Assessment of Law and Practice Relating to the Mortgage Origination Process in Securitisation Programs

By Pelma Jacinth Rajapakse

Abstract

Securitisation is the process by which a credit institution – either a bank or an independent mortgage provider (IMP) – sells assets on its loan book – specifically, accounts receivable on its loan book – to another financial intermediary, which then funds its holdings by issuing asset-backed securities to investors. By this process, the original illiquid asset is transformed into a tradeable, more liquid debt security.

The purpose of this article is to examine the relevant aspects of commercial law and practice as they relate to three of the most critical features of mortgage origination within the securitisation process. Firstly, the article will analyse the following legal and regulatory aspects in the origination stage: (1) the concept of the “security” as it relates to the mortgage securitisation process; (2) the legal consequences for various stakeholders of registering a mortgage as security on a loan; and (3) the impact of the Australian Prudential Regulation Authority’s (APRA) capital adequacy guidelines on relevant stakeholders in the mortgage origination stage within the RMBS programs.

Secondly, the article focuses on a qualitative assessment of the extent to which the current legislative and regulatory provisions governing the mortgage origination process either impede or facilitate the operation and growth of the RMBS market in Australia. The existing legislative and regulatory provisions governing mortgage origination are assessed using a “public benefit test” framework. This framework is based on the principles of social cost-benefit analysis and is used to identify an optimal RMBS legal and regulatory regime that would provide a resolution to the conflicting interests of participants in the RMBS process. This test is similar to that used to evaluate the introduction of Commonwealth and State legislation pursuant to the Commonwealth-State Competition Principles Agreement 1995 and the Statutory Instruments Act 1992 (Queensland).

The results of the qualitative assessment reveal that the following law and regulation facilitates the achievement of the objectives and criteria for the origination of mortgages within the RMBS programs. These include: (a) rights and obligations of the originator and the borrower under relevant contract law and property legislation, which enhance the cash flow for payment to investors in the RMBS; (b) the Torrens system of land registration facilitates mortgage origination and clear transfer of mortgagee’s rights from the originator to the SPV; (c) the law of property permits the right to assign mortgages to a third party in equity, at minimal cost to the assignor and assignee; (d) the Consumer Credit Code’s key requirements for disclosure and standardisation of credit contracts contribute to informational efficiency and reduce information costs for lenders, borrowers and investors. The results of the investigation also reveal that the following aspects of the regulatory provisions in relation to mortgage origination act as impediments to the growth of the RMBS market in Australia. These include: the regulatory capital requirements and the risk-weighting criteria in relation to RMBSs which under APRA’s system of prudential regulation, effectively discourage ADIs from converting on-balance sheet assets to off-balance sheet assets, and risk-weighting RMBSs at 100 percent rather than (for example) 50 percent in line with international proposals, keeps the amount of capital needed to maintain RMBSs at unnecessarily high levels. Furthermore, if this cost is passed on to investors by way of higher prices and lower yields, this discourages investment in the RMBSs issued, and is likely to increase interest rates and charges for borrowers. Finally, the article concludes with some suggestions for re-form of the risk-weighting of RMBSs and the regulatory capital adequacy guidelines in Australia.

Key Words:

Securitisation, Residential Mortgage-Backed Security (RMBS), Mortgage Origination, Capital Adequacy

1. Introduction

Securitisation is the process by which a credit institution – either a bank or an independent mortgage provider (IMP) – sells assets on its loan book – specifically, accounts receivable on its loan book – to another financial intermediary, which then funds its holdings by issuing asset-backed securities to investors. By this process, the original illiquid asset (e.g. a residential mortgage loan, credit card receivable, or motor vehicle lease) is transformed into a tradeable, more liquid debt security.

There are two common forms of residential mortgage securitisation program in Australia. The first common form is a “bank” or “assignment” program. In a typical “bank” securitisation program, a housing loan provider, generally referred to as the originating bank, “pools” selected housing loans and – for a price – transfers its rights under the relevant loan agreements to a special purpose vehicle (SPV), which then – again for a price – issues notes or bonds to institutional investors. In Australia, the SPV is invariably structured as a trust.
The second common form of residential mortgage securitisation program, and indeed the most prevalent in the financial market at the time of writing, is the so-called “conduit” program. These programs are typically established by the smaller regional banks, building societies, credit unions and independent mortgage providers (IMPs) that, individually, lack the asset size to sponsor an assignment program in their own right (i.e., without the guarantee of a larger bank or credit institution). As a result, these institutions “warehouse” (or pool) their mortgages until they reach an aggregate value sufficient to back an RMBS issue. In order to make the bonds that the SPV issues more attractive to institutional investors, the smaller originators typically need to upgrade the quality of their bonds by obtaining the support of a larger bank as “guarantor” or “back-up servicer”.7

The SPV issues notes or bonds, usually in face values of $500,000, to institutional investors who, in return for investing in the issue, receive semi-annual interest until the expiry date of the facility, at which time the face value is returned to them. The price paid by investors reflects the present value of the periodic interest coupons and the face value. In Australia, the notes or bonds are invariably issued by way of a trust, in which the issuer is the trustee for the bondholders.8 The borrowers’ principal and interest repayments act as an income “buffer” to help insulate the investor from the risk of default on the notes or bonds it has issued.

The notes or bonds issued are mortgage-backed in the sense that, if the issuer defaults on its obligation to pay interest (or ultimately the face value of the note) to the investor, a security trustee — in whom the legal rights under the pooled mortgages are vested — can exercise a power of sale over the secured residential properties and recover the monies owed.

There are two purposes of this article. Firstly, it examines relevant aspects of commercial law and practice as they relate to three of the most critical features of mortgage origination within the securitisation process. Accordingly, Parts 1 to 3 of the article will focus on the following aspects: (1) the concept of the “security” as it relates to the securitisation process; (2) the legal consequences for various stakeholders of registering a mortgage as security on a loan so that it is available to be searched on the public record; and (3) the impact of the Australian Prudential Regulation Authority’s (APRA) capital adequacy guidelines on relevant stakeholders in the mortgage origination stage of the RMBS programs.

Secondly, the article focuses on a qualitative assessment of the extent to which the current legislative and regulatory provisions governing the mortgage origination process either impede or facilitate the operation and growth of the RMBS market in Australia. The existing legislative and regulatory provisions governing mortgage origination are assessed using a “public benefit test” framework. This framework is based on the principles of social cost-benefit analysis and is used to identify an optimal legal and regulatory regime that would provide a resolution to the conflicting interests of participants in the RMBS process. This test is similar to that used to evaluate the introduction of Commonwealth and State legislation pursuant to the Commonwealth-State Competition Principles Agreement 1995 and the Statutory Instruments Act 1992 (Queensland).9

The qualitative assessment of law and regulation governing mortgage origination will be based on the discussion in Parts 2 to 3. To aid this investigation, Part 4 identifies the objectives and criteria relating to the mortgage origination process. Based on the framework of “public-benefit” test, Parts 5 and 6 qualitatively assess the extent to which the current law and regulation hinders or facilitates the achievement of the objectives and criteria for the origination of mortgages within the RMBS programs. An outline of the main findings derived from this assessment is provided in Table 5. Finally, Part 7 provides a summary of the legal and regulatory issues that arise in the mortgage origination and conclude the article with some suggestions for re-form of the risk-weighting of RMBSs and the regulatory capital adequacy guidelines in Australia.

In a typical mortgage origination, the borrower applies for a residential home loan from a bank or mortgage originator. In the case of a bank, the loan application is reviewed for approval by bank management, and the residential property to be mortgaged is valued by the bank’s valuer. In the case of a mortgage originator or an IMP,10 they record the details of the borrower’s loan application and forward it to a bank for approval. These IMPs effectively act as “spotter’s” for the larger banks, and the origination fee they receive is effectively in the nature of a “spotter’s fee”. Invariably it is a condition of the home loan contract that the loan be insured,11 either by a bank subsidiary insurance arm, or by an independent insurer. Once the loan is approved, subject to the requirements of the Consumer Credit Code and other relevant legislation, the bank’s solicitors prepare and settle the mortgage and loan documentation. After the mortgage is executed, funds are advanced and the security interest of the originator is perfected.12 The payment by the mortgagor to the originator of the principal and interest instalments under the loan may commence afterwards. After origination, the IMP transfers the mortgages to an SPV in return for a purchase price payable immediately on sale.

The SPV typically authorises the originator to act as “servicer”. In return for a service fee, the originator collects the mortgage repayments on behalf of the SPV. The servicer typically accumulates these mortgage receivables in a separate escrow or trust account,13 from which collections are drawn by the SPV. The SPV uses these collections either to fund immediate interest payments to its bond investors, or to reinvest the money elsewhere so that it can pay bond investors at a later date.

From a commercial point of view, the entire securitisation process can be characterised as a series of contracts or agreements, which are motivated by each participant’s desire for financial gain or profit.14 For example, there are loan contracts between borrowers and the originating credit institution; contracts between the originating credit institution and other financial intermediaries to whom it assigns its mortgagee rights; and contracts between the SPV15 and the institutional investors.

In practice, RMBS issues offer the following incentives to the stakeholders involved in the mortgage origination process:
For banks, IMPs and other originating financial institutions, RMBS programs provide additional opportunities for:

- off-balance sheet financing;
- fee income;
- transforming illiquid assets (i.e. home mortgage loans) into tradeable securities;
- arguably, the transfer of risk;
- obtaining additional liquidity;
- reducing costs through economies of scale and scope.

Thus, the overall securitisation is profit-driven, in the sense that, at each stage of the process, income is generated for the relevant service provider.

2. THE CONCEPT OF A MORTGAGE AS “SECURITY” ON A LOAN

In the context of this article, a mortgage is a transfer of an interest in property by a housing loan borrower to a mortgage originator as security for the repayment of the housing loan. It is created by the borrower, as mortgagor, transferring rights over the security property to the originator, as mortgagee, whom it provides with rights against the mortgaged property (e.g. the right to sell the security property and recoup any outstanding debt owed by the mortgagor), as well as the right to enforce against the mortgagor’s promise to pay.

English law recognised securities as “real” or “personal”, and Australian law preserves this basic distinction. The concepts of the mortgage, lien and charge are said to have their roots in the Roman law transactions of fiducia (the basic mortgage), pigmes (possessory security) and hypotheca (hypothecation or charge). Personal securities are classified into choses in action and choses in possession. The former, being intangible rights over property that are enforceable by legal action, are generally more relevant in the context of this article, except at the point of the borrower’s redemption of the mortgage (e.g. upon early payout of the loan), or where the security trustee exercises its rights as mortgagee in possession.

There is a plethora of scholarly legal writing on the fine distinctions between “property”, “proprietary” and “ownership” interests attributed to the concept of “security”. The search for the “proprietary” interest in a security has largely been resolved on the test of whether, once the relevant res has been identified, the attendant rights are rights in rem or rights in personam. Salmond contends that the principle of “ownership” is based on the relative rights of competing stakeholders, while Sykes has extended this theory by arguing that these rights are conglomerations of rights in a composite sense, capable both of individual and separate existence, and alienation.

In Australian RMBS programs in practice, all mortgages comprising the mortgage pool are registered on each property’s certificate of title, under the so-called Torrens system. This gives the originating mortgagee a statutory charge over the security property for the right to repayment of the loan. The borrower or mortgagor is obliged, under the terms of the mortgage, to repay the principal and interest on the loan, and comply with various positive and negative covenants.

Under the Torrens system, the mortgagor of a registered mortgage remains the legal (registered) owner of the subject property, holding an equity of redemption - i.e. a right to redeem, recognised in equity - subject to the mortgagee’s statutory charge. The mortgagee does not lose his or her legal ownership of the mortgaged property, and the mortgagee has neither possession of, nor legal title to, the security property. The registered mortgage is limited to a set period and, once the debt is repaid and the mortgage released, a clear title reverts back to the mortgagor.

If it is not registered under the Torrens system, the mortgage creates, for the mortgagor, only an equitable interest in the security property. Property legislation in all State jurisdictions requires an equitable mortgage, as an interest in land, to be in writing or created by an equitable assignment. The only substantive requirement of a valid equitable assignment is that there be an expressed (and written) intention to assign.

In the context of Australian RMBS issues, the mortgage originator is typically noted on the certificate of title as the holder of the registered mortgage, while any subsequent (equitable) assignees such as the trustee-issuers are equitable mortgagees. If the mortgagor defaults, the mortgagee has the right to exercise its power of sale, foreclose, appoint a receiver, and enter into possession, as well as sue personally to enforce the mortgagee’s contractual obligation to repay the loan.

Although the subject of priority between competing mortgages is standard fare in most exegeses of the law of mortgages, it has not arisen in the context of RMBS programs in Australia, either in the form of decided cases, or in the Australian scholarly literature. However, it is conceivable that a contest of priorities between competing mortgages might arise in the future, in at least two situations in Australia.

First, it is plausible that a housing loan borrower might, unwittingly or unwittingly, grant a registered mortgage later in time to that granted to the originator, to another lender who has acted bona fide and is unaware that rights under the earlier registered first mortgage have been assigned in equity to the trustee-issuer. In such a scenario, a contest might arise between the equitable assignee of the mortgagee rights - i.e. the trustee-issuer - on the one hand, and this subsequent registered mortgagee on the other. At first glance, it might be thought that the holder of the later registered interest would take priority over the earlier equitable (unregistered) interest.

However, this interpretation would ignore the fact of the (originator’s) earlier registered first mortgage, of which the second registered mortgagee must have been aware, since it would have appeared on the certificate of title to the security property at the time of taking out the later mortgage. Accordingly, the better legal analysis would appear to be that the first registered mortgagee has effectively subrogated its rights to the equitable assignee (the trustee-issuer), who thereby stands “in the shoes” of the first registered mortgagee to take priority over the holder of the later registered interest, which must have been aware of the earlier registered mortgage.

Second, it is possible that a housing loan borrower might grant, later in time to that granted to the originator, an unregistered mortgage to another bona fide lender who is unaware of any equitable assignment to the trustee-issuer. Again, a priority contest might arise between the trustee-
issuer *qua* the equitable assignee, and the later unregistered mortgagee. However, this type of contest should be resolved relatively easily, either on the maxim that where the equities are equal, the first in time prevails or, more correctly, consistent with the foregoing analysis – that the first registered mortgagee has effectively subrogated its rights to the trustee-issuer, who thereby stands “in the shoes” of the first registered mortgagee to take priority over the holder of the later unregistered interest, which must have had knowledge, either actual or constructive, of the earlier registered interest.40

Having said this, any such priority contests are more likely to arise at some distant point in the future – for example, when the market in Australia has matured to the point where each of a number of originators might, without knowledge of the others’ existence, take unregistered mortgages over the same security property, or group of security properties. Indeed, it is difficult to imagine priority problems arising, under the current Torrens system, unless both security interests were unregistered.

3. CAPITAL ADEQUACY GUIDELINES

All banks accept deposits (in the traditional banking sense of bank deposits or credits) on behalf of customers. However, not all IMPs are deposit-taking institutions in this traditional sense. As noted above, some IMPs act as little more than “spotters” for the larger banks, and the origination fee they receive is effectively in the nature of a “spotter’s fee”. These IMPs do not accept deposits in the traditional banking sense.

This classification becomes significant in the context of Australia’s prudential supervision requirements, and particularly APRA’s capital adequacy requirements. In the parlance of Australian prudential supervision, banks and those IMPs that act as deposit-taking institutions (in the traditional banking sense) are known as “Authorised Deposit-taking Institutions” or “ADIs”.

3.1 Capital Adequacy Guidelines Generally

The capital adequacy requirements to which ADIs in Australia are subject are derived from the Bank of International Settlements (BIS) concordat of 1988 (also known as the Basle Accord I).41 The accord is intended to strengthen the stability of the international banking system and to establish a consistent international framework so as to reduce competitive inequalities between international banks. The Basle Accord establishes minimum standards but it is open to national authorities to adopt more stringent requirements. The BIS has decided to introduce a new capital adequacy framework to replace the 1988 guidelines. It has issued a consultative paper entitled “A New Capital Adequacy Framework” in June 1999 (Basle Accord II) and hopes to set forth more definitive guidelines in the future.42

The risk-based capital guidelines adopted by the Australian Prudential Regulation Authority (APRA) attempt to make capital requirements more sensitive to differences in credit risk (the potential risk of default by a borrower or counterparty),

<table>
<thead>
<tr>
<th>Tier 1 (Core) Capital47</th>
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<tbody>
<tr>
<td>• Paid-up ordinary shares.</td>
</tr>
<tr>
<td>• Non-repayable share premium account.</td>
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<tr>
<td>• General reserves.</td>
</tr>
<tr>
<td>• Retained earnings.</td>
</tr>
<tr>
<td>• Non-cumulative irredeemable preference shares.</td>
</tr>
<tr>
<td>• Capital instruments</td>
</tr>
<tr>
<td>• Minority interests in subsidiaries consistent with the foregoing components.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tier 2 (Supplementary) Capital48</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Upper</strong></td>
</tr>
<tr>
<td>• General provisions for doubtful debts.49</td>
</tr>
<tr>
<td>• Asset revaluation reserves.50</td>
</tr>
<tr>
<td>• Cumulative irredeemable preference shares.</td>
</tr>
<tr>
<td>• Mandatory convertible notes and similar capital instruments.</td>
</tr>
<tr>
<td>• Perpetual subordinated debt.</td>
</tr>
<tr>
<td><strong>Lower</strong>51</td>
</tr>
<tr>
<td>• Term subordinated debt.</td>
</tr>
<tr>
<td>• Limited life redeemable preference shares.</td>
</tr>
</tbody>
</table>

Table 1: Definition of Capital46
Zero weight

- Notes and coin.
- Gold bullion held in own vaults or on an allocated basis to the extent backed by gold bullion liabilities.
- Balances with Reserve Bank of Australia.
- Loans and other claims fully secured against cash.
- All claims on the Commonwealth and State (including Territory)
- Governments held on the banking book, including claims on State central borrowing authorities.
- All claims on central governments and central banks of OECD countries held on the banking book.
- All claims on foreign central governments and central banks in non-OECD countries held on the banking book, which are denominated in local currency and funded by local currency liabilities of the country concerned.
- On-balance sheet unrealised gains on market related off-balance sheet transactions where they have been included in off-balance sheet risk weighted asset calculations.

20 per cent weight

- Claims on Australian local governments public sector entities (except those which have corporate status and operate on a commercial basis), and claims guaranteed by these entities.
- Claims on non-commercial public sector entities in OECD countries and claims guaranteed by these entities.
- Claims on Australian and OECD banks, and claims on non-OECD banks from the Asia-Pacific region designated by APRA, and claims guaranteed by these banks.
- Claims on other banks incorporated in countries outside the OECD with a residual maturity of up to one year, and claims of similar maturity guaranteed by these banks.
- Claims on international banking agencies and regional development banks and claims guaranteed, or secured by securities issued, by these agencies and banks.
- Cash items in the process of collection.

50 per cent weight

- Loans for housing, or other purposes, fully secured by registered mortgage over residential property where the ratio of the value of loans to the value of the mortgaged residential property securing the loans is 80 per cent or less or where the loan is 100 per cent mortgage insured through an acceptable lenders mortgage insurer.
- Broking positions awaiting settlement in a stockbroking subsidiary of a bank.
- Credit equivalent of off-balance sheet exposures arising from market related transactions with counterparties that would otherwise attract a 100 per cent risk weight.

100 per cent weight

- Claims on Australian public trading enterprises that have corporate status and operate on a commercial basis (notably in significant competition with private sector enterprises).
- Claims on commercial companies owned by the public sector in OECD countries.
- Claims on, or guaranteed by, non-OECD central governments and central banks other than those denominated in the local currency and funded in that currency.
- Claims on non-OECD foreign banks with residual maturity exceeding one year (unless otherwise specifically agreed by APRA).
- Claims on, or guaranteed by, non-bank parents (including bank holding companies which are not themselves banks) of OECD banks, unless specifically guaranteed by an OECD bank.
- Claims on non-bank private sector, including non-bank financial institutions.
- Holdings of subordinated bonds issued by international agencies and multilateral development banks.
- Premises, sites, equipment and other fixed assets.
- Operating leases covering plant, equipment etc.
- Equity investments and capital instruments issued by other banks held for trading purposes.
- All other assets and claims not included elsewhere.

Table 2: Risk Weights
reflect off-balance sheet exposure, and minimise disincentives to holding liquid, low-risk assets. These guidelines consist collectively of the following: Capital Adequacy - APS 110; Capital Adequacy: Measurement of Capital - APS 111; Capital Adequacy: Credit Risk – APS 112; Capital Adequacy: Market Risks – APS 113; Funds Management and Securitisation – APS 120 (September 2000). 43

The focus of these guidelines is on ADIs holding adequate capital to meet their credit risk. Each Australian ADI is expected to maintain a minimum ratio of total capital to risk weighted assets of 8 percent. 44 Consistent with the approach adopted by the Basle New Capital Adequacy Framework, the APRA has issued a harmonised set of prudential standards covering all banks and other financial intermediaries (ADIs).

ADIs are required to maintain certain minimum ratios of their capital to both their “total asset” and their “risk weighted assets”. The guidelines provide complicated instructions to calculate each of the elements of these ratios. Capital for instance, may have different formulations, each of which is used for a different capital to risk weighted asset ratio. 45

Capital is comprised of core, or “Tier 1 Capital” and supplementary, or “Tier 2 Capital”. Tier 2 Capital is divided into two segments termed Upper and Lower Tier 2 Capital each consisting of different combinations of assets. A summary of the main elements of Capital is given in Table 1. Generally, each definition of capital includes a specific combination of certain of a bank’s ordinary shares, preferred shares, contingency and other financial reserves, allowances for loan or lease losses, minority interests in equity accounts of consolidated subsidiaries, and other financial instruments. In addition, capital is often reduced by any outstanding goodwill and by certain other applicable adjustments. (e.g. future income tax benefits, inter-bank holdings of capital, investments in non-consolidated subsidiaries).

Risk weighting of the capital-to-assets ratio implies that the higher the level of asset risk, the greater is the level of capital backing required. Assets are grouped among four risk-weighting categories, ranging from 0 percent to 100 percent, based primarily on the credit risk of the assets. The risk weighting and the assets within each category are set out in Table 2.

ADIs need not hold capital in respect of assets that are assigned a risk weighting of zero percent. On the other hand, they are required to hold capital on a one-to-one basis (in terms of value) in respect of assets that are assigned a 100 percent risk weighting. Assets in the 20 percent and 50 percent risk weight categories have correspondingly reduced capital requirements associated with them.

Loans for housing or other purposes over residential property are assigned a 50 percent risk weighting, provided

<table>
<thead>
<tr>
<th>Direct Credit Substitutes</th>
<th>Credit Conversion Factor</th>
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</thead>
<tbody>
<tr>
<td>Guarantees.</td>
<td>100%</td>
</tr>
<tr>
<td>Assets sold with recourse where credit risk remains with the bank.</td>
<td>100%</td>
</tr>
<tr>
<td>Standby letters of credit serving as financial guarantees.</td>
<td>100%</td>
</tr>
<tr>
<td>Written put options over specified assets with the character of a credit enhancement.</td>
<td>100%</td>
</tr>
<tr>
<td>Bills endorsed under bill endorsement lines.</td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Trade and Performance-Related Contingent Items</th>
<th>Credit Conversion Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranties, bid bonds, indemnities, performance bonds and standby letters of credit related to particular non-monetary obligations.</td>
<td>50%</td>
</tr>
<tr>
<td>Documentary letters of credit secured against underlying shipment of goods.</td>
<td>20%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Commitments</th>
<th>Credit Conversion Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitments with certain drawdown.</td>
<td>100%</td>
</tr>
<tr>
<td>Sale and repurchase agreements where credit risk remains with the bank.</td>
<td>100%</td>
</tr>
<tr>
<td>Forward asset purchases and amounts owing on partly paid shares and securities which represent commitments with certain drawdown and placements of forward deposits.</td>
<td>100%</td>
</tr>
<tr>
<td>Note issuance facilities and revolving underwriting facilities.</td>
<td>50%</td>
</tr>
<tr>
<td>Other commitments (e.g. formal standby facilities and credit lines) with a residual maturity of:</td>
<td></td>
</tr>
<tr>
<td>(i) one year or less, or which can be unconditionally cancelled at any time without notice.</td>
<td>0%</td>
</tr>
<tr>
<td>(ii) over one year.</td>
<td>50%</td>
</tr>
</tbody>
</table>

Table 3: Off-Balance Sheet Business 44
the ratio of the value of loans to the value of the mortgaged residential property securing the loans is 80 percent or less, or where the total value of the loan is insured with a mortgage insurer.\(^{53}\)

The calculation of an ADI’s “risk weighted assets” involves assigning its assets and certain off-balance sheet items (such as standby letters of credit, guarantees, and commitments to lend or purchase) to broad risk categories. Each category has been assigned a corresponding percentage factor intended to reflect the credit and other risks associated with it. These are set out in Table 3. An ADI’s total risk-weighted assets are equal to the sum of the items in each risk category, weighted according to the category’s corresponding percentage.

The risk weightings reflect, on a portfolio basis, broad guidelines about the potential credit risk of each category of borrower, but are not used in any detailed way to assess the credit risks associated with individual borrowers. Each bank is required, under the guidelines, to individually assess every counterparty’s credit risk, allocate the appropriate amount of capital to cover that risk, and suitably price the transaction to reflect the risk.

### 2.2 Risk-Weighting of RMBSs

Under APRA’s Capital Adequacy guidelines, loans secured by registered mortgages over residential property are given a concessional risk weighting of 50 percent.\(^{57}\) However, APRA has taken the view that if those same residential mortgages are securitised, then at least prima facie, a risk weighting of 100 percent should apply to the corresponding mortgage-backed securities.

Thus, if this prima facie position applies, an ADI’s portfolio of residential mortgages would be weighted at 50 percent for capital adequacy purposes, but an issue of debt securities (e.g., RMBSs) that is backed by those same mortgages would be weighted at 100 percent, meaning that the ADI would need to provide twice as much capital cover for the RMBSs as it would for home loans secured by the same mortgages.\(^{58}\) This prima facie position applies unless the ADI fulfils APRA’s requirements for regulatory capital relief – that is, where APRA grants relief from the prima facie requirement that RMBSs be risk-weighted at 100 percent.\(^{59}\) In general, regulatory capital relief may be granted by APRA where the ADI can demonstrate that:

- risk has been transferred to an SPV by way of a “clean” and final sale;
- there has been sufficient disclosure of the risks of the securitisation to investors in RMBSs;
- the extent to which the ADI is permitted under the RMBS program to deal with the SPV (e.g. as a servicer, or provider of risk management services) is limited and made explicit in the legal documentation; and
- the ADI itself bears the full, or a disproportionately high share of the risk associated with the securitised assets (specifically, by way of so-called “first loss credit enhancements”).\(^{60}\)

As a general rule, if these conditions are met, APRA may for regulatory purposes allow the ADI to deduct the face value of the RMBS facility from its capital base.\(^{61}\) On the other hand, if the conditions are not met or are only partly met, APRA can require the ADI to assign a risk weighting of up to 100 percent to the RMBS issue.\(^{62}\) This represents a “fall back” position for the ADI if it does not secure regulatory capital relief from APRA, and the difference in risk weighting plainly renders APRA’s decision to approve or reject an ADI’s application for regulatory capital relief crucial to whether the RMBS program proceeds or not.

### 3.3 Effects of the Guidelines on Participants

This disparity plainly creates commercial incentives, purely because of the current regulation, for ADIs to use their residential mortgage loans to issue RMBSs, and (arguably) for institutions not to invest in the RMBSs issued.

**Originating ADIs and Sponsors**

The (opportunity) cost of maintaining capital to cover assets for regulatory purposes plainly represents an economic cost to a regulated ADI. If costs increase, ADIs and sponsors that wish to maintain their profit margins face an incentive to increase revenue by raising interest rates and/or bank fees to borrowers,\(^{63}\) to the extent they can within prevailing regulation.\(^{64}\)

Depending on the level of competition they face, profit-oriented businesses also have an incentive to seek to escape incurring any avoidable costs. Similarly, ADIs and sponsors face an incentive to comply with APRA’s requirements for regulatory capital relief in respect of RMBS issues, in order to avoid the cost imposed by having to comply with an APRA-imposed obligation to provide 100 percent capital cover in respect of the issue.

**Initial Borrowers**

The interest rates and bank fees charged to housing loan borrowers on their initial housing loans reflect the current risk weighting assigned to them of 50 percent. If an ADI initiates or sponsors an RMBS issue for which it cannot secure regulatory capital relief, initial borrowers may bear some or all of the additional cost for the ADI of providing 100 percent capital cover in respect of the issue, in the form of higher interest rates or charges.\(^{55}\)

Further, and significantly in the context of this article, it is currently unusual for housing loan borrowers to be informed that their mortgages have been assigned to an SPV under a securitisation. Under the Reserve Bank’s securitisation guidelines,\(^{66}\) this form of transfer is designated a “silent assignment”. The APRA is prepared to regard a silent assignment as a “clean sale” to the SPV, and hence to permit the relevant housing mortgages to be excluded from the originating bank’s capital adequacy calculations, provided that the requirements noted earlier are satisfied.\(^{67}\)

**Credit Enhancement Providers**\(^{58}\)

An ADI providing credit enhancement or liquidity support to a securitisation scheme also may be subject to additional capital requirements (and therefore costs), depending on its risk-weighted capital-to-assets ratio. The APRA guidelines provide a complicated procedure for incorporating off-balance sheet items, such as credit enhancement or contingent liquidity support facilities, into the risk-based capital ratios.

For example, AGN 112.2- Risk-Based Off Balance Sheet
Credit Exposure provides that off-balance sheet items, such as credit enhancement or provision of additional liquidity, are included in the calculation of the risk-weighted capital-to-assets ratio pursuant to a specified formula. The amount of capital required is generally proportional to the “face amount” of an off-balance sheet item multiplied by a “conversion factor”. The conversion factors and the activities within each are set out earlier in Table 3.

Direct credit substitutes are assigned a 100 percent conversion factor (i.e. the maximum risk-based capital must be maintained against them). These include guarantees, assets sold with recourse where the credit risk remains with the ADI, financial standby letters of credit, and other irrevocable undertakings that guarantee the repayment of financial obligations. Trade and performance-related contingencies are assigned a 50 percent conversion factor. These include warranties, bid bonds, indemnities, performance bonds and performance standby letters of credit related to non-monetary obligations. Other commitments (e.g. standby facilities and credit lines) with a residual maturity of over one year are also assigned a 50 percent conversion factor, while other commitments with a residual maturity of one year or less, or those that are unconditionally cancellable at any time, are assigned a zero percent conversion factor.

Investors

If an SPV or sponsor is unable to secure regulatory capital relief in respect of an RMBS issue, and its costs increase because it must resort to its “fall back” position, it is less likely to offer an attractive return to investors. This implies that, other things being equal, investors will be less likely to invest in any RMBSs issued. Alternatively, the SPV or sponsor may simply decide not to proceed with the issue, thereby depriving prospective investors of an avenue for potentially profitable investment, potential interest income, and an ability to diversify into housing mortgages, which would otherwise be unavailable to them.

Having said this, assuming the RMBS proceeds, some investors will take comfort from the fact that APRA has scrutinised the issue; and, if regulatory capital relief has been withheld, that the ADI or sponsor is compelled to provide additional capital cover in respect of the issue. Thus, on balance, it can only be said that the current capital adequacy guidelines arguably create a commercial incentive for institutions not to invest in the RMBSs issued.

3.4 International Comparisons and Proposals

The “fall back” approach adopted by the APRA in Australia to the risk weighting of RMBSs is in marked contrast to that of other prudential regulators overseas. For example, if regulatory capital relief is not obtained by prudential regulators overseas, their “fall back” positions are that RMBSs are risk-weighted at

- 50 percent in France;
- 50 percent, subject to certain conditions, in England and Canada;
- 50 percent in Japan, with further concessional risk weightings of 0-20 percent if the issue is appropriately credit-enhanced; and
- between zero and 50 percent in the United States, based on the risk of the RMBS program sponsor and other stakeholders providing credit enhancement.

However, these “fall back” positions are likely to change by about 2008. As noted earlier, international prudential regulation is scrutinized by the Bank for International Settlements (BIS), which is an international organization based in Basel, Switzerland, whose role, since its establishment in 1930, has been to foster international financial cooperation and acts as bank to the central banks of member countries. A number of standing committees and organisations have been set up by the Bank over the last 40 years to help monitor and influence the international financial system and world financial stability and come up with international “best practice” in the regulation of international financial markets. The Basel Committee on Banking Supervision is one of these, established in 1974 by the Governors of the G10 central banks.

Although it exercises no formal supranational authority and its conclusions have no legal force, the Basel Committee uses its considerable influence to formulate guidelines and “best practice” standards in the expectation that they will be implemented, albeit adapted to local conditions, by the central banks of member countries. In 1988, the Basel Committee recommended the introduction by central banks of a new prudential requirement to be implemented by the end of 1992 – viz. a risk-based capital-to-assets ratio of 8 percent (the so-called Basel Capital Accord) which formed the basis for Australia’s current system of capital adequacy. In June 1999, the Committee issued a proposal for a new capital adequacy framework to replace the 1988 Accord. This is the so-called “Basel Accord II” (abbreviated in market parlance to “Basel II”).

The current Australian risk weighting for fully secured residential housing loans of 50 percent reflects, and is in line with, a Basel II recommendation in 2001. However, under a consultative paper issued in April 2003, the BIS proposed that the relevant risk weightings be further reduced so that after 2008, lending that is fully secured by mortgages on residential properties would be risk-weighted at 35 percent, and mortgage securitisations in general would be risk-weighted as follows:

<table>
<thead>
<tr>
<th>External Credit Assessment</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to BB-</th>
<th>B+ and below or unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>350%</td>
<td>Deduction</td>
</tr>
</tbody>
</table>

Table 4: Long-Term Category (Basel II Proposal)
Basel II has not, at least as yet, distinguished between mortgage securitisations in general, and RMBSs in particular. However, Australian RMBS issues are typically rated AA- or above, meaning that the “fall back” position for ADIs that are unable to obtain regulatory capital relief after 2008 would be that their RMBSs be risk-weighted at 20 percent. This would lead to the curious result that, even if regulatory capital relief was not obtained from APRA, the ADI would, as a “fall back” position, have to provide less capital cover for the RMBS issue than it would for home loans secured by the same mortgages. This is precisely the converse of the current position, and begs the question whether:

- RMBSs may be significantly less risky than residential mortgage loans (commonsense suggests that this is likely where a smaller or regional ADI is utilising a larger, well-known sponsor to upgrade the quality of its RMBSs); and
- the current risk weightings are appropriate at all.

4. QUALITATIVE ASSESSMENT OF MORTGAGE ORIGINATION LAW AND PRACTICE

In this section, the results from the above analysis in Parts 1-3 are brought together and used as a basis in examining the current legislative and regulatory provisions governing the mortgage origination. The “public benefit test” framework is used as a guide in this examination. Within this framework, this section qualitatively investigates the extent to which the current law and regulation hinders or facilitates the achievement of those objectives of the functional stage of mortgage origination within the securitisation process.

In order for the mortgage origination process to work effectively, it is proposed that the following must be achieved:

- Acquisition of good quality mortgage loans for securitisation: Mortgage securitisation is primarily meant to create a security (RMBS) out of a basic asset (the mortgage loans). The originator expects the security to stand on its own worth, and hence, to make the credit rating of the originator insignificant. This would mean the mortgage loans being securitised should be of high quality. This is accomplished by complying with the law of contract, the property legislation and the rating agency’s lending criteria for mortgage pool selection. The cash flow produced by the mortgage loan is used as the source of funds for the payments to be made to the purchasers of RMBS (bond holders);
- Lowering financing costs for originators: a well-regarded pool of mortgages owned by a bank can be used to structure an RMBS of higher credit quality and, therefore, of lower market cost than the bank or corporate entity could itself issue;
- Reduction in regulatory capital: For a banking originator that faces regulatory capital requirements, a securitisation transaction that qualifies as a sale of assets for bank-regulatory purposes reduces the need for holding adequate capital to meet their credit risks; and
- Retention of servicing revenue: The originating bank normally continues as servicer, retaining the servicing fee, which is the excess of the SPV’s revenue over costs and surplus income from the mortgage receivables once the RMBSs are fully paid back to investors.

5. LAW AND REGULATION THAT FACILITATE GROWTH IN THE MARKET

The following section assesses the extent to which these criteria and the objectives of the origination process are achieved by the current regulations and practices in the market.

5.1 Rights and Obligations of the Originator and the Borrower under Property Legislation:

Under the Torrens system of land holding, the mortgages comprising the mortgage pool are registered on each property’s certificate of title. This gives the originating mortgagee a statutory charge over the security property for the right to repayment of the loan. The borrower or mortgagor is obliged, under the terms of the mortgage, to repay the principal and interest on the loan, and comply with various covenants. Thus, the law relating to mortgages facilitates the origination process where the borrowers are obligated to make regular payment on the loans, which would enhance the cash flow for payment to investors in the RMBS.

In the context of mortgage origination in Australia, the originator is typically noted on the certificate of title as the holder of the registered mortgage, and any subsequent (equitable) assignees, such as the trustee-issuer of the SPV, are equitable mortgagees. If the initial borrowers default, the mortgagee has the right to exercise its power of sale, as well as the right to foreclose, appoint a receiver, and enter into possession, and the right to sue personally to enforce the borrower’s loan contract. Priority contests between mortgagees in the context of an RMBS program are unlikely to occur under the current Torrens system, unless both security interests were unregistered. Under the Torrens system, an earlier registered first mortgage is recorded on the certificate of title to the security property and hence, the second registered mortgagee would be aware of the first registered mortgage, which would take priority over the later registered mortgage. This system of registration effectively facilitates a clear transfer of assets from the originator to the SPV.

5.2 Disclosure requirements and Standardisation of Documents under the Consumer Credit Code

Since 1 November 1996, many of the housing loans taken out in Australia have been regulated by the Consumer Credit Code (the Code), which is actually an annexure to the Credit (Queensland) Act 1994 (Qld). The Code requires that certain information be incorporated into the mortgage documents and the related contractual documentation. Standardisation of this information in home loan contracts facilitates securitisation of these loans.

Two limbs of the Code are aimed at ensuring that a debtor is informed of all important terms of a proposed credit contract in an understandable form. They are (i) disclosure requirements and (ii) the mandatory provision of documentation in plain English.

- Disclosure Requirements

Sections 14 and 15 of the Code stipulate that:
(i) a credit contract document must disclose the matters set out in section 15; and

(ii) there must be both a pre-contractual statement setting out all the same matters as are referred to in section 15 (the statement can take the form of a copy of the proposed contract) and an information statement in a form prescribed by the regulations detailing the debtor’s statutory rights and obligations.

In residential mortgage securitisation, in practice, virtually all mortgage originators and banks are credit providers as defined under Section 4 of the Code and are therefore subject to the responsibilities imposed on credit providers by the Code.90 Credit providers who fail to disclose these key requirements are potentially liable for a civil fine of up to $500,000 for each non-disclosure.

Importantly, the matters that need to be disclosed under section 15 in the pre-contractual statement and the credit contract include the commissions to be paid by, or to, the credit provider (section 15(M)), which includes any amounts payable to mortgage originators.

Disclosure of all the key requirements, which include terms and cost of the credit contract will enable the prospective borrowers to make a fully informed decision as to borrowing and their rights and obligations relating to the credit contract. Pre-contractual disclosure can contribute to informational efficiency and ultimately to social welfare by enabling lenders, borrowers, and investors to gather information at a reduced cost. This will result in a borrower becoming increasingly aware of their rights under the Code, and (in the absence of market imperfections) a correspondingly greater incentive on mortgage originators to comply with the Code to avoid penalties.91

The regulatory provisions under the Code require standardisation in all aspects of the loan documentation. Standardisation does not necessarily mean that all lenders must extend using the same criteria or on the same terms but rather that certain fundamental aspects of the lending process are standardised among lenders. For instance, lenders may adopt a standard form of mortgage loan agreement that provides adequate protection to all lenders. It ensures that investors in a pool of mortgage loans or the rating agencies do not have to analyse the risk of several different legal documents. The requirement of standard loan documentation could be expected to facilitate the growth of the RMBS market.

The disclosure requirements under sections 14, 15 and 16 also help to ensure that all credit contracts provide the same type of information to borrowers. This does not mean that each lender must grant credit according to the same criteria, but means rather that each lender must provide the same key information to all borrowers, making it easier for borrowers to compare loans originated by different lenders.92

6. REGULATION THAT IMPEDES GROWTH IN THE MARKET

6.1 Risk-Weighting of RMBS at 100 percent

As discussed in Part 3.2, under the APRA’s prudential standards, an originator’s portfolio of residential mortgages are risk-weighted at 50 percent for capital adequacy purposes, but an issue of RMBS that is backed by those same mortgages is weighted at 100 percent. Consequently, an ADI would need to allocate twice as much capital for the RMBSs as it would for loans secured by the same mortgages. Thus, on balance, it can be said that the current capital adequacy guidelines arguably create a commercial incentive for institutions not to invest in the RMBSs issued.

Therefore, it is important for the residential mortgage securitisation industry that the risk weightings applied to highly rated RMBS be revised and that APRA should amend the capital adequacy guidelines to reflect the important distinctions between investing in a 100 percent risk-weighted entity and highly rated, senior ranking RMBS backed by 50 percent risk-weighted residential mortgages.

Under the current capital adequacy guidelines issued by APRA, Guidance Note 112.1 – Risk-Weighted On-Balance Sheet Credit Exposures (September 2000) the RMBS are allocated a 100 percent risk weighting for capital requirement purposes.93 This risk weighting will not support the growth of residential mortgage securitisation in Australia. The industry groups have made submissions to APRA to reduce the risk weighting applied to highly rated RMBS.94

Moreover, the Bank of International Settlement (BIS) on 29 April 2003 issued a revised proposal for capital requirements for securitisation, namely the Third Consultative Paper on the Treatment of Asset Securitisation.95 Under these new proposals, mortgage loans with credit rating from AAA to AA- would be risk weighted at 20 percent, while those rated A+ to A- will be risk weighted 50 percent and so on, down to B+ or below, after which the full value of a mortgage loan will be deducted from the bank’s capital.

The new risk weightings would appear to offer a credit arbitrage for Australian banks, based on the fact that a typical Australian RMBS issue has no tranche rated lower than AA-. A bank can securitise a pool of mortgage loans and the whole RMBS issue will be risk weighted at a lower rate of 20 percent, compared to the higher rate 50 percent allocated for mortgage loans that secure the same issue, under the Basle Accord I, the BIS 2003 proposals for capital requirements would benefit the RMBS market by giving banks a greater incentive to remove residential mortgage loans from their balance sheets. A 20 percent or 50 percent risk-weighting for RMBS would also encourage investment in RMBS and provide investors with greater opportunities to diversify their mortgage portfolios.

Additional reasons for recommending that highly rated RMBS be risk-weighted at (say) 20% - 50% include that:

- holders of RMBS are, in essence, purchasing a direct interest in the income and principal cash flows generated by the underlying assets;
- the underlying assets are typically a pool of housing loans fully secured by a registered mortgage over residential property which would (if kept on balance sheet) be risk weighted at 50 percent;
- the process of securitisng the underlying assets includes a rigorous due diligence on those assets by a third party global rating agency, which imposes stringent parameters on the vehicle issuing the RMBS; and
- to achieve the necessary ratings on the senior RMBS,
structural and/or third party facilities are put in to place to enhance the underlying assets, which effectively ensure that the securitised underlying assets carry less risk than equivalent on balance sheet assets.

6.2 Implications for RMBS Programs

The (opportunity) cost of maintaining capital to cover assets for regulatory purposes plainly represents an economic cost to a regulated ADI. If costs increase, ADIs and sponsors who wish to maintain their profit margins may increase revenue by raising interest rates and/or bank fees to borrowers, to the extent permitted by prevailing regulation.

If an ADI initiates or sponsors an RMBS issue for which it cannot secure regulatory capital relief, initial borrowers may bear some or all of the additional cost for the ADI of providing 100 percent capital cover in respect of the issue, in the form of higher interest rates or charges.

The Australian Securitisation Forum has commented that investor demand in the domestic RMBS market would be adversely affected, relative to offshore markets, as investors who are APRA regulated ADIs must risk weight RMBS at 100 percent (instead of 50 percent as is the case in other major international regulatory environments such as the United States, Japan and the United Kingdom). This will serve in part to reduce the liquidity of the domestic market.96 Overseas licensed ADIs would be able to purchase RMBS at yields prevalent in Australia while allocating the risk weighting imposed by their own regulatory jurisdictions. This will create a competitive advantage to overseas licensed ADIs, which will achieve a better return on capital than Australian licensed ADIs.

Hence, a reduced risk weighting will enable regional ADIs, as investors, to diversify their mortgage portfolios, creating greater opportunities for spreading risk exposures within the market. This would facilitate the growth of the RMBS market for the benefit of the investing public.

In June 1999, the Bank of International Settlement issued a Consultative Paper entitled “New Capital Adequacy Framework” (Basel Accord II) which provides that a bank’s minimum capital requirements should be based on its overall risk profile.97 In general APRA has accepted the need to revise the risk weighting for RMBS. However, changes to prudential standards have been postponed by APRA in the expectation that this issue would be dealt with as part of the implementation of Basel II.

Basel Accord II is unlikely to be implemented in Australia before 2008.98 The benefits, which would be obtained from a change to the 50 percent risk weighting for RMBS should not be delayed. The need to amend the APRA Guidance Note 112.1 to give effect to a 50 percent risk weighting for RMBS has been widely recognised by the industry. It is suggested that risk-weighting for RMBS should not be 100 percent, but rather should be something less than that – perhaps 50 percent or 75 percent. It certainly should not be weighted at 100 percent as a mandatory rule.

These recommendations would, if implemented, help to ensure that financial institutions are not penalised for their involvement in RMBS transactions as sponsors, issuers or investors. Further, the implementation of these recommendations would help to bring the Australian market into line with other major overseas RMBS markets.

7. SUMMARY AND CONCLUSIONS

In the context of mortgage origination in Australia, the originator is typically noted on the certificate of title as the holder of the registered mortgage, and any subsequent (equitable) assignees, such as the trustee-issuer of the SPV, are equitable mortgagees. If the initial borrowers default, the mortgagee has the right to exercise its power of sale, as well as the rights to foreclose, appoint a receiver, and enter into possession, and the right to sue personally to enforce the borrower’s loan contract. While priority contests between mortgagees in the context of an RMBS program are conceivable at present, it is difficult to imagine priority problems arising, under the current Torrens system, unless both security interests were unregistered.

For capital adequacy purposes, normal residential mortgage loans are risk-weighted at 50 percent, while RMBS based on the same residential mortgages may be risk-weighted at zero, provided that regulatory capital relief has been obtained from APRA. If APRA does not grant regulatory capital relief, the RMBSs may be weighted at up to 100 percent for capital adequacy purposes, depending on the extent of credit enhancement and disclosure to investors. The direction and extent of this disparity in the risk-weightings is somewhat surprising, particularly in the light of:

- recent Basle II proposals;
- the fact that investors in RMBSs have the protection of mortgage insurance in addition to that of the residential mortgages themselves; and
- the fact that regulators overseas weight RMBSs at 50 percent.

Moreover, the disparity plainly creates commercial incentives, purely because of the current regulation, for ADIs to use their residential mortgage loans to issue RMBSs, and (arguably) for institutions not to invest in the RMBSs issued.

The results of the investigation in Part 5 reveal that certain aspects of the current law and regulatory practices relating to mortgage origination facilitate the development of residential mortgage securitisation in Australia. These include:

- Rights and obligations of the originator and the borrower under relevant contract law and property legislation, which enhance the cash flow for payment to investors in the RMBS;
- The Torrens system of land registration facilitates mortgage origination and clear transfer of mortgagee’s rights from the originator to the SPV; and the law of property permits the right to assign mortgages to a third party in equity, at minimal cost to the assignor and assignee;
- The Consumer Credit Code’s key requirements for disclosure and standardisation of credit contracts contribute to informational efficiency and reduce information costs for lenders, borrowers and investors;

The results of the investigation in Part 6 reveal that the following aspects of the regulatory provisions in relation to mortgage origination act as impediments to the growth of the RMBS market in Australia. These include:
The regulatory capital requirements and the risk-weighting criteria in relation to RMBSs which under APRA’s system of prudential regulation, effectively discourage ADIs from converting on-balance sheet assets to off-balance sheet assets, and risk-weighting RMBSs at 100 percent, rather than (for example) 50 percent in line with international proposals, keeps the amount of capital needed to maintain RMBSs at unnecessarily high levels. Furthermore, if this cost is passed on to investors by way of higher prices and lower yields, this discourages investment in the RMBSs issued, and is likely to increase interest rates and charges for borrowers;

It is suggested that the Australian authorities (e.g. APRA and perhaps the Reserve Bank of Australia) would do well to at least consider reducing the risk-weighting for RMBSs in the near future, *inter alia* to determine the extent to which the recent Basel II proposals are appropriate for the Australian markets. A detailed and precise estimation of the appropriate weighting for RMBSs is a statistical exercise and plainly well beyond the scope of this article. However, such an examination would undoubtedly be a useful avenue for future economic or finance research.
<table>
<thead>
<tr>
<th>STAGE</th>
<th>OBJECTIVES</th>
<th>CRITERIA</th>
<th>LAWS, REGULATION &amp; CURRENT PRACTICE</th>
<th>POSITIVE EFFECTS (“Negative”)</th>
<th>NEGATIVE EFFECTS (“Costs”)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Mortgage Origination Process</strong></td>
<td>Originator and borrower enter into housing loan contract according to the pool’s standard terms; the mortgage loan contract is executed; funds are advanced; and the security interest of the originator is perfected;</td>
<td>Acquire good quality mortgage loans for securitisation</td>
<td>Compliance with the law of contract, the property legislation and the lending criteria for mortgage pool selection; pooling homogenous mortgage loans.</td>
<td>Rights and Obligations of the Originator and the Borrower under the contract law and property legislation. The mortgagor is obliged, under the terms of the mortgage, to repay the principal and interest on the loan, and comply with various covenants.</td>
<td>Borrowers’ obligations under the property law enhance the cash flow for payment to investors in the RMBS. The Torrens System of Land Registration effectively facilitates mortgage origination and clear transfer of assets from the originator to the SPV. Priority contests between mortgagees in the context of an RMBS program are unlikely to occur under the Torrens system, unless both security interests were unregistered.</td>
</tr>
</tbody>
</table>

Table 5: Summary of Main Findings
<table>
<thead>
<tr>
<th>STAGES</th>
<th>OBJECTIVES</th>
<th>CRITERIA</th>
<th>LAWS, REGULATION &amp; CURRENT PRACTICE</th>
<th>BENEFITS</th>
<th>COSTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgagor commences payment of principal and interest under the loan to the originator.</td>
<td>By using high quality mortgage loans to secure RMBSs and achieving a higher credit rating for the securities issued by the SPV. RMBS may have a higher investment rating than securities issued directly by the originator; bear a lower interest rate than the originator’s own secured borrowing.</td>
<td>Standard and Poor’s mortgage-backed criteria applied for mortgage loan pooling; and the formal rating process.</td>
<td>Can contribute to informational efficiency and reduce information costs for lenders, borrowers and investors; improve stakeholders’ knowledge on credit contracts (up to a point – e.g. borrowers not told about risk of losing their homes).</td>
<td>Can increase re-drafting costs to securitisers.</td>
<td></td>
</tr>
<tr>
<td>Lowering financing costs for originators.</td>
<td>Originator collects and distributes borrowers’ payments; administers and reports on the assets’ performance; Servicer needs skills in revenue collection, information processing and analysis; with technology to monitor mortgage pool.</td>
<td>Consumer Credit Code: key requirements: Disclosure requirements under s. 14 and 15; Plain English Documentation and Standardisation of Credit contract documents. Regulatory Capital Requirements and risk-weighting of RMBS under APRA Prudential regulation.</td>
<td>Performance of statutory responsibilities involves significant costs.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 5: Summary of Main Findings (cont.)
<table>
<thead>
<tr>
<th>STAGES</th>
<th>OBJECTIVES</th>
<th>CRITERIA</th>
<th>LAWS, REGULATION &amp; CURRENT PRACTICE</th>
<th>BENEFITS</th>
<th>COSTS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Retention of servicing revenue.</td>
<td></td>
<td></td>
<td>Guidelines allows the ADIs to sell off on-balance-sheet assets, and thus, remove them from the balance sheet; Reduce the amount of capital required for regulatory purposes; Allow ADIS to securitise higher risk-weighted assets and use the proceeds to purchase lower risk-weighted assets.</td>
<td></td>
</tr>
</tbody>
</table>

Table 5: Summary of Main Findings (cont.)
Notes

1 This article is based on the author’s PhD Thesis entitled ‘Residential Mortgage Securitisation in Australia: Suggestions for Re-form of Commercial Law and Practice’ (Faculty of Law, Griffith University, December 2005). The author wishes to acknowledge the valuable comments provided by Professor Ellis Ferran, Faculty of Law, University of Cambridge, who is the author of Mortage Securitisation: Legal Aspects (London: Butterworths, 1992); Dr. Richard Copp, Barrister-at-Law, Inns of Court, Brisbane, Associate Professor Justin Malbon, Dean of the Faculty of Law, Griffith University, Dr. Eduardo Roca, Deputy Head, Department of Accounting Finance and Economics, Griffith Business School and Dr. Mark Mourell, Senior Lecturer in Law, Griffith Business School.

2 Alternatively, funding may occur by sub-participation. In a sub-participation, investors lend to the financial intermediary (e.g. the SPV), which then on-lends to the original credit institution an amount typically equal to the market value of the pool of assets (in order to show regulatory authorities that the transfer is bona fide and ‘at arms length’). Sub-participation does not remove the investors’ credit exposure to the original credit institution. For a more comprehensive discussion of sub-participation, see T. Frankel, Securitization: Structured Financing, Financial Asset Pools and Asset-Backed Securities (1st edition, Boston: Little Brown & Co. 1991) Part III.

3 Theoretically, any income-producing asset can be securitised. For example, assets that have been securitised in the United States include home mortgage loans, commercial property mortgages, consumer receivables (car boat and truck loans, credit card receivables, TV rentals, mobile home loans, student loans, health care receivables, telephone charges), trade receivables, equipment leases, e.g. aircraft leases, bank loans (sovereign debts, even project finance loans), bond portfolios, and third world debt: see J. Hu, R. Pollsen & J. Elengical, ‘A Record Year for Residential MBS’ (April 2002) 62 Mortgage Banking 36-42; J. C. Shenker & A. J. Colletta, ‘Asset Securitization: The Evolution, Current Issues and New Frontiers’ (1991) 69 Texas Law Review 1369, 1380; G. Salathe, Reducing Health Care Costs through Hospital Accounts Receivables Securitization, (1994) 80 Virginia Law Review 549, 551.

In Australia, the most commonly securitised asset to date has been residential mortgages. Other assets that have been securitised in Australia to date include commercial mortgages and leases, (office buildings, shopping centres and warehouses), credit card receivables, share loans, corporate loans, utility receivables, trade receivables, automobile loans and consumer finance receivables, infrastructure assets such as pipelines, toll roads, ports, water treatment plants, electricity transmission assets, employee share scheme loans: see Macquarie Bank Homepage, http://www.macquarie.com.au; Standard & Poor’s, ‘RMBS, CDO Activity Lead Australian Securitisation Issuance Growth in 2003’ (July 2003) Credit Ratings Commentary and News 12.

4 The main originating banks that engage in mortgage securitisation in Australia are Westpac, Commonwealth Bank, Citibank, St. George Bank and Adelaide Bank and Bank of Queensland. In this context, the originating bank will generally be the ‘sponsor’ (or promoter) of the program: see Standard & Poor’s, Structured Finance Australia and New Zealand (Melbourne, 2000) 14.

Since 1996, most banks have been forced to establish RMBS programs because of increasing competition in the housing loan market in Australia. While banks remain the major source of housing finance, non-bank lenders currently comprise more than one-fifth of all new lending. The success of the non-bank lenders is due in large part to product innovation, greater borrower accessibility through the introduction of mobile lenders, extensive origination networks, and the ability to securitise their housing loans through RMBS programs. For more detail, Standard & Poor’s, An Investor Guide to Australia’s Housing Market and Residential Mortgage-Backed Securities (Melbourne, 2003) 18-19.


6 An IMP is a third party mortgage provider – i.e., an institution that “originates” (or brings into existence) mortgages, usually as elements of mortgage loans - which is generally unaffiliated with the major banks. For example, IMPs in Australia include Aussie Home Loans Ltd, Australian Mortgage Securities Ltd, Interstar Securities Pty Ltd, RAMS Home Loans Pty Ltd, Macquarie Securitisation Ltd, and Resimac Ltd. The IMP or mortgage originator typically charges an origination fee, which is generally charged to the borrower to cover the costs of initiating the loan.

7 See for example, Macquarie Securitisation Ltd, PUMA – mortgage securitisation program. This program is sponsored by the fund manager, Macquarie Securitisation Ltd, which is a subsidiary of Macquarie Bank Ltd. In this particular program, as well as acting as sponsor and fund manager, Macquarie Securitisation Ltd acts as servicer, and there is a separate mortgage manager- Aussie Home Loans Ltd. Perpetual Trustee Australia Ltd acts as trustee of the fund: see generally, Macquarie Securitisation Ltd., Master Information Memorandum, PUMA Fund P- 7 (Sydney, February 2000) http://www.macquarie.com.au.

8 For the purposes of this article, the term “bondholders” includes not only the holders of bonds, but also the holders of notes. Both bonds and notes are negotiable instruments traded in the financial markets. The main differences
between bonds and notes relate to their tenure, underlying cash flows, and pricing.

9 Pursuant to the Statutory Instruments Act 1992 (Queensland), which is mirrored in every other State, and the Competition Principles Agreement dated 11 April 1995, between the Commonwealth and State and Territory governments, any legislation that is likely to impose appreciable costs on the community, or a section of it, is subjected to a Regulatory Impact Statement to determine whether the legislation is likely to be for the benefit of the public. The legislative review process is undertaken within the “public benefit test” framework, as required by the under the as required under the National Competition Principles Agreement. See National Competition Council, National Competition Principles Agreement, 11 February, 1995, http://www.ncc.gov.au/publication.asp?publicationID=99&activityID=39 (accessed 2 February 2003). The “public benefit test” process involves (a) the identification of the restrictions on competition in the market, (b) an analysis of the effects of legislative restrictions. (c) an analysis of the costs and benefits. (d) and the provision of appropriate recommendations.

10 For example, RAMS Home Loans Ltd, Wizard Loans Pty Ltd, or Aussie Home Loans Ltd.

11 For example, one of the conditions might be that the borrower maintains full replacement home owner’s insurance on the mortgaged property.

12 The mortgagor transfers his/her rights over the security property to the originator, as mortgagee, (the right to sell the security property and recoup any outstanding debt owed by the mortgagor).

13 This escrow account is set up to absorb any losses from the housing loan defaults or repayment shortfalls.

14 In a broad sense, this even applies to the borrowers, who anticipate that ultimately the value of the property they have borrowed to purchase increases sufficiently to more than compensate them for their investment outlay and net borrowing costs.

15 Strictly, these contracts are between the trustee issuer of the SPV and the bondholders.

16 The mortgage originator may have to raise extra capital to comply with risk-based capital adequacy guidelines rules in order to support the total assets retained on-balance sheet. However, the need to do this may be avoided if the assets are sold via a securitisation. Because a securitisation is usually viewed for accounting purposes as a sale of assets/loan receivables rather than as financing, the originator does not record the transaction as a liability on its balance sheet. The proceeds from the sale of loan receivables are used to pay the originating (selling) institution’s liabilities, so that (so long as APRA agrees) originator’s capital-to-assets ratio increases and, other things being equal, it has greater scope for borrowing. Its return on capital is also improved, because the originating (selling) institution has removed the liability from its balance sheet, but still retained the profit. For a more comprehensive discussion of capital adequacy requirements, see T. Valentine, G. Ford and R. Copp, Financial Markets and Institutions in Australia (Sydney: Pearson Education Australia, 2003) Ch. 6. In addition, Reuven and Plaut have conducted an empirical study of substitutability between on and off-balance sheet liquidity for the business sector. They argue that off-balance sheet contingent liabilities of financial institutions (e.g. loan commitments) serve as a substitute for on-balance sheet money, and that off-balance sheet liquidity, like unused credit lines, should be taken account in determining debt-equity ratios for prudential regulation purposes. See G. Reuven and S. Plaut, ‘Money Demand and Off-Balance Sheet Liquidity: Empirical Analysis and Implications for Monetary Policy’ (1989) 1 Journal of Accounting and Finance 147.

17 For example, the originating institution may earn fees from the SPV for acting as “servicer” or “collections account” manager of the receivables. Fee income is desirable for three reasons: (1) it is independent of interest rates; (2) there is limited credit risk; and (3) it can be claimed as income immediately for accounting purposes. Traditionally, bank income was based on returns from loans and a lesser proportion from trading in government securities and currencies service fees and management fees. However, increased competition in conjunction with more volatile interest rates and costs has made reliance on spread income uncertain: see generally, F. Oditiah, The Future for the Global Securities Market: Legal and Regulatory Aspects (Oxford: Clarendon Press, 1996) 91-92. Indeed, Professor Tamar Frankel at Boston University School of Law who commented on this article predicts that the future for financial institutions will involve moving away from the traditional role of financial warehouses, to concentrating primarily or even exclusively on being originators and servicers in return for fees: see T. Frankel, supra note 1 at 145-146. Such a system would allow lenders to continue the business of lending while sending much of the risk downstream in the securitisation process. In the United States, several banking institutions - NationsBank, the First National Bank of Boston, Wells Fargo, and Barnett Banks - have publicly embraced this strategy, by announcing the formation of “conduits” to enable the banks to originate various types of commercial mortgage loans and periodically securitise them through Wall Street underwriting firms: see Anon., ‘Conduits Set Ambitious Goals for 1995’ (February 1995) Commercial Mortgage Alert 6-7.

18 For example, assets can be liquifed at a rate based, not on the originating institution’s credit quality, but on the inherent or enhanced credit quality of the assets themselves. Institutions with a below-investment grade credit quality can securitise their loans at the higher credit rating categories, making them easier to sell to investors. See S. L. Schwarz, ‘The Global Alchemy of Asset Securitization’ (1995) 14 International Financial Law Review 30, 32.

19 These include, credit or default risk; pre-payment risk; servicer performance risk; guarantor risk; liquidity risk; interest rate risk; currency risk and legal risks. For a more detailed discussion of interest rate and currency swaps, see T. Valentine, G. Ford and R. Copp, Financial Markets and Institutions in Australia (Sydney: Pearson Education Australia, 2003) Ch. 14.
For example, the originator raises capital immediately, rather than having to wait for the mortgage receivables to be repaid.

In addition, securitisation may be used by the originator in order to match the cash flows of its assets and liabilities. This is easier where the receivables are exactly used to repay the funding loan, because there is minimal mismatch in the timing of receipts and payments. Moreover, if the payments are structured on a pass-through basis, there is less risk of having to make repayments before the receivables are collected.


The rights of the security trustee are discussed in the author’s article: ‘Insolvency Issues in Residential Mortgage Securitisation’ (currently under review – *Stanford Journal of Law, Business & Finance*).

It has been argued, albeit in a US context, that the affiliated or extended meaning of “security” as described, for example, in section. 92(2) of the *Corporations Act*, is consistent with the notion of a “security” in the general law sense, where a justifiable or real link can be established between the instruments and the subject security property (the *res*) to which a proprietary interest may be traced. If this interpretation is accepted, a mortgage-backed security (based on mortgages of real property interests) may be one example of a derivative “security”, in the sense that existence of the financial “security” is dependent on and flows from the security transaction and is incapable of an existence apart from the mortgage. Other statutes also define tradeable investment instruments, such as bonds, notes, stocks and shares, as “securities”. For further discussion, see T Frankel (1991) 230; and cf. Sykes, who considers personal guarantees to fall short of qualifying as a “security” in the absence of the *res* to which resort could be made: see E.I. Sykes and S. Walker (1993) 11.


Under the Torrens title system, the land ownership passes not by execution of title deeds but by the registration of dealings on a public register maintained by the Land Titles Office. It was first introduced in South Australia in 1858 by the Premier Sir Robert Torrens, and was later adopted by other Australian States. For details see P. Latimer, *Australian Business Law* (24th ed., Sydney: CCH, 2005) paragraph 3.300.

For example, to maintain the property in proper repair, and to pay any rates and taxes.

For example, to prevent the deterioration of the property, nuisance and, in some deeds of mortgage, to not part with possession.

That is, a right to “buy back” the property – in other words, to pay off a mortgage on the property, so that the equitable interest and legal estate merge. “Clogs” on this right to redeem, such as extinguish it or delay it for an unreasonable time, are now generally covered by the unconscionability provisions of the *Trade Practices Act 1974* (Cth) and the consumer credit legislation.

See section 11 of the *Property Law Act 1974* (Qld), which is based on the original English *Statute of Frauds*, and which is replicated in all Australian States.

Again, see section 11 of the *Property Law Act 1974* (Qld).

This effectively extinguishes the borrower’s equity of redemption, so that legal ownership of the security property passes to the mortgagee.

In practice in Australia, equitable mortgagees seek to reserve equivalent powers to those of a legal mortgagee.

Cf. The subject of priority contests between competing mortgagees has arisen in the literature overseas, where the markets are already much more mature than in Australia, although there it is perceived to be a procedural issue, more than one of substantive rights: see e.g. T. Frankel (1991) 231-232.

See e.g. *Land Title Act* 1994 (Qld), section 178, which confers priority on registered securities over unregistered, and later registered securities.

For example, in *Dearle v Hall* (1828) 3 Russ 1; 38 ER 475, it was held that an assignee of a debt may lose priority to a later equitable assignee who was first to give notice to the debtor, and who gave valuable consideration without notice of the earlier assignment.

That is, although the rule in *Dearle v Hall* plainly applies to a priority contest between competing (purely) equitable assignment interests, it is doubtful whether it applies to an assignment of a debt secured by a *registered* mortgage in Australia. For further elaboration, see E. I. Sykes and S. Walker (1993) 405, 803. Moreover, section 62 of the *Land Title Act 1994* (Qld) would seem to override the rule in *Dearle v Hall*. The express conferral of legal and equitable interests by this section allows the rule to be distinguished, as the rule may only apply to competing equitable assignments: E. I. Sykes and S. Walker (1993) 803.

It would be open to argument that the later mortgagee would or should know of the practice (certainly, that of the major banks) that all mortgages may be assigned, and that it has therefore borne a risk of which it ought to have been aware. However, such cases are likely to turn on the facts, and in the absence of distinguishing facts, it is submitted that the foregoing analysis is more correct as a general proposition.

Other types of priority contests are likely to be resolved along conventional lines, as discussed for example, in E.I. Sykes and S. Walker (1993) 454 – 464.
Capital adequacy regulation of banks and other financial institutions in Australia, as in many countries, is based on international guidelines issued by the Basle Committee on Banking Supervision. The Basle Committee, which comprises central banks and bank supervisory agencies from other countries, operates under the auspices of the Bank for International Settlements (BIS) and consults widely with supervisory agencies in other countries and with industry on prudential matters.

See BIS Home Page: <http://www.bis.org>. This will be discussed later in this article.


Goodwill and similar intangible assets are deducted from Tier 1 capital and capital base.

Cannot exceed Tier 1 capital.

Amount included is limited to a maximum of 1.25 per cent of total assets. Associated future income tax benefits should first be deducted from total general provisions before determining the amount of general provisions eligible to be included in Tier 2 capital.

Assets should be valued regularly and prudently. Upward revaluations of securities (which have not been passed through the profit and loss account) are to be reflected in capital.

In total, these items cannot exceed 50 percent of Tier 1 capital and are subject to eligibility criteria.


AGN 112.1 – Risk Weighted On-Balance Sheet Credit Exposure, paragraph 27 and Attachment C. In January 2006, APRA has released revised criteria for authorised deposit-taking institutions (ADIs) to qualify for the concessional risk-weighting of residential mortgage lending for capital adequacy purposes. The revised criteria ensure that the 50 per cent risk-weight applies only to residential mortgage lending by ADIs which have adequate procedures to gauge the ability of the borrower to meet repayment obligations and to assess independently critical information in respect of the borrower. For further details, refer to AGN112.1 - Risk Weighted On-Balance Sheet Credit Exposure (January 2006) <http://www.apra.gov.au> (accessed 20 February 2006).


These items are to be weighted according to the type of assets or issuer of securities and not according to the counterparty to the transaction.

Purchase and resale agreements are to be treated as collateralised loans. The risk is measured as an exposure to the counterparty or according to the asset if it is recognised collateral security within the risk ration framework.


Such prima facie risk weightings imply one of at least four possibilities. Either –

1. The current weightings are appropriate, because an RMBS issue is twice as risky as an equivalent standard residential housing loan (e.g. because more stakeholders are involved, and each of these is of higher risk than the originating bank acting by itself); or

2. The current weightings are inappropriate, and -

the risks of residential housing loans and RMBS issues are equal, so that APRA's risk weightings should likewise be equal (e.g. either both at 50 percent, or both at 100 percent); RMBS issues are riskier, but not twice as risky, as equivalent standard residential housing loans; or

RMBS issues are less risky than equivalent standard residential housing loans (e.g. if the involvement of other stakeholders in the process actually reduces risk, perhaps because these other stakeholders are less risky than the originating bank itself).

Plainly a financial risk assessment of RMBS programs and an evaluation of its impacts on capital adequacy guidelines are beyond the scope of a legal article. Nevertheless, such topics offer intriguing possibilities for future financial research in this area.

If industry participants can be believed, there would appear to be considerable merit in APRA at least considering whether these prima facie risk weightings of RMBSs should be reduced for capital adequacy purposes in Australia. In 2000, the representatives of the Australian securitisation and banking industry made a joint submission to APRA in relation to the risk weighting of RMBSs under the current capital adequacy guidelines: see Australian Securitisation Forum, ‘Submissions to the Australian Prudential Regulation Authority in Response to APS 120 – Fund Management and Securitisation’ 14 June 2000 <http://www.securitisation.com.au/asf> (accessed 8 December 2002). The Australian Securitisation Forum
RMBSs are principally backed by loans secured by a mortgage over Australian residential property, which are rated at least A-. The term “principally” was used because an SPV generally holds, in addition to residential mortgages over the relevant security properties, significant cash with a bank and highly rated short-term securities;

- international ratings agencies thoroughly review and monitor the structures and transaction documents used by SPVs to issue rated RMBSs, in order to ensure that they meet the agencies’ standards of bankruptcy remoteness, liquidity, credit enhancement, management and servicing skills, and security;
- as noted earlier, a number of credit enhancement techniques are typically used to improve the quality (reduce the risk) of the securities issued;
- a risk weighting of 50 percent would be consistent with – and indeed, more conservative and prudent than –

(a) international proposals such as Basel II, which is expected to be implemented in 2008 and suggests that a 20 percent risk weighting would be appropriate for asset-backed securities with a rating of AA- or higher (applying the Standard and Poor’s rating system). See Basel Committee on Banking Supervision, Consutlative Document on Asset Securitisation. January 2001, paragraphs 25-32; and

(b) the current position in the United States, where banks can also assign a risk weighting of 20 percent to mortgage-backed securities rated AA or above. See S.L. Schwarcz, Structured Finance: A Guide to Principles of Asset Securitization (N.Y.: Practicing Law Institute, 1993) 76.

Despite the apparent detail of this submission, however, it could be viewed as an exercise in elaborate posturing and gaming strategy by the banks, since the sponsors of most RMBS programs in Australia have a plain incentive to ensure that their programs meet all of APRA's requirements for regulatory relief. Alternatively, the joint submission can be seen as the industry seeking to ensure that sponsors who do not meet APRA's requirements for regulatory relief have some sort of “fallback” position, which is not too costly for the ADI.

To be specific, the following requirements must be satisfied in respect of each loan asset under APRA Guidance Notice AGN-120.3 – Purchase and Supply of Assets (September 2000):

(i) the selling bank (ADI) must have no residual beneficial interest in the asset (although the selling bank may still retain legal ownership of the asset). Such situations may arise, for example, where transfer of legal property is effected by means of equitable assignment. In these circumstances, a banking group should be able to satisfy APRA, if required, that the party acquiring the assets is able to readily (i) perfect title; and (ii) take possession of any security interests associated with the assets should the need arise to do so.

(ii) the risks and rewards on the assets must be fully transferred, to the buyer and the buyer must have no formal recourse to the seller for losses. In particular, a selling bank is precluded from providing credit support of any kind in relation to a portfolio of securitised assets. However, a selling bank may enter into off-balance sheet transactions with the buyer special purpose vehicle for the purpose of managing interest rate risk provided that an exclusive arrangement is not involved and that transactions are at market prices.

(iii) the selling bank has no obligation to repurchase the asset, or any part of it, at any time, except where that obligation arises from the exercise of a representation, warranty given in respect of the loan at the time of transfer.

(iv) the documented terms of the transfer specify that, if cash flows relating to sold assets are re-scheduled or re-negotiated, the buyer and not the selling bank will be subject to the re-scheduled or re-negotiated terms.

(v) where payments are to be routed through the selling bank, it has no obligation to remit funds to the buyer until they are received from the borrower.

The remaining requirements stem from the APRA’s concern that in a securitisation scheme there may be moral risks, where the originating bank continues to service the portfolio in order to maintain borrower relationships and/or to earn fees. This will be the situation in a typical mortgage securitisation. In the APRA’s view, the continued identification of an originator with the loans can mean that its commercial reputation is committed and that a completely clean break is not achieved: AGN-120.3, paragraph 8. The APRA is concerned that, in this situation, the originator could come under pressure to support losses incurred by the investors and may be inclined to do so in order to protect its name. In the APRA’s view, the risks could assume material proportions.


62 Where the mortgage originator also acts as manager/servicer, the following additional requirements are imposed by APRA:

(i) the servicer must be able to produce evidence to the effect that the terms of the securitisation scheme protect it from any liability to investors in the scheme, except where it is proved to be negligent;
(ii) the servicer must not have any ownership or beneficial interest in the SPV (including the corporate trustee of the SPV);

(iii) the board of the SPV must be independent of the administrator/servicer, although the latter may have one director representing it;

the name of the SPV must not include the name of the servicer or imply any connection with it;

(iv) the servicer must not bear any recurring expenses of the securitisation scheme (this does not exclude the “first loss” and “second loss” facilities provided by the servicer bank to enhance the creditworthiness of the SPV, and that, the servicer will be required for capital adequacy purposes to deduct the amount of the facility from its capital base);

(v) the servicer must not bear any losses arising from the effect of interest rate changes on the securitisation scheme. However, this does not prevent the servicer from entering into interest rate swap agreements at market prices with the SPV;

(vii) the servicer must not fund the SPV or the RMBS program except as outlined above and, in particular, must not provide temporary finance to the scheme to cover cash shortfalls arising from delayed payments or non-performance of loans which it administers; and

(ix) the servicer must not retain an option to repurchase or refinance loans, except where a loan portfolio has fallen to less than 10 per cent of its maximum value and the option extends only to fully performing loans.

If any of these conditions are not met, the originating ADI is required to hold capital against the transferred mortgage assets as if the assets remained on its books. For more detail, see generally AGN 120.1- Disclosure and Separation, paragraphs 10 – 13; AGN 120.5 – Servicing and Managing (September 2000).

There may also be some incentive for cross-subsidisation between different customer types.

The extent to which they can do so is limited inter alia by Reserve Bank monetary policy, the Commonwealth Government’s fiscal policy (e.g. in respect to Bank Account Debts tax), and prices surveillance of bank fees and charges by the Australian Competition and Consumer Commission.

Again, this is subject to the extent to which the ADI can pass this cost on to customers within the constraints provided by prevailing regulation.


See AGN 120.3 – Purchase and Supply of Assets regarding the concept of a “clean sale” in this context. See also A. Liaw and G. Eastwood (2000) 12-14.

Strictly, in this context, APRA’s capital adequacy guidelines apply only to ADIs that provide credit enhancement facilities for RMBS facilities.


Standby letters of credit are distinguishable from performance standby letters of credit (which a re generally assigned a 50 percent conversion factor in that the former are irrevocable obligations to pay the beneficiary when the customer fails to repay an outstanding loan or debt instrument, whereas the latter are irrevocable obligations to repay the beneficiary when the customer fails to perform some other contractual non-financial obligation: see Table 3 above.

Also included in this category are legally binding contractual obligations to purchase assets at a set price on a specified future date.

The capital adequacy guidelines relating to off-balance sheet items are sometimes open to interpretation, and it is not always a straightforward exercise in practice to estimate an ADI’s capital requirements with certainty. For example, there is a distinction between obligations that are deemed to be direct credit substitutes (ie. which carry a 100 percent conversion factor) and those deemed to be mere commitments (ie. those which carry a 0 or 50 percent conversion factor, depending on the commitment’s maturity). According to B. Kavanaugh (1992), irrevocable facilities obliging an ADI to purchase assets at the price paid by the issuer, regardless of the actual losses incurred on the assets, should be deemed to direct credit substitutes. However, facilities that incorporate an “asset quality” test into the purchase price (e.g. where an ADI’s obligation to purchase assets excludes defaulted loans) can be deemed a mere commitment. See B. Kavanaugh, ‘Asset backed Commercial Paper programs’ (Feb., 1992) 78 Federal Reserve Bulletin 25. R. B. Titus, ‘Asset Securitization: Marvel of the Marketplace, But Should We Be Uneasy?’ (1993) 73 Boston University Law Review 271; S. L. Schwarcz (1993) 69-70.

The number, and the amount invested, depends on investors’ attitudes to risk.

See A. Marquardt, ‘Securitization of French and German Assets’ in D. Campbell ed., International Asset Securitization and other Financing Tools (N.Y. Transnational Publishers, 2000) 150-151at which Alexander notes that, like Australia, Germany at this stage remains at 100 per cent.


79 The so-called G10 (or “Group of Ten”) central banks comprise those of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

80 These are subject to the formal approval of the Governors of the G10 central banks.


82 BIS, Basel Accord II Consultative Paper 3 (abbreviated by the Basel Committee to “CP3”) (April 2003).

83 Ibid, Annex 9, paragraph 14.

84 Ibid, paragraphs 526-529. See also, V. Kothari, Securitisation: The Financial Instrument of the New Millennium (Calcutta: Academy of Financial Services, 2003) 120.

85 Standard and Poor’s, Structured Finance Australia and New Zealand (Melbourne, 1999) 17.

86 As noted earlier, a financial risk assessment of RMBS programs is plainly beyond the scope of this article. Nevertheless, this represents a fruitful area for future research.

87 If the asset has any collateral protection, such as guarantees, title or right over an asset, backing it, it adds up to the quality of the assets.

88 The analysis throughout this section assumes that other factors remain equal or constant.

89 In the context of RMBS programs, the Code regulates mortgages for residential owner occupation executed after 1 November 1996, as well as mortgages containing continuing credit provisions (this includes revolving home equity loans) executed before 1 November 1996. Certain provisions of the Code, such as those relating to court applications for a variation of credit terms based on hardship, do not apply to home loan contracts (credit contracts) with a maximum loan amount exceeding $125,000: section 66(3).

90 In the case of those IMPs that effectively act as “spotters” for the banks or larger mortgage providers, the initial lender, not the IMP, will normally be the credit provider for the purposes of the Code. After assignment of originator mortgagee’s rights to the SPV, the issues relating to who is the relevant “credit provider” for the purposes of the Code – i.e. the initial lender or the SPV – are discussed in detail by the author in a separate article entitled ‘Impact of the Consumer Credit Code on Transfer of Mortgagee’s Rights to the SPV’ (currently under review- Annual Review of Banking and Finance Law, Boston University School of Law).

91 The increased uniformity and clarity of the Codes throughout Australia may, other things being equal, help to produce a more informed generation of borrowers. On the other hand, this may have the potential for more disputes to arise regarding the credit contract.

92 Cf. If credit contracts were allowed to contain different sets of information, it would be more difficult for investors to evaluate loans originated by one lender against loans originated by another lender.

93 This requires a thorough economic analysis, which the present article does not address.


99 The analysis assumes that other factors remain equal or constant.

100 The analysis assumes that other factors remain equal or constant.