Feedback on December 2011 consultation on covered bonds

Introduction

1. In December 2011 the Reserve Bank of New Zealand ("Reserve Bank") released the consultation document: "Covered bonds". The Reserve Bank received feedback from 12 respondents. Most respondents addressed all the specific questions in the consultation document, whereas others commented on only one or two particular areas. This note provides a summary of the main substantive issues raised by respondents, and outlines the Reserve Bank's response.
2. This note is divided into four sections. Each section includes the Reserve Bank's response to the issues raised in submissions.
3. The first section discusses the key elements of the legislative framework for covered bonds. The second and third sections discuss two of these elements - registration of covered bond programmes, and legislative amendments, respectively. The fourth section focuses on transition issues.

Section 1: Key elements of the legislative framework

4. Section 2 of the consultation document provided an overview of what the Reserve Bank considers to be the key elements of its proposed legislative framework for covered bonds, and asked respondents for views on other issues that could be addressed in the legislative framework.

Summary of responses

5. Respondents suggested various other matters that could be addressed in the legislation. These included:
    - minimum overcollateralisation requirements;
    - asset eligibility requirements;
    - tax issues;
    - imposing the issuance limit via legislation rather than conditions of registration; and
    - including other securitisations (such as residential mortgage-backed securities ("RMBS")) in the legislative framework.
6. One respondent suggested that the legislation also set out the Reserve Bank's powers in relation to assets sold to a special purpose vehicle ('SPV'). This included powers to modify contractual arrangements between the SPV and the issuer, and to direct the SPV to take actions in relation to cover pool assets.

Reserve Bank response

7. In light of the responses, the Reserve Bank intends that the legislation will give it the power to register covered bonds under different asset eligibility classes. In order to balance investor certainty with the risk that asset eligibility requirements may restrict the types of covered bonds developed, registered classes may either contain no restrictions on the types of assets that may be included in the cover pool, or restrict the asset class. An issue must comply with any asset class designation under which it is registered.
8. The Reserve Bank does not consider it necessary to impose statutory minimum overcollateralisation requirements, as these tend to be set by the market and ratings agencies.
9. The Reserve Bank also does not intend to extend the legislative framework to securitisations in general. Respondents to the Reserve Bank's October 2010 consultation on covered bonds argued that a legislative framework for covered bonds is required because most countries with banks active in the market have a legislative framework in place and investors tend to prefer covered bonds issued under such frameworks. These considerations do not apply to securitisations generally.
10. The Reserve Bank considers that issues regarding the income tax treatment of SPVs are rightly addressed through amendments to the Income Tax Act 2007 and not as part of the framework proposed to be included in the Reserve Bank of New Zealand Act 1989. For this reason this issue has not been considered at this time.

Section 2: Registration requirements

11. Section 3 of the consultation document proposed that the Reserve Bank register covered bond issues that meet the basic structural requirement that the cover pool assets are held by an SPV to segregate them from the issuing bank. Section 4 of the consultation document discussed the proposal to require an independent person to monitor this asset pool.

Summary of responses

Registration

12. The consultation document asked for feedback as to whether the registration requirements set out in the consultation document were appropriate, and what information should be provided on a public register of covered bonds. The consultation document also asked whether registration should be mandatory, whether registration should be at the programme, series, or tranche level, and under what circumstances an issue should be removed from the register.
13. The majority of respondents considered the registration requirements set out in the consultation document to be appropriate. Respondents had various suggestions as to what information should be included on the register, the most common of which were:

    - name of issuer;
    - name of covered bond guarantor;

- ISIN and/or series number;
- principal amount;
- maturity date; and
- coupon.

14. One respondent suggested that the register should indicate the proportion of the bank's assets encumbered for the benefit of bondholders under the issue. Three respondents considered that the details on the register should not replicate banks' prudential disclosure and investor reporting requirements.

15. Only one respondent considered that registration should not be mandatory for covered bonds issued by a New Zealand registered bank. There were mixed views on whether the programme or series should be registered, with views reasonably evenly split between registration at the programme level, series level or either.

16. On the subject of removing issues from the register, respondents indicated that issues should not be removed from the register unless and until the issue has matured, and all obligations to bondholders have been met. Respondents were concerned that deregistration for any other reason would lessen the benefit of a legislative framework by creating uncertainty over the treatment of cover pool assets relating to a de-registered issue. One respondent suggested that, rather than deregistration, the Reserve Bank should have the power to close the register in relation to a particular issuer for all subsequent issues by that issuer after the date of closure.

Asset segregation

17. The consultation document asked respondents to provide views on whether the SPV model is appropriate for New Zealand, and whether the SPV should be restricted to being a New Zealand registered company.

18. All respondents who commented on this issue agreed that the SPV model was the most appropriate model for asset segregation, with many responses noting that this is the current industry practice.

19. Most respondents indicated that it would be appropriate to restrict the SPV to being a New Zealand registered company. Three respondents suggested that the legislation should provide flexibility to allow structures other than companies if commercial practice changed in the future.

20. One submission also suggested that, if the SPV was required to be a New Zealand registered company, the legislation should clarify that the SPV be able to act as a trustee.

Asset pool monitor

21. The consultation document proposed a requirement that issuers appoint an asset pool monitor for each covered bond programme, to carry out certain tests and report to the bond trustee and security trustee. It was suggested that the asset pool monitor be required to be independent of the issuer, or any party related to the issuer, and to be eligible to act as an auditor.

22. Most respondents supported a legislative requirement to have an asset pool monitor. Respondents were concerned that the role of the asset pool monitor should not deviate from commercial practice. Five respondents suggested that the asset pool monitor's role should be limited to verifying tests required under programme documentation, not performing the tests.

23. Responses were mixed as to the frequency of reporting by the asset pool monitor. The consultation document suggested bi-annual reporting, which three respondents agreed with, whereas three respondents said this was too frequent and that reporting should be annually. Two respondents agreed reporting should be to the security trustee and bond trustee, and to the Reserve Bank in the case of a test breach. Two respondents suggested that reporting should be to other parties, such as rating agencies, as prescribed by the programme documentation.

24. As to the restrictions on who can be an asset pool monitor, respondents were broadly in agreement with the proposals in the consultation document. One respondent suggested that the asset pool monitor should be required to be licensed under the Auditor Regulation Act 2011.

25. One respondent considered that the Reserve Bank should undertake supervision of covered bonds, as well as requiring independent monitoring by an asset pool monitor.

Reserve Bank response

26. The Reserve Bank shares the view of the majority of respondents that registration should be mandatory, and considers that registration should be at both the programme and the series level. This will provide the greatest level of transparency in relation to covered bond issues. The Reserve Bank will have the ability to determine the information provided on the register, and will consider respondents' submissions when doing so.

27. Regarding deregistration of covered bond issues, the Reserve Bank intends to adopt the approach outlined in the consultation document. Issues will only be removed from the register at such time as all covered bonds under the relevant issue have matured and all obligations to bondholders have been meet. Once an issue has met the registration requirements and has been registered, it will remain on the register until maturity.

28. In light of the responses, the Reserve Bank is satisfied that the SPV model is the most appropriate method for segregating the cover pool assets from the assets of the issuing bank. The SPV will initially be required to be a New Zealand registered company, with further allowable structures able to be specified in regulations. The Reserve Bank does not consider it necessary to clarify that the SPV is able to act as a trustee.

29. Given the broad agreement from respondents regarding the asset pool monitor, having an asset pool monitor will be a legislative requirement. The Reserve Bank's intention is that the role of the asset pool monitor will be consistent with current commercial practice, and therefore the asset pool monitor will verify the accuracy of the asset coverage test and the amortisation test.

30. After considering the responses, as well as the approach taken in Australia, the Reserve Bank intends to require the asset pool monitor to report to the security trustee and the bond trustee bi-annually, with more frequent reporting in the case of a breach. The Reserve Bank would also receive this more frequent reporting. The Reserve Bank has accepted the suggestion that the asset pool monitor must be registered or licensed under the Auditor Regulation Act 2011.

31. As noted in the October 2010 consultation document, the Reserve Bank does not intend to provide detailed, ongoing supervision of covered bond programmes.

Section 4: Protection in statutory management or liquidation

32. Section 3 of the consultation document proposed that registered issues be 'carved out' of specific provisions of the statutory management and liquidation regimes.

33. Certain provisions of the Reserve Bank of New Zealand Act 1989 ('the Act'), the Corporations (Investigation and Management) Act 1989 ('CIMA') and the Companies Act 1993 were identified as creating uncertainty as to the treatment of cover pool assets should the issuing bank be placed into statutory management or liquidation, and some legislative amendments were proposed. The consultation document asked whether submitters agreed with the proposed amendments, and whether they considered other statutory provisions also created uncertainty.

Summary of responses

34. Respondents agreed with the amendments outlined in the consultation document. One respondent proposed further changes, including –

    - the SPV should be deemed not to be an associated person or a subsidiary of the issuing bank for the purposes of the Act and CIMA.
    - sections 122 and 127 of the Act should not prevent the SPV enforcing contractual obligations against the issuing bank or statutory manger to pay amounts received by the issuing bank on behalf of the SPV.
    - section 128 of the Act should not prevent the SPV from exercising rights under a power of attorney granted by the issuing bank.
    - the pooling provisions in section 271 of the Companies Act should not apply to the SPV in respect of its relationship with the issuing bank.
    - the statutory manager or liquidator should be prevented from disclaiming arrangements as onerous property under section 269 of the Companies Act.
    - transfers of assets from the issuing bank to the SPV should be excluded from the claw-back provisions of sections 292 and 297 of the Companies Act, and section 54 of CIMA.

35. One respondent also suggested that the legislation should clarify that the trust manager of the SPV could be the issuing bank, or a subsidiary, and remain outside of statutory management.

36. As to whether other statutory provisions (such as voluntary administration, the compromises regime) create uncertainty, respondents indicated that it was

unlikely covered bond structures would be subject to these arrangements. Three respondents considered that it would be inappropriate to alter borrowers' rights of set-off, but one respondent submitted that legislation should be used to mitigate the risks of set-off.

37. Two respondents submitted that the Reserve Bank's Open Bank Resolution (OBR) policy may create uncertainty.

Reserve Bank response

38. In light of the responses received, the Reserve Bank intends to continue with the legislative amendments outlined in the consultation document. The Reserve Bank is satisfied that the most appropriate option is to provide narrow amendments to address provisions that create uncertainty when an issuing bank is placed into statutory management or liquidation. It does not believe a wide-ranging carve out for SPVs from legislative requirements (such as deeming the SPV to not be an associated person of the bank) would be appropriate in this instance. Moreover, the Reserve Bank does not consider it appropriate to extend the carve-outs to protect transactions from normal insolvency law principles, for example, where assets have been sold to the SPV at an undervalue.

39. The Reserve Bank does consider that there is merit in clarifying that neither the Act nor CIMA should prevent the transfer from the issuing bank to the SPV of monies collected on behalf of the SPV in its role as collection agent,

40. The Reserve Bank agrees with respondents that it is unlikely that the other regimes noted in the consultation document would apply, and it does not propose specific amendments to address these, or rights of set-off. Legislation clarifying whether the issuing bank or one of its subsidiaries could act as the trust manager of the SPV is not considered necessary.

41. As to the OBR policy, the Reserve Bank does not consider this creates undue uncertainty that is not addressed by the proposed amendments.

Section 5: Transition

42. Section 5 of the consultation document noted the Reserve Bank's intention that the legislative framework apply to all existing issues, and asked submitters about anticipated transitional issues for existing covered bonds programmes.

Summary of responses

43. Respondents generally did not anticipate significant transitional issues, but noted that this would depend on the extent to which the final framework differed from current commercial practice, and any consequent renegotiation of contractual arrangements required, particularly in relation to agreements with asset pool monitors.

44. One respondent suggested that mandatory registration would assist issuers to facilitate any modifications required.

Reserve Bank response

45. The Reserve Bank intends to give issuers time to make any necessary modifications to existing programme documentation, with a six month transition period for existing issues.

Reserve Bank of New Zealand **April 2012**