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The Australian Securitisation Forum Policy Options for Government to resuscitate securitisation and credit markets

Introduction

As the Global Financial Crisis has progressed the securitisation market has become more challenging and indicating an extended timeframe before its liquidity and depth return.

Conditions in credit and securitisation markets deteriorated appreciably following the collapse of Lehman Brothers in September 2008.

With the introduction in a large number of jurisdictions of government guarantees on wholesale funding of prudentially regulated deposit taking institutions there has been a marked shift by investors to a preference for government guaranteed instruments.

This has resulted in a further reduction in investor demand for MBS and other asset backed securities.

With some tightening of credit requirements, the major banks have been able to meet apparent demand for new residential housing lending particularly within the PAYG borrower segment. With the shortage of funding for lending channels which do not attract government guarantees there is a shortage of credit for some important sectors including commercial property, vehicles, plant and equipment and for small and medium enterprises which have not fared as well as PAYG borrowers. These funding supply issues are having significant negative impacts on both asset valuations and the level of business activity.

Therefore, while the stability of the financial system has (and should) remain a key policy priority for the government, the policy response needs to adapt to changing market conditions. As stability returns, the policy considerations should broaden to include other issues such as ensuring an adequate and efficient supply of credit for both businesses and

households and preserving and maintaining competition and choice in the financial system over the medium to long term.

THE ASF BELIEVES THAT SECURITISATION HAS BOTH A SHORT AND A LONG TERM ROLE IN PROVIDING A SIGNIFICANT PART OF THE FLOW OF CREDIT TO HOUSEHOLDS AND BUSINESS ON A COMPETITIVE BASIS, AND THAT IT IS APPROPRIATE FOR THE GOVERNMENT TO CONSIDER ITS OPTIONS FOR A FURTHER POLICY RESPONSE TO SUSTAIN AND REVITALISE THE SECURITISATION MARKET.

This paper sets out a number of options which the ASF believes deserve consideration by government to facilitate the provision of credit from investors in the capital markets (other than sources that rely solely on the balance sheets of major institutions) and to maintain an ongoing capacity for securitisation as part of a competitive and efficient financial infrastructure.

These options provide potential solutions to assist both lenders and investors in managing their operations through the financial crisis.

AN INDEPENDENT ASSESSMENT OF CONDITION OF AUSTRALIAN CREDIT MARKETS, THE IMPACT OF ANY DISLOCATION OF CREDIT MARKETS ON THE AUSTRALIAN ECONOMY AND OPTIONS FOR REOPENING THE SECURITISATION MARKET

The ASF is considering appointing Access Economics to undertake a review of the current condition of Australia's credit markets, the flows of and pricing of liquidity into the segments of those markets, the potential role of securitisation as an efficient supplier of credit both currently and as market conditions normalizes going forward, and an evaluation of the options available to the Australian Government to facilitate that role.

It is an inescapable fact that in the course of the Global Financial Crisis, government intervention has become a significant factor in the day to day operation of credit markets, and that these interventions which have had maintaining the stability of the banking system as a primary objective, have had a range of consequences which need to be managed appropriately.

All interventions have consequences. It is therefore important that those actions, and any subsequent actions, can be rapidly unwound when the conditions that gave rise to the interventions no longer pertain.

Access Economics will independently:

1. examine the effect of dislocated credit markets on the Australian economy – to focus on changes in the supply and pricing of credit and the implications for economic activity, unemployment, asset values and bankruptcies.

This part of the study will consider the impact on credit markets resulting initially from the US subprime crisis, then the collapse of Lehman Brothers and subsequently the more far reaching global financial crisis. It will also consider the impact of government interventions both in Australia and internationally on the supply of funding and its cost to banks and other lenders.

2. evaluate a number of policy options for government identified by various ASF members to address the current dislocation of Australia's securitisation market and facilitate its reopening as an efficient and competitive provider of credit to Australian households and business.

Many of these proposals relate to the term markets and, in particular, the mortgage backed markets. However, the ASF also believes that the short term markets, through asset backed commercial paper (ABCP) also provide a credible source of liquidity and credit to many sectors of the Australian economy and that, as part of its policy response, consideration should be given to any specific measures which would support this market.

Each of the options is intended to address either or both the dislocation in Australia's primary and secondary securitisation markets.

The primary market could be addressed by a government guarantee of RMBS, a government provided liquidity facility, by modifications to the current AOFM securitisation program, by covered bonds or a combination of these initiatives.

The secondary market could be addressed by direct government purchases of securities in the secondary market, a government guarantee on RMBS (possibly only covering calls) and a government provided liquidity scheme. Again, this can be either individually or in combination.

A GOVERNMENT GUARANTEE OF RMBS

This effectively proposes establishing a new, though temporary, asset class which reflects the current international investor appetite only for securities that have a government guarantee. Under this proposal the government would guarantee securities at the trust level with the guarantee fee reflecting the credit rating of the guaranteed tranche of the security. In this way the government could control the quality of eligible assets and provide a fee structure which is consistent with the current arrangements for guaranteeing wholesale funding of ADIs. The market would provide a level playing field, being open to all lenders on

a competitive basis, including major banks, regional banks, building societies, credit unions and non-bank lenders.

By restricting eligible collateral to appropriate classes of Australian assets the use of the guarantee would be applied in full to Australian lending and not have the potential to be used to fund other business activities as can be the case with guarantees of wholesale funding to institutions.

From a broader economic perspective it would directly address funding supply constraints by significantly broadening the potential investor base, both domestically but more importantly in offshore markets, for funding of RMBS transactions. This would be of significant value, particularly for regional banks and other lenders in providing credit to their previous markets. In this way, a proposal of this type is similar to the OzCar scheme for the auto markets and the ABIP scheme for the commercial property market.

There are a number of issues which Access Economics needs to evaluate and address:

- Government's need to control contingent liabilities (when compared to its cash position of a physical investment in asset backed securities)
- Perceptions that the securitisation market is "dead" or "irreparably broken"
- Level of investor interest given the current overhang of securitised assets
- The precedent of guaranteeing something other than a prudentially regulated institution
- The precedent of guaranteeing lending that may have lower capital constraints than an ADI
- The need to preserve the off balance sheet treatment of the guaranteed tranche
- Potential to produce other market distortions and specifically pricing of existing RMBS
- The further impact on pricing of Australian RMBS should such a guarantee not be implemented given that similar guarantees are being implemented in other jurisdictions
- Whether the government guarantee will promote liquidity
- Whether guaranteeing the call will promote liquidity given that credit is not an issue with Australian RMBS

Government Purchase of Assets in the Secondary Market

There is a substantial market overhang of securitised assets that are widely and cheaply available via the secondary market which are adversely affecting demand for, and pricing of, new primary issues and impacting the existing positions of investors who would have appetite to continue participating in new issues were this issue to be rectified.

There are international precedents for addressing these issues with large government programs to purchase securitised assets in the secondary market, albeit that some are directed at credit impaired assets. The mechanisms to address this could range from actual acquisition of the paper as adopted in other countries, provision of favourable funding lines for third parties to acquire the paper or to providing some form of put option at a specified level to investors.

Investors see the removal of the market overhang as a prerequisite to pricing of primary issues at economic rates

There are a number of issues which Access Economics needs to evaluate and address:

- The size of the overhang and the government's capacity to meaningfully address it (e.g. A\$35bn of outstandings in Australia and US\$2.8 trillion of comparable assets in the USA alone)
- Perceptions that offshore investors will get the benefit of Australian Government funding of any secondary market purchase program and not subsequently participate in new issuances.
- The price at which the government would purchase the securities
- The potential risk to the government balance sheet of owning such securities taking into account the government's approach to accounting for and valuing such securities
- Whether its approach to accounting for and valuation of such instruments is appropriate and consistent with other jurisdictions
- Clarification as to whether such a program would result in renewed interest or capacity for investors to participate in new Australian primary issues
- The length of time before the run off of existing securities will resolve the overhang issue
- The extent to which a smaller program or only guaranteeing calls could provide investors of confidence that there is a possible "take out"
- The potential for an alternative asset and liability funding program to avoid cash issuance of bonds to support this program

GOVERNMENT PROVIDES LIQUIDITY SCHEME

One of the issues for small ADIs and non-banks is that they do not have sizeable enough balance sheets to make effective use of RBA open market operations. This could be addressed by the AOFM providing securities lending facilities to appropriately qualified entities, on longer tenors than the RBA's typical liquidity arrangements, with securitised assets as eligible collateral.

The AOFM could also stand in the market to buy and sell RMBS to improve liquidity and pricing. This could provide confidence for investors who would see the AOFM as a possibility for future "take-out."

There are a number of issues which Access Economics needs to evaluate and address:

- Any constraints on the AOFM's capacity to provide CGS into the facility
- The usefulness of such a program to small ADIs and non-banks given buyback obligations
- Whether such a facilities would require legislation
- Eligible collateral
- Term
- Haircuts
- Potential unintended consequences, such as for RBA repo operations
- Whether the second scheme would inject the required confidence to fund managers

MODIFY THE AOFM SECURITISATION PROGRAM

The AOFM Securitisation Program was announced at a time when it was expected that the securitisation would reopen over the course of the following year. That timeframe was fairly quickly put into question by the turmoil surrounding and policy response to Lehman Brothers' failure. The wholesale funding guarantee for banks also had a direct and significant impact on RMBS pricing. Nevertheless the program has worked effectively to provide vital continuing funding to a number of lenders who as a result have been able to undertake additional new lending to residential borrowers thus keeping some level of competition in the market.

Given the ongoing turmoil in the market and the continued pressure on competition, the AOFM Program needs to be modified and extended to maintain as large as possible a base for competitive lending.

Increase size and duration

The program is fixed at \$8bn and at the current level of usage is likely to be exhausted within 6 months and so needs to be increased in size and duration.

There are a number of issues which Access Economics needs to evaluate and address:

- Expected duration of the program and size necessary to maintain the current core of viable lenders to ensure a competitive market in the medium and long term.
- Any capacity constraints on AOFM providing this form of funding (including an analysis of a physical (cash) investment in asset backed securities when compared to contingent exposures by way of a guarantee)
- Pricing issues in current market conditions (e.g. basing pricing on comparable competitive funding such as government guaranteed AA MTNs)
- The risk return trade off to government from the program taking into account its approach to accounting for its ownership of such instruments
- Whether its approach to accounting for and valuation of such instruments is appropriate and consistent with other jurisdictions
- Appropriateness of removing cornerstone criteria from mandates
- The level of competition that exists in the mortgage markets as a result of the AOFM program

Adjust eligible collateral

The program currently does not support lending to small business, the self employed or first home buyers because of restrictions on the proportion of low documentation and higher LVR loans. This is because existing mortgages must be cleared from warehouses to make way for new lending and current program eligible stock in warehouses has been depleted. The solution is to allow deals which contain a high proportion of self employed and first homebuyer lending.

There are a number of issues which Access Economics needs to evaluate and address:

- Quality of collateral and likely default rates under stress of recession
- Potential to separate criteria for eligible collateral from new lending
- The risk in investing in AA- rated subordinated notes

Provide warehouse facilities for ADIs and non-bank lenders

A number of lenders have relied on warehouse facilities provided by major international banks. With these institutions drawing back and refocusing on their own domestic operations, maintenance of these facilities is coming under increasing pressure.

If the market continues to deteriorate it may become necessary for AOFM to provide some warehouse facilities for lenders to support their respective programs.

There are a number of issues which Access Economics needs to evaluate and address:

- The need for legislative authority
- The size of the facilities
- Pricing
- Eligible collateral

There are a number of other industry-wide initiatives that could also be considered as a part of the government's long term response to the issues in the credit markets. This includes covered bonds, which is the subject of a separate ASF working group , with relevance to ADIs only. However, given that it will require government consideration (through amendments to the Banking Act and possibly the passage of specific legislation), it is raised here to provide the full context of the ASF's initiatives. The ASF sees the ability of an ADI to issue covered bonds as a fundamental tool in the recovery of the credit and capital markets, and one which will assist in the transition of those markets from a government-guarantee structure to a stand-alone credit analysis.

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