Commonwealth Bank of Australia

Mortgage Covered Bonds

New Issue

Ratings

Mortgage Covered Bonds	AAA

Key Data

	Jan 2012
Asset type	Residential mortgages
Cover assets (AUDm)	6,841.8
Covered bonds (EURm)	1,500.0
Supporting asset percentage (SAP) (%)	83.3
Residual weighted-average asset maturity (years)	17.4
Residual weighted-average liability maturity (years)	5.0
D-factor (%)	29.9

Related Research

Commonwealth Bank of Australia (April 2011)

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Key Rating Drivers

Rating Rationale: The 'AAA' rating of the mortgage covered bonds issued by Commonwealth Bank of Australia (CBA; 'AA'/Stable/'F1+') is based on the issuer's Long-Term Issuer Default Rating (IDR) and a Discontinuity Factor (D-Factor) of 29.9%. This combination enables the rating on the covered bonds to reach 'AAA' on a probability-of-default (PD) basis, because the overcollateralisation (OC) is sufficient to sustain this level of stress.

D-Factor: The D-Factor of 29.9% assigned to the covered bond programme, reflects: the strength of segregation of the cover assets; a cash reserve covering three months of interest payments due on the covered bonds and a 12-month pre-maturity test on the hard bullet covered bonds to mitigate liquidity gaps; the provision for the guarantor to take decisions after issuer default, aided by the adequate quality of the CBA's IT systems; and the oversight of the issuer under Australian covered bond legislative framework.

Asset Percentage (AP): The asset percentage (AP) cannot exceed 95% at any time. The initial contractual AP is expected to be at or below 83.3%, equating to a nominal OC of 120.1%, which is equal to Fitch Ratings' supporting AP in a 'AAA' rating scenario. A dynamic asset coverage test (ACT) is in place to ensure that a minimum level of OC will be maintained by the issuer. The level of AP supporting the rating will be affected, among other factors, by the current profile of cover assets versus covered bonds, and may therefore change over time.

Programme Highlights

Key Characteristics: As of January 2012, the cover pool consisted of 25,980 loans granted to prime Australian borrowers, with an aggregate outstanding balance of AUD6.84bn. The portfolio's weighted-average (WA) current loan-to-value ratio (LTV) was 58.8%. The pool is diversified across the Australian states, but is mainly concentrated in New South Wales (36.6%) and Victoria (39.0%). It also contains investment loans of 22.9%.

Cover Pool Credit Risk: Fitch calculated the cover pool's WA frequency of foreclosure (WAFF) and WA recovery rate (WARR) in a 'AAA' scenario as 8.3% and 60.4%, respectively. Expected losses were set at 3.3%.

Market Risk: The initial covered bond issued will pay a fixed rate coupon in euros, while the cover pool assets yield an Australian dollar mix of fixed and floating rates. Hedging agreements have been put in place with the bank to hedge any interest rate risk and currency risk for the guarantor.

Ratings Sensitivity: All else being equal, the rating of CBA's mortgage covered bonds could still be maintained at 'AAA' if the issuer was rated at least 'A'.

Key Parties

Issuer	Commonwealth Bank of Australia
Covered bond guarantor	Perpetual Corporate Trust Limited in its capacity as trustee of the CBA Covered Bond Trust
Seller and originator	Commonwealth Bank of Australia
Initial servicer	Commonwealth Bank of Australia
Trust manager	Securitisation Advisory Services Pty. Limited
Intercompany loan provider	Commonwealth Bank of Australia
Demand loan provider	Commonwealth Bank of Australia
Interest rate swap counterparty	Commonwealth Bank of Australia
Covered bond swap counterparty	Commonwealth Bank of Australia
Account bank	Commonwealth Bank of Australia
Principal paying agent	Deutsche Bank A.G., London Branch
Bond trustee	Deutsche Trustee Company Limited
Security trustee	P.T. Limited
Cover pool monitor	Pricewaterhouse Coopers

Source: Transaction documents

Related Criteria

Covered Bonds Rating Criteria (August 2011)

Covered Bonds Counterparty Criteria (March 2011)

APAC Residential Mortgage Criteria (August 2011)

APAC Residential Mortgage Criteria Addendum - Australia (August 2011)

Counterparty Criteria for Structured Finance Transactions (March 2011)

Counterparty Criteria for Structured Finance Transactions: Derivative Addendum (March 2011)

Background

CBA is one of Australia's largest and oldest banks having commenced operations in 1912 when it opened its first branch in Sydney. It provides a broad range of financial products and services to retail, business and corporate customers. The bank has a large domestic branch network with more than 1,800 branches and service centres, more than eleven million customers and over 44,000 employees. At 30 June 2011, CBA had assets of AUD667bn, with a domestic market share of residential mortgages of 28%. CBA, which is listed on the Australian stock exchange with a current market capitalisation of approximately AUD77bn, has significant banking operations in Australia and New Zealand and growing operations in Asia.

The Programme

The CBA covered bond programme allows CBA to periodically issue covered bonds. Under this programme the issuer can periodically issue covered bonds secured over a dynamic pool of Australian residential mortgages and other eligible assets. The covered bonds rank pari passu among themselves and are direct, unconditional, unsecured and unsubordinated obligations of the issuer, guaranteed by the covered bond guarantor, Perpetual Corporate Trust Limited in its capacity as trustee of the CBA Covered Bond Trust. The guarantee will only be called upon in an issuer event of default. The programme is currently limited to issuance of up to USD30.0bn.

The covered bond guarantor will borrow funds from CBA and will utilise these funds to purchase, from CBA, on an equitable assignment basis, a pool of Australian residential mortgages. The covered bond guarantor will guarantee the covered bonds on issue by the issuer. 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. The scope of the covered bond guarantor's activities are limited mainly to acquiring the mortgage loans from CBA (together with their related security), raising funds post issuer default, investing in substitute assets and guaranteeing the covered bonds.

The trust will fund the purchase of the initial cover pool through two loans, provided by CBA; an interest-bearing intercompany loan equivalent in size to the covered bonds issued, which will fluctuate with future issuance and redemption of covered bonds; and an interest-bearing demand loan equivalent in size to the amount of OC, which is comprised of two components: an amount whose balance will fluctuate with the issuance and redemption of covered bonds; and the requirements of the ACT, which is designed to ensure a minimum level of OC on the covered bonds to protect bondholders against specific credit and market risks and is recalculated on each determination date, being monthly, as long as no issuer event of default has occurred. The second component of the demand loan will be an amount serving as voluntary OC in excess of that implied by the contractual AP.

CBA can request repayment of the demand loan at any time. Non-repayment will not cause a covered bond guarantor event of default and repayment of the demand loan is subject to the ACT being met on the date of repayment. Repayment of the voluntary component of the demand loan will rank ahead of other payments in the priority of payments, both prior to and after enforcement. The senior component of the demand loan will be repaid in kind through an in-specie distribution of assets back to the demand loan provider, CBA. Repayment of the contractual component of the demand loan will rank behind all other liabilities of the covered bond guarantor in the priority of payments, but ahead of the residual income unitholder and residual capital unitholder, which is CBA.

For the purposes of collateralising its covered bond guarantee, the covered bond guarantor has granted the security trustee security over the cover pool. The guarantee would only be called on the occurrence of an issuer event of default and the serving of an issuer acceleration notice on the issuer and/or of a notice to pay on the covered bond guarantor.

An issuer event of default includes, but is not limited to, the following:

- Interest or principal is not paid when due, subject to a grace period of fourteen days.
- There is a default of other obligations under the transaction documents that goes unremedied for 30 days.
- The issuer is unable to meet its debts when due or it is wound up.
- The issuer ceases to carry on a banking business in Australia or the issuer's authority under the Banking Act to carry on a banking business in Australia is revoked.
- An ACT breach notice has been served and remains outstanding by the next determination date.
- A pre-maturity test in respect of hard-bullet covered bonds is breached during the 12-month period prior to the maturity of a series of hard-bullet covered bonds and the GIC account is less than the Australian dollar equivalent of the redemption amount of any hard-bullet bonds in respect of which the pre-maturity test has been breached six months prior to their hard-bullet maturity.

While an issuer event of default may have occurred, unless a covered bond guarantor event of default has also occurred, the covered bonds would remain due and payable as scheduled.

A covered bond guarantor event of default includes, but is not limited to, the following:

- Any guaranteed amount is not paid when due, subject to a grace period of 14 days.
- There is a default of other obligations under the transaction documents that goes unremedied for 30 days.
- The covered bond guarantor retires or is removed, as trustee of the trust and another trustee is not appointed within 60 days.
- There is a failure to satisfy the amortisation test on any determination date following a notice to pay on the covered bond guarantee.
- There is a failure to satisfy the amortisation test on any determination date following a notice to pay on the covered bond guarantee.

If a covered bond guarantor event of default were to occur, the security trustee would enforce its security over the cover pool and seek to realise it as soon as possible to repay covered bondholders.

Issuance Diagram

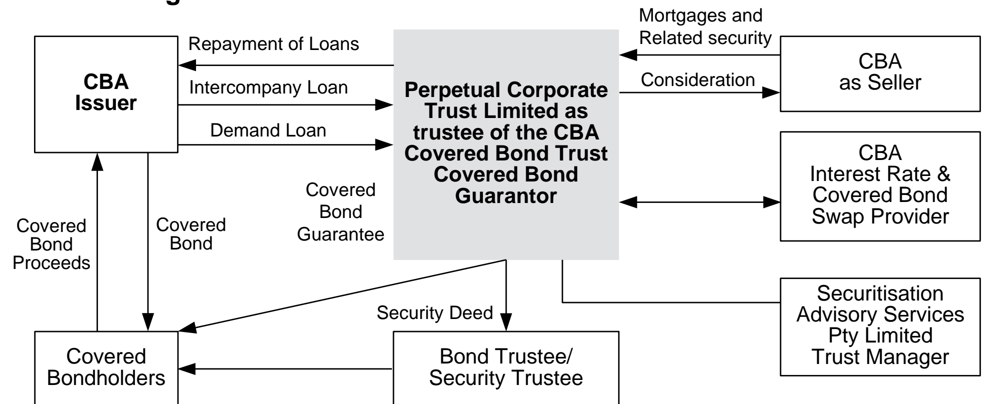
Continuity Analysis

D-Factor Components

- Asset segregation (45%)
- Liquidity gaps (35)
- Alternative management (15%)
- Covered bonds oversight (5%)
- Adjustment for counterparty risk

Figure 1

Structure Diagram



Source: Programme documents

Continuity Analysis

Under Fitch's covered bonds rating methodology, the covered bonds rated by Fitch are assigned a D-Factor between 0% (which stands for perfect continuity) and 100% (which stands for automatic interruption of payment on the covered bonds upon an issuer default). The D-Factor reflects the likelihood of the covered bonds defaulting in the immediate aftermath of a default by the issuer. The D-Factor has four weighted components, which are analysed below in relation to specific aspects of CBA's covered bond programme.

Asset Segregation

Within the asset segregation component, Fitch has analysed the provisions regarding the ring-fencing of cover assets from the rest of the CBA balance sheet for such assets to be protected from the claims of unsecured creditors in the event of insolvency. As consideration for granting the guarantee and allowing the covered bond guarantor to meet its obligations, the originator, CBA, has sold eligible receivables to the covered bond guarantor.

The sale of eligible receivables is executed through an equitable assignment, whereby title to the loans and the equitable title to the related security are transferred to the covered bond guarantor, while CBA will remain the lender of record. Following certain trigger events taking place (see *Alternative Management*), the title to the mortgages will be perfected to the covered bond guarantor. To collateralise its guarantee, the covered bond guarantor has granted security to the security trustee over the cover pool assets.

Fitch has analysed the following points that could, if not properly addressed, hinder the effectiveness of the segregation:

- existence of other privileged creditors;
- commingling risk;
- set-off risk; and
- claw-back risk.

Existence of Other Privileged Creditors

Prior-ranking claims include amounts due to the trustee, trust manager, servicer and paying agent. Fitch has taken these privileged creditors into account in its cash flow analysis. The swap counterparties, except where they are the defaulting counterparty, rank pari passu with covered bond investors.

Commingling Risk

If the issuer were to default, the covered bond guarantor would need to notify borrowers of underlying mortgage loans to make payments directly into the guaranteed investment contract (GIC) account in the name of the covered bond guarantor. Regarding commingling, Fitch considered a scenario in which notification takes one or two weeks and additional time is required for flows from the pool to accumulate in the GIC account.

CBA, as servicer, will transfer all collections from the cover pool to the GIC account on the trust payment date. If CBA's Short-Term IDR falls below 'F1' or its Long-Term IDR falls below 'A', it will transfer the funds to the GIC account within two days following receipt of funds. The agency takes comfort that 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. Additionally, a reserve fund is in place to address any delay in the timing of funds, as long as CBA's Short-Term Unsecured Rating is below 'F1+'. This is sized to cover the higher of three months of covered bond interest accrued on all outstanding covered bonds and cash interest payments due on covered bonds during the next three months, plus one quarter of annual senior expenses and servicing fees due.

Exposure to CBA as initial GIC account provider is mitigated through the programme documents providing that, upon the downgrade of CBA to below a Short-Term IDR of 'F1' or a Long-Term IDR of 'A' or where the Short-Term or Long-Term IDR has been placed on rating watch negative (RWN), the GIC account provider will be replaced within 30 days by a third party with an IDR of at least 'A'/'F1'. For further details on Fitch's counterparty criteria, see *Covered Bond Counterparty Criteria*, published 14 March 2011 and available at www.fitchratings.com.

Set-Off Risk

Borrowers are likely to have deposit accounts with CBA. Borrowers' mortgage agreements, where security is taken directly over the borrower's property, do not allow the borrower any rights of set-off.

Upon the downgrade of CBA below 'BBB−', notice will be given to the borrowers of the sale, transfer and assignment of the loans and related security to the covered bond guarantor. As a result, legal set-off rights that a borrower may have will crystallise and no new rights of set-off can occur.

Claw-Back Risk

The risk of claw-back of assets sold to the covered bond guarantor or covered bond payments made to covered bond holders may exist if a transaction was determined to be insolvent. Under Australian law, an insolvent transaction is one that has been entered into at a time when a company is insolvent. Transactions entered into the previous six months prior to an insolvency could be subject to claw back by secured creditors of the insolvent institution should they be able to prove that the transaction was prejudicial to their interests.

Claw back risk on the assets is mitigated through the provision of a representation and warranty of solvency by CBA each time mortgages are sold to the covered bond guarantor. There is no structural feature in place to mitigate the claw back risk on covered bonds payments. The programme documentation does not include claw back amounts as part of the guaranteed amounts that the covered bond guarantor is required to pay and therefore Fitch views the risk of claw back on liability amounts as fairly remote.

Liquidity Gaps

As with most covered bonds, the maturity profile of the cover assets does not match the bullet maturities of the covered bonds. This can create a need for liquidity, especially if the issuer defaults just prior to a maturity of a covered bond. In this case, the covered bond guarantor may not have time to raise enough funding against the cover pool to repay the covered bonds

on a timely basis. This is particularly true if the assets in the cover pool are not regularly traded, as is the case for Australian residential loans.

For this reason, covered bonds under the CBA mortgage covered bonds programme will either be issued as soft-bullet bonds with a maturity extension period of up to one year or, otherwise, as hard-bullet bonds subject to a 12-month pre-maturity test. This gives the covered bond guarantor up to 12 months to raise liquidity by selling parts of the cover pool. Fitch assumes a 12-month period as necessary to organise a sale of Australian residential mortgage loans in a stressed situation.

The first series of covered bonds to be issued are hard-bullet bonds where a pre-maturity test will be in place, which must be met 12 months prior to a final maturity date. The pre-maturity test will be breached where the issuer's Short-Term IDR falls below 'F1+' and the maturity of the hard-bullet bonds falls within the next 12 months. If the pre-maturity test is breached, then the covered bond guarantor can request a demand loan issuance from CBA, request CBA to repurchase loan assets or commence selling cover pool assets up to an amount sufficient to redeem the relevant maturing covered bonds. During this pre-maturity test period, if sufficient receipts are not available in the pre-maturity ledger to cover expected maturities, all collections from the cover pool assets will, after payment of senior-ranking expenses, be placed into the GIC account pre-maturity ledger.

Where soft-bullet bonds are issued, if the issuer fails to pay all amounts due on the scheduled maturity date (subject to any applicable grace period), the scheduled final maturity will automatically be extended by 12 months to the extended payment date. This contractual arrangement is for the sole benefit of the covered bond guarantor and not an option of the issuer. During the extension period, interest will continue to be payable under the covered bonds. The additional 12 months will allow the covered bond guarantor time to raise liquidity by selling all or part of the cover pool.

Fitch believes that a 12-month pre-maturity test is slightly less protective than a 12-month extension period and therefore the agency's assessment of liquidity gaps is unlikely to change if the issuer decides to also issue soft bullets with a 12-month extension.

As described under *Commingling Risk*, the transaction also includes a reserve fund, established when CBA's Short-Term IDR falls below 'F1+', which will trap available revenue receipts up to an amount sufficient to cover the higher of three months of covered bond interest accrued on all outstanding covered bonds and cash interest due on covered bonds during the next three months, plus one quarter of annual senior expenses and servicing fees on the next payment date.

The programme includes a senior demand loan which serves to provide voluntary OC in excess of the contractual AP. Under the waterfall of payments this senior demand loan ranks senior to payments owed to covered bonds holders. Fitch believes such feature reduces the overall liquidity of the covered bond programme should such payments be made in cash. In the agency's view the availability of liquid assets for repayment to covered bond holders is greatly reduced depending of the size of the senior demand loan at the time of insolvency. Conversely where mortgages assets are required to be sold to repay the voluntary demand loan, this may negatively impact the market value of mortgage assets should the covered bond guarantor also be required to sell mortgage assets in order to repay a covered bond in full. To mitigate these risks the senior demand loan will be repaid through an in-specie distribution of mortgage assets to the demand loan provider (CBA).

These features considerably minimise the risk of the covered bonds defaulting in the immediate aftermath of the issuer's default.

Alternative Management

This section addresses the risk that the transition to an alternative manager does not occur sufficiently smoothly to ensure that all payments are made in the periods directly following the issuer's insolvency. Such risks could materialise if the alternative manager were appointed too late or if the IT systems of the issuer made it too difficult for the new manager to isolate the cover pool and covered bonds from the other assets and liabilities of the bank and, as a result, to manage the cover pool. The potential role of alternative management includes, but is not limited to, arranging for management of the cover pool assets and the potential sale of assets if and when required.

CBA currently acts as servicer of the mortgage loans in the cover pool. Upon CBA's downgrade to a Long-Term IDR below 'BBB−', it must use reasonable endeavours to appoint a third party with the requisite experience and systems to adequately manage residential mortgage portfolios to undertake the servicing obligations. Until a substitute servicer is appointed the covered bond guarantor must act as the servicer. If CBA were to be terminated as servicer, this would also trigger a title perfection event and title to the cover pool assets would be transferred to the covered bond guarantor.

Australia has only in recent years seen the development of a limited external loan servicer market. Given the strong position CBA holds within the Australian banking system, it is Fitch's opinion that the most realistic scenario is that another major Australian bank will take over the servicer role in the event of servicer termination. These banks have similar market positions in Australian residential mortgage loans, offering relatively similar loan products and have processes and systems in place that would allow them to act as an alternative servicer, if required.

The practicality of a transfer to an alternative manager is dependent on the quality of CBA's systems. CBA's IT system and loan documentation processes are deemed to be of good quality. The mortgage business's core IT platform has been sourced externally and can produce data in a format that can readily be utilised by alternative IT systems. All programme data is backed up daily and the IT system has back-up resources whereby business users are redirected to a secondary server in case of the loss of the primary one.

Accounts, as well as cash flows, included in the cover pool are flagged in the system, making them easily identifiable. An application enables raw data for investor and rating agency reporting and cash flow waterfalls to be readily available. Therefore, Fitch expects that a potential back-up servicer and trustee would be able to take over the management of the covered bond guarantor within a relatively short time.

The covered bond guarantor, as a special-purpose company, does not have resources of its own. It will, if required, be controlled by the security trustee. The covered bond guarantor's obligations may involve a decision process around the sale of all or part of the cover pool assets and if this were to occur the transaction documents require the appointment of a sales advisor to manage the asset sale process on behalf of the covered bond guarantor. A sales advisor will be an investment bank or other institution of recognised standing that will be incentivised to achieve the highest possible market price available at that time. The sale of cover pool assets will require the written consent of the security trustee at that time.

Fitch believes that the contractual provisions, the processes and systems in place and the characteristics of the cover pool provide comfort that an alternative management of the cover pool's assets and covered bonds will be fully operational shortly after a possible issuer default or servicer termination event.

Covered Bonds Oversight

Australian covered bond legislation, *Banking Amendment (Covered Bond) Bill 2011,* was passed on 12 October 2011. This legislation applies to all Authorised Deposit-taking Institutions

(ADIs). Legislation sets a cap on the issuance of covered bonds of 8% of Australian assets, minimum overcollateralisation of 3% (equivalent to a maximum asset percentage of 97.09%, requires the appointment of an asset monitor who must report on the cover pool assets every six months and sets out the types of assets that are allowed within the cover pool, which includes loans secured over Australian located residential or commercial property assets. Where the asset is a loan secured over a residential property and the LVR exceeds 80% then the value of the loan is reduced by the excess amount. Where the asset is a loan secured over a commercial property and the LVR exceeds 60% then the value of the loan is reduced by the excess amount. The CBA covered bond programme only allows residential property to be used as collateral.

The Australian Prudential Regulation Authority (APRA), which regulates ADIs, is the regulatory authority for covered bond issuers. APRA has not to-date issued regulatory guidelines, but is expected to do so in the near future. As a result, in the D-Factor assigned to this programme, Fitch has given a low level of credit to the dedicated covered bonds supervision from APRA until regulations are issued. Then a more complete assessment of the regulatory environment can be undertaken.

Adjustment for Counterparty Risk

Fitch has applied an overall increase in the D-Factor to reflect the tighter relationship between the issuer's IDR and the covered bond rating on account of CBA being counterparty to the guarantor for the interest rate swap for the assets. In cases where the issuer or a related entity acts as a derivative counterparty for its covered bond programme, the agency believes that investor protection against risks hedged with the internal counterparty is not improved as much as if external counterparties are used.

Evaluation

Overall, the CBA programme has been assigned a D-Factor of 29.9%; this, combined with CBA’s IDR of ‘AA’, means that the maximum achievable rating of the mortgage covered bonds on a PD basis is ‘AAA’. Fitch has assigned a rating to CBA’s covered bonds by testing the level of OC that would pass ‘AAA’ stressed levels in both Fitch’s Australian RMBS default model (see *Appendix 1)* and its covered bonds cash flow model (see *Cash Flow Analysis*). CBA is one of a minority of mortgage programmes rated by Fitch that is able to reach a ‘AAA’ rating on a PD basis.

All else being equal, CBA’s covered bond rating could still be maintained at ‘AAA’ (based on the PD of the covered bonds and on recoveries from the cover pool in case of a default of the covered bonds) if the issuer was rated as low as ‘A’.

Origination and Servicing

Headquartered in Sydney, CBA is one of Australia’s four major banks in terms of total assets and is currently the largest by market capitalisation. CBA commenced operations in 1912 when it opened its first branch in Sydney. For more information about CBA’s history and financial strength please refer to Fitch’s rating report *Commonwealth Bank of Australia*, dated 15 April 2011.

CBA sources its mortgage loans from its nationwide branch network, mobile sales force, telephone sales operations and third-party mortgage brokers. The team making credit decisions is responsible for a multitude of retail lending functions — including home loans, personal loans, credit cards and overdrafts.

Origination

All loan applications are received from the applicant/borrower via CommSee Home Loans (CHL), and all applicants are accepted or declined by the credit scorecard system or referred to a credit approval officer. The approval process of the application involves assessing the

borrower's ability to fund their mortgage commitments, verifying its application details, and determining the eligibility and valuation of the mortgaged property.

The verification of borrowers involves various checks to provide evidence of income and genuine savings through statements and recent payslips, proof of identity and employment details. In the case of self-employed borrowers, at least two years' annual financial statements are required; and if there is a 20% variance between the last two years' statements, a more rigorous analysis is carried out.

In the case of refinancing, credit checks are performed to provide evidence of no previous disruptions in mortgage repayments. All loan applications are submitted electronically, and the assessment of each applicant is done "on screen" — using dual screens to allow applications and supporting documents to be viewed simultaneously.

Following the verification process, an assessment of each applicant's debt-servicing history is carried out. The applicant must demonstrate an acceptable credit history and satisfy a minimum disposable income level after all commitments, including the proposed housing loan, with an allowance for interest rate increases. The credit assessment decision is carried out via two channels: (i) the credit scorecard, and (ii) credit approval authority. In some cases, the outcome of the credit-scoring process may trigger additional external credit checks, eg new customers to CBA and those loans that require lenders' mortgage insurance (LMI).

Those loans that are not credit scored, and loans that are referred by the scorecard, are referred to a credit analyst. The credit decisions are made by employees of the mortgage manager with varying levels of delegated authority. The level of delegated authority is based entirely on the seniority and level of experience within the credit approval team. Each credit analysts must be assessed prior to receiving credit approval for delegated authority, and CBA has installed a process that constantly monitors and reviews the performance of each analyst.

Underwriting

For successful applications, the maximum allowable LVR must be less than or equal to 95%. CBA has a full suite of options to suit the borrower, with a range of standard variable, fixed and split products. On completion of the verification and credit-decision process, the credit analyst will arrange for a valuation to be carried out on the mortgaged property by either a qualified valuer, a desktop valuation or through a contract document.

The maximum term for a fixed-rate loan is 15 years and the maximum term for all loans is 30 years. No loans secured by vacant land are permitted, and all borrowers must establish and maintain full replacement general homeowners' insurance.

Servicing

CBA services all the housing loans in this transaction. The bank uses an automated collection system, through which all collections are dispersed into the collection account within five business days of receipt; if the collection account ceases to be an eligible deposit account, the trustee (or the manager) will establish a new account with an eligible deposit account. Servicing responsibilities include monitoring of trigger events, and preparation of pool statistics and loan summary reports on a monthly basis.

Arrears Management/Special Servicing

Where a housing loan is in arrears, the system allocates the loan to designated collections officers. Borrowers are initially contacted with an SMS reminder once the repayment is two days overdue, followed up with a call by one of the collection officers once the repayment falls 21 days overdue.

When a loan is 60 days delinquent, a statutory default notice is issued and appropriately served on the borrower, advising that if the matter is not rectified within 30 days Commonwealth Bank

will be entitled to commence loss-mitigation proceedings without further notice. The asset is classified as impaired once the borrower is 90 days delinquent.

Figure 2
Cover Pool Summary
(As of 5 January 2012)

Pool characteristics	
Outstanding principal balance (AUDm)	6,841.8
Average current loan per borrower (AUD)	263,347
Number of loans	25,980
Seasoning (months)	28.9
WA remaining maturity of assets (years)	17.4
WA remaining legal maturity (years)	26.5
Oldest loan in portfolio	2002
Most recent loan in portfolio	2012
Other characteristics	
WA current loan-to-value ratio (%)	58.8
Investment loans (%)	22.9
Interest-only loans (%)	18.4
Maximum loan size (AUD)	1,000,000
Lenders' mortgage Insurance	11.1
Interest-rate type (%)	
Fixed rate	7.8
Floating rate	92.2
WA interest rate	6.7
Performing loans (%)	
Loans in arrears	0.0
Regional concentration (%)	
New South Wales	36.6
Victoria	39.0
Queensland	0.0
South Australia	6.5
Western Australia	12.7
Tasmania	2.4
Australian Capital Territory	1.6
Northern Territory	1.2

Source: Fitch/CBA

Once the statutory default notice has expired, the loss-mitigation team will implement a strategy to either take possession of the mortgaged property or implement hardship plans — depending on the arrears history, the level of equity in the property, and any previous arrangements with the borrower to meet overdue payments. All requests for hardship undergo a full financial assessment together with the appropriate supporting documentation as evidence of the borrower's financial situation. The LMI must be notified once hardship is approved to borrowers where LMI is concerned. There are several hardship options available — which include deferral of payments, waiving fees and charges, and deferral of enforcement proceedings.

Once the account reaches 120 days overdue, a letter of demand and notice to vacate is sent, and at 150 days a statement of claim is sent to the borrower. The above periods assume that the borrower has not taken any action or satisfied the arrangements in relation to the arrears.

All properties obtain a full valuation, and a reserve price is set prior to sale by way of public auction. The experienced asset realisation team will source a number of recovery options — including voluntary sale, guarantees, government assistance schemes, and claims on mortgage insurance and mortgagee sales. The arrears management currently performed by the group is fairly typical of market practices.

Document Custody

CBA will act as custodian, hold all mortgage loan documents with its safe-keeping practices, and ensure that all security packets will be correctly marked and segregated for ease of identification.

Business Continuity

CBA has business continuity plans in place supported by back-up data centres. CBA's business continuity plans are sufficiently robust to allow for the recommencement of operations at alternate locations without any significant interruption to operations.

Cover Pool

On an ongoing basis, CBA has agreed to sell new mortgage loans to the covered bond guarantor on a "best effort" basis to ensure the ACT is met on each calculation date. If CBA proves unable to sell enough new mortgage loans, the covered bond guarantor will retain cash or invest this in substitution assets. The negative carry that this will create needs to be compensated for by adding more cash or substitution assets in accordance with the ACT. Substitution assets, being Australian commonwealth and state debt, bank bills and certificates of deposit carry a limit of 15% of the cover portfolio.

Eligibility Criteria

The covered bond guarantor can purchase new residential mortgages as long as no issuer or covered bond guarantor event of default has occurred. Additional residential mortgages than the current ones may be included in the cover pool provided that this would not adversely affect the then-current rating of the covered bonds. For further advances and product switches on loans already owned by the covered bond guarantor, these conditions must also be satisfied or the loans will need to be repurchased by the seller. CBA has made a series of representations and warranties (made at the time of sale) in respect of the loans in the cover pool, including the following.

- Each loan is regarded as a prime loan.
- Each loan is repayable in Australian dollars (AUD).
- Each loan term does not exceed 30 years.

- Each loan is not in arrears more than 30 days.
- Each loan is secured with a first-ranking mortgage over land located in Australia upon which a residential dwelling or unit is erected.
- The borrower is not an employee of the seller who is paying a concessional rate of interest due to their employment.
- The loan is or has been fully drawn.

In the event of a breach of the representations and warranties, the seller will be required to repurchase the relevant loans. While there is no maximum LVR limit as part of the eligibility criteria, the programme ACT caps the nominal amount of the loans at 80% of the latest current value of the mortgaged property.

Figure 3

Fitch Default Model Output (%)

Rating level	WAFF (%)	WARR	WA MVD	EL
AAA	8.3	60.4	48.1	3.3

WAFF = Weighted-average frequency of foreclosure
WARR = Weighted-average recovery rate
WA MVD = Weighted-average market-value decline
EL = Expected loss
Source: Fitch

Collateral Credit Analysis

The residential mortgage loans are all exposures to prime Australian borrowers. The figures stated in Figure 2 reflect adjustments made by Fitch as described below.

Repayment Types

Where interest-only loans are present Fitch increases the default probability of these loans to reflect the possible payment shock associated with either a bullet repayment or higher repayments required when the loan converts from interest-only to fully amortising. The cover pool currently contains 18.4% interest-only loans.

Investment Loans

Fitch holds the view that investment loans are riskier than owner-occupied loans. Although such loans have performed well in periods of strong economic growth, and investment borrowers would traditionally be considered more creditworthy, the agency believes this may not always be true. The portfolio contains investment loans totalling 22.7% of the cover pool.

Property Type

Detailed property-type data was provided by CBA. The cover pool is at present comprised of 91.7% loans where the collateral is houses, 0.5% semi-detached houses and 7.8% units.

Loans in Arrears

As of the pool cut-off date mortgage loans in arrears greater than 30 days were nil.

Property Valuation

CBA use an automated decision-making system known as VAS which follows a risk based approach to determine if an internal or external valuation is required. All external valuers are carried out by independent third parties. The bank relies on automated valuation models (AVM) to validate owner’s estimates or purchase prices which are within an acceptable tolerance parameter. AVMs are prepared by independent third party providers.

Lenders’ Mortgage Insurance

LMI is a feature of Australian residential mortgage lending, with lenders generally requiring borrowers to pay for LMI if their LVR is greater than 80%. The cover pool has LMI on 11.1% of loans within the pool.

Default Model Output

Based on a loan-by-loan analysis of the cover assets, Fitch derived an expected default likelihood and recovery expectation for the cover pool by applying its Australian prime residential mortgage default model. Figure 3 summarises the findings of Fitch's default analysis in a 'AAA' scenario. Details of the Australian residential mortgage market and the key drivers of Fitch's Australian prime residential mortgage default model can be found in *Appendix 1*.

Cash Flow Analysis

Under its programme, the issuer can issue, from time-to-time, further covered bonds secured on the cover pool, subject to compliance with the ACT. To assign a rating to covered bonds higher than the IDR of CBA, Fitch analyses the cash flows deriving from the cover pool with the cash flows due on the covered bonds following an issuer event of default. In this analysis, the agency assumes that no new assets enter the cover pool to replace maturing or non-performing assets and that there is no further issuance of covered bonds.

Fitch's covered bonds cash flow model tests whether the cover pool, managed by a third party and with the benefit of the derivative contracts, is able to service interest and principal payments on the covered bonds in a timely manner. The cash flows expected from the assets were modified to reflect prepayments, delinquencies and default and recovery assumptions in a 'AAA' scenario and hypothesising the issuer's default at different dates. In addition, the cost of replacing CBA as servicer/manager of the cover pool was modelled and liquidity and market risks arising from the different profiles of the stressed assets and privileged liabilities were simulated. In particular, the projected stressed cash flows were used, among others, to assess the price at which, in a particularly severe economic environment, the pool could be sold or securitised.

Asset Coverage Test and Amortisation 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 and is recalculated monthly as long as no issuer event of default has occurred. If breached, failure to satisfy the ACT on the second calculation date after the breach will constitute an issuer event of default. As part of the ACT formula, loans in the cover pool are only taken into account for the portion below 80% of the current value of the mortgaged properties, ensuring that covered bonds are not funding the portion of loans in excess of this limit. The effect of this increases the amount required under the ACT.

The ratio between covered bonds and cover assets may not exceed 95% (the asset percentage) at any time. The AP will be adjusted during the life of the programme. According to the agency's criteria, in the absence of public communication of the current applicable AP and as long as the issuer has a Short-Term Rating of at least 'F2', Fitch will monitor the highest actual level of covered bonds compared to the cover pool over the last 12 months, and compare it to the asset percentage supporting the assigned rating. The maximum asset percentage supporting the 'AAA' rating currently stands at 83.3%. For issuers with a Short-Term Rating of 'F3' or below, or an equivalent Long-Term Rating, in the absence of public commitment, the agency would run its cash flow analysis based on the maximum AP included in the programme's documentation, in this case 95%.

Non-compliance with the ACT on a determination date will prevent the issuer from issuing further covered bonds for as long as it is not remedied. If non-compliance exists, the covered bond guarantor will use all reasonable endeavours to acquire sufficient additional mortgages from CBA or may make drawings under the demand loan agreement, provided by CBA to the covered bond guarantor, to ensure the ACT is met. If the ACT is not complied with on a monthly determination date and also on the next following monthly determination date, the ACT will be breached and the bond trustee will serve an ACT breach notice on the covered bond guarantor.

If compliance with the ACT were not re-established on or before the next determination date following the service of an ACT breach notice, an issuer event of default would occur and the bond trustee would be entitled to serve an issuer acceleration notice on the issuer and a notice to pay on the covered bond guarantor. If a demand loan were provided by CBA to the covered bond guarantor, the contractual portion of this would rank behind all other liabilities of the covered bond guarantor, but ahead of the residual income and capital unitholders.

After an issuer event of default, an amortisation test verifies whether the adjusted value of the cover pool, including any cash held in the GIC account and any substitution assets, is higher than the notional amount of outstanding covered bonds. The amortisation test mitigates time subordination of covered bonds within the programme. See *Contractual Mechanisms in Covered Bonds: Under the Spotlight* for further information. Failure to meet the amortisation test will trigger a covered bond guarantor event of default and the serving of a covered bond guarantee acceleration notice on the covered bond guarantor. The covered bond guarantor will be obliged to sell the loans and the proceeds from such sale will be used to repay, pro rata, the outstanding covered bonds.

With respect to such sale, the selected assets required amount (SARA) clause limits the use of OC to repay a maturing covered bond to the bond's pro rata share of OC. Therefore, the level of OC needs to be sufficient for all possible sale scenarios and, for a given rating scenario, is generally higher than if such provision was not in place (please refer to the report, *Contractual Mechanisms in Covered Bonds: Under the Spotlight,* published 4 June 2009 and available on www.fitchratings.com).

Maturity Mismatches

The redemption profile of the covered bonds does not match the amortisation of the cover pool. The cover assets are amortising, with a weighted-average remaining maturity of the assets of 17.4 years, while the covered bonds will have a lesser residual maturity. As a result, temporary liquidity surpluses or shortfalls may arise, which would place a strain on available resources.

In cash flow modelling a covered bond programme, Fitch firstly models any cash not needed to repay liabilities as being reinvested with a replacement GIC provider at an assumed rate of 50bp per annum below the one-month Bank Bill Rate. Additionally, the agency assumes that an alternative manager would be able to realise part of the mortgage portfolio within the pre-maturity test period of the covered bonds. The ability to find a buyer will depend on a number of factors, including: (i) buyer appetite given the economic environment; and (ii) the proportion of the portfolio required to be realised. The most likely purchaser will be another financial institution that already originates similar assets, particularly one with covered bond funding capacity. However, the amount that can be realised at any one time is limited, as is the frequency with which sales could be completed.

To determine the stressed price at which such asset sales would occur, Fitch has assumed that any purchaser will assume 'AAA' levels of loss in the portfolio. The portfolio may already include an element of defaulted mortgages at the time of an issuer event of default, as the seller has no obligation to repurchase defaulted mortgages. It has further been assumed that a purchaser would perform a discount analysis using a refinancing cost based on major Australian bank market spreads, increased by a profit margin. The margin assumed reflects margins observed on mortgage pools with comparable characteristics to the covered pool analysed by Fitch

In calculating the potential purchase price for loan sales, Fitch has assumed that any purchaser will assume 'AAA' levels of loss in the portfolio. The portfolio may already include defaulted mortgages at the time of an issuer event of default, as the seller has no obligation to repurchase defaulted mortgages.

A price cap was applied on loan sales occurring within the first 12 months following the assumed default of the issuer because the market would be aware of the pressure to refinance assets, so buyers would find themselves in a stronger position. The cap is binding where other stresses such as interest rate or credit risk do not already reduce sale proceeds beyond a certain level.

Given the limited number of portfolio sale precedents in the Australian market, there is no guarantee that a portfolio could be realised in any prevailing economic environment.

Hedging

Interest Rate Hedging

The covered bond guarantor will enter into an interest rate swap under which the covered bond guarantor pays the interest earned on the performing mortgage portfolio to the swap counterparty and receives in return the monthly Australian Bank Bill Rate plus a margin. The margin will be sufficient, with a buffer, to allow the covered bond guarantor to meet its obligations for interest, fees and costs. The notional amount of the swap will be equal to the mortgages' daily loan balance and will have a maturity equivalent to the maturity of the longest-dated loan asset in the portfolio.

Currency Hedging

CBA has the ability within the covered bond programme to issue covered bonds that are denominated in currencies other than AUD. Consequently, the covered bond guarantor will seek to enter into a series of either forward-starting, or non-forward starting currency swap agreements to hedge the currency risk between the AUD-denominated mortgage loans in the cover portfolio and the non-AUD-denominated covered bonds. These swaps are also expected to provide protection against fluctuations between the AUD base rate on the interest rate swap and any fixed-rate interest payments to be made on the covered bonds.

Termination payments under the swaps have a senior position in the priority of payments, with payments on the interest rate swap ranking ahead of covered bond investors and payments on the covered bond swap ranking pari passu with covered bond investors, unless the reason for the termination is the default of the swap counterparty. The enforceability of the subordination of such termination payments is uncertain due to the lack of a legal precedent. Therefore, the agency would factor the effects of swap termination payments potentially owed by the covered bond guarantor to the counterparty in the event of counterparty insolvency in its cash flow model analysis, providing CBA's Long-Term and Short-Term IDRs were to fall below 'A'/'F1' and no further mitigants were in place.

Fitch applies its covered bond counterparty criteria *(Covered Bond Counterparty Criteria*, dated 14 March 2011 and available at www.fitchratings.com) to the analysis of the swap arrangements. If, at any time, the relevant swap counterparty, for either an interest rate swap or currency swap, is downgraded below 'A'/'F1', the following corrective options are available:

- find a suitably rated swap counterparty to replace the then-current counterparty;
- obtain a guarantee by a third party with the requested minimum rating; or
- post collateral in line with Fitch's then-current criteria.

If the swap provider is downgraded below 'BBB−'/'F3', the collateral option would no longer be available and either a guarantor or a suitably rated replacement counterparty would be sought to mitigate counterparty credit risk. Where a rating is on Rating Watch Negative, Fitch considers this rating to be one notch lower.

If a swap counterparty is required to post collateral to the covered bond guarantor, this will be posted in the covered bond guarantor's account. The value of the collateral will not be taken into account in the ACT, as it does not secure the payments of the covered bonds, but is a guarantee against a default of the swap counterparty.

Cash Flow Model Output

Fitch has calculated a supporting AP of 83.3% for the assigned rating. In the future, supporting AP levels will be affected (among other factors) by the profile of the cover assets relative to outstanding covered bonds, which can change over time, even in the absence of new issuances. Therefore, it cannot be assumed that a given level of OC or AP supporting the assigned rating will remain stable. Fitch will review the AP supporting the rating regularly. OC measures the difference between the cover assets and covered bonds as a percentage of the covered bonds, while AP measures the covered bonds as a percentage of cover assets.

Summary

Fitch has assigned a D-Factor of 29.9% to CBA's mortgage covered bonds. This, in combination with CBA's IDR of 'AA', enables the covered bonds to be rated 'AAA' on a PD basis, subject to OC being sufficient to avert a default under the covered bonds in such a rating scenario. Initially, the covered bonds issued are expected to be an amount that is no larger than that which is compatible with the level of asset percentage supporting the programme's 'AAA' rating, calculated by Fitch as a maximum of 83.3%.

The agency will periodically review the credit quality of the cover pool and perform a cash flow analysis to assess whether the then-current asset percentage provides protection against identified risks commensurate with the rating of the covered bonds issued by CBA. Cover pool and covered bonds information will be displayed on Fitch's covered bond surveillance tool (available at www.fitchresearch.com) and updated regularly.

Appendix 1

Overview of the Australian Residential Mortgage Market and Fitch's Modelling Approach

Australia has a highly developed residential mortgage market with total outstanding residential mortgages of approximately AUD 1.2tr at end-August 2011. The country has a strong culture of home ownership with around 65% of the population being owner-occupiers through private ownership of predominantly freestanding residential properties.

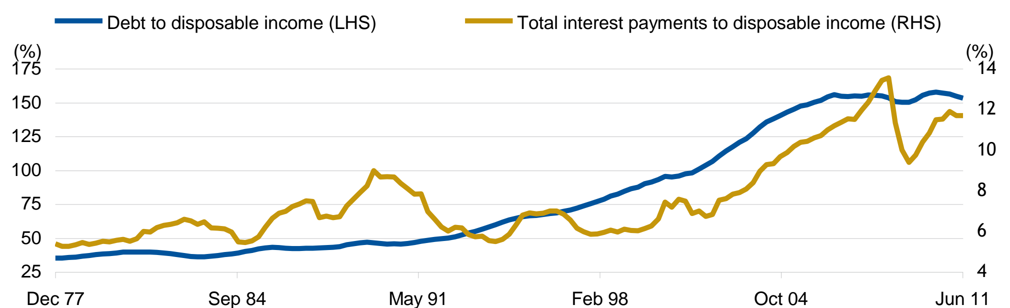
Residential lending is dominated by the four large Australian banks, which together currently account for approximately 85% share of outstanding residential lending in Australia. The four major banks are all listed on the Australian stock exchange. At end-August 2011, the approximate market shares for residential housing lending of Australia's major banks, were Australia & New Zealand Banking Group 15%, Commonwealth Bank of Australia 28%, National Australia Bank 16% and Westpac Banking Corporation 27%.

Residential mortgages in Australia are full recourse to the borrower and have historically performed well with relatively low arrears and loss levels.

Figure 4 shows that household debt levels in Australia have risen substantially over the past decade and are currently sitting at approximately 156% of disposable income.

Figure 4

Australia: Household Debt and Interest as % of Disposable Income



Source: RBA

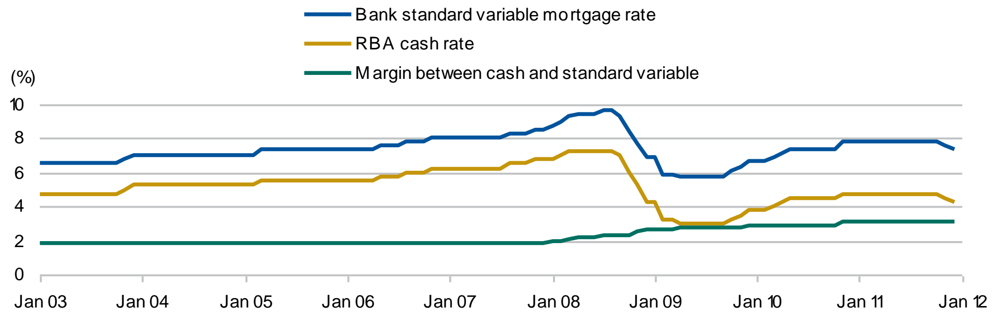
Mortgage Products

The standard residential mortgage product in Australia is a fully amortising 25- to 30-year loan. There are product variations whereby interest-only periods of up to 10 years are provided to some borrowers. Fixed rate loans comprise a relatively small proportion of residential mortgages in Australia with a share of 10%-15%, depending on interest rate movement trends. At the end of a fixed rate period borrowers automatically migrate to a fully amortising floating rate principal and interest loan, unless they have sought to fix their interest rate again. During a fixed-rate period, the loan still generally amortises.

Where interest rates are variable, they are set at the individual bank's residential lending rate, which is often based off the Reserve Bank of Australia's cash rate. Movements in the cash rate are generally a precursor to movements in the bank's variable residential lending rates. While there is a correlation between variable rate moves and the cash rate, insofar as the cash rate is a driver of short-term rates, other factors, such as a bank's funding costs will also influence movements in variable lending rates at any time.

Borrowers generally have the option to prepay a loan, either in part or fully, subject to a prepayment fee and potentially fixed-rate break costs, which are subject to movements in interest rates. Borrowers generally can, subject to their lender's criteria, apply for a further advance on an existing loan or a redraw where they are ahead of their scheduled payments.

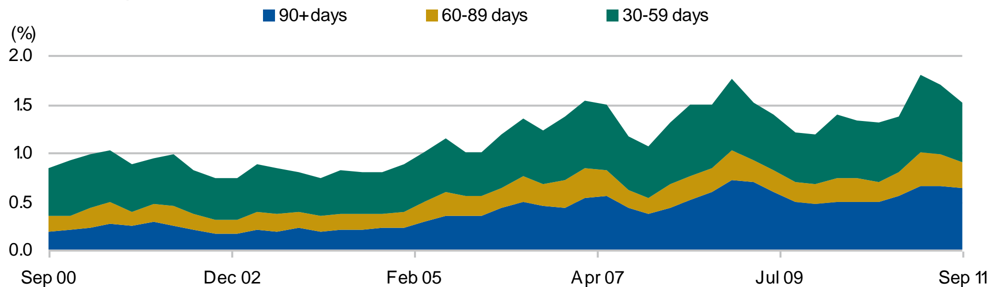
Figure 5



Mortgage Performance

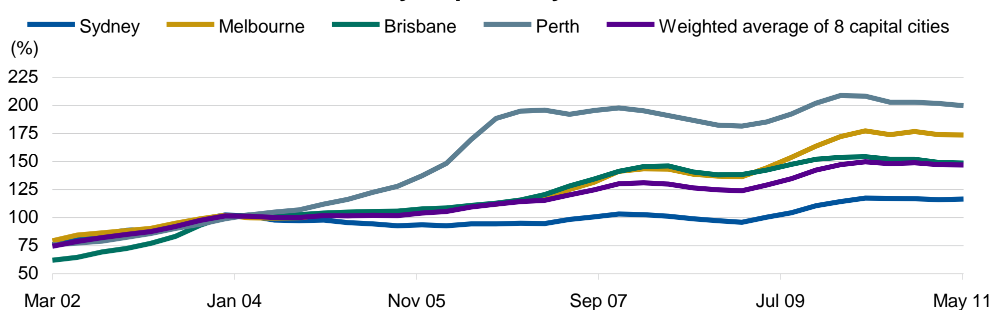
Arrears in the Australian prime RMBS sector slightly decreased in Q211 as no adverse event impacted borrowers' affordability. Households have proven to be able to financially adjust to the variables that have negatively impacted mortgage performance during Q111 (increasing interest rates, natural disasters, seasonal Christmas spending). 30+ days delinquencies were 1.69% in June 2011, down 10bp from the record high of 1.79% delinquency rate in March 2011. As expected, the decrease in arrears was predominantly in the 30-59 days and 60-89 days buckets which were also the buckets that increased the most during Q111. Fitch would expect stabilisation to continue through Q311 as borrowers' serviceability is expected to have remained stable during the quarter.

Figure 6



Property Prices

Figure 7



Australian house prices have risen steadily over the past decade, peaking in mid-2010. The decline in Australian house prices from their peak has not been as severe as the decline in some other international markets, with price falls being unsubstantial and limited to individual markets, rather than being Australia-wide. Figure 7 indicates that prices, while having fallen slightly from their recent peak in 2010, have remained relatively stable over the past year.

Key Model Drivers

Fitch currently rates both conforming and non-conforming residential mortgage transactions in Australia utilising a proprietary model. In analysing pools of residential mortgages, the key model drivers are probability of default and market value declines.

The agency's mortgage default analysis is based on the Australian mortgage default model. Default probabilities are based on current LVR, utilising long-term default data. Additional adjustments can be made to the base default probabilities for various loan product types, such as, but not limited to, investment loans or low documentation loans, and also around the characteristics of borrowers, such as whether they are employees or self-employed. LVRs are generally determined by external valuations with automated valuation models little used in Australia.

Market value declines have been developed for the Australian market based on long-term price trends and expectations of potential market volatility in various stressed scenarios. Fitch's 'AAA' market value decline for Australian residential properties commence at 47% and can be adjusted upwards, dependent on property type, location and property value.

LMI is a feature of Australian residential mortgage lending, with lenders generally requiring borrowers to pay for LMI if their LVR is greater than 80%. It is anticipated that cover pools will include a relatively small proportion of loans that have LMI as a loss mitigant.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

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