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Phase 2 of the Reserve Bank Act Review
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Response to Phase 2 of the Reserve Bank Act Review

The Australian Securitisation Forum (ASF) appreciates the opportunity to respond to the Treasury's Phase 2 Review (and Background Paper) on *Safeguarding our Financial System: The Role of the Reserve Bank and how it should be governed* (November 2018) (Phase 2 Report).

The ASF was formed in 1989 and is the peak industry association representing participants in the Australian and New Zealand securitisation market. A primary role of the ASF is to facilitate the development of industry views and to represent those to policy makers and regulators in Australia, New Zealand and globally. Key objectives of the ASF include supporting the enhancement of market standards and practices, delivering professional development workshops to build the professional standards of industry participants and to promote the Australian and New Zealand securitisation markets to local and global stakeholders. The ASF, in representing a successfully operating regional securitisation market, supports any proposal that strengthens global securitisation markets.

A. <u>Securitisation markets background</u>

Securitisation markets are a key funding channel for an economy, increasing the availability and reducing the cost of funding for households and companies by opening investment opportunities to a wider investor base, diversifying risk across these economies and offering a reliable source of funding for banks and non-bank lending institutions.

Securitisation has traditionally contributed to funding real economy assets such as residential mortgages, auto loans and SME lending and other assets. At a time when businesses and households in many developed economies are experiencing difficulties in accessing finance, securitisation can improve the availability of credit. A functioning and diverse securitisation market plays an important role in developing wholesale funding markets and, in turn, supporting economic growth. It also facilitates investment by wholesale fund managers (including

KiwiSaver), allowing NZ entities to raise domestic debt rather necessarily having to borrow offshore.

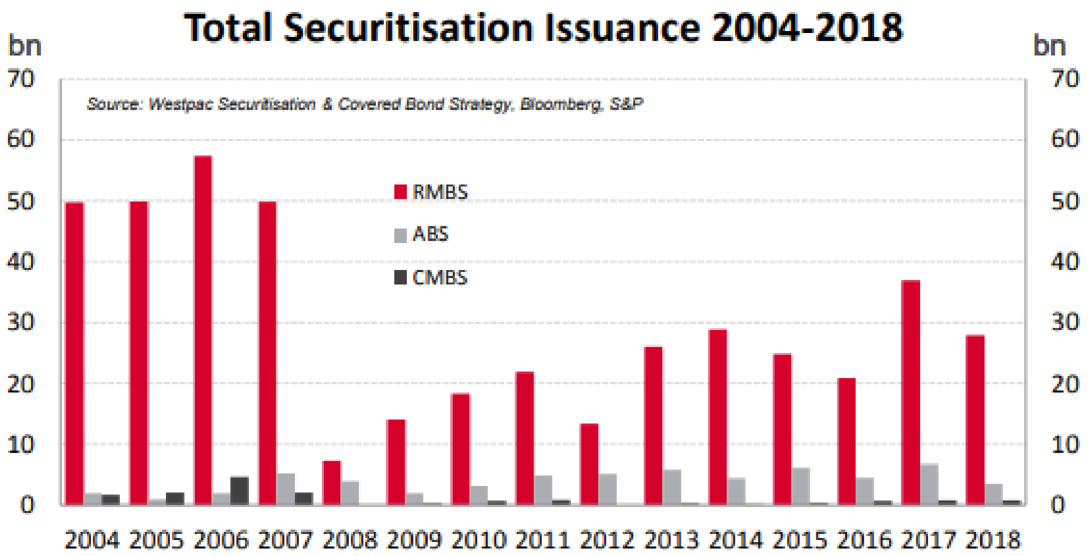
B. Australian securitisation market

In considering the future scope of New Zealand's regulatory perimeter of prudential supervision it is beneficial to explore whether it conforms to international practices in other jurisdictions such as Australia which has a similar financial system to New Zealand. The Australian securitisation market has a history extending back more than two decades. In 2018 public Australian securitisations totalled A$32.3 billion. The dominant asset class is RMBS which represented 87% of all 2018 public securitisations. The remaining 13% includes consumer and SME ABS and commercial mortgage-backed securities (CMBS).

A variety of Australian issuers use securitisation to fund their businesses including banks and other Authorised Deposit Taking Institutions (ADIs) and wholesale funded non-bank lending institutions (NBLIs). All these entities are regulated by either the Australian Prudential Regulation Authority (APRA) or the Australian Securities and Investments Commission (ASIC).

The following chart illustrates annual issuance in the Australian securitisation market

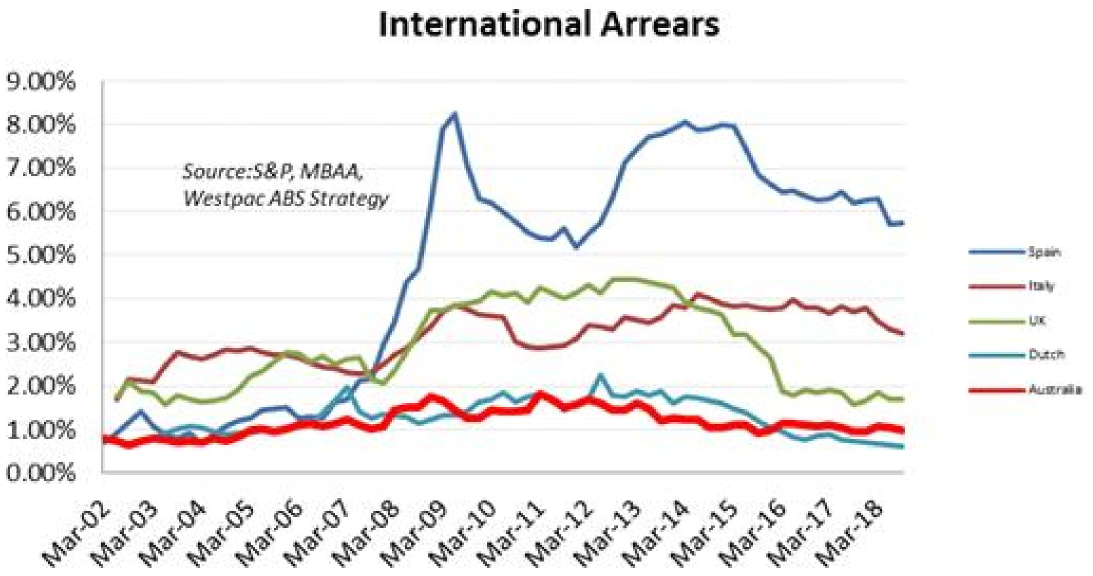
Chart 1



Source: Westpac Banking Corporation

The credit performance of Australian securitisation has been strong and consistent over the last 16 years. Investors have not incurred any loss, prior to or post the GFC, in an Australian RMBS or ABS with an investment grade credit rating, which includes securitisations issued by Australian NBLIs. Although deal volumes dropped post GFC the market continued to function well with continued strong credit performance, albeit with support from the Australian Office of Financial Management (AOFM). The credit performance of the largest asset class RMBS is illustrated below

Chart 2



C. <u>Regulation of the securitisation market in Australia</u>

In Australia, the key regulation of securitisation is Australian Prudential Standard 120 which is administered by the prudential regulator, APRA. This Standard was reviewed several years ago and an updated Standard came into effect in January 2018. APS 120 reflects Australia's adoption of the Basel reforms of regulatory governance of securitisation. More generally APRA and ASIC take a proactive regulatory approach to securitisation but have a supportive policy position towards the role and benefits of securitisation in funding Australia's economic growth.

A supportive regulatory framework creates a well–functioning, transparent securitisation market enabling the development of a diverse and competitive financial landscape. The regulation is targeted to the circumstances of the securitisation segment of the financial market, in which the investors are sophisticated and well-resourced local and international fund managers and other wholesale investors. In particular, it seeks to manage the interconnection between the wholesale securitisation market and prudentially-regulated ADIs, through capital adequacy measures calibrated for ADIs' exposure to the sector, for example by way of warehouse financing facilities.[1] Extending the reach of the RBNZ regulatory perimeter of prudential supervision to directly include NBLIs (that are not in the business of accepting retail deposits) is more than is required to manage the exposure of regulated entities or otherwise

[1] In which a pool of receivables is funded using a securitisation structure initially by an ADI and the originator (which must contribute equity and other credit support). Once there is a pool of receivables of a marketable size, this is sold on a 'pass-through' basis to investors in the wholesale capital markets.

protect the financial system and could have unintended consequences by reducing diversity and competition.

D. Regulation of NBLIs in New Zealand and Australia

The Reserve Bank's prudential mandate relates to the "*efficiency and soundness of the financial system*". The NBLI sector in New Zealand is not involved in the payments system and does not take retail deposits. The data provided in the Phase 2 Report indicates that wholesale funded NBLIs constitute approximately 1.6% of financial system assets. At that level, NBLIs present little threat to the soundness of the financial system given their size as a proportion of the overall market. In addition, the business and funding activities of NBLIs are subject to regulation under New Zealand's financial services laws (including responsible lending obligations), detailed oversight and rigorous market discipline through a combination of bank credit monitoring, institutional investor scrutiny (deal specific and ongoing) and granular credit rating assessments. This is underpinned by the securitisation funding model predominantly employed by NBLIs, which passes the risk of the performance of securitised assets to wholesale sophisticated investors. Thus, it would be incorrect to suggest that NBLIs are not in any way regulated. It is unclear how the application of "prudential" regulation to non-deposit taking NBLIs would positively contribute to financial stability.

The regulatory perimeter for prudential supervision in Australia, UK and Europe is set by reference to whether the lender accepts deposits from the public. In Australia, the Banking Act distinguishes those entities which are regulated ADIs, which take retail deposits, from wholesale funded NBLIs which are outside the prudential regulatory framework administered by APRA. Issuers of securitised assets who are regulated by APRA include the four large Australian banks, regional banks and other smaller mutual banks. While NBLIs are not directly regulated by APRA, they will be subject to new data reporting obligations from June 2020 under the Financial Sector Collection of Data (FSCODA) regime. The Reserve Bank of Australia already imposes reporting requirements for repo eligible notes which ADIs and NBLIs comply with.

NBLIs in Australia are mostly regulated by ASIC in respect of conduct and disclosure requirements. Both ADIs and NBLIs must comply with the provisions of the National Consumer Credit Code regarding responsible lending. This regulatory arrangement is closely aligned with the situation in New Zealand under the FMCA with the FMA acting as conduct regulator, and under the CCCFA with the Commerce Commission overseeing consumer lending and lender conduct, with broadly similar responsible lending principles as those administered by ASIC in Australia.

The regulation of NBLIs in Australia was reviewed by the Australian Government in 2017 with new laws introduced in 2018 to ensure that the activities of NBLIs will not have an adverse impact on the stability of the financial system at any time. However, the Government acknowledged that this initiative is a protective measure in the event that the sector grows exponentially, noting that non-deposit taking NBLIs currently only represent approximately 6% of financial system assets in Australia even if NBLIs have been the most frequent issuer type in the securitisation markets over the last 2 years (reflective of NBLIs' funding models). Although APRA will be entitled to receive from NBLIs FSCODA reporting data from June 2020 (to assist in monitoring the activities of the NBLI sector in Australia), the prudential supervision of ADIs has not been broadened to include NBLIs. The combination of existing laws and structural features of the wholesale securitisation markets, which NBLIs predominantly rely on to fund their assets, function to successfully regulate NBLIs, whilst ensuring sustainability of their business models and their ability to complement ADI funding channels.

E. Impact on competition for NBLIs

While Australian NBLIs were frequent and active securitisation users of wholesale funding via the capital markets before the onset of the GFC, the GFC's impact in relation to the scarcity of market liquidity meant that NBLIs needed to rely on support that the Australian Government made available through the AOFM. After 2012 the NBLI sector in Australia was able to access the capital markets again without AOFM support solely. In contrast, the New Zealand securitisation market, which had no direct Government support, opened again with two public securitisations in 2010 but has not grown at the same rate as in Australia.

Indeed, the debt capital markets can be volatile and reactive and any uncertainty on the viability of NBLIs could have negative effects on the confidence of market investors to fund NBLIs. To indicate that the regulatory perimeter of the Reserve Bank's prudential function should include NBLIs on the basis that NBLIs might pose a future threat to financial stability in New Zealand may have the potential to adversely affect the sustainability of NBLIs' business models, further reducing competition, entrenching the market power of regulated deposit taking institutions, restricting innovation and productivity in the financial sector and ultimately impacting the retail borrower.

Furthermore, a lot of work has been put into educating investors, both domestic and offshore, that investment in NBLI sponsored securitisations is of no greater risk than investment in regulated bank sponsored securitisations. These initiatives are wholly dependent on maintenance of strong credit quality and prudent business practices – including underwriting and loan servicing – a key feature of the NBLI model is that its funding community is sophisticated, has the ability to assess and price for risk, and has no ongoing compulsion to invest. Investor and rating agency due diligence and credit work is rigorous and is highly focused on these matters.

F. Harmonisation and regulatory intervention

As noted above, New Zealand has a similar prudential regulatory framework for banks and non-banks/NBLIs as Australia, including that wholesale funded NBLIs are not subject to prudential supervision. Harmonisation of the prudential framework between the two jurisdictions should ideally be strengthened particularly because the vast majority of the New Zealand banking and insurance system by assets is Australian owned and APRA regulated. Obviously, there are some differences such as the FSCODA regime that now applies to NBLIs in Australia.

The need for regulatory intervention must be proportional to a risk or foreseeable risk to the stability of the financial system and whether there are adequate safeguards in place or not. Where the position is unclear or unresolved, a reasonable approach is to provide for new or alternate information and data reporting requirements to enable the regulators to monitor and respond to any emerging risks or other negative trends relevant to stability and efficiency. We understand that such an approach would be consistent with the graduated and risk-based approach recently recommended by the Reserve Bank in relation to financial markets infrastructure (i.e. payments and settlement systems), allowing the Reserve Bank to monitor that sector with enhanced oversight.

The ASF would welcome the opportunity to discuss any of the matters and views set out in this response with you by conference call. Furthermore, we would be happy to organise a face to face roundtable discussion with members of the industry and the Treasury to discuss the processes (e.g. legal and market driven checks and balances) that NBLIs follow to gain access to their funding needs in the wholesale markets.

Yours sincerely

Chris Dalton

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