CAPITAL MARKETS — FUTURE DIRECTIONS IN SECURITISATION

Commentary

MARK WORMELL

Allen Allen & Hemsley, Solicitors, Sydney

Nancy Fox has made it clear that while securitisation can be seen as a form of financing it also has some practical differences from other forms of financing. In the last couple of years we have seen a fair bit of growth in the securitisation market in Australia, in terms of the number of issues, the range of structures and the range of assets securitised. To date, there has been very little specific regulation of securitisation. There have been one or two limited stamp duty exemptions, the Reserve Bank and AFIC have shown some interest in securitisation, and the privacy laws have been amended to facilitate securitisation. But generally we have had to structure securitisations within the existing regulatory environment. This has not always been easy, given the range and complexity of legislation in the consumer credit area, and the ever present threat of stamp duty. Is this regulatory environment changing, or going to change?

I would like to think that the current review and rewriting of most stamp duty legislation in Australia will result in some sensible, consistent legislation that encourages securitisation. It is ironic that I should be making these comments in Queensland, given that the stamp duty regime in this state is so tough on securitisation. Queensland banks and financial institutions have every right to feel hard done by, and at a distinct disadvantage compared with their southern and western competitors. If you are wondering what I mean, consider the implications for a "Clayton's contract" in relation to a sale of assets in the light of the interaction of sections 25(1) and 54(5) of the Queensland *Stamp Act*. It is not impossible. But it is not easy.

If we do not have helpful reform of stamp duty, we can at least look to change in the regulatory environment for the securitisation of financial assets in the light of the Reserve Bank's Prudential Statement C2, and the *Uniform Credit Code*.

What I want to look at today is an issue that will have a very direct effect on the way that the securitisation market in Australia develops. That is the implications that the *Uniform Credit Code* and Prudential Statement C2 have for banks securitising their own assets. However, before I get to that I would like to raise an issue that concerns me, and will effect the development of securitisation in Australia.

ADEQUATE DISCLOSURE OF UNDERLYING ASSETS

To date there has been no retail issue of securitised paper (that is, commercial paper or notes which are funded from securitised assets). All issuers have targeted the institutional investor market, and taken comfort either from the exemptions under the *Companies Code*, or the "excluded offer or invitation" provisions of section 66 of the *Corporations Law*. This has meant that we have been able to put to one side the detailed prospectus provisions of the companies legislation, and issuers have put together simple offering circulars. I expect this will continue. Issuers will need to accurately assess what the institutional market wants to buy (in terms of tenor, spread and rating). But their major focus will remain on commercial issues, rather than legal ones. There is no suggestion at the moment that securitised paper should be treated any differently under the *Corporations Law* from any other debt security issued into the Australian capital markets.

However, in a regulatory sense, we are still feeling our way. One need only look across the Pacific, to the very much bigger and regulated US market, to see how things might develop. I think some of that regulation can be avoided by participants taking stock of some of the issues that have concerned regulators in the United States. One issue that has come to my attention in the last couple of months is the level of disclosure of the underlying assets that should be made in relation to securitised paper.

In the United States the SEC Rules require regular reporting on the nature and performance of underlying assets. This does not mean that the originator of the assets has to be identified, so that confidentiality can be maintained. But it does require the nature of the asset to be identified, and reasonably detailed reporting of the performance of the assets eg, payment history, default rate etc.

I understand that some Australian programmes have been structured on the basis that the underlying assets are not disclosed to potential investors. In fact, some potential dealers have been kept in the dark. This obviously becomes more of an issue when you have a programme where an issuer acquires a range of cashflows, rather than securitising only one type of asset. Investors are in effect being asked to buy paper on the basis of the term, price and credit rating.

Notwithstanding all the disclaimers that the rating agencies issue regarding the use to which the ratings can be put, I imagine that the rating agencies would feel a bit uncomfortable with this practice. I do not think there is anything legally wrong with this practice. It is like saying "here, buy this black box. The rating agency says that the thing that is in the black box is rated AA. That is all we are going to tell you about it." My concern with this practice is that it leads to an uninformed market. A lack of information in the market will only hinder the market and lead to possible further regulation. We will not need that regulation if a sensible approach to disclosure is taken by market participants.

Nancy defined securitisation as a "cash flow in a bullet proof vehicle with sufficient structured enhancements so as to constitute an attractive investment". I agree. My point is that investors need to know the source of cashflows and have an appreciation of the structured enhancements.

C2 AND THE UCC

There has been a fair bit of discussion about banks securitising their own assets. This will throw up the whole range of issues including customer relations, cross subsidy of products and services, compliance with accounting standards, tax, stamp duty and compliance with Consumer Credit legislation. I do not have time to go into all of these here, but I would like to make some comments.

Nancy Fox has already made the comment that if a bank securitises its assets, they will no longer be the assets of the bank. However, the bank will want to continue to count the borrower as its customer. One obvious thing here is that the bank's procedures manual which regulates the management of the asset will have to be a detailed and accurate reflection of what happens, or the bank wants to happen. If a bank has a reputation for trying to solve problems with customers, and treats enforcement only as a last resort, then no doubt the bank will want to maintain that reputation.

However, if it sells the assets, the purchaser appoints a subsidiary of the bank to manage the assets (which will be permitted under Prudential Statement C2) and the subsidiary promises to apply the procedures manual to those assets, it could find that a conflict exists between what the bank wants to do to maintain customer relations, and what its subsidiary has promised to do under the securitisation documents. The solution to this problem is not necessarily adopting a more aggressive approach to enforcement. Rather, it is to make sure that the procedures manual is a detailed and accurate reflection of what the bank wants to do.

A bank that securitises its assets will want to get them off its balance sheet and not have to provide capital against them under the Reserve Bank's capital adequacy rules. This will require it to comply with Reserve Bank Prudential Statement C2 (I should mention in passing that I expect that building societies and credit unions will be similarly regulated.) One of these requirements is for a clean sale. A clean sale is defined in paragraph 86 of C2 to be:

> "where the transfer (ie, sale) is clean and final ie:
>
> (i) beneficial ownership of the assets have [sic] been transferred (although the bank may still retain legal ownership of the assets); and
>
> (ii) the risks and rewards on the assets have been fully transferred
>
> to the party acquiring the assets."

The bank must obtain formal legal advice that, among other things, the bank retains no residual liability (outside that it incurs separately under the facilities covered by the guidelines) for non performance of the assets or changes in the market value of assets. The bank must also obtain formal advice from its external auditors that they are satisfied that the risks and rewards associated with the assets have been transferred to the purchaser. Importantly, in the context of the *Uniform Credit Code*, the document in terms of the transfer must also specify that, if the payments due on an asset are rescheduled or renegotiated, the purchaser and not the selling bank will be subject to the rescheduled or renegotiated terms.

The question is how to reconcile the need for clean sale with a realistic allocation of risks under the Consumer Credit legislation. I will consider only the position that will exist under the *Uniform Credit Code*, as many bank products (especially mortgages) are currently not regulated by the *Credit Act*. There are two related questions.

(a) Who will take the risk that the asset being sold is tainted by an existing breach of the UCC?

(b) Who will take responsibility in continuing compliance with the UCC?

A credit provider under a regulated credit contract has a number of risks, besides the obvious risk that the borrower may not have the means or inclination to repay debt. These include the following:

(a) The risk that the credit provider has not made adequate pre-contract disclosure or that the contract, mortgage or guarantee does not comply with the mandatory provisions of the UCC.

(b) That continuing compliance is inadequate, eg, in relation to the provision of regular statements of account, or notices relating to changes in interests rates.

(c) Re-opening on the grounds of hardship.

(d) Re-opening or re-writing a credit contract, lease, mortgage or guarantee which is unjust.

It is essential that these risks are clearly allocated among the various parties. It is also essential that whatever risk is allocated to the bank that sells the assets does not compromise the "clean sale".

Just as there are no free lunches, there are no clean sales. If a bank sells any asset it will explicitly or implicitly make a number of representations eg, that it owns the asset, that the asset exists, that the asset is capable of assignment and that the asset is not subject to any adverse claims other than those disclosed to the purchaser. Even if a bank tries to have a non-recourse sale, it will not be able to contract out of the false and misleading statement provisions of section 52 of the *Trade Practices Act*.

In other words, in the ordinary course of business a bank will sell a range of assets (eg, excess branches, old equipment, securities and services) and the Reserve Bank, the bank's auditors and the tax office will treat them as an effective "clean" sale, even there are certain express or implicit representations and warranties which, if breached, will diminish the net return to the bank.

Therefore, when approaching the question of how a bank achieves a clean sale in the securitisation, a common sense approach needs to be adopted. Clearly the bank cannot underwrite the performance of the assets through extensive representations and warranties. A bank cannot directly or indirectly be liable if the debtor or guarantor has not performed. However, as mentioned above, this is only one of the risks that the purchaser will need to address. Let us look at the others:

(a) Non compliance

It will be permissible for a bank to represent and warrant that in originating and documenting a credit contract, the bank complied with all applicable laws (including consumer credit laws). The bank is obviously in the best position to known whether such a representation and warranty is correct, and such a representation and warranty is, in commercial terms, no different from a representation and warranty that a branch that is being sold complies with all applicable zoning and environmental laws. It is the type of representation and warranty that you would expect a seller to give, and there is no reason why it should compromise the clean sale.

Similarly, if there is any defect in a mortgage or guarantee, responsibility for that should be able to be sheeted home to the selling bank. The requirement in paragraph 87(iv) of C2 that the purchaser must have no "formal recourse" to the selling bank for losses must be read in the light of paragraph 83. This paragraph permits representations and warranties by a bank selling assets provided that:

> "(i) any representations and warranties are in accordance with standard market practice (unless otherwise approved by the Reserve Bank);
>
> (ii) representations and warranties refer to an existing state of facts that the bank can verify at the time services are contracted or assets sold;
>
> (iii) the bank undertakes a reasonable due diligence review (in accordance with accepted market practice) before providing or taking on any representations and warranties; ...."

A bank will normally be able to comply with these requirements. There is another condition in paragraph 83 which is extremely odd, and I imagine that it will be corrected when the final version of C2 is issued. This says that if a bank has to repurchase assets which do not comply with a representation and warranty, the repurchase must be undertaken within 120 days of the transfer to the purchaser. This is probably acceptable.

It then goes on to say that if a bank is liable to pay damages for any breach of representation or warranty after this period it must first be "held accountable by a court for losses incurred". A cynical observer could make the comment that this must be the only part of Prudential Statement C2 that has been drafted by a lawyer. It is clearly inconsistent with a sensible commercial resolution of a commercial issue. Given that the bank will not be able to control the purchaser, if it is to comply with other provisions of Prudential Statement C2, it would be far more appropriate to leave a dispute over losses flowing from a breach of a representation and warranty to arms length negotiations between the parties, and failing that the various forms of alternative dispute resolution that now exist, as well as any court action.

(b) Continuing compliance

The bank should be responsible for compliance up to the date of sale. After that you would expect the purchaser to assume responsibility for compliance. The purchaser will typically appoint a subsidiary of the bank to manage the assets. One aspect of that management would be continuing compliance with the UCC. It is appropriate for the subsidiary to assume contractual responsibility for that compliance, but the purchaser and its creditors will need to be aware that the purchaser will be liable under section 166(2) of the UCC to any debtors for non-compliance after the effective date of sale.

(c) Re-opening contracts

Credit contracts of less than $125,000 can be re-opened on the grounds of hardship (see section 65 of the UCC). The consumer has the ability to apply to a financier for changes to the contract term, amount of each repayment and times for repayment. This right is only available if the consumer suffers hardship like illness or unemployment and he or she can still pay the contract out at the end. No doubt the purchaser will not want to buy credit contracts which are the subject of an application for re-opening.

However, if the application for re-opening comes after the effective date of sale, and the seller had no reason to believe at the time of sale that it was likely to be re-opened on the grounds of hardship, the risk of any such re-opening should rest with the purchaser. I think this is a sensible approach to risk allocation. It is also essential in the light of the requirement in Prudential Statement C2 that the purchaser and not the selling bank will be subject to any rescheduled or renegotiated terms.

(d) Unjust contracts

The UCC permits the court to re-open and re-write credit contracts, leases, mortgages or guarantees which are unjust. This may include effectively invalidating them. There are many factors that a court needs to take into consideration. If a re-opened contract proves to be "unjust" the court has a wide range of orders it can make. The risk of unjust contracts can best be handled by the bank's origination and credit checking procedures. I think it is appropriate that a bank make a representation and warranty that no credit contract that is to be sold is unjust, and take the consequences if any subsequently proves to be unjust. I think this is one area where a bank will need to have discussions with the Reserve Bank.

The problem arises in the context of the requirement in paragraph 87(vii) of C2 that the purchaser and not the selling bank will be subject to the rescheduled or renegotiated terms. One of the wide range of remedies that are available to a court is that an unjust contract can be rescheduled or renegotiated. Given the very wide range of issues that a court can take into consideration in determining whether a contract is unjust, and the fact that these criteria cannot be accurately assessed by subsequent due diligence, it is inappropriate for the purchaser to carry this risk.

For example, a court is entitled to take into consideration whether the age or physical or mental condition of the debtor or guarantor meant that person could not reasonably protect his or her interests. The selling bank may have UCC compliance procedures that require an account officer to tick a box that that compliance officer considered the age, physical and mental condition of the debtor, and was satisfied that the person would be able to reasonably protect his or her interests. But no reasonable due diligence on the part of a purchaser is going to work out whether, at the particular time that a person entered into a credit contract, that person was in tip top (or at least acceptable) physical or mental condition.

Similarly, a selling bank may have procedures that require account officers to make reasonable enquiries as to whether a debtor could comply with the payment obligations of the contract. However, if the account officer did not make reasonable enquiries, or chose to ignore evidence to the contrary, and following the sale of the assets the debtor seeks to have the contract renegotiated, I can see no reason why the seller should not be responsible.

This brings me finally to the subject of due diligence. It is usual practice in securitisations for purchasers of the receivables to undertake due diligence. This will typically cover compliance procedures, computer systems, risk policies and documentation. Typically a random, and therefore selective, audit of individual contracts will be conducted. It would be totally impractical to conduct a thorough audit of every contract that is to be sold. Not only would it be impractical, it would also be impossible to do a thorough investigation into the circumstances in which every contract was entered into so as to ensure that each debtor has absolutely no grounds for having a contract re-opened on the basis that it is unjust.

The Reserve Bank needs to recognise this, and accept that, provided a reasonable degree of due diligence is undertaken by the seller and the purchaser, then the purchaser should be able to have recourse against the selling bank if it makes a representation and warranty to the effect that no contracts can be re-opened on the basis that they are unjust. In terms of the application of the relevant provisions of C2, again reference needs to be made to paragraphs 83 and 87, and the analysis and criticism of them that I made in paragraph (a) above in relation to representations and warranties.