RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

RESIDENTIAL MORTGAGE OBLIGATIONS (RMO)

INTRODUCING A HIGH GRADE RESIDENTIAL MORTGAGE-BACKED SECURITIES FRAMEWORK FOR NEW ZEALAND

SUMMARY OF SUBMISSIONS

August 2019

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APPENDIX

1. Background

This document provides an update on the Reserve Bank's (the Bank's) proposal to introduce a high grade residential mortgage backed securities framework for New Zealand through the introduction of Residential Mortgage Obligations (RMO).

It includes a summary of the key issues remaining with regard to the RMO policy, and outlines the next steps to a policy for simple, transparent and comparable mortgage bonds.

Appendix A informs readers about the answers given by submitters to questions the Reserve Bank proposed on RMO in the second consultation. Appendix B summarises the comments and mark-ups received on the residential mortgage framework's draft terms and conditions.

2. Consultation process and progress

The RMO conceptual framework is intended to provide markets with a simple, transparent and comparable (S-T-C) mortgage bond standard, taking account of the lessons learned from the prevailing liquidity and funding regimes in New Zealand and incorporating best practice as outlined by the Bank for International Settlements.[1]

The Reserve Bank published a second consultation paper in November 2018 aimed at introducing a high grade residential mortgage backed securities standard in New Zealand. This followed a review of mortgage bond collateral standards during 2017 and the publication of a summary of findings and first consultation on RMO in November 2017.

Over the course of these two consultations the Reserve Bank has engaged extensively with future issuers and investors in the proposed new standard, as well as with participants already engaged in conventional RMBS. The Bank discussed its proposal in workshops, panel discussions and a round table, and also with a range of stakeholders internationally (such as rating agencies, liquidity portfolio managers and debt capital market brokers).

Overall, the Reserve Bank considers that the consultation process has been successful in delivering major improvements to the initial concept for a new mortgage bond standard to support financial intermediation, liquidity management and funding in New Zealand's markets.

The feedback from issuers, investors and other market participants has been constructive and has helped greatly to inform the common ground required to allow for broad market acceptance. At the same time it has created transparency about countervailing interests of market participants when it comes to sharing risks and rewards from financial market products.

The process of building a common understanding represents an investment into our future capital market infrastructure, and in the financial market's capabilities to manage such products. As such, the proposal to introduce S-T-C RMBS through RMO in the New Zealand market has become part of the Bank's official Statement of Intent (SOI) for the financial year 2019/2020.[2]

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[1] See Bank for International Settlements, "Criteria for identifying simple, transparent and comparable securitisations", https://www.bis.org/bcbs/publ/d332.htm, July 2015.
[2] See https://www.rbnz.govt.nz/about-us/statements-of-intent/statement-of-intent-1-july-2019-30-june-2022.

3. Summary of submissions

As part of the two consultations on RMO, the Reserve Bank received a total of 20 submissions (14 submissions on the first consultation and 6 submissions on the second consultation).

In addition to a number of individual submissions, the Reserve Bank received joint submissions written by the largest market participants on the issuer and investor side.

Other submitters included industry representative bodies, rating agencies, and corporate trustees. In addition, the Bank discussed the proposal informally with other public agencies, domestically and offshore. Where consented, submissions have been listed on the Reserve Bank's website.

From a high level perspective:

- **responses from investors** supported the introduction of a new standard and the exposure draft put forward by the Reserve Bank. Investors in general hold the view that the degree of standardisation (i.e. how comparable the securities are), the frequency of issuance and trading (i.e. how liquid the products are) and the variety of the notes offered (i.e. how attractive the products would yield) will determine if a broader range of investors include these securities in their asset allocation strategies.

- **responses from issuers** were focussed on key technical aspects, the timing and flexibility they would require in bringing the new bond to market, the preferred amount of skin in the game (i.e. trust capital), the disclosure and documentation regime, the possibility to allow for a transaction type that would be more capital efficient, and the benefits of explicit legislation on bankruptcy remoteness for the SPVs used for funding.

  With a view to sustainable market development, the larger banks have asked for placements to investors outside the regulated banking sector to be reduced to 10% and to allow for a two year interval over which those placements should be allowed to be achieved.

  Smaller issuers noted that the high upfront costs associated with establishing a new standard could limit their ability to participate in such a market in the shorter term. Most smaller issuers remain concerned that too ambitious targets for market placements in the initial years could reduce funding efficiency from RMO due to higher pricing.

- **other comments** supported an improved standardisation and documentation, and noted, there remained other legislative areas which, if improved, could raise prospects. Some provisions in the Overseas Investment Act, the trust legislation and the tax code would still pose impediments to raising the efficiency from SPV funding mechanisms.

With regard to the proposed terms and conditions, the following key points were highlighted:

Portfolio guidelines

- Following the collection of mortgage portfolio stratifications from major banks, issuers now accept that the proposed portfolio criteria are by and large representative of the average mortgage portfolio quality at the system level. Some parties see risks that high quality loan requirements could limit available liquidity pro-cyclically in the case of a prolonged crisis.
- Other commentary focusses on changes that could help to expand the scope of eligible mortgages further (e.g. to allow non-resident mortgages from borrowers with work visas and student visas, or, to increase the ratios of loans to investors and interest-only loans).
- Some smaller lenders raise concerns that the criteria for RMO could make it hard for them to participate in funding from RMO while there could be a risk that RMO could capture the bulk of investor interest, thereby crowding out conventional RMBS as a funding source.
- Investors appear by and large to be comfortable with the portfolio criteria. Some note it could become necessary to relax the criteria in a prolonged crisis in order to avoid a disproportionate dilution of asset qualities that originators retain for unsecured creditors.
- The option to replenish the underlying mortgage portfolios now appears largely accepted. Some investors remain doubtful if there was initially appetite for a replenishing structure.

Subordination and risk retention

- Most respondents support the idea of a high quality mortgage bond standard. Such a standard would need to offer a rather high level of protection for senior note holders.
- Some issuers continue to prefer the minimum level of senior note subordination for a AAA rating to be set by an external rating agency. And they think the minimum subordination of 10% set by the Reserve Bank is too conservative when compared with market practice.
- Other issuers are questioning if the high level of risk retention (8% skin in the game) through capital notes was consistent with the incentive schemes seen in other markets. They argue risk retention levels in markets like Australia, Europe or Japan were lower.
- Meanwhile, investors suggest a high level of risk retention was positive to align interests between investors and issuers. This is seen as an important element given the elevated house price risks in the New Zealand market and uncertainty over future developments.

Capital structure

- Most issuers concede that the proposed capital structure was an improvement over the very rigid one proposed in the first consultation. It would leave room for issuers to start closer to conventional RMBS structures and to alter structures once investors were more familiar.
- Some issuers note they would still prefer full flexibility to tailor the senior and mezzanine note structure to actual market demand over the limited flexibility as proposed by the Bank.
- Investors take a clear position in favour of a more standardised structure as it holds many benefits for them, when it comes to investment analysis, process and pricing efficiency.
- Some investors accordingly expect that the higher flexibility within the senior and the mezzanine would not be used initially, as there might not be enough appetite in long dated senior or deeply subordinated mezzanine in domestic as opposed to offshore markets.
- Other comments highlight that some conditions such as the very conservative pro-rata trigger were not in line with conventional RMBS practice. They propose to allow amortisation to become pro rata once a conservative threshold is met and for call options to kick in earlier.

Repo-Eligibility

- Repo-eligibility and the pre-approval of RMO programs by the Bank are widely regarded as crucial features by investors and issuers alike.
- Some issuers note that the approvals required for each single transaction could hamper flexibility to go to the market fast enough. It was unclear if the Reserve Bank could support the new issuance process effectively given the limited resources it had at hand.
- Others remark that it was optimistic to expect RMO senior notes to become instantly liquid in an underdeveloped market with low secondary trading volumes just through the fact that they are repo-eligible. They argue that it could take longer to develop true market liquidity in the instruments unless the Bank would engage itself more actively from the start.
- Some note that the pre-positioning of collateral in a central depository required a clarification that non-NZD notes issued could not be deposited via the NZ Clear system. The terms and conditions should in principle allow for use of relevant offshore depositories.

Disclosure

- Even though the disclosure requirements are limited in comparison to similar regimes in other countries, most issuers remain of the view that the disclosure requirements were extensive and that the Reserve Bank should reduce them to a more manageable level.
- Access to loan level data needed to be strictly controlled and the definition of an interested party in such data would have to be redrafted to ensure protection of privacy to the extent necessary in light of the new proposed changes to privacy legislation in New Zealand.
- Neither issuers nor investors support the move to an industry sponsored central data repository at this point in time but are accepting of the Reserve Bank collecting the data for valuation and lender of last resort purposes in a protected designated data repository.
- Given the Reserve Bank’s proposed data reporting frequency and quality requirements, most submitters note such data could only fully become available after a transition period of up to two years, and taking account of the changes to systems, standards and processes.

Operational Requirements

- Most commentators support the high operational and governance standards that would support RMO programs. However, it was noted that offshore issuance could become much easier if NZ legislative frameworks supported an explicit bankruptcy remoteness for RMO.
- Originators that are majority offshore controlled are concerned that under the revised Overseas Investment Act, any new transactions or upsizing of existing transactions does require the consent of the Overseas Investment Office. This could become an impediment to scaling up or structuring new collateral quickly enough for all major NZ banks in a crisis.
- Some trustee firms think that some provisions in the currently revised trust bill would not fully reflect new RMO requirements, requiring better consistency. Responsibilities of trustees as opposed to trust managers should be defined more precisely in the terms and conditions.

Documentation Requirements

- Investors appreciate that higher transparency and lower due diligence costs could become possible under a reasonably standardised documentation framework for RMO.
- Issuers emphasise their ability to document transactions in line with their own corporate standards remained important. Any harmonisation should be limited to the schedule of documents and the terms and conditions. The Reserve Bank is asked to define more precisely what its understanding of the nature of the master documents would be in the terms and conditions.

Effective Date
- As implementing RMO incurs effort on the side of investors, issuers and other parties contributing to the process, commentators ask for the policy not to become effective before 1 Jan 2020, and for the transition period to be counted only from the policy effective date.
Transitional Arrangements
- While issuers accept the proposed five year transition period, larger issuers ask to be provided with more flexibility for the timing of actual issuances, given the underdeveloped state of the markets, the uncertainty over investor appetite, and other cost considerations. - Investors remark that the market placement of senior notes implied by the proposed placement requirements could be well received. Investor demand would depend on the issuance frequency and attractive yields to participate in the products on a continuous basis. - Larger issuers nonetheless regard the proposed market placement of 15% as still too high and propose to reduce the fraction to be placed to investors initially to just 10%. - Some of the smaller issuers remain concerned about the upfront costs to bring RMO to life. These would be relatively high and could require some to postpone the RMO introduction. - Issuers of internal RMBS think the repo-eligibility of existing internal RMBS should be grandfathered based on their existing portfolios and documentation.
Capital Relief Option
- Given the Bank's plans to require regulated entities to hold more capital, most issuers submit that it could be positive to extend the proposed framework. The sale of a higher fraction of capital notes could establish a permanent risk transfer and reduce regulatory capital needs. - Issuers argue that recognition of capital notes issued by fully consolidated trust SPVs as complementary to conventional capital instruments could make engaging in a market for liquidity related securitisations more attractive, reduce costs and help to achieve the new capital targets faster.

4. Next steps

The Reserve Bank's interest is to improve the contingency risk profile of the Reserve Bank's balance sheet and more broadly New Zealand's financial system, and to contribute to a sustainable securitisation market over the long term.

The Reserve Bank believes that the remaining issues raised are limited but still relevant to the success of product and market development going forward.

The Reserve Bank is aiming to finalise the policy framework in 2019. Our focus is on achieving accurate and effective policy documentation that provides market participants with the highest possible certainty around the RMO key features and implementation process.

The Reserve Bank is in principle open to allowing for a sufficiently long transition period after the RMO policy has been published and become effective, as long as this does not jeopardise the strategic objectives and as long as it is still suited to future market conditions. Should these conditions change, it could become necessary to implement and to transition to RMO sooner.

The Reserve Bank intends to update repo-eligible conditions for internal RMBS independently. This update will include enhanced reporting requirements for any RMBS listed as repo-eligible, and require a pre-approval for portfolio changes, issuance and upsizing of internal RMBS.

More information can be obtained from the Bank's domestic market website.

The Reserve Bank is planning to finalise an implementation plan for the RMO standard in focussed working groups covering three key areas:

The loan level data working group will continue to work throughout July and August 2019 on the consistency in the definitions of the final residential mortgages loan level data template.

Once this is accomplished, this working group will be transformed into an operational implementation working group providing a forum to discuss remaining implementation issues.

The Reserve Bank will finally endeavour to support the relevant legislative processes to consider the bankruptcy remoteness status for SPVs used in securitisations, to help to reduce impediments under the Overseas Investment Act as far as they could affect financial stability, and to clarify the consistency of the new policy framework with planned trust law revisions.

Following these steps, the Reserve Bank is confident a simple, comparable, transparent mortgage bond collateral and securitisation standard can be successfully implemented.