

# Commonwealth Bank

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Mr. Neil Grummitt  
General Manager, Policy Development  
Policy, Research and Statistics  
Australian Prudential Regulation Authority  
Level 26, 400 George Street  
SYDNEY NSW 2001

7 September 2012

Dear Neil,



## Commonwealth Bank of Australia ("CBA")

### Response to Submissions, Covered Bonds and Securitisation matters, dated 12 July 2012 (the "Publication")

CBA welcomes the opportunity to respond to APRA on the Publication. This response relates solely to the matters contained within 'Chapter 3 – Holdings of subordinated tranches of non-originated securitisations' ("Chapter 3") of the Publication.

CBA actively participated in the preparation of the Australian Securitisation Forum ("ASF") submission ("Submission") to the Publication; and supports the contextual and technical aspects in the Submission. CBA also notes the Australian Bankers Association support of the Submission. The Submission is included as Appendix 1 to this response.

CBA is a leading participant in the securitisation market as an issuer, investor, intermediary and facility provider. From its position across these different aspects of the market, CBA believes that the changes proposed within Chapter 3, if implemented as drafted, have the potential to significantly constrain securitisation funding, trading and investment activity by applying a highly penal capital deduction notwithstanding the underlying credit fundamentals of the transaction. We appreciate the desire to simplify structures but are concerned with both the short-term impact this will have on existing structures and, in the longer term, with the effect this may have on the ongoing attractiveness of securitisation as a funding tool.

To this end, we believe that this change needs to be considered in the context of other potential changes including the consideration of including regulatory approval for a workable master trust structure

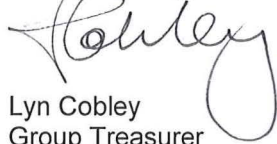
CBA continues to support a stronger regulatory framework. However, CBA is also obliged to raise concerns with draft regulations which may not only be unnecessarily punitive to CBA, but also to the markets in which CBA operates.

In accordance with the proposed change to APS120 as outlined in the Submission, CBA will define the 'most senior tranche' as per footnote 22 in Attachment D of APS 120 as '*A securitisation or resecuritisation exposure is treated as a senior tranche if it is effectively secured by a first claim on the entire amount of the exposures in the pool.*

*For this purpose, the ADI does not have to take into consideration taxes and similar imposts, fees to service providers, amounts due under interest rate swaps, currency swaps or eligible servicer cash advances.'*

CBA welcomes the opportunity to discuss the Submission with APRA both individually and/or as part of a broader industry working group. If you would like any further information, please do not hesitate to contact either myself or Ed Freilikh

Yours sincerely,



Lyn Cobley  
Group Treasurer  
Commonwealth Bank

P:

M:

E:

cc. Gary Dingley, Chief Operational Risk Officer, Commonwealth Bank of Australia.  
Michael Grinham, Executive Risk Adviser, Prudential Group Regulatory compliance,  
Commonwealth Bank of Australia

## **Appendix 1 – ASF Submission**



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07 September 2012

Neil Grummitt  
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Level 26, 400 George Street  
SYDNEY NSW 2000  
email:

Dear Mr Grummitt,

We refer to APRA's Response to Submissions publication ("Publication") dated 12 July 2012 and Discussion Paper titled 'Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures ("Discussion Paper").

We would also like to take this opportunity to thank you and Catherine Maxwell for your time on 21 August 2012 to discuss the proposals set out in Chapter 3 of the Publication (*Holdings of subordinated tranches of non-originated securitisations*) and the proposed changes to Attachment B of APS 120 set out in the Attachment to the Publication ("Proposed 10% Rule") with members of the Australian Securitisation Forum ("ASF"). The clarity you provided during that meeting was helpful in framing our response to the Publication.

In particular, we note APRA's commitment to the principle that ADIs will be required to deduct their holdings of "subordinated tranches" in securitisations from Common Equity Tier 1. Cognisant of this commitment, the ASF has focused its response on proposing certain modifications to the definition of "subordinated tranche" in the Proposed 10% Rule. As requested, we attach a mark-up of the Proposed 10% Rule showing the ASF's proposed changes ("ASF Modifications").

The ASF appreciates that the Discussion Paper called for comments on certain other modifications to APS 120 (in addition to the inclusion of the Proposed 10% Rule) relating to the implementation of Basel III. However, this submission by the ASF is limited to our response with respect to the Proposed 10% Rule. A supplementary submission may follow if the ASF's members deem it necessary. This submission has been developed by members of the ASF's Regulatory and Prudential subcommittee and has included a representative of the Australian Bankers' Association ("ABA"). The ABA has indicated it will confirm its support of this submission directly to you.

#### **Subordinated holdings**

The ASF understands that APRA's primary objective of the Proposed 10% Rule is to eliminate the potential for capital arbitrage in prime RMBS transactions. The ASF supports the spirit of APRA's proposed changes to APS 120 in this regard and shares APRA's concerns about the potential for capital leakage from the banking system that may occur if there were instances of ADIs cross-holding subordinated notes in prime RMBS transactions.



That said the ASF does hold genuine concerns for the stability and viability of the domestic securitisation market, including provision of funding to ADIs, if the Proposed 10% Rule is implemented in its current form.

The ASF holds two key concerns with the current wording of the Proposed 10% Rule:

- (a) As currently drafted, the Proposed 10% Rule:
  - 1. penalises tranchised securitisation transactions without regard to the funding ADI's credit exposure to those transactions; and
  - 2. exempts a single tranche structure (with exactly the same credit exposure as a multi-tranche structure) on the basis that it is the most senior tranche.
- (b) The Proposed 10% Rule imposes the requirement to deduct from Common Equity Tier 1 securities that are:
  - 1. eligible securities for open market operations by the RBA (i.e. repo eligible);
  - 2. included within the Reserve Bank of Australia's ("RBA") Committed Liquidity Facility; and
  - 3. eligible for purchase under the Australian Office of Financial Management RMBS investment programme.

The ASF's proposed amendments to the Proposed 10% Rule are designed to address these concerns. The new sub-paragraph (b) (iv) is a self-explanatory approval mechanism. The ASF recommends the removal of the existing paragraph (b) in the Proposed 10% Rule as it is not reflective of warehouse transactions.

Outlined below are the ASF's detailed rationales for including the new sub-paragraphs (b) (ii) and (b) (iii) in the ASF Modifications:

**(b)(ii) Penalisation of Multi-Tranche Securitisations**

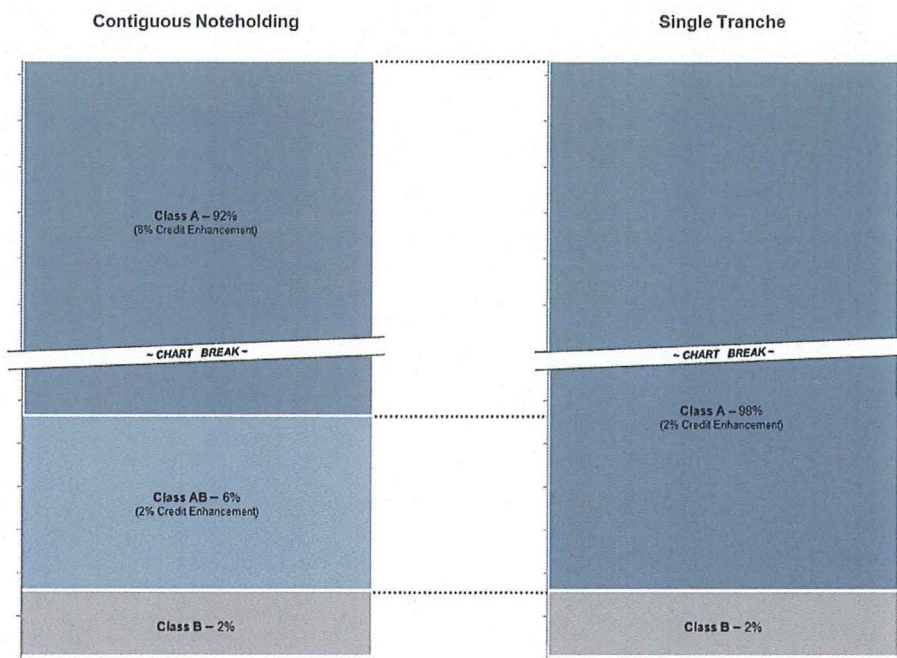
The regulatory treatment of an ADI's funding exposures across more than one tranche in a securitisation should be comparable to the regulatory treatment of an ADI's funding exposures to a single tranche in a securitisation where the credit risk is the same. For instance, ADIs often use tranching for warehouses to establish:

- a) appropriately risk-adjusted funding structures; and/or
- b) a significant proportion of the exposure to be RBA repo and Committed Liquidity Facility eligible.

In these tranchised warehouse transactions, the funding ADI will typically hold a contiguous capital structure from the most senior note down to a mezzanine or junior note. In some securitisation transactions, including prime RMBS transactions, this can include an exposure to within the bottom 10% of the capital structure.

If an ADI has a contiguous holding of notes from the top of the securitisation capital structure down to a particular risk attachment point, then the credit risk associated with that aggregate holding of notes is identical to that of an ADI funder of a single tranche from the top of the capital structure to the same risk attachment point in an alternatively structured securitisation of the same assets. However, under the current drafting of the Proposed 10% Rule, the single tranche structure would not be penalised as it would also be the most senior tranche whereas a multi-tranche structure (even if the ADI held contiguous tranches) would be penalised.

The ADI funding the multi-tranche structure could avoid the capital penalty by collapsing the different note classes into a single tranche. However, such restructuring across numerous transactions would cause significant disruption to business, additional resourcing and material legal and compliance costs. These costs cannot be reconciled against the fact that removing the tranching from such transactions would not change the credit risk to the funding ADI.



Therefore the punitive capital charges on all tranching transactions is inappropriate, given that the funding ADI (holding contiguous tranches) has the same credit risk as in a single tranche structure. The purpose of the proposed language in paragraph (b) (ii) in the attached ASF Modifications is to deem such contiguous vertical holdings of notes to the top of a capital structure in a securitisation to be the most senior tranche.

**(b)(iii) Common Equity Tier 1 deduction for RBA Repo-Eligible Securities**

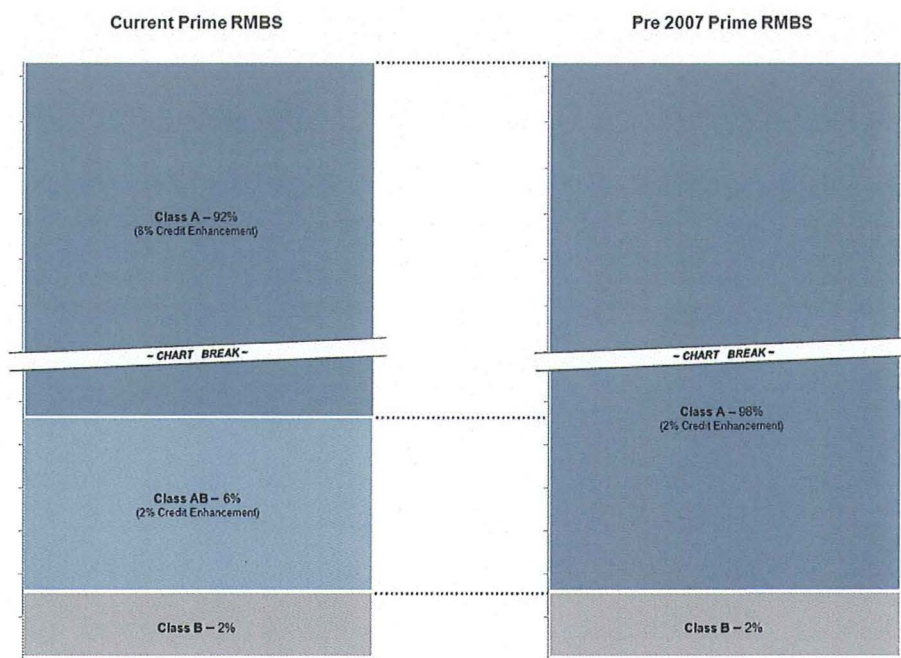
The Proposed 10% Rule will trigger a deduction from Common Equity Tier 1 for securities that are included within the RBA Committed Liquidity Facility, are RBA repo eligible and are eligible for purchase under the Australian Office of Financial Management RMBS investment programme.

The recent shift to include mezzanine 'AAA' rated tranches is to optimise the issuance, based on investor appetite. Some investors require additional protection against a potential downgrade of the 'AAA' rated tranche. This typically achieved by increasing the level of subordination in the structure. Other investors only require a lower buffer; therefore the mezzanine 'AAA' rated tranche is structured to meet this category of investor demand (albeit with a higher margin). This results in maximising the issuance size of the securitisation with an overall efficient price.



Assumptions as follows:

- 'AAA' credit enhancement requirement (pre LMI benefit) is 8%
- 'AAA' credit enhancement requirement (including LMI benefit) is 2%



As outlined above, both transactions have the same amount of credit support below the 'AAA' notes, and hence credit risk. Both transactions include securities which are repo eligible. In today's RMBS transactions the (previously) single senior 'AAA' rated tranche is split into two tranches so that if the LMI providers are downgraded by rating agencies, only the mezzanine 'AAA' rated tranche could potentially be downgraded, that is, the most senior tranche has no rating dependency on LMI providers.

The ASF submits that mezzanine RBA repo eligible tranches should be excluded from the proposed paragraph 30 Attachment B of APS 120 for the following reasons:

- The tranches satisfy the RBA's repo eligibility and committed liquidity facility criteria;
- The tranches carry the same credit risk that exists in all transactions which historically were structured with a single senior tranche before market dynamics led to greater demand for LMI independent tranches in Australian RMBS transactions. Despite this, the mezzanine tranche already carries a higher risk weight reflecting the fact that it is not the most senior tranche in the structure. Importantly an ADI holding both the senior and mezzanine tranches holds more capital than an ADI holding a single senior, LMI dependent, tranche; and
- The purchase of mezzanine tranches in no way assists the originating ADI to achieve regulatory capital relief via the securitisation transaction, noting that it is the distribution of the subordinated tranche (typically referred to as Class B Notes) to third parties that is core to a claim for capital relief pursuant to APS 120.

## Conclusion

The ASF also notes APRA's commitment to develop a new prudential standard for securitisation by ADIs. Therefore, as an interim measure pending the finalisation of the new standard, the ASF believes that making the suggested ASF changes to the Proposed 10% Rule would still address APRA's key concern of eliminating opportunities for capital arbitrage in prime RMBS transactions while avoiding the adverse consequences for the securitisation market highlighted herein.

Please call if you have any questions or wish to discuss these comments further.

Yours sincerely

A handwritten signature in black ink that reads "Chris Dalton". The signature is written in a cursive, flowing style.

Chris Dalton



# Proposed Changes to APS 120

## Holding of subordinated tranches of securitisations originated by another entity

- (a) ~~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.
- (b) ~~(a)~~ For the purposes of ~~this~~ paragraph (a), a subordinated tranche is any ~~tranche of class of securities issued by an SPV in~~ a securitisation that is exposed to the first 10 percent of potential credit losses as a share of the initial capital structure, unless ~~it is also the most senior tranche~~:
- (i) it is also the most senior tranche; or
  - (ii) it is held by the ADI contiguously with each more senior tranche in that securitisation; or
  - (iii) it is an "eligible security" for repurchase agreements with the Reserve Bank of Australia; or
  - (iv) upon application by an ADI in respect of a class of securities, APRA confirms that those securities are not a subordinated tranche for the purposes of this paragraph.
- ~~(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 tranced;~~
  - ~~(ii) — it intended to sell the relevant exposure into the market when the warehouse was tranced; and~~
  - ~~(iii) — it is less than six months since the warehouse was tranced.~~