

Box D

Covered Bond Issuance by Australian Banks

Covered bonds are on-balance sheet asset-backed securities issued by financial institutions. Investors in covered bonds have a preferential claim on a pool of assets (called the cover pool) in the event that the issuing institution fails to make the scheduled payments on the covered bond. If the cover pool is insufficient to meet the issuer's obligations to investors, they have an unsecured claim on the issuer for any residual amount.¹

Covered bonds typically have a higher credit rating than that of the issuer because the cover pools are usually comprised of high-quality assets such as prime mortgages, covered bond holders rank above unsecured creditors, and extra collateral is held in the cover pool.

There is a well-developed global market for covered bonds, particularly in Europe. In Australia, however, authorised deposit-taking institutions (ADIs) have only recently been permitted to issue these bonds, following the passing of legislation – the *Banking Amendment (Covered Bonds) Act 2011* – in October 2011. Under the new legislation, there is a cap on covered bond issuance by ADIs to limit the subordination of depositors to covered bond

investors. An ADI must limit the value of its cover pools to a maximum of 8 per cent of its assets in Australia. Given that Australian ADIs have set their cover pools at close to 120 per cent of the value of covered bonds – with some variation of this 'over-collateralisation' across banks – this implies that covered bonds could provide up to around 6¾ per cent of total on-balance sheet funding for Australian assets. This is equivalent to about \$140 billion for the major banks, based on the current level of their assets in Australia. The covered bond programs of the four major banks have all received a AAA credit rating, which is higher than the issuer credit ratings of these banks of AA or AA- (depending on the rating agency).

The major Australian banks have issued \$17 billion in covered bonds since October (Table D1). While terms have ranged from 3 years to 18 years, most issuance has been at the 5-year and 10-year tenors. This is longer than that typically available for senior unsecured bonds, which usually have a 3- or 5-year tenor. The ability to achieve longer-term funding reflects the high credit quality of covered bonds, as well as an expanded investor base. Over one-third of the issuance has been in the domestic

Table D1: Covered Bond Programs of the Major Banks

Issuer	Program size (A\$ billion)	Issuance to date (A\$ billion)	Tenor (years)	Currency
ANZ	20	3.5	3, 5, 7, 10, 11	CHF, EUR, NOK, USD
CBA	30	6.4	5, 10, 15, 18	AUD, EUR, GBP, NOK, USD
NAB	20	2.8	3, 5, 10, 15	EUR, GBP, NOK
WBC	20	4.5	5, 10	AUD, NOK, USD
Total	90	17.3		

Source: RBA

¹ Under the *Banking Amendment (Covered Bonds) Act 2011*, any residual claim of covered bond investors on an issuer ranks below claims of most depositors and the government.

market in Australian dollars, comprised of two large bond issues (Graph D1). The vast majority of these two issues was taken up by local investors, such as pension funds and other asset managers. The remainder of the issuance has been across five foreign currencies, primarily in euro for which the covered bond market is quite well developed. The wide range of currencies, in part, reflects the desire of the major banks to establish themselves as issuers in these markets. Some of the issues in the less-traded currencies have been placed privately.

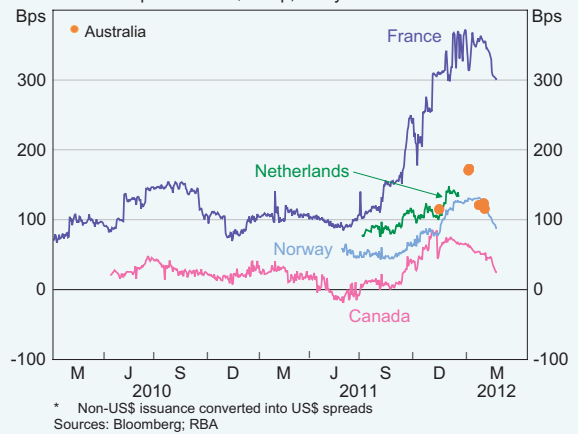
The Australian major banks' issuance has been at broadly similar spreads to many of their foreign peers (Graph D2). Covered bonds issued by some European banks, such as those in France, have been trading at much higher spreads, highlighting investor concerns about those banking systems. Canadian banks' covered bonds have tended to trade at lower spreads, in part because the cover pools for these bonds typically include residential mortgages that are insured by the Canadian Government. Notwithstanding these differences, issuance costs have been high, with spreads on a number of the major bank 10-year covered bond issues in excess of 230 basis points over the bank bill swap rate. However, secondary market yields suggest that these spreads have narrowed noticeably since they were issued.

A comparison of 5-year covered bonds issued by the major Australian banks since the start of the year shows that after accounting for the cost of hedging back into Australian dollars, the overall cost has been relatively similar across issues in Australian dollars, US dollars and Swiss francs (Graph D3). However, issuance costs in euro-denominated covered bonds have been higher. This largely reflects the relatively high cost of hedging these issues back into Australian dollars. At the same time, Australian banks have indicated a desire to establish themselves in the euro covered bond market, given it is the deepest and most developed globally. ↕

Graph D2

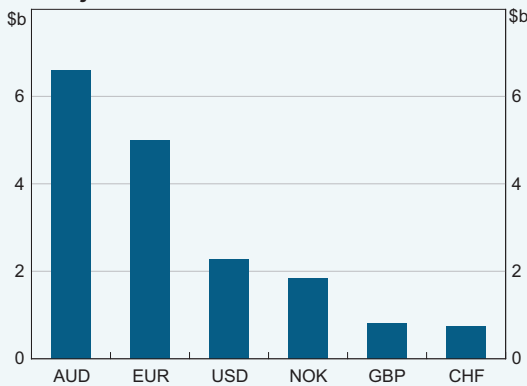
Covered Bond Pricing*

Spread to US\$ swap, 4-6 year AAA rated



Graph D1

Major Banks' Covered Bond Issuance



Graph D3

Covered Bond Primary Market Pricing*

Spread to A\$ swap, 5-year

