ASIC

Australian Securities & Investments Commission

Global developments in securitisation regulation – an ASIC perspective

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Today I would like to talk about developments in regulatory reform of global securitisation markets, and ASIC's ongoing work in this space.

Our Chairman, Greg Medcraft, spoke about ASIC's strategic priorities when he presented here last year, but I would like to reiterate them today. ASIC's key priorities are to ensure:

1 confident and informed investors and financial consumers;

2 fair and efficient financial markets; and

3 efficient registration and licensing.

ASIC's work with respect to securitisation falls into our first priority – confident and informed investors. ASIC has been working in a number of key areas over the last few years to assist in restoring confidence in the Australian securitisation market, and to encourage cross-border capital flows. These include:

- international regulatory reform work;
- working with the ASF to develop securitisation standards for industry; and
- ASIC's work in supporting the development of the corporate bond market.

ASIC has also been involved in other areas of work which indirectly promote the restoration of confidence in securitisation markets, for example, through our regulation of:

- credit rating agencies; and
- credit providers.

International regulatory reform

Background

In response to a request from the G20, the Financial Stability Board (FSB) has been developing recommendations to strengthen oversight and regulation of the shadow banking system. Regulation of securitisation is one key area of this work.

ASIC has had active involvement and strong representation in the international reform work led by the FSB and the International Organization of Securities Commissions (IOSCO).

- ASIC Chairman Greg Medcraft was recently elected Chairman of the Board of IOSCO and will commence his term in March 2013; and

- ASIC is Co-Chair of IOSCO's Task Force on Unregulated Markets and Products (TFUMP) with the French securities regulator, Autorité des Marchés Financiers (AMF).

Why is this international reform work so important?

Securitisation offers an important market-based source of finance and an alternative source of funding for the banking sector at a time when funding diversification is needed.

The Government also recognises the importance of securitisation as a source of funding to smaller lenders, whose presence in the residential mortgage market assists in maintaining interest rates at competitive levels to enable more Australians to own homes.[1]

The recovery of sustainable and sound securitisation markets is needed to play an important role in supporting economic growth.

Prior to the GFC, securitisation markets were global in nature with significant cross-border capital flows, and a return of cross-border issuance will underpin the recovery of these markets.

Differences in regulatory approach between jurisdictions may impede the return of cross-border capital flows and thereby impede recovery of securitisation markets. The international reform work being undertaken seeks to recognise these differences in regulatory approach and address them where appropriate.

Of course, the other factor critical to a recovery of securitisation markets is a restoration of investor confidence and trust, and this is a focus of the reform work being undertaken. For this to happen, securitisation must be, and be perceived to be, a mechanism for managing and reducing risk, not merely transferring or hiding risk.

And why is this international work important to Australian markets?

Over half of our pre-GFC investor base comprised foreign investors. The recovery of the Australian securitisation market relies heavily on the return of off-shore investors so we must be mindful of international regulatory developments to remain competitive on a global scale.

[1] Since October 2008, the Government has supported the RMBS market by directing the Australian Office of Financial Management (AOFM) to invest up to A$20 billion in high-quality, AAA-rated residential mortgage-backed securities (RMBS) issued by smaller Australian lenders, As at 27 September 2012, AOFM purchase of RMBS totalled A$15.5 billion across 45 transactions.

Current status of IOSCO work

IOSCO issued its *Final Report – Unregulated Markets and Products* (PDF 503 KB)in September 2009. That report, prepared by the Task Force on Unregulated Markets and Products, made recommendations about improvements in regulatory oversight of securitisation markets intended to assist in restoring investor confidence and market quality. Recommendations included requirements for:

- enhanced transparency and standardisation of disclosure; and
- risk retention, or 'skin in the game'.

There have been various consultations undertaken and reports issued by IOSCO since 2009 providing guidance to industry and regulators on the implementation of these recommendations. Amongst these:

- IOSCO's April 2010 *Final Report – Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities* (PDF portfolio 3.64 MB);
- IOSCO's March 2011 *Implementation Report – Task Force on Unregulated Markets and Products* (PDF 341 KB); and
- IOSCO's Principles for On-going Disclosure for Asset-Backed Securities, currently in final draft form.

Most recently, the FSB, as part of its ongoing work in the shadow banking sector, asked IOSCO to undertake a 'stocktaking' exercise on certain aspects of securitisation regulation and to develop policy recommendations, as necessary. IOSCO recently issued a *Consultation Report – Global Developments in Securitization* (PDF 421 KB) (with the final report due for publication later this year), which outlined the results of IOSCO's 'stocktake' on global securitisation regulation, and consulted with industry on a range of key issues. Key questions asked of industry in this consultation included:

- Transparency: Should issuers be required to provide investors with stress testing results/scenario analysis and was there investor appetite for this?
- Standardisation: Should industry be encouraged to develop best practice disclosure templates and pursue harmonised approaches?
- Risk retention: Are there material differences in risk retention across jurisdictions (the focus being on the EU and the US) and if so, what might be done about such differences?

Note that IOSCO's recommendations have not yet been finalised, so my comments today are about some of the early observations and findings from the consultation responses.

Risk retention

Risk retention has been a key focus of regulatory attention since the GFC, and was a key focus of the IOSCO's consultation. Risk retention is intended to avoid misaligned incentives arising in securitisation structures, by ensuring the originator/sponsor has an interest in the performance of the transaction over its life.

Differences in approaches to risk retention across jurisdictions have been highlighted and considered in the consultation. In particular, the emerging differences between EU requirements and US proposals are viewed by the Task Force on Unregulated Markets and Products and by industry participants as being 'significant' in terms of their impact on cross-border transaction flows.

The EU has implemented risk retention requirements for EU credit institutions through the Capital Requirements Directive[2] and these requirements are to be extended to other types of institutions such as insurance companies. The EU framework imposes the risk retention obligation on investors.

US requirements are still being developed through implementation of the Dodd Frank Act.[3] Under the proposed US rules the obligation is imposed on the sponsor, and subject to various carve-outs for certain high-quality assets.

In some other jurisdictions, market practice and industry standards exist, or are being developed, that provide for a similar outcome, that is, requiring meaningful exposure to credit risk to be retained by originators, thereby incentivising them to conduct appropriate due diligence on, and monitor, the underlying asset pool.

Given the differences between existing and proposed frameworks and the different stages of development and implementation, IOSCO's approach is now focused on working towards 'equivalent regulatory outcomes' at the national level, rather than imposing prescriptive risk-retention requirements in each jurisdiction. This work is ongoing, but current work seems to be favouring:

- the establishment of domestic risk retention frameworks in each jurisdiction; and

[2] EU Capital Requirements Directive framework imposes obligations on regulated institutional investors to address risk retention requirements. The CRD 2 prohibits EU credit institutions from investing in securitised instruments unless the originator/sponsor/original lender of the securitisation retains no less than 5% of the economic interest in the securitisation.

[3] Proposed US rules for credit risk retention in ABS transactions require a sponsor to retain an economic interest equal to at least 5% of the credit risk of the assets collateralising an issuance of ABS. The obligation is imposed on the sponsor.

- ‘harmonisation’ of different risk-retention approaches across jurisdictions (via appropriate exemptions and adjustments) in order to facilitate cross-border ABS transactions.

Transparency

Responses regarding transparency acknowledged the benefits of clear and effective disclosure to assist investors in making informed investment decisions and understanding the risks inherent in securitisation, and to avoid over-reliance on CRAs (credit rating agencies). While CRAs remain a useful tool, it should be recognised that they are only ‘one tool in the kit’ in terms of an investor’s assessment of a securitised product. This approach promotes the empowering of investors to make better informed investment decisions and to be responsible for these decisions.

IOSCO’s analysis indicated well-developed regulatory requirements or industry standards in many jurisdictions regarding upfront and on-going disclosure for public or listed offerings of asset-backed securities (ABS), and a general level of consistency in the information provided to investors across jurisdictions. There was, however, certain information that IOSCO considered may assist investors which is not required in most jurisdictions, such as stress testing and scenario analysis.

There was some divergence of opinion as to whether it was best for stress test results to be provided to investors by issuers, or more appropriate for investors to be provided the detailed underlying data to conduct their own due diligence and scenario analysis.

Given the potential conflicts of interest that may arise in issuer stress testing, IOSCO’s position seems to fall on a requirement for investors to be provided the necessary information to perform their own analysis, although this is still under discussion.

I think it is worth noting here that much of the backlash against securitisation at the outset of the GFC was based around transparency and complexity. While initiatives to improve transparency will better enable investors to take responsibility for their own assessment of securitised products, this does not exempt issuers from responsibility. We expect that issuers play a responsible role in bringing ‘good’ securitisation products to market rather than developing overly complex products, and we must be careful that issuers do not consider enhanced transparency for investors solely as a mechanism for limiting liability. (Given the relatively vanilla structures typical of the Australian securitisation market, this is probably a concern more relevant to other jurisdictions).

Improved transparency and risk retention are key planks to restoring investor confidence in securitisation.

Standardisation

On standardisation of disclosure information, survey results indicated that, while few jurisdictions require standard disclosure templates, there are significant regulatory and industry initiatives underway.

While industry is generally supportive of the concept of industry best practice templates, it has cautioned that differences between structures and assets across jurisdictions must be taken into account in standardisation initiatives.

In the Australian market, the Reserve Bank of Australia has today announced its information requirements for residential mortgage-backed securities (RMBS) to be accepted as eligible collateral for its new Committed Liquidity Facility and its existing repurchase arrangements. We understand that the ASF may undertake a review of its RMBS Disclosure and Reporting Standards to ensure consistency with any new regulatory requirements that were not contemplated in their original drafting.

Australia’s response to international reforms

The reason I refer to ‘Australia’s response’ to these international regulatory reforms, and not ‘ASIC’s response’ is that there are currently no regulatory requirements in Australia that mandate any specific wholesale disclosure content.

So while Australian securitisation markets are limited to wholesale issuance, ASIC does not have the power to establish a disclosure regime for offerings of securitisation products, or impose specific risk retention requirements.

ASIC supports industry self-regulation and the work of the ASF in developing standards consistent with international reforms. The ASF has:

- developed and implemented industry standards for RMBS, recommended as the minimum level of best practice for the Australian industry on all issues since 1 July 2012; and
- recently released similar disclosure and reporting standards in relation to ABS.

We have also seen the ASF actively participating in regulatory consultations to represent the views of Australian industry in the international regulatory forum, such as the IOSCO consultation on Global Developments in Securitisation that I discussed earlier.

In particular, the ASF’s submission to this recent consultation noted the importance of the material differences in relevant risk retention initiatives, given the global nature of the securitisation market and the importance of cross-border liquidity to the Australian market.

ASIC supports the ASF in its establishment of a risk retention framework that satisfies IOSCO's objective of consistency in 'regulatory outcomes'.

Supporting the development of corporate bond markets

Initiatives to encourage the development of Australian debt capital markets more broadly go some way to supporting a recovery in securitisation markets, particularly in terms of broadening the investor base for debt products, and expanding debt issuance to retail investors.

- The main benefit to superannuation and retail investors is allowing diversification of portfolios across equities and fixed income products (where this investor group has previously had limited direct exposure).
- Developing retail and superannuation fund appetite for more vanilla debt products such as corporate bonds may lead to a broadening of the investor base for securitisation products in the future.
- ASIC would support such a development to the extent that this does not compromise the protection of retail investors.

ASIC has been involved in various initiatives to support the development of the corporate bond market:

- ASIC has relaxed disclosure requirements by issuing 'vanilla bond' Class Order relief[4] in May 2010 to allow listed entities to offer vanilla bonds under a simplified prospectus regime;
- ASIC has issued guidance on satisfying prospectus content requirements and how to present prospectuses in a 'clear, concise and effective' manner for retail investors (Regulatory Guide 228 *Prospectuses: Effective disclosure for retail investors*);
- ASIC has been in discussions with Treasury regarding proposals to reduce directors' liability for prospectus disclosure. This work considers both civil and criminal liability of directors, and is yet to be finalised;
- ASIC is currently undertaking work to facilitate retail trading of Commonwealth Government Securities[5] (CGS), which is important in terms of encouraging retail investors to diversify into fixed-income products, but also in terms of creating a visible pricing benchmark for the corporate bond market;

[4] Class Order [CO 10/321]] and associated Regulatory Guide 213 *Facilitating debt raising*.

[5] Consultation Paper 181*: Retail trading in Commonwealth Government Securities*, ASIC, July 2012.

- ASIC's work in this space also extends to the education of retail investors to promote confident and informed investors, and we have developed an investor guide on investing in corporate bonds.

I would like to reiterate that while ASIC recognises the importance of assisting recovery of markets, we favour a balanced approach and are mindful of extending disclosure exemptions of reducing directors' liability too broadly.

Other ASIC work

ASIC has also been involved in other areas of work which indirectly promote the restoration of confidence in securitisation markets, for example, through our regulation of credit rating agencies and credit providers.

Credit providers

Credit providers came under ASIC's regulation in July 2010 following the introduction of new responsible lending obligations under the *National Consumer Credit Protection Act 2009*. These obligations are intended to raise standards in the consumer credit industry, and include:

- making reasonable inquiries into a consumer's financial situation;
- taking reasonable steps to verify a consumer's financial situation; and
- assessing whether the consumer will be able to comply with their financial obligations under the proposed credit contract without substantial hardship.

ASIC's Regulatory Guide 209 *Credit Licensing: Responsible lending conduct* assists industry in understanding the responsible lending obligations.

ASIC has also undertaken a number of targeted reviews of the responsible lending practices within industry, including our 2011 review of the conduct of 18 mortgage brokers, particularly with respect to 'low-doc' residential loans. A further review of how credit providers in the home lending market are meeting their responsible lending obligations is currently in its early stages, with a public report scheduled for release in 2013.

Another area of work which indirectly assists the restoration of confidence in securitisation markets is ASIC's action against fraudulent loan applications.

ASIC has seen some falsification of documents in connection with loan applications, with offenders in the majority of instances being brokers who have created and submitted false documents in support of loan applications to lenders.

Since 1 July 2010 ASIC has banned three finance brokers from engaging in credit activities as a result of fraud or misconduct relating to information provided in loan applications, and has 17 ongoing matters concerning similar alleged conduct. Possible outcomes may be bannings and criminal charges.

Credit rating agencies

ASIC and Treasury reviewed the regulatory settings for credit rating agencies (CRAs) in mid-2008.

To strengthen regulation of CRAs and increase ASIC's oversight of the Australian operations of these global businesses, from 1 January 2010 ASIC required CRAs to hold an Australian Financial Services (AFS) licence.

As AFS licensees, CRAs are required to comply with the general licensee obligations that go to integrity and consumer protection. In addition, CRAs must comply with specially tailored licence conditions that, among other things, require compliance with the IOSCO *Code of Conduct Fundamentals for Credit Rating Agencies* (PDF 191 KB) and the annual lodgement of a compliance report with ASIC.

The IOSCO Code is comprised of measures designed to improve:

- the quality and integrity of the rating process;
- independence and management of conflicts of interest;
- transparency and timeliness of ratings disclosure; and
- the protection of confidential information.

Built on the foundation of the IOSCO Code, Australian regulation of credit rating agencies is consistent with global regulatory standards. Both the European Securities and Markets Authority (ESMA) and the European Union have confirmed that credit ratings issued in Australia are endorseable for use for regulatory purposes in the EU, having found Australia's CRA regulation to be at least as stringent as that in the EU.

Conclusion

In conclusion, while ASIC has limited powers with respect to wholesale markets, we remain actively involved in work to assist the recovery of Australian securitisation markets:

- primarily through our participation in IOSCO's reform work, and our relationship with the ASF; but also
- through our work in facilitating retail investment in corporate bond markets; and

- our oversight of CRAs and the lending practices of credit providers.

Through our active involvement in global regulatory reform work we seek to ensure that there are no unintended detrimental regulatory outcomes for the Australian market.

There still seems to be some way to go, particularly with respect to a global position on risk retention, and we expect to have more guidance on this with the release of IOSCO’s recommendations by the end of this year.

And through our relationship with the ASF, we will continue to encourage the establishment of an appropriate "self-regulation" framework to position the Australian industry as "best practice" amongst its global peers.

The common goal is, and will remain, that investors can have confidence in securitised products, that the risks are both reasonable and reasonably disclosed, and that securitisation can then be an effective contributor to economic growth.

Thank you for your time today.