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Securitisation in Australia

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Australia has well-established and increasingly sophisticated markets in both traditional asset-backed securitisation and synthetic securitisation. As Australia is one of the oldest securitisation markets in the world, most structural, regulatory and legal issues that arise in securitisation transactions have been successfully addressed in the Australian market. In addition, the inherent characteristics of the Australian market, such as its political stability, AAA foreign currency rating, innovative and sophisticated capital markets and the high credit quality of financial assets available, provide a solid framework for a deep and healthy securitisation market.

Structures

Companies or trusts

An Australian-based special purpose issuing vehicle (SPV) is typically a trust or a company, or (in a two-tier structure) a combination of both.

Trust structures

A trust structure involves the appointment of a trustee (typically a well-established independent trustee company) which, on behalf of the trust, acts as the owner of the underlying assets and the issuer of the relevant securities.

The beneficiaries of the trust hold units representing an interest in the capital of the trust and units representing an interest in the excess income of the trust. Typically, the holders of capital units are entitled to any assets of the trust which remain after all the obligations of the trustee (on behalf of the trust) to the creditors of the trust (principally the holders of the debt securities) are met. The holders of the income units are entitled to receive distributions of any excess income after the day-to-day expenses of the trust (eg, interest obligations on the debt instruments and fees and expenses) are met.

The trustee typically grants a charge or other security interest over the assets of the trust (acquired after the creation of the trust) to a security trustee. The security trustee agrees to hold that charge for the benefit of certain secured creditors, including the holders of the debt securities. If the trust were to be wound up, the security trustee would be required to ensure that the assets of the trust are distributed according to a pre-determined order of priority, which is set out in the relevant documents for the transaction.

The advantages of a trust structure include the following:

- The Australian market, particularly for mortgage-backed securities, is familiar with the trust structure;
- It is easier to issue specifically tailored equity interests out of a trust;
- The manager of the trust will be allocated formal management duties under the trust deed and will make most of the day-to-day decisions relating to the management of the trust and its assets;
- Annual returns need not be filed with the Australian Securities and Investment Commission (ASIC) for a trust, whereas such returns are required for a company; and
- Under current Australian tax laws, the beneficiary of a trust, rather than the trust itself, is taxed on the net income of the trust provided that the beneficiary is presently entitled to that income. This means that tax neutrality is relatively simple for a trust.

The disadvantages of a trust structure include the following:

- Notwithstanding the presence of a manager, the trustee as the legal owner of the assets usually needs to be involved in each act concerning the assets and liabilities of the trust - for example, the day-to-day management and administration of the trust and the execution of any agreements to be entered into by the trust;
- The structure involves more legal entities than a corporate structure and hence is more complex and can take longer to negotiate;
- As the trustee of the trust is the issuer of the debt securities, a sponsor may not achieve the degree of branding to the market that it would with a corporate vehicle; and
- Fees will be payable to the trustee (and its advisers), as well as to the security trustee.

Corporate structures

A company incorporated under the Corporations Act can include within relevant documents the various restrictions required to satisfy the bankruptcy-remote criteria prescribed by the rating agencies (eg, at least one independent director and a restriction on amendments to the constitution).

An Australian proprietary company need have only one director. The mechanics of establishment and ongoing filing requirements are routine. If the SPV needs to be 'off-balance sheet', the equity owner of the corporation is often an unrelated discretionary trust.

As with a trust structure, a corporate SPV typically grants a charge over its assets in favour of a security trustee under a security trust deed for the benefit of certain secured creditors (including the holders of the debt securities). The charge is granted over all the assets of the corporate SPV. Alternatively, some structures allow for separate charges over different groups of asset.

An Australian corporation is a taxable entity. It is required to lodge federal income tax returns with the Australian Taxation Office. However, typically allowable deductions largely offset its assessable income. Australia has no state-based income tax regime.

The advantages of using a corporate SPV include the following:

- Apart from the restrictions in its constituent documents and the inclusion of limited recourse and non-petition covenants in documents to which it is a party, third parties can deal in an unrestricted manner with the corporate SPV. The corporate SPV can be established easily, quickly and cheaply;

- No trustee acts as legal owner of assets;
- Different transactions undertaken by the corporate SPV can be modified with little or no structural or documentary change. Subject to some structuring issues, one series of debt securities issued by the corporate SPV can give the holders of those securities entirely different rights compared to those of other series (this is also possible for a trust); and
- The name of the corporate SPV will be the name known to customers and investors.

The disadvantages of a corporate structure include the following:

- In off-balance sheet securitisations there will be loss of equity control of the vehicle;
- Independent directors must be found and fees paid to them, and often appropriate directors' and officers' insurance must be obtained; and
- The corporate SPV will be required to prepare and lodge annual returns with ASIC.

Two-tier structures

Under two-tier structures, an issuing SPV and an asset-holding SPV are involved. In Australia, typically the same institution sponsors both. The issuing SPV uses the proceeds of the debt securities it issues to make a loan (in exchange for a note) to the asset-holding SPV. In turn, the asset-holding SPV uses the proceeds of the loan to buy or lend against the security of the relevant assets. The issuing SPV grants one or more charges over its assets (primarily the notes issued by, or other financial arrangements entered into with, each asset-holding SPV) to a security trustee for the benefit of its creditors (primarily the holders of the debt securities). The asset-holding SPV also grants a charge over all its assets (the underlying assets) to a security trustee for the benefit of its creditors (primarily the issuing SPV).

There can be more than one asset-holding SPV, particularly where there are different classes of asset to be held or where new assets are added at different times.

The advantages of a two-tier structure include the following:

- The same issuing SPV can issue different series of security (eg, asset-backed commercial paper) with different ratings;
- It is relatively simple at a later date to add new assets into the transaction which provide security to a discrete group of support facility providers by adding a new asset-holding SPV, and for the issuing SPV to issue new debt securities; and
- The risk of asset commingling is minimised. The issuing SPV holds only notes issued by the asset-holding SPVs. The asset-holding SPVs (each a distinct legal entity) typically hold only a pool of related assets.

Offshore

Australian SPVs have been increasingly issuing debt securities in the global capital markets to access what have traditionally been deeper funding sources and more liquid markets. In particular, putting aside the period since August 2007, offshore issuance of residential mortgage-backed securities by Australian SPVs reached record levels (according to *An Investor Guide to Australia's Housing Market and Residential Mortgage-Backed Securities*, published by Standard & Poor's). In addition, many local asset-backed commercial paper conduits have direct or indirect access to the US asset-backed commercial paper market.

It is a relatively straightforward legal process for an Australian issuer of either commercial paper or term debt to issue its securities globally and domestic programme documents are often established with the express intention of issuing debt securities offshore (denominated in both Australian dollars and offshore domestic currencies).

Regulatory regime

Corporations Act

Australia's securities markets are principally governed by the federal Corporations Act. The term 'securities' is broadly defined under the act and virtually always includes the instruments that are issued to the market in a securitisation transaction.

Any issue of securities must be in compliance with the act's provisions, which impose a variety of obligations on issuers. One example is the obligation to lodge disclosure documents with ASIC that contain information that investors and their professional advisers would reasonably require to make an informed assessment about the issued security. However, certain types need not comply with the disclosure requirements. These include issues where the amount raised by the body issuing the securities is less than A$2 million in any 12-month period or where the minimum subscription price paid by each investor is A$500,000.

In addition, each party to a securitisation transaction must consider whether its role in the transaction constitutes the provision of a financial service that requires an Australian financial service licence. A breach of this licensing requirement can have serious consequences, including the imposition of fines and (where individuals are convicted) imprisonment. Specific exemptions from this licensing requirement exist and some can apply to parties to securitisation transactions and should be considered.

Tax neutrality

A securitisation transaction will require the SPV to remain tax neutral, in the sense that the SPV must have no significant net taxable income during the life of the securitisation. In order to achieve this it is necessary to ensure that, to the extent possible, the assessable income of the SPV is fully matched by the allowable deductions for tax purposes in any year of income.

The assessable income of the SPV will typically include amounts such as:

- interest or discounts derived from its assets;
- the income or profit element of certain assets assigned to the SPV;
- any gains on the sale or maturity of assets;
- the gross amount of swap payments received;
- interest on any authorised investments; and
- any amount of a debt or loan owed by the SPV which is released or charged off.

Allowable deductions incurred by the SPV may include:

- interest or discounts payable on the debt securities it issues to finance the acquisition of its assets;
- losses realised on a disposal of an asset by the SPV;
- deductions for bad debts;
- the gross amount of payments due under swaps; and
- fees and expenses borne by the SPV.

The precise tax treatment of an SPV depends on whether it is a trust or a company. The beneficiary of a trust, rather than the trust itself, will be liable to tax on the trust's income provided that the beneficiary is presently entitled to that income.

This tax treatment does not apply in the case of a corporate SPV, which will pay tax on its net assessable income at the standard corporate tax rate.

Insolvency

For corporate issuers the insolvency regime is contained primarily in the Corporations Act, with the balance contained in common law and equitable principles. The statutory test for whether a company is insolvent is whether that company is able to pay all of its debts as and when they become due and payable. Under the act, if a company is insolvent a court may order that it be wound up upon the application of certain persons. Payment of claims against the company is carried out according to the act's provisions.

Where an SPV issuer is the trustee of a trust and the obligations which the trustee has properly incurred as trustee of the trust (eg, under the debt securities issued by it) cannot be met from the proceeds of the trustee's indemnity from the assets of the trust, the rights of the holders of the debt securities are extinguished to the extent of the shortfall since the liability of a trustee in a securitisation programme is typically limited to the trustee's right of indemnity from the assets of the trust.

If the trustee were to become insolvent (for whatever reason) in its personal capacity, the trust deed invariably provides for the trustee to be replaced and for the assets of the trust to vest in the newly appointed trustee.

Bank regulatory issues

The Australian Prudential Regulation Authority (APRA) is responsible for the prudential regulation of authorised deposit-taking institutions, which include banks, building societies and superannuation funds. The authority's Prudential Standard APS 120 – Securitisation is a regulatory statement that aims to ensure that authorised deposit-taking institutions adopt prudent practices to manage risks arising from their involvement in (both synthetic and traditional) securitisation activities and to ensure that sufficient regulatory capital is held against the exposures in those activities. APS 120 was revised and reissued in January 2008 to accommodate the implementation of the Basel II capital framework in Australia.

APS 120 applies to all roles undertaken by, and investments of, an authorised deposit-taking institution in a securitisation. For example, if an authorised deposit-taking institution acts as the sponsor of an SPV, provides a facility to an SPV or sells its assets to an SPV, the provisions of APS 120 apply.

In broad terms APS 120 requires that:

- an authorised deposit-taking institution acts on arm's-length market terms in relation to its dealings with the SPV and any investors involved in a securitisation;
- there is no actual or perceived additional support provided by the authorised deposit-taking institution for the obligations of an SPV (beyond its contractual obligations with the SPV);
- an authorised deposit-taking institution holds appropriate levels of regulatory capital against the credit risk presented by its exposure to an SPV; and
- there is appropriate disclosure of the authorised deposit-taking institution's involvement in the securitisation (and express in offering material confirmation that the obligations of the SPV do not represent deposit or other liabilities of the authorised deposit-taking institution).

A self-assessment compliance regime applies but APRA can request a written assessment by the authorised deposit-taking institution of its compliance with APS 120.

Authorised deposit-taking institutions regulated outside Australia are expressed in APS 120 to be bound by the disclosure and separation requirements, the self-assessment regime, and the requirements relating to the Board and senior management responsibilities.

Credit default swaps not insurance

The Australian securitisation market has relied on legal advice provided to participants to the effect that properly drafted credit derivatives do not comprise an indemnity for loss and, as a result, are not contracts of insurance. On that basis, the Australian regulatory regime and common law duties relating to insurance contracts do not apply to properly drafted credit derivatives. This advice is consistent with the view taken by the International Swaps and Derivatives Association Inc and has been supported by a recent US decision in *Aon Financial Products Inc v Société Générale* (US Court of Appeals, Second Circuit, February 5 2007).

Equitable assignment

A right to a particular cash flow or monetary obligation is a 'chose in action' that is represented by a debt due by one person to another. The laws of each state and territory of Australia regulate the legal transfer of a debt. For example, in New South Wales Section 12 of the Conveyancing Act 1919 requires the assignment of a debt to be absolute and in writing, and notice of the assignment to be given to the debtor. In most asset-backed securitisations the seller of the asset will not want notice of the assignment to be given to the debtor. In addition, the written assignment of a debt may incur stamp duty in certain states and territories. Therefore, asset-backed securitisation transactions in Australia typically involve an equitable, rather than legal, assignment of the debt.

For an equitable assignment to be effective, valuable consideration must be given and (consistent with English legal principles) the parties must have a clear intention to assign. An equitable assignment can be carried out by the seller making a written offer, which is accepted by the SPV buyer by payment of the purchase price for the assets. Equity will recognise such an assignment as transferring the beneficial ownership of the assets to the SPV buyer, even though all the formalities required by the Conveyancing Act have not been followed. The transfer of ownership of assets in this manner means that notice to debtors is not required and the transfer does not give rise to any stamp duty.

However, there are certain disadvantages in having an equitable rather than a legal assignment. For example, until notice of the assignment of the debt is given to the debtor, the debtor is still able to obtain a good discharge for the debt from the seller and is able to exercise equitable remedies such as set-off in respect of the debt. In most securitisation transactions involving equitable assignment, provision is made for the SPV buyer to protect its title to the assets that have been assigned. This is generally achieved by giving notice of the assignment to the debtors. Usually this can occur only when certain defined title perfection events have occurred.

Stamp duty

Stamp duty is a tax imposed by each state or territory on certain documents or transactions. The stamp duty legislation has developed differently in each state and territory and, as a result, considerable differences exist between the various jurisdictions with regard to:

- which documents or transactions are subject to duty;
- the rates of duty; and
- the exemptions which are available.

In a securitisation transaction the transfer of assets, the creation of trusts and the creation of security interests (eg, mortgages and charges) may attract stamp duty. Consequently, careful structuring of each transaction, taking account of any applicable anti-avoidance provisions, is required in order to minimise any stamp duty payable on a transaction. There are several means by which the various components of a securitisation transaction can be structured in such a way as not to attract stamp duty (eg, equitable assignment).

Consumer Credit Code and draft finance broker legislation

The Consumer Credit Code regulates the provision of long-term (more than 62 days) personal, domestic and household credit. Therefore, it applies to personal loans, overdrafts, home loans, credit cards, consumer leases, consumer hire purchase and any other provision of consumer credit. The code is directed primarily towards, and imposes obligations on, credit providers and has a significant impact on asset-backed securitisation transactions. Although the obligations are directed at credit providers, which would usually be considered to be the originator, the code also applies to assignees of debt.

There are a number of possible consequences of a breach of the code. The debtor may not be required to pay any interest under the credit contract or the credit provider may be required to make a payment to consolidated revenue or into a statutory trust fund. Pursuant to the code, a court or tribunal can re-open the transaction that gave rise to an unjust contract, mortgage or guarantee (or an unjust variation of such an instrument). Therefore, asset-backed securitisation transactions in Australia involving assets regulated by the code have often included specific indemnities from the seller (and/or a sufficiently creditworthy entity related to the seller) relating to amounts paid (including legal fees) as a result of breaches or violations of the code.

In November 2007 the Ministerial Council on Consumer Affairs released a consultation package on a proposed national finance broking scheme. Broadly speaking, the scheme aims to regulate finance brokers by creating a licensing requirement and also requiring certain disclosures to be made to consumers. The scheme contains a number of provisions that, if implemented, may affect securitisation. For example, the draft bill allows for a stay of enforcement proceedings against a borrower pending resolution of a dispute between the borrower and a finance broker in specified circumstances. The Australian Securitisation Forum has submitted a response to the consultation package and will continue to monitor the position as the proposed legislation progresses.

Anti-money laundering

The federal Anti-Money Laundering and Counter-Terrorism Financing Act 2006 will apply to a securitisation programme if it involves the provision of a "designated service". The term designated service is defined broadly and may capture a range of activities. For example, the origination or acquisition of loans or trade receivables, the issue of notes and the provision of custodial and depository services may each be a designated service. You should also be aware that the act purports to have broad extraterritorial effect. For example, it may apply to the offshore activities of an Australian company or a foreign subsidiary of an Australian company.

An entity will be subject to various obligations if the act applies. These include the establishment an anti-money laundering and counter-terrorism financing programme, an obligation to carry out initial and ongoing customer due diligence and various reporting requirements.

Interest-withholding tax

Unlike interest paid to Australian resident noteholders, interest on debt instruments issued by the SPV that is paid to non-residents of Australia will generally attract Australian interest-withholding tax unless an exemption is available - for example, under Section 128F of the Income Tax Assessment Act 1936. There are a number of requirements for the exemption to be available, but the key requirement is that the issue of the debt securities satisfies the public offer test set out in Section 128F.

The Australian government has signed new or amended double tax conventions with the United Kingdom and the United States. These conventions apply to interest derived by UK or US residents.

The conventions effectively prevent interest-withholding tax applying to interest derived by certain unrelated financial institutions resident in the United Kingdom, the United States, Finland or Norway, which substantially derive their profits by carrying on a business of raising and providing finance.

The conventions complement the interest-withholding tax exemption in Section 128F of the act by allowing Australian borrowers (including securitisation vehicles) to fund in the UK and US debt markets by borrowing directly from US and UK-resident banks and other financial institutions (possibly including multi-issuance securitisation vehicles) on a interest-withholding tax-exempt basis.

Goods and services tax

Goods and services tax is a federal tax which was introduced in Australia on July 1 2000. When an entity supplies taxable goods and services it must remit to the Australian Taxation Office goods and services tax equal to 10 per cent of the total consideration received for the supplies.

Typically, goods and services tax should not be a significant cost for most securitisation transactions, but it is still necessary to consider how it may affect transactions. In particular, it is important to consider whether payments made by the SPV in accordance with servicing and management agreements will incur goods and services tax and, if so, whether quoted fees are expressed to be inclusive or exclusive of goods and services tax. If goods and services tax is to be paid by the SPV, it will need to have income available to pay the goods and services tax owing in each tax year. In addition, if the SPV is seeking to claim input tax credits it will need to be registered under the New Tax System (Goods and Services Tax) Act 1999.

Asset classes

Traditional assets

Residential mortgage-backed securities (RMBS) account for the majority of the total volume of the Australian securitisation market (*Australia and New Zealand Securitization New Issuance Roundup: December Quarter 2006*, published by Standard & Poor's). In 2006

RMBS issuance contributed approximately 80 per cent of the total volume of issues in the Australian securitisation market.

Australian RMBS are attractive for a number of reasons, including the fact that Australian residential mortgages have always had a reputation for low credit risk and sound underwriting standards (*Australian Residential MBS Criteria*, published by Standard & Poor's). In addition, house prices tend to be more stable than in Europe and the United States and defaults are considerably low by global standards (*An Investor Guide to Australia's Housing Market and Residential Mortgage-Backed* Securities, published by Standard & Poor's). The low rate of default can be attributed to a number of factors:

- Personal liability attaches to the borrower under Australian mortgage loans. If the borrower defaults and the property does not realise an amount sufficient to satisfy the balance of a home loan, the lender has recourse to the borrower to recover the residual balance.
- Australia has a culture of home ownership - almost 70 per cent of households in Australia live in houses that they own and, of these, 54 per cent own their property outright and 46 per cent have mortgage loans secured by their properties (*An Investor Guide to Australia's Housing Market and Residential Mortgage-Backed* Securities, published by Standard & Poor's). In addition, there is a strong willingness to repay obligations, which is reflected in a relatively low personal bankruptcy rate.
- In Australia, the interest charged on mortgage loans is not tax deductible, while interest earned on investments (including savings) is taxed, which increases the incentive to repay a home loan faster.

Current assets

Although RMBS dominate the Australian securitisation market by volume, there continues to be a trend towards the securitisation of other asset classes. In 2006 the number of non-RMBS transactions exceeded the number (but not the volume) of RMBS transactions in the Australian market (*Australia and New Zealand Securitization New Issuance Roundup: December Quarter 2006*, published by Standard & Poor's) - non-RMBS transactions made up 57 per cent of the total number of Australian securitisation transactions in 2006. Australia is acknowledged as a sophisticated market with a variety of asset classes being securitised, such as:

- commercial real estate;
- corporate loans;
- low-doc or self-certified residential mortgages;
- sub-prime mortgages;
- reverse mortgages;
- construction loans;
- trade receivables;
- credit cards;
- leases and loans (eg, equipment and automobiles);
- sale contracts;
- cash flows from public-private partnerships;
- aircraft; and
- rolling stock.

Synthetic securitisation

The synthetic securitisation of assets involving the issue of debt securities backed by derivatives such as credit default swaps is a constantly evolving and growing part of the Australian securitisation market. In the past, the most common synthetic securitisations by Australian SPVs have included:

- synthetic collateralised debt obligations;
- synthetic collateralised loan obligations;
- synthetic collateralised mortgage obligations;
- collateralised debt obligations referencing other collateralised debt obligations (known as collateralised debt obligations squared); and
- capital protected products (eg, constant proportion portfolio insurance products).

It is unclear how this segment of the Australian market will develop in the short term in the light of recent volatility in global credit markets.