

## **3.2 AUSTRALIA**

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### **I. FRAMEWORK**

The legal framework is principally a contractual one in nature, with a statutory overlay that makes certain provisions for the prudential regulator to make regulations in relation to issuers' covered bond programmes, as well as provisions for minimum overcollateralisation levels (103% at all times).

Prior to the introduction of amending legislation, the prevailing view among the regulatory community was that the Banking Act 1959 prohibited banks from placing any other class of creditors above depositors. The amendment to the Banking Act in November 2011 permitted this to occur, subject to an encumbrance limit of 8% (or such other percentage as may be prescribed by regulations) of an issuer's *assets in Australia*, as defined.

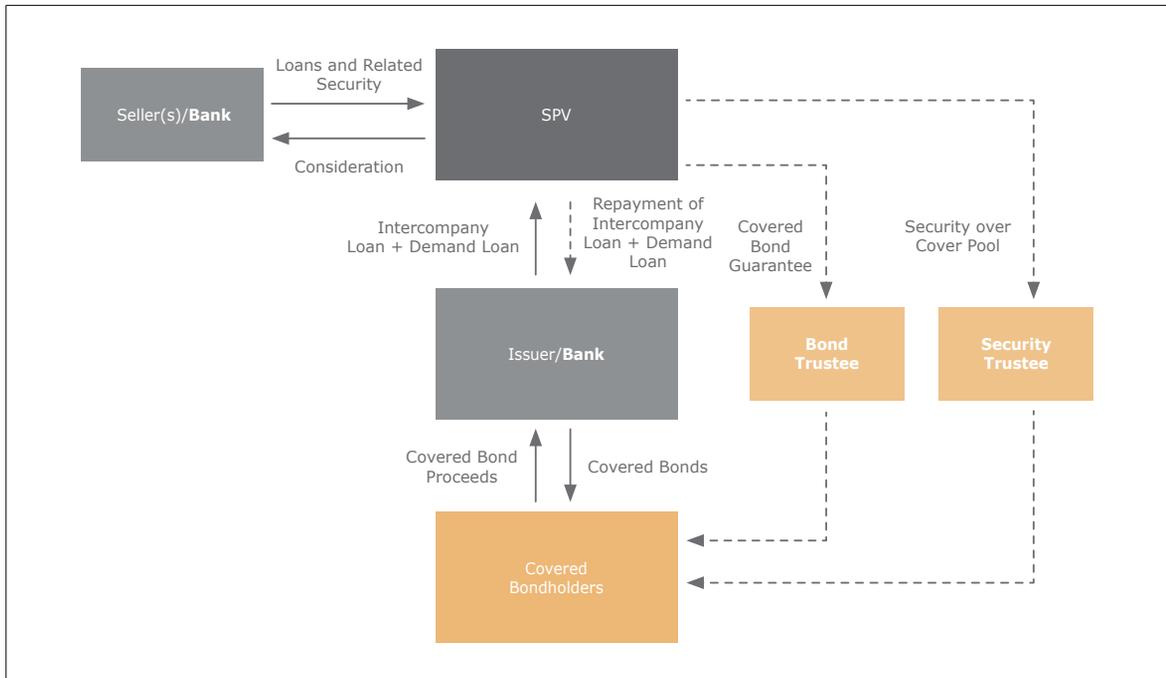
### **II. STRUCTURE OF THE ISSUER**

Australian banks are the issuers of covered bonds; not SPVs or any other entity. However, the issuer makes an inter-company loan to the cover pool SPV to enable the SPV to acquire the cover pool and therefore provide a guarantee over the issuer's obligation to bond holders. This guarantee will be called upon in an event of default in respect of the issuer. The cover pool permits the SPV to continue to make scheduled payments on the bonds following an issuer event of default and the bond holders' benefit from security granted by the SPV over the cover pool to secure the SPV's obligations, including in respect of the guarantee. At present, the cover pool assets may not exceed 8% of an issuer's *assets in Australia*. With the exception of the fixed 8% maximum, the Australian covered bond resembles the British and New Zealand models. The charge over the assets of the cover pool does not, however, remove any claim creditors may wish to also make on the estate of the bank issuer.

Under the Banking Act, the value of the cover pool cannot exceed 8% of the issuer's *assets in Australia*. An Authorised Deposit-taking Institution (ADI) must not issue a covered bond if the combined value of assets in cover pools securing covered bonds issued by the ADI would exceed this 8% but there may be voluntary overcollateralisation (e.g. in the form of a demand loan) that takes the total value of assets held by the SPV over 8%. The voluntary overcollateralisation may rank equally with covered bonds (thus forming part of the cover pool and subject to the 8% cap) or senior to the covered bonds (thus outside the 8% cap). In keeping with other jurisdictions the voluntary overcollateralisation serves as a management buffer in order to avoid inadvertent contractual breaches in respect of the Asset Coverage Test and to make ongoing covered bond issuance more efficient. Where the voluntary overcollateralisation ranks senior to the covered bonds (i.e. it is not part of the cover pool) such voluntary overcollateralisation remains part of the bank's estate and may be returned to the bank at any time. Further, if the bank exceeds the 8% maximum in breach of the Banking Act, it will also attract a deduction from its regulatory capital base equal to the value that exceeds 8%.

Any amount recovered against the insolvency estate (and for which bondholders rank equally with all other senior unsecured creditors but behind depositors) will be paid over to the SPV to be held as additional collateral which is used to make payments under the guarantee. Any excess of assets in the SPV over and above the amount of the bonds issued – once repaid – will, after the satisfaction of other secured liabilities of the SPV, be paid to the insolvency estate of the issuer by way of repayment of the amount outstanding under any remaining intercompany loan amounts. However, where voluntary overcollateralisation ranks senior to covered bond payments, the voluntary overcollateralisation will be returned to the issuer ahead of payments on the covered bonds.

> FIGURE 1: STRUCTURE



Source: Australian Securitisation Forum

### III. COVER ASSETS

The Banking Act 1959 – Section 31<sup>1</sup> sets out the assets that can be included in the cover pool. These are:

- a. an at call deposit held with an ADI and convertible into cash within 2 business days;
- b. providing no greater than 15% of the total cover pool, a bank accepted bill or certificate of deposit that:
  1. matures within 100 days; and
  2. is eligible for repurchase transactions with the Reserve Bank; and
  3. was not issued by the ADI that issued the covered bonds secured by the assets in the cover pool;
- c. a bond, note, debenture or other instrument issued or guaranteed by the Commonwealth, a State or a Territory;
- d. a loan secured by a mortgage, charge or other security interest over residential property in Australia;
- e. a loan secured by a mortgage, charge or other security interest over commercial property in Australia;
- f. a mortgage insurance policy or other asset related to a loan covered by paragraph (d) or (e);
- g. a contractual right relating to the holding or management of another asset in the cover pool;
- h. a derivative held for one or more of the following purposes:
  1. to protect the value of another asset in the cover pool;
  2. to hedge risks in relation to another asset in the cover pool;
  3. to hedge risks in relation to liabilities secured by the assets in the cover pool.

<sup>1</sup> [http://www.austlii.edu.au/au/legis/cth/consol\\_act/ba195972/s31.html](http://www.austlii.edu.au/au/legis/cth/consol_act/ba195972/s31.html).

At the time of publication, all Australian covered bond issuers have limited their programmes to residential mortgage collateral for their cover pools and no such programmes include commercial mortgages.

#### **IV. VALUATION AND LTV CRITERIA**

Contractually, cover pool assets are subject to revaluation every month by way of indexation, which varies between programmes. Please refer to each issuer's individual website for details of the index used and the methodology applied.

LTV criteria – in addition to indexation – are contained in Section 31A<sup>2</sup> of the Banking Act. Specifically, they are as follows:

- > Residential mortgages – if the mortgage exceeds 80% of the value of the property then the value of the loan is reduced by the amount of the excess.
- > Commercial mortgages – if the mortgage exceeds 60% of the value of the property then the value of the loan is reduced by the amount of the excess.

#### **V. ASSET – LIABILITY MANAGEMENT**

This is principally a matter for the credit rating agencies in relation to timely payment and their opinions on the value of the pool in liquidation scenarios. The issuers have regard to ECAI's methodologies and criteria to seek to ensure maintenance of AAA ratings.

#### **VI. TRANSPARENCY**

Since August 2012, an Australian Transparency Template has been in force, followed by each of the five Australian covered bond issuers. It is in line with the guidelines of the ECBC's Covered Bond Label Initiative, and covers the following areas of each issuer's programme:

- |                                      |                 |                            |
|--------------------------------------|-----------------|----------------------------|
| > Legend                             | > Prepayments   | > Disclaimer               |
| > Dates                              | > Pool Summary  | > Terminology              |
| > Parties                            | > Mortgage Pool | > Ratings Compliance Tests |
| > Asset Coverage Tests Bond Issuance | > Contact       |                            |

Please refer to the Australian Securitisation Forum's covered bonds landing page<sup>3</sup> to access the template in full as well as web links to individual issuer's programmes.

#### **VII. COVER POOL MONITOR AND BANKING SUPERVISION**

Prudential Standard APS 121 – Covered Bonds<sup>4</sup> contains the regulations set by the administrator (regulator) of the Banking Act in Australia.

The cover pool monitor is appointed by the bank issuer but must be independent and must provide reports in respect of the cover pool to the bank regulator on request. Specific tasks it must perform, and report on, biannually are:

- > No breach of the 103% statutory minimum overcollateralisation;
- > Assess compliance by the issuer with assets permitted to be in the cover pool under the Banking Act;
- > Confirm that the covered bond pool asset register is being maintained in line with prudential standard APS 121, and
- > Contractually, also obliged to check the arithmetic accuracy of asset coverage tests on an annual basis.

<sup>2</sup> [http://www.austlii.edu.au/au/legis/cth/consol\\_act/ba195972/s31a.html](http://www.austlii.edu.au/au/legis/cth/consol_act/ba195972/s31a.html).

<sup>3</sup> <http://www.securitisation.com.au/cbprofile>.

<sup>4</sup> <http://www.apra.gov.au/adi/PrudentialFramework/Documents/120719-APS121-Covered-bonds-final2.pdf>.

The bank regulator has the power to instruct – publicly or privately – a bank to cease topping up its cover pool should it wish to invoke its broad powers under the Banking Act, in the event that it has broader concerns about the bank’s prudential condition.

#### **VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS**

Cover pool assets are sold by the bank issuer to the SPV, backed by contract. The security interest held over the cover pool assets is recognised at law and will not be jeopardised in the event of the bankruptcy/insolvency of the issuer.

#### **IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION**

Not in compliance with UCITS because Australian issuers are not domiciled in member states of the EEA.

Risk weighting varies depending upon the jurisdiction concerned, pending standardised risk-weights from the EBA and the outcome of the current Basel consultation.

Covered bonds issued by Australian issuers are currently not eligible assets for repurchase agreements with the ECB or NCBs, or the BoE. There is however, a view that some Australian covered bonds may be eligible for inclusion in the calculation of LCR in some regulatory jurisdictions.

Covered bonds issued by Australian issuers and denominated in Australian dollars are repo eligible with the Reserve Bank of Australia subject to satisfying an assessment by the Reserve Bank of Australia and the issuer meeting disclosure requirements on an ongoing basis. Furthermore, covered bonds may be deemed to be Level III LCR assets on a case by case (under the Australian Prudential Regulation Authority’s implementation of Basel III LCR guidelines) subject to satisfying an application for repurchase eligibility with the Reserve Bank of Australia (and which must be made separately for each covered bond issue).

There are no special Australian federal or state investment regulations regarding Australian covered bonds.

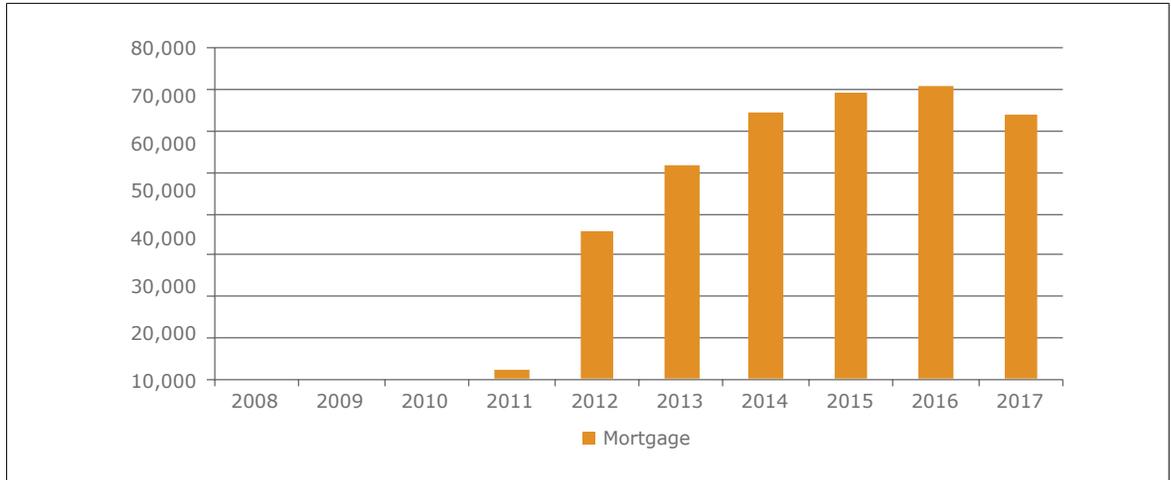
#### **X. ADDITIONAL INFORMATION**

The development of the Australian covered bond market largely came about due to the financial crisis and the effective seizure of non-sovereign global capital markets through this period. After the events of 2008 and 2009, the Australian Federal government recognised the need for increasing funding diversity within the Australian banking system. The Australian Federal government subsequently passed changes to the Banking Act, enabling banks to prioritise claims subject to the regulators interpretation of the changes to the Act. The first covered bond issues from Australian banks occurred in late 2011. Issuance volumes subsequently increased dramatically through 2012 as issuers properly established their programs in global bond markets.

In principle, Australian ADIs have three primary term funding options for their balance sheets: senior unsecured bonds, residential mortgage backed securities and covered bonds. In practice, the larger institutions have effective access to all three options while smaller institutions principally used senior unsecured bonds and residential mortgage backed securities for term funding.

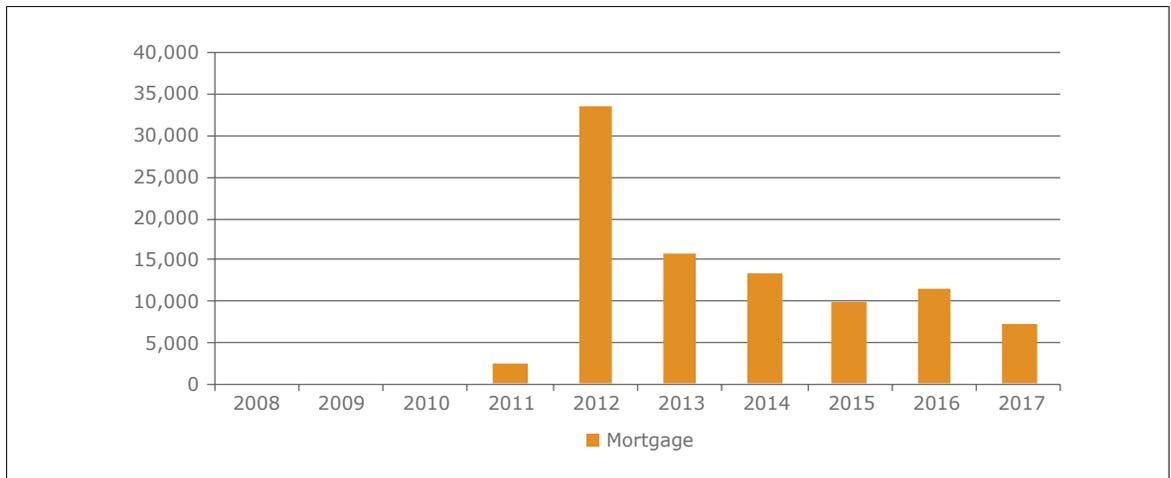
It is expected that Australian covered bond issuers will use their issuance capacity sparingly; balancing maintaining a global market presence against the higher all-in funding costs associated with covered bonds and program management costs (in comparison to funding through senior unsecured bonds or residential mortgage backed securities), and the need to be able to respond quickly to deterioration in funding conditions. Feedback from a range of market participants suggests that this funding strategy may drive a scarcity premium in terms of the relative valuation of Australian covered bonds against other forms of Australian bank secured financing and other global covered bond markets.

> FIGURE 2: COVERED BONDS OUTSTANDING 2008-2017, EUR M



Source: EMF-ECBC

> FIGURE 3: COVERED BONDS ISSUANCE, 2008-2017, EUR M



Source: EMF-ECBC

**Issuers:** There are seven issuers of Australian covered bonds. These are Westpac Banking Corporation, National Australia Bank Limited, Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia, Suncorp Bank, Macquarie Bank and Bank of Queensland. These seven Australian banks have issued a hard and soft-bullet covered bonds and in the case of Bank of Queensland, a conditional pass-through covered bond (CPTCB). In June 2017, Bank of Queensland Limited issued its inaugural CPTCB and is the first Australian ADI to issue a covered bond in that format. It is unlikely that the smaller Australian ADIs will be seeking to issue Australian covered bonds. The reason for this is due to the legislative asset encumbrance limit restriction of 8%. This is perceived by many issuers as compromising their ability to support a sufficiently broad market in a prospective programme.

**ECBC Covered Bond Comparative Database:** [http://ecbc.eu/framework/98/Australian\\_Covered\\_Bonds](http://ecbc.eu/framework/98/Australian_Covered_Bonds).