ATTACHMENT

OBPR ID: 2014, 16917

INDEPENDENT REVIEW – REVISIONS TO THE SECURITISATION FRAMEWORK

Background

APRA has undertaken an independent review regarding changes to the prudential framework for securitisation. The independent review is to satisfy a similar process to that required for a Regulatory Impact Statement (RIS) as set out in the Australian Government Guide to Regulation (the Guide).[1] Its purpose is to assist APRA in making a decision on proposals aimed at strengthening the Australian banking system, specifically with regard to securitisation. The issues canvassed in this RIS were considered by APRA at each major decision point in the development and finalisation of the proposals.

Securitisation involves selling a 'pool' of assets (typically loans) to a special purpose vehicle, which then obtains funding for these assets from the capital markets. Securitisation can be an important and cost-effective mechanism by which an authorised deposit-taking institution (ADI) can obtain funding for its business. Australian ADIs have used securitisation successfully for many years to diversify their funding base and make efficient use of capital.

As with loans and other exposures, ADIs that choose to hold exposures to securitisation vehicles must hold regulatory capital against these exposures. In addition, ADIs may be able to reduce the amount of regulatory capital APRA requires them to hold against securitised loans by removing them from their balance sheets (a capital relief securitisation). *Prudential Standard APS 120 Securitisation* (APS 120) sets out the criteria that ADIs must meet to achieve regulatory capital relief. The prudential standard also includes general requirements applying to an ADI's involvement in all types of securitisation activities and the methodology for calculating an ADI's regulatory capital requirement for securitisation exposures.

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and superannuation fund members within a stable, efficient and competitive financial system. APRA carries out this mandate through a multi-layered prudential framework that encompasses licensing and supervision of institutions. In the case of the banking industry, APRA is empowered under the *Banking Act 1959* (the Banking Act) to issue legally binding prudential standards that set out specific prudential requirements with which ADIs must comply. These standards are supported by prudential practice guides (PPGs), which clarify APRA's expectations with regard to prudential requirements.

APRA regularly reviews its regulatory regime and amends its prudential requirements as a result of a number of factors including:

- international developments;
- changes in financial market conditions or changes in risk management practices, in response to identified weaknesses in the prudential framework; and
- to reduce potential negative impacts of emerging industry issues.

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[1] *Australian Government Guide to Regulation*, March 2014

One of the key components of APRA's prudential framework is the suite of prudential standards which require ADIs to hold regulatory capital against the risks which they undertake (capital standards). These capital standards include APS 120. APRA's capital standards for ADIs follow closely those set by the Basel Committee on Banking Supervision (Basel Committee).[2] The capital standards set by the Basel Committee were always intended to be subject to ongoing review.

The Basel Committee regularly reports to the Group of Twenty (G20) Leaders, which includes Australia's Prime Minister, and to the Financial Stability Board (FSB).[3, 4] Since the global financial crisis (the market disruptions of 2007-2009), G20 Leaders have committed to fully and consistently implement the international framework known as 'Basel III'. As part of its strategic response to address weaknesses revealed by the global financial crisis, the Basel Committee has undertaken a review of its existing securitisation framework (Basel II securitisation framework).[5]

In December 2014, the Basel Committee released its updated securitisation framework (Basel III securitisation framework).[6]

Questions 1 & 2 – Assessing the problem and objectives of government action

In its first two consultation papers (refer to Question 5 below), APRA outlined the problem in regard to securitisation, the prudential regulation of securitisation and why regulatory initiatives were needed. Refer to the *first consultation paper (Chapter 1 Introduction on pages 10-13)* and the *second consultation paper (Chapter 1 Introduction on pages 10-15 and Chapter 4 Implementing the Basel III securitisation framework on pages 26-29*).

APRA's objective in revising the prudential framework for securitisation is to establish a simplified framework, taking into account global reform initiatives and the lessons learned from the global financial crisis. One of the lessons was that securitisation had become excessively complex and opaque, while prudential regulation of securitisation had become similarly complex.

The origins of the global financial crisis stemmed fundamentally from a failure to properly assess and manage risk. Amongst other things, the search for higher returns drove the supply of increasingly complex securitisation products, in which the risks were not well understood.

During and in the aftermath of the global financial crisis, APRA has supplemented APS 120 with *ad hoc* letters and additional guidance. In practice, responding to an increasingly complicated product with increasingly complicated prudential requirements has proven unsatisfactory.

In addition, since the global financial crisis, some ADIs have preferred to place a greater emphasis on securitisation as a source of funding and have been less concerned with securitisation for regulatory

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[2] The Basel Committee, of which Australia is a member, is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.

[3] The G20 is the premier international forum for cooperation on global economic governance.

[4] The FSB is an international body that monitors and makes recommendations about the global financial system.

[5] 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 – 'E*nhancements to the Basel II framework*, July 2009'.

[6] The Basel Committee's Basel III document '*Revisions to the Securitisation Framework*', December 2014

capital relief. This has had the effect of making the requirements within the current APS 120 (January 2015) less relevant, since it is predicated on securitisation being used primarily for regulatory capital relief.[7]

The global financial crisis also highlighted several weaknesses in the Basel II (and current Australian) securitisation framework, including insufficient regulatory capital for certain securitisation exposures. Under the existing regulatory framework, there are very low regulatory capital requirements on some securitisation exposures with high credit ratings (namely AAA-rated exposures), which proved to be inadequate from the experience of the global financial crisis.

The most significant revisions with respect to the Basel II securitisation framework relate to changes in the approaches used to calculate regulatory capital, the risk drivers used in each approach and the amount of regulatory capital banks must hold for exposures to securitisation. These are designed to respond to the shortcomings that have been identified in the current regulatory framework.

Questions 3 & 4 – Options that may achieve the objectives and impact analysis – costs, benefits and risks

Policy options to address the problem in regard to securitisation and the likely net benefit of each option were outlined in APRA's *second consultation paper (refer to Annexure: Policy options and comparative net benefits on pages 31-34)*.

These three policy options were as follows:

- the first option was to maintain the *status quo* under which no changes would be made to APS 120 and associated reporting standards and forms;
- the second option was for APS 120 and associated reporting standards and forms to be amended to simplify the framework, in consideration of submissions received, but without incorporating the Basel III securitisation framework; and
- the third option was to include in APS 120 both APRA-initiated proposals and the Basel III securitisation framework (with appropriate Australian adjustments), in consideration of submissions received.

APRA noted that the third option, if chosen, would be achieved by amendments to APS 120 and associated reporting standards and forms.

The APRA-initiated proposals reflected in the second and third options include:

- simpler approaches to calculating regulatory capital requirements;
- higher capital requirements for certain more risky ('non-senior') securitisation exposures;
- conservative treatment for complex types of securitisation i.e. synthetic securitisation, asset-backed commercial paper securitisation and securitisation of revolving credit facilities; and

[7] An ADI may undertake a securitisation primarily to raise funding (a funding-only securitisation) or for both funding and to reduce regulatory capital requirements (a capital relief securitisation). The existing regulatory framework places some restriction on ADIs in regard to funding arrangements.

- flexibility for ADIs in their funding arrangements i.e. the explicit recognition in APS 120 of securitisation used purely for funding purposes (funding-only securitisation) and not capital relief.

The only material difference between the second and third options is the update to the Australian standard to align with the Basel III securitisation framework.

APRA has considered all relevant compliance costs (e.g. administration and substantive compliance costs and delay costs) in estimating the regulatory cost of each option. This includes the costs of complying with revised capital requirements i.e. the capital compliance costs primarily relate to performing an alternative capital calculation. Regulatory costs have been estimated with regard to APRA's understanding of the average number of staff involved in an ADI's compliance area specific to securitisation and the cost of staff, including specialist legal staff.

It is important to note that not all ADIs undertake securitisation activity and those ADIs which participate in securitisation may have different roles within a securitisation. For the purpose of the Australian Government's Burden Measurement Tool, APRA has taken a conservative approach and assumed all ADI participants in securitisation take on all types of roles. In practice, APRA would expect that ADIs that only have a limited role, e.g. as an investor or a facility provider in a securitisation, would have a lower proportion of the estimated costs than ADIs that issue securitisation.

The consideration of regulatory costs as reflected in the average annual regulatory costs relates to additional compliance costs and does not include regulatory capital costs. APRA has considered the regulatory capital costs of each of the options separately.

The first option

Compliance cost

Under the first option, ADIs and other stakeholders would not incur any additional compliance costs (Table 1 below).

Table 1 – Average annual regulatory costs (first option)

Change in costs ($m)	Business	Community Organisations	Individuals	Total change in costs
Total by sector	$0	$0	$0	$0

Regulatory capital cost

Under the first option, ADIs would not incur any additional capital costs.

The second option

Compliance cost

Under the second option, it is likely ADIs would incur additional compliance costs (Table 2 below).

Table 2 – Average annual regulatory costs (second option)				
Change in costs ($m)	Business	Community Organisations	Individuals	Total change in costs
Total by sector	$4.583	$0	$0	$4.583

The figure in Table 2 represents the one-off implementation costs and not the average annual ongoing costs, as APRA estimates that no additional annual ongoing costs would accrue.

As part of its first consultation, APRA invited submissions on any increases or decreases to regulatory costs incurred as a result of each option. Respondents were invited to use the Australian Government's Burden Measurement Tool to assess regulatory costs. None of the submissions took up this invitation to use the tool. However, one submission indicated the items set out in the tool are estimated to be relatively small (refer to Question 5 below in regard to consultation).

The current APS 120 (January 2015) requires an ADI to assess, in writing, each securitisation in which it participates to demonstrate compliance with the prudential standard. For the second option, APRA is not proposing any change to this requirement.

The additional compliance costs under the second option involve a one-off update to an ADI's self-assessment processes and policies to reflect revisions to the prudential standard. The prudential standard does not prescribe the most appropriate format for the self-assessment and therefore each ADI is free to determine the most appropriate format.

APRA is proposing transitional arrangements for existing securitisation transactions; ADIs will not be required to revisit these individual self-assessments. For new securitisations, ADIs will be required to conduct a self-assessment, but apart from the one-off update to an ADI's processes and policies, APRA estimates there will be no additional on-going compliance costs for new securitisation transactions.

Compliance costs also include those associated with prudential reporting requirements. ADIs are currently required to report their securitisation activities to APRA and are required to calculate regulatory capital requirements. In regard to the second option, APRA is proposing to streamline the prudential reporting requirements so that the volume and detail of reporting is reduced. The additional cost under the second option involves a one-off update to reporting forms which will require some system changes. APRA considers each ADI would have the existing data to complete updated reporting forms and that any system changes would be immaterial in regard to existing infrastructure.

Under the second option, ADIs will also need to revise their methodologies for calculating regulatory capital requirements. APRA does not expect that the calculation of regulatory capital requirements is materially more complex than under the current prudential standard, and in some cases will be simplified. Overall, APRA considers the costs of complying with the regulatory capital requirements as being comparable to the current costs of complying (i.e. the calculation under the second option is not any more burdensome that the first option).

APRA considers there are no delay costs in relation to the second option (e.g. expenses and loss of income incurred by an ADI through an application delay or an approval delay) as there is no requirement for an application or approval to undertake a securitisation under the second option.

Under the second option, APRA envisages a start date of 1 January 2018 for the introduction of the reforms. APRA considers there would be sufficient notice of proposed prudential standard and reporting requirements to allow ADIs to undertake any necessary changes to self-assessment and reporting processes. When estimating compliance costs for business, given the quantum of compliance costs, APRA considers it likely these compliance costs are easily absorbed by business and would not be passed on to consumers.

Regulatory capital cost

For ADIs with securitisation exposures, there are likely to be additional capital costs under the second option.

Clearly capital costs can vary from transaction to transaction however (aggregate) capital costs for the most common structures such as typical Australian residential mortgage-backed securities are estimated to be higher than the first option, depending on whether the ADI is an Advanced ADI or Standardised ADI (refer to Table 4).[8] For Advanced ADIs in particular, risk weights for AAA-rated senior exposures would rise from 7-12 per cent to 20 per cent. The impact on Standardised ADIs would be much less.[9]

The introduction of funding-only securitisation under the second option does not impose additional capital costs for originating ADIs.[10] In addition, APRA initiatives to treat complex securitisation, i.e. synthetic securitisation, asset-backed commercial paper securitisation and securitisation of revolving credit facilities as funding-only (not eligible for capital relief) are not considered material as these types of securitisations are not a large feature of the Australian market.

The benefits of funding-only securitisation may improve ADIs' ability to secure long-term, stable wholesale funding and reduce their funding costs. ADIs are likely to achieve cost savings from funding-only securitisation, including a reduction in funding costs with the ability to issue 'soft bullet' securities; the extent of this price benefit for ADIs is difficult to determine, but some industry estimates indicate an annual cost saving for residential home loans of up 0.05 per cent for Australian dollar issuance and up to 0.30 per cent for foreign currency issuance.[11]

In relation to funding-only securitisation, industry has indicated possible further annual cost savings for each ADI issuer of between $500,000 to $1.0 million by way of reduced establishment and operational costs including savings in legal costs; rating agency fees and trustee fees. Additionally, industry has indicated annual cost savings for each ADI issuer of approximately $300,000 to

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[8] An Advanced ADI is an ADI that uses the complex advanced modelling approaches to measuring credit risk for capital adequacy purposes. A Standardised ADI is an ADI that uses the simpler standardised approach to measuring credit risk for capital adequacy purposes.

[9] For senior notes, assume 8 per cent credit enhancement from subordinated notes, compared with around 3 per cent for mezzanine notes.

[10] Securitisation was originally conceived as a tool to enable ADIs to achieve both funding and capital benefits. Industry practice has evolved to create a class of ADIs which is only interested in funding, not capital benefits. These ADIs have asked APRA to allow securitisations used only for this purpose, which is not explicitly contemplated within the current APS 120 framework.

[11] Industry in their submissions have argued that funding-only securitisation (which may include date-based call options) promotes greater secondary market transparency and liquidity as investors attain greater confidence of maturity of the securities issued. Funding-only securitisation may also reduce the cost of foreign currency issuance because the hedging profile of foreign currency cash flows is known with greater certainty.

$500,000 per annum through reduced reporting cost for the managing ADI arising from only needing to report to investors on one trust as opposed to multiple trusts.[12]

A simplified prudential framework is likely to support growth in the volume of securitisation, particularly offshore issuance. This is likely to make securitisation a more attractive funding option for ADIs. However, under this option, non-compliance with the Basel III securitisation framework could act as a counterweight to any significant growth in the volume of securitisation, particularly offshore issuance. Overseas investors could be less likely to invest in ADI-issued securitisation if the Australian prudential framework was not internationally compliant.

The third option

Compliance cost

Under the third option, ADIs would likely incur additional compliance costs (Table 3 below).

Table 3 – Average annual regulatory costs (third option)				
Change in costs ($m)	Business	Community Organisations	Individuals	Total change in costs
Total by sector	$4.583	$0	$0	$4.583

The third option is likely to have similar compliance costs as the second option.

Regulatory capital cost

For ADIs with exposures to securitisation, there are likely to be additional capital costs. Capital costs can vary from transaction to transaction; however, aggregate capital costs for typical Australian residential mortgage-backed securities are estimated to be somewhat higher than the first and second options, reflective of the revised Basel III securitisation framework risk weights. (Refer to Table 4).

The benefit of higher capital requirements under the third option is to address risks highlighted by the global financial crisis of insufficient capital for certain types of securitisation exposures. Additional risk drivers such as maturity of a securitisation's tranche address weaknesses in the current framework. An overall risk weight ‘floor’ ensures that all ADI securitisation exposures are backed by a minimum prudent level of capital.

Under the third option, ADIs would be able to use the standardised approach under the Basel III securitisation framework to assign risk weights, in the absence of external ratings. While there is some increase in capital for certain types of structures under the standardised approach, in light of the minimum ‘floor’ risk weights imposed under the Basel III securitisation framework, APRA considers the overall impact of not adopting the advanced approaches is not significant for the most common structures.[13]

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[12] Industry has commented that funding-only securitisation can be significantly more efficient from a timing and logistical perspective. Because it allows for programmatic issuance rather than specific bespoke issuance, funding-only securitisation can reduce documentation, rating agency and other internal costs materially for new issues. Importantly, funding-only securitisation can facilitate speedier execution of new issuance.

[13] The objective of the Basel III securitisation floor risk weight is to ensure that the level of capital across the banking system does not fall below a certain level. This also enhances the comparability of capital outcomes across banks.

Also similar to the second option, there are no additional capital costs for originating ADIs in regard to funding-only securitisation. Commercially, ADIs would achieve cost savings from funding-only securitisation similar to that of the second option. Implementing the Basel III securitisation framework would assist growth in the volume of securitisation, particularly offshore issuance. Overseas investors would be more likely to invest in ADI-issued securitisation knowing that the Australian prudential framework was internationally compliant.

Table 4 – Capital costs (first, second and third options)

Exposure	Risk weight (first option)	Risk weight (second option)	Risk weight (third option)
AAA (senior)	20%* (7%**)	20%	15-20%+
AAA (non-senior)	20%* (12%**)	20%	15%-70%+
AA (non-senior)	20%* (15%**)	20%	30%-120%+
A (non-senior)	50%* (20%**)	Common Equity Tier 1 Capital (CET1) deduction	CET1 deduction
BBB (non-senior)	100%* (75%**)	CET1 deduction	CET1 deduction
Unrated (non-senior)	1250%	CET1 deduction	CET1 deduction

* Using the external ratings-based approach under the current APS 120 (January 2015)
** Using the advanced approaches under the current APS 120 (January 2015)
+ Using the external ratings-based approach under the Basel III securitisation framework

Summary of policy options and net benefits

Table 5: Summary of the net benefits of each option

	First option	**Second option**	**Third option**
Compliance cost	No change	Low to moderate cost	Low to moderate cost
Regulatory capital cost	No change	Low to moderate cost	Moderate cost
Compliance with G20 agreements and Basel III securitisation framework	Does not meet this criteria	Does not meet this criteria	Meets this criteria
Overall	High net cost	Moderate net cost	Low to moderate net cost

Question 5 – Consultation

APRA has undertaken two rounds of public consultation in revising its securitisation framework. APRA has also engaged informally with a variety of stakeholders, including individual institutions and industry associations.

APRA first consulted on initiatives to simplify its prudential framework for securitisation in April 2014 with the release of the Discussion Paper '*Simplifying the prudential approach to securitisation*' (first consultation paper).[14] This first consultation paper was an exploratory paper. APRA sought

[14] The first consultation paper is available on the APRA website.

feedback on its proposals in its first consultation paper, noting that it intended not to finalise any reforms to its prudential framework for securitisation until, at least, the completion of the Government's Financial System Inquiry (FSI) and the finalisation of revisions to the Basel Committee's Basel II securitisation framework.[15]

APRA received eighteen submissions in response to its first consultation paper.

In November 2015, APRA released a second consultation paper which included APRA's response to submissions to its first consultation paper and its proposed implementation of the Basel Committee's Basel III securitisation framework. APRA also released a draft revised APS 120 at this time. APRA amended its initial proposals in a number of areas following consideration of the issues raised in submissions (refer to the *second consultation paper Chapter 2 Response to submissions – 'Simplifying the prudential approach to securitisation'*).[16]

APRA received sixteen submissions to its second consultation paper. In the final version of APS 120, APRA has clarified or amended its proposals in a number of areas following consideration of the issues raised in submissions.

Question 6 – Conclusion

Under the first option, there would be no additional compliance and regulatory capital costs. However, the securitisation framework would remain relatively complex and not internationally compliant. This option would have a high net cost. The developments during the global financial crisis also highlighted the need for reform. These reforms have been agreed by governments of the G20 countries. The first option is therefore not considered viable.

In regard to the second and third options, compliance costs and regulatory capital costs are estimated to increase. Commercially, some savings may be achieved by ADIs that issue funding-only securitisation.

APRA considers there is no material difference in regard to compliance costs for the second and third options. However, APRA considers the third option the best option from those considered as it adopts the Basel III securitisation framework, with appropriate Australian adjustments, and provides for a simplified framework. This best addresses the objective that the prudential framework for securitisation should be simpler and easier for stakeholders to understand, and is internationally compliant.

Question 7 – Implementation and review

APRA anticipates release of the final revised APS 120 in late 2016 which will provide industry with one year to make changes necessary to comply with the new requirements with effect from 1 January 2018.

As delegated legislation, prudential standards impose enforceable obligations on affected APRA-regulated institutions. APRA monitors ongoing compliance with its prudential framework as part of its supervisory activities. APRA has a range of remedial powers available for non-compliance with a

[15] The final report of the FSI is available on the FSI website. The Government's response to the Financial System Inquiry is available on the Department of the Treasury website.

[16] The second consultation paper and draft revised APS 120 is available on the APRA website.

prudential standard, including issuing a direction requiring compliance, the breach of which is a criminal offence. Other actions include imposing a condition on an APRA-regulated institution's authority to carry on its business or increasing regulatory capital requirements.

Under APRA's policy development process, reviews of new measures are typically scheduled for between two and three years from implementation. Such a review would consider whether the requirements continue to reflect good practice, remain consistent with international standards, and remain relevant and effective in facilitating sound risk management practices. APRA will also take action within a shorter timeframe where there is a demonstrable need to amend a prudential requirement.