

ASSESSMENT OF INSOLVENCY ISSUES FOR THE MORTGAGE ORIGINATOR AND TRUSTEE-ISSUER IN SECURITISATION PROGRAMS

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I INTRODUCTION

In a typical mortgage securitisation program in Australia, an originating bank or independent mortgage provider ('IMP')¹ with a substantial pool of residential mortgage loans, sells or transfers a portfolio of its mortgages to a special purpose vehicle ('SPV'). This SPV is a trust, established separately from the originating bank or IMP. The transfer is intended to separate the mortgages from risks associated with the originator. For this reason, the originating bank must structure the transfer so that it constitutes a 'true sale', that is sufficient under insolvency law to remove the mortgages from the originating bank's asset pool.

To raise the funds to purchase these mortgages, the SPV issues residential mortgage-backed securities ('RMBSs') to professional investors (for example, investment banks, insurance companies, superannuation funds) in the capital markets.² The interest and principal from these RMBSs are paid for from collections or repayments on the housing loan mortgages purchased by the SPV. The investors of the RMBSs therefore look to the cash flow from the mortgages, and not necessarily to the credit of the originating bank for repayment.

The notes or bonds issued are mortgage-backed in the sense that, if the trustee issuer defaults on its obligation to pay interest (or ultimately the face value of the

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1 An IMP is a third party mortgage provider – that is, an institution that 'originates' (or brings into existence) mortgages, usually as elements of mortgage loans – which is generally unaffiliated with the major banks. IMPs in Australia include Aussie Home Loans Ltd, Australian Mortgage Securities Ltd, Interstar Securities Pty Ltd, RAMS Home Loans Pty Ltd, Macquarie Securitisation Ltd, and Resimac Ltd. The IMP or mortgage originator typically charges an origination fee, which is generally charged to the borrower to cover the costs of initiating the loan.

2 By way of example, Macquarie Bank Ltd's PUMA Fund operates one of the largest residential mortgage-backed securitisation programs in Australia: See Mark B Johnson, 'Oz Securitization Gathers Pace' (2001) 12(2) *Asiamoney* 47, 48; 'PUMA Securitisation Pioneer', *Euroweek* (London), May 1999, 20.

note) to the investor, a security trustee – in whom the legal rights under the pooled mortgages are vested – can exercise a power of sale over the secured residential properties and recover the monies owed.³ To the extent that the proceeds from the sale of the residential properties are insufficient to meet the outstanding debts to bondholders, the bondholders will rank as unsecured creditors in the event of a winding up of the trust. Issues also arise if the borrower has been loaned more money than the value of the property, or if the mortgaged property has decreased in value since the loan was provided, as occurred in the subprime crisis.

In an RMBS program, the SPV must be structured in a way as to be insolvency-remote, in order to gain acceptance in the market as an issuer of RMBSs. ‘Insolvency-remote’ in this context means that the SPV is unlikely to be adversely affected in the event that the originating bank or IMP becomes insolvent.

The trustee of the SPV is entitled to all repayments received from home loan borrowers/mortgagors. In order to cover the possibility that the mortgage pool will not provide sufficient income to enable payment of the bond interest when it falls due (for example as a result of borrowers’ failure to pay), some form of credit enhancement is also provided. Generally this includes mortgage insurance, the division of the bond issues into senior (Class A) and subordinated bonds (Class B), and a cash reserve.

After obtaining credit enhancement, the issuer has the RMBSs rated by a rating agency such as Standard and Poor’s Ratings Group or Moody’s Investor Services. The issues of RMBSs are usually structured so as to attract a higher rating (for example, AAA rating) by the rating agencies. In practice in this market, the issuer trustee’s creditworthiness and the quality of the mortgage asset pool and the credit enhancements are considered as primary factors in assigning a high rating. The highest rating is not given unless the rating agency is convinced as to the financial integrity of the RMBS issue. The structure of the securitisation must therefore be designed to ensure that the issuer trustee will be in a position to pay its debts throughout the life of the RMBS issue and that its financial security will not be undermined by the insolvency of any other party in the securitisation program.

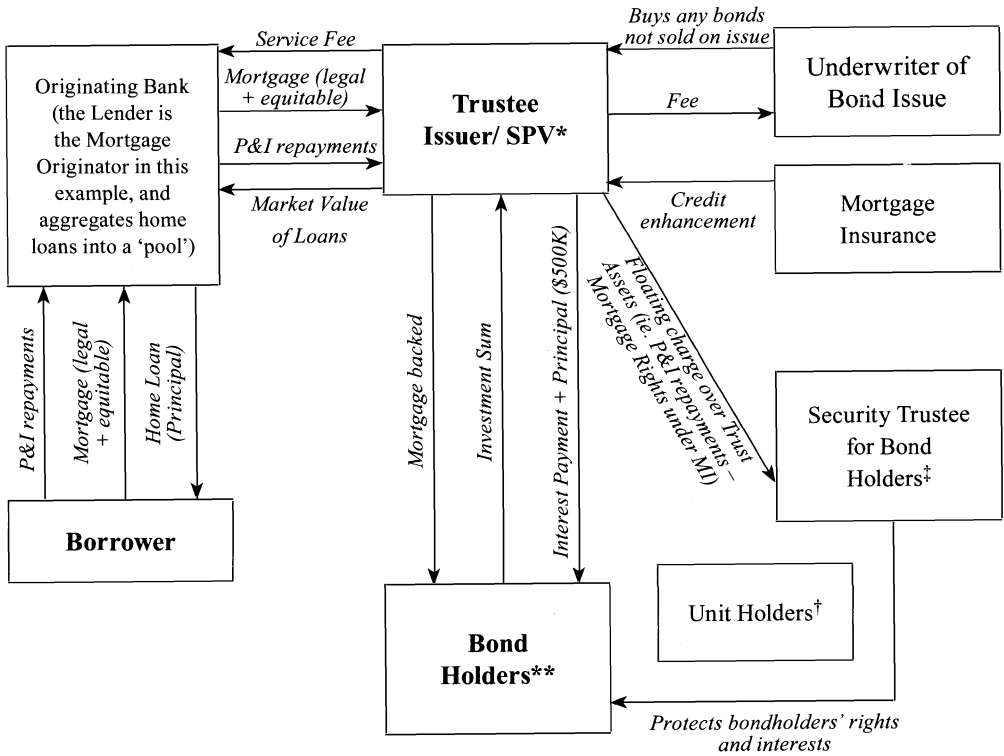
The efficacy of these rating agencies and their process has been under increased scrutiny recently, especially in light of the subprime crisis in the United States. As an example, senior securities issued in a collateralised debt obligations (‘CDO’) transaction will usually be rated AAA, even though the income-generating assets may include subprime mortgages.⁴ The relationship between securitisation process and the subprime crisis will be considered in more depth below.

A structure of a typical RMBS program managed by an originator bank is illustrated in Figure 1 below.

3 The relevant clauses are set out in the Macquarie Securitisation Ltd, *Master Information Memorandum, PUMA Fund – P12* (2006) 94–5.

4 Steven L Schwartz, ‘Disclosure’s Failure in the Subprime Mortgage Crisis’ (Working Paper No 123, Duke Law School Faculty Scholarship Series, Duke University Law School, 2008) 5.

Figure 1: Structure of Typical ‘Bank’ RMBS Program



* Depending on the context, the issuer of the securities is also termed the Special Purpose Vehicle ('SPV'), the Special Purpose Entity ('SPE'), or simply the trustee.

** The bonds or notes are issued in a unit trust structure. The bonds themselves comprise principal and interest components. Usually there are a number of classes of bondholders, whose rights vary with the class of bonds held. For example, Class A bondholders may have priority rights to interest or principal distributions over Class B bondholders.

† Unit holders in the trust are generally subsidiaries of the sponsoring bank, and may be capital unit holders or income unit holders. Capital unit holders are those who hold capital units, and are entitled, generally on winding up of the trust, to any residual trust capital or 'corpus'. Income unit holders are those who hold income units, and are entitled to net trust income, if any exists, generally up to a maximum 'token' amount (for example, \$1,000) which is specified in the trust deed.

‡ The Security Trustee holds a floating charge over trust assets on behalf of the bondholders. The trust assets include the right to principal and interest repayments (ultimately from borrowers on the initial housing loans), the right to exercise power of sale under those mortgages, and any rights to mortgage insurance payouts.

The overall goal of mortgage securitisation is to obtain low-cost capital market funding by separating the originator's mortgage receivables from the risks associated with that originator.

This article has two purposes. First, it examines the consequences for stakeholders if the mortgage originator or subsequent assignee of its rights – the trustee issuer – becomes insolvent and considers the main legal and financial risk issues that can arise in an RMBS program in Australia. In a sense, this discussion is fairly theoretical insofar as it relates to trustee issuers since insolvency should be a remote possibility for them, but in order to appreciate fully the effectiveness of the typical RMBS structure, it is essential to identify the problems that could arise if that structure were not in place. Second, the article focuses on a qualitative assessment of the extent to which the current regulatory provisions governing the insolvency of the originator and trustee issuer either impede or facilitate the operation and growth of the RMBS market in Australia. The existing regulation for insolvency of the originator and issuer and their financial security are assessed using a 'public benefit test' framework. This framework is based on the principles of social cost-benefit analysis and is used to identify an optimal RMBS legal and regulatory regime that would provide a resolution to the conflicting interests of participants in the RMBS process. It is similar to that used to evaluate the introduction of Commonwealth and State legislation pursuant to the Australian *Commonwealth-State Competition Principles Agreement 1995* and the *Statutory Instruments Act 1992* (Qld).⁵

Accordingly, the structure of the article is as follows: Part II of the article outlines the insolvency procedures and remedies available to the creditors in an RMBS program generally. Part III examines the potential impacts on the stakeholders in the RMBS program, other than home loan borrowers, if the originator were to become insolvent.⁶ This includes an inquiry into the types of transactions, such as uncommercial transactions and unfair preferences, which may be void or voidable due to such insolvencies, and the potential impacts on secured creditors (for example, bondholders, redraw facility providers, interest rate swap providers). In Part IV, the likely impacts on the secured creditors, if

5 Pursuant to the *Statutory Instruments Act 1992* (Qld), which is mirrored in every other State, and the *Competition Principles Agreement* dated 11 April 1995, between the Commonwealth and State and Territory governments, 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. The legislative review process is undertaken within the 'public benefit test' framework, as required under the National Competition Principles Agreement: National Competition Council, 'Competition Principles Agreement' *Compendium of National Competition Policy Agreements* (2nd ed, 1998) s 5(9), <<http://www.ncc.gov.au/publication.asp?publicationID=99&activityID=39>> at 15 September 2008.

The 'public benefit test' review per s 5(9) should: (a) clarify the objectives of the legislation; (b) identify the nature of the restriction on competition; (c) analyse the likely effect of the restriction on competition and on the economy generally; (d) assess and balance the costs and benefits of the restriction; and (e) consider alternative means for achieving the same result including non-legislative approaches.

6 The insolvency event is expressed throughout this article in the past subjunctive and modal auxiliary forms since, to the author's knowledge, no bank, IMP or trustee-issuer involved in an RMBS program in Australia has as yet gone into insolvency.

the trustee issuer were to become insolvent, is discussed with an emphasis on the enforcement and validity of the security. Part V briefly considers the issue of securitisation and the subprime crisis. It is recognised that these issues are extremely important, however an in-depth analysis of the relationship be beyond the scope of this paper. In Part VI, the techniques for minimising the financial risks for other stakeholders (for example, unsecured creditors, subordinated bondholders, program sponsor, mortgage indemnity providers, pool insurers, and the fund manager or administrator) in the RMBS program are examined. It discusses how to best structure an insolvency-remote issuer, at least from the point of view of the rating agencies. Based on the 'public-benefit' test framework, Sections B and C of Part VII qualitatively assesses the extent to which the current regulation and practice impede or facilitate the achievement of the objectives and criteria for structuring an RMBS issue. This assessment is based on the insolvency issues and financial risks discussed in Parts I–VI of the article. Finally, Part VII summarises the results of the investigation of legal and regulatory issues governing the insolvency of the originator and issuer.

II INSOLVENCY AND THE OPTIONS GENERALLY

Section 95A(1) of the *Corporations Act 2001* (Cth) ('*Corporations Act*') provides: '[a] person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.'⁷

For secured creditors such as bondholders who are not paid their debts, the usual remedy would be the appointment of a receiver to the trust fund, under the terms of their charge.⁸ The consequence of such an appointment is that the security trustee on behalf of the bondholders would exercise its right of sale in respect of the residential mortgages assigned by the originator to the SPV.

Whether a security trustee would exercise its right of sale in respect of the mortgages would depend on the composition of the mortgage pool,⁹ and the wishes of bondholders. As stated above, if for some reason the bondholders are not being paid their interest and/or principal, they may well direct the security trustee to sell the charged assets, in the same way as any mortgagee or chargee may choose to exercise its power of sale in appropriate circumstances. This would be entirely possible in an economic downturn, recession or significant increases in interest rates and cost of living, as Australia is currently experiencing, and could happen through no fault of individual borrowers.

7 Less usefully, the section goes on to state, that '[a] person who is not solvent is insolvent': *Corporations Act 2001* (Cth) s 95A(2).

8 The relevant provisions are set out in the Macquarie Securitisation Ltd's RMBS program: *Master Information Memorandum, PUMA Fund – P12*, above n 3, 90–1.

9 It means the composition of the portfolio in terms of 'good mortgages' (that is, mortgages where there is a stable cash flow and a relatively low risk and 'poor mortgages' (that is, where there is a substantial risk of default in respect of those mortgages). A bank would be better off disposing the poor mortgages, and retaining the good ones, in terms of maximising their overall returns.

Other things being equal, presumably the most those borrowers could do as against the security trustee is to temporarily enjoin it – for example as a third party – from selling the charged assets (that is, the borrowers' homes). The bank or SPV are more likely to be sued by borrowers, either individually or by way of a class action, for negligence, misrepresentation, a breach of s 52 of the *Trade Practices Act 1974* (Cth) or a similar cause of action. This is how housing loan borrowers might, in the foreseeable future, find their homes sold out from them through no fault of their own.

However, two other main alternatives exist for unsecured creditors, and for secured creditors such as bondholders, who are still owed money after the security trustee has exercised its right of sale in respect of those properties comprising the mortgage pool (effectively making them unsecured creditors to the extent of any shortfall).

Ultimately, if a company (for example an originating bank or IMP, or a trustee-issuer) becomes insolvent,¹⁰ the court can order that it be wound up on the application of any of a number of persons, including the company itself, a director of the company, or a creditor of the company (even if the creditor is a secured creditor, or is only a contingent or prospective creditor).

Secondly however, and more usually, before this point is reached, there is some likelihood that the company might trade out of difficulty. In this case, an administrator is normally appointed (for example under a voluntary administration or 'VA' procedure) to manage the affairs of the company until the creditors determine how best to recoup the debts owed to them.¹¹ There are essentially three options open to creditors at this stage. They may resolve:

- (a) That the company execute a deed of company arrangement specified in the resolution (even if it differs from the proposed deed (if any) details of which accompanied the notice of meeting); or
- (b) That the administration should end; or

10 A company will be considered insolvent if, despite the fact that its assets significantly outweigh its liabilities, these assets are illiquid and are unable to be utilised to meet the company's liabilities as and when they fall due and become payable. Insolvency may be established by a company failing to comply with, or dispute, within 21 days a statutory demand served on the company by a creditor: *Corporations Act* s 459C(2)(a). Other evidence that has been considered to prove solvency of a company include, failure to disclose assets: *Garseabo Nominees Pty Ltd v Taub Pty Ltd* [1979] 1 NSWLR 663; maintenance of cash flow: *Molnar Engineering Pty Ltd v The Herald and Weekly Times Ltd* (1984) 1 FCR 455; net asset position: *Fat-sel Pty Ltd v Brambles Holdings Ltd* (1985) 6 FCR 440. See generally Stephen Colbran, 'Security for Costs Against Corporations: Section 1335 of the *Corporations Law*' (1993) 11 *Company and Securities Law Journal* 273, 276–7.

11 An administrator may be appointed by the company itself; its liquidator or provisional liquidator; or a person who is entitled to enforce a charge on the whole, or substantially the whole, of a company's property: *Corporations Act* ss 436A, 436B and 436C.

- (c) That the company be wound up.¹²

III INSOLVENCY OF THE ORIGINATOR

Financial distress (and ultimately, insolvency) on the part of the mortgage originator could threaten the existence of an RMBS program,¹³ for three main reasons:

12 *Corporations Act* s 439C. The VA procedure under Pt 5.3A of the Act can be summarised as follows. For the sake of convenience and economy of language, the procedure is discussed in the context of an originating bank, however, it could equally apply to an originating IMP, or the trustee–issuer of RMBS program (in relation to its unsecured creditors). Once appointed, the administrator’s main objective would be to convene meetings of the originating bank’s creditors. An initial meeting must be held within 5 days of the administrator’s appointment, with another later meeting being held to report to creditors on the originating bank’s position and prospects, so that the creditors can decide the bank’s future. In general, this second meeting to decide the originating bank’s future must occur within five business days after the end of the ‘convening period’ (that is, 21 days from the date of appointment). There is an exception if the convening period straddles the Easter or Christmas breaks, in which case it will be 28 days: *Corporations Act* s 493A(5). The court has discretion to extend the convening period: *Corporations Act* s 439A(6). However, the section does not go on to suggest the circumstances in which this discretion should be exercised. Given the potential complexity of the matters requiring consideration by the administrator and the originating bank’s creditors, the statutory period of 21 days can prove very tight, and applications for an extension are reasonably common. If granted, the extension also prolongs the freeze on assets described below. Pending a resolution of the originating bank’s creditors terminating the administration, Pt 5.3A would put the assets and affairs of the originating bank in the control of the administrator and seek, with certain exceptions, to freeze those assets and suspend any enforcement action in relation to them. This effective ‘moratorium’ would have several impacts in relation to RMBS programmes:

- *In relation to property generally of the originating bank* – s 437D would render void any transaction affecting the originating bank’s property while it is under administration, unless the administrator either consented to that transaction or the transaction had been entered into under an order of the court.
- *In relation to charges over the whole or substantially the whole of the originating bank’s property* – provided it obtains the administrator’s consent or the leave of the court under ss 437D(2) and 440B, a chargee over the whole or substantially the whole of the originating bank’s property may enforce the charge during the ‘decision period’, which runs from the date that chargee receives notice of the administrator’s appointment (assuming the chargee did not itself appoint the administrator) through to the tenth business day after that date. This is conditional on the chargee enforcing its charge in relation to all of the originating bank’s property that is subject to the charge. If the chargee were to do this, then the general moratorium would not apply to assets the subject of that charge, and the administrator’s powers and functions would be subject to those of the chargee (or the chargee’s receiver or other agent appointed to enforce the charge: s 441A). If the chargee did not enforce its security in that manner before or during the decision period, then that chargee would be bound by the general moratorium. Furthermore, the general moratorium would not apply to property subject to a charge if enforcement action under s 441B (for example, entering into possession, agreeing to sell, or arranging for a sale or invitation to tender) were taken before the administrator’s appointment.
- *In relation to debts secured over substantially less than all the assets of the originating bank* – in this case, enforcement would almost certainly be slowed down by the moratorium, unless the trustee under the RMBS programme was able to pre-empt the appointment of the administrator and commence enforcement beforehand, within the meaning of s 441B. Of course, secured creditors have an extra element of protection, in that they are not bound by a deed of company arrangement unless they themselves voted in favour of it. In contrast, an unsecured creditor could be in the minority, but nevertheless become bound to accept a compromise that is disadvantageous to it.

13 Nor is this a mere academic or hypothetical risk. Prudential regulation by APRA is generally very good by international standards, but, as the recent high profile case of HHH shows, APRA’s prudential regulation is by no means a guaranteed prophylactic against insolvency.

- (i) In an RMBS issue, mortgages and related insurance policies are generally transferred by way of equitable assignment to the trustee-issuer at the outset of the securitisation. The originator remains the legal owner of the mortgages and, so far as mortgagors are concerned, there is generally little or no indication that their mortgages have been sold. This position would almost certainly change substantially, however, if the originator encountered severe financial difficulties;
- (ii) An originator in financial distress would not be likely to be in a position to compete for new mortgage business, so that its ability to provide new mortgages for use as substitutes in the securitised pool might be substantially impaired, and the securitisation brought to a premature end. This problem could be exacerbated if uneasy existing borrowers refinance elsewhere, rather than incur the risk that their originating bank's interest rates or enforcement policies get too far out of line with those of rival banks or IMPs;¹⁴ and
- (iii) If a mortgage originator became insolvent and winding up proceedings commenced,¹⁵ there would be a risk that transfers of its mortgagee rights to an SPV might be 'clawed back' if they occurred in the six months prior to insolvency, under the voidable transactions provisions of the *Corporations Act*,¹⁶ which are discussed below.

A Insolvent or Voidable Transactions

Under ss 588FC and 588FE,¹⁷ any transfer of property made after the commencement of winding up of the originator company is voidable, unless the courts order otherwise. Transactions may even become voidable up to two years after they are effected, if they fall within s 588FE(3) and the originator becomes insolvent within that time. On another relevant note, circumstances might arise in which an originator has transferred mortgages to an issuer (for example substitute mortgages in replacement for others that have been redeemed) at about the time that a winding-up order has been presented against the originator. However, these transfers would not necessarily be void under s 588FJ if the agreement to transfer the mortgages 'straddled' the date of presentation of the winding up petition. For example, in *Re French's (Wine Bar) Ltd*,¹⁸ a company had entered into a specifically enforceable unconditional contract for the sale of property before the presentation of a winding-up petition. The contract had been completed after the

14 If borrowers attempted to refinance, a separate question also arises as to whether other banks or IMPs would be willing to refinance them, once these other banks or IMPs became aware that their mortgages had already been equitably assigned to an SPV.

15 While the voidable transactions provisions apply only where a company is in winding up, an administrator must nevertheless make an estimate of the possible monies that could be 'clawed back' under the voidable transactions provisions *if* the company were to be wound up. In this sense, the voidable transactions provisions relate to both the winding up and administration stages of insolvency.

16 See *Corporations Act* Pt 5.7B, div 2.

17 *Corporations Act*.

18 [1987] BCLC 499.

winding up petition had been presented. The UK courts held that the sale of property would not constitute a disposition within the meaning of s 127 of the *Insolvency Act 1986* (UK), which is similar to s 588FJ of the *Corporations Act*.¹⁹

B Uncommercial Transactions

In order to determine whether a transfer of mortgages to an issuer of mortgage-backed securities incurs an uncommercial transaction, and constitutes a breach under s 588FB,²⁰ the following requirements must be established: (a) the transaction had taken place at a time when the company was insolvent; and (b) the value of the consideration received by the originator was significantly less than the value of the consideration which it provided to the issuer.²¹ In addition, the originator must, at the time of the transaction, have been unable to pay its debts within the meaning of s 95A of the *Corporations Act*, or have failed to pay a debt, which is due and undisputed.²² In an RMBS program, the portfolio of mortgages transferred to the trustee-issuer is generally in practice sold at a price equal to the present value of the principal amount of the loans comprising that pool. Hence, it would be very difficult for the liquidator or administrator to prove the transfer to be an uncommercial transaction in the context of an RMBS program. Secondly, prior to the transfer of mortgages by the originator to the SPV, the directors of the originator are required to certify that the originator is a solvent company at the time of the transfer. Thirdly, the court would be precluded from voiding the transaction if it were not an unfair loan; the SPV came to the transaction in good faith, has changed its position in reliance on the transfer; and, at the time of the transfer, the SPV had no reasonable grounds for suspecting that the assigning bank or IMP was insolvent.²³

During the life of the RMBS issue, where mortgagor requests for refinances, some mortgages may have to be released from the trustee's security and transferred back to the originator. In practice, such mortgages can be sold back to the originator for cash or, for so long as is permitted, in exchange for new mortgages.²⁴ If a mortgagor wishes to redeem his or her mortgage under the existing mortgage conditions, the originator is bound to do so by retrieving the mortgage from the securitised pool. In practice, it would not be possible for RMBS documentation to restrict such substitutions to circumstances where the directors of the originator can certify the originator's secure financial position. Having said all this, it would presumably be rare in practice that a re-transfer of mortgages would constitute an uncommercial transaction, since the relevant documentation generally seeks

19 See generally Eilis Ferran, *Mortgage Securitisation: Legal Aspects* (1992) 200.

20 *Corporations Act*.

21 See Roman Tomasic, James Jackson and Robin Woellner, *Corporations Law: Principles, Policy and Process* (4th ed, 2002) [15.43].

22 *Taylor's Industrial Flooring Ltd v M & H Plant Hire (Manchester) Ltd* [1990] BCLC 216; *Re DKG Contractors Ltd* [1990] BCC 903.

23 *Corporations Act* s 588FG(2).

24 See, for example, *Master Information Memorandum, PUMA Fund – P12*, above n 3, 42–3.

to ensure that the value of any re-purchased mortgages are not 'significantly less' than the value of the substitute assets provided by the originator (although ultimately this would be a question of fact for a court).²⁵

Also, any subordinated loan facilities provided to the trustee issuer by the originator prior to securitisation transactions must be approved by the directors of the originator, who must ensure that it was financially stable.

C Unfair Preferences

It is possible for issues to be raised with regards to unfair preferences. An unfair transaction, under s 588FA of the *Corporations Act*, is dependent on the creditor receiving more in the pre-liquidation period than they would have received had they provided in the winding up, similar to the issues of due preferences.²⁶ The precise meaning of 'transaction' in s 588FA has yet to be determined and appears to require High Court interpretation.²⁷

Section 588FJ of the *Corporations Act* also needs to be considered. It provides that, in relation to a company being wound up in insolvency, a floating charge created on property of the company during the six months ending on the relation-back day (or between the relation-back day and the start of the winding up) is, unless the court otherwise orders, void. The winding up would be deemed to have commenced at the time of the presentation of the petition for winding up.²⁸

In practice however the problem of unfair preferences would appear to be more theoretical than real. In theory, a transaction could be vulnerable as a preference if, in the event of the originator's insolvency, it had the effect of putting the trustee-issuer in a better position than it would have been in without the transaction. This transaction would generally need to have taken place within six months prior to the appointment of an administrator. The English courts have held that such a transaction would not be a preference unless (in the present context) the originator positively wished to improve the trustee-issuer's position, and this positive wish must have influenced its decision to proceed with the transaction. Having said this, the court made it clear that this positive wish need not be the only influencing factor, nor even the one which 'tipped the scales' in making the decision to transact.²⁹

In practice, it is unlikely that the transfer of mortgages to the trustee-issuer would have the required effect of placing the issuer in a better position than it would have been otherwise. This could generally only happen if the mortgages were transferred at an under-value and, in practice, the mortgages are usually sold to the trustee-issuer at the present value of their aggregate outstanding

25 *Re MC Bacon Ltd* [1990] BCLC 324, 340. See also Ferran, above n 19, 202.

26 Andrew Keay, 'An Exposition and Assessment of Unfair Preferences' (1994) 19 *Melbourne University Law Review* 54.

27 Tomasic et al, above n 21, [15.42].

28 See *Corporations Act* s 9.

29 See *Re MC Bacon Ltd* [1991] BCC 213.

principal amount, with the directors of the originator being required to certify the originator's solvency at that time. Assuming this practice is followed and the directors' certificates are correct, no problem of unfair preferences should arise in practice.³⁰

For a court to determine that the transactions between the originator and the trustee issuer were vulnerable as unfair preferences, it would have to be established the same requirements as provided under s 588FB.

Because of these risks, RMBS programs are structured in an 'insolvency-remote' fashion in order to minimise the impacts that originator insolvency would have on the trustee-issuer, by ensuring that all requirements for the true valid transfer of mortgage rights to the trustee-issuer are effected. Generally the terms of sale oblige the originator to complete the transfer of mortgages to the trustee-issuer (including effecting registration of the issuer as the legal owner of the mortgages)³¹ if the trustee considers that the security is in jeopardy.

IV INSOLVENCY OF THE TRUSTEE-ISSUER

A *Insolvency in the Capacity of Trustee*³²

Where the trustee in an RMBS program issues bonds, it is the trustee that incurs the liability. In RMBS programs, the liability of the trustee-issuers to bondholders and other creditors will invariably be limited to the assets of the trust out of which the trustee is indemnified for the liability, provided the trustee did not commit a fraud or negligent act by incurring the liability. If this indemnity from the assets of trust is insufficient, the trustee will have to meet its liabilities with respect to the trust from its own assets, unless otherwise agreed.³³ If the trustee cannot meet its obligations, it could cause the trustee to become insolvent.³⁴ Even though, the trustee has properly limited its liability in respect of its obligations, its failure to meet its obligations in full may impact on the agreement between the trustee-issuer and bondholders. In these circumstances, the investors may demand accelerated repayment of principal on their bonds, and the enforcement of security given by the trustee to the bondholders could be triggered.

Nevertheless, trustee insolvency may arise due to the trustee being unable to meet liabilities unconnected with the trust or the RMBS program, or as a result of a failure by the trustee to otherwise properly perform its duties as trustee. Generally, the trustee issuers in RMBS programs also act as trustees of other

30 See generally Ferran, above n 19, 205.

31 David Glennie and Edward de Bouter, *Securitisation* (1998) 5.

32 Trusts cannot become insolvent in a technical sense. Because trusts do not have any separate legal capacity (for example, they cannot sue or be sued), they cannot have liquidators or administrators appointed to them.

33 See *Master Information Memorandum, PUMA Fund – P12*, above n 3, 84, 90.

34 See generally Bruce Taylor, 'The Enforceability of Debt Securities Issued by Trustees in Securitisation Programs' (1998) 26 *Journal of Banking and Finance Law and Practice* 261.

investment schemes or trusts. A breach of obligations by the trustee issuer relating to any of these investment schemes could cause the trustee to incur personal liability or to become insolvent.³⁵

However, it is unlikely that the insolvency of the trustee-issuer would cause serious risks to RMBS programs because the assets of the RMBS trust will not be available to meet the trustee's liability to creditors of the other trusts. Also, if a trustee issuer becomes insolvent, in practice, a new trustee company will be appointed to issue the securities (who usually appointed by the fund manager of the RMBS program).³⁶

Furthermore, RMBS programs in Australia involve trusts that typically take a charge over assets and hold them for the ultimate benefit of investors who purchase the bonds issued. While they may hold other assets, these are relatively small parcels of liquid assets such as government bonds. There are no other significant assets. Accordingly, it would not, in general, be commercially viable to place the trustee of an RMBS program in Australia in to voluntary administration or liquidation. In the event of insolvency, bondholders would be better off simply exercising their rights under the mortgages and related insurance contracts.

B Insolvency in the Capacity of Issuer³⁷

1 Minimising the Risk to Bondholders

Where the issuer is a trustee company, the debt securities issued by the trustee-issuer will be debt obligations of the trustee in the capacity of issuer. Investors will be relying on the trustee-issuer's ability to indemnify itself from the trust assets, in order to enable its payment obligations under the bonds issued to be met. The risk that the trust assets will not be sufficient to meet the liabilities incurred by the trustee-issuer in relation to the trust is minimised in practice by:

- Requiring the trustee-issuer to give a charge over the trust assets to an independent security trustee, which holds that mortgage on trust for the holders of securities. The mortgage effectively 'bypasses' the trustee-issuer's right of indemnity so that, if the trustee does not make a payment in full on the securities, the security trustee may independently enforce the mortgage over the trust assets and apply the proceeds of sale to meet the payment;³⁸
- Including in the trust deed a relevant provision specifying an order of priority in which the liabilities are to be met;³⁹ and

35 Ibid 272–3. See also Joyce Chen, 'Asset Securitisation and the Singapore Insolvency Regime' (2001) 16 *Journal of International Banking Law* 198.

36 See, for example, *Master Information Memorandum, PUMA Fund – PI2*, above n 3, 86–7.

37 It is assumed throughout the following discussion that the trustee-issuer has validly acquired the mortgages from the originator and that the transfer or assignment is not liable to be set aside or adjusted.

38 See *Master Information Memorandum, PUMA Fund – PI2*, above n 3, 92–4.

39 Ibid 95–6.

- Strengthening the indemnity clause in the trust deed to provide that the trustee-issuer may indemnify itself to the extent necessary to meet payments on the securities, notwithstanding any other breach of trust it may have committed.

2 Enforcement of the Security

In an RMBS program, the security will become enforceable upon the occurrence of an event of default. For example, the events of default set out in the security trust deed issued by Macquarie Securitisation Ltd's PUMA Fund – P12 include the following:⁴⁰

- If the trustee does not pay in full any moneys payable to bondholders, which include payment of interest and repayment of principal, within 5 banking days of the due date;
- If the trustee or the originator or any other agent fail to perform other relevant obligation;
- If any event of insolvency occurs in relation to the affairs of the trustee issuer's business.⁴¹

The security trust deed generally provides that the issuer must inform the security trustee in writing of the occurrence of any event of default as soon as issuer becomes aware of it.⁴² Events of default within the latter two categories must be certified by the security trustee to the trustee issuer that, in its opinion, their occurrence is prejudicial to the interests of the bondholders. If an event of default occurs, the security trustee must give notice to the trustee issuer declaring the mortgage-backed securities to be due and payable. Provision is also usually included whereby the security trustee is required to convene a meeting of the bondholders to seek directions as to the action it should take, which will be given by way of an extraordinary resolution of the bondholders.⁴³ If the bondholders direct the security trustee to enforce the security, it must immediately repay the bonds at their principal amount together with accrued interest. In the event of the service of enforcement notice, any floating charge in the security package will automatically become crystallise. In doing so, it effectively becomes a fixed charge.⁴⁴ The adverse ramifications of this decision for other persons who, in their dealings with an issuer company, are unaware that a floating charge over its assets has crystallised in this way have already been addressed at length

40 Ibid 93; see also H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (10th ed, 2001) [25.060].

41 Events of insolvency includes imminent cessation of the issuer's business, the passing of a resolution or the making of an order for the winding up of the issuer, the presentation of a petition for an administration order in respect of the issuer or the taking, by a third party, of significant enforcement proceedings against the issuer.

42 *Master Information Memorandum, PUMA Fund – P12*, above n 3, 92–3.

43 Ibid.

44 See *Re Brightlife Ltd* [1987] Ch 200; [1986] 3 All ER 673, in which Hoffmann J held that the service of a notice of crystallisation was effective to cause a floating charge to crystallise into a fixed charge. See also *Re Permanent House (Holding) Ltd* (1989) 5 BCC 151.

in the literature,⁴⁵ and need not be repeated here. Upon the enforcement of the security, the security trustee is empowered to appoint a receiver to the assets of the securitisation program.

The proceeds from the enforcement of the security will be applied in the order of priorities as specified in the security trust deed. The first payment will usually be for the sums due in respect of fees, costs and expenses of the security trustee and of any receiver appointed to realise the assets. Second payment will be made for all other outgoings in relation to the trust assets as the security trustee or the receiver thinks fit. Other categories of payment listed in the order of priority include the interest and principal balance owing to Class A bondholders and the secured monies owing to redraw facility and interest rate swap providers.⁴⁶

3 Validity of the Security in an RMBS Program

One of the important features of an RMBS structure is that its security should remain valid notwithstanding the trustee issuer's financial difficulties. Under s 266 of the *Corporations Act*, liquidators and administrators can apply to court in order to have securities created by the companies to which they are appointed set aside, if the securities have not been registered with the Australian Securities and Investment Commission.

As noted earlier, if an event of default occurs, the RMBS programs are normally structured to give the security trustee a power to appoint a liquidator to realise the assets of the trust fund. If a trustee issuer of mortgage-backed securities were to encounter severe financial difficulties, the security it has given to the security trustee will be challenged by a liquidator.

Provided that the security held by the security trustee includes a floating charge over the whole of the issuer's assets, the security trustee will have the power to appoint a receiver.⁴⁷ In order to ensure that the security trustee is entitled to exercise its power to appoint a receiver at the appropriate time, the presentation of a petition for an administration order must be included as a 'default event' in the trust deed and documentation (for example, information memorandum) to the RMBS issue.

45 For example, an automatic crystallisation may occur without the knowledge of either the company or the secured bondholder. The result might be prejudicial to third parties, who have given credit to the company. Third party unsecured creditors might find that all the company's assets, including goods that they have delivered on credit, had been swept up by the secured creditors. The public interest requires balancing of the advantages to the economy of facilitating the borrowing of money against the possibility of injustice to unsecured creditors: See Roy M Good, *Legal Problems of Credit and Security* (1982) 70–3; R Pennington, 'Loans to Companies; the Development of the Law' in B G Pettet (ed), *Company Law in Change* (1987) 103–7; and A J Boyle, 'The Validity of Automatic Crystallisation Clauses' [1979] *Journal of Business Law* 231. Boyle has suggested that automatic crystallisation should be prohibited on grounds of public policy.

46 See, for example, *Master Information Memorandum, PUMA Fund – P12*, above n 3, 82–3, 95–6.

47 A receiver is broadly defined within the meaning of s 90 of the *Corporations Act* as a receiver and manager of the whole (or substantially the whole) of a company's property appointed by or on behalf of the holder of a debenture secured by a charge. See Pamela Hanrahan, Ian Ramsay and Geoffrey Stapledon, *Commercial Applications of Company Law* (2002) [23–100].

In contrast, it is not possible for an RMBS program to be structured in a way that eliminates the possibility of the issuer being put into liquidation. Certain creditors of the issuer, including the originator if they have not been paid in respect of the transfer of the underlying mortgages, are required to give undertakings to the issuer not to enforce their rights against the SPV, although the SPV may well have other creditors, such as the tax authorities, who are not so restricted. If a creditor of an issuer were to have the issuer put into compulsory liquidation under s 459 of the *Corporations Act*, this would not, of itself, prevent the security trustee from enforcing its security. However, a liquidator would be likely to scrutinise the security package very closely in order to satisfy itself that it was not vulnerable in this respect.⁴⁸

4 Is there any Risk that the Security might be Found Void or Voidable by the Courts?

An apparently valid security might be found by the courts to be void or voidable in the event of an issuer's liquidation in the following circumstances. First, as noted earlier, a charge may be wholly or partially void against a liquidator if it is a registrable charge, but the relevant registration requirements have not been fully complied with.⁴⁹

48 See also Ferran, above n 19, 187.

49 *Corporations Act* s 266.

Secondly, the security might be vulnerable in the event of issuer insolvency because of the operation of ss 588FA,⁵⁰ 588FB,⁵¹ 588FD⁵² or 588FJ.⁵³ In the context of an RMBS program, these provisions would be relevant upon the winding up of the issuer, any seller of assets to the issuer (in this context, the originator), or any other person who provides rights to the issuer as part of the RMBS program (for example, a liquidity facility or swap provider).

5 Insolvency and Subordination

Typically, an issuer of RMBSs in Australia issues some of its bonds in a separate tranche, and on a subordinated basis⁵⁴ – that is, in the event of issuer insolvency and subsequent enforcement proceedings in relation to the security trust deed,

50 As noted, s 588FA is concerned with unfair preferences. If a company gives a preference which effectively puts one of its creditors into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that act had not been done, then subject to satisfaction of certain other conditions specified in s 588FA, the court can set aside a preference at the request of a liquidator by making such order as it thinks fit for restoring the position to what it would have been if the preference had not been given. See, for example, *Hanrahan et al*, above n 47, [24–170].

51 *Corporations Act 2001* (Cth) Pt 5.7B provides that a transaction may be set aside by the court if it is an uncommercial transaction within the meaning of s 588FB and is also an insolvent transaction under s 588FC. An insolvent transaction is an ‘unfair preference’ or an ‘uncommercial transaction’ which:

- was entered into or given effect to at a time when the company was insolvent; or
- caused or contributed to the company’s insolvency. See, for example, *Tomasic et al*, above n 21, [15.43]; [15.47].

However, a court is not allowed to make an order materially prejudicing a right or interest of a party to an uncommercial transaction and unfair preference if it is proved that:

- the person became a party to the transaction in good faith; and
- at the time when the person became a party to the transaction, they had no reasonable grounds for suspecting that the company was or would become insolvent, and a reasonable person in their circumstances would have had become insolvent; and
- the person provided valuable consideration under the transaction or changed their position relying on the transaction.

Section 588 FG protects investors against subsequent winding up of any party to a transaction in a securitisation program. However, rating agencies are concerned to ensure that the transactions in a mortgage securitisation program are commercial and, in particular, that any sale of assets to the issuer is a true sale for full value.

52 A loan to a company is unfair if the interest on it or the charges relating to it are extortionate. Such transactions may be set aside under Pt 5.7B of the *Corporations Act 2001* (Cth): See s 588FD(1) and P Lipton and A Herzberg, *Understanding Company Law* (2003) 703. There have been no reported Australian cases that have considered the meaning of the term ‘extortionate’ in the context of this section. It is generally the case, however, that interest rates on bonds issued, or on funds borrowed under a liquidity facility, in an RMBS program are determined with reference to prevailing market rates. It is unlikely that interest rates determined in this manner would be regarded by the courts as extortionate.

53 This section deals with floating charges created within six months before the relation-back day.

54 See generally *Master Information Memorandum, PUMA Fund – P12*, above n 3, 67–8.

these subordinated bonds such as Class B notes rank after any senior and fast-prepayment bonds (Class A notes), in relation to both principal and interest.⁵⁵

V SECURITISATION AND THE SUBPRIME CRISIS

A Background to the Subprime Crisis

Subprime mortgages are secured loans provided to people who are considered higher risk and therefore not prime borrowers. Subprime borrowers are a diverse group, but tend to have the following characteristics:

- Credit score of 620 or below on the FICO scale, indicating a poor credit history;⁵⁶
- Inability to qualify for traditional loans;
- Mortgage repayments are usually a significant portion of borrowers' income;
- Loan approved on a 'no-doc' or 'low-doc' loan;
- Mortgage will have a higher risk and therefore a higher interest rate.⁵⁷

Lending money to subprime borrowers is a higher risk than mortgages to prime borrowers, as they are considered to have an increased chance of defaulting on their loan, to the detriment of the lender. There are benefits however for lenders operating in the subprime mortgage industry as the remuneration tends to be higher than the prime mortgage industry.⁵⁸

Traditionally it was difficult for subprime lenders to access credit, including mortgages. Due to these increased benefits and the lack of regulation of the financial industry, the beginning of the 21st Century saw an explosion of subprime loans. There was also an increase in the variety of loans available, including loans of up to 110% of the property value and loans with 'honeymoon periods' with artificially low interest rates and repayments. Soon after they were provided, a number of the subprime borrowers had difficulties continuing their mortgage repayments, especially in light of the increased interest rates and rising cost of living expenses.

55 Ibid 82–3, 95–6. These bonds are still generally secured, in favour of the security trustee on behalf of the bondholders. Cf the claims of the unsecured creditors of an insolvent entity rank equally, without preference (*pari passu*) and, in the event of there being insufficient funds to pay all of them, they will be paid proportionately: *Corporations Act* s 555. However, debts that are validly secured against the insolvent entity's property are not subject to the above *pari passu* principle, and rank in priority in the event of a winding up.

56 The FICO score is a credit score developed by the Fair Isaac Corp, a California-based company. The scoring scale runs from 300 to 850. The factors determining the credit score include the borrower's payment history, credit history, and the amount of outstanding debt compared to the borrower's credit limit: See *Fico Credit Scores Explained*, FreeCreditReport4U, <<http://www.creditrepairsite.com/FICOscores.html>> at 10 August 2008.

57 R Foreman, 'Subprime Mortgage Crisis: A legal perspective' (October 2007) *Law Society Journal*, 56–7.

58 'Opportunity knocks for non-conformers' (2008) 58 *Australian Broker*, 45.

By the end of 2007 the inadequate underwriting habits of US lenders has lead to 7.2 million subprime loans being in default. The consequences of the subprime crisis are still being debated, and it is difficult to determine the exact losses that have been suffered. *Mortgage Business* estimates that the losses to US lenders are as high as US\$400 billion and with global stock market losses of around US\$7.7 trillion.⁵⁹

B The Role of Securitisation in the Crisis

The securitisation process was a crucial part of the subprime crisis. Whilst securitisation is important for access to liquidity, the complex arrangements used often disguised the individual borrower's default risk. The securitisation process is explained in depth at the beginning of this article.

There were however other factors involved in the creation and exacerbation of the crisis. Standard and Poor outline that the borrower, lender, underwriter and broker all were involved in providing the, sometimes inappropriate and unjustifiable, loans to subprime lenders.⁶⁰ Furthermore, the specific economic climate, in particular the increase in interest rates and decreases in property values, significantly impacted the crisis that we are now witnessing.

C Impact of Subprime Lending in Australia

It is difficult to find a specific estimation of the cost of the subprime crisis in Australia, however it is generally agreed that it is significantly less detrimental than the crisis in the United States. It is positive to note that Standard and Poor's Rating Service believes that the impact of subprime borrowing in Australia will be significantly less than the crisis experienced in the United States. This is due to a number of distinguishing factors between the two countries, including:

- The amount of subprime mortgages;
- Australian subprime offer a wider variety of subprime loans, including subprime products to prime lenders;
- There are more extensive recourses available for lenders in Australia;
- The Uniform Credit Code required higher levels of accountability and professionalism in the lending industry;
- Australian lenders are more risk-adverse than their US counterparts; and
- The US subprime industry is more mature than Australia's.⁶¹

59 'Uncle Sam and the sub-prime fall out' (May 2008) *Mortgage Business*, 33.

60 F Michaux, 'Will the US Subprime Downturn Impact the Australian RMBS Market?' (2007) *Standard and Poor's Commentary Report*.

61 Ibid.

Even though the subprime experience in Australia has not been as detrimental as that experienced in the United States, it is still important to ensure that a similar experience does not occur again. A consideration of this issue however is beyond the scope of the current paper.

VI TECHNIQUES OF MINIMISING RISK FOR OTHER PARTICIPANTS

Mortgage-backed securities transactions are rated primarily on the basis of the creditworthiness of the mortgage pools assigned to secure the rated securities, and not (directly at least) the creditworthiness of the seller/originator or borrower. In order to ensure that the SPV is 'bankruptcy-remote', so that the entity is unlikely to be subject to voluntary or involuntary insolvency proceedings, the rating agencies normally insist that the following governance measures be included in the trust deed and other relevant documentation, and that these governance requirements are actively implemented by the SPV and its sponsor.⁶²

A Restrictions on Objects and Powers

The reason for restricting the SPV's objects and powers is to reduce the risk of insolvency to the SPV because of potential claims from activities unrelated to its core business of mortgage securitisation and issuance of RMBSs.⁶³ In practice, therefore, sponsors tend to limit the SPV's objects and powers to those barest activities necessary to effect the RMBS transaction.

Accordingly, the trust documentation typically includes an objects clause that defines the purpose of the SPV (for example to hold the mortgage receivables; collect them, pass them on, reinvest them and so forth); and constrains the SPV to carrying on those activities needed to ensure the sufficiency of cash flow to pay its RMBSs, and to powers incidental to that purpose. The trustee-issuer is generally not given powers to carry on any other activity.

By limiting the powers of trustee-issuers, it is possible to limit the potential for creditors who have access to the assets of the trust (for example, through subrogation to the trustee's right of indemnity). Thus, for instance, if a trustee were prohibited by the terms of the trust deed from engaging employees in its capacity as trustee and then if, in breach of the trust deed, the trustee purported to engage employees in its capacity as trustee, neither the trustee nor those

62 See generally V Kothari, *Securitisation, the Financial Instrument of the New Millennium* (2003) Ch. 6; Standard and Poor's, *Structured Finance Australia and New Zealand* (2000) 92; R B True, 'Risk and Insolvency Issues in Japanese Asset Securitization' (1996) 28 *New York University Journal of International Law and Politics* 505.

63 It might be thought that, since the trustee-issuer is generally a company, it is not restricted in terms of its objects and powers: See *Corporations Act* ss 124–129. However, the SPV is primarily a trust vehicle, albeit generally with a corporate trustee. In such a context, ss 124–129 of the *Corporations Act* are not really applicable.

employees (in their capacity as agents) would be entitled to be indemnified for unpaid wages and the like from the trust assets.

Even if the objects and powers of an SPV were not restricted in this manner, it would be risky for the SPV to engage in unrelated business activities unless the parties to a transaction were willing to allow the rating to reflect the effect of those activities on the entity's resources, cash flows, and the SPV's ability to pay its obligations in a timely manner.

B Debt Limitations

The trust deed governing the SPV normally allows the SPV to issue multiple classes of debt, provided those classes of securities all have the same credit rating.⁶⁴ These requirements in relation to the issuance of additional bonds are designed to ensure that a holder of additional bonds would be unable to affect the creditworthiness of the SPV, or bring about the winding up of the SPV.

If the trust deed and related documentation allows, the SPV may be able to issue subordinated non-recourse debt. In this case, holders of such bonds have no recourse⁶⁵ to the SPV, and their rights are subordinated to those of existing bondholders. In both cases, the risk to the SPV should be no greater than that posed by the original RMBS issue, because the additional debt is rated at least as highly as the rating assigned to the original issue. To reduce the risk of involuntary liquidation or other insolvency proceedings against the SPV, the creditors are sometimes asked in practice to execute an agreement with the SPV that they will not file an involuntary petition against the SPV until at least one year after the RMBSs have been repaid.⁶⁶

C Independent Directors for Corporate Trustee-Issuers

In some RMBS structures (typically bank assignment programs), the corporate issuer is established by a sponsoring bank whose own directors serve on the board of the corporate issuer (SPV). Alternatively, the directors of the corporate trustee-issuer of the SPV may be officers of the originating bank, or of support providers (for example liquidity support providers).

64 See, for example, the multiple series of bonds issued by the PUMA Fund in the *Master Information Memorandum, PUMA Fund – P12*, above n 3, 67–8.

65 In this context, 'recourse' refers to the obligation of the issuer to pay for those mortgage receivables that run into default. Normally, in an RMBS transaction, there is a right of recourse, but it is limited to the cash collateral (and any over-collateralisation) placed by the originator, and to the underlying assets securing the bond issue. Bondholders and other secured creditors, such as swap providers in the case of the SPV's unpaid swap obligations, therefore have no recourse to any other assets of the issuer for satisfaction of the issuer's obligations under the related bonds. See, for example, *Master Information Memorandum, PUMA Fund – P12*, above n 3, 81–2.

66 It should be noted, however, that even if they do execute such agreements, the legal efficacy of this 'contracting out' procedure remains uncertain.

Such inter-relationships are likely to give rise to conflicts of interest.⁶⁷ Because of concerns about potential conflicts, rating agencies frequently require that the SPV's board be staffed with independent directors.⁶⁸ This can be seen as part of the wider current debate about corporate governance and independent directors.⁶⁹

D Separateness Covenants

The SPV's existence, separate and distinct from that of the originator, is reflected not only in the structure of the RMBS program, but generally also in separateness covenants which are included in the documentation governing the ongoing operations of the program. These separateness covenants help to ensure that the SPV is perceived to be an entity that is truly independent of its sponsor, or of the originator. The risk, if the SPV does not act, or is not seen to act, as if it is independent, is ultimately that a court might decide, in the event of the sponsoring bank's insolvency, that the assets of the SPV form part of the sponsor's asset pool for prospective distribution to the sponsor's creditors. Separateness covenants generally include obligations:⁷⁰

- To maintain books, records and accounts separate from those of any other person or entity;
- Not to commingle its assets with those of any other entity;⁷¹

67 For example, if the sponsor was to become insolvent but the SPV was performing adequately, the sponsor might have an incentive to seek to liquidate the SPV and consolidate its assets with those of the sponsor.

68 Arguably, for example, the risk of the SPV going into liquidation is lessened if the corporate issuer has at least some directors who are independent of the sponsoring bank and other facility providers, assuming of course that these directors' votes are required in any motion to liquidate the SPV or amend its constitution to more easily facilitate liquidation of the SPV, and they decide to vote against it.

69 A detailed discussion of this debate is beyond the scope of this article. For a summary of the debate, see L C Keong (ed), *Corporate Governance: An Asia-Pacific Critique* (2002).

70 See, for example, Standard and Poor's, *Structured Finance Australia and New Zealand* (2000) 93.

71 Where the mortgage originator in an RMBS program is also the servicer, the cash collected by the originator may at times (whether deliberately or not) become co-mingled with the cash collected by the originator in the capacity of servicer. The result is that the cash collected by the SPV cannot be clearly identified so that, in the event of insolvency, such cash could become part of the originator's asset pool, and not be available to the SPV, even though it strictly belongs to the SPV. Plainly, in order to avoid uncertainty, such commingling of assets should be avoided. This is particularly important in the context of practice in Australia, where the issuer is invariably a trustee. In such cases, the assets of the trust must be distinguishable from, and not mixed in with, any other assets of the issuer, or the assets of any other trust of which the issuer is a trustee. If the assets do become mixed, they may lose their characterisation as property of the trust, and consequently their protection from claims by any general creditors of the trustee.

Another situation that might arise is that, as noted earlier, the trust deed governing the SPV normally allows the SPV to issue multiple classes of debt, provided those classes of securities all have the same credit rating. Again, in order to avoid complications, any commingling of assets should be avoided. In some overseas jurisdictions (for example, in the United States) where issuers may be companies or trusts, it is common for corporate issuers to market segregated series of securities. These are separate series of bonds, which are backed by different types or qualities of assets, and which are rated independently by the rating agencies. Segregated series of bonds may have different ratings. Because of this, the asset backing for each bond series must be kept separate so that the security for one series may be enforced without impacting on the continued operation of another series.

- Not to guarantee or become obligated for the debts of any other entity, or hold out its credit as being available to satisfy the obligations of others;
- Not to acquire obligations or securities of its members or shareholders;
- Not to pledge its assets for the benefit of any other entity, or make any loans or advances to any other entity;
- To generally not create or permit any encumbrances over any of the underlying securities to the RMBS issue, other than those by which its RMBS issue is secured;
- Not to discharge any person from his obligations under any of the agreements that form part of the trustee's security, except in certain specified circumstances (for example repayment of the loan amount); and
- Not to have any subsidiaries other than those specifically contemplated by the program documentation.

E Elimination of Tax Liability

An unexpected tax liability for an issuer could have the potential to force the the issuer into insolvency, and make it necessary to enforce the security held on behalf of the investors and other secured creditors, thereby resulting in an early termination of the program. One way of mitigating this risk is to structure the issuer so that it is 'tax neutral', meaning that the issuer manages its tax liabilities so that its revenue (assessable income) is offset by an equal amount of deductions or exemptions. In practice in Australia, RMBS programs are frequently structured in this manner.

F Limited Recourse of Creditors

Again, to help ensure that the SPV is 'bankruptcy-remote', RMBS issues generally include 'limited recourse' provisions, phrased in such a way that they would be upheld even in the event of the issuer's insolvency.⁷² If a bond series were issued without effective limited recourse provisions, the bondholders could be entitled to have their debts repaid from any of the issuer's assets. In the event of a default, these bondholders might have a significant incentive to commence insolvency proceedings, or to take other action in an attempt to access those assets of the issuer that secure other tranches or classes of bonds. Even if an attempt to access the issuer's other assets did not ultimately succeed (for example because of the first priority fixed charges granted to a security trustee for the benefit of the

72 As noted earlier, in an RMBS transaction, there is normally a right of recourse, which is limited to the cash collateral (and any over-collateralisation) placed by the originator, and to the underlying assets securing the bond issue. Bondholders and other secured creditors, such as swap providers in the case of the SPV's unpaid swap obligations, therefore have no recourse to any other assets of the issuer for satisfaction of the issuer's obligations under the related bonds. See, for example, *Master Information Memorandum, PUMA Fund – PI2*, above n 3, 89, 91.

other bondholders), it may prevent timely payments of amounts due to the other bondholders.⁷³

VII ASSESSMENT OF CURRENT REGULATION – FINANCIAL AND INSOLVENCY RISKS

The following section provides a qualitative assessment of the extent to which the existing regulation relating to insolvency and financial security of the originator and issuer impede or facilitate the achievement of the objectives and criteria in RMBS issues in practice.

Broadly, the risks inherent in mortgage securitisation can be divided into insolvency and financial risks.⁷⁴ A number of investor risks are associated with securitised mortgages. Additionally, risks exist within the RMBS structure. RMBS issues are usually structured so as to attract an AAA rating. Technically this rating is assigned to the RMBS issue rather than to the issuer since the likelihood of default in an RMBS program depends on the quality of the mortgage pool and related credit enhancements and not on the issuer's general creditworthiness. AAA rating is the highest possible rating and it is not given unless the rating agency is certain as to the financial integrity of the issue. The subprime situation in Australia and the United States has however cast some doubt on the effectiveness of these rating processes and their ability to predict default rates, especially with regards to non-conforming loans. Therefore, the structure of the mortgage securitisation must therefore be designed to ensure that the issuer will be in a position to pay its debts throughout the life of the issue and that its financial security will not be undermined by the insolvency of the originating bank or any other party to the transaction. Thus, the sponsor of a mortgage securitisation must be able to minimise and appropriately allocate these risks efficiently.

A Objectives and Criteria

- Developing an insolvency risk-remote legal structure and managing the financial risks such as asset risks, credit risks, liquidity risk, prepayment risk and interest rate risk are the two biggest challenges or objectives in structuring an RMBS issue;
- Protecting the financial security of issuers; and
- Protecting the issuer's exposure to third party insolvency. Third parties include originator/servicer, mortgage insurers, and junior or subordinate bond holders.

⁷³ From a rating agency's point of view, limiting the recourse of creditors of a trustee-issuer is not a matter of a momentous concern, since the insolvency of the trustee should not of itself result in termination of the RMBS program. However it is, naturally, a significant issue from the trustee's perspective, and in terms of the rights of creditors against trustee-issuers.

⁷⁴ Within each of these broad groupings, there is a substantial overlap of risks.

B Regulations that Facilitate Growth in the Market

1 Measures used for Minimising Risks

As noted above, mortgage securitisation reduces the role of intermediaries and more efficiently allocates the risks inherent in the underlying mortgages with those willing to bear that risk, and thus, improves the efficiency of the overall financial system. The following measures are used in practice to minimise those risks.

The risk of issuer insolvency is minimised by making that entity a special purpose vehicle (trust), which is legally separated from the originating bank (ring-fenced), has little or no other business, has strict borrowing limits, and has enough cash from the outset to meet fees, and other costs. An independent trustee company is appointed to act as trustee issuer of securities. These measures are in fact provided under the Australian Prudential Regulation Authority's ('APRA') prudential regulations, which facilitate for the isolation of risks from the originating bank.⁷⁵

One of the major factors that contribute to the financial security of issuers and to the protection of investors is the quality of the mortgage pool and collateral security. In a typical case, this will comprise mortgages which have been selected as high-quality assets in respect of which perceived risk of default or delayed payments is low.⁷⁶ In the transfer of mortgagee rights to the SPV, the originator is usually required to give representations and warranties on various matters including: satisfaction of the applicable lending criteria, the status of the mortgages as registered first legal mortgages and compliance with applicable registration requirements; the valuations, and the existence of accompanying insurance policies. The transfer of mortgages usually also specifies that, in the event any warranty proving to be incorrect, the originator is required to repurchase the mortgages in question.⁷⁷

Various credit facilities are also usually made available to the issuer in order to ensure that it is able to meet its payment obligations fully and promptly. These include subordinated loans from the originator (or sometimes from a third party), the purpose of which is to meet initial costs and expenses and often to provide it with some initial capital. The sums advanced are fully subordinated, which means that the loan is not repaid until all principal and interest payments due on the bonds are paid in full.⁷⁸

To reduce the insolvency and financial risks associated with the borrower/mortgagor, several credit enhancement techniques are used. The most common method of addressing credit risk in issues of RMBS is to obtain mortgage pool

75 APRA, *Fund Management and Securitisation – APS 120* (September 2000).

76 The lending criteria that mortgages have to satisfy in order to be included in a typical securitisation are discussed in detail in Standard and Poor's, 'Mortgage-Backed Criteria' in *Structured Finance – Australia and New Zealand* (1998) 15–7.

77 See, for example, *Master Information Memorandum, PUMA Fund – P12*, above n 3, 49–50.

78 *Ibid* 85.

insurance. The obligations of the individual borrowers are the subject of insurance policies, which guarantee payment of principal and interest. One disadvantage of this form of credit enhancement is that if the paying ability of the insurer is downgraded, this can threaten the rating of the RMBS unless the risk is re-insured elsewhere.

The second means of addressing credit and liquidity risks is the creation of senior/subordinated tranches of RMBSs, wherein default and prepayment risks substantially lie. The senior bonds receive preferential sequential payment of principal and interest, with payment on more junior or subordinated bonds dependent on complete payment of the senior bonds.⁷⁹ Although secured on the same mortgage pool, the subordinated bonds rank behind the senior bonds in point of security and in the event of enforcement, no sums are paid in respect of the interest and principal due on the subordinated bonds unless the interest and principal due on the senior bonds are repaid in full. In the event of the issuer's insolvency, the subordination of the bonds in this way would be effective, since the secured lenders rank for payment in accordance with their positions on the priority ladder.

A third way of addressing credit and liquidity risks is over-collateralisation. This basically involves assigning with values exceeding the value of RMBSs issued, to the mortgage pool. A 'reserve' of assets is held to cover the risk of borrower insolvency and default. The 'reserve' also creates a buffer against large unanticipated prepayments.

One of the measures used to mitigate the interest rate differential risk⁸⁰ is to adjust the rate of interest on the mortgages.⁸¹ For an originator who wants to remain an active participant in the RMBS programs, charging significantly higher interest rates than those prevailing generally is unlikely to be an attractive policy in view of the adverse impact it would be likely to have on its ability to attract new business. In addition to commercial constraints, there may also be legal restrictions, which preclude adjusting mortgage interest rates deal with interest rate risks. Legal restrictions may arise from the terms of the securitised mortgages. Even though RMBS are usually (but not invariably) backed by variable rate, rather than fixed rate mortgages, it does not necessarily mean that the interest rate can be varied entirely at the lender's discretion. Under the *Consumer Credit Code*, the courts have power to strike out mortgage terms, which they consider to be unconscionable and a mortgage may be re-opened under ss 66, 68 and 70, if it constitutes an unfair or unjust credit bargain.

Interest rate risk can also be addressed by means of an interest rate swap structured so as to ensure that the issuer has funds available to it, which is sufficient to make

79 Ibid 77–8.

80 That is the risk that the rate of interest being paid by borrowers will be insufficient to enable the issuer to make payments due on the RMBSs.

81 See generally *Master Information Memorandum, PUMA Fund – P12*, above n 3, 55–6.

the payments due on the bonds.⁸² Structuring an interest rate swap facility allows investors to receive a market-based interest rate.

The terms of redemption of the bonds are also drafted so as to minimise the issuer's exposure to liquidity risk in respect of principal repayments. The provisions for compulsory redemption are usually included in the trust deed, which require the issuer to redeem bonds out of the proceeds of mortgage redemptions, or sale or enforcement proceeds that the issuer is able to obtain.⁸³

C Regulations that Impede Growth in the Market

As discussed in Parts III and IV of the article, the effects of insolvency of the originator and issuer of the securitisation program are crucial to an assessment of the risks for investors who acquire RMBSs.

1 Risks in Investment in RMBSs

Regardless of the form of the SPV (corporate or trust), the issuer poses potential risks of losses for investors if the originator of the loans becomes insolvent, if the borrowers under the loans become insolvent, or if the issuers become insolvent. Where the issuer is acting as the trustee of a trust, two possible insolvencies can occur – the insolvency of the trust and the insolvency of the trustee. If the trust is insolvent, one of the major problems that arise is whether the assets of the trust will be distributed in the manner intended by the securitisation transaction documents. If the trustee, but not the trust, is insolvent, it is important that the insolvency of the trustee has a minimal impact on the operation of the trust and payments under the RMBSs. It must be possible to replace the trustee issuer and ensure that the assets of the trust are not available for the general creditors of the insolvent trustee-issuer.

In an RMBS program, the bonds issued are debt obligations of the trustee issuer only in its capacity as trustee of the trust. The bonds do not represent an obligation of the trustee issuer in its individual capacity or any of the other parties to the securitisation transaction. The assets of the trust will be the sole source of payments on the RMBSs. However, if the trustee issuer is negligent, commits a fraud or fails to comply with an obligation imposed upon it under the trust deed, the trustee issuer's assets will be used to make payments on the RMBSs. Therefore, if the assets of the trust are insufficient to pay the interest and principal on the bonds when due, there will be no other source from which to receive these payments and investors may not recover their entire investment or achieve the yield they expect to receive.

There is a risk in RMBS programs that the originator may become insolvent. Unless the assignment of the mortgages to the SPV is structured to be a true sale,

82 Ibid 98.

83 Ibid 72–3.

and not a secured loan, the mortgages may be clawed back into the originator's assets. Such structuring is not difficult to achieve, but substance should be adopted to the extent possible over form.⁸⁴ The risk that underlying cash flows could suffer or be fragmented as a result of originator insolvency may be higher when equitable assignment only is used in transferring the mortgages to the SPV.⁸⁵ As mentioned previously, equitable assignment is used primarily when the originator remains to service the loan; the relationship between the borrower is maintained by the façade of legal ownership. If the originator of the mortgages becomes insolvent, the originator's trustee in bankruptcy may claim the loans for the originator's creditors. Therefore, even if the mortgage loans are of the highest quality, if the originator's financial position is weak, investors in these RMBS are vulnerable.

The insolvency laws and the laws governing the foreclosure of collateral (mortgages) are somewhat diverse and cumbersome. When an entity enters into voluntary administration, be it the issuer, originator or the borrowers, 'a stay' is imposed on all the creditors' actions against the insolvent entity, including actions related to the collateral, except in limited circumstances.⁸⁶ A stay can cause delay in payments to creditors and prevent them from liquidating the collateral in their possession. If the originator fails, a stay may also adversely affect the mortgage pool and the bondholders. Usually, the originator continues to service the loans, receiving payments from the borrowers for transfer to the mortgage pool and sometimes the originator is obligated to transfer more mortgage assets to the pool. In these cases, the stay may prevent him from making transfers to the mortgage pool.

It is possible that the borrowers become insolvent or fail to make payments of interest and principal under the mortgage loans when due, especially in the event of unforeseen interest rate rises and increasing cost of credit. Therefore the credit enhancement is not enough to protect bondholders from the borrower's failure to pay, the bondholders would suffer losses.

A variety of legal, economic and tax factors could affect the performance of borrowers in making payments under the mortgage loans. Under the *Consumer Credit Code*, among other remedies, a court may order a mortgage loan to be varied on the grounds of hardship.⁸⁷ Any such variance would reduce the principal or interest payable under a particular mortgage loan. In particular, if interest rates increased significantly, borrowers could experience distress and default rates on the mortgage loans would increase.

Generally, the mortgage insurance policies are subject to exclusion clauses from coverage.⁸⁸ Therefore, borrowers' payments may then not be covered because

84 See, for example, *Re Lovegrove* [1935] Ch 464, 495 (Maugham LJ).

85 Moody's Investor Service, *Structured Finance – Special Report* (1994) 2–3.

86 *Corporations Act* ss 440 and 441A.

87 *Consumer Credit Code* (Qld) ss 66, 68, 70 as set out in the *Consumer Credit (Queensland) Act 1994* Appendix.

88 See, for example, *Master Information Memorandum, PUMA Fund – PI2*, above n 3, 65.

of these exclusions. Moreover, mortgage insurance providers may be unable to perform obligations under the policy or the mortgage insurance policy may be held unenforceable under the *Insurance Contract Act 1984* (Cth). If such circumstances arise, the bondholders may not receive full repayment of principal and interest on the bonds.

The trustee-issuer may, at a cost, enter into interest rate swaps to manage the mismatch between the variable rate of interest on the mortgage loans and the floating rate of interest payable on the RMBS. If the interest rate swap agreement is terminated or the swap provider fails to perform its obligations, the investors may be exposed to the risk that interest payable on the RMBS will be greater than the variable rate of interest charged on the mortgage loans, which may cause losses to investors.

2 Priority Rights and Enforcement of Security Trust Deed

If the security provided by a mortgage is enforced and the proceeds of the sale of a mortgaged property, net of liquidation expenses, are less than the amount due under the related mortgage loan, losses to bondholders could result, to the extent where the difference was not covered under a mortgage insurance policy.

Where the RMBSs are issued under a senior/subordinated structure, the holders of senior (Class A) bonds are entitled to principal and interest payments before the subordinate (Class B) bonds, following enforcement of the charge under the security trust deed. Consequently, Class B bondholders would not receive full repayment of principal or payment of interest on the Class B bonds. Prior to enforcement of the charge under the security trust deed, if an amount is outstanding under a redraw facility or liquidity facility, repayment of those outstanding amounts will be ranked ahead of the Class B bonds.⁸⁹

If the security trustee were to enforce the security interest on the assets of the trust after an event of default under the security trust deed, there would be no assurance that the market value of the assets of the trust will be equal to or greater than the outstanding principal and interest due on the bonds, or whether the security trustee would be able to realise the full value of the assets of the trust.

According to the order of priorities under the security trust deed, the fees and expenses owed to the trustee issuer, the security trustee and the receiver would generally be paid from the proceeds of the sale of assets of the trust, prior to payment on the bonds. Consequently, the proceeds from the sale of the assets of the trust after an event of default under a security trust deed may be insufficient to pay the amounts due to bondholders.

In addition, the trustee-issuer would be subject to the penalties and compensation provisions of the *Consumer Credit Code*. The trustee issuer normally has a limited indemnity from the fund manager in respect of such liabilities.⁹⁰ If the

⁸⁹ Ibid 95–6.

⁹⁰ Ibid 46.

trustee issuer was unable to recover any such liabilities under the *Consumer Credit Code* from the fund manager, the assets of the trust would normally be used to indemnify the trustee issuer prior to payments to the bondholders. This could delay or decrease the amount of collections available to make payments to bondholders.

VII SUMMARY AND CONCLUSIONS

The insolvency of the mortgage originator in an RMBS issue, and to a lesser extent, the insolvency of the trustee-issuer, would plainly threaten the efficacy of the program. In both cases, a 'stay' would generally be imposed on all creditors' actions against the entity, including actions related to the collateral. Such a stay causes further delays in payments to creditors.

Usually, the originator would continue to receive and on-transfer borrowers' repayments on their housing loans to the mortgage pool. The originator might even need 'top up' the security pool by transferring additional mortgage assets to the pool.

It might be thought that there is some risk that, if the originator became insolvent, its liquidator would be able to claim the transferred loan repayments for the originator's creditors. This is one reason why it is important that the SPV be structured so that it is 'bankruptcy-remote'.

The results of the investigation reveal that certain aspects of the current regulatory practices facilitate the development of residential mortgage securitisation in Australia. These include:

- Use of an SPV transfers risk from the originating bank to an insolvency-remote vehicle;
- Subordinated debt facilities and credit enhancement techniques help to ensure that investors are repaid their bond principal and interest, that default and prepayment risks for investors are minimised, that the creditworthiness of the SPV is enhanced and that minimal credit risk to the issuer would result in the event of a default by a home loan borrower; and
- Priority rights in relation to the enforcement of investors' rights under the security trust deed help to ensure repayment to bondholders and third party liquidity facility providers.

The results of the investigation also reveal a number of aspects of the regulatory provisions that act as impediments to the growth of the RMBS market in Australia. These include:

- Where the originator or trustee-issuer files for administration or liquidation, a stay is imposed on all creditors' actions against the insolvent entity. If the assets of the trust are insufficient to pay the bonds as and when they fall due, investors may not recoup all of their investment;

- Insolvency on the part of the originator could cause delay in payment, or non-payment to creditors. Moreover, the originator's liquidator could potentially claw back any payments to the originator's creditors within six months of the date of his or her appointment, and attack any priority rights of the trustee-issuer to the SPV's mortgage asset pool; and
- If the issuer were to become insolvent, bondholders could suffer losses if the credit enhancements were insufficient, or if the proceeds of any property sales were less than the outstanding amount of the loans.

In Australia, APRA's prudential regulation of RMBSs helps to make the risk of insolvency relatively low, both for originators and trustee-issuers. However, as experience in recent years has shown, prudential regulators in Australia – and APRA, in particular⁹¹ – are hardly omniscient in terms of identifying corporate distress in those institutions they oversee.

⁹¹ Recall the collapse in 2001 of HIH Insurance Limited, the largest collapse in Australian corporate history: See Robert Baxt, 'The HIH Litigation' (2002) 30 *Australian Business Law Review* 145.