

DEVELOPMENTS IN THE RMBS MARKET

This note reviews developments in the Australian primary RMBS market and the AOFM's activities in the market to the end of October 2010. It updates material in the AOFM's Annual Report for 2009-10. An earlier review is on the Treasury's web site.¹

Recent Developments

Global credit markets have been fragile through much of the 2010 calendar year. Conditions strengthened in the first quarter, but deteriorated in the second quarter; since then, there have been some improvements in credit conditions and the number of new issues has increased.

In order to further support competition in lending for housing, the AOFM adjusted its approach to investment in the second quarter. It announced in May that it was prepared to shift its cornerstone investment towards longer dated tranches, which it would price at tighter levels, balanced with the desire to encourage continued private sector participation in AOFM supported RMBS.

This change in approach has facilitated the creation of shorter-dated tranches that have been in demand among both traditional 'cash-enhanced' investors and domestic financial institution balance sheets. The AOFM has thus typically purchased the 'slowest to repay' third of the majority of transactions since this time, although has been called upon to invest in a higher proportion of some smaller transactions.

The faster paying tranches that have been facilitated by the AOFM's change in approach have typically priced at around BBSW+100 basis points per annum, generally without AOFM investment. At the same time, the AOFM's pricing on the longer senior tranches has been between BBSW +110 and BBSW + 130 basis points per annum.

The revised approach has seen primary issuance pick up once again, with the third quarter experiencing the greatest volume of issuance since the program commenced, with c. \$6.9 billion in AOFM-sponsored issuance (of which around \$2.25 billion was invested directly by the AOFM).

The change has allowed the AOFM's share of primary market activity to stay relatively low. The above numbers for the third quarter can be expressed as the AOFM's contribution being around 32 percent of the total; in other words, the private sector was prepared to invest, on average, slightly over \$2 for every \$1 of public money invested.

Over the six months to October 2010, the AOFM has invested around \$2.8 billion of a total issuance in AOFM-supported transactions of just over \$9 billion, a share of just under one third. These figures include only transactions that were supported by the AOFM; there has also been one standalone deal at the end of March undertaken by Bankwest. When included, this brings total RMBS issuance since the March review to just under \$9.7 billion, further reducing the ratio of AOFM investment.

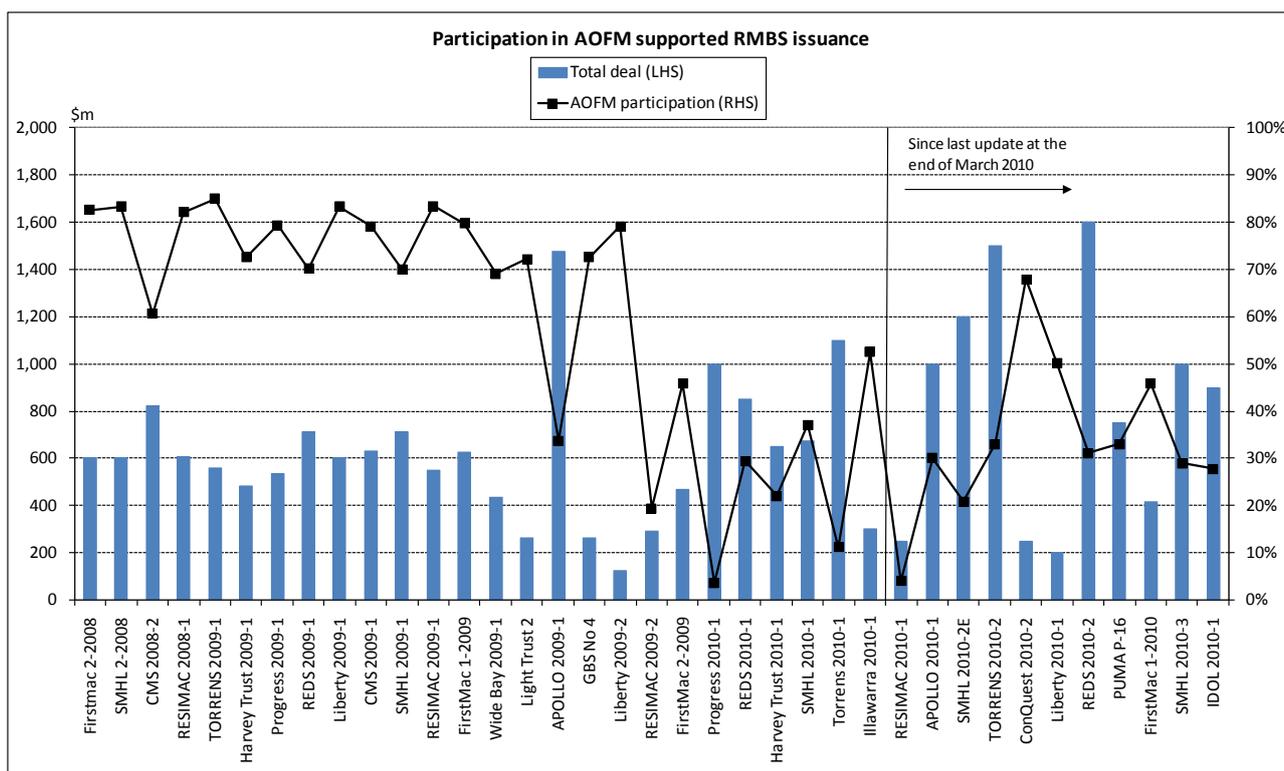
Secondary market margins on three-year Australian RMBS widened in the second quarter to around BBSW + 150 basis points, largely as a result of the continued global credit situation. That

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said, in recent months secondary margins have tightened as a result of a recovery in global conditions and a shortage of primary issuance of domestic RMBS with maturities longer than two years.

The AOFM has no intention of divesting its holdings of RMBS, but has received some unsolicited approaches from investors which suggest that the secondary market for RMBS with remaining weighted average lives of around two to three years has improved to around BBSW + 120 basis points.

The following chart shows the size of RMBS transactions supported by the AOFM and the level of AOFM participation in each. Note that the share of AOFM participation has tended to be higher in smaller transactions.



Michael Bath and Robert Baldi, November 8, 2010.