1 March 2016

Mr Pat Brennan
General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

Dear Mr Brennan,

Revisions to the Prudential Framework for Securitisation

Thank you for the opportunity to comment on the APRA Discussion Paper *Revisions to the prudential framework for securitisation* and the revised *Draft APS 120* released on 26 November 2015.

As you know, COBA is the industry association for Australia's customer-owned banking sector, comprising 71 credit unions, 14 mutual banks and 5 building societies.

COBA welcomes APRA's willingness to respond to stakeholder concerns about the 2014 Securitisation Discussion paper, including those on warehouse arrangements and the 'skin in the game' requirement. As noted in our 2014 submission, COBA welcomes the explicit recognition of funding-only securitisation.

COBA is encouraged by APRA's statements that:

- it would like to see a large and liquid securitisation market supporting competition in Australian home lending; and
- APRA's preference is to have a method by which smaller ADIs can have improved access to term securitisation markets, without creating undue prudential risk.

Securitisation is an important current and potential funding source for COBA members and can reduce our sector's heavy reliance on retail deposits.

COBA strongly endorses the Discussion Paper's observations that:

- Securitisation can be a valuable means by which to diversify sources of funding and increase balance sheet resilience; and
- A deeper and more resilient securitisation market should help smaller ADIs compete with larger ADIs that have greater access to other sources of debt funding.

While COBA supports many of the changes APRA has made since its earlier proposal, we do have concerns about some elements of the draft standard which could increase the costs of securitisation, and may negatively impact on competition and diversity in the banking sector.

As a general point, COBA supports APRA's principles-based approach, but past experience has shown that APRA will issue a clarification where there is a difference between industry's commonly applied interpretations of the principles and APRA's view. This can force some ADIs to review and potentially amend their facilities, often at great effort and expense, particularly for smaller ADIs. While COBA supports a principles-based approach to regulation, we also believe that some level of specificity in the prudential standard will clarify ambiguity and will deliver greater certainty to the industry.

COBA highlights the following specific issues identified by COBA member ADIs:

Changes to Capital Requirements and Warehousing

COBA acknowledges that APRA has found that "…warehouse arrangements have been the most difficult of the new proposals for APRA to balance."[1] When APRA is considering the balance between financial stability and competition, COBA believes that APRA should try to ensure that the costs of warehousing are not prohibitive to smaller ADIs. This includes recognising smaller ADIs are 'price-takers' who will bear the cost of changes to ADIs that provide warehouses, and recognising the greater cost of uncertainty for smaller ADIs.

COBA is concerned about the impact of changes to the hierarchy of approaches used to calculate regulatory capital requirements. These changes remove the ability of the advanced banks to assess credit risk using the Internal Assessment Approach (IAA) and the Internal Ratings Based (IRB) approach. This is despite these approaches providing a more granular assessment of risk than the External Ratings-Based Approach (ERBA) and the Standardised Approach (i.e. Supervisory Formula Approach).

Typically, smaller ADIs have warehouse programs provided by advanced Australian ADIs. If the warehouse providers are required to use either the ERBA or the Supervisory Formula Approach, this will result in an increase in the funding cost of the warehouse.

COBA understands that the Supervisory Formula Approach would result in more than double the capital required to be held against the senior tranche. Acquiring a rating from a credit rating agency to use the ERBA approach will add significant surveillance costs. We understand that the estimated cost of surveillance to be more than $200,000 over a 5 year transaction.

COBA is also concerned about the blanket use of capital deductions for non-senior tranches. These unnecessary capital charges will increase the cost of securitisation and lead to originating ADIs having to either hold these tranches, or sell them at a higher coupon rate to a limited pool of non-ADI investors or to ADIs who will need compensation for the increased capital charges. This is despite the fact that some of these non-senior securities are highly rated and are not exposed to material credit risk.

Similarly, COBA believes that the inflexible use of capital deductions for resecuritisations, combined with changes to the definition of resecuritisation, is punitive and disregards APRA's underlying 'risk sensitive' approach.

In funding-only transactions, there is no leakage of capital from the banking system. Increasing the capital charges on the warehouse provider leads to excess capital being held against the same mortgage pool. These changes, regardless of whether the Supervisory Formula Approach or the ERBA is applied, will push up costs for ADIs that use warehousing. This will result in either higher funding costs, which would be passed on to borrowers, or in the event securitisation becomes non-viable, reduced competition and reduced funding diversification in the banking market.

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[1] Pat Brennan speech to the Australian Securitisation Forum in Sydney on 1 December 2015

Nomination

COBA understands APRA's desire for ADIs to signal their intentions to pursue capital-relief or funding-only securitisation at inception. However, COBA is concerned that this limits the flexibility for ADIs to:

- respond to market conditions at issuance (by selling or holding junior notes); or
- utilise securitisation as a contingent capital management tool (holding junior notes to sell off to claim capital relief when required).

We request that APRA allow ADIs to change the nomination post-inception, if the securitisation meets the relevant requirements.

Funding-only securitisation and the two class credit structure

COBA welcomes APRA's move to explicitly recognise funding-only securitisation in the prudential standard. However, COBA is concerned at APRA's proposal for a single junior tranche in a funding-only securitisation.

While COBA appreciates APRA's desire to simplify the structure of funding-only securitisation by requiring the originating ADI to retain the junior tranche, this removes the flexibility to have multiple junior tranches in a funding-only transaction.

This is particularly relevant in warehouse transactions, where capital constraints on a senior lender may require funding from a third party mezzanine lender. For example, if an ADI designates their transaction as a capital relief trade (which contains multiple junior tranches each with different credit tranching), but ultimately fails to 'sell all the way down the structure', then our understanding is that for an ADI to adhere to the funding-only 'two tranche' provision of the draft APS 120, these tranches would need to be consolidated into a single junior note (retained by the originating ADI), or otherwise require a mandatory sell down of the junior tranches. COBA would welcome clarification from APRA on the prudential consequences of this situation.

If consolidation is required, our concern is that the transaction could not proceed on this basis because the deal has already been preliminary rated by multiple credit rating agencies and marketed to investors with a specific tranche structure. This could undermine investor confidence in slower selling securitisations, which may disproportionately affect smaller ADIs.

Additionally, COBA believes that there are circumstances where a mezzanine tranche is appropriate in a funding-only securitisation. Where a junior tranche (retained by the originating ADI) does not satisfy all of the required credit support for the senior note, the ADI would fail the 'significant risk transfer' test for capital relief but is still comfortable accounting for the assets on its balance sheet (in accordance with APS 112), which would not be permitted under the Draft APS 120.

Having a three tranche funding-only transaction does not in any way change the capital outcome for the ADI. Nor does it add further complexity to the deal. It does however provide the ADI with the flexibility to seek additional funding from the same pool of assets.

Given that there will be explicit rules governing what is required to achieve 'significant risk transfer', an oversimplified two tranche funding-only model is unnecessary and acts as a potential barrier to innovation.

Recognition of multi-seller structures

COBA notes that while the Discussion Paper does not explicitly mention the issue of multi-seller structures, the paper does refer to a situation "where there are two or more originators of the underlying pool in a securitisation…".[2]

COBA strongly endorses accommodation of multi-seller structures in the securitisation framework. Multi-seller structures offer smaller ADIs economically viable vehicles to participate in securitisation markets. The prudential framework should explicitly recognise and allow for the use of multi-seller structures.

Where smaller ADIs are unable to access securitisation individually due to the high fixed costs, multi-seller structures (aggregating exposures into a pool from multiple originating ADIs) can overcome scale disadvantages to diversify their funding sources.

However, COBA members have encountered resistance from APRA in relation to specific multi-seller securitisation proposals. If there is ambiguity about APRA's position on multi-seller structures, this can lead to a situation where ADIs will be unwilling to incur the upfront costs to pursue innovative structures due to the perception that the regulator may not approve them.

Resolving this ambiguity is consistent with the Government's FSI response which states that 'policies should enable innovation'.[3] A clear acceptance of multi-seller structures will facilitate greater competition in retail banking.

We understand that APRA has some specific concerns around multi-seller structures, and we understand that these relate to the potential contagion risk and distribution of excess spread. These concerns can be addressed. For example, the contagion risk can be mitigated by dedicated subordination within each individual seller's pool. On the other hand, the distribution of excess spread in a multi-seller securitisation is a matter for the ADIs involved in the transaction and this should be confirmed in the new standard.

If the proposed changes to capital requirements are implemented, warehousing is likely to become expensive for individual ADIs. Therefore, multi-seller structures will be increasingly attractive for smaller ADIs looking to either access funding or liquidity through securitisation markets, including through self-securitisation.

COBA believes that it is important that the new standard should explicitly allow multi-seller securitisations and should include principles to address APRA's concerns about these types of transactions.

Doing this would send a clear signal that APRA recognises the need for smaller ADIs to have access to securitisation markets and supports innovative models that increase funding options available to smaller ADIs. Failure to support these models could impede efficiency improvements and hinder competition.[4]

Minimum Liquidity Holding (MLH) Requirements

COBA believes that the current proposal imposes excess liquidity costs on MLH ADIs relative to their Liquidity Coverage Ratio (LCR) counterparts. This will increase the costs of securitisation.

[2] See APRA Discussion Paper *Revisions to the prudential framework for securitisation* 2015 (Page 21).
[3] See *Improving Australia's financial system Government response to the Financial System Inquiry: Summary* (page 2).
[4] Under, APRA's Supervision Blueprint, APRA seeks to maintain a low incidence of failure of regulated entities while not impeding continued improvement in efficiency or hindering competition.

APRA is proposing that originating MLH ADIs may only exclude the liabilities of the securitisation in the calculation of the MLH ratio if it meets the operational requirements for regulatory capital relief. In other words, should an MLH ADI issue a funding-only securitisation it will not receive any relief from holding the prescribed percentage of high quality liquid assets (HQLA) against these liabilities. This would apply for both term funding transactions as well as shorter dated warehouse arrangements.

On the other hand, for an ADI that uses the LCR methodology to calculate liquidity, the date based call is modelled at the first date the originating ADI can effectively call the securities. Under the LCR, this means that in the 30 days prior to the call date 100% of the value of the call will need to be held in HQLA and it is therefore an incentive to actually call the transaction.

Failure to account for differences in the MLH and LCR models will lead to an unfair increase in liquidity costs on MLH ADIs. For example, a MLH ADI needs to hold a minimum of 9% of the liability per month up until the call date while a LCR ADI only needs to hold 100% of the liability for one month prior to call date. If there is a long enough time to the call date, this leads to a situation where the MLH ADI incurs a higher overall liquidity cost. The costs of holding compliant lower return liquid assets is significant and is estimated to be a 2 percentage point decrease in the rate of return.

COBA also notes that APRA only allows date based calls to be available to originating ADIs if the originating ADI retains full discretion over whether to exercise the call. Should an originating ADI fail to exercise the call the investor would have no recourse and this safeguard is clearly built into both funding-only and capital relief term securitisations. This ultimately protects the liquidity position of the originating ADI. If MLH ADIs do not have sufficient liquidity, then they can allow the call option to lapse with no recourse.

COBA submits that where a securitisation is issued so that there is no asset liability mismatch, that is, the tenor of the notes matches the tenor of the longest contractual maturity of the exposures in the pool,[5] the existing arrangements for liquidity relief should be maintained. This should be the case whether a transaction is funding-only or capital relief.

Trust-Back Arrangements

COBA's view is that a typical trust-back arrangement provides the ADI with substantially equivalent rights and protections to the holding of a formal second mortgage. Therefore, there should be equal capital treatment for exposures held in qualifying trust-back arrangements to those under formal second mortgages. Otherwise this will increase the costs of securitisation with risk weights for such arrangements increasing from around 40% to a minimum of 100%.

Under a typical trust-back arrangement, the ADI has a claim to any excess proceeds from a shared mortgage once all amounts payable under the relevant securitised loan (to which that shared mortgage relates) have been repaid. This effectively produces the same economic outcome as if the ADI had the benefit of a formal second registered mortgage and consequently the same risk weighting regime which applies to second mortgages should apply to trust back arrangements.

COBA also believes that the need for a second mortgage is unnecessary given that excess proceeds are already distributed in the same manner. The process of getting a second mortgage will create an excess burden on borrowers for little gain.

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[5] As outlined in Draft APS120 Attachment A paragraph 10 regarding Permanency of Funding

On behalf of our member ADIs, we look forward to engaging with you on this submission. This process is an opportunity for APRA and its regulated community to work together to deliver a more competitive banking sector and to implement “policy choices that, where possible, add to the competitive dynamic of the industry when this doesn’t undermine prudential outcomes.”[6]

Please do not hesitate to contact me on 02 8035 8448 or Sally MacKenzie on 02 8035 8450 to discuss any aspect of this submission.

Yours sincerely

LUKE LAWLER
Head of Public Affairs

[6] APRA Chair’s speech on 29 January 2016 to Australian Economic Forum