THE AUSTRALIAN SECURITISATION MARKET

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ABSTRACT

The Australian securitisation market has developed rapidly in recent years into one of the most active outside the U.S. Securitisation techniques provide local institutions with additional flexibility in managing the credit, liquidity and other risks involved in originating and funding loans. Depending on the particular structures utilised, these risks can either be retained (in part or in whole) by an originating institution or passed on to investors and others involved in the schemes.

This paper overviews the Australian securitisation market largely from the perspective of lending institutions, in particular prudentially regulated deposit-taking institutions. The paper outlines: the rationale and mechanics of the securitisation process; the main features of the market in Australia; and the prudential requirements that are applied to regulated institutions' securitisation activities.

Prudential supervision in Australia has aimed to facilitate the development of the securitisation market, recognising the potential benefits for financial institutions, whilst seeking to ensure that the associated risks are adequately captured by regulated institutions' risk management systems. On the regulatory front, the emphasis has been on ensuring that minimum capital adequacy guidelines provide appropriate coverage where risks are retained rather than shed by regulated institutions. An important focus of the capital rules has been to ensure appropriate treatment of ‘first-loss’ protection facilities, whereby regulated institutions can take on disproportionately large shares of the credit risk associated with securitisation schemes, and potentially large ‘moral hazard-related’ risks.

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1 INTRODUCTION

Securitisation, a form of structured finance, has been practised in Australia since the mid 1980s. Specialist commercial vehicles established by state governments to finance public housing loan schemes (e.g. FANMAC) were the first organisations to exploit this technique, leading to the development of the Australian secondary mortgage market. Securitisation has since emerged as a mainstream financing tool. Authorised deposit-taking institutions (ADIs)\(^1\) and other institutions in Australia are now offering local and overseas capital markets a growing range of securities backed by assets that include residential mortgages (which still comprise the bulk of securitised assets), commercial property loans, credit card, lease and trade receivables etc. The securitisation of other commercial and corporate loans is at an embryonic stage but has the potential to become an important segment of the market over time.

This paper outlines: the rationale and mechanics of the securitisation process; the main features of the Australian securitisation market; and the prudential requirements that are applied by the Australian Prudential Regulation Authority (APRA) to the involvement of ADIs in the securitisation market.

2 RATIONALE FOR SECURITISATION

Securitisation, in essence, is simply a mechanism for funding assets. Broadly, securitisation refers to the process whereby loans, receivables or other forms of usually illiquid, non-traded assets are converted into tradeable securities – variously referred to as mortgage- or asset-backed securities or as collateralised bond or loan obligations. The relevant assets are pooled into a special purpose vehicle (SPV), which funds itself by issuing securities backed by the cash flows of the asset pool. The assets may either be originated directly into the SPV or transferred off an institution’s balance sheet.

In principle, securitisation can be implemented using any type of asset but is best suited to pooled assets that produce reasonably predictable cash flows; typically, assets that are small in relation to the aggregate size of the pool and are reasonably homogenous (such as consumer or commercial loans that have comparable maturity and risk profiles as well as similar terms and conditions).

Compared with more traditional funding strategies, securitisation may be grouped with a broadening range of financial techniques that offer financial institutions and their customers greater flexibility in unbundling the risks involved in asset origination and funding. The underlying rationale is that, through the securitisation structure, these risks can be repackaged and reallocated to other parties better able and/or more willing to accept such risks, thereby improving the potential risk/reward trade-off for all parties involved.

\(^1\) ADIs include banks, credit unions and building societies.
Though the transfer of credit risk is generally the main driver behind most securitisation schemes, other risks (such as liquidity risk, interest rate risk, currency risk, prepayment risk and servicing risk) may also be transferred. Generally speaking, the extent and flexibility with which credit and other risks can be reallocated via securitisation schemes is increasing as issuing and investing institutions' experience with this segment of the capital markets expands.

Particular benefits for lending institutions from securitisation can include:

- greater diversity of funding sources at lower cost – securitisation may provide an institution with access to a wider range of investors and interest rates (including rates normally reserved for entities with better credit ratings), potentially leading to a larger pool of available funds at a lower ‘all in’ cost of funding. By enhancing the liquidity of an institution's assets, securitisation may provide more options for the institution during periods of market disturbance or when the institution, itself, is operating under stress;

- improved balance sheet and capital management – by transferring risk to other parties, securitisation can free up regulatory and/or economic capital thereby facilitating on-going expansion of lending activities, the acquisition of new businesses or the return of capital to shareholders. By securitising loans, and/or investing in asset-backed securities, an institution might seek to limit the build-up of portfolio credit risk concentrations whilst continuing to make new loans in niche markets. Similarly, securitisation might help better match an institution's asset/liability maturity and interest rate profiles;

- increased fee income and reduced reliance on (declining) interest rate margins – participation in securitisation programs via the provision of credit enhancement, liquidity, advisory and/or other services can facilitate the response of lending institutions to on-going disintermediation trends within the financial sector.

Securitisation can also prove attractive where the pooled assets would, if left on an institution's balance sheet, attract high capital charges from prudential regulators or ratings agencies relative to the institution's internal assessment of the risks involved. More generally, securitisation will often favourably affect traditional measures used by financial analysts when assessing an institution's performance and prospects.

3 MECHANICS OF SECURITISATION

Securitisation structures vary according to the objectives of the originating institution, the assets involved and the targeted investors but all are essentially variations on a theme – the main components of which are illustrated in Figure 1.
Central to the securitisation process is the creation of an SPV, which may be established under either trust or corporations law. The originating institution (e.g., an ADI) sells assets to the SPV, transferring ownership of the relevant pool of loans, receivables, etc., and any associated collateral rights. The SPV pays for the assets by issuing securities backed by the asset pool. Cash flow from the underlying assets is used to meet the SPV’s debt servicing obligations, any other on-going costs such as trustee, management, and custodian fees, and to repay principal as the issued securities either mature or are retired.

In this way, the SPV serves as the mechanism by which risk is transferred from the originating institution to investors. The investors must absorb any bad debts that emanate from the asset pool as well as any other events that may reduce the adequacy of the underlying cash flows to service the issued securities (unless other parties within the securitisation structure cover such losses). The SPV thus operates as a barrier; it acts to separate investors from the credit risk of the originating institution and that institution from any subsequent deterioration in the performance of the transferred assets.

In practice, credit enhancement is a key feature of most securitisation structures. Where used, its purpose is to protect investors by absorbing credit losses, thereby improving the credit rating (if rated) and marketability of the securities issued by the SPV. The amount of credit enhancement needed is determined by analysing the historical loss experience of the underlying asset pool in comparison with the risk appetite of the targeted investors. The appropriate degree of credit enhancement can either be built in structurally or obtained externally:

- external credit enhancement typically involves letters of credit, insurance (e.g., lenders’ mortgage insurance), guarantees and/or credit derivatives provided either by the originating institution or a third party. The credit enhancement is called upon if an asset in the pool defaults, with the credit enhancer purchasing the asset at face value or otherwise restoring value to the SPV;
• structural enhancement, on the other hand, does not rely on an injection of outside resources to replace losses, instead it reallocates losses among the scheme’s investors:

- typically, this involves subordination, where the SPV issues several classes or tranches of securities of varying seniority. As long as losses do not exceed the face value of the subordinated class(es), the senior class(es) will be repaid in full. Credit risk is thus concentrated in the more junior (lower-rated) securities. The most junior (usually unrated) tranche is often retained by the originating institution;

- spread accounts are another form of structural enhancement. These are first-loss accounts that are established to absorb credit losses ahead of any securities on issue. Funding of the accounts is either by initial deposit from the originating institution or a third party, and/or accumulated from excess servicing income generated by the assets that would otherwise flow to the originating institution.

The aggregate amount of credit enhancement is generally limited to some (small) fraction of the total value of the securities on issue but because of its first-loss ranking carries a disproportionately large share (usually the bulk) of the credit risk within the underlying asset pool. If provided by the originating institution it will typically represent the retention of a credit exposure with loss expectations and volatility many times higher than an ‘average’ credit exposure with a similar face value.

In addition to credit enhancement, various liquidity and/or hedging facilities may need to be embedded into the securitisation structure in order to achieve marketability of the securities. For example, liquidity facilities may be required to assure investors of the timely receipt of principal and interest (eg to cover mismatches or delays in the SPV’s receipt of scheduled funds from the asset pool and its obligation to make scheduled payments to investors). Liquidity facilities might also be needed to guard investors against market disruptions where, for example, maturing short-term securities are regularly rolled over to fund longer-term assets. Similarly, if there are interest rate or currency mismatches between the underlying assets and securities on issue, relevant hedging facilities will need to be established.

As is the case for credit enhancement, these additional facilities may either be provided by the originating institution or a third party; where provided by the originating institution, the facilities represent a retention of risk (including some measure of credit exposure to the underlying asset pool). Liquidity and hedging facilities generally benefit from any credit enhancement that has been established to protect the scheme’s external investors. However, in some securitisation schemes these facilities are subordinated to the interests of investors and therefore also take on a first-loss (credit enhancement) role. This is most likely to happen where the originating institution is also the facility provider.
More recently, synthetic securitisation structures have been developed as alternatives to traditional securitisation schemes. These newer structures use credit derivatives to transfer the credit risk, but not the legal ownership, of the underlying assets from the originating institution to the capital markets. A basic synthetic securitisation structure involves a credit derivative between an institution wanting to hedge its credit risk and a SPV. The SPV issues securities into the market, usually investing the proceeds in government or other highly rated securities. If a credit event occurs, the credit derivative is triggered and the SPV sells some of its investments to meet its obligations to the protected institution.

4 MARKET PROFILE

The US securitisation market was the first to develop and remains the most sophisticated worldwide. Residential mortgage-backed securities, supported by the guarantee of government sponsored agencies, were introduced into the US market in 1970. Asset-backed securities have subsequently become a major feature of US financial markets, with housing, other personal and commercial loans widely securitised.

After 30 years, the percentage of loans securitised in the US is continuing to grow and is now around 58 per cent for housing, 31 per cent for personal and 9 per cent for business loans (Graph 1). The Australian market has existed for around 15 years and is one of the most active outside the US. At present, about 15 per cent of all housing loans in Australia have been securitised. Though the range of securitised assets is expanding, the proportion of non-housing loans that have been securitised remains relatively insignificant.

Graph 1: Securitisation as a percentage of all loans

Source: Australian Bureau of Statistics, Reserve Bank of Australia, US Federal Reserve
Although the US experience may be an indication of how the Australian market could develop, US institutions generally have much higher incentives to securitise their loan portfolios. Compared with Australia (and many other countries), the US has:

- a large number of relatively small, geographically constrained financial intermediaries. Securitisation enables these intermediaries to raise funds that otherwise would not be available, at least at the same cost. In the US, a good deal of geographic intermediation also occurs externally via money and capital markets that, in Australia, is internalised by nationally operating institutions;

- extensive government support of housing loan securitisation schemes facilitates access by issuers to lower-cost and more reliable funding – almost 85 per cent of US residential mortgage-backed securities are backed by government-sponsored agencies;

- accommodative regulatory, legal and accounting guidelines, including in certain respects less stringent securitisation capital adequacy guidelines applied to prudentially regulated depository institutions; and

- strong investor demand from a relatively larger funds management sector.

After struggling for growth for around a decade, the volume and diversity of the Australian securitisation market have expanded rapidly since the mid 1990s (Graphs 2 & 3). By June 2000, total securitised assets had grown from under $10 billion in mid 1995 to around $64 billion (supporting around $53 billion asset-backed securities on issue). While asset-backed securities increased more than five-fold over this period, total credit provided to the private non-finance sector by all financial institutions grew by around 62 per cent (Graph 4). Housing finance grew at a similar rate.

The difference between assets and the volume of asset-backed securities on issue largely reflects assets funded by direct loans to securitisation vehicles from banks and other financial institutions, spread accounts, and accrued servicing income awaiting dispersal to investors and other service providers. Direct loans from financial institutions are often used to warehouse assets prior to the issue of securities. Warehousing facilitates efficient security issuance. It provides the securitiser with greater flexibility in respect of the precise timing of a securities issue, including time to build up a sufficient volume of securities for issuance.
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Graph 2: Asset-backed securities issued

Graph 3: Composition of securitised assets

Graph 4: Asset-backed securities and credit aggregates - 12-months percentage change

Source: Australian Bureau of Statistics, Reserve Bank of Australia

\[\text{Total credit to the private non-finance sector by all financial institutions.}\]
Private sector issues have far outweighed the run-off from now mostly defunct state government-backed securitisation schemes. Much of this growth has occurred against the background of relatively buoyant economic conditions and low interest rates. Consequently, most local securitisation schemes and market participants have yet to experience the effects of harder economic times, which will provide a better measure of the robustness of the various structures that have been employed. That said, reflecting credit and other enhancements that have been put in place, most asset-backed securities are highly rated. According to Standard & Poor's, 88 per cent of asset-backed securities have been assigned the highest possible rating (AAA for long-term securities and A1+ for short-term securities). Less than 1 per cent of rated securities have been assigned the equivalent of BBB or worse.\(^3\)

Residential mortgage-backed securities remain the dominant asset class. Mortgages over real estate currently account for around 64 per cent of total securitised assets, including commercial property mortgages. Though likely to grow in importance, the latter currently account for less than 1 per cent of total securitised assets.

Other securitised assets, such as credit card, lease and trade receivables, amount to around 22 per cent of total securitised assets. A further 21 per cent of assets relates to the securitisation of securities, which involves the use of commercial paper backed by various securities (including other asset-backed securities) that have been repackaged to exploit arbitrage opportunities.

In aggregate, asset-backed commercial paper (ABCP) accounts for around 43 per cent of total asset-backed securities on issue.\(^4\) This includes ABCP used by some securitisers to warehouse assets prior to the issuance of longer-term securities. Longer-term asset-backed securities mostly comprise floating rate notes. Fixed-rate instruments account for a declining (currently around 4 per cent) share of the overall market and there are small amounts of other instrument types, including CPI-indexed bonds, annuities etc (Graph 5).

Graph 5: Types of asset-backed securities – Per cent of asset-backed securities on issue

\(^3\) Standard & Poor's (2000), p16

\(^4\) Standard & Poor's (2000), pp21-33
Over the past few years, growth in demand for asset-backed securities has largely been driven by relatively strong inflows into superannuation and the other managed funds, coupled with reductions in government debt. On the supply side, much of the impetus has come from the housing loan market, where falling wholesale interest rates in the early 1990s provided an opportunity for non-depository mortgage originators to enter the market, undercutting banks and other ADIs in mortgage lending. As part of the competitive response to these trends (and an increased focus on risk-adjusted returns and capital management issues), depository institutions have also increased their issuance of asset-backed securities - a development facilitated by revised prudential guidelines covering ADIs' involvement in the securitisation market issued in late 1995. Currently, ADI originators account for around 35 per cent of the residential mortgage-backed securities market and 31 per cent of the overall securitisation market (Graph 6).

Graph 6: Originating institutions - Percent of asset-backed securities on issue

![Graph showing the percentage of asset-backed securities issued by different originating institutions over the years.]

Source: Standard & Poor's, Reserve Bank of Australia

The continuing trend for the household sector to hold financial assets other than deposits, increasing reliance of depository institutions on wholesale funding and greater familiarity of the market with securitised products are likely to be accompanied by further strong growth in the securitisation market, a broader range of securitised assets and the issuance of more complex securities. Last year, for example, the first issues of securities backed by sub-prime residential mortgages with up to 100 per cent loan-to-value ratios and no lenders' mortgage insurance occurred. Over the medium term, issues of securities backed by commercial mortgages, leases and automobile receivables are expected to be the main growth areas in the non-residential sector of the market, along with the use of commercial paper backed by trade receivables. Longer term, a wider range of corporate and other commercial exposures seem likely to be securitised (facilitated by the on-going development and market acceptance of loan grading technology).
Increased issuance of asset-backed securities has been accompanied by a lowering of funding costs. The average issue margins over bank bills of floating-rate mortgage-backed securities, for example, have fallen from around 80-90 basis points in the mid 1990s to just over 30 basis points in more recent years (Graph 7). In this latter period, senior tranches have generally ranged from 30 to 35 basis points and subordinated tranches from 90 to 120 basis points. The narrowing of the margin over bank bills is mainly due to a better understanding of the risks involved by domestic investors, greater liquidity in the secondary mortgage market and growing access by issuers to offshore markets.

Graph 7: Issue margin on mortgage-backed securities - Basis points over bank bills

Offshore issuance of structured products (mainly of residential mortgage-backed securities) has surged over the past few years. By June 2000, offshore issues accounted for 38 per cent of asset-backed securities outstanding and more than half of the increase in securities outstanding over the previous 12 months. Continued growth is expected due to the larger size of the overseas investor base, geographic diversification as a risk mitigation strategy among offshore investors and lower liquidity premiums in the larger markets.

5 PRUDENTIAL REGULATION

ADIs can incur substantial risk exposure not only from the explicit obligations that they enter into with respect to securitisation schemes but also through the operation of ‘moral hazard’. Moral hazard-related risks arise where name-associated branding and operational involvement in securitisation schemes create commercial incentives for ADIs to support poorly performing schemes beyond their legal obligations to do so.

As in other areas of their operations, APRA, in its supervisory activities, looks to ADIs to maintain appropriate systems to identify, measure and control risks arising from their participation in securitisation schemes, including by developing clear business strategies and associated board-approved risk management policies. Additionally, specific securitisation-related prudential regulation has been directed towards ensuring appropriate treatment of relevant exposures under APRA’s capital adequacy guidelines.
Initial securitisation guidelines, introduced in 1992, were replaced in late 1995 by a more elaborative set of requirements that were more detailed than the previous rules, but less restrictive in application. The guidelines are based on the principal of separation - that ADIs should maintain clear separation (be bankruptcy remote) from any securitisation schemes with which they become involved. The aim is to afford protection to the regulated entity should any of these schemes come under pressure. Thus, where adequate separation (ensuring effective risk shedding) cannot be demonstrated, regulatory capital relief should not be available.

The guidelines:

- establish the conditions under which the risks associated with securitised assets will be considered to have been truly transferred to a securitisation scheme (including in relation to the establishment of the SPV and ‘clean sale’ of assets);

- emphasise disclosure and other requirements aimed at ensuring investors in asset-backed securities understand that they have no claims, beyond any explicit legal entitlements, against any associated ADIs if their investments perform poorly;

- specify the conditions under which ADIs can transact with securitisation schemes (including through the provision of on-going services such as credit enhancement, liquidity support, hedging facilities and administrative services), deal in issued securities, purchase assets from, or supply additional assets to, a scheme. Given the potential for continuing connections to undermine the ‘separateness’ of securitisation schemes, ADIs, among other things, are required to establish (and disclose) clear boundaries as to the extent of their involvement in any securitisation scheme and to conduct any dealings on an arm’s-length basis;

- establish regulatory capital charges associated with the provision of such services. To this end, the requirements distinguish between first-loss credit enhancements and other facilities provided to securitisation schemes. Where first-loss facilities are provided (ie where an ADI takes on the bulk or a significantly disproportionate share of the credit risk associated with the securitised assets), the ADI is required to deduct the amount of the facilities from its capital base. Where other facilities are provided, which do not offer first-loss credit protection, normal regulatory capital charges apply; and

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6 In some situations, eg involving the purchase of a scheme’s securities or underlying assets and/or the transfer of additional assets to a scheme, APRA has established overriding regulatory limits on the potential to which an ADI may transact with the scheme.
• withhold capital relief in cases where ADIs fail to meet the separation and other conditions referred to above, go beyond their legal obligations in supporting associated securitisation schemes or otherwise give the impression that they would be willing to do so.

The guidelines also recognise that ADIs' involvement in securitisation can give rise to issues in relation to a range of risks that are not explicitly built into the existing capital adequacy rules. This is especially the case in relation to operational and legal risks, or where 'cherry-picking' (ie the securitisation of low-risk assets) leads to deterioration in the average quality of an ADI's remaining assets. To deal with such situations, APRA may adjust an ADI's minimum capital ratio to better reflect the additional risks borne but not effectively captured in the standard regulatory capital calculation.

Proposed changes to international capital adequacy rules

Further refinement of the securitisation requirements is likely to flow out of the current review of international capital guidelines being undertaken by the Basel Committee on Banking Supervision.7

One of the major proposed reforms is the use of credit risk ratings to make regulatory capital charges more sensitive to differences in credit risk. Under the proposals, highly rated exposures, including to securitisation schemes, will receive lower capital charges. On the other hand, low-rated and unrated credit exposures to securitisation schemes are likely to be deducted from an ADI's capital base. Given that such exposures typically represent first-loss exposures, the proposals are largely consistent with APRA's current approach to first-loss facilities. In some countries, however, the proposals are likely to have a bigger impact on institutions that retain first-loss exposure to securitisation schemes. This is because, unlike the situation in Australia, existing overseas securitisation rules often do not distinguish between first-loss and other facilities, or only apply a capital deduction where securitised assets have been transferred from an ADI's books (not where the assets have been transferred from another organisation's books or originated by the ADI directly into the SPV).

The Basel Committee also proposes to introduce an explicit operational risk charge. While few details of the proposal have been released, this could have the effect of requiring some capital to be held against the fiduciary and other operational risks that ADIs generally retain even when all credit risk has been shed in the securitisation process.

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7 Capital adequacy regulation of banks and other ADIs in Australia, as in most countries, is based on international guidelines issued by the Basel Committee on Banking Supervision. The Basel Committee, which comprises central banks and bank supervisory agencies from G-10 countries, operates under the auspices of the Bank for International Settlements (BIS) and consults widely with supervisory agencies in other countries and with industry on prudential matters. The Committee's initial reform proposals, including in relation to securitisation, are contained in a consultative paper, A New Capital Adequacy Framework, issued in June 1999 (available from the BIS website at www.bis.org). APRA's submission on these reform proposals is also available (at www.apra.gov.au/policy).
6 CONCLUDING REMARKS

Properly effected, securitisation can assist ADIs and other institutions to improve earnings and better manage the credit, liquidity and other risks associated with originating and funding loans. This has been a driving force behind the growth of securitisation over recent years. At the same time, institutions can incur substantial risk exposure through their securitisation activities. As a prudential regulator, APRA’s general approach has been to facilitate growth in the market by the application of ‘market friendly’ rules but also to focus closely on the extent of risk retention by regulated institutions and apply the full weight of its capital requirements to those exposures.

As noted above, APRA’s securitisation guidelines are more detailed than in a number of other countries with similarly developing securitisation markets. APRA’s experience has been that this assists regulated institutions by clarifying the conditions under which their participation in securitisation schemes can lead to regulatory capital relief. Though APRA’s rules are more stringent in some respects than generally applies in other markets, eg in relation to the treatment of first-loss facilities and moral hazard-related risks, growth in the local securitisation market offers little to suggest that its current requirements are holding the market back. Moreover, to the extent that its requirements act to restrict regulatory arbitrage incentives compared with other countries, APRA can have greater confidence in the capital adequacy of regulated institutions. Proposed changes to international capital guidelines are expected to narrow some of the differences in national treatment of depository institutions’ securitisation activities, notably in relation to first-loss credit exposures.
References


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