ALLEN & OVERY

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Australian Covered Bonds Legislation

The Banking Amendment (Covered Bonds) Act 2011 (the **Act**) was passed by the Australian Federal Parliament on 13 October 2011 and received royal assent shortly thereafter. The act incorporates a new Division 3A in Part II of the Australian Banking Act 1959 (Cth) (**Banking Act**) to specifically facilitate the issuance of covered bonds by Australian banks and other regulated deposit-taking institutions (**ADIs**).

The key features of the proposed Australian covered bonds issuance regime are set out below.

Eligibility requirements

Notably the Australian regime does not provide for any eligibility requirements limiting ADIs who may issue covered bonds. In theory, provided an ADI complies with the structure mandated and other provisions of the legislation, any bank, credit union, building society or other deposit-taking institution regulated by the Australian Prudential Regulation Authority (**APRA**) under the Banking Act can issue covered bonds.

Guarantor SPV structure mandated

Cover pool assets must be owned by a special purpose vehicle whose sole purpose is to hold the cover pool assets and guarantee the issuing ADI's obligations under the covered bonds (*new Section 26 of the Banking Act*). This effectively replicates the structure for covered bond issuance in the UK, New Zealand and other jurisdictions. Although it is not the more traditional continental European structure where the assets remain on the balance sheet of the issuing credit institution we understand that this structure is now well known to traditional covered bonds investors.

On an insolvency of an ADI, the cover pool assets will not be available to general creditors of the ADI (including depositors) (*refer to new Section 13A(3A) of the Banking Act that clarifies the operation of the ADI insolvency priority regime set out in the Banking Act*). However, holders of covered bonds will have recourse to both the ADI and the cover pool in those circumstances. In this regard, it is expected that the programme documentation will require the bond trustee appointed to the programme to seek to recover the amount owed by the ADI under the covered bonds outstanding in those circumstances. Any amounts recovered will be paid through to the special purpose vehicle to be used, with its other assets, to make the contractual payments owed under all covered bonds under the guarantee given by it. In this regard, an event of default in relation to the issuing ADI accelerates the covered bonds as against the ADI but not the special purpose vehicle (until an event of default in relation to the special purpose vehicle occurs).

8% cap and the treatment of voluntary OC

The Act effectively imposes a regulatory cap on covered bond issuance by limiting the assets of an ADI in Australia that may be transferred into a cover pool to 8%. It is tested at the time of issuance but may be subject to revision in regulations (leaving scope for future amendment) (*see new Section 28 of the Banking Act*). The Act facilitates an issuing ADI structuring its programme with a senior ranking demand loan (referable to the funding of voluntary over-collateralisation) which permits the issuing ADI to exclude the assets referable to that senior ranking obligation from the 8% cap (on the basis that these do not form part of the cover pool, as defined).

Additionally, APRA has been given the power to direct the special purpose vehicle to return assets to the issuing ADI which do not secure covered bond liabilities (*see new section 31F of the Banking Act*). A covered bond liability does not include a senior ranking liability to the issuing ADI (other than fees payable for the provision of services and obligations under swaps), which would include a senior ranking demand loan (*see new section 26 of the Banking Act*). A problematic aspect of this power is that it is subject to secrecy requirements which means investors will receive no notice that APRA has given a special purpose vehicle any such direction (*see new section 31F(9) of the Banking Act*).

Eligible assets and minimum over-collateralisation requirement

Cover pool assets are limited to cash, government debt instruments, certain bank accepted bills or certificates of deposit (up to a limit of 15% of the face value of the covered bonds secured by the assets), swaps entered into by the special purpose vehicle for hedging purposes, residential mortgage loans (with a loan-to-value ratio (LVR) no greater than 80%, for the purpose of testing the statutory minimum over-collateralisation requirement described below), commercial mortgage loans (with an LVR no greater than 60%, for a similar purpose) and any other asset specified in the regulations (*refer to new Section 31 of the Banking Act*).

A common feature of covered bond regimes is the inclusion of a minimum over-collateralisation requirement. The Act adopts a minimum requirement for Australian covered bonds of 3%. Any such requirement is likely to have little material impact as issuing ADIs would be expected to set a higher minimum threshold for their programmes in their contractual arrangements and an asset coverage test will usually govern the arrangements to ensure that covered bonds receive their target rating on issuance.

Cover pool monitor

Europeans give preferential capital treatment to covered bonds issued by issuers in jurisdictions where there is specific regulation in relation to covered bond issuance and rating agencies also take comfort from a more rigorous legislative regime when assigning ratings to covered bond programmes. Although Australia's proposed framework is generally light-touch and does not propose active regulation by any regulator of covered bond programmes specifically (other than APRA's current role in regulating ADI issuers), the Act requires that a cover pool monitor must be appointed to provide some independent oversight of the programme and the cover pool. This role is more extensive than the role currently played by "asset monitors" in typical UK and New Zealand structures (who are accounting firms whose role is typically limited to checking the ACT calculation on an annual basis).

A cover pool monitor must be appointed to perform certain specified functions including:

- assessing the keeping, by the issuing ADI or covered bond SPV, of a register of the cover pool assets; and
- monitoring compliance with the Banking Act in relation to the nature of the assets in the cover pool and compliance with the statutory over-collateralisation requirement,

on a six monthly basis and providing reports of the reviews conducted to the issuing ADI and APRA on request.

The cover pool monitor must hold an AFSL (or benefit from an exemption in its role as cover pool monitor) or be a registered auditor and must not be an associate of the relevant ADI.

APRA powers

APRA has been given a number of specific powers in connection with covered bond programmes. In certain circumstances, APRA may direct an ADI not to issue covered bonds (*refer to new Section 29 of the Banking Act*). Also, APRA has the power to issue directions in certain circumstances (for instance where an ADI has breached a prudential requirement or its financial condition is deteriorating) to prevent an ADI from transferring further assets into the cover pool (and thereby preferring its covered bond holders over its depositors) (*refer to the amendments to Section 11CA(2) of the Banking Act*).

In addition APRA has the power to impose requirements on ADIs in relation to the issuance of covered bonds or the maintenance of covered bonds already issued by that ADI through prudential standards (*refer to new Section 31D of the Banking Act*).

Club structures

Although there was a significant lobby for the inclusion of provisions permitting special purpose ADIs to be established for the purpose of facilitating aggregated issuance by multiple ADIs these provisions were not included in the bill presented to Parliament. The Act does make provision for two or more ADIs to make an aggregated issuance through another entity (a special purpose vehicle) that issues debt instruments backed by covered bonds issued by each participating ADI to that entity (loosely based on a model employed for aggregated issuance in Spain).

For further information, please see link to the Act:
http://www.comlaw.gov.au/Details/C2011A00125

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