Australia > Securitisation

Australian Securitisation: RMBS spotlight

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National Australia Bank

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The Australian housing market represents approximately AUD1.2 trillion of residential mortgages outstanding. Home ownership remains central to the Australian culture with ownership levels at approximately 67%. Mortgages are predominately full recourse with a typical prime borrower being an owner occupier with a variable rate, principal and interest loan for a term of 25-30 years. However, RMBS notes are generally structured with a weighted average life of (WAL) of 3-5 years.

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The Australian RMBS Market is a non-agency issuer market with issuance conducted by a broad range of industry lenders from major banks and offshore banks to mutuals and building societies. Domestic demand for Australian RMBS continues to be strong and issuers have been recently encouraged by a greater participation of real money accounts in capital markets issuance.

Australian RMBS Performance 10

The underlying assets backing Australian RMBS continue to demonstrate stable arrears performance better than almost all other global markets. Arrears greater than 30 days past due, as measured by the industry benchmark of the S&P Prime SPIN, have consistently remained below 2% and severe arrears (>90 days past due) have remained below 0.80% for the past decade. Cumulative losses by vintage have been modest with the largest losses to date arising from the 2005 vintage at 0.2% of the total issuance for that year. Lenders' mortgage insurance (LMI) payout performance market wide has been consistently high at over 90%.

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As part of a package to improve banking competition and sustainability in Australia, legislation was passed in October 2011 by Federal Parliament amending the Banking Act 1959 (Cth) (Australian Act) to allow covered bond issuance. The Australian major banks were well progressed with programme establishment prior to legislation finalisation and have since issued circa AUD31bn (approximately two-thirds offshore).

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From a relative value perspective RMBS is primarily in competition with senior unsecured debt and more recently covered bond issuance from a range of bank issuers. Of the three products, covered bonds and RMBS are seen as more defensive products (due to their secured nature and triple A rating), with RMBS spreads generally remaining less volatile than senior unsecured and covered bonds during times of market volatility.

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1. The Australian Economy and Lending

The Australian economy shows every sign of continuing to grow at a moderate pace and remains fundamentally stable with low unemployment (at 5.2% June 2012), increased household savings (at close to 20 year highs) and low interest rates (RBA cash rate of 3.50% September 2012).

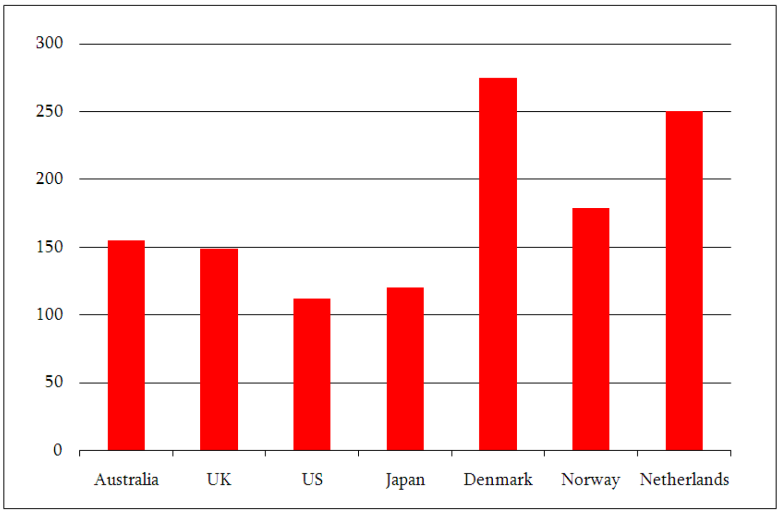
The housing market has shown tentative signs of stabilisation in 2012 following a period of considerable softness through 2011. National house prices weakened recently but only slightly as evidenced by the 2.1% weighted average house price decrease over the 12 months to June 2012, however short term indicators are pointing to the beginnings of house price stabilisation (0.5% rise for the June quarter, ABS). Building approvals as a leading indicator fell 2.5% in June following a 2.7% rise in May however private housing approvals remain weak. Australia is also experiencing a slow recovery in credit growth with the annual pace of growth still at a low 4.4% as at June 2012. Overall Australian house prices continued to defy the “property bubble” stigma. While property prices are expected to continue to soften, Australia’s housing market fundamentals including the ethos of home ownership, strong demand driven by an underlying national shortage of housing, stable economic conditions, conservative lender underwriting and low interest rates are expected to continue to support prices.

Economic Indicators	CY11 (A)	CY12 (F)	CY13 (F)
Private Consumption (%)	3.3	3.8	2.3
Underlying Business Fixed Investment (%)	1.1	-7.6	4.5
Dwelling Investment (%)	19.5	18.3	10.7
GNE (%)	4.3	3.8	3.0
Exports (%)	-1.3	7.0	6.4
Imports (%)	11.4	6.5	6.0
GDP (%)	2.1	3.6	2.9
Federal Budget Deficit (AUDb)	29.0	7.0	NA
Current Account Deficit (AUDb)	32.0	52.0	61.0
(%) of GDP	2.3	3.5	3.9
Employment (%)	1.6	0.8	1.3
Total CPI (%)	3.1	2.7	2.9
Core CPI (exc. Carbon) (%)	2.7	2.4	2.8
Core CPI (inc. Carbon) (%)	2.7	2.7	3.1
Unemployment Rate (%)	5.1	5.3	5.1
RBA Cash Rate (%)	4.25	3.50	4.00
10 Year Govt. Bonds (%)	3.67	3.50	4.30
AUD/USD	1.02	0.97	0.95
AUD - Trade Weighted Index	74.8	71.5	70.0

Source: NAB Group Economics (As at August 2012)

The wider Australian economy continues to be impacted by many significant forces and remains multi speed in nature with divergent conditions between different states, regions, and industries. The mining investment boom continues with the mining investment outlook remaining positive despite weaker commodity prices. Many services sectors (utilities, legal services, business professionals, health etc) are also reporting solid activity and confidence levels. The trade-exposed manufacturing sector continues to struggle with poor conditions, while the construction industry has softened noticeably on the back of a softening property market and reduced fiscal spending. Activity in industries dependant on consumer demand, retail and wholesale, remains soft – especially discretionary retailing. Heightened retail discounting in conjunction with a continuing high AUD has seen core inflation fall to levels towards the bottom of the RBA’s target range and could well go lower leaving further flexibility for policy moves. While the outlook for weakening global demand is likely to see further softening in commodity prices, they should remain high relative to history, keeping the terms of trade elevated. That in turn is likely to keep the AUD high.

Chart 1: Household debt to income ratio (%)



Source: RBA, Moody's.

Australian economic growth is increasingly sensitive to the Chinese economy. China overtook Japan as Australia's single largest export destination in 2009 due to rapid industrialisation fuelling strong demand for Australia's commodities given our close geographic proximity and abundance of natural minerals and resources. Expectation that China's demand for raw materials is set to increase, has led to an unprecedented pipeline of mining related capital expenditure in Australia which will drive economic growth for years to come. Should a significant economic downturn in China occur, Australia is in the fortunate position of still having room to stimulate the economy through expansionary fiscal policy and monetary policy. Moreover, both these arms of policy continue to have potency in terms of affecting domestic demand in Australia. A sharp decline in commodity prices would also lead to a sharp decline in the value of the Australian dollar. These policy responses and an Australian dollar decline would cushion the downside from lower commodity prices and export demand.

2. Features of the Australian Housing Market

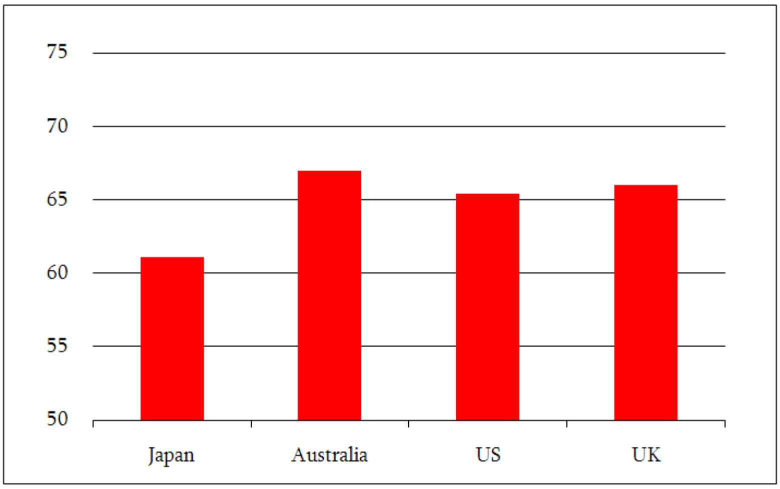
The Australian housing market represents approximately AUD1.2 trillion of residential mortgages outstanding. The four major domestic banks being National Australia Bank Limited (NAB), Commonwealth Bank of Australia (CBA), Australia and New Zealand Banking Group Limited (ANZ) and Westpac Banking Corporation (WBC) hold between 75% and 80% market share of the residential lending market. Market share of the majors increased through the GFC as borrowers looked to larger lenders in a volatile market and capitalised on the major banks' competition for market share in a credit constrained environment and significant consolidation in the industry.

The other prevalent lenders in the Australian market include other domestic banks including the non-major banks (such as Suncorp-Metway, AMP Bank, ME Bank, Bendigo and Adelaide Bank, and Bank of Queensland), global banks (including ING and HSBC), Credit Unions and Building Societies (including Heritage Bank and Credit Union Australia) and Non Banks (including Pepper Homeloans Limited, RESIMAC Limited, Liberty Financial Pty Ltd and Firstmac Ltd).

Home ownership remains central to the Australian culture with ownership levels at approximately 67%. Mortgages are full recourse with a typical prime borrower being an owner occupier with a variable rate, principal and interest loan for a term of 25-30 years. However, RMBS notes are generally structured with a weighted average life of (WAL) of 3-5 years.

"There has been a recurring question over recent years about Australian property prices and whether they are set on course for a correction. It is the fundamentals that we talk about: we have a fully-priced market and high household leverage, but we are also experiencing strong population growth. There isn't an oversupply in the market in general, and where there is – like south-east Queensland – there has been correction."
John Barry

Chart 2: Homeownership rate (%)



Source: Japanese House and Land Statistic Survey, Australia Census, US Census, English Housing Survey 2010-11.

3. The Australian RMBS Market

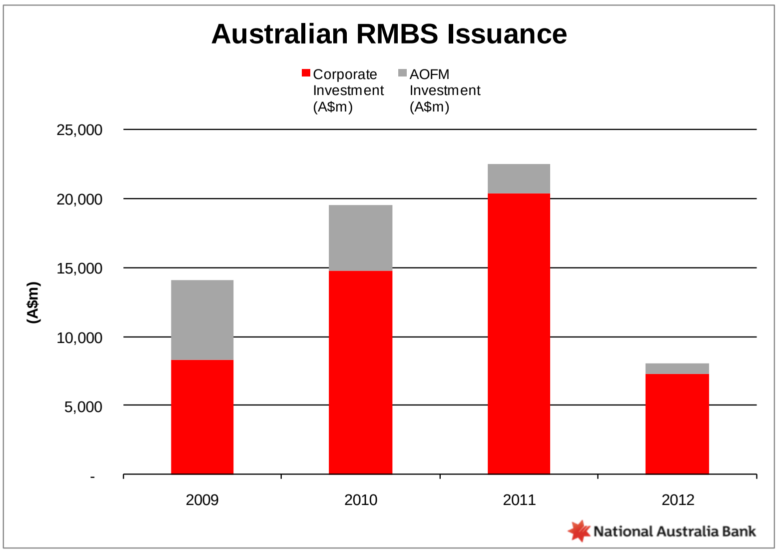
The Australian RMBS Market is a non-agency issuer market with issuance conducted by the full suite of industry lenders from major banks and global banks to mutuals, building societies and non-banks. Following the cessation of public issuance at the start of the GFC in 2007, support from the Australian Office of Financial Management (AOFM) assisted issuers to return to the debt markets in late 2008. Participation by the AOFM has supported 20 non-major bank issuers in 61 transactions totalling over AUD39.7bn.

Domestic and offshore demand for Australian RMBS remains relatively stable and issuers are encouraged by the greater participation of real money accounts in capital markets issuance. Throughout 2010 and early 2011, bank balance sheets and AOFM investment in RMBS provided for a significant portion of investor demand. Furthermore, the tailoring of senior RMBS tenors and other structuring innovation encouraged institutional investors to increase their participation. In late 2011 and 2012, we have seen an emergence of demand in the mezzanine and subordinated RMBS tranches as investors who understand the product and the historical strength of the collateral performance are attracted to the strong risk / reward proposition. Although offshore demand fell substantially following the GFC, we have recently seen the return of US investors, albeit at relative modest volumes. More encouragingly, we are also beginning to receive significant enquiries from other offshore markets such as Japan.

"It is definitely a worthy cause to try to tap into offshore investors but I think it will be a challenge. In the end it will be investors who are comfortable with the underlying pools and the quality of the servicer, and who have formed a view on the sufficiency of the first loss and the benefit of LMI, who participate In a recent non-conforming transaction we were able to sell specialist loan-backed paper, without LMI, to offshore investors right down the capital structure to single-B notes. That gives us some cause for optimism."

John Barry

Chart 3: Australian RMBS Issuance (Jan 09 to Aug 12)



Source: NAB

4. Features of Australian Mortgages

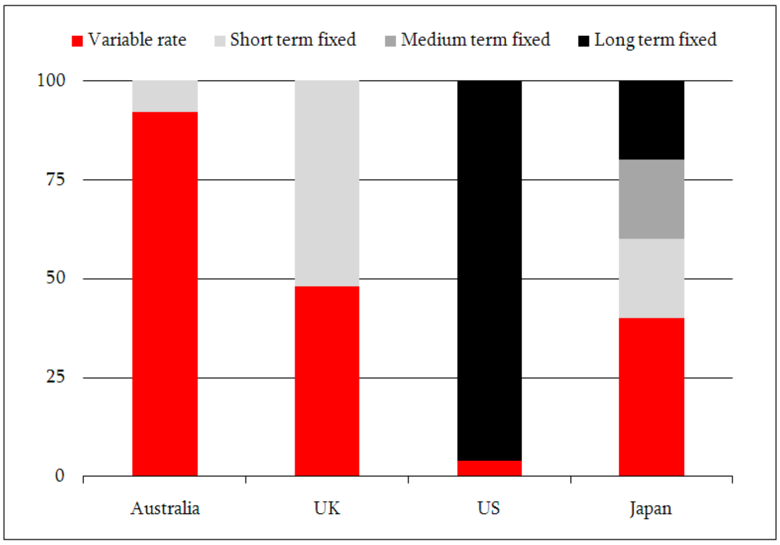
Australian residential mortgages are primarily to owner occupier borrowers (approximately two-thirds), amortising principal and interest, and variable rate. Investment loans are common primarily due to the favourable tax treatment whereby mortgage interest is tax deductable for these properties only. As a result, the popularity of interest only investment loans has increased to take advantage of the tax treatment, deferring the repayment of principal to a later date.

Fixed rate home loans peaked at approximately 25% of new applications in March 2012 according to the AFG Mortgage Index (AFG is the largest mortgage broker who processes mortgage applications of between AUD2-3bn per month) and has since reduced to 16.5% in June 2012 reflecting the expectation of continued low interest rates. The average mortgage size has consistently remained below AUD400k and the loan to value ratios (LVRs) remain stable at mid 60% levels reflecting additional lender conservatism. Over the last 12 months, refinancing has remained above 35%. Since the GFC, the market share of the major banks has fallen slightly to under 80% as brokers, non-banks and other Authorised Deposit-taking Institutions (ADIs) gradually recover market share.

"We have spent a lot of time educating offshore investors on our mortgage market. That includes themes like the full-recourse nature of Australian loans, the fact that our owner-occupied loans are non-tax deductable – which encourage faster repayment – and the fact that we have not had a decline in lending standards such as that experienced in the US."

John Barry

Chart 4: Interest Variability (%)



Source: International Comparison of Mortgage Product Offerings (2010), Dr. Michael Lea, San Diego State University

5. RMBS structural features

Australian RMBS has been issued with a range of innovative structural features which have been adopted to respond to the underlying loan characteristics, lender product features, the regulatory environment and investor requirements.

Australian public RMBS issuances have predominantly been closed pool issuances. Master Trust issuance is not currently a feature of the Australian market due to its ineligibility under the current regulatory framework. Work is currently underway to develop an Australian master trust structure that would work within the prudential framework going forward. Public series RMBS issuances rarely have substitution periods, and thus allow for a more exacting risk assessment at the transaction's inception. Additionally, Australian issuers have been transparent in their reporting, with line by line loan data becoming more readily available to investors.

"The Australian market is relatively unique in the lack of agency parties associated with RMBS. While issuances in the Australian market have been supported by the AOFM, there is no government housing lending agency, nor are there mortgage insurance providers supported by the government."

John Barry

The majority of new Australian RMBS structures now also benefit from formalised back-up servicer arrangements which are in place should the original servicer (in most cases the originator) default or be unable to perform their obligations in respect of servicing the securitised portfolio. The documentation formalises the roles, responsibilities and procedures for the back-up servicer to perform their duties if required.

The following are additional structural features in relation to loan characteristics and mechanisms in Australian RMBS Structures:

Redraws and further advances – Australian borrowers are generally permitted to redraw on their mortgage back up to the schedule balanced (for amortising loans). This is available where borrowers have repaid their mortgage principal ahead of their scheduled repayments. Redraws are commonly accommodated within the RMBS structures. By contrast, loans approved for a further advance are generally subject to a re-underwrite by the respective lender. Securitised mortgage pools generally require loans which have been approved for a further advance to be removed (repurchased by issuers) from RMBS pools.

Threshold rate mechanism – The lender is generally required to maintain a minimum interest margin on the securitised mortgage loans that is sufficient to cover all fees and expenses of the trust, plus a margin buffer (usually 0.25%). Bank issuers often include a basis swap to maintain a certain margin.

10% Call Option – In 2008, APRA banned date-based calls for ADI issuers, with only 10% clean up calls being permissible. Subsequently, the wider market has conformed to a 10% call option allowing the issuer to ‘clean-up’ the outstanding loans in a public term securitisation once the outstanding loan balance falls below 10%. Should an ADI issuer already have a date-based call, it can only be exercised if the pool has paid down to 90% of its original balance. Australian nonconforming RMBS issuers (only non-bank) at times provide call options at 20-30%.

Equitable Assignment – Allows the seller to remain the lender of record and is the prevalent approach for assigning mortgages to a special purpose vehicle (SPV) to undertake an RMBS issue. The alternative being legal assignment is generally avoided due to the requirement to notify borrowers and change title documents for the new mortgage interest.

Legal Title Perfection – Occurs when the legal title of the mortgage loans is transferred to the SPV, making it the legal owner (rather than just holding a beneficial interest) in the loans. Title perfection events are outlined in the transaction documents and usually pertain to the unsatisfactory performance of a key transaction party.

Excess Spread – Excess spread is the income available post the payment of all note coupons and amounts due to secured creditors. To the extent available excess spread can be applied to meet net credit losses post the payout from LMI providers or reinstate any unreimbursed note charge-offs carried forward from prior periods. Should income still remain at the bottom of the payment waterfall, it is released to the residual income unitholder (or retained for additional credit enhancement) on the payment date.

Set off risk – Set-off risk may arise in Australian RMBS if the issuer is a deposit-taking institution and the loans have been equitably assigned to the trust. That is, if the seller becomes insolvent, borrowers may seek to offset payments due against deposits held by the bank. The risk is usually mitigated by explicit terms in the underlying mortgage agreements stating that the loan payments are required to be free from set-off.

Bankruptcy Remote – RMBS are structured to be bankruptcy remote with repayments based on the cash flows of the underlying assets legally belonging to the trust only, with no recourse back to the issuer. Similarly, parties other than creditors of the SPV do not have claims against the SPV’s assets (eg. In originator insolvency).

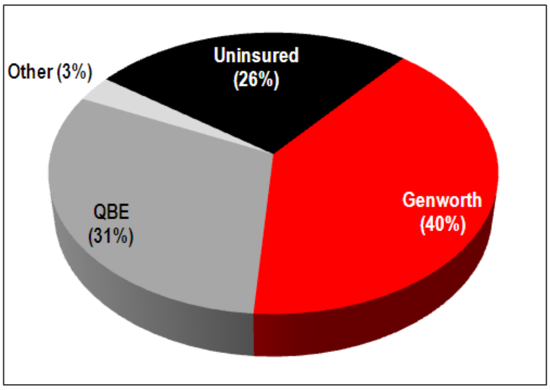
Pro rata Repayment – Subject to certain performance and structural triggers including a minimum time period from issuance, RMBS transactions can convert to pro rata repayment which allocates principal proportionally to all tranches based on the note balance outstanding. As credit enhancement is required to have built to certain levels by this time (typically double the initial credit enhancement level), this mechanism preserves the credit profile of the structure (which has improved since inception) while reducing the weighted average margin over time for the issuer.

Liquidity Mechanisms – Required in all rated RMBS structures to be available to meet interest payments to secured creditors in the event that there are timing mismatch between income collections and required payments. Liquidity mechanisms can be in the form of a committed facility from a lender to the SPV, a cash reserve or principal draws which allow principal collections to meet certain interest obligations.

6. Lenders' Mortgage Insurance (LMI)

LMI is a standard feature for >80% LVR loans and features in many Australian prime RMBS structures. Typical prime RMBS pools have up to 100% cover for principal loss, foregone interest and reasonable expenses. Over the past decade of global volatility and instability, the financial performance of the Australian LMI providers has remained sound. The two most prominent insurers in Australia are Genworth Pty Ltd and QBE LMI Ltd, who continue to pay valid claims in a timely manner. S&P have affirmed the financial strength and issuer credit rating of both LMI providers at 'AA-/Stable' (Genworth August 2012, QBE September 2011) in recognition of their respective market leading positions in the LMI industry, financial strength, operating performance and very strong capitalisation. There has never been a charge-off to any rated Australian Prime RMBS Note.

Chart 5: LMI Distribution of Australian Prime Securitised Mortgages



Source: S&P

LMI providers essentially provide an additional layer of credit assessment of the mortgage following the originator's initial assessment and underwrite. Only once the file is reviewed by the LMI, or in some cases where authority has been delegated, is considered by the originator to have met the LMI underwriting criteria, can insurance be granted. Lenders who have delegated underwriting authorities from the LMI providers are monitored. Major bank and larger lenders typically only seek to insure prime mortgage loans with LVRs greater than 80%, although blanket policies can be taken out to insure loans with LVRs greater than 80% for RMBS to ensure all loans have LMI cover. Non-conforming mortgage loans are not covered by LMI.

7. Australian RMBS Collateral Performance

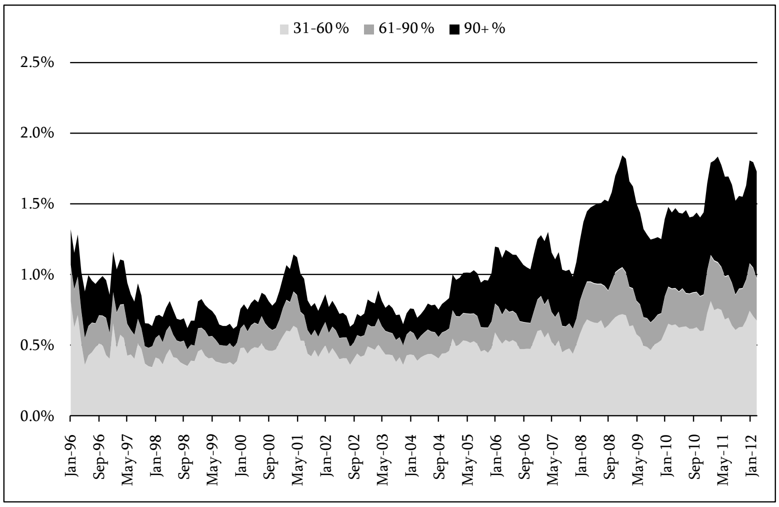
Arrears Performance

Australian RMBS continues to demonstrate strong stable performance, better than almost all other global markets. Arrears greater than 30 days past due, as measured by the industry benchmark of the S&P Prime SPIN have consistently remained below 2% and severe arrears (>90 days past due) below 0.80% over the past decade, see Chart 6 below. Cumulative losses by vintage have been low with largest losses to date arising from the 2005 vintage at 0.2% of the total issuance for that year. LMI payout performance market wide has been consistently at over 90%. Interestingly, Australian Prime RMBS arrears continued to perform well during the GFC in 2008 and 2009, particularly relative to other parts of the world.

"There is also a perception that Australia has a high-quality banking system which is extremely helpful – and, from our perspective, well-deserved. Offshore investors appear to welcome the involvement of Australian banks in deals as mortgage underwriters or as support facility providers. In the flight-to-quality environment that has emerged in recent times Australian issuers have been able to benefit from this."

John Barry

Chart 6: S&P Australian Prime RMBS Arrears Performance

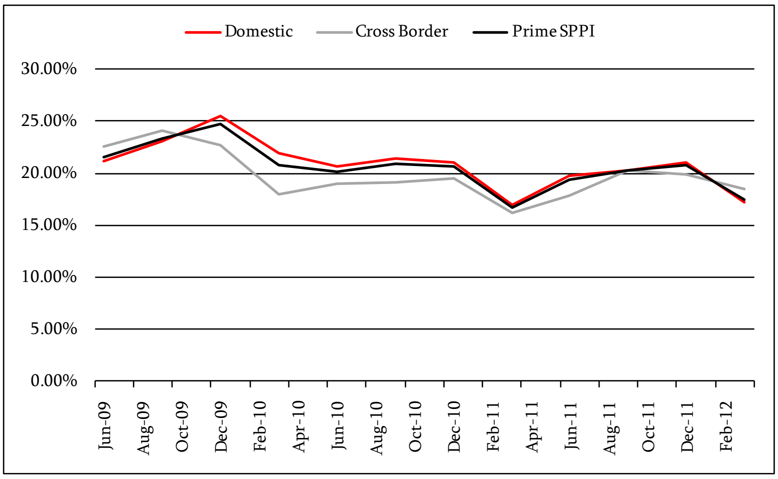


Source: S&P

Prepayment Statistics

Prime mortgage Constant Prepayment Rates (CPRs) have trended lower in recent years at approximately 20% down from 25% in 2009. Nonconforming mortgage CPRs have also trended down towards 25% following the 30%+ CPRs experienced prior to 2009. This can be attributed to many factors including availability of credit, and the tightening of lending criteria which reduces the opportunities for self employed and other non-conforming borrowers to refinance, and the effective elimination of no-doc products (due to the National Consumer Credit Protection (NCCP) regulations) which resulted in non-conforming products becoming closer in credit quality to prime.

Chart 7: Australian Prime Standard & Poor's Prepayment Index (SPPI) by Market



Source: S&P

Australian bank issuers have a strong history of meeting calls excluding date based calls incorporated in earlier deals and subsequently prohibited by APRA. ADI issuers are now permitted to use percentage calls (10%) to continue to call deals consistent with standard practice in order to provide comfort to investors concerned about extension risk. Non-call risk is further mitigated by issuer reputational drivers and structural features including step up margins on the notes. Warehouse banks remain conscious of issuer call requirements and have supported many issuers to meet clean up calls where required. The Australian market has seen the reshaping and consolidation of the non-bank issuer market which has resulted in some issuances from names no longer active in the market remaining outstanding beyond call dates.

The strength in the arrears and loss performance of Australian RMBS are likely attributable to the stringent underwriting standards of Australian lenders relative to other markets. Funders, rating agencies, and investors complete in depth due diligence on lenders and the stringency of their underwriting standards, controls and performance. Of recent focus has been the conservatism of the property valuations which is of particular importance for validating LVR assessments in a declining house price environment. Borrowers are typically qualified on a buffered interest rate to assess their ability to meet repayments in a rising interest rate environment. Lenders rigorously assess borrower employment history, income and credit history to both satisfy the requirements under NCCP and ensure that the credit quality of the lending book is consistent with sound risk management practices.

8. Structures and Innovation

Since 2008, typical prime Australian RMBS have incorporated a three tranche structure with Class A, AB and B notes. The Class A note tends to be a 3-3.5y weighted average life (WAL) pass-through note targeted at domestic investors. However, alternative investor demand has been catered for through innovative structuring techniques.

Novel structures and the re-emergence of offshore issuance have assisted issuers in broadening investor bases and reduce reliance on AOFM support. This has included the return of bullet structures, both soft bullets with a scheduled refinance date and hard bullets supported by a committed redemption facility that can be drawn if refinance via reissuance is unsuccessful. Redemption facilities have also been used to provide fixed date put options to investors enabling them to redeem their securities at certain documented dates to mitigate extension risk.

Controlled amortisation tranches have also been incorporated in order to manage extension risk and minimise the costs of a balance guarantee cross currency swap for issuances of foreign currency amortising tranches. Offshore issuance has resurged with Australian issuers structuring JPY and USD tranches in order to satisfy specific demand for target investors. Greater structuring flexibility and innovation has encouraged reverse enquiry issuance for certain names, allowing issuers to opportunistically enter the market and provide investors with a tailored investment product.

SMHL Series SF 2012

- On 13 April 2012, Members Equity Bank Pty Limited (ME Bank) priced the second residential mortgage backed securities issue for calendar 2012 being the SMHL Series Securitisation Fund 2012-1.
- NAB was appointed Arranger and Joint Lead Manager on the deal and had been actively exploring ways to diversify investor markets and innovate in alternative markets.
- The deal, which offers different securities in various currencies for investors, splits the securities to provide a US dollar tranche of bonds aimed at the US money market investors, a tranche tailored to meet the requirements of fixed rate investors and more traditional tranches

9. Australian Office of Financial Management (AOFM)

In September 2008 the Australian Government announced that the AOFM could purchase triple-A rated RMBS to support competition in the mortgage market. The program is targeted towards lenders historically dependent on the securitisation market and is not available for the major banks or nonconforming lenders. The program has been increased several times and had a total investment mandate of AUD20bn to date with AUD15.5bn invested (as at end of August, 2012).

The AOFM investment mandate requires the pool composition to be within strict criteria such as 100% prime, mortgage insurable residential mortgages with a maximum loan size of AUD750k, maximum LVR of 95% and additional requirements for low documentation loans where the 10% threshold is exceeded.

The AOFM will perform regular reviews of its investment program in consideration of changing market conditions and has publicly encouraged a transition towards a sustainable and innovative securitisation market that is not reliant on Government financial support. This will encourage further development of sustainable RMBS deal structures including deepening both Australian and offshore investor bases. NAB has also seen increasing demand for mezzanine and subordinated tranches of RMBS structures demonstrating the attractive risk / return profile of both the prime and nonconforming Australian deals.

10. Rating Agencies

Australian RMBS issuance is generally rated by two of the three major Rating Agencies in Australia, being Standard and Poor's (S&P) Moody's Investor Services (Moody's), and Fitch Rating Services (Fitch). All three rating agencies have recently introduced more conservative criteria relating to the assessment of Australian mortgage risk, counterparty risk (for support parties such as cross currency and interest rate swap providers), and ratings of LMI providers. This has resulted in higher levels of credit enhancement (provided predominantly through subordinated tranches) being required in recent transactions (since 2010), and almost all prime transactions now featuring a senior triple A tranche which has been assessed as being independent of LMI (so can withstand the stresses applied assuming there is no LMI to cover any losses).

11. Australian Regulatory Framework

The Australian Banking System is regulated by the Australian Prudential Regulation Authority (APRA) which was established on 1 July 1998 and in addition to regulating the banking industry has the responsibility for the regulation of the insurance and superannuation industry. Australia has a "twin peaks" model of regulation with APRA as the prudential regulator and the Australian Securities and Investment Commission (ASIC) regulating market conduct and disclosure.

The strength of the banking system is evidenced by the major banks' current 'AA-/Stable/A-1+' (S&P) credit rating and their stable performance through the GFC. During the GFC, all major banks remained profitable and were able to raise wholesale funding to assist the continuation of lending.

For Securitisation, Banks are regulated by APRA under the applicable regulatory standard being APS 120. APS 120 outlines the capital requirements for Banks undertaking securitisation and in respect of Securitisation exposures held by them. Key additional regulatory requirements and industry frameworks in relation to Australian RMBS are as follows:

Skin in the Game

Australia's "skin in the game" approach is still being debated and discussed amongst industry participants. "Skin in the game" refers to the issuer-retained subordinated tranches in RMBS which is viewed as alignment of the interests of issuers and investors and assist in ensuring best practice lending by issuers.

National Consumer Credit Protection (NCCP)

NCCP is a regulation for mortgage lenders including a requirement for lenders to assess and verify the suitability of loans for borrowers. On balance, the NCCP regulation has enhanced the quality of lending, in particular low documentation lending as lenders must take greater care in ensuring borrowers have adequate means to repay their loans. In conjunction with NCCP, borrowers now have two industry bodies which are available for arbitration should conflict in relation to lender standards and behaviours occur.

"One question we have been asked is around whether the market needs more or less regulation. The Australian regulatory environment has proved very effective throughout the crisis era, with the conservative stance of the local regulators serving us well.
The challenge is around the sheer volume of regulatory change and the difficulty engendered by the uncertainty involved. I'm sure the market will adapt to new regulation, but ideally what we need is more regulators harmonisation between Australian and international rules. We certainly want to avoid a situation like the one that has occurred in Europe where regulations are biased against securitisation product and in favour of covered bonds."

John Barry

12. Covered Bonds

"One of the reasons investors sometimes prefer covered bonds over standalone RMBS is the additional liquidity."
John Barry

In October 2011 as part of a package to improve banking competition and sustainability, legislation was passed by Federal Parliament by way of amendment to the Banking Act 1959 (Cth) (Australian Act) to allow covered bond issuance. The Australian major banks were well progressed with programme establishment prior to legislation finalisation and have since issued circa AUD31bn (approximately 2/3 offshore) since inception.

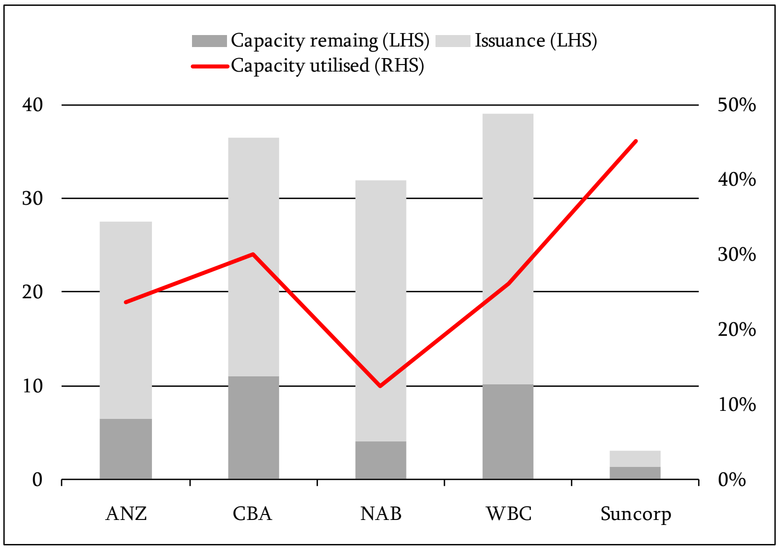
Covered bond issuance is capped at 8% of the aggregate value a Bank's assets. The four major banks have issued between 13-32% of their caps to date (16 July 2012).Covered bonds are dual recourse instruments having recourse both to the covered bond issuer and the series assets.

The series assets are segregated pools with the assets unavailable to general creditors of the bank in the event of its insolvency (therefore not available to depositors). Bank issuers must maintain (3%) over-collateralisation. Eligible assets for covered pools are limited to residential mortgage loans (up to 80% LVR), commercial mortgage loans (up to 60% LVR), cash, government securities, bank accepted bills or certificates of deposit (up to 15% of the cover pool), hedging transactions and other assets approved by regulation.

While covered pools and RMBS are created from the same collateral, RMBS is expected to remain strategically important to bank issuers for both funding diversity and the ability to issue in volume without being restricted by a cap, as demonstrated through 2011 where the Australian major banks issued AUD10.8bn of prime RMBS in deal sizes of between AUD1-3bn.

Additionally, in conjunction with covered bonds, AAA rated RMBS remains strategically important to both issuers and Australian investors due to their repo eligibility with the RBA. Both covered bonds and RMBS will qualify as collateral under the RBA committed liquidity facility provided to Australian banks to meet liquidity coverage ratio shortfalls under Basel III. Australia Covered Bond Issuance volumes to date (August 2012) are depicted in the chart 8 below.

Chart 8: Australian Covered Bond Issuance (A$bn)



*Issuance capacity based on the current size of bank resident assets and overcollateralisation levels

Source: APRA, RBA

13. Relative Value of Australian RMBS

Australian RMBS provide offshore investors a geographically diverse investment in a stable political, social and economic environment.

Pricing

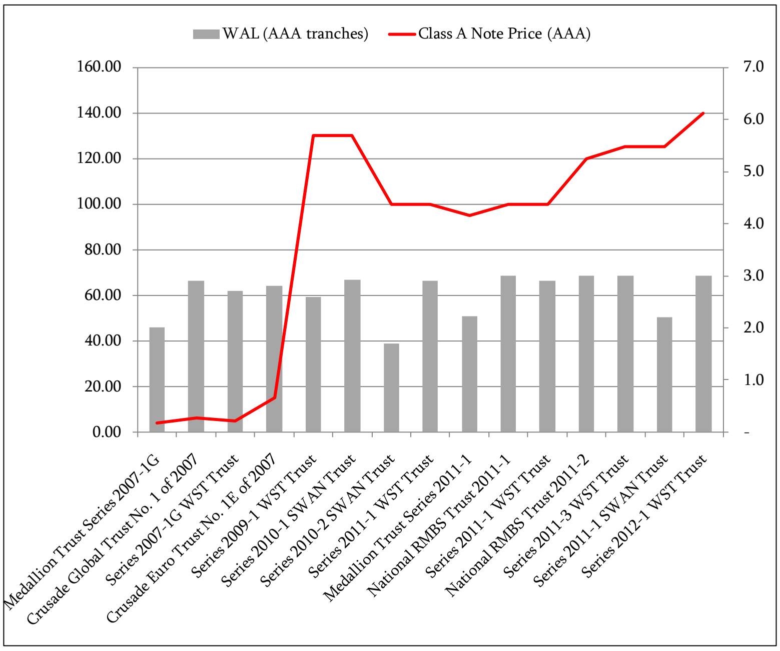
From a relative value perspective RMBS is primarily in competition with senior unsecured debt, and more recently covered bond issuance from a range of bank issuers. The table below details the current relativities in major bank issuance:

Product	Spread (bps)	Benchmark	Comment
Covered Bond	60-65	3M BBSW	Multiple price points, AAA Rated, Liquid
Senior Unsecured	85-90	3M BBSW	Multiple price points, AA- Rated, Liquid
RMBS	c140	1M BBSW	Usually 2.5-3yr, AAA Rated, Secondary market usually more brokered in nature

Source: National Australia Bank (As at 18 September 2012)

Of the three products Covered Bonds and RMBS are seen as more defensive products (due to their Secured nature and triple A rating), with RMBS spreads generally remaining less volatile during times of market volatility.

Chart 9: Weighted Average Life (WAL) and Pricing of Major Bank RMBS Issuance in Australia



Source: NAB Syndicate (As at May 2012)

Buyers

- It is important to note that there are two categories of domestic investor, and whilst they both require spreads on RMBS to make sense from a relative value perspective, they also have different motivations in relation to the product.

Bank Balance sheet

- Repo eligible / Committed liquidity facility inclusion an attractive feature
- Generally more buy and hold investors
- Buy in size

Fund Manager

- Look purely at the relative value
- Bid according to their mandate / asset allocation overlay
- Accept that it is not the most liquid product on issue
- More focused on Issuer type (Bank, Credit Union, non-bank)

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