Discussion Paper

Revisions to the prudential framework for securitisation

26 November 2015

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Preamble

This discussion paper outlines the Australian Prudential Regulation Authority's (APRA) proposed revisions to its prudential framework for securitisation. It includes APRA's response to submissions to its April 2014 discussion paper 'Simplifying the prudential approach to securitisation' and its proposed implementation of the Basel Committee on Banking Supervision's (Basel Committee) Basel III securitisation framework, released in December 2014.

APRA invites written submissions on the proposals in this discussion paper. Following consideration of submissions received, APRA intends to finalise *Prudential Standard APS 120 Securitisation* (APS 120), with proposed effect from 1 January 2018.

This discussion paper is available on APRA's website at www.apra.gov.au. Written submissions should be sent to APS120review@apra.gov.au by 1 March 2016 and addressed to:

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All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

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Glossary

Term	Definition
ABCP	Asset-backed commercial paper
ADI	Authorised deposit-taking institution
Advanced ADI	An ADI approved to use the advanced approaches to measuring risk for capital adequacy purposes.
APRA	Australian Prudential Regulation Authority
APS 001	*Prudential Standard APS 001 Definitions*
APS 112	*Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*
APS 113	*Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*
APS 116	*Prudential Standard APS 116 Capital Adequacy: Market Risk*
APS 120	*Prudential Standard APS 120 Securitisation*
Banking Act	*Banking Act 1959*
Basel Committee	Basel Committee on Banking Supervision
Basis swap	An interest rate swap aimed at limiting basis risk in a securitisation. A basis swap includes a payment stream on one leg of the swap based on an observable market rate or index, and a payment stream on the other leg based on rates set by a party to the swap, typically the originating ADI.
CDO	Collateralised debt obligation
CET1	Common Equity Tier 1 Capital
CLF	Committed liquidity facility, provided by the Reserve Bank of Australia as part of Australia's implementation of the Basel III liquidity standards.
Credit enhancement	A contractual arrangement in which the ADI or other entity provides some degree of protection against credit losses to other parties holding a securitisation exposure.
Implicit support	Support to a securitisation that is in excess of an ADI's explicit contractual obligations.
IOSCO	International Organisation of Securities Commissions
Junior securities	Debt securities issued in a securitisation which rank lower than senior securitisation exposures.
Junior securitisation exposure	A non-senior securitisation exposure. Junior securitisation exposures typically are structured to absorb substantially all of the credit risk in a securitisation.

Term	Definition
LCR	Liquidity Coverage Ratio. A prudential requirement to ensure that an ADI has an adequate level of unencumbered high-quality liquid assets to meet their liquidity needs for a 30 calendar day period under a stress scenario.
MLH	Minimum Liquidity Holdings. A simple liquidity ratio prudential requirement for ADIs that have been exempted from the LCR requirement.
Originating ADI	An ADI that directly or indirectly originates exposures in the pool, is the managing ADI for the securitisation, or provides a facility (other than a derivatives transaction) or a credit enhancement to an asset-backed commercial paper (ABCP) securitisation.
Pool	The underlying exposure or exposures that are securitised by way of assignment or transfer of rights and obligations to an SPV. The pool may consist of, but need not be limited to, loans, bonds or equities.
RBA	Reserve Bank of Australia
Resecuritisation exposure	A securitisation exposure in which at least one of the underlying exposures in the pool is a securitisation exposure.
Revolving securitisation	A securitisation in which one or more underlying exposures represent, directly or indirectly, current or future draws on a revolving credit facility, or a securitisation which provides for the compulsory replenishment of underlying exposures held by the SPV upon the maturity or payout of an existing underlying exposure.
Securitisation	A financing structure where the cash flows from an underlying pool are used to make payments to at least two tranches or classes of creditors (typically holders of debt securities), with each tranche or class entitled to receive payments from the pool before or after another class of creditors, thereby reflecting different levels of credit risk.
Securitisation exposure	On-balance sheet and off-balance sheet risk positions held by an ADI arising from a securitisation including, but not limited to, investments in securities issued by an SPV, credit enhancements, liquidity and other funding facilities and derivatives transactions.
Self-securitisation	A securitisation which is solely for the purpose of using the securities created as collateral in order to obtain funding via a repurchase agreement with a central bank (including the RBA).
Seller interest	An interest held by an originating ADI of a revolving securitisation that is collateralised by the revolving pool of underlying exposures, equivalent in size to the total asset

Term	Definition
	pool less the investor interest.
Senior securities	Debt securities issued in a securitisation which are senior securitisation exposures.
Senior securitisation exposure	A securitisation exposure effectively backed or secured by a first claim on the entire amount of the assets in the underlying pool.
SPV	Special purpose vehicle
Standardised ADI	An ADI that uses the standardised approach to measuring risk for capital adequacy purposes.
Synthetic securitisation	A securitisation whereby only the credit risk, or part of the credit risk, of a pool is transferred to a third party, which need not necessarily be an SPV. The transfer of credit risk can be undertaken through the use of funded (e.g. credit linked notes) or unfunded (e.g. credit default swaps) credit derivatives or guarantees.
Warehouse	An SPV that accumulates assets until a sufficiently large pool is available for issuance of securities to third-party investors in a securitisation.

Executive summary

APRA is proposing revisions to its prudential framework for securitisation that bring together its proposals to simplify securitisation for originating ADIs and the updated Basel securitisation framework which primarily focuses on the regulatory capital requirements for ADIs that invest in, or provide facilities to, securitisations.

This package of proposals has changed substantially since the first consultation package was released. APRA is seeking feedback on all the proposals in this discussion paper, including aspects previously consulted on, and on any transitional impacts.

In April 2014, APRA released the Discussion Paper 'Simplifying the prudential approach to securitisation' (first consultation paper) [1] which outlined simplification proposals, taking into account the lessons learned from the global financial crisis. APRA sought feedback on its proposals, noting that it intended not to finalise any reforms to its prudential framework for securitisation until, at least, the completion of the Financial System Inquiry[2] and the finalisation of revisions to the Basel Committee's Basel II securitisation framework.[3]

In December 2014, the Basel Committee released its final revisions to its securitisation framework (Basel III securitisation framework).[4] The Basel III securitisation framework aims to address a number of shortcomings in the Basel II securitisation framework and to strengthen regulatory capital standards for securitisation exposures held in the banking book.

This paper summarises the main issues raised in submissions to the first consultation paper, along with APRA's responses. It also outlines APRA's proposed implementation of the updated Basel securitisation framework. Accompanying this discussion paper, APRA is releasing a draft *Prudential Standard APS 120 Securitisation* (APS 120).

The main issues raised in submissions to the first consultation paper related to APRA's proposals regarding credit risk retention or 'skin-in-the-game', the two credit class structure, funding-only securitisation and warehouse arrangements. APRA has amended its proposals in a number of areas following consideration of the issues raised in submissions. APRA's amended proposals include:

- dispensing with a skin-in-the-game requirement;
- allowing for more flexibility in funding-only securitisation;
- removing explicit references to warehouse arrangements in the draft APS 120; and
- requiring term securitisation as a pre-condition for regulatory capital relief.

APRA considers the amended proposals will, on balance, aid the further development of the Australian securitisation market and assist ADIs to further strengthen their funding profile.

In the case of warehouse arrangements APRA has taken a principles-based, rather than rules-based, approach in removing explicit reference to these structures in the draft APS 120. APRA remains open in this consultation to alternative approaches that would address the risks associated with warehouse arrangements consistent with the principle that capital requirements remain commensurate with underlying risks.

The most significant revisions introduced by the Basel III securitisation framework include changes to:

1 http://www.apra.gov.au/adi/Documents/securitisation-discussion-paper-april-2014.pdf

2 On 7 December 2014, the Government released the final report of the Financial System Inquiry available at: http://fsi.gov.au/. The Government's response to the Financial System Inquiry is available at: http://www.treasury.gov.au/fsi

3 Basel II securitisation framework 'Basel II – International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive version, June 2006' and Basel 2.5 – 'Enhancements to the Basel II framework, July 2009'.

4 The Basel Committee released the Basel III document 'Revisions to the Securitisation Framework' in December 2014, available at: http://www.bis.org/bcbs/publ/d303.pdf

- the hierarchy of approaches that ADIs must use to assign regulatory capital for securitisation exposures;
- the risk drivers used in each approach; and
- the amount of regulatory capital ADIs must hold for securitisation exposures.

APRA proposes to implement the Basel III securitisation framework, with appropriate Australian adjustments. The main Australian adjustments proposed are:

- simplification of the approaches to determining regulatory capital requirements for ADIs' securitisation exposures – that is, allowing only the External Ratings-based Approach and the Standardised Approach, both of which would apply equally to all ADIs;
- simplification of the External Ratings-based Approach by reducing the number of credit rating grades applicable to senior exposures; and
- the application of a CET1 deduction to resecuritisation exposures and all non-senior securitisation exposures.

In proposing revisions to its securitisation framework, APRA has sought to find an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality. On-balance, APRA considers the proposals in this discussion paper will deliver improved prudential outcomes and provide efficiency and competitive benefits to ADIs.

The Basel Committee has determined that the Basel III securitisation framework should come into effect from 1 January 2018. Subject to consultation on this discussion paper, APRA proposes to implement the revised prudential framework in Australia from 1 January 2018. If industry provides sound reasons for doing so, APRA is willing to consider earlier implementation of some aspects of this reform, notably the new arrangements for funding-only securitisation.

APRA also intends to release a draft prudential practice guide (PPG) and reporting standards and reporting forms, including a reporting standard and reporting form for covered bonds, for consultation in the first half of 2016. APRA expects that the final prudential standard, PPG, reporting standards and reporting forms, will be released in the second half of 2016.

In July 2015, the Basel Committee and the International Organisation of Securities Commissions (IOSCO) issued final non-binding criteria for identifying simple, transparent and comparable (STC) securitisation.[5] The Basel Committee issued a consultative document in November 2015 that includes proposals to incorporate STC criteria into the securitisation framework.[6] APRA will separately consider the need for further amendments to APS 120 once the Basel Committee has finalised its proposals.

5 The Basel Committee and IOSCO document 'Criteria for identifying simple, transparent and comparable securitisation July 2015', available at: http://www.bis.org/bcbs/publ/d332.pdf

6 In November 2015 the Basel Committee released a consultative document on the 'Capital treatment for "simple, transparent and comparable" securitisation', available at: http://www.bis.org/bcbs/publ/d343.htm

Chapter 1 — Introduction

APRA requires ADIs to adopt prudent practices in managing the risks associated with securitisation and hold sufficient regulatory capital against the associated credit risk.

APRA's first consultation paper and the Basel III securitisation framework set out a number of problems associated with the existing securitisation arrangements. The resulting policy responses were designed to address undue complexity and mitigate the significant risks exposed by the global financial crisis.

1.1 The first consultation paper

The global financial crisis highlighted that securitisation, and the prudential regulation of securitisation, had become unduly complex. In practice, attempting to address the risks of an increasingly complicated product with increasingly complicated requirements proved unsatisfactory.

As outlined in APRA's April 2014 consultation paper, APRA's objective is to establish a simplified framework, taking into account the lessons learned from the global financial crisis and global reform initiatives. In doing so, reform of the prudential framework for securitisation should assist in the further recovery of the securitisation market, which has been relatively subdued in the period since the global financial crisis.

APRA's proposed approach in the first consultation paper included the following features:

- a set of key principles that applied to securitisation, rather than an expanded set of prudential requirements;
- a simple two credit class structure, which reduced the likelihood of opaque risk transfer and enhanced benefits for system stability;
- a simple credit risk retention or skin-in-the-game requirement to mitigate agency risks;
- explicit recognition of funding-only securitisation, with a simple but robust prudential regime that also allowed for revolving securitisation;
- simpler requirements for capital relief, that better align the amount of regulatory capital to the risk of securitisation exposures;
- better integration of securitisation with the ADI liquidity regime; and
- clarification of the treatment of warehouses and similar structures.

APRA invited submissions on its proposals, but noted that it did not intend to finalise any reforms to its prudential framework for securitisation until, at least, the completion of the Financial System Inquiry. APRA indicated that it would also have regard to proposed revisions to the Basel II securitisation framework, which were subsequently finalised in December 2014.

APRA received eighteen submissions in response to its first consultation paper. Thirteen of these were from ADIs, three from industry associations and two from other stakeholders. Seven of the eighteen submissions were confidential.

1.2 The Basel III securitisation framework

The Basel III securitisation framework aims to address a number of shortcomings in the Basel II securitisation framework that were identified in many jurisdictions during the global financial crisis. In particular:

- external credit ratings often did not adequately reflect the risk of securitisation, particularly complex securitisation. In the case where rating agencies understated the risk of certain exposures, regulatory capital requirements proved insufficient;
- there were sharp increases in regulatory capital requirements as rating agencies downgraded their ratings on certain securitisation exposures. Rapid rating downgrades also exacerbated mark-to-market losses for many banks;
- the internal assessments of certain banks' securitisation exposures were not as robust as expected; in some cases banks imprudently

managed the risk of securitisation exposures; and

- important risk drivers, such as maturity, were not appropriately captured in the regulatory framework.

To address these issues, the Basel III securitisation framework includes changes to:

- the hierarchy of approaches that ADIs must use to assign regulatory capital for securitisation exposures;
- the risk drivers used in each approach; and
- the amount of regulatory capital ADIs must hold for securitisation exposures.

A key consideration for APRA in determining whether the Basel III securitisation framework should be implemented in Australia is that the Australian banking sector operates in a global financial system and as such, global developments have a direct impact on Australian ADIs. This impact is compounded by the Australian banking sector having a material reliance on foreign funding and maintaining investor confidence is influenced by the extent to which a prudential framework is consistent with international norms.

Box 1 summarises APRA's proposed securitisation framework reflecting appropriate updates after consideration of submissions received, and its proposed implementation of the Basel III securitisation framework.

1.3 Policy options and estimated comparative net benefits

This discussion paper sets out APRA's proposals to reform the current prudential framework for securitisation through amendments to APS 120. In setting out such an approach APRA is choosing between three broad policy options.

One option would be to maintain the *status quo*, under which no changes would be made to APS 120. Securitisation issues would continue to be addressed through supervision, including *ad hoc* industry letters, notes and advices that may be required to clarify the operation of the existing APS 120.

A second option would be for APS 120 to be amended to simplify the framework, based on proposals in APRA's first consultation paper, adjusted where appropriate to reflect submissions received, but without incorporating the Basel III securitisation framework. Under this option, APS 120 would be amended to a more simplified framework, however would not reflect international reforms.

The third option is to incorporate both the APRA-initiated proposals that were outlined in the first consultation paper, adjusted where appropriate to reflect submissions received, and the Basel III securitisation framework. The draft APS 120 accompanying this paper has been prepared on this basis.

The estimated comparative net benefits of each option are detailed in the Annexure to this paper.

1.4 Balancing safety and competition

In proposing revisions to its securitisation framework, APRA has sought an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality. On-balance, APRA considers the proposals in this discussion paper will deliver improved prudential outcomes and provide efficiency and competitive benefits to ADIs. For example:

- if operating effectively, securitisation can be a valuable means by which to diversify sources of funding and increase balance sheet resilience. As a result, regulatory changes that simplify and clarify regulatory requirements should support the efficiency of this market and its role in both competition and prudent funding;
- securitisation markets tend to be used more extensively by smaller ADIs to fund, in particular, their housing lending activities. A deeper and more resilient securitisation market should help smaller ADIs compete with larger ADIs that have greater access to other sources of debt funding; and

- aligning requirements between Advanced ADIs and Standardised ADIs should also assist competitive neutrality.

APRA invites stakeholders to provide views on the impact its proposals may have on these objectives, including views on proposals that might enhance competition without jeopardising prudential safety objectives.

1.5 Timetable

APRA is proposing to implement the revised APS 120 on 1 January 2018, in line with the Basel Committee's suggested implementation date of the Basel III securitisation framework. A transition period for originating ADIs in relation to existing securitised exposures, as outlined in the draft APS 120, would apply. If industry provides sound reasons for doing so, APRA is prepared to consider an earlier implementation of the funding-only aspects of this reform. APRA intends to release a draft PPG and reporting standards and reporting forms, including a reporting standard and reporting form for covered bonds, for consultation in 2016. APRA expects that the final prudential standard, PPG, reporting standards and reporting forms, will be released by the end of 2016.

In the period between the release of the final standard and its effective date, APRA expects that originating ADIs will structure new securitisations consistent with the final standard. Securitised exposures that are inconsistent with the spirit of the final standard would likely be ineligible for transitional arrangements.

In July 2015, the Basel Committee and IOSCO issued final criteria for identifying STC securitisations. The purpose of these non-binding criteria is to assist the financial industry's development of simple, transparent and comparable securitisation structures. The Basel Committee issued a consultative document in November 2015 that includes the proposed options for incorporating the STC criteria into the revised securitisation framework. APRA's preference is to continue with the proposed changes to APS 120 outlined in this discussion paper independently from this further work being considered by the Basel Committee. APRA will separately consider the need to further amend APS 120 upon the finalisation of the Basel Committee's proposals.

1.6 Structure of this paper

Chapter 2 summarises the main issues raised in submissions to APRA's first consultation paper, along with APRA's responses.

Chapter 3 outlines APRA's proposed implementation of the Basel III securitisation framework.

Chapter 4 outlines other APRA proposals, including consequential changes to prudential standards to incorporate minor cross-referencing and other changes flowing from proposed changes to APS 120.

The Annexure summarises policy options and the estimated comparative net benefits of each option.

1.7 Request for cost-benefit analysis information

In determining the most appropriate option, APRA will undertake a cost-benefit analysis. To assist in this process, APRA requests that all interested stakeholders use this consultation opportunity to provide information on the compliance impact of the proposed policy options outlined in section 1.3, including any changes to reporting standards and reporting forms and any other substantive costs associated with these. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any increases or decreases to the compliance costs incurred by businesses as a result of each option.

Consistent with the Government's approach, APRA will use the methodology behind the Regulatory Burden Measurement Tool to assess compliance costs. This tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at: https://rbm.obpr.gov.au/home.aspx.

Respondents are requested to use this methodology to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their cost assessment to APRA, respondents are asked to include details of any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements or expectations, not activities that institutions would undertake regardless of regulatory requirements in their ordinary course of business.

Box 1: APRA's proposed securitisation framework

Securitisation of underlying exposures

An originating ADI may undertake a securitisation primarily to raise funding (a funding-only securitisation) or for both funding and to reduce capital requirements (a capital relief securitisation). For both forms of securitisation, an originating ADI must meet the requirements relating to separation and disclosure and exposures transferred in a securitisation. Investors in a securitisation may only have a claim on the underlying pool of exposures and any applicable facilities.

In addition to the above, to achieve capital relief an originating ADI must meet additional requirements, including:

- significant credit risk transfer;
- the securitisation must provide funding for the life of the underlying pool of exposures; and
- holding regulatory capital against any securitisation exposures it retains.

Table 1 - Securitisation structures for originating ADIs

Underlying pool of exposures	
Capital relief	**No capital relief**
• **Significant credit risk transfer**	• **Funding-only** - ABCP securitisation - Revolving securitisation - Self-securitisation • **Synthetic securitisation**

Securitisation exposures

An ADI must hold regulatory capital for credit risk against its securitisation exposures.

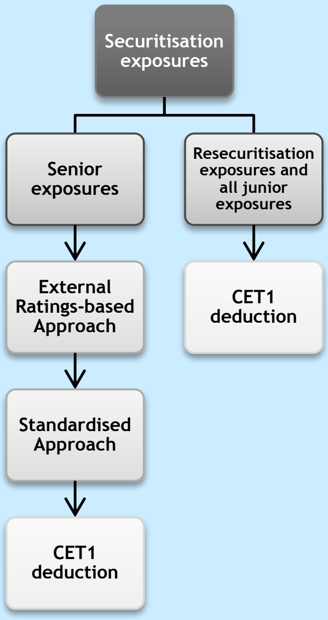
With the exception of those exposures that are required to be deducted from Common Equity Tier 1 Capital (CET1), securitisation exposures must be risk weighted. The risk-weighted asset amount of a securitisation exposure is calculated by multiplying the exposure amount by the appropriate risk weight.

There are two approaches to determine the appropriate risk weight – the External Ratings-based Approach and the Standardised Approach. In general, an ADI that cannot use either of these approaches will be required to apply a CET1 deduction.

The External Ratings-based Approach assigns risk weights according to the external rating of the exposure. In the case of long term exposures, risk weights depend on the maturity of the tranche as well as the external rating grade.

The Standardised Approach is a supervisory formula approach that uses the capital charge as determined under *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112) that would apply had the underlying exposures not been securitised.

Figure 1 – Regulatory capital requirements for ADIs' securitisation exposures



Chapter 2 — Response to submissions - 'Simplifying the prudential approach to securitisation'

2.1 Credit risk retention

In its first consultation paper, APRA proposed a simple credit risk retention or skin-in-the-game requirement to mitigate agency risks. APRA proposed that ADIs that originate exposures, either directly or indirectly, into a pool, be required to retain at least 20 per cent of the junior securities[7] in each of their securitisation structures.

Comments received

In general, submissions did not support the proposed skin-in-the-game requirement. Submissions commented that inconsistency with overseas requirements would likely lead to operational complexity and collateral inefficiency.

Some submissions requested alignment with overseas requirements, favouring the representative sample approach available in some overseas jurisdictions.[8] Some submissions saw the proposed 20 per cent requirement as conservative in comparison to overseas requirements.

A number of submissions commented that a skin-in-the-game requirement imposed on ADIs in Australia would put ADIs at a competitive disadvantage to non-ADI originators in the local market. In addition, one submission expressed a view that investors were not advocating the need for a skin-in-the-game requirement in Australia.

APRA's response

Since the release of APRA's first consultation paper, the concept of skin-in-the-game has evolved internationally. Skin-in-the-game requirements have settled at around 5 per cent, albeit with a number of different calculation bases. Options for skin-in-the-game also vary across jurisdictions, and include various 'vertical', 'horizontal' and complex 'L-shaped' alternatives. Some jurisdictions have eliminated the representative sample approach on the basis that it is overly burdensome with respect to disclosure requirements. It is also noted that a number of overseas jurisdictions do not recognise any other jurisdiction's corresponding requirement as meeting local needs. Therefore, if APRA were to implement a skin-in-the-game requirement which differed to the requirements offshore, securitisation would become more complex for ADIs seeking to issue internationally. This would run contrary to APRA's objective of creating a simplified framework, and may detract from competition and competitive neutrality benefits that may otherwise be achieved.

In summary, a variety of skin-in-the-game requirements has emerged internationally which are considerably less conservative than APRA's proposal and introduce complexity for ADIs that intend to access funding through securitisation in overseas jurisdictions.

Given the submissions received, APRA has given credit risk retention careful consideration. APRA notes that, generally, Australian ADI originators do not adopt an 'originate-to-distribute' business model.[9] As such, securitisation structures typically represent a relatively modest and representative portion of an ADI's loan portfolio. Australian ADI originators also generally retain a number of linkages to their securitisation structures through excess spread (a direct financial interest in cashflow surpluses that typically accumulate in Australian ADI securitisations) and loan servicing where ADIs maintain the direct customer relationship with the underlying borrowers in the pool. Many Australian ADI originators also provide basis swaps and various other facilities to their securitisation structures, as well as managing the schemes. Such linkages distinguish securitisation programs of Australian ADIs from many overseas

7 Junior securities were described as B class securities in the first consultation paper. APRA has renamed these in the draft APS 120 to avoid confusion with letter-based credit ratings.

8 A representative sample is an approach where a randomly selected subset of assets representing the securitised pool in terms of credit risk is retained by the originator.

9 Originate-to-distribute lending is a model whereby lenders write the vast majority of their loans with the intention of selling them to investors, as opposed to holding the loans to maturity.

structures and reinforce Australian ADIs' incentives to maintain the quality of lending standards for loans in their securitised pools.

For these reasons, APRA is now proposing not to introduce an explicit skin-in-the-game requirement.

2.2 Two credit class structure

2.2.1 Tranching of funding-only

In its first consultation paper, APRA proposed a two credit class structure: the A class or senior portion of the structure and the B class or junior portion of the structure. In a funding-only securitisation there would be no time tranching or credit tranching of the B class, with the originating ADI holding all the B class securities.

Comments received

A number of submissions requested flexibility to convert funding-only to capital relief securitisation should the securitisation meet all the requirements for regulatory capital relief. Submissions highlighted that difficult market conditions at the time of issuance could result in an ADI being unable to sell the B class securities, but may subsequently seek to sell all or some of the B class securities later once markets had recovered.

APRA's response

APRA's objective is to achieve clarity and simplicity in a funding-only structure. A single tranche of junior securities supports this objective. Furthermore, time or credit tranching is not needed as the originating ADI holds all the junior securities in a funding-only securitisation. In the interests of clarity and simplicity, APRA does not propose to allow for time tranching or credit tranching of the junior class in a funding-only securitisation. APRA expects that ADIs would not time tranche or credit tranche the junior securities unless regulatory capital relief is sought at the securitisation's inception.

2.2.2 Trading in own senior securities[10]

In its first consultation paper, APRA proposed to remove the existing 20 per cent securities holding limit.[11] An ADI could trade its own A class securities provided this was 'incidental to normal activities' in financial markets.

Comments received

Some submissions sought clarity on the meaning of trading in own A Class securities provided this was 'incidental to normal activities'.

APRA's response

As detailed in the draft APS 120, APRA is proposing that an ADI will generally be free to purchase its own senior securities, however any purchase must not otherwise provide implicit support to a securitisation. Implicit support could be evident where, for example, a security is purchased to repay investors that would not otherwise be permitted or where the purchase of securities is above market prices.

Outside routine market making whereby purchased securities are usually resold within a short period, APRA would expect that an originating ADI would not hold a disproportionate share of its own senior securities. For this purpose, APRA is proposing a guide, similar to the current limit, of less than 20 per cent of the value of senior securities outstanding to be included in the PPG. APRA will consider reporting requirements in 2016 to allow it to better monitor the volume of securities purchased by ADIs.

2.2.3 Deduction of junior securitisation exposures

In its first consultation paper, APRA proposed that a CET1 deduction would be applied to junior securitisation exposures (including B class securities) that are held by an ADI.

10 Senior securities were described as A class securities in the first consultation paper. APRA has renamed these in the draft APS 120 to avoid confusion with letter-based credit ratings.

11 Under the current APS 120, an originating ADI must ensure, on an on-going basis, that the volume of securities (held in both the trading and banking book) is not disproportionate to the amount of securities outstanding issued by the SPV (i.e. the volume must be less than 20 per cent of the value of securities outstanding).

Comments received

Some submissions remarked that APRA's proposal would be unnecessarily punitive. Submissions suggested the proposal would have a wider impact on the market given that ADIs may no longer be willing to 'make a market' in these securities. Some submissions commented that it was likely that the proposal would shrink the investor base for B class securities.

Some submissions opined that the credit risk profile of a junior securitisation exposure with multiple tranches below it, and exposed to very little credit risk, did not correlate with a CET1 deduction. A few submissions highlighted that some B class securities were, or potentially are, 'AAA' rated and eligible securities for repurchase agreements with the Reserve Bank of Australia (RBA).

APRA's response

APRA's objective is to materially reduce the incentives for ADIs to invest in any tranches other than senior securitisation exposures and where ADIs provide facilities, or have other exposures to securitisation structures, be incentivised to ensure they are senior in the cash flow waterfall.

APRA is therefore not intending to alter its proposal to treat junior securitisation exposures as 'equity-like'. This approach reflects APRA's view that senior securitisation exposures (including senior securities) benefit from the credit enhancement received from the junior securitisation exposures – the latter positions reflect substantially all the credit risk in a securitisation.

In the case of some junior securities that are 'AAA' rated, these are likely to be subject to conditional credit enhancement (e.g. lenders' mortgage insurance whereby a claim on a loan has to go through an insurer's internal assessment process and is covered by the insurer only if the claim is successful) and so these subordinated positions could bear losses in the first instance and recoup only a portion of such losses.

2.3 Date-based call options

In its first consultation paper, APRA proposed that date-based call options be allowed in funding-only securitisation on the proviso that the call date set at inception was based on the originating ADI's projection of when the pool would amortise by 90 per cent or more.

Comments received

Submissions expressed a strong view that originating ADIs should be allowed to facilitate bullet repayments through date-based call options unrelated to the projected 90 per cent amortisation of the pool.

Submissions commented that APRA's proposal would add little value in attracting a broader range of investors and would not reduce the costs of issuance. Submissions asserted that more flexible date-based call options would provide greater certainty of maturity, lower hedging costs, and facilitate a much larger and cheaper funding-only securitisation market.

Submissions also noted that under APRA's proposals, ADIs wishing to facilitate bullet repayments may achieve this by providing assets to the pool in volumes significantly in excess of the value of external investors' interests.

Submissions emphasised that there was no legal obligation on the originating ADI to exercise a date-based call option, however, any increased liquidity risk associated with a date-based call option should be captured under APRA's liquidity rules in the same way as any other maturing obligation.

APRA's response

Bullet style funding creates rollover risk when bullet repayments become due. This is similar to the liquidity risk associated with many other bullet instruments on an ADI's balance sheet, most notably senior unsecured debt securities.

In a securitisation, however, a prudential objective is that investors have no recourse to the originating ADI. Investors should only have recourse to the pool of underlying exposures. It is this lack of recourse to the originating ADI that differentiates securitisation from covered bonds.

Notwithstanding, APRA is prepared to accommodate more flexibility around date-based call options in funding-only securitisations by removing the linkage to the projected 90 per cent amortisation of the pool. Such options will be permitted provided:

- investors fully bear all the credit losses associated with their holdings to the call date;
- the originating ADI retains full discretion whether to exercise the call;
- the securities repurchased by the originating ADI are done so at market value;[12] and
- for liquidity purposes, the date-based call is modelled at the first date the originating ADI can effectively call the securities.

APRA's advice from industry is that this approach will facilitate a material increase in funding-only securitisation by many Australian ADIs. This expectation will be incorporated into APRA's ongoing administration of the 'all reasonable steps' principle, to reduce reliance by ADIs upon the RBA's Committed Liquidity Facility.

2.4 Revolving securitisation

2.4.1 Early amortisation provisions

In its first consultation paper, APRA proposed not to allow early amortisation provisions in revolving securitisations. Such provisions, if triggered, accelerate the reduction of the investor's interest in the underlying pool of exposures and allow investors to be paid out prior to the originally stated maturity of the securities.

Comments received

Submissions commented that early amortisation provisions are critical in protecting an ADI from having to replenish a revolving securitisation with new assets.

Submissions suggested that triggers that end the revolving period prior to the scheduled amortisation and stop new assets being sold into the securitisation should be allowed on the basis that the seller's interest is never structurally subordinated to the investor's interest from the time early amortisation is triggered.

Submissions reiterated comments made relating to date-based calls, in that any prohibition on early amortisation would not meet the objective of further developing the market.

APRA's response

In a funding-only securitisation, the originating ADI is deemed to retain all the credit risk of the pool and holds capital as if the underlying loans had not been securitised. Early amortisation, where treated as a funding-only transaction, does not impact this outcome. That said, allowing an investor to be paid out earlier than anticipated may result in the investor absorbing less credit risk than would otherwise be the case. An ADI may end up absorbing a greater share of the credit risk, particularly if the ADI is structurally subordinated (see 'Treatment of seller's interest' in section 2.4.2).

Early amortisation shifts the funding of exposures from one source (the securitisation) to another (the originating ADI). In essence, a liquidity impact also occurs to the extent that the seller's interest increases; i.e. the ADI takes on the funding of assets in place of investors in a securitisation.

If an amortisation provision simply involves the flow through of principal payments to investors and the seller on a *pro rata* basis, the ADI's seller's interest does not increase and so it takes on no additional funding or liquidity risk. On the basis that cash flows in the amortisation phase are *pro rata*, APRA is proposing to change its initial proposal and allow early amortisation provisions.

2.4.2 Treatment of seller's interest

In its first consultation paper, APRA proposed that the seller's interest must never be subordinated to the investor's interest, including in the revolving period.

Comments received

Most submissions agreed that non-subordination of the seller's interest should apply, but only when

12 Where an underlying pool is fully performing, the market value of securities at the time of the call would generally be expected to be their par value.

the securitisation is winding down (amortisation period).

Submissions commented that at other times (revolving period) cash flows could appropriately be directed to investors (to fund an upcoming maturity) or the ADI (to absorb fluctuations in the securitisation). Submissions highlighted that any subordination of the seller's interest would only be for liquidity risk rather than credit risk.

Submissions pointed out that an inability to direct cash flow in the revolving period may result in greater balance sheet encumbrance or even make structures unworkable.

APRA's response

In response to comments received, APRA is proposing to allow the seller's interest in the revolving period to vary to facilitate structural cashflows only, provided that the seller's interest is never subordinated in regard to any losses associated with the underlying exposures.

APRA considers that the amended proposals relating to revolving securitisation should aid the further development of the Australian securitisation market and assist ADIs to further strengthen their funding profiles.

2.5 ABCP securitisation

In its first consultation paper, APRA proposed to require an originating ADI of an ABCP securitisation to have sound funding arrangements in place to cater for a (hypothetical) two-year closure of securitisation markets.

Comments received

Submissions commented that the proposal was unnecessary and sought clarification as to why an originating ADI would have to have other funding arrangements in place for these securitisations as liquidity is often provided by another ADI in the event the ABCP securitisation is unable to roll the securities at maturity.

APRA's response

Under APRA's proposal an originating ADI must treat ABCP securitisation as funding-only. An originating ADI is required to hold capital (and liquidity) for the assets it assigns to the pool. In addition, a third party ADI providing liquidity or credit enhancement to an ABCP securitisation is required to hold capital (and liquidity) for the pool.

As a result, APRA will not specifically require an originating ADI to have arrangements in place to cater for at least a two year closure of securitisation markets. However, ADIs must have regard to *Prudential Standard APS 210 Liquidity* and prudently manage the liquidity risk associated with ABCP securitisation.

2.6 Capital relief

In its first consultation paper, APRA put forward for consideration two approaches for determining capital relief: the significant credit risk transfer approach - the approach adopted in the existing APS 120 - and the *pro rata* approach.

Comments received

Most submissions supported the significant credit risk transfer approach over the *pro rata* approach, on the basis that the significant credit risk transfer approach was more risk sensitive.

Comments also noted that the *pro rata* approach was divergent from approaches to capital relief adopted by other jurisdictions.

Some submissions suggested that the significant credit risk transfer approach would be enhanced by additional guidance, as this approach required a degree of judgement.

A few submissions suggested approaches adopted by other jurisdictions, as a means of providing more clarity around significant credit risk transfer.

APRA's response

The *pro rata* approach is a simple approach, however it lacks some degree of risk sensitivity. The *pro rata* approach allows an originating ADI to obtain some capital benefits, without achieving significant credit risk transfer. Retaining significant securitisation exposures, depending on the proportion of risk held, may however undermine the intent of a securitisation to transfer credit risk.

A secondary, but not insignificant, consideration is that the *pro rata* approach would necessitate significant changes to APRA's prudential reporting framework.

On balance, after considering submissions received, APRA has decided to retain the significant credit risk transfer approach. This approach will also achieve a greater degree of consistency with the Basel securitisation framework.

In response to the comments received on this approach, APRA proposes to adopt some quantitative thresholds for when significant credit risk is deemed to occur. That is, to obtain regulatory capital relief, APRA proposes that an originating ADI and any member of a group in which the ADI belongs[13] must not, in aggregate, and at any time:

- hold more than 20 per cent of the junior securities issued in the securitisation, or more than 20 per cent of any tranche of junior securities issued in the securitisation; and
- hold junior securities and hold or provide other loss positions or credit enhancements, which in combination represent more than 20 per cent of the loss cover provided in the securitisation to support senior securitisation exposures.

Where there are two or more originators of the underlying pool in a securitisation, an originating ADI must apply the above tests according to the proportion of assets originated by the ADI to the total amount of assets into the pool.[14]

13 This does not include a member of a group that acts independently on behalf of third parties e.g. statutory funds of life insurance companies, responsible entities, trustees or custodians acting on behalf of beneficiaries or members.

14 In these circumstances, the maximum holding of junior securities or exposures specified are multiplied by the proportion of assets originated in the pool to the total amount of assets originated in the pool. The maximum holding of junior securities or exposures for a managing ADI is based on the lowest proportion of assets originated into the pool by any originator, except in the case of a third party managing ADI (an ADI that does not contribute any assets into the pool), where the third party managing ADI must apply the tests as if the ADI has originated all the assets in the pool.

2.7 Warehouse arrangements

In its first consultation paper, APRA proposed that if assets remain in a warehouse after a period of one year, the ADI providing the warehouse funding would incur a capital charge under APS 112 or APS 113, as appropriate, as if those assets were on its balance sheet.

Comments received

Some submissions noted that some (typically small) ADIs genuinely require more than one year to aggregate a pool of sufficient size to undertake a term securitisation and that it is administratively burdensome to identify assets that have been in a warehouse arrangement for more than a year.

Some submissions remarked that there was 'double counting' of capital if the originator did not obtain capital relief and the warehouse provider was also required to hold capital as if all the assets were on its balance sheet. It was noted that the proposal, if left unchanged, could impact competition by making warehouse funding more expensive. APRA notes, however, that there is nothing preventing such ADIs from holding the loans on their own balance sheet, until achieving a critical mass to place in the securitisation market.

Other submissions suggested that the proposed one year requirement was not necessary as warehouses should be either funding-only for the originator or there should be no specific requirements for warehouses. For warehouses that fund certain assets, such as trade receivables, submissions argued that there was no need for a one year requirement if there was no asset-liability mismatch.

APRA's response

Warehouse arrangements are a means by which an ADI obtains funding, usually from another ADI, allowing the assets to be removed from the originating ADI's balance sheet before a pool of sufficient size has been amassed to undertake a term securitisation. The current arrangements provide for regulatory arbitrage, given the risk associated with the loans in the banking system is unchanged by placing loans in a warehouse, while capital requirements are effectively reduced.

This approach is predicated on the basis that there is reasonably prompt issuance of term securitisations. However, some warehouse arrangements in practice have not been temporary in nature. In addition, the nature of the renegotiation of the terms of warehouse funding at the notional expiry of the arrangement has pointed to a true sale not having occurred.

APRA's proposal in the first consultation paper was to allow a continuation of the existing capital treatment but to limit this to a period of one year. APRA notes that submissions that objected to this proposal did not provide suggestions of alternatives that recognised the prudential concerns that some warehouse arrangements are not temporary, and simply facilitate regulatory arbitrage.

To address this issue APRA considers that a principles-based, rather than rules-based, approach is preferred. APRA is proposing to remove all references to warehouses in the revised APS 120. Instead the focus in the standard will be on whether there are at least two tranches of credit risk (and so qualifies as a securitisation), whether there is term funding and whether there is significant credit risk transfer (in the case of capital relief securitisations).

In commercial terms, warehouse arrangements may still be used for funding. ADIs will continue to be able to aggregate assets in a warehouse without any time limit. If there is no tranching of credit risk, ADIs will apply APS 112 or APS 113, as appropriate. In the event of a true loan sale, an originating ADI is likely to attain capital relief under the existing general credit risk framework.

If there are at least two tranches of credit risk, APS 120 will apply. In this instance an originating ADI can achieve capital relief if the relevant requirements are met, including that the securitisation provides funding for the life of the underlying exposures and there is significant credit risk transfer. This is consistent with traditional securitisation structures whereby assets and liabilities are matched and funding is provided for the life of the underlying pool. In practice, this means any pool that requires rollover or refinancing will be ineligible for capital relief.

APRA is cognisant of the importance of warehouse arrangements in facilitating securitisation. Warehouse arrangements have enabled some ADIs with limited access to wholesale funding markets to raise funds at more competitive rates; in the period up to the global financial crisis this contributed to increased competition and an associated reduction in lending spreads. The current regulatory requirements for warehouse arrangements have, however, led to less capital being held in the banking system relative to the risk retained in the system.

APRA therefore has put forward these new proposals regarding warehouse arrangements in light of the lack of support for the previous version. However, APRA remains open in this consultation to submissions with viable alternative proposals that adequately address the risks associated with warehouse arrangements, consistent with the principle that capital requirements remain commensurate with each ADI's underlying risks, and opportunities for regulatory arbitrage are limited.

2.8 Credit risk mitigation

2.8.1 Synthetic securitisation

In its first consultation paper, APRA proposed that an originating ADI would not be able to recognise any capital relief in a synthetic securitisation.

Comments received

Submissions contended that an originating ADI should be able to obtain capital relief in a synthetic securitisation.

Submissions noted that synthetic securitisation may facilitate risk management by allowing risk transfer of certain (illiquid) exposures in the absence of secondary loan markets.

Some submissions considered it inconsistent to recognise the use of credit risk mitigation (guarantees, eligible collateral and credit derivatives) for regulatory capital purposes outside of securitisation transactions, but not for securitisation purposes.

APRA's response

APRA considers there are important practical differences between a synthetic securitisation and traditional securitisation where an SPV is involved. These differences make synthetic securitisation more complex.

Synthetic securitisation exposes the protection buyer to counterparty credit risk. These structures often include additional characteristics that increase risk, such as leverage or opaque terms. APRA considers that there is greater incentive for issuers to provide support to such structures in time of stress.

For these reasons, APRA does not intend to recognise synthetic securitisation for capital relief.

To clarify, in a traditional securitisation with an SPV involved, credit risk mitigation may be used as part of the structure. An ADI may also recognise credit risk mitigation to cover a senior securitisation exposure to the SPV, but it cannot recognise the use of that credit risk mitigation if it results in tranched cover of the exposure as this would be considered a synthetic securitisation of that asset.

2.8.2 Credit risk mitigation on junior securitisation exposures

In its first consultation paper, APRA also proposed that the use of credit risk mitigation on junior securitisation exposures in a traditional securitisation would not be recognised for regulatory capital purposes - this means the ADI would have to physically sell B class securities to third parties.

Comments received

Two submissions requested that ADIs should be able to recognise credit risk mitigation to cover a junior securitisation exposure.

APRA's response

APRA's notes the approach taken in the capital framework generally is that credit risk mitigation is not recognised for exposures that are required to be deducted from capital. APRA intends to maintain a consistent approach, and for this reason has retained the proposal from the first consultation paper in the draft APS 120.

2.9 Self-securitisation

In its first consultation paper, APRA proposed that self-securitisation must be structured in the same manner as funding-only securitisation.

Comments received

One submission requested flexibility to buy-back loans, redeem notes and sell additional loans into a self-securitisation at any time.

Another submission requested that self-securitisation should allow the ADI to terminate the arrangement to the extent it is determined that it should no longer form part of an ADI's funding or liquidity plans.

APRA's response

The draft APS 120 clarifies 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. This allows for efficient management and seamless transition to a securitisation structure at the point funding is obtained.

2.10 Trust-back arrangements

In its first consultation paper, APRA proposed to maintain its existing policy that (non-securitised) loans subject to trust-back arrangements are not eligible for a risk weight of less than 100 per cent, unless a formal second mortgage arrangement is in place.

Comments received

Submissions commented that trust-back arrangements may be structured so as to afford protection to originating ADIs substantially equivalent to that of formal second mortgages (even though a second mortgage from the borrower may not formally be in place). Some submissions also noted the administrative issues and increased expense associated with obtaining formal second mortgages.

APRA's response

APRA retains its reservations regarding the effective equivalence of trust-back arrangements with a formal second mortgage. Consistent with APS 112 and APS 113, only where an ADI has direct and unequivocal access to collateral can that collateral be recognised for risk weighting purposes. To assign a risk weight less than 100 per cent for these non-securitised loans, the required legal form of a second mortgage is required. APRA remains open in this consultation to submissions that outline alternative arrangements. APRA considers that to be prudentially sound, any alternative arrangements would need to be equivalent to a formal second mortgage under all scenarios.

2.11 Representations and warranties

In its first consultation paper, APRA reiterated its existing policy that an ADI may repurchase assets that breach a representation and warranty if the repurchase is completed within the first 120 days. After the expiry of that time period, the ADI must not have any obligation to, and there must be no expectation that it will, automatically repurchase exposures to rectify a breach.

Comments received

One submission highlighted that investors in offshore markets are not used to seeing such restrictions. Another submission sought clarification as to when the 120 days begin.

APRA's response

A 120-day period is viewed as sufficient to allow the trustee of the SPV time to undertake appropriate due diligence on the pool and replace non-complying assets. The 120 days is taken to begin from the time the exposures are transferred to the SPV.

Where an ADI has equitably assigned exposures it should no longer have any responsibility for, or control over, the exposures. The representations and warranties are made by the ADI at point of transfer based on the information in the possession of the ADI. This reinforces the principle of separation between an ADI and the SPV.

As a result, APRA has not changed this aspect of the proposals.

2.12 Notification of secured funding arrangements

The current APS 120 requires an ADI to notify APRA prior to entering into a secured funding arrangement, other than covered bonds issued consistent with the Banking Act or a capital relief securitisation, that involves providing an interest in or over assets originated by the ADI, to a funding provider. In certain circumstances, an ADI is required to seek approval for such arrangements.

In its first consultation paper, APRA proposed to explicitly recognise funding-only securitisation in the revised APS 120. In this case an ADI would not be required to notify and seek approval from APRA to enter such an arrangement, provided the securitisation met all relevant aspects of the revised standard.

Comments received

One submission was of the view that the current APS 120 notification and approval requirements for secured funding arrangements created inefficiencies and were based on securitisation concepts that were considered no longer appropriate.

APRA response

Funding-only securitisation will be a form of secured borrowing which, along with capital relief securitisation, will be specifically catered for in the revised standard and will therefore not require prior notification and approval. To provide clarity for ADIs, APRA is proposing to exclude other specific forms of secured funding from the prior notification requirement. Those funding arrangements not requiring prior notification will include marketable (publically rated and tradeable) securities subject to repurchase agreements, securities lending agreements, or agreements which provide for collateral as a part of over-the-counter or centrally cleared derivatives transactions.

However, a prior notification requirement for other secured funding arrangements is considered necessary to ensure ADIs do not encumber their balance sheets to the detriment of depositors. Where prior notification is required, an ADI will need to establish to APRA's satisfaction that the proposed arrangement does not undermine the depositor protection provisions of the Banking Act.[15] APRA expects that these arrangements would be infrequent.

The notification requirement will maintain APRA's ability to determine an appropriate capital charge. This may include, consistent with the treatment of excess assets in cover pools for covered bonds, a CET1 deduction of the underlying exposures for secured funding arrangements outside those not requiring prior notification and any securitisation that does not meet the requirements of APS 120.

2.13 Other issues

2.13.1 Implicit support and other risks

In its first consultation paper, APRA proposed to require an ADI that provides implicit support to publically disclose the support. This was to align more closely with the Basel securitisation framework. However, given APRA's intention to retain its long standing policy of prohibiting implicit support, APRA has reconsidered this position and now views any mandatory disclosure requirement to be extraneous.

2.13.2 Integration with liquidity requirements

In its first consultation paper, APRA proposed various liquidity treatments for Minimum Liquidity Holdings (MLH) ADIs. These included proposed arrangements associated with warehouse and term securitisation.

As outlined earlier in this discussion paper, APRA is proposing to remove all references to warehouses in the revised APS 120, to require that funding being provided for the life of the underlying exposures is a pre-requisite to regulatory capital relief and to accommodate more flexibility in funding-only securitisation (including revolving securitisation).

As a result, and for simplicity, APRA is proposing to retain the existing liquidity treatment, that is, an MLH ADI that is an originating ADI may only exclude the liabilities of the securitisation in the calculation of the MLH ratio if it meets the operational requirements for regulatory capital relief.

2.13.3 Reporting requirements

In its first consultation paper, APRA proposed that an originating ADI report the securitisation SPV on-balance sheet for prudential reporting.

In response to submissions, APRA is not proposing to introduce a skin-in-the-game requirement and is proposing to retain the significant credit risk transfer approach to regulatory capital relief.

As a result, and for simplicity, APRA is proposing to retain the existing securitisation deconsolidation principle for prudential reporting purposes.[16] An originating ADI may treat the securitisation SPV as a non-consolidated entity for prudential reporting purposes provided it meets the operational requirements for regulatory capital relief.

15 The application of subsection 13A(3) of *Banking Act 1959* provide for a schedule of repayment of creditors of an ADI. This schedule seeks to provide depositors and other nominated creditors with a priority of repayment above other creditors, including secured creditors.

16 The securitisation deconsolidation principle allows an originating ADI to exclude the securitised assets in certain prudential reporting forms if significant credit risk transfer is achieved.

Chapter 3 — Implementing the Basel III securitisation framework

The performance of securitisation exposures and the central role they played during the crisis were a key reason for the Basel Committee to undertake a broad review of its securitisation framework for regulatory capital requirements.

The crisis highlighted weaknesses in the Basel II securitisation framework, including concerns that it generated insufficient capital support for certain exposures. The Basel Committee identified a number of shortcomings relating to the calibration of risk weights and a lack of incentives for sound risk management, including:

- mechanistic reliance on external ratings;
- excessively low risk weights for highly rated securitisation exposures;
- excessively high risk weights for low-rated senior securitisation exposures;
- cliff effects; and
- insufficient risk sensitivity of the framework.

The Basel III securitisation framework responds to these shortcomings and strengthens regulatory capital standards for securitisation exposures held in the banking book.

The most significant revisions introduced by the Basel III securitisation framework include changes to:

- the hierarchy of approaches that banks must use to assign regulatory capital for securitisation exposures;
- the risk drivers used in each approach; and
- the amount of regulatory capital banks must hold for securitisation exposures.

The revised hierarchy of approaches is intended to reduce reliance on external ratings.

At the top of this hierarchy is the IRB Approach. The underlying model is a supervisory formula approach and it uses K_{IRB}[17] as a key input. A bank that cannot calculate K_{IRB} for a given securitisation exposure must use the External Ratings-based Approach - where credit ratings are permitted to be used in the jurisdiction.

A bank that cannot use the External Ratings-based Approach (for example, the securitisation exposure is unrated) must use the Standardised Approach. The Standardised Approach includes a supervisory formula approach that uses K_{SA}[18] as a key input.

Additional risk drivers such as maturity and tranche thickness (i.e. the size of the tranche relative to the entire securitisation transaction) for non-senior exposures have also been introduced.

Regardless of the approach used, the Basel III securitisation framework introduces a risk weight floor of 15 per cent. This compares to the lowest available risk weight of 7 per cent under the Basel II securitisation framework.

Maximum risk weights on senior exposures have been introduced as well as limitations on maximum capital requirements (on the pool as a whole).

APRA proposes to implement the Basel III securitisation framework, with appropriate Australian adjustments.

3.1 Hierarchy of approaches

Consistent with APRA's objective to simplify the framework, APRA proposes to adopt a simple hierarchy in the revised APS 120 comprising two approaches only - the External Ratings-based Approach and the Standardised Approach. These two approaches will be applicable equally to both

17 K_{IRB} is the capital charge for the underlying exposures using the IRB Approach under APS 113 in relation to general credit risk exposures.

18 K_{SA} is the capital charge for the underlying exposures using the Standardised Approach under APS 112 in relation to general credit risk exposures.

Advanced ADIs and Standardised ADIs. An ADI that cannot use either of these approaches for a given securitisation exposure will be required to apply a CET1 deduction.

APRA is of the view that this approach, combined with related proposals outlined below, constitutes a significant simplification of the capital framework for securitisation exposures. Given the current limited use of some of the approaches that APRA is proposing to remove, these benefits can be achieved with little, if any, loss of risk sensitivity.

3.1.1 IRB Approach

Under the IRB Approach in the Basel III securitisation framework, a bank must use a supervisory formula if it can calculate K_{IRB} for a given securitisation exposure. This supervisory formula is similar to, although considerably more complicated than, the supervisory formula used in the Basel II securitisation framework as implemented in the current APS 120. Currently, the supervisory formula approach is sparingly used by ADIs.

The Basel III securitisation framework continues to permit a bank to use an Internal Assessment Approach (IAA)[19] for an ABCP securitisation only. To use the IAA the Basel III securitisation framework requires the ABCP issued by the SPV to be externally-rated. APRA currently provides a broader scope of application for the IAA than the Basel II securitisation framework. APRA also allows Advanced ADIs, subject to certain conditions, to use the IAA for certain non-ABCP securitisation exposures.

Under the Basel III securitisation framework, a bank that cannot calculate K_{IRB} for a non-ABCP securitisation exposure and cannot use the External Ratings-based Approach must use the Standardised Approach. Under this latter approach, the input K_{SA} (as determined for all the underlying exposures in the pool) is used to calculate capital requirements.

On the basis that the current supervisory formula that uses K_{IRB} as key input is sparingly used in Australia, and consistent with APRA's objective to simplify the securitisation framework, APRA proposes to remove the use of the IRB Approach in the revised APS 120. This would include the 'top-down' approach[20] to purchased receivables and the concept of 'mixed pools'[21].

Ancillary to this, the application of the IAA will be discontinued under APRA's proposals. APRA is proposing that an originating ADI of an ABCP securitisation treat the securitisation as funding-only. For ADIs that are not originators, a non-senior exposure will be deducted from CET1 under APRA's proposals. For senior exposures, an ADI that is not an originator would be able to use or infer a rating from the externally-rated ABCP.

3.1.2 Senior exposures

The Basel III securitisation framework has revised the External Ratings-based Approach. To use this approach for a given tranche of a long-term securitisation exposure, a bank would need to know the external or inferred credit rating, seniority (i.e. whether the tranche exposure is senior or subordinated) and the maturity of the tranche. Risk weights for long-term exposures are assigned according to a look-up table where risk weights vary by rating and maturity.

APRA proposes to simplify this look-up table under the External Ratings-based Approach by reducing the number of credit rating grades applicable to senior exposures. Senior exposures with investment grade ratings only will be eligible for risk weighting under this approach. This reduces the number of credit rating grades for long-term securitisation exposures from eighteen under the Basel III securitisation framework to eleven credit rating grades under APRA's proposals.

Senior exposures comprise approximately 90 per cent of a typical Australian home loan securitisation. Most of these exposures are 'AAA'

19 The IAA is essentially an internal modelling approach to securitisation, based on the Advanced ADI replicating credit rating agency methodologies for similar publicly rated transactions.

20 A 'top-down' approach makes it possible to calculate capital requirements without having to look at the properties of the individual items in a pool of receivables.

21 A mixed pool is a securitisation pool for which a bank is able to calculate IRB parameters for some but not all of the underlying exposures.

rated which reduces the need for more granular risk weights for senior exposures.

3.1.3 Non-senior securitisation exposures

The Basel III securitisation framework has revised the extent to which external ratings reflect some other relevant risk characteristics such as the tranche thickness of non-senior securitisation exposures. As noted in section 2.2.3, APRA proposes that a CET1 deduction would be applied to junior securitisation exposures. Consequently APRA does not intend to adopt the Basel III risk weights for non-senior securitisation exposures.

3.2 Resecuritisation

A slightly modified (and more conservative version) of the Standardised Approach, whereby the risk weight will not be less than 100 per cent, is the only approach provided for resecuritisation exposures under the Basel III securitisation framework. The proposal in APRA's first consultation paper is simpler and more conservative, with such exposures treated as CET1 deductions. APRA's proposal reflects doubts regarding the ability to determine accurate capital charges on resecuritisation exposures given the typical complexity of resecuritisation structures and uncertainty over of the quantum and flow of risk. Given these concerns, APRA has maintained the approach in the draft APS 120 and is not proposing to adopt the Basel III securitisation framework approach for resecuritisation exposures.

3.3 Overlapping exposures

The Basel III securitisation framework allows an ADI to 'split' or 'expand' exposures in appropriate cases to arrive at an overlap for the purpose of calculating regulatory capital requirements. This approach allows a bank to assume for capital purposes that obligations with respect to one of the overlapping exposures are larger than those established contractually.

APRA does not propose to allow ADIs to split or expand exposures to arrive at an overlap. In the absence of any contractual right for the application of one facility to extinguish, in all circumstances, the other facility provided by an ADI, exposures under both facilities must be recognised for prudential purposes including for the calculation of capital adequacy. Where there is a contractual right to extinguish in all circumstances the other exposure, ADIs may continue to treat exposures as overlapping.

3.4 Maximum capital requirements

3.4.1 Risk weight cap for senior securitisation exposures

Under the Basel III securitisation framework, a bank may apply a 'look-through' approach to determine a risk weight cap for senior securitisation exposures (based on the weighted average risk weight of the underlying exposures in the pool), provided the bank has knowledge of the composition of the underlying exposures at all times. In addition, where the maximum risk weight is lower than the risk weight floor of 15 per cent, the lower risk weight resulting from the risk weight cap will apply.

APRA proposes to allow originating ADIs to use this look-through approach for senior securitisation exposures. However, APRA does not propose to adopt the approach that allows the risk weight cap to override the risk weight floor as the floor is intended to address the risk associated with the effectiveness of certain credit enhancements in the securitisation structure.

3.4.2 Maximum capital requirements (for the pool as a whole)

Maximum capital requirements are designed to ensure consistency with the general non-securitisation framework and discourage arbitrage. The maximum capital requirement provisions of the Basel III securitisation framework (under which a bank's capital requirement will not exceed the capital requirement for the underlying pool of exposures if they were all held by the bank directly) applies to banks, except non-originating banks under the Standardised Approach. In addition, maximum capital requirements may also be applied proportionally based on the largest portion of any tranche held by the bank.

Historically, APRA has applied the maximum capital requirement to originating ADIs only. APRA proposes to maintain this application.

The application of the maximum capital requirements, where applied proportionately, introduces complexity into the framework. APRA does not propose to adopt this Basel III securitisation treatment.

3.5 Deduction approach

The Basel III securitisation framework, consistent with the Basel II framework, applies a risk weight of 1250 per cent for certain exposures. In particular:

- a bank that cannot use the hierarchy of approaches for a given securitisation exposure would assign the exposure a risk weight of 1250 per cent;
- for a bank to use the risk weight approaches of the securitisation framework, it must meet the due diligence requirements, otherwise, the bank must assign a 1250 per cent risk weight;
- originating banks can offset 1250 per cent risk-weighted securitisation exposures by reducing the securitisation exposure amount by the amount of their specific provisions on underlying assets of that transaction and non-refundable purchase price discounts on such underlying assets;[22] and
- the External Ratings-based Approach where risk weights for certain ratings are set at 1250 per cent.

Under APRA's proposals, a CET1 deduction is applied for non-investment grade exposures, unrated exposures and non-senior exposures. For consistency purposes, APRA is proposing to apply a CET1 deduction to exposures rather than a 1250 per cent risk weight, even though it may produce, in some instances, a slightly lower capital requirement than the deduction approach.

3.6 Other issues

3.6.1 Definition of originating ADI

APRA's definition of originating ADI is wider than that of the Basel III (and Basel II) securitisation framework and also includes third party ADIs that manage non-ABCP securitisation.

APRA's approach has been that the definition of an originating ADI should not depend upon the type of structure of the securitisation but rather on the ADI's role. APRA proposes to maintain its definition of originating ADI in the revised APS 120.

It is not APRA's intent that third party ADIs who solely manage a securitisation scheme be subject to the funding-only requirements. However, third party managing ADIs will be still be required to meet the requirements for regulatory capital relief.

3.6.2 Facilities

The Basel III securitisation framework eliminates certain exceptional treatments of the Basel II securitisation framework including the 'Eligible Facility' treatment. Although this treatment is redundant under the Basel III securitisation framework, the qualitative criteria in the current APS 120 pertaining to an eligible facility includes, among others, restrictions on the facilities being drawn to cover defaulted assets.

APRA considers it appropriate for some qualitative criteria to remain in the revised APS 120 to limit the circumstances for which liquidity and other facilities may be drawn and to ensure that repayments are not subordinated to the claims of investors.

22 For the purposes of deducting securitisation exposures, an ADI may net any specific provisions raised against the relevant exposures or holdings before making the necessary deductions from capital.

Chapter 4 — Other APRA proposals

4.1 Risk management framework

The proposals outlined in this discussion paper and in the draft APS 120 are aligned with the principles reflected in APRA's letter of 28 August 2015.[23] The letter outlined APRA's plans to review the clarity of its requirements of boards, and ensure they are communicated in a way that properly reflects the respective roles of the board and management.

4.2 Consequential amendments to other prudential standards

APRA is taking the opportunity in this discussion paper to propose other amendments to prudential standards to support the implementation of the revised APS 120. These consequential changes to prudential standards incorporate minor cross-referencing changes that flow from APRA's proposals.

The main changes are to:

- paragraph 4 of APS 001, to align the definition of securitisation to that used in APS 120;
- paragraph 2(d) of Attachment B to APS 001, to clarify that the securitisation SPV is excluded from the Level 2 group where the originating ADI meets the operational requirements for regulatory capital relief for the securitisation;
- paragraph 40 of Attachment I of APS 112, to remove the exceptional treatment in regard to first-to-default credit derivatives where the risk weights applied are to equivalently rated securitisation exposures;
- paragraph 26 of Attachment B of APS 113 and paragraph 12 of Attachment C of APS 113, to reflect the requirement that an ADI must hold required capital against undrawn balances associated with securitised exposures; and
- paragraphs 11, 12, 13 and 14 of Attachment B of APS 116, to reflect the proposed deduction from CET1 of non-senior securitisation exposures, resecuritisation exposures and those securitisation exposures currently subject to 1250 per cent risk weights.

4.3 Encumbrance

At a later date, APRA intends to give further consideration to encumbrance and secured funding in general, including the merits of introducing a quantitative limit to encumbrance.

Encumbered assets have the potential to adversely impact the preferential payment of claims of depositors or other creditors from assets of ADIs provided for under the Banking Act. A potential quantitative limit may protect depositors' preferential claims by limiting the extent of encumbrance (including securitisation) an ADI can provide.

Recent experience has demonstrated that structured credit markets can close to securitisation issuers, for extended periods. For this reason APRA considers it imprudent for any ADI to rely unduly upon these markets for funding. ADIs must have regard to the extent that its activities are funded with diversified and stable sources of funding on an ongoing basis.

23 The letter is available on APRA's website: http://www.apra.gov.au/adi/Publications/Pages/other-information-for-adis.aspx

Annexure — Policy options and estimated comparative net benefits

APRA considers three broad options in considering the reform of the current prudential framework for securitisation contained in APS 120. Each option and the related costs and net benefits are outlined below.

The net benefits for each option are considered in respect of ADIs, depositors and other creditors, other consumers, financial market participants and government. While the proposals have direct impacts on ADIs, other stakeholders, particularly debt investors, benefit from securitisation and can be indirectly impacted through changes in the product offering and operations of ADIs.

The analysis of costs associated with each option focuses on compliance costs, that is, the direct administrative, substantive (business) and financial costs incurred by ADIs in complying with government regulation. Indirect costs for ADIs and other stakeholders arising as a consequence of regulation (or not applying regulation) are also considered.

Any information provided in response to APRA's request for cost-benefit analysis information (see section 1.7) would be used by APRA to quantify the change in regulatory burden using the Regulatory Burden Measurement Tool and inform calculations of the net benefits of the proposals.

First option

The first option is to maintain the *status quo* under which no changes would be made to APS 120. Securitisation issues would continue to be addressed through supervision, including *ad hoc* industry letters, notes and advices that may be required to clarify the operation of the existing APS 120.

The *status quo* would not have any immediate additional compliance costs for ADIs. That said, if APRA's proposals for simplifying the prudential approach to securitisation are not implemented there would be a range of indirect costs:

- there would continue to be complexity and a lack of clarity for stakeholders as the current prudential framework is somewhat patchwork in nature, consisting of APS 120 and a series of stand-alone letters setting out APRA's expectations on different securitisation matters; and
- funding-only securitisation, which industry has asked APRA to explicitly address, would not be reflected in APS 120. Some stakeholders have commented that the Australian securitisation market may stagnate without a more flexible funding-only regime with little growth in offshore issuance or the securitisation of new asset classes.

These indirect costs are not easily quantifiable but could be moderate to significant. The costs somewhat depend on the extent of securitisation undertaken by an ADI and its exposure to such securitisation, as well as its risk management more generally.

In some cases, these indirect costs are likely to have a negative effect on the ability of ADIs to issue securitisation to a broader market. All other things being equal, this would negatively impact an ADI's ability to prudently diversify its funding sources, as well as seek lower cost sources of funding. This diversification is an important part of a broader risk management strategy to adjust exposure to risk and improve profitability.

There could also be indirect costs associated with not updating APS 120 to reflect the Basel III securitisation framework. The Basel framework is an internationally understood benchmark that allows market participants to understand and place reliance on the nature and standard of regulation to which an ADI is subject.

The *status quo* would mean that the deficiencies in the existing Basel II securitisation framework, as highlighted by the global financial crisis would not be addressed.

Once a jurisdiction does not meet the Basel framework, the nature of regulation and oversight that banking institutions are subject to becomes less certain by international standards. A lack of compliance may adversely affect the views of analysts, credit ratings agencies, investors and other banks about Australian ADIs.

Implications of not updating APS 120 to reflect the Basel III securitisation framework potentially include:

- limitations on access to capital markets, as overseas market participants prefer to deal with banks which are subject to regulatory systems that are understood and substantially equivalent to internationally-agreed frameworks;
- a higher cost of funding. Even when Australian ADIs can access overseas capital markets, it is possible that market participants might demand higher premiums (the Australian banking system currently sources a material portion of its funds in international funding markets); and
- in a future crisis, ADIs in Australia would be more vulnerable to shocks in funding markets and reduced confidence due to the local jurisdiction's non-compliance with the Basel framework.

Failure to implement the Basel standards may adversely affect Australia's standing globally, given the commitments by Group of 20 (G20) members to implement the Basel framework in a full, timely and consistent manner.[24] Australia's reputation as a member of the Basel Committee, Financial Stability Board and G20, founded on a long-standing commitment to adhere to international standards, could be diminished, limiting Australia's capacity to influence these developments.

Overall, APRA believes the net impact from the *status quo* would be negative, reflecting the material, though not readily quantifiable, potential indirect costs. The costs associated with this option would become more prominent over time as Australia's securitisation framework would be viewed by relevant stakeholders as falling behind international standards.

Second option

A second option is for APS 120 and associated reporting standards and forms to be amended to simplify the framework, making the proposals in the first consultation paper legally binding, but without incorporating the Basel III securitisation framework.

ADIs would be required to comply with the new regulation from 1 January 2018. This timing would allow industry sufficient time to make changes to recognise the final amended APS 120.

APRA expects that this option would lead to a small increase in compliance costs. The types of compliance costs would be the same as set out under the third option but the second option would have a lower burden as it does not incorporate the Basel III securitisation framework.

A simpler, more streamlined prudential approach to securitisation would have some benefits for ADIs and other stakeholders. Clarity would be provided for ADIs who seek capital relief. A simpler, more streamlined prudential approach is likely to reduce ambiguity and enhance consistency of interpretation. Simplifying the existing approach would allow issues raised by industry, including funding-only securitisation, to be addressed in the prudential framework.

A more flexible funding-only regime may increase the potential size of the term securitisation market and therefore expand the ability of ADIs to secure term wholesale funding. A more flexible funding-only regime that facilitates a larger funding-only securitisation market may lower legal, audit, trustee, management and rating agency costs over time as more securitisation is issued using an established vehicle rather than a stand-alone trust for each securitisation issuance. Hedging costs, particularly cross-currency swaps for issues in foreign currencies, may also be cheaper with a more flexible funding-only regime.

Some incremental increases in capital charges are likely as a result of the simplification of the

24 See Group of 20 Leaders, Cannes Summit Final Declaration, November 2011.

framework. However, in some areas this will also reflect a better alignment with underlying risks.

Implications of not adopting the Basel III securitisation framework would be the same as those identified in the first option and mean moderate to significant indirect costs for ADIs.

APRA believes the net impact from this option would be negative. The costs associated with this option would become more prominent over time as Australia's securitisation framework would not be viewed by relevant stakeholders as robust as international standards.

Third option

A third option is to make both the APRA-initiated proposals that were outlined in the first consultation paper, adjusted where appropriate reflecting submissions received, and the Basel III securitisation framework legally binding. This would be achieved by amendments to APS 120 and associated reporting standards and forms.

ADIs would be required to comply with the new regulation from 1 January 2018. This timing would allow industry sufficient time to make changes to recognise the final amended APS 120.

As with any change to the *status quo*, APRA anticipates that ADIs subject to the revised APS 120 would face additional compliance costs. To comply with the proposed requirements, APRA would expect:

- some incremental increases in capital charges to ensure that capital requirements are better aligned with underlying risks;
- some ADIs to adjust their securitisation exposures, which may incur transactional costs and may initially result in a comparatively higher cost of securitising assets. However, over time, cost savings may be achieved by way of reduced establishment and operational costs;
- an initial increase in costs to amend compliance processes, particularly associated with amendments to reporting standards. However, any increase in reporting costs are likely to be at the margin; and
- some ADIs may incur additional legal, educational, procedural and purchasing costs in order to comply with the proposed requirements, depending on internal structures and processes.

A simpler, more streamlined prudential approach to securitisation would have benefits for ADIs and other stakeholders. Clarity would be provided for ADIs who seek capital relief. A simpler, more streamlined prudential approach is likely to reduce ambiguity and enhance consistency of interpretation.

Simplifying the existing approach would allow issues raised by industry, including funding-only securitisation, to be addressed in the prudential framework. A more flexible funding-only regime may increase the potential size of the term securitisation market and therefore expand the ability of ADIs to secure term wholesale funding. This would aid the further development of the Australian securitisation market and assist ADIs to further strengthen their funding profile.

A more flexible funding-only regime that facilitates a larger funding-only securitisation market may lower legal, audit, trustee, management and rating agency costs over time as more securitisation is likely to be issued using an established vehicle rather than a stand-alone trust for each securitisation issuance. Hedging costs, particularly cross-currency swaps for issues in foreign currencies, may also be cheaper with a more flexible funding-only regime.

Whilst the use of securitisation, particularly for smaller ADIs, is important in facilitating competition, a better capitalised banking system is likely to enhance systemic benefits.

The third option is the only option that ensures Australia maintains its commitment as part of the G20 to fully and consistently implement Basel III. A decision to pursue this option means that ADIs should not face any indirect costs or risks associated with non-compliance outlined under other options.

Instead, the Basel III securitisation framework would enhance domestic and international investor confidence in the Australian securitisation market. Overseas market participants are more likely to invest in securitisations issued by ADIs which are subject to regulatory systems that are understood and substantially equivalent to internationally-agreed regulatory frameworks. This is important for Australian ADIs, particularly large ADIs who source a significant portion of their funding from global wholesale funding markets. Australia's reputation for compliance with international best practice would be maintained.

APRA proposes to implement the Basel III securitisation framework, only making targeted adjustments that are appropriate for Australian circumstances, as outlined in this paper.

APRA's view is that the benefits from streamlining and simplifying securitisation requirements, as well as aligning them with international standards, would likely materially outweigh any increase in the compliance costs to ADIs which would mostly be short-term.

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