Resuscitating Securitisation

One of the major calamities of the financial crisis has been the demise of securitisation. Before it was "over-engineered" by the financial rocket scientists creating CDOs, the basic securitisation model provided a simple way of tapping non-bank sources of mortgage funding with identifiable, sensible risk diversification – focused primarily on mortgage pre-payment risk.

Of course, all was not perfect. Creating and selling tranches of marketable securities with different risk characteristics out of pools of mortgages involves incentive and agency problems.

Mortgage originators may not apply adequate credit standards to potential borrowers, and low quality assets may be sold-off. Since investors recognise this, originators often retained some high risk tranche leaving them exposed to significant risks not adequately captured in capital requirements. Third party insurance obtained from monoline insurers ensured high credit rankings and often led investors to pay inadequate attention to the underlying credit risk.

Despite Australian residential mortgage backed securities (RMBS) being backed by high quality mortgages, the local market has been tarred with the sub-prime brush and essentially closed to new issues since late 2007. As part of its stabilisation package, the Australian Government has introduced a scheme for the Australian Office of Financial Management to buy prime RMBS from Australian originators. This supplements the ability of financial institutions to use prime RMBS as collateral in repurchase agreements with the RBA.

It is to be hoped that this temporary measure does not morph into something more permanent akin to Freddie Mac, Fannie Mae, or similar government (sponsored) entities elsewhere. There is no need for a government owned entity underpinning RMBS issuance to achieve a well-functioning securitisation market in the longer run.

Another alternative is to remove or amend depositor preference legislation to permit the issuance by Authorised Deposit Taking Institutions (ADIs) of Covered Bonds. Such bonds, common in Europe, are bonds issued by (and an obligation of) ADIs which are secured against a specified pool of mortgage assets on the ADI's balance sheet.

Unlike the US inspired style of securitisation used in Australia, the mortgages remain on the ADI balance sheet and covered bond holders have a claim on the ADI secured against those mortgages. If the ADI fails, then covered bond holders have first claim against those assets and, in the event of a shortfall in value, a residual claim on the ADI.

Why would this be preferable? The on-balance sheet nature of the covered bond should provide better alignment of the ADI's incentives as both originator and residual risk bearer. There is less risk of obscuring risk bearing and sharing than in the current securitisation model (which could still be used by non-ADI originators). Bank backing makes the covered bonds attractive to investors.

To permit covered bond issuance, it is necessary to amend depositor preference legislation which prevents any creditor having and equal or higher ranking claim on any bank assets than that of Australian depositors.

Prior to the introduction of 100 per cent deposit guarantees, depositor preference was argued (correctly) to be an important safety net for Australian depositors – reducing the need for deposit insurance. Currently, given the blanket guarantee, it is irrelevant. Moving forward, it is not crucial to a limited guarantee scheme – although some amended form of preference arrangements may be desirable to reduce the cost of any such scheme.

While covered bond issuance means that depositors do not have first claim over all assets on the ADI's balance sheet, the appropriate comparison is with current securitisation techniques. There, the pool of mortgage assets is taken off the ADI's balance sheet and is thus not available to depositors either.

Covered bonds provide an alternative form of securitisation which warrants attention as preferable to current arrangements. It requires amendments to depositor preference legislation and its consideration should be high on the government agenda for dealing with financial sector reform and recovery.

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