

ADDRESS BY

JOHN LONSDALE

GENERAL MANAGER, FINANCIAL SYSTEM DIVISION,

MARKETS GROUP

THE TREASURY

**“UNDERSTANDING THE KEY ELEMENTS OF
COVERED BONDS LEGISLATION”**

INSTO COVERED BONDS CONGRESS

15 AUGUST 2011

Good morning.

Thank you for inviting me to speak to you today about the Government's decision to allow Australian banks, credit unions and building societies to issue covered bonds.

Let me start by saying that this measure represents a significant change in the bank funding landscape. For the first time, Australian approved deposit-taking institutions (or ADI's) will be able to tap into the established offshore covered bond market.

Further, while there have been a couple of covered bond issues by foreign banks in the Australian market, the measure provides an opportunity to develop a covered bond market domestically.

And perhaps most importantly, the measure to allow ADIs to issue covered bonds could provide cheaper, more stable, and longer-duration funding for the Australian banking system over the medium to long term.

But firstly, I would like to be clear about what I can't discuss. The final wording of the law has not been released, and I'm sure the Treasurer wouldn't be impressed by making announcements on his behalf!

While I won't be going into the details of the final Bill, I can talk about some of the key concepts in the draft legislation, as released by the Government in March. I will also comment on the discussions Treasury has had with industry stakeholders over the

last few months.

As well, I will touch on the policy issues the Government grappled with in coming to its decision to allow ADIs to issue covered bonds. I will also provide some context around the expected timing of the Bill.

In doing so, I hope to give you an insight into the thinking behind Government's draft legislation, and how it fits into Australia's regulatory system.

What is a covered bond?

When this process started for us, the characteristics of covered bonds seemed straightforward and widely accepted.

As defined by the European Covered Bond Council, covered bonds have four essential characteristics:

- First, the bond is issued by, and the bondholders have full recourse to, a regulated credit institution.
- Second, bondholders have a claim against a cover pool of assets in priority to all other unsecured creditors.
- Third, the credit institution has an ongoing obligation to maintain enough assets in the cover pool to satisfy the claims of covered bondholders.
- And finally, the obligations of the credit institution are supervised by an independent regulatory body.

While this definition seems straightforward, as I have found during this process, the devil is in the detail.

When looking at other jurisdictions, the amount of diversity in covered bond frameworks worldwide is surprising. This is particularly the case in Europe, where covered bonds are so well established.

While the four essential characteristics remain constant across jurisdictions, the details depend on the particular country in which covered bonds are issued.

Depending on the jurisdiction, a covered bond could be backed by shipping loans, gold, public sector loans or securitisation products, in addition to the traditional security of residential and commercial mortgages.

Most European countries have complex laws relating to substitution assets, valuation frameworks, and asset liability management requirements, as well as asset segregation, bankruptcy remoteness and regulatory oversight.

Although the draft legislation attempts to obtain international best practice, it does not simply replicate the European framework, which in general is highly prescriptive, and is adapted for the Australian context.

One benefit of the diversity in offshore jurisdictions is that we can observe how these frameworks operate in practice, allowing us to

pick and choose those features that seem to work best.

For example, one of the key decisions is whether to provide a specific legislative framework, or just allow ADIs to issue unregulated covered bonds — that is, structural covered bonds.

Going down the unregulated route has some attractions. It would provide ADIs a lot of flexibility in how they structure and market covered bonds. And it would also reduce regulatory costs.

However, after looking at the European market, the Government has decided to follow the lead of European countries and opted for the legislative route. I note that several non-Euro jurisdictions such as New Zealand, the US and Canada are also planning to follow the same route. Industry stakeholders also agreed this approach.

In developing the Australian covered bonds framework, I also note that regulatory issues have arisen since the global financial crisis.

For example, the issue of asset encumbrance has been raised in international forums over the last year. Some offshore regulators are becoming increasingly concerned about the volume of covered bonds issued by banks, and what this means for the unsecured bank funding markets, as well as the position of depositors and other non-secured creditors.

The proposed legislative cap of eight per cent on covered bond issuance by ADIs seeks to address any asset encumbrance concerns, while also meeting regulatory best practice.

As well as looking at offshore best practice, we have listened closely to the views of stakeholders on how the new Australian legislative framework should be designed.

This included undertaking a consultation on an initial draft of the legislation in March and April. And since then, some of the key stakeholders have remained engaged.

As you might expect, when it comes to designing new legislation, investors have a different view to issuers. Prudential regulators and credit rating agencies also have different, but very relevant, perspectives.

One of the challenges of developing this legislation has been trying to mould the divergent views of stakeholders into something that will meet the needs of the market, while also protecting the integrity of Australia's financial system.

In designing the legislation, one approach could have, for example, simply allowed the issuance of covered bonds and left the details up to contractual arrangements. However, the feedback from the consultation process is that the legislation should provide clarity on issues such as the cover pool, prudential treatment, the need to appoint a covered pool monitor and the powers of APRA, and an ADI statutory manager or external administrator in the event of a failing ADI.

Much of this additional clarity in the legislation is aimed at protecting the interest of covered bond investors. And in doing so, this is

expected to improve the marketability of Australian covered bonds to domestic and offshore investors.

In particular, this additional clarity should assist rating agencies in assessing the credit worthiness of Australian covered bonds.

This broad approach is consistent with the feedback we have received from all key stakeholders. But as you might expect, their views differed about how this approach would be implemented in practice.

Another issue which was considered in developing the legislation is how covered bonds would fit with the current Australian prudential structure.

As you would be aware, Australian banking law includes the longstanding concept of depositor preference.

That is, if bank is wound up, all of its assets in Australia are available to meet the claims of depositors, who are given priority over all other unsecured creditors.

This preference, together with APRA's prudential standards, has historically provided depositors with confidence when they deposit money in a bank, credit union or building society.

Because covered bonds are a form of secured borrowing where the investor has a priority claim over certain ADI assets, this is inconsistent with the historical concept of depositor preference.

Offshore jurisdictions have employed various methods to protect the interests of depositors and other non-secured creditors, while still allowing the issuance of covered bonds.

Traditionally, covered bonds in Europe were generally restricted to specialised credit institutions that did not take deposits. This completely avoided the issue of depositor subordination.

Some jurisdictions rely solely on prudential supervisors to exercise discretion in managing the subordination of depositors in deposit-taking institutions that issue covered bonds.

Other, mainly non-European, countries have tried to minimise the risk to depositors by establishing a cap on the amount of covered bonds a bank can issue.

As you would be well aware, the Australian Government is not moving away from the principle of depositor protection in Australia's legislative and prudential system.

In addition to the ongoing prudential supervision undertaken by APRA, the Government has taken several steps to ensure that depositors can continue to have confidence in depositing funds in Australian banks, credit unions and building societies.

Firstly, the Government has confirmed the financial claims scheme as a permanent part of the Australian financial system. Under the Scheme, the Australian Government effectively "insures" depositors up to a specified maximum, currently set at \$1 million.

In addition, as mentioned earlier, the Government plans to place an eight per cent cap on the value of assets a bank can pledge to covered bond investors.

I would like to briefly expand on this issue, because the draft legislation does have some intricacies that you should be aware of. In particular, there are essentially two “eight per cent” caps in the draft legislation.

There is a “legislative” cap on the amount of covered bonds a bank, building society or credit union can issue. It is proposed to be set at eight per cent of an ADI’s assets in Australia. Importantly, this test applies only at the point of issuance of a new covered bond, not continuously over time.

There is also a “prudential” cap, which is also set at eight per cent of a bank’s assets in Australia. In essence, this means that if an ADI is under the eight per cent cap, the assets in the cover pool providing security to covered bondholders are treated as assets of the ADI. This treatment is directed at ensuring, in broad terms, capital neutrality when issuing covered bonds.

However, this test applies continuously over time, with a breach potentially resulting in a prudential penalty for the ADI in respect of those assets above the 8 per cent benchmark.

That is, the prudential cap deals with the possibility that an ADI could breach the eight per cent benchmark over time because of the possibility of needing to top up the cover pool of assets

supporting covered bonds, or because the ADI's assets in Australia falls.

In essence, the prudential cap provides an ADI additional flexibility in exceptional circumstances, while providing a strong prudential incentive to remain within the eight per cent benchmark.

Given the three safeguards — that is, the cap on issuance, the Financial Claims Scheme, and APRA's ongoing prudential regulation —the decision to allow ADIs to issue covered bonds does not place depositor funds at risk.

Further, I like to note that under the Financial Claims Scheme, Australian taxpayers are fully protected because this Scheme allows the Australian Government to levy all remaining ADIs afterwards in the event a failed ADI's assets are insufficient to meet the claims of depositors.

In summary, what the draft covered bond legislation seeks to do is adopt the key features of European covered bonds, and align with international best practice regulations, while taking the views of stakeholders into account.

Benefits of covered bonds

Before I get into the details of the proposed framework for allowing ADIs to issue covered bonds, I would like to provide some context around the Government's decision.

The Treasurer announced the decision to allow banks, credit unions and building societies to issue covered bonds in December 2010, as part of the *Competitive and Sustainable Banking System* package.

As outlined in that announcement, covered bonds can bring several clear benefits for the Australian financial system.

The first, and most obvious, is diversification.

Diversification can increase the pool of investors by providing banks with access to new markets. It can also allow existing investors to diversify their risk by holding a broader range of securities.

As well, diversification of funds reduces the risks associated with dislocation in one or more credit markets.

Secondly, from an investor's perspective, the features of covered bonds, such as dual recourse, public supervision, high-quality collateral and a dedicated legal framework, make them one of the safest types of investment.

Their heavily-regulated structure, combined with security over a pool of high-quality assets and a guarantee from the issuer, effectively provides covered bondholders with a triple layer of protection.

Because the risk to investors associated with covered bonds is lower than for other forms of wholesale funding, covered bonds provide comparatively lower cost funding.

Thirdly, covered bonds provide the opportunity to raise funds with longer maturity.

Compared with the shorter actual maturity of securitisation funding, the longer maturity profile of covered bonds can allow ADIs to better match the asset and liability columns of their balance sheet.

And lastly, covered bonds are already well-established in offshore markets, and are attractive to a particular class of investors.

Although they were not immune from the effects of a global financial shock, historically covered bonds have been more resilient to severe market stress and recovered faster than other wholesale funding instruments, such as asset-backed securities and unsecured bank debt.

Outline of legislation

I would now like to provide a bit more detail of some issues in the draft legislation. Specifically, I'll cover the concept of the cover pool, safety features for covered bondholders, and aggregation models.

Cover pool

One of the key concepts in the draft legislation is the “cover pool”. This concept is used throughout the draft legislation, so it's integral to understanding what the legislation does, and doesn't, do.

Broadly speaking, the cover pool contains those assets that are owned by a special purpose vehicle on which covered bondholders have first, and primary, claim over.

So if the contractual documents supporting the issuance specify that certain assets are secured for investors, then they are in the cover pool for the purposes of the legislation.

The “cover pool” is a defined term. That is, it is defined for the purposes of the legislation. It is important to note that the draft legislation is not restricting issuers from using other terms or concepts in contractual arrangements, for example in determining asset coverage tests. However, the legislative definition applies for the purposes of determining the 8 per cent cap.

Investor protection

As I have mentioned, the draft legislation includes several provisions that reassure covered bond investors about the ongoing quality of assets in the cover pool.

The legislation restricts the type of assets that can be included in the cover pool. Only cash, certain high-quality liquid assets, and of course, Australian residential or commercial mortgages will be allowed in the cover pool.

Industry feedback has suggested that other assets, such as securitisation or credit card receivables, should not be included in a cover pool. This restriction reflects the fact that these kinds of

assets are perceived as comparatively more risky. Removing them ensures the high quality of assets in the cover pool.

The draft legislation proposes that it be mandatory for each cover pool to have a “cover pool monitor” to audit the value and type of assets in the cover pool. Industry stakeholders agreed with including this requirement in legislation.

Again, while the legislation specifies a number of requirements for the cover pool monitor, there is no limit on what other obligations the cover pool monitor can be contractually obliged to carry out in the interests of investors.

Separation in bankruptcy

One of the key considerations for investors and credit ratings agencies is the degree of protection for covered bondholders in the event that an ADI defaults.

The cover pool is required to be owned by a special purpose vehicle, whose purpose must relate only to covered bonds. This special purpose vehicle is a separate entity to the ADI issuing the bonds, and as such, is bankruptcy remote.

However, the draft legislation makes it clear that a statutory manager or external administrator has no power over assets in the cover pool, other than those outlined in their contractual agreement.

Further, APRA has no powers over assets providing security to covered bondholders once they have been transferred to the cover pool.

APRA oversight

In terms of regulatory oversight, the legislation clarifies that APRA will have the power to prevent an ADI from issuing covered bonds or topping up the cover pool under certain circumstances, such as the ADI experiencing severe financial stress or breaching the requirements of the *Banking Act 1959*.

Disclosure

One issue arising from the consultation process earlier this year is the request from investors for some regulatory disclosure requirements for covered bonds. This will standardise Australian disclosure, and help to inform offshore investors.

This proposal appears to be widely supported. After discussions with the Australian Securitisation Forum, I understand that they will work with industry to develop such a framework, similar to that developed for the RMBS market.

Aggregation Model

I would also like to discuss the aggregation models.

A feature of covered bonds in offshore jurisdictions is their high credit rating. This mainly stems from a high quality and diverse

pool of cover assets, from large regular issues and the credit rating of the issuer.

As a way to develop these characteristics, smaller banks, credit unions and building societies can pool their assets in order to issue covered bonds. This has been done successfully in offshore jurisdictions. The Government is interested in providing a mechanism to allow smaller ADIs to issue covered bonds into the Australian market in particular.

In the draft legislation released in March, it allowed for the possibility of aggregation models

While an aggregation model is not likely to be used in the period immediately after the covered bond bill becomes law, it provides opportunity for the small ADIs to innovate and create a successful aggregation program over the medium to long term.

Timing

One of the most common questions I am asked is when covered bonds can be issued.

Unfortunately, I can't give an exact answer to this question.

What I can say is that we are working towards giving the Treasurer the option to introduce the Bill early in the 2011 Spring sittings of Parliament.

Parliament sits until late November this year, so with the support of Parliament, the legislation may be passed by then. This may mean

that the covered bond bill could receive Royal Assent some time before Christmas. If not, then the legislation is likely to pass through Parliament early in 2012.

I should also add that APRA will revise some of its prudential standards to facilitate the issuance of covered bonds. I understand that APRA will consult with industry on these changes in the coming months.

After that, it will be up to industry to take the timetable forward.

Conclusion

In conclusion, covered bonds could become, over time, an important source of funding for the Australian banking system.

Covered bonds could provide cheaper, more stable, and longer-duration funding for the Australian banking system over the medium term.

They also provide an alternative debt instrument for investors to invest in. In this sense, allowing ADIs to issue a small amount of covered bonds assists both issuers and investors to diversify their risks.

The Government has consulted closely with industry throughout the design of the legislation.

I would like to take this opportunity to thank everyone who has helped us to develop this policy, as well as their continued assistance during the drafting process.

The end product should provide a sound legislative base on which the industry can build a successful Australian covered bond market in the years ahead.

Thank you.