Q&A session for ASF forum Sydney 30 July (RMBS divestment)

Q1: You say that the reserve price is based on where you see the secondary market. In a recent auction there was one line in particular from Apollo that seemed to have multiple bids at least four times of what was on offer. In most markets that would indicate where the market was. The question is how do you explain why are you away from that? Is there some adjustment needed to your view?

A: We set a reserve price that is below where we see mid-market (or wide of mid-market in spread terms). Some investors have submitted opportunistic bids. The range of bids on the Apollo note in the second auction was BBSW + 86-130. It had a 1.5 or 1.6 year WAL (weighted average life) and over 40% credit enhancement. Compare this to where the recent 2.8 year SMHL transaction subsequently came to market: BB+95 for the top tranche with 8% credit enhancement and BB+102 for the second tranche with just over 5% credit enhancement. These tend to reinforce our view that setting the reserve level on a 1.5 year Apollo with 40% credit enhancement at tighter than BBSW+86 was the right call.

Q2: We have regularly talked about the lack of a secondary market. Do you think one of the things is with the shorter WAL paper there isn't as much depth and understanding around what the value is in that and that there are not a lot of comps (comparators)?

A: Yes, we get a fair handle on paper with WALs between 2.5 and 3.25 years from the primary market. There are also some good comps with the 5 year senior unsecured market, but the shorter market is less transparent. Over time people will be able to derive information from the bids that are both accepted and rejected. To illustrate how the AOFM's fair value and reserve prices interact, if the AOFM receives $300 million or more of bids at better than the reserve price but not better than the fair value price, then the AOFM will sell $300 million. If the AOFM receives more than $300 million worth of bids at better than its assessment of fair value, then the AOFM will sell more than $300 million, up to a maximum of $500 million.

Q3: How much do rate sheets influence your perception of mid-market? Do you expect investors to take up front losses versus their rate sheets?

A: It's up to investors to set their revaluations where they see appropriate. We are mindful of relativities between notes with similar WALs and other characteristics. Also, the wide bid/ask spreads seen in revaluation sheets and the infrequency with which they are updated may not be helping.

Q4: Thank you for the opportunity to ask questions; I will have a go at answering your question.
I think that multiple price may impact the propensity for someone to bid high.

A: This is something that has been considered. While the AOFM will not rule out a change from multiple to single price auctions, the fact that multiple notes are being auctioned could create some odd outcomes under a single price auction.

Q5: Given the notes the AOFM is selling are trading at a price premium, do you make any adjustment to reflect the prepayment risk arising where a note subsequently shortens?

A: Not to date, as the premiums have not been huge on most of the notes selected. Given we are required to report the traded margin at which we sell, the AOFM is also mindful of the risk of causing margins to appear artificially wide.

Q6: Have there been any bids in the first auctions from offshore based investors?

A: We don't know and if we did we probably wouldn't disclose it anyway.

Q7: Once the portfolio has been fully divested, is there an intention to maintain an infrastructure or a standing readiness for the future should such an intervention be required again?

A: No discussion about that has been held at this stage.

Q8: How much do you anticipate the program will make for tax payers?

A: It is actually very difficult to estimate in net terms because the AOFM does not 'match fund' these assets with specific bonds, so it is difficult to determine how much of the gross interest payments that have been made since late 2008 should be ascribed to financing the RMBS portfolio. In gross terms, the AOFM reports on returns each year via its annual report. Furthermore, there is no single objective for the RMBS program, such as profitability.

Q9: What are you thinking as to whether people are looking more comfortable with the process or not? Do you think you will revisit the process or just keep it going the same way because people are now understanding how the process works?

A: A considerable amount of thought has gone into this and we have sought some advice as to how we should conduct the process. The challenge looking forward is, given market conditions, how we adjust our expectations about where the bid should be. On any side of a trade there is an expectation that there will be a gap and meeting that gap will be what develops over time. We have a bit of time to do this and no doubt as the process goes on market conditions will change and the reality is if we had started this process six months ago it might have got going more quickly but it still would have hit this patch that we have had in the last couple of months where market conditions have softened.

Q10**:** I would like to talk about the pricing of the RMBS market. At the moment it seems that reserve prices where ever you set them is not where perhaps the market is willing to pay and there is always going to be opportunistic investors in capital markets, but generally for a declared volume/amount of stock, there is a clearing price for that. How can the market begin to think for the next auction and the upcoming auctions begin to get a better idea of that reserve price?

A: Observing the prices we have traded at and the bids we have rejected is a good place to start. Note that in the first auction, we rejected a bid for Apollo 2010-1 A2s that would have taken us to $300 million in sales, by the smallest of margins, namely 0.001 per $100 face value. While steps have been taken to reduce the likelihood of a repeat of the situation where the market infers that we have rejected a bid at a margin that would have been accepted were it rounded to the nearest basis point, this example demonstrates that, to meet the highest standards of probity, the AOFM will not move its reserve pricing once officials have seen the bids. Note that the AOFM makes an assessment of both fair value and reserve prices each month, immediately prior to each auction. If bidders wish to submit multiple bids that effectively define their demand curve for each note, they are more than welcome to do so and could be expected to derive more information from doing so, based on the bids that are rejected by the AOFM and the information it discloses publicly after each auction.

Q11: How do you keep the investors engaged in the process while maintaining discipline around fair market value?

A: We come to forums like this and tell people how we see the world and seek feedback on how the process can be improved.

Q –supplementary: The concern is that the AOFM seems to be seeking to price at or near the offer side of the market.

A: While it is true that the sales the AOFM undertook between March 2012 and June 2014 were probably at or near the offer, we reiterate that under the divestment process commenced in June 2015, reserve prices have been set below (that is: wider, in traded margin terms) where the AOFM sees mid-market or fair value. That said, the AOFM's mandate requires it to avoid adding to market volatility, so this could cause the AOFM to avoid printing a new, wider level in a period of market weakness.

Q – supplementary: If you wait for spreads to tighten, given you are known to be a seller, could the AOFM itself become the reason spreads are wide?

A: The need to sell $4 billion, with no time limit, in the context of a market that brings an annual primary volume of $30 billion makes us think that this is unlikely.

Q12: Would you consider reverting to the old way of executing private sales?

A: This would be inconsistent with our Direction.

Q – supplementary: Should the dealer group discourage opportunistic bids close to the end of an auction?

A: Provided the bid is submitted to us by the close, this is likely to be less of an issue for the AOFM than for members of the dealer group, but we have been clear to indicate that we are not holding a fire sale.

Q13: What if you published the reserve price for RMBS auctions?

A: It is an option that we have considered. It is important to consider any potential unintended consequences of such a change. However, the AOFM reserves the right to make such a change in the future. The AOFM is not a 'normal' seller, but an agency of Government selling assets owned by the taxpayer in manner consistent with the highest standards of probity.

Q14: Does the Treasurer have the option to discontinue the divestment process after the next auction?

A: Divesting the portfolio is a policy decision, so the Treasurer always has that option. However, in his current Direction, the only pre-defined consequence of the third auction failing to clear at least $300 million in sales is that that the AOFM is required to provide him with advice on the state of the market. It does not call for a review of the process per se.