Article

Singapore Covered Bond Market all set to take off

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Background

Following the footsteps of USA, UK, Australia, Canada, New Zealand and several others countries, Monetary Authority of Singapore (MAS) released a "Consultation paper on Covered Bond" on 9th March, 2012[1] to draft a suitable framework for strengthening Singapore's debt market. Public comments on consultation paper were open till 10th April, 2012. Post feedback, MAS redrafted the consultation paper. Accordingly all banks incorporated and licensed in Singapore to conduct banking business are permitted to issue covered bonds subject to such conditions under MAS Notice 648[2]. But due to certain loopholes in the regulatory framework, the bond market that would have by now made a lucrative deal of about S$25 failed to even attract a single issue. In order to combat the dearth of interest shown by the bankers in the issue of covered bonds *"MAS has put out a new consultation paper on covered bonds that aims to clear up several outstanding snags that have held back bank from issuing,"* as reported[3].Looking forward to the proposed amendments, analysts hope that the covered bonds will hit the market by the middle of this year.

Definition of Covered bonds as per Consultation paper on Proposed Amendments to MAS Notice 648 on Issuance of Covered Bonds by Banks incorporated in Singapore4 :

As per Clause 4 of the aforementioned Consultation paper "*Covered bonds" means any bonds, notes or other debentures issued by a bank or an SPV where payment of the liabilities to the holders of such covered bonds and any liabilities arising from the enforcement of the rights of the holders of the covered bonds are:*

(a) secured by a cover pool; and
(b) recoverable from the bank where whether or not the cover pool is insufficient to pay off such liabilities;

Structure of Covered Bonds:

Covered bond structures are either "legislative" or "structured":

Legislative Covered Bonds:

Under this structure, a special provision of legislation gives bankruptcy protection to the investors in terms of collateral attached to the bonds. This means that the aggregate assets of the originator (say, Bank) are grouped in such a way that the cover pool assets encumbered specifically for the benefit of the bondholders are separated from other asserts. This assures that

[1]http://www.mas.gov.sg/~/media/resource/publications/consult_papers/2012/9%20March%202012%20Covered%20Bonds%20Issuance%20by%20Banks%20Incorporated%20in%20Singapore.pdf

[2]http://www.mas.gov.sg/~/media/MAS/Regulations%20and%20Financial%20Stability/Regulations%20Guidance%20and%20Licensing/Commercial%20Banks/Regulations%20Guidance%20and%20Licensing/Notices/MAS%20Notice%20648%20on%20Covered%20Bonds_31%20Dec%2013.pdf

[3] http://www.coveredbondnews.com/Article/3428608/Singapore-needs-to-sort-out-its-covered-bond-confusion.html

[4]http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/29%20Jan%2015%20Consultation%20Paper_MAS%20648_Covered%20Bonds.pdf

the collateral underlying the issue of bonds will not be served to meet the creditor's obligations at the time of insolvency of the originator**.**

Structured Covered Bonds:

Several countries do not have any specific laws to supply bankruptcy protection. In these countries, cover assets are transferred to an affiliate entity (SPV) to insulate the bondholders from the originator's insolvent estate. Even the rules pertaining to Singapore covered bonds contemplate the use of structured covered bond structure.

Singapore Covered Bond Rules – Regulatory Overview:

On 31st December, 2013 MAS issued MAS notice 648 Issuance of Covered Bonds by banks incorporated in Singapore. Additionally, it also published the responses[5] to feedback on consultation paper in respect of the draft-version of the Covered bonds rules and also the proposed amendments to the rules. Recently, MAS released a new consultation paper in January 2015 which attempts to settle down all the anomalies in the previous drafted versions of consultation paper.

The key features of the Consultation paper, both December, 2013 version and the proposed version of amendments in January, 2015 that will now clear all hurdles blocking the issue of covered bonds in Singapore are discussed in detail below.

Salient features of Covered Bond rules in Singapore, December 2013:

- Cover assets allowed to form part of cover pool shall comprise of mortgage loans secured by residential property (whether in Singapore or elsewhere); other loans secured by the same residential property; assets forming part of all security provided for residential mortgage loans (including guarantees and indemnities); derivatives held for the purpose of hedging risks from the issuance of covered bonds; cash; Singapore Government Securities; and MAS Bills.

- The aggregate value of cover assets included in cover pool shall not exceed 4% of the value of the total assets of the bank (including assets of branches but not assets of the subsidiaries of the bank). Further, the aggregate percentage of cash; Singapore Government Securities; and MAS Bills shall not exceed 15% of the total cover assets in the cover pool.

- Capital Adequacy requirements shall be maintained in accordance with MAS Notice 637 on Risk Based Capital Adequacy Requirements for Banks Incorporated in Singapore ("MAS Notice 637"). In the case where the bank uses an SPV to issue covered bonds or where the cover pool is held by an SPV, the bank shall apply a "look through" approach,

[5]http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Response%20to%20Feedback%20Received%20on%20Consultation%20on%20Covered%20Bonds_31%20Dec%2013.pdf

wherein the bank and the SPV shall be treated as a single entity for the purpose of risk based capital adequacy requirements.

- Minimum Loan-to-Value ratio to be maintained at 80% (as determined by the current market valuation of the residential property that is used to secure the residential mortgage loan as referred above) shall be applicable to residential mortgage loan.
- The originator (say Bank or SPV) must ensure that the value of assets in a cover pool shall be at least 103% of the face value of the covered bonds secured by the assets at all times.

2. Risk Management Requirements:

Banks need to adhere to the following conditions to manage the risks arising from the issuance of covered bonds:

- The Bank or SPV shall make appropriate governance arrangements to regularly perform performing asset coverage tests to ensure collateral quality and the proper level of over-collateralization, and conducting regular stress tests on risks arising from issuing covered bonds such as default, pre-payment, currency, interest rate, counterparty and liquidity risks.
- Apart from the above, Bank or SPV also needs to appoint a cover pool monitor (say, an external third party) for the verification, assessment and reporting on the adequate adherence to the rules established by MAS. Cover pool monitor will also be required to submit an annual report to the MAS and inform on the breaches of any of the conditions laid down by the Authority.

3. Notification Requirements:

One month prior information shall be submitted to the MAS by the banks issuing the covered bonds. In addition, the bank shall notify the MAS in writing, at least three business days prior to the issuance of any covered bonds under the covered bond programme submitted to the Authority.

What shelved the issue of Covered bonds?

The bankers were not able to digest the regulatory framework notified by MAS majorly due to lack of certainty as to whether banks will be able to hold the assets on their balance sheets. There are certain structural issues unique to the Singapore Covered Bond rules and the associated banking regulations. Singaporean banks do not have first claim to most of the mortgages they lend out. It is the Central Pension Fund (CPF) that has the first access over the mortgaged assets. This creates friction in the structuring of a typical covered bond in Singapore.

Role of CPF in the Covered bond Market:

In Singapore, CPF is a compulsory savings scheme to assist the Singapore citizens to enjoy the basic amenities including housing in the old age. Under this plan, the amount so invested is kept separately in the trust and the members are allowed to make use of these investments in future that includes repayment of mortgaged loans. If the homeowner chooses this route, CPF will have a priority claim on homes financed. This complicates the proposed Covered bond structure in Singapore, where the cover pool includes cover assets which are mortgages funded by the CPF.

Though this scheme gives relief to the home owners, it annoys the banks as the entire concept behind issuing covered bonds gets hindered in terms of priority claim over the assets in the cover pool. Since the banks do not occupy first concern to mortgages funded by CPF, bondholders will be subordinated to the CPF in case of default by the issuer. This dismisses the purpose of buying a covered bond in Singapore at the first instance.

The aforesaid structure needs to be addressed by MAS by requesting the CPF to subordinate its claim over the cover assets. In addition to this, obtaining CPF's graphic approval for transferring the underlying mortgaged assets in the cover pool. This will ensure full recourse to the cover assets in the cover pool.

Proposed Amendments to Covered Bond rules in Singapore, January, 2015:

Though the notice currently does not prescribe the structure that banks have to adopt when issuing covered bonds, it will ensure greater flexibility to the covered bond structure. MAS brings transparency in the updated rules related to segregation of assets, cap on cash and cash equivalent and Loan-to- Value (LTV) limit of Residential Mortgage loans. Covered bonds issuing banks will be allowed to hold assets on balance sheet under a declaration of trust. New rules on segregation of assets ensure that in case of defaulting loan recoveries, the covered bond holders will get a first charge over the mortgage proceeds.

"*The MAS proposal to amend the rules regarding the 15% limit on liquid assets by allowing cash and equivalents up to 12 months of payment obligations in a covered bond programme, if enacted, will better enable programmes to manage liquidity levels where maturing covered bonds come due. This would also be the case where there is a time lag for when mortgage assets can be substituted into the cover pool.*" as reported by Fitch Ratings[6].

Also, the rules governing the LTV specify that the limit of 80% will apply at the time of inclusion of the loans in the cover pool. Subsequently, residential mortgage loans with LTV in excess of 80% may be retained in the cover pool subject to certain conditions.

Following the recent developments and proposed amendments in Singaporean covered bond market and rules, analysts expect to the see the first issue of covered bonds by the middle of the 2015.

[6] https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Singapore-One-Step?pr_id=979138