RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Residential mortgage obligations (RMO) framework

QUESTIONS & ANSWERS

1. Why is the Reserve Bank proposing a new mortgage bond standard?

The Reserve Bank is proposing a new mortgage bond standard to support confidence and liquidity in the New Zealand markets. This follows an initial consultation in November 2017 and ongoing discussion with issuers and investors over the past year.

The new mortgage bond standard aims to:

- reduce contingency risks for the Reserve Bank as a lender of last resort and ensure financial intermediaries supply sufficient high quality and liquid assets; and
- provide issuers and investors with an additional funding and investment instrument, supporting the development of deeper capital markets.

The Reserve Bank believes that a viable mortgage bond framework should set the highest possible reference standard for the domestic markets in terms of the quality of the underlying portfolios, the safety and liquidity of the financial instruments issued, and their reliability and versatility across most domestic liquidity and funding operations.

The standard is primarily tailored to address the specific situation in the New Zealand markets. However, a wider offshore market acceptance for the securities issued also requires, that the standard broadly aligns with international guidelines such as the 'simple-transparent-comparable (STC) guidelines by the International Organisation of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BIS) or the Australian Prudential Regulation Authority (APRA) securitisation standards.

2. Why are high grade mortgage bonds important for our financial markets?

A key function of any central bank is managing the liquidity available to the economy. When a central bank supplies liquidity, it relies on securities as 'collateral' against the risk that the borrower of liquidity might not repay. The quality of those securities affects the credit risk or the potential loss facing the central bank, and affects the capacity of the central bank to lend.

The central bank manages its risks by 'haircutting' or discounting securities so that, say, $100 million face value counts as only $80 million of security. However, the higher these haircuts would be, the more assets would need to be encumbered and taken away from other creditors of a bank (such as depositors or unsecured bond holders). And there is a trade-off between the quality of the securities used and the resilience in balance sheets.

The availability of sufficient high quality securities will reduce the need for large haircuts and support the Reserve Bank's ability to lend and help to prevent liquidity shocks.

3. How get mortgage loans transformed into high grade mortgage bonds?

In the absence of deeper stocks of high quality and liquid securities (like government bonds), it is important to have instruments in place that allow the Reserve Bank to transform good quality but illiquid assets (such as residential mortgage loans) into higher quality assets (such as securities that are based on these loans), if needed.

Residential mortgage loans are the deepest pool of financial assets available. The nature of the mortgage loans that support a security plays thus an important role.

A safe transformation of mortgage loans into tradable securities mainly requires that:

- the loans underlying a high quality security are carefully selected;
- the loans are assigned to a trust which is not associated with the originator and which is protected against losses by sufficient capital;
- the originator of these loans retains a reasonable risk and 'skin in the game';
- the loans would be serviced at the same high standards as with the originator; and
- the governance and operational risk standards are high and are fully transparent.

4. How could these mortgage bonds become attractive to the market?

If the securities became more standardised, simple and transparent, it is likely they would be attractive to issuers and investors in the market, and therefore be tradable.

The tradability of securities mainly requires that:

- their structure is based on reasonably safe, simple and transparent principles;
- the securities on issue would be homogenous and their relative value comparable;
- the securities are frequently issued and included in asset management strategies;
- issuers and investors can agree on a fair trade-off in pricing the risks and returns; and
- the process of trading the securities allows for continuous price discovery.

As with any new instrument or product there are costs for issuers (banks) to introduce them and there is a risk that investors (as buyers) might not like them as much as expected.

The Reserve Bank envisages a longer transition period to allow for a controlled phase-in and to provide issuers and investors alike with some time to test the new instruments.

5. What were the key findings in the Reserve Bank's mortgage bond review?

The Reserve Bank started to accept securities that are backed by residential mortgage loans during the 2008 financial crisis. However, standards in these mortgage bonds differed widely and the Reserve Bank became unsure whether they would be efficient collateral given imbalances in the housing market.

Moreover, in light of recent global developments, it could be helpful to have an additional term funding instrument to support lending to the economy and households more broadly.

As opposed to other countries, New Zealand has not developed a deeper capital market with a broader offering of products for domestic and offshore investors over the last two decades.

The 2017 review of mortgage bond collateral standards found that current mortgage bond standards add to that drag, and to be deficient in three main areas:

1. The types of bonds issued could impede the effectiveness of liquidity transformation as they require high haircuts against a steep drop in property prices, are likely to subordinate depositors in a crisis and potentially undermine market confidence.
2. The current regime seemed to set ambiguous incentives for banks to rely on the central bank in their regulatory liquidity management, thereby increasing the contingency risks for the Reserve Bank as a lender of last resort.
3. The high level of “internal securitisations” (non-standardised loan portfolios that are wrapped up into non-tradable securities) held by large banks appeared to undermine the development of a deeper and sound domestic capital market, as it implied that most bonds were not placed or priced in the market, thereby restricting transparency over risks and prices and reducing wholesale investment alternatives.

The Reserve Bank has worked in consultation with issuers and investors over the past 18 months to develop improvements with the aim of a simpler, transparent framework; to formalise the underlying structures; and to make the products more attractive.

6. What are the key features of the new securities framework?

The distinguishing feature of high grade mortgage bonds in New Zealand is that they rely on a regulated and standardised framework which is reasonably prescriptive with regard to:

- the quality of the underlying mortgage loan portfolios;
- the types of securities that may be issued;
- the disclosure and documentation requirements;
- the repo-eligibility of all senior notes issued under a pre-approved programme; and
- the market placement of a fraction of the total issuance during a reference period.

The **quality of the loan portfolios** is governed based on principles that ensure:

- a fair mix of qualities of mortgage loans is chosen through portfolio criteria and limits;

- incentives to cherry pick either very good or very bad mortgage loans are balanced; and
- the portfolios present a reasonable reflection of the asset quality in our market.

The **types of securities on issue** are restricted by:

- a high level of 10% points of minimum subordination in support of the senior notes;
- a simple capital structure with three classes of notes and strictly sequential waterfalls; and
- a limited range of structures that may be offered, with a funding-only purpose.

The **disclosure and documentation** is thorough and standardised, requiring that:

- the Reserve Bank and investors can analyse the quality of the portfolios independently;
- the issuers provide high quality performance reports as part of the surveillance; and
- the wholesale marketing and legal documentation is reasonably standardised.

The **repo-eligibility of senior notes** will be governed by the Reserve Bank through:

- in principle pre-approval of a new RMO issuance programme;
- approval of any new series of notes prior to the issue date; and
- acceptance of RMO senior notes as collateral in all financial market operations.

The **market placement of the notes** is incentivised through:

- limiting the retention of senior notes by an originator for use as regulatory liquidity;
- an obligation for issuers to place a fraction of the notes during a reference period; and
- a marketing process that ensures an arms-length process and price discovery.

7. How can I get further information or make a submission?

For further details including the consultation paper and the key terms and conditions see Review of mortgage bond collateral standards.

The final consultation opened on 13 November 2018 and submissions must be received by 5.00pm on 22 February 2019.