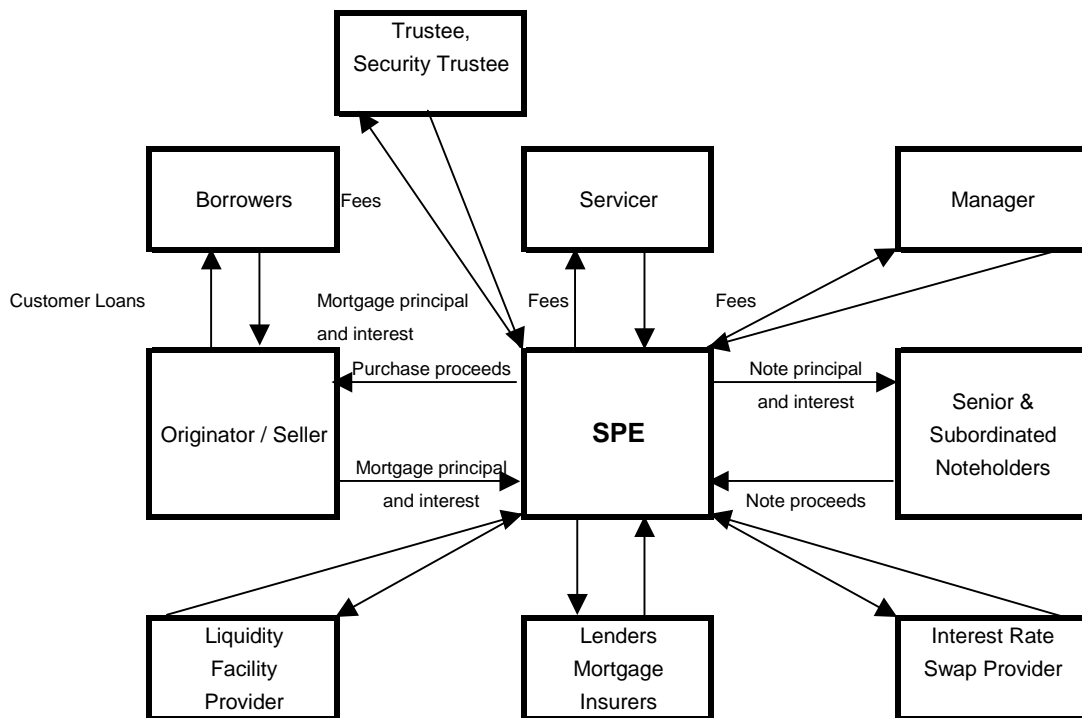


Residential Mortgage-Backed Securitisation

Objective

This paper was prepared jointly by the Australian Securitisation Forum and the ABA Accounting Committee, and provides a brief analysis of the application of UIG Abstract 28 “Consolidation – Special Purpose Entities” (UIG 28) to typical residential mortgage backed securitisation (RMBS) structures in the Australian market. Residential mortgages are the dominant asset class for securitised debt issues in Australia. Other classes of assets that are securitised include lease receivables, credit cards and corporate loans.

Structure Diagram



Summary

Under Australian accounting requirements the consolidation of an entity is normally decided by which entity retains the majority of the risks and benefits related to the entity.

Within securitisation structures the largest potential risk is usually the credit risk related to the housing loans owned by the SPE. The risk of credit losses is first

covered by the collateral held, then by the independent mortgage insurance company, then by any residual income in the SPE (normally relatively immaterial) and then by the investors. The originator's only exposure to credit risk is to the extent of any residual income not yet paid to it. There is no right of redress by the investors back to the originator.

Similarly, the investors receive an interest margin above the standard funding rate, which is the major financial benefit in the transaction.

The originator often supplies various services to the transaction eg, loan servicing, liquidity support, but these are incidental to the major risks and benefits. Throughout the period of the securitisation transaction (typically six years) any residual income within the SPE is passed to the originator and in substance represents deferred purchase consideration from the original sale.

The SPE principally operates for the benefit of investors, who in turn carry the majority of risk. The originator has no power to unwind the SPE or alter its activities. The SPE is in substance a conduit to effect the sale of a portfolio of housing loans to multiple investors that would not normally be able to make such an investment. On this basis, it is considered that the originator does not control the SPE and therefore should not consolidate the SPE.

The specific guidance clauses of UIG 28 are analysed in detail within this paper.

Description of Transaction

An Australian residential mortgage-backed securitisation is typically executed through the sale of assets (in this case residential mortgages) from the originator to a special purpose entity (SPE), which then issues publicly rated debt securities to institutional and other investors which are collateralised by the assets.

The originator sells a portfolio of residential mortgages by way of equitable assignment to the SPE (ie beneficial interest in the mortgages is transferred, though legal title remains with the originator) for cash consideration. The cash raised by the SPE through issuance of debt securities to investors is used to purchase the underlying residential mortgage portfolio from the originator, normally at par value.

Credit Risk

The SPE, normally a trust, is structured to be independent of the originator such that investors are not directly exposed to the financial performance or credit deterioration of the originator (ie the SPE is bankruptcy remote). Instead, investors are directly exposed to the performance of the residential mortgage portfolio held within the SPE.

This is commonly referred to as a 'pass-through' structure whereby investors in the securities issued by the SPE effectively have a direct ownership in the underlying portfolio of residential mortgages through an equitable assignment. In most instances, credit enhancement is provided to the SPE-issued debt securities in the form of Lenders Mortgage Insurance (LMI). The LMI provider, an independent insurance company, receives premium income and pays cash into the SPE for

qualifying losses (ie claims meeting the terms and conditions of the underlying policies).

To the extent that the mortgage insurer failed, the maximum credit risk exposure of the originator is only the remaining amount of any residual income receivable. The balance (and greatest potential portion) of the credit losses would then be borne by the investors. There is no right of redress by the investors back to the originator.

Loan Servicing

The loan servicer collects the interest and principal payments on the underlying loans and passes them on directly to the SPE. All of the principal receipts and the majority of the interest receipts are subsequently paid directly to the investors. A market-rate servicing fee is paid to the servicer for ongoing loan administration, out of the difference between the interest received by the SPE and the coupon paid to the investors. Often the servicer will be a subsidiary of the originator, however third-party servicers are also prevalent in the Australian market.

Interest Rate Swap

Australian residential mortgage-backed transactions also commonly involve an interest rate swap provider who provides a basis swap to the SPE to enable it to pay investors a fixed interest margin over a benchmark on the issued debt securities. The basis swap transfers the risk of interest rate volatility on the underlying mortgage assets from the investors to the swap provider.

Liquidity Facility

A short-term liquidity facility is also normally provided by a rated counterparty to protect investors from timing mismatches which may occur between when income is received and when certain obligations or expenses of the SPE are due to be paid. Such facilities are designed to meet the temporary liquidity needs of the SPE and are limited in size to a small percentage of the aggregate notes on issue.

Right to Residual Income

The originator typically retains the right to receive any excess profits remaining in the SPE after the investors have been paid their interest and all expenses of the SPE have been satisfied (eg servicing fees, trustee fees, swap costs, etc). The residual or excess profits are normally swept out of the SPE on a monthly or quarterly basis and are generally immaterial to the transaction cash flows. In effect, this residual income right represents deferred consideration to the originator on the structuring of the transaction and initial sale of its residential mortgage portfolio to the SPE.

Economic Rationale

The institutional and other investors receive a market interest rate and have their investment 'backed' by the residential mortgage portfolio held within the SPE. The investors are typically at risk for credit losses in excess of insurance cover or

where the mortgage insurers fail to meet their obligations of paying for qualifying losses (subject to the credit losses borne by the originator up to a maximum of any residual income not paid). The originator has the potential for further income relative to the sale, being the residual profit in the SPE. This is generally a relatively immaterial amount. Where applicable, the originator also receives servicing income.

Originators undertake securitisation transactions for one of a number of different reasons. One factor is capital management, releasing capital to boost return on equity, and evaluating which assets should remain on balance sheet and which can be used to obtain cheaper cash than by borrowing in the originator's own name. Other factors include the transfer of risk, access to new markets and greater volume or term of funds than would otherwise be possible.

Banks have used securitisation for years to build their residential lending activities and manage liquidity. By selling the mortgages to an SPE the banks reduce the amount of regulatory capital required to be held against these assets. Furthermore, the rating agencies and equity analysts give them credit for diversifying their funding sources and for reducing their reliance on the corporate debt market in the face of a shrinking supply of retail deposits.

Regulatory Capital

For originators that are ADIs, the regulatory capital treatment of securitisation transactions is also critical. APRA Prudential Standards permit an ADI to cease holding regulatory capital in support of assets sold into a SPE where the sale is a "clean sale" and the SPE has no recourse to the ADI. The typical transaction described in this paper would qualify as a "clean sale".

Accounting Analysis

The key accounting issue surrounds the question of whether or not the SPE should be consolidated by the originator. In Australia we look to AASB 1024 "Consolidated Accounts" and UIG 28 "Consolidation – Special Purpose Entities".

UIG 28 "Consolidation – Special Purpose Entities"

In July 1999, the Urgent Issues Group issued Abstract 28 "Consolidation - Special Purpose Entities" (UIG 28) to clarify the circumstances under which an entity should consolidate a special purpose entity (SPE) in Australia.

Most securitisation transactions involve the formation of a dedicated SPE. UIG 28 looks at the economic relationship between the SPE and its parent and whether that relationship evidences in substance control by the originator or seller over the SPE.

Specifically, UIG 28, Paragraph 13 states that the following circumstances “would normally indicate a relationship in which an entity controls an SPE and consequently must consolidate the SPE”:

- (a) in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE’s operation;
- (b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an “autopilot” mechanism, the entity has delegated these decision-making powers;
- (c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
- (d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

In determining which entity (if any) should consolidate the activities of an SPE within a typical Australian RMBS structure, it is important to recognise that there is a wide dispersal of risks and rewards between the various parties to the transaction, including – the seller/originator of the underlying mortgages, the noteholders, the LMI insurers who provide the primary credit support, the trust manager, the trustee, the security trustee, the servicer, the interest rate swap and liquidity facility providers, and the residual income unitholder in the SPE.

It is also important to acknowledge that certain entities can perform a multitude of these functions within the same transaction (eg originator, servicer, trust manager, liquidity facility provider, etc).

The following analysis principally focuses on whether or not the originator in a typical Australian RMBS transaction should be required to consolidate the SPE established for the purposes of that transaction.

UIG 28, Paragraph 13(a). The activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operation.

- In the typical transaction described above, the SPE is formed *principally* on behalf of the investors or noteholders. It is the investors who are entitled to the majority of the cashflows stemming from the SPE, and the activities of the SPE are conducted principally to protect and fulfil the investors' rights.
- The SPE fulfils the specific business needs of all significant parties involved in a typical RMBS transaction.
- The need for an SPE is driven by the investors, such as superannuation funds, which cannot otherwise readily and affordably purchase mortgage loan assets (or the majority components thereof). Further, securitisation enables investors to acquire a proportional share in a large pool of loan assets, providing them with greater diversification than through the purchase of a smaller pool of loans. Securitisation also produces a security which is far easier and far

cheaper for an investor to trade than is a pool of housing loans, thus providing greater liquidity. The SPEs act as a conduit to facilitate these purchases.

- To the extent the originator is involved in determining the structure of the SPE and the transaction documents, it does so to effect the sale of the home loans.
- The rights of the seller are generally restricted in order to protect the investors' interests.

UIG 28, Paragraph 13(b). The entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an "auto-pilot" mechanism, the entity has delegated these decision-making powers.

- The activities of an SPE in the typical Australian RMBS transaction are governed by the Trust Deed which is normally developed by the trustee and trust manager (normally also the seller or a related entity of the seller) in consultation with the Ratings Agencies.
- The Ratings Agencies are involved to ensure that the SPE's activities are independent from all involved parties and also that the investors' best interests are not jeopardised by any of the clauses in the underlying Trust Deed.
- Once the SPE is formed, the trust manager has no decision-making authority outside the Trust Deed.
- The SPE in a typical Australian prime RMBS structure operates on 'auto-pilot' – its activities are permanently limited by the legal documents establishing it. The SPE operates principally on behalf of the investors, with its permitted activities limited to: (i) holding equitable title to the mortgage assets; (ii) issuing beneficial interests (debt securities) to the investors; (iii) collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to the investors, and otherwise servicing the assets held; (iv) distributing cash entitlements to the investors; and (v) paying operating expenses and generally administering the pre-determined cash flow waterfall of the SPE. All of these permitted activities are established for the benefit of the investors as a whole, because the financial assets sold to the SPE cannot be otherwise separated into pro-rata portions and sold to the individual investors.
- The seller has no unilateral ability to dissolve the SPE or to alter its permitted activities under the terms of the Trust Deed after it has been established. Typically the only parties that can alter the activities of the SPE after its formation are the investors.
- The seller or trust manager does not have control over an SPE simply by virtue of establishing the SPE or predetermining its activities. Other indicators of control need to be considered, such as determining who the SPE principally acts for and the distribution of the risks and benefits of its activities.

UIG 28, Paragraph 13(c). The entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE.

- This indicator of control recognises that the entity with access to the majority of the benefits arising from an SPE's activities would (especially where the SPE was on autopilot) control the SPE.
- The benefits of the SPE are divided among the various participants – the noteholders receive an interest margin above the standard funding rate (BBSW) which is a major benefit in the transaction; the trust manager receives

a management fee; the trustee and security trustee are entitled to trustee fees for their services; the servicer receives an administration fee; the interest rate swap provider and liquidity facility provider receive commitment fees, interest and other fees; while the residual income unitholder (often the seller) receives a residual return after all expenses of the SPE have been satisfied.

- The residual interest does not give the seller an equity-type interest in the SPE such that the seller can in fact control the SPE or all (or the majority of) the financial assets held by the SPE.
- In substance, the right to residual income is a mechanism to return an amount of deferred purchase consideration to the originator. The consideration is deferred because the Rating Agencies require some 'buffer' in the SPE to cover any unforeseen expenses.
- Were a third party to purchase the residual income right from the originator, it would seem incongruous to expect that third party to consolidate the entire SPE by virtue of its exposure to the relatively immaterial amount of residual income of the SPE. It is important to note that the residential income, or a large component of it, can and has been sold to investors in a number of Australian and offshore securitisation transactions.

UIG 28, Paragraph 13(d). The entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

- The largest potential risk is usually the credit risk related to the housing loans owned by the SPE. The risk of credit losses is first covered by the collateral held and then by the lenders mortgage insurance. Such insurance is provided by an independent insurer. Any excess credit losses are typically covered, first, through any residual income due to the originator and, then, by the noteholders. That is, the maximum credit risk the originator is exposed to is any residual income receivable (to the extent residual income has already been distributed, it is fully earned by the originator and not available to cover any future credit losses). All other credit losses are borne by the noteholders. For example, if the mortgage insurer failed, then the noteholders would bear the greatest exposure to potential credit loss.
- The second most significant risk of the SPE's activities is mortgage prepayment risk. This is the risk that more borrowers than expected will repay their loans ahead of schedule, monies might be invested temporarily by the SPE in authorized investments earning a lesser return, and then noteholders will receive their principal earlier than expected. The majority of this risk is borne by the noteholders.
- The originator or seller is normally exposed to the loss of any residual net benefit arising from the activities of the SPE. This risk of loss is relatively immaterial compared to the potential losses mentioned above.
- In essence, this risk is the risk of the seller not receiving its full entitlement to purchase consideration on selling financial assets, and that is how the transaction should be accounted for (ie, as a sale). The seller's retained ownership of a 'residual' interest in these circumstances does not confer an equity-type controlling interest to the seller, and should not result in it consolidating the SPE.

Conclusion

UIG 28 recognises that the indicators of control are specific circumstances that would normally *but not always* indicate a relationship in which an entity controls an SPE. In a typical mortgage loan securitisation the SPE is merely a conduit to the effective transfer of the majority of the risks and benefits of the loans to investors/purchasers. The SPE's activities are structured on auto-pilot, and overseen by Ratings Agencies, to effect the sale and protect the rights of the investors/purchasers. The originator cannot unilaterally invade the SPE and acquire or change the assets or liabilities. Hence, while some UIG 28 indicators may appear to be triggered, an appropriately balanced interpretation and view is that the originator in this situation does not control the SPE, and therefore should not consolidate the SPE.

Accounting Concepts

As a logic check it is important to consider whether the assets and liabilities recognised on the originator's consolidated statement of financial position (SFP) meet the SAC 4 definitions of assets and liabilities.

It would not be appropriate for the originator to recognize the entire mortgage receivables on its consolidated SFP.. SAC 4 defines assets to be "future economic benefits controlled by the entity as a result of past transactions or other past events" and control of an asset to mean "the capacity of an entity to benefit from the asset in the pursuit of the entity's operations and to deny or regulate the access of others to that benefit".

In the situation described, the originator surrenders its rights to the assets sold. The originator receives no economic benefits from the assets sold. The originator can no longer exchange or pledge or otherwise use the assets sold. The principal repayments, for example, belong to the noteholders and even if the originator went into liquidation, its creditors could not reach those principal repayments. Hence, it is not appropriate to recognize the entire mortgage loans on the originator's consolidated SFP.

Likewise, the noteholders' rights to receive principal and interest repayments are not obligations of the originator. They do not involve the originator sacrificing economic benefits (the originator has already surrendered its rights to those economic benefits through the sale and derecognition of the assets sold). The originator cannot influence the repayments (eg timing, amount) to the noteholders. Similarly, the noteholders do not have recourse to the assets of the originator. Hence, it is not appropriate to recognize the noteholder liabilities on the originator's consolidated SFP.

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