SECURITISATION: IT'S MADE ITS MARK

HOW IT BEAT THE ODDS IN THE EIGHTIES

By ANNA BORZI

Once considered esoteric and mysterious, securitisation has established its place in Australia's financial markets—but there may be more negotiations with the regulators.

In the increasingly volatile financial arena it is easy to overlook the fact that securitisation in Australia emerged only four years ago from a standing start and with every potential impediment imaginable. By comparison with most other industries, securitisation has not only survived but thrived, with its growth measured in gargantuan leaps. At the end of 1990, mortgage-backed securities outstanding in the professional market totalled $6 billion—about 73 per cent of the size of the corporate bond market—and showed considerable growth potential.

As it grew, the industry's ability to withstand the impact of external factors was rigorously tested: the 1987 stockmarket correction; 90-day bank-bill rates moving from 16 per cent in 1987 to 12 per cent in 1988, 19 per cent in 1989 and back to 12 per cent in 1990; the yield curve twice moving from inverse to normal; the commercial and residential property market collapse from 1989; the shake-out in the financial industry; a flight to quality in all markets but in particular the capital market, from which the industry funding is sourced; and last, but not least, the confusion in the regulatory environment as it moved towards deregulation and then swung back to reregulation.

Continued growth against these odds is a result of the commitment of some of Australia's largest, and not so large, financial institutions, and the hard work and vision of the industry participants. These participants have continued to educate and develop the markets on which securitisation relies.

Securitisation, in its broadest definition, includes the equities market, the financial markets from bank bills to bank certificates of deposit, the unitisation of single properties such as the Grosvenor Place office complex in Sydney, or portfolios of smaller commercial properties. This article will rely on the "pure" definition of securitisation—the conversion of a pool of illiquid homogeneous financial assets into negotiable and fungible financial instruments.

These financial instruments are commonly referred to as mortgage-backed securities (MBS) for pools of residential and commercial mortgages and asset-backed securities (ABS) for all other financial assets, such as trade and consumer receivables. So far, only MBS have been issued in the Australian capital markets.

The participants

During 1990 the industry experienced a year of consolidation and shake-out. The performance of the

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three major players reinforces the theory that mass will support the difficult years. However, in the longer term, some of the new entrants should not be overlooked. At the end of 1990 the industry looked something like this:

FANMAC Limited

- capital of $6 million and return on capital employed (ROCE) of 60 per cent for the year ended 30 June 1990;
- MBS outstanding at 31 December 1990 totalled $2,750 million;
- staff at 30 June 1990 totalled 16;
- shareholders (one feels inclined to insert the adjective "happy") continued to be dominated by the NSW Government with 26 per cent, with the remainder including the AMP Society, Westpac and building societies;
- during the year Fanmac introduced two new concepts into the investor market and was the first non-bank in the Australian capital markets to issue $500 million at one time. The first initiative, a long-term, single-tranche structure using the average life concept, is the optimum pricing technique for full pass-through MBS in an inverse yield curve environment. The second innovation was the collateralised mortgage obligation (CMO), again a full pass-through which issues in tranches of varying average life. The CMO achieves optimum pricing in a normal yield curve, so with this dual product strategy Fanmac has ensured its issuing environment is unaffected by yield-curve volatility;
- Fanmac stood as the fifth-largest manager of a residential mortgage portfolio among all financial institutions in Australia.

MGICA Securities Ltd (MSL)

- capital of $13 million at 31 December 1990 with an ROCE estimated at 30 per cent (MSL results are consolidated with its parent);
- MBS outstanding at 31 December 1990 totalled $958 million;
- staff at 31 December 1990 totalled 15;
- the shareholding remained constant throughout 1990 but an interesting twist occurred on 1 January 1991 when the AMP Society bought MSL from MGICA Ltd (itself a wholly owned subsidiary of AMP), whose core business is mortgage insurance;
- MSL introduced no new products during the year and, in response to the general shake-out in the capital markets, has called a halt to its existing program until the volatility clears. Anecdotal comment suggests there may be an updated version of its existing fixed-interest product.
- MSL remains the only participant to have developed a national base of mortgage originators, having done so by capitalising on its association with MGICA Ltd.

National Mortgage Market Corporation Limited (NMMC)

- capital of $5.36 million at 30 June 1990 with a ROCE of 33 per cent;
- outstanding MBS at 31 December 1990, issued by NMMC or under management, totalled $1,427.7 million, spread over five products;
- staff numbered 33;
- some shareholder changes occurred during the year with the demise, or integration into parents, of some, and the introduction of the Western Australian and South Australian governments diluting the 26 per cent portion previously wholly owned by the Victorian government. The shareholder base consists of a contingent of strong financial institutions;
- during the year NMMC introduced a new structure, issuing MBS with discounted commercial paper and fixed-interest bond characteristics. The primary purpose is to fund the welfare housing programs of the three shareholder governments. However 1990 was not a good year for two other of the NMMC products—indexed bonds and straight fixed-interest bonds—which failed to achieve anticipated growth.

Others

- ANZ McCaughan's fixed-interest program produced growth to $500 million outstanding at 31 December 1990. (its operating results cannot be determined as they are consolidated with the ANZ Group's financial statements);
- Prudential Bache also introduced a MBS program similar to a fixed-interest bond, with a total of $28 million outstanding at the end of 1990. Independent industry comparisons cannot be determined from published data.
- Financial Security Assurance, an American corporation whose core business is guaranteeing the performance of financial structures, brought a new product to the market. This product, 'SAFE' (also similar to a fixed-interest bond), had an issued volume outstanding of $100 million at the end of 1990. SAFE's marketing documents claim an ability to securitise any type of financial asset into the one structure. Should this prove achievable and sustainable in all market environments, it will be a world first and will change the direction of product development for other participants;
- Credit Lyonnais Australia launched an $A-denominated MBS in the US capital markets in January 1991. Australian participants have issued without great success in the Euro market; this is the first issue in the US and is unusual in using $A.

Those that didn't make it this year

Like nearly every industry in Australia, securitisation has experienced a shake-out. Achieving a viable and sustainable place in the securitisation industry requires long-term commitment. Of those listed here which did not make it in 1990, some should not be disregarded in future years.

- Capel Court Bonds, supported by National Mutual Life Assurance, will not continue;
- Security Pacific Australia Ltd has its securitisation arm on the market as part of a general retraction of its offshore interests;
- Schroders Australia Ltd has also put its securitisation program PUMA on the market. This is the only stand-alone, fixed-interest-only MBS and will be a good strategic buy for any of the three major players;
- The Leasing Trust of Australia, developed by Macquarie Bank Ltd, would have been the first ABS issue but is yet to come to market.

The future for these and new entrants relies on a number of factors. First is a broad and sound origination base, without which a sustainable program is not viable. The growth in this supply part of the industry (which largely comprises co-operatives, mortgage bankers, building societies and second-tier banks) has stagnated over the past year and, in some areas, contracted through attrition. Second, MBS and ABS need an international rating if they are to attract funds from those with the most dollars to invest—the domestic institutional investor or offshore markets. Securitisation is similar to other markets in that it must compete internationally or die. Last, a continuing education of all participants in the market, from the consumer to the investor, is essential.

Regulatory environment

The regulatory environment during 1990 produced both pluses and minuses.

The **Corporation Law** has failed to address some fundamental obstacles to securitisation retained from the Companies Code. For example, the concept of "offers to the public" has now been replaced by a prohibition against offering or issuing subscriptions for any securities without a prospectus unless the issue or allotment comes within 12 specific exclusions. These exclusions are very narrow and impede securitisation sales to the retail market.

Another example is buy-back provisions. With securitisation, retail investors may not liquefy their investment through a buy-back as this would create a mismatch of assets to liabilities, which is counter to the fundamentals of securitisation. The retail market has learnt, to its regret, that this provision does not provide safety, as has been shown in the mortgage unit trust market over the past year. If this had been a securitised market, of similar high quality to the wholesale market, there may not have been so serious a loss of confidence in Australia's financial markets.

The WA government is drafting amendments to its Stamp Act and Trustees Act to facilitate the securitisation of mortgage and other financial assets. It is expected to adopt a framework similar to that introduced by the Victorian government. Broadly, this will exclude all aspects of the transaction from stamp duty assessment if defined criteria are met (with some discretion by the commissioner), and introduce a prescribed rating to attain trustee status for the MBS or ABS. This continues the trend towards a uniform market, which is seen by industry participants as a necessity.

The Privacy Amendment Bill 1990 was amended before its ratification to facilitate securitisation. Dissemination of information about financial assets is a crucial aspect of securitisation, and although the information should be handled carefully, some latitude is important.

The RBA has chosen not to issue formal guidelines for securitisation of assets.

During 1990 the Insurance and Superannuation Commissioners ruled that debt-type MBS and ABS were excluded from provisions of Section 39(2)(b) of the Life Insurance Act 1939. This section limited the investment in MBS and ABS issued as equity, or beneficial units in a trust, to a maximum of 5 per cent of the investor's statutory funds. This, while still a half-way measure in the industry's view, is a move in the right direction.

Considerable hurdles remain to be overcome—for example, the proposed uniform consumer credit legislation and accounting guidelines, such as those relating to the treatment of sold assets with retained management rights.

The new standard AAS24 (consolidation by control) and Discussion Paper No 14 AARF (conceptual framework for reporting) may require securitised assets currently off balance sheet to be placed back on balance sheet if interpreted in their present form.

Capital adequacy

One of the most debated issues in securitisation has been the application of capital adequacy guidelines to banks wishing to securitise assets and/or invest in MBS and ABS. The consensus in the securitisation industry is that until banks, with their large homogeneous portfolios of financial assets, enter the market it will not achieve the desired depth. Before reviewing the validity of this opinion it is important to understand some benefits to a bank from the use of securitisation. These include:

- interest rate risk management;
- liquidity management;
- profitability;
- growth and market share;
- product innovation and spread;
- capital adequacy.

Banks optimise balance-sheet risk management and strategic management by the prudential control of their equity, retained earnings and debt. At any time, depending on the purpose, the issue of equity or debt (including their various derivatives) may be the best management tool. Securitisation provides a bank's management with an alternative to the equity/debt decision. This is being recognised by central banks throughout the world.

The Reserve Bank of Australia has two options: either to issue guidelines or to deal with securitisation on a case-by-case basis. Either way, it will satisfy only part of the market, as the response to the Bank of England guidelines indicates. Without guidelines, the banks will find it difficult to make policy decisions on the implementation of securitisation. With guidelines, they may be inhibited in finding innovative solutions because of the RBA's relative inflexibility.

The RBA has chosen not to issue formal guidelines for securitisation of assets. It has, however, indicated a general position: that banks need to hold capital against assets that have been securitised when there is residual credit or financial risk attaching to the bank. This relates not only to the bank's legal obligation to make good any losses attributable to assets it has sold, but also to possible "moral" risks. The RBA has maintained that the sponsoring bank's position must be made clear to investors.

In contrast with arrangements in some other countries, the RBA does not take into account the nature of the assets backing securitisation issues. All holdings of MBS and ABS are risk-weighted at 100 per cent in Australia.

Many other issues remain to be dealt with in overcoming the unintended effect of legislation and regulation, and in continuing to educate investors and originators of financial assets about the benefits of securitisation. Nonetheless, securitisation will continue to gain prominence as an industry in its own right, as an advanced management tool for financial institutions, and as an instrument for use in the privatisation of the funding needs of welfare housing programs. □