<u>Opening Comments for ASF forum Sydney 30 July (RMBS divestment)</u>

Thank you to the ASF for convening this session and to Allen and Overy for hosting it. Given the audience, I don't propose to provide a potted history of the RMBS program since its inception in 2008 – this is well known, as should be the diligence and careful thought that the AOFM has exercised regarding its involvement in the RMBS market to date.

Instead I will focus on the task at hand, namely the AOFM's approach to an orderly divestment of the Government's RMBS investments, while not devaluing taxpayer assets. I will start with a brief discussion of the Treasurer's Direction of 5 May, and in doing so share with you its key points and what the AOFM specifically does <u>not</u> infer from it. I will then briefly explain the means by which we have implemented the Treasurer's Direction. Having now put detail into the public domain about how we are undertaking the divestment process and given that the first two auctions have prompted some feedback, this is an opportunity to respond to that feedback. Finally, I will take the opportunity to reinforce some messages that you should take away from today's session.

The key elements of the Treasurer's Direction are:

1. The entire RMBS portfolio is to be divested (but there is no set time frame by which this is to be achieved);

2. This divestment is to occur through a regular, competitive process (which we call 'auctions');

3. The AOFM can exercise discretion over the timing and volume of auctions so as to minimise potential market disruptions, subject to an upper limit on the volume to be sold in any one month of $500 million;

4. The AOFM has discretion not to proceed with a sale if an acceptable price cannot be achieved; and

5. Transparency and probity are paramount.

In addition to these considerations, the AOFM remains bound by a broader governance framework, given that we are an agency of the Government selling public assets. This means taking steps to ensure the preservation of taxpayer value. Together with the need to minimise potential market disruptions, these were the key drivers behind the design of the divestment process.

We think that the Direction is clear on the desire to avoid unravelling the positive outcomes achieved by the investment phase of the RMBS program, so minimising market disruption is important, but so too is the need to avoid selling too cheaply for preservation of capital reasons. The impact of these considerations is clearly evident from the first two auctions in which the volume of notes we agreed to sell in each case was significantly below the amount offered. Let me be absolutely clear in that we do not feel pressured to respond in future auctions by selling larger volumes at lower than reasonable prices to in any way ‘catch-up’ to a pre-determined rate of divestment. Given the lack of trading data for the secondary RMBS market we fully expected that it would take some time for expectations to adjust, although we had probably underestimated the extent of the gap in expectations revealed so far. It may still take more time to reach a better alignment, although our agreeing to address you today will hopefully facilitate that process.

But what remains clear is that these considerations push us towards the need, among other things, to carefully formulate an AOFM view on the value of the notes being offered and to carefully set reserve prices for each auction. The emphasis on probity means that these reserve prices are to be set in advance of each auction, so that we cannot be accused of acting in a manner that benefits one bidder over another, either in a contemporaneous sense, or through time. We are fully aware of the need for the AOFM to be seen both through and after the event as having acted with the utmost integrity and in a manner consistent with full accountability.

Further, if we think the market lacks important information, our need to run a process that meets the highest standards of probity will also cause us to seek to address this. This is what lies behind our Operational Notice of 14 July that drew attention to the Transfer Options embedded in two of the securities being offered in the third auction.

Moving on to the things we do <u>not</u> take away from the Direction, the first is that it is clear that we are not to run some sort of 'fire sale'. Further, the Budget papers noted that, subject to market conditions, the portfolio could be expected to be divested by the middle of next calendar year - although this should only be seen as a natural consequence of having a stock of around $4.5 billion at the start of a process that sees sales of up to $500 million occurring each month. I want to stress that nowhere in the Direction does it say that the portfolio is to be completely liquidated by a certain date. There has also been some discussion about the need for us to report back to the Treasurer with an assessment of market conditions if three consecutive monthly auctions yield less than $300 million in sales. Once again, to be clear, we do not interpret this as the Treasurer telling us to put ourselves over a barrel for the next auction if two consecutive auctions have failed to produce $300 million in sales. It simply means that we would need to provide an assessment of market conditions so that expectations regarding the rate of progress of the divestment process overall can be recalibrated if necessary.

Given that the divestment process requires some guidance about the *rate* at which it is to occur, this has been provided in the form of an <u>upper</u> bound (ie $500 million per month). Notably, there is no <u>lower</u> bound. We can therefore infer from the Direction that the Treasurer is more concerned about negatively impacting the RMBS market than meeting some arbitrary deadline.

Furthermore, I presume that if it takes us considerably longer than the next 12 months to fully divest the portfolio that this would be disappointing for the people in this room as it would imply that market conditions have not been terribly favourable for your issuance and/or investment activities over the year ahead.

I'd like to think that we could accept that this is something that we might not be able to change, particularly where it is as a result of credit market conditions such as have prevailed globally since early June. Equally, I'd like to think we would have the wisdom to avoid adding to the problem by conducting a fire sale if conditions were to worsen.

Turning now to our operationalisation of the Direction, I want to point out that the AOFM puts a great deal of emphasis on our communications with the market generally. We seek to treat market participants equitably, which means that communicating via Operational Notices is our preference. It also means that we are putting these opening comments on the AOFM website. A significant amount of time has gone into planning the divestment process and thinking about the information that needs to go into the public domain and the timing of its release. I would encourage you to read our Operational Notices and bidding instructions carefully. If you need to ask a question, there is a facility to do that too.

The second operational matter I want to discuss is that, consistent with our desire to minimise market disruption, we are seeking to reduce the potential for market congestion by mapping out our auction plans well in advance. Our expectation is that issuers and their JLMs will be able to work around our announced schedule in formulating their own issuance plans. A potential drawback of this approach is that it reduces our ability to react to market interest for us to sell specific securities in a timely manner. We see this as a necessary trade-off and are of the view that announcing our plans up to a few months ahead strikes the right balance between competing considerations, with the timing having been determined on the basis of our understanding of gestation periods for primary transactions.

Moving on to feedback we have received, directly and indirectly, from market participants, this has varied from "*I thought it was an auction, but the use of reserve prices seems to be in the fine print*" through to "*As an investor in RMBS, I'm glad they aren't having a fire sale and pushing out spreads to meet some arbitrary monthly volume target*."

On the first point, nothing the AOFM puts into the public domain is "*in the fine print*". Consistent with this, our RMBS releases have been clear that the AOFM will set an undisclosed reserve price. For what it's worth, having to explain the case for a 'reserve price' at an auction seems somewhat strange to us but frankly, we see the use of reserve prices as a *good* thing in light of the bids we have received to date.

However, I will take a moment to make some observations on our approach to setting these reserve prices.

First, each reserve price has been below where we see mid-market (that is, we see the traded margins associated with our reserve prices as being wide of the mid-market rate). Second, once set, we do not exercise judgement on whether to shift that reserve price in light of an examination of the bids we receive. In one case, specifically the APOLLO 2010-1 note in the very first auction, the difference between the reserve price and lowest bid was particularly small. However, our process does not allow for moving the reserve price once bids have been examined. To do so would cut across our objective of maintaining the highest standards of probity.

Before taking questions as part of the panel discussion, there are a few messages I would like to leave you with today – and these we will not hesitate to repeat if the questions invite that response:

- divestment panel members should not combine bids across different notes into one ‘omnibus’ spreadsheet. Our instructions are clear to this end;
- do not tell us non-public information about your issuance plans or those of your clients or even rumours about the issuance plans of third parties; and thirdly
- do not assume that we are compelled to lower our expectations on reserve prices leading into the third auction, due to the need to report to the Treasurer on market conditions.

In closing, Michael and I are happy to take questions, but before we do, I’d like to share with you the question we are contemplating at the AOFM: *Has the design of the divestment process itself reduced the propensity of market participants to engage positively, or has this been more to do with broader global market conditions?* Feel free to answer this question before you ask your own.