Reference	:	Treasury/JS
If telephoning, contact	:	James Shaw

15 August 2014

Mr Neil Grummitt
General Manager, Policy Development
Policy, Statistics and International Division
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

Dear Neil,

APRA Discussion Paper: Simplifying the prudential approach to securitisation, 29 April 2014 ("Discussion Paper")

We welcome the opportunity to comment on APRA's Discussion Paper. We support the reforms to the securitisation prudential framework to promote a more active and sustainable securitisation market in Australia, based on a principles-based framework. We believe the Discussion Paper represents a positive step in addressing the lessons learned from the 2008 global financial crisis and removing some of the unnecessary prescription in the existing APS 120. We also recognise 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. This letter sets our comments in relation to some of the key proposals set out in the Discussion Paper.

1.   Date based clean up calls

We note that APRA are proposing to amend APS 120 to allow originating ADIs to set a call date (based on the modelled 10% clean up call) for funding only securitisations but not for capital relief securitisations. We would recommend that this concession also be extended to capital relief securitisations for the same reason that it benefits funding only securitisations, namely increased investor participation and improved pricing (as extension risk mitigated), improved secondary market and improved pricing of cross currency swaps for securitisation structures. We would also like the opportunity to discuss more broadly with APRA the rationale behind fixing the call date modelled on the 10% clean up call and, in particular, whether the call date for funding only transactions can be applied to different tranches of securities.

2.   20% Securities Holding Rule

We welcome APRA's proposed removal of the 20% securities holding limit. The 20% securities holding limit currently requires BOQ to sell down subordinated notes in the REDS EHP ABS deals. This unnecessarily increases BOQ's cost of funds by paying away net interest margin and therefore reducing retained earnings (and therefore core equity tier one). It also requires BOQ to obtain a rating on subordinated tranches so that they can be sold to third party investors (to satisfy the 20% securities holding rule). It is BOQ's preference to move to the funding structure proposed in the

Discussion Paper, namely a Class A Note (rated AAA) and a Class B Note (unrated). We request that this particular proposal be brought forward and be implemented immediately.

3. Warehousing arrangements

We note that APRA is proposing that warehouses funded by asset backed commercial paper be funding only transaction (i.e. no capital relief) on the basis that the term of the funding does not match the term of the underlying assets. In keeping with principle of substance over form, we recommend that capital relief for warehousing arrangements only be permitted in instances where the term of funding matches the term of the underlying assets. If this requirement is met than capital relief should be permitted for warehouses in the same way it is for term transactions (see discussion under 4. below). Effectively, it would require an ADI to structure the deal as a private placement to a third party funder (with a defined revolving period – say one year) that then amortises at an agreed up front cost of funds. At the end of the one year revolving period, the ADI could extend for a further one year that then amortises at an agreed up front cost of funds. If the warehouse funder does not extend after one year, then the transaction simply amortises at the agreed up front cost of funds. If the 'warehouse' was structured in this way, APRA could dispense with the proposed one year holding rule (where the funder is required to hold capital against the assets if they have been in the warehouse greater than one year) and allow 10% clean up calls. Given that we currently have 6 warehouses with various providers (of which 2 came across as part of the Investec acquisition), we would like to discuss this proposal in greater detail with you and, in particular, transitional relief for warehouses that we currently achieve capital relief on.

4. Capital relief securitisations

We note that APRA has proposed two possible approaches ('significant credit risk transfer' and 'pro rata') for originating ADIs to obtain capital-relief using securitisation. We welcome these proposals although in order to appropriately assess the merits of each approach, greater clarity is needed in a number of areas.

Significant Credit Risk Transfer

We would appreciate an opportunity to engage with APRA to develop detailed guidelines that would provide clear guidance to originating ADIs in determining whether 'significant credit risk transfer' has occurred (with such rules taking into account compliance with its skin in the game obligations), with a view to mitigating the risk that ADI's incorrectly interpret the criteria needed to be satisfied to achieve capital relief. Whilst we support APRA's "more principles-based than rules-based" approach generally, we submit that in certain limited instances (such as determining whether significant credit risk transfer has occurred) more detailed guidelines can enhance the overall operation of the prudential standards. We note that APRA requires the originating ADI to elect upfront whether the securitisation is a capital relief or funding only securitisation. Therefore, it is important that the rules for significant credit risk transfer be clearly defined as this has important structuring ramifications and, if the desired capital relief was not obtained, adverse net interest margin impacts (and therefore adverse retained earnings and capital impacts). The reason there is adverse net interest margin impacts is that it is cheaper to issue securities of a similar tenor in other markets, such as senior unsecured markets, rather than sell down the subordinated securities and not achieve capital relief. We note that prior to the GFC, significant risk transfer was linked to off balance sheet accounting treatment (by selling 2 times expected net losses). Whilst we are not advocating that this approach be adopted, we are of the strong view that clear regulatory guidelines need to be adopted in order to establish 'significant risk transfer'.

Pro-rata approach

Under the pro rata approach APRA has capped potential capital relief at 80%. This appears to be linked to the credit risk retention requirement (i.e. skin in the game) of 20% of each sub-class of junior notes. It is not clear why capital relief is capped at 80% and why there is an apparent linkage

between the concepts of skin in the game and capital relief. We submit that the assessment of capital relief should be risk sensitive (and should not therefore be capped at 80%) and that the issues of capital relief and skin in the game should be de-linked and treated as a separate issue (that is, the objective of better aligning the interests of originators and investors can be met without regard to a risk sensitivity analysis of the securitisation exposures retained by the originating ADI).

Also, the capital relief outcome under the pro rata approach has the potential to be distorted by relatively small tranches of sub-classes of B class securities. We have set out five different scenarios in Appendix A and would also be happy to share this model with you if it is of assistance.

By way of example, assume the following:

- Total pool size of $1Billion. Class A notes are $920M.

- Three classes of B class securities, B1 of $60M, B2 of $15M and B3 of $5M.

- The B3 class represents the first loss tranche and therefore the most risk.

Case 1

- The originating ADI holds 20% of the B3 securities, 20% of the B2 securities and 50% of the B1 securities.

- The originating ADI is entitled to 50% capital relief. [1]

Case 2

- The originating ADI holds 20% of the B3 securities, 20% of the B2 securities and 100% of the B1 securities.

- The originating ADI is not entitled to any capital relief.

In both Case 1 and Case 2 the originating ADI is exposed to substantially the same credit risk as the B3 class represents (given historical losses) substantially all of the risk in the transaction, yet very different capital relief outcomes result for the originating ADI.

Alternative approach: combination of pro-rata and capital deduction

Recognising the pitfalls of both the approaches, we propose an alternative 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 greater than the capital held before securitisation). This alternative 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 exposures to the subordinated securities.

By way of example, assume an originating ADI would need to hold capital of 3.5% prior to securitisation (i.e. assuming a lowest risk weight of 35% for residential mortgages under the standardised approach and a capital ratio of 10%). Post-securitisation the originating ADI would work out the thickness of each tranche (assume: 0.5% - B3 notes as bottom tranche; 1.5% - B2 notes; 6% - B3 notes and 92% - A notes). The ADI would then allocate capital notionally to each tranche – hence, under the example, B3 notes get the 'first' 0.5% of capital, B2 notes get the 'second' 1.5% of capital and the B3 notes get the 'third' remaining 1.5% of capital. To the extent that the ADI holds either the B2 or B3 notes (assuming these notes make up less than 2% of structure as per Appendix A), it results in a dollar for dollar capital deduction (each dollar of face value of

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[1] The mathematics is as follows – under the proposed pro rata approach the capital for originating ADI: (3.5% x MAX(retention B1 note, retention B2 note, retention B3 note)) = 1.75%

bond equates to a dollar of capital). Once the transaction is complete, the originating ADI would hold capital for the retained tranches on the basis of this allocation.

By way of example, assume the following:

- Total pool size of $1Billion. Class A notes are $920M.

- Three classes of B class securities, B1 of $60M, B2 of $15M and B3 of $5M.

- The B3 class represents the first loss tranche and therefore the most risk.

Case 1

- The originating ADI holds 20% of the B3 securities, 20% of the B2 securities and 50% of the B1 securities.

- The originating ADI is entitled to 67% capital relief.[2]

Case 2

- The originating ADI holds 20% of the B3 securities, 20% of the B2 securities and 100% of the B1 securities.

- The originating ADI is entitled to 46% capital relief.

We have also set out further case studies (cases 3 – 5) in the Appendix. If the ADI holds the same percentage in each class on notes, then the capital relief is the same under the Pro-rata approach as it is for the Alternative Approach (see Case study 3). Case studies 4 & 5 show the binary outcome of the Pro-rata approach in that no capital relief is allowed if the ADI owns 100% of any B note.

Our submission is that the Alternative Approach results in a fairer capital allocation and we would be happy to discuss this approach or a variation of this approach further with you.

If you have any queries please do not hesitate to contact me.

Yours sincerely,

Tim Ledingham
Treasurer
Bank of Queensland Ltd

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[2] The mathematics is as follows – under the alternative approach the capital for originating ADI: (20% x 0.5%) + (20% x 1.5%) + (50% *1.5%)= 1.15%

Appendix A – Case studies for Pro-rata Approach and Alternative Approach

Mortgages	$ 1,000,000,000
RWA*	35.0%
Capital Ratio**	10%
Capital $	$ 35,000,000
Capital/Mortgages%	3.50%

*Due to LMI, majority of mortgages are ~35% RWA

**include CET1 & AT1

				ADI holding %				
Notes	Volume	Volume %	Rating	Case Study 1	Case Study 2	Case Study 3	Case Study 4	Case Study 5
Class A	$ 920,000,000	92.0%	AAA	0%	0%	0%	0%	0%
Class B1	$ 60,000,000	6.0%	AAA	50%	100%	20%	20%	20%
Class B2	$ 15,000,000	1.5%	AA-	20%	20%	20%	20%	100%
Class B3	$ 5,000,000	0.5%	AA-	20%	20%	20%	100%	20%
Total	$ 1,000,000,000	100.0%						

Pro-rata Approach where capital relief equal to: (100% - maximum holding of any class)

	Case Study 1	Case Study 2	Case Study 3	Case Study 4	Case Study 5
Capital relief %	50%	0%	80%	0%	0%
Capital relief $	$ 17,500,000	$ -	$ 28,000,000	$ -	$ -
Capital Held $	$ 17,500,000	$ 35,000,000	$ 7,000,000	$ 35,000,000	$ 35,000,000
Capital %	1.75%	3.50%	0.70%	3.50%	3.50%
RWA (post securisation)	17.5%	35.0%	7.0%	35.0%	35.0%

Alternative Approach - combination of prorata and capital deduction

	Case Study 1	Case Study 2	Case Study 3	Case Study 4	Case Study 5
Capital relief %	67%	46%	80%	69%	46%
Capital relief $	$ 23,500,000	$ 16,000,000	$ 28,000,000	$ 24,000,000	$ 16,000,000
Capital Held $	$ 11,500,000	$ 19,000,000	$ 7,000,000	$ 11,000,000	$ 19,000,000
Capital %	1.15%	1.90%	0.70%	1.10%	1.90%
RWA (post securisation)	11.5%	19.0%	7.0%	11.0%	19.0%

	Case Study 1	Case Study 2	Case Study 3	Case Study 4	Case Study 5
Difference - Capital Relief %:	-17%	-46%	0%	-69%	-46%
Difference - Capital relief $	-$ 6,000,000	-$ 16,000,000	$ -	-$ 24,000,000	-$ 16,000,000

Capital Held Against Each Note (Alternative Approach):

	Case Study 1	Case Study 2	Case Study 3	Case Study 4	Case Study 5
Class B1	$ 7,500,000	$ 15,000,000	$ 3,000,000	$ 3,000,000	$ 3,000,000
Effective RWA of B1:	250%	250%	250%	250%	250%
Class B2	$ 3,000,000	$ 3,000,000	$ 3,000,000	$ 3,000,000	$ 15,000,000
Effective RWA of B2:	1000%	1000%	1000%	1000%	1000%
Class B3	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 5,000,000	$ 1,000,000
Effective RWA of B3:	1000%	1000%	1000%	1000%	1000%
Capital held:	$ 11,500,000	$ 19,000,000	$ 7,000,000	$ 11,000,000	$ 19,000,000

	Case Study 1	Case Study 2	Case Study 3	Case Study 4	Case Study 5
Bond Face Value At risk $:	$ 34,000,000	$ 64,000,000	$ 16,000,000	$ 20,000,000	$ 28,000,000
Bond Face Value At risk %:	3.4%	6.4%	1.6%	2.0%	2.8%
Effective RWA of Bonds:	338%	297%	438%	550%	679%