

February 29, 2016

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To Members of the Australian Prudential Regulation Authority:

The International Association of Credit Portfolio Managers<sup>1</sup> (the “IACPM”) appreciates the opportunity to comment on the APRA discussion paper “Revisions to the prudential framework for securitisation” (the “discussion paper”). The IACPM’s institutional member firms comprise some of the world’s largest financial institutions, and as such overlap the membership of several other financial industry associations. Our perspective is different, however, in that the IACPM represents the teams within those institutions who have responsibility for managing credit portfolios, including actively controlling concentrations and managing the return of the portfolio relative to the risk and capital.

In carrying out these responsibilities successfully, credit portfolio managers contribute to maintaining the safety and soundness of their respective financial institutions. Effective credit portfolio management is critically important to our prudential supervisors and to policy makers more broadly because of its role in supporting financial institutions ability to lend.

The IACPM’s members regularly use synthetic securitisations to manage and transfer credit portfolio risk; therefore, our comments in this paper will be focused on these structures. The discussion paper addresses synthetic securitisations in section 2.8.1 and suggests no regulatory capital relief be given for these transactions. APRA’s reasoning includes these concerns: the deals are complex, the protection buyer will be exposed to counterparty credit risk and behaviorally the true sale nature of credit exposure may be compromised.

We believe that these arguments do not reflect the stronger regulatory environment that has addressed weaknesses found in securitisations<sup>2</sup>. Importantly, credit portfolio managers utilise what the EBA calls “bank balance sheet synthetic securitisations<sup>3</sup>” (also referred to as tranching covers<sup>4</sup>), which are significantly different from the arbitrage synthetics that caused problems leading up to the financial crisis. Balance sheet synthetic transactions use a financial guarantee or credit derivative to transfer the credit risk of a pool of assets held on a bank’s balance sheet to an investor. These are risk sharing transactions where a bank partners with an investor to share both the risk and return of a bank’s core lending business in a way that aligns interests, transfers risk and increases lending capacity. Arbitrage synthetic transactions are generally transactions that arbitrage between the higher spread received and lower spread paid on the product. While balance sheet synthetic securitisations are not currently a common feature of the Australian market, we believe they can be an effective tool for managing risk in naturally concentrated portfolios, and recommend that regulatory capital relief be recognised for these transactions when used in the way described below.

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<sup>1</sup> The IACPM is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Membership of the IACPM is open to all financial institutions that manage portfolios of corporate loans, bonds or similar credit-sensitive financial instruments. The IACPM represents its members before regulatory and administrative bodies around the world, holds conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk. Currently there are 97 financial institutions worldwide that are members of the IACPM. These institutions are based in 19 countries and include many of the world’s largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers. More information about the IACPM may be found on our website: [www.iapcm.org](http://www.iapcm.org).

<sup>2</sup> The Basel Committee on Banking Supervision’s revisions to the securitisation framework. The Basel Committee on Banking Supervision’s revisions to the securitisation framework aim to address a number of shortcomings in the Basel II securitisation framework and to strengthen the capital standards for securitisation exposures held in the banking book. (<http://www.bis.org/bcbs/publ/d303.htm>).

<sup>3</sup> “The EBA Report on Synthetic Securitisation” Terminology used within the document identifies the main types of synthetic securitisations: balance sheet synthetic securitisations or arbitrage synthetic securitisations. Page 7-8, (<http://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-26+EBA+report+on+synthetic+securitisation.pdf>).

<sup>4</sup> The IACPM letter to BIS/IOSCO which defines the term tranching cover, Page 1: (<http://web.iapcm.org/dotAsset/66585.pdf>).

In this paper, we will provide information as to why synthetic securitisations are an effective tool for credit portfolio managers in managing risk. There are three main arguments we wish to discuss:

1. Where legal or relationship challenges prevent asset transfer, synthetic securitisations can effectively replace the risk transfer of a cash securitisation.
2. Allowing capital reduction where risk is transferred via synthetic securitisation can enable capital to be re-used for lending to the real economy, and these transactions are accepted in other jurisdictions for this purpose.
3. When used properly, synthetic securitisations are an effective risk transfer method from a systemic standpoint.

Finally, we will address the points raised by APRA around the complexity of these structures and the concern that a protection buyer will be exposed to counterparty credit risk.

Synthetic securitisations can be an important risk management tool because they allow for economic interest to be transferred precisely when a true sale transfer is extremely difficult or impossible to execute. This risk management tool is used for direct hedging of loan commitments that are originated by a bank's lending business and often it is the only tool available for transferring risk in certain asset classes. Typically, middle market, SME and emerging market loan documentation do not contemplate a transfer of legal ownership, and additionally many onshore loans contain non-assignability clauses, or have very low liquidity. Furthermore, it is not possible to maintain customer relationships for many clients if an outright loan sale is used to manage risk, unlike easily cash securitisable assets.

The flexible nature of bank revolving credit facilities to large corporates also limits the ability of banks to reduce individual exposures although such exposures could be included in a synthetic transaction. Using Credit Default Swaps (CDS) to hedge a bank's credit risk is also limited since only a few rated corporates trade actively in Australia. In addition, trade finance is an area that could see benefits from synthetic securitisation deals. The physical transfer of trade finance commitments is unrealistic given the short nature of the deals (typically 6-12 months) and the only efficient structure would require a replenishment period governed by eligibility criteria that would ensure significant risk transfer. By allowing effective prudential treatment, banks can continue to service customer needs while credit portfolio managers can more effectively manage risk and concentration which in turn allows banks the ability to free lending capacity for the real economy. Further, Australian financial institutions tend to have risk that is heavily concentrated within the country and region as well as natural concentration risk to certain sectors. Non recognition of capital benefit would discourage banks from considering what are sometimes the only viable avenues to reduce exposure.

Banking regulators in many jurisdictions continue to recognise synthetic securitisations as an effective risk transfer tool. In addition, we reference the recent paper submitted by the EBA on 18 December 2015<sup>5</sup> supporting allowing originator banks to apply Simple, Transparent and Standardised (STS) capital requirements on senior synthetic tranches of SME portfolios if certain conditions are met. We are fully supportive of this development and specifically the idea that the synthetic nature of a deal should allow for recognition of capital relief. Credit portfolio managers execute balance sheet synthetic transactions to allow the bank to mitigate risk by including a sizeable number of loans in a structure that provides material benefit to the portfolio.

Another benefit of these transactions is the introduction of overseas investors in any or all levels of the capital structure. There is a genuine risk transfer to a community of non-bank investors which includes credit funds as well as prudentially regulated insurance, pension funds and multilateral banks. These are sophisticated investors who engage in thorough due diligence. The risk taken by these investors is suitable and we reference the recent Position Paper written by the Dutch pension fund PGGM titled "*Simple Synthetic Securitisation: Why and how we invest in synthetic balance sheet securitisations*"<sup>6</sup>. Any transfer of risk to offshore jurisdictions may help mitigate systematic risk for the Australian Banking System.

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<sup>5</sup> Page 6, <http://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-26+EBA+report+on+synthetic+securitisation.pdf>.

<sup>6</sup> Please see <https://www.pggm.nl/wat-vinden-we/Documents/pggm-position-paper-synthetic-securitisations.pdf>

Regarding risk transfer, we believe the onus is on each bank to demonstrate that significant risk transfer is achieved in each transaction. This is a common requirement in order for recognition of capital relief in many jurisdictions. Much work has been done on significant risk transfer for instance as outlined by the PRA in the Supervisory Statement SS9/13<sup>7</sup>, but we hope to work together with regulators to ease any remaining concerns.

Regarding the concern around the complexity of synthetic securitisations, we also note that synthetic securitisations are in many ways far simpler than cash securitisations. For example, cash securitisations often involve complex cash waterfalls or complexity in transferring legal ownership. The PGGM paper describes very well how synthetic transactions are conceptually very simple (see PGGM, p.3). Our members often refer to synthetic transactions as risk sharing transactions as it is important there is an alignment of interest between the bank and investor. The structure of these deals is conceptually simple in nature so the key is to make sure interests are aligned properly.

We recognise that there may be counterparty credit risk for synthetic securitisations, however, this risk can be mitigated through fully funded/collateralised structures. The EBA notes in its paper that a vast majority of transactions are funded. Therefore, this concern is already commonly addressed within existing structures.

In the Australian context, CBA and ANZ had previously completed cash funded synthetic securitisation transactions that provided an effective tool to hedge credit risk. For example, CBA issued Medallion 1999 Credit Linked Trust to hedge the credit risk of a portfolio of large corporate exposure and the Medallion 2003-1 SME Credit Linked Trust to hedge exposure to SME receivables<sup>8</sup>.

In closing, we recognise the concern around the complexity of these deals but in many ways they are less complex than cash securitisations. We highlight that the use of these structures can be accomplished within a set of rules and guidelines that are used to mitigate APRA's behavioral concerns, and that funded/collateralisation is an effective mitigant of counterparty exposure. Our members continue to be active in discussions globally with regulators and local jurisdictions to ensure these deals are well understood. To that point, we would welcome the opportunity to establish an ongoing dialogue with APRA on how bank credit portfolio managers can effectively use synthetic securitisations.

We understand that synthetic securitisations are not a common feature of the current Australian market but we highlight the work being done within the global regulatory framework. We are hoping to collaborate with APRA to further strengthen the regulatory framework by recognising the benefit of synthetic securitisations as a risk mitigation tool. We hope APRA will reconsider the current position and move forward to allow capital relief for balance sheet synthetic securitisations where significant risk is deemed to be transferred in a prudential framework. We propose that individual transactions could be subject to approval by APRA with a requirement of the ADI seeking relief to demonstrate that the risk is being transferred to another party and that the counterparty credit risk has been mitigated.

The IACPM appreciates your attention to our thoughts and concerns. We would be pleased to discuss any aspect of our response in further detail should it be of interest to APRA.

Sincerely,



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Executive Director  
International Association of Credit Portfolio Managers

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<sup>7</sup> The Prudential Regulatory Authority defines expectations for banks using the securitisation product, Page 7 (<http://www.bankofengland.co.uk/pru/Documents/publications/ss/2013/ss913.pdf>).

<sup>8</sup> **Medallion 1999-1 Credit Linked Trust** <https://www.commbank.com.au/about-us/Securitisation/asset-backed-securities/series-1999-1-medallion-credit-linked-trust.html>  
**Medallion 2003-1 SME Credit Linked Trust** <https://www.commbank.com.au/about-us/Securitisation/asset-backed-securities/series-2003-1-sme-credit-linked-trust.html>