



Consultation Document: Covered Bonds

Consultation Document

The Reserve Bank invites submission on this Consultation Document by 16 March 2012.

Submissions and enquiries about the consultation should be addressed to:

Felicity Barker

Adviser, Financial System Policy

Prudential Supervision Department

Reserve Bank of New Zealand

PO Box 2498

Wellington 6140

Email: felicity.barker@rbnz.govt.nz

Please note that a summary of submissions may be published. If you think any part of your submission should properly be withheld on the grounds of commercial sensitivity or for any other reason, you should indicate this clearly.

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SECTION 1: INTRODUCTION

1. Covered bonds are debt securities under which the bond holder is both an unsecured creditor of the issuer and holds a secured interest in a specific pool of assets (the cover pool). In October 2010, the Reserve Bank published a consultation document setting out proposals for a framework to support the issuance of covered bonds by New Zealand registered banks. The document covered proposals for constraints on the level of issuance and proposals for a supporting legislative framework.¹
2. In April 2011, a condition of registration was imposed on New Zealand incorporated banks prohibiting these banks from encumbering more than 10% of their total assets to support the issuance of covered bonds. This condition of registration addresses a key risk arising from covered bonds, namely that a bank's unsecured creditors would be subordinated to covered bond holders in relation to cover pool assets in the event an issuing bank failed.² The Reserve Bank is not revisiting the issuance limit for locally incorporated banks and hence the issuance limit is not discussed in this document.
3. This document sets out proposals for a legislative framework for the issuance of covered bonds. The 2010 consultation document considered a spectrum of options ranging from retention of the status quo, under which covered bonds can be issued relying on contract law, to the creation of a new legislative framework for covered bonds. Industry responses to the consultation indicated widespread support for a legislative framework. A legislative framework is likely to increase investor confidence in New Zealand issued covered bonds and hence provide banks with increased access to a source of funding that is relatively stable in times of stress in financial markets. As such, a legislative framework is expected to make a contribution to financial system stability.
4. The regime proposed in this document provides a simple and low cost approach to regulating covered bonds. It would apply both to New Zealand incorporated registered banks and New Zealand registered banks that are branches of overseas incorporated banks. The key aspects of the proposal are:
 - a. covered bond issues must be registered;
 - b. cover pool assets must be held by a special purpose vehicle (SPV);
 - c. an asset pool monitor must be appointed to monitor the cover pool;
 - d. legislative amendment to provide that the SPV cannot be included in the statutory management of the issuing bank and that certain "moratorium provisions" of the statutory management and liquidation regimes will not prevent the SPV gaining full legal control of cover pool assets.

¹ <http://www.rbnz.govt.nz/finstab/banking/4430899.html>

² We use the term issuer to mean a bank or subsidiary thereof that issues covered bonds.

SECTION 2: KEY ELEMENTS OF THE LEGISLATIVE FRAMEWORK

5. Investors in covered bonds hold a secured interest over cover pool assets. Currently investors rely on contractual arrangements to provide them with priority to the cover pool. The Reserve Bank considers that there are unnecessary costs involved in establishing current structures in order to provide priority for covered bond holders to cover pool assets. Further, some market participants appear to be uncertain as to the potential application of the statutory management regime to cover pool assets. The Reserve Bank considers that a statutory framework aimed at clarifying the treatment of cover pool assets in the event an issuing bank fails would be beneficial. The proposal involves two main elements: a requirement that covered bond issues are registered and a “carve-out” of registered issues from specific parts of the statutory management and liquidation regimes. These proposals are discussed in section 3.
6. As discussed in the 2010 consultation document, the Reserve Bank does not intend to undertake supervision of covered bond issues. However, the Reserve Bank considers that there would be benefit, in terms of increased investor certainty, from legislatively requiring independent monitoring of cover pools by an asset pool monitor. This is discussed in section 4.
7. In the 2010 consultation document the Reserve Bank sought views on setting legislative asset eligibility requirements. Some submitters considered that asset eligibility requirements were unnecessary as asset eligibility will be determined by market practice. Other submitters supported the introduction of legislative restrictions on asset eligibility. Having considered the views of submitters, the Reserve Bank considers that contracting parties are best placed to determine asset eligibility and does not intend to impose restrictions legislatively.
8. Some submitters considered that the framework should provide that covered bond issues are repo-eligible with the Reserve Bank. We do not consider that it would be appropriate, or necessary, to provide for repo-eligibility in legislation as this would create inflexibility. Hence we do not discuss repo-eligibility further in this paper.

Question:

1. Are there any other key issues that should be addressed in the legislative framework?

SECTION 3: CERTAINTY IN STATUTORY MANAGEMENT

9. The Reserve Bank considers that there are two elements that are essential to providing certainty as to the rights of covered bond holders to the cover pool assets:
 - a. identification of the assets over which the bond holders have a priority claim;
 - b. making certain the treatment of those assets in the event of statutory management or liquidation of the issuing bank.
10. This paper proposes that the Reserve Bank be empowered to register covered bond issues that meet the basic structural requirement that cover pool assets are held by an SPV. Registered covered bond issues would then be carved out of specific provisions of the statutory management and liquidation regimes. We discuss these elements below.

3.1 Asset segregation

11. It is important that the assets in the cover pool are clearly identifiable and can be distinguished from the other assets of the issuing bank. New Zealand issued covered bond programmes have segregated cover pool assets from the other assets of the issuing bank by way of sale (by legal or equitable assignment) of those assets to an SPV. However, in some jurisdictions the law allows banks to ring fence assets held within the banking entity (the “integrated model”).
12. The Reserve Bank does not intend to create an integrated model for New Zealand. In the Reserve Bank’s view the SPV structure provides a simple, transparent and cost effective mechanism to segregate cover pool assets. As this approach accords with current industry practice, submitters were supportive of a policy approach that relies on the SPV structure. Adopting another approach would also pose challenges in terms of allowing current issues to receive the benefits of the legislative framework. Further, this is the approach used in the United Kingdom (UK) and Australia and proposed in Canada.
13. Given the above, the Reserve Bank proposes that the statutory management protections, discussed in 3.3 below, will only be available for issues where the cover pool assets are held by an SPV, and are registered issues as discussed below. An SPV would be defined as a person:
 - a. to whom any member of the Banking Group has sold, assigned or otherwise transferred any asset;
 - b. who has granted or may grant, a security interest in its assets for the benefit of any holder of any covered bond; and
 - c. who carries on no other business except for that necessary or incidental to guarantee the obligations of any member of the Banking Group under a covered bond.

14. We consider that the SPV should be restricted to being a New Zealand registered company. The Reserve Bank understands that this is the structure currently used by New Zealand issuers and that other structures, such as the limited partnership model, are not likely to be attractive in New Zealand. The company may act as trustee.

Questions:

2. Do you agree that the SPV model is appropriate for New Zealand?
3. Do you agree that the SPV should be restricted to being a New Zealand registered company?

3.2 Registration

15. The 2010 consultation document asked for submitters' views on whether it would be sufficient for the legislative framework to set requirements as to asset segregation ("safe harbour") or whether registration of covered bond issues should also be possible. Several submitters considered that, while a "safe harbour" was a good first step, registration of covered bond issues would provide investors with additional certainty as to the treatment of cover pool assets as there would be no doubt that the asset segregation requirements were met. Registration of covered bond issues is undertaken by several other jurisdictions, such as the UK, and is proposed in Canada.
16. The Reserve Bank considers that the legislative framework should include provision for the Reserve Bank to maintain a public register of covered bond issues undertaken by New Zealand registered banks. The legislative framework would provide the Reserve Bank the power to set the registration process, including setting requirements as to the information an issuer must provide. The Reserve Bank would be interested in views on what information should be made public on the register.
17. A registered covered bond issue would then have the protections discussed in section 3.3. The proposed requirements for registration are:
- a. the issue must be an issue of covered bonds;
 - b. the issuer is a New Zealand registered bank or an associated person thereof;
 - c. the cover pool assets have been sold, assigned or otherwise transferred (including in equity) to an SPV that is a New Zealand registered company; and
 - d. the issuer meets any obligations relating to covered bonds imposed under the Reserve Bank of New Zealand Act 1989.
18. It is proposed that registration of covered bond issues be mandatory. Registration would remain valid until an issue is removed from the register. The Reserve Bank would be able to de-register an issue when the obligations to bond holders have expired. The

Reserve Bank is considering whether an issue should also be able to be de-registered in other circumstances, such as if the registration requirements are no longer being met.

Questions:

4. Do you consider the above registration requirements appropriate?
5. What information should be provided on the register?
6. Do you agree that registration should be mandatory?
7. Under what circumstances should an issue be removed from the register?
8. Should issues be registered at the programme or series or tranche level?

3.3 Protection in statutory management or liquidation

19. A bank may be placed into statutory management under either the Reserve Bank of New Zealand Act 1989 (the Act) or the Corporations (Investigation and Management) Act 1989 (“CIMA”). There are a number of conditions that may trigger statutory management, with insolvency being one of these.
20. Should a bank be placed into statutory management, there are two potential issues regarding the SPV. These are:
 - a. the potential inclusion of the SPV in the statutory management of the bank; and
 - b. the need for the SPV to enforce certain obligations against the bank.

Inclusion of the SPV in statutory management

21. An SPV could potentially be included in the statutory management of the bank if it is considered an associated person of the bank or a subsidiary of the bank. This is because section 117(1)(a) of the Act (and section 38(1)(a) of CIMA in relation to corporations) provides that any registered bank, and any associated person of a registered bank may be placed into statutory management. Under section 117(2) of the Act (and section 38(2) of CIMA) any subsidiary of a registered bank placed into statutory management is automatically so placed, unless declared otherwise.
22. The inclusion of the SPV in the statutory management of the bank would be undesirable for covered bond holders as this may restrict their ability to enforce their security interest over the assets. Hence, SPV structures are generally designed so as not to be considered an associated person or subsidiary of the bank. However, some market participants are uncertain about the effectiveness of such arrangements and avoiding these tests creates costs for the issuing bank, such as the need to outsource key roles, and may discourage some banks from issuing covered bonds.

23. In order to address these issues, the Reserve Bank is proposing legislative amendments regarding sections 117(1)(a) and 117(2) of the Act and 38(1)(a) and 38(2) of CIMA. These amendments would provide that an SPV constituted under a registered covered bond programme could not be included in the statutory management of the issuing bank as an associated person or as a subsidiary of the issuing bank.

Right of SPV to enforce certain obligations against the bank

24. Submitters also considered that the Act, CIMA and the Companies Act 1993 create uncertainty as to the SPV's ability to perfect the legal title to certain loans or security, to enforce contractual obligations against the bank, or exercise its power of attorney regarding the cover pool assets, in the event the issuing bank is in statutory management or liquidation. This problem arises as covered bond programmes are generally structured such that the bank retains the legal title to loan security and also undertakes the role of loan servicer.

25. Provisions that may create uncertainty are:

- a. Section 122 of the Act and section 42 of CIMA – which provide that, among other things, no person shall exercise any rights under any security over the property of the entity in statutory management; and that no person may without the leave of the statutory manager commence any proceedings or seek to enforce any judgment against the entity in statutory management;
- b. Section 126 of the Act and section 43 of CIMA - that prevent the transfer or removal from New Zealand of any property of the entity in statutory management, except with the consent of the statutory manager;
- c. Section 128(2) of the Act and section 45(2) of CIMA- which provide that no other person may act as an agent of an entity in statutory management without the consent of the statutory manager;
- d. Section 248 of the Companies Act – which provides that a person must not commence legal proceedings against a company in liquidation or exercise a right over the property of a company in liquidation without the consent of the liquidator or by order of the court; and
- e. Section 127 of the Act and section 44 of CIMA - that allow the statutory manager to suspend the repayment of any deposit, or the repayment of any debt, or the discharge of any obligation to any person.

26. In the event that an SPV were structured as a related company, section 271 of the Companies Act could also create uncertainty. This section provides that, where two related companies are in liquidation, the liquidation of the two companies may proceed together if this is considered just and equitable by the Court.

27. Although it can be argued that these provisions may not in fact prevent the SPV from gaining full legal control of the cover pool assets in the liquidation or statutory

management of the issuing bank, the Reserve Bank considers that statutory certainty would put this issue beyond doubt. The Reserve Bank proposes that legislative amendments should be made to each of these sections to provide that these sections shall not prevent the transfer of legal title to loans and related security, and any relevant documentation or data, to an SPV constituted under a covered bond issue registered with the Reserve Bank where the SPV holds the beneficial interest in those loans.

Questions:

9. Do you agree with the amendments outlined above?
10. Are there any other statutory provisions that create uncertainty, such as in the voluntary administration or compromises regimes or in relation to borrowers' rights of set-off in liquidation?

SECTION 4: ASSET POOL MONITOR

28. A common feature of other legislative regimes is a requirement that issuers appoint an asset pool monitor. Australia, the UK and Canada all propose to formalise this role in their legislative framework. We understand that this is currently standard practice for New Zealand issuers. An asset pool monitor provides investors with increased certainty as cover pool assets are monitored by an independent party.
29. We consider that there would be benefit from a legislative requirement that issuers appoint an asset pool monitor for each covered bond programme. The asset pool monitor would have the right to inspect all relevant documents to fulfil their role. To ensure the asset monitor can undertake this monitoring function, issuers would be required to ensure that a register of the assets in the cover pool is maintained.³
30. The issuer would also be required to ensure that the asset pool monitor verifies that:
 - a. the value of assets in a cover pool is greater than the outstanding liabilities to covered bond holders; and
 - b. the SPV holding the cover pool assets is able to meet its debts as they become due in the normal course of business.
31. The Reserve Bank considers that verification should be undertaken bi-annually. The issuer would be required to provide the asset monitor's report to the bond trustee and the security trustee. As the role of the asset pool monitor is one of verification, we consider that they should be required to take account of any test specified in programme documentation. Where no test is specified the asset pool monitor would develop their own test.

³ These obligations apply to the SPV if the bank is insolvent.

32. The Reserve Bank considers that, in the event that the asset pool monitor finds that either of the tests above is not satisfied, the monitor should be required to undertake the test on a monthly basis, until either the test is satisfied or the SPV enters receivership or liquidation. Where there is a breach of the test, the issuer will be required to provide the asset monitor's report to the Reserve Bank in addition to the bond and security trustee.
33. The issuer would also be required to ensure that the asset pool monitor verifies that the issuer makes arrangements to maintain a register of cover pool assets and must take steps to verify the accuracy of that register. In the event that the issuer does not maintain such a register, the asset pool monitor must report to the Reserve Bank, the bond trustee and security trustee.
34. Investors would need re-assurance that the asset pool monitor is a firm or individual of repute, and that it can provide an objective assessment. The Reserve Bank proposes that the asset pool monitor must be independent from the issuer, or from any party related to the issuer. In some legislative frameworks, the asset pool monitor must be eligible to act as an auditor; we would be interested in views on whether this restriction is appropriate in New Zealand.

Questions:

11. Do you agree that the role of asset pool monitor should be provided for in legislation?
12. Do you agree that the role of the asset pool monitor should be to verify the tests as stated above?
13. Do you agree with the proposed frequency of tests and reporting requirements?
14. What restrictions (if any) do you consider there should be on acting as an asset pool monitor in New Zealand?

SECTION 5: TRANSITION

35. It is intended that the legislative framework is able to apply to all covered bonds issued by New Zealand registered banks. Transition rules will be developed to allow pre-existing issues to be registered. As the proposed framework is intended to support existing commercial practice, it is expected that existing issues will meet the registration requirements.

Question:

15. What issues do you anticipate in bringing existing issues into the proposed framework?

Regulatory Impact Statement: Covered bonds legislative framework

Regulatory Impact Statement

Title of Proposal: Covered bonds legislative framework

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by the Reserve Bank.

It provides an analysis of options to provide legal certainty as to the treatment of cover pool assets in the event that a bank that has issued covered bonds is placed into statutory management or liquidated.

The Reserve Bank first publicly consulted on the possibility of a legislative framework for covered bonds in October last year. This consultation document incorporates the feedback from the prior consultation. The Reserve Bank has also reviewed other legislative frameworks and the existing literature on covered bonds in developing the framework. The Reserve Bank has consulted with the Ministry of Economic Development, the New Zealand Treasury, the Australian Treasury, ratings agencies and key financial institutions in developing this framework.

The purpose of the consultation document is to seek feedback on a proposed solution. The consultation document sets out 15 questions on which feedback is sought, including whether there are any other key issues to address and whether the proposed solutions are appropriate. Industry feedback on technical issues will be taken into account before final recommendations are made on this proposal.

As the objective of the legislation is to provide legal certainty, rather than to impose new requirements, the proposal will not impose new costs on business, impair property rights or market competition or the incentives of businesses to innovate or invest or override fundamental common law principles.

Felicity Barker, Adviser, Financial System Policy, Reserve Bank of New Zealand

Status quo and problem definition

- Covered bonds are a form of debt instrument issued by banks. New Zealand banks have been issuing covered bonds since last year.
- In a covered bond issuance, the issuing bank provides a guarantee as to payment of the obligations under the covered bonds and also specifically tags certain assets, called the cover pool, to be held as collateral for payment of the obligations. Covered bonds are a useful instrument for banks to be able to issue as they provide access to an alternative investor base, are typically issued at longer terms than senior unsecured debt and have proved to be a resilient form of funding at times when other funding markets are closed. For this reason covered bonds can contribute to financial system stability by providing banks with greater certainty as to access to funding.
- Until April this year there were no legal restrictions on banks issuing covered bonds. In April this year the Reserve Bank imposed a condition of registration on locally incorporated banks restricting the level of covered bond issuance which these banks may undertake to 10% of total assets. This limit addresses the key risk of covered bonds, namely the subordination of the other creditors of the bank in relation to the cover pool assets. The issuance limit is not the subject of the current consultation.
- Internationally legislative frameworks for the issuance of covered bonds are common place and are often seen as a pre-requisite for investment by European investors. Hence, the lack of a New Zealand legislative framework may impede New Zealand issuers' access to the covered bond market.
- Furthermore, past consultation undertaken by the Reserve Bank indicated that there is a level of uncertainty as to how the statutory management provisions of the Reserve Bank Act 1989 and the Corporations (Investigation and Management) Act 1989 would be interpreted regarding assets in the cover pool should an issuing bank become insolvent and, additionally, that banks are incurring unnecessary costs in establishing structures to mitigate some of this uncertainty.
- This legal uncertainty is likely to impact on both the quantity of covered bonds a New Zealand bank can issue, particularly at times of stress in financial markets, and the price that a bank has to pay.

Objectives

- The objective is to provide legal certainty as to the treatment of cover pool assets in the event an issuing bank was to become insolvent. Legal certainty would increase economic efficiency and financial stability as banks would not have to pay an uncertainty premium to obtain covered bond funding and because certainty would improve banks access to covered bonds markets.

Regulatory impact analysis

- There are two key elements to providing certainty as to the legal status of cover pool assets;
 - Clear segregation of cover pool assets from the bank's other assets;
 - Making certain the treatment of cover pool assets under legislative provisions which would apply should an issuing bank be insolvent.
- In relation to the first point, it is proposed that covered bond issues be registered by the Reserve Bank and that cover pool assets must be held by a special purpose vehicle (SPV). These requirements would be set by amendment to the Reserve Bank Act 1989, as the Reserve Bank does not consider that it has the power to impose these requirements by way of condition of registration. These requirements would impose minimal additional costs on banks. This is because the SPV structure is standard industry practice and because, although the Reserve Bank may be able to impose a fee for registration of covered bonds, it is most likely that such a fee would not be imposed. If, however, the Reserve Bank did impose a fee, for example if there was a high value of transactions which put pressure on current funding, this is not likely to be a significant cost given the minimal requirements for registration. Previous consultation indicates that banks are supportive of the imposition of these requirements. This is because the gain, in terms of greater investor confidence in New Zealand issues, would significantly outweigh any potential compliance costs.
- Legal certainty as to the treatment of cover pool assets in the event of the insolvency of an issuing bank can only be provided through legislative amendment to the statutory management provisions of the Reserve Bank Act 1989 and the Corporations (Investigations and Management) Act 1989 and potentially sections 248 and 271 of the Companies Act 1993. Legislative change is needed because the source of the uncertainty arises from uncertainty as to the interpretation of these Acts as pertains to the cover pool assets. The Reserve Bank considers that these changes are minor in nature. As they are effectively clarifications of the law, the economic impact comes from the reduction in legal uncertainty. This is likely to have a modest positive impact on banks' ability to issue covered bonds.
- In addition it is proposed that banks be legally required to appoint a cover pool monitor to undertake monitoring of cover bond issues for the benefit of investors. Cover pool monitors are a normal feature of covered bond issues and hence this requirement does not impose significant additional costs. Making this a legal requirement provides additional certainty to investors as to the quality of covered bond programmes. Cover pool monitors are a common feature in other legislative framework.
- The Reserve Bank also considered whether it would be appropriate to set asset eligibility requirements for the cover pool legislatively, as has been done in Australia. The Reserve Bank considers that this is unnecessary as restrictions on the cover pool assets can be set contractually.

Consultation

- The Reserve Bank undertook public consultation on the potential for a legislative framework for covered bonds in October 2010. The banking industry is strongly supportive of a legislative framework for the issuance of covered bonds, particularly as Australia has recently implemented such a framework.
- The Reserve Bank has also consulted rating agencies and key market participants, such as buyers of covered bonds. These entities have indicated that investors have a strong preference for legislatively backed covered bonds.
- The Reserve Bank consulted the Ministry of Economic Development, the New Zealand Treasury and the Australian Treasury in the preparation of this consultation document.

Conclusions and recommendations

- The main elements of the proposed framework are:
 - A requirement that covered bonds be registered on a register maintained by the Reserve Bank;
 - A requirement that cover pool assets be held by a special purpose vehicle, which is a separate legal entity to the issuing bank;
 - A requirement that an asset pool monitor be appointed to undertake certain specified tests on the cover pool assets.
 - Amendments to the Reserve Bank Act 1989, The Corporations (Investigation and Management) Act 1989 and sections 248 and 271 of the Companies Act 1993 to provide certainty as to the application of those Acts to cover pool assets in the event an issuing bank is placed into statutory management or liquidation.

Implementation

- The proposal will be given effect through amendment to the Reserve Bank Act 1989, the Corporations (Investigation and Management) Act 1989 and the Companies Act 1993. It is intended that existing issues will be brought within the regime through transition rules.
- Any risks associated with the proposal should be brought to light through the consultation process. However, as the proposal is one of clarification and is based on existing commercial practice the Reserve Bank considers that the risks are minor and that there is no impact on the integrity of the statutes being amended.
- As the objective of the legislation is to provide legal certainty, rather than to impose new requirements, the proposal will not impose new costs on business, impair property rights or market competition or the incentives of businesses to innovate or invest or override fundamental common law principles.

- The Reserve Bank will be able to assess compliance with the requirements through existing supervisory processes.

Monitoring, evaluation and review

- The policy will be reviewed consistent with the regulatory impact analysis requirements in section 162AB(1)(b) of the Reserve Bank Act. The main sources of information the Reserve Bank will rely on to assess the effectiveness of legislation are discussions with supervisory contacts in registered banks which the Reserve Bank supervises and contacts with covered bond investors and other regulatory agencies.