09 March 2018

Toby Andres  
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Reserve Bank of New Zealand  
Wellington

By email: stcproject@rbnz.govt.nz

Dear Toby

Submission on the Reserve Bank’s Review of mortgage bond collateral standards November 2017 (Consultation Paper)

Kiwibank welcomes the opportunity to submit on the above Consultation Paper. This submission is in addition to the joint response on behalf of ANZ, ASB, BNZ and Kiwibank (Joint Submission). This submission does not repeat all of the key points raised in the Joint Submission but rather raises further matters and points of emphasis. Our key submissions are set out below. Responses to selected questions posed in the Consultation Paper are in the attached addendum

Key submissions

Kiwibank agrees the development of a mortgage bond market in New Zealand would be positive for investors, issuers, regulators and the debt capital markets in general. However, we are against the Residential Mortgage Obligations (RMO) proposal as we consider it is skewed heavily in favour of investors over issuers, is inflexible and does not reflect the existing RMBS markets in Australia and New Zealand. The cost to banks of establishing RMO programmes, together with investor expectation they will need to receive a margin over senior spreads to offset perceived illiquidity, create the very real risk that the mortgage bond market does not develop in New Zealand.

Of particular concern to Kiwibank is the negative carry created by the RMO structure. The requirement to invest the principal amortising from the mortgage pool into securities where the yield is lower than the margin paid on the ‘AA’ notes is problematic. With principal amortisation running at around 25% per annum, this negative carry to Kiwibank is estimated at $3-7m annually\(^1\). This is in contrast to existing internal RMBS programmes (I-RMBS) where there is no forced accumulation of amortised loan principal and negative carry does not occur. Kiwibank maintains that the Reserve Bank’s requirement for a high quality asset does not necessitate negative carry.

The Consultation Paper states that the external RMBS market has not developed due to a lack of conformity among external offerings and an overreliance on I-RMBS. This is not the case. While the volume of I-RMBS is a factor, it is the lack of supply due to cost relative to senior issuance that has inhibited market growth, rather than product non-conformity. Any new mortgage bond standard should be flexible enough to permit differences in

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\(^1\) Range reflects AA notes at 20% and 45% of capital structure, 1 and 2 year maturities and $1.1b programme size.
mortgage pools among issuers which in turn will maximise the pool of eligible loans available to an issuer and thereby support the Reserve Bank's objective of scalability. Standardised reporting will deliver comparable information for investors so they can identify any differences in collateral between banks and value them accordingly.

Kiwibank recognises the development of a mortgage bond market in New Zealand could lessen banks' reliance on I-RMBS but doubts whether a truly liquid market for mortgage bonds will ever develop in New Zealand. Regular issuance would be best supported through a more economically efficient model that meets Reserve Bank needs together with investor preference for discrete pools without trapping cost in the structure. To that end Kiwibank has worked with its peers to develop an alternative mortgage bond, included in the Joint Submission, that will meet the Simple, Transparent and Comparable (STC) objectives required by the Reserve Bank. It features a replenishing pool supporting a retained RMBS and discrete pools for external issuance.

The introduction of a new mortgage bond standard will require a measured approach. The July 2019 deadline proposed in the Consultation Paper for removal of I-RMBS is unachievable. There is great risk in having aggressive and inflexible targets for transition should the market not develop as desired, both in terms of size and speed. Kiwibank recognises that banks need to be incentivised to establish an RMO programme and get issuance underway, and supports a collaborative approach with the Reserve Bank. Regular bilateral communication between banks and the Reserve Bank will be required during the transition period to assess progress. The Reserve Bank will need to be flexible when determining the timing.

Before any new mortgage bond is introduced into the New Zealand market, the impact on New Zealand sovereign and bank credit ratings also needs careful consideration. Some investors have indicated participation in a mortgage bond would substitute their existing bank senior debt capacity. Depending on the scale of that cannibalisation, banks are likely to fund the shortfall from offshore sources thus adding to existing and persistent rating agency concerns around the reliance on offshore debt.

Further consultation is required to ensure a product is developed which is supported by investors, affordable to banks, acceptable to regulators and does not result in any negative rating agency assessment. To that end, the recent roundtable was very constructive and an excellent opportunity to share ideas and shape the development of the product. Kiwibank welcomes similar engagement in the future.

Yours faithfully

R A Schofield

Richard Schofield
Treasurer

cc: Malcolm Bruce, Chief Risk Officer
Geoff Martin, Head of Funding
Loretta DeSourdy, Head of Regulatory Affairs
Kiwibank’s Response to Questions:

We respond to following specific questions in the Consultation Paper:

Section 1.3

A5 Do you agree that it is feasible to create more resilient mortgage bond markets?
Yes, but we do not consider the RMO as proposed is the appropriate response.

A6 What would be the critical features required to achieve this?
Liquidity

A7 Which are the challenges creating those in the New Zealand market?
The depth of a small market such as New Zealand is problematic. It can be argued only NZ government bonds are traded frequently enough to be considered truly liquid on a global scale. It is likely that New Zealand mortgage bonds will trade like Local Government Funding Agency or Kauri bonds - infrequently with barely any trading during periods of volatility - an assumption supported by investors who expect to command a premium for the lack of liquidity. Regular issuance will support liquidity therefore a cost effective structure for issuers, rather than the one proposed in the Consultation Paper, is imperative.

Section 2.1

A9 How much weight should the Reserve Bank put on RMO securities actually being traded relative to the other characteristics discussed?
As outlined in the response to A7 above, we think trading in the RMO will be limited outside of new issue distribution with the product likely to appeal to ‘buy and hold’ investors. Barely any trading of RMOs is likely in periods of market volatility.

A10 Are there alternative instruments the Reserve Bank could consider as eligible collateral in order to reduce reliance on i-RMBS?
An alternative structure has been drafted by a team of securitisation professionals from each of ANZ, ASB, BNZ and Kiwibank with the assistance of Russell McVeagh and forms part of the Joint Submission. We believe the terms of the securities set out in that alternative structure will be attractive to investors, meet with regulatory approval and achieve the STC goal stated by the Reserve Bank.

Section 3.1

B1 Do you agree that safety, risk versus return, and cost are the most important considerations when appraising a mortgage bond standard? Are there other aspects to consider?
Cost should be viewed from both an investor and an issuer perspective. If the cost is prohibitive to issuers, they will be incentivised to issue senior debt to fund the purchase of liquid assets.

Section 3.2

B2 Do you agree with the considerations underlying the merits of a high quality liquidity substitute? Are there other considerations that should be included?
The right balance needs to be struck between establishing a new high quality liquidity substitute that is attractive to investors and that is not prohibitively expensive to issuers. We consider that the RMO as proposed does not strike the right balance.
B3 Do you agree that the proposed RMO default capital structure could help to address current impediments to develop safer assets and a deeper market?

Kiwibank does not believe the impediments to developing a deeper market for safe assets are product based. Investor demand for securitised product is a function of limited supply as banks have sufficient capacity to complete funding requirements without issuing external RMBS. By contrast, the Australian parent banks have much larger funding tasks than their NZ subsidiaries and are prepared to issue RMBS externally despite the cost being higher than senior debt. The Australian majors are able to take down large chunks of funding through issuing RMBS and reduce the pressure on other markets and programmes.

The capital structure needs to be flexible enough to meet the demands of investors, including those which demand greater credit risk and corresponding return. The proposed structure creates extension risk to the class AB notes resulting from re-issuance of class A notes; this extension risk is highly undesirable to investors and will reduce demand for, and increase the price of, the class AB notes.

B5 Do you agree the above portfolio limits strike a balance between being conservative enough while providing enough depth in eligible mortgage loans? Are there any technical hurdles to access data or select loans based on the criteria above the Reserve Bank should be aware of? Should any additional limits be incorporated?

No, the pool for the RMO should be representative of a bank’s total mortgage pool. There is a concern that the current criteria could lead to ‘cherry picking’ to ensure compliance. Kiwibank believes the criteria set out in the alternative structure will result in representative loan pools. This will maximise the pool of eligible loans to each bank and support the scalability goal of the Reserve Bank.

B9 Do you agree that repo eligibility would support RMO to become more widely accepted financial instruments in domestic markets? What would markets be able to accommodate as an initial market placement?

Yes, repo eligibility will make RMO more attractive to investors. It is important for the Reserve Bank to ask investors to estimate their demand for RMOS and the proportion that would likely be cannibalised from other asset classes; and in particular from senior bank debt.

B10 Do you agree the information disclosure as outlined would be sufficiently comprehensive? Are there other disclosure requirements that should be included? Would an external data repository as outlined provide an adequate solution for NZ markets?

Standardised reporting would benefit the development of a mortgage bond market in New Zealand and help achieve the Reserve Bank’s ‘comparable’ goal. We believe banks will be supportive of a move to provide this directly and that it is essential.

It is unclear that a central data repository will provide any additional benefit over banks conforming to an agreed standardised template and providing that data via their respective websites.

Section 3.4

B13 Do you consider a more active role of the Reserve Bank as beneficial? Would there be other functions the Reserve Bank would need to consider to support the creation of lower risk assets and a future market development effectively?
Kiwibank does not believe that the Reserve Bank taking a more active role is warranted and is concerned this could slow issuers’ speed to market. Appropriate criteria and standardised reporting reduce the need for the Reserve Bank to be more involved.

Section 3.5

B14 Do you agree with the Reserve Bank’s view that the potential benefits from RMO could be high? Are there benefits not mentioned in here?
Kiwibank does not believe the benefits outlined in section 3.5 of the Consultation Paper outweigh the significant costs of establishing and issuing RMOs.

B15 Do you agree with the cost components and scenarios above? Are there other costs or risks the Reserve Bank should be aware of in this context?
The analysis of costs does not include negative carry. Kiwibank’s prepayment rate is around 25% which means that significant cash balances will accumulate in the trust. The requirement to replace amortising loans with low-yielding securities, where the yield on those securities is less than the cost of funding the senior notes, is estimated to cost Kiwibank between $3-7m annually (assuming $1.1b required programme size and depending on the proportion and term of the AA notes issued).

Section 4.2

B16 Do you agree that a period of 12 months would be sufficient to restructure existing legal documentations for non-tradable I-RMBS?
Kiwibank does not believe that a 12 month transition period is achievable. It will take many years for an external RMBS market to develop. We consider that the Reserve Bank should assess the success of any new product before phasing out I-RMBS. It seems that the only way for the market to absorb the existing volume of I-RMBS is for retained RMO or for banks to hold each other’s RMO securities. Neither scenario results in a significant improvement in the Reserve Bank’s contingent balance sheet risk.