Australian Securitisation Forum

Chris Dalton | Chief Executive Officer

3 Spring Street, Sydney NSW 2000

T +61 (0)2 8243 3906
M +61 (0)403 584 600
E cdalton@securitisation.com.au

www.securitisation.com.au

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Manager, Corporations and Schemes Unit
Financial Systems Division
The Treasury
Langton Crescent
PARKES ACT 2600
Email: insolvency@treasury.gov.au

Dear Sir/Madam

Submission on Improving Bankruptcy and Insolvency Laws Proposal Paper (Proposal Paper) – exemption sought for securitisation and covered bond special purpose vehicles.

The Australian Securitisation Forum (**ASF)** is the peak industry body representing participants in Australia's securitisation and covered bond markets. The ASF's goals are to facilitate the formation of industry positions on policy and market matters, represent the Australian industry to local and global policymakers and regulators and to advance the professional standards of the industry through a comprehensive suite of educational courses and workshops. This submission is made by the ASF through its Regulatory and Prudential subcommittee.

Some further background of the ASF is set out in Annexure A. Some details as to the significance of the securitisation industry is set out in Annexure B. An outline of a typical securitisation structure is set out in Annexure C. This annexure also includes some details in relation to covered bond transactions.

The ASF appreciates the opportunity to provide a submission on the Proposal Paper and, in particular, the proposals relating to ipso facto clauses. Whilst the Proposal Paper raises a number of potential issues for financing transactions generally, this submission by the ASF is confined to issues uniquely relevant to securitisation and covered bond transactions.

Unique features of securitisation and similar financing arrangements

A fundamental premise of securitisation transactions[1] is that they are intended to be "bankruptcy remote". This means that the special purpose vehicle (**SPV**) that sits at the centre of a transaction (whether it be a company or a trust with a corporate trustee), owns the securitised assets (legally or beneficially) and can survive the insolvency of the sponsor of the SPV (typically the party who has originated the assets) or any other entity which provides services or facilities to the SPV.

Accordingly, the main credit risk taken by investors in exposures to (including debt obligations of) a securitisation SPV is to the securitised assets and not to any counterparties to the transaction. This premise is fundamental to the credit analysis performed by investors in relation to securitisation transactions and is also key to the review undertaken by rating agencies for compliance with their criteria in order to rate the notes issued by the SPV (in rated structures). Accordingly, a number of protections are included in the documentation for securitisation and covered bond transactions that would permit the SPV to survive the occurrence of an insolvency event in relation to such a counterparty. These include:

- the ability to promptly terminate a facility provider or service provider (including a servicer, manager, originator, trustee, security trustee, account bank, liquidity facility provider and swap provider) and replace them with another provider;
- the ability to exercise rights to perfect legal title to assets where the SPV has relied on an equitable assignment of the assets to the SPV (including providing notices to obligors and registering transfers of mortgages or other security interests); and
- flip clauses that shield investors from credit risk against swap providers and the mark-to-market swap costs due by the SPV to a swap provider where the swap is terminated early due (amongst other things) an insolvency event in relation to the swap provider. These operate by subordinating those break costs in the securitisation cashflows so they are subordinated to investors (particularly those investors who hold rated notes).

This premise and the features outlined above have also been identified as one of the criteria for Simple, Transparent and Comparable Securitisations published by the Basel Committee and the International Organization of Securities Commissions in July 2015. We refer you to criterion 14 in relation to fiduciary and contractual responsibilities which requires: "*Provisions should be documented for the replacement of servicers, bank account providers, derivatives counterparties and liquidity providers in the event of failure or non-performance or insolvency or other deterioration of creditworthiness of any such counterparty to the securitisation*.". The Basel Committee proposes to incorporate those criteria into the framework for regulating securitisation and is in consultation in relation to the changes.

[1] The bankruptcy remote / insolvency principles described in this paper in relation to securitisation transactions also apply to the SPV that guarantees covered bonds issued by an ADI under the Banking Act 1959 (**Banking Act**), so the exemptions and treatments proposed in this paper are in respect of both securitisation and covered bond SPVs.

The Australian Prudential Regulation Authority has also indicated that it will consider implementing the criteria in Australia's prudential framework for securitisation once the Basel Committee has finalised its proposals. Accordingly, future securitisation regulation will likely require these features as essential for a compliant transaction.

Financing techniques similar to securitisation but which do not make use of an SPV (such as factoring, where the assets are acquired directly by the financier onto its balance sheet) also raise similar issues. Ipso facto clauses are also used in those arrangements to protect the financier from the insolvency of the originator or servicer of the assets being acquired (or "financed").

Proposed exemption for swaps

The ASF supports the general exemption proposed in relation to swaps and close-out netting contracts protected under the Payment Systems and Netting Act 1998. That would protect the ability of the SPV to terminate a swap transaction if an insolvency event occurs in relation to a swap provider. As indicated above, in those circumstances the securitisation cashflows (or cashflows applicable to the covered bond SPV) may provide for any break costs payable to the counterparty to be subordinated. On the basis that the 'flip clause' mechanic imposes a new arrangement for payments the industry is concerned that these provisions would be caught by the ambit of the proposals. To the extent that these cashflow provisions would be caught, they should be specifically excluded.

Query 3.2b Should any legislation be introduced which makes ipso facto clauses void have retrospective operation

The ASF strongly advocates for any changes to take effect prospectively only. In some cases, it may not be possible to obtain the consents that would be necessary (for instance from investors) to amend securitisation documentation to ensure compliance. The administrative burden and costs involved in such an exercise would also be material.

Query 3.2.2 What contracts or classes of contracts should be specifically excluded from the operation of the provision?

The ASF strongly advocates for an exemption for securitisation and covered bond transactions from the operation of the provision. As indicated above, a number of so called "ipso facto" provisions which would appear to be caught by the proposals are essential features of a securitisation transaction. Without them, there is a risk of significant disruption to, and the introduction of uncertainty into, the securitisation and covered bond markets in Australia. The ASF suggests that careful consideration be given to the detrimental effect of an *ipso facto* moratorium on debt capital markets (and other markets), and whether they offset the intended benefit of the proposals that seek to encourage Australian entrepreneurs. This is particularly the case to the extent that the proposals are modelled off, or otherwise look to, specific provisions of another jurisdiction (for example, Chapter 11 in the United States) where there may be an extensive regime dealing with all aspects of insolvency which put the specific provisions in a particular context and not just an ad hoc implementation in the Australian legal regime.

The ASF notes, for example, that the US Bankruptcy Code provides an exemption for debt financing in the United States from the *ipso facto* moratorium (see section 365(e)(2)(B) of the US Bankruptcy Code) and it may be that Treasury is already considering appropriate exemptions in an Australian context. However, even in the context of the United States exemption, structured finance transactions contain components which of themselves are not financial accommodation or derivatives (such as the cashflow provisions which are often in a separate document to the financial accommodation or the derivatives) and therefore fall outside the exemptions, even though the transaction taken as a whole is predominantly for the purpose of providing financing (see for *example Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Serv'cs Ltd. (In re Lehman Brothers Holdings Inc.)*, Adv. Pro. No. 09-01242 (JMP) (Bankr. S.D.N.Y. Jan. 25, 2010).

Given the importance of their role and its potential impact on structures, participants in securitisation and covered bond transactions should be permitted to be treated differently to preserve the integrity of these structures. Continuing to adopt a creditor friendly insolvency regime is key to the continued ability of the Australian securitisation and covered bond market to access both domestic and offshore investors.

In terms of drafting any such exemption the ASF requests that it be broad enough to cover:

- the statutory definition of covered bonds in the Banking Act; and
- securitisations that use an SPV to acquire or originate or otherwise fund assets using the proceeds of debt or equity serviced by those assets and similar funding arrangements (including those which may not use an SPV, such as on-balance sheet factoring) in which payments to financiers are supported by cashflows from one or more assets funded by one or more classes of financiers.
- In order to assist in the appropriate framing of any proposed exemption that covers the second bullet point above, reference could be made to transactions that use an SPV that fall within the definition of a special purpose entity in Subsection 820-39(3) of the Income Tax Assessment Act 1997 relating to an exemption for thin capitalisation, and in particular the reference in (c) to "*an entity that is an insolvency-remote special purpose entity according to the criteria of an internationally recognised rating agency that are applicable to the entity's circumstances*"; and
- to extend the exemption to similar financing techniques which do not use an SPV, the definition of debt factoring in section 149 of the Duties Act 2001 (Qld).

As noted above the aim would be to frame the exemption widely enough to capture a range of legitimate securitisation and securitisation-like structures.

We would be pleased to discuss our submission with you further at your convenience.

Yours sincerely

Chris Dalton

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ANNEXURE A – ABOUT THE ASF

The 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 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:

(a) transforming pools of relatively illiquid assets into more liquid investible securities, including residential mortgages and infrastructure assets; and

(b) 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.

ANNEXURE C – TYPICAL SECURITISATION TRANSACTIONS

We have set out in this annexure a brief summary of typical securitisation transactions. In the final paragraph, we also note some brief details of covered bond transactions.

Broadly speaking, securitisation typically involves the issue of financial instruments (or 'notes') by a special purpose vehicle (each, a **securitisation entity**), 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 securitisation entity. Swaps are often used to hedge interest rate and currency positions. While they are not in any way exotic or speculative in nature, as their terms need to reflect the underlying asset pool, these swaps would likely not satisfy the requirement for central clearing.

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:

1. Bankruptcy remoteness

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

2. Assets quarantined from originator/seller insolvency

The beneficial ownership of the assets held by the securitisation entity 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 securitisation entity. 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.

3. Limited recourse/non-petition language

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

Amortising assets – limited life securitisation entity. 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 entity are typically linked to the notional value of one or more asset classes (e.g. fixed-rate loans) in the amortising asset pool.

4. Security

Security is granted over the assets of the securitisation entity 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).

5. 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 provide some further detail on some common structures used in the Australian market below.

1. 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 (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 securitisation entity achieve certain levels of creditworthiness required by their rating.

2. 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.

3. 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.

Covered bond transactions share many similar characteristics with securitisation transactions. However, in covered bond transactions, the Australian banks are the issuers of the covered bond - not the special purpose vehicles. The bank issuer makes an inter-company loan to the special purpose vehicle to enable the special purpose vehicle to acquire the cover pool of assets. The special purpose vehicle then provides a guarantee of the issuer's obligation to bond holders. This guarantee will be called upon in an event of default in respect of the bank issuer. The cover pool of assets permits the special purpose vehicle to continue to make scheduled payments on the bonds following an issuer event of default. The bond holders benefit from security granted by the special purpose vehicle over the cover pool to secure the special purpose vehicle's obligations, including in respect of the guarantee. Swaps would often be entered into to hedge the transaction.