Australian Prudential Regulation Authority

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To all locally-incorporated authorised deposit-taking institutions

REGULATORY CAPITAL TREATMENT FOR SECURITISATION

Prudential Standard APS 120 Securitisation (APS 120), which became effective in January 2008, requires authorised deposit-taking institutions (ADIs) to undertake, and provide to APRA upon request, written self-assessments of each securitisation in which they participate. In line with this requirement (paragraph 18), APRA has requested and reviewed a number of self-assessments.

After securitisation markets globally and in Australia struck difficulties from 2008, a number of ADIs originated securitisations under which the senior tranche or tranches were placed with third-party investors but the originating ADI retained all, or nearly all, of the securitisation's most subordinated tranche. Some ADI issuers have concluded appropriately that such a structure fails to meet the fundamental requirement for significant credit risk transfer and have retained the requisite risk assets and capital requirements on their balance sheets. In other cases, however, APRA has found that regulatory capital relief for credit risk has been claimed inappropriately.

In APRA's view, originating ADIs holding the most subordinated tranche(s) of a securitisation have retained a substantial majority of the credit risk in the transaction. In particular, APRA does not accept:

(a) lenders mortgage insurance on the underlying loans in the securitisation structure;
(b) excess spread available to absorb losses ahead of the most subordinated tranche; and/or
(c) holdings of subordinated tranche(s) being less than the 20 per cent threshold referred to in APS 120 Attachment F paragraph 8(c),

as adequate justifications that significant credit risk has been transferred to third parties.

Operational requirements for regulatory capital relief

An originating ADI must assess the extent to which expected losses on the pool will be borne by its retained positions, including any securities held, prior to being absorbed by credit enhancements provided by third parties.

Some ADIs have referred to lenders mortgage insurance on the underlying loans, and excess spread in structures, as being credit enhancements supporting securitisations. In APRA's capital adequacy framework, lenders mortgage insurance on a housing loan may result in a more favourable risk-weight being applied to the housing loan but does not result in the ADI being able to claim it has shed all the credit risk to the insurer. Consistent with this, it is not appropriate for ADIs to base their assessment of significant credit risk transfer through securitisation on the existence of lenders mortgage insurance. Furthermore, lenders mortgage insurance is a conditional credit enhancement, given that a loss on a loan has to go through a claims process and is covered by the insurer only if the claim is successful. This means that subordinated investors could bear losses in the first instance and recoup only a portion of losses from the insurer.

In accordance with APS 120 Attachment B paragraph 2, the requirements for capital relief must be satisfied at both the time of transfer and afterwards. Given that excess spread does not exist at the inception of a securitisation (i.e. the time of transfer), ADIs should not be recognising potential future excess spread as a means through which credit risk is transferred.

An originating ADI holding the most subordinated tranche(s) of notes (even if rated) in a securitisation, that has no externally provided credit enhancement other than lenders mortgage insurance to absorb losses unconditionally in the first instance, would not be considered as having achieved significant credit risk transfer to third parties. In such instances, the originating ADI cannot exclude the securitised assets from its calculation of regulatory capital for credit risk under *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* or *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*, as appropriate.

APRA acknowledges that ADIs may use securitisation solely for funding purposes. However, where an ADI undertakes a securitisation for this purpose but has not transferred significant credit risk to third parties, the ADI must demonstrate to APRA that third-party investors have no recourse to the ADI, and it must hold capital against the securitised assets as if they were on its balance sheet.

Acquisition of securities

The 20 per cent threshold referred to in APS 120 Attachment F paragraph 8(c) is intended to allow an ADI to undertake modest market-making activities in the securities issued by a securitisation it has originated. It is not the measure by which significant credit risk transfer is determined. An originating ADI could hold securities well within the 20 per cent threshold and yet not have transferred significant credit risk to third-party investors, by virtue of the subordination of the securities held and the level of expected losses on the underlying pool. Complying with the 20 per cent limit is a necessary, but not sufficient, condition to attain regulatory capital relief in a securitisation structure.

The 20 per cent limit is determined relative to outstanding securities. This means that the limit applies throughout the life of the securitisation and should be monitored where tranches held by an originating ADI amortise, or are repaid, at a slower rate than the average for all securities issued by the special purpose vehicle. To clarify this requirement, APS 120 will be revised to reflect that the limit applies to 'holdings', as opposed to 'purchases', of securities by originating ADIs.

Cross-holding of securities

APS 120 paragraph 9 requires ADIs to deal with a special purpose vehicle and its investors on an arm's-length basis and on market terms and conditions. APRA will not take a favourable view of originating ADIs entering into bilateral, or multilateral, arrangements to purchase the subordinated tranche(s) of other ADI-originated securitisations. Should this occur, APRA will reconsider the capital treatment applicable to subordinated tranches.

APRA will contact the ADIs it has identified as originating securitisations for which the above matters are relevant, in order to arrange appropriate remediation where necessary. If you have participated in any securitisations where the content of this letter is applicable and are unsure of the capital treatment, or have any questions regarding the APS 120 requirements, please contact your APRA Responsible Supervisor.

Yours sincerely

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Policy, Research and Statistics