

Australian Prudential Regulation Authority

400 George Street (Level 26) T 02 9210 3100
 Sydney NSW 2000 F 02 9210 3102
 GPO Box 9836 W www.apra.gov.au
 Sydney NSW 2001



John F. Laker
 CHAIRMAN

COPY

25 January 2005

Mr David Addis
 Chair ASF Prudential Committee
 Head of Structured Product Organisation and Sales
 ANZ Investment Bank
 c/- GPO Box 3655
 SYDNEY NSW 2001

Mr Brian Salter
 Partner
 Clayton Utz
 c/- GPO Box 3655
 SYDNEY NSW 2001

Dear Messrs Addis and Salter,

Thank you for your submission of 15 November 2004 on covered bonds. This submission raises some important prudential issues, which the APRA Members have considered carefully. We have also looked closely at the approach of other countries and regulators.

APRA accepts that covered bonds may allow authorised deposit-taking institutions (ADIs) to generate a lower cost of funds than straight securitisation issues and to access a broader investor base. These benefits to issuers flow from the fact that covered bonds, in substance, subordinate the interests of depositors of ADIs to the interests of the bond holders.

Depositor preference is a fundamental tenet of the *Banking Act 1959* and of APRA's approach to prudential supervision. It represents a key element in the protection which Parliament has, for many years, clearly intended should be afforded depositors of ADIs in Australia. The submission acknowledges that, however the issues are structured, covered bond holders would have first priority over assets of an ADI, ahead of the ADI's depositors. We cannot see how such arrangements can be consistent with the principle underpinning Australia's depositor preference regime that depositors have the ability to claim on the assets of an ADI in Australia in preference to all other potential creditors.

In APRA's view, a weakening in the protection afforded to depositors of ADIs must outweigh any incremental benefits to issuers associated with lower cost funding or greater funding diversity. You would also appreciate that APRA cannot undermine the will of Parliament on depositor protection. Hence, we could not agree to any watering down of depositor preference on a selective basis (by limiting the ADIs that could issue covered bonds) or for arbitrary amounts (by limiting the volume of covered bonds that could be issued), as proposed in the submission.

Because of Australia's unique circumstances – an explicit depositor preference regime but no deposit insurance arrangements – the experience of other countries does not, in APRA's view, provide useful guidance. The submission cites European experience and, in particular, the approach of the Financial Services Authority (FSA) in the United Kingdom. We would note that the FSA does not administer any deposit preference provisions of the type set out in the *Banking Act 1959*. Nonetheless, the FSA has judged that covered bonds issues "...have the potential to pose additional risks to depositors" and its policy response, at this stage, is that these additional risks (for "material" issuance of covered bonds) would be reflected in its assessments of issuers' individual capital ratios.

In summary, APRA believes that the issuance of covered bonds would not be consistent with Australia's depositor preference regime and it is not, as a matter of principle, prepared to accept issuance of such bonds (or structures with equivalent effect) by ADIs in Australia. Because of the interest expressed by the industry, we will be writing to ADIs outlining these views.

As you know, the Government is reviewing the merits of introducing a limited explicit guarantee into parts of the Australian financial system. If this review were to lead to changes in Australia's depositor preference regime, APRA would, of course, be willing to revisit its approach to covered bonds.

Yours sincerely,



John F. Laker