

## Securitisation News Q3 2004

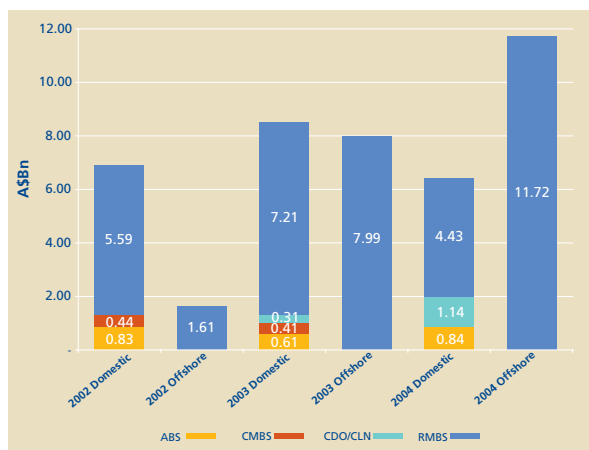
### Something old, something new

Mark Copping\* looks at the performance of the Australian securitisation market during Q3 2004. He notes the continued dominance of RMBS volumes and identifies some significant new asset classes that are finally beginning to raise their profile.

Despite the spectre of regulatory and accounting changes casting a growing shadow over the global securitisation market, Australian issuance levels continued unabated in the Q3 2004. Whilst RMBS once again took the lion's share of issuance in the period, several newer asset-classes, many that have been touted for some time as the next big thing, made a significant contribution.

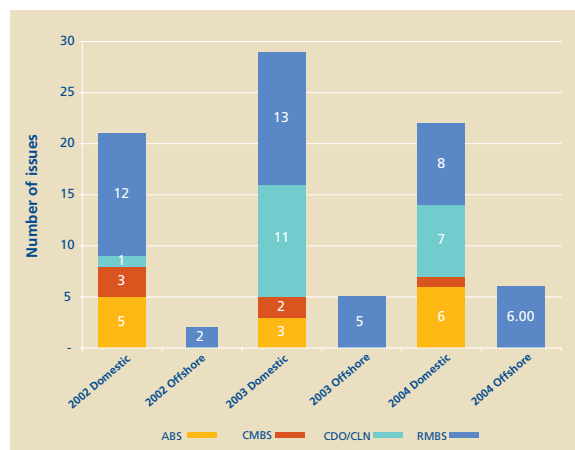
In the Q3 2004 issuance was roughly in line with 2003 figures. This is a good achievement given recent negative impacts on the market including the uncertainty in housing loan origination volumes. Issuance in Q3 2004 was in the order of \$18bn. It comprised of 28 deals with the RMBS dominating breakdown by asset-class. See the following charts:

Q3 2002 – 2004 Issuance by A\$



Source: Standard and Poor's

Q3 2002 – 2004 Issuance by no. of deals



### Prime RMBS – keeping the scoreboard ticking over

Once again, RMBS dominated the Q3 2004 issuance volumes with A\$16bn and 14 issues comprising 89% of total issuance by value. The regular prime RMBS issuers again brought the majority of the deals to market with National Australia Bank, Macquarie Securitisation and St. George Bank all featuring. These volumes were achieved in the face of inconsistent housing finance levels with many potential borrowers waiting on the sidelines for a clear signal on house prices and interest rate rises.

### Some new faces

Also of interest in the period were the number and type of non-RMBS asset classes that were brought to market. Market commentators have been talking up newer ABS asset classes for a number of years but until recently there was limited follow-up.

DaimlerChrysler (auto receivables, A\$500m), Bank of Queensland (auto and equipment receivables, A\$223m), and Elderslie (equipment receivables, A\$25.3m) brought in the diversity to the current market which had become accustomed to a diet of prime RMBS and larger CMBS transactions.

Small ticket (SME) CMBS continues to receive positive feedback from market participants with IMB bringing an A\$233m deal to market with earlier in 2004. We are also aware of further speculation around certain other major financiers seeking to get a foothold in this apparently growing market.

### The way ahead

The jury is out on whether this uplift in non-RMBS asset classes is the beginning of a new wave of issuance in the Australian market or whether it is in fact a mere blip on the investor's radar. The key to any new asset-class gaining traction in the current market is liquidity. A deep and liquid market is likely to translate into greater seasoning and a better understanding of the asset-class performance which should flow through into tighter pricing.

Along with all market participants we will be watching the performance of these new deals with keen interest.

\* Mark Copping is a Associate Director in Corporate Finance

# International Financial Reporting Standards

Global discussion has continued throughout the year on the proper interpretation of securitisation accounting embodied within the IFRS framework. It is scheduled to be adopted in Australia from 1 January 2005. Stephen Gustafson\* looks at the critical issues, examines some of the detail and outlines some of the approaches the industry is taking.

IFRS provides guidance on two issues that are critical to the question of off balance sheet accounting: consolidation of Special Purpose Entities (SPEs) and derecognition of financial assets.

Consolidation of SPEs has long been a source of debate in Australia. However it is increasingly accepted that the IFRS based interpretation on the issue will be adopted in Australia. This will mean many existing securitisation vehicles, currently accounted for off balance sheet, will come on balance sheet under IFRS.

## Capital treatment for securitisation

Whilst this accounting change will gross up the balance sheets of many financial institutions, the issue causing greater market concern is the resultant capital treatment for assets likely to be accounted for on balance sheet.

As APRA's prudential guidelines require off balance sheet accounting treatment in order to receive capital relief, a likely change in the accounting interpretation calls into question the future capital treatment in respect of these assets. Recent pronouncements from APRA suggest capital relief will remain linked to accounting treatment under current Australian accounting interpretations, but that further evaluation of the capital relief criteria will be undertaken in the coming year.

## Derecognition of financial assets

Whilst the consolidation accounting issue has had full public debate over a number of years, the new rules for derecognition of financial assets are possibly more perplexing. No such guidance currently exists for securitisation transactions in Australia and the new rules are proving difficult to interpret.

New IFRS requirements introduce a decision tree to guide users through different tests to determine the proper accounting treatment. See this decision tree and the resultant accounting outcomes opposite.

***This test highlights a common theme of the new framework: an increased need for detailed modelling to justify accounting decisions.***

## Risks and rewards

The concepts of the transfer of risks and rewards are central to the derecognition criteria introduced by IFRS. To evaluate the transfer of risks and rewards it is necessary to compare the entity's exposure, before and after, with the variability in the amounts and timing of the net cash flows of the transferred asset. If the present value of the cashflows is not changed significantly then the entity has substantially retained all the risks and rewards. This test highlights a common theme of the new framework: an increased need for detailed modelling to justify accounting decisions.

Where all the risks and rewards are neither substantially transferred nor retained, then a secondary test is critical to evaluate the proper accounting treatment. This involves an assessment of 'control' over the assets, assessed by reference to who has the capacity to sell the assets.

Should control be retained by the institution in question, then a continuing involvement accounting model is adopted. This model is still not absolutely clear and it will be the subject of considerably more debate.



### Some of the issues

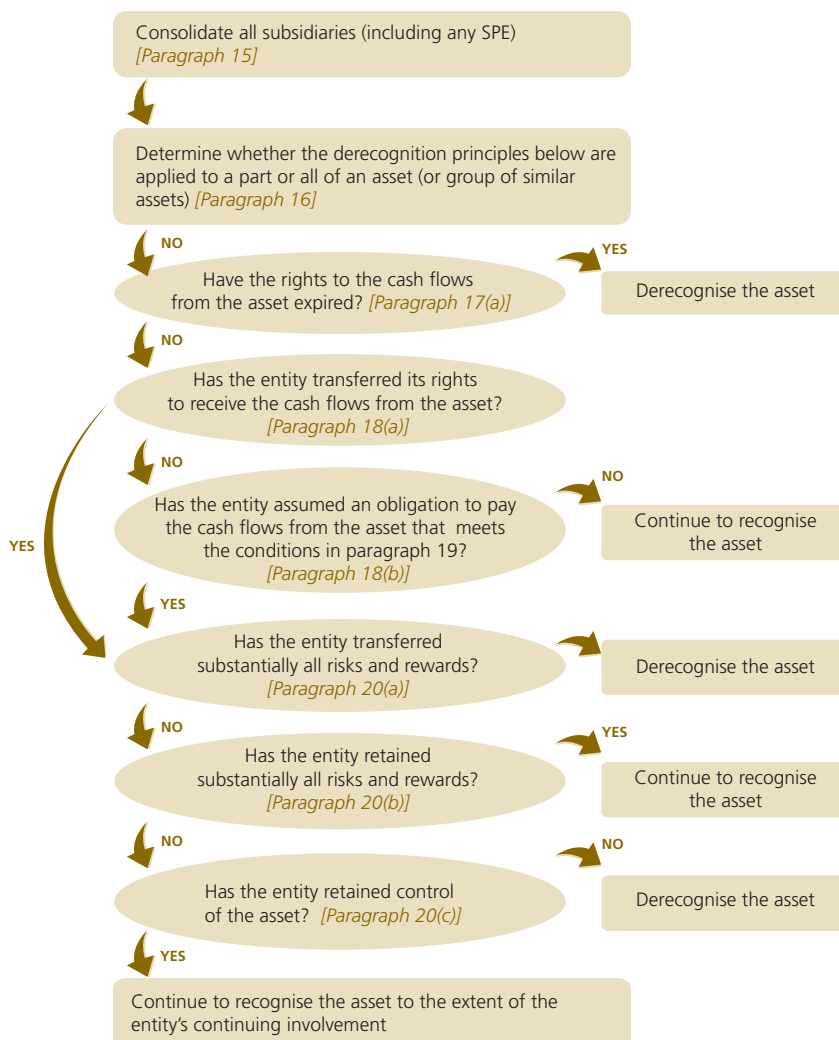
The Australian Securitisation Forum has been active in attempting to influence the direction of securitisation accounting, as well as gain greater clarity as to the proper interpretation of the new derecognition rules. Just some of the issues raised directly with IFRIC by the ASF include:

- what constitutes the transfer of 'substantially all' the risks and rewards
- do equitable assignments qualify as transfers
- how should the modelling required to underpin this analysis be performed
- how is the continuing involvement accounting model to be applied.

### Global securitisation framework

In addition to these efforts, a Global Securitisation Accounting Convergence Committee has been constituted to bring together representatives of the Australian, American and European Securitisation Forums. The long term goal of this committee is to influence the direction of a single global securitisation accounting framework. Given existing confusion over the IFRS rules, and the divergence of this model from existing US accounting guidance, the challenges ahead of this group are great.

*\* Stephen Gustafson is a Partner in Assurance and Advisory*



# GST and securitisation

Elizma Bolt\* looks at the ATO's surprise ruling on GST which is impacting the many institutions in Australia that offer debt securities backed by a wide variety of assets including residential mortgages, commercial property loans and trade receivables.

Most entities that entered into securitisation arrangements thought they had the GST of the many implications under control. That was until 26 May 2004, when the Australian Taxation Office released a final ruling, GSTR 2004/4, on the application of the GST to securitisation arrangements.

In this ruling the ATO states that acquisitions that relate to the establishment of securitisation programs, that is the setting up of Special Purpose Vehicles, normally a Trust and the drafting of Trust deeds, are directly attributable to the assignment to the payment stream of the SPV. This means any GST incurred on these costs would be irrecoverable.

## In our opinion

The ATO's view that the set up costs are directly attributable to the initial input taxed assignment of the payment stream, fails to take into account that the originator, in its capacity as the manager and servicer, will also generate taxable income, i.e. the management and servicer fees.

Hence it appears inequitable to allocate the costs solely to the input taxed assignment of the payment stream.

**Some form of apportionment for GST recovery on the set up costs would appear more reasonable.**

## Servicer fees

A second and important issue with GSTR 2004/4 relates to the recoverability of the GST incurred by the SPV in relation to the servicer fee.

The ATO's opinion is that the GST incurred on the servicer fee is only recoverable as a Reduced Input Taxed Credit on the basis that the servicer fee relates to debt collection services under Item 17 of Regulation 70-5.02.

This means that the ATO seeks to further restrict the recoverability of GST incurred. The result of this is an increase in the cost of the SPV and the interest rate payable by the debtor.

The ATO position on servicer fees was a surprise. It was contrary to the position taken in the draft of the ruling GSTR 2003/D6 which was open to comment by the industry and its advisers.

## Submissions

Various submissions have been put to the ATO requesting a review of the ruling. These submissions put the case that to recover GST on some portions only of the servicer fees is contrary to the original intention of the Reduced Input Taxed Credit legislation which was aimed at avoiding a bias against outsourcing.

We also argue that all components of standard servicer fees do actually fall within various RITC items of the GST regulations.

## Under discussion

At this stage the ATO has indicated that it is aware of these concerns and that it will enter into further discussion with industry representatives to clarify the matters.

*\*Elizma Bolt is a Partner in Tax Services*



# Managing reverse mortgage risk

Paul Swinhoe\* looks at the emerging reverse mortgage product, its risks and how to mitigate them with sophisticated modelling techniques.

Australia is on the verge of a boom in the supply of reverse mortgage products. An aging population, significant increases in property prices, low fixed interest returns and ever increasing life expectancy mean that the market is now ripe for the increased use of this product.

Also known as home equity release schemes, or home income plans, a reverse mortgage enables a home owner to receive a lump sum payment and/or income stream. These payments to the home owner represent loan payments which accrue with interest until the owner moves house or dies.

At this point the accumulated loan is repaid from the proceeds of the house's sale. Because of its structure the reverse mortgage can be very relevant for asset rich, cash poor individuals and offers a way for retirees to supplement their income.

## The risks

The risks associated with offering reverse mortgages should not be underestimated however, especially when contracts may last for anywhere up to 30 years or more.

To avoid a loss, the lender must attempt to make certain that the accumulated amount owed does not exceed the house value. Future interest rate variations are a risk. The amount owed to the company may grow substantially if interest rates are greater than anticipated, due to the compounding nature of the debt.

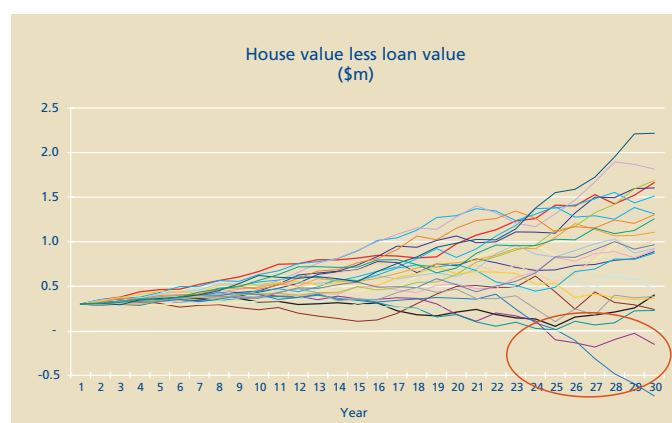
On the asset side of the equation, if house prices were to fall or remain static over an extended period of time, lenders are again exposed to loss.

Other risks such as increasing longevity coupled with remaining in the family home, bad publicity, fraud and the level and accuracy of customer advice, should not be underestimated. The UK reverse mortgage market is only now recovering from the misselling of products in the 1980s.

## Managing with modelling

There are various methods lenders and others can use to manage these risks and remain profitable. Modelling the financial contract, especially those that run over long periods of time, is a key strategy to minimise the possibility of losses.

By using 'what if' scenario testing, it is possible to identify the financial consequences of changes in the economic environment.



The benefit of doing stochastic projections. In the real world house prices and interest rates vary unpredictably over time. To account for this volatility thousands of financial simulations are performed. While the majority of simulations show that the lender's debt is fully covered, a number of simulations have led to losses. By conducting a stochastic analysis the lender can adjust their product pricing to the level of risk they are willing to accept.

See the above diagram to consider how with the use of stochastic modelling techniques and economic models, the implications of product design can be determined while taking into account the interaction of interest rate cycles, property price cycles and improving mortality. Furthermore, these techniques can be extended and used in the valuation of a portfolio of loans and in determining capital requirements.

## Future developments

This is a new market that will continue to develop. We foresee growing complexity as competition increases. A strategic approach to the product incorporating the learnings on how it has been introduced and received in other markets – those successes and pitfalls – is important. And the use of sophisticated modelling processes to manage the variables that influence the success of reverse mortgages and ensure they meet the aspirations of both borrowers and lenders are just two of the strategies that are needed to mitigate the risks.

This is a product that has a niche to fill in a lender's portfolio in an increasingly discriminating market that has much value tied up in retaining its long term borrowers.

\* Paul Swinhoe is a Partner in Actuarial and Insurance Services.

# Australian student loans – Taking securitisation back to school

Mark Copping\* looks at the vexed issue of student loans and using the US as a benchmark asks two key questions. Can you sell the loans to students? Can you sell the notes to investors?

## The context

In addition to soaring admission scores and competition for places, Australian University students are also facing the prospect of a mountain of debt at the end of their years of study. One answer may be the establishment of a student loan market funded through securitisation which is a proven model in the US. If done correctly, this could have the positive effect of providing a life-line to HSC students making the leap into university life and creating a sought-after asset class for investors hungry to diversify away from the traditional securitisation asset-classes.

As Federal Government reforms clear the way for universities to increase the repayment to the Higher Education Contribution Scheme, HECS, on courses by a further 25 per cent from 2005, there are growing liabilities for university tuition across the country. This is in addition to allowing for more full-fee places outside of the HECS program.

Under the recently proposed higher education reform package, about one-third of university places will be reserved for full-fee paying students who will need to privately fund their tuition fees. This may well run into tens of thousands of dollars.

## The HECS program

Students typically qualify for a HECS place through their HSC score or through their existing university results. The HECS program enables students to accumulate a debt whilst studying and then gradually paying off the deferred university fees through their personal income tax when their incomes reach a threshold, which in 2003-04 was set at \$25,347.

In certain cases a student may be eligible for a full-fee paying university position which they would typically fund through the assistance of family members or through a personal loan. With an increasing number of full-fee paying places becoming available, the dilemma facing students is whether to take a HECS place in a non-preferred course, hoping to transfer into a HECS place in their preferred course, or to bite the bullet and fund the preferred course from the outset.

Students are increasingly looking for flexibility and options in order to pursue their career and lifestyle ambitions and are increasingly looking to the financial markets to provide them with solutions.

## The US model

Since its inception in 1965, the secondary education student loan market in the US expanded due to greater increases in the cost of higher education relative to the general inflation rate.

At current levels the US college loan market is around A\$74 billion, A\$65 billion of which is funded through federally guaranteed loan programs with the balance A\$9 billion funded privately. Market observers in the US are touting 20% growth rates in the privately funded student loan industry over the next few years.

Within the US, there are three types of students loans used to finance post-secondary education — FFELP loans, direct loans and private loans. FFELP loans are guaranteed at 98% or 100% of principal and accrued interest, depending on origination date, by an eligible guarantor and reinsured by the US Department of Education up to the same amounts. Direct loans are funded directly by the government to the student. Private loans do not have a federal guarantee, but may be self-insured or guaranteed by a private loan guarantor, insurer, or surety bond provider.

## Securitising student loans in the US

In the US, unlike the current situation in Australia, student loans are initially financed through the commercial banking system. The originating bank's strategy is to either hold the loans on balance sheet or sell them to a special purpose corporation, where they earn an initial premium in addition to the net present value of the cash flows over the life of the transaction. If the banks sell the loans to the secondary market, the secondary usually finances the purchase with warehousing lines of credit or commercial paper in the short term and, subsequently, with long-term debt financing.

Until 1993, most of the debt issuance in the US was through the secondary markets, either using a senior/subordinate structure, wrapping the transaction using a monoline insurance company, or using a fully supported structure with a direct-pay letter of credit or a standby bond purchase agreement. Subsequent to the relaxation of the Investment Company Act of 1992, which allowed for the securitisation of student loans, this market has grown significantly. Banks which once sold their student loan portfolios to the secondary market began securitising their holdings.

***An answer could be the establishment of a student loan market funded through securitisation – a proven model in the US.***

## Loan structure and performance

Regardless of the loan type, the borrower is obliged to pay principal and unless subsidised interest. However, the timing of interest and principal payments can vary according to the loan type and the borrower's status.

A student loan can be classified into one of the following four stages over the course of its life:

**In school:** This is the time period before the eligible borrower's graduation or departure from school. No principal is required to be repaid and interest is either government subsidised or allowed to capitalise.

**In grace:** Generally a six to 12 month period from graduation.

**In repayment:** This is the time period during which the borrower makes interest and principal payments on the loans.

**In deferment:** This is the time period after repayment has begun, in which the eligible borrower may suspend interest and principal payments. Most deferments last up to three years.

As with many other asset classes, credit risk analysis on student loans focuses on two elements: default frequency and loss severity.

The frequency of defaults experienced by a student loan pool have been shown to depend primarily on loan type, school type, seasoning, and regional economic conditions. In general, differences in default frequency are caused by the relative ability of the student to achieve gainful employment following graduation.

Students attending certain schools stand a better chance of obtaining better paying jobs than their counterparts at other schools. For instance students at four year institutions have generally better credits than students attending two year institutions, while proprietary school students generate the highest default frequency.

## Would the US model work here?

With Australian students facing the increasing likelihood that they may be required to fund their university tuition, the question is would the US securitisation model work here? And if so, who would take up that demand?

From an investors' perspective, the lack of historical data on the performance of these loans in the Australian market and the initial low levels of liquidity compared to RMBS/CMBS notes would be an issue. However, this may be compensated by the ongoing demand from investors for new asset classes.

The demand from students is likely to be a function of the pricing and the features that could be built into the loans including flexibility in the repayment profile. If a financier can strike a balance between these two elements then there is likely to be an opportunity to tap into what may become a growing market.

So the challenge is there for a financier who can use the US model as a guide and create a new market in this country.

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