

Cover Up - European Mortgage Bonds

Rates

The structure of covered bonds

Rising differentiation and complexity within the covered bond segment urges a closer look at the respective features that characterise covered bonds and the implications of changing them. Although the financial impact of altering these features can be significant for the bondholder, the market does not appear to be reflecting these differences in the pricing yet.

 Europe
Covered Bonds

Chart 1 : Gross issuance of traditional and structured covered bonds



*Structured CH, UKCB, FA, OF
 Source: ABN AMRO

Traditionally, covered bonds were defined as bank obligations that were secured by the covered bondholder's preferential claim on a pool of high-quality assets. Other elements of a covered bond include the special bank principle, dynamic cover pools, non-acceleration in case of the issuer's default and a full recourse of the covered bondholders. However, not all covered bond frameworks are based upon all these core features.

The success of structured covered bonds is likely to fuel the development of rising differentiation within the segment. We expect that in some cases the characteristics of new structured covered bonds will differ significantly from those of traditional covered bonds, and their features may differ from the aforementioned. In some cases this will move covered bonds further away from their traditional understanding and closer towards off-balance sheet securitisation products such as asset-backed securities (ABS) and mortgage-backed securities (MBS).

Although the line between covered bonds and asset-backed securities is most likely to continue to fade, both products are unlikely to become fully exchangeable to issuers who just chose the product with the lowest funding cost. Covered bonds and ABS/MBS are not equally well suited for all asset classes.

Disclosures and analyst certifications are at the end of the body of this research.

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The structure of covered bonds

The growing number of covered bond frameworks and the increased use of structured covered bonds (CB) are leading to a broader range of covered bond systems with different characteristics and a rising level of complexity. While this increases the diversification within the covered bond group, it also raises the need to take a closer look at the respective features that characterise CB and the possible variations. The alteration of these features may have a major impact on a CB's characteristics and also have a significant economic effect.

As all these products will be sold under the brand name 'covered bonds' or 'structured covered bonds', the market tends not to always differentiate between the various structures. CB structures are often compared by their rating and characteristics regarding their collateral, eg loan-to-value (LTV) ratios or level of over-collateralisation. These quantitative features are more easy to compare, however, they are not necessarily the most important determinants of a CB's character. In addition, the current low differentiation is also supported by the compressed Jumbo swap spreads, which increase the market's appetite for new structured CB that offer some pick up. As the market matures and participants become more acquainted with structured CB, the pricing impact of the CB features described below could increase, thus changing the perception of the different CB systems.

Characteristics of covered bonds

In a traditional way, CB have been defined as bank obligations that are secured by a preferential claim of the CB holders on a pool of **high quality assets** (either public sector debt or mortgages). In many frameworks, eg the German, the Irish or the French, the business activities of the issuing institutes are limited to low risk activities, such as public sector and mortgage lending, generally referred to as the **special bank principle**. Although the mortgage collateral often have an amortising repayment schedule, the outstanding covered bonds use a **hard bullet** structure. This is possible due to the **pool's dynamic**, which allows the issuer to replace maturing or defaulting assets with fresh mortgages. Another core feature of the CB is the bankruptcy remoteness, ie the segregation of the cover pools and the CB from the balance sheet of the issuer if the latter defaults. Ideally, the **CB are not accelerated when the issuer defaults**, but remain outstanding and continue to pay interest until their scheduled maturity. If the collateral pool is insufficient to satisfy all CB holders, their remaining claims rank pari passu with the unsecured creditors of the issuer. The issuer's obligation to replace assets within the pool in a pre-insolvency scenario and the residual claim of non-satisfied CB holders are referred to as **full recourse**.

Recourse of CB holders

A core element of all CB is the preferential claim of the CB holders against a pool of assets or the proceeds arising from it, respectively. However, this does not necessarily mean that the CB holders have a claim only against the collateral pool. Usually, in the first instance, a CB is a senior debt obligation of the issuing bank. As long as the bank is solvent, it will pay interest and notional on the outstanding CB out of its cash flows arising from the whole balance sheet. In this respect a covered bond does not differ from a usual unsecured bond by the same issuer, even if there is a

shortfall in cash flow arising from the collateral pool, the bank would be obliged to fully serve the outstanding CB. In the case of the issuer's insolvency and the split off of the cover pools from its balance sheet and the bankruptcy proceedings, the CB holders have a preferential claim against the cover pool. If the CB holders are not fully satisfied by the cover pool, their remaining claims rank *pari passu* with the unsecured creditors of the issuer. This constellation results in a full recourse of the CB holder against the issuer and is a main feature of, for example, the German Pfandbrief system.

The recourse of the CB holder could be limited by excluding the residual claim against the bank in case the cover pool is insufficient to fully repay all CB. In this instance there is only a general recourse against the issuer, including the issuer's obligation to the substitute defaulting and maturing assets within the pool. So far this has only been factually the case in countries (eg France) where the issuer has no assets besides the collateral assets.

In a no-recourse scenario the CB holder would only have a claim on the proceeds from the cover pool. The issuer would have no obligation to substitute assets in the cover pool. In this case it would be possible that the CB defaults while the issuer is still solvent. The no-recourse structure puts the character of on-balance sheet securitisation into question. In fact it is a lot closer to the off-balance sheet securitisation where there is no recourse of the note holder against the originator if the assets in the SPV are not sufficient to cover all claims of the note holder. Also the exclusive recourse against the cover pool changes the character of the CB insofar that it is at least economically not a bank bond anymore. In our opinion, the no-recourse scenario collides with most of the core principles of CB as we know them so far. The expected implications on the risk weighting (ie potentially more than 20%) and the required extensive analysis of the collateral pool could also result in an at least partially different investor group.

It is important to note that a full recourse of the CB holder does not automatically result in a high linkage of the CB rating to the unsecured rating of the issuer. The extent to which the legal framework provides immunity to the CB against the bankruptcy of the issuer is by far the most important factor for the de-linking of the two ratings. Even in a limited or no-recourse scenario, a strong link between the bankruptcy of the issuer and the CB is possible if there is no over-collateralisation and a high level of cash flow mismatches or missing post-bankruptcy procedures lead to delays in payments.

Special bank principle

Not only do specialised banks and commercial banks issue CB, the market also knows quasi-SPV and full SPV structures. A quasi-SPV would be a special bank that has no own asset origination capacities. It merely acts as a funding vehicle of its parent bank which originates the assets and transfers them to the funding subsidiary. This is the case in the French Obligations Foncières (OF) market and, to some extent, in the Irish ACS market. In some cases (eg France) the issuer is protected from the possible bankruptcy of its parent company. However, this is mostly regulated in the respective insolvency laws rather than in the CB framework. The fact that the assets of these institutes consist (almost) exclusively of cover assets limits the economic value of the recourse of the CB holders. In an insolvency event there would be no or very limited additional assets outside the collateral pools that could cover potential unsatisfied claims of CB holders. In some cases there might be support from the parent company, which may have provided a letter of comfort or a keep-well agreement to its subsidiaries. However, this does not translate into a direct claim of the CB holder against the parent company.

The more non-collateral assets there are in relation to cover assets on the balance sheet of the issuer, the more important is the full recourse of the CB holder. The highest potential economical value of such a recourse exists where the issuer is a commercial bank. The system of Spanish Cédulas Hipotecarias goes even further and offers an additional preferential recourse of CB holders on mortgages that do not qualify as collateral for the CB.

In a full SPV structure, as that being used in UK covered bonds, the assets are held by a SPV, while the bonds are issued by a bank. The SPV is a consolidated part of the issuer until the latter is not bankrupt. The bonds are guaranteed by the SPV, while the CB holder has a full recourse against the issuer and the guarantor. The assets are sold to the SPV and transferred via an equitable assignment. When a certain event occurs (eg the issuer's insolvency or rating trigger), the transfer of the assets is completed. As long as the issuer remains solvent, it substitutes maturing and defaulting assets within the pool.

Repayment structure

Traditionally CB use hard bullet repayment structures while structured covered bonds sometimes contain soft bullet structures. This means that the maturity of the covered bond can be extended in a post-bankruptcy scenario in the case of an intermediate shortfall of cash flows without the pool facing bankruptcy. So far this structure has been used in the Spanish Structured Cédulas and some of the UK covered bonds in order to achieve triple-A ratings which would otherwise not been awarded due to the missing timeliness of payment. If the isolated collateral pool cannot fully satisfy all CB holders at the time of repayment, the legal maturity of the CB is extended by a pre-determined period (so far one to three years). This timespan is then assumed to be sufficient to liquidate the existing cover assets. During this period the CB holders continue to receive coupon payments under the terms and conditions of the CB. The additional time could also lead to a higher recovery value than under an immediate forced sale scenario. In a hard bullet structure a failure to re-pay the CB holders would result in the immediate bankruptcy of the collateral pool. Still, the assets would need to be liquidated, which might take an equal amount of time as under the soft bullet scenario. In this respect the soft bullet structure does not primarily influence the time of ultimate payment, rather it determines the legal status of the CB holder until ultimate payment.

Acceleration on issuer's default

A general feature of most covered bonds is the fact that the insolvency of the issuer does not trigger the acceleration of the CB. What does change in such an event is that the cover pool loses its dynamic nature. The issuer will no longer substitute defaulting or maturing assets in the pool. This means that the pool will be exposed to credit deterioration and negative carry risks as well as cash flow mismatches until the last CB has been repaid. Holders of longer-dated CB face a risk that is over-proportionally higher than that of holders of shorter-dated CB. Since all CB holders rank pari passu among each other, it is likely that the shorter CB could be repaid using up collateral buffer or by liquidating ordinary collateral otherwise needed for the longer-dated CB. An additional factor is the administrative cost that arises until the last CB is repaid. These costs depend more on the timespan than on the size of outstanding CB, which again is in favour of the CB maturing earlier. Recent enhancements of CB frameworks like the German one in April 2004 were addressing these problems by implementing an additional collateral buffer and stricter asset-liability management (ALM) requirements.

An automatic acceleration of the CB because of the issuer's default could increase the chances of full repayment of a longer-dated CB. On the other hand, re-investment risk is the highest for holders of a long-dated CB. One aspect to watch in this respect

is the price at which the CB will be repaid. Apart from pari, a redemption at the higher of market price and pari is possible. An automatic acceleration clearly puts an increased weight on a potential minimum over-collateralisation provided by the respective framework, while ALM matching requirements play a less important role. So far, the Spanish Cédulas market has been a good example of this. In general, security requirements in an acceleration system can be less strict, as the collateral pool need not to be always held at a level where it could survive a period of several years after it has become static.

Quality of collateral

The quality of the collateral is the most basic of the features described here. It is another important pricing factor, which can be seen in markets that have both mortgage and public sector debt CB, as the market differentiates between the two asset classes used as collateral. The different perception is also reflected in the rating agencies' approach. S&P has different over-collateral requirements within its rating method for public sector and mortgage CB. Moody's generally awards a higher notching for a public sector CB than for a mortgage CB. Despite several differences like LTV levels, valuation methods, limitation of commercial mortgages or geographical distribution of the cover assets, the collateral type has so far been limited to the two main categories.

In the future, other especially lower rated asset classes, like credit card or car lease receivables, might be used for collateral of CB. It is likely that the pricing impact will be relatively high, even if the CB is rated triple A. The high visibility of the collateral type as a CB feature should be the main reason for this, while the economic impact might be relatively low compared to the other features described above. Note, the maturity structure of the collateral portfolio might be more important than the credit quality of the asset. While lower credit quality can be compensated via over-collateralisation, a relatively short maturity of the cover assets, as in credit card receivables, could have larger implications. The high turnover of assets within the pool and the constant substitution of assets could collide with typical CB characteristics like hard bullet repayment and non-acceleration of the CB if the issuer defaults. A split off and thus static pool could easily run into a negative carry scenario, given the high rate of maturing assets and their high yielding character compared with potential substitution assets. It is thus likely that CB covered by these asset classes would significantly differ in their re-payment structure and/or post-bankruptcy procedures than 'traditional' CB.

Conclusion

The CB market should continue its differentiating trend especially in the field of structured CB. New CB structures will show a combination of the above-mentioned features, in some cases moving further away from the traditional CB and closer towards off-balance sheet securitisation products like ABS and MBS. While the rating differentiation should remain low, with most products aiming for the triple-A area, the character of the structures could differ significantly. As the market matures it is likely that we see a shift in pricing relevance towards the characteristics described herein. The future challenge will not be to decide whether a new structure can be called CB or not, it will be to assess the respective structure or framework to find out whether the character of product meets the investor's expectations. Usually, investors favour CB due to their high level of standardisation and homogeneity which results in a limited analysis effort.

Although the line between CB and asset backed securities will most likely continue to fade, both products are unlikely to become fully exchangeable to issuers who just chose the product with the lowest funding cost. It should become more apparent that CB and ABS/MBS are both suited for special kinds of assets, which are not always

identical. The dynamic collateral and bullet repayment of covered bonds is more suited for long-term assets. The non-acceleration of CB in case of the issuer's insolvency especially suits high quality assets with low default ratios. This reduces the risk of negative carry or a breach in eligibility criteria if the cover pool has become static and is run on its own. Although ABS/MBS can also be used for securitisation of high quality long-dated assets, the real strengths of ABS/MBS will be exploited in case of lower quality assets. This will become even more apparent under Basel II when the relative capital relief on these assets will increase. Short-dated assets are a lot easier to securitise since their repayment structure can be replicated in the ABS redemption profile. The generally lower level of standardisation of ABS/MBS makes them suitable for a wider range of underlying assets. With the potential broadening of the collateral base for CB, the highest risk would be the loss of standardisation and homogeneity, which so far has been a key strength of the product.

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