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Westpac New Zealand Limited

Submission to the Reserve Bank of New Zealand on the Review of Mortgage Bond Collateral Standards

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1. Westpac's submission

1.1 This submission to the Reserve Bank of New Zealand (**Reserve Bank**) is made on behalf of Westpac New Zealand Limited (**Westpac**) in respect of the *Review of Mortgage Bond Collateral Standards* **(Consultation Paper).** Westpac's contact for this submission is:

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2. Executive summary

2.1 The Consultation Paper proposes an enhanced mortgage bond standard aimed at supporting confidence and liquidity in the financial system, and is intended to replace current internal residential mortgage bond securities (**I-RMBS**) structures in New Zealand. The Reserve Bank's new format for mortgage bonds are called Residential Mortgage Obligations (**RMOs**).

2.2 The RMO proposed structure will be costly to implement and administer. The RMO structure will provide inferior investor returns ("AA" tranche) and unacceptable cashflow subordination and extension risk ("AB") for RMO investors. The increased costs for issuing banks of RMOs, when compared with costs for current local I-RMBS structures, do not appear to be materially offset by the benefits identified in the Consultation Paper. The inferior returns and unacceptable structural issues for investors will impact demand to the extent that the product will not be viable as a liquid security.

2.3 We would like all information contained in the Appendix to remain confidential in accordance with section 105 of the Reserve Bank Act 1989.

3. Introduction

Historical approach to I-RMBS and market constraints

3.1 Historically, I-RMBS structures used in New Zealand have been similar to those used in the United Kingdom and Australia (focusing primarily on prime first-ranking residential mortgages). Under such structures, a special-purpose vehicle (**SPV**), which is bankruptcy-remote, is established to purchase the mortgages. Debt securities (**Notes**) are then issued to fund the purchase of the mortgages. In most cases, the originator of the Notes is also the sponsor of the SPV. The SPV is, however, managed under the oversight of an independent trustee.

3.2 The primary constraint for issuing Notes in New Zealand is the lack of depth in the New Zealand debt market. This lack of depth has resulted in low liquidity and a lack of transparency in pricing of the Notes. This means that potential buyers of the Notes tend to be limited to larger more sophisticated institutional investors. Despite the high quality secured nature of I-RMBS in New Zealand, retail investors have shown limited interest. This is because the Notes have lower yields relative to other interest rate options (in particular, bank term deposits).

<u>Protection from bank default</u>

3.3 From the Reserve Bank's perspective, the key purpose of I-RMBS is to significantly protect the Reserve Bank from bank default. The current level of protection inherent in I-RMBS means that, given the haircut undertaken for repo activity, there is no material risk of taxpayer loss using any reasonable hypothetical test. For example, a 19 percent haircut on securities coupled with the 6-8 percent subordination of AAA securities and the 80 percent LVR limit on eligible loans, means that, in the unlikely event of a 50 percent fall in house prices (accompanied by a 50 percent default rate on mortgages), the Reserve Bank would be made whole on any defaulted repo loan.

4. Westpac's comments on RMOs

4.1 The RMO structure will be costly to implement and administer with significant negative carry for the banks. These increased costs are not balanced by resulting benefits to the NZ economy. The RMO structure will be unfamiliar to New Zealand and international investors. Key New Zealand investment managers have informed us that it will be unlikely to meet current investment mandates. For example:

(a) The returns for investors as a result of the "gold-plated" senior structure (AA Notes) would suggest a return consistent with sovereign assets.

(b) The extension risks of the AB-Note and the subordination in the waterfall, along with uncertainties over future repo eligibility would either not fit into standard fixed income mandates or would demand a return characteristic more akin to senior unsecured funding.

(c) The RMO structure would not fit into a portfolio typically attracted to standard RMBS. As such, any issuance would "cannibalise" existing senior unsecured markets.

(d) The impact of the uncertainties around the RMO structure, and the likely impact on unsecured markets, will lead to a less stable local capital market.

<u>RMO not suited to New Zealand market</u>

4.2 The Reserve Bank recently noted [1]:

[1] "Guidance for the preparation of a separation plan for BS11: Outsourcing policy" (December 2017):

"Banks are complex and varied institutions, so what is relevant to one bank may not be relevant to another based on their business lines and organisational structure. Therefore, uniform requirements that call for homogenous plans may not be appropriate".

4.3 The RMO structure is based on the Danish model. However, Denmark has a significantly different mortgage (and banking) market. Given the differences in mortgage markets, legislative frameworks and capital markets practices, translating the Danish model to New Zealand carries considerable risk for the New Zealand banking environment.

4.4 The RMO structure does not suit the underlying nature of the New Zealand mortgage market. Features of the New Zealand market, such as frequent repricing and the short average life of NZ mortgages, are well catered for in the current I-RMBS structure. The RMO structure will not accommodate these market features in the same way. Additionally, in the New Zealand mortgage market borrowers are free to move seamlessly from fixed to floating (and back again). This movement requires extensive hedging (and hedge adjustments) to be included in any securitisation structure. This extensive hedging would not be adequately catered for in the proposed RMO structure.

4.5 The RMO structure differs materially from the approach taken in comparable jurisdictions, such as Australia, UK and US along with most European jurisdictions (other than Denmark).

Investor marketability

4.6 Based on the information contained in the Consultation Paper, and our discussions with the Reserve Bank, it appears that the Reserve Bank has carried out insufficient investigation regarding the marketability of RMOs in the New Zealand market.

4.7 There is no similar product to either the AA or AB notes in the New Zealand or Australian debt marketplace. While the Consultation Paper states that the RMO product will increase demand for securitised product, no explanation has been provided as to how this might occur, and why New Zealand investors will purchase RMOs. In contrast, there are real doubts that institutional investors will create a demand for RMO securities.

4.8 The absence of a formal credit rating for RMOs will also further restrict investor appetite.

RMOs as a market pricing bench mark

4.9 Promoting RMOs as a standard or benchmark for market pricing appears unjustifiably optimistic given the absence of international support. By comparison, even securities with unquestionably strong credit expectations (such as government bonds) failed to withstand the impact of GFC markets. In fact, New Zealand government bonds lacked significant liquidity during the

2009/10 period and traded at a discount to swap rates. Therefore, it is not possible to conclude that RMOs will provide a security with a less volatile price path and the capacity to support benchmarking for the broader New Zealand securities market.

Implementation timetable

4.10 For the reasons noted in this submission, Westpac does not consider that there are sufficient benefits to New Zealand in adopting the RMO structure proposed. However, if one is adopted, more consideration will be required on the timeframe for transitioning to RMOs. The proposed timeframe does not take sufficient account of the fact that the introduction of RMOs would represent a major shift for New Zealand markets. Additionally, the potential investor base for RMOs would need to be assessed before any reasonable decision could be taken regarding the timing for transition to a new securitisation standard.

Other risks and downsides

4.11 The Reserve Bank's proposed single documentation process will inhibit market development and, with different originators, will inevitably restrict collateral and therefore limit market growth. We have doubts regarding the feasibility of developing universal documentation that meets the needs of each mortgage originator. There is no parallel for standardised documentation in international markets.

4.12 There is also a risk that security portfolios would significantly distort the broader bank portfolio such that this may ultimately compromise bank senior ratings as a result of the cherry picking of the bank's mortgage portfolio.

4.13 An independent selection process has limited merit when considered in the context of additional administration costs along with a lack of available expertise in New Zealand.

Standby mortgage servicer

4.14 The case has not been made for a standby mortgage servicer. The Reserve Bank's Open Bank Resolution contemplates using a statutory manager in the event of a bank failure in New Zealand. Given the existence of a statutory manager, we do not understand the value of also having a standby mortgage servicer, as proposed by the Reserve Bank. Bank failure would not result in the cessation of that bank's mortgage servicing capacity. The statutory manager of the failed back would, instead, be incentivised to ensure that the bank continues to service its broader loan portfolio (including securitised loans).

5. Westpac's proposed alterative I-RMBS structure

5.1 Our alternative solution, as described below, better reflects, and addresses the needs of, the New Zealand I-RMBS market, issuing banks, investors and the Reserve Bank.

Eligible securities

5.2 In line with Covered Bond eligibility, and given the mortgage writing standards in New Zealand, security eligibility for any I-RMBS should be consistent with the underlying markets with eligible assets, set as:

(a) Prime first ranking residential mortgages

(b) Minimum LVR 80 percent.

(c) Maximum size $1.5m.

(d) Maximum maturity date at origination 30 years.

(e) Minimum seasoning period 90 days.

Eligible Structure

5.3 A critical feature of any I-RMBS standard is the marketability of its securities. Familiarity with investors and portfolio trustees is key. Therefore, we believe that the new I-RMBS structure should be substantially in line with those used in Australian and other similar markets. For this reason, we recommend a three-tranche structure as detailed in Appendix. It is expected that only the Class A (AAA rated) Notes will be distributed, however Westpac does not believe that any restriction on the distribution of the B and C Notes is necessary.

Market Dynamics

5.4 While banks should be expected to distribute the A notes, there would appear to be no substantive risk in the bank retaining a material portion of the A Notes from each tranche. Retention of a material portion of the A Notes ensures that the bank maintains an inventory of repo eligible securities for both the Reserve Bank and its Australian parent, for the purpose of funding in the event of liquidity disruption. On the assumption that there is no restriction on "cross-bank" holdings, we believe that a minimum distribution of 50 percent for each issue could be achieved without market distortion. At this minimum level, the requisite degree of transparency of market valuation can be achieved, providing all participants (including the Reserve Bank) with confidence around liquidity, and quality of securities.

Implementation timetable

5.5 Using our proposed I-RMBS structure, we believe that transition could be achieved within a relatively short period of time.

5.6 Additionally, given the high quality of existing self-securitised vehicles, we do not believe there is any urgency for transition to the new RMBS structure. In any event, given the relative speed of NZ mortgage pre-payments, we believe that transition would be achieved over a 5-year period by way of the non-replenishment of current self-securitised (I-RMBS) structures.

5.7 Self-securitised I-RMBS will amortise at a rate of 15 percent to 20 percent. By replacing self-securitised assets with our proposed I-RMBS structure, a seamless transition could be undertaken at a pace that would allow new Notes to be absorbed into the New Zealand market. At the end of 5 years, a simple "clean-up call" on outstanding (I-RMBS) Notes could complete that transition process.

5.8 Minimising disruption to the market place and allowing for the gradual drip feed of new securities into the market place in this manner would allow investors to build confidence in the new securities, while also allowing banks to maintain a robust inventory of repo eligible securities throughout the transition process.

Operational requirements

5.9 Operating standards for NZ Covered Bond portfolios meet international acceptable standards. We believe that the same operational standards would be well suited to supporting RMBS. Maintaining similar operating models also provides a robust and familiar operating environment that can be easily leveraged.

Legal requirements

5.10 We propose adopting the same legal framework used for Australian I-RMBS programmes, as amended to reflect any New Zealand specific sovereign requirements. This Australian framework has the benefit of being well established and consistent with international legislation.

Regulatory Issues

5.11 The Reserve Bank appears under resourced to undertake portfolio selection or monitoring beyond that which broader international markets currently accept. Further, the relatively simple structure and vanilla nature of underlying loans do not justify any additional regulatory oversight than portfolio data currently disclosed on NZ Covered Bond portfolios. Further, Westpac understands that institutional investors will find simplicity and standardisation of structure, collateral and portfolio reporting is more important than excessive (and redundant) granulation of the collateral pool.

6. Future engagement

6.1 We look forward to engaging further with senior Reserve Bank management regarding its I-RMBS proposals. We suggest having a further workshop with the Reserve Bank, industry and investors once the Reserve Bank has had an opportunity to consider the submissions.

6.2 We would also be more than happy to meet with the Reserve Bank bilaterally to work up a more detailed alterative I-RMBS structure.