

AUSTRALIAN COVERED BONDS

by Student's name

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Australian Covered Bonds

The Australian government issued covered bonds through the Australia's prudential regulatory authority as covered bonds for the first time. The covered bonds were issued as a result of tenets of deposit holder protection enshrined in Australian banking legislation. In 2011, the banking industry and other financial services were authorized by the Australian government to issued covered bonds on certain conditions. The bonds have become very popular in the recent years, notably driven by low interest rates and, thereby, low risk.

According to Ferran (2012), in October 2011 the Banking Amendment Act 2011 (covered bonds) was endorsed by the Australian Government for the first time and the Australian authorized deposit-taking institutions (ADIs) were permitted to issue covered bonds. The covered bonds were to protect the depositor in various ways; APRA would issue the regulation on covered bonds (APRA, 2014). The banking amendment act 2011 makes a legislative cap that restricts ADI to issue covered bonds when cover pool assets value is more than 8% that of the ADI's asset. Moreover, finally, the government deposit guarantee still gives the security offered to depositors

Covered bonds are a risk adverse form of secured finance and used as an alternative to securitization. They facilitate cash securitization by providing investors with homogenous risks and assist intermediaries with funding (Liu, Lejot & Arner 2013). Covered bonds create a security interest for bondholders who get preferential rights on claims on the originating intermediary balance sheet of assets funded. There is collateral cover of these assets without claims transfer with regards to securitization. Covered bonds are issued by banks and other financial institutions that are asset-backed securities on the balance sheet. They give bondholders asset cover pool in case of failure of the issuer to make set payments on the bonds (RBA, 2012). The credit rating of covered bonds are high that those of the issues and

have a high-quality cover pools such as unsecured creditors rank below bondholders and prime mortgages.

The reason covered bonds have a low risk because they are issued at a spread of between 5 and ten years. Banks have also been able to reduce their risks of funding and diversify investor base. The bonds have been classified as AAA and have attracted investors funding with AAA mandate (Aylmer, 2013). Due to the demand by the European investors of covered bonds, banks have been driven to issue wholesale debts to different currencies. Banks have benefited from covered bonds by being able to increase issuance tenor of their outstanding debt. Low risk has also been to increase the issuance of bonds more to the domestic market which has surpassed issuers' projections (Debelle 2014). Uptake of covered bonds in the offshore markets has improved significantly due to the increase in demand.

A limit has been placed by the Australian government to the banks on the issue of covered bonds. This is because in case of stress in the global market, the reserves held by banks will help caution the stress in the financial markets. Investors risk extensions and prepayments have been minimized in the recent past as a result of bullet structures preference by investors and especially offshore investors (APRA, 2011). Most of these are played part by investors mandate to hold securities with finite maturities. For bullet structures to deal, certain arrangements have been put in place such as rollover features and liquidity underwriting (APRA, 2011). The issuers have also placed a limit such that bullet structures can be incorporated to the extent that they can be incorporated without a great amount of liquidity underwriting costs or a greater value of collateral.

The banking amendment act has issued a cap to ADIs on covered bonds to limit depositors' subordination on covered bonds. Covered bonds have a cover pool which must be limited by ADI in Australian for its assets to a maximum of 8% (APRA, 2012). Over securitization is also experienced in Australia banks have set near 120% of their cover pool

(APRA, 2012). These cover pool have enabled banks to offer funding of approximately 7% of its balance sheet (APRA, 2012). Credit rating of major banks in Australia stands at AAA greater than the AA and AA- credit rating of the issuer (RBA, 2012; APRA, 2011). The regulations set by the banking act states that ADI cannot issue covered bonds that exceed the limit of 8% ADI asset value (APRA, 2012). Any operation contrary to APRA regulation is deemed as a breach of legislation of those limits.

In conclusion, covered bonds were issued by banks in the Australian government to investors over a spread of 5 to 10 years. They are of low risk because they contain a cover pool of assets that cautions it against market fluctuations. Over the years, covered bonds issuance has improved in the global market (offshore) and the domestic market significantly. APRA places a limiting legislation in order to hedge reverses held in the case of an economic crisis. Australian covered bonds have been credit rated well above others with an AAA making them the best securities traded in the global market.

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