Response to Submissions

Covered bonds and securitisation matters

12 July 2012

Preamble

In November 2011, the Australian Prudential Regulation Authority (APRA) released a discussion paper, *Covered bonds and securitisation matters*, and a draft prudential standard, *Prudential Standard APS 121 Covered Bonds* (APS 121). The discussion paper and draft standard set out APRA's proposals to ensure that authorised deposit-taking institutions (ADIs) adopt prudent practices when issuing covered bonds. The discussion paper also set out a proposed change to the capital treatment under *Prudential Standard APS 120 Securitisation* (APS 120) of holdings of subordinate tranches of securitisations held by an ADI other than the originator of the loans.

APRA received nine written submissions in response to the consultation package and discussions were held with range of industry participants. This paper sets out APRA's responses to the matters raised through this consultation process. It is accompanied by the final APS 121. This response paper also sets out the text of proposed changes to APS 120 to give effect to the securitisation proposal.

APS 121 will take effect from 1 August 2012. Minor consequential changes to other standards relating to covered bonds will take effect from 1 January 2013.

APRA will invite written submissions on the text of the proposed changes to APS 120 at the same time as consulting on amendments to APS 120 relating to the implementation of Basel III. Written submissions on this item should be forwarded to Basel3capital@apra.gov.au and addressed to:

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Important disclosure notice – publication of submissions

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.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

Contents

Glossary

ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS 110	*Prudential Standard APS 110 Capital Adequacy*
APS 111	*Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*
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*
APS 121	*Prudential Standard APS 121 Covered Bonds*
APS 221	*Prudential Standard APS 221 Large exposures*
APS 222	*Prudential Standard APS 222 Associations with Related Entities*
Banking Act	*Banking Act 1959*
Corporations Act	*Corporations Act 2001*
Covered Bonds Act	*Banking Amendment (Covered Bonds) Act 2011*
Covered bond SPV	Covered bond special purpose vehicle
Eight per cent rule	The rule contained in section 28 of the Banking Act
PCR	Prudential capital requirement

Chapter 1 – Introduction

1.1 Overview

Amendments to the *Banking Act 1959* (Banking Act) that allow authorised deposit-taking institutions (ADIs) to issue covered bonds commenced on 24 October 2011. In November 2011, APRA released the discussion paper *Covered bonds and securitisation matters*[1] and a draft prudential standard, *Prudential Standard APS 121 Covered bonds* (APS 121). Those documents set out APRA's proposals to ensure that ADIs adopt prudent practices when issuing covered bonds. The discussion paper also canvassed a change to *Prudential Standard APS 120 Securitisation* (APS 120) relating to the capital treatment of subordinated tranches of securitisations issued by another entity.

APRA received nine written submissions in response to the consultation package. Discussions were also held with a variety of industry participants.

This paper sets out APRA's responses to issues that were identified during consultations. Responses to issues relating to covered bonds are contained in Chapter 2, while issues relating to the securitisation proposal are contained in Chapter 3.

1.2 Covered bonds

In finalising APS 121, APRA has had regard to issues identified during the consultations and has examined the covered bond structures used by ADIs to issue their initial covered bonds.

All covered bond programs must comply with all aspects of APS 121. If an existing covered bond program genuinely cannot comply with some aspect of APS 121, an ADI may request that APRA consider using its powers under the amendment and exclusion provision contained in APS 121.

The November 2011 discussion paper also foreshadowed consequential amendments to other standards. These minor amendments will be made at the same time as changes to the standards to give effect to Basel III. The affected prudential standards are:

- *Prudential Standard APS 110 Capital Adequacy* (APS 110)
- *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111)
- *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112)
- *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* (APS 113)
- *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116)
- *Prudential Standard APS 120 Securitisation* (APS 120)
- *Prudential Standard APS 221 Large Exposures* (APS 221); and
- *Prudential Standard APS 222 Associations with Related Entities* (APS 222).

1.3 Holdings of subordinated tranches of non-originated securitisations

Informed by its consideration of the feedback discussed in Chapter 3, APRA is proposing amendments to APS 120 to require ADIs to deduct holdings of subordinated tranches of non-originated securitisations from their regulatory capital. APRA will invite written submissions on the text of these proposed at the same time as consulting on amendments to APS 120 relating to the implementation of Basel III. Subject to feedback received, APRA intends to amend APS 120 so that these changes will take effect from 1 January 2013.

1 Available at www.apra.gov.au/adi/Pages/Covered-bonds-and-securitisation-matters-Nov-2011.aspx

Chapter 2 – Prudential requirements for covered bonds

Responses to submissions generally focussed on common themes. For example, a number of responses commented on matters associated with asset identification, capital and the requirement in draft APS 121 for asset registers. Other topics raised include the capital treatment of assets outside cover pools, cross-default, disclosure and collateral securing derivatives. Some submissions sought clarification of requirements in draft APS 121 that they considered to be ambiguous. These issues, including APRA's responses, are set out in more detail below.

2.1 Asset identification

The depositor preference provision of the Banking Act (subsection 13A(3)) requires that all of an ADI's assets in Australia, other than those in cover pools, are to be available to meet liabilities to depositors ahead of other liabilities. Further, the Banking Act prohibits an ADI from issuing covered bonds if the value of assets in its cover pools is more than eight per cent of its assets in Australia.[2] Consequently, it is critical whether an asset is part of a cover pool or remains subject to depositor preference can be identified quickly and unambiguously.

Draft APS 121 proposed to ensure certainty as to which category an asset fell by mandating the use of registers individually identifying each asset transferred to a covered bond SPV and whether it forms part of the cover pool, secures covered bond liabilities or can be returned to the ADI (and thus remains subject to depositor preference).

Comments received

A number of submissions argued that the requirement to identify assets individually on registers and to transfer them between registers as asset values and minimum collateralisation requirements change is administratively burdensome. Some submissions also noted that the register requirement could prevent the use of a covered bond model, used in some overseas markets, where the cover pool is not specified prior to a default. This model typically uses an asset coverage test based on the minimum amount of collateral required by the covered bond contract to select assets from a broader pool of assets held by the covered bond SPV. The contract may then allow any residual to be allocated to the ADI. Several ADIs have used structures based on this approach to issue covered bonds.

APRA's response

Identification of the claims on an asset is critical to certain aspects of the operation of the Banking Act:

- unless an asset secures covered bond liabilities, it is subject to depositor preference. If an asset's status is ambiguous, it may be unclear whether depositors or covered bondholders have the priority claim over the asset;
- ADIs are prohibited from issuing covered bonds if the value of assets in their cover pools is more than eight per cent of their assets in Australia. If assets in cover pools cannot be identified and valued, it may be unclear whether an ADI is above or below the eight per cent limit; and
- cover pool monitors are required by paragraph 30(4)(a) of the Banking Act to assess the keeping of an accurate register of assets in the cover pool.

2 In contrast, most other countries with limits currently apply them to the amount of covered bonds that can be issued. However, asset encumbrance is gaining increased regulatory and market attention internationally. The Monetary Authority of Singapore has recently proposed applying a limit on assets in cover pools of 2% of total assets.

APRA expects that assets listed on a register as 'in the cover pool' for the purposes of paragraph 30(4)(a) of the Banking Act will also be treated as in the cover pool for the purposes of calculating compliance with the eight per cent rule contained in section 28 of the Banking Act. Reflecting feedback in submissions, APRA has modified APS 121 to make the maintaining of other registers by the ADI optional. However, the final APS 121 does not permit an ADI to apply a concessional risk-weight to an asset held by the covered bond SPV when calculating its capital requirements unless it is either part of the cover pool (and thus counted towards the eight per cent limit) or is individually identified on a register as not forming part of the cover pool.[3]

2.2 Risk-weighting of assets outside the cover pool

An ADI may transfer assets to a covered bond SPV that do not form part of the cover pool. This is normally done via a loan by the ADI to the covered bond SPV, which then uses the proceeds to purchase assets from the ADI. Draft APS 121 stated that the default risk-weighting applied to assets held by the covered bond SPV but not forming part of the cover pool is 100 per cent. This corresponds to the risk-weighting that would apply to the ADI's loan to the covered bond SPV under APS 112 and APS 113.[4]

In some circumstances, an ADI might transfer an asset to a covered bond SPV but retain a very high degree of control over the asset, similar to holding the asset directly, and it is unambiguous that the asset does not form part of the cover pool. In this case, draft APS 121 proposed that the issuing ADI be permitted to treat the asset for capital adequacy purposes as if it held the asset directly by applying a concessional risk-weight, if relevant.

Comments received

Several submissions argued that ADIs should be permitted to apply concessional risk-weights to all assets held by a covered bond SPV, even if they are not counted as part of the cover pool for the purposes of the eight per cent test nor individually identified and listed on a register as outside the cover pool. Submissions argued that this would allow ADIs to realise administrative savings because ADIs would not need to update registers as often, but would instead allocate collateral between the cover pool and the ADI after a default.

APRA's response

From a prudential perspective it is preferable that ADIs hold assets directly, rather than indirectly via intermediaries such as a covered bond SPV. Consequently, APRA considers that allowing ADIs to apply risk-weights of less than 100 per cent subject to strict conditions is already concessional and should not be extended to assets over which the ADI has a lower quality claim.

Covered bond structures that allocate assets between the cover pool and the ADI after a default involve additional risks because assets may become part of the cover pool or be subject to claims from covered bond holders. Consequently, the ADI's ability to reclaim such assets or deal with them as it sees necessary, both before and after a default, is more likely to be limited if the assets are not identified on a register as being outside the cover pool.

3 To be eligible for a concessional risk-weight, an asset that is not part of the cover pool must meet all of the requirements set out in APS 121, including the requirement for it to be separately identified on a register.

4 This loan will typically be an unrated loan to a related corporate entity. See Paragraph 16 of Attachment A to APS 112 and paragraph 11 of Attachment E to APS 113.

If collateral is allocated between the cover pool and the ADI after a default, there is a risk that some of the assets could deteriorate between when the ADI defaults and when the assets are allocated. Because these models normally allocate an amount to the cover pool before allocating the residual back to the ADI, the ADI's share incurs the first loss across the entire pool. In practice, this means that the ADI's share is effectively subordinated to covered bond holders until the allocation is complete, even if the ADI's share is regarded as senior in some other context.

Other risks with structures that apportion a larger pool after default are that even once assets are assigned to the ADI's share, covered bond holders could seek to delay their return to the ADI. This could occur if the accounting valuations used to allocate the assets were challenged or if covered bondholders perceive themselves to be secured by all of the assets of the covered bond SPV.

APRA considers that the treatment contained in the draft and final versions of APS 121 provides ADIs with considerable flexibility in structuring and operating their cover bond SPVs. They may choose not to individually identify assets transferred to the covered bond SPV but must then apply a risk-weight of at least 100 per cent. Alternatively, if an ADI wishes to apply a concessional risk-weight to an asset, they may treat it as part of the cover pool (and count it towards the eight per cent cap), identify it on a register as outside the cover pool, or retain it within the ADI.

2.3 Default

A cover pool is only intended to collateralise a guarantee by the covered bond SPV of the issuing ADI's obligations under a covered bond. It is not intended to secure any other liabilities of the issuing ADI. To prevent covered bondholders from making a claim on assets held by the covered bond SPV following a default on a more junior instrument, draft APS 121 proposed that ADIs must ensure that covered bond contracts do not permit covered bondholders to make a claim on the covered bond SPV unless the issuing ADI has defaulted on its obligations under a covered bond secured by the same cover pool.

Comments received

Several submissions identified that it is possible for a covered bond SPV to breach its obligations under a covered bond without the ADI breaching its obligations under the covered bond. The submissions argued that, as worded in the draft APS 121, the prohibition on cross-default clauses would prevent covered bondholders from making a claim on the covered bond SPV in such circumstances.

Submissions argued that paragraph 30 of draft APS 121 should be narrowed to exclude breaches by both the issuing ADI and the covered bond SPV of their obligations under a covered bond.

APRA's response

APRA did not intend that the prohibition on cross-default clauses would also prevent the operation of dual recourse to both the issuing ADI and the covered bond SPV. Accordingly, the final APS 121 has been modified to permit clauses in covered bond documentation that would allow covered bondholders to make a claim on a covered bond SPV if it breaches its obligations under the covered bond.

Breaches by the covered bond SPV of its obligations under a covered bond should be extremely rare as a covered bond SPV should not make payments to covered bondholders prior to a default by the issuing ADI. Consequently, breaches by the covered bond SPV are most likely to be operational in nature. APS 121 requires ADIs to have policies and procedures in place to mitigate such risks.

Clauses that would allow covered bondholders to make a claim on a covered bond SPV without a failure by the ADI or the covered bond SPV to meet their obligations relating to a covered bond remain prohibited.

2.4 Publication of information about cover pools

Draft APS 121 did not contain any requirement for issuing ADIs to publish information about the assets in their cover pools.

Comments received

Several submissions suggested that APS 121 should require ADIs to publish detailed information about the characteristics of loans in their cover pools. The submissions argued that such information would better inform covered bond investors about the quality of the assets securing their claims by increasing market transparency.

APRA's response

In APRA's view, these arguments relate to the efficiency of the covered bond market and the security of covered bond investors, rather than depositors. Accordingly, APS 121 does not include a requirement for ADIs to publish information on assets in their cover pools, nor does it prevent an ADI from publishing such information if it chooses to do so or if this is how the market develops.

2.5 Liabilities between the ADI and the covered bond SPV

Subsections 31D(3) and 31D(4) of the Banking Act require that liabilities between an issuing ADI and its covered bond SPV that relate to assets in a cover pool are to be disregarded when applying prudential standards. The Banking Act does not specify how other liabilities, unrelated to assets in the cover pool, are to be treated for prudential purposes. To ensure consistency and simplicity, draft APS 121 proposed that all liabilities between an issuing ADI and its covered bond SPV should be disregarded, except for collateral supporting derivatives between an issuing ADI and its covered bond SPV.

Comments received

Submissions sought clarification of the intended treatment of collateral supporting derivatives between an ADI and its covered bond SPV.

APRA's response

APRA has reviewed the proposed treatment of collateral supporting derivatives between an issuing ADI and its covered bond SPV. If an ADI lodges collateral under a derivative with the covered bond SPV, the underlying assets remain on the ADI's balance sheet. Consequently, the collateral itself continues to attract a capital charge for credit risk based on the relevant risk-weight. The derivative itself should not create additional credit risk because the covered bond SPV should only default on its obligations to the ADI under the derivative if the ADI itself defaults on its obligations to the covered bond SPV. In other words, the credit risk is that of the ADI itself. Consequently, there is no need for separate treatment of derivatives and associated collateral as initially proposed in draft APS 121.

APRA has simplified the final version of APS 121 by combining the various provisions in draft APS 121 so that all liabilities between an issuing ADI and its covered bond SPV will be disregarded when applying prudential standards.

Neither the provisions in the Banking Act or the final APS 121 apply to liabilities or derivatives involving third parties as they create a net exposure outside the ADI. Consequently, such exposures will continue to attract capital charges for credit risk, operational risk and/or market risk as appropriate.

2.6 Return of assets outside the cover pool

Paragraph 16(a) of draft APS 121 required that all assets that do not secure covered bond liabilities must be returned to the issuing ADI 'immediately' following a covered bond default.

Comments received

Some submissions queried the timeframe in which assets that do not secure covered bond liabilities must be returned to the ADI following a default on a covered bond. Some also asked whether delays of up to one month are consistent with returning assets 'immediately'. In particular, they noted that it will not be possible to return assets 'immediately' if a covered bond structure does not allocate a broader pool of collateral between the cover pool and the ADI until after a default.

APRA's response

As noted above, the quality of an ADI's claim on an asset is better if it is held directly by the ADI rather than indirectly via a covered bond SPV. The final version of APS 121 requires that all assets that are outside the cover pool must be returned to the ADI within one month of a default on a covered bond. This arrangement should accommodate structures where assets are not allocated to the cover pool until after a default or with monthly payments and transfers between an ADI and its covered bond SPV. However, an asset must be returnable immediately (ie straight away) if the issuing ADI wishes to apply a concessional risk-weight for capital adequacy purposes.

2.7 Issuer's right of pre-emption

A covered bond SPV may need to sell assets from the cover pool to pay covered bondholders or to satisfy liquidity requirements. However, if it sells the assets for less than they are worth to the issuing ADI, then the ADI will incur a loss. To mitigate this risk, paragraph 16(c) of draft APS 121 required an issuing ADI to ensure that covered bonds structures only permit the SPV to sell assets:

- after first providing the ADI with a reasonable opportunity to acquire the assets on similar terms; and
- if they are not acquired by the ADI, in a way that maximises the value received for the assets.

Comments received

Some submissions argued that 'maximising' the value received for cover pool assets is ambiguous and could prevent their timely sale. It was suggested that, for example, if markets are disrupted such that the market price for cover pool assets is less than the expected net present value of future cash flows, maximising the value received could necessitate waiting for market conditions to improve. It was suggested that the requirement in section 420A of the *Corporations Act 2001* (Corporations Act) in relation to the sale of property by a controller contains a similar requirement that is well understood and thus more certain. The Corporations Act provision requires sale at the market price, if there is one, or otherwise for the best price reasonably obtainable.

APRA's response

APRA agrees that the Corporations Act approach removes the potential for ambiguity and has incorporated this approach into APS 121.

2.8 Selection of assets for cover pools

If an ADI transfers its highest quality assets to a cover pool, the average quality of the assets remaining to secure depositors and other creditors will decline. Draft APS 121 noted that if an ADI transfers assets to its cover pool such that the risks remaining in the ADI become excessive relative to its capital, then APRA may consider adjusting the ADI's prudential capital requirement (PCR) to reflect the ADI's overall risk profile.

Comments received

During the consultation period, APRA was asked whether cover pools must be a representative sample of the asset classes from which they are drawn.

APRA's response

An ADI may select assets for its cover pools as it considers appropriate. However, APRA expects ADIs to fully assess the risks associated with issuing covered bonds prior to transferring assets to a cover pool. This includes the risk that encumbering an ADI's highest quality assets might undermine the confidence of unsecured creditors. Accordingly, APS 121 requires an ADI to have policies and procedures to assess the effect of issuing a covered bond, including under stress conditions, on the ADI's ability to raise other sources of funding and the cost of such funding.

When determining an ADI's PCR, APRA may take into account risk factors that have not been incorporated or accounted for in the risk-based capital adequacy framework. This ensures that the minimum capital adequacy requirements for an ADI are consistent with its overall risk profile. Consequently, any change in risk due to how an ADI selects assets for inclusion in its cover pool may be taken into account when determining an ADI's PCR.

2.9 Indexation clauses

Comments received

Several ADIs have sought APRA's views on the use of indexation clauses in their covered bond programs. Such clauses are used to calculate the minimum amount of collateral that an ADI is contractually required to provide to support its covered bond issuance.

APRA's response

APRA considers that the use of indexation clauses in this context is a contractual matter between the issuing ADI and potential covered bondholders. However, this does not mean that an ADI may use the indexed value for other purposes, such as prudential reporting and calculating compliance with the eight per cent cap on assets in cover pools. If an ADI includes an indexation clause in its covered bond contracts, then it must take into account the impact of potential index movement when assessing the risks associated with issuing covered bonds.

2.10 Assets not securing covered bond liabilities

Subsection 31F(1) of the Banking Act allows APRA to direct a covered bond SPV to return to its issuing ADI an asset that does not secure covered bond liabilities.

Comments received

Some submissions sought clarification as to when APRA might make a direction under subsection 31F(1) due to concerns that collateral securing covered bondholders might be reduced. Other submissions sought guidance as to what amount of assets an ADI could transfer to a covered bond SPV apart from the cover pool before APRA would direct their return.

APRA's response

It is critical that covered bondholders understand that the cover pool securing their covered bonds may only be a subset of the assets held by a covered bond SPV. An ADI may also transfer additional assets to a covered bond SPV, which do not form part of the cover pool. Such assets remain subject to the depositor preference provisions in the Banking Act. Consequently, APS 121 requires that issue documentation must clearly set out the rights of covered bondholders and the ADI in relation to the various classes of assets held by a covered bond SPV.

APRA's power to direct the return of assets under section 31F(1) only applies to assets that do not secure covered bond liabilities. Therefore, such a direction cannot reduce the size of the cover pool or reduce the security of covered bondholders.

In relation to the amount of assets that an ADI may transfer to a covered bond SPV apart from the cover pool, it is not possible to mechanically predetermine an appropriate limit. Instead, APRA requires that ADIs should manage their covered bond programs prudently and not transfer an excessive amount of assets to a covered bond SPV having regard to what is reasonably necessary for the efficient operation of that covered bond program. Accordingly, a requirement to this effect has been included in the final version of APS 121. Some of the factors that may be relevant when determining what is reasonable include the ADI's covered bond issuance plans, contractually required levels of overcollateralisation and how easily an ADI may reclaim surplus assets from the covered bond SPV if it wishes to do so.

2.11 Assets in Australia

In the discussion paper, APRA noted the desirability of aligning the definitions of assets in Australia used to assess compliance with the limit on covered bond issuance in section 28 (and section 31D) of the Banking Act with that contained in subsection 13A(4), which relates to assets in Australia and deposit liabilities in Australia. This follows because the tests in subsection 13A(4) and section 28 both relate to the level of assets available in Australia to meet deposit liabilities in Australia.

The discussion paper also proposed that, as a practical matter, the measure of total assets as reported on *ARF 320.0 Statement of Financial Position (Domestic Books)* (ARF 320.0) be used as an appropriate measure of assets in Australia.

Comments received

Written submissions supported APRA's objective of aligning the definition of assets in Australia used to assess compliance with sections 13A(4) and 28 of the Banking Act. However, during consultations APRA has identified several issues with the proposed approach. One is the potential for assets held by a covered bond SPV to be double-counted if an issuer counts both the underlying assets and a loan to the covered bond SPV that is secured by the same assets. There is the potential for similar double-counting in some securitisations (including self-securitisations) and repurchase transactions.

APRA's response

Consistent with the objective of the statutory limit on covered bond issuance, the Banking Act excludes goodwill, assets in cover pools and related loans to covered bond SPVs from the definition of assets in Australia for the purposes of subsection 13A(4) because those assets may not be available to repay depositors in Australia. Accordingly, the final APS 121 requires ADIs to exclude assets outside Australia, goodwill, assets in cover pools and loans to covered bond SPVs from total assets as captured on ARF 320.0 when calculating the eight per cent limit.

It is possible that an ADI's accounting statements can also include assets that are double-counted. This typically occurs if an ADI sells an asset but the sale does not meet the requirements for accounting derecognition because the ADI remains exposed to the risks and rewards of ownership. For example, an ADI could lend money to a covered bond SPV, which the SPV then uses to buy receivables from the ADI. As the ADI remains exposed to the risks associated with those receivables, the ADI might record both the receivables and the loan to the SPV as assets on its balance sheet.[5] Other transactions where similar double counting might occur include self-securitisations, funding only securitisations and repurchase agreements.

APRA considers that it is inappropriate to double-count assets where there would only be a single asset available for the benefit of depositors if the ADI were wound up. Accordingly, consistent with measuring the level of assets in Australia that are actually available to cover deposit liabilities in Australia, APS 121 requires that ADIs identify all instances of double-counting that may be included in their ARF 320.0 returns and exclude them from their calculation of assets in Australia for the purposes of sections 28 and 31D of the Banking Act.

5 If an asset is double-counted, this would be balanced in the ADI's accounts by an offsetting liability such that both the assets and liabilities sides of the ADI's balance sheet increase by the same amount.

Chapter 3 – Holdings of subordinated tranches of non-originated securitisations

The November 2011 discussion paper foreshadowed a change to APS 120 relating to holdings of subordinated tranches of securitisations involving receivables originated by another entity. This matter is unrelated to covered bonds but was included in the discussion paper for convenience.

3.1 Deduction of subordinate tranches

The discussion paper proposed that APS 120 be amended to require an ADI to deduct from Common Equity Tier 1, any holdings of subordinated tranches of securitisations that are originated by another entity.

To this effect, APRA proposes to insert the text contained in the Attachment to this paper into Attachment B of APS 120. Comments on this text will be invited as set out below.

Comments received

Several submissions argued that swapping subordinate tranches of securitisation is only occurring in isolated cases and is not a widespread market practice. Accordingly, they argued that APRA should use its existing powers to respond to these isolated cases rather than imposing additional requirements on all ADIs. Submissions also argued that the proposal should not apply to securitisations originated outside of the ADI industry because such transactions do not lead to a reduction in system-wide capital holdings.

APRA's response

APRA continues to believe that ADIs should deduct holdings of subordinate tranches of securitisations originated by another entity. Swapping of subordinate tranches to circumvent prudential requirements is only one example of why APRA considers that ADIs should not hold such tranches.

Securitisation can be a useful tool for transferring risk from the ADI industry. There are risks, not appropriately captured by APRA's existing prudential framework, if securitisation is used to move risk around within the ADI industry or to bring risks originated by non-ADIs into the ADI industry. These risks include the loss of transparency as to where risk ultimately resides and increased contagion risks. Such risks can make depositors, lenders and other investors less confident about the ADI industry in general and exacerbate risk across the industry during periods of market stress.

If risk associated with securitisation remains within the ADI industry, it is preferable that it be retained by the originator. Relative to other ADIs, the originator is better placed to understand and manage these risks.

3.2 Definition of subordinate tranches

The discussion paper proposed that for the purposes of the rule discussed above, a subordinated tranche should be defined as any tranche of a securitisation that is exposed to the bottom 10 per cent of the initial capital structure, unless that tranche is also the most senior.

Comments received

Several submissions suggested that defining a subordinate tranche based on credit ratings is preferable to the proposed 10 per cent rule. They argued that using credit ratings would be more consistent with other aspects of the Basel framework, which make use of credit ratings. Some also noted that the risk associated with the bottom 10 per cent of a securitisation can vary significantly depending on the underlying assets. For example, the bottom 10 per cent of a securitisation involving prime residential mortgages is likely to involve less credit risk than a securitisation involving a riskier class of underlying assets.

Other submissions sought clarity as to the proposed treatment of securitisations tranches that straddle the 10 per cent threshold.

APRA's response

The global financial crisis demonstrated the risks of over-reliance on assessments by credit rating agencies, especially in relation to the risks associated with securitisation structures. APRA has therefore adopted the simple and transparent definition proposed in the discussion paper.

In the case of straddling tranches, APRA intends that any tranche that is exposed to the bottom 10 per cent of a securitisation's initial capital structure should be deducted unless it is the most senior. A tranche that is only partly exposed to the bottom 10 per cent of the initial capital structure would satisfy this definition and must be deducted in whole.

3.3 Warehouses exposed to subordinate tranches

Comments received

Several submissions expressed concern that warehouse providers could be required to deduct the value of their exposures by virtue of the warehouse being exposed to the first 10 per cent of credit losses associated with the warehoused assets.

APRA's response

In APS 120, a securitisation warehouse is a short-term SPV that accumulates exposures until a sufficiently large pool is available for issuance of securities to the market in a securitisation. By definition, a warehouse can only have a single tranche. Consequently, an exposure to a warehouse should be the most senior and therefore will not need to be deducted.

Once a warehouse is tranched, it becomes a securitisation, even if there is a delay in selling the tranched notes into the market. To allow for possible administrative or other delays, APRA proposes that a warehouse funder that holds subordinate tranches with the intention that they be sold into the market at the earliest practical opportunity will not need to deduct its exposures to relevant tranches for the first six months after the tranching occurs. This concession is intended to allow sufficient time for an ADI to resolve any administrative complications that might prevent the sale of securities into the market after the warehouse is tranched, while recognising that warehouses are also intended to be temporary and time limited in nature.

3.4 Further consultation and commencement

Proposed changes to APS 120 are set out in the Attachment to this response paper. APRA will invite comments on the wording of these changes at the same time as consulting on amendments to APS 120 relating to the implementation of Basel III.

3.5 Request for cost-benefit analysis information

To improve the quality of regulation, the Australian Government requires all proposals to undergo a preliminary assessment to establish whether it is likely that there will be business compliance costs. In order to perform a comprehensive cost-benefit analysis, APRA welcomes information from interested parties on the financial impact of the proposed change to the regulatory capital treatment of subordinated tranches of non-originated securitisations and any other substantive costs associated with the proposed reforms. These costs could include the impact on balance sheets, profit and loss, and capital.

As part of the consultation process, APRA also requests respondents to provide an assessment of the compliance impact of the proposed changes. Given that APRA's proposed requirements may impose some compliance and implementation costs, respondents may also indicate whether there are any other regulations relating to ADI capital adequacy that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

Respondents are requested to use the Business Cost Calculator (BCC) to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. APRA would appreciate being provided with the input to the BCC as well as the final result. The BCC can be accessed at www.finance.gov.au/obpr/bcc/index.html.

Attachment – Proposed changes to APS 120

Insert the following into Attachment B of APS 120

Holding of subordinated tranches of securitisations originated by another entity

30. An ADI must deduct an exposure from Common Equity Tier 1, whether in the trading or banking book, where that exposure is to a subordinated tranche of a securitisation originated by an entity other than the ADI or an extended licensed entity of the ADI:

    (a) For the purposes of this paragraph, a subordinated tranche is any tranche of a securitisation that is exposed to the first 10 per cent of potential credit losses as a share of the initial capital structure, unless it is also the most senior tranche.

    (b) An ADI that holds a subordinate tranche of a securitisation for which it provided warehouse funding may elect not to treat the relevant tranches as a subordinate tranche if:

        (i) it has held the exposure continuously since the warehouse was tranched;

        (ii) it intended to sell the relevant exposure into the market when the warehouse was tranched; and

        (iii) it is less than six months since the warehouse was tranched.

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