model is a government supported initiative that can provide access to sustainable, long term, capital markets funding. The ASF proposes that it would be limited in size (A$10-A$20 billion p.a.), competitively neutral and incorporate a "regulation lite" regime for its participants.

After reviewing a number of agency MBS models around the world, many believe that the Canadian MBS model is one of the best agency models in the world. Canada's MBS program issues high quality, government guaranteed mortgage-backed bonds. Canada Mortgage Bonds (CMB) offer a higher spread than treasury bonds and are included in the major fixed income index, making them highly attractive to investment hungry pension funds and other institutional investors.

Introducing a model similar to the Canadian MBS program in Australia has the potential to deliver wide reaching benefits to the Australian market. For consumers, mortgage rates could fall, helping first homeowners break into the residential property market. A new source of government guaranteed fixed income securities would be created while the long term stability and solvency of the financial system is strengthened by increased competition, transparency and liquidity.

Canadian MBS program at a glance

The Canadian Mortgage and Housing Corporation (CMHC) introduced the National Housing Act Mortgage-Backed Securities program (NHA MBS) in 1985 in response to rising mortgage costs. Over the past two decades the Canadian MBS model has evolved into a vibrant and highly liquid market that has reduced mortgage costs for borrowers and improved market transparency and liquidity.

The program had four main aims:

1. To create a more competitive market that would allow smaller financial institutions to provide housing finance at comparable rates to larger institutions.
2. To provide investors with high quality MBS that are secured by a government guarantee and underlying mortgage-insured property.
3. To lower mortgage rates to the consumer.
4. To strengthen the solvency of the financial system by adding another liquidity source for housing finance.

CMHC guarantees the timely payment of principal and interest on MBS issued by approved issuers and backed by eligible mortgages. Refer to the diagram below.

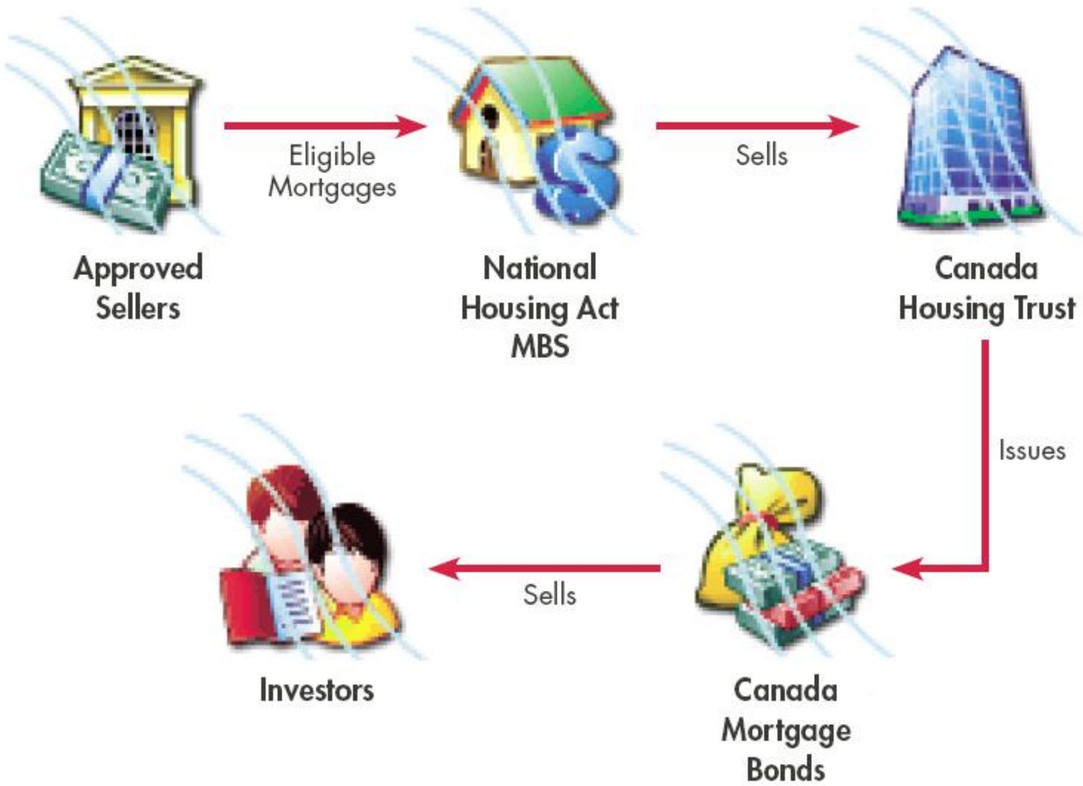

Figure 12 - Canadian MBS program

Some key outcomes that may also benefit Australia are:

- Proven source of long term capital market liquidity
- Competition and consumer choice
- Lower mortgage rates to borrowers
- Investor confidence is underpinned by government guarantee
- Less reliance on offshore debt markets
- Allows for broader supervision of the mortgage lending sector
- Enhanced market transparency
- Reduced risk of credit rationing
- Limited budgetary impact
- Simple implementation
- A public/private sector model

Refer to Annex 8 for further details: The Australian mortgage-backed securities market. Is an enhanced model needed to lower mortgage rates? The ASF, April 2008.

Covered Bonds

Background

The ASF believes that, subject to regulatory and market requirements, each market participant must have access to a broad range of funding mechanisms. This allows a market participant to have diverse sources of funding, and mitigates the risk and effect of a disruption in any particular segment of the market. As this submission has noted, the availability of funding alternatives is an important element in both the level of competition in the market for credit as well as the pricing of that credit.

Australian regulated lenders (that is, banks and other financial institutions which are regulated by APRA) have raised with APRA a number of times the question of allowing the issue of covered bonds. APRA's position, which was again confirmed in recent months, is that an Australian regulated financial institution is not permitted, for regulatory reasons, to issue covered bonds or enter into a transaction that has the same economic effect as an issue of covered bonds. The ASF believes that this places an Australian regulated financial institution in a position of competitive disadvantage compared to lenders which are regulated in other jurisdictions, and also denies them access to the covered bond market. The ASF believes that Treasury should engage in this issue. As it understands it, APRA's view is based on the need for it to properly protect deposit holders' claims in the event of the insolvency or other liquidation of a regulated financial institution, and that an issue of covered bonds (which segregates a pool of assets for the benefit of the holders of the covered bonds, but which also represents a claim against the financial institution itself) weakens that position. The ASF does not agree with that analysis, and believes that the Treasurer's recent announcement that he will legislate to introduce a Financial Claims Scheme adds weight to the argument that an issue of covered bonds should be allowed by APRA.

Benefits

There are many benefits to issuers of covered bonds:

- Lower cost of funds as the covered bonds typically have a higher rating than the senior unsecured debt of the relevant issuing financial institution.
- Diversification of funding sources.
- Lengthen the duration of an ADI's funding book (from the typical 3-5 year traditional capital markets debt to 5-10 years) reducing the annual refinancing task.
- Logical part of an ADI's suite of fundraising techniques, in addition to the wholesale capital markets, retail deposits and equity capital.

There are also benefits for investors in covered bonds:

- Covered bonds are bullet maturities which satisfies investor appetite.
- There is liquidity in this market due to active market makers.
- Issuers of covered bonds must be a regulated mortgage provider.

Refer to Annex 9 for the ASF's submission to APRA on covered bonds.

ASF Initiatives

The ASF is proposing several initiatives to reinvigorate the securitisation market and is working in consultation with the equivalent industry body associations in Europe and the United States.

The ASF is exploring other means of improving the liquidity of RMBS including:

- Creating an RMBS index to appeal to bank bill referenced, cash enhanced funds.
- Structuring bullet maturity securities that can be accepted into the UBS composite index.
- Improve liquidity further by linking maturities to benchmark dates.
- Appointing market makers to RMBS issues.
- Developing a CDS for RMBS in Australia. The advent of greater pricing transparency via the establishment of a rate setting environment for RMBS which would build a reference point for all securities to be priced off.[25]

The ASF is also advocating an increase of RMBS/fixed income allocation to super funds and sovereign funds (e.g. Future Fund). This introduction of fresh funds to RMBS would bring increased demand and, as market forces take hold, place downward pressure on spreads. As spreads decline, RMBS would once again become a viable funding option, attracting issuers (mortgage lenders) back to the market.

In addition, the ASF is working to ensure that Australia has a “world’s best practice” framework covering:

- Issuer transparency
  - Servicing standards
  - Post issuance investor information
- Pricing transparency
  - Explore the implementation of centralised dealer price and volume reporting
- Rating Agency transparency
  - Participate in review recently announced by Government
  - Aim for transparent methodology and comparability

[25] At present Interactive Data (an industry pricing provider for managed funds and investment portfolio’s) only reprice RMBS/ABS/CMBS every 2-3 weeks. Also, there are other issues that have flow on effects for pricing of this asset class however there is no current alternative.

Conclusion

A healthy securitisation market is good for competition. The current liquidity issues in the securitisation market are increasing the Australian bank and non-bank cost of funds, which is driving up mortgage rates over and above official RBA rate rises. Furthermore, the smaller financial institutions and non-bank lenders, who rely on securitisation for the majority of their funding, are in serious risk of being forced out of the market if the current situation continues, jeopardising competition in the mortgage market.

Without intervention the securitisation market may not recover which would have a negative impact on competition in the Australian banking and non-banking sectors. The ASF advocates measures to ensure that Australia continues to enjoy a healthy securitisation market. This requires some industry led initiatives but also some government support including:

- RBA repurchase agreements - has provided short term relief but in its current form is practically inaccessible to non-banks and small financial institutions. Short term liquidity issues may be addressed via expansion of existing arrangements and/or the introduction of a special liquidity scheme.
- AOFM - has longer term potential to aid competition. Under this proposal, liquidity can be provided to the market as needed, it is quick in implementation, increased return on government funds raised to provide a government benchmark, and balancing the supply and demand in the mortgage-backed securities market at a price that creates a level playing field.
- Agency model - creates a new investor base for mortgage-backed securities and has limited exposure to mortgage risk for the government.
- Covered bonds – provides an opportunity to expand the investor base for mortgage-backed securities.

The ASF welcomes the Federal Government’s review of these markets and thanks you for the opportunity to make these comments.

Yours faithfully,

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Australian Securitisation Forum

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