

# Regulatory Impact Statement: Covered bonds legislative framework

## Regulatory Impact Statement

**Title of Proposal: Covered bonds legislative framework**

### Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by the Reserve Bank.

It provides an analysis of options to provide legal certainty as to the treatment of cover pool assets in the event that a bank that has issued covered bonds is placed into statutory management or liquidated.

The Reserve Bank first publicly consulted on the possibility of a legislative framework for covered bonds in October last year. This consultation document incorporates the feedback from the prior consultation. 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 Australian Treasury, ratings agencies and key financial institutions in developing this framework.

The purpose of the consultation document is to seek feedback on a proposed solution. The consultation document sets out 15 questions on which feedback is sought, including whether there are any other key issues to address and whether the proposed solutions are appropriate. Industry feedback on technical issues will be taken into account before final recommendations are made on this proposal.

As the objective of the legislation is to provide legal certainty, rather than to impose new requirements, the proposal will not impose 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.

Felicity Barker, Adviser, Financial System Policy, Reserve Bank of New Zealand

## Status quo and problem definition

- Covered bonds are a form of debt instrument issued by banks. New Zealand banks have been issuing covered bonds since last year.
- In a covered bond issuance, the issuing bank provides a guarantee as to payment of the obligations under the covered bonds and also specifically tags certain assets, called the cover pool, to be held as collateral for payment of the obligations. 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 longer terms 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.
- Until April this year there were no legal restrictions on banks issuing covered bonds. In April this year the Reserve Bank imposed a condition of registration on locally incorporated banks restricting the level of covered bond issuance which these banks may undertake to 10% of total assets. This limit addresses the key risk of covered bonds, namely the subordination of the other creditors of the bank in relation to the cover pool assets. The issuance limit is not the subject of the current consultation.
- Internationally legislative frameworks for the issuance of covered bonds are common place and are often seen as a pre-requisite for investment by European investors. Hence, the lack of a New Zealand legislative framework may impede New Zealand issuers' access to the covered bond market.
- Furthermore, past consultation undertaken by the Reserve Bank indicated that there is a level of uncertainty as to how the statutory management provisions of the Reserve Bank Act 1989 and the Corporations (Investigation and Management) Act 1989 would be interpreted regarding assets in the cover pool should an issuing bank become insolvent and, additionally, that banks are incurring unnecessary costs in establishing structures to mitigate some of this uncertainty.
- 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.

## Objectives

- The objective 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.

## Regulatory impact analysis

- There are two key elements to providing certainty as to the legal status of cover pool assets;
  - Clear segregation of cover pool assets from the bank's other assets;
  - Making certain the treatment of cover pool assets under legislative provisions which would apply should an issuing bank be insolvent.
- In relation to the first point, it is proposed that covered bond issues be registered by the Reserve Bank and that cover pool assets must be held by a special purpose vehicle (SPV). These requirements would be set by amendment to the Reserve Bank Act 1989, as the Reserve Bank does not consider that it has the power to impose these requirements by way of condition of registration. These requirements would impose minimal additional costs on banks. This is because the SPV structure is standard industry practice and because, although the Reserve Bank may be able to impose a fee for registration of covered bonds, it is most likely that such a fee would not be imposed. If, however, the Reserve Bank did impose a fee, for example if there was a high value of transactions which put pressure on current funding, this is not likely to be a significant cost given the minimal requirements for registration. Previous consultation indicates that banks 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.
- Legal certainty as to the treatment of cover pool assets in the event of the insolvency of an issuing bank can only be provided through legislative amendment to the statutory management provisions of the Reserve Bank Act 1989 and the Corporations (Investigations and Management) Act 1989 and potentially sections 248 and 271 of the Companies Act 1993. Legislative change is needed because the source of the uncertainty arises from uncertainty as to the interpretation of these Acts as pertains to the cover pool assets. The Reserve Bank considers that these changes are minor in nature. As they are effectively clarifications of the law, the economic impact comes from the reduction in legal uncertainty. This is likely to have a modest positive impact on banks' ability to issue covered bonds.
- In addition it is proposed that banks be legally required to appoint a cover pool monitor to undertake monitoring of cover bond issues for the benefit of investors. Cover pool monitors are a normal feature of covered bond issues and hence this requirement does not impose significant additional costs. Making this a legal requirement provides additional certainty to investors as to the quality of covered bond programmes. Cover pool monitors are a common feature in other legislative framework.
- The Reserve Bank also considered whether it would be appropriate to set asset eligibility requirements for the cover pool legislatively, as has been done in Australia. The Reserve Bank considers that this is unnecessary as restrictions on the cover pool assets can be set contractually.

## Consultation

- The Reserve Bank undertook public consultation on the potential for a legislative framework for covered bonds in October 2010. The banking industry is strongly supportive of a legislative framework for the issuance of covered bonds, particularly as Australia has recently implemented such a framework.
- 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.
- The Reserve Bank consulted the Ministry of Economic Development, the New Zealand Treasury and the Australian Treasury in the preparation of this consultation document.

## Conclusions and recommendations

- The main elements of the proposed framework are:
  - A requirement that covered bonds be registered on a register maintained by the Reserve Bank;
  - A requirement that cover pool assets be held by a special purpose vehicle, which is a separate legal entity to the issuing bank;
  - A requirement that an asset pool monitor be appointed to undertake certain specified tests on the cover pool assets.
  - Amendments to the Reserve Bank Act 1989, The Corporations (Investigation and Management) Act 1989 and sections 248 and 271 of 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

- The proposal will be given effect through amendment to the Reserve Bank Act 1989, the Corporations (Investigation and Management) Act 1989 and the Companies Act 1993. It is intended that existing issues will be brought within the regime through transition rules.
- Any risks associated with the proposal should be brought to light through the consultation process. However, 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.
- As the objective of the legislation is to provide legal certainty, rather than to impose new requirements, the proposal will not impose 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 Reserve Bank will be able to assess compliance with the requirements through existing supervisory processes.

#### **Monitoring, evaluation and review**

- The policy will be reviewed consistent with the regulatory impact analysis requirements in section 162AB(1)(b) of the Reserve Bank 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 and contacts with covered bond investors and other regulatory agencies.