



*Australian
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14 June 2000

Mr Brian Gray
Executive General Manager
Policy, Research and Consulting
Australian Prudential Regulatory Authority
Level 26, 400 George Street
SYDNEY NSW 2000

Dear Mr Gray

Submissions in response to the draft Prudential Standard – Capital Adequacy: Funds Management and Securitisation for Authorised Deposit-Taking Institutions (00.12) and regarding the application of risk weightings to highly rated mortgage backed securities

I am writing to you in my capacity as Convenor of the Regulatory Issues Committee of the Australian Securitisation Forum (“**ASF**”). The ASF is the peak body representing the securitisation industry in Australia.

I enclose the formal response of the ASF to the draft Prudential Standard on Funds Management and Securitisation for Authorised Deposit-Taking Institutions (“**Harmonisation Standard**”) which was released for industry comment by the Australian Prudential Regulatory Authority (“**APRA**”) on 9 May 2000. In addition to making a number of comments on the Harmonisation Standard, the response also incorporates a submission regarding the application of risk weightings to highly rated mortgage backed securities.



The submission has been prepared by the Regulatory Issues Committee of the ASF with input from the industry participants listed in the Annexure to this letter. Prior to submission to APRA on behalf of the ASF, it was also circulated to a broad range of industry participants, inviting their comments.

The ASF would be happy to discuss the recommendations contained in the attached submission with you in more depth if you feel this is necessary. To arrange such a discussion, or if you have any queries in relation to the submission, please contact me on (02) 9229 9976.

Yours sincerely

Phillip Vernon
Convenor
Regulatory Issues Committee
Australian Securitisation Forum



ANNEXURE

Leanne Gordon	Australia and New Zealand Banking Group Limited
Gary Sly	Colonial State Bank Limited
Leanne Leong	Commonwealth Bank of Australia
Matthew O'Hare	Macquarie Bank Limited
Kevin Lee	Macquarie Bank Limited
Kristen Carroll	National Australia Bank Limited
Roger Desmarchelier	St George Bank Limited
Sonya Jenkins	Westpac Banking Corporation
Susan Bannigan	Westpac Banking Corporation



Australian Securitisation Forum

**Submission to the Australian Prudential Regulation Authority in response to the draft
Prudential Standard on Funds Management and Securitisation
for Authorised Deposit-Taking Institutions (00.12)**

and

**Submission to the Australian Prudential Regulation Authority regarding the application of
risk weightings to Mortgage Backed Securities**

14 June 2000



SUBMISSIONS TO THE AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY ON BEHALF OF THE AUSTRALIAN SECURITISATION FORUM

INTRODUCTION

The submissions contained in this paper are made to the Australian Prudential Regulation Authority (“APRA”) by the Australian Securitisation Forum (“ASF”):

- (a) in response to the draft Prudential Standard on Funds Management and Securitisation for Authorised Deposit-Taking Institutions (00.12) (**Harmonisation Standard**); and
- (b) regarding the application of risk weightings to highly rated residential mortgage backed securities (“MBS”).

This paper is divided into 4 parts. Part 1 comprises a description of the ASF and Part 2 comprises an overview of securitisation. Part 3 sets out the submissions made on behalf of the ASF in response to the Harmonisation Standard including recommendations for certain amendments to remove discrepancies between the Harmonisation Standard and the existing Prudential Statement on Funds Management and Securitisation (“PS C2”).

The ASF believes it is also an opportune time to review the application of risk weightings to MBS in Australia. Part 4 sets out submissions made on behalf of the ASF regarding the application of risk weightings to MBS and includes recommendations for an interim amendment to be made to the capital adequacy guidelines to more accurately reflect the risk associated with MBS.

1. THE AUSTRALIAN SECURITISATION FORUM

- 1.1. The ASF is the peak body representing the securitisation industry in Australia. It has been in existence for over 10 years and its purpose is to promote the development of securitisation in Australia.
- 1.2. The ASF is constituted by an Australian national committee of 10 members, a further 7 sub-committees and an associate membership of over 250 participants in the securitisation market. The ASF’s members include representatives from the major banks, investment banks, insurers, rating agencies, trustees and legal and accounting firms.

2. AN OVERVIEW OF SECURITISATION

- 2.1. Securitisation is a key balance sheet management tool used for funding, liquidity and credit risk management by many financial institutions including banks, credit unions and building societies. As recognised by the Basel Committee it is an efficient way of redistributing credit risks of a bank to other parties providing better risk diversification and improving financial stability.



2.2. Securitisation enhances balance sheet liquidity. A bank's ability to securitise assets may provide access to funding or liquidity during periods of financial stress.

3. SUBMISSIONS IN RESPONSE TO THE HARMONISATION STANDARD

3.1. Guidance Note 3 - Purchase and Supply of Assets (including Securities Issued by SPVs)

- (a) Paragraph 11(i) of Guidance Note 3 replaces paragraph 99(ix) of PS C2. The second sentence of paragraph 99(ix) of PS C2 reads as follows:

“This is not required where the banking group holds capital against the undrawn facilities through the ‘revolving’ and ‘amortising’ periods in accordance with normal capital adequacy requirements.”

This sentence has not been included in paragraph 11(i) of Guidance Note 3. There appears to be no strong basis for having excluded this proviso. An ADI should be permitted to continue funding these undrawn facilities provided it holds capital against them in accordance with normal capital adequacy requirements.

- (b) Paragraph 17(d) of Guidance Note 3 requires that the total value of assets purchased from an SPV and held on the books of the ADI “represents less than 10 per cent of the maximum value of the assets held by the SPV”. This differs from paragraph 75(iv) of PS C2 which requires only that the purchased assets “represent a small proportion of the maximum value of assets held by the vehicle. A figure of 10 per cent (of the maximum value of assets held) will be taken as a guide.” The ASF recommends that the flexibility offered to APRA by paragraph 75(iv) of PS C2 be preserved in the Harmonisation Standard (as there may be legitimate reasons for a higher figure in any particular case).

3.2. Guidance Note 4 – Liquidity, Underwriting and Lending Facilities

Paragraph 3 of Guidance Note 4 replaces paragraph 36 of PS C2. The reference in paragraph 36 of PS C2 to market disruption and timing differences in the payment and receipt of interest and principal from pooled assets was phrased as an inclusive example of situations where a liquidity facility could be used, although it appears to have been interpreted by APRA as the exclusive reason for drawing liquidity. The reference to market disruption and timing differences remains in paragraph 3 of Guidance Note 4 without the inclusive language, indicating that APRA does not recognise any broader use for a liquidity facility. To reflect that a liquidity facility may be used in a number of situations (other than as a credit support), the ASF recommends that the word “despite” in the second line of paragraph 3 of Guidance Note 4 be deleted and replaced with the words “for reasons including, but not limited to,”.

4. SUBMISSIONS REGARDING THE APPLICATION OF RISK WEIGHTINGS TO MBS

- 4.1 The ASF believes that it is an opportune time to review the application of risk weightings to highly rated (AA- or above) MBS in light of the recent consultative paper “A New Capital Adequacy Framework” issued by the Basel Committee on Banking Supervision (**Basel Committee**), other international regulatory environments and as a revisit of the draft Asset Backed Securities guideline issued by APRA in September 1996 (**ABS Guideline**). The ASF calls for a risk weighting of 50% to be applied to highly rated MBS to more accurately reflect the lower risk



associated with MBS and to bring our market into line with other major international regulatory environments.

4.2 MBS have historically been risk weighted in Australia at 100% because they are viewed as representing obligations of 100% risk weighted entities. The ASF believes that it is important for the securitisation industry that the risk weightings applied to highly rated MBS be revised and recommends that APRA amend the capital adequacy guidelines to reflect the important distinctions between investing in a 100% risk weighted entity and highly rated, senior ranking MBS backed by (what would be) 50% risk weighted registered residential mortgages.

4.3 The rationale for recommending that highly rated MBS be risk weighted at 50% is:

- Holders of MBS are, in essence, purchasing a direct interest in the income and principal cashflows generated by the underlying assets.
- The underlying assets are typically a pool of 100% mortgage insured housing loans, fully secured by a registered mortgage over residential property which would (if kept on balance sheet) be risk weighted at 50%¹.
- The process of securitising the underlying assets includes a rigorous due diligence on those assets by a third party global rating agency, which imposes stringent parameters on the vehicle issuing the MBS.
- To achieve the necessary ratings on the senior MBS, structural and/or third party facilities are put in to place to enhance the underlying assets, which effectively ensures that the securitised underlying assets carry less risk than equivalent on balance sheet assets.

4.4 The ASF believes that a reduction by APRA of the current 100% risk weighting applicable to MBS under the capital adequacy guidelines will support the growth of an increasingly important securitisation market in Australia. Arguments in support of the recommendation by the ASF to reduce the risk weighting applied to highly rated MBS include the following:

- Investor demand in the domestic market is adversely effected, relative to offshore markets, as investors who are APRA regulated ADIs must risk weight MBS at 100% (instead of 50% as is the case in other major international regulatory environments such as the United States, Japan and the United Kingdom). This has served in part to reduce the liquidity of the domestic market.
- The anomaly which exists between ADIs licensed in Australia and those licensed overseas but operating branches in Australia. Overseas licensed ADIs are able to purchase MBS at yields prevalent in Australia while allocating the risk weighting imposed by their own regulatory jurisdiction. This creates a competitive advantage to overseas licensed ADIs which achieve a better return on capital than Australian licensed ADIs.

¹ In accordance with the Prudential Statement on Capital Adequacy of Banks, as updated in August 1998, housing loans which are 100 per cent mortgage insured through an acceptable lenders mortgage insurer or which are uninsured but for which the LVR does not exceed 80 per cent attract a 50% risk weighting. This methodology has also been retained in the draft Prudential Standard on Capital Adequacy: Credit Risk released by APRA on 12 April 2000 to be applied to all ADIs.



- A reduced risk weighting will enable regional ADIs, as investors, to diversify their mortgage portfolios, creating greater stability in the banking and finance sector by spreading risk exposures from state concentrations to national economic exposure.
- 4.5 The ASF encourages APRA to implement a reduction in the risk weighting of MBS to 50% ahead of the implementation of the guidelines proposed by the Basel Committee as an *interim* measure as timing on the Basel guidelines is uncertain (with a revised proposal to be published by the Basel Committee during the course of this year). This interim reduction would then be superseded if and when the proposals of the Basel Committee to introduce a risk weighting framework based on the credit rating assigned to the securities are adopted.
- 4.6 The ASF supports the implementation of a risk weighting reduction based on the ABS Guideline. The form of the ABS Guideline would need to be adjusted to take into account the August 1998 changes to the 50% risk weighting criteria applicable to 100% mortgage insured on balance sheet housing loans. There are also a number of other amendments that the ASF recommends be made to the ABS Guideline to reflect current market practice. The ASF would be willing to work with APRA regarding any interim amendment to the capital adequacy guidelines (including any adjustments to be made to the ABS Guideline).
- 4.7 The ASF believes that the implementation of this proposal should be supported by APRA because it will bring our market into line with other major overseas securitisation markets, thus serving to deepen the domestic market and providing additional investment opportunities to Australian ADIs.

5. CONCLUSION

- 5.1 Securitisation is a key balance sheet management tool used by financial institutions for funding, liquidity and credit risk management. The ASF generally endorses the APRA's policies and objectives as a means of ensuring that regulatory capital charges reflect a bank's actual risk profile.
- 5.2 The ASF has recommended a number of specific amendments to the proposed Harmonisation Standard and has submitted that the risk weighting applicable to MBS should be reduced from 100% to 50%. These recommendations are intended to ensure that financial institutions are not penalised for their involvement in securitisation transactions as arrangers, issuers, investors or support facility providers. The regulatory capital requirements in excess of that justified by the economic risk position will discourage the use of securitisation as a prudent risk management tool.