

25 February 2016

Mr Pat Brennan
General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

By email: APS120review@apra.gov.au

Dear Mr Brennan,

**DISCUSSION PAPER: REVISIONS TO THE PRUDENTIAL FRAMEWORK FOR SECURITISATION
DATED 26 NOVEMBER 2015**

Introduction

This submission is made by Pepper Group Limited ("**Pepper**"). Pepper is an Australian headquartered, diversified global financial services business with specialist experience in lending, advisory and asset management across residential and commercial property and consumer, auto and equipment finance. In Australia, Pepper offers auto and equipment finance and home loan products to both prime and non-conforming borrowers and plans to also shortly offer personal loans.

As a non-bank lender, Pepper plays an important role as being an alternative to the banks as a source of housing and leasing finance for consumers. We are one of the few providers of specialist or non-conforming loans, which is an important segment of the market that is underserved by the banks. In the 1990's, the emergence of non-bank lenders such as Aussie Home Loans changed the lending landscape and the competition they provided was responsible for margins on consumer loans being significantly reduced. Since the GFC however, banks have regained a large portion of the market share in the home loan and auto finance markets that they previously lost, which has enabled them to widen margins on such lending. Our presence in the market, along with other non-bank lenders, is important in providing competition to the traditional bank lenders and in ensuring consumers get access to loans at the best possible price.

Pepper sources a significant proportion of its funding from the warehouse and term securitisation markets. Pepper currently has 1 and 2 year warehouse facilities provided by a number of the major banks. These warehouse facilities provide interim funding prior to term out in the capital markets by means of a securitisation transaction. Pepper has been a regular RMBS issuer, having issued A\$6.8 bn of securities through 15 non-conforming and 4 prime backed issues since inception, and was the seventh largest Australian RMBS issuer by issuance volume in 2015¹.

Access to competitively priced warehouse and term securitisation funding is essential to Pepper and other non-ADIs being able to continue to fund new lending activities. Pepper is concerned that some of the proposed changes to APS120 will increase the price and reduce the availability of warehouse funding provided to non-ADIs and reduce the level of investment made by ADI's in RMBS issues from non-banks, thus reducing the ability of Pepper and other non-banks to continue to remain competitive.

¹ Source: Bloomberg

Areas of Concern

We have the following main concerns with the proposed APS120 changes;

- No longer allowing ADI's to use the Internal Assessment Approach to risk weight securitisation exposures;
- The imposition of a CET 1 deduction to an ADI's investment in anything other than the most senior class of a securitisation.

Our concerns in regards to each of these matters are as follows.

1. No longer allowing the use of the Internal Assessment Approach to risk weight securitisation exposures

We note that APRA is proposing to no longer allow ADI's to use the internal assessment approach (IAA) for risk weighting securitisation exposures. ADI's will instead only have the choice of using the **external ratings-based or standardised approaches**. The unduly onerous capital charges imposed by the standardised approach will result in an overuse and reliance on external credit ratings. This will have a significant impact on the industry given the majority of warehouse funding facilities are currently assessed using the IAA.

We are surprised that APRA would prefer ADI's to use the external ratings-based approach over the internal assessment approach. A key shortcoming of the Basel II securitisation framework identified by numerous global banking regulators following the GFC, was the mechanistic reliance on external ratings. It would seem that a change which embeds reliance on external ratings over the ADIs' own internal credit assessment is incongruent with this learning.

In addition, needing to obtain external ratings on warehouse facilities will impose a significant administrative and cost burden on non-banks due to the requirements of rating agencies to conduct a ratings analysis on the warehouse pool each time a funding is requested.

The agencies will also take an extremely conservative approach and assume that the composition of the warehouse portfolio are written to the boundaries of all loan parameter and concentration limits, which will result in higher amounts of required credit enhancement and less funding being provided by ADI's. This will require existing facilities to be restructured and lead to inefficient funding structures for non-banks, substantially increasing the cost of warehouse funding for these institutions.

The rating agency requirement of 5 years performance history in order to assign a rating will also significantly stifle the ability of non-banks to innovate and enter new lending markets and will limit product development.

Furthermore, the fees charged by rating agencies, comprising an upfront fee to assign a rating and ongoing annual fees to maintain the rating through the life of the transaction, introduce a significant additional cost burden.

In short, the need to obtain an external rating is a substantial barrier to entry for new players, and will impose significant costs and limitations which will restrict the expansion and growth of existing non-banks and will thus do very little to support the growth of the industry and to encourage competition.

Consequently, Pepper strongly supports the use of the internal assessment approach for risk weighting securitisation exposures and requests APRA reconsiders its position on this matter.

2. The imposition of a CET 1 deduction to an ADI's investment in anything other than the most senior class of a securitisation

APRA has proposed a CET1 deduction for all non-senior securitisation exposures, reflecting its view that all non-senior exposures "reflect substantially all the credit risk in a securitisation".

Certainly the lower you progress down the note structure, the amount of credit risk borne by the tranche increases. However a number of tranches can be non-senior but still not be materially exposed to the credit risk of the asset pool. Whilst it is difficult to generalise, Pepper is strongly of the view that the risk of non-senior tranches such as those with "AAA", "AA" and "A" ratings suffering loss is negligible, which has certainly been demonstrated by the performance of Australian securitisation issues since the inception of the market.

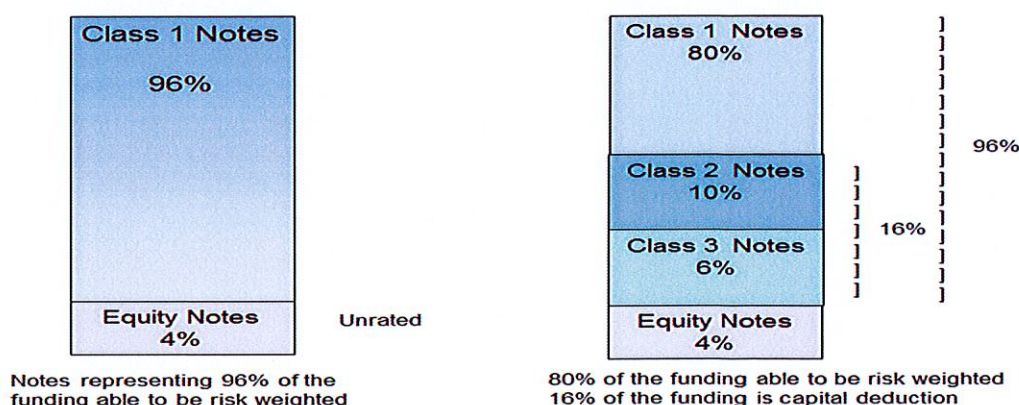
We also point out that APRA's assertion that junior securities that are 'AAA' rated are likely to be subject to conditional credit enhancement (e.g. lenders' mortgage insurance (LMI)) may be true of bank sponsored issues but has not taken consideration of transactions that exist in the broader securitisation market. There are many market transactions that do not rely on LMI at all, yet such transactions typically issue two AAA rated tranches, which is known as a "super-senior" structure. This is the case for auto ABS and non-conforming or uninsured prime RMBS issues, which are more typically issued by non-banks.

Whilst the identification of which tranches bear substantially all the credit risk in a securitisation may be clear for LMI insured RMBS structures with only 2 or 3 tranches, absent LMI where there will be a number of classes of securities (typically one for each rating level (ie. AAA, AA, A, BBB) it is far less clear. With such issues, it is not as clear as to where the line would be drawn between senior and junior securities. We think that to impose a CET1 deduction on anything below the most senior tranche, which would typically be any tranche rated less than AAA (but could even include tranches rated AAA) would be unnecessarily punitive.

Further, with respect to warehousing, we believe APRA's proposal fails to take into account the situation where the one ADI warehouse provider holds 100% of the top 2 or 3 tranches. In such a scenario, the risk exposure is equivalent to holding the one most senior note, but will result in a significantly different capital treatment.

This is best explained by example. The diagram below illustrates 2 warehouse structures. In the diagram on the left, the ADI holds the Class 1 Notes representing 96% of the notes issued. As it is the most senior note, it can be risk weighted. In the diagram on the right, the ADI holds 100% of the Class 1 through Class 4 notes, which also represent 96% of the notes issued. However, the holding of Notes 2 through 4 will attract a CET1 deduction. The risk exposure is identical, but the capital outcome is significantly different.

Equivalent Risk Profile : Vastly Different Capital Treatment



Requiring a CET1 capital charge for all non-senior exposures under the Proposed APS120 is arbitrary given the potential for significant variation between issues in the size of the most senior tranche, and disproportionate to the credit risk profile of the tranche.

Pepper recommends that APRA consider consistency with the Basel Committee's advanced approaches, which we view as more risk-sensitive and producing risk weight outcomes which are more aligned with the actual risk profiles.

We note that on data provided by some of our warehouse providers, the Standardised Approach produces risk-weight results which are up to 10 times higher than those under the advanced approaches. This outcome would make it uneconomic for Pepper to utilise warehouses facilities.

Australian major ADIs are significant providers of funding to non-bank lenders such as Pepper. Sourcing mezzanine and junior funding is essential for Pepper and aside from the major ADIs there are only a limited number of providers, with a limited amount of funding. Removing a major source of funding will have a significant impact on non-bank lenders and hence to the provision of loans to borrowers.

Conclusion

While we applaud APRA's desire to encourage simplicity in the securitisation issues offered by the industry, we believe the changes highlighted above will result in a substantial reduction in the ability of non-banks to provide significant competition to the banking industry. This will lead to a widening of loan margins and an increase in the cost paid by consumers for loan finance. We respectfully ask that APRA reconsider its position on these matters.

Yours sincerely,

A handwritten signature in dark ink, appearing to be "Todd Lawler", written over a circular stamp.

Todd Lawler
Group Treasurer