Australia and New Zealand Banking Group Limited

Mortgage Covered Bonds

Full Rating Report

Ratings/Outlook

Mortgage covered bonds	AAA/Stable

Rating Rationale

Bank IDR/Outlook	AA-/Stable
IDR uplift	0 notches
Payment Continuity Uplift (PCU)	3 notches
Tested Rating on a PD basis	AA+
Recovery uplift	1 notch
Covered bonds rating	AAA
AP Fitch considers in analysis (%)	90.5
AAA breakeven AP (%)	91.0

Key Data

Key Data	31 Oct 17
Asset type	Residential mortgages
Maturity profile of bonds	Hard/soft bullet
Cover assets (AUDbn)	19.5
Covered bonds (AUDbn)	13.9
Nominal AP (%)	71.5
WAL of assets (years)	15.6
WAL of liabilities (years)[a]	4.8

[a] As of December 2017

PCU Reduction

Asset segregation	No
Alternative manager	No

Rating Constraint

None

Related Research

Australia and New Zealand Banking Group Limited (March 2017)
APAC Covered Bonds Quarterly – 3Q17 (November 2017)
Covered Bonds Surveillance Snapshot - Amended (October 2017)
'B' Portfolio Loss Rates for Covered Bonds (September 2017)

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Key Rating Drivers

One-Notch Downgrade Buffer: The 'AAA' covered bond rating is based on Australia and New Zealand Banking Group Limited's (ANZ) Long-Term Issuer Default Rating (IDR) of 'AA-', an IDR uplift of zero notches, a payment continuity uplift (PCU) of three notches, a recovery uplift of one notch and an asset percentage (AP) of 90.5% used in the programme's asset coverage test, which Fitch relies upon in its analysis, and provides a small buffer compared with the agency's breakeven AP of 91%.

The Stable Outlook reflects the one-notch buffer against a downgrade of ANZ's IDR.

Lower than Standard PCU: Fitch's three-notch PCU is driven by the limited cure period of up to six months under the 12-month pre-maturity test for the outstanding hard-bullet bonds (13.7% of total), which we consider weaker than the 12-month extension period on the soft bullet bonds (86.3% of total). The PCU also reflects the interest-protection provisions in the form of a reserve covering interest payments and senior expenses on a rolling three-months.

Zero IDR Uplift: The IDR uplift remains at zero notches. Australia does not have a specific advanced resolution regime, but the regulator can resolve a bank under its regulatory powers pursuant to the Banking Act. Even so, the covered bonds are not explicitly exempt from bail-in should a bank be resolved, giving rise to the risk of enforcement of the cover pool. Therefore, ANZ's Long-Term IDR remains the floor for its covered bond rating.

Recovery Uplift Capped: The recovery uplift is capped at one notch, as Fitch believes that foreign-exchange (FX) risk could have a material impact on recoveries should the covered bonds default. This is because assets are denominated in Australian dollars while 95.0% of covered bonds outstanding are denominated in other currencies. While there are liability swaps in place, we expect these to terminate upon a bond default, such that longer-dated Australian dollar asset cash flows would provide recoveries in a different currency than most of the bonds.

Asset Disposal Drives AP: The 'AAA' breakeven AP of 91% equates to a breakeven OC of 9.9%. The 12.7% asset disposal loss is the main contributor to this OC and reflects considerable maturity mismatches with a weighted average (WA) asset residual life of 15.6 years compared to 4.8 years for the bonds (as of December 2017) and a potential need to sell assets to make timely payments. As Fitch models excess spread for the programme, the cash flow component reduces the breakeven AP by 6.1%. The credit loss component is 3.6%.

Programme Highlights

Stable Credit Quality: The cover pool comprises 100% prime Australian residential mortgages (AUD19.5 billion at 31 October 2017). The WA loan/value ratio (LVR) was 65.2% (Fitch-calculated indexed WA LVR of 61.1%). Fitch's 'AAA' cumulative WA frequency of foreclosure (WAFF) for the pool is 9.6%, and WA recovery rate (WARR) is 57.0%.

Interest/FX Risks Hedged: ANZ acts as swap counterparty for both the asset and liability swap. The cover assets yield both fixed and floating rates, and a swap is in place to transform interest collections from the cover assets into a one-month bank bill swap reference rate, plus a spread. The bonds have been issued in euros (71.6%), US dollars (11.4%), UK pounds (7.3%), Australian dollars (5.0%), Swiss francs (2.4%) and Norwegian kroner (2.3%).

Selected Peers for Comparison

Issuer/ programme	IDR/ Outlook	CVB Rating
Commonwealth Bank of Australia	AA-/ Stable	AAA/ Stable
National Australia Bank Limited	AA-/ Stable	AAA/ Stable
Westpac Banking Corporation	AA-/ Stable	AAA/ Stable

Source: Fitch

Peer Comparison

The table below compares the key rating drivers for ANZ with those of three other regulated Australian covered bonds issued by banks rated in the 'AA-' category. The selected peers are listed in the table in the left margin.

ANZ has the lowest PCU compared with peers, driven by the limited cure period of up to six months under the 12 month pre-maturity test for the outstanding hard-bullet bonds, which the agency considers weaker than the 12-month extension period on soft bullet bonds. ANZ's cover pool credit quality is in line with, if not, superior to the peer average, as shown by the 'B' portfolio loss rate of 0.3%. The asset disposal loss component is slightly higher than that of peers due to the presence of hard bullet bonds in ANZ's programme, for which Fitch does not model the extension period, thus increasing the need to sell assets. This also explains why the breakeven AP is slightly lower than the peer average despite the cover pool credit risk being in line with peers'. Please see the *Covered Bond Surveillance Snapshot (October 2017)* and related *excel file*, for a detailed comparison of rating drivers across Fitch-rated covered bond programmes.

Peer Comparison: Key Rating Drivers

	ANZ	Selected peer average	Selected peer range
IDR/Outlook	AA-/Stable	AA-/Stable	AA-/Stable
IDR uplift	0	0	0
PCU	3.0	6.0	6.0
'B' portfolio loss rate (%)	0.3	0.4	0.2 - 0.6
'AAA' breakeven AP (%)	91.0	92.5	91.5 – 94.0
Breakeven OC components (%)			
Credit loss (%)	3.6	3.4	3.1 – 3.9
Cash flow valuation (%)	-6.1	-6.3	(7.9) – (4.9)
Asset disposal loss (%)	12.7	11.0	9.3 – 13.2

Source: Fitch; data as at 1 December 2017

Country Risk Impact

This section does not apply as the programme is not affected by country risk. This is because its 'AAA' rating is in line with Australia's Country Ceiling and is the maximum rating achievable. Please see *Structured Finance and Covered Bonds Country Risk Rating Criteria*.

Sensitivity Analysis

The covered bonds would be vulnerable to a downgrade if the relied upon AP rises above the 'AAA' breakeven AP of 91%, or if the bank's Long-Term IDR falls two or more notches to 'A' or below.

Fitch does not give credit to excess OC in the programme, as under Australia's covered bond legislation cover assets not required to repay the covered bonds are not available to preferred creditors upon the insolvency of the issuer. Therefore, Fitch relies on the AP published monthly within the asset coverage test (ACT) which, standing at 90.5%, provides a small buffer relative to the agency's breakeven AP. Nevertheless, there is a substantial cushion relative to the nominal AP of 71.5% based on the cover pool and covered bonds outstanding as of 31 October 2017.

The rating on the covered bonds would fall to 'AA', one notch above ANZ's IDR, if the nominal AP in the programme rises to the maximum 95% contractual AP stipulated in the programme documents.

Related Criteria

Covered Bonds Rating Criteria (December 2017)

APAC Residential Mortgage Rating Criteria (July 2017)

Global Bank Rating Criteria (November 2016)

Structure Finance and Covered Bonds Counterparty Rating Criteria (May 2017)

Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum (May 2017)

Fitch's Cover Asset Refinancing Spread Level (RSL) Assumptions - Excel File (October 2017)

Abbreviations

AP: Asset percentage
PCU: Payment Continuity Uplift
IDR: Issuer Default Rating
OC: Overcollateralisation
PD: Probability of default
WAL: Weighted average life
WAFF: Weighted average frequency of foreclosure
WARR: Weighted average recovery rate

The Issuer

ANZ was the second-largest banking group by total assets of Australia's four major banks at the end of the financial year to September 2017, and has significant banking operations in Australia, New Zealand and the Asia-Pacific region. The bank provides a broad range of banking and financial products and services to retail, small business, corporate and institutional clients. At September 2017, ANZ had total assets of AUD897.3 billion and its share of the Australian mortgage market was approximately 15.7% as of end-September 2017. ANZ primarily originates mortgages through its extensive domestic branch network, broker distribution channel and mobile distribution network. The bank maintains approximately 680 branches throughout Australia (as of September 2017).

Fitch's most recent reports on ANZ's bank ratings are a *Full Rating Report* (March 2017), *Credit Update* (March 2017) and *Ratings Navigator* (March 2017).

IDR Uplift: Zero Notches

Fitch understands the option to resolve authorised deposit-taking institutions is possible as part of the Australian Prudential Regulation Authority's (APRA) supervisory powers under Australia's Banking Act. However, Fitch believes the framework does not contemplate the power to bail-in creditors and covered bonds are not explicitly exempt from this, giving rise to the risk of the direct enforcement of recourse against the cover pool for the payment of the outstanding covered bonds. An IDR uplift of zero notches is therefore applicable for all Australian covered bond programmes rated by Fitch.

PCU: 3 Notches

The PCU of 3 notches reflects the strength of the liquidity protection under the 12-month pre-maturity test, which includes a cure period of six months on the outstanding hard-bullet bonds. Due to the bonds' cure period, which could allow for only up to six remaining months in which the covered bond guarantor must sell assets to fund maturing hard-bullet covered bonds, the liquidity provisions surrounding the hard bullet bonds are considered relatively weaker by the agency, compared to the 12-month extension period on the outstanding soft-bullet bonds. The PCU also reflects the interest protection provisions in the form of a reserve that will cover three months of interest payments and senior expenses.

The hard-bullet bonds outstanding, in Fitch's view, remain the main driver of cross-default risk in the programme. They make up 13.7% of the programme's outstanding liabilities, and are considered material by the agency given that a substantial proportion (11.3%) does not mature until 2022. The risk of cross default of the remaining hard-bullet bonds will change over time, as ANZ is expected to issue more soft-bullet bonds from the programme. While there remain two types of issuance from the programme, Fitch looks to the weaker protection as the basis of the PCU uplift.

None of the other factors influencing payment continuity analysed by Fitch (see Appendix 2) represents a high risk, which in Fitch's view would be otherwise reflected in a PCU reduction.

Default Model Output (%)

Rating level	WAFF	WARR	WA MVD	Loss rate
AAA	9.6	57.0	56.8	53.0
AA+	8.8	60.9	54.0	49.1
AA	8.0	64.8	51.1	45.2

MVD: Market Value Decline
Loss rate = WAFF * (1-WARR)
Source: Fitch

Recovery Uplift: One-Notch

The recovery uplift on the rating is capped at one notch, as Fitch believes that foreign-exchange risk could have a material impact on recoveries given a default of the covered bonds. This is because the cover assets are denominated in Australian dollars whilst 95.0% of the covered bonds outstanding are denominated in other currencies. In a default scenario, Fitch expects that the covered bond swap will be terminated so that the longer-dated asset cash flows would provide recoveries in a different currency than most of the covered bonds, which could lower recovery expectations.

Cover Pool

Cover pool data were available on a loan-by-loan basis as of the end of October 2017.

ANZ's Cover Pool

Characteristics as of 31 October 2017

General		Geographical breakdown (%)	
Current principal balance (AUDbn)	19.5	New South Wales	29.2
Number of loans	71,698	Victoria	29.0
Number of borrowers	60,302	Queensland	17.7
Average loan per borrower (AUD)	323,377	Western Australia	13.2
WA seasoning (months)	37.2	South Australia	6.4
WA interest rate (%)	4.5	Tasmania	2.0
WA remaining term to maturity (years)	25.9	Australian Capital Territory	1.6
WA current LVR (%)	65.2	Northern Territory	0.9
Fitch WA indexed current LVR (%)	61.1		
Maximum loan balance (AUD)	2,000,000		
Interest only (%)	22.7		
Investment loans[a]	35.4		
		Substitute assets	
		Cash in GIC account (AUDm)	0.0
Loan arrears (%)			
>30 days and <= 60 days	0.3	**Loan type (%)**	
>60 days and <=90 days	0.1	Fixed	14.2
>90 days	0.0	Variable	85.8

[a] Fitch-calculated, see Cover Pool Credit Analysis section below
Source: ANZ/Fitch

Cover Pool Credit Analysis

Fitch analysed the collateral portfolio using its applicable mortgage loss criteria for Australia in its *APAC Residential Mortgage Criteria*. ANZ's quality of origination, servicing procedures and staff qualifications are in line with other Australian prime lenders and Fitch's expectations. The composition and credit quality of the cover pool may change over time because of the dynamic nature of the programme.

The cover pool's credit risk has remained stable over the past 12 months. It comprised 71,698 loans to 60,302 borrowers, with an aggregate outstanding amount of AUD19.5 billion as of end October 2017. All loans are secured by a first-ranking mortgage. The WA current loan-to-value ratio (LVR) was 65.2% and the WA seasoning of the mortgage loans was 37.2 months. Interest-only loans formed 22.7%. As well as taking into account occupancy type and loan product type, Fitch also considers all loans collateralised by multiple properties as investment loans, which comprise 35.4% of the loan portfolio under this methodology. The cover pool was geographically diversified across Australia, with the largest concentrations in New South Wales (29.2%) and Victoria (29.0%), followed by Queensland (17.7%) by balance (see Cover Pool table above). The cover pool composition is in line with the eligibility criteria described in Appendix 4, and Fitch views the cover pool to be of high quality.

ANZ has provided Fitch with a comprehensive set of loan-by-loan data, which includes the majority of data fields used in the agency's analysis of Australian residential mortgages.

Further advances to borrowers are permitted as long as the loans satisfy the programme's eligibility criteria. As such, the agency adjusts the PD across the cover pool by 5%.

According to Fitch's methodology, the two key components of the default probability on the residential loans are the willingness and ability of a borrower to make payments on the loan. Willingness to pay is usually measured by the current LVR: higher default probability is assigned to high LVR loans. The ability to pay is measured by the ratio of the borrower's income to the mortgage payments: the debt/income ratio. ANZ does not supply Fitch with income information to assess ability to repay. Therefore, Fitch makes a conservative assumption based on the originator's underwriting standards and market information. In this case, the agency increased the PD on the loans by 20%, corresponding to a Fitch debt burden-to-borrower income class of 5 (35% to 40%).

Fitch further adjusts the default probabilities to account for borrower- and asset-specific characteristics. The recovery rates are mainly driven by market value decline (MVD) assumptions.

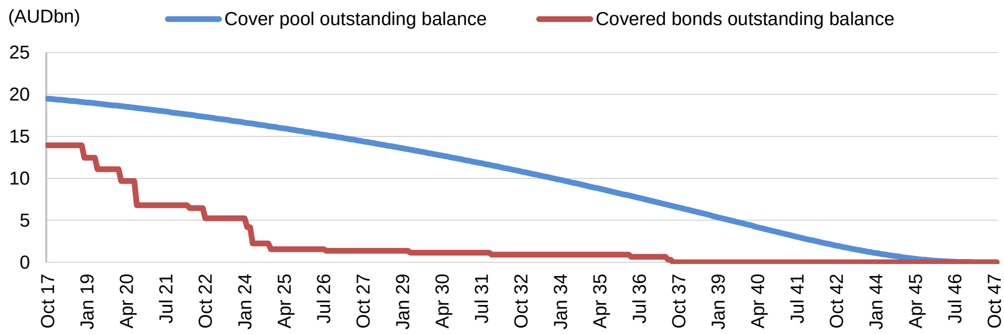
Fitch derived a stressed cumulative default rate and recovery rate for the cover pool based on the loan-by-loan analysis of the cover assets, and taking into account the features of the mortgages. In a 'AAA' rating scenario, the WA foreclosure frequency (WAFF) equated to 9.6% and the WA recovery rate (WARR) 57.0%, which is equivalent to an expected loss rate of 4.1% (see *Default Model Output* table).

Cash Flow Analysis

Fitch's cash flow model simulates the asset cash flows to reflect prepayment, servicing costs, delinquencies, defaults and recoveries in multiple stress scenarios under various issuer default timings. The model tests whether the cover pool can service principal and interest payments on the covered bonds in a timely manner, while hypothesising a switch to the cover pool as a source of payment at different dates. Based on Fitch's analysis, an AP of 91% is sufficient to withstand the agency's 'AA+' tested rating on a PD basis under the covered bonds cash flow model.

The graph below shows the amortisation profile of the assets assuming no prepayments and the amortisation of the outstanding covered bonds.

Amortisation Schedule



Source: Fitch/ANZ

Maturity Mismatches

The cover assets are amortising, with an average remaining maturity of 15.6 years, while the covered bonds have an average residual maturity of 4.8 years (as of December 2017). As a result, temporary liquidity surpluses or shortfalls may arise, putting a strain on available resources. Fitch models any cash not needed to repay liabilities as being reinvested with a new deposit account provider, at an assumed rate of 50bp below the one-month bank bill reference rate (BBSW).

The agency assumes that if there is a liquidity shortfall, an alternative manager would be able to sell part of the mortgage portfolio within the timeframe provided by the maturity extension on the soft-bullet covered bonds. The ability to find a buyer will depend on a number of factors, including buyer appetite in light of the economic environment, and the proportion of the portfolio required to be liquidated.

Under the documents, the amount of assets that can be sold for any one bond is contractually restricted to a pro rata proportion of that bond against the total covered bond liabilities outstanding. This restriction ensures that earlier-maturing covered bonds cannot use cover pool assets over and above their pro rata allocation to the detriment of later-maturing ones (see Appendix 1, Section 1.3). Fitch replicated this feature in its cash flow modelling of the programme.

Refinancing Costs

To determine the stressed price at which such asset sales would occur, Fitch has assumed a refinancing cost (shown below) for any potential buyer. However, in light of the lack of a precedent in Australia, there is no guarantee that a portfolio can be realised in any prevailing economic environment.

Refinancing Spread Levels

(bp)	AAA	AA	A	BBB	BB	B
Australia mortgage loans	250	218	189	165	144	125

Source: Fitch

Hedging

The covered bond guarantor (CBG) has entered into an interest rate swap agreement with ANZ to swap the interest paid on the loans into BBSW plus a margin every month. The CBG has also entered into a covered bond swap for each series of covered bonds, with ANZ, to hedge currency-exchange risk between the Australian dollar flows received from the interest rate swap and those due on the foreign-currency-denominated covered bonds. The covered bond swaps in place are forward-starting swaps; this means there will be no exchange of cash flows under the covered bond swaps as long as ANZ acts as swap counterparty, and as long as no issuer event of default has occurred. No foreign exchange stresses are applied as the programme is hedged.

Summary of Hedging in Programme

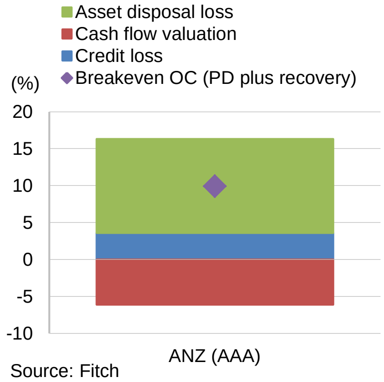
Swap type	Currency	(%)	Swap provider	Rating
Fixed-floating (assets)	No	100.0	ANZ	AA-/Stable/F1+
Fixed-floating (liability)	Yes	100.0	ANZ	AA-/Stable/F1+

Source: Fitch/ANZ

The cover assets, which are a mix of fixed- and variable-rate mortgages, are hedged with a total return swap (TRS) provided by ANZ. Fitch models the lower of the swap margin for the fixed-rate mortgage loans and 2%, which is the maximum swap margin given credit for in the modelling of the programme. For the variable-rate products, we assume a stressed-asset margin of 2% as we do not expect the TRS to be replaced for the variable-rate products.

Fitch models all liabilities with floating rates in Australian dollars as this is their post-swap status and all swap documentation entered into provide mitigants to counterparty risk, including the swap counterparty having to post collateral for its obligations should it be downgraded below certain rating levels, or novation of the swap counterparty. This is in line with Fitch's criteria.

Breakeven OC Components



Source: Fitch

Breakeven AP for the Rating

Fitch calculated a 'AAA' breakeven AP of 91%, which equates to an OC of 9.9%. The 'AAA' breakeven AP relates to a 'AA+' tested rating on a PD basis and one-notch recovery uplift to the 'AAA' covered-bond rating. The breakeven AP is dependent on multiple factors that could be affected by significant movements in the WA interest rate on the bonds or a change to the WA remaining term. Fitch will regularly reassess the breakeven AP in line with the covered bond ratings and upon new issuances or cover pool changes.

The equivalent 'AAA' breakeven OC of 9.9% is mainly driven by the asset disposal loss component (12.7%) due to the significant maturity mismatches between the cover assets and the covered bonds. The credit loss component contributes 3.6%, and the cash flow valuation component decreases the breakeven OC by 6.1%, due to the available excess spread modelled by Fitch in the programme based on a stressed WA life of the assets (8.0 years inclusive of prepayments) versus the stressed WA life of the liabilities (4.5 years), post an assumed switch to the cover pool as simulated by Fitch in its cashflow analysis.

The breakeven AP for the rating will be affected, among other things, by the cover pool's credit quality and the profile of the cover assets relative to the outstanding covered bonds. These factors can change over time.

AP Fitch Relies On

Fitch does not give credit to excess OC in the programme, as under Australia's covered bond legislation cover assets not required to repay the covered bonds are not available to preferred creditors upon the insolvency of the issuer. Therefore, Fitch relies on the AP published monthly within the asset coverage test (ACT) which, standing at 90.5%, provides a small buffer relative to the agency's breakeven AP. Nevertheless, there is a substantial cushion relative to the nominal AP of 71.5% based on the cover pool and covered bonds outstanding as of 31 October 2017.

Programme Review

Fitch will periodically review the credit quality of the cover pool and perform a cash flow analysis to assess whether the AP taken into account by the agency provides protection against identified risks commensurate with the rating of the covered bonds issued by ANZ under this programme. Cover pool and covered bonds information is updated on a quarterly basis and displayed on Fitch's covered bond surveillance tool (available at www.fitchratings.com) and in the quarterly *Covered Bonds Surveillance Snapshot*.

Disclaimer

References in this report to the content and impact of relevant legislation and/or regulation represent Fitch's interpretation. Fitch relies on legal opinions or memoranda provided by issuers' and/or other outside legal counsel. As Fitch has always made clear, Fitch does not provide legal advice or confirm that a country's legal or regulatory framework, the legal opinions or memoranda, or any other programme documents or any structures are sufficient for any purpose. The disclaimer at the foot of this report makes it clear that this report does not constitute legal, tax and/or structuring advice from Fitch, and should not be used or interpreted as legal, tax and/or structuring advice from Fitch. Should readers of this report need legal, tax and/or structuring advice, they are urged to contact relevant advisers in the relevant jurisdictions.

Appendix 1: Programme Summary

ANZ can issue up to USD30 billion of covered bonds under this programme. The bonds are guaranteed by the covered bond guarantor and secured by a dynamic pool of Australian residential mortgages. The covered bonds rank pari passu among themselves and are direct, unconditional, unsecured, and unsubordinated obligations of the issuer. The covered bondholders benefit from their dual recourse against the guarantor secured by the cover assets and an unsecured, unsubordinated recourse against ANZ. The covered bond guarantor will borrow funds from ANZ through an intercompany loan that is split into two components – the guarantee loan and the demand loan. It will use these funds to purchase residential mortgages, on an equitable assignment basis, or substitute assets from ANZ. The covered bond guarantor has been established solely to provide an unconditional and irrevocable guarantee whereby it will pay, under certain circumstances, interest and principal on the covered bonds when they become due.

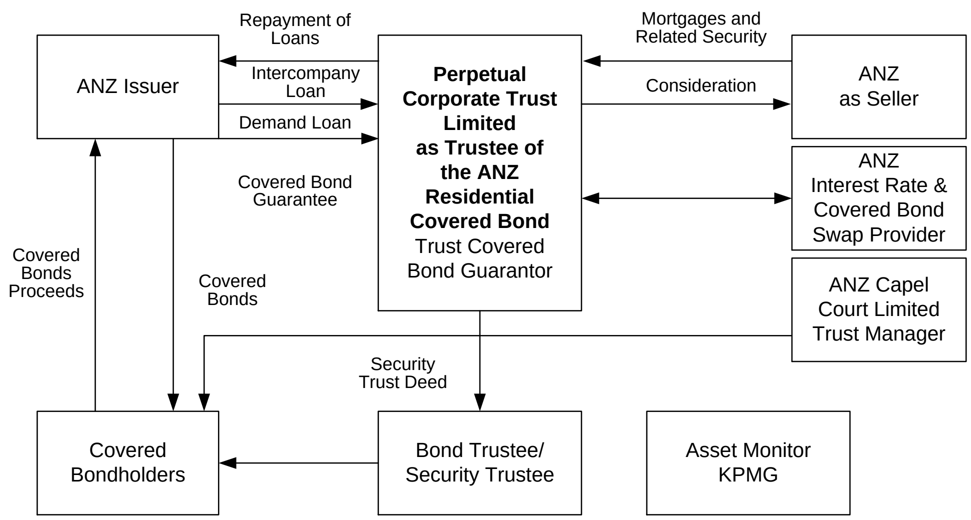
1.1 Main Parties

Role	Counterparties	Long-/Short – Term Ratings	Comments
Issuer **Seller/originator** **Servicer** **Intercompany loan provider** **Demand loan provider** **Interest rate swap provider** **Covered bond swap provider** **Account bank**	Australia and New Zealand Banking Group Limited	AA-/Stable/F1+	
Covered bond guarantor	Perpetual Corporate Trust Limited	Not Rated	
Trust manager	ANZ Capel Court Limited	Not Rated	
Bond trustee	DB Trustees (Hong Kong) Limited	Not Rated	
Security trustee	P.T. Limited	Not Rated	
Principal paying agent	Deutsche Bank AG, Hong Kong Branch	Not Rated	
Asset monitor	KPMG	Not Rated	

Source: Fitch, Programme documents

1.2 Structure Diagram

Structure Diagram



Source: Programme documents

1.3 Australia and New Zealand Banking Group Limited Mortgage Covered Bonds: Summary of Structural Features

Structural feature	Explanation
Covered Bond Guarantee (CBG)	Provides credit support to the issuer.
Pre-maturity Test	Provides liquidity to the covered bond guarantor in relation to amounts of principal due on the final maturity date of the hard bullet covered bonds.
Asset coverage test	The ACT is designed to ensure a minimum level of OC on the covered bonds, to protect bondholders against specific credit and market risks. It is calculated monthly, both before and after an issuer event of default, so long as bonds are outstanding under the programme. If breached, failure to satisfy the ACT on or before the immediately succeeding monthly calculation date after the breach will constitute an issuer event of default. The ratio between covered bonds and cover assets may not exceed 95% (the maximum AP) at any time.
Amortisation test	After an issuer event of default, an amortisation test verifies whether the value of the cover pool, including any cash held in the GIC account and any substitute assets, adjusted to account for delinquencies and collateral value, is higher than the notional amount of the outstanding covered bonds. Failure to pass the amortisation test will trigger a covered bond guarantor event of default, which allows the bond trustee to serve a guarantor acceleration notice. The covered bond guarantor will be obliged to sell the loans and the proceeds will be used to repay, pro rata, the outstanding covered bonds. The amortisation test mitigates time subordination of covered bonds within the programme.
Reserve fund	Established in the GIC account to trap available revenue receipts or to credit the remaining proceeds of a term advance if ANZ's short term credit rating falls below 'F1+'. The reserve fund amount will cover interest payments and senior expenses on a rolling three-month basis.
Selected asset required amount (SARA)	The amount of assets that can be sold for any one bond is contractually restricted to that bond's pro rata proportion of the committed amount of OC. This restriction is so that earlier-maturing covered bonds cannot use cover pool assets over and above their pro-rata allocation, to the detriment of later-maturing ones.
Soft bullet extension	If the issuer fails to pay the final redemption amount of the relevant series of covered bonds on the maturity date (subject to applicable grace periods), then payment of the unpaid amount pursuant to the covered bond guarantee that cannot be paid by the CBG on the final bond maturity date shall be automatically deferred (12 months after bond maturity date). Any amount representing the final redemption amount due and remaining amount unpaid on the extension determination date may be paid by the CBG on any interest payment date thereafter, up to the relevant extended due for payment date.

Source: Program documents

1.4 List of Outstanding Mortgage Covered Bonds

Series	Rating	Currency	Size(m)	Type	Coupon rate (%)	Payment frequency	Maturity	ISIN
2012-1	AAA	NOK	2000	Hard	5.00	Annual	Jan 22	XS0730566329
2012-2	AAA	EUR	1000	Hard	3.63	Annual	Jul 22	XS0731129234
2012-3	AAA	CHF	325	Hard	1.50	Annual	Feb 19	CH0143838032
2013-2	AAA	EUR	1000	Soft	1.13	Annual	May 20	XS0928456218
2013-3	AAA	EUR	150	Soft	2.77	Annual	Jan 29	XS0953107025
2013-4	AAA	AUD	700	Soft	5.00	Semi annual	Aug 23	AU3CB0212322
2013-5	AAA	EUR	1000	Soft	1.38	Annual	Sep 18	XS0968449057
2014-1	AAA	EUR	1250	Soft	2.50	Annual	Jan 24	XS1014018045
2014-2	AAA	EUR	130	Soft	2.13	Annual	Apr 26	-
2014-3	AAA	EUR	1000	Soft	0.38	Annual	Nov 19	XS1139088071
2015-1	AAA	USD	1250	Soft	2.05	Semi-annual	May 20	US05252EAD58
2015-2	AAA	EUR	151.5	Soft	1.47	Annual	Aug 31	XS1280773679
2016-1	AAA	EUR	180	Soft	1.72	Annual	Jan 36	XS1346839373
2016-2	AAA	GBP	500	Soft	3m GBPL + 50	Quarterly	Feb 19	XS1362381672
2016-3	AAA	EUR	750	Soft	0.45	Annual	Nov 23	X1523136247
2017-1	AAA	EUR	230	Soft	1.44	Annual	Mar 37	XS1576701665
2017-2	AAA	EUR	205	Soft	1.52	Annual	May 37	XS1611856805

Source: ANZ

Appendix 2: Other Payment Continuity Risk Considerations

Asset Segregation

Fitch expects that ring-fencing of the cover pool will be effective given the ‘all or nothing’ nature of this risk. The ring-fencing of cover assets from any claims from unsecured creditors of the defaulted financial institution is achieved by virtue of law – often in the form of an exemption to normal bankruptcy legislation, or through a transfer of the assets to a bankruptcy-remote special-purpose vehicle (SPV) acting as a guarantor of the issued covered bonds.

Asset Segregation: No Impact on PCU

Component driver	Fitch assessment
Segregation of cover pool from other creditors of issuer	Special-purpose vehicle (SPV) model used – contractually achieves asset segregation from the issuer’s insolvency estate through the “true sale” of the mortgage assets to the SPV, by way of equitable assignment to the covered bond guarantor. Upon title perfection, full legal title is transferred to the covered bond guarantor. The cover assets will be unavailable to any other creditor of the issuer until the claims of preferred creditors are satisfied fully, unless part of the pool is deemed as excess assets in accordance with the legislation in Australia.
Excess OC at risk	Excess cover assets, defined under the legislation as assets that are not required to repay the covered bonds, will not be available to preferred creditors after issuer insolvency.
Asset and liability claw back risk	Asset claw-back risk is addressed through the provision of solvency certificates by the issuer as a condition of each sale of assets, providing evidence that the issuer is solvent at the time of entering into the sale. There is no feature to mitigate the claw-back risk on covered bond payments. However, the programme documentation does not include claw-back amounts as part of the guaranteed amounts the covered bond guarantor is contractually required to pay.
Commingling risk	ANZ currently provides the GIC account. In the event its rating falls below a Short-Term IDR of ‘F1’ or a Long-Term IDR of ‘A’, the GIC account is to be replaced within 30 days with a financial institution rated at least ‘A/F1’. Commingling risk is sufficiently addressed by security over the collection account, in the name of the covered bond guarantor, which should remain bankruptcy-remote in the event of the insolvency of the issuer. It is also mitigated through the transfer of the collections to the GIC account within two days of receipt if the servicer’s rating falls below a Short-Term IDR of ‘F1’ or Long-Term IDR of ‘A’.
Set-off risk for deposits	Set-off of deposits is specifically disallowed within the underlying mortgage agreements entered into by borrowers.

Source: Fitch

Alternative Management

Systemic Alternative Management

Fitch takes into consideration the framework or contractual clauses governing the appointment of a substitute manager – together with the length of time required to appoint one – any potential conflict of interest (in cases where a single administrator in a bankruptcy takes care of covered bonds and other creditors), the manager’s responsibilities in the servicing and liquidation of the cover assets to meet payments due on the covered bonds and any further protection due to oversight or potential support for regulated covered bonds.

If Fitch assesses that systemic alternative management represents a high risk to payment continuity, the otherwise achievable PCU for the programme will be reduced by one notch if the otherwise achievable PCU is in the one-to-three-notch range and by two notches if it is in the four-to-eight-notch range.

Systemic Alternative Management: No Impact on PCU

Component driver	Fitch assessment
Administrator takes exclusive care of covered bondholders? When are they appointed?	In an issuer event of default, it falls upon the covered bond guarantor to make arrangements in the interest of covered-bond holders in accordance with the programme documents. The security trustee can also appoint an administrator where there is a covered bond event of default by the covered bond guarantor.
Importance of timeliness of payments in the legal provisions	Following a switch of recourse to the cover pool, the covered bond guarantor is required to ensure timely payment of the covered bonds. ANZ currently acts as servicer. The servicer will be replaced where its Long-Term IDR falls below 'BBB-'. If the servicer defaults, it needs to be replaced immediately; the covered bond guarantor takes on this role until an appropriate servicer is appointed.
Substitute manager able to sell cover assets or borrow to make timely payments?	Should liquidation of the cover pool be contemplated, the covered bond guarantor can appoint a sales advisor to manage the asset sale on behalf of the covered bond guarantor. A sales advisor can be an investment bank or an accountant of recognised standing that will have incentives to achieve the highest possible market price available at that time. The conditions of the sale would be subject to the security trustee's consent.
Regulatory oversight	Fitch considers oversight by APRA to be positive. Covered bond issuers have ongoing reporting requirements to demonstrate that the covered bond programmes fulfil the requirements of the legislation and APRA's prudential requirements under Prudential Standard APS 121: Covered Bonds.

Source: Fitch

Cover Pool-Specific Alternative Management

Fitch focuses on the likely ease of the transferability of relevant data and information technology (IT) systems to an alternative manager and buyer, basing its judgement on the quality and quantity of data it receives.

If Fitch assesses cover-pool-specific alternative management to represent a high risk, we will lower the programme PCU. It will reflect a greater link to the Long-Term IDR of the issuing institution via a reduction of one notch if the otherwise achievable PCU is in the one-to-three notch range and two notches if it is in the four-to-eight notch range.

Cover Pool Alternative Management: No Impact on PCU

Component drivers	Fitch assessment
Cover assets, debtors' accounts and privileged swaps clearly identified within IT systems	Adequate IT systems and processes are in place, which allow for the identification of cover assets and swaps belonging to the covered-bond programme.
Standardised or custom-made IT systems used.	ANZ's IT system, loan documentation processes and data are deemed to be satisfactory by the agency. ANZ uses an externally sourced loan management and core banking systems to perform its operational functions. Borrower loan accounts, as well as cash flows belonging to the cover pool, are flagged in the IT system, making them easily identifiable. This, along with data supplied from its internally developed data warehouses, provides the raw data that is input into ABS Suite. This system is a highly functional automated market developed system, performing the calculations and reporting required for ANZ to manage its covered bond programme.
Automation and speed of cover pool reporting	ANZ provides data that is considered highly adequate and within Fitch's requirements with only a small amount of data missing.
Adequate filing of loan documentation, evidence of security	Fitch considers the filing of loan documentation as satisfactory.

Source: Fitch

Appendix 3: Origination and Servicing

Origination and Underwriting

Mortgage applications are originated through ANZ’s main distribution channels – branch, phone, mobile lending and broker, with the majority of mortgages originating through the broker channel. Regardless of origination channel, all credit assessment, income verification and underwriting is performed by ANZ staff.

Approximately 35% of loan originations are carried out through ANZ’s branches. ANZ maintains approximately 680 branches throughout Australia, and attracts customers with its solid brand name and traditional marketing methods.

ANZ’s broker distribution channel originates approximately 50% of ANZ’s total mortgage loans and is sourced through some 50 top mortgage aggregator groups in Australia. ANZ currently has more than 14,650 brokers, who have completed an accreditation with their own mortgage aggregator as well as ANZ’s accreditation training. Arrears performance of loans originated via brokers is reported separately and monitored monthly by ANZ’s risk team. Credit approvals are either conducted through the bank’s credit scoring models or by ANZ’s dedicated broker credit assessment team. Brokers do not have any credit approval authority.

Loan applications are screened at the initial application stage to assess the borrower’s character and their capacity to service a loan. All borrower income is verified by an employer letter, direct credit payments, tax returns or payslips. An applicant must demonstrate an acceptable credit history, employment, evidence of genuine savings and also satisfy a minimum disposable income level after all commitments – including the proposed housing loan. In some cases, as part of the serviceability analysis, ANZ will apply haircuts to certain income flows that are not guaranteed, for example, residential rental income or overtime and commission income.

To provide assurance on the valuation of the property, the credit assessor may utilise the contract of sale, a modelled estimate or a kerbside valuation. Full valuations, which include an internal inspection of the property and a comparison of sales for the area, are required for a higher LVR loan and higher-value properties depending on the property’s location. ANZ utilises a panel of accredited property valuers whose valuations are monitored against actual sale prices, to ensure accurate reporting.

All loan applications are assessed firstly via ANZ’s automated credit decision systems. The system will produce an applicant score, which is combined with the customer behavioural scores to achieve better efficiency and segmentation of perceived risk. Only straightforward applications are approved without a full assessment. Those that are not automatically declined will be referred by the system to be manually assessed by a credit approved lending officer.

The lending system will provide a recommendation to the lending officer assessing the loan; and when the officer is satisfied conditions are met, approval will be granted. The credit team bases its assessment on information such as: customer identification; loan purpose; proof of income; statement of personal living expenses and all credit commitments; property valuation; and credit bureau checks.

Higher levels of authority are required for larger mortgage loans, as well as those with higher LVRs. All loan applications must comply with ANZ’s documented credit policy and procedures, which enable ANZ’s credit to be applied consistently to each credit application and to complement the scorecards in the decision-making process. Credit policy also includes the procedures for approving loans that are considered exceptions, which are assessed on a lending principles basis and require a higher level of authority.

For the purpose of quality assurance, hindsight reviews are conducted on a sample of mortgages to determine if the recommendation made by the assessor is acceptable based on the information held on the file and also to check that the processing is conducted in the correct manner. Hindsight reviews are conducted on all loans greater than AUD1.0 million.

ANZ's credit assessment team has 456 full-time employees. The majority of credit officers for the more complex assessment teams are Australia based, and there are also significant operations based in Bangalore (India), Chengdu (China) and New Zealand.

Servicing

In addition to the lending service centres, ANZ has approximately 470 collections officers covering the retail book (including home loans collections), whose role is to minimise the bank's credit losses by recovering account arrears through prevention, rehabilitation and recovery. First, contact with a delinquent borrower is made by ANZ's early-arrears team, who handle arrears from 0-60 days. Different collection procedures are undertaken based on the borrower's risk classification. Behavioural scorecards determine which collections path is followed in respect of a customer and will result in systems-generated letters, SMS messages or phone contact being established with the customer.

ANZ's late-stage arrears team handles accounts that are 60-149 days delinquent as well as deceased estates and bankruptcies. This team attempts to develop process strategies, and tries to assist the customer to resolve the underlying problem with the account through solutions, such as restructuring the loan or selling the property. ANZ also has collections officers dedicated to those delinquencies with larger exposures of a complex and sensitive nature. This is a specialised team involved in formulating tailored solutions.

Quality Assurance

ANZ maintains a quality assurance programme that involves periodic testing of randomly selected loans, to ensure that all documentation required for a credit decision to be made has been obtained, details recorded on ANZ's in-house systems are correct, and appropriate security has been taken or held. In addition, there are compliance checks that ANZ's credit policies have been adhered to, lending applications have been approved by the appropriate credit approval authority, and all legislative requirements have been met.

Business Continuity

ANZ has business continuity plans in place supported by back-up data centres. ANZ's business continuity plans are sufficiently robust to ensure adequate response to disruptions and recover critical business functions, allowing for the recommencement of operations at alternate locations without any significant interruption to operations.

Appendix 4: Legal Framework

The table below is based on Fitch's understanding of certain aspects of the applicable regime and is not a substitute for the original texts and/or Australian legal advice.

Main Characteristics of Australian Legislative Covered Bonds

Issuer	Australian-based authorised deposit-taking institutions
Supervision	The Australian Prudential Regulation Authority (APRA) is the regulator under the covered bond framework. Responsibilities and authority include the issuing of covered bonds, assets in cover pools, the monitoring and maintenance of cover pools and enforcement of compliance with such rules
Covered bond guarantor requirements	A person who is a statutory trustee or a wholly owned subsidiary of a statutory trustee.
Eligible assets	• loans secured by mortgages, charges or other security interest over residential properties in Australia, and the associated mortgage insurance policies or other assets. Residential mortgages with LTV ratios of more than 80% can be included in the pool, but the value of the loan is reduced by the amount of the excess (above 80% LTV) for the calculation of the 3% legal minimum OC. • loans secured by mortgages, charges or other security interest over commercial properties in Australia, and the associated mortgage insurance policies or other assets. Commercial mortgages with an LTV ratio of more than 60% can be included in the pool, but the value of the loan is reduced by the amount of the excess (above 60% LTV) for the calculation of the 3% legal minimum OC. • Derivatives held: (i) to protect the value of another asset in the cover pool; (ii) to hedge risks related to another asset in the pool; (iii) to hedge risks related to covered bonds. • Substitute assets in the form of Australian-dollar deposits, bank bills, certificates of deposit with a maturity of less than 100 days that are not issued by the covered bond issuer, are capped at 15% of the covered bonds issued. Bonds, notes or debentures issued by the Commonwealth, a State or a Territory of Australia are also eligible as substitute assets.
Regulatory limit	No more than 8% of the issuer's banking group assets can be cover assets.
Asset percentage	Lowest of either the contractual (maximum) AP or other such percentage notified to the covered bond guarantor, bond trustee and security trustee on any date, and is applied in the asset coverage test.
ACT	Adjusted collateral value of each loan in the pool, capped at the lower of 80% of the indexed value of the property securing the mortgage and the asset percentage.
Protection against mismatches	Mismatches addressed via contractual arrangements, i.e. a 12-month maturity extension on soft-bullet bonds, and 12-month pre-maturity test on hard-bullet bonds.
Interest rate and currency risks	Interest rate and currency mismatches are hedged though swaps entered into by the covered bond guarantor with a suitably rated counterparty, in this case with the issuer. Should the counterparty be downgraded below 'A'/ 'F1', then swap collateral will be posted according to the credit support agreement. Swap documentation stipulates rating triggers for the replacement of the swap counterparty.
Treatment of swap counterparties	Swap counterparties rank pari passu with covered bondholders in the post-enforcement priority of payments; termination payments due to counterparty default are subordinated to covered bond interest payments.
Bankruptcy remoteness	• Special-purpose vehicle (SPV) model used – contractually achieves asset segregation from the issuer's insolvency estate through the "true sale" of the mortgage assets to the SPV by way of equitable assignment to the covered bond guarantor. Upon title perfection, full legal title to the underlying mortgages will be transferred. • Asset pool unavailable to any other creditor of the issuer until the claims of the preferred creditors are met unless deemed as excess assets. • Excess cover assets are defined under the legislation as assets not required to repay the covered bonds, and will not be available to preferred creditors post issuer insolvency. • Preferred creditors to retain an unsecured claim against the issuer if claims not fully satisfied from the pool.

Main Characteristics of Australian Legislative Covered Bonds (Cont.)

Title perfection events	• Upon the service of a Notice to Pay. • The sale of mortgages to a third party, other than the seller. • By order of a court. • Termination of the issuer's role as servicer. • Seller requesting perfection of sale. • An insolvency event in relation to the seller. • The seller's Issuer Default Rating falls below 'BBB−'.
Asset monitor	Qualified auditor, or holds an Australian financial services licence, or exempt to provide such licence and is independent to the issuing Authorised Deposit-taking Institution (ADI) to verify the accuracy of the asset register, the asset coverage test, the amortisation test and compliance of the ADI.
Alternative manager	No alternative or dedicated independent manager appointed upon issuer insolvency. The covered bond guarantor, who is also the trustee of the SPV, is obliged to select and sell assets with the assistance of a sales advisor to make repayment of the covered bonds. In the event of a covered bond guarantor default, the security trustee has the power to appoint a receiver, whose duties are prescribed by the specific programme documents.

Source: Fitch

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.