AUSTRALIAN SECURITISATION FORUM SUBMISSION ON THE TREASURY PROPOSALS PAPER

G4-IRD central clearing mandate (February 2014)

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SECTION 1 – INTRODUCTION

1. The Australian Securitisation Forum ("ASF") welcomes the opportunity to respond to the Treasury Proposals Paper: G4-IRD central clearing mandate – February 2014 ("Paper"). See Annexure A for more details about the ASF.

2. Our submission provides feedback on the following issues from the perspective of the securitisation industry:

    a. whether the clearing mandate should be confined to G4 dealers;

    b. whether any types of transactions should be exempted; and

    c. whether the exemption of end-users from trade reporting should be made permanent and the appropriateness of its current scope.

3. Although not directly raised by the Paper, our submission also provides feedback on the implications of margin requirements for non-centrally cleared OTC derivatives for the securitisation industry, given that many of these implications are the same as those arising under a clearing mandate.

4. In summary, our submission is seeking:

    a. certainty that securitisation swaps will be exempted from a clearing mandate;

    b. confirmation that uncleared securitisation swaps will not subject to margining; and

    c. end-user treatment of securitisation special purpose vehicles ("SPVs") for the purposes of trade reporting.

5. We have articulated arguments in support of these objectives in Sections 2-4 of our submission. To assist your consideration of our submission, see Annexures B, C and D for detailed information on securitisation structures and the securitisation industry more generally.

SECTION 2 - SECURITISATION SWAPS SHOULD BE EXEMPTED FROM A CLEARING MANDATE

Question One

Do you have comments on the benefits and costs of complying with a mandatory central clearing obligation, from the point of view of your business and/or that of your customers?

7. The ASF strongly supports an exemption for securitisation swaps from the proposed central clearing mandate. See paragraphs 12 - 28 below for our comments on the costs of complying with a mandatory central clearing obligation from the point of view of the securitisation industry.

We request that, in commenting, you quantify compliance costs as far as possible, including whether costs are likely to change over time, are transitional or projected ongoing costs. For example, costs may include:

- ***legal costs;***
- ***staff cost — for example number of staff hours and training costs;***
- ***IT costs; and/or***
- ***increased costs of managing risks or funding projects.***

Please separate additional costs that would come about as a result of this proposal, as well as other regulatory costs that could be mitigated if you are able to comply with Australian regulation rather than many different countries' regulations.

To assist this analysis it would be useful to know whether your trades, and/or those of your clients, are becoming subject to central clearing obligation from other countries and whether your counterparties prefer central clearing of trades.

8. See paragraphs 12 - 28 below for our comments on the costs of complying with a mandatory central clearing obligation from the point of view of the securitisation industry. The ASF would be happy to provided quantitative information separately, if required. See Annexures F and G in relation to the comparative position for securitisation SPVs in the US and EU.

Question Two

Do you have comments on the proposal to mandate central clearing in respect to G4-IRD? Please also consider the costs and benefits of a wider or narrower scope. Could you comment on the incremental costs and benefits of a broader or narrower scope of coverage? For example, including only USD IRDs or alternately including all IRDs.

9. The ASF strongly supports an exemption for securitisation swaps from the proposed central clearing mandate. If securitisation swaps have the benefit of an exemption, the scope of coverage will not be a relevant consideration for the securitisation industry. Having said this, the ASF cannot on the balance of costs and benefits see any net benefit in requiring a wider scope of derivatives to be cleared.

Question Three

Do you agree with the proposal to restrict ASIC rulemaking to entities that are considered to be G4 Dealers, and to exempt intra group trades?

10. The ASF strongly supports the proposal to restrict ASIC rulemaking to entities that are considered to be G4 Dealers, and to exempt intra group trades. In addition, the ASF strongly supports an exemption for securitisation swaps entered into by securitisation SPVs for the reasons outlined below.

Could you comment on the incremental costs and benefits of including or exempting other types of entities or transactions? For example including all AFSL holders and ADIs or alternately setting a high threshold of activity.

11. We have outlined below the costs associated with including securitisation swaps in a central clearing mandate.

Impact on hedging

12. Securitisation swaps typically have the following non-standard features:

    a. termination dates that are not set, but defined by reference to contingent events (e.g. the "date on which the balance of the assets of the Trust is reduced to zero"); the typical cleared swap has a fixed termination date;

    b. notional amounts which amortise according to prepayments on the underlying pool of assets and are therefore uncertain; the typical cleared swap has either a fixed notional amount that does not decrease or increase or a notional amount which amortises according to a fixed (i.e. certain) amortization schedule; and

    c. economic terms which are defined by reference to provisions or definitions in other securitisation documents; the typical cleared swap specifies economic terms which are determined by reference to standard industry documents such as the 2006 ISDA Definitions.

13. These features mean that CCPs do not currently offer clearing services for securitisation swaps, either because they do not have the operational capability to clear non-standard products, or because these services would be commercially unviable. Therefore, imposing a central clearing mandate which does not exempt securitisation swaps will have the unintended consequence of prohibiting parties from entering into securitisation swaps. This will result in unhedged SPV obligations that will not meet rating agency criteria or investor requirements. This is because securitisation SPVs (as distinct from, for example, operating companies) do not have access to other funds to cover the risks typically hedged by securitisation swaps and, accordingly, investors would bear these risks if appropriate hedging was not accessible to the SPV. This is likely to ultimately lead to a withdrawal of investor support for the securitisation market.

Other consequences for the securitisation market and broader economy

14. Even if securitisation swaps were clearable, we do not believe they should be subject to a central clearing mandate for the following reasons:

    a. the central clearing of securitisation swaps will not result in a reduction in systemic risk; instead it has the potential to increase systemic risk;

    b. the margin requirements in relation to cleared swaps will create structural and operational issues for the industry and negatively affect securitisation cash flows; and

    c. these impacts will have serious economic consequences for the securitisation industry, which could threaten its viability, with flow on consequences for the broader economy.

15. We have expanded on these reasons in paragraphs 16- 24 below.

No reduction in systemic risk

16. The main purpose of the proposed central clearing mandate is to reduce systemic risk. Australian securitisation transactions should be exempt from a clearing mandate as they already mitigate the risk of default arising from their reliance on OTC derivatives, and hence systemic risk, through their use of the legal and structural protections outlined below:

    a. *Bankruptcy remoteness.* The assets of each SPV are segregated under a bankruptcy remote structure. Under each securitisation transaction, the recourse of the swap providers and other creditors following default is confined to a defined asset pool. Moreover each securitisation swap is entered into for a specific hedging purpose or defined activity, or a series of such transactions (typically subject to defined rating agency criteria). The administrators of the SPV (ie the trustee and/or manager) cannot make operational decisions other than as prescribed in advance and carefully limited under the nature of the SPV documentation.

    b. Assets quarantined from seller insolvency. The beneficial ownership of the assets held by the SPV is isolated from the insolvency risk of the seller by achieving a “true sale” of those assets from the seller. Under the "true sale", the economic risk on the asset pool is shifted from the originator/seller to the SPV. In the event of the seller's insolvency, the assets will not be included in the seller’s assets as part of its insolvency proceedings, but are available to creditors of the trust including noteholders and swap providers.

    c. Protection against swap provider insolvency. Investors are protected against the risk of swap provider default by the substantial security package. In the case of rated transactions, the leading rating agencies also require swap providers to post collateral (or otherwise novate or obtain alternative credit support, such as guarantees) to cover an SPV’s swap exposure, unless the swap provider is sufficiently rated.

    d. *Limited recourse and non-petition language.* The recourse of the creditors of the SPV is limited to the assets (i.e. the mortgage or other receivables) of that SPV. Secured creditors are also bound by non-petition language which limits their right to petition a court to commence insolvency proceedings against the SPV.

    e. Security. Swap providers have the benefit of a security interest over all of the SPV’s assets and rank above (or at least equal to) senior noteholders in an enforcement scenario (for further details see paragraph 21 below).

17. In summary, Australian securitisation transactions already build in robust protections against systemic risk. Imposing a central clearing mandate on securitisation swaps will not reduce systemic risk beyond the levels already achieved through these protections.

18. In addition, as securitisation swap activity is relatively limited and motivated primarily by hedging of underlying cash flows and exposures, the systemic risk reduction achieved by a clearing mandate for securitisation swaps is likely to be limited, regardless of whether the above protections are in place.

19. Moreover, mandating clearing of securitisation swaps could increase systemic risk either by forcing SPVs to forego hedging their risk or by spreading the performance risk of the pools of assets that underlie the securitisation. Under the typical securitisation, this performance risk is borne by the investors and the swap providers. If such a risk was then transferred to a CCP, the risk of performance of many different asset classes, such as mortgages, auto loans and credit cards, would likewise be transferred to the CCP (albeit collateralised by the posting of margin).

Structural and Operational issues

20. If a central clearing mandate is imposed on securitisation swaps, CCP margin rules will require the SPV to collateralise its swap exposures by the posting of initial and daily variation margin.

21. Under current securitisation structures, SPVs do not have access to funds for margining. Instead, swap providers' exposures are collateralised by the pool of underlying assets, which eliminates the need for the SPV to post daily margin. Because swap exposures are secured over the entire pool of trust assets, the swap provider has access to a much larger pool of collateral than would be posted under clearing house or margin rules, arguably providing greater protection than liquid margin would. In effect, the security arrangements remove the credit requirement for liquid collateral, as the swap exposure to the SPV is instead covered by the pool of underlying assets. However, this credit support does not fit with CCP margining requirements.

22. Any shift from the current non-liquid security arrangements to a liquid margin requirement will present a number of significant structural and operational challenges. In particular:

a. margin calls will need to be funded either through a loan facility or cash reserves (funded out of cash flows generated by the SPV assets). This will result in additional funding costs which would probably be payable ahead of other SPV creditors (including noteholders). This will affect the cash flow analysis for securitisation programmes and, in particular, dilute the return to the income unitholder (i.e. excess spread would reduce);

b. to the extent margins are funded by a bank, the bank would need to be bought into the security and pre and post-enforcement waterfalls. Custodians may also be involved in holding the SPV's and swap provider's initial margin. Any margin funding banks or custodians would need to meet rating agency criteria in order to be properly integrated into transactions, which could require the introduction of new structural features and cause significant changes to programme documentation;

c. sophisticated models for calculating initial/variation margin and haircuts would be needed; the SPV's role would not ordinarily extend to performing these types of calculations. If the SPV's role was expanded to cover this calculation function, this would involve costs similar to those outlined in paragraphs 46 - 53 below (in relation to an expansion of the SPV's role to cover trade reporting); and

d. SPVs allocate cash collections to investors, swap providers, security trustees and other service providers on a monthly basis; SPVs would therefore only have funds available to meet *monthly* margin calls. This does not fit with the *daily* margining requirements of CCPs. Although the cashflow waterfalls could be amended to accommodate a daily margining requirement, this would require the cashflows to be restructured and significant changes to programme documentation and rating criteria, all of which would reduce the commercial viability of securitisation programs.

23. Navigating these challenges will have obvious economic implications for the securitisation industry and could lead to a slowdown in the securitisation market as new transaction structures and practices are developed to allow for the posting of margin.

Cost issues

24. The above structural and operational issues will have a significant impact on the cost and efficiency of securitisation transactions. In particular, the potential cost of establishing cash reserves or margin funding facilities will result in additional funding costs which would be payable ahead of other SPV creditors (including note holders). This means that there would be less money available to meet payments on the notes, and ultimately less excess spread. This cost outcome could bring into question the viability of the Australian securitisation market at a critical time in its recovery. Even if the industry remained viable, it could lead to a reduction in the available funding for receivables financed by the securitisation market or in the pricing of the underlying receivables (including residential mortgages).

Summary

25. Securitisation swaps should be exempted from the proposed central clearing mandate for a number of reasons:

    a. at an operational level, clearing services for securitisation swaps are not available; therefore, if they were subject to a central clearing mandate, SPVs would be prevented from entering into securitisation swaps, leading to unhedged liabilities and the withdrawal of investor support for the securitisation market; and

    b. even if securitisation swaps were clearable, they should not be subject to a central clearing mandate because:

        - securitisation transactions already build in robust protection measures against systemic risk; imposing a central clearing mandate on securitisation swaps will not reduce this risk beyond the levels already achieved through these protective measures and, moreover, has the potential to increase systemic risk;

        - the significant restructuring required to accommodate margining under the structures will cause a slowing down of the securitisation market as new transaction structures and criteria are developed; and

        - it will lead to significant costs which may limit the economics of securitisation transactions and restrict their availability as a funding tool, which will further erode competition within the banking sector.

Conclusion

26. Exempting securitisation swaps from a clearing mandate will give the Australian securitisation industry certainty on this issue and remove the negative consequences for the industry and broader economy referred to above.

27. It will also strike an appropriate balance between ensuring markets are stable and provide appropriate protections to investors on the one hand, and the government's clear aims to minimise the regulatory burden for business and promote market efficiency and competition on the other hand.

    We have an expectation that foreign regulators would take a similar position to this, but it is too early to say how this will evolve. See Annexures E and F for a summary of the comparative experience in the US and the UK.

28. Although not directly raised by the Paper, Section 3 of our submission also provides feedback on the implications of margin requirements for non-centrally cleared OTC derivatives for the securitisation industry, given that many of these implications are the same as those arising under a clearing mandate.

    Question Four

    Do you have comments on the calculation methodology used for determining the proposed threshold of activity and the appropriate level of the threshold? Do you have views on whether notional OTC derivatives or notional OTC IRDs is the more appropriate basis for calculating the threshold? Or would you prefer a different methodology and if so, why?

29. The ASF strongly supports an exemption for securitisation swaps from the proposed central clearing mandate. If securitisation swaps have the benefit of an exemption, this issue will not be a relevant consideration for the securitisation industry.

    Question Five

    Do you have comments on the proposed timetable for implementing the central clearing obligation? Could you comment on the incremental costs and benefits of an earlier or later start date than what is proposed?

30. See our comments in paragraph 29 above.

    Question Six

    Do you have comments on the proposal that some CCPs may be prescribed in order to ensure Australian market participants have appropriate access to CCPs? Or is there another option you prefer? If so, why?

31. See our comments in paragraph 29 above.

    Question Seven

    From the point of view of your business and/or that of your customers, what is your preliminary

view on the costs and benefits of mandatory central clearing of:

- ***AUD-IRD?***
- ***North American and European referenced CDS?***
- ***Any other derivatives?***

32. See our comments in Section 2 above from the perspective of the securitisation industry.

Question 8

Do you have views on the appropriate timing of the introduction of such mandatory requirements? Are there any preconditions that should be met before such mandatory requirements are introduced?

33. See our comments in paragraph 29 above.

Question 9

What do you view as the characteristics that make a trading platform suitable for mandatory trading of derivatives?

34. See our comments in paragraph 29 above.

SECTION 3 - UNCLEARED SECURITISATION SWAPS SHOULD NOT BE SUBJECT TO MARGINING

Issue

35. The final framework for margin requirements for non-centrally cleared derivatives has been released by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (BCBS/IOSCO).

36. There is a concern that if the BCBS/IOSCO framework is implemented in Australia, securitisation swaps will be caught by new margin requirements for uncleared swaps. This concern exists because the framework requires margin to be exchanged with respect to uncleared OTC derivatives between two "covered entities". In other words, securitisation swaps entered into by an SPV will be governed by the framework if the SPV and its counterparty are both "covered entities".

37. Although the framework defines covered entities in terms of "financial firms" and "systemically important non-financial entities" it does not give any guidance as to what these terms mean; instead, this is left to national regulators. Given that the majority of swap providers are ADIs, we have assumed that swap providers will be treated as "financial firms" for the purpose of the BCBS/IOSCO framework. However, if the approach to translating BCBS/IOSCO's reference to "financial entity" is, locally, "AFSL holders and ADIs" (as per the reporting regime and, and as suggested in the clearing proposals paper), securitisation SPVs (all of which will hold an AFSL) could be inside the scope of the framework.

38. If uncleared securitisation swaps become subject to a margining requirement, the negative consequences stemming from the need to margin would be the same as the negative consequences of margining as a result of a central clearing mandate for securitisation swaps, as outlined in Section 2 above. These negative consequences are significant relative to the regulatory impact of margining, which is arguably negligible given that margining will not have a greater impact on systemic risk than the protections already developed for securitisation structures, also as outlined in Section 2 above.

Conclusion

39. Securitisation swaps should be exempted from any proposed margin requirements for uncleared OTC derivatives. The exemption will give the Australian securitisation industry certainty on this issue and remove the potential for the negative consequences for the industry and economy, as outlined above.

SECTION 4 - SECURITISATION SPVS SHOULD BE TREATED AS END-USERS FOR TRADE REPORTING PURPOSES

Question 10

Do you have comments on the proposals relating to:

Making the exemption of end-users from trade reporting permanent, subject to ensuring that appropriate information on systemically important OTC derivatives trading is available to regulators?

40. The ASF strongly supports the proposal to make the exemption of end-users from trade reporting permanent. We believe that the cost impact of imposing a reporting obligation on end users will be quite significant and outweigh the value of any reporting data that is likely to be reported to regulators. In addition, the costs associated with the reporting requirements could also result in end users opting not to engage in hedging activity to manage their risks.

A more tightly targeted AFSL reference in the regulations?

41. The ASF supports a more tightly targeted AFSL reference in the regulations. It further believes that securitisation SPV AFSL holders should be permanently exempted from trade reporting as end-users (see below for our detailed reasoning for this).

Or is there another option you prefer?

42. Given the nature of securitisation SPVs, imposing trade reporting obligations on them will result in a cost impact for the industry that will outweigh the regulatory impact. All securitisation SPV AFSL holders should therefore be permanently exempted from trade reporting as end-users.

If so, why?

43. We have provided detailed reasoning in support of this argument below. See also Annexure G for background information on the impact of the reporting obligations on securitisation SPVs.

Nature of securitisation SPVs

44. The role undertaken by the SPV is essentially passive. All of its programme responsibilities are delegated or subcontracted to another party. Consistent with this, in entering into any securitisation swap, the SPV acts and relies on the judgment and directions of the trust manager.

45. Therefore, while the SPV is required to hold the economic benefit of each securitisation swap that it enters into, any determinations and calculations in relation to the swap payments are made by the trust manager as swap calculation agent. See paragraphs 48 - 50 below for a discussion on the cost impact of expanding the SPV's role to cover the reporting function.

Significant burden

46. Swap providers to securitisation SPVs will generally already be reporting information in respect of their securitisation swap exposures under the Australian and/or offshore (e.g. Dodd-Frank and EMIR) derivatives regimes. The imposition of securitisation swap reporting obligations on these entities is therefore only incrementally significant.

47. In contrast, Australian SPVs have not been required to report under Australia's reporting regime to date. The reporting obligation will therefore impose a significant burden on SPVs who do not have systems and infrastructure in place to record and report the transactions. The nature of an SPV's burden will depend on whether or not it elects to delegate its reporting obligations (as permitted under the trade reporting rules).

Costs of Non-delegated reporting

48. If an SPV does not delegate its reporting obligations this will raise a number of feasibility and economic issues:

    a. Feasibility Issues

        - SPVs do not have access to all the trade information that they would be required to report.

        - The trade information that must be reported is either static or dynamic in nature. Whilst static information can be obtained by the SPV from the face of the swap documents, dynamic information requires valuation or other judgment to be exercised. This type of information cannot be readily ascertained by the SPV (see Annexure H for a summary of this type of dynamic information). The SPV would therefore need to obtain the dynamic information from the trust manager or the swap provider. Many trust managers would not have this data – so it is likely that the SPV, or the trust manager on its behalf, would need to obtain the information from the swap provider. Therefore, the SPV/trust manager is reliant on the cooperation of the swap provider in agreeing to provide any swap information.

    b. Economic Issues

        - The fees received by the SPV reflect the fact that all of its obligations are delegated or subcontracted to third parties. If the SPV did not delegate its reporting obligations this would require the SPV to become involved in operational matters in a manner not required by its broader role in the securitisation programme. This, in turn, could lead to a substantial uplift in the SPV fees to cover operational costs.

        - In addition, there are likely to be substantial out-of-pocket costs associated with reporting to a trade repository including ongoing reporting fees charged by the repository and the substantial investment involved in building the SPV's computing infrastructure capability to enable the SPV to collate the data and connect to the reporting repository. In aggregate, this is likely to amount to a substantial cost. We estimate that there are more than 500 securitisation SPVs in the Australian market, and a substantial majority of these are likely to have hedging arrangements in place. In addition, there are some programmes where fixed rate loans are hedged on a loan by loan basis – rather than a portfolio wide approach (so one SPV may have multiple swaps in place). For these programmes, it would be necessary to report trade and position information on a loan by loan basis.

49. Each of these matters would result in additional SPV costs that would need to be recouped by the SPV. These amounts would be payable to the SPV ahead of other SPV creditors (including note holders), meaning that there would be less money available to meet repayments on the notes, and ultimately the "excess spread" would reduce. This may adversely affect the economics of the

transactions, and could lead to either an increase in pricing for the underlying receivables (including residential mortgages) or a decrease in the availability of capital (through a reluctance to securitise).

50. In addition, as a practical matter, the SPV will seek to renegotiate its fee arrangements to provide for the right to recoup these additional costs. This will probably take some time given the number of SPVs involved and the various consents to the amendments that would be needed from the primary transaction parties and rating agencies (given that these additional costs will be paid ahead of note holders and therefore reduce the amounts available for repayment of the notes).

Costs of delegated reporting

51. For the reasons given above, it will not be feasible or cost-effective for an SPV to report its securitisation swap exposures. Consistent with this, trustee SPVs servicing the securitisation industry have indicated that they will seek to delegate all of their securitisation swap reporting obligations to their swap providers. This will result in the relevant swap provider reporting both sides of the trade.

52. The delegation arrangements that an SPV will need to put in place for this purpose will involve significant challenges for the securitisation industry, including the following:

    a. the risks and responsibilities for inaccurate reporting will need to be properly allocated between participants, including how the SPV should be protected from any losses which may be arise as a result of inaccurate reporting by its delegate (under the reporting rules, the SPV will remain liable for inaccurate reports by its delegate). The agreed position will need to be negotiated, which could be time consuming and costly whilst a standard industry approach develops;

    b. commercial agreement on the appropriate risk allocation will not only require consultation with the various program sponsors, swap providers and trust managers, but also consultation with rating agencies who will need to determine the rating impact on the affected transactions.

53. In addition, there could be significant costs associated with the SPV's compliance with post 1 October 2014 reporting obligations; including, where delegation arrangements have been entered into, costs associated with a requirement (under the reporting rules) for the SPV to take reasonable steps to ensure the information reported on its behalf by a delegate is true.

Regulatory impact

54. The main value of the two-sided reporting lies in ASIC receiving valuation, collateral, beneficiary and purpose information from "both parties" to a trade. In particular, obtaining 2 sets of data will allow discrepancies in valuations, and outliers of valuations and collateral, to be readily identified by ASIC. This cross-checking advantage will not be relevant in the context of a securitisation swap due to the fact that securitisation SPVs will delegate their reporting function. Any discrepancy checks by ASIC will therefore have limited value as they will be performed against two sets of information that has been prepared by the same party. If ASIC requires swap valuation and collateral data to be verified, a more cost-effective alternative to achieving this may be to require parties to conduct portfolio reconciliation.

55. In addition, some of the key information that ASIC is seeking under a two-sided arrangement, will not be relevant in the context of a securitisation swap. For example, no collateral is posted by the SPV, and therefore this reporting field should not be relevant (assuming that illiquid security

arrangements are not reportable collateral). In addition, given the structured nature of securitisation swaps, they will always be entered by SPVs for hedging purposes and the nature of the beneficiaries will not change. This information should also remain static throughout the life of each programme. Imposing two-sided reporting to obtain this information seems disproportionate to the costs involved for the SPV.

56. In summary, exempting SPVs from the requirement to report should not have a material regulatory impact. In particular, it will not affect the quality of the information that ASIC will receive from the swap provider reports. ASIC will still be able to determine from these reports the relevant SPV's exposure. Although ASIC will not be able to check for discrepancies in this information by reconciling it with the SPV reports, this will always be the case regardless of whether an exemption is available (i.e. in the absence of an exemption, SPVs will still need to delegate their reporting obligations to the swap provider, who will essentially report both sides of a trade).

Conclusion

57. Securitisation SPV AFSL holders should be treated as end-users for trade reporting purposes and exempted from the requirement to report securitisation swaps. This will ensure that SPV reporting will not subject the securitisation industry (and therefore the mortgage market) to costs which are not justified by the regulatory benefit. This result would be consistent with the government's stated objectives of reducing red tape to decrease the cost of doing business in Australia.

ANNEXURE A – ABOUT THE ASF

The Australian Securitisation Forum ("ASF") is the peak industry body representing participants in Australia's securitisation markets. Its 96 corporate members range from issuers (banks and non-banks), institutional investors (fund managers and superannuation funds), trustees, credit rating agencies, accounting and law firms, data vendors, and others involved in the securitisation value chain.

The main objectives of the ASF are summarised below.

Representation

- Representing the interests of the securitisation market to regulators, Government, the media and other stakeholders to achieve a market environment that supports a robust and growing securitisation market.

- Leading consensus building within the industry on issues of broad importance to the participants involved to support the sustainability and growth of the securitisation market.

Promotion

- Providing a forum to promote the market to domestic and global investors and other stakeholders through seminars, conferences and resources.

Development

- Informing and increasing the knowledge and skills of the securitisation community and related stakeholders. This is achieved through delivering high-quality conferences, workshops and professional development programmes.

- Developing and implementing appropriate market standards and practices to enhance the efficient operation, transparency and investor confidence in Australia's securitisation market.

More information about the ASF is available from our website at http://www.securitisation.com.au, including a list of our members, and details of our various Committees and activities, in particular, our work in relation to financial law and regulatory reform.

ANNEXURE B – SIGNIFICANCE OF THE SECURITISATION INDUSTRY TO THE AUSTRALIAN ECONOMY

Securitisation is an important market-based source of finance for the Australian economy. The need for businesses to access market-based financing solutions is of increasing importance as banks continue to deleverage in response to the post- global financial crisis environment, due in part to regulatory changes.

Securitisation performs an important role in achieving the right balance in funding sources between markets and the banking sector to drive more competition in Australia's financial sector. In particular, at an Australian financial system level, approximately 5% of ADI funding is sourced from securitisation but this proportion is greater for non-banks (~100%) and non-Major ADIs such as regional ADIs and mutuals (0-25%). This demonstrates the importance of securitisation to the ability of small ADIs and non-ADI lenders to fund through capital markets to compete in market segments such as residential mortgages, auto finance and equipment finance. Securitisation has also driven innovation in residential mortgage markets and provided consumers with a wider choice of lenders and products.

Besides competition, securitisation also plays an important part in developing a deep and broad-based fixed income market by (1) transforming pools of relatively illiquid assets into more liquid investible securities, including residential mortgages and infrastructure assets and (2) reducing reliance on the four major ADIs for funding the Australian economy and allowing lenders to access high quality and safe securities, providing a key source of fixed income investment products suitable for superannuation and retirement income sectors as well as liquidity to the banking system (via the Committed Liquidity Facility provided by the RBA).

Securitisation also increases the capacity of the financial system to lend to key sectors and helps generate economic growth through its potential to finance a wide array of assets beyond residential mortgages, including small and medium enterprises and infrastructure assets

ANNEXURE C – TYPICAL SECURITISATION TRANSACTIONS

Broadly speaking, securitisation typically involves the issue of financial instruments (or "notes") by an SPV, the proceeds of which are used to acquire or lend against the security of assets which are the primary collateral for the repayment of the notes. Payments of interest and principal on the notes are generally made from collections received on the designated pool of assets transferred to and owned by the SPV.

Generally, the seller/originator of the assets retains a direct equity interest in the asset pool through holding a residual income unit or like security. In the majority of the cases the originator or seller of the securitised assets also continues in a servicing role and hence has a direct interest in ensuing the assets perform optimally to generate the expected level of economic return to the original seller or originator.

In Australia, asset classes that are commonly securitised include residential mortgages and equipment and/or automobiles receivables, such as leases and chattel mortgages (by both ADI originators and non-ADI originators).

Fundamental legal principles of a securitisation structure

The key principles of a typical securitisation structure are:

a. *Bankruptcy remoteness.* The risk of the SPV becoming insolvent must be remote in accordance with well-established legal practices. The SPV is typically either a trust or a special purpose company, but in Australia is more commonly a trust.

b. *Assets quarantined from originator/seller insolvency.* The beneficial ownership of the assets held by the SPV is isolated from the insolvency risk of the seller by achieving a "true sale" of those assets from the originator/seller. The economic risk on the asset pool is shifted from the originator/seller to the SPV. In the event of the originator/seller becoming insolvent, the assets will not be included in the originator/seller's assets as part of its insolvency proceedings, but are available to creditors of the trust including noteholders and swap providers.

c. *Limited recourse/non-petition language.* The recourse of the secured creditors of the SPV is limited to the assets (i.e. the mortgage or other receivables) of that SPV. Secured creditors are also bound by non-petition language which limits their right to petition a court to commence insolvency proceedings.

d. *Amortising assets – limited life SPV.* The asset pool in a typical securitisation is amortising. As the asset pool of mortgages or other receivables are repaid by borrowers, principal is passed through to noteholders. On this basis, swaps provided to a securitisation SPV are typically linked to the notional value of one or more asset classes (e.g. fixed-rate loans) in the amortising asset pool.

e. *Security.* Security is granted over the assets of the SPV in favour of a security trustee. If an event of default (including non-payment to a swap provider) arises the security trustee is able to enforce the security acting on instruction from the secured creditors. A swap provider will typically rank senior or *pari passu* with the senior rated noteholders (typically the "AAA" tranche in a rated structure).

f. *Tranching of securities.* Traditionally, securities or notes issued in securitisation transactions are tranched to reflect a different degree of credit risk (i.e. one class of

creditors is entitled to receive payments from the underlying pool before another class of creditors).

Securitisation techniques

Securitised assets can be originated within the banking system (i.e. by ADIs) or outside the banking system (e.g. corporate balance sheets or by non-ADI lenders), as described below. Securitisation techniques typically contain the key principles of securitisation structures described above. We have included structure diagrams illustrating the various parties typically involved in two of the more common securitisation techniques in Annexure D for reference, and provided some further detail on some common structures used in the Australian market below.

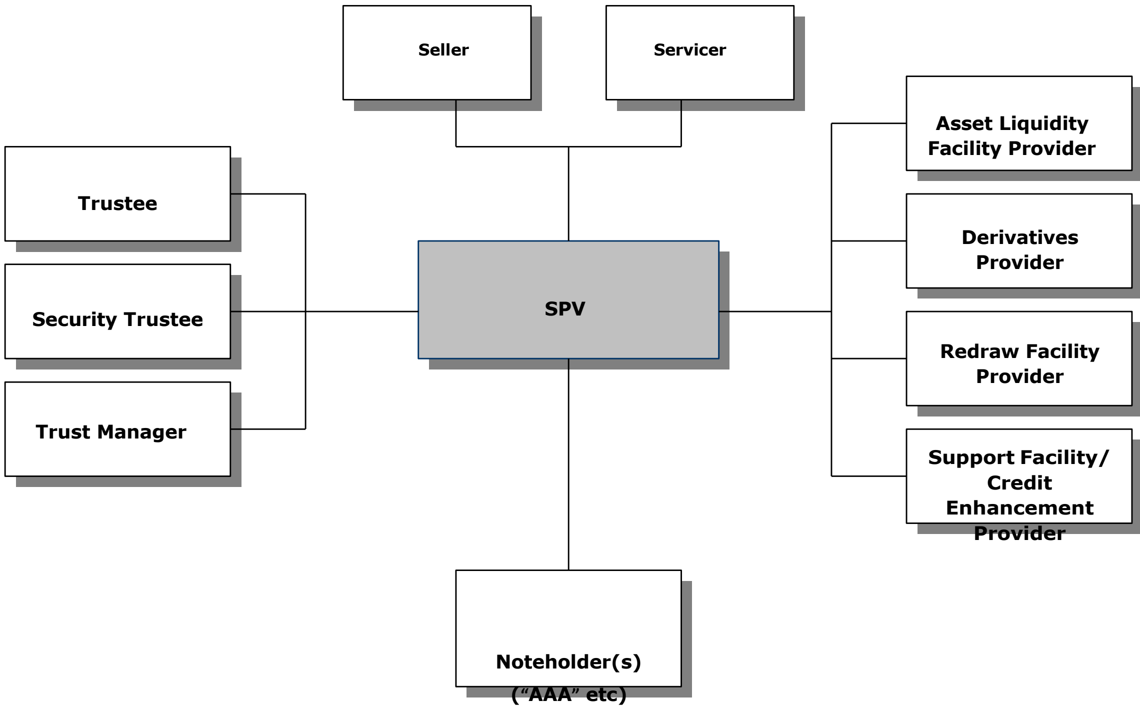
a. *Warehouse Arrangements - Facilities typically funded by banks (typically the major banks and the international banks with a presence in Australia).* Warehouse arrangements generally involve regular asset sales by the seller into the securitisation structure but can also, for example, provide temporary funding for an acquired portfolio prior to that portfolio being in whole or in part termed out into a capital markets transaction, or provide funding for assets that are more difficult to term out in the capital markets. Typically an originator/seller may enter into a warehouse transaction, with funding provided by an ADI that is not related to originator or seller ("Non-Related ADI"). Warehouse arrangements may be structured with a single tranche or with more than one tranche of notes. A lower tranche of notes (the "seller note") may be held by the seller/ originator of the assets. Tranching in this way is one of the means by which credit support can be provided to the more senior class(es) of notes. This may be undertaken so that the financial instruments issued by the SPV achieve certain levels of creditworthiness required by their rating.

b. *Asset-backed commercial paper ("ABCP").* Similar to funding arrangements above, ABCP provides short-term funding, however, the source of funding is short-dated (money market) capital markets investors as opposed to balance sheet funding by a Non-Related ADI. ABCP structures are less common today due to the embedded costs of liquidity required to support the commercial paper in a market disruption.

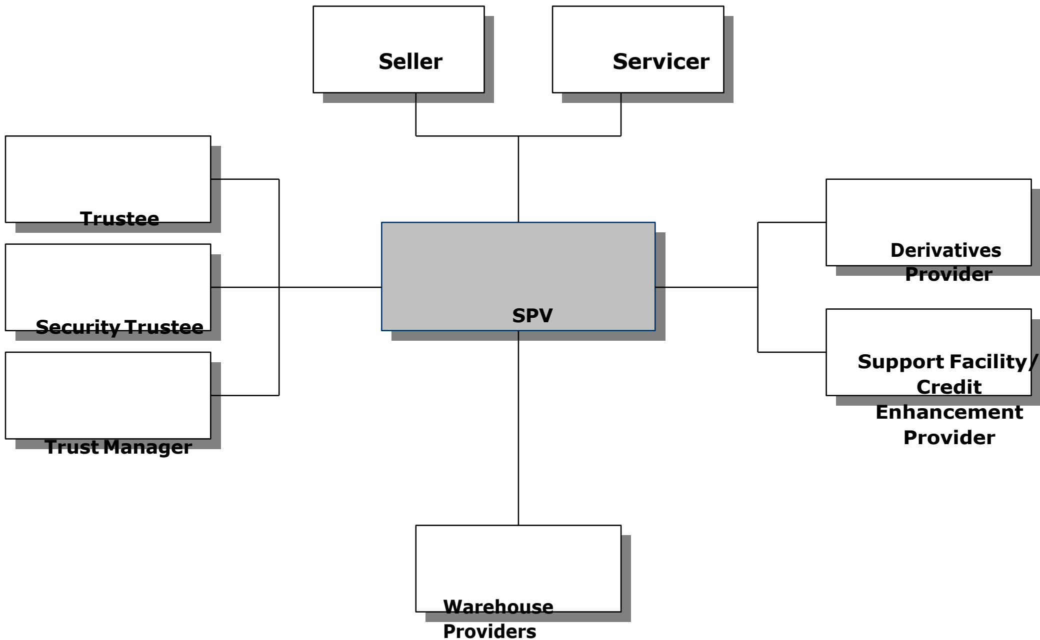
c. *Term Securities in the Capital Markets (Asset-Backed Securities "ABS", including Residential Mortgage- Backed Securities "RMBS").* These are the most common securitisation transactions utilised by ADIs. For longer-dated assets, originators/sellers are able to achieve asset-liability maturity match funding via issuing ABS into the domestic and global capital markets. The decision to issue term securities rests with the seller (e.g. the non-bank or ADI originator). Similarly the originator/seller decides which third parties to appoint to the securitisation transaction, such as the dealers, trustee and rating agencies.

ANNEXURE D – SECURITISATION STRUCTURE DIAGRAMS

A typical term (rated) securitisation structure



A typical securitisation structure for a warehouse arrangement



ANNEXURE E – US EXPERIENCE: INAPPLICABILITY OF MANDATORY CLEARING FOR MOST SECURITISATION SWAPS

On 13 December 2012 the Commodity Futures Trading Commission ("CFTC") made its first mandatory clearing determination by adopting regulations requiring two classes of credit default swaps and four classes of interest rate swaps that contain certain product specifications to be cleared by a derivatives clearing organization (a "DCO"), if an eligible DCO clears the swap.

A two-step process determined whether the clearing requirement applies to a particular swap:

1. Does the swap fall within one of the covered classes and, if so, do any of the eligible DCOs clear that swap?
2. Are all the product specifications required under the DCO's rules met?

If the swap does not fall within one of the covered classes, or if it does but no eligible DCO accepts the swap for clearing because there is a different product specification, then the swap is not required to be cleared.

There are four classes of interest rate swaps that are required to be cleared:

- Fixed-to-floating swaps
- Basis swaps
- Forward rate agreements
- Overnight index swaps.

The CFTC also listed three affirmative and three negative product specifications for each class of covered interest rate swaps:

Affirmative Specifications

- Currency in which the notional and payment amounts are specified
- Interest rates referenced for each leg of the swap
- Stated termination date.

Negative Specifications

- No optionality (as defined by the DCOs)
- No dual currencies
- No conditional notional amounts

If an interest rate swap is in a specified class and meets each of the six specifications, the swap is subject to the clearing requirement if a DCO clears the particular swap. However, if an interest rate swap does not satisfy one or more of these specifications, it is not subject to the clearing requirement.

Most, if not all, securitisation swaps typically fail to satisfy one or more of the aforesaid negative specifications. For example in a securitisation swap, it is often the case that the notional amount of the swap changes with the aggregate principal amount outstanding under the securitised pool, and as such would likely fail to satisfy the "no conditional notional amounts" specification. Further, many global securitisation transactions utilise cross-currency swaps, which would fail to satisfy the "no dual currencies" specification.

As indicated above, the applicability of the clearing requirement also depends on whether any eligible DCO accepts a particular type of swap for clearing. Insofar as we are aware at this time, no eligible DCO has yet accepted for clearing a swap that contains limited recourse and/or non-petition provision. Securitisation swaps typically contain limited recourse and/or non-petition provisions, and thus at this time such swaps would not be subject to the clearing requirement.

On May 16 2013, the American ASF submitted a paper to the CFTC's Division of Clearing and Risk ("DCR") requesting the DCRs confirmation that securitisation vehicles may enter into swaps containing limited recourse and non-petition provisions without having to comply with clearing requirements. On May 21, 2013 the American ASF advised its members that the DCR had confirmed this view in a phone call with the American ASF.

ANNEXURE F – EU EXPERIENCE: MANDATORY CLEARING EXEMPTION FOR SECURITISATION SWAPS

The European Market Infrastructure Regulation ("EMIR") came into force on 16 August 2012 and introduced a range of measures intended, amongst other things, to increase the transparency of the over-the-counter ("OTC") derivatives markets and reduce counterparty credit risk.

EMIR Counterparties

EMIR applies to a market participant differently depending on whether it is:

- a financial counterparty ("FC") being an investment firm, credit institution, insurance undertaking, reinsurance undertaking, UCITS, pension scheme, or alternative investment fund managed by an alternative investment fund manager, in each case, where authorised or registered in accordance with the relevant EU Directive; or
- a non-financial counterparty ("NFC") being an undertaking which is established in the EU, other than an FC and a CCP, which either:
  - has positions in OTC derivatives with a gross notional value ("GNV") above the specified "clearing threshold" in respect of a certain class of OTC derivatives (set at EUR 1 billion in GNV for credit derivatives; EUR 1 billion in GNV for equity derivatives; EUR 3 billion in GNV for FX derivatives; EUR 3 billion in GNV for interest rate derivatives; and EUR 3 billion in GNV for commodity and other derivatives) (an "NFC+"); or
  - has positions in OTC derivatives with a GNV below the specified "clearing threshold" (an "NFC-").

In determining whether an NFC's positions in OTC derivatives exceed the relevant clearing threshold, OTC derivative contracts that are 'hedges' (that is, OTC derivative contracts that are 'objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty), are excluded from the calculation.

The clearing obligation

One of the key areas covered by EMIR is a requirement for the clearing of OTC trades through a central counterparty (a "CCP"). A CCP is defined in EMIR as "*a legal person that interposes itself between the counterparties to the contracts traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer*"[1].

A CCP established in the European Economic Area ("EEA"), which includes the European Union ("EU") and Iceland, Lichtenstein and Norway, must be authorised under Article 14 of EMIR, while a CCP established outside the EEA must be recognised under Article 25 of EMIR.

The clearing obligation requires counterparties to clear an OTC derivative transaction if:

- it pertains to a class of OTC derivatives that has been declared subject to the "clearing obligation" pursuant to the process set out in EMIR;

- the counterparty on each side of the transaction is either an FC, an NFC+ or an entity from a third country that would be subject to the "clearing obligation" if it were established in the European Union (a "Third Country Clearing Entity"). If both counterparties are Third Country Clearing Entities, they will only be required to clear the OTC derivative if the contract has a

[1] Article 2(1) EMIR, p. 14

direct, substantial and foreseeable effect within the European Union or where such an obligation is necessary or appropriate to prevent the evasion of any provision of EMIR;

- it has been entered into or novated on or after the date from which the clearing obligation takes effect; or on or after notification by a competent authority to ESMA that a CCP has been authorised to clear a class of OTC derivatives but before the date from which the clearing obligation takes effect if the contracts have a certain remaining maturity.

Determination of Contracts Subject to Mandatory Clearing

ESMA assesses whether or not a contract is subject to clearing based on certain specified criteria, including, amongst other things, the degree of standardisation of the contractual terms and operational processes, the volume and liquidity of the contract, and the availability of fair and reliable pricing information. ESMA is required to maintain a public register identifying classes of derivatives subject to the clearing obligation.

ESMA uses the bottom-up or top-down approach to determine the classes of OTC derivatives that are subject to the clearing requirement:

- Bottom-Up Approach: Under the bottom-up approach, a CCP applies to the national competent authority ("NCA") in its home jurisdiction for authorisation to clear certain types of derivative contracts. Upon authorisation of such contracts, the NCA is then required to notify ESMA. ESMA will maintain a public register of notifications it has received in this regard. Within 6 months of receipt of the notification, ESMA must decide, after a public consultation and consulting with the European Systemic Risk Board ("ESRB") and, where the contract involves a CCP that is recognised in a third country, with such third-country regulators, whether the clearing obligation should apply to such contracts. After this consultation period, ESMA is required to submit a draft regulatory technical standard ("RTS") to the European Commission, setting out the details of how the clearing obligation will apply to such classes of OTC derivatives. The draft RTS must be endorsed by the European Commission in 1-3 months (unless otherwise indicated in the RTS) and subsequently non-objected by both the European Parliament and the Council in 1-3 months (unless otherwise indicated in the RTS).

- Top-Down Approach: Under the top-down approach, ESMA, on its own initiative, can:
  - conduct a public consultation and consult with the ESRB and, where the contract involves a CCP that is recognised in a third country, with third-country regulators;
  - notify the European Commission the classes of derivative contracts that it believes should be subject to the clearing obligation, but for which no CCP has yet received authorisation; and
  - following notification to the Commission, publish a request for a development of proposals for the clearing of those classes of derivatives.

Status of Authorisation of CCPs

Existing CCPs must have applied for authorisation by the relevant NCA before 15 September 2013. As of 4 April 2014, two CCPs have been authorised by their NCA through the Bottom-Up Approach.
The first, NASDAQ OMX Clearing AB, was authorised by the Swedish regulator Finanspektionen on 18 March 2014. It has been authorised to provide clearing services for all products currently cleared by NASDAQ OMX Clearing, including equity, fixed income and commodity derivatives, traded on exchange as well as OTC. This authorisation triggered ESMA's obligation to submit draft RTS to the European Commission on or before 18 September 2014. After endorsement by the Commission and non-objection by the European Parliament and the Council, this timeline means the clearing requirement

will not commence until at least December 2014. Dutch regulator De Nederlandsche Bank authorised the second EMIR CCP, European Central Counterparty N.V. ("EuroCCP"), on 1 April 2014. EuroCCP clears cash equities; its authorisation has no effect on EMIR requirements for clearing obligations.

The application of the clearing obligation to securitisation swaps

In the case of a European securitisation transaction where the SPV is located in a European jurisdiction (Ireland, the Netherlands and Luxembourg are frequently used), subject to the SPV not constituting an "alternative investment fund" (see further below), the SPV will be an NFC. In light of the relevant clearing thresholds, in the case of most securitisation transactions, it is likely that the SPV will be an NFC-. However, there is some uncertainty as to whether an SPV can be said to have a "commercial activity or treasury financing activity". If it has no such activities, the SPV would not benefit from the ability to exclude the GNV of "hedges" from its calculations in determining whether its positions in OTC derivatives exceed the relevant clearing threshold (as to which see above).

In addition, EU Derivative 2011/61/EU on Alternative Investment Fund Managers ("AIFMD") provides for a framework for the regulation of alternative investment funds ("AIFs") and alternative investment fund managers ("AIFMs"). An SPV will be exempt from the requirements of AIFMD, provided that it qualifies as a securitisation special purpose entity ("SSPE"). Given the potentially high risk of misuse of this exemption for circumventing AIFMD, the EU Commission supported the idea of the development of guidelines by ESMA against circumvention of AIFMD. As a result, it may not be excluded that the new guidelines may be adopted and that an SPV, in respect of certain securitisation transactions, may not benefit from the SSPE exemption. Although this outcome is considered by most commentators to be unlikely, the market is awaiting guidance from the EU Commission on the availability of the SSPE exemption from AIFMD.

If AIFMD were to apply to an SPV, the SPV would be classified as an FC under EMIR. If the SPV were determined to be an FC or an NFC+ it would be subject to EMIR's clearing requirements.

ANNEXURE G – IMPACT OF THE TRADE REPORTING REGIME ON SECURITISATION SPVS

Australia's mandatory OTC derivative reporting regime came into effect for phase 1 entities from 1 October 2013 and phase 2 entities (including AFSL holders with notional exposures exceeding A$50 billion in total) from 1 April 2014. Under phase 3 implementation, it will came into effect for all remaining AFSL holders, including securitisation SPVs, from 1 October 2014.

The reporting regime will impose obligations on both the SPV and the swap provider to report certain trade and position information in respect of their securitisation swap exposures (i.e. “two-sided reporting"). The information will be reported to ASIC via licensed trade repositories.

In July 2013 (see ASIC CP 205), ASIC consulted on whether the market preferred a one-sided or two-sided reporting obligation. It received substantial feedback on this issue, with the majority of respondents indicating a preference for one-sided reporting for the following reasons:

a. collection of more accurate data;

b. a reduction in unnecessary duplication;

c. easier data aggregation; and

d. a reduction of the regulatory cost to participants.

While ASIC recognised that implementing two-sided reporting would present a number of challenges, it ultimately mandated two-sided reporting because "there is important information that it can only obtain under a two-sided arrangement". This includes: "information from both counterparties of the valuation of a derivative; the value of the collateral exchanged; beneficiary information; and whether the trades are being executed for hedging purposes." (See p 56, ASIC Report 357: Response to submissions on CP 205 Derivative transaction reporting.)

However in recognition that two-sided reporting obligations would impose a significant burden for non-financial corporations and other end-users, ASIC stopped short of mandating trade reporting for end-users.

ANNEXURE H – SUMMARY OF DYNAMIC INFORMATION

We have set out below (by way of example) a summary of the type of dynamic interest rate derivative reporting information which a securitisation SPV will not be able to determine:

a. in respect of transaction information:

Table S2.1(1): Common data

(i) 28 - "Maturity, termination or end date"

(ii) 30 - "Mark-to-market/mark-to-model/other value of Derivative"

(iii) 31 – "Currency used for mark-to-market/mark-to-model/other valuation"

(iv) 32 – "Valuation type (mark-to-market/mark-to-model/other)"

(v) 41 – "Collateral portfolio"

(vi) 42 – "Collateral portfolio code"

(vii) 43 – "Value of collateral"

(viii) 44 – "Currency of collateral value"

Table S2.1(5): Interest rate derivative data

(ix) 1 – "Notional amount for leg 1"

(x) 2 – "Notional amount for leg 2"

b. in respect of position information:

Table S2.2(1): Common data

(xi) 20 - "Mark-to-market/mark-to-model/other value of Derivative"

(xii) 21 – "Currency used for mark-to-market/mark-to-model/other valuation"

(xiii) 22 – "Valuation type (mark-to-market/mark-to-model/other)"

(xiv) 28 – "Collateral portfolio"

(xv) 29 – "Collateral portfolio code"

(xvi) 30 – "Value of collateral"

(xvii) 31 – "Currency of collateral value"

Table S2.2(5): Common data

(xviii) 1 – "Notional amount for leg 1"

(xix) 2 – "Notional amount for leg 2"