CAPITAL MARKETS — FUTURE DIRECTIONS IN SECURITISATION

Commentary

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INTRODUCTION - EVOLUTION

As Nancy Fox's paper emphasises, the financial markets are constantly evolving. Today there is an increasing emphasis in Australia on securitisation as a financing technique.

Securitisation is not a new financing technique. Most commentators trace the history of securitisation to the development in the United States in the late 70s of the mortgage-backed security market. However, the original deals linking small unmarketable loans with a broader capital market were made in Silesia over 200 years ago.

Sliesia was financially devastated following the seven years war between Austria and Prussia. Because owners of land in Sliesia needed credit, but lacked access to funds, the Prussian Government organised the land owners into something known as a "landschaft". Under the "landschaft" scheme a member could issue a mortgage bond representing up to half the value of his estate. He was responsible for selling the bond, but it was collaterised by both his own land and the estates of all landschaft members. The borrower paid a fixed rate of interest to the landschaft which in turn remitted payments to the bondholders. A transaction which is not unlike a modern securitisation structure.

Although in the early 1980s securitisation as we now know it was principally, if not solely, an American financing technique, since those days its practice, or at least the desire for its practice, has spread to most financially sophisticated countries, including Australia. Securitisation, by whatever name it might have been known, has been around for a long time. It appears to be here to stay and we should look forward to the directions the market is likely to take.

STRUCTURES

The early architects of securitisation structures in Australia discovered that the legal structures that had worked (and continue to work) so well in the United States do not travel with the same ease as the economic rationale and financial aims for securitisation. In the early years this led to sceptics concluding that securitisation could not be done in many jurisdictions because of the absence of an appropriate legal framework. Without wanting to understate the legal difficulties in putting together a securitisation, experience suggests that it is usually possible to find a legal framework in most jurisdictions within Australia which will suit the commercial aim of those who wish to securitise assets, of whatever nature.

SPECIAL PURPOSE VEHICLES

One of the greatest areas of growth and innovation in the United States is the creation of special purpose vehicles which issue commercial paper to invest in short-term financial assets of all kinds. Recently we have seen the birth of this type of vehicle in Australia.

The variety of financial assets which can be securitised is exceedingly broad and the best structure for securitising any assets will vary greatly depending upon their nature.

It is probably true to say that the essential purpose of any securitisation structure is the same, that is to provide a framework to isolate the financial assets being acquired from the claims of parties other than investors and, which after payment of investors and credit and liquidity providers, will permit a timely transfer of payments from the underlying obligors to investors.

VARIETY OF ASSETS

The packaging of portfolios can create securities particularly suited to the needs of investors be they credit, rate or maturity related. In many cases, the securitised investments will be more marketable and attractive to investors than the underlying assets which support the structure. Almost any asset which generates a regular income stream can be securitised.

The most common form of asset which has been securitised to date in Australia is residential mortgages, although large markets have been created overseas in a wide variety of assets.

Although we are only just starting to see a definite trend towards asset backed securitisations in Australia as a financing technique which has enormous growth potential, some examples of assets which have been successfully securitised overseas are:

- real property mortgages
- shopping centres
- loan receivables
- credit card receivables
- equipment lease receivables
- chattel lease receivables
- aircraft lease receivables
- boat and mobile home loans
- income-producing real estate
- export financing receivables
- trade receivables
- instalment sales contracts

- royalties from films
- receipts from junk bond exposures
- telephone accounts and time-share cash flows
- health care receivables
- insurance premiums

The markets for non-mortgage asset backed securities in Australia are still virtually untapped, despite the large amounts of receivables from credit cards, car loans and leases which are outstanding.

If securities backed by assets such as these can be tailored to the needs of investors and with the appropriate credit enhancements in place, there is no reason why a market for securities backed by assets other than mortgages cannot be promoted along the same lines as mortgage backed securities.

REGULATORY IMPEDIMENTS

Mark Wormell's paper considers a few of the regulatory hurdles in the form of the Reserve Bank of Australia capital adequacy considerations and the soon to be introduced new Consumer Credit legislation. In addition to these areas there are still a number of other continuing obstacles and hurdles which need to be overcome to expand the development in the Australian market both in the mortgage and non-mortgage backed area.

As Mark points out in his paper, to date, issues of securitised instruments to investors have taken advantage of the exemptions under the *Corporations Law* of the "excluded offer" or "invitation" provisions. The Corporations Law Committee of the Australian Securitisation Forum is currently examining a number of possible regulatory reforms, including what would be needed to enable securitisation programmes to issue to the public. A good example of how the evolution of securitisation in the financial markets has outstripped the existing provisions of certain legislation, such that the legislation becomes unworkable when applied to these products, is found in the *Corporations Law.*

Corporations Law

As Nancy indicates in her paper, securitisation structures often take the form of debt securities issued by a trustee of a trust. Assume that you wish (as I understand occurs in the USA) to offer these highly rated debt securities to "the public" - can you do so? The answer is, not without real difficulty, and, even then, the existing provisions of the legislation are clearly not designed with this type of product in mind.

The underlying, and still unresolved, issue remains to what extent are such debt securities unique: requiring either the introduction of new provisions to the *Corporations Law* or modification of the existing provisions in the light of their unique characteristics.

Debentures versus prescribed interests

In the ASC's 1992 Draft Policy Statement "Debt Securities Issued in the Context of Unit Trusts", the ASC recognised that the debenture and prescribed interest provisions of the *Corporations Law* do not specifically address the situation where debentures are issued by a trustee on behalf of a trust. The ASC in opposing the recognition of these type of debt securities as debentures under Division 4 forwarded a restrictive definition of "debenture" which I think ignores the unique characteristics of these debt securities.

Debentures and prescribed interests are mutually exclusive under their respective statutory definitions. Debentures are excluded from the definition of "participation interest" and therefore the definition of "prescribed interest". The prescribed interest provisions in Division 5 of Part 7.12 are more onerous than Division 4, and are designed to encompass a far broader range of investments.

However, the ASC took the view that the term "debenture" is limited to securities where there is an **unlimited obligation** by a party to the issue (either issuer or guarantor) to repay a loan or deposit OR (emphasis added) where the money is borrowed or received by the body corporate **in its own right**.

Definition of debenture

Determining the meaning and scope of the term "debenture" is one of the more vexed questions within the law of security. The High Court in *Handevel Pty Limited v Comptroller of Stamps (Vic)*[1] acknowledged that the word "debenture" lacks a precise meaning. But Mason, Wilson, Deane and Dawson JJ said:[2]

> "However it has been generally agreed that two characteristics of a debenture are, first, that it is issued by a company and, secondly, that it acknowledges or creates a debt".

The exhaustive statutory definition under section 9 of the Law is:

> "A document issued by the body that evidences or acknowledges indebtedness of the body in respect of money that is or may be deposited with or lent to the body, whether constituting a charge on property of the body or not, other than (a specific list of exceptions which are not relevant to this paper)".

Clearly, while the essential features of the debenture have been identified as being an acknowledgement of indebtedness and the covenant to pay or repay, there are many borderline cases.

Operation of Division 4

When analysing the meaning of "debenture", it is instructive to consider the conceptual basis of the current regulatory framework for the issuance of debentures.

As holders of debt securities, debenture holders are exposed to risks of non-repayment; a risk intimately tied to the performance of the borrowing company. Where a limited liability company issues debt securities, Division 4 requires the creation of a trust deed between the company and a non-related trustee (section 1052(5)). Specifically, this deed outlines the rights of the debenture holders and the powers and duties of the trustee as well as the obligations of the borrowing company in an effort to minimise risk exposure for debenture holders (see section 1054 for specific covenants).

The appointment of an independent trustee ("Lender's Trustee") under a trust deed is one of the central protections for debenture holders against risks of abuse by the borrowing company.

In all cases there is considerable advantage for the debenture holders to be represented collectively by a Lender's Trustee for the purposes of:

(a) negotiating the terms of the trust deed;

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1 (1985) 157 CLR 177.

2 At 195.

(b) keeping the borrowing company's activities under surveillance and supervising its compliance with the terms of the borrowing (including restrictions on its borrowings and liabilities); and

(c) enforcing guarantees and charges and otherwise taking steps necessary to obtain repayment of the loan or payment of the interest, if necessary.

The role of the Lender's Trustee is determined by the terms of the trust deed provisions, which provide for the following to be included in the deed:

- the trustee's powers as against the borrowing company and its guarantors;
- the trustee's duties, rights and discretionary powers in relation to the debenture holders; and
- the rights and powers which the trustee is to have against the borrowing company (and, where applicable, against its guarantors).

Overall, the Lender's Trustee acts in two distinct capacities:

(a) on the one hand, as between itself and the borrowing company it is the secured creditor, a mortgagee, and, because of the existence of the borrowing limitations and the paraphernalia which accompanies them, the general watchdog in relation to the company's affairs; and

(b) on the other hand, the Lender's Trustee is a trustee for and the nominated representative of and the protector of the interests of the debenture holders who can be bound by many of the trustee's decisions and over whose investment with the borrowing company the trustee has a very large measure of control.

As Austin and Vann recognise,[3] a Lender's trusteeship involves a careful weighing of interests (ultimately, in favour of the debenture holders):

> "Experience in administering debenture trusteeships appears to have developed a professional attitude amongst the more active trustees in which a supervisory approach is well-tempered with the recognition that the borrowing company must be left as free to manage its own affairs as is compatible with the due protection of the interests of the debenture holders".

The rationale underlying section 1052 is the need to protect debenture holders (investors) from substantial compromise of their interests by the trustee. As was raised in the ASC draft policy statement of 1992 entitled "Debt Securities issued in the context of Unit Trusts" ("Statement"):

> "The ASC considers independence ... fundamental to the regulatory regime ... under Division 4, clearly differentiating the interests of holders of debentures from the members of a corporation".

In requiring that a Lender's Trustee not be related to the borrowing corporation, the regulators have imposed an appropriate requirement on **limited liability companies** issuing debt securities. For a limited liability company the appointment of an non-related Lender's Trustee is a means of ensuring that debenture holders interests are not tainted by the "affairs" of the company (ie conflicting directors duties to shareholders).

However, the underlying nature of a special purpose Trust (whether or not a unit trust), the trustee of which issues Bonds or Notes to finance a securitisation is quite different from a limited liability company who raises finance by the issue of debt securities. The provisions in the *Corporations*

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3 *Law of Public Company Finance* (1986) at page 302.

Law regulating the issue of debentures are not designed to cope with securitisation structures involving the issue of debt by trustee companies.

Counter-arguments

The ultimate position of the ASC was to suggest that these type of securities should generally be treated as prescribed interests rather than debentures, a hybrid security, to which both debenture and prescribed interest provisions of the *Corporations Law* would be applicable.

This view necessitates reading into the definition of "debenture" in section 9 of the *Corporations Law* the words "in its own capacity". I am not aware of any judicial authority which supports such interpretation. Moreover, judicial authorities support the view that the definition of "prescribed interest" should be interpreted literally (not liberally); thus on a literal interpretation of the definition, I consider that the securities proposed to be issued are clearly **NOT** prescribed interests.

"In its own right"

Whilst a trust itself has no separate legal personality, the debts incurred by a trustee are the personal debts of the trustee although, in practice, the trustee's liability is limited to the assets of the trust. However, the trustee will always be liable for any debt incurred. There is a wealth of authority on this issue; see Latham CJ in *Vacuum Oil v Wiltshire*[4] "In respect of debts incurred by him in so carrying on the business he [the trustee] is personally liable to the trading creditors - the debts are his debts". Clearly, where a security otherwise falls within the definition of "debenture", the fact that the security is issued by a body corporate in its capacity as trustee does not alter the underlying nature of the security, given that the trustee will always be personally liable for the indebtedness represented by the debenture.

It is worth remembering in the context of this debate that similar mortgage-backed securities issued by a corporate trustee have long been recognised by the Insurance and Superannuation Commission, the Australian Taxation Office and the Office of State Revenue of New South Wales as debt securities (although admittedly in different statutory contexts).

Unlimited recourse

The very nature of a limited liability company is that the liability of the company is limited and that, as a general rule, shareholders' assets are not available to meet the liabilities incurred by the company. I see no difference between this situation and the situation where a trustee issues debt limited in recourse to the assets of the trust. Also limited liability companies can (and do) regularly issue debt ("debentures" within the meaning of the *Corporations Law*) limited in recourse to particular assets. Again, how can a distinction be drawn between these situations and a trustee issuing debt limited in recourse to the assets of the trust?

There is one further point which should be raised. The Commission is obviously of the view that debt securities issued by a limited liability company would be "debentures" even if that company had little or no assets of its own.

Appropriateness of Division 4

The following analysis outlines the arguments in favour of the recognition of such debt securities as "debentures" under Division 4, subject to certain modifications and the inappropriateness of imposing the specific debenture approved deed provisions contained in Division 5 of Part 7.12 of the *Corporations Law*. This analysis reveals the manifest need for the introduction of new, or

4 (1945) CLR 319 at 324.

carefully modified, provisions to clarify this area of securities law. Clearly the impending introduction of new legislation following upon the Collective Investments Review may have an additional impact upon this debate.

Many of the provisions contained in Division 4 regulating public offers of debentures are difficult to reconcile with a securitisation structure. Consequently one option that regulators should consider is the granting of certain exemptions to Division 4 in order to achieve a commercially appropriate regulatory framework. For example:

- The debenture provisions of the *Corporations Law* focus on the assets of the company who issues the debt. The personal assets of a trustee who issues debt limited in recourse to the assets of the trust are clearly irrelevant to debenture holders.

- The debenture provisions in the *Corporations Law* require a separate independent trustee to be appointed as trustee for debenture holders. (See for example sections 1022, 1028, 1043B, 1043D, and corresponding regulations, 1054(1) and (3), 1056, 1058 and 1060). The role of a debenture trust deed (or security trust deed) in a securitisation structure is usually to provide a "fall back" position in the event that the trustee's right of indemnity is not available. The role of such a document provides quite a different level of protection from that contained in the *Corporations Law.* It is the trust deed establishing the securitisation trust which provides most protection to investors in the debt securities.

- Section 1045 of the *Corporations Law* sets out a number of descriptions which may be used in relation to various classes of debentures. Many of these descriptions are not appropriate for a securitised instrument.

- A typical securitisation structure using trust usually includes a manager and trustee, whose responsibilities are divided along the lines of the responsibilities in a typical public (or non-public) unit trust. The debenture provisions of the *Corporations Law* do not reflect these provisions. Some of the statutory responsibilities of the trustee would be better if they were performed by the manager (for example, sections 1021(13), 1023, 1030(6), 1047, 1048, 1054, 1058 and 1060).

In the past the ASC has indicated that it will consider modifications to the requirements of Division 4 on the basis that the bonds are to be issued as listed debt instruments and that they comply with the Australian Stock Exchange listing requirements. It is unlikely that bonds of this nature will be listed. Therefore, under the present regime, if an issuer wishes to offer these securities to the public, it will be required to satisfy the requirements of both Division 4 and Division 5 of the *Corporations Law*, which is clearly impractical.

Other regulatory impediments

Briefly, there are still a variety of other problems which exist for potential securitisers:

- Some restrictions remain which prohibit investors (such as trustees of superannuation funds) from investing in mortgage backed or asset backed securities. For example, the relevant trust deeds may prohibit such investment, even if the *Trustee Act* in the appropriate jurisdiction would otherwise allow investment).

- Legislation such as the *Privacy Act* can have the effect of compromising access to financial data that might be required to ensure that there is full information on the security backing of the bonds or notes.

- Stamp duty is relevant to each stage in a securitisation transaction. Some exemptions exist in New South Wales and Victoria for mortgage-backed securities, however these exemptions are not uniform and in any event are of limited value where mortgage assets are located in all jurisdictions.

- Uncertainty has arisen relating to securitisation structures which involve a trustee of a trust issuing asset backed debt securities. For example:
  - can a trustee validly issue a promissory note within the meaning of the *Bills of Exchange Act* when recourse is limited to the assets of the trust?
  - can a trustee company hold debt securities in its capacity as trustee of one trust where these securities were issued by it in its capacity as trustee of another trust?
  - is it appropriate for investors in debt securities issued by the trustee of a trust to be reliant upon repayment upon the trustee's right of indemnity out of the assets of the trust, particularly in light of contradictory cases relating to the circumstances in which that right of indemnity can be prejudiced or destroyed?
- Last, but not least, our complex taxation regime means that any securitisation has to be structured having regard to taxation problems and, on occasions, there may be no simple taxation solutions.

Accounting treatment

In terms of accounting treatment, the trend in Australia and the rest of the world is towards restricting of balance sheet accounting which diminishes the attractiveness of securitised structures. However, as Nancy Fox has outlined in her paper, there are still good reasons to securitise.

RECENT TRENDS IN AUSTRALIA

So what has been happening recently in Australia?

In the last couple of years, there have been some interesting new developments.

Mortgage backed securities

Into the mortgage securitisation market have come an increasing number of private mortgage backed security issuers, such as PUMA, RAMS, ARMS, SPIRS and OPAL. These issuers (with the exception of RAMS) use trust structures as the special purpose issuing vehicles. Also nowadays most of these structures are enhanced by using a senior/subordinated structure for the issue of the bonds. Generally, the subordinated bonds will be rated significantly less than the senior bonds, if in fact they are rated at all.

Citibank has successfully securitised its "Mortgage Power" mortgages through 2 separate securitisation issues known as "MP1" and "MP2".

A few months ago Adelaide Bank announced that it would be entering the securitisation market with a $200,000,000 securitisation of its residential housing loans, arranged by SBC. If (as seems likely) other banks enter the securitisation market, the future for the mortgage backed securities market in Australia will continue to grow. In the United States the mortgage backed securities market is many times larger than the entire equities market.

Asset backed securitisations

Over the last few years a number of new special purpose vehicles have entered the asset backed securitisation market. These structures are varied. Some structures link the bonds or notes to a specified pool of underlying assets, some securitise a single pool of assets only (such as the securitisation of BHP's employee loan receivables), some securitise multiple assets and some (such as SABRE) do not disclose the nature of the assets contained in the underlying pool.

The first of these vehicles was SAFE, which has been followed by a number of vehicles, such as ACE, ACE Overseas, BEST, Prime Asset Vehicle, Prime Investment Entity, SABRE, WARATAH, Rhein-Main No 4 (which securitised BHP employee loan receivables) and MAST, to name but a few.

There is potential for great growth in the asset backed securities market in Australia, notwithstanding existing regulatory impediments. The markets for non-mortgage asset backed securities are virtually untapped, despite the large amount of receivables from credit cards, car loans and leases which are outstanding. If securities backed by these assets can be tailored to the needs of investors and with the appropriate credit enhancements in place, there is no reason why a market for securities backed by assets other than mortgages cannot be promoted along the same lines as the market for mortgage backed securities.