



Prudential Standard APS 121

Covered bonds

Objectives and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that authorised deposit-taking institutions adopt prudent practices when issuing covered bonds and managing the risks associated with exposure to a covered bond special purpose vehicle.

The key requirements of this Prudential Standard are that an authorised deposit-taking institution must:

- adopt policies and procedures to manage risks relating to its issuance of covered bonds; and
- apply an appropriate capital treatment to exposures involved with covered bond issuance.

This Prudential Standard should be read in conjunction with Division 3A of Part II of the *Banking Act 1959*, which sets out the legislative framework for covered bonds.

Authority

1. This Prudential Standard is made under section 11AF of the *Banking Act 1959* (**Banking Act**).

Application

2. This Prudential Standard applies to all authorised deposit-taking institutions (**ADIs**), other than a foreign ADI within the meaning of subsection 5(1) of the Banking Act. It does not apply to a bond, note or other debenture, liabilities in relation to which are secured wholly by assets that are not in Australia
3. A covered bond is not a securitisation for the purposes of *Prudential Standard APS 120 Securitisation* (APS 120).

Definitions

4. The terms *covered bond*, *cover pool*, *covered bond liabilities*, *covered bond special purpose vehicle*, and *issuing ADI* have the same meanings as in the Banking Act.
5. For the purposes of this Prudential Standard, references to the ADI's assets in Australia shall be taken to be references to an ADI's total assets as required to be reported on form *ARF 320.0 Statement of Financial Position (Domestic Books)* by *ARS 320.0 Statement of Financial Position (Domestic Books)*.

Key principles

6. The Board and senior management of an issuing ADI must establish and implement policies and procedures relating to:
 - (a) decisions to issue covered bonds and the structuring of covered bond issuance;
 - (b) the ADI's dealings with covered bond special purpose vehicles (including cover pools); and
 - (c) the management of exposures involved in the issuance of covered bonds.
7. The policies and procedures established by an ADI relating to its issuance of covered bonds must include:
 - (a) appropriate risk management systems to identify, measure, monitor and manage the risks associated with the ADI's issuance of covered bonds;
 - (b) how the ADI will monitor the effects of its issuance of covered bonds on its risk profile, including exposures to the covered bond special purpose vehicle;

- (c) consideration, under stress scenarios, of the impact on the ADI of contractual obligations to maintain collateral levels required for covered bonds;
 - (d) assessment of the effect, including under stress scenarios, of covered bond issuance on the ability of the ADI to raise other sources of funding and the cost of such funding; and
 - (e) how the ADI will ensure that it is meeting the requirements of this Prudential Standard and of Division 3A of Part II of the Banking Act.
8. The documentation associated with a covered bond issuance must clearly set out:
- (a) the events of default that would enable covered bond holders to access collateral held in the cover pool;
 - (b) that claims by covered bond holders on the covered bond special purpose vehicle are limited to assets in the cover pool;
 - (c) how assets forming part of the cover pool are identified;
 - (d) the interests of the ADI in assets held by the covered bond special purpose vehicle and the rights of the ADI to recover such assets;
 - (e) the undertakings, if any, given by the ADI in relation to assets transferred to the cover pool and the extent of any mechanisms for ensuring compliance;
 - (f) provisions governing the topping up and removal of collateral held in the cover pool by the covered bond special purpose vehicle and any return of collateral to the issuing ADI; and
 - (g) the provisions, if any, to ensure the continuance of the covered bond special purpose vehicle beyond any default by the ADI.

Covered bond special purpose vehicle

9. All agreements, rights and obligations between the ADI and covered bond special purpose vehicles must be formally and legally documented and must set out the full scope of such agreements, rights and obligations. All affected assets must be dealt with in accordance with these agreements.
10. Where assets that have been transferred by the ADI to a covered bond special purpose vehicle are administered by the ADI or an affiliated entity, the assets should, to the maximum extent practicable, continue to be administered consistently with the ADI's policies for similar assets and this requirement should be contained in relevant legal documents.

11. An ADI must maintain accurate and up-to-date registers of:
 - (a) assets in the cover pool;
 - (b) other assets securing covered bond liabilities;
 - (c) assets held by the covered bond special purpose vehicle that do not form part of the cover pool or secure covered bond liabilities; and
 - (d) those assets listed on the register referred to in subparagraph (c) that the ADI can readily and unconditionally withdraw from the covered bond special purpose vehicle under all circumstances.
12. An ADI must be able to report to APRA at any time, upon written request, assets in the registers referred to in paragraph 11 above.
13. When determining whether an asset is part of a cover pool, an ADI must have regard to the priority of claims under all possible scenarios, not just under a business-as-usual scenario.
14. Any assets added to the cover pool, or otherwise provided to the cover bond special purpose vehicle, or returned to the ADI, must be clearly identified.
15. The ADI must be able to identify, at all times, all derivatives and other transactions outstanding with a covered bond special purpose vehicle.
16. An ADI must ensure that agreements between the ADI, the covered bond special purpose vehicle and covered bond holders:
 - (a) require that all assets not securing covered bond liabilities return to the ADI immediately following an issuer event of default;
 - (b) only permit assets of the covered bond special purpose vehicle to become part of the cover pool or otherwise subject to claims by third parties following an express written instruction to do so by the ADI; and
 - (c) only permit assets of the covered bond special purpose vehicle to be sold, liquidated or otherwise disposed of:
 - (i) after first providing the ADI with a reasonable opportunity to acquire the assets on similar terms; and
 - (ii) in a way that maximises the value received for the assets if they are not acquired by the ADI.
17. Where the ADI has assets in the covered bond special purpose vehicle that:
 - (a) the covered bond special purpose vehicle holds only on trust for the ADI;
or

- (b) the ADI retains a right to freely withdraw from the covered bond special purpose vehicle at any time, including after a default by the ADI or the covered bond special purpose vehicle on the covered bonds;

the existence of such arrangements must be clearly set out in any issue documentation and in any legal documentation involving the ADI, covered bond holders and the covered bond special purpose vehicle. It must be made clear to holders of covered bonds that such assets are unavailable as collateral securing their bond holdings.

18. Where an ADI acquires assets from a covered bond special purpose vehicle, including by way of substituting assets to maintain levels of collateral held by the covered bond special purpose vehicle, the ADI must, to the extent that this has not already occurred, ensure:

- (a) the returning assets are subject to impairment testing (and provisioning as necessary); or
- (b) the returning assets are marked to market;

depending on how the acquired assets are to be accounted for by the ADI.

Assets in the cover pool

19. An ADI must deduct from Tier 1 capital the aggregate amount of assets in cover pools that do not qualify for treatment as assets of the ADI in accordance with section 31D of the Banking Act.
20. When applying Prudential Standards, assets in cover pools that qualify for treatment as assets of the ADI in accordance with section 31D of the Banking Act will be treated as if they were held directly by the ADI, without reference to the interposed structures.
21. If the selection of assets for the cover pool leads to the overall level and/or concentration of risks remaining in the ADI becoming excessive relative to its capital, APRA may consider adjusting an ADI's prudential capital ratio to reflect the ADI's overall risk profile (see *Prudential Standard APS 110 Capital Adequacy*, APS 110).

Assets outside the cover pool

22. Where:
- (a) an asset held by the covered bond special purpose vehicle is separately identifiable;
 - (b) no part of the asset is in the cover pool or secures covered bond liabilities;

- (c) the issuing ADI has an unconditional authority to deal with the asset, including to require that it be returned to the ADI at any time;
- (d) an ADI has at all times unequivocal enforcement rights over a mortgaged residential property (including a power of sale and a right to possession) in the event of default by the borrower; and
- (e) the asset otherwise complies with paragraphs 10 and 11 above;

the asset must be treated for purposes of applying Prudential Standards, including calculating capital requirements, related-party exposures and large exposures, as an asset of the ADI.

23. Where an ADI retains an interest in collateral that is shared with an asset in the cover pool, it will not be treated as satisfying the test in paragraph 22(c) above unless there is a formal second mortgage arrangement in place that meets the requirements of Attachment C of *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112).

24. Where an asset held by a covered bond special purpose vehicle:

- (a) does not form part of the cover pool; and
- (b) is not subject to paragraph 22 above;

it must be treated as an asset of the ADI for the purposes of applying Prudential Standards, including related-party exposures and large exposures, but such an asset must, for capital adequacy purposes, be risk-weighted at the greater of 100 per cent or the relevant risk-weight detailed in Attachment A to APS 112.

25. APRA may, at its discretion, require an ADI to obtain at the ADI's expense an opinion, from an appropriate independent expert agreed by APRA, on whether an asset meets the requirements of paragraph 22.

Liabilities between the ADI and covered bond special purpose vehicle

26. Liabilities of the covered bond special purpose vehicle to the issuing ADI (and the associated asset of the ADI) will be disregarded for the purposes of applying Prudential Standards.

27. Liabilities of the issuing ADI to the covered bond special purpose vehicle (and the associated asset of the covered bond special purpose vehicle) will be disregarded for the purposes of applying Prudential Standards.

28. Paragraphs 26 and 27 apply to liabilities associated with derivatives between the ADI and the covered bond special purpose vehicle. However, collateral lodged against such derivatives is not to be disregarded:

- (a) when applying Prudential Standards, collateral lodged by the issuing ADI in relation to a derivative contract with the covered bond special purpose vehicle is to be treated as if it were lodged with an independent third party; and
- (b) collateral lodged by a covered bond special purpose in relation to a derivative contract with the issuing ADI is to be treated as an asset securing covered liabilities¹.

Reports

29. Where APRA requests a report from a cover pool monitor pursuant to paragraph 30(4)(d) of the Banking Act, this will be at the expense of the ADI.

Cross default provisions

30. An ADI must ensure that documentation associated with a covered bond issue does not permit covered bond holders to make a claim on the covered bond special purpose vehicle or the cover pool unless the issuing ADI has defaulted on its obligations under a covered bond secured by the same cover pool.

Implications for other obligations

31. Prior to issuing a covered bond, an ADI must identify all existing obligations (whether financial or otherwise) subject to a negative pledge or similar commitment. The ADI will need to assess the impact, if any, of any such negative pledge or similar arrangement, including whether the issuing of the covered bonds could expose the ADI to requirements to accelerate payments or offer (or increase) collateral or security against the existing obligations.
32. For each obligation identified in paragraph 31 as potentially exposing the ADI to requirements to accelerate payments or offer (or increase) collateral or security, an ADI must, prior to issuing covered bonds:
- (a) identify the circumstances in which it could be required to accelerate payments or offer collateral or security against the obligation, and the quantum of collateral that might be involved;
 - (b) assess the implications for the its capital, liquidity and borrowing capacity if it were required to provide collateral against the obligation; and
 - (c) where relevant, assess whether the provision of collateral against the existing obligation would breach any requirement of the Banking Act or a Prudential Standard.

¹ Such an asset may also be part of a cover pool if it satisfies the test in subsection 26(3) of the Banking Act.

33. Where an ADI identifies an obligation pursuant to paragraph 31, it must consult with APRA prior to issuing covered bonds. APRA may, at its discretion, require an ADI to obtain at the ADI's expense an opinion, from an appropriate independent expert agreed by APRA, on any of the matters referred to in paragraph 32.

Notifications

34. An ADI must also provide to APRA as soon as practicable after the issue of a covered bond, a written declaration signed by a responsible person of the ADI certifying that at the time of issue of the covered bond, the combined value of assets in cover pools securing covered bonds issued by the ADI, including the issue undertaken, do not exceed 8 per cent of the value of the ADI's assets in Australia (or such other percentage as may be prescribed in regulations pursuant to section 28 of the Banking Act).
35. An ADI must provide APRA with a copy of all relevant documentation relating to the issue of covered bonds on request.
36. An ADI must notify APRA in writing, as soon as practicable after it becomes aware that the value of assets in cover pools securing covered bonds issued by the ADI exceeds, or will exceed, 8 per cent of the value of the ADI's assets in Australia (or such other percentage as may be prescribed in regulations pursuant to section 28 of the Banking Act). Such notification must include the value of the assets in the cover pool, the amount in excess of the specified percentage, reasons for the excess and an indication of the ADI's plans and a proposed time frame in which assets held in the cover pool may fall below the specified percentage.