AOFM Opening Statement – Economics References Committee: Inquiry into the post-GFC banking sector 21 September 2012

The AOFM appreciates the opportunity to add to the record regarding its involvement in the Residential Mortgage Backed Securities market and in particular its exposure to low doc loans. To clarify the means by which it participates in RMBS, the AOFM does not purchase loans per se, but rather it invests in securities, which are secured by prime home loans, some of them low doc loans. Furthermore, there are no 'subprime' loans amongst the mortgages underpinning the RMBS in which the AOFM has invested.

AOFM's involvement in RMBS can in principle be considered from two perspectives. One perspective is the exposure of taxpayer funds to risky investment losses; and a second, the financial returns and risk aside, whether the approach by AOFM to deals in which has been a supporter stands up to the broader scrutiny expected of a government agency.

Let me take the first of these perspectives for comment, but before that explain the basis for AOFM's involvement in low doc loans. Since the commencement of the RMBS program in 2008, the AOFM has maintained the view that its mandate does not include seeking to fundamentally change the nature and structure of the RMBS market, and the mortgage market more generally. We see our role as facilitating the use of securitisation as a means of capital raising for the small ADIs and non-ADIs, thereby providing more general support to competition in the market for prime mortgages. We have not sought to impose value judgements about the sort of lending that is worthy of Government support. As low doc lending was a valid form of lending to the self-employed and small business owners, had we declined to invest in RMBS supported by pools containing at least some low doc loans, it is likely that the availability of credit to the self-employed would have been negatively impacted.

That said, the AOFM went into this investment activity aware that the performance of low doc mortgages is on average worse than for full doc mortgages. By this we mean that the arrears experience for pools of predominantly low doc prime loans is typically above that of pools containing solely full doc prime loans. To illustrate this point, as at the end of June this year Standard and Poor's reported a 30day+ arrears rate for all prime pools of 1.50 per cent, which they decomposed into 1.26 per cent for prime full doc loans and 6.07 per cent for prime low doc loans.

For pools containing more than 10 per cent low doc loans, the AOFM has insisted on RMBS sponsors meeting additional criteria and measures, including that a cap on the maximum loan to value ratio of all of these loans be set at a lower level, and requiring that these loans be covered by lenders mortgage insurance. To date, the AOFM has participated in only one transaction where the share of low doc loans was greater than 10 per cent of the underlying pool, and in this case it only invested $10 million, of which over half has been repaid without incident in the two years since the investment was made.

The AOFM has in place a risk-based due diligence program for its RMBS investment activity. However, the level of assessment varies depending on the particulars of the sponsor. A small unrated sponsor will typically receive a site visit from us in which we conduct interviews with key personnel, with a focus on the organisation's loan approval process and its ongoing servicing and collections frameworks. The AOFM will raise any concerns and require satisfactory changes prior to agreeing to invest. These site visits continue on a regular basis, even if no further investment is in prospect. The AOFM recently answered questions on notice regarding the number of rejections it has made of RMBS investment proposals, including those rejected on risk management grounds. For reasons of confidentiality, we don't want to get into the detail on who specifically has been rejected and why.

Suffice to say, the AOFM believes it has allocated sufficient professional expertise to the management of the RMBS program and specifically to anticipate the resulting risks to the taxpayer. As at the end of July, the 30day+ arrears for its portfolio stood at 1.1%; this was below both the full doc and broader prime benchmarks to which I just referred. Furthermore, just two of 98 securities in which the AOFM has invested over the last four years have been downgraded. Both of these downgrades occurred as a result of a rating agency changing its methodology; and both have since had their AAA ratings reinstated.

As well as the AOFM's due diligence activities, its investments benefit from a number of lines of defence. Specifically, the AOFM also requires what are known as 'pool' and 'tie back' audits. We insist that each pool audit specifically reference AOFM's minimum criteria. As another line of risk defence, lenders mortgage insurance covers the vast majority of pools, with the weighted average coverage rate being around 98% across the AOFM's RMBS portfolio. Yet another and crucial line of risk defence is the so-called 'tranching' of each transaction; together with the limits placed on the AOFM's investments to AAA rated notes, this means that the owners of more heavily subordinated, or 'first loss' tranches, provide additional protection to the AOFM's interests.

There are extreme circumstances that would test the robustness of these lines of defence – an obvious one being the case whereby mortgages are declared legally invalid, resulting in a loss of access to the associated stream of payments. We are aware through the media and this inquiry that allegations have been made regarding fraudulently originated mortgages although we have not seen or heard of any evidence of this in connection with the mortgages underpinning AOFM's RMBS portfolio.

Having said that, and despite these defences we could consider in theory the impact of this as a scenario, and in fact take it to its extreme and assume that all low doc loans were considered worthless from an RMBS investment standpoint.

First, the AOFM’s investment stood at around $11.1 billion as at 31 August. The mortgage pools backing these investments contained a total of around $25 billion at this time. Of these $25 billion in mortgages, less than 2 per cent, or just over $400 million, comprised low doc loans. However, the ranking of the tranches in which the AOFM has invested means that any losses, even in the most catastrophic event, would be significantly less than this amount.

It is unlikely that one of our lines of defence, namely lenders’ mortgage insurance, would provide protection in this scenario. However, the third line of defence in the form of subordination would provide a significant buffer. We estimate in this extreme scenario the AOFM would suffer a loss on its investment equating to around 0.5 per cent of the AOFM’s total investment.

Finally, because the AOFM only invests in RMBS that contain mortgages that have already been originated, it has neither involvement in nor control over how the practice of mortgage lending is undertaken. This is clearly a matter for the financial industry to organise, practise and monitor. Furthermore, it would simply not be practical (or reasonable) for the AOFM to employ the substantial resources required to vet the detail of every mortgage behind every RMBS transaction in which it has or may be asked to support. We estimate that there are over 129,000 mortgages that underpin the RMBS transactions that we have been asked to analyse and support, and of this total about 2,000 of those would have been low doc loans.