

3.1 AUSTRALIA

By Alex Sell, Australian Securitisation Forum

AUSTRALIA

The 'Aussie' covered bond market is in its infancy with legislation expected to pass Parliament toward the end of 2011 (August predictions are for a November 2011 enactment). Given legislation has yet to pass Parliament, the below summary is based on the most recent draft legislation.

The four 'Major' Australian banks, made up of Commonwealth Bank (Aa2, AA, AA), Westpac Banking Corporation (Aa2, AA, AA), ANZ (Aa2, AA, AA-), and National Australia Bank (Aa2, AA, AA), are all poised to be the main covered bond issuers, with estimates of inaugural deals coming to market Q1 2012. Based on the 8% issuance cap, as at May 2011, the total for all potential issuers (seven in total) is AUD 167 bn¹.

Two of the four Major Australian banks have been issuing covered bonds during the past twelve months out of their New Zealand subsidiaries. This issuance has given both management and systems experience ahead of issuing out of the Australian parents.

Others banks with both the balance sheet size and credit rating to issue AAA covered bonds include Macquarie Group Ltd (A2, A-, A), Citigroup Pty Ltd (A2, A+, NR), Suncorp (A2, NR, A), Bendigo & Adelaide Bank (A2, BBB+, A-), and ING Bank (Australia) Limited (A1, A, A), which is the 5th largest retail bank in Australia.

AUSTRALIAN COVERED BONDS

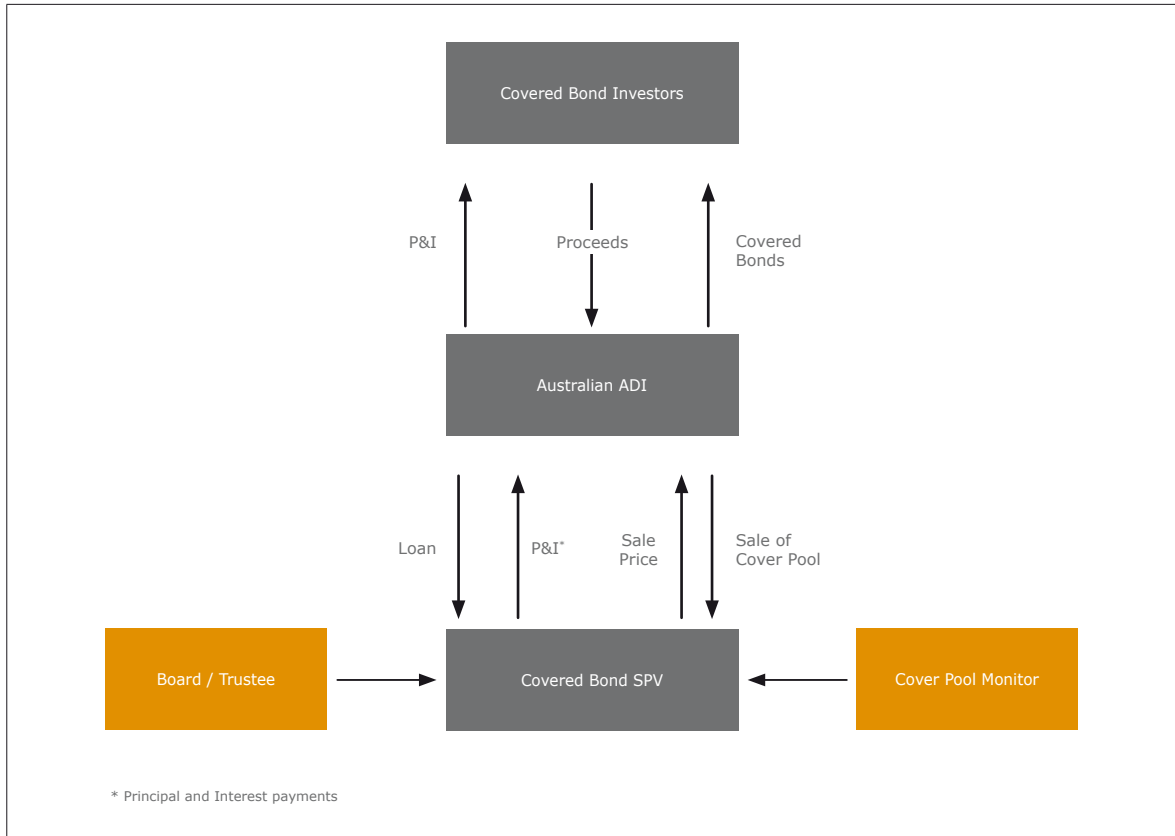
Australian Covered Bond programs follow similar structures as the UK, Canada and New Zealand, given the similarity of the legal systems. Australian Covered Bonds will be direct, unconditional obligations of the Issuer. In the event of Issuer insolvency or default, investors have a claim over the pool of cover assets and a claim on the issuer ranking subordinate to depositors but *pari passu* with unsecured creditors. The cover assets are held in a bankruptcy remote special purpose entity, the Guarantor, which provides an unconditional and irrevocable guarantee of the Issuer's obligations under the Covered Bonds. In Australian Covered Bond programs, the Guarantor is likely to be structured as a company or a trust (not an LLP, like the UK, on account of tax ramifications). A security trustee holds security over the cover assets on behalf of the investors. Following an issuer event of default, the Guarantor is required to meet the covered bond obligations using the cash flows generated from the cover assets. The Guarantor is likely to only be permitted to sell the cover assets up to the contractual maximum; not any voluntary OC, which is held in the form of a senior claim by the Issuer, becoming a part of the Issuer's senior unsecured obligations to which covered bond holders rank *pari passu* - but behind depositors.

See Figure 1 for how the Australian Government's draft legislation² illustrates an Australian covered bond.

¹ Equivalent in foreign currencies: EUR 126 bn, US\$ 181 bn, GBP 111 bn at 26th July 2011.

² p.25, *Exposure Draft – Banking Amendment (Covered Bonds) Bill 2011*.

> FIGURE 1: GENERIC AUSTRALIAN COVERED BOND PROGRAMME STRUCTURE



Banks issuing covered bonds: ADIs³ are permitted to issue covered bonds subject to complying with the covered bond regulatory structure.

Cap on covered bond issuance: A cap on the value of the cover pool of assets (including contractual and voluntary over-collateralisation) is set at 8% of an ADI’s ‘Assets in Australia.’ This cap prevents covered bondholders having claim over more than 8% of an ADI’s assets in Australia at the point of issuance of covered bonds. In effect, this cap limits the subordination of unsecured creditors such as depositors. ‘Assets in Australia’ is to be defined by the prudential regulator but it is not expected to be controversial or material however so defined. (N.B. There are two 8% tests in the legislation; the first test is a point-in-time only test for issuance purposes, which if failed results in a prohibition on issuance under legislation; the second test is a prudential test, which is a continuous reporting test that, if breached, may result in a deduction from regulatory capital equivalent to the excess over the 8% cap.)

3 *Authorised Deposit-taking Institutions* (“ADIs”), as they are known locally, are the equivalent of an EEA credit institution.

Ring-fencing the cover pool of assets: The cover pool of assets providing security to covered bondholders and service providers needs to be held by a covered bond special purpose vehicle separate from the ADI issuing the covered bonds, or by a *Covered Bond Credit Institution* if the arrangement involves several ADIs. The covered bond special purpose vehicle or *Covered Bond Credit Institution* owns (beneficially or otherwise) the cover pool assets. These entities may hold other assets related to issuing covered bonds outside the cover pool of assets (such as voluntary over-collateralisation and assets linked to assets held in the cover pool).

Australian Prudential Regulation Authority's powers: The prudential regulator has the power to restrict the issuance of covered bonds where *inter alia* the ADI has not complied with the covered bond legislation. However, APRA has no powers over the cover pool of assets which are for the benefit of covered bondholders, or any statutory manager. APRA may provide prudential standards on any matters relating to covered bonds including:

- > the issuing of covered bonds;
- > assets in cover pools; and
- > maintenance of cover pools.

Eligible assets: The eligible assets which can be included in the cover pool are specified in the legislation. These assets are essentially high quality assets (such as residential mortgages).

Maintenance of the cover pool: The ADI is required to maintain the cover pool of assets so that the value of these assets is sufficient to meet 103% of the face value of the outstanding covered bonds. This may involve the ADI transferring additional assets to the cover pool and replenishing assets in the cover pool. APRA has the power to prevent an ADI maintaining the cover pool in particular circumstances, however.

Cover pool monitor: The ADI issuing the covered bonds is required to appoint a cover pool monitor. The functions of the cover pool monitor include:

- > auditing the ADI's register of the assets in the cover pool; and,
- > reviewing the cover pool's compliance with the ADI's requirement in respect of the nature of the assets in the cover pool, and the value of the cover pool of assets.

As a matter of law, the organisation must:

- > be registered as an *Approved Auditor under the Corporations Act 2001*; or
- > hold an *Australian Financial Services Licence issued under the Corporation Act 2001*.

Winding up the cover pool: In the event of resolving a failing ADI, an ADI statutory manager or external administrator has no powers over the cover pool of assets apart from contractual matters. This is to ensure that the resolution process relating to the ADI does not impact on the cover pool of assets providing security to covered bondholders. Further, as mentioned above, APRA has no powers over the cover pool of assets at any time other than to prevent top-ups.

Arrangements involving several ADIs: Two models will be facilitated by law to enable a group of ADIs to enter into an arrangement to facilitate the issuing of covered bonds. One model involves the ADIs establishing a specialised ADI, called a Covered Bond Credit Institution, which pools assets of the participating ADIs and issues the covered bonds. The other model involves the participating ADIs establishing a separate entity that aggregates covered bonds issued by these ADIs and issues a new instrument backed by these covered bonds. The merits of the *Covered Bond Credit Institution* as an ADI regulated by APRA remains under consideration. The four 'Major' Australian banks are unlikely to utilise these aggregating structures.

I. FRAMEWORK

The Australian covered bond regime emulates the UK RCB in most respects. The issuance is from the bank rather than a SPV. With the benefit of an intercompany loan from the issuer, the SPV acquires the cover pool collateral from the issuer's balance sheet, but the cover pool assets remain consolidated on the issuer's balance sheet for accounting, tax and prudential (regulatory capital) purposes.

II. STRUCTURE OF THE ISSUER

The legislation requires the issuer to be an ADI (or, in the case of the yet to be confirmed CBCI aggregated structure). See Figure 1.

Australian Covered Bonds are direct, unconditional obligations of the issuer; however, investors also have a priority claim over a pool of cover assets in the event of the insolvency or default by the issuer. The legislation requires all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being sold to the SPV, which guarantees the issuer's obligations under the bonds.

III. COVER ASSETS

Assets permitted in the cover pool that are restricted to this list must be exclusively Australian (e.g. US dollar cash or a New Zealand residential mortgage would not qualify):

- > cash;
- > an at call deposit held with an ADI and convertible into cash within 2 business days;
- > any bank accepted bills or certificates of deposit not issued by the ADI issuing the covered bonds that are eligible for repurchase transactions with the Reserve Bank of Australia;
- > an [Australian] government debt instrument issued by the [Australian] Commonwealth, an [Australian] State or an [Australian] Territory;
- > a loan secured by a residential property;
- > a loan secured by a commercial property;
- > a contractual right relating to the holding or management of another asset in the cover pool (for example, a mortgage insurance policy and a right for compensation in the event the ADI does not meet any of its contractual obligations in respect to managing the assets in the cover pool); and
- > a derivative used for the purposes of protecting the value of another asset in the cover pool.

IV. VALUATION AND LTV CRITERIA

The properties securing the mortgage loans are likely to be valued using Australia mortgage market accepted practice, unless otherwise specified in the transaction documents. Whatever valuation method is used, it must be the most recent.

The LTV limit for mortgages must not vary across different programmes (80% for residential mortgages; 60% for commercial mortgages).

It is important to note that mortgages above one of the two LTV limits are able to be included in the cover pool but the amount of any loan that exceeds the LTV limit is excluded from the contractual Asset Coverage Test (see Section V below).

V. ASSET-LIABILITY MANAGEMENT

The legislation prescribes a minimum level of overcollateralisation (OC) of 3% and requires the cover pool to be capable of covering all claims attaching to the bonds at all relevant times.

It is predicted that, contractually, issuers are likely to perform a dynamic Asset Coverage Test (ACT) most likely on a monthly basis to ensure minimum OC requirements are satisfied.

The issuer is required to cure any breach of the ACT by the next calculation date by transferring additional cover assets to the SPV. If the breach is not rectified by the following calculation date, the trustee will serve a notice to pay on the SPV, subject to any further 'cure' periods allowed under the transaction documentation.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

An issuer under the legislation must be an ADI (unless it is a CBCI or aggregation SPE for the sole purpose of aggregated issuance).

The issuer is responsible for monthly cover pool monitoring; however, the ACT calculation is likely to be independently verified by an *Approved Auditor* or an *AFSL* holder.

The legislation only deals with the legislative tests – further obligations regarding ACT calculations will likely stem from the contracts.

APRA has the power to order the issuer to cease transferring additional assets to its cover pool if it believes in doing so the issuer threatens its broader solvency (especially its ability to meet the claims of depositors).

VII. HOW ARE SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS REGULATED?

Broadly-speaking the covered bond legislation requires cover pool assets to be beneficially-owned by a special purpose vehicle, not by the ADI. If the ADI is in default, its statutory manager (or APRA) still cannot touch the cover pool assets unless they constituted part of the voluntary over-collateralisation.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Australian covered bonds – to the extent they are issued out of a non-EEA entity – will not by definition achieve UCITS compliance, even if they meet every other [non-jurisdictional] UCITS requirement. This has consequences for insurance companies subject to Solvency II, such that they would likely be subject to 100% risk-weight rather than 10% risk-weight.

The Australian central bank, The Reserve Bank of Australia, has indicated that it is likely to add Australian covered bonds to the list of open market operations' ("OMO") eligible collateral⁴. It already accepts so-called 'Kangaroo' covered bonds from Canadian, French and Danish AUD issuers of covered bonds. Entry on to the OMO list is seen as crucial because the collateral is mirrored in the recently announced central bank Secured Committed Liquidity Facility, which is Australia's Basel liquidity LCR solution, required because of the dearth of Level 1 securities locally (and nil Level 2 securities). This, then, creates a captive investor base in the form of local bank balance sheets and in turn encourages real money investors, thereby promoting liquidity and depth further. But this will take time, and much hinges on its development because once it is liquid in the prudential regulator's eyes it will likely become eligible as a Level 2 liquid asset. This is significant because the central bank facility, in contrast, attracts a disincentive fee to encourage only necessary reliance upon it.

Certain EEA nations, notably Norway, have permitted Australian RMBS on to their local central bank's eligible collateral lists. There must surely be some hope that this will continue for Australian covered bonds, offering as they will diversification away from EEA sovereigns, issuers, and collateral.

IX. DEVELOPMENT OF THE MARKET

The volume of outstanding Australia regulated covered bonds could amount to about \$145.5bn, based on the 'Assets in Australia' of the most likely issuers. Clearly, it will take time for issuers to reach their 8% limits.

⁴ See: <http://www.rba.gov.au/mkt-operations/xls/eligible-securities.xls>

> FIGURE 2: OVERVIEW – AUSTRALIAN COVERED BOND PROGRAMMES*

	CBA	WBC	ANZ	NAB	ING (AUS)	SUN	BAB	CITI (AUS)	MQG
Programme volume in (MAX)	Statutory 8% (including OC) of 'assets in Australia' issuance limit								
AUD (bn)	43.0	43.8	29.5	34.3	3.8	4.6	3.4	1.5	4.3
EUR (bn) ⁵	31.6	33.0	22.2	25.8	2.9	3.5	2.6	1.1	3.2
USD (bn) ⁶	45.5	47.4	31.9	37.1	4.1	5.0	3.7	1.6	4.7
LTV cap	Mortgages: 80% Residential 60% Commercial								
House price index	n/a								
Maximum asset percentage applied in ACT	No statutory ACT								
Minimum over-collateralisation	103%								
Current asset percentage applied in ACT	n/a								
Current over-collateralisation	n/a								
In arrears accounting	Not defined (likely to be contractually defined as either of missed payments or scheduled balance methodology)								
Hard bullet	n/a								
Asset monitor	No issuance yet. Only <i>Approved Auditors</i> and AFSL holders permitted.								

Source: Australian Securitisation Forum

Data: based on 8% Resident Assets, May 2011, Australian Prudential Regulation Authority

Note: *No issuance yet – all figures are illustrative based on 8% assets in Australia statutory encumbrance limit at May 2011 and the exchange rate at 25 July 2011.

⁵ Equivalent, estimated using exchange rate AUD1.00:EUR0.752 at 25 July 2011.

⁶ Equivalent, estimated using exchange rate AUD1.00:USD1.083 at 25 July 2011.