



# Discussion Paper

## **Implementation of the Basel II Capital Framework 6. Securitisation and the standardised approach to credit derivatives in the banking book**

13 November 2006

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## Introduction

Since the release of the 1988 Basel Capital Accord, securitisation markets – globally and in Australia – and the participation of financial institutions in these markets have grown significantly. Individual regulators, including APRA, have developed their own prudential framework for such activities. The Basel II capital adequacy regime, known as the Basel II Framework, now includes internationally agreed guidance on securitisation. This paper introduces APRA's revised Basel II prudential standard for securitisation *APS 120 Securitisation* (APS 120) and the prudential practice guide *APG 120 Securitisation* (APG 120) which reflect the Basel II guidance.

In April 2005, APRA released its draft proposals for the standardised approach to credit risk. At that time, *APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) did not include capital adequacy requirements for credit derivatives in the banking book. In view of the use of credit derivatives in synthetic securitisations, APRA is also releasing proposed requirements for credit derivatives with APS 120. When APRA's Basel II prudential standards are finalised, the treatment of credit derivatives in the banking book under the standardised approach to credit risk will be included as an Attachment to APS 112.

## Prudential standard

### Securitisation

The draft APS 120 sets out the methodology for the calculation of an authorised deposit-taking institution's (ADI's) regulatory capital charge for its securitisation exposures. The main requirements of the draft prudential standard are:

- an ADI must hold regulatory capital against securitisation exposures arising from both traditional and synthetic securitisations. This applies to all roles undertaken by, and any investments of, an ADI in a securitisation;
- an ADI that uses the standardised approach to credit risk for the purpose of determining its regulatory capital requirement for the type of exposures in the pool of securitised exposures must use the standardised approach for determining the regulatory capital requirement

for its securitisation exposures. Similarly, ADIs that generally use the internal ratings-based approach (IRB) to credit risk must use the IRB approach for securitisation exposures;

- certain involvement by an ADI in a securitisation must be clearly disclosed to investors;
- the securitisation must be clearly separate from any ADI involved in the securitisation and meet specific separation requirements; and
- an ADI must have in place an appropriate risk management system to manage the risks arising from its involvement in securitisation.

### Standardised approach to credit derivatives in the banking book

The treatment of credit derivatives in the banking book under the standardised approach to credit risk is somewhat similar to APRA's current approach as detailed in *AGN 112.4 – Treatment of Credit Derivatives in the Banking Book*. The main changes relate to the alignment of APRA's existing requirements to the Basel II Framework and include the following:

- second-to-default basket products are recognised for credit risk mitigation purposes;
- for first-to-default basket products, purchased credit protection may only be recognised against the reference entity with the lowest risk-weighted amount;
- the deduction of materiality thresholds included in purchased credit derivative contracts must be made 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital;
- the specification of eligible credit protection providers for credit default swaps, total-rate-of-return swaps and first- and second-to-default credit derivative basket products; and
- the inclusion of the Basel II operational requirements for purchased credit derivatives.

The requirements for the recognition of credit derivatives in the banking book under the internal ratings-based approach to credit risk are included in *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113). These will be amended, as appropriate, in the second draft of APS 113 which is expected to be released in early 2007.

The draft APS 120, APG 120 and the proposals for the standardised approach to credit derivatives in the banking book are available on APRA's website at [www.apra.gov.au](http://www.apra.gov.au). Written submissions on these documents should be forwarded by 19 January 2007 to:

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### Outstanding issues

One issue for APS 120 remains outstanding. APRA is yet to finalise the transitional arrangements that may be available for ADIs' securitisation exposures that have been approved under the current funds management and securitisation prudential standard. In their submission on draft APS 120, ADIs are encouraged to detail the type of transitional arrangements they may need. APRA expects that any new or modified securitisations that are undertaken subsequent to the release of draft APS 120 will be broadly in line with the new proposed requirements.

The requirements for funds management detailed in the current funds management and securitisation prudential standard are not included in the draft APS 120. These requirements will be included in a separate funds management prudential standard that will be released for consultation at a future date.

### Policy issues surrounding APS 120

Over the past number of years, the securitisation market in Australia has matured and grown significantly. APRA considers that it is now opportune to amend its securitisation framework to reflect market developments at the same time as the Basel II proposals are incorporated into a new prudential standard.

### Notification

Similar to the existing requirement, draft APS 120 requires an ADI to obtain APRA's written approval of the appropriate regulatory capital treatment that is to apply to a new or modified securitisation.

APRA is considering alternatives to this proposal, such as sole reliance on an ADI's self-assessment of compliance with the prudential requirements for securitisation. In this case, an ADI's securitisation activities would be included in APRA's routine supervision activities of the ADI. Alternatively, APRA could obtain independent legal advice regarding an ADI's compliance with APS 120.

As part of their submission on draft APS 120, ADIs are encouraged to detail alternatives to the proposed notification requirement in the draft standard.

### Role of the manager

APRA's current securitisation requirements prohibit an ADI from acting as a manager, trustee or responsible entity or in a similar role in a securitisation. These activities are currently required to be conducted through a stand-alone subsidiary or other associate that is not itself an ADI. The intention of this requirement was to address the impact on an ADI of operational and other risks arising from its provision of such services to a securitisation and, in particular, the absence of any capital charge for the risks arising from such functions.

The formal role of the manager in a securitisation is often performed by a non-regulated subsidiary of an ADI; however, in practice the ADI's own personnel often service and manage the securitised exposures by way of formal agreement with the manager. This has resulted in a blurring of the separation between the ADI and the independent manager.

APRA has considered both current Australian market practice and the approaches taken by other international regulators and has formed the view that, given the more limited risks associated with the management of a securitisation and the introduction

in the Basel II Framework of a regulatory capital charge for operational risk, an ADI itself may undertake the role of manager in a securitisation. In this light, draft APS 120 no longer prohibits an ADI from acting as a manager or responsible entity in a securitisation. For existing securitisations where an ADI has incorporated a subsidiary manager, it is proposed that the activities of these entities will be included in APRA's supervision of the consolidated banking group.

As a consequence of allowing ADIs to undertake the role of manager, APRA is proposing to strengthen the requirement regarding trustee activities. The trustee for a securitisation will be required to be independent of the ADI group that has established the securitisation.

### **Separation requirements**

Separation requirements between an ADI and a special purpose vehicle (SPV) are designed to ensure that an SPV stands clearly separate from an ADI involved in a securitisation and that clear limits governing the extent of the ADI's involvement in the securitisation are in place. Separation is important to ensure that investors, managers and other parties in a scheme are unable to make claims against an ADI for credit, operational or other losses incurred by the SPV. The introduction of International Financial Reporting Standards (IFRS) has resulted in a number of off-balance sheet assets and SPVs being brought back on-balance sheet due to more stringent de-recognition and consolidation criteria. In practice, this has blurred the separation between ADIs and associated SPVs.

The separation criteria between an ADI and an SPV have been strengthened in draft APS 120.

### **Basis swaps**

The use of basis swaps in securitisations is particular to the Australian market where variable rate mortgages predominate. Generally, an SPV will enter into a basis swap with an originating ADI to protect investors against differences in the spread between the benchmark interest rate received on a pool of exposures and the benchmark interest rate paid on securities to investors. In practice, there can be significant fluctuation in the spread between both

benchmark rates which gives rise to basis risk, a form of interest rate risk. Where a basis swap is constructed with insufficient margin, the originating ADI could be providing implicit support to the securitisation.

APS 120 states that an ADI entering into a basis swap with an SPV must be able to demonstrate to APRA that the basis swap is constructed with sufficient margin so that the ADI is not expected to be a net payer during the life of the basis swap. In addition, where the ADI expects to be a net payer for a significant period, there are reporting requirements to APRA.

### **Repurchase of securitised exposures**

The current prudential standard for securitisation allows any ADI, subject to certain conditions, to purchase assets from an SPV.

In practice, it is generally only originating ADIs that repurchase assets from an SPV. Draft APS 120 has been aligned with market practice and allows an originating ADI, subject to certain conditions, to repurchase exposures from an SPV outside of the exercise of a clean-up call. The current 10 per cent repurchase limit has been removed; however, the conditions include the restriction of the repurchase to non-defaulted exposures for the purpose of providing a further advance to the borrower.

### **Purchase of securities**

The current prudential standard for securitisation limits the purchase by ADIs of securities issued by a securitisation. This requirement was introduced at a time when the Australian securitisation market was in its initial developmental stage. As the market has matured, the need to limit such investments for non-originating ADIs has decreased. However, due to the risk of implicit support, the limit remains for originating ADIs.

### **Basel II supervisory discretions**

The Basel II Framework for securitisation includes a number of discretions where supervisors are able to reflect local prudential approaches.

### **Eligible liquidity facilities available in the event of market disruption**

Paragraph 580 of the Basel II Framework allows a zero per cent credit conversion factor (CCF) for eligible liquidity facilities that are only available in the event of market disruption.

APRA has not exercised this discretion.

### **Alternative approach to calculating $K_{IRB}$ for liquidity facilities**

Under the internal ratings-based approach to securitisation, where an ADI is unable to calculate  $K_{IRB}$ <sup>1</sup> using the bottom-up or top-down approach for a liquidity facility, paragraph 639 allows an alternative treatment on an exceptional and temporary basis.

APRA has exercised this discretion.

### **Eligible servicer cash advances**

Paragraph 582 allows undrawn servicer cash advances that are unconditionally cancellable without prior notice to be eligible for a zero per cent CCF.

APRA has exercised this discretion.

<sup>1</sup>  $K_{IRB}$  is the ratio of the IRB capital charge (including the expected loss portion) for the pool to the exposure amount of the pool.



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