



29 April 2008

To All Authorised Deposit-Taking Institutions (ADIs)

COVERED BONDS

APRA has been consulting with industry participants on covered bonds for some years. Covered bonds are secured ADI funding structures whereby an ADI issues debt instruments in conjunction with a cover pool of the ADI's assets, which are held by the ADI or in a separate vehicle for the benefit of bond investors in the event the ADI is unable to meet its obligations on the debt instruments.

APRA wrote to all ADIs in January 2005 indicating its in-principle objection to covered bond structures that, in substance, subordinate the interests of depositors of ADIs to the interests of the covered bond holders. In APRA's view, such structures are not consistent with the provisions of the *Banking Act 1959* requiring that, if an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet that ADI's deposit liabilities in Australia in priority to all other liabilities of the ADI.

Following further industry consultation, APRA re-confirmed its position on covered bonds when it released the revised *ADI Prudential Standard APS 120 Securitisation*, part of a suite of Basel II prudential standards, in November 2007. Paragraph 7 of APS 120 states:

"Covered bonds are not considered to be consistent with depositor preference provisions set out in the Banking Act and hence are prohibited."

More recently, APRA has received additional proposals for issuance of covered bonds and similar structured financing transactions by ADIs. APRA has carefully considered the latest proposals against the background of recent global credit market developments. In our view, and notwithstanding market developments, the arguments advanced in support of such structures, many of which have been raised before, do not adequately address APRA's in-principle objection to covered bonds.

Accordingly, paragraph 7 of APS 120 prohibiting the issue of covered bonds will continue to apply. In addition, other synthetic or structured transactions that are in economic substance equivalent to covered bonds will also not be acceptable. In the current global environment, it is not surprising that new financing structures are being developed and proposed to ADIs. However, APRA expects ADIs to carefully consider the full implications of any proposed new forms of financing for their risk profile; it is unlikely that more complex, opaque or legally untested structures will ultimately increase the ADI's funding resilience or meet with market or APRA acceptance in the current climate.

Sincerely,

Charles Littrell
Executive General Manager