
Discovering covered bonds – the market, the challenges, and the Reserve Bank’s response

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Covered bonds are corporate bonds that are backed by a pool of high-quality assets originated by the issuer. Popular in Europe for around 300 years, they are a relatively new source of funding for New Zealand banks.

This article provides some background on covered bonds and the international covered bond market. It then looks at the benefits and the policy challenges arising from banks’ issuance of covered bonds, and the Reserve Bank’s response to the development of the New Zealand covered bond market.

1 Introduction

Originating in Europe around 300 years ago, covered bonds are considered to be a relatively safe investment, and in recent years have also become an attractive funding source for banks outside Europe. The distinguishing feature of a covered bond is that it provides dual recourse – the bond holder has a secured claim on a specific pool of the issuer’s assets and an unsecured claim on the issuer. Canadian, Australian and New Zealand banks have recently begun issuing covered bonds and there are currently signs of a covered bond market developing in Asia and the United States.

Several countries have restrictions on banks’ issuance of covered bonds. Specific covered bond legal frameworks are in place in many countries, including all western European countries, the United Kingdom, Canada and Australia. The Reserve Bank of New Zealand has recently developed the Reserve Bank of New Zealand (Covered Bonds) Amendment Bill (the Bill) which will apply to New Zealand registered banks’ covered bond programmes.²

This article explains what covered bonds are, describes the international market for covered bonds, and discusses the benefits of covered bond issuance, and the policy challenges that they pose. It then describes the Reserve Bank’s response to the development of the covered bond market in New Zealand, including limits on New Zealand banks’ issuance of covered bonds, and the new Bill.

2 What are covered bonds?

A covered bond is a bond that is backed by a pool of high-quality assets originated by the issuing bank.³ This so-called ‘cover pool’ consists largely of relatively low-risk assets, such as residential mortgages and public debt. The bank has an obligation to ensure that the value of the cover pool remains at least equal to the outstanding value of the covered bond, so it may add assets to the cover pool to compensate for any decline in the quality of the cover pool assets. The cover pool assets are segregated from the bank’s other assets so that covered bond investors are able to enforce their security interest over them in the event of the bank’s default.

Covered bond holders’ recourse to this cover pool is a key distinction between covered bonds and unsecured bonds. A holder of an unsecured bond has recourse only to the issuing bank. Covered bond holders have dual recourse to the cover pool and to the bank. If the bank defaults, covered bond holders’ interests are secured by the cover pool assets. If these subsequently prove to be insufficient to meet covered bond holders’ claims, the covered bond holders continue to have an unsecured claim against the bank for the residual amount due to them, which ranks equal to the claims of other unsecured creditors.

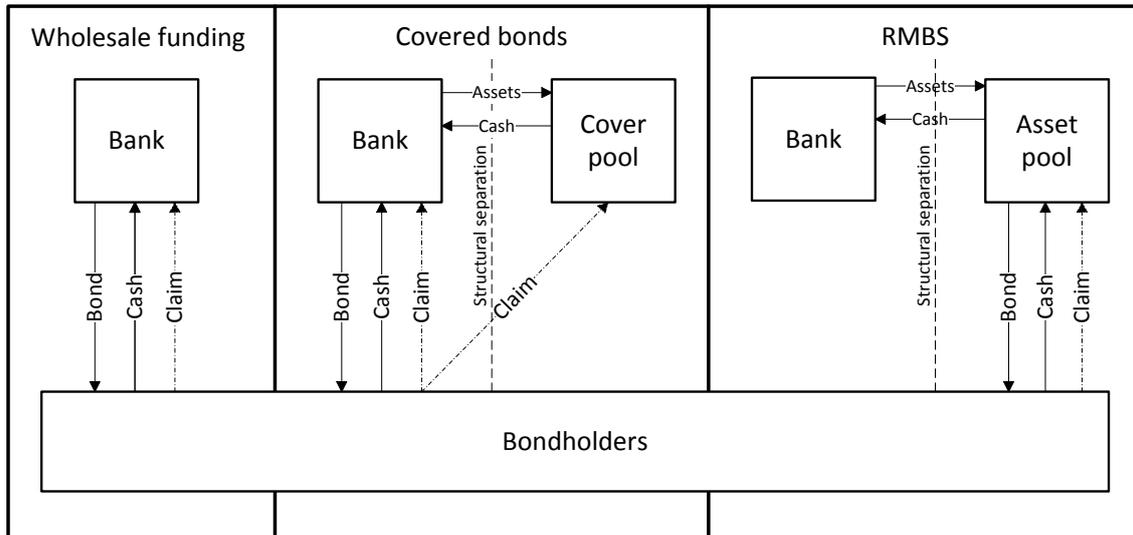
Covered bonds also differ from residential mortgage backed securities (RMBSs). Although RMBSs also involve the segregation of assets, the bank does not have an obligation to maintain the value of the segregated asset

¹ The authors are grateful to Felicity Barker, Michael Reddell and Jeremy Richardson for their valuable comments.

² The Bill makes provision to extend the law to other entities by regulation.

³ This article looks at covered bonds issued by banks (or by banks’ funding vehicles), or by bank-equivalent entities (such as “credit institutions” in Europe), and generally refers to issuers as “banks”.

Figure 1
Wholesale unsecured funding, covered bonds, and RMBS



Source: Australian Treasury, RBNZ.

pool, and RMBS investors have a claim only against the asset pool, not a direct claim on the bank. Accordingly, a bank that has issued RMBS does not have a continuing financial interest in the asset pool, and is not liable to RMBS investors for any shortfall in its value.

Figure 1 illustrates the structural differences between covered bonds, RMBS and other wholesale funding, such as unsecured bonds.

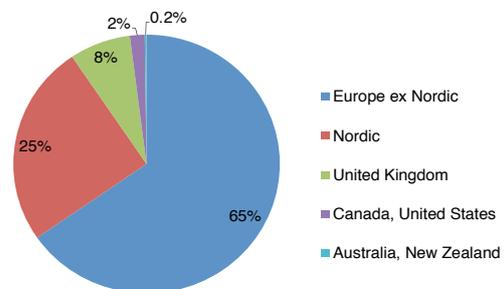
3 Covered bond market

The global market for covered bonds is substantial, with more than EUR 2,500 billion of covered bonds outstanding in 2011, issued by more than 300 issuers from 25 countries.⁴ Europe is the oldest and largest covered bond market, with Germany being home to the largest investor base. However, the international market for covered bonds has experienced steady growth outside Europe over the past ten years. At times during the global financial crisis (GFC), term funding in unsecured markets became difficult for banks to obtain, and it has remained more expensive since then. Following the GFC, banks have also sought to diversify their funding sources and lengthen the maturity of their funding, partly in response to regulatory requirements. In 2012 more than half of the

total value of new covered bond issues came from outside Europe.⁵

New covered bond markets have emerged in Canada, New Zealand and Australia. As shown by figure 2, covered bond issuance from New Zealand and Australia is relatively small on an international scale, although it is growing, as shown by new issuance in 2011 (figure 3). This growth is driven by international investors who currently look favourably on New Zealand and Australian covered bonds as they are less exposed to the effects of the European banking crisis. There are also indications of the development of an Asian covered bond market, particularly in Singapore and South Korea.

Figure 2
Total covered bonds outstanding as at 2011

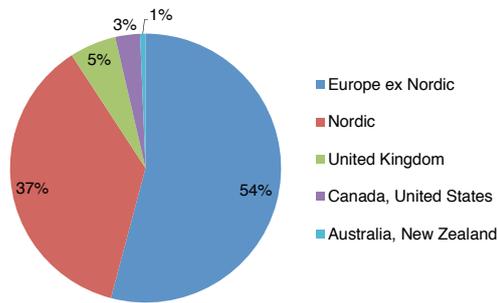


Source: European Covered Bond Council (2012)

⁴ UniCredit (2012); European Covered Bond Council (2012).

⁵ PriceWaterhouseCoopers (2012).

Figure 3
Covered bond issuance in 2011



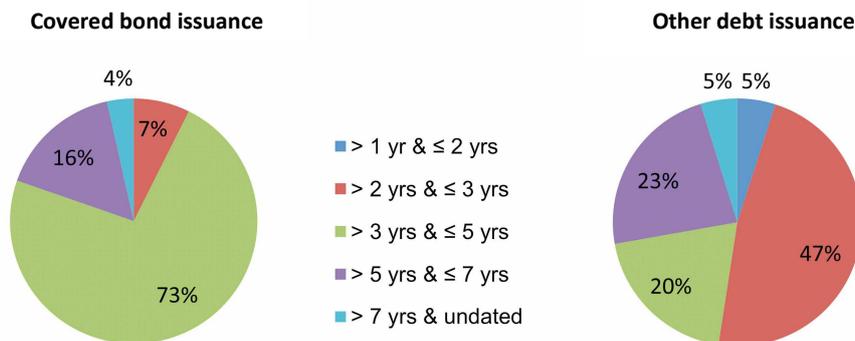
Source: European Covered Bond Council (2012)

4 Benefits of covered bond issuance

Covered bond issuance is generally considered to have benefits in reducing the liquidity and refinancing risk facing financial institutions. This may in turn help strengthen financial system stability. Compared to senior unsecured debt, the greater security of covered bonds attracts relatively longer-term and more risk-averse investors such as insurers, pension funds and central banks. Access to these investors allows issuers to diversify their funding, increase their liquidity at a lower price, and reduce their probability of default in times of economic stress.

As figure 4 shows, the tenor of covered bond funding by New Zealand banks tends to be longer than for other debt funding. Longer-term funding has become

Figure 4
New Zealand banks' covered bond and other debt issuance March 2011- December 2012

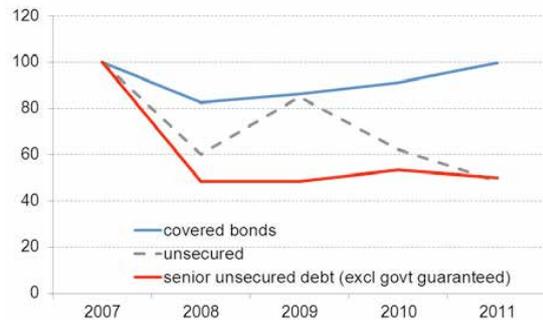


Source: RBNZ

increasingly desirable for banks, after the GFC revealed the dangerously high exposure of many banks to rollover and funding risk, due to their heavy reliance on short term debt. New Zealand banks have also been seeking to lengthen the term of their funding in response to regulatory liquidity requirements imposed by the Reserve Bank.

The attractiveness of covered bonds to risk-averse investors made them a comparatively more resilient funding mechanism during the GFC. The GFC adversely affected unsecured funding markets, but figure 5 shows how the issuance of covered bonds by EU banks held up relatively well during a period when it was difficult to obtain funding through unsecured bond markets.

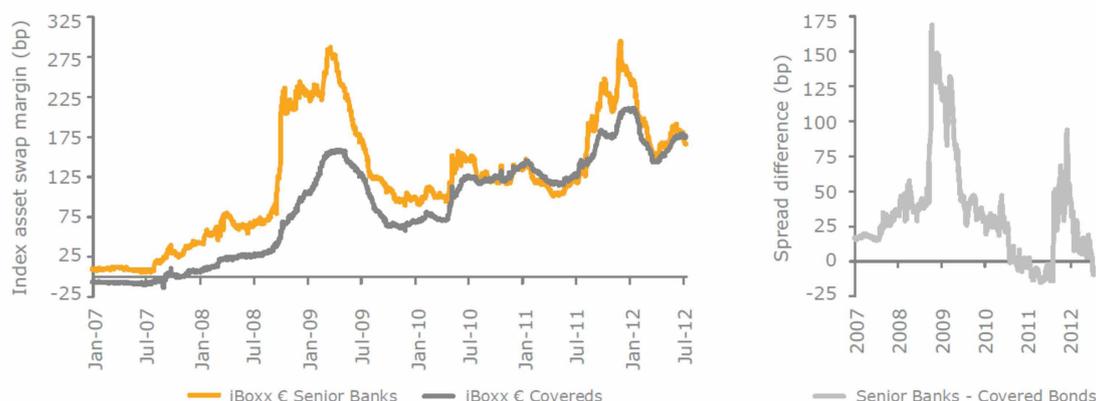
Figure 5
Change in EU banks' covered bond and senior unsecured debt issuance 2007-2011



Source: European Systemic Risk Board (2013)
Note: 2007=100.

Figure 6

Swap spread EUR indices for senior unsecured bank debt and covered bonds



Source: European Covered Bond Council (2012)

Note: "iBoxx" is a series of fixed income indices produced by Markit Financial Information Services.

The lower risk and longer tenor of covered bonds means that they have also had historically lower premiums relative to senior unsecured debt, even during a crisis. Figure 6 illustrates that, throughout the GFC in 2008-09 and the European sovereign debt crisis in 2010-12, covered bond spreads have generally been lower than those of senior debt.

5 Policy challenges from covered bond issuance

Although banks' use of covered bonds to fund themselves can contribute to financial system stability, the potential losses for a bank's unsecured creditors if the bank defaults may be greater if the bank has issued covered bonds than they would otherwise be. This is because covered bond holders have a priority claim over the cover pool assets, so the claims of unsecured creditors, including depositors, must be satisfied out of the remaining assets of the bank, i.e. those that are not in the

Table 1
Limits imposed internationally

Country	Limit	Imposed by
Australia	Cover pool assets < 8% of total assets at time of issuance. Capital deduction if cover pool assets > 8% of total assets.	Legislation Supervisory agency
Belgium	Cover pool assets < 8% of total assets.	Legislation
Canada	Issuance limited to 4% of total assets.	Supervisory agency
Italy	Limit of 25%, 60% or 100% of assets based on capital ratio of bank.	Legislation
New Zealand	Cover pool assets < 10% of total assets at all times.	Supervisory agency
Norway	Case-by-case assessment.	Supervisory agency
United Kingdom	Case-by-case assessment.	Supervisory agency
United States	Issuance limited to 4% of issuer's liabilities after issuance.	Supervisory agency
Singapore	<i>Proposed limit of issuance < 2% of total assets.</i>	<i>Legislation</i>
South Korea	<i>Proposed limit of issuance < 8% of total assets.</i>	<i>Legislation</i>

Source: European Covered Bond Council (2012), individual economies' frameworks.

cover pool. In principle, this risk should be reflected in price, with unsecured creditors demanding a higher rate of interest to compensate for the subordination of their claim.

Internationally, limits are increasingly being used to balance the costs and benefits of covered bond issuance, by preventing bank assets from becoming too heavily encumbered by covered bond programmes (table 1). Note that these limits are not directly comparable, as countries differ in how they define various aspects of the limit, such as total assets.

Furthermore, many jurisdictions have specific legal frameworks for covered bonds. Covered bonds can be categorised as legislative covered bonds (LCBs) or structured covered bonds (SCBs). LCBs are established under a specific legal framework with generic requirements that apply to all issues under that framework. SCBs are established via contract, with the details agreed upon between the bank and the bond holder through individual contracts.

Although Europe does not have a unified covered bond legal framework, covered bond legal frameworks in Europe tend to be broadly similar and relatively prescriptive in nature. This is due to the influence of UCITS, a set of European Union requirements which accords preferential treatment to covered bonds that comply with certain criteria.⁶ In the United States, legislation has been proposed, while Canada and Australia both implemented covered bond legislation in 2012. Some Asian countries, including Singapore and South Korea, have also recently been looking to develop legislation.

Investors look for two key elements in covered bond legal frameworks. These are:

- the effectiveness of the segregation of the cover pool assets from the assets of the issuing bank; and
- the supervision of the assets in the cover pool.

Effective segregation is important as it ensures that, in the event of an issuing bank's default, the cover pool assets remain separate from the assets of the bank, so that covered bond holders are able to enforce their security interest over this collateral. Supervision helps to ensure that the value of the cover pool assets remains sufficient to cover the bonds. To this end, many countries' legal frameworks provide for supervision of covered bond issues by a public authority, and/or include a requirement to have an asset pool monitor.

6 New Zealand's response

6.1 Reserve Bank regulatory limit

Before 2011 there were no legal impediments to New Zealand entities issuing covered bonds. New Zealand banks began issuing covered bonds in 2010, and five have done so to date: ASB, ANZ, BNZ, Westpac and Kiwibank. Total issuance by New Zealand banks as at April 2013 was approximately NZD 13,954 million, and has largely been in euros, Swiss francs and New Zealand dollars.

Covered bond issuance improves banks' ability to source long-term funding, and allows them to do so at lower cost. This helps banks to meet the minimum core funding ratio requirement under the Reserve Bank's liquidity policy and, more generally, improves their resilience in the face of short-term funding disruptions.

In April 2011, the Reserve Bank of New Zealand imposed a limit on New Zealand-incorporated banks' issuance of covered bonds by way of a condition of their registration. This limit was introduced to balance the benefits of New Zealand banks issuing covered bonds against the potential costs to unsecured creditors, including depositors. This is consistent with the Reserve Bank's statutory purpose, to promote the maintenance of a sound and efficient financial system (see section 1A Reserve Bank of New Zealand Act 1989).

As a result of this limit, a locally incorporated bank may not encumber more than 10 percent of its total assets as collateral for covered bonds. Banks generally build in a safety margin when complying with regulatory limits, so the actual maximum value of a bank's cover pool assets will be somewhat lower than 10 percent of its total assets,

⁶ Undertakings for Collective Investments in Transferable Securities (UCITS) are a set of European Union Directives. Article 22(4) sets out the minimum requirements, summarised as: the issuer must be a credit institution; issuance must be governed by a special legal framework; issuers must be subject to special prudential public supervision; eligible cover pool assets must be defined by law; the cover pool must have sufficient collateral to cover bond holder claims throughout the term of the covered bond; and covered bond holders must have priority claim on the cover pool in the event of issuer default. (European Covered Bond Council (2013)).

Table 2
Stylised example of the impact on unsecured creditors of a given loss

Bank A – Covered bond issuance			Bank B - No covered bond issuance			
<i>Balance sheet (\$bn)</i>						
Cover pool assets		8				0
Non-cover pool assets		92				100
Total assets		100				100
<i>Bank funding (\$bn)</i>						
	Regulatory capital	Covered bonds	Unsecured debt	Regulatory capital	Covered bonds	Unsecured debt
Funding base	7.5	8	84.5	7.5	0	92.5
Loss equivalent to 20% of total assets						
Amount of loss borne	7.5	0	12.5	7.5	0	12.5
Loss (% of funding base)	100%	0%	14.8%	100%	0%	13.5%

and its actual level of issuance will be lower again. The Reserve Bank considers that this limit appropriately mitigates the risk to depositors and other unsecured creditors.

Table 2 sets out a stylised example to compare the potential losses for unsecured creditors in the event of a New Zealand bank failure, between the case of a bank which has issued covered bonds up to the effective limit, and a bank that has not issued any. Bank A is assumed to have issued covered bonds with a value of 8 percent of its total assets, which allows for a prudent buffer below the actual regulatory limit of 10 percent of assets in the cover pool. The rest of Bank A's and all of Bank B's funding are in the form of regulatory capital and unsecured funding. In both cases total capital is assumed to be 7.5 percent of total assets, which is close to the current average for large New Zealand banks.⁷

The table shows the impact on the two banks of losses equivalent to 20 percent of the bank's total assets, and it is assumed at the same time that the assets in Bank A's cover pool remain unimpaired. Both banks' losses are allocated first to regulatory capital and second to unsecured creditors. The outcome is that Bank A's

unsecured creditors lose 14.8 percent of the value of their claim on the bank, while Bank B's unsecured creditors lose 13.5 percent. This shows that even under these extreme assumptions,⁸ covered bond issuance with the regulatory limit in place only increases unsecured creditors' loss rate by 1.3 percentage points.

In practice, even losses sufficient to push a bank into insolvency are very unlikely in New Zealand, given the high levels of capital held by New Zealand banks, which have increased further in response to increased regulatory minima following the GFC. Under any reasonable assumptions about the level of bank losses, the bank's capital will fully absorb those losses. So overall, with the 10 percent limit in place, any increase in risk for the bank's other creditors arising from covered bond issuance is very low, and should be offset by the bank's increased resilience from being able to issue covered bonds.

Figure 7 shows that New Zealand banks' cover pool assets are within the 10 percent regulatory limit. BNZ is the largest issuer of covered bonds in New Zealand and has encumbered around 7 percent of its total assets in favour of covered bonds.

⁷ The banks' total capital adequacy ratios, which are calculated using risk-weighted assets, are currently in the range of 11.5 to 13 percent.

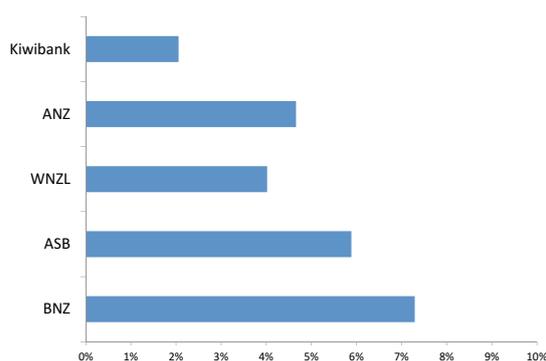
⁸ The United Kingdom Independent Commission on Banking (2011) indicates that overseas bank losses during the GFC tended to be below 10 percent of total risk-weighted assets.

Table 3
New Zealand and Australian banks' covered bond limits

		Total assets	Cover pool limit (NZ 10%; AU 8%)	Value of assets in cover pool
New Zealand (NZD mn)	BNZ	72,798	7,280	5,308
	ASB	65,588	6,559	3,860
	WNZL	69,660	6,966	2,800
	ANZ	119,077	11,908	5,548
	Kiwibank	15,371	1,537	316
Australia (AUD mn)	NAB	763,090	61,047	10,500
	CBA	718,229	57,458	22,300
	Westpac	675,000	54,000	18,900
	ANZ	642,127	51,370	13,800

Source: New Zealand registered banks' Disclosure Statements as at 31 March 2013; UniCredit (2013)

Figure 7
New Zealand banks' cover pool assets as a percentage of total assets



Source: New Zealand registered banks' Disclosure Statements as at 31 March 2013; UniCredit (2013)

Australia passed covered bond legislation in 2011 which imposes an 8 percent limit on cover pool assets. This limit is specified differently from the New Zealand limit. The New Zealand limit applies at all times, whereas the Australian limit applies only at the time of issuance. In addition, if an Australian bank holds cover pool assets in excess of the limit, it must deduct the value of the excess amount from its capital in calculating its regulatory capital adequacy ratios: if a New Zealand bank breaches its cover pool limit, it is in breach of its conditions of registration.

The Reserve Bank considers that a different limit for New Zealand banks is appropriate. Table 3 shows the total amount of assets that New Zealand and Australian banks are permitted to encumber in favour of covered bonds by comparison with the actual amounts currently

encumbered. Total issuance by Australian banks as at April 2013 was around AUD 36,950 million.

Being able to issue larger absolute amounts is advantageous for two reasons. Firstly, the value of an individual covered bond issue must be relatively substantial to attract buyers on the international market – typical issuance size for covered bonds in the European market is €0.5 billion to €1 billion. Secondly, it allows repeat issuance, which is generally required to provide the necessary liquidity to attract a wide range of investors. The Reserve Bank considers that an 8 percent limit in New Zealand could prevent the small to medium sized banks from entering the covered bonds market, or from repeat issuance. This could impact on competitiveness within the New Zealand banking sector.

6.2 Legislation

New Zealand does not yet have any covered bond legislation in place and, as a result, all covered bonds issued by New Zealand banks are SCBs. All else equal, investors can be expected to look more favourably on LCBs, and internationally there is evidence that LCBs trade at lower spreads than SCBs, particularly during periods of reduced market liquidity.⁹ Consequently, without covered

⁹ A study by the European Central Bank (European Central Bank (2008)) found that the complexity of SCBs reduces their transparency for investors with regard to the segregation of the cover pool, and investor protection. Market turmoil in 2007 and 2008 led to a reduction in liquidity for SCBs, with the spreads of these widening relative to LCBs.

bond legislation, New Zealand banks risk being at a disadvantage, particularly given their comparatively small size. Investors may be deterred by having to spend time negotiating individual contracts with small New Zealand banks that are only able to make one-off issues: a single covered bond framework applying to all New Zealand banks should address this concern. This has the potential to reduce the banks' funding costs, a saving which they can in principle pass on to their borrowers.

As noted above, there are two key desirable features of covered bond legislation. The first is independent supervision of cover pool assets, but there is currently no legal requirement for the cover pool assets of New Zealand-issued covered bonds to be monitored by an external party.

The second desirable feature of covered bond legislation is that the cover pool assets are effectively segregated from the assets of the issuing bank. New Zealand covered bonds are structured so that the cover pool assets are segregated from the bank's other assets via sale to an independent special purpose vehicle (SPV) that holds the cover pool assets as collateral for the covered bonds. However, New Zealand's bank failure management regime, which includes liquidation and a separate statutory management regime,¹⁰ raises two questions about the effectiveness of this segregation.

First, statutory management (or liquidation) triggers a moratorium and gives the statutory manager (or liquidator) certain rights, such as the right to suspend the discharge of any obligations. Under normal circumstances, the bank retains legal title to certain cover pool assets, and retains the management of these assets. If the bank defaults, the SPV (or its agent) takes over the legal title and the management of the cover pool, including the management of loan repayments on the cover pool assets. However, the moratorium may prevent the SPV (where it is only the beneficial owner of the cover pool assets) from doing this.

Second, if the SPV is found to be an 'associated person', 'subsidiary' or 'related company' of a bank in

statutory management or liquidation, there may be a risk that it is placed into statutory management along with the bank, or that its assets are pooled with those of the bank in liquidation. This may prevent the covered bond holders from enforcing their security interest over the cover pool assets.

6.3 Reserve Bank of New Zealand (Covered Bonds) Amendment Bill

To address these issues, the Reserve Bank of New Zealand (Covered Bonds) Amendment Bill ('the Bill') was introduced to Parliament in May 2012. The objectives of the Bill are to:

- a) provide legal certainty about the effective segregation of cover pool assets from the other assets of a bank that issues a covered bond; and
- b) provide for a minimum level of monitoring of New Zealand banks' covered bond programmes.

The Bill requires banks¹¹ to register their covered bond programmes, subject to certain registration requirements in the Bill that relate to the segregation of the cover pool assets and their supervision by an independent cover pool monitor. The Bill also clarifies the segregation of cover pool assets from the bank's other assets, and gives legal certainty to the separation and legal ownership of cover pool assets if a bank is liquidated or placed into statutory management under the Reserve Bank of New Zealand Act 1989, the Corporations (Investigation and Management) Act 1989, the Insurance (Prudential Supervision) Act 2010, or the Companies Act 1993. Once the legislation comes into force banks will only be able to issue covered bonds under registered programmes, so programmes that existed before the legislation came into force will have to be registered before new bonds can be issued under them.

New Zealand's legislation aims to support the contractual issuance of covered bonds, and is therefore

¹⁰ Statutory management can be used in a number of circumstances, including potential insolvency of the bank, and involves the appointment of an external manager who has a range of powers, including powers to manage a bank closure.

¹¹ The Bill will only apply to registered banks in New Zealand, although it makes provision to extend the law to other entities by regulation. As a result, only registered banks will be able to issue LCBs; indeed they will be restricted to issuing LCBs. Other entities that wish to issue covered bonds, such as non-bank deposit takers or corporate issuers, will have to issue SCBs, and the requirements in the Bill will not apply.

less prescriptive in terms of programme requirements than some European frameworks. However, it does impose a number of requirements on issuing banks, including a requirement to maintain an asset register in accordance with documented procedures. To facilitate monitoring by the Reserve Bank, there are also notification requirements on each bank in respect of any registered covered bond programme it has set up. The bank must notify the Reserve Bank of every covered bond issuance under each such programme, and of any substantial changes to any existing registered programme. The bank must also notify the Reserve Bank if at any time the value of cover pool assets is less than the value of the bonds outstanding under a registered programme.

7 Conclusion

Covered bond issuance outside Europe has grown over recent years, largely as a result of the GFC. Many banks have issued covered bonds as they provide access to a new investor base, longer term funding and reduced funding costs. This can help to increase their resilience at times when funding markets are disrupted.

Covered bond issuance has the potential to increase the risk for a bank's unsecured creditors, including depositors. This sets a natural limit on how many covered bonds a bank would be able to issue – other creditors would demand an increasingly high price to compensate for the subordination of their claim. In addition, regulatory limits have increasingly been put in place around the world to reinforce this market discipline, and hence to balance the costs and benefits of banks issuing covered bonds. There is also a growing trend for countries outside Europe to develop specific legal frameworks to provide for supervision of cover pool assets, and for effective segregation of cover pool assets from the assets of the issuer.

New Zealand banks entered the covered bond market in 2010. The Reserve Bank has since imposed a limit restricting cover pool assets to 10 percent of total assets, and the Government has introduced specific covered bond legislation to support the issuance of covered bonds by New Zealand banks. The Reserve Bank expects that the

covered bond market will continue to provide a resilient source of funding for New Zealand banks, particularly in times of stress.

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