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Dear Mr Salisbury

## **Australian Securitisation Forum Thin Capitalisation**

We refer to the latest proposals circulated under cover of your email dated 4 September 2002.

First, I would like to express the gratitude of the members of the Tax Committee of the Australian Securitisation Forum for the continuing efforts of you and your colleagues in seeking a satisfactory resolution to the difficulties posed for securitisation vehicles by the thin capitalisation regime. We believe that considerable progress has been made and that a resolution is close.

### **1. Definition of Securitised Assets**

We agree with the deletion of the definition of securitised assets.

### **2. Definition of Securitisation Vehicle**

The proposed concept of an entity established for the purpose of pooling assets funded by the issue of securities is generally satisfactory. However, it is important that warehouse arrangements (ie. where assets are transferred into a special purpose vehicle (**SPV**) but funded by a conventional loan to the SPV rather than the issue of any notes or bonds) should be also covered. That is, security needs to be defined in an expanded way such as in subsection 159GP(1) which specifically includes secured and unsecured loans.

In addition, as discussed in more detail below, the definitions need to accommodate developments in securitisation practices. One such development is that an SPV may pool assets, as well as making a loan (either in the traditional sense of that word, or by subscribing for a debenture) to another entity which is secured over that entity's assets. There is also increasing activity in the area of synthetic securitisation in which there is no actual transfer of assets into the SPV. Nevertheless, there is an equivalent transfer of risk to the SPV achieved through the entry into of credit derivatives (eg. a credit default swap) between the sponsor/originator and the SPV. Therefore, the definition of securitisation vehicle needs to be broad enough to encompass this style of transaction.

Whilst we appreciate the concern that broad definitions may allow favourable treatment inappropriately to non-bona fide arrangements, we believe that the risk is better managed

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through the rules set out below concerning the satisfaction of APRA Standards or Australian Accounting Standards rather than through an overly restrictive definition of securitisation vehicle.

It follows from the above that the proposed 'activity test' should accommodate synthetic securitisations as well as the more traditional style, and also permit the SPV to enter into all transactions which are related to the securitisation (such as derivative transactions and short term investment of surplus cash).

### **3. Grouping for Thin Capitalisation Purposes Only**

We would request that you reconsider allowing grouping of a securitisation vehicle with the sponsor group outside the normal consolidation regime.

Due to concerns that a trustee of a securitisation trust may, inappropriately, under the joint and several liability rules, be liable for the tax liability of an entire consolidated group, many securitisation vehicles are being structured so that they are not eligible to be members of a consolidatable group and thus will not be part of a consolidated group. This means that even where a transaction remains on the balance sheet of the sponsor group, deductions for interest may be denied notwithstanding that the sponsor group has 'surplus' equity which, if the securitisation vehicle were to be consolidated with the sponsor group would result in the normal safe harbour tests being satisfied and no amount of interest deduction being denied. In the case particularly of securitisation trusts, due to the income beneficiary being presently entitled to the income of the trust, it is, in reality, the sponsor group which suffers the effect of the denial of any interest deduction to the trustee of the securitisation trust. It is therefore inequitable and iniquitous that the sponsor group is not able to group the securitisation trust.

We do not see any adverse impact for the revenue in allowing securitisation vehicles to be grouped for thin capitalisation purposes only. It seems to us that it simply corrects an anomaly which otherwise arises where a group, for reasons unrelated to the securitisation vehicle, may choose not to form a consolidated group at all or, if it does form a consolidated group, the securitisation vehicle is left outside it in order to prevent the absurd situation of the trustee becoming liable for tax liabilities unrelated to the trust, notwithstanding that the securitisation vehicle is a tax neutral vehicle. On the basis that this limited form of grouping is available only to securitisation vehicles, we see little risk of abuse.

### **4. Eligibility for Zero Capital Concession**

For the reasons set out below, we believe that the formulation of the eligibility criteria should be as follows:

A securitisation vehicle will be entitled to claim the zero capital concession if any one of the following three tests is satisfied:

- (i) the sponsor/originator (or an entity of which it is an associate) is regulated by APRA and both of the following conditions are satisfied:
  - (a) the 'separation' and 'clean sale' requirements imposed by APRA under its prudential standards and related guidance notes are satisfied such that APRA does not require the sponsor/originator (or the associate) to hold

- capital in support of assets transferred by the sponsor/originator to the securitisation vehicle; and
- (b) Either:
- the credit enhancement (as defined under APRA's prudential standards and guidance notes) satisfies the arms length test; or
  - the amount of regulatory capital required to be held against any credit enhancement provided by the sponsor/originator, as determined under APRA's prudential standards and guidance notes, is less than 8%;
- (ii) the 'separation' requirements imposed by APRA under its prudential standards and related guidance notes are satisfied such that APRA does not require the sponsor/originator (or the associate) to hold capital in support of any facilities provided by the sponsor/originator to the securitisation vehicle; and
- (b) Either:
- the credit enhancement (as defined under APRA's prudential standards and guidance notes) satisfies the arms length test; or
  - the amount of regulatory capital required to be held against any credit enhancement provided by the sponsor/originator, as determined under APRA's prudential standards and guidance notes, is less than 8%;
- (iii) the sponsor/originator (or an entity of which it is an associate) is regulated by APRA but subsection (i) or subsection (ii) does not apply, and both of the following conditions are satisfied:
- (a) the sponsor/originator has transferred risks relating to holding certain assets to the securitisation vehicle without having transferred the assets themselves; and
- (b) the sponsor/originator (or the associate) is required under APRA prudential standards and guidance notes to hold less than 8% of regulatory capital against the residual risk retained/borne by the sponsor/originator;
- (iv) neither the sponsor/originator nor an entity of which it is an associate is regulated by APRA and all of the following conditions are satisfied:
- (a) no entity is required under Australian Accounting Standards, to account for its investment in the securitisation vehicle using equity accounting principles;
- (b) no entity is required, under Australian Accounting Standards, to record any asset of the securitisation vehicle on its balance sheet;
- (c) the securitisation vehicle is not required, under Australian Accounting Standards, to be consolidated with any other entity; and
- (d) any credit enhancement satisfies the arm's length test or is less than 8% of the value of the assets subject to the securitisation arrangement.
- (v) The arm's length test is satisfied if any one of the following paragraphs is satisfied:
- (a) the provider of the credit support is not related to the issuer; or

- (b) the level of credit enhancement has been determined by a rating agency (whether by way of a private or public rating opinion) and the rating relates either directly or indirectly to an issue of securities; or
- c) in a case to which neither paragraph (a) nor paragraph (b) applies, either:
  - (i) the level of credit enhancement is commensurate with the level of credit enhancement determined under either paragraph (a) or paragraph (b) above in respect of a similar transaction; or
  - (ii) it is commensurate with the level of *first loss credit* enhancement as defined in the APRA Prudential Standards; or
  - (iii) it is of a level that does not require the provider of the credit support to consolidate the vehicle under Australian Accounting Standards.

#### 5. Reasons for Amendments in 4. above

We have attempted to reflect the APRA prudential standards which appear to require a determination first of whether the clean sale and separation criteria are satisfied or not and then provide that the existence of credit enhancement (by the ADI) does not, of itself, impact upon the clean sale test but that some deduction from capital must be made for credit enhancements (by the ADI). Accordingly, we have reversed the order of the application of the tests and also qualified the credit enhancement requirement to that provided by the sponsor/originator. The real issue is whether the SPV should be treated as a stand alone entity and the fact that mortgage insurance or a credit wrap is provided by a completely independent insurer on arm's-length terms will not infringe the APRA requirements which only looks to credit enhancement provided by the ADI. There is no reason why a different approach should be adopted for tax purposes.

We have also included a separate test for the circumstance where an ADI is a true "sponsor" of a securitisation vehicle - for example, a multi-seller conduit - to which the ADI does not sell assets itself but provides certain facilities. In that circumstance, any requirement for true sale would be an issue for the third party seller of the assets to the securitisation vehicle and the requirement for the ADI should be limited to separation.

It also follows from the above that the terminology used (ie. credit enhancement rather than credit support) should follow that adopted by APRA and explained in some detail in APRA's Guidance Note AGN 120.2.

As alluded to earlier in this letter and as reflected in the additional eligibility test above there are circumstances where it is not possible or appropriate to actually transfer assets to the Securitisation Vehicle. For example, some receivables may be non-assignable, in other cases, the tax cost of sale may make the transaction uneconomic. Therefore, it is necessary that the zero capital concession is available to an SPV even if there is no clean sale (because there is no attempt at a sale) but APRA recognises, through a reduction in the capital required to be held against the assets, that substantially all the risks have been transferred to the SPV. Typically this will be achieved through some form of credit derivative such as a credit default swap or through notional (credit) contracts, risk participation agreements and similar arrangements. If APRA recognises these transactions as having a similar effect, from a risk perspective, as a clean sale then, we

submit, they should be accorded the same treatment and we have tried to reflect that in the additional test above.

We have also retained our original proposal that a special arm's length test be used to determine appropriate levels of credit enhancement.

## 6. **Justification of 'Safe Harbour' Credit Enhancement**

We believe that, having regard to market practice, the imposition of an arbitrary limit on credit enhancement could unduly impact adversely on some demonstrably commercial, securitisation transactions. Therefore, we continue to believe that the primary test should be an arm's length one. Only where this is not met, should resort to the 8% safe harbour be necessary.

Subject to the preceding paragraph, we believe that the permissible level of credit enhancement which should be the subject of the safe harbour should be 8%. This is based on the minimum level of regulatory capital required to be held by an ADI against its assets (adjusted for risk weighting). If the level of capital required to be held as a result of the ADI entering into a credit enhancement for a securitisation vehicle is less than 8%, then it demonstrates that the risks have been effectively transferred to the securitisation vehicle. Therefore, we believe that this is an appropriate, independently regulated method for determining whether a securitisation vehicle should be regarded as appropriately funded. Higher (or lower) thresholds might be appropriate but none involves the same 'independence' as APRA's minimum regulatory capital.

Whilst the regulatory capital regime does not, of course, apply to sponsor/originators that are not regulated by APRA, we submit that it would not be appropriate to apply a different safe harbour level of credit enhancement to those entities; although the method of valuation of that credit enhancement may differ (refer below).

Sponsor/originators regulated by APRA will be required to deduct the amount of any credit enhancement from their capital. However, the deduction from capital is limited to the amount of capital that the sponsor/originator would be required to hold against the assets which are the subject of the securitisation transaction. For example, for a pool of \$100 of assets, the securitisation vehicle may issue highly rated notes of, say, \$88 and receive \$12 of credit enhancement from the sponsor/originator. Prima facie, the sponsor/originator would deduct \$12 from its capital but, this is limited to the amount of capital that the sponsor/originator would have had to hold against the assets if the securitisation transaction had not been entered into (ie.  $\$100 \times 8\% = \$8$ ).

## 7. **Conduit Structures/Secured loan structures**

In those cases where the assets are not actually transferred but funds are raised and on lent by the SPV to the sponsor/originator on the security of those assets/cashflows, the question arises as to the appropriate point in a chain of entities at which to apply the thin capitalisation test.

For example, in a commercial mortgage backed securitisation (**CMBS**) the responsible entity of a property trust, rather than transferring the properties or the rights to receive rent etc. may issue debentures to an SPV which will fund the acquisition of those debentures through the issue of bonds either directly or through one or more other SPVs.

In these circumstances, we submit that the test should be applied only at the level of the asset owning entity (in the above example, the responsible entity) which incurs interest expense on the debentures and not at any other point in the conduit chain. This way, if the funding by the RE of the real assets (ie. the property assets) breaches its thin capitalisation safe harbour (subject to the arm's length test) then it is appropriate for the RE to be denied an interest deduction but it is not appropriate for the funding structure to suffer a denial of interest deductions as well.

Where all the entities in the chain are associates, an appropriate result should be achievable through the existing Associate Entity Debt and Average On-lent Amount concepts. However, where the entities in the chain are not associates, the existing regime does not assist and specific amendments are required.

#### **8. Definition of Sponsor/Originator**

Care is needed not to cast the net too widely. For example, we would not regard a manager as a "sponsor". Many transactions are arranged by independent third parties, which also provide the management services and associates of which may provide swaps and/or liquidity facilities to the securitisation vehicle in which they have no ownership interest. Many securitisation vehicles are also sponsored by an ADI and, while the ADI's involvement with the securitisation vehicle may meet the requirements of APRA, the assets to be sold by a seller to that securitisation vehicle may require a level of credit enhancement that has an adverse consequence for the seller (in that it may not achieve a "true sale" for the seller). In this case, the ADI (as the sponsor of the securitisation vehicle) should not be prejudiced.

We would be pleased to discuss these issues further with you and will make ourselves available whenever and wherever possible.

Yours sincerely

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