BASEL II AND SECURITISATION: THE NEW APS 120

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It is certainly an interesting time to be having a conference on securitisation. It is a particularly interesting time to be involved in regulation of this quickly changing market. The organisers of this conference should be congratulated on their sense of timing!

Last year, this conference was just held days after APRA released our first draft of the new APS 120, which is APRA's prudential standard on securitisation. APS 120 applies to all authorised deposit-taking institutions (or ADIs). The second draft, incorporating industry feedback on the first, was issued in mid-July of this year, just days before the securitisation markets around the world began to shut down due to concerns about the US subprime mortgage developments.

We received industry feedback on the second draft in mid-August, and proceeded to considered the issues in detail against the backdrop of this unprecedented and continuing disruption in the securitisation markets.

Today, APRA is releasing the final version of APS 120, as well as the other ten or so Basel II prudential standards. APS 120 now incorporates the Basel II capital calculations for standardised and Internal Ratings-Based (IRB) approaches to credit risk capital as well as the other Basel II and pre-existing APRA requirements. We are also providing a prudential practice guide (PPG) that provides further guidance and commentary to support implementation of APS 120.

The underlying principle on which APRA's requirements are based is that of independence. Essentially, prudential regulators have allowed securitised assets to be exempt from balance sheet capital reporting (regardless of whether the accountants take the same view or not), and as a result we expect that these assets pose no material risk to the ADI, except as explicitly contracted and priced and with appropriate capital held against that remaining risk. In order to result in a capital reduction, securitisation must be more than a mere funding mechanism. In other words, we expect the ADI to be independent of its securitisation vehicles and vice versa.

This independence principle has certainly been put to the test in recent months. Some securitisation structures around the world have not met this test very successfully. While APRA has been monitoring the market situation and its impact on ADIs very closely, we remain of the view that our regulated institutions are well positioned to weather the current turbulence. As has been stated here often in the last day or so, credit quality in Australia remains strong.

Now on to the specifics of APS 120. In my talk this morning I will try to cover some of the main points that are probably of most interest to you.

Transitional provisions

First, transitional arrangements, a key point of debate over the last year. As proposed previously, APRA is not providing a blanket exemption or grandfathering for existing programs. A policy decision has been taken that we do not want to see non-complying structures out in the market for potentially many years to come.

ADIs and investors have had several years to prepare for these changes, and should be well aware that regulatory requirements can and do change from time to time.

However, in the final standard we have provided some additional leeway for ADIs to bring their programs into compliance. Given the late hour at which the standard is being released, ADIs will have until mid-2008 to assess their programs and facilities against the standard's new operational requirements, and if necessary, apply to APRA for transition relief for up two years. Note that the new securitisation capital calculations for standardised and IRB banks will apply as of 1 January along with the other Basel II requirements; the transition relief applies only to changes to operational aspects of the standard, such as clean sale provisions and facility criteria, and only to pre-existing programs and facilities, that is, those issued before 1 January.

We have modified some of the proposed technical provisions in response to industry comments, which I think should alleviate some of the specific transitional concerns, as I'll discuss in a minute. In addition, any programs or facilities that can be wound up or terminated during 2008 will not need to comply with the operational requirements. I would note that despite the industry's widely voiced concerns about problems modifying existing programs to comply with the new standard, we did watch with interest as issuers indicated they would be moving quickly to restructure programs to comply with the Reserve Bank's new repo-eligibility criteria, in some cases reportedly within a matter of days.

Specific provisions of APS 120

APS 120 itself is detailed and complex. This largely reflects the complexity of the Basel II Framework, from which, like other regulators around the world, we have simply lifted much of the new APS 120 wording. We have melded this with APRA's existing APS 120 requirements, but have streamlined and updated those where appropriate after careful consideration. We have made a number of technical changes to the original proposal in response to the helpful and detailed comments from the Australian Securitisation Forum (ASF) and other industry participants.

However, we have resisted suggestions to provide detailed clarifications of various matters in the standard itself, because we find that the more detail we put in, the harder it is to focus on the underlying principles we are trying to achieve, and the more likely it is to create avenues for circumventing the rules, which calls for more detail and prescription, and so we end up chasing our tail. But for many points made in the comments, we felt it preferable to provide some examples or commentary in the PPG, so please have a look at it as well. I am sure we will receive more queries over the next few months, and where we can clarify these in the PPG we will.

Independence

A number of industry commenters asked for more guidance about what we mean by 'financial and operational independence' of the securitisation vehicle. The PPG provides some examples of areas where we would expect to see such independence and practices we may consider acceptable or less acceptable. For example, APRA does not expect a securitisation vehicle to have its own operations and staff, but it would need to have an appropriate independent governance structure that allows it to contract for operational services. Similarly, the PPG provides some examples of practices that APRA might consider to be 'implicit support', in the Basel II sense.

Providing implicit support leads to the securitisation being treated as on-balance sheet for capital purposes.

Threshold rates and basis swaps

One area where we have in the end provided guidance rather than prescription is on the issue of threshold rate or required rate clauses. Our July draft proposed some restrictions around the use of threshold rates. Why were we concerned about threshold rates?

In Australia, variable mortgage rates are controlled on an ongoing basis by the lender, and ADIs usually have both securitised and unsecuritised loans being charged the same rate. Threshold rates create some prudential concerns for us because if they are not structured with sufficient margin, changes in the securitisation's funding costs can spill over into the ADI's other business, which undermines the principle of independence. Raising the threshold rate can lead to the ADI's other loans being affected; conversely, not raising the rate could lead to the ADI absorbing the securitisation vehicle's funding costs.

Arguments were put to us, however, along the lines that as the securitisation vehicle now own the rights and obligations relating to the mortgage, it should be able to set the borrowing rate as it sees fit. We accept this basic concept, and we have also accepted that threshold rate clauses in themselves may not undermine independence. As a result, the final standard does not include restrictions on threshold rate clauses, but in the PPG, we have gone on to describe certain practices that we would not view as consistent with independence or with not providing implicit support. These include, for example, an ADI seeking to refinance loans it originated into a securitisation vehicle where the threshold rate is above its normal lending rate for similar loans, or accepting a lower fee in lieu of passing on the full increase in a required or threshold rate.

Basis swaps raise somewhat similar issues. In the current environment, with spreads significantly higher than they were when many programs were issued, we have seen some originators paying out on basis swaps. The new APS 120 highlights these risks by requiring that basis swaps be structured such that the ADI is not expected to be a net payer. This doesn't mean the ADI must prove it will <u>never</u> be a payer, only that on a net or present value basis there is an adequate buffer. Again, this comes back to independence--the ADI should not be contributing to the ongoing funding costs of the securitisation vehicle.

Some market speculation has centred on originators in the current environment issuing mortgage-backed securities at a loss. Certainly, for ADIs it is hard to imagine how this would be consistent with the principles under APS 120.

Date-based calls

Date-based calls also generated some discussion. The Basel II framework sets a very clear 10 per cent limit on clean-up calls. This is to avoid a clean-up call being used as a form of credit enhancement. We have maintained this internationally agreed limit, which is also the same as APRA's current restrictions on repurchasing assets from a securitisation. However, APS 120 does not actually prohibit date-based calls as such. It would prohibit a date-based call from being exercised where more than 10 per cent of the pool was still outstanding.

Under the transitional provisions, we would not necessarily require a date-based call to be removed from an existing issue provided that the ADI commits not to exercise the call until the pool reaches 10 per cent. And there is no prohibition on third-parties exercising clean-up calls or repurchasing assets; our concern is primarily with the originating ADI implicitly retaining risks of the pool.

Warehouses

We have also recently been focusing attention on warehouse facilities, both in terms of working out a sensible capital treatment under Basel II, as well as in understanding their role in the Australian securitisation market in light of the current market dislocation.

Warehouse arrangements are used by smaller ADIs to hold loans pending term securitisation. We have been tracking indicators of warehouse capacity in recent months and getting a better understanding of their funding sources, costs, and ongoing availability. Many local mortgage warehouse programs are funded by asset-backed commercial paper (ABCP), supported by liquidity lines from major or foreign banks, or funded by major banks directly. We have seen that some 'committed' warehouses are not quite as committed as one might have thought.

Warehouse structures don't necessarily fit neatly into any of the Basel II methodologies—the funding may not be tranched or rated and an ADI providing funding to a warehouse may not have sufficient information to calculate credit parameters (PDs and LGDs) on the underlying assets. We have as a result made some changes to APS 120 to better accommodate warehouses, including adopting the ASF suggestion that the Internal Assessment Approach (IAA) be made available to IRB banks, on a case-by-case basis and subject to APRA approval. Basel II restricted the use of the IAA to ABCP programs only, but we did not see any logic, particularly in the current environment, in preserving a concessional treatment for ABCP facilities.

Other matters

Otherwise, as a general matter we have deliberately avoided straying far from the internationally agreed Basel II requirements. We have not adopted certain industry recommendations, such as allowing the use of non-public credit ratings, or not incorporating certain Basel II deductions from capital.

We have not reversed our prior position on the credit conversion factor for market disruption liquidity facilities. We were told by commenters back in August that not adopting the zero capital weight was unreasonable and would place Australian ADIs at a competitive disadvantage. I doubt we will find many countries still supporting the idea that liquidity facilities to ABCP programs are so low risk they don't require any capital. A perhaps more interesting question is the amount of economic capital that banks' internal models were assigning to these contingent liquidity and credit exposures.

In the final standard, as in the original proposal, APRA has decided to allow ADIs to manage and service securitisations directly. This is the norm overseas and it does not appear to raise prudential concerns, although we expect the relationship between the ADI and the securitisation vehicle to be an arm's-length one, with appropriate servicing fees and contracts. However, we are not comfortable with ADIs acting as trustee for their own programs, where we would be concerned about

independence as well as potential conflicts between the ADI's interests as the originator and as fiduciary to investors.

In many other respects, the securitisation rules won't change. While some of APRA's longstanding requirements may have seemed outdated only a few months ago, in hindsight they have proven their usefulness in a time of stress and you will not be too surprised to see that these are still in the final standard. For example, some institutions have recently rediscovered an existing APS 120 requirement that limits an ADI's holdings of securities in a particular securitisation issue to 20 per cent of the total program.

Self-assessment

I wanted to highlight the new requirements in APS 120 for risk management and self-assessment. APRA has had for some years a perhaps unique practice among prudential regulators of pre-vetting all ADI securitisation deals. As you can imagine this is very time consuming for APRA and for ADIs wishing to get issues to market. It has had the side benefit of allowing APRA to become quite familiar with all of the structures in the market issued by regulated institutions, and in enforcing a certain amount of consistency. However, in my view transaction-based approvals are not really consistent with being a risk-based prudential supervisor.

Going forward, while APRA will obtain regular statistical reporting on securitisation activity, we will not be reviewing transactions prior to issuance. Unlike in the past, APRA will not normally issue letters confirming compliance with APS 120, unless there are particularly unique or novel concerns not addressed in the standard.

APRA supervisors will, however, be covering securitisation more thoroughly in on-site visits, and will review self assessments in that context. Supporting the self-assessment process, we hope to find well-developed risk management and compliance policies and procedures for securitisation activities. These would be designed to provide assurance that an ADI is complying with its contractual obligations, managing all contracted risks and not providing implicit support to its programs.

Compliance with APS 120 has not been an area that we sense ADIs have devoted large amounts of resources in the past. It is sometimes difficult, particularly at the smaller ADIs, to find anyone other than the external lawyers who is able to discuss the prudential issues arising in some of these transactions.

As a result, the ASF recent announcement about an industry effort to standardise investor documentation is very welcome. APRA would strongly urge the industry to go further and actually standardise the structures and transaction documentation to the extent possible. Standardisation would facilitate the compliance and supervision process and we would be happy to work with the ASF or other industry participants on such an effort.

Conclusions

What are the implications of current market developments from a regulatory perspective? I am not sure we really know yet. But at this point, while I think there are emerging lessons to be learned, APRA is not planning to reassess regulatory requirements or capital for securitisation again any time soon. That

said, APRA supervisors are likely to pay more explicit attention to contingent liquidity commitments, such as ABCP liquidity lines, in assessing the adequacy of ADI's liquidity risk management going forward. We are also less likely to accept that the ability to securitise assets is an automatic source of liquidity.

Some observers overseas are placing blame for the US subprime credit problems on the securitisation model itself. Some are calling for banks to be required to retain more of the credit risk on securitised loans, to ensure they have incentives to continue to monitor them. Prudential requirements on banks are designed to do exactly the opposite—that is, to ensure that credit risk is transferred away from the originator. In practice, we see no evidence that ADIs here monitor securitised assets less rigorously or that they deliberately securitise poorer quality assets. On the contrary, if anything they tend to pick the better, more seasoned loans, which of course presents the opposite prudential problem. I would be surprised if staff at an ADI servicing a mortgage even know whether it is securitised or not. It could also be argued that regular reporting to the market on arrears and other data on securitised pools provides much more transparency and oversight on an ADIs lending practices than would be the case if it didn't securitise any of its loans.

In summary, Australian ADIs, including those that rely heavily on securitisation, remain well capitalised with adequate and well managed liquidity. But a sustained period where the securitisation market is not functioning could leave some of them needing to reconsider their funding and business models.

Existing regulatory requirements have shown their value in this time of stress, and the Basel II changes will bring more risk-focused requirements for operational independence and capital adequacy. We can't rule out any future international initiatives to revisit these requirements at some point, and we would certainly watch any such developments with interest. But I think it would be fair to say that the capital and transparency required by regulators now seems somewhat second order relative to the capital and transparency required by the market.