

ASSESSMENT OF LAW RELATING TO THE TRANSFER OF MORTGAGEE'S RIGHTS TO THE TRUSTEE ISSUER IN MORTGAGE SECURITISATION¹

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Securitisation is the process by which a credit institution – either a bank or an independent mortgage provider (IMP) – sells assets on its loan book – specifically, accounts receivable on its loan book – to another financial intermediary established specially for securitisation transactions, known as a special purpose vehicle (SPV), which then funds its holdings by issuing asset-backed securities to investors. One of the key steps in a residential mortgage securitisation process is that the originator transfers its mortgagee rights in the loans to the SPV. The mortgagee rights form the backing for the residential mortgage backed securities (RMBSs) issued by the SPV. In practice, the transfer of mortgagee rights is effected by an equitable assignment. The mortgagor is not a party to the sale agreement and is not notified of its existence. The assignment or transfer is structured so as to be “bankruptcy-remote” to gain investor acceptance in the capital market securities. In general, this is achieved by ensuring that the assignment or transfer constitutes a “true sale” by the originator to the SPV.

Firstly, the article examines the ways in which the originating mortgagee's rights and the underlying collateral can be transferred to the trustee-issuer (SPV) and considers the main legal issues that can arise in an RMBS program in Australia. Secondly, it focuses on a qualitative assessment of the extent to which the current legislative and regulatory provisions governing the transfer of mortgagee rights to the SPV either impede or facilitate the operation and growth of the RMBS market in Australia. The existing legislative and regulatory provisions governing the transfer of mortgages are assessed using a “public benefit test” framework. This framework is based on the Australian Commonwealth-State Competition Principles Agreement 1995 and the Statutory Instruments Act 1992 (Queensland).

Finally, the article provides a summary of the legal and regulatory issues involved in the transfer of mortgagee rights and concludes the article with some suggestions for reform of the consumer credit legislation in Australia.

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I INTRODUCTION

Securitisation has been one of the most significant financial innovations in the capital markets over the last twenty years.² It is the process of converting illiquid but income-producing assets and receivables³ that are not necessarily marketable, into securities that can be more readily placed and traded in the capital markets. One example of the securitisation process, namely ‘residential mortgage securitisation’, is the focus for this article.⁴

In a typical residential mortgage securitisation program, a housing loan provider, generally referred to as the originating bank,⁵ ‘pools’ selected housing loans and – for a price – transfers its rights under the relevant loan agreements to a special purpose vehicle (‘SPV’), which then – again for a price – issues notes or bonds to institutional investors. In Australia, the SPV is invariably structured as a trust.

The rights transferred by the bank originator to the trustee issuer include the lender’s right to receive principal and interest repayments from the borrower, the lender’s right to exercise its power of sale under the terms of the residential mortgage and the lender’s right to any mortgage insurance payout in the event of default by the borrower. These rights of the original mortgagees must be transferred to the SPV in a manner that is legally effective and commercially practical.

The transfer of mortgagee rights from a mortgage originator to the trustee issuer (SPV) could be effected by legal or equitable assignment.⁶ Under an effective legal assignment, the mortgagee’s rights would be vested absolutely in the SPV. Under an equitable assignment, the SPV would be recognised in equity as having acquired those mortgagee rights, but not in law – in law, the transferor would remain their legal ‘owner’, holding the mortgagee rights on bare trust for the SPV

2 See Joseph Hu, Robert Pollsen and Jay Elengical, ‘A Record Year for Residential MBSs’ [2002] *Mortgage Banking* 36; Joseph Shenker and Anthony Colletta, ‘Asset Securitization: The Evolution, Current Issues, and New Frontiers’ (1991) 69 *Texas Law Review* 1369, 1380.

3 The term ‘receivables’ encompasses the receipt of loan repayments, including residential mortgage loans, car loans, credit card receivables, lease receivables, corporate trade receivables and an ever-growing list of asset types.

4 In practice however, the term ‘securitisation’ can be used to denote other transactions such as loan participations and syndications. Indeed, a leading United States text on securitisations devotes whole chapters to discussing similarities between loan participations and syndications and the pooling process of mortgage securitisation. See generally, Tamar Frankel, *Securitization: Structured Financing, Financial Asset Pools, and Asset-Backed Securities* (2nd ed, 2006) Pt III.

5 Since 1996, most banks have been forced to establish residential mortgage-backed securities (‘RMBS’) programs because of increasing competition in the housing loan market in Australia. While banks remain the major source of housing finance, non-bank lenders currently comprise more than one-fifth of all new lending. The success of the non-bank lenders is due in large part to product innovation, greater borrower accessibility through the introduction of mobile lenders, extensive origination networks, and the ability to securitise their housing loans through RMBS programs. The main originating banks in Australia are banks such as Macquarie Bank, Westpac, Commonwealth Bank, Citibank, St. George Bank and Adelaide Bank. In this context, the originating bank will generally be the ‘sponsor’ (or promoter) of the program. See generally, Standard and Poor’s, *An Investor Guide to Australia’s Housing Market and Residential Mortgage-Backed Securities* (2005) 26–27; Deutsche Morgan Grenfell, *Mortgage-Backed and Asset-Backed Security Research* (1998).

6 These concepts, and their relevance to residential mortgage-backed securities (RMBS) issues, are discussed in more detail in Part II of this article.

as trustee for the bondholders.⁷ The mortgagor is not a party to the sale agreement and is not notified of its existence.

In Australia, most of the smaller banks and independent mortgage providers ('IMP') equitably assign their mortgages to a 'warehouse trust fund' or 'sub-fund' administered by a larger bank, which sponsors the residential mortgage-backed securities RMBS program. In such a case, the instrument of assignment typically provides that the transfer is to be perfected or completed in particular circumstances,⁸ such as the mortgage originator entering into insolvency administration or going into liquidation.⁹

The securitisation structure must ensure that the mortgages in the pool are effectively transferred to the SPV and separated from any insolvency risks associated with the originator in the even the originator becomes insolvent. To use the United States expression that has found its way into the Australian market nomenclature, the assignment or transfer is structured so as to be 'bankruptcy-remote'¹⁰ to gain investor acceptance in the capital market securities.¹¹ In general, this is achieved by ensuring that the assignment or transfer constitutes a 'true sale' by the originator to the SPV. Provided the sale is perceived to be arm's length at a genuine market price and its timing is at least six months before any stakeholder insolvency, then even if the mortgage originator becomes insolvent, the mortgaged properties in the pool will generally, under insolvency law, be insulated from other assets of the originator that may be used to satisfy its creditors.¹² The separation of the originator from the mortgaged assets generally, also enables funds to be raised at less cost, through securities issued by the SPV, than if the originator were to raise funds in its own right.¹³

A 'true sale' (sometimes called a 'clean sale' in the overseas literature¹⁴) is important for an RMBS program so that:

- 7 See generally, the Macquarie Bank's PUMA program: Macquarie Securitisation Ltd, *Master Information Memorandum, PUMA Fund P-12* (2006) 40, 54 ('PUMA Fund').
- 8 See David Glennie et al, *Securitization* (1998) 4–5.
- 9 See Pelma Rajapakse, '*Residential Mortgage Securitisation in Australia: Suggestions for Reform of Commercial Law and Practice*' (D Phil Thesis, Griffith University, 2005).
- 10 Ibid; see also Thomas Gordon, 'Securitization of Executory Future Flows as Bankruptcy-Remote True Sales' (2000) 67 *The University of Chicago Law Review* 1317. Insolvency remote in this context means that the SPV is unlikely to be adversely affected by a bankruptcy of the originator.
- 11 Lois Lupica, 'Circumvention of the Bankruptcy Process: the Statutory Institutionalisation of Securitization' (2000) 33 *Connecticut Law Review* 199.
- 12 Larry Engel and Andrew Koslow, 'Securitization Advice for Asset-Based Lenders', in J Cunningham (ed), *Asset Based Financing* (1996) 479.
- 13 Andrew Finch, 'Securitisation' (1995) 6 *Journal of Banking and Finance Law and Practice* 247, 262.
- 14 A 'true sale' is also referred to as a 'clean sale' under the APRA Capital Adequacy Guidelines: APRA Guidance Note, AGN 120.3 – *Purchase and Supply of Assets* (2000) Australian Prudential Regulatory Authority <<http://www.apra.gov.au>> at 20 March 2004.

- the authorised deposit taking institution ('ADI') can obtain regulatory capital relief from the Australian Prudential Regulatory Authority ('APRA') for capital adequacy purposes to ensure that, so far as is possible;¹⁵
- the RMBSs are issued by an SPV which is insolvency-remote, so far as the mortgage originator is concerned;
- the issue complies with taxation legislation – eg the transfer must be bona fide and at arm's length; and
- the issue is consistent with the law of trusts and equity.

A transfer of mortgages constitutes a 'true' sale where the originator, in assigning its mortgagee rights in equity to the SPV, separates itself sufficiently from the SPV. The purpose of separation is to avoid the risk that it is seen to have any commercial (or even, for capital adequacy purposes, 'moral') obligation to support the liquidity of the program or the market value of securities issued, or to make good any losses suffered by investors. The mortgage assets assigned in equity include the mortgagee's rights under the mortgage, relevant security property insurance policies and mortgage insurance policies, and the originator's interests in any contracts it may have with solicitors, valuers or other professionals in connection with the origination of the mortgages.

There are two purposes of this article; first, it examines the ways in which the originating mortgagee's rights and the underlying collateral can be transferred to the trustee-issuer (SPV) and considers the main legal issues that can arise in an RMBS program in Australia; and secondly, it focuses on a qualitative assessment of the extent to which the current legislative and regulatory provisions governing the transfer of mortgagee rights to the SPV either impede or facilitate the operation and growth of the RMBS market in Australia. The existing legislative and regulatory provisions governing the transfer of mortgages are assessed using a 'public benefit test' framework. This framework is based on the principles of social cost-benefit analysis and is similar to that used to evaluate the introduction of Commonwealth and State legislation pursuant to the Australian *Commonwealth-State Competition Principles Agreement 1995* (Cth) and the *Statutory Instruments Act 1992* (Qld).¹⁶

15 See APRA guidelines: *Capital Adequacy* – APS 110; *Capital Adequacy: Measurement of Capital* – APS 111; *Capital Adequacy: Credit Risk* – APS 112; *Capital Adequacy: Market Risks* – APS 113; *Funds Management and Securitisation* – APS 120 (2000); see Australian Prudential Regulatory Authority <<http://www.apra.gov.au>> at 20 March 2004.

16 Pursuant to the *Statutory Instruments Act 1992* (Qld), which is mirrored in every other state, and the *Competition Principles Agreement*, signed in 1995, by the Australian Commonwealth, States and Territories, any legislation that is likely to impose appreciable costs on the community, or a section of it, is subjected to a 'Regulatory Impact Statement' to determine whether the legislation is likely to be for the benefit of the public. This is undertaken within the 'public benefit test' framework: see National Competition Council, *National Competition Principles Agreement* (1995) National Competition Council <<http://www.ncc.gov.au/publication.asp?publicationID=99&activityID=39>> at 20 January 2003.

The 'public benefit test' process involves: (a) the identification of the restrictions on competition in the market; (b) an analysis of the effects of legislative restrictions; (c) an analysis of the costs and benefits; and (d) the provision of appropriate recommendations.

Part II of the article focuses on the legal issues involving the transfer of mortgagee's rights to the trustee issuer (SPV). Section A examines the extent to which the transfer of mortgagee's rights to the SPV is a 'true sale' or a mere financing arrangement. Section B discusses the issues relating to the equitable and legal assignment of mortgagee's rights to the SPV. Section C examines and analyses the impact of the *Consumer Credit Code*, Appendix to the *Consumer Credit (Queensland) Act 1994* (Qld) ('Code') on the transfer of mortgage rights to the SPV and on the RMBS issues. Part III provides a qualitative assessment of the law and practice in this area. Some objectives and criteria relating to the transfer of mortgagee's rights are identified in Section A of Part III. Based on the framework of 'public-benefit' test, Sections B and C of Part III qualitatively assess the extent to which the current law and regulation hinders or facilitates the achievement of the objectives of the transfer of mortgagee's rights to the SPV in the RMBS programs. This assessment is based on the legal issues discussed in Part II of the article. Finally, Part IV provides a summary of the legal and regulatory issues involved in the transfer of mortgage rights and concludes the article with some suggestions for reform of the consumer credit legislation in Australia.

II LEGAL ISSUES INVOLVING THE TRANSFER OF MORTGAGEE'S RIGHTS TO THE TRUSTEE ISSUER

A Creating a 'True Sale' of the Mortgages

In a residential mortgage-backed securities program, the securitised mortgages and the mortgagee rights attached to them are transferred to a newly formed SPV or a trustee issuer to insulate them from the credit risk of the originator.¹⁷ If the transfer is not properly effected and structured so that it qualifies as a 'true sale' or absolute conveyance that cannot be re-characterised as a collateralised borrowing, there is a risk that it will be treated as a loan from the issuer to the originator, and the mortgages considered as a part of the originator's estate in the event of its insolvency.

The term 'true sale' is somewhat misleading however, because a given transfer of mortgages may well be a sale for certain purposes but not others. For example, it has been argued that the criteria for establishing an accounting sale under

17 Steven Schwarcz, 'Structured Finance: The New Way to Securitise Assets' (1990) 11 *Cardozo Law Review* 607, 608.

generally accepted accounting principles¹⁸ are more stringent than the criteria for establishing a sale under insolvency law.¹⁹

In interpreting the term ‘true sale’, a court could come to a conclusion that the real intent of the transaction was not to legally or equitably transfer the mortgages to the SPV, but was a financial (credit) transaction masquerading as a securitisation. This approach is variously referred to in the literature as a ‘substance over form’ approach, or a ‘re-characterisation’.²⁰ The courts take the view that, as a matter of law, the label attached to a transaction is not conclusive, and can be departed from where the court considers that the true character of the transaction differs from that by which it has been described. Having said this, the courts do construe

- 18 The originator transferring the mortgages to the SPV will usually want the transfer to constitute a sale for accounting purposes. That way the financing is reflected on its balance sheets as a sale of assets, and not as a secured loan (which would increase leverage). The originator may also seek the transfer to be treated as a sale if the mortgage origination deed restricts the originator’s ability to incur debt or pledge its assets. The deed may provide that accounting terms such as ‘debt’, when used in the deed, must be construed in accordance with Australian Accounting Standards. However, whether a given transfer of mortgage or mortgages violates the terms of the deed is a legal question that turns closely on the precise language of the instrument.

The Accounting Standards Board (UK), *Application Notes D – Securitised Assets* (FRS 5) requires the following tests to be applied to determine whether the mortgages have effectively been sold by an originator to an SPV for accounting purposes:

- the transfer must not contravene the terms and conditions of the underlying mortgages;
- the originator must have no residual beneficial interest in the principal amount of the mortgages, and the issuing vehicle must have no formal recourse to the originator for losses;
- the originator must be under no obligation at any time to repurchase the mortgages; and
- the arrangements for the transfer must be such that, if mortgages are re-scheduled or re-negotiated, the issuing vehicle and not the originator must be subject to the revised terms.

If any of these tests is not satisfied, the transaction must be treated as a secured loan. As a secured loan, the mortgages must be retained on the individual balance sheet of the originator, and the originator must also record a liability for any amounts received in respect of the purported sale. See generally, Eilis Ferran, *Mortgage Securitisation: Legal Aspects* (1992) ch 6; Andrew Lindsay and Samuel Thomson, ‘Accounting and Tax Issues’, in D C Gardner (ed), *Securitisation* (1997) 24–25. As noted earlier, these tests have been incorporated into the *Australian Prudential Standards – APS 120* for capital adequacy purposes. See further, Rajapakse, above, n 9.

In a US context, the relevant accounting standard is SFAS 77, *Accounting for Receivables Sold with Recourse*. See further, accounting principles for securitisation: US Financial Accounting Standard Board Statement No 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (FASB 140) (2000); Accounting Standards Board (UK) *Application Note on Securitisation* (FRS 5); International Accounting Standards Committee, *Accounting for Financial Instruments* (IAS 32) Australian Accounting Standard Board, Urgent Issues Group (UIG – 28) *Consolidation of SPV* (1999), which is based on IAS 32. See also, Ian Plater, ‘Accounting and Tax for Off-Balance Sheet Financing’ (Paper presented at the IIR Conference, Sydney, 12 September 1992) 6–12; Christopher Wheeler, ‘Accounting Aspects of Securitisation’ in Charles Stone et al. (eds.), *Asset Securitisation Theory and Practice in Europe* (London: Euromoney Publications, 1991) ch 40.

In January 2005, Australian, UK, USA, and other international accounting standards converged, see AASB, ‘AASB Adoption of IASB Standards by 2005’ (2004) Australian Accounting Standards Board <<http://www.aasb.com.au>> at 3 October 2004. While a detailed discussion of accounting issues is plainly beyond the scope of this article, a brief account of some of the principles laid down by the courts in relation to whether a ‘true sale’ has occurred is given below, and these are relevant for the accounting treatment of RMBSs.

19 Vinod Kothari, *Securitisation: The Financial Instrument of the New Millennium* (2003) 224.

20 See *ibid*; see also, Tamar Frankel, *Securitization: Structured Financing, Financial Asset Pools, and Asset-Backed Securities* (1991) [7.21–7.22]. This ‘substance over form’ approach is fairly common in taxation law and in the interpretation of accounting standards.

the transaction in its entirety, accustomed as they are to honouring the language of an instrument and generally refusing to go behind that language if its meaning is clear.²¹

In evaluating the substance (as opposed to the mere form) of the transaction, the term 'true sale' is most often used in analysing whether the transfer of mortgage loans has effectively removed the mortgages from the originator for insolvency-remoteness purposes. If the originator becomes insolvent and the mortgages are no longer owned by the originator, but instead are owned by the trustee (or security trustee) of the SPV, then the SPV would also own the rights to the repayments on those mortgage loans. Assuming the repayments were made and the trustee-issuer had priced its issue profitably, the SPV would have sufficient cash to pay its RMBSs without defaulting. However, if the transfer were held *not* to be a sale for insolvency purposes, it would be deemed an advance of funds by the SPV to the originator, secured by the mortgages. The SPV would then be a creditor of the originator and have a security interest, but not an (equitable) ownership interest, in the mortgages. Further, if the originator becomes insolvent, the SPV might not be able to collect sufficient repayments on the initial housing loans to pay the interest and principal it owes the investors in its RMBSs.

1 The United Kingdom

In overseas jurisdictions, the courts have held that particular securitisations of loan receivables should be 're-characterised' as collateralised borrowings. For example, in *Re Curtain Dream Plc*,²² the sale of asset was held to be a secured financing agreement. The court found that for a transaction to be re-characterised as secured borrowing, it is not necessary to show the parties' agreement to be pretence intended to cover their true agreement. Rather, it is sufficient that the agreement does not fall into the legal category within which the parties have required to place it.²³

In *Re George Inglefield Ltd*,²⁴ the English Court of Appeal was called upon to review the term 'true sale' to determine the true nature of a securitisation transaction. The court emphasised that consideration must be given to the whole of the agreement. In this case, the court outlined the features that distinguish a secured loan from an absolute sale as follows:²⁵

21 Plater, above n 18, 6–12; Michael Cohn, 'Asset Securitization: How Remote is Bankruptcy Remote?' (1998) 26 *Hofstra Law Review* 929.

22 [1990] BCLC 925.

23 *Welsh Development Agency v Export Finance Co Ltd* [1990] BCC 393 ('Welsh Development Agency'): see Ferran, above n 18, 153.

24 [1933] 1 Ch 1 (CA) ('*George Inglefield*'). See also Christopher Wheeler, 'The Accounting aspects of Securitisation in the United Kingdom' in Charles Stone, et al. (eds), *Asset Securitisation Theory and Practice in Europe* (1991) 535, 540–1; Peter Mancini, 'Bankruptcy and the UCC as Applied to Securitization: Characterizing a Mortgage Loan Transfer as a Sale or a Secured Loan' (1993) 73 *Boston University Law Review* 873.

25 *George Inglefield* [1933] 1 Ch 1 (CA), 28. On the facts of that case, the transfer of assets was regarded as a 'true sale'. See generally, Ferran, above n 18, 153; Kothari, above n 19, 228.

- In a 'true sale' transaction, the vendor is not entitled to get back the subject matter of the sale by returning the purchase price. However, in the case of a mortgage or charge, the mortgagor is entitled, until foreclosure, to get back the subject matter of the mortgage or charge, by repaying the loan to the mortgagee;
- In a 'true sale', if a purchaser sells the subject matter of the purchase, and realises a profit, he does not have to account to the vendor for that profit. However, in the case of a mortgage or charge, if a mortgagee realises the subject matter of the mortgage for a sum of more than is sufficient to repay it, it must to account to the mortgagor for the surplus;
- In a 'true sale', if a purchaser were to resell the property she had just purchased, at a price that was less than the price she paid to the vendor, she would not be entitled to recover the balance from the vendor. However, in the case of a mortgage or charge, if a mortgagee realises the mortgaged property for a sum that is insufficient to repay it the money that it has paid to the mortgagor (by way of the loan), the mortgagee is entitled to recover the balance of that money from the mortgagor.

However, the courts have not followed the above criteria in a consistent manner. For example, in a number of cases, the courts have upheld transactions as 'true' sales of loan receivables, even though the vendors had a personal obligation to support the purchasers of the receivables for any default in payment by the debtors.²⁶

Moreover, in *Orion Finance v Crown Financial Management*,²⁷ the court reviewed the tests in *George Inglefield* and held that none of the three conditions could, by itself, destroy the characterisation of a transaction as a 'true sale'. The court held:

No single one of these features may be determinative. The absence of any right in the transferor to recover the property transferred is inconsistent with the transaction being by way of security; but its existence may be inferred, and its presence is not conclusive. The transaction may take the form of a sale with an option to repurchase, and this is not to be equated with a right of redemption merely because the repurchase price is calculated by reference to the original sale price together with interest since the date of the sale.

On the other hand, the presence of a right of recourse by the transferee against the transferor to recover a shortfall may be inconsistent with a sale; but it is not necessarily so, and its absence is not conclusive. A security may be without recourse. Moreover, the nature of the property may be such that it is impossible or at least very unlikely that it will be realised at either a profit or loss. Many financing arrangements possess this feature. The fact that the transferee may have to make adjustments and payments to the transferor after the debts have been got in from the debtors does not prevent the transaction from being by way of a sale.²⁸

26 See, eg, *Olds Discount Co Ltd v John Playfair Ltd* [1938] 3 All ER 275, referred to in *Welsh Development Agency* [1990] BCC 393. See also, Ferran, above n 18, 154.

27 [1996] 2 BCLC 78 ('*Orion Finance*'). See also Kothari, above n 19, 228.

28 [1996] 2 BCLC 78, 82.

As commented by Kothari, the problem with the *Orion Finance* decision is that it adopts a 'neither this, nor that' approach,²⁹ and offers no clear guidance to the courts, legal scholars or practitioners advising on RMBS issues. According to the facts of the case, the relevant agreement expressly provided that the transfer of assets was for security purposes, and was construed as such. However, in not providing more concrete guidelines, while at the same time arguably reversing previous decisions on point, the *Orion Finance* decision would appear to be a retrograde step unless it can be limited to its facts. The consequence would appear to be that, in the UK at least, scholars and practitioners must await a case coming before the House of Lords to definitively decide the issue. Perhaps for Australian practitioners, the decision is of only persuasive influence in this jurisdiction.³⁰

2 Canada

Recently, in the case of *Metropolitan Toronto Police Widows and Orphans Fund v Telus Communication Inc*,³¹ the Canadian courts have followed a similar approach to that of the earlier English decisions. The case provides some guidance as to whether an RMBS program involves a 'true sale' or merely a secured loan transaction. The court laid down the criteria to be considered when deciding whether an originator had actually achieved a genuine sale of assets to the SPV. In deciding that the transaction was a 'true sale', the court looked to seven main factors: (a) the intention of the parties; (b) the wording of the contract – in particular, the contract contained no references to a loan, security, or the repayment of principal or interest on a loan; (c) the conduct of the parties; and whether it was in BC Tel's (predecessor to Telus Communication) interest to structure the transaction as a sale or a secured loan; (d) BC Tel's interest to structure the transaction as a sale or secured loan; (e) the transfer of ownership risk and recourse to the purchaser; (f) the right to any surplus; the appointment of the seller as the servicer of the assets sold; (g) whether the seller retained the right of redemption with respect to the assets sold (which the court described as the ultimate test to be applied to determine the characterisation of the transaction).³²

29 See Kothari, above n 19, 229.

30 It has been argued that the approach of the courts contrasts sharply with the approach that was taken in the UK: Accounting Standards Board, 'FRS 5 *Accounting for Securitisation*' (Policy Statement) ('FRS 5'). In the first place, it is argued that the criteria specified in FRS 5 do not coincide with those that have been discussed by the courts in determining the true character of a transaction. For example, there is no reference in the case law to the question of whether or not the transaction is in accordance with the terms and conditions of the assets transferred. Furthermore, under FRS 5, a transaction that fails to satisfy any of the specified criteria fails to qualify as a sale for accounting purposes, and there is no flexibility in this respect. See further, Kothari, above n 19, 229; Mark Raines and Gabrielle Wong, 'Aspects of Securitization of Future Cash Flows Under English and New York Law' (2002) 12 *Duke Journal of Comparative and International Law* 453.

31 [2003] OJ No 128 (*Metropolitan Widows Fund*) (ONSC). In that case, BC Tel used the proceeds of a securitisation transaction entered into between BC Tel and the RAC Trust (an SPV) to redeem a series of bonds. The plaintiff argued that, for every \$100 of principal, the redemption of the bonds cost \$115 and the redemption price paid by BC Tel pursuant to the trust deed was approximately \$103, resulting in a substantial loss to bondholders of \$12. The bonds were not set to mature until 2005. The defendant argued that BC Tel did not in fact sell the receivables to the RAC Trust.

32 (ONSC), [40–1].

There is no clear test that would determine the extent to which the seller as the servicer may retain the credit risk in relation to the receivables that have been sold. In the BC Tel's case, the court cited an English decision, *Welsh Development Agency*, which found that although no real risk passed from the seller to the purchaser, the transaction was nonetheless one of sale. Canadian and English courts therefore appear to acknowledge a true sale where the only risk (albeit a remote one) to the SPV is a bankruptcy of the originator. The court distinguished between recourse as to collectibility and economic recourse, which guarantees a return on an investment regardless of the quality of the asset sold. In commenting that the recourse available to the purchaser was not, in all events, a full recourse with respect to collectibility and was not economic recourse in the sense of guaranteeing the repayment of the purchase price, the court found that the recourse available to the purchaser in the circumstances of the particular case did not preclude a determination that a transaction was a sale.

The appointment of the seller as the servicer of the receivables is generally not considered to impair the true sale analysis (which the court confirmed in the BC Tel case). The manner in which interest rate risk is retained would need to be assessed on a case-by-case basis. In these areas, the parties are free to make their own arrangements.

Overall, the BC Tel's case gives guidance as to the issues to be analysed in determining whether or not a receivable securitisation transaction is a true sale. The decision is currently under appeal and it is expected that this will provide additional clarity on the matter.

The evolution of accounting standards for securitisation may influence future court decisions. Although there is no reason at law why a court could disagree with the accounting profession as to whether a particular transaction is or is not a sale, a court could consider the accounting treatment of a transaction. This is particularly true in the present environment where a considerable amount of public policy analysis is going into the formulation of accounting standards. It would not be wise to be complacent in structuring future transactions based on the BC Tel's judgement without reference to the overall context of the agreement.

3 The United States

In contrast, the approach taken by the US courts in the decision of *Major's Furniture Mart v Castle Credit Corp*³³ is that the parties' intention is not, at least in the United States, a primary factor in determining whether a securitisation transaction involves a 'true sale' or a secured loan. The facts of the case provided that the language of the agreement expressly referred only to sales and purchases and, on that basis, the parties did not intend to effect a security transfer. The court emphasised that it was not bound by the classification that the parties applied to their transaction. In examining the nature of the agreement, the court focused on the business activities of the parties. The court found that there was full recourse

33 602 F 2d 538 (3rd Cir 1979).

to the seller, and noted the following elements of recourse provided by the plaintiff, Major's Furniture Mart:

- the plaintiff obligated to pay the SPV's costs incurred in collecting delinquent or uncollectible receivables;
- the plaintiff warranted that all receivables sold met a certain eligibility criteria set forth by the defendant;
- the plaintiff established a credit collection policy with respect to the purchased receivables;
- the plaintiff guaranteed that all accounts receivable will be paid by the customers;
- the plaintiff provided indemnity out of a reserve account for breach of those warranties;
- the plaintiff had a right to repurchase transferred receivables that remained in default for more than 60 days.³⁴

In the circumstances, it was held that the true nature of the transaction was such that the legal rights and economic consequences of the agreement bore a greater similarity to a secured borrowing than to a 'true sale'.

In *Endico Potatoes Inc v CIT Group Factoring Inc*,³⁵ the court adopted a similar economic, as opposed to intention-based, approach to the question of true sale. In particular, the court focused on the level of risk transferred to the purchaser. In a sale or assignment of loan receivables, there is always a risk that the obligor – the initial borrower in this context – will not pay. The court held that if this risk was not fully and finally transferred to the SPV, a true sale had not occurred and the transaction was, in effect, a secured loan.

In adhering to this strict view (which, incidentally, is the same as that adopted by APRA for Australian capital adequacy purposes), it will be noted that this US decision is at variance with some of the English and Canadian authorities, which have held that even full recourse back to the originator is not incompatible with a concept of a legal sale.³⁶

34 Ibid. A similar approach was adopted in *Re Evergreen Valley Resort* (1982) 23 BR 659. See also, Kothari, above n 19, 227.

35 67 F3d 1063 (1995).

36 [2003] OJ No 128 (ONSC) paragraphs [50–1]. Indeed, in the English decision of *Welsh Development Agency* [1990] BCC 393 discussed earlier, the court found that although no real risk had passed from the seller to the purchaser, the transaction was nonetheless one of sale. Dillon LJ emphasised that there was no clear touchstone for determining whether an agreement is really a sale or a secured transaction. See further Steven Schwarcz, *Structured Finance: A Guide to the Principles of Asset Securitization* (1994) 28. See further the Canadian decision of *Metropolitan Widows' Fund* [2003] OJ No 128.

4 Summary of Overseas Decisions

Although various courts have considered whether a given transfer of loan receivables constitutes a sale or a secured loan for insolvency purposes, the facts of the decided cases have not, for the most part, been representative of modern mortgage securitisation transactions. The English courts and those of the British Commonwealth are, as a matter of tradition based on common law, more inclined to honour the expressed intention of the parties than read an implied intention into the circumstances.³⁷ However, the US courts have delivered several decisions ignoring the body of an agreement and regarding a securitisation program as a financial transaction (ie essentially, as a secured loan). There are other possible reasons for differing decisions, such as social and capital market differences between jurisdictions, which include the fact that different capital markets are subject to different rules, the age of the judicial decisions and the level at which the case was decided in the courts hierarchy. Accordingly, the cases are not easily harmonised, and the relevant factors and which of these should be given greater weight are open to interpretation. This uncertainty in the judicial treatment prompted some to quip that a court could flip a coin, and find support in the case law for either characterisation – ‘true sale’ or secured loan.³⁸

5 Australia

There has been no case law to date in Australia that deals with whether a purported sale in a securitisation transaction (or, more specifically, an RMBS program) will be re-characterised as a secured loan.

However, it is possible to meaningfully comment on what would constitute a ‘true sale’ in Australia by reference to the Australian Corporations law, which, of course, incorporates the Australian accounting standards.³⁹ In Australia, the use of a trust structure in mortgage securitisations facilitates an off-balance sheet treatment for accounting purposes, where the trustee company is not related to or a subsidiary of the originator. It is therefore important when structuring a RMBS transaction that an off-balance sheet trustee (more usually, a trustee company) be established as the SPV, where the originator cannot be seen to hold a majority interest in the trustee company for the purposes of the Australian accounting standard on consolidation.⁴⁰

37 See, eg, *Welsh Development Agency* [1990] BCC 393; *Metropolitan Widows Fund* [2003] OJ No 128.

38 Robert Aichler and William Fellerhoff, ‘Characterisation of a Transfer of Receivables as a Sale a Secured Loan Upon Bankruptcy of the Transferor’ (1991) 65 *American Banking Law Journal* 181, 183. See generally Thomas Plank, ‘The True Sale of Loans and the Role of Recourse’ (1991) 14 *George Mason University Law Review* 287, 315.

39 See pt 2M.5 Corporations Act 2001 (Cth).

40 Australian Accounting Standard, *Consolidated Accounts*, AASB 1024, (May 1992), [xxi–xxiii]. See also, APRA, *Disclosure and Separation*, Guidance Note AGN 120.1 (2000) [11]: ‘An ADI should not have any ownership or beneficial interest in a SPV or control the SPV such that it would need to be consolidated in accordance with Australian Accounting Standards’.

In the present context, this standard would require the mortgage originator not to hold any ownership interest in the SPV (or vice versa). It posits two key tests for determining a consolidation, namely; (a) whether the entity operates as part of another economic entity,⁴¹ and (b) who *controls* the entity. 'Control' is defined in AASB 1024 as '*the capacity of an entity to dominate decision making, directly or indirectly, in relation to the financial and operating policies of another entity...*'⁴² Accordingly, at least insofar as the AASB 1024 is concerned, the question of control depends on substance rather than form. Insofar as the accounting standards form part of the Australian Corporations law, it is arguable that the Australian courts would also adopt a 'substance over form' view to decide whether an RMBS transaction is a 'true sale', or a secured loan.

B Assignment of the Mortgagee's Rights to the Trustee Issuer

Under general law, a debt or other chose in action may be assigned by two methods: legal assignment or equitable assignment.⁴³ In Australian RMBS programs, the originating mortgagee's rights are invariably assigned in equity to the trustee issuer (SPV). Commercially, there are good reasons for this.

To be valid at law, an assignment of mortgagee rights to the SPV would need to be; (a) absolute – ie not by way of a charge only; (b) in writing; (c) for the whole of the debt; and (d) notified expressly in writing to the debtor.⁴⁴ Any assignment that did not satisfy all four criteria would generally be given effect as an equitable assignment, not a legal one.⁴⁵

The most common way to effect the assignment is by way of a deed of assignment which, by virtue of s 199 of the *Property Law Act 1974* (Qld), must comply with all of the requirements for a legal assignment of a debt, and is subject to all existing equities having priority claim over the rights of the assignor.⁴⁶

41 See also, *ibid* 1024, [xxv] and [xxvi].

42 See Plater, above n 18, 12.

43 Contractual rights, being choses in action as opposed to things in possession, were not assignable at common law without the consent of both parties to the original contract. The courts of equity, however, did give effect to assignments of choses in action. Perhaps the most significant feature of the division between the common law and equity was the almost complete refusal by the courts of law to recognise equitable rights, titles and interests. Each system, law and equity, devised its own procedural rules and remedies, resulting in substantive differences in the approaches of the two jurisdictions. See further Roderick P Meagher et al, *Equity Doctrines and Remedies* (4th ed, 2002) 36–41.

44 *Jones v Humphreys* [1902] 1 KB 10; *Forster v Baker* [1910] 2 KB 636; *In re Steel Wing Co Ltd*, [1921] 2 Ch 349. A legal assignment operates from the date on which notice is given to the underlying debtor to transfer (i) the legal right to the debt; (ii) the legal and other remedies for the same; and (iii) the power for the assignee to give a good discharge for the debt without the concurrence of the assignor. See further, Hairani Saban, *Corporate Debt Securitisation* (1994) 42.

45 See ss 199–200 of the *Property Law Act 1974* (Qld). Difficult and unresolved issues may arise as to whether consideration is necessary for the effectiveness of an equitable assignment. However, a detailed discussion of these issues is not only beyond the scope of this article, but would be entirely moot since, in an RMBS context, the SPV as equitable assignee does provide consideration: it pays the originating mortgagee a sum equal to the present value of the mortgagee's rights and obligations.

46 See also *Newfoundland Government v Newfoundland Railway Co* (1888) 13 App Cas 199 (PC); *Smith v Parks* (1852) 16 Beav 115; *Re Tout and Finch Ltd* [1954] 1 All ER 127.

The effect of an assignment is that it transfers only rights and not obligations.⁴⁷ It is not possible to 'assign' obligations without obtaining the consent of the debtor – notwithstanding the frequency with which the rule is misunderstood.⁴⁸ In the context of a mortgage securitisation, therefore, it is only the originating mortgagee's rights⁴⁹ under the residential mortgage that are capable of assignment.

There are, however, practical problems with using a legal assignment. First, a legal assignment accompanied by notice effectively removes the originator (assignor) from the transaction, as the mortgage and the mortgagee's rights become vested in the trustee-issuer (assignee), with direct recourse to the borrower.

Second, a legal assignment deals with the transfer of an 'entire loan', as there is no legal basis at law for a legal or absolute transfer of *part* of a loan.⁵⁰ Thus, a legal assignment cannot transfer any obligation for the trustee-issuer to provide further funds in a loan facility where the loan has not yet been fully drawn down by the borrower.

Third, to be recognised at law, express notice of the assignment would need to be given to the initial borrower. One of the fundamental reasons why mortgages are generally assigned to the SPV in equity,⁵¹ but not in law, is precisely because the mortgage originator has a commercial incentive not to make its customers aware of the securitisation of their assets.⁵²

An equitable assignment has positive advantages for a mortgage originator wishing to securitise its mortgage interests, which in part mirror the disadvantages of a legal

47 Thereby effecting a novation. In the context of securitisation, a novation involves a tripartite arrangement whereby the two parties to an original contract, the originator and the debtor, agree with an SPV that the SPV shall become a substitute for the originator, and thus assume the originator's rights and obligations under that contract and in the creation of a new contract between the SPV and the debtor.

48 See *Tolhurst v Associated Portland Cement Manufacturers Ltd* [1902] 2 KB 660, 668 (Lord Collins MR); where his Lordship stated: '*Neither at law nor in equity could the burden of a contract be shifted from the shoulders of a contractor onto those of another, without the consent of the contractee.*' In an Australian context, see Brian Salter, *An Overview of the Legal Issues Relevant to Securitisation in Australia* (2000) 5.

49 Strictly, it is the mortgagee's 'rights, title and interest' that are assigned.

50 *Encyclopaedia of Forms and Precedents* vol 4, 566. This is the case in all Australian jurisdictions except Western Australia: s 20(3) of the *Property Law Act 1969* (WA). In the other Australian jurisdictions however, an assignment of part of a loan is recognised in equity: see *Williams v Atlantic Assurance Co* [1933] 1 KB 81 and *Re Steel Wing Co* [1921] 1 Ch 349.

51 Bruce Taylor, 'Assignments of Securities in Corporate Re-Financing' (1998) 13 *Australian Banking and Finance Law Bulletin* 141–55.

52 In some jurisdictions, the giving of notice to the underlying mortgagors will be a necessary formality in the transfer of mortgages. This is the case in most European systems. For example, the Spanish Civil Code provides compulsory notice to the debtor in order to effect the transfer. Similarly, in France, Luxembourg, Italy, Japan and South Korea, the giving of notice to the debtor is a formal requirement. See Jane Borrows, 'Legal and Regulatory Issues' in D C Gardner (ed), *Securitisation* (1997) 15; Phillip Wood, *Title Finance Derivatives, Securitisation, Set-Off and Netting* (1995) 53.

assignment.⁵³ An equitable assignment must still be in writing,⁵⁴ and there must be evidence that the originator as assignor intends to immediately and irrevocably transfer its interest to the SPV as assignee – usually by deed,⁵⁵ although a letter has been held to be sufficient.⁵⁶ Importantly, however, notice need not be given to the initial borrowers that their mortgages have been assigned, for the assignment to nevertheless be effective in equity as between the originator and the SPV.⁵⁷

1 The Problem of Notice

In Australian RMBS programs, home loan borrowers are not notified that the mortgagee rights to their loans have been assigned to the trustee issuer. This situation potentially exacerbates a moral hazard problem and may have implications for economic efficiency. In purely legal terms, however, neglecting (or worse still, deliberately failing) to notify borrowers of a risk that their houses could be sold through no fault of their own, would seem at the least to be unconscionable.⁵⁸ As Kirby P poignantly put it in *Canham v Australian Guarantee Corporation Ltd*:

The ultimate theory behind the philosophy of truth in lending ... is that disclosure ... will help to ensure honesty and integrity in the relationship (where one party is normally disadvantaged and even vulnerable); promote

- 53 An equitable assignment will operate to transfer only the beneficial interest in the asset, and legal title will remain with the assignor: *Holroyd v Marshall* 11 ER 999 (HL 1862); *Howard v Miller* [1915] App Cas 318 (PC). Like a legal or absolute assignment, an equitable assignment does not operate to transfer obligations from the originator to the issuer. An equitable assignment will, however, transfer all rights of the originator in the loan or part thereof to the issuer, since a transfer of part of a right or chose in action is permissible under an equitable assignment: see *Jones v Humphreys* [1902] 1 KB 10; *Williams v Atlantic Assurance Co Ltd* [1933] 1 KB 81. This in effect gives the SPV/assignee recourse to the borrower in equity, albeit only to the extent of the beneficial interest in that part of the loan assigned, and only when the originator/assignor (or the owner of the legal title) is joined as a party to a claim. See *Derham Bros. v Robertson* [1898] 1 QB 765 (CA); *William Brandt's Son and Co v Dunlop Rubber Co Ltd* [1905] App Cas 454. Issues relating to sub-participations are not discussed here, as they are beyond the scope of this article.
- 54 The assignment of equitable interests has historically been regulated by statute. For example, s 9 of the *Statute of Frauds 1677* (UK) required all 'grants and assignments' inter vivos of 'any trust or confidence' to be in writing, signed by the assignor. For any assignment to be valid, it had to be in writing from the beginning. See Harold Ford and William Lee, *Principles of the Law of Trusts* (2004) ch 3.
- 55 *Norman v Federal Commissioner of Taxation* (1963) 109 CLR 9, 29.
- 56 *Re Ward* (1984) 55 ALR 395.
- 57 This is not to say that notice of the assignment to the debtor is unimportant. It could be highly significant in at least two situations in practice. First, where there are competing assignments of the same mortgage (in effect, this boils down to a priority problem): see Rajapakse, above, n 9. Second, where the borrower purports to pay off his or her loan to the assignor/originator, unaware that its mortgagee rights have been assigned, and obtaining the originator's purported discharge of the debt: *Stocks v Dobson* [1853] 43 ER 411. If a borrower were to pay the originator, which then became insolvent immediately after receiving the payment but prior to paying the SPV, the SPV would have no recourse against the debtor: see Rory Derham, *Set-Off* (2nd ed, 1996); Phillip Wood, *Title Finance, Derivatives, Set-Off, and Netting* (1995). The SPV would then need to either claim that the originator received the payment in trust for the SPV, or claim against the originator's estate, in common with other creditors (this might occur, for example, if the SPV was unable to establish a proprietary right to the payment received, or trace its proprietary interest in the payment into the hands of the originator).
- 58 Indeed, there would seem to be an appreciable future risk of litigation against the banks, IMPs and/or sponsors for contravention of the 'unconscionable conduct' provisions of the *Trade Practices Act 1974* (Cth).

informed choices by consumers; and allow the market for financial services to operate effectively.⁵⁹

Moreover, there are other potential problems if borrowers are not given notice that their mortgages have been assigned.⁶⁰ While not informing borrowers of the assignments may be expedient for the banks, it is contrary to the conventional wisdom on mortgage transfers. For instance, according to at least one leading text:

[T]he transfer of a mortgage is an unsafe investment, unless the mortgagor concurs or joins in the transfer as a party to the transaction ... if a transferee makes the initial mistake of not obtaining the concurrence of the mortgagor, it is vital that notice of the transfer should at once be given.⁶¹

Generally, it is prudent for a transferee of a legal or equitable title of a mortgage to give notice to the borrower that the mortgage has been transferred. The main risk, if notice is not given, is that the mortgagor might continue to make payments to the assignor/originator, and the mortgagor cannot be obliged to pay again in the event the originator fails to remit those payments to the SPV.⁶² In RMBS programs, this problem is minimised by paying the mortgage borrowers' repayments directly into the trustee-issuer's bank account, so that they do not pass through the originator's hands.⁶³ However, this practice could not be implemented where the borrowers make their mortgage repayments by cheque, without informing borrowers in some sense (even if only by virtue of the account details on their bank statements).⁶⁴

Another problem that arises due to the failure to notify the borrower of the assignment is that it may permit the borrower to set off claims that he or she has against the originator, against obligations he or she owes to the originator. Under general law, an assignee (legal or equitable) takes 'subject to equities' which means, in effect, that the SPV/assignee should be in no better position vis-a-vis the debtor than the originator/assignor was prior to the assignment.⁶⁵ Once the SPV/assignee notifies the borrower of the assignments, any future right to set-off will be lost because, under general law, once notice of assignment has been given, the

59 (1993) 31 NSWLR 246, 254.

60 These potential problems tend to exist in all common and civil law jurisdictions. See generally, Wood, above n 57, 52–3.

61 Edward Cousins, *The Law of Mortgages* (2nd ed, 1989) 384–6.

62 *Williams v Sorrell* (1799) 31 ER 198; *Norrish v Marshall* [1814] All ER Rep 587; *Re Lord Southampton's Estate* [1880] 16 Ch D 178; *Parker v Jackson* [1936] 2 All ER 281. See also Ferran, above n 18, 54.

63 PUMA Fund, above n 7, 58–9.

64 The lack of notice to borrowers also exposes the banks to the risk of litigation. Nor should the banks be unaware of this risk: for example, the foreign currency lawsuits of the early 1990s were largely a result of management in the major banks failing to inform their borrowers of the potential risks involved in non-traditional borrowing. See, eg, *Clenae Pty Ltd and Ors v ANZ Banking Group Ltd* (unreported, Supreme Court of Victoria Court of Appeal, Winneke P, Charles and Callaway JJA, 9 April 1999); *David Securities Ltd v Commonwealth Bank* [1990] 23 FCR 1; *Chiarabaglio v Westpac Banking Corporation* (1989) ATPR 40-971; *Leitch and Ors v Natwest Australia Bank Ltd and Anor* (unreported, Federal Court of Australia, Cooper J, 12 October 1995).

65 *Dawson v Great Northern and City Railway Co* [1905] 1 KB 260; *Re Harry Simpson and Co* (1964) NSWLR 603, 605.

debtor cannot do anything to take away or diminish the rights of the assignee as they stood at the time of the notice.⁶⁶ Set-off rights will continue to exist and be binding on the assignee, however, to the extent that they arise out of the same contract that gives rise to the loan asset.⁶⁷

Under the banks' RMBS programs, set-off rights become primarily important for two reasons. First, because banks are deposit-taking institutions, some borrowers will also maintain deposit or trading accounts with their lenders, and may therefore be entitled to set off their deposits against their debt obligations to the bank.⁶⁸ Once the SPV/assignee has given notice to the borrower of its interest in the loan,⁶⁹ the borrower will lose any future right to set off deposits, but will retain any rights or equities accrued up to the date on which he or she received notice.⁷⁰ Second, if a bank has extended a mortgage loan to the borrower and the bank fails to honour that commitment, any damages that the borrower incurs as a result of the bank's failure may be set off against the borrower's loan obligation.⁷¹

A right of set-off exercised by a mortgagor against the mortgage lender would create a risk for an issuer, where it may not receive the expected mortgage repayments. This risk can be minimised by including relevant provisions in the mortgage documents. Typically, this takes a form whereby each mortgagor agrees not to exercise any right of set-off he or she may have against the mortgage originator under general law. Such an agreement would generally be valid until such time as a mortgagor becomes insolvent. The operation of insolvency set-off might then result in the reduction of the trustee-issuer's income in respect of a particular mortgage.⁷²

66 *Roxburghe v Cox* [1881] 17 Ch D 520, 526; see generally, Derham, above n 57, ch 2.

67 *Business Computers Ltd v Anglo African Leasing Ltd* [1977] 1 WLR 578.

68 See generally, Mark Wormell, 'Securitisation and Set-Off' (1998) 9 *Journal of Banking and Finance Law and Practice* 181.

69 Or, for example, in the context of US law, once contractual privity is established between the borrower and the SPV.

70 *Diesel Motors Co v Kaye*, 345 NYS 2d 870, 875 (1973); Schwarcz, above n 36, 30–1; Frankel, above n 20, [7.23].

71 *Government of Newfoundland v Newfoundland Railway Co* [1888] 13 App Cas 199.

72 Due to the competing claims that could arise, and which could be set off against each other, it is clearly prudent for mortgages in favour of the originator's employees to be excluded from the pool of mortgages that make up the backing for an issue of RMBS. The same argument can be made for the exclusion of mortgages in favour of persons who are depositors with the originator. However, an originator that is authorised to take deposits (eg, a bank or building society) might find it difficult to implement this, especially if its general policy is only to grant mortgages in favour of its own depositors. Moreover, a mortgagor who is originally unconnected to the originator might become one of its employees or depositors. When considering the seriousness of this risk arising from the operation of equities, however, it is important to bear in mind that equities exercisable by individual mortgagors are likely to give rise only to isolated problems in specific cases. Since such isolated incidents are unlikely to undermine the value of the trustee-issuer's earnings to any significant extent, they can therefore be viewed as being of relatively limited importance in practice. See also, Ferran, above n 18, 55.

2 Implications

One of the key concerns in RMBS programs, both for law and prudential regulatory purposes, is whether sufficient risk and reward have been transferred from the originating bank to the SPV in order to justify a finding that a ‘true sale’ of the mortgagee’s rights has occurred. It will not be if, for example, the originating bank retains influence over the setting of interest rates or the way in which delinquent assets are followed up; if the originator retains a right to share in any profits of the SPV; or if investors in the RMBSs have any recourse back to the originating bank.

If a ‘true sale’ has not been effected, the mortgaged loans unsuccessfully assigned will lose their off-balance sheet status for regulatory and accounting purposes, and will be re-characterised as normal on-balance sheet secured loans. This plainly has significant consequences for, amongst other things, a financial institution’s capital adequacy and taxation obligations. Ascertaining whether a ‘true sale’ has occurred is made more difficult by the fact that there is no Australian case on point, and the few cases that have been decided overseas are somewhat inconsistent.

C Impact of the Consumer Credit Code

Since 1 November 1996, many of the housing loans taken out in Queensland have been regulated by the Code⁷³. Substantially similar codes exist in all Australian States, although some differences do exist between States. The law in the State where the loan was taken out normally governs the term of the contract, even when the borrower moves interstate.⁷⁴

For present purposes, the principal aspect of the Code that has caused concern in the industry has been whether the SPV, as well as the originator, may be classed as a ‘credit provider’, and whether the SPV is therefore subject to the responsibilities imposed on credit providers by the Code. These responsibilities include the provision of:

- full, pre-contractual disclosure to borrowers and guarantors of the details of credit contracts;⁷⁵

73 Certain provisions of the Code, such as those relating to court applications for a variation of credit terms based on hardship, do not apply to home loan contracts (credit contracts) with a maximum loan amount exceeding A\$125 000: s 66(3). See also Rajapakse, above n 9.

74 These mirror codes, which are State legislation, were introduced across Australia on 1 November 1996. In the context of RMBS programs, they regulate mortgages for residential owner occupation executed after 1 November 1996, as well as mortgages containing continuing credit provisions (this includes revolving home equity loans) executed before 1 November 1996. They also regulate all contracts entered into by credit providers with individuals where the credit is wholly or predominantly for personal, domestic or household purposes, including all personal loans, overdrafts, credit card facilities, credit and debt facilities, consumer leases, consumer hire purchases and retail credit: see, eg, s 4 of the Code. The majority of the financial assets that have been securitised in Australia to date have been residential real property mortgages and guarantees.

75 See ss 14–15 of the Code.

- regular account statements and notices⁷⁶ (including notices of any changes in the interest rate, and account keeping fees and charges)⁷⁷ so that borrowers are aware of the current state of their loan accounts; and
- key rights to borrowers, such as:
 - the right to negotiate a variation of loans up to \$125 000 on the grounds of temporary hardship (eg illness, unemployment);⁷⁸
 - a right to apply to a court or tribunal to reopen unjust transactions⁷⁹ and review unconscionable interest and other charges;⁸⁰ and
 - a right to protection against enforcement of unfair loan agreements by the lender.⁸¹

76 See ss 31–34, and 58–64 of the Code.

77 See also Anthony Duggan and Elizabeth Lanyon, *Consumer Credit Law* (1999) ch 11.

78 Sections 66–9 of the Code. Debtors who are unable to meet their repayment obligations because of substantial hardship caused by circumstances such as unemployment or illness may apply to the credit provider for extensions of time, or postponement, or reduced payment arrangements. These provisions apply only if the debtors can reasonably expect to meet their obligations if these variations are granted. A debtor may apply to a court if the provider refuses to agree to a variation. This right is not available if the credit amount exceeds A\$125 000.

79 Sections 70–1 of the Code. A debtor, mortgagor or guarantor may apply to a court for a determination on whether a credit contract is unjust: ss 70–3 of the Code. If this is proven, the contract may be reopened and appropriate remedies granted. The meaning of 'unjust' is very wide. Under s 70(7) of the Code, it includes 'unconscionable, harsh or oppressive' credit contracts, and could go further. For example, it is not inconceivable that a credit contract might be found to be unjust if it breaches the moral standards that the community expects from business operators. The court must consider 'the public interest', and all the circumstances of the case, in a manner reminiscent of the factors considered under the unconscionability provisions of the *Trade Practices Act 1974* (Cth). The court also has wide powers to reopen an unjust transaction. Those orders include relieving the debtor or guarantor of his or her payment obligations. Section 74 of the Code enables the court to join, as parties to proceedings, additional persons who have an interest in the profits of the mortgage or a beneficial interest in a mortgage, and to make orders affecting the persons if the court holds the mortgage to be unjust: *Crococo v Esanda Finance Co Ltd* (1993) ASC 56, 223. It is conceivable that, if the court holds the residential loan contracts in an RMBS program to be unjust, the court could join the trustee of the SPV as a party to the proceedings, and make an order concerning the trustee which, while not explicitly, could indirectly impact in an adverse manner on the interests of bondholders in the sense that the trustee would seek indemnification from the trust fund. It is also conceivable that an originating lender might join the trustee of the SPV and seek a contribution from it for compensation payable. See Trevor Robinson, 'Securitisation Update' (Paper presented at the Seventh Annual Credit Law Conference, Melbourne, 1997) 4–5.

80 Section 72 of the Code. In practice, an application fee is generally payable by the mortgagor to the Originator/Servicer. Section 72 of the Code provides that upon the application of a debtor or guarantor, the court may declare an establishment fee or charge to be unconscionable and annul or reduce the fee or charge. Section 72(3) states:

In determining whether an establishment fee or charge is unconscionable, the court is to have regard to whether the amount of the fee or charge is equal to the credit provider's reasonable costs of determining an application for credit and the initial administrative costs of providing the credit or is equal to the credit provider's average reasonable costs of those things in respect of that class of contract.

While there is no formal definition of 'establishment fee or charge' in the Code, s 72(3) of the Code indicates that it is the fee imposed for determining the application, together with the initial administrative costs of providing credit. While s 72(3) of the Code does not strictly compel credit providers to ensure that their establishment fees or charges exceed the credit provider's costs, it plainly creates considerable incentive for the credit provider to do so when read together with the other provisions in s 72 of the Code. Under these other provisions, credit providers who do not relate establishment fees to reasonable costs run the risk of actions by debtors and guarantors for court orders. Section 19 of the Code also gives the debtor the right to terminate the credit contract before credit has been provided.

81 See pt 5 of the Code.

Plainly, across all borrowers in a mortgage pool, performing these statutory responsibilities involves significant costs. Moreover, failure by the credit provider to perform its responsibilities under the Code can involve civil⁸² and criminal⁸³ liability, not only for itself, but also for any linked supplier⁸⁴ who is also deemed a 'credit provider' for the purposes of the Code.

1 Who is the Credit Provider in an RMBS Program?

A 'credit provider' is defined in the Code as '*a person that provides credit, and includes a prospective credit provider*'.⁸⁵ 'Credit' is defined in the following terms:⁸⁶

For the purposes of this Code, 'credit' is provided if, under a contract:

- (a) payment of a debt owed by person (the debtor) to another (the credit provider) is deferred; or
- (b) one person (the debtor) incurs a deferred debt to another (the credit provider).⁸⁷

82 A debtor or guarantor in a relevant residential mortgage loan may apply to court regarding a possible breach of any of the key requirements of the Code: ss 100–1. If the breach is proven, the credit provider may lose all the interest charges owing on the mortgage loan. Alternatively, if it is a continuing credit contract, the credit provider could lose all interest charges for the period ordered, which could be significant if the interest is compounded, for example, on a monthly basis. Where the debtor's or guarantor's loss is greater than the amount of outstanding interest charges, the credit provider may be ordered to pay compensation to the actual loss: ss 103, 107.

The extent of any civil liability might even depend upon who makes the application for the imposition of these civil consequences. If it is the debtor, then the size of the penalty can be significantly greater than would be the case if the credit provider or the 'State Consumer Agency' – for example in Queensland, the Office of Fair Trading – brought the application. The credit provider is subject to a maximum fine of A\$500 000 for each key contravention under the Code.

In terms of other forms of civil liability, div 2 pt 6 of the Code provides that a court may order the credit provider to make restitution or pay compensation to any person affected by a contravention, other than one for which a civil penalty is specifically provided for in the Code. This could conceivably extend to securitised bondholders. In addition, a credit provider's failure to comply with certain requirements in connection with a mortgage or guarantee may result in the mortgage or guarantee (or particular provisions of those documents) being ordered void or unenforceable.

83 If the credit provider, or officers of a corporate credit provider, commit an offence or aid and abet the commission of that offence, they would be exposed to monetary penalties. The level of penalty varies according to the seriousness of the contravention, but the maximum penalty currently provided for in the Code is A\$10 000.

84 In terms of the liability of such a linked credit provider, a credit provider may become 'linked' to a loan contract if a supplier of goods and services regularly refers its customers to that credit provider or has a contract, arrangement or understanding with the credit provider. For example, an agent for a bank often arranges home mortgage finance for clients of a building company, which sells house and land packages. The bank might be classified as a linked credit provider to the building company on the basis of these dealings. This linked credit provider might become liable under ss 117–18 of the Code for misrepresentations or breaches of contract by the supplier, if it is not commercially worthwhile to sue the supplier (eg, because it is insolvent or in liquidation).

85 See sch 1 of the Code.

86 Section 4 of the Code.

87 According to s 4(2) of the Code, the amount of credit is the amount of the debt actually deferred, excluding interest and certain other charges under the contract.

Except in the case of IMPs who effectively act as spotters for the banks or larger mortgage providers,⁸⁸ in practice, virtually all mortgage originators are credit providers under this definition and are therefore subject to the responsibilities imposed on credit providers by the Code.

However, in the context of RMBS programs, once the originator's mortgagee rights have been assigned in equity to the SPV, the real question is whether, for the purposes of the Code, the credit provider is the originating lender or the trustee-issuer. This question is governed by s 166 of the Code. It provides that:

- (1) If the rights of a credit provider under a credit contract, mortgage or guarantee are assigned or pass by law to another person, this Code from then on applies to that other person, and does not impose any further obligation on the credit provider.
- (2) The debtor, mortgagor or guarantor has and may exercise the same rights in respect of the credit contract, mortgage or guarantee against the assignee as the debtor, mortgagor or guarantor has against the credit provider.
- (3) Subsection (1) does not apply while the credit provider continues to receive payments from the debtor ...

Taken together, these provisions would seem to imply that, after their housing mortgage has been assigned in equity to an SPV, the borrowers/mortgagors would hypothetically have the same rights against the trustee-issuer (assignee) as they had against the originating bank or IMP (ie assignor)⁸⁹ who made the loan to them.⁹⁰

However, as noted earlier, in practice, notice of the assignment is not generally given to debtors. Borrowers would therefore not normally be aware that an assignment has taken place, and would continue to make repayments to their initial credit provider (the assignor). This would seem to imply⁹¹ that the originating bank or IMP, rather than the SPV, remains the 'credit provider' for the purposes of the Code. This is, of course, a line of argument that the banks and sponsors of RMBS

88 In the case of those IMPs that effectively act as 'spotters' for the banks or larger mortgage providers, the initial lender, not the IMP, will normally be the credit provider for the purposes of the Code. After assignment, the issues relating to who is the relevant 'credit provider' for the purposes of the Code – ie, the initial lender or the SPV – are the same as set out in s 166.

89 Section 166(2) of the Code; see also Robinson, above n 79, 4. Borrowers/mortgagors would also acquire the usual rights under general law against the equitable assignee that result from equitable assignment: see Meagher et al, above n 43, [699], [6100], [6101]; Anthony Duggan, 'Regulated Credit: The Sale Aspect' (1986) [12.32]. For example, if the originating bank or IMP (assignor) imposes excessive charges on the mortgagor in contravention of ss 21 or 30 of the Code, the mortgagor would be able *ex facie* to assert a right to recover the amount of the excess from the SPV (assignee). Similarly, the mortgagor may potentially have rights, actionable directly against the SPV (as assignee), in respect of misrepresentations or misleading conduct by the originating bank or IMP, either at common law or under legislation such as the *Trade Practices Act 1974* (Cth).

90 In short, they may sue the trustee-issuer of the SPV as assignee of the originating mortgagee's rights. By itself, s 166(1) of the Code is plainly a statutory gloss on the equitable rule that obligations cannot be assigned.

91 By virtue of s 166(3) of the Code.

issues would have considerable incentive to employ, should any cases on point be litigated.⁹²

At least for typical RMBS programs, the effect of s 166 of the Code would seem to be that the originating bank or IMP remains the credit provider so long as it continues to receive repayments from the mortgagors but, once that ceases, the trustee-issuer of the SPV should effectively become the credit provider, and assume the attendant responsibilities under the Code. The effect is more likely to be of intellectual curiosity than of practical significance since, if borrowers are never notified of the assignments to the SPV, in the normal course of events they will continue making repayments on their loans to their originating lender until the loans are paid off. After that point, there should, in general, be no practical concern as to whether the SPV or the originator is the relevant 'credit provider' under the Code.

In any event, under the recently enacted s 169A,⁹³ the Code allows stakeholders to grant indemnities in respect of civil and criminal liability under the Code. As noted earlier, the trustee-issuer is, in practical terms, not responsible for compliance with the Code and probably does not strictly need an indemnity against liability potentially arising under it. Nevertheless, a court or tribunal order may still be made under s 74 of the Code, and it would be imprudent if trustees did not obtain an indemnity from the credit provider against such a liability. Such indemnities are justified on the basis that, if they were not given, the trustee-issuer of the

92 A counter-argument is that, in this situation, while the borrowers are continuing to make post-assignment repayments to the bank or IMP as credit providers from the borrowers' perspective, the bank or IMP is receiving the repayments as agent from the SPV's (assignee's) perspective. However, the problem with this counter-argument is that the borrowers are not given notice of the assignment, so that the bank or IMP would appear to be acting as agent for an undisclosed principal. According to the doctrine of the undisclosed principal, it is arguable that the originating bank or IMP remains liable as the credit provider, not only on the basis of s 166(3) of the Code, but also at common law. See, eg, *Keighley, Maxsted and Co v Durant* [1901] AC 240, 261; *Vital Finance Corporation Pty Ltd v Taylor* (1993) ASC 56-205, 58, 179, 182; Donald Greig and Jim Davis, *The Law of Contract* (1987) 1001; Simon Fisher, *Agency Law* (2000) ch 10.

93 Section 169A was inserted into the Code by the *Consumer Credit Code Amendment Act 1998* (Qld). It provides that:

- (1) An indemnity for any liability under this Code is not void, and cannot be declared void, on the grounds of public policy, despite any rule of law to the contrary.
- (2) The liabilities to which this section applies include the following -
 - (a) a liability for any criminal or civil penalty incurred by any person under this Code;
 - (b) a payment in settlement of a liability or alleged liability under this Code;
 - (c) a liability under another indemnity for any liability under this Code.
- (3) This section is subject to s 169(2).
- (4) This section does not derogate from any other rights and remedies that exist apart from this section.
- (5) This section extends to any indemnity obtained before the commencement of this section.

In short, the section allows any stakeholder who is potentially liable under the Code to obtain an indemnity from another person, who may themselves in turn obtain an indemnity from anyone except the borrower or guarantor: s 169(2). In general, rights and remedies under general law are preserved. Section 169A(2) allows a credit provider to contract out of liability for a criminal penalty under the Code. At common law, such an agreement would be void as contrary to public policy, but s 169A(1) displaces this rule. It provides that an indemnity from any person for any liability under the Code is not void on the ground of public policy. The provision also validates indemnities obtained retrospectively.

SPV would not be obtaining 'clean' mortgagee rights, for which it gave good consideration when those rights were assigned to it in equity. Not surprisingly, it is common, not only for trustee-issuers (or their fund managers) to obtain such indemnities from originators,⁹⁴ but also: for originating banks or IMPs to obtain similar indemnities from their agents or 'spotters'; for trustee-issuers to obtain indemnities from their fund managers, usually to a pre-specified limit,⁹⁵ and thereafter from the trust assets;⁹⁶ and for the security trustee to obtain indemnities from the trustee-issuer.

2 Prepayment of Housing Loans

Early payout, or 'prepayment', of loans by borrowers is one of the chief cash flow management problems that face any lender. Notwithstanding the age of information technology and financial engineering, prepayment still interferes significantly with a lender's operating budgets, since unexpected prepayments interfere with the timing and duration⁹⁷ of interest income, principal repayments and expenses that the lender has carefully scheduled and factored into its cash flow management algorithms.⁹⁸

In the context of RMBS issues, the SPV, as equitable assignee of the originating mortgagee's rights, is in a similar position to that of the traditional lender when initial borrowers in the mortgage pool pay out their loans early. The normal way that lenders deal with borrowers' prepayment of loans is to levy an early prepayment charge, which generally equates to the capitalised value of the estimated net interest and fees foregone.

Under the Code, the mortgagor-borrower or guarantor is not only entitled to pay out the loan contract at any time,⁹⁹ but is also entitled to make partial prepayments at any time and be given credit for them.¹⁰⁰ Like traditional lenders, RMBS program sponsors cannot prohibit prepayments ahead of time. As a solution, the RMBS program sponsors, like traditional lenders, impose fees upon partial prepayment

94 See, eg, in the context of Macquarie Bank's RMBS programs, PUMA Fund, above n 7, 46–7. Perhaps, interestingly, APRA does not regard this as a contravention of its prudential regulatory guidelines in relation to the assignment being a 'true sale', presumably because indemnities in respect of liability under the Consumer Credit Code are not regarded as granting the SPV recourse back to the originator in respect of its primary debt obligations (which is the main thrust of the prudential requirements).

95 For example, under the Management Deed of the Macquarie Securitisation Program, the PUMA Fund, the Fund Manager has agreed to indemnify the trustee-issuer against any civil liability under the Code up to a maximum of A\$500 000.

96 See, eg, PUMA Fund, above n 7, 86–7.

97 Duration, in this context, is defined in a financial engineering sense, as a measure of the average time at which payments are made, weighted by the size of the payments: see Ben Hunt and Chris Terry, *Financial Institutions and Markets* (3rd ed, 2002) 192; Tom Valentine, Guy Ford and Richard Copp, *Financial Markets and Institutions in Australia* (2003) 173–82.

98 See generally, Valentine, Ford and Copp, above n 97, ch 7.

99 Section 75(1) of the Code.

100 Section 24 of the Code.

as well as early payout.¹⁰¹ This is permitted under the Code, which also regulates the level of the fees charged.¹⁰²

In practice, the amount of the fee will reflect the costs and loss of income associated with reinvestment of the prepaid principal from the date of prepayment to that of the final scheduled payment under the loan. These costs and losses are generally also covered by mortgage insurance policies,¹⁰³ in the event that the sponsor makes significant losses (for example, because the prepaid principal cannot be reinvested at comparable rates).¹⁰⁴

3 State-Based Legislation for the Consumer Credit Code

The *Consumer Credit Code* is based on the *Consumer Credit (Queensland) Act 1994* (Qld). Under the *Australian Uniform Credit Laws Agreement 1993*, the Australian States and Territories were required to enact legislation enabling the Code to take effect in their jurisdiction. Although the aim is to provide for uniform national legislation, the *Australian Uniform Credit Laws Agreement 1993* specifically allows variation in legislation between States and territories to provide for:

- the establishment, jurisdiction and functions of the government consumer agency;
- the designation of the court or tribunal having jurisdiction to hear matters arising out of the Code;
- the regulation of credit providers.

While the *Australian Uniform Credit Laws Agreement 1993* has similar objectives, the regulation and administration of each State *Consumer Credit Code* varies, resulting in potentially significant differences in the incidence of:

- licensing of credit providers in each State;
- methods of enforcement actions between tribunals and the civil penalties imposed in each State;
- stamp duty, such as the stamp duty charged on the re-financing of existing mortgages in the pool;

101 A related issue is whether an early termination or prepayment fee can take into account not only the administrative costs of the SPV, but also of other parties such as the servicer. To the extent that these costs are generally reflected in those of the SPV itself, the answer would appear to be in the affirmative, for reasons similar to those set out here.

102 Section 72(4) of the Code provides:

For the purposes of this section, a fee or charge payable on early termination of the contract or a prepayment of an amount under the credit contract is unconscionable if and only if it appears to the court that it exceeds a reasonable estimate of the credit provider's loss arising from the early termination or prepayment, including the credit provider's average reasonable administrative costs in respect of such a termination or prepayment.

103 For example, Macquarie Bank's PUMA Fund: see PUMA Fund, above n 7.

104 In fairness to the banks and other IMPs, home loan borrowers are often also entitled to redraw on previously prepaid principal amounts (generally without penalty): see *ibid*, 56–7.

- land tax, such as on rental properties in the pool (principal places of residence are typically exempt from State land tax);¹⁰⁵
- transaction taxes (eg State financial institutions duty¹⁰⁶); and
- State government administration fees, such as fees imposed by State government departments for processing dutiable transactions.

The following table provides the details of the legislation passed in each State, the differences between jurisdictions in the administration of the *Consumer Credit Code* and general differences in their approaches to licensing and registration of credit providers.

Consumer Credit Legislation and Administration by State/Territory

State	Legislation	Administrative Authority	Court/Tribunal	Licensing Scheme for Credit Providers
Queensland	<i>Consumer Credit (Queensland) Act 1994</i> (Qld) Enacted template legislation	Office of Fair Trading	Courts (jurisdiction determined by monetary limit) Small Claims Tribunal	Negative licensing
New South Wales	<i>Consumer Credit (New South Wales) Act 1995</i> (NSW) Enacted template legislation	Department of Fair Trading	Consumer, Trader and Tenancy Tribunal Courts (jurisdiction determined by monetary limit)	Negative licensing: <i>Consumer Credit Administration Act 1995</i> (NSW)
Victoria	<i>Consumer Credit (Victoria) Act 1995</i> (Vic) Enacted template legislation	Consumer and Business Affairs	Civil and Administrative Tribunal Courts (jurisdiction determined by monetary limit)	Credit providers must register with the Credit Authority in Victoria: <i>Consumer Credit Code (Victoria) Act 1995</i> (Vic) s 11

¹⁰⁵ See *Land Tax Act 1915* (Qld) s 13.

¹⁰⁶ However, the Bank Account Debits Tax is a Commonwealth tax and therefore is applied uniformly across all States: see *Debits Tax Act 1982* (Cth) ss 3–5, ss 8–10.

South Australia	<i>Consumer Credit (South Australia) Act 1995 (SA)</i> Enacted template legislation	Office of Consumer and Business Affairs	Small Claims Division of the Magistrates' Court Courts (jurisdiction determined by monetary limit)	Negative licensing – <i>Credit Administration Act 1995 (SA)</i>
Tasmania	<i>Consumer Credit (Tasmania) Act 1996 (Tas)</i> Enacted template legislation	Office of Consumer Affairs	Small Claims Division of the Magistrates' Court Courts (jurisdiction determined by monetary limit)	Negative licensing
Northern Territory	<i>Consumer Credit (Northern Territory) Act 1995 (NT)</i> Enacted template legislation	Department of Industries and Business	Local Court (Small Claims Court) Courts (jurisdiction determined by monetary limit)	Negative licensing
Australian Capital Territory	<i>Consumer Credit (Australian Capital Territory) Act 1995 (ACT)</i> Enacted template legislation	ACT Consumer Affairs Bureau	Small Claims Division of the Magistrates' Court Courts (jurisdiction determined by monetary limit)	Credit providers must register with the Credit Authority in ACT (based on the Victorian system): <i>Consumer Credit Administration Act 1996 (ACT)</i> s 7
Western Australia	<i>Consumer Credit (Western Australia) Act 1996 (WA)</i> Enacted template legislation in 2002	Ministry of Fair Trading	Small Claims Division of the Magistrates' Court Courts (jurisdiction determined by monetary limit)	Positive licensing scheme for credit providers remain in place: <i>Credit Administration Act 1984 (WA)</i> s 6

Source: This Table is compiled from information supplied in: KPMG Consulting Group, *NCP Review of the Consumer Credit Code* (2000) The Uniform Consumer Credit Code <<http://www.creditcode.gov.au>> at 12 December 2004; Anthony Duggan and Elizabeth Lanyon, *Consumer Credit Law* (1999).

Although one of the aims of the Code is to create uniform regulation of lending to consumers, this has not impacted on certain administrative forms of regulation, including licensing. As shown in the above table, each State and Territory is free to adopt its own form of licensing of credit providers,¹⁰⁷ or to have no specific licensing and to rely instead on the Code (ie, negative licensing).¹⁰⁸

New South Wales, Queensland, South Australia and the Northern Territory introduced negative licensing of credit providers, instead of licensing, with the conduct of credit providers supervised by the Government Consumer Agency of each State and Territory (for example, the Office of Fair Trading (Qld)). Not all credit providers have to be licensed under the Code, and licensing is required only where 'providing credit' is by way of a regulated contract or a regulated mortgage.¹⁰⁹

Licensing of credit providers can be considered as a measure of controlling their conduct, and entry of participants into the credit industry. It appears from the above table that the regulatory regime for the licensing of mortgage securitisation industry participants throughout Australia is inconsistent, although a negative licensing regime generally applies in some States under the Code.

The lack of uniformity between jurisdictions in the administration of the *Consumer Credit Code* and differences in the licensing of credit providers have the effect of substantially increasing uncertainty for mortgage industry participants, and result in increased compliance costs and barriers to interstate expansion. Further, the different interpretations and methods of enforcement actions between tribunals in each State could seriously undermine the efficiency of lenders.

4 Civil Penalties for Defaults

The civil penalty regime under Part 6 of the Code¹¹⁰ could potentially increase the compliance cost of mortgage securitisers. The costs incurred by mortgage originators in a civil penalty application and the damage to the originators' reputation can be more significant than the actual civil penalty imposed. The rating agencies have expressed concerns about the potential financial burden of penalties meted out under the Code for inadvertent violations.¹¹¹ The cost of additional enhancement by mortgage securitisers to offset these concerns would generally be passed on to consumers in terms of higher interest rates or charges.

107 *Credit Administration Act 1984* (Vic); *Credit Administration Act 1984* (WA); *Credit Administration Act 1995* (SA); *Consumer Credit (Administration) Act 1996* (ACT).

108 Negative licensing means either automatic registration or no requirement for registration at all, subject to deregistration or exclusion from the industry.

109 The following are exempted from licensing under the Code because they are regulated under their own legislation, but still must comply with other requirements of the Code: the Crown, a public or local authority, banks, insurance companies, pawnbrokers, friendly societies, building societies, co-operative societies, credit unions and pastoral finance companies.

110 Sections 100–6 of the Code.

111 Standard and Poor's, *An Investor Guide to Australia's Housing Market and Residential Mortgage-Backed Securities*, above n 5, 19–20.

Further, the potential cost of being subjected to the civil penalty regime may act as a barrier to entry for small scale IMPs and may cause small firms to leave the mortgage securitisation industry.

On the other hand, the civil penalty provisions reinforce borrower confidence in housing loan contracts, encourage compliance by avoiding penalties for breaches of 'key requirements' of the Code, and compensate borrowers for loss suffered as a consequence of contraventions. In this regard, the civil penalty regime would facilitate the objective of truth in lending, and fair trading objectives such as the provision of redress mechanisms for housing loan borrowers and ensuring minimal misleading and deceptive conduct by securitisation industry participants.

III QUALITATIVE ASSESSMENT OF LAW AND PRACTICE

A Objectives and Criteria

In order for the sale of mortgages to the SPV to occur effectively, the following objectives and criteria must be achieved. These include:

- the off-balance sheet treatment of assets: if structured as a sale of mortgage receivables, securitisation can allow the originator to remove its assets from the balance sheet, reduce its assets and its debts, thereby increasing its scope for borrowing. In effect, mortgage securitisation allows an ADI to achieve greater leverage;
- making the SPV 'insolvency-remote': the SPV must be insulated, to the extent practicable, from a possible insolvency of the originator;
- separating the source of payment i.e. mortgage receivables from the originator in the event the originator becomes insolvent: the SPV must be 'ring-fenced' from the originating bank or mortgage originator; that is, the SPV structure must be legally separated from the originating lender and its management;
- bringing into effect a 'true sale' of the mortgages;
- reduction in the cost of funds for originators and issuers: RMBS issues may alleviate the agency costs of primary debt lending, by lowering the costs of monitoring borrower behaviour. RMBSs are also rated more highly than normal corporate bonds by rating agencies, because of the isolation of mortgages in an 'insolvency-remote' entity, thus reducing the cost of funds to the originator when compared to other traditional forms of financing. In addition, assigning its rights as mortgage lender or originator reduces the bank's or IMP's regulatory compliance costs, and its overall cost of funds;
- opportunity for risk management afforded to originators: for example, credit risk and interest rate risk are the key uncertainties that concern ADI lenders. By passing on these risks to investors, or to third parties when credit enhancements are involved, ADIs are better able to manage their risk exposures.

B Law and Regulation that Facilitate Growth in the Market

This section provides a qualitative assessment of the extent to which the existing law and regulation relating to the transfer of mortgagee rights to the SPV impedes or facilitates the achievement of these objectives and criteria in RMBS issues in practice.

1 Property Legislation

Mortgage securitisation involves transfer of a lender's right to receive principal and interest repayments on the mortgage – it is a transfer of a right to the assignee (SPV). It is therefore, required that the law of property or the contract between the parties should not prohibit the right to assign mortgages to a third party in equity at minimal cost to the assignor and assignee. If the underlying mortgage contract has an obligation on the part of the issuer, which cannot be divested from the rights of the originator, then the rights cannot be transferred independent of the obligations. Hence, the risks associated with the assets cannot be eliminated, in which case mortgage securitisation cannot function.

2 SPV Trust Structure

In Australia, the use of a trust as an SPV in residential mortgage securitisations facilitates an off-balance sheet treatment of assets for accounting purposes, where the trustee company is not related to, or a subsidiary of, the originator for the purposes of the Australian accounting standard on consolidation.¹¹² The 'insolvency-remoteness' of the SPV is accomplished by establishing the SPVs as master trusts, which cannot be insolvent or become the subject of a bankruptcy case. This is because trusts do not have any legal capacity separate from the trustee or beneficiaries. In practice, the SPVs comprise two classes of trust funds – warehouse funds and sub-funds. The assets of the master trust cannot be used to meet the liabilities of any other trusts, and none of the assets of other trusts are available to meet the liabilities of the master trust fund.¹¹³ Such a structure provides comfort to investors that they are investing in a pool of mortgages which is not subject to any subsequent deterioration in the credit quality of the originator. In this way, a separation of the originating bank and the SPV is achieved.

The transfer of the originating bank's rights to a legally separate trust alleviates the agency costs of primary debt lending, by lowering the costs of monitoring borrower behaviour.¹¹⁴ Separating the originating bank from the mortgage loans in the pool can enable the originator to raise funds at lower cost, through the RMBSs issued by the SPV, than if it raised funds through securities issued directly. For example, the RMBS issued by the SPV, depending upon the structure of the

¹¹² Australian Accounting Standard, above, n 40 [xxi –xxiii].

¹¹³ See, eg, PUMA Fund, above n 7, 38–9, 89.

¹¹⁴ See Bernadette Minton, Tim Opler and Sonya Stanton, 'Asset Securitisation Among Industrial Firms' (Working Paper, Fisher College of Business, Ohio State University, 1997).

transaction, may have a higher investment rating than securities issued directly by the originator (particularly if the originator is a regional bank or an IMP) and, therefore, would typically bear a lower interest rate than the originator might be able to obtain for its own securities. Accordingly, the use of a trust structure in the RMBS programs ensures insolvency-remoteness of the SPV, and off-balance-sheet financing for the originator (for accounting purposes) in a manner that would appear to be in the stakeholders' interest and for the public benefit.

3 APRA Guidelines for Achieving a 'Clean Sale'

Having accomplished a separation of the originator and the SPV, the stakeholders must ensure that the ownership of the mortgages, together with the attendant risks and rewards in respect of the assets, are effectively transferred to the SPV. This is necessary in order to justify a finding that a 'true sale' or 'clean sale' of the mortgagee's rights has occurred. APRA has issued prudential guidelines setting out the criteria for a 'true sale', with which banks and SPVs should comply.¹¹⁵ These guidelines assist originators in the sense of providing clear criteria for achieving a clean transfer of the assets and therefore capital relief for capital adequacy purposes. In ensuring that these criteria are achieved in an RMBS issue, the key considerations are the method of transfer of the mortgage assets and the so-called 'moral' risks retained by the originating bank. A 'true sale' will not be effected if, for example, the originator retains a right to share in any profits of the SPV, or investors in the RMBSs have any recourse back to the originating bank.

4 Consumer Credit Code Disclosure Requirements

The *Consumer Credit Code* requires that certain information is incorporated into the mortgage documents and the related contractual documentation. Standardisation of this information in home loan contracts facilitates securitisation of these loans.

Two limbs of the Code are aimed at ensuring that a debtor is informed of all important terms of a proposed credit contract in a form that is readily understood. They are: (a) disclosure requirements; and (b) the mandatory provision of documentation in plain English.

In terms of disclosure requirements, ss 14 and 15 of the Code stipulate that:

- (i) a credit contract document must disclose the matters set out in s 15; and
- (ii) there must be both a pre-contractual statement setting out all the same matters as are referred to in s 15 (the statement can take the form of a copy of the proposed contract) and an information statement in a form prescribed by the regulations detailing the debtor's statutory rights and obligations.

¹¹⁵ APS 113; *Funds Management and Securitisation* – APS 120 (2000) Australian Prudential Regulatory Authority <<http://www.apra.gov.au>> at 25 March 2004.

Credit providers who fail to disclose these key requirements are potentially liable for a civil fine of up to \$500 000 for each non-disclosure. To protect against this potential liability, issuers in practice typically need to obtain additional credit support of up to a \$500 000.

Importantly, the matters that need to be disclosed under s 15 in the pre-contractual statement and the credit contract include the commissions to be paid by, or to, the credit provider (s 15(M)), which includes any amounts payable to mortgage originators.

Disclosure of all the key requirements, which include terms and cost of the credit contract, will enable the prospective borrowers to make a fully informed decision as to borrowing, and to know their rights and obligations relating to the credit contract. Pre-contractual disclosure can contribute to informational efficiency and ultimately to social welfare by enabling lenders, borrowers and investors to gather information at a reduced cost. This will result in a borrower becoming increasingly aware of their rights under the Code, and (in the absence of market imperfections) a correspondingly greater incentive on mortgage originators to comply with the Code to avoid penalties.¹¹⁶

The regulatory provisions under the Code require standardisation in all aspects of the loan documentation. Standardisation does not necessarily mean that all lenders must extend using the same criteria or on the same terms but rather that certain fundamental aspects of the lending process are standardised among lenders. For instance, lenders may adopt a standard form of mortgage loan agreement that provides adequate protection to all lenders. It ensures that investors in a pool of mortgage loans or the rating agencies do not have to analyse the risk of several different legal documents. The requirement of standard loan documentation could be expected to facilitate the growth of the RMBS market.

The disclosure requirements under ss 14, 15 and 16 also help to ensure that all credit contracts provide the same type of information to borrowers. This does not mean that each lender must grant credit according to the same criteria, but means rather that each lender must provide the same key information to all borrowers, making it easier for borrowers to compare loans originated by different lenders.¹¹⁷

5 Amendment under Section 169A of the Code

Under many RMBS programs, the initial credit provider for the housing loan is the originator of the loans for the program. As discussed earlier, under s 166 of the Code, the originating bank or IMP remains the credit provider so long as it continues to receive repayments from the mortgagors but, once that ceases, the trustee-issuer of the SPV effectively becomes the credit provider, and assumes the attendant responsibilities

¹¹⁶ The increased uniformity and clarity of the codes throughout Australia may, other things being equal, help to produce a more informed generation of borrowers. On the other hand, this may have the potential for more disputes to arise regarding the credit contract.

¹¹⁷ Cf if credit contracts were allowed to contain different sets of information, it would be more difficult for investors to evaluate loans originated by one lender against loans originated by another lender.

under the Code.¹¹⁸ These amendments to the Code are likely to substantially encourage the development of the RMBS market in Australia and facilitate the delivery of the benefits of mortgage securitisation to program participants.

There would appear to be room for further amendment to the Code, in order to clarify the meaning of the 'nominated credit provider' within an RMBS program. The Code should, to remove any doubt, provide that the mortgage originator or fund manager named in the credit contract is the 'nominated credit provider' for the purposes of the Code.¹¹⁹

C Law and Regulation that Impede Growth in the Market

The common law requirements or criteria for establishing a 'true securitisation' are less stringent than those from an accounting standards perspective.¹²⁰ In considering the issues concerning whether a 'true sale' has taken place, the courts have not developed a definitive formula or set of factors to distinguish, in a securitisation context, between a true sale and a secured financing arrangement. It is possible for a court to come to a conclusion that the real intent of the securitisation transaction was not to legally or equitably transfer the mortgages to the SPV, but rather that it simply comprises an alternative financing arrangement. In the US, there have been cases where securitisations of loans receivables have been re-characterised by the courts as financing transactions, rather than effective transfers of mortgagee rights to the SPV.¹²¹

- 118 Trustees act as a bare trustee or mortgagee of record for mortgages on behalf of the lending institutions who may contract the mortgage origination process to mortgage originators. The Trustee's duty is to hold the legal interest on their behalf. Whether the Trustee becomes the credit provider for the purpose of the Code following the assignment of the loan and supporting security from the originator to the Trustee depends on whether the originator continues to receive payments from the borrowers following the assignment. However, Trustees' responsibilities are to their lender beneficiaries, bondholders and not to borrowers or mortgagors. Trustees do not have any day-to-day involvement in the origination or provision of funds for the housing loan, or the management or enforcement of mortgage loans. Instead, these functions are undertaken by the fund manager and/or by specialist mortgage originators appointed pursuant to a trust deed.
- 119 This again assumes no information asymmetry between the parties, and that existing market power regulation, such as the *Trade Practices Act 1974* (Cth), is sufficient to deal with any imbalances in market power between the parties.
- 120 See Plater, above n 18, 6–12; Christopher Wheeler, 'Accounting Aspects of Securitisation', in Charles Stone, Anne Zissu and Jess Lederman (eds), *Asset Securitisation Theory and Practice in Europe* (1991) ch 40.
- 121 If the originator becomes insolvent and the mortgages are owned in equity by an SPV, then the SPV would also be entitled to the repayments on the mortgages. Assuming the mortgages were paid, the SPV would then have sufficient cash to pay its securities without defaulting, which would be beneficial to investors in RMBS. If the transfer were held not to be a true sale, it would be deemed to be an advance of funds by the SPV to the originator, secured by the mortgages. This has significant consequences for, amongst other things, a financial institution's capital adequacy and taxation obligations. If the originator's rights have not been transferred to the SPV, it may aggravate the agency cost of primary debt lending by increasing the cost of monitoring borrower behaviour. The SPV would then be a creditor of the originator and have security interest, but not an equitable interest, in the mortgages. In such a case, the originator's insolvency would automatically result in a stay of all actions by creditors to foreclose on or otherwise obtain property of the originator. If the courts treat the transaction as a substantive borrowing, the investors would be worse off than a secured lender, as they would not even hold a perfected security interest.

Ascertaining whether a 'true sale' has occurred in Australia is made more difficult by the fact that there is no Australian case in point, and the few cases that have been decided overseas are somewhat inconsistent. Various courts have considered whether a given transfer of loan receivables constitutes a true sale or secured borrowing. The facts of the decided cases have not, for the most part, been representative of securitised transactions. It has been argued that the approach of the UK courts contrasts sharply to the approach that was taken in the UK FRS 5.¹²² In these circumstances, it is arguable that this gap in the existing law and regulation impede the growth of the RMBS market in Australia.

1 Notice of Assignment

In RMBS programs in practice, when mortgages are equitably assigned to the SPV, the mortgagors are generally not notified that the mortgagee rights to their loans have been assigned to the SPV-issuer, and they are not parties to the contract, in a legal sense. The risks of not notifying home loan borrowers impacts on RMBS programs in Australia in various ways. By informing the borrowers of the assignment of mortgages, the SPV would have an opportunity to obtain an acknowledgment from each of the borrowers as to the amount of his or her outstanding indebtedness. Each borrower would thereafter generally be estopped from claiming that, in fact, a lesser sum was due.¹²³ Since the borrowers are not informed of the equitable sales or transfers of their mortgages, the issuers would only be able to claim from them the amount actually due on the mortgages, and borrowers would not be estopped from bringing claims for greater amounts. There is, of course a theoretical risk of a mortgage being sold to an SPV on the basis of incorrect information as to the amount of the mortgage debt. However, in practice, the originator would be required to give a warranty as to the accuracy and truth of the particulars of the portfolio for the purpose of securitisation.¹²⁴

As discussed earlier, the banks' and the IMPs' failure to give notice to home loan borrowers that the mortgagee rights to their loans have been assigned, could create a moral hazard problem and have implications for economic efficiency. In addition, neglecting or deliberately failing to notify borrowers of a risk that their houses could be sold through no fault of their own, would seem at the least to be unconscionable and potentially in breach of consumer credit and trade practices legislation.

The SPV-assignee of a mortgage transferred under an equitable assignment is in a less secure position than it would have been, if that mortgage had been transferred under a legal assignment. While it is important for an SPV-assignee to minimise all unnecessary legal risks, this must be balanced against the cost of the

122 The English courts are more inclined to honour the expressed intention of the parties than read an implied intention into the circumstances. However, the US courts have delivered several decisions ignoring the body of an agreement and regarding a securitisation program as a financial transaction (ie essentially, as a secured loan). Accordingly, the cases are not easily harmonised, and which factors are relevant, and which should be given greater weight are open to interpretation.

123 *Dixon v Winch* [1900] 1 Ch 736 (CA); *Turner v Smith* [1901] 1 Ch 213.

124 PUMA Fund, above n 7, 49–50.

administrative inconvenience involved in providing the extra comfort of a legal assignment or complete transfer. Where the cost of this protection is excessive relative to the degree of risk involved, the ratings agencies are likely to (and in practice, frequently do) accept an equitable assignment of mortgages, provided the credit quality of the originator is good and, where necessary, alternative protection is provided through appropriate insurance policies.¹²⁵

It seems trite to suggest that, where mortgage rights have been or are about to be equitably assigned, legislation ought to require the bank or IMP, on the grounds of fairness as well as economic efficiency, to inform its borrowers of the sale and the identity of the new payee (assignee). Upon receipt of this notice, borrowers might well choose to continue to pay the SPV-assignee. However, if they elect to continue to pay the originator-assignor, legislation should be introduced to ensure that their loan could not be discharged, avoided or repudiated. Plainly such a statutory requirement for notification would be costly for the banks and IMPs. However, not to do so would be patently unfair to borrowers who discover too late that the power of sale over their mortgages has been exercised, through no fault of their own and without their knowledge.

In terms of the notice to borrowers, it might even be economically efficient to require under legislation that any assignments of mortgagee rights under RMBS programs be notified on the title deeds to the particular properties, so that the borrowers or the potential buyers of those properties are aware that the mortgage rights have been assigned to an SPV. This might be a relatively straightforward way of ensuring appropriate disclosure in a way that provides a demonstrable net public benefit.¹²⁶

Such legislation might also require the fine print in mortgage documents that relates to notice to borrowers to be drawn to the attention of the borrowers, with the implications of it being spelled out to borrowers in plain English. In the words of Master of the Rolls Lord Denning in *Thornton v Shoe Lane Parking Ltd*,¹²⁷ such clauses '*would need to be printed in red ink with a red hand pointing to it*'. Further, the effect of any assignment – viz that borrowers could lose their houses through no fault of their own – should be printed in big bold letters.¹²⁸ Once borrowers were alerted to this risk and could impart the information to others, the current information 'gap' between borrowers and originating lenders is likely to reduce. It could be argued that this may discourage the ADIs securitising the mortgages, and that the only reason they are involved in securitisation programs is that their borrowers are unaware of these risks.

125 Standard and Poor's, *Lenders Mortgage Insurance: A Form of Credit Enhancement to Australian RMBS* (2003) 19–22; Standard and Poor's *Australian & New Zealand RMBS Analysing Credit Quality* (2004) 35.

126 Plainly a rigorous 'public benefit test', perhaps along the lines of a social cost-benefit analysis, would need to be conducted to determine whether the social benefits outweigh the social costs.

127 [1971] 2 QB 163, 169.

128 This would help to ensure clear communication and a 'meeting of minds' between all of the parties and stakeholders concerned. The RMBS process is essentially a nexus of contracts. In an equitable environment, this 'meeting of minds' is one way to ensure that those contracts, and the points at which they interface, are mutually beneficial to the parties and other stakeholders.

2 Mortgage Prepayment

In drafting the terms of housing mortgage loan agreements, lenders are constrained by a range of consumer protection provisions in the Code. For investors, these protections create risk and uncertainty, which, in turn, raise the costs of securitisation or increase the costs of capital for issuers. From a policy perspective, the Code must balance the competing needs for consumer protection and investor protection.

The rates of principal and interest payments in mortgage loan pools vary between pools, and are influenced by economic, legal and demographic factors such as prevailing market interest rates for housing loans, and the terms and conditions of loans. There is no guarantee as to the actual rates of prepayment on the mortgage loans comprising the pools. Issuers usually have the right to 'call' (repay) the bonds they issue.¹²⁹ Borrowers typically prepay their fixed rate loans when interest rates fall, and that is precisely the time when investors would not welcome their money back. Thus, the rate and timing of principal and interest payments and the ability to redraw principal or request a further advance on a housing loan affect the rate and timing of payments on RMBSs, which in turn would affect the yields on the bondholders' investment. Overall, for investors, there will typically be a mismatch in terms of timing and structure of cash flow, which to them represents a cost.

The problem has not been resolved by property laws that stipulate the right of mortgagors to prepay without penalty. Risks to investors from prepayments are typically addressed by structuring SPVs so that the risks of prepayments are shifted and allocated between bondholder classes by distinguishing between the holders of senior and subordinated bonds.¹³⁰ This nonetheless presumably increases the cost of capital, because investors in the riskier series of RMBSs are likely to demand compensation from the SPV for their higher risks.¹³¹

129 See, eg, PUMA Fund, above n 7, 73.

130 In addition, investors' market risks from falling interest rates may be addressed in practice – albeit at a cost – by derivative contracts, such as swaps.

131 Establishment fees also represent a cost for borrowers. From the ADIs' perspective, credit providers are at risk in relation to their establishment fees or charges by virtue of s 72(1) of the Code, which permits a court to annul or reduce an establishment charge if it is 'unconscionable'. Pursuant to s 72(3), in determining whether an establishment charge is 'unconscionable', a court is to have regard to whether the amount of the charge 'is equal to the credit provider's reasonable costs of determining an application for credit and the initial administrative costs of providing the credit or is equal to the credit provider's average reasonable costs of those things in respect of that class of contract'. Plainly this is useful for borrowers.

However, the restriction has a special impact in the context of RMBS programs. It is quite commonplace in many programs that an originator obtains a substantial part of its revenue for procuring the settlement of a mortgage through the payment of an establishment fee by the debtor/mortgagor. Section 72 in effect prohibits this and generally requires RMBS programs to restructure the means by which originators are remunerated for introducing mortgages. The implication is that the RMBS program must either account to the originator on an ongoing basis for a share of the interest accrued in respect of the credit provided, or alternatively pay an upfront fee to the originator out of the program's own funds and absorb that cost over time. Under both these techniques, the ultimate cost of the originator's remuneration is passed on to borrowers. Bearing in mind that the amount and nature of any establishment fee or charge must be fully disclosed in a pre-contractual statement as well as in the contract document itself (s 15(G) – so that the debtor will always be aware of the amount of the establishment fee before entering into the credit contract – it is questionable whether this impact of s 72 was unintended by Parliament.

3 Mitigation of Risks under ss 66, 68 and 70 of the Consumer Credit Code

(a) 'Hardship Risk'

Additional liquidity risk would be introduced to mortgage-backed securities programs as a result of the application of ss 66 or 68 of the Code, which deals with borrower hardship. The programs may need to provide additional structural enhancements to mitigate the risk: ie an additional amount of cash collateral will generally be needed to provide sufficient reserves to cover any temporary payment relief granted to borrowers, and the maturity date of the RMBSs will require extension beyond the maturity date of the underlying mortgages. In addition, the programs must ensure whether the mortgage insurance will explicitly insure the lender against the risk introduced where the loan contracts are varied by either the credit provider or the courts. If the mortgage insurance policies do not cover these risks, the programs will need to incorporate additional credit enhancement into the RMBS structure. Such enhancement can add a significant cost to the transaction and, depending on the circumstances, may make it uneconomic.

(b) 'Unjust Contract' Risk

Under s 70 of the Code, the credit tribunal has the power to re-open unjust credit contracts, mortgages and guarantees where unfair tactics have been employed in the origination of these credit contracts; where the credit provider should have known that the borrower could not afford the loan; or where the terms of the contract could only be met with some financial hardship. Substantial delays may result in enforcing the credit contracts and security held; the assessment of the mortgage defaults, compliance and recovery options by the rating agencies would be costly and time consuming.¹³²

As a result of the operation of this section of the Code, additional credit support may need to be included in RMBS programs to mitigate the effects of credit risk for investors in RMBSs. Credit providers will also need to obtain professional indemnity insurance to cover the liability created by a breach of s 70.

4 Administration of the Code in Each State

The various codes in each State could cause significant difficulties in the future, as the regulation and administration of each code varies through modifications and related regulations in each State. As noted above, the different interpretations and methods of enforcement actions between tribunals in each State could seriously undermine the efficiency of lenders.

132 See generally, Standard and Poor's, above n 5, 36–42.

The rating agencies have expressed concerns about the potential financial burden of penalties meted out pursuant to the Code for inadvertent violations.¹³³ The cost of additional enhancement by mortgage securitisers to offset these concerns would generally be passed on to consumers in terms of higher interest rates or charges.

IV SUMMARY AND CONCLUSIONS

Although there have been no cases on point in Australia on whether an RMBS program involves a 'true sale' of mortgagee rights or should be viewed in essence as a complicated secured loan, and the overseas decisions offer little (and, even then, somewhat conflicting) guidance. However, to the extent that the accounting standards form part of the Australian corporations law, it is arguable that the Australian courts would look to see whether, in substance and taking account of all of the circumstances of the case, the mortgage originator owns or controls the SPV, or vice versa. The expressed intention of the parties, as evidenced by the documentation surrounding the issue, is likely to be of lesser importance in the courts' determination of the issues. Thus, merely calling the transaction a 'residential mortgage-backed securitisation' program is unlikely to be sufficient to make it one, if the overall transaction appears in substance to be a secured loan arrangement.

A crucial strategic issue for management in RMBS programs is whether there has been a 'true sale' of the mortgagee's rights to the SPV. As the relevant regulator, one of APRA's key concerns in relation to securitisation programs is whether sufficient risk and reward have been transferred from the originating bank to the SPV in order to justify a finding that a true sale of the mortgagee's rights has occurred. It will not be if, for example, the originating bank retains influence over the setting of interest rates, the way in which delinquent assets are followed up, or the right to share in any profits of the SPV; or if investors in the RMBSs have any recourse back to the originating bank.

If a 'true sale' has not been effected, the mortgaged loans unsuccessfully assigned will lose their off-balance sheet status, and will be re-characterised as normal on-balance sheet secured loans. This plainly has significant consequences for, amongst other things, the ADIs' capital adequacy and taxation obligations. As noted above, APRA's task as the regulator is made more difficult by the fact that there is no Australian case on point, and the few cases that have been decided overseas are inconsistent.

The originating mortgagee's rights in Australian RMBS programs are invariably assigned to the SPV in equity, principally because an equitable assignment involves fewer formalities than a legal assignment. Provided the intention to assign is manifested in writing, there is no need for the originator or the SPV to notify initial borrowers that their mortgages have been assigned, in order for an equitable assignment to be valid. To the extent that this minimises costs, it tends to

¹³³ These penalties arise under general state government regulations.

be consistent with the commercial interests of the originator and the SPV. Whether it is in the interests of housing loan borrowers, however, is open to question.¹³⁴

The SPV in Australia is generally structured as a unit trust, whose beneficiaries hold units representing equitable interests in the underlying residential mortgages. The income from these mortgages (in the form of borrowers' repayments) is received by the SPV and disbursed to the RMBS investors, or bondholders. The excess income and corpus, if any exists, is ultimately distributed to the unit holders, who are generally subsidiaries of the program sponsor.

In terms of the Code, the main issue for RMBS programs in Australia is whether the SPV as well as the originating lender are 'credit providers' under the Code, with all the attendant responsibilities, which that role implies. Despite the concern that the Code has aroused in the industry, its impact is more likely to be illusory than real. Since borrowers are practically never notified that their mortgages have been assigned to the SPV, they typically continue to make their loan repayments to their originating lender, until the loans are paid off. The Code seems to provide that, so long as this occurs, the SPV will not be regarded as the 'credit provider', thereby escaping liability unless a court orders *ex post* that key aspects of the loan contract are unjust or unconscionable. However, even then, the Code allows the SPV to be indemnified in respect of such liability, and such indemnities are in practice a prerequisite to the equitable assignment occurring in the first place.

As part of the structure of an RMBS program, the mortgage originator's (eg lender's) rights are assigned, or sold at a price, to the SPV. This means that, assuming the assignment is comprehensive and effective, the lender is able to 'wash its hands' of any liability as a credit provider to the initial housing loan borrowers under the Code, leaving all liability with the downstream SPV. Not surprisingly, in light of their experience with litigation, as with the foreign currency lawsuits of the early 1990s,¹³⁵ the major bank lenders in particular therefore face an incentive, other things being equal, to securitise their home loans using RMBS programs in this way.

From a public interest perspective, there may also be a moral hazard problem¹³⁶ inherent in RMBS programs, in that ADIs may have an incentive to lend housing loans to their customers too easily, if they know they can assign their rights and responsibilities under the loans to an SPV and believe that, as a result, they will not be held responsible if downstream participants in the issue default or become insolvent. One useful avenue for future research would be an investigation of the extent of this problem and, if it needs to be rectified, the best means of doing so. If a significant moral hazard problem exists, it may be useful for government to

134 See further, Rajapakse, above n 9.

135 See, eg, *Clenae Pty Ltd v ANZ Banking Group Ltd* [1999] 2 VR 573; *Davids Securities Ltd v Commonwealth Bank* (Unreported, Full Federal Court, Lockhart, Beaumont and Gummow JJ, 10 May 1990); *Chiarabaglio v Westpac Banking Corporation* (1989) ATPR 40-971; *Leitch v Natwest Australia Bank Ltd* (Unreported, Federal Court of Australia, Cooper J, 12 October 1995).

136 See, eg, *Locker and Woolf Ltd v Western Australian Insurance Co Ltd* [1936] 1 KB 408; *Jester-Barnes v Licenses and General Insurance Co Ltd* (1939) 49 Ll L Rep 231.

legislate to compel ADIs to accept their 'fair share' of responsibility (eg in tortious actions) for failures of their RMBS programs.

In addition, while they have similar objectives, the regulation and administration of different State codes vary, resulting in potentially significant difference in licensing of credit providers, enforcement methods and civil penalties for defaults, stamp duty and land tax, transaction taxes (eg financial institutions duty) and State government administration fees. To alleviate such disparities, which become significant when aggregated across all mortgages in the pool, it could be useful for all States to co-operatively enact mirror legislation on consumer credit, perhaps by interstate and Commonwealth agreement. It is suggested that any reform in the administration of the codes should be handed over to a Commonwealth department, so that one agency can adopt a centralised, consistent approach to consumer credit regulation in Australia. Alternatively (and some libertarians might argue, preferably), all States could co-operatively enact 'mirror' consumer credit legislation – for example, by interstate and Commonwealth agreement, similar to that underpinning the *Competition Policy Reform Acts*¹³⁷ of each State.

¹³⁷ See National Competition Council, *National Competition Principles Agreement*, above n 16.