REGULATORY IMPACT STATEMENT

COVERED BONDS REGISTRATION REQUIREMENTS AND INSOLVENCY PROTECTIONS

AGENCY DISCLOSURE STATEMENT

1 This Regulatory Impact Statement ('RIS') has been prepared by the Reserve Bank of New Zealand ('Reserve Bank'). It provides an analysis of options to provide legal certainty as to the treatment of covered bonds in the event that a bank that has issued covered bonds is placed into statutory management or liquidated.

2 The proposals in this RIS have been subject to public consultation. The Reserve Bank first publicly consulted on the possibility of a legislative framework for covered bonds in October 2010. A second consultation was carried out in December 2011. The banking industry is strongly supportive of the proposals and would like to see legislation introduced as soon as possible. Industry feedback on technical issues has been taken into account in formulating the proposals.

3 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 Financial Markets Authority, the Australian Treasury, ratings agencies and key financial institutions in developing this framework.

4 The proposals in the Cabinet paper, to register covered bond issues, and statutory amendments to clarify the law as it relates to covered bonds when a bank is in statutory management or liquidation, are aimed at providing legal certainty. Hence, these proposals will not impose material 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 requirement for covered bond issuers to appoint an asset pool monitor may impose some small additional costs on issuers. This is because, although asset monitors are standard commercial practice, the proposal requires that the asset monitor report on a more frequent basis than is currently the case for some issuers. The frequency of reporting is however consistent with that required in Australia and will provide investors with additional certainty.

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Reserve Bank of New Zealand **28 March 2012**

STATUS QUO AND PROBLEM DEFINITION

5 Covered bonds are a form of debt instrument issued by banks. New Zealand banks have been issuing covered bonds under contractual arrangements since 2010.

6 In a covered bond issuance, the issuing bank provides an unsecured guarantee as to payment of the obligations under the covered bonds and also specifically tags certain assets, called the cover pool, as security for payment of the obligations. For issuance undertaken by New Zealand banks, the cover pool assets have been sold to a separate legal entity, called a special purpose vehicle (SPV), which issues a guarantee as to payment of the bonds, secured against the cover pool assets.

7 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 a longer term 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.

8 However covered bonds do pose a risk to unsecured creditors. This risk arises as the assets to which covered bond holders have a priority right will not be available to unsecured creditors should a bank fail.

9 Internationally, legislative frameworks for the issuance of covered bonds are common place and are a pre-requisite for investment for some investors. Australia has recently passed legislation putting in place a legislative framework for covered bonds. The lack of a New Zealand legislative framework is likely to put New Zealand issuers at a disadvantage and may impede New Zealand issuers' access to the covered bond market.

10 An important aspect of covered bond programmes is the ability of the cover pool assets to be segregated from the assets of the issuing bank in the event the issuing bank is insolvent. This segregation is essential so that bond holders can enforce their security interest over the cover pool assets. Consultation undertaken by the Reserve Bank has indicated that there is a level of uncertainty as to how certain provisions of the Reserve Bank Act 1989 ('the Act'), the Corporations (Investigation and Management) Act 1989 ('CIMA') and the Companies Act 1993 would be interpreted regarding assets in the cover pool should an issuing bank become insolvent and placed into statutory management or liquidated. 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.

11 The legal uncertainty arises from two main sources:

(a) the potential inclusion of the SPV (and hence the cover pool assets) in the statutory management or liquidation of the bank as an associated person, subsidiary or related company;

(b) the potential inability of the SPV to take over from the bank the management of cover pool assets, should an issuing bank fail, due to various 'moratorium' provisions in the Acts which prevent individuals from dealing with bank assets.

12 This legal uncertainty can only be remedied by amendments to the Act, CIMA and the Companies Act, as these Acts are the source of the uncertainty.

13 Additionally, the Reserve Bank considers that the current regime does not provide sufficient certainty as to the independent verification of the information provided by issuers on cover pools. It is common in other legislative frameworks for independent monitoring of cover pools to be required.

OBJECTIVES

14 The main objective of the legislation 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.

15 The secondary objective is to improve investor confidence in New Zealand covered bond issues by providing independent verification of information provided by issuers on cover pools.

REGULATORY IMPACT ANALYSIS

Issuance Limit

16 Due to covered bonds potentially subordinating the claims of unsecured creditors, in October 2010 the Reserve Bank consulted on an issuance limit for covered bonds. Such an issuance limit was imposed by way of condition of registration on locally incorporated banks in April 2011. This limit restricts the level of covered bond issuance which these banks may undertake to 10% of total assets, with this limit calculated on the value of assets encumbered for the benefit of covered bond holders. The Reserve Bank intends to extend this restriction to banks operating in New Zealand through branches.

17 The Reserve Bank considered a range of possible limits, from no limit to a higher limit. The argument in favour of having no limit is that the market, and rating agencies, would effectively discipline banks to not issue to much secured debt. However, the risks of covered bonds may not be apparent until the market is disrupted and hence market discipline may not be effective in benign times.

18 Statements by ratings agencies support setting the limit at about 10% of the bank's asset base. Ratings agencies have indicated that the issuance of covered bonds up to this amount is a positive rating factor for the bank as a whole. This is because the benefits of covered bonds, in terms of supporting banks wholesale funding activities, outweigh the risks to unsecured investors.

19 A limit of 10% is also similar to the limit set in Australia. The Australian limit is set at 8% at the time of issuance. As the New Zealand limit of 10% applies at all times, our understanding is that banks are managing to an internal limit of around 8% so as not to inadvertently breach the regulatory limit.

Legislative framework

20 The proposed legislative framework is aimed at providing certainty that cover pool assets can be effectively segregated from the other assets of the bank, should the bank be insolvent. There are two main elements to the proposal in this respect:

(i) requirements to ensure the clear segregation of cover pool assets from the bank's other assets (section 1 below);

(ii) protection of covered bond issues from various provisions of the statutory management and liquidation regimes (section 2 below).

14 The proposal also requires the appointment of an asset pool monitor to provide independent verification of information provided by the issuer (section 3 below).

Section 1: Asset segregation

21 In order to ensure that covered bond SPVs, and hence cover pool assets, are not included in the statutory management or liquidation of an issuing bank, the cover pool assets must be clearly segregated from those of the bank.

22 There are two elements to asset segregation on which the Reserve Bank has consulted. First whether assets should be segregated by way of sale of the asset by the bank to an SPV or whether a mechanism should be developed to identify cover pool assets which remain the property of the issuing bank (called the integrated option). This point was consulted on in both October 2010 and December 2011.

23 Submitters were strongly in favour of requiring that cover pool assets be sold to a covered bond SPV. This is consistent with current commercial practice and consistent with the requirements of the Australian and United Kingdom legislative frameworks. Submitters considered that it would take significant work to develop an integrated option in the New Zealand context, given this would require the development of a legal paradigm that does not currently exist. Even if such an approach was developed, being untested in New Zealand law it would not necessary deliver the necessary certainty.

24 The second element considered was whether covered bond issues should be registered or whether a safe harbour would be appropriate. If covered bond issues are registered, the protections from the statutory management and liquidation regimes (see paragraph 20(ii)) would apply to all registered issues. Under safe harbour, issues meeting various statutory requirements would be eligible for the protections from the statutory management and liquidation regimes. The Reserve Bank consulted on this issue in October 2010. Submitters were strongly supportive of registration, in order to provide greater certainty that a particular issue complied with the requirements for the statutory protections. Submitters on the December 2011 consultation document were strongly in favour of registration being mandatory and applying new and existing issues.

25 Given the above, the proposal is that covered bond issues meeting certain registration requirements be registered by the Reserve Bank. These requirements would be set by

amendment to the Act, as the Reserve Bank does not have the power to impose these requirements by way of condition of registration. Registration is likely to entail minimal compliance costs for business.

26 Registration will apply to both existing issues and new issues. The possible introduction of a registration framework has been well signalled by the Reserve Bank and anticipated by banks. Banks have indicated a preference that existing issues be registered as well as new issues.

27 The first registration requirement is that only covered bonds issued by New Zealand banks can be registered. This is because at present only banks have the capability to issue into the covered bond market, as the typical issuance size is in excess of EUR 1 billion. Further the covered bond market as it exists at present is a market for bank funding. However, as this may change in the future the class of issuers who may register covered bonds will be able to be extended by regulation.

28 The second registration requirement is that cover pool assets must be held by a SPV that is a New Zealand registered company. Submitters on the December 2011 consultation were in favour of this requirement, as it accords with current practice. However, some submitters argued that the legislation required future proofing in case alternative entity types were considered necessary in the future. For this reason the proposals include a power for regulations to be made to enable other entity types to be eligible to be the covered bond SPV.

29 The other registration requirements are the requirement that an asset pool monitor be appointed, discussed below, and a requirement that the issuer otherwise comply with the legislation. The registration requirements may be expanded by regulation.

30 Some submitters on the December 2011 consultation argued that the legislation should restrict the assets that may be included in cover pools in order to provide greater investor certainty as to the composition of cover pools. The risk of this is that the asset class restrictions may restrict financial market development. Balancing these issues, the proposal gives the Reserve Bank the power to register covered bonds under different asset class designations. These designations may restrict the assets in a class or provide a class with no restriction on the assets.

31 It is proposed that the Reserve Bank have the power to impose a fee for registration of covered bonds. The Reserve Bank considers it unlikely that such a fee would be imposed. If, however, the Reserve Bank did impose a fee, for example if there was a high volume of transactions which put pressure on current RBNZ funding, this is not likely to be a significant cost given the minimal requirements for registration.

32 Consultation indicates that banks and the investment community 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.

Section 2: Certainty of treatment in insolvency

33 In order to remedy the uncertainty as to the treatment of cover pool assets, in the event an issuer is placed into statutory management or liquidated, two sets of amendments are proposed.

34 The first set of amendments which is proposed is to amend the Act, CIMA and the Companies Act to provide that a covered bond SPV cannot be put into statutory management or liquidation with an issuing bank by virtue of being an associated person, subsidiary or related party of the issuing bank (this amendment applies to section 117 of the Act, section 38 of CIMA and section 271 of the Companies Act). This amendment would mean that any failure resolution process applying to the bank would not apply to the covered bond SPV.

35 One submitter on the December 2011 consultation document considered that the SPV should be deemed not to be an associated person, subsidiary or related company of the bank. We consider this amendment would be too wide. There are a number of powers that the Reserve Bank, statutory manager or liquidator can exercise over entities so related to a bank (such as the power to require certain information be required) which the Reserve Bank considers appropriate to retain.

36 In order to ensure that the management of the cover pool assets can pass from the bank to the SPV (or parties it contracts with) in the event of failure of a bank, amendments are proposed to the Act, CIMA and the Companies Act. These amendments would be made by way of the insertion of a new section in these Acts to provide that nothing in section 122, 126, 127, 128 of the Act (and the corresponding sections in CIMA) and nothing in section 248 of the Companies Act shall:

(a) prevent the transfer of legal title to cover pool assets from an issuer to a SPV constituted under a registered covered bond issue where the SPV is the beneficial owner of those assets;
(b) prevent the transfer under contract of any documentation or data relating to cover pool assets from an issuer to a SPV under a registered covered bond issue where the SPV is the beneficial owner of the relevant assets;
(c) prevent the exercise by a SPV under a registered covered bond issue of a relevant power of attorney granted by the issuing bank in relation to cover pool assets of which the SPV is the beneficial owner;
(d) suspend the discharge of a contractual obligation of the issuing bank to pay to a SPV under a registered covered bond issue monies collected on behalf of the SPV in relation to cover pool assets;
(e) prevent the enforcement of any of the above rights.

37 Submitters on the December 2011 consultation document were supportive of these amendments. Clauses (d) and (e) have been included following the December 2011 consultation. This is because one submitter considered that there was some uncertainty

as to the treatment of monies collected by the bank, in its role as servicer of the cover pool assets, on behalf of the SPV.

38 One submitter considered that amendments should be made to a number of other sections of the Act, which in the main deal with sales at an under-value. The Reserve Bank does not consider that the powers of the statutory manager or liquidator to disclaim sales made from the bank to the SPV at an under-value should be curtailed and hence has not proposed amendments to these sections.

39 The Reserve Bank considers that these changes are minor in nature, as they are effectively clarifications of the law. The economic benefit comes from the reduction in legal uncertainty. This is likely to have a modest positive impact on banks' ability to issue covered bonds.

Section 3: Asset pool monitor

40 It is proposed that banks be statutorily required to appoint an asset pool monitor to undertake monitoring of cover bond issues for the benefit of investors. Asset pool monitors are a common feature in other legislative frameworks.

41 Most submitters on the December 2011 consultation paper were in favour of a mandatory requirement for an asset pool monitor in order to increase investor confidence. Some submitters felt the requirement was unnecessary given that asset pool monitors are standard industry practice. On balance, the Reserve Bank considers that an asset pool monitor is an important part of the framework. Providing the role in legislation allows minimum standards to be set regarding the asset pool monitor.

42 Submitters on the December 2011 consultation paper considered that greater clarity was needed as to the role of the asset pool monitor. Submitters considered that the role of the asset pool monitor should be to verify tests specified by and performed by or on behalf of the issuer, as opposed to developing their own tests. The proposals have been amended to clarify this. The role of the monitor is to provide a report which:

(a) verifies the accuracy of solvency tests undertaken on behalf of the issuer;

(b) verifies that the issuer maintains a register of cover pool assets;

(c) verifies that cover pool assets are consistent with any asset class designation under which it is registered;

(d) provides for any other matter specified in regulations made under the Act.

43 The requirements in 42(b) and 42(c) provide additional responsibilities for the asset pool monitor, compared to the status quo. These functions are considered necessary to ensure that accurate records are kept of cover pool assets and to ensure that legislative requirements relating to asset class designations are met.

44 Reports of the asset pool monitor are to be provided to the bond and security trustee, as is current practice. Under the proposal the report must be provided to the Reserve Bank if one of the tests in 42 is not met or if the Reserve Bank so requests. The requirement

to provide reports to the Reserve Bank is an extra requirement imposed by this proposal and provides an extra check that issuers are providing accurate information.

45 Given that asset pool monitors are standard industry practice, the requirements will impose only minimal additional costs on issuers. One aspect that submitter have commented on is the requirement that the asset pool monitor undertake its test biannually, as opposed to the current annual testing. This is likely to impose some additional cost (our understanding is that the additional cost will be in the order of $3000-$5000 per year and will be met by the SPV). The Reserve Bank considers this cost would be justified by the benefit in terms of greater investor confidence in the information provided. Biannual testing is consistent with the Australian legislation.

CONSULTATION

46 The Reserve Bank undertook public consultation on the legislative framework for covered bonds in October 2010 and December 2011. The Reserve Bank received 12 written submissions on each consultation document.

47 The banking industry is strongly supportive of the proposals for a legislative framework for the issuance of covered bonds, particularly as Australia has recently implemented such a framework. The banking industry would like to see the proposal introduced as soon as possible.

48 The main issue that was raised in submissions on the December 2011 consultation document was clarification that the role of the asset monitor is one of verification. As discussed, this has been addressed. Some submitters considered the framework should apply more widely to securitizations in general. The Reserve Bank considers that there are a number of risks with so extending the framework, and so these proposals relate only to covered bonds.

49 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.

50 The Reserve Bank consulted the Ministry of Economic Development, the New Zealand Treasury, OEGI, and the Australian Treasury in the preparation of this policy.

CONCLUSIONS AND RECOMMENDATIONS

51 The main elements of the proposed framework are:

(i) a requirement that covered bonds be registered on a register maintained by the Reserve Bank;

(ii) a requirement that cover pool assets be held by a special purpose vehicle, which is a New Zealand registered company;

(iii) a requirement that an asset pool monitor be appointed to undertake certain specified tests on the cover pool assets; and

(iv) amendments to the Act, CIMA and 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

52 The proposal will be given effect through amendment to the Act, CIMA, and the Companies Act 1993. Existing issues will be required to be registered 6 months after the passage of the legislation. New issues will require registration prior to issuance.

53 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.

54 As the main objective of the legislation is to provide legal certainty, the proposals will impose only minimal new costs on business, and will not impair property rights or market competition, or the incentives of businesses to innovate or invest, or override fundamental common law principles. Minor additional costs may be imposed due to the requirement that reports of the asset monitor be required to be provided more frequently than is standard practice.

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

MONITORING, EVALUATION AND REVIEW

56 The policy will be reviewed consistent with the regulatory impact analysis requirements in section 162AB(1)(b) of the 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, as well as contacts with covered bond investors, ratings agencies and other regulatory agencies.