AUSTRALIAN BANKERS' ASSOCIATION INC.

Submission

ABA response to APRA's Simplifying the prudential approach to securitisation – Discussion Paper

15 August 2014

Australian Bankers' Association Inc. ARBN 117 262 978
(Incorporated in New South Wales). Liability of members is limited.

Contents

1. Introduction

The Australian Bankers' Association (**ABA**) welcomes the opportunity to comment on the Australian Prudential Regulation Authority's (**APRA's**) Discussion Paper, *Simplifying the prudential approach to securitisation*, 29 April 2014 (**Discussion Paper**). This submission sets out the interim views and comments of the ABA in relation to proposals set out in the Discussion Paper. The ABA notes that the Basel Committee on Banking Supervision (**BCBS**) is currently reviewing the methodology for calibrating risk weights for securitisation exposures. Accordingly, it is not possible for the ABA to respond definitively on the Discussion Paper until the BCBS consultation process has been completed and the BCBS has published its final rules with respect to the calibration of securitisation risk weights. The ABA understands that further details of the revised securitisation framework will follow over the next 12 to 18 months. We look forward to further engaging with APRA during this period.

The ABA believes the Discussion Paper represents a positive step in addressing the lessons learned from the 2008 global financial crisis (**GFC**) and removing some of the unnecessary prescription in the existing *Prudential Standard APS 120 - Securitisation* (**APS 120**). We believe that the Australian securitisation market has an important role to play in supporting bank funding, market liquidity, and competition in Australia, with a vibrant securitisation market likely to add material benefits to the real economy.

The ABA supports a principles-based securitisation framework that promotes a more active and sustainable securitisation market in Australia. We welcome APRA's decision to explicitly link the revised APS 120 with the liquidity requirements introduced under *Prudential Standard APS 210 – Liquidity* (**APS 210**) and we support APRA's move to explicitly allow for funding-only securitisations. However, we believe there are a number of areas in the current proposals that remain unnecessarily prescriptive and punitive, specifically in the case of funding-only securitisations and synthetic structures. Without greater flexibility, the ABA is concerned that APRA's approach will unduly limit the ability of originating authorised deposit-taking institutions (**ADIs**) to make greater use of securitisation as part of their funding, capital and liquidity plans.

The proposals, as they stand, would not meet the objective of further developing the securitisation market. The limitations in the proposals primarily relate to conditions on the date-based calls and the prohibition of early amortisation triggers. These limitations are overly restrictive when compared with the prudential and systemic risks associated with funding-only structures. The limitations would reduce investor demand for master trust structures, would work against banks' efforts to better match their asset and liability profiles, and work against efforts in moving to a more stable funding profile. The ABA also disagrees with APRA's proposal to restrict synthetic securitisation as a means of capital relief. Synthetic securitisation represents a robust and well-tested means of risk transfer for ADIs.

Similarly, the one-year refinance requirement on warehouse arrangements will disadvantage smaller and regional ADIs that obtain matched funding through such arrangements. The one-year requirement will also create an advantage to foreign ADIs operating in Australia as warehouse funding providers, given they are not subject to APRA's regulatory capital requirements. This would undermine competition, efficiency and contestability in the ADI industry.

The ABA is concerned that some aspects of APRA's proposals are divergent from the proposed BCBS securitisation framework as well as from offshore approaches to 'skin in the game' and capital relief securitisation. The ABA is of the view that such divergences will lead to unintended consequences for the Australian banking system and also shift securitisation exposures and related activity to non-ADI participants.

ABA Recommendations

The ABA recognises some of the issues covered in the Discussion Paper will evolve over the coming period in light of developments from the BCBS, the Financial System Inquiry (**FSI**) and industry consultation. Nevertheless, the ABA makes the following recommendations consistent with APRA's principles-based prudential regime:

- ***Date-based calls*** – Remove the condition that a date-based call must be set at a date no earlier than the projected 10 per cent clean-up point for any funding only securitisation (including master trusts).
- ***Master trusts*** – Remove the prohibition of early amortisation triggers in master trusts.
- ***Tranching and conversion*** – Allow funding-only securitisations to have multiple tranches of subordinated notes and allow ADIs to convert funding-only securitisations to capital relief securitisations.
- ***Self-securitisation*** – Grandfather existing self-securitisations using APRA's existing prudential requirements.
- ***Warehouse arrangements*** – Remove the one-year refinance requirement and the prohibition on clean-up calls. Capital relief should no longer be permitted unless specific conditions are met.
- ***Skin in the game requirements*** – Align skin in the game requirements to the approach adopted by the European Banking Authority (**EBA**) and allow for a range of avenues to meet the skin in the game requirements. The ABA notes that there would be disparity in the market if these requirements applied only to ADIs.
- ***Capital relief securitisations*** – Provide further clarity in a number of areas. Importantly, a risk-sensitive approach should be adopted and the skin in the game requirements should not limit the amount of capital relief that an ADI can achieve.
- ***Capital requirements for non-senior notes*** – Reconsider the deduction of all subordinated notes from Common Equity Tier 1 (**CET1**) capital.
- ***Synthetic securitisation*** – Reconsider the application of a blanket rule prohibiting capital relief when using synthetic securitisation. The ABA welcomes further discussion on how APRA can enable ADIs to use such structures for valid purposes and within limitations.
- ***Resecuritisations*** – Reconsider the scope and capital requirements for resecuritisations in order to align with the BCBS.
- ***Trust-back arrangements*** – Remove the 100% risk-weight requirement on exposures that are covered by trust-back arrangements and not subject to a second mortgage.
- ***Asset Backed Securities (ABS)*** – Clarify any implied limitations on non-residential mortgage-backed security (**non-RMBS**) structures.

The remainder of this submission provides further detail supporting these recommendations. Section 2 sets out our general remarks on the importance of the securitisation market in Australia and, in this context, our high-level views on the importance of maintaining a principles-based prudential framework for securitisation. Section 3 sets out the ABA's views on areas for further consideration, including concerns with specific proposals and areas requiring further clarification.

2. General comments on the Discussion Paper

2.1. Importance of the securitisation market in Australia

The securitisation market is an important part of the Australian financial landscape. It provides long-term funding for a diverse range of financial institutions and companies, promotes competition among lenders, and is an important component to the development of debt capital markets in Australia. Hence, it is critical that the regulatory framework for securitisation in Australia provides a platform that supports growth and investment by domestic and offshore investors.

As APRA is well aware, the funding structure of the Australian banking system has changed markedly since the 2008 financial crisis, with banks having significantly increased the proportion of funding from stable sources (deposits, term wholesale funding and covered bonds). Despite the greater demand for more-stable funding sources, banks have not been able to reliably draw on the maturity-matched funding offered by securitisation. Indeed, banks' reliance on securitisation as a funding source has continued a downward trend from its peak in mid 2007 (see Figures 1 and 2).

Figures 1

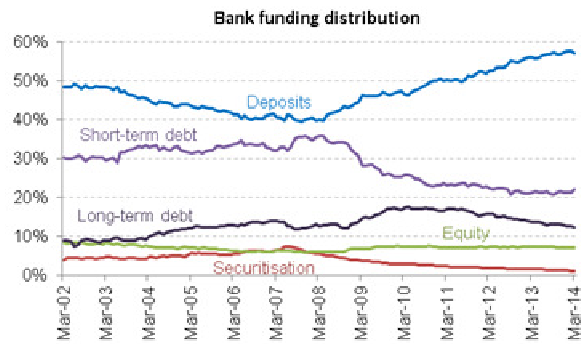
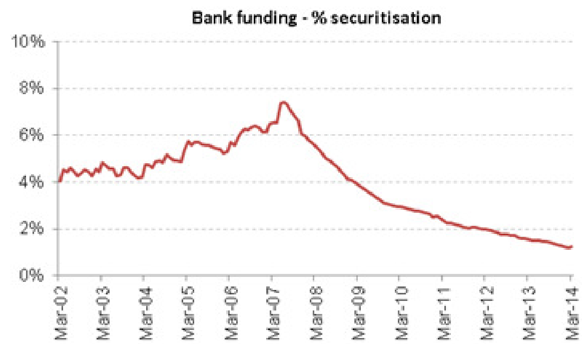


Figure 2



Source: RBA

While the negative impact of the 2008 crisis on global securitisation markets has been the primary factor in the downward trend to mortgage-backed securitisation in Australia, a change in offshore investors' preferences has also affected the recovery. In particular, offshore investors now place greater importance on reducing extension and prepayment risks. This is reflected in the strong upward trend in issuance levels of ABS since 2008, in which the underlying cash-flow generating assets have shorter maturities than is the case for residential mortgages. The shift in demand from offshore investors towards shorter maturities has helped the ABS market to recover quickly, to the point where issuance levels now exceed pre-crisis levels (see Figure 3).

Figure 3

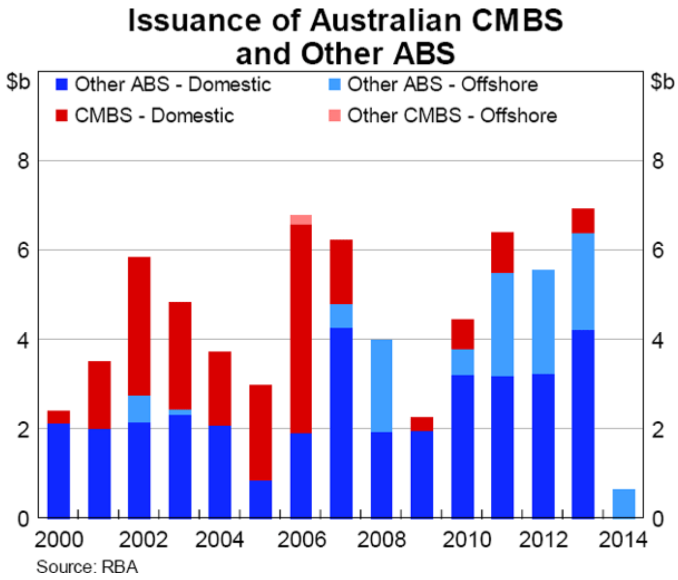
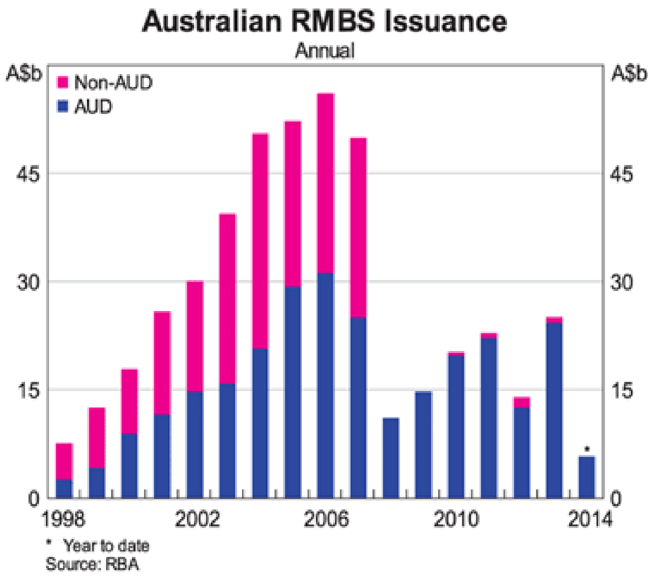


Figure 4



Australian ADIs issuing residential mortgage-backed securities (**RMBS**) however, have not benefited from this offshore demand (see Figure 4). This is in part due to limitations imposed by the existing APS 120; specifically, the current APS 120 prohibits date-based calls and master trusts, both of which are ideally suited to reducing (but not eliminating) extension and prepayment risks for offshore investors.

Re-invigorating offshore demand for securitised assets is important from a policy perspective. Not only would it help address the structural loan-to-deposit gap in the Australian banking system, but it would also help reduce concentration risk associated with the investor base for ADIs. While other sources of funding such as additional deposits, unsecured wholesale funding, and covered bonds also play a role in addressing the funding gap, securitisation has some advantages relative to these other sources. For example, accumulating sizable deposit funding is typically a very time-intensive process. Covered bonds also have limitations, in that regional and smaller ADIs lack the size, necessary credit rating, and geographic diversification to access such sources of funding, while the larger ADIs have onerous compliance requirements (such as dynamic obligations, higher collateral requirements, and the risk of a forced sale of assets). Importantly, securitisation provides non-recourse term funding, while allowing access to an expanded investor base and reduced investor concentration risk.

2.2. Offshore developments to support securitisation markets

Since the release of APRA's Discussion Paper, there have been a number of offshore developments to support securitisation markets. For example, the European Central Bank (**ECB**) has recently highlighted that the ABS sector can play a role in price stability, financial stability, and the stability of central bank balance sheets.[1] Accordingly, both the ECB and the Bank of England (**BOE**) have initiated efforts to revive the securitisation market to facilitate funding through public placements of ABS.[2] These efforts

[1] Mercsh, Y., *Next steps for European securitisation markets*, Address to the IMN Global ABS Conference, 11 June 2014.
[2] European Central Bank and Bank of England, *The Impaired EU Securitisation Market: Causes, Roadblocks and How to Deal With Them*, April 2014.

have focused on developing high-level principles relating to securitisation, standardisation of information disclosures, enhanced transparency of credit ratings, and design of ancillary facilities.[3]

In line with these offshore developments, the ABA encourages APRA to draw on the lessons from international experience to revive the Australian securitisation market. We encourage APRA to consider the guidelines developed by the BOE and ECB as ways of avoiding unnecessarily prescriptive rules on the structure of funding-only securitisations. This would assist Australian ADIs to develop structures that suit investors' risk appetite and preferences and, in so doing, attract an expanded funding base in terms of maturity, investor type, and currency. Such an outcome would allow APRA and ABA to achieve the common objective of creating a deep and liquid securitisation market for Australian ADIs and assist in developing a more resilient Australian financial system.

2.3. Implications for the revised APS 120

Against this background, the ABA welcomes the direction taken by APRA to apply a principles-based approach to the prudential requirements for securitisation and to allow for greater flexibility in how securitisations are structured (such as the use of revolving or master trust structures). While we support these initiatives, there are several areas in the current proposals that appear to be contrary to the intended shift towards a principles-based prudential regime. In addition, certain aspects of the proposals unintentionally create disparity across ADIs, as well as between ADIs and non-ADIs.

The ABA would prefer APRA to adopt a principles-based approach with respect to funding-only securitisations, warehousing, and synthetic securitisations, instead of the proposed prescriptive rules. As currently drafted, the proposals would unnecessarily restrict growth in the securitisation market and would not achieve APRA's stated goal of increasing liquidity and demand for securitisation. Indeed, the APRA proposals risk reducing liquidity and demand at a time when greater use of securitisation, for both large and smaller ADIs, should be promoted. The case for promoting, rather than restricting, securitisation arises from its role as an alternative funding source, its importance in risk management, and its use generating liquidity to the banking system.

The ABA notes a number of the proposals in the Discussion Paper are not only inconsistent with APRA's principles-based prudential regime, but also are inconsistent with the approach taken by the BCBS and offshore jurisdictions.[4] The ABA understands that these proposals are driven by a number of APRA's concerns relating to securitisation structures in place prior to the GFC. These structures, however, existed offshore and were not prevalent in Australia. The ABA sees no compelling reason why originating ADIs should be penalised for practices in which neither they, nor the wider Australian market, engaged.

The ABA is of the view that APRA should, where possible (respecting APRA's mission to protect Australian depositors), seek to align its securitisation framework with those frameworks adopted offshore. This alignment is essential in ensuring that Australian ADIs are not placed at a competitive

[3] European Central Bank and Bank of England, *The case for a better functioning securitisation market in the European Union*, May 2014.

[4] Specifically, these relate to date-based calls, early amortisation triggers, credit risk retention (skin in the game requirement), the capital treatment for non-senior securitisation exposures, rules applicable to warehouse arrangements and the use of credit derivatives/synthetic securitisations.

disadvantage relative to offshore competitors in terms of attracting investors, enhancing the liquidity of the market, and mitigating risk. In particular, the proposed conditions on date-based calls and the prohibition of early amortisation triggers would not provide the desired level of certainty to the market. On the contrary, they would make it difficult for originating ADIs to attract offshore investors, putting them at a disadvantage in global funding markets.

The skin in the game requirements (or risk retention rules) in other jurisdictions have (appropriately) been applied to the entire securitisation market. In contrast, the APRA proposals would be applied to the, arguably, safest and most robust segment of the market (i.e. clean sale securitisations by ADIs of their own assets). APRA's proposed approach may unintentionally create disparity between ADIs and non-ADIs. Similarly, the ABA is concerned with the limited applicability of the proposals relating to warehouse arrangements given that the one-year refinance requirement will not apply to warehouse providers that are foreign ADIs.

3. Areas for further consideration

This section provides detailed comments on the areas of the Discussion Paper that the ABA believes warrant further consideration. As noted above, the ABA's key concerns relate to the need for a principles-based approach to funding-only securitisations, warehousing, and synthetic securitisations, and ensuring consistency between Australian and equivalent offshore regulatory frameworks.

3.1. Approach to funding-only securitisations

As mentioned above, the ABA strongly supports APRA's move to recognise funding-only securitisations in the revised APS 120. The ABA, however, believes that the approach is overly conservative and restrictive. In particular, the restrictions outlined in the Discussion Paper, if implemented in their current form, would mean that ADIs would be unable to create securities that would appeal to offshore investors and unable to establish funding-only master trusts, effectively eliminating the benefits associated with such structures.

The ABA notes that the philosophy underpinning the existing APS 120 is that a securitisation is primarily undertaken for capital relief purposes and is therefore more than a funding mechanism. The ABA believes this philosophy has evolved given post-GFC market dynamics (i.e. a capital scarce environment), with APRA explicitly recognising funding-only securitisations a number of years ago.

In funding-only securitisations (with or without date-based calls), an originating ADI would be subject to the same capital requirements as would apply to the underlying assets if they were held directly on the ADI's balance sheet. ADIs, through their liquidity books, are also investors in RMBS and ABS and hence would also be subject to APRA's capital requirements for these securitisation exposures. Hence, although exposures in the banking system would not be expected to increase, the overall capital in the system (attributable to funding-only securitisations) would increase.

Given these developments, the ABA strongly believes that an ADI should have greater flexibility to structure funding-only securitisations than what is proposed in the Discussion Paper. In turn, this would allow for greater securitisation issuance by ADIs helping to improve their liquidity position and develop a more resilient financial system.

3.1.1 Date-based calls

Through industry discussions, APRA has recognised in its Discussion Paper the benefits of allowing date-based calls. These benefits include reducing (but not eliminating) extension risk, increasing investor participation, improving bond and swap pricing, and building a better-functioning secondary market. The ABA agrees with these observations.

APRA has also balanced these benefits against its concern that date-based calls (earlier than the 10 per cent clean-up point) shift the timing risks on winding down the pool from the investor to the originator. That is, an early exit by investors protects them from absorbing credit losses they might have otherwise incurred if they remained in the securitisation. APRA is also concerned that if an ADI allows its date-based calls to lapse, it could potentially send a negative signal to the note holders of the special purpose vehicle (**SPV**) and to its other debt investors.

Each of these concerns is considered below:

- ***Date-based calls earlier than the 10 per cent clean-up point facilitate an early exit for investors, protecting them from absorbing credit losses had they otherwise remained in the securitisation***[5] – The ABA believes that APRA's concerns relating to a disproportionate amount of losses in the asset pool is predicated on the assumption that an originating ADI will always meet their date-based calls in funding-only securitisations, thus, allowing an early exit to the investors. In order to mitigate this concern it could be possible to have an automatic non-call trigger if there is a material deterioration in the performance of the assets in the securitisation pool. The ABA highlights that investors would have no recourse to the ADI, but the margin paid on the notes would likely increase by a pre-determined amount (reflecting the increase in cost to investors for the extended tenor).

- ***Impact of lapsed date-based calls*** – The ABA understands that APRA is concerned about the potential negative impact of an ADI not meeting its date-based calls. This includes the ability to raise future funding through securitisation and the negative signal to investors in the ADI's other wholesale funding sources including covered bonds and senior unsecured debt. The ABA notes that the rationale behind this concern is based on the assumption that holders of covered bond and senior unsecured securities will respond negatively when an originating ADI allows a date-based call to lapse. These two concerns are unsubstantiated. On one hand, the terms and conditions typically allow for step-up margins when a date-based call is allowed to lapse. Hence, investors are compensated for the extension risk incurred. On the other hand, holders of covered bonds and senior unsecured securities could view the ability to extend the term of funding (i.e. ability of the ADI to allow the date-based call to lapse) as an avenue for the ADI to

5 This would occur particularly in a severe and sustained downturn, where losses extend beyond the junior notes in the structure held by the originating ADI.

remove pressure from its balance sheet.[6] That is, if exercising a call will adversely affect the liquidity and funding position of an ADI, the ADI has the ability to allow the call to lapse.

APRA has proposed a condition that date-based calls are set at a date no earlier than the 10 per cent clean-up point. The ABA recognises that APRA views this condition as a means of transferring risk to investors. The ABA is of the view that the purpose of date-based calls is in fact to reduce prepayment and extension risk, rather than alter the credit risk, for investors. That is, the condition placed on date-based calls would not expose investors to any material additional credit risk. It does, however, expose them to unwanted prepayment and extension risks which, in turn, would limit the available investor base.

Against these views, the ABA recommends APRA remove the condition that date-based calls are set at a date no earlier than the projected 10 per cent clean-up point. Recognising APRA's concern about shifting potential credit risk losses to originating ADIs, the ABA welcomes further discussion with APRA on other workable conditions that may be included in the event there is a material deterioration in the asset pool (e.g. requiring the date-based call to lapse). Overall, the ABA believes that in order for a funding-only securitisation to meet its objective of providing ADIs with an alternate and longer-term source of funding, the use of date-based calls is a necessary evolution in APRA's clean-sale philosophy.

3.1.2 Master trusts

The ABA supports the direction APRA has taken in relation to master trusts. Allowing the use of master trusts will assist in facilitating access to offshore investors. Before discussing particular aspects of APRA's approach to master trusts, the ABA would like to highlight several key characteristics of these structures. We note that the ABA supports the use of simple structures that achieve the required funding objectives in the most efficient manner. We recognise that master trusts structured in offshore jurisdictions have not always conformed to these principles.

- ***Funding-only securitisation*** – The ABA supports APRA's recognition of master trust securitisation as a secured funding source. The ABA acknowledges that capital relief is not available for these structures.

- ***Benefits*** – APRA has recognised that one of the key benefits from using a master trust structure is the ability structure soft bullet securities efficiently. The ability to issue securities with soft-bullet payments allows ADIs to attract a wider offshore and domestic investor base. This assists in increasing an ADIs funding capacity, achieving a more diversified funding base and reducing reliance on short-term and less stable funding. Overall, enabling access to this expanded investor base will lead to ADIs that are more resilient and better prepared for the uncertainties ahead.

- ***Single recourse*** – Securities issued from master trusts are single recourse in nature, that is, investors only have a single recourse to the pool of assets within the trust. This is no different to term securitisations although distinct from covered bonds in which investors have dual recourse (i.e. recourse to the ADI and a secondary recourse to the specified cover pool).

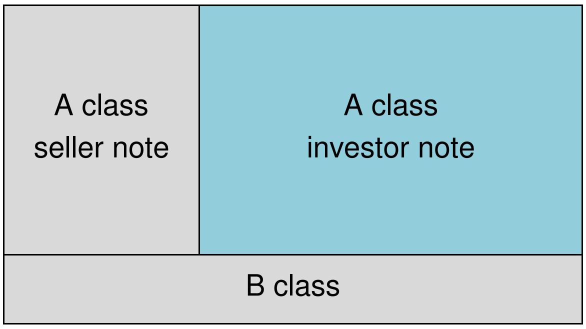
[6] The ABA notes that the securitisation and repo markets are the only two secured sources of funding that allow ADIs to extend the term of funding without necessarily creating a negative signaling effect. The former has the added benefit of providing maturity-matched funding.

- ***Structure*** – Master trusts conform to APRA's preference for a two credit class structure in funding-only securitisations (i.e. a senior and junior tranche).

  The senior tranche is divided into the senior seller share (A class seller note) and the senior investor share (A class investor note) with the two notes structured in proportions as needed (e.g. 30% senior seller share and 70% senior investor share). The two notes rank *pari passu* with respect to the allocation of loses and hence, for credit purposes, are not structurally subordinated to each other in any way.

  There is only one subordinated tranche, that is, the subordinated seller tranche (B class). As is the case with a term securitisation, the B class retains the majority of the credit risk from the pool of underlying assets.

Figure 5 – Master trust structure



- ***Features*** – In order for master trusts to achieve their objectives, date-based calls and early amortisation triggers have become integral and necessary features.

  The effect of a date-based call in a master trust would be to redistribute the proportions of the A class seller note and the A class investor note. The B class is unaffected and still retains the majority of the credit risk. If the date-based call lapses (e.g. post an amortisation event), the structure immediately enters into the amortisation phase (see below).

  Early amortisation triggers terminate the revolving phase of the master trust, after which no new assets can be sold into the structure. The triggers relate to an originating ADI's insolvency or a material deterioration of the asset pool. Effectively, such triggers transform revolving master trusts into a static pool of pass-through securitisation with prepayment and extension risk shifting to the investor. Once the amortisation phase has commenced, all levels of subordination and the proportion between the A class seller note and the A class investor note will remain static. Any credit losses to the A class notes from this point are allocated *pari passu* on this proportion.

  Overall, the combined features of date-based calls and early amortisation triggers allow master trusts to continue to issue securities as part of the revolving phase and to make soft-bullet payments as required by investors. More importantly, these features protect depositors as they reduce the amount of encumbrance required to structure soft bullet securities and they also prevent an ADI from adding new performing assets to the securitisation pool in times of stress.

The ABA recognises that providing greater flexibility in the way master trusts can be structured may raise some potential concerns with APRA. We understand that most of these concerns stem from APRA's observations of prudential weaknesses governing master trusts in offshore jurisdictions. The ABA is of the view that the proposed structure described above addresses these concerns. The corresponding concern is that setting up prescriptive rules will only impede the growth and liquidity in the Australian securitisation market.

In the context of the characteristics described above, the ABA notes that APRA's proposed limitations on date-based calls and early amortisation triggers in master trusts would largely make such structures unworkable. The ABA understands that these limitations have been proposed by APRA based on three key concerns. These are outlined below along with responses to each:

- ***Early amortisation triggers (asset and non-asset) lead to a larger allocation of losses to the senior seller share as the senior investor share is amortised, in effect creating surrogate covered bonds*** – Early amortisation triggers are critical in protecting an ADI from having to continue to replenish a master trust with new assets. Despite the use of amortisation triggers, master trusts are securitisations not covered bonds. As mentioned above, investors have no recourse to the sponsoring ADI. As soon as an amortisation trigger is breached, the master trust essentially becomes one large static pool transaction with all the outstanding notes converting to pass-through securities. At that point, any asset and liability mismatch associated with the presence of soft-bullets and call options will terminate. The asset pool will enter into an amortisation phase which is significantly different to the potential forced sale of assets as may be the case with covered bonds. This serves to reinforce the integrity of the clean sale of assets into the master trust. The mechanics of master trust programs was tested by the failure of Northern Rock and the amortisation of its Granite Master Trust Program.[7] This allowed the Granite program to be entirely excised from the bank resolution process which was not the case for the Northern Rock covered bond program.

- ***Date-based calls outside the 10 per cent clean-up point provides an extra line of support from the seller (i.e. access to the assets in the pool and support from the originating ADI through a liquidity facility which are characteristics similar to those of covered bonds)*** – The ABA disagrees with APRA's comments on the potential similarities between master trusts and covered bonds. The ABA emphasises the clear distinction between, on the one hand, an ADI missing a discretionary call on a soft-bullet RMBS and, on the other hand, failing to repay a senior unsecured or covered bond on its maturity date. The former is explicitly permitted under the terms and conditions of the security, whereas the latter represents an event of default (and likely to be associated with the failure of the ADI).

[7] For example, Northern Rock's Granite Master Trust Program had multiple series of soft-bullet RMBS outstanding which converted to pass-through securities and extended when the program breached a Non-Asset Trigger in November 2008. Despite this extension, no investors in any Granite bonds (senior and mezzanine), which were investment grade rated on issuance, have suffered any credit losses.

Under APRA's proposed restriction on date-based calls, an originating ADI would need to have a substantially larger pool of assets in the securitisation so that enough cash is generated to fund a soft-bullet payment without bringing assets back on its balance sheet. Hence restricting date-based calls would lead to an increase in the amount of assets encumbered and away from the reach of depositors.[8] Alternatively, an originating ADI could simply repurchase the required amount of securities from note holders of the master trust. The securities can then be used to generate the funds required (e.g. through the use of a repurchase agreement) in order to fund the soft-bullet payment. The ABA understands that these scenarios are not the preferred approaches, either from the standpoint of APRA or the originating ADI. In contrast, by allowing the originating ADI to incorporate a date-based call (outside the 10 per cent clean up point), the amount of assets that would be encumbered would be substantially lower.

- ***The potential pressures on an originating ADI's liquidity or funding position as a result of meeting date-based calls*** – Regarding liquidity and funding concerns, the ABA believes that the proposed conservative assumptions in an ADI's LCR calculations (and NSFR in due course) adequately model the risks to an ADI's cash flow or funding position as a result of date-based calls. Provided an ADI holds the required amount of liquid assets against the outflows associated with a call (as per APS 210), the ABA is of the view that any liquidity and funding pressures would be substantially mitigated.

In assessing the concerns above, the ABA would like to highlight a key benefit of master trusts when compared to covered bonds, – namely, a default on a covered bond would trigger a forced sale of assets, whereas default in relation to a master trust would trigger amortisation, thereby preventing any cascading effect on performing loans.

In light of the above issues, the ABA recommends removing the current level of prescription embedded in the prudential framework for master trusts (and other funding-only securitisation) structures. More specifically, the ABA recommends removing restrictions on the use of date-based calls (as per the recommendation in Section 3.1.1) and removing the prohibition of early amortisation triggers in master trusts. We note that the BCBS (in line with other offshore regulators) allows date-based calls and amortisation triggers in funding-only securitisations.

The ABA recognises that the risks associated with master trusts will need to be managed. In particular, liquidity risk and overcollateralisation associated with meeting date-based calls and early amortisation will need to have appropriate liquidity backing. The ABA notes that APRA's Discussion Paper has not recognised how an originating ADI would provide subordination to a master trust structure independent of the A class seller note (i.e. through the B class). The ABA believes these aspects will require further discussion and consultation with APRA over the coming consultation period.

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[8] Although this will depend on the conditional prepayment rate (CPR) of each master trust program, it is estimated that the seller share needs to be in the order of 40 to 50% to fund date-based calls without breaching the 10 per cent clean-up point condition.

3.1.3 Prepayment and extension risk

APRA views its proposed restrictions on date-based calls and early amortisation triggers as a means of transferring risk to the investors. The ABA notes that, in instances where a currency swap is in place, the extension and prepayment risks will also be transferred to the ADI providing the swap. In practice, one of the major banks (through their trading books) would typically be providing the required swaps.

Major Australian banks have the necessary credit rating needed to provide cross-currency swaps to their own securitisation programs. As swap providers, they charge for the risk arising from the uncertain timing of payments. The more uncertainty involved, the higher the cost of the swap will be. Uncertainty in timing of payments may arise via prepayment or extension risk. While APRA's objective appears to be to encourage an increase in securitisation issuance, the prepayment and extension risks involved will have the opposite effect.

Prepayment and some level of extension risk can be competently managed in trading books by including mitigants, such as margin step-ups or capped margin resets, and by risk-monitoring through ongoing stress testing and active hedging. Substantial extension risk, however, as is likely to arise without date-based calls and early amortisation triggers, cannot be addressed in the same manner.

If an issuing ADI is its own swap provider, the liquidity risk that the issuing ADI's treasury division would otherwise have had (e.g. through the call option) would be transformed to a re-hedging risk in the issuing ADI's trading book. There would be no clean transfer of liquidity risk from the issuing ADI to investors. Instead, this risk would be transferred to the ADIs trading book. It is not clear whether this was APRA's intention. Arguably treasury departments of ADIs should be better able than their trading desks to manage liquidity risk (via holding repo-eligible high-quality liquid assets (**HQLA**)).

The ABA is concerned that APRA may not have fully contemplated the potential interaction of the proposed structural restrictions on master trusts with the BCBS's Fundamental Review of the Trading Book (**FRTB**). The FRTB will make extension risk more expensive for banks to warehouse in their trading books, which will lead to a compounding effect. This includes the increase in extension risk generated by APS 120 (if implemented as proposed by APRA) and an increase in the capital requirements held against that extension risk (as per the FRTB). The combined cost could well make currency swaps for securitisation master trusts prohibitive.

Allowing date-based calls and early amortisation triggers would result in a very substantial reduction in swap provider extension risk (and consequently the cost of providing the swaps). Therefore, these features should be considered as having merit from both a macro-prudential risk perspective, as well as, facilitating efficient cross-border securitisation issuance by Australian ADIs.

3.1.4 Tranching and conversion

The fundamental tenet of securitisation tranching is to facilitate redistribution of risk to investors with varying risk-return profiles. The ABA highlights the proposed prohibition against having more than one B tranche in a funding-only securitisation and the requirement to elect upfront whether a securitisation is funding-only or capital relief. The ABA understands these two requirements are driven by APRA's preference for simplicity and transparency in securitisations. Nevertheless, the requirements will negatively impact the amount of funding able to be raised through the use of securitisation. The ABA notes that there is investor appetite across various non-senior tranches, and that level of appetite may not be completely apparent at the time of the initial issue. By restricting the number of tranches, an ADI would not have access to the broad range of investors the market has to offer.

The restrictions would also lead to ADIs having to commit resources in order to restructure existing self-securitisations for no real benefit. ADIs would also be incentivised into nominating securitisations as capital relief (at least initially) to allow for maximum flexibility in structuring the transaction. Overall, the ABA is of the view that these limitations would contribute to impeding the growth of the securitisation market as an alternative funding source for ADIs.

The ABA recommends that APRA afford greater flexibility to structuring funding-only securitisations. More specifically, it recommends allowing for more than a single B tranche in funding-only securitisations. The ABA also recommends allowing conversion of a funding-only securitisation into a capital relief securitisation after inception, provided any significant credit risk transfer requirements are met.

3.1.5 Self-securitisations

APRA's proposal to capture self-securitisations within the definition of funding-only securitisation is likely to create unnecessary changes to transaction structures. Self-securitisations are used as a source of contingent liquidity and to assist in providing collateral against the Committed Liquidity Facility (**CLF**) provided by the Reserve Bank of Australia (**RBA**). The associated securities are held by the treasury departments of ADIs and there is no active secondary market. The only external party (apart from the originating ADI) that could potentially hold these securities is the RBA.

As discussed above, APRA has expressed concerns relating to the transfer of risk and has proposed limitations and restrictions on funding-only transactions. These limitations would also apply to self-securitisations which represent substantial components of an ADI's balance sheet. To the extent these limitations are not relaxed, this would constrain the capacity of an ADI to manage liquidity risk through the use of self-securitisation.

Against this discussion, the ABA recommends APRA grandfathering all existing self-securitisations (including top-ups to, and repurchases from, self-securitisations) using APRA's existing prudential requirements. An alternate view, favoured by one member bank, is that the new standard should specifically contemplate how self-securitisations operate in preference to putting grandfathering arrangements in place.

3.2. Warehouse arrangements

APRA has recognised in its Discussion Paper that warehouse arrangements can provide efficient access to capital markets for ADIs leading to a greater diversity of funding and at lower cost. The ABA welcomes and agrees with this view. In formulating its prudential framework for warehouse arrangements, APRA has proposed specific requirements and restrictions based on various working assumptions and concerns as to how warehouse arrangements are structured. We explore each of these below:

- ***Term-matched funding*** – APRA appears to have built its framework on the basis that warehouse arrangements work on the underlying premise that the term of funding does not match the term of the underlying assets. In practice, many warehouse arrangements are structured to enable the relevant terms to match. Put simply, these types of arrangements should be considered another form of term securitisation which are privately placed (facilitating the aggregation of assets) before the funding can be refinanced in capital markets. In a tranched warehouse arrangement, the ADI warehouse provider would hold the senior notes and the junior notes would either be retained by the originating ADI or sold to third-party investors. It is important to note that an ADI warehouse provider will not provide funding through the senior notes until the junior notes are legally held by the originating ADI or third parties, that is, at no time would a warehouse provider be exposed to, or underwrite, the subordinated tranche.

  The ABA is of the view APRA should base its framework for warehouse arrangements on their substantive form rather than their purpose. In keeping with this principle, where the term of funding matches the term of the underlying assets, APRA should apply the same principles and requirements to that of a term securitisation. It follows that any specific requirements applying to warehouse arrangements should only apply to arrangements that involve asset and liability mismatches.

- ***Capital leakage*** – One of the concerns APRA has expressed in the Discussion Paper is that lower capital may be held in the banking system for warehouse arrangements given the concessional treatment allowed by APRA. While this was true to some extent prior to the GFC, the majority of post-GFC warehouse arrangements are markedly different. More specifically, the advent of tranched warehouse arrangements leads to the ADI warehouse provider holding the senior notes, with the junior notes either retained by the sponsor (originating ADI) or sold to a third-party investor. Given advent of tranched warehouse arrangements, the overall capital across ADIs would increase. This increase becomes more pronounced for funding-only warehouse arrangements. In instances where capital relief is sought, the ABA is of the view that appropriate incentives to term fund should be included within APRA's securitisation framework.

- ***Rollover/refinance risk*** – APRA has indicated that warehouse funding providers are exposed to the rollover/refinance risk should a term issue not occur prior to the notional expiry of the warehouse. For warehouse arrangements in which the term of funding matches the term of the underlying assets, the ABA is of the view that any rollover/refinance risk would be limited. If the terms are not matched, any liquidity risk borne by the originating ADI would be addressed through APS 210 given that liquidity requirements must be modelled based on the earliest funding date. Further to this, funding plans of ADIs reflect consideration of the relevant rollover/refinance risk associated with warehouse arrangements, as is the case with other funding arrangements.

- ***Revolving period*** – While not acknowledged in the Discussion Paper, the majority of warehouse arrangements are structured to include a revolving phase, similar to that of a master trust structure. At the end of the revolving phase, the originating ADI can term fund the assets within the warehouse through a public term securitisation. Should this not be possible, the warehouse would enter into an amortisation phase. Likewise, if at any time during the revolving phase the originating ADI and the warehouse provider cannot agree on terms for the next revolving period (e.g. terms relating to excess spread), the warehouse arrangement would also enter into an amortisation phase. The terms and duration of the amortisation are pre-agreed at the inception of the warehouse agreement and cannot be changed during the revolving phase.

Against these characteristics, and based on the principle of substance over form, the ABA is of the view that capital relief for an originating ADI using a warehouse arrangement should only be permitted, where the following criteria are satisfied:

- The term of funding at least matches the term of the underlying assets (i.e. the structure is term match funded and essentially a term securitisation);
- The B class notes are sold to unrelated third parties (i.e. the ADI satisfies any significant credit risk transfer requirements); and
- The revolving phase of the warehouse arrangement has ended (i.e. new assets cannot be sold into the warehouse and the pool remains static over the remaining term). This aligns with APRA's proposals for master trusts, which include a revolving period and are limited to funding-only transactions.

The ABA would like to comment on two further important aspects included in the Discussion Paper, namely, the one threshold and the prohibition of clean-up calls. The ABA believes that such prescriptive rules and limitations are not only inconsistent with a principles-based regime, but also are inconsistent with the proposed securitisation framework of the BCBS.

- ***One year threshold*** – APRA has proposed that a warehouse provider hold capital against assets in the warehouse that have not been transferred to a term securitisation within one year (in accordance with APS 112 or APS 113 as appropriate). This threshold represents a departure from APRA's stated objective of moving towards a principles-based regime for securitisation. While the ABA recognises APRA's view that warehouse SPVs are largely intended to be temporary arrangements, the ABA believes that principles-based requirements, such as sound funding, liquidity and capital backing, are more appropriate than applying a one-year threshold.

  We understand that APRA's primary reason in proposing a one-year threshold is to limit any capital leakage from the banking system due to capital relief warehouse arrangements that are not temporary in nature. As noted above, for funding-only warehouse arrangements, no such capital leakage will occur. For capital relief warehouse arrangements, the ABA has proposed to limit the application of any such capital relief to the criteria specified above.

  The one-year threshold may also have some unintended consequences. For example, originating ADIs and non-ADI mortgage originators may bypass domestic funding ADI warehouse providers. That is, they could use foreign ADI warehouse providers operating in Australia which do not have the same one-year threshold applied to them.

The ABA recommends that APRA remove the one-year threshold from the proposed securitisation framework. The imposition of any such threshold would materially impact the provision of warehouse arrangements by ADIs, with the effect of significantly limiting the use of warehouses as a source of funding for many ADIs and non-ADIs.

- ***Clean-up calls*** – APRA has indicated that, for warehouse arrangements, it "would not normally envisage a role for clean-up calls". The ABA is of the view that there is a valid and important role for clean-up calls in warehouse arrangements. Clean up calls are simply used to remove residual loans that are unable to be refinanced in a term securitisation[9] and to subsequently terminate the warehouse. This includes the use of a clean-up call at the end of the amortisation phase of a warehouse arrangement. APRA's approach would also be inconsistent with the BCBS's revised framework for securitisation. More specifically, the BCBS allows for clean-up calls where securitisation transactions are not seeking capital relief.[10]

  The ABA recommends that APRA reconsider its position on the use of clean-up calls in warehouse arrangements.

3.3. Skin in the game requirement

As noted in Section 2, APRA's skin in the game requirement is inconsistent with those adopted in offshore jurisdictions. The ABA understands that APRA has examined skin in the game requirements in other jurisdictions and has chosen an approach that is significantly different. APRA considers its approach to be simpler and more transparent than those adopted offshore. The ABA acknowledges these objectives, although it highlights that, in practice, an originating ADI will have to satisfy both APS 120 and requirements from offshore regimes. Hence, it would be placed at a competitive disadvantage.

The European Banking Authority (**EBA**) requires maintenance, on an ongoing basis, of a material net economic interest of no less than 5% of nominal value of the transaction.[11] The retained interest can be met through a range of options including:[12]

- pro rata retention in each of the tranches sold or transferred to investors;
- retention of the originator's interest for revolving exposures;
- retention of randomly selected exposures;
- retention of the first loss tranche; or
- retention of a first loss in every securitised exposure.

[9] The situation of residual loans being in a warehouse may occur for a variety of reasons. For example, an originator may have multiple warehouses for commercial reasons and may decide to aggregate loans in those warehouses for the purpose of terming out; or there may be insufficient volume originated for a deal and/or market conditions have changed.

[10] Refer to para 28 and 29 in Section IV, *Revisions to the Basel Securitisation Framework - Consultative Document*, December 2013.

[11] The net economic interest includes retained positions, interest or exposures that equates to 5% of the nominal value of the transaction, but shall not be subject to any credit risk mitigation or any short positions or any other hedge and shall not be sold. The net economic interest is determined by the notional value for off-balance sheet items. See Article 405 of Regulation (EU) No 575/2013.

[12] European Banking Authority (EBA), *Consultation on draft Technical Standards on securitisation retention rules,* Consultation Paper, EBA/CP/2013/14.

The ABA notes that a similar approach has been adopted under the Dodd-Frank Act in the United States. Some ADIs in Australia have already adopted structures that meet the ECB/Dodd-Frank Act requirements. Adopting a significantly different requirement in Australia may result in an otherwise transferrable risk being retained in the Australian banking system.

Consistent with its preference for simplicity and transparency, APRA has proposed not to recognise other arrangements, such as a representative sample, as meeting credit risk retention. This is due to APRA's view that there would be added complexities associated with monitoring the randomisation process and any relevant disclosures. The ABA disagrees with this view. There are a number of ADIs who currently adopt a representative sample to meet offshore requirements. In many instances securitisation SPV managers are required to provide monthly reports on performance of the asset pool. Hence, providing a report on the performance of a randomly selected pool would not be difficult nor considered an added complexity.

Moreover, the ABA is concerned that the proposed skin in the game requirement has been linked to a particular class of notes, that is, the subordinate or junior notes. The ABA is of the view that any skin in the game requirements should not be linked to the credit risk associated with a specific class of notes, as this implicitly links the requirement to the external rating criteria for those notes. Similarly, the ABA is also concerned that the proposed requirement to retain 20% of the subordinated or class B securities may limit the amount of capital relief that smaller ADIs could obtain, especially given their use of securitisation as an alternative source of capital.

The ABA understands that APRA's regulatory perimeter (and hence the scope of APS 120) does not include non-ADI originators. The ABA highlights that limiting the applicability of skin in the game requirements to ADIs will create unnecessary disparity between ADIs and non-ADIs that primarily rely on securitisation as a source of funding. Most jurisdictions have applied skin in the game requirements to all securitisation issuers (both banks and non-banks) and hence the proposed disparity in Australia would be at odds with global practice. An approach that is not universally co-ordinated and applied could lead to agency risk concerns arising in the shadow banking sector (particularly, in a low credit growth environment). The ABA highlights that any such agency risk concerns could impact ADIs both directly, through warehouse arrangements, and indirectly, through ancillary services provided by ADIs.

Against these concerns, the ABA recommends that APRA align its skin in the game requirements to the EBA regime. Consistent with the EBA regime, the ABA recommends that an originating ADI should have a range of avenues (including the representative sample arrangements) to meet the skin in the game requirements.

3.4. Capital relief securitisations

The ABA notes that APRA has proposed two possible approaches (significant credit risk transfer approach and *pro rata* approach) for originating ADIs to obtain capital relief using securitisation. The ABA welcomes these proposals although, in order to appropriately assess the merits of each approach, greater clarity is needed in a number of areas. In the sections below, we provide comments on each of the approaches (along with two alternatives to consider), followed by a list of recommendations.

3.4.1 Significant credit risk transfer approach

Under the significant credit risk transfer approach, the issuer is required to determine, using its own judgement (via a self-assessment process), whether it has transferred "significant credit risk" associated with the assets assigned to an SPV. The ABA requests further clarification as to whether a capital tiering structure would apply, given the required judgement for significant credit risk transfer. The ABA notes that such judgement would not likely be binary and hence a binary capital outcome of 80% capital relief or no capital relief seems inappropriate.

The Discussion Paper has not considered the interplay between the approach to significant credit risk transfer and the proposed skin in the game requirements. The 20% retention of subordinated or B class securities would result in exposing the originating ADI to a material amount of credit risk. The ABA also notes that APRA's proposed skin in the requirements would make an assessment of significant credit risk transfer under APS 113 unnecessarily complex. The ABA is of the view that any skin in the game requirement should be in isolation of significant credit risk transfer. Such an approach is adopted by the Prudential Regulatory Authority (**PRA**) in the UK, that is, the PRA expects that securitisation instruments used to transfer credit risk do not contain provisions that materially limit the amount of risk transferred.[13]

The ABA would like to propose two alternative approaches to achieving significant credit risk transfer for APRA's consideration:

1. The approach adopted by the PRA/EBA, which is built on the principle of substance over form.[14] The approach not only allows significant credit risk transfer through self-assessment, but also recognises significant credit risk transfer in following instances:

    - Where there is a proportional sell down of mezzanine exposures, subject to certain criteria; or

    - Where there are no mezzanine exposures, significant credit risk transfer is achieved provided the originator does not hold more than 20% of the junior notes.

    The EBA has recently released guidelines to provide more guidance on the assessment of the significant credit risk transfer.[15]

2. An approach based on the principle of capital neutrality (i.e. once a pool of assets has been securitised, the sum of the capital held post-securitisation should not be materially greater or less than the capital held before securitisation).[16]

    The approach would require an originating ADI to calculate the capital requirement of the underlying assets as if those assets remained on the ADI's balance sheet. The ADI would then compare this requirement to the risk it has retained through its exposure to the subordinated securities.

13 Refer to paragraph 2.5, PRA, *Supervisory Statement SS9/13 – Securitisation*, December 2013.
14 Refer to Article 243, *Regulation 575/2013 of the European Parliament and of the Council*, 26 June 2013
15 Refer to *Guidelines on Significant Credit Risk Transfer relating to Articles 243 and Article 244 of Regulation 575/2013*, 7 July 2014
16 It does not however, address the interplay between skin in the game requirements and capital relief discussed in Section 3.4.1.

By way of an example, assume an originating ADI is required to hold capital equivalent to 3.5% prior to the securitisation (i.e. assuming a risk weight of 35% for residential mortgages under the standardised approach and a capital ratio of 10%). Post-securitisation the originating ADI would calculate the thickness of each tranche (assume 2% of B2 notes as the most subordinated tranche, 6% of B1 notes, and 92% of A notes). The ADI would then allocate capital notionally to each tranche. Under the example, the B2 notes get the first 2% of capital and the B1 notes get the remaining 1.5% of capital.

Once the transaction is complete, the originating ADI would hold capital for the retained tranches on the basis of this allocation. Thus, assuming the originating ADI retains 50% of the B2 notes and 30% of B1 notes, then it would be required to hold capital of 1.45%, rather than 3.5% (before securitisation) and 1.75% (under proposed *pro rata* approach).[17]

3.4.2 Pro rata approach

The alternative *pro rata* approach provides for a reduction in capital requirements to the extent that an originating ADI can sell the B class securities to third parties. In other words, an originating ADI would only gain capital relief against the smallest proportional sell-down of any of the sub-classes of subordinated securities.

The ABA considers the mechanics of this approach to be relatively blunt and conservative. That is, while the *pro rata* approach introduces a tiered structure, it appears to limit the potential capital benefit to less than 80% in securitisations with multiple sub-classes of subordinated (or class B) securities. Borrowing the example from the Discussion Paper (where an originating ADI only obtains 30% capital relief), despite selling 50% or more in proportional value of B1 and B2 notes, it appears that an originating ADI would never be able to achieve the maximum reduction unless it sells 80% of its exposures in *all* subordinate notes. In short, the approach proposed by APRA discourages ADIs from selling class B notes.

The ABA highlights that the key limitation of the *pro rata* approach is that it does not take into account the size of the tranches being sold. Hence, regardless of the amount of non-senior notes sold, if one tranche is retained (irrespective of its size) no capital relief is achieved, even though a significant amount of the credit risk may have been transferred.

3.4.3 Recommendations

Against the limitations of the approaches outlined in the Discussion Paper, the ABA makes the following recommendations and comments:

- The ABA recommends the implementation of a skin in the game requirement that is in isolation and consistent with the principle of significant credit risk transfer. The ABA also recommends that APRA provide guidelines governing how an ADI achieves significant credit risk transfer.

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[17] The calculations are as follows: 1) Under the alternative approach the capital for originating ADI: (0.5 x 2%) + (0.30 x 1.5%) = 1.45% 2) Under the proposed *pro rata* approach the capital for originating ADI: (3.5% x MAX(retention B1 note, retention B2 note)) = 1.75%.

- The ABA requests the opportunity to provide further comments on the significant credit risk transfer approach once APRA has considered how the approach would be allowed to operate in practice and its interaction with any skin in the game requirements.
- The ABA recommends that APRA consider the alternative approaches presented in Section 3.4.1, which better align capital requirements with the credit risk retained through subordinated tranches.
- Even though the ABA has requested further clarity and guidance on the significant credit risk transfer approach, the ABA highlights that it supports this approach over the proposed pro rata approach. The strong, but not unanimous view, of ABA members is that the *pro rata* approach, as it stands, is not a credit risk-sensitive measure given the limitations discussed in Section 3.4.2. The dissenting view was that further information was required before this opposition could be expressed.

3.5. Capital requirements for non-senior notes from any issuer

APRA is proposing that any holding of subordinated securities by an ADI would result in a one-for-one deduction from CET1 capital. The ABA acknowledges that non-senior tranches should attract higher risk-weights by their nature (as per the capital requirements of the BCBS). This is also currently the case under APS 120, where non-senior exposures attract higher risk-weights but do not necessarily require a deduction from CET1 capital.

The ABA is of the view that the proposed CET1 deduction would be unnecessarily punitive and is concerned with the significant misalignment of APRA's proposal with the BCBS's proposed securitisation framework.[18] The additional conservatism is not warranted and the Discussion Paper lacks any justification supporting the significant mis-alignment with BCBS's proposed securitisation framework.

The ABA notes that APRA's conservative approach would have a wider impact on the market given that ADIs may no longer be willing to 'make a market' in these securities. The effects of this would be significant, including increased spreads in the secondary market and reduced liquidity. Any impacts on secondary market transactions would also likely affect pricing in the primary market.

In light of the above issues, the ABA recommends that APRA reconsider its position. The ABA does not support the proposed CET1 deduction. The ABA requests that APRA consider all the associated investor-related issues and requirements (including capital requirements) in its second consultation paper.

3.6. Credit derivatives and synthetic securitisation

The use of credit derivatives in a prudent and controlled manner is an important tool that ADIs have available to manage credit risks on wholesale exposures. In this context, credit derivatives can also be an effective tool to manage an ADI's loan portfolio, releasing capital where appropriate and supporting additional lending to the real economy. The appropriate and controlled use of credit derivatives in securitisation transactions can assist in developing a more efficient and competitive market.

[18] BCBS, *Revisions to the Basel Securitisation Framework - Consultative Document*, December 2013.

The ABA is of the view that the revised APS 120 should allow for the use of credit derivatives in capital relief securitisations, where there is a valid reason for transferring the risk synthetically. The ABA recognises that some synthetic securitisations can be highly complex, and credit derivatives have been used in the past to synthetically create additional leverage in the absence of any underlying balance sheet assets.

The ABA highlights that some corporate, project finance, or small and medium enterprise (**SME**) loan securitisation structures can only be achieved if done synthetically. A key reason for this constraint is that the underlying loan contracts do not allow the loans to be assigned to an SPV, which impacts on the originating ADI's ability to affect a clean sale of the relevant assets.

The ABA would like to highlight other second-order concerns with APRA's proposed approach:

- As reflected by the credit risk mitigation (**CRM**) rules in APS 112 and APS 113, credit derivatives are recognised as a robust and well-tested means of risk transfer. The ABA is of the view that it would be inconsistent for APRA to allow guarantees or credit derivatives to mitigate credit risk outside of securitisation transactions, while at the same time completely prohibiting their use for securitisation purposes. This would also unduly limit the ability of originating ADIs to use synthetic securitisations as a capital and risk management tool.

- The BCBS has not proposed any blanket restrictions on the use of synthetic securitisations. APRA's proposal would place Australian ADIs at a clear disadvantage to their offshore peers which have these tools available to them. The ABA is of the view that it is reasonable to allow Australian ADIs to utilise the same tools as offshore peers in a prudent and controlled manner for the transfer of risks and the associated relief of capital.

The ABA recommends that APRA reconsider the application of a blanket rule prohibiting capital relief when using synthetic securitisation. The benefits of such transactions have not been acknowledged or considered as part of APRA's Discussion Paper. The ABA welcomes further discussion on how APRA can enable ADIs to use such structures for valid purposes and within appropriate limitations. The ABA recognises that a case-by-case review and approval by APRA is one alternative that may be considered. To assist with such an alternative, the ABA suggests that APRA provide guidelines for synthetic securitisations to limit speculative activities and mitigate any prudential concerns.

3.7. Resecuritisations

The ABA recognises APRA's concerns regarding the potential complexity of resecuritisation transactions and APRA's decision to require resecuritisations to be deducted from CET1 capital. In applying its requirements for resecuritisation, APRA has taken a very broad interpretation of what constitutes resecuritisation. The ABA highlights that this broad interpretation is not only inconsistent with the definition, but also with the capital treatment proposed by the BCBS. In particular, the BCBS has recognised that there are instances, where "retranching" would not alter the structure or exposure.[19]

[19] "A resecuritisation exposure is a securitisation exposure in which the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation exposure. In addition, an exposure to one or more resecuritisation exposures is a resecuritisation exposure. Exposures resulting from retranching are not resecuritisation exposures if, after retranching, they act like a direct

The ABA recommends that APRA reconsider the scope and capital requirements for resecuritisation in order to align to the approach proposed by the BCBS. The ABA sees no specific local features or characteristics of the securitisation market that warrant a divergent approach, including in respect of ABCP conduit programmes.

3.8. Trust-back arrangements

The ABA understands APRA's concerns in relation to trust-back arrangements, where an originating ADI retains an interest in collateral assigned to an SPV due to further advances post-securitisation but does not obtain a formal second mortgage. More specifically, APRA is concerned that trustees with obligations to protect investors would not necessarily seek to enforce the collateral to protect an originating ADI's secured exposures that are not part of the securitised pool of mortgages. As a result, APRA intends to maintain its long-standing policy position that a risk-weight of less than 100% can only apply where there is a formal second mortgage in place.

Contrary to APRA's view, the current trust-back arrangements currently provide an effective and robust framework for an ADI to enforce the collateral for all secured loans. Notwithstanding APRA's concerns, the ABA notes that securitisation programmes are now structured so as to afford protections to originating ADIs. The effect of these protections are equivalent to those of formal second mortgages (even though a formal second mortgage from the borrower may not formally be in place).

The ABA also notes the fiduciary obligations existing under typical securitisation and trust-back arrangements. These obligations require the trustee acting in its capacity as trustee of the seller (bare) trust to act in accordance with the directions of the originating ADI with respect to its interests in the collateral in the seller trust. This includes the additional secured exposures of the ADI which are secured by mortgages which remain in the SPV trust. These fiduciary obligations assist in ensuring that an ADI's interest in that collateral is appropriately protected.

Although APRA has focused on formal second mortgages, the ABA notes that such mortgage arrangements would not always provide the additional protection that APRA expects. The ABA highlights the following practical implications of incorporating formal second mortgage arrangements:

- A borrower may simply refuse to accept a formal second mortgage for existing loans. Further to this, borrowers are typically unaware of the sale of some of their loans into a securitisation.
- Loans with second mortgages are typically not permitted for sale into a securitisation. Hence, the majority of assets available for term securitisation and/or covered bonds will not be eligible for secured funding through these mechanisms.
- While second mortgages are not required for self-securitisations, when an ADI uses the self-securitised notes for contingent liquidity purposes and as collateral for CLF purposes (i.e. upon drawdown of the CLF), it will not be practical to implement a second mortgage, given time constraints and the costs involved.

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tranching of a pool with no securitised assets. BCBS, *Revisions to the Basel Securitisation Framework - Consultative Document*, December 2013.

The ABA is of the view that the 100% risk weight requirement on secured exposures outside the securitisation would disincentivise ADIs to securitise any eligible loans that are covered by trust-back arrangements. The implications of this disincentive include:

- If the loans are not securitised, the loan pool available for securitisations (including self-securitisations) would significantly be reduced, which would ultimately increase an ADI's reliance on the CLF.
- If the loans are securitised, this would result in a more penal capital impact for the loans covered by trust-back arrangements and therefore result in higher overall capital charges for a funding-only securitisation (when compared to pre-securitisation), despite the protections provided by the trust back arrangements.

The ABA recommends that APRA reconsider its long-standing policy position and remove the 100% risk-weight requirement on exposures that are covered by trust-back arrangements.

3.9. Asset Backed Securities (ABS)

The ABA understands that the focus of APRA's Discussion Paper is on issuer-related behaviour, although it is unclear why APRA has predominantly focused on RMBS securitisation structures. The ABA is concerned that this may imply that ADI's use of ABS (excluding RMBS) should be limited to some extent, notwithstanding the ability of using ABS to allow for maturity-matched funding. The ABA recommends that APRA clarify any implied limitations on non-RMBS structures if this was its intention.

As discussed in Section 2, non-RMBS ABS experienced rapid recovery and have already recorded issuance levels above pre-crisis levels, aided by offshore demand. Not surprisingly, there are a number of non-RMBS structures that have been created for funding purposes with assets originated by non-ADIs. The market for non-RMBS (including ABS, commercial mortgage-backed securities (**CMBS**) and small ticket CMBS) is important to Australia's economy given its significant role in funding non-residential mortgage credit provided to households (e.g. credit cards and personal loans) and businesses (e.g. SME loans and leases).

The ABA also highlights that, in order for the non-RMBS market to continue to grow, smaller ADIs should also be allowed to access the market as an alternative funding source. Given their size and lack of geographic diversification in assets, their ability to access wholesale debt capital markets, including senior unsecured and covered bonds, is constrained.[20]

4. Consultation Process

The ABA welcomes the opportunity to engage with APRA in developing the revised APS 120. The ABA notes APRA's intention to release a second consultation package, which will include a response to submissions on the Discussion Paper and a draft APS 120.

[20] The lower stand-alone rating of regional and smaller ADIs means their covered bond issuance rating would be capped. In other words, their size and risk profile (due to lack of geographic diversification) would cap their covered bond programs' rating at AA, which makes the deal economics unworkable.

Given the Discussion Paper has focused solely on issuer-related behaviour, the ABA is of the view that a second discussion paper is warranted prior to releasing a draft APS 120. The second discussion paper will afford APRA the opportunity to receive further feedback based on outcomes from the BCBS, the FSI, as well as offshore developments relating to investor behaviour. More specifically, we expect APRA to consult on the application of a rating hierarchy and changes to the revised risk-weights. We also expect APRA to have regard to developments such as the proposals by the European Insurance and Occupational Pensions Authority that has introduced capital requirements for securitisation exposures more broadly, that is, for insurance companies.