Azure Kingfisher

A sharp eye on structured finance

DEBT CAPITAL MARKETS

University of Melbourne
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Lecture 6: Covered Bonds

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History, market, benefits and risks

A. COVERED BONDS (FT)

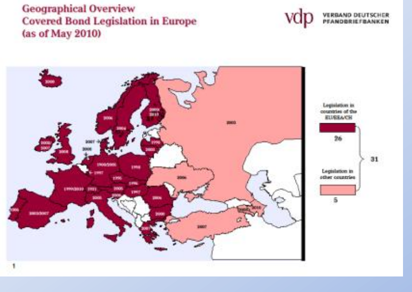
Description

- A bond issued by a financial institution
- with full recourse to the issuer
- and priority recourse to a segregated pool of assets (the 'cover pool') in the event of a default by the issuer
- whilst the cover pool is 'managed' by the issuer
- and should at all times maintain sufficient assets in the pool
- under public supervision

History

- Traditionally civil law product, but evolving:
  - Germany: *Pfandbriefe* since 1769 – Frederick the Great
    Development of German mortgage banks in 19th century
  - Denmark: *Realkreditobligationer*
  - Austria: *Pfandbriefe* since 1899
  - France: *Obligations Foncières* since 1999
  - Spain: *Cedulas Hipotecarias*
  - UK: First structured covered bonds issued 2003
  - USA: First issue 2006
  - Canada: First issue 2007
  - Australia: ?
  - US: ??

Overview



Market Today

- Currently US$ 2.5 trillion outstanding, almost on parity with ordinary senior bonds (from a niche market!)
- Limitations on supply (assets, regulatory)
- Covered bonds rules in the US?

(a) Issuer Benefits

- High investment limits for European funds, broadening the investor base
- Additional source of funding
- Long term funding
- ECB eligible collateral (especially now)
- Very strong historical performance
- Ability to issue securities with a credit rating higher than the issuers (though not fully de-linked) cheap funding (compare senior bonds / securitisation)

Investor Benefits

- Regulatory: low risk weighting for investors (10%) if compliant with EU UCITS Directive (collective investments Directive), otherwise 20%
- Better secondary market liquidity (compared with CDOs)
- Higher yield as compared to government bonds (and currently even higher than unsecured senior bank bonds, market anomaly)
- *Key:* as the underlying credit risk is not transferred off balance sheet, incentive for issuer to maintain underwriting standards

Sidestep: UCITS Directive

- Issuer: EU credit institution
- Eligible assets only (prescribed)
- At all times: assets capable of covering the bondholders' claims
- Priority claim in the event of default
- Special public supervision (under statute)

(b) Risks

- Collateral
- Liquidity
  - regulatory limits
  - finding new assets

Regulated and unregulated covered bonds

B. STRUCTURES

Two Structures

- Depending on how recourse is structured, key differentiating factor is transfer of assets
- Segregation of assets achieved by:
  - Statute in majority of (mostly civil law) jurisdictions with a tradition in covered bonds (Germany, France, Spain, Italy, Ireland)
  - Contractual arrangements in others, "structured" deals (UK, Netherlands, USA, Canada)
- Banks may use both platforms, and deals may combine both features (e.g. O/C higher than statute)

Two Structures

Statute ('Integrated')

- Continental
- Segregation of assets achieved by statute
- No need for actual transfer of cover pool assets
- Bondholders have a superior claim in insolvency

Structured ('Segregated')

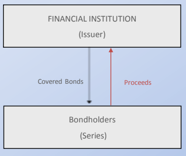
- Cover pool assets *are* transferred to a third party to isolate them from the issuer's insolvency risk
- Guarantee-based

Statutory Covered Bonds

- To be included in the structure, step by step diagram.

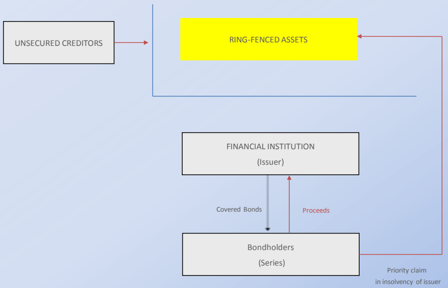
Key Features

- Issuer is a financial institution, not an SPV
  - with exceptions



Ring-fenced Assets

- How?
  - Exclude from insolvency estate by special law
  - Bondholders provided with a preferred claim over unsecured creditors within the insolvency estate by special law (both statute)
  - Excluding from bankrupt estate by transferring assets to an affiliate
  - Pledging assets under Collateral Directive (both contract)

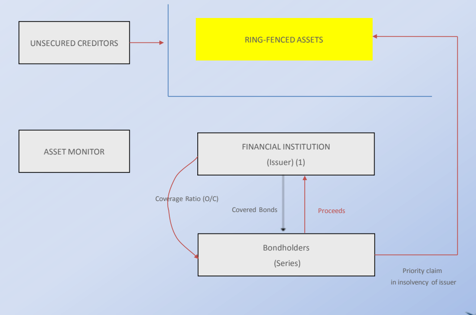


Asset Pool

- Typical assets in the pool:
  - Residential or commercial mortgage loans
  - Public sector loans
  - Shipping loans
  - RMBS / CMBS or ABS
- Not: equity, real estate, commodities
- Regulators keen to avoid 'cherry-picking' of assets by issuers (FSA)
- Good quality assets > structural subordination of other creditors such as deposit holders of the issuer?

Eligibility Criteria

- Determined by regulation under statute and / or contract, plus (European) Central Bank requirements
  - The eligibility criteria include not just type, but also size, granularity, yield, tenor,
  - Example; no 'NPLs' (need to define NPL, follow issuer's accountancy along with applicable regulation)
  - Or no 'restructured' loans

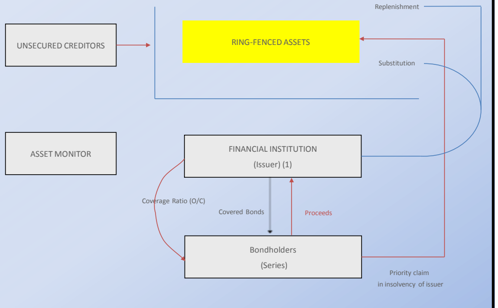


Security Coverage Ratio

- Main protection for investors: over-collateralisation
  - Irrespective of the series of notes (pari passu)
  - ‘must be maintained at all times’ (regulatory requirement)
  - How often tested
  - Percentage (regulatory and / or contract)?
  - What if breached? Proceeds into segregated account, then through waterfall?

Covenants

- Financial covenants (O/C)
- Negative pledge / disposal of ring-fenced assets (either by statute or by law)



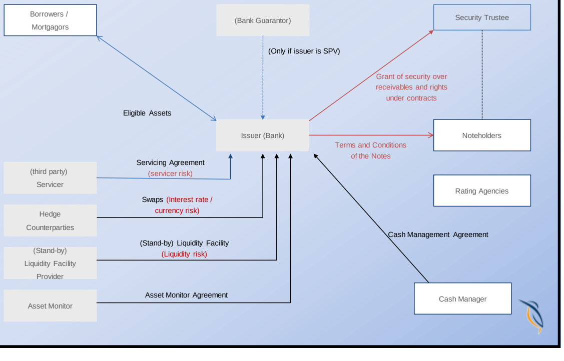
Public Supervision

- The obligations of the credit institution in respect of the cover pool are supervised by public or other independent bodies.
- Typical features of “special” supervision include:
  - a special cover pool monitor (or ‘security supervisor’, typically a reputable auditor)
  - periodic audits of the cover pool by the cover pool monitor
  - ongoing management and maintenance of the cover pool upon the credit institution’s insolvency to ensure the timely payment of covered bondholders.

Pool Mechanics?

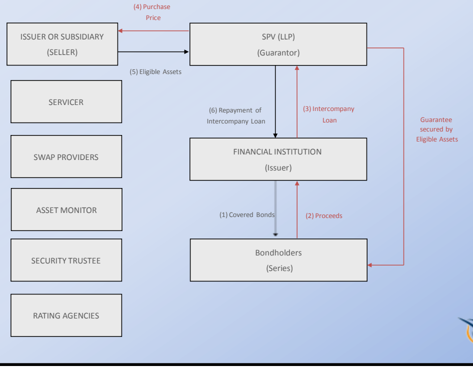
- Again, how is the quality of the cover pool maintained?
  - What happens if a loan becomes ineligible (for instance because it is past due more than 60 days)? It must be replaced
  - What happens if a loan in the pool is repaid? Funds used to replenish the pool
  - What happens if a series of notes is repaid? Assets de-selected at random

Documentation of Covered Bonds



Structured Covered Bonds

- By comparison: UK 'segregated' structure



C. COMPARE WITH SECURITISATION

Differences

Securitisation

- Issuer is SPV
- Limited recourse (assets only)
- Often off-balance sheet for accountancy purposes
- CRT (regulatory capital relief)

Covered Bonds

- Issuer is Financial Institution (or affiliate)
- Dual Recourse (issuer and ring-fenced assets)
- On-balance sheet
- No credit risk transfer

Differences (2)

Securitisation

- Often one-off transaction
- Actively managed (CDO) or replenished (RMBS)
- (Often) amortising (RMBS)
- Prepayment risk (RMBS)
- Advanced de-linking from credit risk issuer

Covered Bonds

- Documentation is program-based
- Dynamic pool (even if eligible)
- Bullet repayment
- No prepayment risk
- Limited de-linking from credit risk issuer

Australia

- Hitherto: APRA judged covered bonds to be inconsistent with depositor preference provisions in the Banking Act, therefore prohibited (APS 120)
- 'other synthetic or structured transactions that are in economic substance equivalent to covered bonds will also not be acceptable'
- Yet compelling argument for bank funding…

Green light

- Effect of covered bonds on depositor protection mitigated by cap on issuance
- Securitisation's loss is covered bond's gain (facilitate bank access to stable funding)
- Same for senior unsecured bank debt

References

- www.pfandbrief.de
- www.coveredbondnews.com/
- http://ecbc.hypo.org/ (European Covered Bond Council)