

**Australian Securitisation Conference  
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**THE AOFM'S INVESTMENT IN RESIDENTIAL  
MORTGAGE-BACKED SECURITIES**

**Speaking Notes – Neil Hyden, Chief Executive Officer,  
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The Government's objective in directing the AOFM to invest in RMBS is to support competition in lending for housing.

Twenty or more years ago lending for housing was provided largely by deposit taking institutions. The development of securitisation of residential mortgages provided an alternative source of funds and increased competition in lending.

The recent disturbances in financial markets reduced the funds available for investment in RMBS. This is likely to be a temporary phenomenon, as Australian residential mortgages are generally of high quality and can provide a sound base for securitisation.

The Government's intervention is designed to help maintain the RMBS market in the interim and encourage investors to return to it, thereby supporting competition in housing lending.

**Consultations**

Following the Government's decision, the AOFM consulted with a wide range of industry participants, mostly by telephone. This enabled us to cover a lot of ground quickly.

The consultations were very helpful in the design of the approach we have adopted. In particular, it strengthened our decision to focus on primary issuance as a cornerstone investor.

- We regard this as the most effective means of encouraging other investors to return to the market, while maintaining market-based pricing of the securities we purchase.
- The alternative of purchasing securities through reverse auctions was less attractive. It could have resulted in a race to the bottom on prices if distressed sellers dominated the auction. And it would have provided no assurance that the funds would be used for further lending for housing.

The consultations also underlined the importance of avoiding congestion between new issues in the market. There are two aspects to this - to avoid overloading investors with competing proposals, and to avoid overloading the ratings agencies' evaluations of proposed issues.

### **The approach adopted**

Accordingly, the AOFM has adopted a cornerstone investor approach, spreading mandates out over time. We invited a first round of proposals on 13 October. The first two issues have now been completed and two further mandates issued. We expect to see the latter completed in the next couple of weeks.

We intend to invite a second round of proposals early next month. This will be for mandates to be issued in the New Year.

We are currently reviewing the selection criteria and minimum requirements for this second round in the light of our experience with the first round. We will also take account of feedback from the industry, including from this conference.

### **Selection criteria**

The detailed selection criteria we use in evaluating proposals were set out in the Request for Proposals (which is on our website). They are directed to assessing the contribution the proposals will make to maintaining competition in housing lending.

They include the extent to which the mortgage originators associated with a proposal have relied on RMBS in the past to finance their lending for housing.

- This criterion does not exclude proposals originated by institutions such as the major domestic banks whose reliance on securitisation as a source for funds for housing lending has been relatively small. But such lenders will tend to score lower on this criterion.
- We expect that this will help us meet the Government's stipulation that at least half of the investments we make in RMBS are to be allocated to issuers that are not authorised deposit-taking institutions.

Another criterion is the expected participation of other investors in the proposed issue. Bringing in other investors is not easy in current market conditions, but it is of key importance for the objective of reinvigorating the RMBS market.

The role of arrangers is crucial in bringing on other investors. The experience and capabilities of the arranger is one of our selection criteria. We assess this on the basis of their past performance.

A further criterion relates to the extent to which the funds raised by a proposed issue will be used to originate new residential mortgages in the near term, rather than simply clearing warehouse facilities or reducing balance sheets. Some proposals have been more forthcoming than others in this regard.

- We aim to assess the intentions of the parties and of associated entities such as warehouse providers.
- We will take a close interest in what happens with the investments we make and take this into account in considering further proposals involving the same parties.

### **Minimum requirements**

Another factor of key importance in attracting other investors is the quality of the mortgage pool. This is also important to the AOFM in the security of the taxpayers' funds we are investing.

- The minimum requirements we have specified for securities and mortgage pools provide the starting point in this regard.

One requirement is for an AAA rating from at least two of the major credit rating agencies. This is an essential requirement for us.

In the light of the recent financial turmoil, some people have questioned how much reliance can be placed on such ratings.

- We have had detailed discussions with two of the agencies about the procedures they follow in evaluating RMBS securities. They appear to be thorough, systematic and in depth, and go well beyond what the AOFM could do by itself.
- We attach considerable value to these processes and the resulting ratings. We don't just look at the rating, but consider the detail in the reports and ask our own questions.

We have also had discussions with mortgage insurers and, again, have been impressed by the extent and depth of their procedures.

For the initial round of proposals we set as a minimum requirement that mortgage pool comprise insurable loans. We will reconsider this requirement for the next round of proposals.

- ‘Insurability’ is an imprecise concept that does not impose the same rigour as having mortgages accepted by an insurer.
- All four proposals that we have given mandates to so far have been fully insured and we could make it a requirement for the next selection round.
- Where mortgages are insured by an entity that it is related to the issuer, we would look for evidence that the insurer is equally rigorous in its approach as the major mortgage insurers.

Loan to valuation ratios are important indicators of the risk of default on mortgages, and thus of the quality of a mortgage pool. We have set limits on maximum and average LVRs. In doing so, we have sought to strike a balance between obtaining high quality RMBS and supporting competition in lending for a broad range of borrowers.

- Some proposals put to us have had pool characteristics very close to the specified limits. Such tailoring can produce artificial results that may have unintended consequences. My own preference is to look at the distribution curve of LVRs across the pool, rather than just one or two parameters, but it is difficult to find a way to do this and still maintain clarity in our requirements.
- We will look at this again before the next selection round, but I expect that we will not change the maximum LVR for the next round.

We have asked arrangers to whom we have given mandates to provide an audit confirming that the pool is consistent with the data provided in the proposal and the information memorandum.

This is normal practice in the US but, surprisingly, not uniformly in Australia.

- We see this as important and will include it in the requirements for next selection round.

### **Number and size of investments**

The AOFM invested around \$500 million in each of the two proposals so far completed. In each case, other investors contributed around \$100 million. We have been keen, in these initial investments, to get issues under way quickly in order to provide support for market and to allow further issues to be launched.

The size of the AOFM's contribution in future issues will not necessarily be \$500 million, which represents a maximum,

- and we will look for larger contributions by other investors.

We will monitor the extent of congestion affecting investors and the ratings agencies, with a view to seeing whether the market can handle more issues as it recovers. Concerns about congestion may also diminish once the summer holiday period has passed.

Over time, we expect to support a range of issuers, including smaller issuers where practicable.

But I don't expect that we will be able to take up every proposal put to us, or to invest in every issuer.

It may be sensible for some smaller issuers to band together in a single issue to achieve economies of scale in issuance and obtain a higher place in the queue.

## **Conclusion**

The objective of the initiative is to promote competition in lending for housing.

Competition generally involves change and it is to be expected that market structures will change in the wake of the current crisis.

In implementing this initiative, the AOFM does not seek to shape how the RMBS market evolves. But we will lean in the direction of supporting the development of high quality RMBS securities and of market practices that will encourage investors to return to it.