

# Briefing Paper on Final Draft APS 120

July 2007

## 1. Introduction

On 11 July 2007 APRA released its response to the submissions that it had received to its November 2006 draft of APS 120, along with a "final draft" of the new APS 120 (including Attachments A to G). The new draft reflects the changes agreed by APRA as a result of comments from the industry and also a streamlining of the Prudential Standard to be consistent with APRA's commitment to a more principles-based approach to prudential regulation. Some of the previous detailed requirements that have been omitted from this draft will continue to be relevant and will be contained in the prudential practice guide APG 120. A revised draft of the practice guide has yet to be published but, interestingly, APRA has indicated that the detailed requirements will be "non-binding".

Submissions to APRA in relation to the final draft Prudential Standard are due by 10 August 2007.

In summary, some of the changes APRA has made in the revised draft are positive and address a number of the comments made in submissions to APRA on the November 2006 draft. Highlights include:

- the introduction of a self assessment regime for ADIs involved in securitisation (see paragraph 4 of this paper below);
- a narrowing of the scope of the "originating ADI" concept (see paragraph 5 of this paper below);
- changes made to the application of a maximum capital charge in relation to securitised pools (see paragraph 7 of this paper below);
- a clarification of the requirements in relation to the replacement of ADIs providing facilities or services to an SPV (see paragraph 12 of this paper below);
- a clarification of the treatment of cash collateral facilities (see paragraph 15 of this paper below); and
- removal of the requirement for certain legal opinions to be obtained in connection with a securitisation (see paragraph 16 of this paper below).

A number of new provisions have been inserted or provisions from the November 2006 draft retained which, if introduced without amendment, will present real challenges to ADIs involved in securitisation. Examples of these provisions include:

- the limited transitional arrangements proposed by APRA (see paragraph 2 of this paper below);
- the treatment of warehouse facilities (see paragraph 3 of this paper below);
- the still expansive definition "originating ADI" (see paragraph 5 of this paper below);
- the new restrictions on threshold rate provisions (see paragraph 6 of this paper below);
- the tightening of restrictions on clean-up calls (see paragraph 10 of this paper below); and
- the prohibition on the subordination of servicing and management fees (see paragraph 17 of this paper below).

## 2. Limited transition arrangements

In the November 2006 draft APRA indicated that it had not yet finalised the transition arrangements for securitisation exposures approved under the existing APS 120. APRA encouraged ADIs to detail the type of transitional arrangements they needed. APRA also stated that it expected that any new or modified securitisations undertaken subsequent to the release of draft APS 120 would be brought in line with the proposed amendments.

The submissions on this issue generally provided for existing securitisations to be grandfathered and for the Prudential Standard to only apply to new transactions after the commencement of the Basel II Framework in Australia on 1 January 2008.

In the latest draft APRA has recognised that it is difficult for structures to comply with the new requirement before they are finalised. However, it has rejected the grandfathering approach. Instead APRA proposes to apply the new Prudential Standard in full to all existing securitisations from the date it comes into force (which is expected to be 1 January 2008) (paragraph 22 of the new draft). However, where this would result in a significant increase in the capital requirement for an ADI, the draft proposes that APRA may, for a transition period of up to two years (the period has been square-bracketed in the draft), impose a lesser capital requirement, suspend the operation of provisions of the new Standard or continue the operation of the existing APS 120 in relation to a particular securitisation exposure, on a case-by-case basis (see paragraph 23 of the new draft).

## 3. Traditional and synthetic securitisations, warehouse facilities and covered bonds

### Traditional and synthetic securitisations

As with the November 2006 draft, APRA proposes that the new APS 120 will extend to "traditional securitisations", "synthetic securitisations" and securitisations that have features of both. Importantly, however, APRA has revised the draft to enable it to apply the Prudential Standard to a particular transaction or structure "if it has similar features to a securitisation and gives rise to similar prudential risks" (paragraph 9 of the draft).

APRA has not reformulated any of the specific rules which apply to synthetic securitisations. However, some of the changes to the requirements applying to traditional securitisations will also apply to synthetic securitisations. A summary of these changes appears in paragraph 23 of this paper below.

### Treatment of warehouse facilities

The new draft has been amended by APRA to specifically bring facilities provided to a "warehouse SPV" within the scope of APS 120.

In the November 2006 draft, a "securitisation" was defined as a structure with at least two different tranches or classes of creditors. Under that definition, some warehouse structures would have been securitisations, while others would have not. This had the potential to lead to very different capital treatment outcomes for ADIs, even though the relevant warehouse structures were very similar. The new draft attempts to eliminate this uncertainty by specifically including within the definition of a securitisation a "warehouse SPV".

A "warehouse SPV" is defined in the new draft as an SPV that accumulates exposures until a sufficiently large pool is available for issuance of securities to the market in a securitisation (paragraph 4(z) of the draft). This definition is quite narrow and potentially excludes a number of facilities which may not necessarily be refinanced in the manner described. Until this is clarified by APRA there is, therefore, still potential for different capital treatment for facilities provided to similar warehouse structures.

Under the new draft, a facility provided to a warehouse SPV will be treated as a securitisation exposure with the result that an ADI providing a warehouse facility will need to comply with the requirements for funding facilities in APS 120.

APRA in its Response to Submissions released with the new draft indicated that it had included provisions to accommodate warehouse facilities in Attachment E, however, these are not entirely clear. APRA has

modified the requirements in Attachment E so that it appears easier for a warehouse facility to qualify as an "eligible facility". As a result, a qualifying warehouse facility may be entitled to the concessionary capital treatment for an unrated eligible facility provided by an ADI employing the standardised approach (see paragraph 13 of Attachment C). Under this approach, an ADI providing a warehouse facility will be able to risk-weight its exposure for drawn amounts at the highest relevant risk-weight (as determined by APS 112) for any of the underlying individual exposures covered by the facility. The implication of APRA's proposal is that careful structuring will be necessary by ADIs for their facilities where different risk-weighted assets are being funded.

There are also some additional complications with the approach adopted by APRA. The definition of "funding facility" inserted in the new draft specifically excludes funding provided through the ordinary purchase of securities issued by an SPV. However, this is the manner in which most warehouse SPVs are funded in order to take advantage of, amongst other things, the mortgage or asset-backed securities exemptions for stamp duty purposes. As a result facilities structured in this manner will not qualify as "eligible facilities. Further in order for a facility to be a "funding facility", it cannot be provided for the purpose of the SPV acquiring the initial exposures in the pool (unless the facility is a "temporary funding facility" under paragraph 6 of Attachment E) and it must not be "expected to fund a disproportionate amount of the pool of the SPV" (see paragraph 5(b) of Attachment E). It is possible, therefore, that warehouse facilities will not be able to comply with APRA's preconditions for a qualifying "funding facility" and, may instead, need to meet the requirements for a "temporary funding facility". In order to qualify as a "temporary funding facility" the facility must be provided for the purposes of funding the acquisition of the initial exposures by the SPV "pending the issue of securities". Some warehouse facilities may not fit comfortably with this requirement either and hence not qualify for treatment as an "eligible facility".

Overall, APRA's treatment of warehouse facilities appears to require further clarification. In this regard, APRA has indicated that the treatment of facilities provided to a warehouse SPV is still open and that it would welcome feedback on this issue.

#### Covered bonds

APRA has reiterated its position in the November draft of APS 120 that covered bonds are inconsistent with the depositor preference provisions set out in the Banking Act and hence are prohibited (see paragraph 8 of the new draft).

## 4. Self assessment implemented

Currently, APRA generally reviews all new securitisation structures or issues prior to issuance to assess compliance with APS 120. APRA has indicated that this process is burdensome for it and it recognises that this is also the case for ADIs. While APRA repeated the pre-vetting requirement in the November 2006 draft, it also encouraged submissions on alternative compliance approaches.

In its Response to Submissions APRA has indicated that it is of the view that, in general, routine transactional approvals are not consistent with its principles-based approach to prudential supervision. Under the new draft, ADIs will no longer be required to consult with APRA ahead of issuing a new securitisation. However, ADIs must undertake a written self-assessment of their involvement in each securitisation which they must provide to APRA on request (paragraph 19 of the new draft). APRA intends to continue to provide interpretative guidance on novel structures or complex issues where appropriate but does not plan to routinely review securitisations ahead of issuance or provide a written confirmation of compliance on a transactional basis once the new APS 120 is finalised.

To support this approach, APRA proposes to collect additional quarterly data on securitisation activities in the context of the new Basel II returns. APRA also proposes to develop a programme to undertake risk-focussed reviews of the securitisation activities of ADIs.

This is a very positive development and will represent a substantial decrease in the timeframe taken for an ADI to complete a transaction. This change will enable ADI's to more efficiently take advantage of favourable market conditions.

## 5. Changes to requirements relating to participants in a securitisation

### The securitisation vehicle

Under the previous draft, APRA required that an SPV had to be a corporation or trust. In the new draft APRA has expanded eligible SPV structures to include any other entities (see paragraph 8(a) of Attachment A and the definition of SPV in paragraph 4(v) of the new draft).

APRA will now allow an originating ADI to hold a non-material interest in the shares of an SPV, including the shares of a trustee of an SPV trust (see paragraph 6 of Attachment A). Interestingly, APRA has extended the requirement to include indirectly held interests in a trustee or corporate SPV (paragraph 6 of Attachment A). The draft also clarifies that an ADI may hold an ownership interest in a specific class of securities issued by a corporate SPV to facilitate access to excess earnings (see footnote 4 to paragraph 6 of Attachment A).

The previous draft Prudential Standard required that the SPV must have its own "separate personnel" to the ADI. This has now been dropped, however, in its place APRA expects that the SPV must be "operationally independent of the originating ADI" (paragraph 8 of Attachment A). It is not entirely clear what is meant by "operationally" independent and this will need to be clarified with APRA.

APRA has also removed the requirement in the previous draft that an ADI must "retain evidence that it has taken all precautions to ensure that it is not obliged to support any losses suffered by the securitisation or the investors outside of those detailed in the supporting legal documentation".

### Originating ADIs

Under both the November and July drafts of APS 120, originating ADIs are subject to more stringent requirements than ADIs that hold unrelated securitisation exposures. The definition of "originating ADI" in the November 2006 draft was wider than provided for in the Basel II Framework as it included all ADIs that provide a facility or service to a third party securitisation. In the new draft this element of the definition of "originating ADI" has been deleted. However, in its place the concept has been extended to include a "managing ADI" and, consistent with the Basel II Framework and November 2006 draft, to an ADI that provides a facility (other than a derivative) to an "ABCP securitisation" (see the definition in paragraph 4(o) of the new draft).

A "managing ADI" is a new concept and is defined as an ADI that manages a securitisation (paragraph 4(n) of the new draft). This can include an ADI undertaking responsibility for the day-to-day administration of the issuing SPV, the allocation of collections, the calculation of payments and the preparation of investor reports. A managing ADI may also manage swaps, liquidity and other facilities and events such as the issuance, refinancing or calling of securities.

The concept of a "managing ADI" is not limited only to where an ADI acts as a manager but extends to any member of the ADI's consolidated group (as defined in APS 110) that acts in this capacity (see paragraph 3(b) of the draft).

An "ABCP securitisation" is defined to be a securitisation "in relation to which the securities issued are predominately commercial paper with an original maturity of one year or less" (paragraph 4(a) of the new draft). An ABCP securitisation extends to the short-term securitisation of mortgage assets and it is important to note that the securities need only to be "predominately" of an original maturity of one year or less. APRA's extension of the definition of "originating ADI" to any ADI which provides facilities to an ABCP securitisation is the product of APRA's view that facilities provided to ABCP programs present greater risks to ADIs than those provided to "standard" securitisation programs and is consistent with the Basel II Framework.

The effect of the above change is that where either:

- (a) an ADI or one of its consolidated subsidiaries (as defined in APS 110) is acting as manager for a third party securitisation; or
- (b) an ADI provides any facility to an ABCP securitisation,

the ADI will be an "originating ADI" for the purposes of APS 120 and will need to ensure that the Prudential Standard is complied with. Otherwise, at worst, the ADI will need to include the pool of exposures that are being securitised in the calculation of its own risk-weighted assets.

### Foreign ADIs

Under the previous draft, foreign ADIs were required to comply with the provisions in the Prudential Standard relating to disclosure and separation. APRA has extended their compliance obligations to include board and senior management responsibilities (paragraphs 17 & 18 of the draft) and self-assessment (paragraph 19). The prohibition on the use of related trustee companies, first raised in the November 2006 draft, continues to apply to foreign ADIs.

## 6. Threshold rates and basis swaps

APRA has introduced a new requirement that will affect the use of threshold rate provisions. An originating ADI will not obtain capital relief for a pool of securitised exposures unless, amongst other things, the ADI does not, and is not required to, increase the interest rate charged to borrowers, such as under a required rate or threshold rate agreement in response to:

- (a) a deterioration in the credit quality of the pool, an originator or a facility or service provider;
- (b) an increase in the margin payable by the SPV to investors (for example, due to a step-up on issued notes);
- (c) an increase in the cost of facilities or services provided to the SPV; or
- (d) any other increase in costs to the SPV (see paragraph 2(f)(iv) of Attachment B).

In its Response to Submissions APRA has indicated that in its view threshold rate agreements of the type referred to above undermine the separation between the securitisation and the ADI and the transfer of risks from the ADI to the securitisation and can place pressure on an ADI to charge an uncommercial rate on the securitised pool. APRA believes that a securitisation should be structured so that it can meet its obligations without the need for the ADI to increase the interest rate charged to customers.

APRA's motivation for this change also appears to be tied to its tightening of the circumstances in which an originating ADI can repurchase securitised exposures (see paragraph 10 of this paper below). APRA is concerned that date-based calls may affect originating ADI's where non-exercise of the call results in a step-up on the margin of the securities issued by the SPV which may require the ADI to increase the interest rates charged to borrowers in respect of the underlying pool. The restrictions APRA has included in relation to threshold rate mechanisms clearly go beyond this concern.

APRA's approach to threshold rate mechanisms is likely to be quite contentious, particularly for the rating agencies, and needs to be carefully considered by all interested parties.

APRA has recognised that it is difficult for basis swaps to satisfy the requirement that applies to every facility provided by an ADI to a securitisation that the facility must "be provided on an arm's length basis, be subject to the ADI's normal credit approval and review process and be transacted on market terms and conditions" (paragraph 1(b) of Attachment E). APRA has exempted basis swaps from meeting all of these requirements provided that the ADI must not be expected to be a net payer during the life of the transaction. It has, in addition, clarified that this extends to contingencies that could affect the margin received or paid on the swap (for example, because of step-up provisions or credit rating downgrades) (see paragraph 8 of Attachment E). Basis swaps which are structured on the basis that the ADI is required to pay a base rate plus the weighted average margin of the securities at the relevant time are likely to breach these new requirements. In addition, where the ADI expects to be a net payer for an extended period the ADI must report to APRA the fair value or expected net present value of the transaction at current market rates and APRA may require this amount to be deducted from the ADI's capital (paragraph 9 of Attachment E). Unlike the previous draft, no guidance is given as to what constitutes an extended period for this purpose.

## 7. Maximum capital requirements

The November 2006 draft of APS 120 required an ADI to obtain written approval from APRA in order to take advantage of a cap on the capital required to be held by it in connection with its exposures to a securitisation at the level it would have otherwise held against the securitised pool under APS 112 or APS 113. This cap will now apply at the election of the ADI. However, the ADI is not permitted to change its election during the life of the transaction (see paragraph 24 of the new draft). In addition, the ADI will still have to comply with the separation and disclosure requirements of APS 120.

## 8. Implicit support

The new draft has altered some of the previous provisions relating to the giving of "implicit support" by an ADI to an SPV.

An ADI must not provide, *or knowingly allow the perception to arise that it will provide*, support to a securitisation that is in excess of the ADI's explicit contractual obligations (the words in italics are new). To do so will constitute "implicit support" (see paragraph 12 of the draft).

If an ADI provides implicit support to a securitisation, or otherwise does not comply with APS 120, APRA may, in writing, increase the ADI's minimum regulatory capital requirement in an amount specified by APRA (paragraph 20 of the new draft). The amount must be commensurate with the risks arising from the provision of the implicit support or other breach of APS 120. It must not exceed the amount of the regulatory capital requirement that the ADI would be required to hold under APS 112 or APS 113 (as appropriate) against:

- (a) the relevant pool(s), if the exposures in the pool were reported as assets held by the ADI; or
- (b) the full value of all securities by the relevant SPV(s) if the securities were reported as assets held by the ADI.

If an ADI is providing implicit support to a securitisation, APRA may in writing, require the ADI to disclose this. Such disclosure must be in accordance with the relevant pillar 3 disclosure instrument (which is yet to be released) and must include details of any implicit support and its capital impact.

APRA has also inserted a new requirement that the board and senior management of an ADI must take reasonable precautions to ensure that the ADI is not providing implicit support for a securitisation (paragraph 18 of the Prudential Standard).

## 9. Private and inferred ratings

APRA has not agreed to the industry's submission that ADIs should be able to rely on private ratings for the determination of risk-weightings for securitisation exposures or that a rating should be capable of being inferred under the standardised approach if it is less than another rated exposure (even though, interestingly, the latter is permitted under the IRB approach (see paragraphs 9 & 10 of Attachment D)).

## 10. Repurchase of securitised exposures

APRA has placed greater restrictions on an ADI's ability to repurchase securitised exposures (see paragraphs 2 to 5 of Attachment F).

APRA has made it clear that a clean-up call can only be exercised when the pool has been amortised to 10% of its original value and APRA will no longer give case-by-case approvals to date-based calls above 10% (as it has been previously willing to and as was contemplated by the previous draft of APS 120) (see paragraph 2(c) of Attachment F).

In its Response to Submissions, APRA notes that this would not prevent a third-party repurchasing receivables via date-based calls (so this would presumably allow an ADI to transfer the exposures into a warehouse facility), provided that the originating ADI is not affected by the exercise or non-exercise of the call, that is, the ADI is not required to increase the interest rate charged to borrowers should the call option not be exercised. This would presumably prevent margin step-ups with date-based calls unless, perhaps, it can be shown that the step-up will not cause the ADI to increase rates charged to borrowers. It is probably unlikely

that APRA would accept the argument that there is sufficient margin in the transaction at its inception to accommodate a step-up but if the ADI covers any increased cost in the structure through a basis swap entered into at the beginning of the transaction and which itself complies with the new basis swap requirements (see paragraph 6 of this paper above) then this may be acceptable.

On a positive note, APRA has widened the ability to re-purchase individual receivables from a pool. The previous draft allowed this to occur in order to allow further advances to borrowers (subject to certain criteria, such as the loan not being in default). Such purchases are now permitted to enable further advances to borrowers or for a "similar purpose" (paragraph 5 of Attachment F).

## 11. Release of capital rules amended

APRA has re-cast some of the requirements which must be met for an "originating ADI" to exclude from the calculation of its risk weighted assets a pool of exposures that are securitised under a traditional securitisation (see paragraph 2 of Attachment B).

The November 2006 draft required that the securities issued in connection with the securitisation had to be freely transferable "without restriction". APRA has now amended this to permit restrictions necessary for compliance with legal requirements. This would still not extend to, nor permit, restrictions imposed on the provider of a warehouse facility (which involves the purchase of securities) by its client for commercial reasons.

The November 2006 draft also required that the ADI's securitisation exposures in connection with the securitisation not be significant compared to the credit risk of the relevant pool had it not been securitised. This requirement was further clarified in paragraph 7 of the November draft APG 120 which contained a general quantitative test based on the difference between the capital requirements applicable to the exposures before and after securitisation (being a 25% test). APRA has suggested in its Response to Submissions that this quantitative test would be removed given its desire for a principles based approach. It has also re-cast the requirement in paragraph 2(d) of Attachment B such that now "significant credit risk" must be transferred from the ADI to third parties in connection with the securitisation. This is consistent with APRA's view that where a securitisation is purely a funding exercise no capital relief will be available.

It is not clear how this requirement will operate where an ADI has to comply with the release of capital rules in paragraph 2 of Attachment B as a result of qualifying as an "originating ADI" because it is a "managing ADI" or provides a facility to an ABCP securitisation. Clearly, in those two circumstances the ADI would have had no exposure to the underlying pool prior to the transaction and the transaction will actually represent an increase in the ADI's exposure. This is an element which will require clarification from APRA and which clearly demonstrates some of the issues in connection with the use of the still broadly defined term "originating ADI" in the draft Prudential Standard.

The release of capital rules in paragraph 2 of Attachment B also still include the requirement inserted in the November 2006 draft that the ADI must not be required to increase a retained first loss position or credit enhancement after the inception of the securitisation (paragraph 2(f)(ii) of Attachment B). This requirement will present an issue in connection with warehouse transactions if it is not amended and is likely to be detrimental from an economic perspective in that context as it would probably mean that any required credit enhancement will have to be pre-funded from the inception of the transaction. Again, this issue should be the subject of submissions to APRA by the industry.

APRA has retained the requirement introduced in the November 2006 draft for a legal opinion to be obtained in connection with the release of capital rules although the scope of the opinion, as compared to what had been originally proposed, has been substantially narrowed. The subject matter of the opinion will now be closer to the existing requirement in paragraph 4 of AGN 120.3. In addition, the opinion now also needs to cover enforceability of all the securitisation documents. This means that the usual opinion required by the rating agencies in connection with rated transactions will now also need to be obtained in the context of unrated transactions. Interestingly, though, we note that enforceability opinions are not normally obtained from swap counterparties even in rated transactions (where they are a large financial institution), dealers or from warehouse facility providers. Enforceability opinions will now need to be obtained from these parties in order for any originating ADI involved in the transaction to comply with the new "clean-sale" requirements.

## 12. Replacement of ADIs providing facilities and services to an SPV

The November 2006 draft of APS 120 provided that an ADI providing a facility to a securitisation or services (management or servicing) must be able to withdraw from its commitment following a reasonable period of notice of no more than 90 days and that the SPV and/or investors must have an express right to select an alternative party to provide the facility or service. Both of these requirements have been modified in the new draft. The 90 day notice provision has been deleted (so that the notice period need only now be "reasonable" and, in the case of facilities, only applies if the facility has no fixed maturity date) and, consistent with the existing APS 120, the SPV's and/or investors' right to select an alternative provider can be "subject to reasonable qualifications" or "reasonable qualifying conditions" (see paragraphs 1(c) & (d) and 14 (c) & (d) of Attachment E).

## 13. Eligible facilities

Although APRA has not abandoned the concept of "eligible facilities" as submitted by the ASF and there is still some confusion regarding the status of warehouse facilities and how they fit within the requirements for these (see paragraph 3 of this paper above), APRA has addressed a number of the more problematic aspects of the previous draft APS 120 in relation to facilities (for instance, see paragraph 12 of this paper above). However, a number of other submissions made by the industry in relation to these provisions have not been taken up, including clarification of what constitutes the most "senior exposure" of a securitisation for the purposes of paragraphs 7 to 9 of Attachment C in order to qualify for concessionary capital treatment for senior unrated securitisation exposures.

The new draft now expressly defines "liquidity facilities", "underwriting facilities" and "funding facilities" (see paragraph 4 of the new draft). Although the definitions of liquidity facilities and underwriting facilities are consistent with market practice and not controversial, what remains unclear is how certain warehouse facilities will fit within the definition of a "funding facility".

APRA have introduced a new requirements for facilities to qualify as "eligible facilities". Namely:

- (a) that the facilities are subject to an asset quality test that preclude them from being drawn to cover defaulted exposures (as defined in APS 112 and 113); and
- (b) in the case of a liquidity facility, that if the exposures the facility is required to fund are externally rated securities (say in the case of a liquidity facility provided to an ABCP securitisation), the facility can only be used to fund securities that are externally rate investment grade at the time of funding.
- (c) These new requirements should not be controversial.

In addition to the requirements referred to above, the draft Statement includes additional requirements where an "originating ADI" provides an underwriting, funding or temporary funding facility. These are set out in paragraphs 3-6 of Attachment E.

## 14. Redraw funding facilities to SPVs

Like the previous draft, APRA repeats its view that a redraw funding facility (included within a "funding facility") provided to an SPV may constitute a credit enhancement. Interestingly, where the provider of the redraw facility is an "originating ADI", further requirements are imposed for it to be an "eligible facility". They are:

- (a) any draw-down under the facility incorporates a specified maturity date;
- (b) the facility is not expected to a fund a disproportionate amount of pool of the SPV at any time during the life of the securitisation (the previous draft provided a 20% fixed limit); and
- (c) repayments of drawings under the facility ranks senior or pari passu to the interest of the investors.

The November draft of APG 120 provided that a redraw facility which includes a clause that permits charge offs against the drawn facility regardless of whether the charge offs relate to loans for which the facility has been drawn would most likely be considered a credit enhancement. This requirement has not been included in

the revised draft of APS 120 and given APRA's indication that the Practice Guide would not be binding it appears that this requirement will no longer be mandatory (even if it remains in the Practice Guide once it is revised and released again by APRA).

## 15. Cash collateral facilities

In the new draft APRA has introduced express provisions relating to cash collateral facilities which had not been addressed at all by the November draft. Cash collateral facilities refer to collateral posted by smaller ADIs who do not have the rating required by the rating agencies to support the facilities provided by it to a securitisation.

Paragraph 17 of Attachment E provides that cash collateral amounts posted by an ADI, together with the undrawn portion of the relevant facility, may be treated as overlapping securitisation exposures (and therefore double capital is not required) if the following conditions are met:

- (a) the cash collateral funds are legally and operationally segregated from other funds and assets of the SPV;
- (b) earnings from the investment of the cash collateral accrue for the benefit of the ADI;
- (c) the cash collateral can only be drawn to meet the ADI's actual obligations under an eligible facility;
- (d) the cash collateral cannot be drawn to pre-fund a future obligation of the ADI; and
- (e) the undrawn balance of the cash collateral will be repayable to the ADI immediately upon ceasing to be a facility provider.

The above requirements are aimed at ensuring that the collateral posted does not increase the ADI's exposure to the securitisation by being used to provide support to the SPV. Provided the above requirements are met the ADI will only be required to hold capital against the larger of the two exposures (the cash collateral exposure and the exposure under the undrawn portion of the relevant facility). The requirement in paragraph (d) requires some clarification from APRA on the basis that it appears to cut across the very purpose of collateral provisions. It may be that the requirement is merely attempting to prevent collateral which has already been posted by the ADI with the SPV from actually being used by the SPV prior to the relevant collateralised obligation of the ADI actually arising, which is a reasonable requirement, but this is not clear from the drafting.

## 16. Legal opinions

The November 2006 draft required ADI to obtain written legal advice in relation to various aspects of a securitisation including:

- (a) advice that APRA's separation requirements will be met;
- (b) advice that the ADI was protected from any legal liability from investors in the securitisation, apart from liabilities arising from the contracts into which the ADI had entered; and
- (c) advice that all the release of capital rules in paragraph 2 of Attachment B will be complied with.
- (d) These requirements have been dropped, however:
- (e) a legal opinion is still required for the purposes of capital relief although its terms are much narrower (see paragraph 11 of this paper above); and
- (f) APRA has retained the discretion to require an ADI to seek a legal opinion on any of the separation requirements or on the release of capital requirements from an independent legal counsel chosen by APRA at the expense of the ADI (see paragraph 7 of Attachment A and paragraph 5 of Attachment E).

## 17. No subordination of servicing and management fees

The provision in paragraph 9 of the current APS 120 which permits an ADI acting as servicer to receive a performance-related payment (or benefit from surplus income) for its role as servicer, in addition to a market based fee, has been deleted from the new draft. Instead it has been replaced with a general requirement that a servicing ADI and a managing ADI must not subordinate, defer or waive the receipt of fees or other income for its role as a service provider (paragraph 16 of attachment E). Fee splitting arrangements which are commonly used in the context of corporate SPVs will clearly breach this new requirement. It is not clear what has motivated APRA to make this change as no explanation for it was given in the Response to Submissions.

## 18. Simplification of investor disclosure requirements

APRA has significantly streamlined the existing requirements regarding the content of disclosure by an ADI and made these easier to comply with. In particular:

- (a) they now only apply to an originating ADI (in the previous draft and the existing APS 120 they applied to any ADI);
- (b) the required disclosure when inviting investment in a securitisation is shorter (for example, it no longer requires a statement that the investments are subject to investment risk or that the ADI does not in any way guarantee the value or performance of the relevant securities);
- (c) the required disclosure now needs to be presented "prominently" at the beginning of the relevant disclosure document, rather than as a stand alone item on the inside of the front cover of the document (it is not clear whether the current practice of placing the disclosures on the inside front cover will be regarded by APRA as sufficient compliance with this requirement); and
- (d) the requirement to obtain signed acknowledgements from investors has been removed.

## 19. Revolving exposures clarified

Attachment G sets out the circumstances in which an ADI, which has transferred a pool of revolving exposures to a third party and retained an interest in those exposures, will be required to hold regulatory capital against that transferred pool. Revolving exposures are exposures which arise from revolving (redrawable) facilities (as defined in paragraph 4(q) of APS 120). In the new draft APRA has clarified the fact that redrawable home loans will not be treated as revolving exposures where the amounts likely to be redrawn in any collection period are expected to be immaterial relative to the size of the securitised pool and there are formal arrangements in place for the SPV to acquire the additional exposures or for the ADI to repurchase the underlying exposure (see paragraph 5 of Attachment F).

## 20. Representations and warranties by ADIs

An ADI that provides facilities and services, or transfers exposures, to an SPV, may make representations and warranties to the SPV concerning those services or exposures provided that this does not constitute implicit support by the ADI (Attachment E, paragraph 18). This paragraph has been amended in the new draft to permit only complying representations and warranties made "*to the SPV*" (suggesting that representations and warranties cannot be made to other parties such as a provider of a warehouse facility, as is often the case). This change will need to be clarified with APRA.

## 21. Purchase of securities

Pursuant to paragraph 8 of Attachment F, the restrictions on an ADI acquiring securities in a securitisation now apply only to an originating ADI (but note the wide definition of originating ADI). The conditions for the acquisition of securities in a securitisation as set out in the existing AGN 120.3 have been scaled back.

## 22. Board and senior management responsibilities

APRA has modified some responsibilities of an ADI's board and management in relation to a securitisation. In particular, APRA no longer requires the board and senior management to put in place policies and procedures

dealing with how the ADI will assess the average asset quality of the exposures for which the ADI retains ownership (in a traditional securitisation) or credit risk (in a synthetic securitisation) following the securitisation. (See generally paragraph 17 of the draft).

## 23. Synthetic securitisations

The new draft APS 120 does not contain any new requirements specific to synthetic securitisations. However, changes made by APRA to some of the requirements applying to traditional securitisations will also affect synthetic securitisations. The main changes which fall within this category include:

- (a) the revision of maximum capital requirement provisions (see paragraph 7 of this paper above);
- (b) the new implicit support provisions in paragraph 20 of the new draft APS 120 (see paragraph 8 of this paper above);
- (c) amendments to the clean-up call provisions; in particular APRA has clarified that the clean-up call in relation to a synthetic securitisation will include any provision for the extinguishment of credit protection (see paragraph 10 of this paper above);
- (d) the changes made to the release of capital rules applying to synthetic securitisations in paragraph 3 of Attachment B are consistent with those made to the equivalent rules applying to traditional securitisations (see paragraph 11 of this paper above) except that the new threshold rate restrictions do not apply, as they are not relevant, to synthetic securitisations (see paragraph 6 of this paper above);
- (e) the modifications made to the circumstances in which an ADI providing facilities or services to an SPV can be replaced or retire (see paragraph 12 of this paper above);
- (f) the new requirements for eligible facilities (see paragraph 13 of this paper above);
- (g) the new cash collateral facilities provisions introduced in the revised draft (see paragraph 15 of this paper above);
- (h) the changes to certain legal opinions required in connection with a securitisation (see paragraph 16 of this paper above);
- (i) the amendments made by APRA to the investor disclosure requirements (see paragraph 18 of this paper above);
- (j) new requirements in relation to representations and warranties (see paragraph 20 of this paper above);  
and
- (k) the modifications APRA has made to some of the responsibilities of an ADI's board and management in relation to a securitisation (see paragraph 22 of this paper above).

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