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Covered bonds push RMBS funding out of reach

It's been a difficult time for non-bank lenders in particular as their traditional securitisation funding has all but dried up or has been crowded out by other instruments, such as covered bonds. This was one of the main points to emerge from a panel discussion at the AB+F Mortgage Innovation Forum, run in Sydney yesterday.

This is especially so for lenders outside the Big Four banks, noted Rob Camilleri from Realm Investment House, and along-time investor in the Australian securitisation market. "We no longer have $100 billion in offshore investors' money coming into Australia to fund RMBS (residential mortgage-backed securitisation) issuers, and this has left most mortgage originators out of the market," he said.

He also warned that the good work in explaining the Australian mortgage securitisation story has been lost as a result of the GFC. "There is a re-education element [needed] as to why our housing sector has stayed intact, compared to offshore. "

Further there is a differential cost in terms of swapping foreign investors' funds back into Australian dollars, which in some ways penalises us for our success, Camillieri noted.

Chris Dalton, chief executive officer at the industry body the Australian Securitisation Forum agreed, adding that there is a demand for Australian RMBS among overseas investors, but in many instances these investors' mandates dictate the currency the instruments need to be issued in, usually US dollars or in euros.

"However, central banks are recalibrating what currency basket they want to have exposures to and Australia has stood out as especially credit-worthy," he said.

"The initial introduction of covered bonds in late 2011 at attractive margins, approaching 200 basis points over the swap rate, have temporarily crowded out securities like RMBS, although covered bond margins have since come back in [now at about 130 to 140 bps over swap]."

Camillieri put this down in part to a simple 'demand-supply' equation – there were a lot of covered bonds being marketed to investors at about the same time.

"Longer-term, the industry expects this to have a flow-on effect to RMBS issuance. Dalton noted that sale of covered bonds has brought in new group of investors "who now have exposure to Australia's residential home loan market and that assists [further] in the story when the time is right to go back and offer RMBS to them".

Camillieri warned: "With securitisation it either works or it doesn't work [as a funding source].

"For private label issuers whose only source is securitisation, the market is effectively closed for a period of time until margin comes inside the threshold, where pricing makes sense."

Graham Mott, assurance and advisory partner at Deloitte, observed that it was no surprise to him that the covered bond deals from all the Big Four Australian banks at the end of 2011 and the start of 2012 have been snapped up by investors, to the detriment of RMBS issuers.

"From my perspective, investors got a fantastic deal through Christmas and January to buy securities with a AAA rating," Mott said. "All the banks going to market at the same time made the supply side just too big; investors could just pick and choose."

He suggested this was 150 basis points or less, adding "we should see some issuance being brought to market in coming months."

Mott then gave a back of the envelope explanation of the maths needed to make funding via a securitisation transaction work for the smaller institutions and non-bank lenders: "There are standard variable rates [offered by] the banks of 740 basis points [7.4 percent]. Let's take 100 basis point off as a discount, to make the maths easy. The cash rate is at 425. Add a bank bill spread of say 25 bps. Off that remaining 190 basis point margin comes the 150 bps spread for the AAA tranche of RMBS funding [based on the most recent deals by non-banks, back in 2011]; and subordinated tranches need to be kept on balance sheet at very expensive rates.

"That gives 40 basis points to play with. The cost of the broker channel is about 30 bps [in present value terms]. That leaves 10 bps to service the loan and allow for credit risk.

"There's just nothing there for the non-banks trying to compete against banks that can offer 100 basis point discounts," concluded Mott.

"So that's where the non-banks are, going down the credit curve, moving to a higher loan to value ratio; but they need to

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fund that, and they need to take the funders with them.”

The dynamic is different for the majors who can sacrifice some profit margin to retain market share, but they have constraints in other areas, such as cost to income ratios, noted Mott. “[This is] why we saw NAB with a 9 basis point reduction in their [headline] margin for the December quarter.”

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