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Senior Advisor
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The Treasury
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via email: fsi@treasury.gov.au

Dear Mr Crawford

**Submission to the Final Report of the Financial System Inquiry**

The Australian Securitisation Forum (ASF) appreciates the opportunity to make comment on the recommendations of the final report of the Financial System Inquiry (FSI).

The ASF is the principal industry body representing participants in the Australian securitisation and covered bond markets. Our members include APRA regulated financial institutions, ASIC regulated credit providers and securitisers, domestic fixed income investors, arrangers, advisors and service providers to the securitisation and covered bond markets. One of the key objectives of the ASF is to represent the interests of issuers of mortgage and asset-backed securities (RMBS and ABS) which are secured by Australian loan receivables.

In its submission to the interim report of the FSI, the ASF sought to highlight the importance of, and benefits that securitisation provides to the financial system, including contributing to competition amongst lenders within the system which ultimately provides choice and benefits to consumers. Securitisation is an important funding tool for a wide range of financial institutions including non-bank lenders, and helps to fund a range of asset classes, particularly loans to retail borrowers and small and medium sized enterprises. The ASF suggests that any recommendations adopted by the Government from the final report of the FSI should recognise the role Australia's securitisation plays in terms of competition within a highly concentrated financial system whilst also fostering a stable and efficient system.

A key focus of the ASF is on the securitisation market and a large number of the recommendations of the final report are not directly relevant to the securitisation market. Hence this submission focuses on one key recommendation, **Recommendation 30** regarding competition policy within the financial sector, repeated below.

> ***Rebalance the regulatory focus towards competition:*** *Not surprisingly, regulators have increased their focus on resilience in the wake of the GFC. However, the Inquiry believes there is complacency about competition, and that the current framework does not systematically identify and address competition trade-offs in regulatory settings.*
>
> *Although the ACCC is responsible for competition policy in the financial sector, this is part of its broader economy-wide responsibilities. Furthermore, the ACCC is not responsible for reviewing how decisions by other regulators affect competition. It is not always clear how APRA and ASIC balance their core regulatory objectives against the need to maintain competition. Policy makers and regulators need to take increased account of competition when making regulatory decisions, while ASIC should be given an explicit competition mandate. Periodic external reviews of the state of competition should be conducted, including assessing whether Australia can reduce barriers to market entry for new domestic and international competitors.*

The ASF supports Recommendation 30 in its intent to strengthen the focus on competition in setting the regulatory framework of the financial system. In particular, we support the proposal that regulators should take increased account of competition when making regulatory determinations.

The key regulator for securitisation in Australia is APRA. APRA's prudential standard APS120 governs the manner in which ADIs can use securitisation for funding as well as the regulatory capital required for investing in or trading RMBS and ABS. The RBA has a significant impact on the securitisation market through its repo-eligibility requirements for RMBS and ABS. Issuers typically seek to have the senior ranking tranches of a securitisation satisfy the RBA's repo-eligibility requirements. This gives investors some comfort that there may be some increased secondary market liquidity for securities that are repo-eligible compared to those that are not. ASIC does not have a direct regulatory oversight of securitisation, as mortgage and asset-backed securities are issued to wholesale investors, but is influential in its participation in IOSCO and its global reform agenda.

APRA is expected to release a new version of APS120 later this year. The industry is seeking some flexibility within the new standard to facilitate competition and growth within the securitisation market, and in particular is seeking a pragmatic approach to the capital treatment of warehouse facilities that are important to smaller ADIs looking to use securitisation to access term funding markets to diversify their funding profiles. The industry is also seeking a new prudential approach that will allow ADIs to use master trust issuance vehicles as well as incorporating tranches with scheduled amortisation and/or soft bullet structures. These features will be needed to facilitate greater access to international investors which will allow larger ADIs to potentially replace some of their funding from short term, and more volatile commercial paper funding markets.

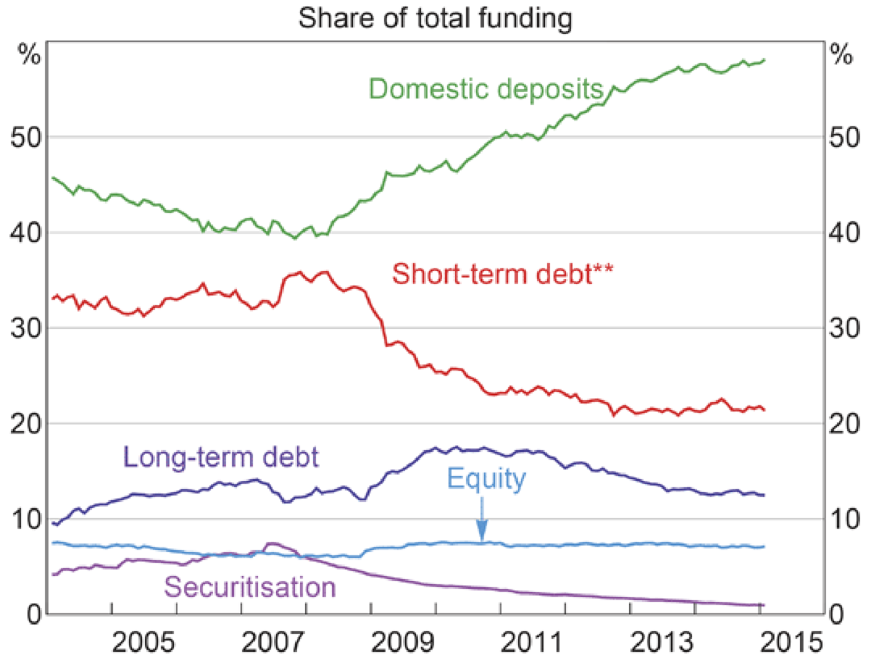
Securitisation has, and continues to be, an important component of competition in Australia's financial system. The ASF submission to the Financial System Inquiry highlighted the important role of securitisation in the following key areas:

1. Securitisation technology is an important tool for transforming pools of relatively illiquid assets into more liquid investible securities, including residential mortgages and other financial assets with predictable cash flows;
2. Securitisation forms an essential funding source for smaller lenders, particularly non-ADI lenders, and therefore is important for competition; and
3. Securitisation efficiently generates high quality and creditworthy securities, providing a key source of fixed income investment products suitable for superannuation and retirement income sectors as well as liquidity to the banking system via the Committed Liquidity Facility provided by the RBA.

It is important to note that the Australian securitisation market was one of the few global markets that continued to function throughout the financial crisis and did not suffer any credit related problems that affected some other markets, notably the United States. While activity has steadily increased since 2009 the percentage of funding of the financial system provided by securitisation is still very modest and far below its potential.

Chart 1 below highlights the diminished role securitisation has played since the 2008 financial crisis. We highlight securitisation as one of the few competitive components of the financial system and one that can contribute significantly more to competition.

**Chart 1:** Funding composition of Banks in Australia*



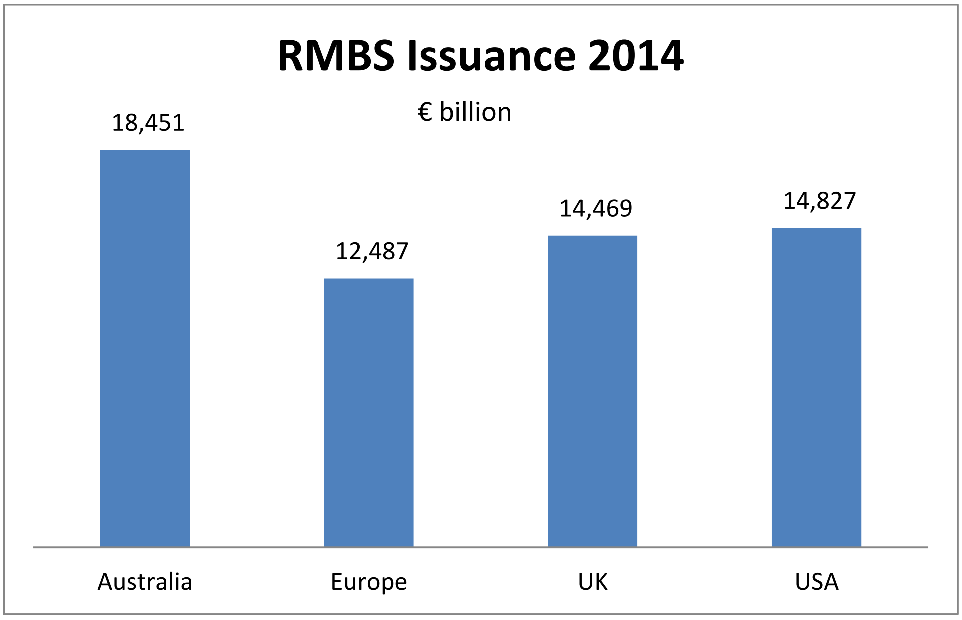

* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

It is also worth noting that while the size of the Australian RMBS market is small, it remains one of the few larger non-government sponsored RMBS markets in the world.

**Chart 2:** Australia vs international RMBS issuance in 2014




**Classification of High Quality Liquid Assets**

A clear example of where new regulation may have foreseeable competition trade-offs is in the application of the Basel III Liquidity Framework, and in particular the definition of High-Quality Liquid Assets (HQLA).

HQLA are used in calculating a bank's Liquidity Coverage Ratio, and are the stock of unencumbered assets that can be converted easily and immediately in private markets into cash to meet a bank's liquidity needs for a 30 calendar day liquidity stress scenario. The Basel III Liquidity Framework has defined and classified these assets into Level 1, Level 2A and Level 2B assets. From the ASF's perspective, the focus is on covered bonds (Level 2A assets) and RMBS (Level 2B assets).

In applying the Basel III Liquidity Framework, regulators in different jurisdictions have chosen to recognise or not recognise covered bonds and RMBS as HQLA therefore creating disparities and potential competition implications. This is evidenced by the table below:

| Regulator (Jurisdiction) | Level 1 assets | Level 2A assets | Level 2B assets |
|---|---|---|---|
| **Basel III Liquidity Framework** | ▪ Cash<br>▪ Central bank reserves<br>▪ Marketable securities representing claims on or claims guaranteed by sovereigns, quasi-sovereigns, central banks and multilateral development banks (assigned 0 risk weight under Basel II standardised approach for credit risk) | ▪ Marketable securities representing claims on or claims guaranteed by sovereigns, quasi-sovereigns, central banks and multilateral development banks (assigned 20% risk weight under Basel II standardised approach for credit risk)<br>▪ Corporate bonds (not issued by a financial institution or any of its affiliated entities) rated at least AA-<br>▪ Covered bonds (not issued by a financial institution or any of its affiliated entities) rated at least AA- | ▪ RMBS (not issued by a financial institution or any of its affiliated entities) rated at least AA. Underlying mortgages are “full recourse loans”, max LTV of 80% and securitisations subject to “risk retention” regulations. Subject to 25% haircut.<br>▪ Corporate debt securities (not issued by a financial institution or any of its affiliated entities) rated between A+ and BBB-. Subject to 50% haircut.<br>▪ Ordinary shares (not issued by a financial institution or any of its affiliated entities). Exchange traded and centrally cleared. Subject to 50% haircut. |
| **APRA (Australia)** | | ▪ Does not recognise covered bonds | ▪ Does not recognise RMBS |

| Regulator (Jurisdiction) | Level 1 assets | Level 2A assets | Level 2B assets |
|---|---|---|---|
| **European Commission (EU) & Prudential Regulation Authority (UK)** | ▪ Certain covered bonds to be included | ▪ Other EU covered bonds rated ECAI 2 and non-EU covered bonds rated ECAI 1 (AA- or above) | ▪ High quality securitisations for RMBS, auto, SME & consumer loans<br>▪ Rated AA- or above, seniority in the capital structure, WA LVR < 80% (some exceptions), minimum issue size of EUR 100m and max WA life of no more than 5 years.<br>▪ All securitisations must have borrowers resident in the EU and SMEs established in the EU to be eligible (RMBS excepted) |
| **Federal Reserve & Federal Deposit Insurance Company (USA)** | | ▪ Does not recognise covered bonds | ▪ Does not recognise RMBS |
| **Hong Kong Monetary Authority (Hong Kong)** | | ▪ Covered bonds (not issued by a financial institution or any of its affiliated entities) rated at least AA- | ▪ RMBS rated AA or above (subject to Hong Kong Monetary Authority approval on case-by-case basis) |

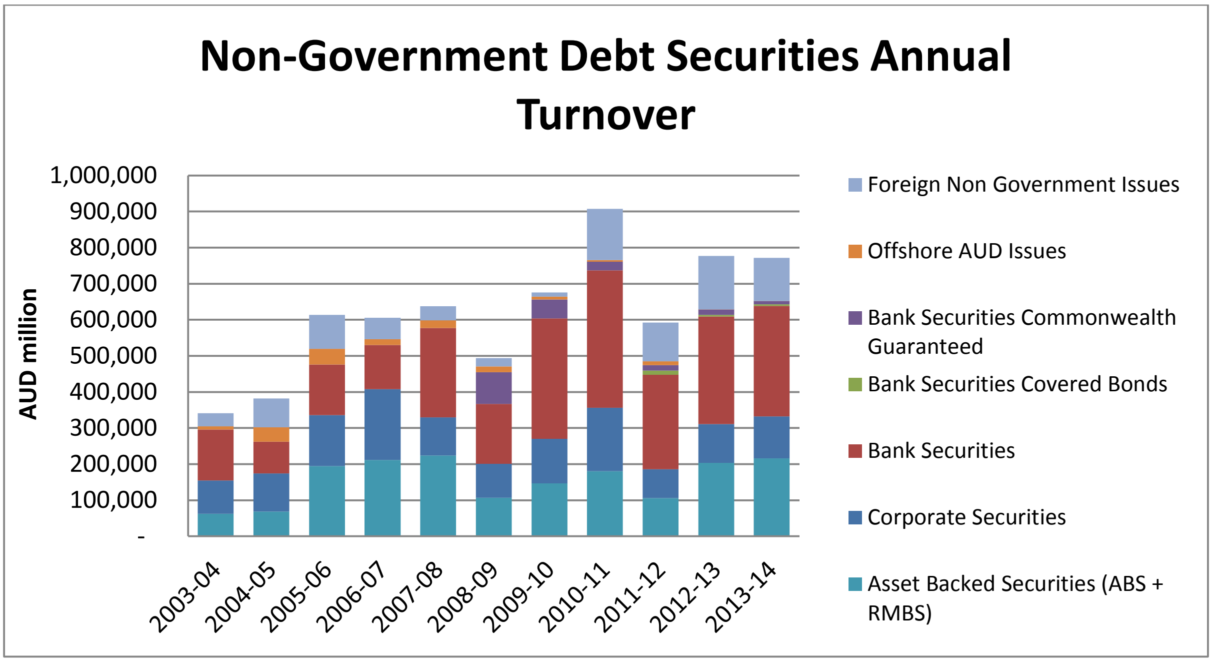
By excluding RMBS and covered bonds from HQLA while other jurisdictions permit them, APRA could undermine investment in these markets and increase their cost of funding, thereby reducing their competitiveness. It could also lead to distortions in the market, such as dramatically increased demand for limited supplies of asset classes which are permitted and hoarding of HQLA by financial institutions.

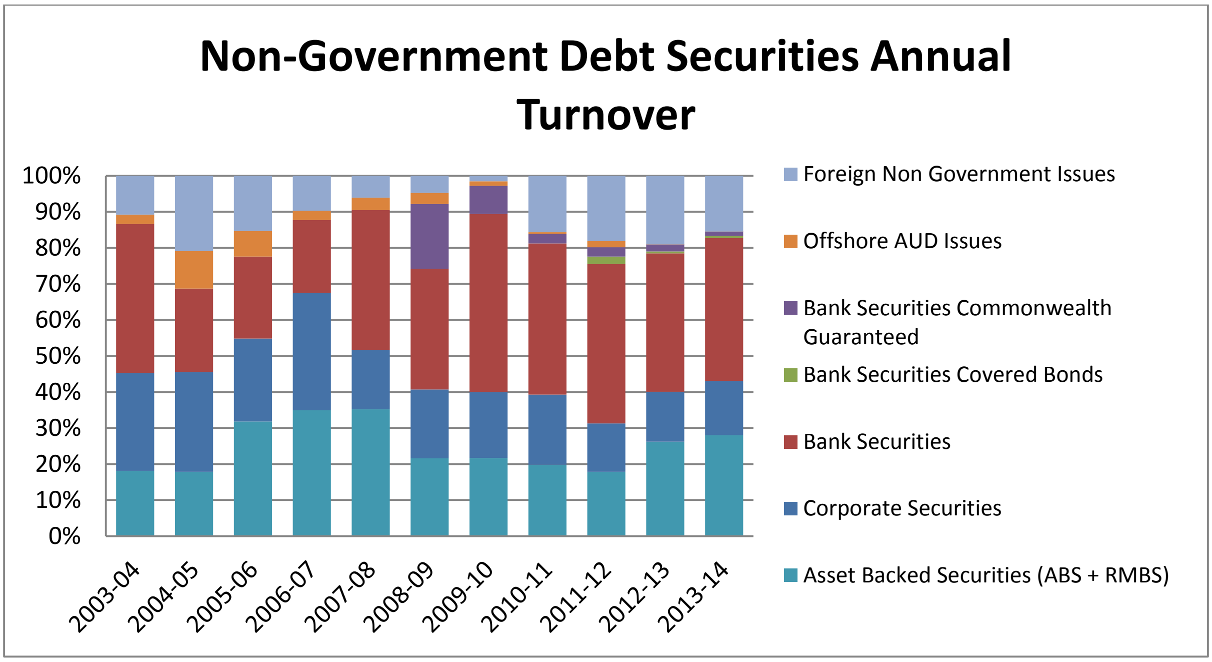
It is interesting to note that while ABS has not been contemplated in the Basel III Liquidity Framework, it has been recognised as Level 2B assets by the European Commission and Prudential Regulation Authority. Again, this disparity may have unintended consequences for competition.

**Why RMBS and covered bonds should be recognised as Level 2A and Level 2B HQLA**

APRA's main argument for not including these instruments is one of liquidity – it believes these instruments do not trade in large, deep and active markets and are not liquid in a time of stress, particularly during market disruptions such as that of 2007-2009.

The charts below show Non-Government Debt Securities annual turnover for the last 10 years based on the Australian Financial Markets Report from AFMA.



The main observations are:

- ABS has accounted for between 18-35% of annual turnover volumes in the Non-Government Debt sector over the last 10 years.
- ABS turnover is second only to Bank Securities (i.e. Senior unsecured issues)
- Even during market disruptions of 2007-2009, ABS accounted for 20-30% of Non-Government Debt Securities annual turnover.

ABS instruments are high quality liquid assets that have performed well, even during times of market disruption.

Other reasons for including RMBS and Covered bonds as HQLA:

- These assets are repo-eligible with the RBA for normal market operations and are eligible collateral for the CLF from the RBA. As such they provide a reliable source of funding during stressed market conditions.
- Although they can't treat them as outright HQLA, larger Australian banks with access to the CLF are able to use RMBS and Covered bonds as eligible collateral towards meeting the Liquidity Coverage Ratio. Banks without access to the CLF cannot use these assets to meet their liquidity requirements. Permitting RMBS and Covered bonds as HQLA would level the playing field for the larger and smaller banks.
- Greater international alignment of Australia's liquidity standards with other jurisdictions, particularly Europe and the UK.
- The extra risks (liquidity, market , concentration) when allowing RMBS and Covered bonds as HQLA would be mitigated by the following:
    - Haircuts – Level 2A assets subject to 15% haircut; Level 2B assets subject to larger haircuts (25-50%). Repo-eligibility haircuts could be used here.
    - Concentration limits - Level 2 assets limited to 40% of the total stock of HQLA; Level 2B assets limited to 15% of the total stock of HQLA

In conclusion, the ASF submits that securitisation can provide the system with diversity, innovation, flexibility and responsiveness. Hence we support the recommendation that regulators explicitly take into account its role and benefits in the future financial system when making regulatory determinations.

The ASF would be happy to meet with Treasury should you wish to discuss this submission in greater detail.

Yours sincerely

Chris Dalton

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