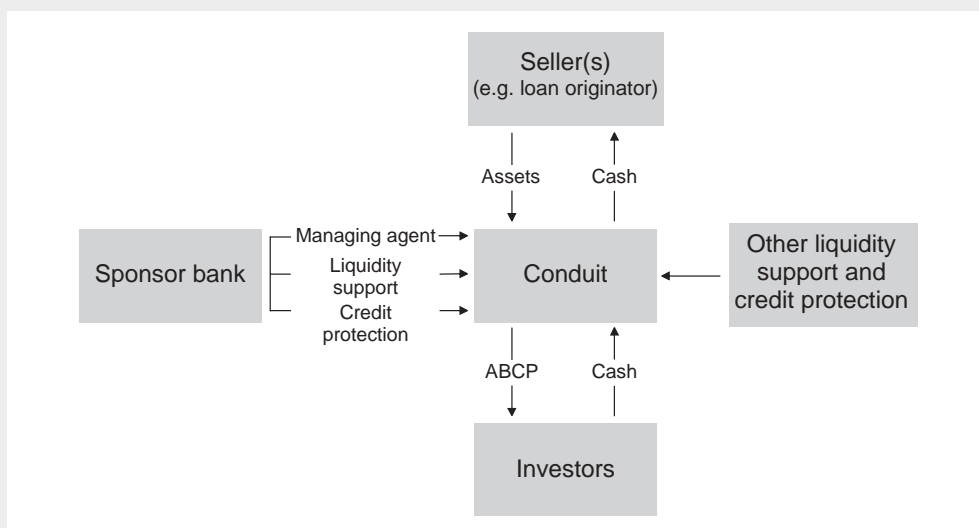


Box A: The Australian Asset-backed Commercial Paper Market

The recent turbulence in global financial markets has focused attention on the links between banks and the asset-backed commercial paper (ABCP) market.

ABCP – which typically has a term to maturity of between 30 days and one year – is issued by so-called conduits in order to finance the purchase of financial assets, including mortgages, receivables and securities (particularly residential mortgage-backed securities (RMBS)) from a variety of ‘sellers’, including loan originators. Conduits are usually set up, or ‘sponsored’, by a bank, though the conduit is a legally separate, ‘bankruptcy remote’, entity.¹ The sponsor provides administration services and, as discussed below, also often provides liquidity support to the conduit as well as some form of credit enhancement. Figure 1 shows a stylised representation of a conduit structure.²

Figure 1: Conduit Structure



Conduits can be used for a number of purposes. In some cases, they are used to temporarily ‘warehouse’ mortgages, until the pool of mortgages is of sufficient size for an RMBS to be issued. Loans temporarily financed in this way can be originated either by the sponsor of the conduit, or by third parties, including both bank and non-bank lenders. Conduits can also be used for longer-term financing of mortgages, although this form of financing entails significant roll-over risk (see below). Conduits are also used for the financing of a wide variety of other

¹ Under a bankruptcy remote structure, the solvency of the conduit is independent of the sponsor (and the sellers).

² Although not shown in Figure 1, it is common for assets to be held in an additional special purpose vehicle, in which the conduit either acquires an interest or provides a loan.

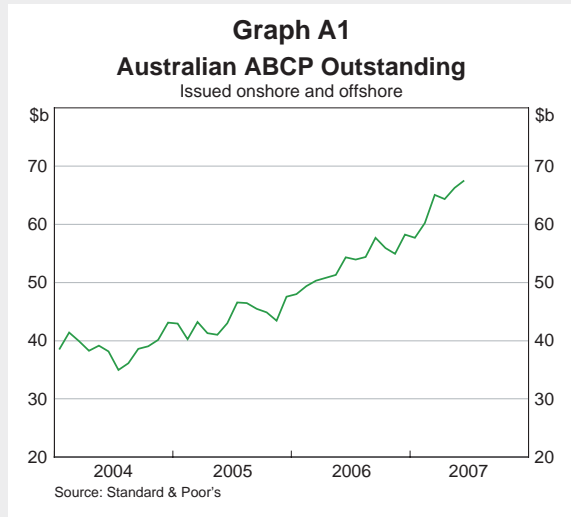
assets, including margin loans and vehicle leases that typically have much shorter maturities than mortgages and RMBS.

The Australian ABCP market has grown strongly in recent years, although it remains relatively small compared with that in many other countries. Based on programs rated by Standard & Poor's, it is estimated that the value of outstanding ABCP almost doubled over the past three years, to around \$68 billion as at June 2007 (Graph A1).³ Around half of the outstanding ABCP had been issued onshore, with most of the remainder issued in the United States, and a small share in the European market. In total, it is estimated that there are 560 pools of assets backing around 60 different ABCP programs.

Of the ABCP outstanding, over 80 per cent had been issued by 'multi seller' conduits, which, as the name suggests, buy assets from a number of different originators. Within a multi-seller structure, individual ABCP issues can either be backed by the conduit's entire pool of assets, or by specified assets within the total pool; the latter type of ABCP is known as a segregated issue.

According to data from Standard & Poor's, around 45 per cent of the underlying collateral for Australian ABCP is residential mortgages, and a further 17 per cent is RMBS (Table A1). Only a small share of these loans was non-conforming (2 per cent) and, according to Standard & Poor's, Australian ABCP has little, if any, exposure to US sub-prime mortgages or collateralised debt obligations backed by US sub-prime RMBS. The ABCP backed by residential mortgages accounts for just 3½ per cent of the value of Australian housing loans; in comparison, longer-term RMBS account for around one quarter of total housing loans.

The credit quality of ABCP is potentially higher than that of the assets which back it. This is because most ABCP programs have credit enhancement which protects investors against default on the underlying assets. Reflecting this, ABCP is generally highly rated – around 80 per cent of outstanding ABCP is rated 'A-1+' by Standard & Poor's, the highest rating available. Credit enhancement can be transaction-specific or program-wide. Many conduits use a combination of both; the transaction-specific enhancement usually provides first-loss protection ahead of the program-wide enhancement. Transaction-specific credit enhancement provides protection on a specific asset pool and cannot be used to cover losses on the rest of the



³ These data do not include programs that are privately placed or unrated. Note that the value of the collateral underlying the outstanding ABCP is slightly higher.

Table A1: Collateral Underlying Outstanding ABCP

June 2007

	\$ billion	Per cent of total
Residential mortgages	32.9	45
<i>of which:</i>		
Prime	32.1	44
Non-conforming	0.8	1
Residential mortgage-backed securities	12.3	17
<i>of which:</i>		
Prime	11.6	16
Non-conforming	0.7	1
Auto/equipment loans & leases	4.8	7
Equities	4.2	6
Margin loans	4.0	6
Infrastructure bonds	3.9	5
Small business loans	2.1	3
Trade receivables	2.1	3
Commercial mortgage-backed securities	1.7	2
Collateralised debt obligations	1.4	2
Corporate bonds & loans	0.6	1
Credit card receivables	0.5	1
Other	2.0	3
Total	72.5	100

Source: Standard & Poor's

maturing paper. Given the roll-over risk, most conduits have back-up lines of credit, which typically cover the full value of the maturing ABCP. These back-up arrangements are often provided by the sponsor, but third parties are also sometimes involved. According to Standard & Poor's, \$24 billion (or 37 per cent) of the liquidity facilities for rated Australian conduits were provided by the four largest Australian-owned banks as at June 2007; the remainder were largely provided by branches of foreign-owned banks operating in Australia.⁴

An alternative to the back-up lines is to issue paper with an option to extend the maturity if the conduit is unable to roll over the paper. Once the paper is extended, the issuer pays a higher rate (often an extra 25 basis points) to the current holders and the paper is repayable by a fixed maturity date, normally in less than 270 days. This alternative arrangement is in place

conduit's portfolio of assets. Often it is provided by over-collateralisation of the asset pool, commonly 10 per cent. Program-wide credit enhancement is frequently provided by the sponsoring bank in the form of a letter of credit (often equal to 10 per cent of the ABCP). At times, it may also be provided by the issuance of subordinated notes that absorb losses first. When ABCP is backed by highly-rated securities, rather than loans or receivables, the program usually does not have additional credit enhancement, though the underlying securities may be highly rated because of their own credit enhancement, through subordination and/or lenders' mortgage insurance.

The term to maturity of ABCP is usually less than the maturity of the underlying assets, so funding of the assets generally relies on the ability of the conduit to roll over its maturing paper, with the new paper being used to repay investors in the

⁴ It is worth noting that these figures understate the overall exposure of Australian banks to conduit vehicles, as banks also provide liquidity support to conduits not captured in the Standard & Poor's data, such as foreign conduits and unrated programs.

for only around 10 per cent of Australian ABCP, and most extendible ABCP has been issued in the United States.

There are a number of potential issues raised by the back-up lines of credit associated with the ABCP market.

One is that the provider of the credit line needs to maintain sufficient liquidity to be able to meet its commitment at short notice; in most cases, funds are required to be available on a same-day basis. In the current environment, the possibility that further liquidity will need to be provided to ABCP programs has meant that some banks have taken a conservative approach to their own liquidity management.

A second issue is that the provision of back-up liquidity facilities exposes the provider to the credit risk of the underlying assets, given that these facilities are secured by the underlying assets, or may even take the form of purchasing the assets.

A third issue is the potential effect of a drawdown on the capital requirements of the provider. Standby lines of credit are recorded by banks as an off-balance sheet exposure, and under Basel I do not attract a regulatory capital charge if the term to maturity is less than one year, which is normally the case. However, when the facility is drawn, a regulatory capital requirement applies. The impact on overall regulatory capital is, however, likely to be manageable. By way of example, the \$24 billion in lines of credit provided by the four largest banks is equivalent to only 2 per cent of their \$1 100 billion of risk-weighted assets as at June 2007. Accordingly, if these lines of credit were all drawn, the aggregate capital ratio for these four banks could be reduced by up to 20 basis points. ↗