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Mr Pat Brennan  
General Manager, Policy Development  
Policy and Advice Division  
Australian Prudential Regulation Authority  
Level 26  
400 George Street  
SYDNEY NSW 2000  
By email : APS120review@apra.gov.au

Dear Pat

## APRA Discussion Paper: Revisions to the prudential framework for securitisation

The Australian Bankers' Association (**ABA**) welcomes the opportunity to provide feedback on APRA's Discussion Paper *Revisions to the prudential framework for securitisation (discussion paper)* and the draft version of Prudential Standard APS 120 Securitisation (**APS 120**). The ABA agrees with APRA for the critical need to revive the domestic securitisation market in order to encourage banks to originate more credit into the real economy.

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA works closely with the Australian Securitisation Forum (**ASF**) which is the industry body representing participants in the securitisation and covered bond markets and has a focus on promoting, protecting and strengthening the Australian market, to build investor confidence and drive sustainable growth. The ABA and ASF share common members and given the particular expertise of the ASF on this topic, it was decided that the ASF would take the lead in working with industry to complete the primary industry submission on behalf of both ABA and ASF members. Therefore APRA, when considering the ASF submission should note that the ABA supports the ASF position.

ABA's comments below should also be read in conjunction with the ABA's response<sup>1</sup> to APRA's 2014 Discussion Paper *Simplifying the prudential approach to securitisation* and, most importantly, with reference to the ASF submission mentioned above.

The ABA recognises the significant amount of time that APRA has spent to date consulting with industry on the securitisation framework in order to develop a meaningful regime to strike a balance between 'financial safety and efficiency, competition, contestability and competitive neutrality'. The ABA believes this has greatly contributed towards developing a principles-based prudential framework in the Australian context.

The ABA also commends the efforts of the Basel Committee on Banking Supervision (**BCBS**) in developing criteria to use in determining when simple, transparent and comparable (**STC**) securitisations can apply favourable capital treatment, and the ABA agrees with the rationale presented

<sup>1</sup> <http://www.bankers.asn.au/Submissions/Prudential>



by the BCBS to support such treatment. The ABA also supports the ASF and International Banking Federation (**IBFed**) STC submissions to the BCBS dated 5 February 2015.

The ABA notes that many features of the proposals in the discussion paper will assist in strengthening the resilience of the Australian securitisation market.

The ABA welcomes the approach that APRA has taken in working with the industry to achieve the following outcomes:

- 1) Developing a broader and deeper investor market for asset-backed securities, by allowing Authorised Deposit-taking Institutions (**ADI's**) the ability to issue more flexible structures for funding purposes (and appreciating the variety of skin-in-the-game requirements offshore), thereby increasing the breadth of investors.
- 2) Providing a framework that allows issuers to reduce some of the costs of issuing non-AUD tranches (and thereby further increasing the diversity of the investor base).
- 3) Encouraging the issuance of a broader category of asset classes (including credit card and personal loans).
- 4) Providing consistent application by ADIs to achieving capital relief using clear guidance on significant risk transfer.

The ABA agrees with the IBFed view that only functioning securitisation markets can complement traditional bank loans in providing sufficient credit to companies, particularly to small and medium-sized enterprises (**SMEs**) in the common aim of supporting economic development. The ABA is concerned that APRA's proposed capital treatment and divergence from the BCBS standard would have a counterproductive effect. The ABA believes there is an advantage in APRA pursuing a harmonised implementation of criteria, aligning Australia with those other jurisdictions recognising the securitisation framework as defined by the BCBS.

A clear prudential framework for STC securitisations provides appropriate incentives necessary to revive securitisation markets, especially in jurisdictions like Australia, where no public agency currently acts to consistently facilitate and support the market<sup>2</sup>. Banks, particularly here in Australia, are vital participants in the securitisation market, acting as originators, sponsors and investors. Therefore, the ABA believes that banks should be incentivised and not overly penalised in terms of regulatory capital requirements for securitisation exposures they hold on their balance sheets (including on their trading book) when the transaction/instruments are compliant with STC and any additional criteria.

The ABA supports the full alignment of the implementation date for risk-weights attaching to Australian STC compliant transactions with BCBS so as not to place Australian issuers and investors at a material disadvantage. To the extent BCBS aligns the implementation dates for STC and the Basel III framework (i.e. 1 January 2018), the ABA would support such alignment.

With the implementation of the Basel III liquidity reforms and the introduction of the Committed Liquidity Facility by the Reserve Bank of Australia (**RBA**), Australia's largest banks have become important investors in Australian securitisation deals post the global financial crisis (**GFC**).

The demand for 'AAA' rated senior ranking residential mortgage-backed security (**RMBS**) and Asset-backed securities (**ABS**) by Australian ADI's has provided a great deal of support to the securitisation market since the Australian Office of Financial Management's withdrawal from the market in April 2013<sup>3</sup>.

Major Australian ADIs play important roles in the intermediation of finance between smaller ADIs and non-bank financial institutions and the financial markets. Preserving these roles are critical for competition and efficiency in the retail and SME banking markets. In addition, with the withdrawal of a number of offshore banks from the Australian securitisation market, warehouse funding to regional

<sup>2</sup> [http://aofm.gov.au/files/2013/07/Treasurer-Directions-for-RMBS-2013\\_9\\_april.pdf](http://aofm.gov.au/files/2013/07/Treasurer-Directions-for-RMBS-2013_9_april.pdf)

<sup>3</sup> [http://aofm.gov.au/files/2013/07/Treasurer-Directions-for-RMBS-2013\\_9\\_april.pdf](http://aofm.gov.au/files/2013/07/Treasurer-Directions-for-RMBS-2013_9_april.pdf)



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banks, credit unions and building societies and non-ADIs is now predominantly provided by the major ADIs.

In this context, it is important to understand that APRA's proposed modifications of the Basel III framework will have a significantly more concentrated impact on the Australian banking industry than would have been the case a number of years ago when securitisation (warehouse funding) was provided by both domestic and offshore banks.

## Capital treatment

The ABA has concerns regarding APRA's proposed deviation from the BCBS securitisation capital framework, in particular the exclusion of Internal Ratings-Based (**IRB**) Approach from the rating hierarchy. The capital treatment, as proposed by APRA, does not strike a balance between financial stability and competition and will place Australian ADIs at a distinct competitive disadvantage to US and European banks from investing and funding the Australian economy. The proposals, impose significant capital increases for Australian ADIs who provide securitisation funding to other ADIs or invest in term securitisations. These capital obligations will have a detrimental impact on both the availability and the cost of securitisation funding for regional banks, smaller Australian ADIs, the mutual sector and non-ADIs. The ASF submission provides an analysis of these impacts.

The ability for Advanced ADIs to adopt an advanced assessment of securitisation exposures provides those ADIs with the ability to provide cost effective securitisation funding to all other Australian ADIs and non-bank financial institutions. This meets APRA's objectives to promote "a deeper and more resilient securitisation market...[to] help smaller ADIs compete with larger ADIs".

The ABA and ASF are concerned with APRA's proposed hierarchy of approaches to regulatory capital. The ABA recommends the following hierarchy of approaches to assess regulatory capital requirements under the Basel III framework:

- 1) IRB Approach for approved asset classes to be adopted by accredited ADIs
- 2) External Ratings-Based Approach (**ERBA**)
- 3) Internal Assessment Approach (**IAA**), as a sub-set of ERBA for approved asset classes to be adopted by accredited ADIs; and
- 4) Standardised Approach.

The ASF submission provides examples which demonstrates the unintended outcomes which would result from APRA's proposed deviation from the BCBS's securitisation framework.

In addition to the detail provided in the ASF paper, the key issues of importance to ABA members are outlined below.

### Internal Ratings-Based Approach

The ABA and ASF, strongly support the use of the IRB Approach in the Basel III framework. This is a risk-sensitive approach to assessing securitisation exposures and provides ADIs with the ability to more accurately assess the risks inherent in a securitisation when assigning regulatory capital without any mechanistic reliance on external ratings. The removal of the IRB Approach from APRA's proposed securitisation capital framework, combined with the proposed removal of the IAA, will significantly increase risk-weights of securitisation exposures and have a detrimental impact on the banking industry, particularly in relation to the availability of warehouse funding facilities, the provision of derivatives and other facilities to securitisation transactions as well as demand for RMBS/ABS.

The impact of APRA's proposed hierarchy of approaches will include warehouse facilities needing to either be externally rated or restructured with additional credit enhancement levels to minimise the proposed capital increases for these facilities. This will lead to inefficient funding structures for smaller ADIs and substantially increase the cost of securitisation funding for these smaller institutions. The proposals as they stand will do little to support competition or the growth of the industry.



The ABA supports the recommendations outlined in the ASF submission to address any concerns APRA may have on the IRB Approach to operational requirements.

### Internal Assessment Approach

The ABA supports APRA's recognition of the IAA in the Australian environment and continued recognition of the IAA under the Basel III framework where IRBA may not be applicable. The BCBS framework also acknowledges the IAA for jurisdictions where ERBA is permitted<sup>4</sup>.

The ABA notes that warehouse funding in Australia is predominantly sourced from balance sheets of Advanced ADIs. This contrasts with those offshore where warehouse funding is predominantly funded from the asset-backed commercial paper markets.

With the IAA approval granted to the Advanced ADIs, APRA has assessed each bank's ability to perform similar analyses for assets such as trade receivables. On this basis, it follows that the ABA supports APRA's approach to permit IAA to be used for asset classes that cannot adopt IRBA. Noting the IAA has been used extensively in the industry with controls established to monitor its performance, the ABA fully supports the use of the IAA in the Basel III framework. The ABA submits that given the nature of asset classes for which the IAA is approved under the current APS 120, an Australian-specific use of IAA is justified.

### Non-senior securitisation exposures

The ABA understands APRA's concerns in relation to contagion risk in the financial system when an ADI takes on credit exposures originated by other ADIs. Higher capital charges for non-senior tranches over senior tranches aim to discourage ADIs from holding non-senior exposures as outlined in the BCBS document<sup>5</sup>.

However, the ABA and ASF, strongly disagree with APRA's proposal to impose a Common Equity Tier 1 Capital (**CET1**) deduction for all non-senior securitisation exposures.

The ABA believes:

- Not all non-senior exposures are akin to holding an equity position.
- A CET1 capital charge for all non-senior exposures under the Draft APS120 is arbitrary, overly onerous and disproportionate to the credit risk profile of the tranche; and
- Such a punitive capital charge is not justified for all non-senior exposures where those tranches are not materially exposed to the expected loss/unexpected loss of the securitised assets.

With the benefit of a now finalised BCBS position for the hierarchy of approaches to assess a securitisation exposure, the ABA recommends APRA reconsiders its position for non-senior tranches.

The ABA and ASF's strong preference is to align the applicable risk-weights for non-senior tranches in the proposed APS 120 to the Basel III framework, as this strikes an appropriate balance in an Australian context between prudent risk management and competition, and positions Australian ADIs on a level playing field domestically and internationally.

Noting APRA's reluctance to adopt the Basel III framework for non-senior risk-weights, the ABA looks forward to the opportunity for specialist members of the ABA and the ASF to work with APRA in developing a risk-sensitive Basel III-consistent approach. To assist with developing this approach, and based upon the principles above, the ABA believes that the capital treatment of all non-senior securitisation exposures should:

- Reflect a risk-sensitive approach, rather than a straight-line CET1 deduction.
- Remove the reliance on external ratings; and

<sup>4</sup> BCBS *Revisions to the Basel Securitisation Framework*, December 2012, Paragraph 45

<sup>5</sup> Section 3 of BCBS document outlines higher risk-weights for non-senior securitisation exposures under each rating approach



- Attract a higher risk-weight for any non-senior tranche that is not materially exposed to credit risk (therefore meets APRA's objective to discourage ADIs from holding securitisation tranches that are exposed to credit risk).

Given the finalised BCBS position for the hierarchy of approaches to assess a securitisation exposure, the ABA recommends that APRA reconsiders its position for non-senior tranches. It is the ABA's strong preference that APRA aligns the applicable risk-weights for non-senior tranches in the proposed APS 120 to the Basel III framework as this strikes an appropriate balance in an Australian context between prudent risk management and competition and positions Australian ADIs on a level playing field domestically and internationally.

The ABA understands that individual ABA members, in their submissions, will provide APRA with technical analysis and recommendations on the treatment of non-senior tranches in the context of the Basel III framework. Once APRA has had time to assess industry feedback on this subject, the ABA is happy to facilitate member engagement to assist APRA in developing a risk-sensitive approach, consistent with the BCBS.

## Balance sheet synthetic securitisations for capital relief

The ABA appreciates that capital relief for synthetic securitisations is not included in the draft APS120. The use of synthetic securitisations in a prudent and controlled manner is an important risk management tool that ADIs could use to manage credit risks on wholesale exposures. The ABA recognises that some synthetic securitisations can be highly complex, and credit derivatives have been used in the past to synthetically create additional leverage in the absence of any underlying balance sheet assets. However, appropriate and controlled use of credit derivatives in securitisation transactions can assist with developing a banking system with ADIs holding well-managed corporate and institutional banking portfolios.

The ABA recommends that APRA reconsiders the application of a blanket rule prohibiting capital relief when using synthetic securitisation. The ABA welcomes further discussion on how APRA can enable ADIs to use such structures for valid purposes, within appropriate limitations using existing risk management and compliance frameworks.

The ABA notes that the BCBS framework outlines operational requirements for synthetic securitisations<sup>6</sup> and suggests that guidelines are established to ensure synthetic securitisations are simple and safe, limits speculative activities and mitigates any prudential concerns.

Guidelines may include the following:

- 1) Each synthetic securitisation should have a clear, documented business purpose that could be made available to APRA on either a pre or post-closing basis in order to allay concerns that transactions are being undertaken for reasons other than prudent risk management.
- 2) Demonstrate significant risk transfer from the ADI to investors has occurred. This analysis could be made available to APRA.
- 3) To mitigate counterparty credit risk; be either fully collateralised consistent with APS 112 Attachment H, or subject to prior approval from APRA, be with government guaranteed or multilateral agencies (i.e. ECA's, World Bank or similar).
- 4) Demonstrate that the risk transfer agreement within the synthetic securitisation (whether it is documented as a CDS, financial guarantee, or similar) satisfies certain minimum legal standards, supported by an appropriate external opinion if required by APRA. Specifically, the opinion could address enforceability against the issuing entity, security of claims over collateral, and confirmation that the contract and collateral rights do not automatically terminate in the event of the appointment of statutory manager to an ADI; and

<sup>6</sup> BCBS, *Revisions to the Basel Securitisation Framework*, December 2012, Section I.C(2) paragraph 25



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- 5) Provide representations and warranties that do not constitute implicit support including those relating to the future credit worthiness of the exposures, the performance of the SPV or securities issued.

## Proposed treatment of trust-back arrangements

The ABA strongly supports the ASF recommendation for APRA to reconsider the equivalency of the trust-back arrangements to a formal second mortgage arrangement. This is based on advice from leading Australian securitisation law firms confirming that trust-back arrangements provide an ADI with the same rights, ranking and cash-flows as a registered second mortgage, including following a title perfection event.

The ABA agrees with the ASF analysis that the requirement for an ADI to obtain a formal second mortgage in respect of loans (one of which is securitised) where there is a shared mortgage instead of utilising a trust back arrangement has significant cost and operational impacts for ADIs. This includes the delays incurred (at the borrower level) in documenting and registering the second mortgage at the Land Titles Office (LTO), as well as the additional LTO fees that will be passed on to the underlying borrower. Please refer to the ASF submission for detailed examples.

In order for the securitisation market to function efficiently in Australia it is important that an ADI is able to deal with a securitised loan and a non-securitised loan in the same manner. The second mortgage arrangements required under the proposal would be in contravention of this.

The ABA recommends that APRA removes the requirement for an ADI to hold a minimum 100 per cent risk-weighted assets against assets subject to trust-back arrangements. APRA's requirement to qualify for a risk-weighting of less than 100 per cent to register second mortgages is not practical and does not change the underlying rankings, priorities and cash flows. Furthermore, this arrangement is both costly and operationally inefficient, and likely to represent a significant barrier to the securitisation industry in Australia.

## Revolving securitisations

The ABA supports the proposed provisions in APS 120 to allow for revolving securitisations. We believe that this will broaden the investor base and facilitate the securitisation of new asset classes.

The ABA would appreciate further clarification in the proposed drafting in APS 120, specifically in relation to its impact on future master trust programs. In particular, the ABA seeks clarification in relation to the 20 per cent holding limit not applying to an ADI's seller share in a master trust and in relation to the ADIs ability to continue to fund new exposures in the asset pool during scheduled or early amortisation.

To be effective, particularly for funding revolving assets (such as credit card receivables), master trusts will require the flexibility to have the seller share exceed 20 per cent of the senior securities in order to meet the obligations to fund new purchases for revolving assets during an amortisation period. The funding of the new receivables by the ADI may be provided within or external to the master trust.

## Treatment of self-securitisations

The ABA supports the ASF recommendation that funding-only requirements only apply to self-securitisations during the period when term funding is provided by the RBA (i.e. excluding ordinary money market operations).

ADIs have established a self-securitisation to comply with APRA's liquidity standard APS 210. The self-securitisations are only intended to be used as collateral to be pledged to the RBA and not intended to raise funding from external investors. The majority of ADIs established the self-securitisations in 2008 and 2009.



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All the major banks and some regional ADIs that are Tier 1 participants in the Bulk Electronic Clearing System are currently obtaining funding from the RBA using self-securitisation as collateral in the “open repo” operations. The face value of self-securitisations that are required to be lodged are determined by the RBA.

APRA has proposed new requirements in the draft APS 120 discussion paper which will significantly increase the cost and operational complexity of maintaining the self-securitisations.

Paragraph 36 of the proposed APS 120 and section 2.9 of the discussion paper propose “that an ADI that undertakes a self-securitisation must comply with funding-only requirements only from the point it uses the securities as collateral to obtain funding under a repurchase agreement from the RBA. Up to this point, an ADI has the flexibility to buy-back loans, redeem notes, sell additional loans into the pool, or terminate the arrangement.” ADIs currently receive funding from the RBA via the “open repo” operations or other open money market operations provided by RBA. There is no intention to sell the self-securitisation to other third party investors such as fund managers or other ADIs.

The ABA requests that APRA allows ADIs to manage assets in self-securitisations flexibly and to “buy-back loans, redeem or issue notes and sell additional loans into the pool” at all times, as this is essential to continuous satisfaction of RBA eligibility criteria. If ADIs do not have this flexibility, they may be required to establish two (or more) self-securitisation trusts or to sell additional assets to their self-securitisation special purpose vehicle to deal with RBA’s increased haircuts which would be costly and operationally cumbersome for all ADIs.

The ABA also requests that the proposed requirement for self-securitisations to be funding-only structures with a single junior tranche not be imposed on existing self-securitisation structures and that grandfathering be permitted. The self-securitisation structures of most issuers were established post GFC. To restructure existing self-securitisations to have only a single junior tranche of securities would be expensive and reduce flexibility in ADI liquidity management.

## Conclusion

The discussion paper is of critical importance for the Australian banking industry and the Australian economy. There are many economic and competitive benefits resulting from the revitalisation of the securitisation market.

It is therefore crucial that APRA’s policy framework facilitates prudential outcomes that create efficiency and competitive benefits for Australian ADIs, (as originators, sponsors, facility providers and investors) coupled with the flexibility for ADI’s to manage their balance sheets. A securitisation framework with appropriate prudential incentives is critical in facilitating stakeholders to play their various roles in securitisation markets in Australia.

The ABA thanks APRA and the ASF for the considerable work undertaken to date, and we look forward to future discussions on these issues.

Yours sincerely

Aidan O'Shaughnessy  
Policy Director - Industry Policy  
Aidan.OShaughnessy@bankers.asn.au