The Co·operative Bank Ltd
Cnr Featherston & Ballance Streets
PO Box 54, Wellington 6140
Telephone (04) 495 7700, Fax (04) 495 7701

Email headoffice@co-operativebank.co.nz
www.co-operativebank.co.nz

9 March 2018

Toby Andres
STC Project Management
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

Dear Toby,

Submission on the Review of Mortgage Bond Collateral Standards

Thank you for the opportunity to provide a submission on the *Review of Mortgage Bond Collateral Standards*. As one of the smaller banks in New Zealand we do not currently have the option of issuing covered bonds or long dated senior bonds at a viable price. Being able to issue external and internal RMBS senior bonds is therefore important to maintaining a diversification of funding that includes wholesale debt. Without this potential source of funding, smaller banks could face increased liquidity exposure from an unexpected withdrawal of retail funds. The main issue therefore for us is the proposal to phase out the RMBS structure and replace it with the proposed RMO structure.

We have confined our comments to the matters we regard as most significant:

Market Dynamics - Liquidity

The proposed RMO structure would create a strong incentive for the smaller banks to set up permanent Warehouse structures and not issue into the market. The negative carry costs of retaining the principal repayments to meet the AA Note maturity date as cash or short term investments would have a significant economic cost.

Making the AA Note rank ahead of the AB Note in repayment would also reduce the attraction to investors of the more material and difficult to issue AB Notes.

We believe the liquidity of the AA Note would fall short of expectations, with the uncertainty of the soft bullet maturity putting off a number of potential investors.

We further believe any replenishment of the mortgage pool would reduce liquidity through:

- Creating uncertainty for investors around the quality of mortgage assets being purchased; and
- Through extending the maturity date. From an issuer perspective the longer duration will be viewed negatively due to the additional margin that will have to be priced in. From an investor perspective, we would also expect reduced appetite for long term debt whose maturity is further extended.

Market Dynamics – Interest Rate Risk

A fixed rate AA Note and any fixed rate AB Note tranches would increase the hedging complexity and cost for the issuing bank. The mortgage books of New Zealand banks typically have a remaining fixed term between 1 to 24 months, with very few having a remaining fixed term of exactly 1 or 2 years at issuance, and many that do can be expected to be repaid before maturity. Given the re-pricing profile of fixed rate mortgages and the expected rate of early repayment, both pay fixed & receive fixed swaps would need to be regularly adjusted to manage the interest rate exposure.

By comparison, swapping all mortgages with just pay fixed swaps under the RMBS structure is simpler and more cost-effective.

Any feature that increases the duration of the securitised structure (e.g. RMO replenishment) would increase interest rate risk, arising from potential adverse margin movements (as distinct from adverse wholesale rate movements). While the repricing profile of fixed mortgage assets averages around 1 year, the margin on AB Notes would be locked in until maturity.

The review paper states that for Capital-Notes, "Coupon payments would be based on a floating rate of OIS3m + spread and would be quarterly frequency" (refer to section 9.2 in Part C of the Review). We would recommend that the RBNZ does not stipulate an interest rate on Capital-Notes. Not charging interest can be a useful mitigation against adverse changes in mortgage margins, thereby enhancing the credit worthiness of the debt. The Originator is still incentivised to service the loans to protect their principal invested in the Capital-Notes (refer to section 33.3 in Part C of the Review), as well as maximise the Capital Reserve deposit in the Interest Waterfall (refer to section 27.17 in Part C of the Review).

Eligible Structures

We strongly believe that having RMBS standards that are consistent with Australia would have more liquidity benefit than adopting the proposed RMO approach. It is difficult to see potential investors from Australian and other jurisdictions putting the background research into understanding a securitisation model that we understand is only used in Denmark.

We do recognise there is a benefit to standardising the RMBS approach to reduce the credit risk for the RBNZ and to enhance market liquidity. Issuing vanilla internal RMBS senior bonds with a discrete mortgage pool that are rated AAA provides originators the potential alternative of selling these bonds to investors as opposed to relying only on repo-eligible with the RBNZ.

While we believe that investors prefer bonds with a fixed rate and hard bullet maturity, a floating rate amortising mortgage bond results in the liquidity risk and interest rate risk being far more appropriately managed. In our view the main objective of a repo eligible mortgage bond should be the management of these financial risks. Under a liquidity stress scenario, all structured bonds are likely to become illiquid, at which point the key issue is which structure provides the best likelihood of returning to investors the principal and interest owed.

Eligible Asset Criteria

We disagree with the proposed requirement for at least 45% of mortgages to be fixed rate:

- Fixed rates loans have been consistently priced at lower margins than variable rate mortgages, with the margin they do earn at risk when they subsequently re-price:
    - ➢ The re-pricing duration on fixed mortgage books in the New Zealand market is relatively short at around 1 year;
    - ➢ We have observed margin changes in fixed mortgage margins over the last few years of up to 0.5%;
    - ➢ As previously stated, any reduction to fixed mortgage margins cannot be offset by lower debt funding margins which are locked in over the life of the securitised structure; and
    - ➢ The rating agency for our RMBS senior debt issues does not require a minimum margin on the variable rate mortgages, but does require the documented minimum margin on the fixed rate loans over the pay fixed swaps hedging them.
- The mortgage portfolio of The Co-operative Bank has changed from under 30% being fixed rate in 2012 to around 80% in 2017. In our view, a securitised book should to the extent possible represent the mortgage market to assist diversification, unless there are good credit risk reasons to exclude a certain category of loan. This is not the case with variable rate mortgages.

Transition Requirements

We believe that if there are to be changes to what constitute repo eligible securities, there should be a longer transition period that recognises the existing RMBS issues as repo eligible. Otherwise banks will have to write-off the set up costs of recent issuance which were being amortised over their expected life and immediately incur the cost of setting up new facilities. This will particularly impact the smaller banks' who have had to incur similar fixed set-up costs as larger banks but on smaller scale issuance. RMBS issues typically have a 5 year call date, which would be consistent with losing their repo-eligibility at the end of 2022.

We appreciate the opportunity to provide feedback on the review paper.

Yours sincerely

Bevan Miller
CFO
The Co-operative Bank

Andrew Gray
Treasurer
The Co-operative Bank