



10<sup>th</sup> December 2010

To all locally incorporated authorised deposit-taking institutions

## REGULATORY CAPITAL TREATMENT FOR SECURITISATION

On 26 August 2010, APRA wrote to ADIs clarifying its policy on the regulatory capital treatment for securitisations that do not involve significant credit risk transfer to third parties. That letter resulted from a review of securitisations under which the originating ADI placed the senior tranche(s) with third-party investors but retained all, or nearly all, of the most subordinated tranche(s). Under *Prudential Standard APS 120 Securitisation* (APS 120), retention of the most subordinated tranche(s) in a securitisation is inconsistent with the requirements for significant credit risk transfer and, hence, for regulatory capital relief.

Attachment C of *Prudential Standard APS 110 Capital Adequacy* (APS 110) requires securitisations that do not comply with APS 120 to be included in an ADI's consolidated accounts. As a result, an originating ADI that undertakes a securitisation that does not transfer significant credit risk to third parties is required to hold capital against the pool of assets securitised as if they were on-balance sheet in accordance with *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) or *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113) as appropriate.

Following discussions with industry, APRA is prepared to approve an alternative capital treatment to that required under APS 120, but one that is consistent with the intent of the standard. Subject to APRA's prior approval, an originating ADI retaining any subordinated tranche(s) of a securitisation will be able to deduct those holdings from Tier 1 capital. This deduction would be capped at the dollar amount of the total capital required as if the pool of assets were held on-balance sheet. The required deduction would be reduced to the extent that the ADI sells down subordinated tranches to genuine third-party investors.

Attachment A sets out a worked example.

This alternative capital treatment may be utilised only in respect of securitisations where non-compliance with APS 120 is due solely to inadequate credit risk transfer. ADIs are expected to comply with all the other requirements of APS 120.

APRA wishes to emphasise that this alternative capital treatment is only an interim measure that will apply, to both existing and future transactions, until the Basel Committee's enhancements to the Basel II Framework, which deal *inter alia* with securitisations, come into effect from 1 January 2012. APRA's final position will be decided in the context of its consultations on a revised APS 120.

#### Impact of non-complying securitisations on the calculation of the HQLA ratio

A related issue arises in relation to the treatment of non-complying securitisations in the calculation of the high quality liquid assets (HQLA) ratio. Attachment C of APS 110 results in the securitisation amount being included in the liabilities base for the calculation of HQLA in Reporting Form ARF 210.0.

An ADI may apply to APRA for written approval to exclude from its 'liabilities' any medium-term notes issued under structured securitisations that do not comply with all the requirements of APS 120

If you have participated in any securitisations where the content of this letter is applicable and are unsure of the capital treatment, or have any questions regarding the APS 120 requirements, please contact your APRA Responsible Supervisor.

Yours sincerely



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## Attachment A

Assume a securitised pool of mortgages of \$200 million with an average risk-weight of 45 per cent. The ADI has a Total Prudential Capital Requirement (PCR) of 10 per cent and a Tier 1 PCR of 5 per cent.

If held on-balance sheet, the capital requirement under APS 120 would be:

$$\text{Tier 1 capital} = 200 \times 0.45 \times 0.05 = \$4.5\text{m}$$

$$\text{Total capital} = 200 \times 0.45 \times 0.10 = \$9.0\text{m}$$

Further assume that the ADI holds the bottom 3 per cent of securities (ie the subordinated tranches) amounting to \$6 million.

The alternative treatment discussed in this letter allows the ADI to deduct from Tier 1 capital the amount of the subordinated tranches held, where this is less than the amount of total capital required if the assets were held on-balance sheet.

In this example, the relevant amounts are \$6 million for the subordinated tranches held and a total on-balance sheet capital requirement of \$9 million. The Tier 1 deduction is therefore \$6 million.

If the ADI were able to sell down some of the subordinated tranches, this would enable a proportional reduction in the amount deducted. For example, if the ADI sold-off half its subordinated tranche position, the Tier 1 deduction would be reduced to \$3 million.