RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

RESIDENTIAL MORTGAGE OBLIGATIONS (RMO)

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

EXPOSURE DRAFT

November 2018

Submission contact details

The Reserve Bank invites submissions on this policy draft by 5pm on 8 March 2019.*
Please note the disclosure on the publication of submissions below.

Interested parties can address submissions and enquiries to:

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Publication of submissions

All information in submissions will be made public unless you indicate you would like all or part of your submission to remain confidential. Respondents who would like part of their submission to remain confidential should provide both a confidential and public version of their submission. Apart from redactions of the information to be withheld (i.e. blacking out of text) the two versions should be identical. Respondents should ensure that redacted information is not able to be recovered electronically from the document (the redacted version will be published as received).

Respondents who request that all or part of their submission be treated as confidential should provide reasons why this information should be withheld if a request is made for it under the Official Information Act 1982 (OIA). These reasons should refer to section 105 of the Reserve Bank of New Zealand Act 1989, or the grounds for withholding information under the OIA. If an OIA request for redacted information is made the Reserve Bank will make its own assessment of what must be released taking into account the respondent's views.

The Reserve Bank may also publish an anonymised summary of the responses received in respect of this Paper*.*

*This has been updated to reflect the extension to the consultation period.

Contents

1. Introduction

In November 2017, the Reserve Bank published the results of its Review of mortgage bond collateral standards and sought feedback on the terms under which it accepts mortgage bonds and a proposed new standard in Residential Mortgage Obligations (RMO).

On 22 May 2018, the Bank published a summary of submissions received. The Bank is now issuing this exposure draft of the RMO standard for a second and final consultation.

1.1. The RMO framework

The RMO framework defines a “high grade RMBS standard” to: address the shortage of High Quality Liquid Assets (HQLA) in the New Zealand markets; offer mortgage lenders an additional funding tool; and support developing deeper private label mortgage bond markets.

The Reserve Bank has consulted intensively with industry experts over the past year to refine the concept for RMO. This note summarises changes the Bank proposes in response to the key issues raised by industry and sets them out for a second consultation.

The deadline for final submissions on the RMO standard is **22 February 2019**. The Bank aims to publish a final policy defining the RMO framework in **March 2019** and commence implementation from **June 2019.** The technical details are provided as a draft term sheet. The term sheet should be used as the primary reference for technical or legal submissions.

1.2 . Changes in response to submissions

In February 2018, the Reserve Bank discussed the strategic targets and key features in a Round Table with interested parties from the Australian and New Zealand financial industry.

After reviewing the submissions in March and April 2018, the Reserve Bank engaged further with key domestic stakeholders during May to July 2018 on a future potential market in RMO.

This process allowed the Reserve Bank to gain insights from data delivered on the mortgage books held by key players and to develop options to resolve on the key issues as related to:

- the quality of mortgages loans and pools acceptable under the RMO framework;
- the level of subordination and risk retention required to protect RMO from losses;
- the flexibility Issuers would have in regard to tranche structures and note classes;
- the repo-eligibility, pre-approval and pre-positioning process when utilising RMO;
- the disclosure requirements and processes for supply of Loan Level Data (LLD);
- the operational requirements for parties that contribute to a RMO transaction;
- the level of standardisation and comparability of legal documentations supplied; and
- the period required for transition and to encourage development of a market in RMO.

The Reserve Bank believes that the development of the RMO framework will help to address the insufficient supply of HQLA in the New Zealand market. Underlining the specific purpose and nature of the new securities, the Reserve Bank believes it is beneficial to label them as a program which is different from more flexible conventional RMBS structures in the market.

While a concept for HQLA remains naturally focussed on quality, liquidity, scalability and avoiding distortionary features, the Bank is hopeful that the amended proposal may help to strike a compromise between the interests of investors, issuers and the Reserve Bank.

QUESTION 1: Do market participants understand the key distinguishing features of RMO as a high grade mortgage bond standard? Would the acronym “RMO” present issuers and investors with major disadvantages, as opposed to a different name?

2. Portfolio guidelines

The composition and quality of a mortgage loan portfolio that is sold in a securitisation defines the performance of the note structure and the risk profile of individual note classes. Selection of the mortgage loans is thus important to protect RMO holders from future losses.

2.1. Eligible mortgage loans

Our objective is for RMO to be considered as “high grade RMBS” for liquidity management, term funding and investment purposes. As such, they should be supported by higher quality mortgage loan portfolios that are prescribed by portfolio guidelines defining their quality at the mortgage loan and mortgage loan portfolio levels. At the closing date (the date when the mortgage pool becomes defined), the following portfolio guidelines and ratios shall apply:

Table 1: Summary of RMO portfolio guidelines

LIMIT TYPE	POOL LEVEL	LOAN LEVEL
Nature of loans and obligors	NZ residential mortgages	NZ Citizen or NZ residents
Pool and loan size	>= NZD 100 million	<= NZD 2.0 million
Obligor concentration (by principal balance outstanding)	Top 10 obligors: <= 5 % Top 50 obligors: <= 10 % Min. # of loans: 500	N/A
Loan Level Indexed LVR	Weighted average LVR: <= 60% LVR bucket 70-80%: <= 30 % LVR bucket up to 60%: >= 50 %	LVR <= 80%
Investment or Interest only loans	<= 25%	N/A
Legal maturity	N/A	<= 30 years
Loan seasoning	N/A	>= 90 days

The Reserve Bank believes the average portfolio quality expressed through these limits is relatively high, supporting the high quality objective, and reflecting the average mortgage book qualities as they had been presented to the Reserve Bank by major stakeholders.

2.2 Replenishment

RMO Issuers will have the option to replenish the underlying loan pool over a maximum of two years calculated from the closing date, by reinvesting the principal collected from mortgages into the purchase of new eligible mortgage loans from the same Originator. At the end of the replenishment period, the mortgage loan portfolio will be closed.

During the replenishment period the pool quality shall remain within the portfolio guidelines including a weighted average LVR of 60% in relation to the mortgage loan pool notional. The Issuer has to disclose the new loans as part of investor reports. Replenished loans that fail to comply with the representations and warranties will have to be purchased back by the seller, subject to other regulatory requirements applicable or, alternative, be indemnified.

The Reserve Bank believes that these guidelines and replenishment criteria are sufficiently flexible to allow Originators to issue RMO on an ongoing basis. The Reserve Bank reserves the right to alter the portfolio requirements for new transactions as future situations demand.

QUESTION 2: Do market participants agree with the proposal to include more loans for RMO purposes? Is a replenishment subject to the above criteria acceptable?

3. Subordination and risk retention

The subordination and risk retention provided in support of RMO senior notes are important to keep RMO holders confident in the underlying credit risk profile and rating stability, and to allow to treat RMO as primary liquidity assets for regulatory purposes on a permanent basis.

3.1 Minimum subordination

The minimum subordination in support of any senior notes shall be defined by the greater of:

a. **10 percentage points** in relation to the principal balance of the mortgage loan portfolio as at the closing date;

or

b. the level of subordination required to **mitigate credit losses and write-offs** subject to AAA rating requirements as set out by the relevant rating agency.

During periods of financial instability, the Reserve Bank may require greater levels of subordination to achieve repo-eligibility for new transactions. The Reserve Bank will give registered banks prior written notice if it proposes to exercise this right.

The Reserve Bank believes that basing the subordination requirements upon a number of tests that anchor it on a high fundamental credit value including avoiding temporary write offs on senior notes, is a good way to address uncertainties with respect to future expected losses, and allows a consistent accommodation of the securities under evolving accounting standards.

3.2 Minimum risk retention

The minimum level of risk retention from Originators at the closing date shall be defined as either:

a. **10 percentage points** where an Issuer chooses to issue only one subordinated note;

or

b. **8 percentage points** where an Issuer chooses to issue two or more subordinated notes subject to additional subordinated notes adding at least **2 percentage points** to the 10 percentage points subordination total, which may be held by third parties.

The minimum risk retention will require a seller of the loans to be exposed to the first losses from a mortgage loan portfolio. Obtaining insurance from a third party for loans that are part of the securitised mortgage pool will not qualify as compliant with the risk retention criteria.

The Reserve Bank believes that a reasonably high level of risk retention is best designed to make markets confident in a strong interest alignment, through the Originator facing the first losses, committing to servicing the loans diligently and supporting their overall performance.

QUESTION 3: Do market participants agree that the minimum subordination provides enough credit loss protection for the senior notes? Is the further credit enhancement derived from a write-off test sufficient to reduce price volatility in RMO senior notes?

4. Capital structure

The tranches eligible for offer in a series of RMO require a balance being struck between their quality as primary liquidity assets, the value they contribute to the Originators' term funding, and the suitability of note classes to a broader range of investors.

4.1 Eligible tranches

a. **RMO senior tranches** may be issued in two **exclusive** structures:

   i. one bulk senior note (Class A); or
   ii. two classes of senior notes that are term-subordinated (Class A1 and Class A2), so that Class A1 notes provide issuers and investors with a shorter duration while Class A2 notes provide them a longer duration by allocating principal collected to the Class A1 notes first, while any charge-offs for Class A1 and A2 are incurred on a pari-passu basis.

b. **RMO mezzanine tranches** may be issued optionally depending on investor demand as Class B, and must be strictly subordinated to Class A or Class A1 and A2 notes.

c. **RMO capital tranches** must be issued as the most junior tranche (Class C) and may only be issued for repurchase by the Originator of the loans.

4.2 Securities features

Key features	Standards	Other requirements
Senior tranches	a) Class A only, or b) Class A1 and A2.	a) Max Class A size: 90% pts b) Max Class A1 size: 75% pts
Subordinated tranches	c) Class B (optional) d) Class C (to be retained)	c) Min. Class B size: 2% pts d) Min. Class C size: 8% pts
Call rights (optional)	e) Any time after: 5 years, or f) If 10% pool factor triggered	e) Based on the issue date f) Based on the closing date
Waterfalls	g) Strictly sequential	g) Pass-through all principal
Pro-rata trigger (optional)	h) After: 5 years; and only if no charge-offs were recorded.	h) applies to all note classes of a series issued
Note Registration	One ISIN per note class	

Transactions may vary with regard to the individual capital structure and note classes offered as part of a transaction. Each note class will be denoted by its own ISIN and rank.

4.3 Priority of payments

Unless pro-rata conditions are met, the priority of payments (waterfalls) shall be strictly sequential, shall start with the most senior note class, and shall run in strictly reverse order for any write downs on a note class.

The Reserve Bank believes that the flexibility offered in the eligible tranches and note classes can cater to a broader range of funding and investment options, while creating the certainty how new transactions could be alternatively structured in periods of market stress.

QUESTION 4: Do market participants agree that the proposed structures allow to utilise RMO senior and mezzanine notes better compared to the initial proposal?

5. Repo-eligibility

The Reserve Bank is willing to support the future development of markets in RMO as private label securities by making RMO senior notes fully repo-eligible and by accepting them as regular collateral in its market operations.

5.1. Utilisation of RMO

At any one point in time, RMO senior notes may be utilised as either of the following:

- Security in repurchase and reverse repurchase transactions; or
- Security pledged as collateral for margining purposes in market operations; or
- Primary liquid assets for regulatory purposes (in compliance with BS 13 reporting).

The Reserve Bank believes that the retention of RMO as primary liquidity assets through an Originator should be limited, and stay conditional on transitional provisions and incentives.

5.2. Central Depository and information on holdings

Issuers of NZD-denominated RMO senior notes shall use NZ Central Securities Depository Ltd. (NZCSD) as their Depository and holder of notes, their note owners remaining free to assign, pledge or transfer their interest or ownership in the notes as required. Regulated entities shall report their holdings monthly.

The Reserve Bank believes that the safest, most transparent and accountable way to transact in a domestic market context would be to deposit RMO in the NZCSD system.

5.3. Pre-Approval

An Originator or RMO Issuer shall request a pre-approval for repo-eligibility of a new RMO program prior to marketing and seek approval immediately prior to the issue date of each new series. Approvals will be documented and may be referred to when marketing the notes.

The Reserve Bank believes that a pre-approval supports establishment of a market in RMO and is likely to support market confidence and market stability in times of market stress.

5.4. Repo limits and haircuts

RMO senior notes shall generally be repo-eligible and be ready for utilising them as security in any of the Reserve Bank's market operations, subject to minimum haircuts (Table 3):

Table 3: RMO note classes, limits and haircuts

NOTE CLASSES	LIMIT PER ISIN & SERIES ISSUED	MIN HAIRCUT AT REPO Weighted Average Life		
		<= 1y	>1 y	> 5y
Class A1	Up to 100% issued amount per ISIN	3%	4%	5%
Class A and Class A2	Up to 100% issued amount per ISIN	6%	7%	8%
Class B	Not eligible	N/A		
Class C	Not eligible	N/A		

The Reserve Bank believes that the repo-eligibility of RMO senior notes requires all senior notes outstanding to be repo-eligible. The Reserve Bank reserves the right to apply higher haircuts, depending on the pool performance and the market conditions at that time.

QUESTION 5: Do market participants agree that the utilisation, the Depository and haircuts provide RMO holders with sufficient flexibility to decide on their best use?

6. Disclosure

Any receivables from RMO rely on future expected principal and interest cash flows from underlying mortgage loans. Access to loan level data thus is important in order to make informed funding or investment decisions and to price risks and returns in RMO efficiently.

6.1 Information requirements

To support information in primary and secondary markets or collateral usage any RMO Issuer will be required to:

a. supply Loan Level Data (LLD) based on a standardised "LLD RMBS template" prior to issuance and thereafter for the lifetime of the transaction on a quarterly basis;
b. enable access to such data to interested parties on request through electronic means or through a data service provider allowing to perform independent analysis;
c. provide the Reserve Bank with a final pool cut as of the closing date and a monthly pool cut to process valuations, surveillance and regulatory reporting;
d. provide interested parties with at least quarterly investor reports including stratified loan performance data, delinquencies, defaults and the balance of the principal deficiency ledger.

The Reserve Bank believes these standards are relatively common in the operations of market participants, reflect standards applied by central banks that operate similar platforms, and are most often already part of the process to obtain or survey external ratings.

6.2 RBNZ LLD RMBS template

LLD supplied for a series of RMO shall:

a. accurately reflect the specifications of the mortgage loans at the time of the pool cut;
b. be delivered free of processing errors, compliant and consistency checked;
c. be provided in machine readable formats that do not restrict a user's applications;
d. be compliant with the RBNZ LLD RMBS template's definitions and data formats.

The Reserve Bank believes the provision of comparable loan level data is required to allow Issuers, investors, rating agencies and the Reserve Bank the same quality of independent analysis. A template will support consistent data quality and reduce information asymmetry.

6.3 Data protection and processing

LLD supplied for a series of RMO shall be:

a. protected or redacted to the extent necessary to comply with New Zealand law;
b. centrally supplied through a data repository as designated by the Reserve Bank;
c. provisionally supplied through Originator's or Issuer's until informed otherwise.

The repository used for the data management shall be:

d. controllable with regard to any access rights to sensitive data;
e. operational to allow performance and scenario analysis on loan and pool level;
f. customizable to allow data users to use and analyse such data efficiently.

The Reserve Bank believes that access to Loan Level Data is critical to markets as well as the Reserve Bank performing key functions effectively. The Reserve Bank shall choose the efficient means to accomplish its function, and allow for reasonable implementation periods.

QUESTION 6: Do market participants agree with the disclosure standard and the Reserve Bank's role in defining and designating a loan level repository for RMBS?

7. Operational requirements

To protect investors and creditors in RMO transactions, it is important that legal Issuers are disassociated from an Originator to the extent necessary, and that sensitive functions are separated to provide for effective management, supervision, and governance frameworks.

7.1 Parties to a transaction

All parties that contribute to a RMO transaction shall be listed at the time of offering a series of RMO and be clearly defined with regard to their operational functions and responsibilities. Appendix 1 lists the key parties, functions, and any identification or separation requirements.

7.2 Disassociation of assets and liabilities

RMO Issuers shall be financially and organisationally disassociated from an Originator of the mortgage loans to an extend that allows the Issuer to operate all of its functions, and control its operations independently. The issuer must deliver a legal opinion addressing whether its assets and liabilities would be clawed back in the event of an insolvency of an originator.

7.3 Governance framework

RMO shall be equivalent in the standards they are operated and supervised at. This means:

a. all parties to a transaction shall engage staff that are qualified for their roles, and shall make required systems, processes and resources available;
b. a security Trustee shall hold the security on behalf of all note owners, and if in conflict or doubt, its actions shall ensure they are to the benefit of the most senior note class;
c. a manager shall be appointed to facilitate the day-to-day operations of the Issuer, and hold delegated authority subject to the Trustee approving the required actions;
d. a Servicer of sufficient credit standing shall be mandated for the servicing of the loan portfolio, and a back-up servicing arrangement shall define how sufficient resources and system access could be transferred conditionally to another third party Servicer;
e. a swap provider of sufficient credit standing shall be mandated to provide the Issuer with swaps that mitigate differentials in interest payments, being adjusted monthly;
f. an account bank of sufficient credit standing shall be engaged to provide an Issuer with trust bank accounts and transactional accounts, as required for its operations;
g. a paying agent shall be mandated to calculate payments due on each payment date on each note class, in accordance with waterfalls and subject to Trustee supervision;
h. a rating agency shall be engaged by the Issuer to assess a RMO transaction, assign a rating for note classes other than Class C, and provide regular surveillance reports.

The Reserve Bank believes a transparent operational and governance framework remains important to make market participants comfortable in the framework. Where functions are not disassociated from an originator of the loans, provisions and covenants have to be put in place that define triggers and rights on how such functional separations could be enhanced.

QUESTION 7: Do market participants agree with the functional separation, the disassociation requirements and with the governance framework?

8. Documentation requirements

RMO transactions shall be based on a reasonably harmonised documentation standard for all RMO issued to ensure a transparent documentation, to allow an efficient comparison of transaction risks, and to reduce marketing, operational, reputational or documentation risks.

8.1 Master Document

A RMO Issuer shall provide interested parties with exposure drafts and execution copies of a RMO Master document outlining the transaction and documentation, including the following:

a. transaction summary;
b. conclusive term sheet;
c. catalogue of definitions;
d. schedule of documents; and
e. legal disclaimer.

8.2 Supporting documents

a. Transaction summary

The transaction summary shall be an offering circular or a presentation outlining the risks and returns arising from a RMO, and shall mitigate Issuer misrepresentations effectively.

b. Term sheet

The term sheet shall be equivalent in all material aspects to the term sheet provided herein and provide an informed party with all relevant key terms and conditions in reasonable detail so as to allow an efficient preliminary assessment.

c. Definitions

The definitions shall include functional or technical terms regularly used in RMO transactions and define them so as to allow a general understanding of their meaning in the transaction.

d. Schedule of documents

The schedule of documents shall list legal documents, deeds, representation and warranties. Standard documents shall be identifiable against transaction-specific documents (if any).

8.3 Legal disclaimer

The disclaimer shall provide a fair representation of the qualifications required to assess the risks from a RMO transaction and of the general risks incurred in purchasing RMO notes.

While the actual documents provided under the schedule may differ among RMO Issuers, the Reserve Bank believes that a reasonable standardisation through a Master Document remains a key pre-requisite to make market participants confident in the RMO framework. Being a key stakeholder in future RMO, the Reserve Bank shall support the process of developing a Master Document and schedule until the date this policy becomes effective.

QUESTION 8: Do market participants agree that the proposed requirements make the preliminary assessment more efficient and transaction standards more comparable? To what extent will a Master document help to reduce legal due diligence costs?

9. Effective date

This policy shall become effective and binding on **1 July 2019** and in principle allows to use RMO in market operations with the Reserve Bank subject to successful pre-approvals.

10. Transitional arrangements

A transition period of **five years** starting on **1 July 2019** and ending on **30 June 2024** shall be provided to allow market participants to develop their operations in new RMO financial instruments, and to adjust their liquidity, funding or investment strategies accordingly.

During the transition period the following conditions shall apply:

Issuers of Internal RMBS shall re-document the underlying documentation in consultation with the Reserve Bank and legal advisers to, in principle, conform with:

i. the portfolio guidelines herein;
ii. a Class A/C capital structure; and
iii. the disclosure requirements.

The remainder of the documentation may remain unchanged and stay effective.

The re-documentation shall take place within a six-month period starting on 1 July 2019 and ending on 31 December 2019, and the exchange of the actual pools shall take place within a twelve-month period starting 1 July 2019 and ending 30 June 2020. The pools of Internal RMBS may stay revolving during the entire transition period.

Internal RMBS remain repo-eligible subject to limits. The Reserve Bank will reduce the repo limit available for each of the Internal RMBS series issued by 20% per annum in relation to their notional (as at 1 July 2019) from the effective date of 1 July 2019, such that the first reduction will occur on 30 June 2020.

Registered banks may utilise remaining amounts in Internal RMBS senior notes and new amounts in RMO senior notes subject to transitional limits. In each annual reference period starting with the effective policy date of 1 July 2019:

a. a maximum notional amount of 50% of senior notes of RMO issued in that period being retained / held by an Originator as primary liquidity assets in fulfilment of regulatory liquidity purposes;
b. a maximum notional amount of 35% of senior notes of RMO issued in that period being initially placed with regulated third parties;
c. a residual notional amount of at least 15% of senior notes of RMO issued in that period being initially placed into the markets to non-regulated entities / investors.

One year prior to the transition period ending, the Reserve Bank will notify Originators of the maximum limit of RMO senior notes from new issuances which may be retained as primary liquidity assets in fulfilment of regulatory purposes.

The Reserve Bank will define temporary and long-term loan level data requirements based on a RMBS LLD template. RMBS LLD and investor reports may provisionally be supplied bilaterally or via an Originator's or issuer's website to interested parties. The Reserve Bank will supply an upload function for loan level data delivered to it. The Reserve Bank will inform of a central data repository function to transact in loan level data once it becomes available.

QUESTION 9: Do market participants agree to the timing of transitional arrangements and are these considered to be effective to incentivise market placements of RMO?

APPENDIX 1: Key parties, functions, identification and separation requirements

KEY PARTIES	KEY FUNCTIONS	REQUIREMENTS
a) Obligor	the borrower under a mortgage loan (owner occupier, investor)	identifiable borrower or jointly and severally liable group
b) Originator	the Originator of mortgage loans in the pool	
c) Servicer	the Originator or a third party facilitating the loan servicing	subject to rating agency requirements
d) Arranger	the Originator or a third party that co-ordinates an issue	
e) Issuer	the legal entity that issues a series (SPV trust)	"bankruptcy remote" from the Originator
f) Manager	the party facilitating Issuer's operations	must not be an entity that impacts the "bankruptcy remoteness" of the Issuer in relation to the Originator
g) Trustee	a corporate trustee or a NZ SPV company established by a corporate trustee	
h) Security Trustee	a corporate trustee holding security for the benefit of all secured creditors (including the noteholders)	acts in a fiduciary capacity for secured creditors
i) Account Bank	the Originator or a third party providing the Issuer with bank accounts	subject to rating trigger
j) Swap Counterparty	the Originator or a third party providing IR or FX swaps	subject to rating trigger
k) Central Depository	a third party facilitating the depository and settlements	system provider designated by the Reserve Bank
l) Registrar	a third party holding record of the registered noteholder	
m) Paying/Calculation Agent	a party checking interest payment calculations and facilitating payments on notes	
n) Rating agency	a third party assessing the credit risk in the transaction	separation from the Originator and Issuer
o) Data Repository	A third party facilitating secure data management	system provider designated by the Reserve Bank
p) Central bank	public agency facilitating the repo-eligibility and valuation	separation as per RBNZ Act and applicable legislations
q) Dealer	the Originator or a third party facilitating orders and sales	

Where a separation is conditional on a rating trigger, the process for addressing a future separation is documented in the transaction documents.