

Covered bonds: A GLOBAL INSTRUMENT

with unlimited potential?

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Barclays Capital defines a covered bond as a senior debt instrument of the issuer having priority recourse to a pool of assets ring fenced from the other assets of the issuer. Covered bonds are hybrid instruments combining the flexibility of unsecured debt with the low risk nature of specific assets. The main difference between a covered bond and a securitisation note is the recourse to the issuer: while the obligation to repay a covered bond rests with the issuer, and only upon default will the investor have recourse to the pool of assets, investors in securitisation transactions can only look to the underlying assets for repayment.

Not only do covered bond investors benefit from the management expertise of the issuer to take pre-emptive action against a downturn in the market, while still being protected by recourse to a specific pool of assets, investors are also protected against structural risks that are present in securitisations. Investors in securitisation transactions are repaid by the cash flows from the assets only and should the performance of the assets or the structural integrity be affected by external factors, there is little action that can be taken. Exhibit 1 provides an overview of the main differences between covered bonds and securitisation notes generally observed.

COVERED BONDS ORIGINS

Covered bonds originated from a need for a safe financing instrument which could attract funds in times

of bad economic climate. The first Pfandbriefe were issued in Germany in 1769 after the Seven Years' War and were secured on property. In the mid 19th century Pfandbriefe were issued by public law credit institutions. Not long after the first Pfandbriefe, Denmark created its own covered bond when in 1797 the first mortgage credit institution was established with the purpose to provide people with loans to rebuild their houses destroyed by the great fire of Copenhagen. The first mortgage law in Denmark was established in 1850. Over time more jurisdictions recognised the efficiency of the covered bond instrument to finance relatively low risk assets, and covered bond frameworks have been established all across Europe. The latest covered bond instruments are the structured covered bonds, instruments created within the general legal framework. While in most countries specific legislation is needed to

Differences between covered bonds and securitisation note

Exhibit 1

| | Covered bonds | Securitisation note |
|---|--|--|
| 1 | The issuer is generally the originator of the assets and an operating entity. | The issuer is a special purpose company |
| 2 | The originator is responsible for repaying the covered bonds independent of the performance of the collateral. | Only the cash flows from the collateral will repay the investors. |
| 3 | The assets are generally limited to public sector or mortgage assets. | There are no restrictions on the type of underlying assets |
| 4 | Structural risk is generally limited due to recourse to the originator. | Without recourse to the originator, structural risk is borne by the investors. |
| 5 | Regulatory supervision of the issuers provides comfort to covered bond investors. | The issuers are generally not regulated |
| 6 | The characteristics of a covered bond are standard (fixed rate bullet repayment) | Securitisation notes are generally floating rate and the term of the notes is influenced by the type of assets |

Source: Barclays Capital

ring fence assets from the general insolvency legislation, in certain countries like the UK the general legislation is sufficiently creditor friendly to allow ring fencing without the benefit of specific legislation.

apply a reduced risk weighting between government and bank risk weightings. These characteristics make covered bonds an important hedging tool for the swap markets and supply of covered bonds is an important driver of swap spreads.

CHARACTERISTICS OF THE COVERED BOND MARKET

As outlined previously, covered bond instruments are issued directly from the balance sheet of an issuer with priority recourse to low risk assets which are mainly loans to public sector institutions or mortgage assets. The term of covered bonds varies between three and 30 years, but the main issuance is seen at five, seven and 10 years, providing long-term financing for the issuers. Covered bonds are generally euro-denominated at a fixed rate and are by many market participants considered as gilt-edged securities. Certain jurisdictions acknowledge the reduced risk compared to unsecured issuance and

GEOGRAPHIC REACH IS EXPANDING

The first covered bonds in Germany and Denmark were sold domestically. Cross border marketing was limited, mainly caused by currency risk. The arrival of the euro opened up the European covered bond markets, and the popularity of covered bonds both for issuers and investors has increased significantly. The Spanish market has attracted widespread investor interest and the outstanding amount has reached €88bn. Two Austrian benchmark issuers have expanded their investor base into Asia and new covered bond markets have started to

Coverage of covered bonds

Exhibit 2



Source: Barclays Capital

develop. A Hungarian issuer has brought one issue already to market and is already preparing a Euro-denominated transaction. Ireland has seen its first mortgage covered bond, and Barclays Capital would expect issues out of Sweden, Norway and Italy in the near future. The efficiency of covered bonds has also been discovered by countries with a common legal system. Countries such as the UK have successfully issued structured covered bonds, and this success has prompted interest from other similar jurisdictions such as Australia.

The rapid growth has been the result of accelerating institutional investor interest in covered bonds. In general, covered bonds have become increasingly attractive for the traditional government bond investors. Covered bonds provide a higher yield compared to a government bond, have strong credit ratings and a high degree of liquidity due to the market-making agreements of the underwriting banks. At a time when many finance ministries are running larger budget deficits, covered bond issuers can

issue only under strict guidelines and offer a balanced and diversified portfolio risk. As a result portfolio managers around the globe have included covered bonds in their indices, causing increased purchasing.

Another driver of growth is the funds placed in covered bonds by equity investors which provide an attractive alternative to hedge funds. The amount of hedge fund money moving into covered bonds has been noticeable in cities as diverse as Sydney, Hong Kong, London and New York.

There are also specific local reasons driving this growth. In Japan, where yields in yen are low, many investors have been willing to invest in high-quality, liquid, Euro-denominated securities for the extra yield. In Australia, many investors (including mineral exporting companies) have found their liquidity rising on better commodity prices due to strong Asian demand. With the Australian dollar yield differential reducing and the currency expected to weaken this liquidity has helped the demand for covered bonds.

In non-Japan Asia, the higher return of covered bonds can provide central banks with an alternative to government bonds. The movement of central bank money flowing into covered bonds has been strong for the last few years. Many more central banks from diverse regions such as Asia, Middle East, Africa, Eastern and Western Europe and the South Pacific, are now investing reserves in covered bonds. These central banks are also attracted by the tight controls surrounding covered bonds.

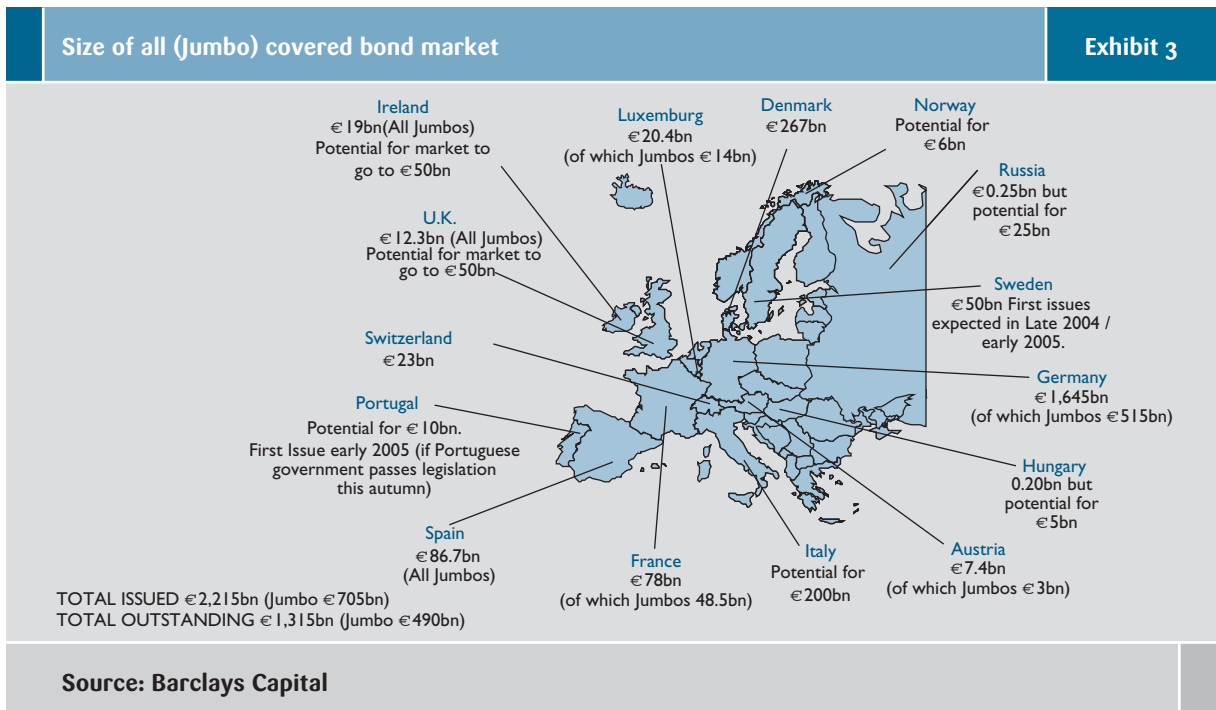
Going forward the market is likely to be supported by an increasing number of countries developing a covered bond instrument. Exhibit 3 indicates that many local investors, who might not have been involved in the covered bond market previously, are now investing in their local market. As a result, cross border investments in other covered bond instruments are becoming more common. The inaugural UK covered bond opened up a lot of traditional UK-focused investors not only to UK covered bonds, but also covered bonds from other jurisdictions. Many covered

bond issuers outside the UK have seen the participation from UK investors in their programme increase.

This trend for covered bond investment is now spreading to the other side of the Atlantic. More issuers of covered bonds have been issuing 144a eligible securities that have been placed with qualified institutional buyers. More covered bond issues are now denominated in US dollars compared to a few years ago, and the accountancy issues with the US agency market has freed up liquidity for investment in covered bonds in North America. As some of the issuers have increased their lending activity in the US, this increased investment interest in covered bonds should continue.

CREDIT RATINGS UNDERSTOOD

With the rapid expansion of the covered bond market, and more covered bonds being sold cross-border, ratings



have increasingly become a focus. Historically, the issuer's credit strength was the driver for the rating of the covered bond, with the secured nature and quality of the collateral being reflected by a few notches. Over time issuers and regulators have invested a lot of time and effort in strengthening the covered bond instruments. This has improved the security position of the investors and has introduced the ability to analyse the risk of the collateral independent of the credit strength of the issuer. The result is that more sophisticated risk assessment tools can be used and the highest ratings can be achieved irrespective of the rating of the issuer.

To achieve the highest credit ratings there are generally four categories of risk that need to be considered. The first category is the credit strength of the assets. While most covered bond instruments are restricted by the type of assets, the risk within a certain type can vary materially. For example, the loan-to-value restriction for mortgage assets is only one of the determinants of the risk inherent in the mortgage asset. Other factors such as affordability, credit quality of the borrowers and diversification play an important role. For public sector assets the level of creditworthiness will vary by the amount of government support in the system. It also makes a difference in which jurisdictions the assets are located. The assets in the pool in combination with any overcollateralisation for the benefit of the investors should be compliant with the rating level.

The second category of risk deals with market risk. Market risks are introduced when the assets are either paying interest on a different basis, or are paying interest in a different currency. Covered bonds have historically and still are predominantly fixed rate, while the interest rates on the assets often vary. Public sector assets are often also fixed rate, which creates a manageable mismatch. Mortgage assets across Europe however are predominantly based on a floating rate, with the notable exception of Germany. The mismatch between floating rate on the mortgage assets and fixed rate on the covered bonds will need to be mitigated to obtain the highest rating levels.

The third category is asset-liability management risk ("ALM"), also called liquidity risk. The risk stems from the different repayment profiles on the assets compared to the covered bonds - while covered bonds are bullet securities, the underlying assets either are bullet but do not mature on the same dates (public sector assets), or are not bullet but follow for example an annuity repayment profile (mortgage assets). This risk takes two forms: 1) reinvestment risk, because the principal cash flow received before a repayment of the covered bond is due will need to be reinvested and 2) refinancing risk, because when a bullet covered bond is due for repayment, there will not be sufficient principal receipts to repay the bullet. Apart from Denmark, where the balance principle matches the term of the bonds with each individual mortgage, all other covered bond jurisdictions are subject to this refinancing risk. The size of the refinancing risk will depend on the liquidity and quality of the assets in the pool, which will determine the ease of monetising the assets.

The fourth risk is the operational risk, which includes for example the certainty of segregation of the assets within the legal framework and the certainty there will be a quick resumption of servicing obligation in the event of issuer default.

The mitigation of the four risks outlined above creates a further risk: counterparty risk. A risk is only mitigated as long as the counterparty is able to fulfil its obligations, and thus counterparties are generally highly rated well established financial institutions, but the rating agencies will also insist that substitute counterparties are found if the credit rating deteriorates. Investors should be aware that specific covered bond legislation does not and probably cannot mitigate all the risks outlined above to the requirement of the rating agencies. However, as long as the operational risks are mitigated by the specific legislation, the remaining risks can generally be mitigated by contractual arrangement.

For a covered bond to obtain the highest credit ratings, the risks outlined above will need to be mitigated to the

requirement of the rating agencies. The three rating agencies apply a different methodology to rating covered bonds, and these differences need to be understood to assess rating volatility.

S&P's rating methodology starts with the assessment of the legal framework to establish whether the rating on the covered bonds can be de-linked from the rating of the issuer. This would mean that upon default of the issuer, the access to the cash-flows from the assets is not interrupted by the insolvency procedures. If covered bonds are not deemed to be de-linked, for example in Spain, the rating on the covered bond will be notched from the rating of the issuer. If the covered bonds are de-linked, S&P will apply a collateral analysis methodology akin to the methodology applied in securitisation transactions, focusing on the risks outlined above. These risks will need to be mitigated to comply with the rating level sought to the covered bonds, which generally would be AAA.

The methodology applied by Fitch is broadly in line with S&P. If there is a legislative and regulatory framework, the first step is to review and discuss the framework with legal counsel and the appropriate authorities. The goal is to assess whether the cover pool and the related covered bonds are able to survive the insolvency of the issuer. If this is the case, Fitch would be able to assign a rating on the covered bonds that is not directly dependent on the rating of the issuer. For instance, this is the methodology that would be used to rate the French and Irish covered bonds. If the related covered bonds cannot survive the insolvency of the issuer, the rating on the covered bonds would be directly determined by the rating of the issuer. Due to the secured nature of covered bonds, in this case Fitch would typically award a certain number of notches above the reference rating, reflecting the level of expected recoveries. This is the current approach on Spanish covered bonds, despite the latest changes to the bankruptcy regimes.

In case the covered bonds rely on a set of contractual agreements under the general legal and regulatory

framework rather than on specific laws or guidelines from the regulators, Fitch would review the applicable documentation in order to answer the same question, i.e. whether the bonds are protected from a bankruptcy of the issuer. From a rating agency point of view, covered bonds issued out of countries with and without a legislation (for instance in the UK) have reached the highest rating, which means their credit risk is equivalent.

The second step is the analysis of the assets backing the covered bonds. Fitch will analyse each sub-portfolio (i.e. residential loans, commercial mortgage loans, loans to public entities) in isolation, to judge their credit quality. Expected default and recoveries are assessed according to similar criteria than those applied in the residential and commercial mortgage backed securitisations, or CDO methodologies. Fitch also focuses on concentrations in the cover pool, both geographic and debtor concentrations.

The third aspect concerns the asset/liability management. In certain cases, Fitch is sufficiently confident to assume that liquidity can be obtained against the cover pool assets to redeem the covered bonds, or that the assets are sufficiently liquid to be sold, and appropriate scenarios are applied. Fitch also makes assumptions on the cost of negative carry.

In addition to maturity mismatches, Fitch will analyse the market risk and the amount of support through for example overcollateralisation available for unhedged positions. Any hedges put in place would be assessed taking into account the credit quality of the counterparties. Lastly, Fitch would form a view on the operational capacity of the originator and the likelihood of finding a substitute servicer.

The Moody's approach historically has been a notching approach, with the amount of notches applied based on a relative ranking of frameworks by comparing the high level parameters such as type of asset, loan-to-value and geographic spread. If the notching approach is used, this automatically implies a strong linkage to the rating of the issuer, and thus would imply a link between the

default probabilities of the issuer and the covered bonds. If S&P and Fitch were to classify a framework as sufficiently strong to de-link the two ratings, the different methodologies may cause confusion in the market about the actual credit risk of the covered bond. The amount of notches that can be achieved in the Moody's methodology will depend on a relative value assessment between different frameworks, but generally varies between one and three for mortgage-backed covered bonds and one notch more for public sector covered bonds.

However, it is also possible to obtain a Moody's rating on the covered bonds using a similar approach to S&P and Fitch. In this case the driver of the rating will be the collateral and the level to which the risks outlined above have been mitigated, either by legislation or by contractual arrangements. In this methodology Moody's also believes that there is a certain amount of linkage, but this linkage could be minimised to the same amount of linkage observed in securitisation transactions. If this approach is followed the rating volatility or probability of downgrade, should be the downgrade experience of Aaa notes in a securitisation. However, it should be noted that the rating linkage will depend on the level of flexibility sought by an issuer: the higher the flexibility, the higher the linkage.

THE OUTLOOK FOR THE COVERED BOND MARKET

The covered bond market has seen a dramatic growth over the last few years and some market observers are asking whether the recent growth is sustainable. As more

investors around the world participate in this market and new investors in traditional markets become involved (such as the smaller German savings and cooperative banks) the future looks positive. When one compares the outstanding jumbos of the covered bond market compared to the size of the European government bond market and US agency market, the growth potential is great.

From the supply side, the number of covered bond jurisdictions is growing, and for the first time has moved across the Atlantic to Mexico. The new frameworks will increasingly be tailored to ensure the highest credit ratings can be achieved, hence focusing on being able to mitigate the risks outlined above, which should have a positive impact on the homogeneity of covered bonds going forward. There will always be differences in collateral to be observed, but these differences can be mitigated in a consistent manner. With the increase in the number of issuers and jurisdictions, the strength of the covered bond globally is beyond doubt.



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