Speech

Securitisation: Past, Present and Future

RESERVE BANK OF AUSTRALIA

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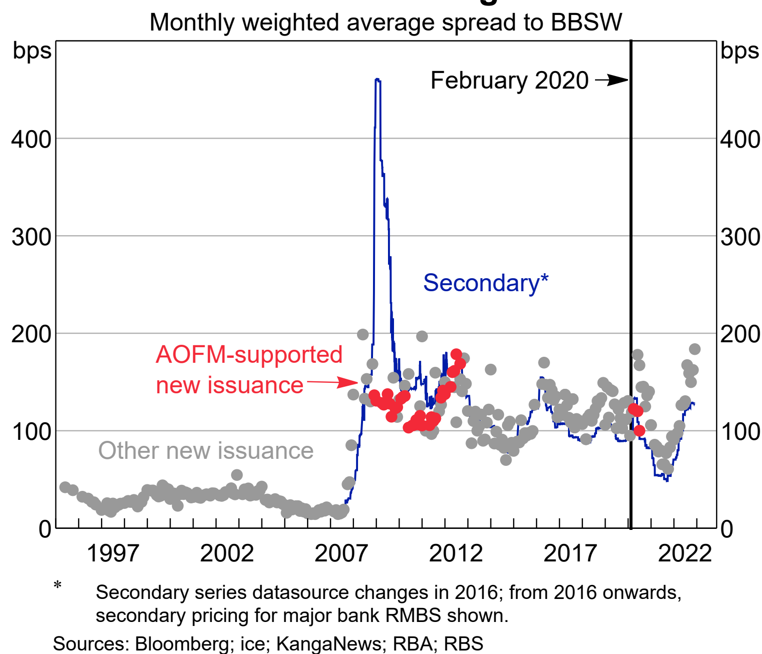
Thank you for the opportunity to speak with you today. A lot has changed since my colleague Marion Kohler addressed this conference a year ago. While COVID-19 still exists in our community, we have moved on from the most severe health, social and economic effects of the pandemic. Given the strong economic recovery from the pandemic and the very high levels of inflation in Australia and many other countries, central banks have significantly tightened financial conditions from ultra-low levels of interest rates.

Today I will reflect on how the Australian residential mortgage backed securities (RMBS) market has evolved against this changing backdrop. RMBS provides an important source of funding for Australian lenders; it backs around 70 per cent of mortgages issued by Australian non-bank lenders and 8.5 per cent for non-major bank lenders. To begin, I will discuss how the various policy responses to the pandemic have affected the RMBS market. I will then discuss current conditions, before offering some thoughts on the period ahead.

Reflecting on the recent past: Securitisation through the pandemic

Like most aspects of the Australian economy and financial system, the securitisation market fared better through the pandemic than many of us initially feared. When Australia's financial markets reacted in early-March 2020 to the emergence of a global pandemic, RMBS spreads to bank bill swap rates (BBSW) increased by around 40 basis points (Graph 1). This increase was modest compared with previous peaks; and it was short lived as RMBS spreads decreased over the course of 2020 into 2021 to the narrowest levels since before the global financial crisis (GFC). Overall, securitisation markets continued to provide competitively priced funding for Australian non-bank lenders throughout the pandemic.

This was a stark contrast to the GFC. That crisis originated within US subprime securitisations, leaving investors wary of the entire asset class, including the more 'plain vanilla' Australian RMBS. Back then secondary market RMBS spreads increased by over 400 basis points, as some offshore investors sold their Australian RMBS holdings (Graph 1).[1] Access to funding via securitisation markets was impeded for many issuers, and the market continued to draw on support from Australian Office of Financial Management (AOFM) investments for several years.[2]



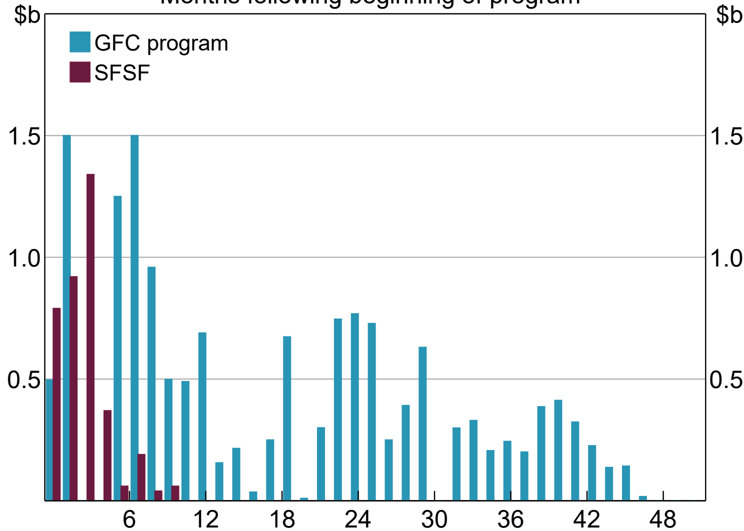
There were two key differences between the pandemic and the GFC that led to these different outcomes: first, the recent public-health shock was external to the financial sector; and second, post-GFC reforms had made the financial sector more resilient. Had the financial system been as fragile as it was in 2007, the consequences of the pandemic would have been much more severe. Instead, in 2020 our financial system was well positioned to absorb, rather than amplify, the pandemic shock. Banks' funding profiles and liquidity management were much more resilient, having benefited from important banking reforms implemented since the GFC.[3]

We also saw an unprecedented level of policy support in Australia during the pandemic, from the national and state governments, as well as the Reserve Bank and others. These actions helped to limit the initial downturn and restore economic activity. By supporting the Australian economy more broadly, the suite of policy actions assisted securitisation markets. However, some policies had a more direct impact on securitisation markets.

Structured Finance Support Fund

The policy with the most immediate effect on securitisation markets was the Structured Finance Support Fund (SFSF), which was introduced by the Australian Government to support small lenders and was administered by the AOFM. Through this fund, the AOFM invested in a range of securitisation securities. These investments were designed to encourage continued private investor participation, and to support competition in the securitisation market for smaller lenders by providing access to reasonably priced finance.

The structure of this program was broadly similar to the AOFM support offered during the GFC, but there were important differences. While the announced size of the SFSF, at $15 billion, was larger than the volume initially available for the GFC support, actual investments turned out to be much smaller and over a significantly shorter timeframe (Graph 2). The SFSF had a broad investment mandate, allowing the AOFM to invest in both the primary and secondary markets, as well as private warehouses. This included a 'forbearance special purpose vehicle' that assisted non-bank lenders to offer repayment deferrals. It was also able to support any part of the capital stack (other than first loss notes). This was significantly broader than the investment mandate of the GFC support program. The breadth of the SFSF enabled the AOFM to fill some gaps left by private investors. As a result, mezzanine tranches of both term deals and warehouse transactions were a key focus. The speed of implementation of this program also helped to restore securitisation market conditions quickly.[4]



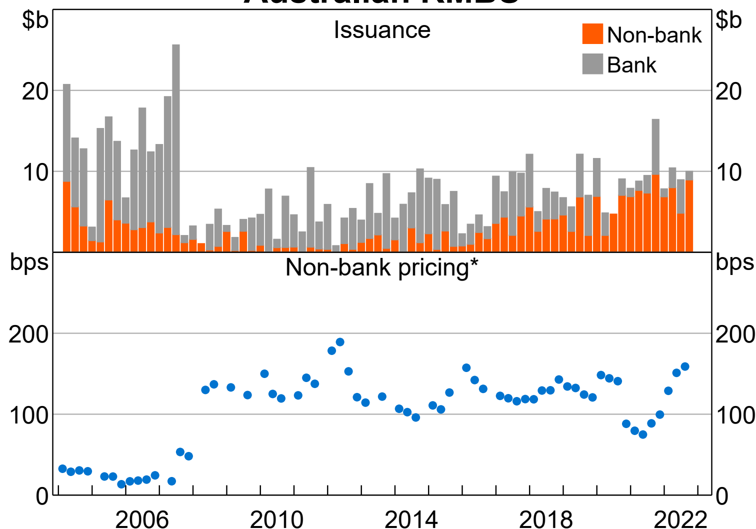
* GFC investments started in November 2008; SFSF investments started in April 2020.

Source: AOFM

Lowering the structure of interest rates in Australia

Many of the policy actions taken by the Reserve Bank during the pandemic worked to lower the structure of interest rates in Australia. This included the reduction in the cash rate, the Term Funding Facility (TFF) that provided low-cost funding to banks, a yield target and forward guidance, as well as purchases of Australian Government Securities via the bond purchase program.[5]

As a result, yields fell to historical lows across all debt funding instruments. By Q4 2020, RMBS spreads to BBSW were the narrowest they had been since before the GFC (Graph 3). While these narrower spreads were following market moves more generally, they were further supported by relatively high investor demand for RMBS amid a search for yield and few other attractive investment options.

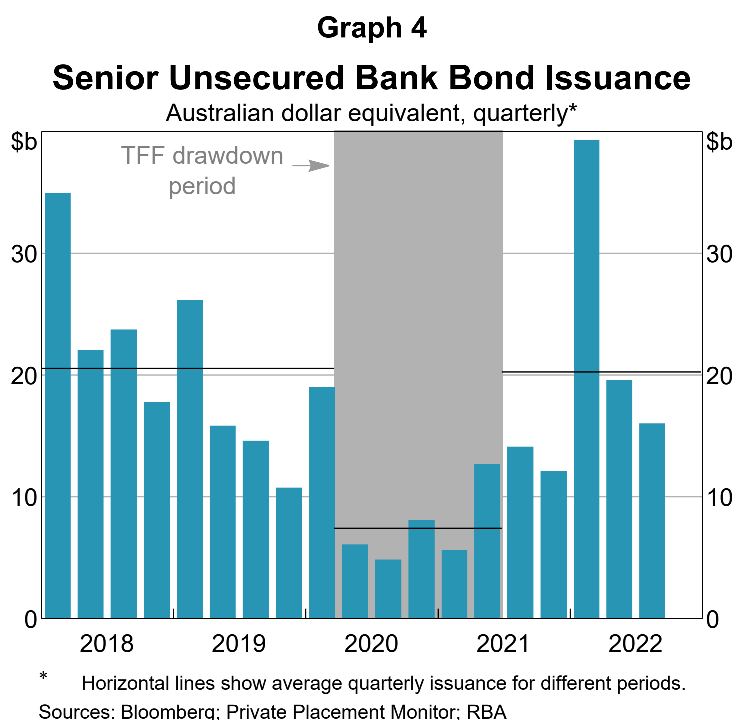


* Face-value weighted quarterly average of the primary market spread to BBSW for AAA-rated notes.

Sources: Bloomberg; KangaNews; RBA

Reduced supply of alternative investments

Demand for RMBS was further bolstered by a significant reduction in banks' issuance of senior unsecured bonds (Graph 4). This encouraged some investors to purchase RMBS, which can offer a broadly similar credit-risk through a different form of exposure to the Australian household sector and housing market. Senior unsecured bond issuance slowed because banks had ample access to other sources of funding. In particular, the TFF provided low-cost three-year funding to banks, at the same time that banks were receiving large deposit inflows.[6]



A point of contrast between the pandemic and the GFC was that the broad policy measures affecting bank funding during the pandemic supported demand for RMBS, whereas arguably this was not the case during the GFC.[7]

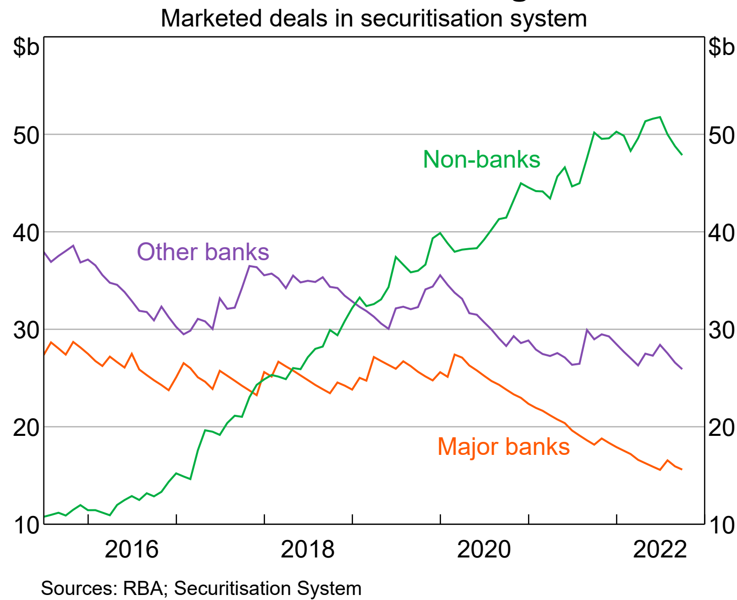
Altered balance of bank and non-bank issuance

Banks not only reduced their issuance of senior bonds through the pandemic, but also their issuance of RMBS (Graph 5). Over prior years, the major banks were already infrequent issuers of RMBS – they had access to cheaper alternative funding sources and so only issued RMBS from time to time to maintain relationships with investors and diversify their funding. Regional banks tended to issue RMBS more frequently given they had more expensive and restricted access to capital markets than the major banks.

Non-bank RMBS had already been increasing as a share of issuance for several years, and this picked up further over the pandemic. In Q3 2021, non-banks issued $9.6 billion of RMBS – several times the issuance of five years earlier. And non-bank issued securities now comprise about half of the outstanding prime RMBS stock.[8] This has implications for the characteristics of the Australian RMBS stock; non-bank RMBS typically have lower average seasoning and higher loan-to-value ratios (LVRs) than bank RMBS (Graph 6).

Graph 5

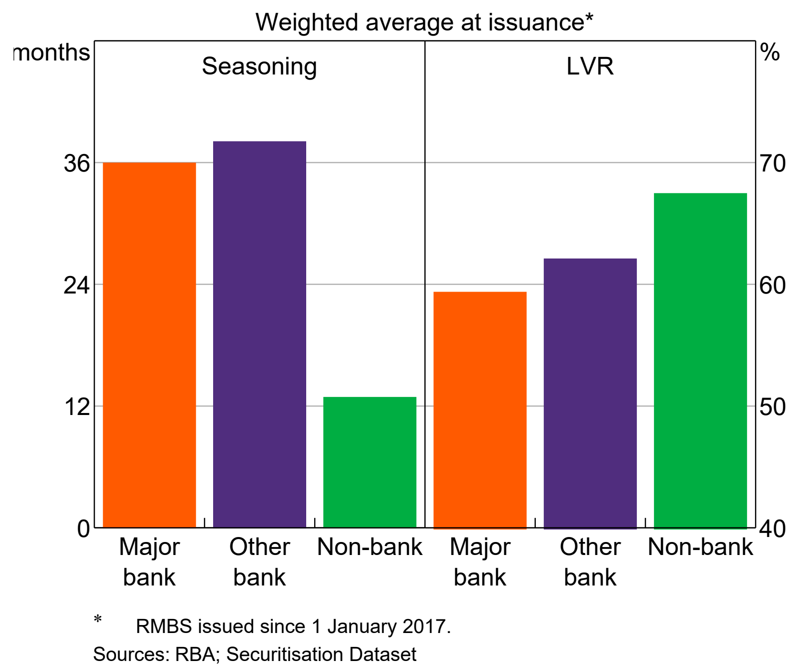
RMBS Outstanding



Sources: RBA; Securitisation System

Graph 6

Attributes of Australian RMBS



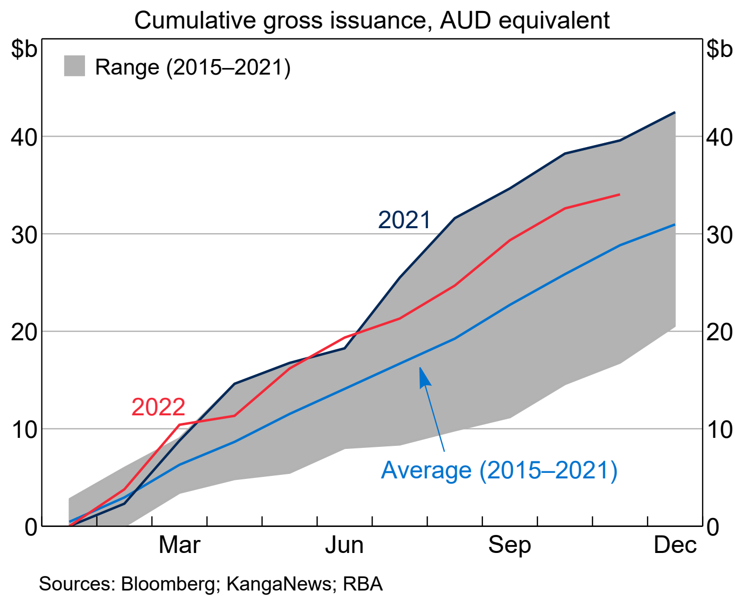
* RMBS issued since 1 January 2017.

Sources: RBA; Securitisation Dataset

Considering the present: Current state of the market

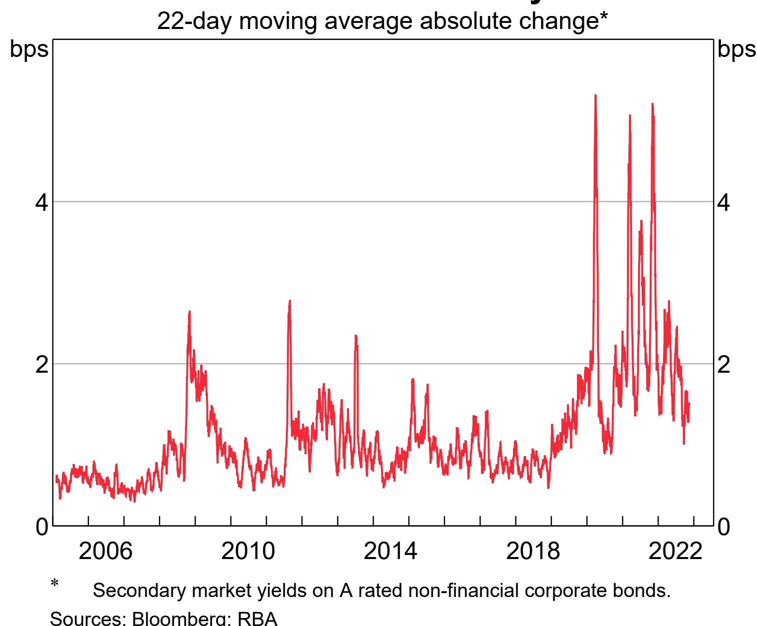
By early 2022, securities markets were beginning to resemble more 'normal' conditions. In Q1 2022, spreads had widened from their COVID-19 lows, and were approaching pre-pandemic levels. Issuance volumes were particularly strong in the first quarter of 2022, with over $10 billion raised, and have remained fairly high through the year (Graph 7).

Graph 7



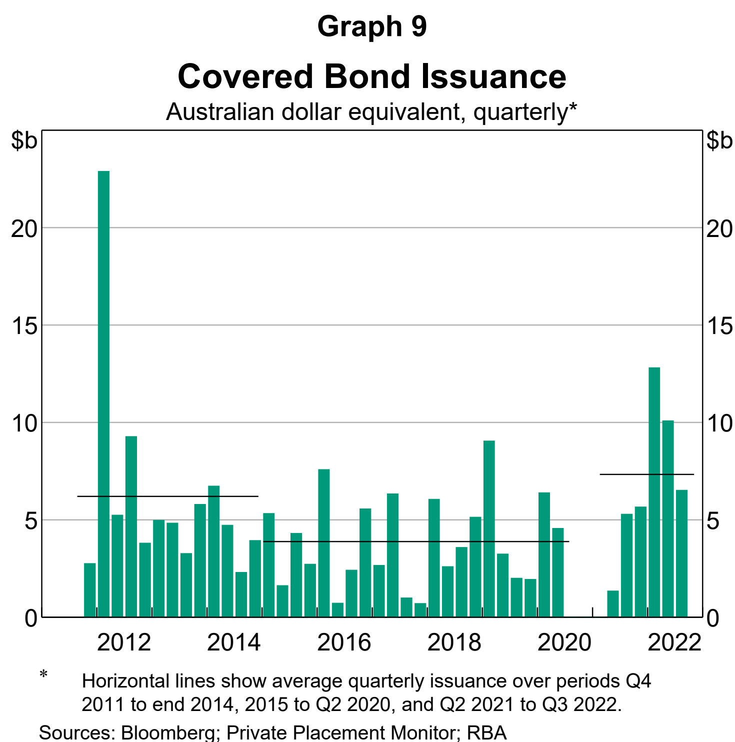
However, there have been bouts of volatile market conditions this year (Graph 8). In late February, Russia's invasion of Ukraine led to an increase in risk aversion, which impeded the flow of RMBS issuance for a time. Some deals were downsized, and a bank RMBS deal was withdrawn from the market after launch, citing volatile market conditions, which is a relatively uncommon occurrence. Reportedly, joint-lead managers also provided substantial volumes of support to deals during this period.

Graph 8



Amid this instability, banks increased their issuance of covered bonds (Graph 9). Covered bond issuance over 2022 so far exceeds $35 billion, which is already the second highest annual total since 2012, with the first issuance of covered bonds in Australia. This might reflect a desire to replenish covered bond stocks, which declined over the pandemic period. Banks typically hold covered bond stocks at a relatively steady proportion of around 50 per cent of the maximum allowed under their caps imposed by the Australian Prudential Regulation

Authority. Maintaining head room under this cap means they have the option to increase covered issuance during periods of uncertainty. Market liaison has suggested that banks might have preferred to issue covered bonds rather than RMBS as pricing was more favourable for the same use of collateral.



There was an additional period of financial market instability in late September, as volatility in UK gilt yields increased following the announcement of the UK Government's mini-budget. Some UK defined-benefit pension funds needed to raise cash to meet margin calls. One of the assets that was sold in large volumes was Australian RMBS, including many close to maturity. Even so, this selling was met by resilient demand, with RMBS secondary market liquidity greater than many anticipated.

Rising interest rates are also affecting securitisation markets. Higher rates reduce the performance of home loans, which are the underlying collateral for RMBS. Mortgage interest rates are rising at the same time that housing prices have declined, and so arrears rates are likely to increase. However, there are several factors that support the outlook for RMBS collateral. While housing prices have declined, they are still 20 per cent higher than at the onset of the pandemic. Meanwhile, the unemployment rate is at its lowest level in nearly 50 years, which will limit entry into arrears.[9] Finally, arrears started this episode around record-low levels.

In addition to affecting the underlying collateral, rising interest rates can affect the securities themselves, even though these are floating-rate securities referencing floating-rate benchmarks. With rising interest rates, investor preferences might shift towards shorter tenor securities. And the steepness of the short end of the yield curve has presented a challenge for many RMBS investors throughout this year, who benchmark the performance of their funds to three-month BBSW, while RMBS pay a spread over one-month BBSW.

Thinking about the future: Looking ahead

The past few years have reinforced how quickly economic and financial conditions can change. So I won't claim to be able to predict the future but I will mention some upcoming developments and how they might affect securitisation markets.

Wind-down of the Committed Liquidity Facility (CLF) and refinancing the TFF

One change that we know is coming is the wind-down of the CLF to zero at the end of 2022. The CLF was introduced in Australia in 2015 because there were insufficient high-quality liquid assets (HQLA) for banks to hold to meet their liquidity coverage ratio (LCR) requirements. With the increase in government debt outstanding, the CLF is no longer required. Another upcoming change is that TFF funding will begin to mature, with maturities concentrated in Q3 2023 and Q2 2024. The wind-down of the CLF and the maturing of TFF funding might affect banks' securitisation market activities, through both their role as issuers and as investors.

In terms of their role as issuers, it is possible that banks might issue additional securities, including RMBS, to fund the purchase of additional HQLA to replace the CLF and/or to refinance TFF funding. Given banks have multiple funding sources available to them – including deposits – whether they choose to issue more RMBS will ultimately depend on price.

The primary collateral type that banks hold for the TFF and CLF is self-securitisations. All else equal, the upcoming changes to these facilities will reduce banks' need to hold self-securitisations, although this reduction will be slightly offset by new LCR guidance that stipulates minimum holdings of self-securitisations as a contingency. If the stock of self-securitisations declines, banks would have more mortgages on their balance sheets that they could use to issue RMBS. But, the availability of mortgages isn't currently constraining issuance. On balance, a more important driver of issuance decisions will continue to be the relative cost of different funding sources, as well as decisions on funding diversity.

In terms of their role as investors, banks hold a small amount of marketed RMBS as collateral for repos under the CLF and TFF facilities. As the CLF is wound down and TFF funding matures, banks might find they have less need to hold these securities, and hence reduce their demand. But we have heard in liaison that this reduction has not yet transpired.

The growth of Green RMBS?

One growing specialty area of securitisation is the issuance of green RMBS. Australian green-labelled securitisation hit a record high in the first half of 2022 (Graph 10). In fact, as a share of total domestic securitisation issuance, green issuance in Australia frequently exceeds that in the United States and the European Union. In the European Union, green covered bonds are more popular.

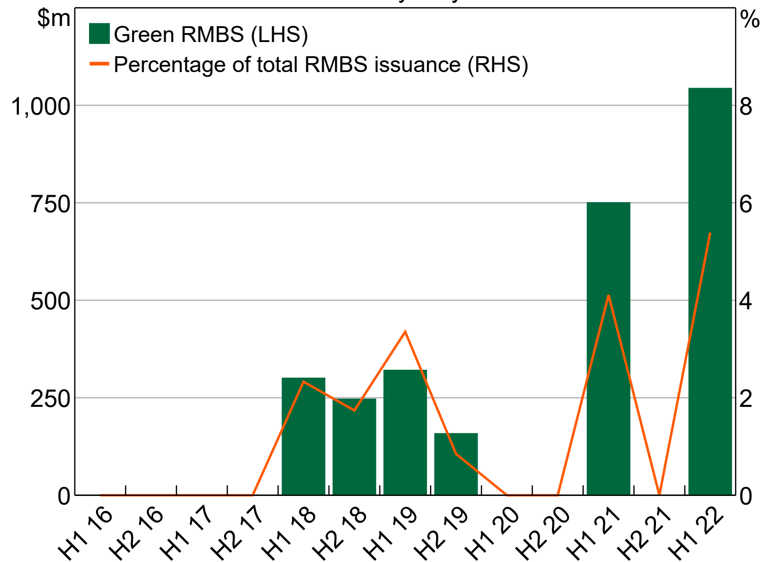
A green RMBS is collateralised by 'green loans', or has proceeds funded by 'green lending'. But what is classed as 'green' can be broad and is at the discretion of the issuer. It could be that the loans are for properties with high energy ratings, or they have specific features such as solar panels. Issuers often attain a third-party certification that a mortgage is 'green', although they can also use self-designed criteria.[10]

This market-based approach to green classification is in line with the practice in the United States, but differs from the European Union where the taxonomy prescribes what are 'green activities'. For green RMBS in Australia, it is essentially up to investors to assess the merits of disclosed green criteria. It is good to see the Australian Securitisation Forum (ASF) and industry working in this area. As we've seen with securitisation markets more broadly over the years, improved disclosure and greater consistency improves investor confidence and so the size of the investor base. An interesting development will be how green criteria in Australia evolve and interact with definitions used elsewhere.

Graph 10

Green RMBS Issuance

Half yearly



Sources: Bloomberg; Kanganews; RBA

Robust fallback language for securities referencing BBSW

There is another development to mention that may not be front of mind for everyone, but is very important and timely – in fact, it comes into effect from tomorrow. As announced by the Reserve Bank in September 2021, floating rate notes and marketed asset-backed securities issued on or after 1 December 2022 that reference BBSW must include robust fallback provisions to be eligible as collateral in the Bank's liquidity facilities.[11]

Financial regulators globally have been urging market participants to make financial products more robust by including fallback provisions that apply if the referenced benchmark rate is discontinued. Fallbacks provide important insurance when using any benchmark. If there's one thing that LIBOR has shown us, it is that we shouldn't take existing benchmarks for granted. While BBSW is currently a robust benchmark, this could change in the future so it is important that robust fallbacks are in place.

On behalf of their constituents, the ASF and Australian Financial Markets Association have developed template language to include in deal documentation. The Bank has engaged with both industry bodies as they have developed these templates and currently considers the final versions of the templates to meet the requirement of a robust fallback. We thank industry for the ongoing engagement on this issue.

Unfreezing self-securitisation prices for the TFF

A final topic to note relates to upcoming changes to the treatment of self-securitisations as collateral. As self-securitisations are not traded in the market, the Reserve Bank values these securities by calculating prices using an internal model. This model captures the behaviour of spreads in the secondary market for asset-backed securities as a key input. At the start of the TFF in March 2020 when there was substantial volatility in markets, the Bank decided to freeze the modelled prices of notes issued from self-securitisations for three years to mitigate the impact of price volatility on collateral values and margining frequency. This policy was beneficial during the period of high volatility and uncertainty; however, with improved economic and financial market conditions as we approach the end of this horizon, the Bank is planning to unfreeze prices in early 2023. Based on current market conditions, this is expected to generate margin calls for a number of TFF borrowers. The Bank will issue a market announcement and be in contact with affected institutions.

Conclusion

Summing up, the past couple of years have been far from boring for securitisation. It is pleasing to see that the securitisation market has played its part in a resilient financial system that mitigated the impact of the pandemic on the economy. This reflects the improvements in the securitisations market after the GFC, but also the impacts of various pandemic-era policy measures. The coming period will see further unwinding of those measures that have served their purpose and the development of new measures designed to make securitisation even more resilient. Importantly, the securitisation market will continue to see innovation. Time will tell what that innovation may be – we may be talking about the role securitisation plays in greening the financial system at future ASF conferences.

Endnotes

[*] Thanks to Claire Johnson for fabulous assistance.

[1] Debelle G (2009), 'Whither Securitisation?', Address to the Australian Securitisation Conference 2009,Sydney, 18 November.

[2] For an overview of the actions that the AOFM was taking at the time, see Australian Office of Financial Management (2009), 'Annual Report 2008–09', p 29 onwards.

[3] The GFC highlighted the inadequacy of banks' capital and liquidity buffers, prompting a major rewrite of global banking standards by the Basel Committee on Banking Supervision. For further detail, see Yuksel M (2019), 'A Decade of Post-crisis G20 Financial Sector Reforms', RBA *Bulletin*, June. Australia implemented these capital and liquidity reforms through standards issued by the Australian Prudential Regulation Authority. For more information, see RBA (2013), 'Box B: The Basel III Capital Reforms in Australia', *Financial Stability Review*, September; RBA (2015), 'Box A: The Basel III Liquidity Reforms in Australia', *Financial Stability Review*, March.

[4] The speed of implementation of the SFSF prevented an overhang of RMBS stock in the secondary market. The SFSF was announced on 19 March 2020, legislation was introduced and passed on 23 March, royal assent was received on 24 March, supporting instruments issued by the Treasurer on 26 March and the first investment was made on 27 March. See Australian Office of Financial Management (2020), 'Annual Report 2019–20', pp 68–70.

[5] The Reserve Bank has carried out reviews on each of these policies: see RBA (2022), 'Review of the Yield Target'; RBA (2022), 'Review of the Bond Purchase Program'; RBA (2022), 'Review of the RBA's Approach to Forward Guidance'.

[6] For an explanation of how the Reserve Bank's purchase of bonds and the TFF contribute to deposits, see RBA (2020), 'Box D: Recent Growth in the Money Supply and Deposits', *Statement on Monetary Policy*, August.

[7] During the GFC, bank debt was supported by government guarantees. This increased the relative attraction of bank debt compared with RMBS, at a time when investor interest in RMBS was already very low. This likely posed an additional headwind to the recovery of the RMBS market at that time.

[8] S&P Global Ratings (2022), 'Australian RMBS Performance Watch Part 1 Market Overview', June.

[9] Bergmann M (2020), 'The Determinants of Mortgage Defaults in Australia – Evidence for the Double-trigger Hypothesis', RBA Research Discussion Paper No 2020-03.

[10] Recently, Australian lenders' green criteria have accepted: the Australian Government's 'National Household Energy Rating System' certification; the Green Building Council of Australia's 'Green Star Homes' certification; and the Australian Passive House Association's 'Passive House Certification'.

[11] RBA (2021), 'Robust Fallbacks Required for BBSW Securities', Media Release No 2021-20, 13 September.