RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Review of mortgage bond collateral standards

Summary of submissions

May 2018

Contact details

Interested parties can address enquiries related to this document to:

(email)
stcproject@rbnz.govt.nz
Subject line: RMO Consultation

(Hard copy)
Toby Andres
STC Project Management
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

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1. Intentions of the consultation

The Reserve Bank published a consultation paper in November 2017 aimed at reviewing mortgage loan securitisation standards in the New Zealand market. The consultation paper assessed existing mortgage backed securities like Residential Mortgage Backed Securities (RMBS) and Covered Bonds against a set of criteria for 'ideal collateral' in the context of central bank financial market and lender of last resort operations. The criteria were described as their 'quality, liquidity, scalability and other non-distortionary features'.

Part A of the consultation paper set out that, in the Reserve Bank's assessment, a majority of RMBS and Covered Bonds issued to date would not suit these ideal collateral criteria. The majority of RMBS issued were so called "Internal RMBS" that were structured for using as collateral in RBNZ operations and regulatory liquidity policy purposes rather than for the purpose of seeking funding in the domestic or offshore capital markets, or holding tradable assets. Internal RMBS amounted to between 25 to 30 billion New Zealand dollars (around 10 % of GDP). They are a significant fraction of the total liquidity assets held by regulated entities.

However, current Internal RMBS were found:

- to expose the Reserve Bank to higher than necessary credit, market and operational risks should the current available collateral ever need to be used as part of a large scale and longer term liquidity response following a crisis or prolonged downturn;

- to create market distortions by not providing sufficient incentive for regulated entities to replace internal RMBS held for liquidity with marketable and funded liquidity assets;

- to discourage the development of deeper mortgage bond segments that would provide an alternative investment for domestic savers.

To mitigate these weaknesses, standardise mortgage bonds further and make them more comparable and transparent, the Reserve Bank proposed in Part B of the consultation paper a new mortgage bond collateral standard in Residential Mortgage Obligations (RMO).

This standard had primarily been formulated with a view to improve collateral quality. This included features, structures and documentation standards the Reserve Bank would like to see in RMBS collateral it is lending against or could invest in as part of monetary or lender of last resort operations.

The Reserve Bank is aware that setting a collateral standard can have implications for the relative value, liquidity and attractiveness of existing products for issuers and investors. The new standard has thus been formulated under a secondary objective of testing it against interests that issuers and investors might have when issuing or investing in RMBS in a market environment domestically and offshore.

While the primary objective is focussed on the features that eligible RMBS should have, the secondary objective is focussed on the 'price discovery' which can be achieved in trading such securities in the domestic and offshore markets. Both elements are important to allow the Reserve Bank to treat these sources of collateral as eligible in market operations.

If the RMBS market segment became temporarily dysfunctional or illiquid, the Reserve Bank could still discount the securities based on their pricing in a normal market environment. This is likely to stabilise their values in a crisis and it ensures that the Reserve Bank could reduce risks from the securities it holds once markets revert to normal, by selling such securities.

The mortgage bond structure proposed would offer a short-term and a medium-to-longer-term maturity and complement existing Covered Bonds as long term funding instruments. That would allow investors to purchase a secured instrument (with a range of terms) that would provide mortgage funding for NZ borrowers. And it is likely to support banks to hold such bonds issued by third parties as funded liquidity assets while seeking more maturity-matched funding through selling such instruments themselves.

The RMO as proposed would have a rather simple capital structure. The bonds would consist of a senior tranche and a capital tranche. The senior tranche would be split into a short-term and a longer-term note which would be subject to the same level of credit enhancement from the capital provided. The risk retention for an originator of the underlying loans would be 10% and would have to be fully provided for in capital notes being held by the originator. Being for funding-only purposes, they would allow no mezzanine notes as part of the capital structure.

The Reserve Bank invited interested market participants to a Round Table on RMO in February 2018 to discuss technical features of the proposal, address questions and support market participants in shaping their responses.

2. Responses to the proposal

Following a three month consultation period, the Reserve Bank received submissions from investors, banks, non-bank lenders and agencies in March 2018.

From a high level perspective:

- <u>responses received from the investor community</u> broadly supported most of the issues raised and the draft proposal put forward by the Reserve Bank. It is natural that the responses from investors would appear more aligned in this context, as the investors would face similar risks from RMBS to those faced by the Reserve Bank from Repos.

- <u>responses from issuers</u> ranged from strong opposition to replacing Internal RMBS with an improved marketable mortgage bond standard, to supporting an improved standard, subject to keeping it simpler, more closely aligned to conventional mortgage bonds, more cost efficient and with an easier transition path than proposed.

- <u>other respondents</u> supported the move towards a better standardisation, however, advised that a regime shift needed to be cautiously treated with respect to the likely investor reception, possible externalities on other segments of the funding markets, the higher cost incurred for smaller issuers, and a sufficiently long transition period.

The Reserve Bank has opted to keep the focus of the summary on the key technical issues raised with regard to the proposed standard. A more detailed summary of the answers to the questions asked on collateral policy as part of the consultation is provided in the appendix.

There were eight key technical areas of commentary that emerged from the Round Table and the various submissions received. These are summarised in the following table:

1.	**Primary & secondary collateral policy objectives**
-	Investors mostly support the issues raised and targets outlined in the Reserve Bank proposal. They agree that a consistent liquidity back-up infrastructure is likely to lower liquidity and systemic risks; this could be further improved if the concept included more eligible parties in the future. They assert that tradability of mortgage instruments in the domestic markets and a greater and more regular supply of bonds would make the segment more attractive in the future;
-	Banks as issuers partly disagree with the objectives as outlined in the Reserve Bank's proposal. Some argue the Reserve Bank should stick to setting some high level principles for RMBS; others see limited value added from RMO when compared with traditional RMBS as found in regional markets such as Australia; the majority of banks expressed a preference to hold on to an internal RMBS regime as opposed to having to preposition funded liquidity assets issued by third parties.
2.	**Eligible mortgage loan quality**
-	Investors support the idea of creating transparency over the qualities of eligible loans as it makes credit portfolio assessments easier and allows risk monitoring over the life of a transaction; they advise that some of the eligible loan criteria settings might have been too conservative as to allow for a higher scale in liquidity operations and more depth to evolve in the domestic RMBS markets; some emphasise that discrete pools (where loan portfolios are fixed at the start of a transaction and could not be changed) are in general much easier to analyse than replenishing pools; if the pools become standardised trading RMBS in secondary markets is much more likely.
-	Banks raise concerns that the proposed eligible loan criteria would be too restrictive. This could result in cherry picking good loans off a bank's balance sheet in a crisis leaving depositors worse off; some respondents emphasise that the scalability of liquidity support in a crisis would require to relax the loan quality to support bank liquidity as much as possible; others are concerned that monitoring the compliance with these criteria will create new costs and in many cases would require IT system and possibly front line process changes, to be borne by their customers.
3.	**Eligible capital and product structures**
-	Investors support a simple, transparent and comparable capital structure approach; they prefer the RMO concept to become less complex and strictly sequential in proposed waterfalls; some assert that short term and longer term notes would be desirable to be issued; others advise that the required capital support should be allowed to differ among issuers as their mortgage loan origination standards varied; elements of negative carry for some of the notes could be avoided.
-	Banks disagree with the rationale of some of the safety features in RMO; a lower yield and negative carry can be a cost to issuers and investors alike; others would agree to simpler and safer RMBS but raise concerns that a Reserve Bank standard could likely crowd out traditional RMBS; some banks argue if internal RMBS were structurally safer compared with external RMBS, this could make them in principle tradable, even though they differ structurally from RMBS traded in markets. RMO as a standard should be made as simple and cost effective as feasible. Some banks provided the Reserve Bank with respective proposals how that could be achieved.
4.	**Disclosure and data**
-	Investors express a preference for prospectuses, documentation and data to be of a rather high standardisation to allow for a more efficient internal analysis and more reasonable management

cost; consistent loan level data is needed to allow an independent risk assessment and risk monitoring; investor reports and data should be of a high quality and supplied on a regular basis;

- Banks remark that current RMBS disclosure practices align with regular market practices in Australia; some promote a minimum standard for investor reports which would be sufficient for risk monitoring; others raise concerns that the requirement of a central data repository could create very high costs; some regard regular supply of loan level data as less necessary as the bonds would have to remain externally rated and rating agencies provided regular risk reviews.

5. Operational requirements

- Investors express some preference for a central back-up servicer solution given the small market and high operational risks in an event of default of a major originator; control rights should be clearly defined, and move to the senior note classes subject to trigger events; to legally disassociate a trust or SPV effectively from an originator remains important and it would be positive if the current legal regime could be aligned with that prevalent for Covered Bonds. Common reserves within a trust and other elements of cross-collateralisation could be avoided.
- Banks highlight that the rules upon which the servicing could be transferred from an originator to a third party would have to become clearer to avoid any operational risks or negative incentives; they emphasise that in case of an originator default the back-up servicing was usually provided through the administrator and additional back-up services would thus be largely redundant; banks argued that a reasonable divergence of payer and receiver positions in a trust or SPV are unavoidable but they could continuously be managed through adjustable swap arrangements.

6. Legal documentation

- Investors support a standard documentation framework as it reduces the costs of due diligence; they prefer shorter and more transparent documents that allow quicker analysis; and they support the idea of a fixed suite of standard documents to be extended as necessary.
- Banks express doubt that a standard documentation could be reflective of all business situations; some highlight that existing RMBS documentations are already pretty similar in their content; others suggest the Reserve Bank should continue to accept different documentation standards.

7. Regulatory Incentives

- Investors highlight that the Reserve Bank should consult fund management advisors to ensure the products resulting from the standard would fit well into strategic asset allocations of a broader investor community; they advise that the attractiveness of the new standard would also depend on how the resulting instruments would be ranked under Solvency II and liquidity regulations;
- Banks highlight that regulatory conditions have been a key reason why few RMBS had been issued over the past decade; some think that the Reserve Bank should review capital rules in order to avoid additional capital charges from holding RMBS liquidity assets; others suggest the Reserve Bank should continue to accept traditional RMBS as liquidity assets for smaller lenders. To become eligible offshore, the securities would need to comply with respective requirements.

8. Transition process

- Investors confirm positive market demand for the products subject to a stepwise roll-out; they remark that the transition needs to allow for a reasonable time frame for investment mandates to be changed before investments can start; they recommend the standard should be discussed and promoted with major fund management and strategy advisors; they recommend the new standard to be supported with a communication strategy that would include the central bank.
- Banks remark that the proposed transition period to introduce the new standard is too short; some suggest that the Internal RMBS could be amended to still comply for an interim period; others advocate that the Reserve Bank should allow for a period of at least five years to market up to 50% of current Internal RMBS in the market and pre-position respective third party collateral instead; some banks highlight that the Reserve Bank could support market liquidity if it engaged itself in this market or if it accredited more holders of RMO as eligible in its market operations.

3. Further Process

The Reserve Bank intends to follow up on the key issues raised with stakeholders. There appears to be a preference from some investors and most banks for the RBNZ's collateral standard to allow for a variety of RMBS structures that, while becoming simpler, remain closer aligned with conventional mortgage bond features, as well as for instruments that pay some or all investors back more quickly (as it had been proposed in RMO). There are also areas where additional flexibility was requested (e.g. certain mortgage loan quality standards).

The Reserve Bank considers that the proposed standard can be adjusted in these areas while still meeting the underlying goals to improve critical features, documentation and information infrastructure. It is also willing to discuss the proposed transition path with stakeholders again.

The Reserve Bank is planning to consult on a revised proposal and to finalise the mortgage bond collateral policy review in the second half of 2018. Work on certain details (e.g. operational aspects, legal documentation, information platform) may extend past that date.

APPENDIX

Question	Part A, Section 1 – Requirements for mortgage bond collateral
A1	**The Reserve Bank has formulated some ideal characteristics [high quality, liquidity, scalability, non-distortionary] it would like to see in eligible collateral. Do you agree these are appropriate to seek in eligible mortgage bond collateral?**
Investors	Investors agreed that high quality, liquid, scalable and non-distortionary are sound characteristics for central bank eligible collateral. They noted that in many instances around the world this is not the case, with collateral frameworks having distortive (pricing) effects on financial markets and the economy. Collateral with the characteristics proposed should enhance private provision of liquidity in the medium term, helping to reduce such distortions and open up more investment opportunities. Submitters believed that the wider the range of acceptable collateral, the more likely there could be broader distortions in financial markets as the central bank is indirectly influencing the pricing of a wider range of securities. If these pricing distortions are persistent they can become equivalent to implied subsidies. Due to economies of scale in funding, the benefits arising could tend to go mainly to large financial intermediaries.
Banks	Bank submissions agreed that these characteristics would be desirable in any repo-eligible asset. However, they suggested the Reserve Bank's proposal to achieve them was not the only way. Banks argued that the additional security structure proposed would not achieve some of the desired characteristics very effectively. More specifically, based on the proposed structure and stricter eligible loan criteria, the scalability of liquidity provision may be too limited, restricting the maximum amounts the Reserve Bank could lend to financial intermediaries in a crisis. Some bank submitters suggested that rather than formulating a security standard, it would be better for the RBNZ to adopt a principles-based approach that provided some high level guidelines for key criteria, leaving it up to each originator to make changes to their RMBS programmes to bring them into line with these high-level principles. This would be less distortionary for RMBS markets, as they exist today, while still leaving room to provide for higher pricing transparency for RMBS markets in general. Other bank submitters were more agreeable on the benefits of implementing such a standard if that could be achieved at reasonable cost, by preferably grandfathering existing Internal RMBS for an interim period and by providing a reasonable transition period. Some of the smaller banks and non-bank lenders agreed in principle to the desirable features. Others were concerned a standardisation of RMBS could crowd out one of their major funding sources as some institutional investors could redirect their invested amounts into these new securities, likely to restrict their room to operate.
Other	The ideal characteristics of collateral proposed in the consultation document found broad agreement with respondents. However, it was noted that the standard should not be so conservative that it overly restricted the range of loans that were eligible for inclusion in the pool and lead to pricing distortions. While standardisation is likely to assist liquidity, reduce costs and facilitate volume creation in times of need, too much standardisation can alter the competitive landscape and inhibit the provision of tailored or innovative lending and funding solutions. Some submitters felt that the standardising of legal documentation was a positive move, and could be achieved.

A2	**Do you see scope for Reserve Bank counterparties to hold other satisfactory collateral?**
Investors	Investors noted that the availability of other satisfactory collateral was limited by the funding programmes of highly rated issuers (e.g. NZ government, LGFA). Supra Sovereign Agencies (SSA's) were another high quality asset class where issuance was much less constrained. RBNZ counterparties could build up larger single name exposures if SSA (Kauri) investments were to increase significantly. However, if the Kauri market delivered sufficient supply of safe securities in the long run was uncertain. Investors noted that an alternative means of achieving a sufficient volume of satisfactory collateral could be to introduce a higher quality retained RMBS and charge a fee for liquidity sufficient to incentivise banks to explore alternative liquid assets. This would be more equivalent to the Committed Liquidity Facility (CLF) in Australia. While that would help to address the scalability of collateral, it would not reduce distortions. And it would also not be helpful to develop deeper domestic mortgage bond markets.
Banks	Bank submitters commented that in a liquidity crisis, the only securities that can be defined as 'liquid' are securities that are repo-eligible at the central bank. Other non-NZGB assets that the RBNZ could accept on repo, and are therefore 'liquid', include: Kauri bonds, local authority bonds and some SOE bonds. In general these could be seen as satisfactory as repo eligible assets. However, banks would not be able to liquidate or repo these securities in the market in anything like the volumes that might be required to keep the banking system liquid. It is only their status as repo-eligible instrument that encourages banks to hold them in current volumes. Some banks expressed doubt that in a liquidity crisis the market would be able to absorb higher quality liquidity assets in the volumes the banking system might seek to liquidate given non-banks' asset positions at any point in time. To purchase or repo securities from the banks, market participants would need to raise cash from either their bank accounts (which defeats the purpose from a banks' liquidity management viewpoint) or liquidate other assets. This problem would persist as the low number of eligible parties to Reserve Bank market operations in practice makes banks (and here especially large banks) a primary liquidity broker rather than just an intermediary. But while acting as a de facto liquidity broker the banks themselves cannot create temporary liquidity in the same way a central bank can do.
Other	Submitters noted that the availability of collateral was largely a function of the funding programmes of issuers, as would be the case for NZGB and in particular SSAs. So there remains an amount of uncertainty if there would be sufficient liquidity assets.
A3	**Do you agree that I-RMBS and Covered Bonds are unlikely to meet the Reserve Bank's 'ideal criteria' for eligible collateral set out above?**
Investors	Submitters believed that Internal RMBS do not meet the Reserve Bank's 'ideal criteria' for eligible collateral. Covered Bonds could, if programmes were regular and there was an increase in the [legal] cap on issuance. Overcollateralization, in the case of Covered Bonds, is sized to the risk of the collateral, and should give the RBNZ comfort regarding the credit risk it assumes as a lender or investor. However, the lack of standardisation with the current Internal RMBS and Covered Bonds means the programmes could be quite different in all respects (collateral, structure, documentation etc.). The RBNZ's proposed standards could thus benefit markets.

Banks	Some submitters thought Internal RMBS could meet the criteria as well as RMO, with some structural amendments. More specifically, some suggested that they could maintain regular issuance of RMBS into the market while holding similar Internal RMBS for use as eligible collateral. The marketed RMBS would provide a pricing guide for the internal RMBS. The Internal RMBS would allow replenishment but replenishment could stop while securities were used in RBNZ repo transactions. After these changes, those submitters felt the Internal RMBS could meet most objectives set out above. Submitters also believed Covered Bonds would potentially better meet the criteria than RMO. Internal RMBS could be amended relatively easily to comply with a set of guidelines without formulating a more prescriptive standard.
Other	There was broad agreement that I-RMBS and covered bonds did not meet the ideal characteristics of eligible collateral outlined in the paper. But it was seen as equally important not to undermine existing securities. A standard should better complement existing products rather than crowding them out or changing the market pattern.
A4	**Would there be benefits from making mortgage bonds tradable to liquidity providers other than the Reserve Bank in normal times or periods of stress?**
Investors	Investors thought the primary benefits of tradable mortgage bonds would be that other sources of funding/liquidity could potentially be accessed at a reduced haircut. While issuers would have to invest into creating a new funding channel and accept that investors may require temporarily higher liquidity premiums in the beginning, there was a real chance these liquidity premiums would reduce significantly if such mortgage bonds ultimately become very liquid. At that point they could become competitively and consistently priced funding for issuers. And through a process of price discovery all parties involved would also benefit from transparency of pricing and therefore of being able to observe market-implied credit and liquidity premiums of the pools traded.
Banks	Banks themselves see few benefits to them of having more tradable mortgage bonds, other than for some price transparency. In their view, ‘liquidity providers other than the Reserve Bank’ are not a major force in the New Zealand market. They further argue that in the normal course of business domestic buyers of securities were not different from depositors in that they simply provided funding based on their own flows of funds and asset allocation criteria through domestic or offshore investment products. However, during times of liquidity stress, by definition, these lenders to banks could become unwilling to roll over their lending even if a high quality collateral asset was available. Assuming offshore funders would also generally be unwilling to fund New Zealand banks in a liquidity crisis, the net liquidity provider in the NZ financial system in a stress situation would be the RBNZ. In that regard having more tradable mortgage bonds would not be of a material difference to other high quality collateral assets.
Other	Some submitters referred to the role played by the Australian Government during the stressed period beginning in 2008 when the Australian Office of Financial Management (AOFM) invested up to A$20 billion in new issues of prime RMBS. However, the high standard currently proposed was seen as being too inflexible to meet the requirements of alternative liquidity providers, particularly in times of stress.
A5	**Do you agree that it is feasible to create more resilient mortgage bond markets?**
Investors	Investors were positive on the prospects for deeper mortgage bond markets. Submitters noted that a standardised mortgage bond market could become liquid, and

	therefore more resilient, as has been the case with the LGFA debt as the market has developed (relative to when issuance began). However, based on the experience of other countries, they noted that a market will take some time to develop in New Zealand. Some investors noted that in New Zealand, as opposed to other countries, only a very limited amount of the savings collected would be re-allocated on a long term basis directly into mortgages. A high ratio of savings would end up as deposits, the majority of which were short term in nature and rather expensive as a funding source. A deeper bond market could create a number of positive spill-over effects.
Banks	Most bank submitters agreed on the feasibility of creating a more resilient mortgage bond market and that it would be beneficial to continue to develop New Zealand securitisation markets. However, some did not agree with the proposition that investors were unwilling to invest in traditional RMBS. They noted that some New Zealand investors already invest in traditional RMBS. They also noted that the Australian RMBS market developed without having a standard documentation, a standardised structure, etc. Thus the Australian market demonstrates good demand for bank originated RMBS and submitters would expect a similar, limited, appetite from New Zealand investors. Some banks argued that the main reasons why there has been little incentive for banks to issue residential mortgage securities historically included that RMBS were more expensive than unsecured funding and of short tenor due to high prepayment rates; it was not certain whether there was sufficient investor capacity to absorb both RMBS and unsecured funding; cheaper funding and longer tenor was accessible through Covered Bonds providing higher investor diversification and increased market access. Submitters also suggested that the RBNZ could play a more significant role in the market than it had proposed. If the RBNZ was prepared to make a market in RMO and purchase RMO outright rather than taking them as collateral only, this would demonstrate its confidence in these instruments and be more likely to create the level of liquidity sought by investors and the Reserve Bank. This, in turn, would help bring new domestic and offshore investors into the market for such a regulated instrument.
Other	A resilient bond market was seen as requiring a frequent pattern of issuance with a committed investor pool. In addition, a more flexible structure was seen as contributing to a more resilient market as it could better adjust to changing market conditions.
A6	**What would be the critical features required to achieve a more resilient market?**
Investors	Investors stated that regular issuance of RMBS would be critical, as would repo-eligibility, marketing and education. There would be a need to fully engage both offshore and domestic asset consultants, asset owners and retail investment advisors. Initial offerings would need to be priced in a manner that attracts and builds confidence among investors. Investors would also like to see banks’ trading desks incentivised to support secondary market trading and to quote these securities on a regular basis. To achieve this, stable external ratings and repo-eligibility of the instruments with the Reserve Bank would be essential. A more active role of the RBNZ could be beneficial.
Banks	Banks believed a critical feature required to achieve more resilient mortgage bond markets would be for the RMO to provide a more competitive source of funding (relative to unsecured funding and Covered Bonds) or provide other advantages to originators (e.g. longer tenor, capital relief, investor diversification) in order to incentivise originators to issue. They would need to do so without adversely impacting originators’ depositors, unsecured creditors and existing funding markets.

	Another aspect would be the flexibility for originators to tailor transactions to meet their own and investor objectives (while remaining within guidelines agreed with the RBNZ). Banks would be less in favour of adopting a rigid, untested structure, where its assumed liquidity in all circumstances was based on its repo-eligibility with the RBNZ. While the RBNZ and investors might be interested in doing their own risk and pricing assessments, AAA (sf) public ratings for securities from at least one rating agency would remain desirable and in some cases essential to comply with investment policy. A good performance history for the relevant assets had to be demonstrated through the available asset performance data and investor reports. But ultimately for an issuer to invest in a new financial instrument would require there is positive investor appetite and that this appetite was likely to remain relatively stable over time.
Other	Other respondents believed the critical features were: broad-based investor participation, incentivised issuers, repo-eligibility, education of investors, standardisation and regular issuance. Some submitters felt that a cannibalisation of existing markets should be avoided, notably that of senior unsecured, covered bonds and traditional RMBS. Greater weight should be given to credit rating agency input.
A7	**What are the challenges creating those conditions in the New Zealand market?**
Investors	Investors noted that absolute standardisation may be difficult to achieve. A more realistic outcome was maybe a limited number of programmes with different risk and maturity profiles that could better match the needs of all interested parties involved. Submitters expected some tension in the pricing between investors and issuers when market issuance begins. They noted there will be a significant liquidity premium until programmes are established and investors become comfortable with the asset class (it was noted that this was the case when the LGFA first began issuing). However, they noted that for any new financial market product the burden of initial development and placement cost was mostly on the issuer. This aspect would not be RMO specific. Submitters further noted that they expected banks would naturally compare the cost of raising funds using RMO to the cost of raising other funding sources and to the capital levels required for BAU mortgage lending provision. Submitters noted that the eligible loan criteria could affect mortgage pricing (e.g. mortgages that are harder to put in an RMO could become more expensive).
Banks	Submissions by issuers emphasised that the main challenge would be the higher pricing on RMBS versus Covered Bonds and unsecured debt. In this regard, they expressed doubts around cost savings of RMO because they are effectively RMBS, albeit with pre-determined tranching and portfolio parameters and minimum capital requirements. High prepayment rates could continue to make it difficult to achieve a longer tenor on pass-through RMBS, keeping them unattractive versus Covered Bonds or unsecured debt. It was highly unlikely that regulatory capital relief would be achievable with the RMO because of the constraints around the seller retaining the full amount of the subordinated note and the trapping of excess spread in the structure. Issuers also expressed doubts whether the repo-eligibility of RMO will necessarily ensure that RMO become a sufficiently liquid instrument. Some investors were precluded from leveraging assets and in some cases repo operations were considered as borrowing, even if the underlying legal contract entails an asset sale and repurchase. If the RBNZ was prepared to participate in an RMO market and purchase

	some RMO outright (e.g. in primary issuance), this would help provide the level of liquidity sought by investors until the market could become more self-sustaining. Issuers did not consider RMO to be inherently different from RMBS. If investors would not invest in RMBS because of extension risk, for example, it was unlikely that they would be able and willing to invest in RMO, as the standardisation as such would not change the nature of these risk drivers substantially enough. Some IT system and process changes would be required to meet enhanced data provision and reporting requirements. Issuers said the costs of these changes would ultimately have to be passed on to the banks' customers.
Other	The key challenge was seen to be creating a standard that would satisfy the requirements of a wide range of issuers. This would require compromises.
A8	**Do you agree that RMO broadly meet the criteria set out by the Reserve Bank for 'ideal collateral' (a detailed description of RMO being provided in Part B)?**
Investors	While investors agreed RMO would meet most criteria, they noted that the RMO criteria could mean lower rated borrowers might incur a higher borrowing cost as it has been observable in Australia following investor lending restrictions imposed by APRA. As such, investors see a requirement to support any policy move with a communication strategy to avoid misunderstanding about the intentions of the Reserve Bank, issuers or domestic institutional investors when any new funding program is launched.
Banks	Banks generally felt the spirit of the RMO went well beyond the intention of the "simple, transparent and comparable" guidelines and represented an attempt to create a risk free asset. In this regard some banks noted that their RMBS were already AAA rated, the highest potential external structured finance rating. Minimum capital requirements in excess of the rating agency requirement at AAA rating levels, coupled with the trapping of excess spread (including cross collateralisation across series), conservative eligibility criteria and portfolio parameters, cash collateralised liquidity reserves, investment of principal collections in RMT eligible assets all suggest an originator could be held to provide capital in excess of a stressed loss estimate implied. Banks felt an approach requiring more risk capital than might be necessary to cover the relevant economic risks inherent in mortgage loan portfolios could well distort markets and be inconsistent with APS120. Some banks questioned how the RBNZ would treat other securities which are currently repo-eligible if the requirements for the very safe RMO were to become the new benchmark for repo-eligibility. Or, whether this would mean the current repo-eligibility of other securities (like traditional RMBS) would be withdrawn if the RMO standard was introduced. Some banks believed such an approach would send a wrong signal to investors and could well have a negative impact on the existing market. They also believed a structure that achieves "no principal loss even in severe stress scenarios" was likely to run into implicit support issues which could be problematic under APS 120 regulations. If RMO were issued into the market by Australian regulated banks they should meet APS120 requirements for a funding-only securitisation.
Other	In general, RMO were seen as meeting the criteria of 'ideal collateral'. However, submitters believed consideration should be given to making the standard more flexible to enable broader issuer participation including smaller banks and non-banks.

A9	**How much weight should the Reserve Bank put on RMO securities actually being traded relative to the other characteristics discussed?**
Investors	Investors believed the credit quality and homogenous aspects of the securities and their documentation would be important and necessary. To protect the Reserve Bank (and the taxpayer) from losses should remain a primary objective. The tradability of the bonds would mainly imply that banks would have to fund a higher fraction of the liquidity assets they are holding and it would create a higher price transparency if there was a more continuous flow of issuance undertaken in the markets. Some investors expressed the view that a move away from a higher amount of unfunded I-RMBS to a higher quality funded RMO instrument could be easier achieved if a reasonable amount of issuance was placed among banks to hold them as regulatory liquidity assets. However, if the ratio of RMO being held among regulated entities was very high, the securities were not traded more widely, and the price would then likely remain below that required to attract alternative liquidity providers on a permanent basis. So while investors were in general supportive of the idea that banks hold these assets partially as liquidity assets themselves, the Reserve Bank needed to ensure that a reasonably high fraction was ultimately placed with non-banks in the market.
Banks	Banks argued that liquidity in the New Zealand fixed income markets was currently mainly supplied by banks. Given their exclusive access to the RBNZ, RMO liquidity would likely be similar to Kauri bonds. However, the extent to which RMO were traded in normal times would not necessarily provide certainty as to how they would trade during a liquidity stress situation. Some banks noted if they were compelled to pre-position collateral assets in normal times by selling RMO in normal market conditions, they would then have to reinvest the proceeds in other repo-eligible assets they would need to buy from the market. This would tend to encourage reciprocal placement of RMO among banks in order to minimise the cost of pre-positioning liquidity assets. While illiquid mortgages were transformed into tradable securities through a market process, there was no net new funding flowing into the banking system to the extent that RMO are held among banks. Alternatively, for the fraction of RMO that would be traded between banks and non-bank investors this could result in a transfer of value from banks to other market participants. For instance, as market participants were switching out of low yielding New Zealand Government bonds or unsecured bank bonds into higher yielding RMO or banks themselves switching out of RMO into Government Bonds the profitability left for the banking system might become lower than under the current liquidity regime. RMO could impact the pricing and liquidity of a number of existing instruments. Some banks argued that some of the RBNZ's marketing process assumptions did not appear to represent current market behaviour, such as the assumption of auctions instead of a book building process when marketing mortgage bonds. However, arm's length conditions and price discovery could be assured either way.
Other	No views expressed.
A10	**Are there alternative instruments the Reserve Bank could consider as eligible collateral in order to reduce reliance on I-RMBS ?**
Investors	Investors thought that unfortunately there were only limited alternatives due to the limited funding requirements of other high quality debt issuers in New Zealand. Even if issuance were to increase compared to current levels, the demand from strategic

	investors to hold these asset classes to maturity rather than as liquid assets would be potentially very high. That could reduce the chances to utilise them effectively.
Banks	Some banks thought that a higher limit for Covered Bonds could help to address the problem partially. The international track record for Covered Bonds by New Zealand issuers was well established. Some issues that were denominated in local currency had been well received by domestic investors. Other banks did not believe an increase in covered bond issuance would necessarily prejudice depositors and unsecured creditors as the levels of over-collateralisation required under Covered Bonds are generally consistent with what is sought as a minimum for the proposed RMO.
Other	Some submitters felt that standardising the I-RMBS could be given a priority over the development of more standardised mortgage bonds like the RMO would represent.
A11	**Do you think RMO would be in principle compliant with APS120? Are these requirements reasonable in the New Zealand regulatory and market context?**
Investors	No views expressed.
Banks	Some banks thought that the current RMO proposal would push recourse to originators beyond what would be acceptable under APS120. Some requirements did not appear reasonable (i.e. highly conservative) in comparison with existing repo-eligibility criteria in Australia and New Zealand as they exist today. Ultimately only a confirmation of the proposed regime through APRA could deliver the certainty required for Austrian bank subsidiaries to make its implementation more valuable.
Other	Concern was raised over whether the eligible loan criteria would reduce the credit quality of assets left on an originator's balance sheet, which would be contrary to the principles set-out in APS120 of taking a representative slice of the mortgage book.
A12	**Are there any other areas that should potentially be addressed in the context of developing the Reserve Bank's ability to lend to eligible parties?**
Investors	Some investors expressed interest in the Reserve Bank reviewing its approach to accrediting eligible parties. The prevalent limited number of eligible parties could in practice lead to an increase in liquidity and systemic risks in a crisis. Non-bank financial intermediaries, corporates and households were relying on access to liquidity through the traditional banking system acting as a central liquidity broker. While this was not a problem in normal times it had turned out to be problematic in a number of countries where the banking systems temporarily became a bottleneck for payments and economic activity on a larger scale. This could be addressed by allowing non-bank financial intermediaries to become eligible parties or by purchasing securities outright which could help to supply liquidity to parties not mandated to undertake borrowing against collateral directly with the Reserve Bank.
Banks	Banks noted that non-bank New Zealand investors currently hold approximately $33bn (35%) of all outstanding repo-eligible securities. In principle, the Reserve Bank could open its repo facilities to these holders of securities to unlock a much wider stock of tradable securities for liquidity management purposes. However, some banks expressed doubts if the default nature of asset allocations in many existing funds and the strict limits imposed on funds not to undertake leveraged borrowing, would ultimately be helpful to access liquidity in the dimensions potentially needed. But a

	majority of banks seemed to agree that in general these options could be further explored to manage liquidity and concentration risk across the entire system.
Other	No particular views were expressed.
A13	**Are there other essential requirements to developing secured funding markets?**
Investors	Investors highlighted that investment mandates would have to be reviewed and amended to accommodate RMO as a new asset class. Some investors believed that a central back up servicer role could be beneficial for a small market and could support confidence that the market would perform even in times of crisis. Some investors said that the Reserve Bank could initially promote the market by engaging as an anchor investor in RMO. Others indicated there could be a role for the RBNZ or an alternative agency as a central issuer and servicer of such bonds in the future.
Banks	Banks noted that an adequate time would be needed to develop the depth of the market. They noted that the RBNZ proposal seemed to assume that large volumes of RMO instruments could be placed immediately. This was unlikely to be the case. Investor mandates would need to allow the purchase of these instruments if they were being presented with a new asset class which is neither a RMBS nor a covered bond. Some banks suggested a substantial investor education programme would be needed.
Other	Parties agreed that 'skin-in-the-game' in the form of risk retention was important. However, such risk retention should stay consistent with economic risks estimated.