

Covered Bonds in Asia

Background:

The covered bond industry has come a long way since the first issuance in Germany in 1769. The first issuance in Denmark happened in 1797 after the fire of Copenhagen in 1795. Although covered bonds have been in existence for centuries, both the issuance and amount outstanding of covered bonds have grown considerably only since the mid-1990s. Announced issuance of covered bonds has increased from less than €100 billion in the mid- 1990s to over €350 billion in 2006. In mid-2007, the outstanding amount of covered bonds was at least €1.7 trillion. This expansion has coincided with dedicated covered bond legislation being enacted in quite a few countries to facilitate the growth of the covered bond market and also the use of structuring techniques to issue covered bonds without the need for special legislation.

Covered bonds are finding a new acceptability. Even before the subprime crisis blew up to its full dimensions, certain US issuers had started using covered bonds – Washington Mutual is perhaps the first one to come up with US covered bonds in Sept 2006, followed by Bank of America in the next year. Post the subprime crisis, US Treasury Secretary Paulson came out with the Treasury's plan to promote covered bonds, including a statement of Best Practices. This has created a promise that the USA, with its vast, and unarguably, the world's largest, mortgage finance market, would join the list of countries that use covered bonds.

Hitherto, US mortgage refinancing market has depended substantially on off-balance sheet securitizations over the past 3 decades. On the contrary, the European market, particularly the Continental Europe, has been using covered bonds for years. In some countries, for instance, in Germany, the history of mortgage bonds or *pfandbriefs* goes to some 300 years. The growth in covered bonds issuance has been slower than that of securitization. The outstanding covered bonds issuance end-2007 was estimated to be about \$ 2.6 trillion, with the issuance in 2007 being \$ 242 billion. Covered bonds have historically been associated with the German (Pfanbbrief) and Denmark (realkreditobligationer) market. However, over time, covered bond instrument has been promoted actively all over Europe, and even outside Europe. Some 20 European countries have passed laws to enable covered bonds. Outside of Europe, in Sept 2006, Washington Mutual became the first US issuer of covered bonds.

Understanding of Covered Bonds:

Meaning of Covered Bonds:

The European Covered Bond Council describes covered bond as –

Debt instruments secured by a cover pool of mortgage loans (property as collateral) or public-sector debt to which investors have a preferential claim in the event of default. While the nature of this preferential claim, as well as other safety features (asset eligibility and coverage, bankruptcy-remoteness and regulation) depends on the specific framework under which a covered bond is issued, it is the safety aspect that is common to all covered bonds.

Some of the features of covered bonds are:

- They stay on balance sheet so the benefit of capital relief that securitization provides are not there, but may qualify for preferential risk weightings
- There is dual recourse
 - o To the ring fenced assets called the “cover pool” comprising of high quality of assets. The standard for quality of assets are either laid down in the specific law or is stated in the contract, if guided by the common law
 - o To the originator, so the default risk and prepayment risk are not transferred to the bondholders as in case of securitization
- The bonds have capital market liquidity as in case of securitization
- Bankruptcy remoteness is attained not by a true sale as in securitization but by ring fencing of assets, i.e the pool of assets backing the bonds can be identified at any point. Thus in case of bankruptcy of the originator, the security interest of bondholders would not be frustrated or compromised
- Issuer rating does not affect the ratings of Covered Bonds

Structure of covered bonds:

Covered bonds are on-balance sheet securitizations. If by “securitization” is meant the transfer of a pool and its transformation into securities, then covered bonds are not securitization: they are closer to a secured bonds issuance. In a mainstream covered bonds transaction, there is no transfer of the assets to a special purpose entity. On the other hand, the assets are identified and ring-fenced as per local law, and are placed as a security for the bonds. In the event of bankruptcy of the mortgage originator, a general secured lending law or a special law relating to the covered bonds grants the bond holders recourse against the pool of mortgages over which security interest had been created. In

the event of defaults on the mortgages, investors still have recourse against the bond issuer. In other words, investors have recourse against the bond issuer as well against the collateral – a covered bond is a case of collateralized borrowing by the issuer.

The word “covered bonds” clearly indicates this feature of these securities. These securities, structured as bonds, are backed by assets of a particular value. The value of assets that back up the bonds are the “cover assets”. The bond instrument requires maintenance of a particular cover, mostly containing an element of over-collateralisation, at all times. In case of bonds backed by mortgages, the cover assets are obviously mortgages. Hence, like in case of securitization, there is identification of a pool. However, the pool is not isolated by true sale: the requirement of bankruptcy remoteness is satisfied by law rather than by sale of the assets.

While the generic legal structure of covered bonds is similar to a secured bond with security interest over a pool of assets, the finer details of the legal structure have been adapted differently in different jurisdictions. For example:

- In UK, a common law country, it is felt that a specific law is not required. Here, in some transactions, assets have been put in the name of an SPV. The SPV in turn guarantees the bonds issued by the borrower. The parking of the assets in the books of the SPV supposedly provides bankruptcy remoteness to the structure.
- In US transactions, the bonds have been issued by the SPV, which then lends the money to the bank, and the bank creates collateral on the loans.

Pricing and risk assessment of covered bonds:

As per theory, the spreads on covered bonds should be lower than those for securitization, and higher than those for unsecured bonds. The spreads being higher than unsecured bonds is easy to understand, as covered bonds are backed by effective collateral and are mostly AAA rated. The reason for the spreads being lower than securitization is because in case of securitization, investors do not have a recourse against the originator, and importantly, investors face prepayment risk. The asset-liability mismatch inherent in the pay-back profile of the loans is taken entirely by the investors. In case of covered bonds, investors are not affected by the prepayment risk, and the payment term is mostly in form of hard bullet.

Legal structure:

The key question as regards the legal structure of covered bonds is – can the bonds survive the bankruptcy of the bond issuer? The answer has to come from the legal structure of the country in question. In most of the continental European countries, there are special laws dealing with covered bonds. In absence of specific law, the issuance has to be backed by the common law security interest structure that effectively provides the bondholders the right of enforcement even in the event of bankruptcy of the issuer.

Covered bonds are structured with security covenants like asset cover, selection criteria, etc which are most common for most other secured bonds or debentures. The differences between securitization and covered bonds are obvious – covered bonds do not rely on any isolation of assets for the sake of bankruptcy remoteness; hence, there is no legal separation of the assets. As such, the assets stay on the balance sheet of the issuer. Consequentially, there are no issues of booking of any profits on sale, etc.

What are the significant differences between covered bonds and traditional secured borrowings or bonds? Essentially, it is the efficacy of the security interest that outlines the difference, if any, between traditional balance sheet bonds and covered bonds. If special law, or special structure of security interest creation, ensures that the security would not be frustrated or partly compromised in the event of bankruptcy of the issuer, then covered bonds is a notch better than traditional secured corporate financings. It is only based on this test of survival in bankruptcy proceedings that can give higher ratings to covered bonds than the issuer.

Covered bonds: where is the cover?

Most of the European jurisdictions which have been using covered bond structures have special laws dealing with covered bonds; however, recently, covered bond structures have spread also to countries which do not have specific laws. In absence of specific national law that distinguishes covered bonds from traditional secured financings, the question that obviously comes up is – if covered bonds are immune from issuer bankruptcy risk, then there is no basic difference between other forms of secured financing and covered bonds. UK is an example – UK has been considering, but does not currently have, a law on covered bonds. The usual security interest principles of UK common law are used to create covered bonds. Netherlands is another example of a country that has successfully issued covered bonds recently, without any specific law. The first of the US covered bonds has also been announced in the beginning of Sept 2006, and the US also does not have a specific law dealing with covered bonds. This issue has been discussed in light of Art 22 (4) of the EU regulation Undertakings for Collective Investment in Transferable Securities (the "UCITS" Directive, 85/611/EEC). Art 22 (4) provides for a preferential treatment to covered bonds, at par with government

securities, in view of their special nature. EU States may provide for 10% risk weight to covered bonds for the purpose of capital requirements. It has been felt that the insolvency law of UK is highly creditor-friendly, as opposed to that of continental European countries. Therefore, it has been opined that in UK, a special law granting immunity to covered bonds is not required as the common law principles can effectively achieve the same purpose¹. UK structures have been based on isolation of the assets into a special purpose vehicle. The bonds are issued by the originator, and not by the SPV, and the bonds are the obligations of the originator. The SPV guarantees the obligations of the issuer, and in consideration, the originator agrees to transfer the loans to the SPV. The transfer of the loans is a true sale, but since the bonds remain the obligations of the issuer/originator, the loans are not removed from the books of the originator. The structure is almost a mid-way between traditional secured bonds and a securitization transaction. The first of the UK covered bonds issuances, HBOS, used this structure, and since then, the structure has been repeated in several UK covered bonds.

Since the UK-type covered bonds have a lot of similarity with securitization transactions, these covered bonds have sometimes been called “structured covered bonds”.

There are at least 19 countries in Europe as of now with enacted legislations and 9 more countries where legislations are under consideration. Recently there was a move to introduce a covered bond act in the United States.

Why Invest in Covered Bonds?

Though these assets remain on the books of the issuers, but the relief is that in such bad markets, this capital market route for raising funds still remains open for the issuers and also because of the additional security provided to the investors in the form of recourse to the originator/ issuer, the lenders have to pay less interest on these bonds.

In addition to the EU’s favourable regulations on investing in covered bonds, several inherent characteristics make the asset class attractive to investors, including:

- **High credit quality**-The major credit rating agencies have slightly different approaches to rating covered bonds, but all focus on the structure of the cover pool and the quality of the mortgages. To a lesser degree they factor in the issuer’s rating. Most covered bonds carry ratings of double- or triple-A.
- **Yield**- Covered bonds can potentially offer investors yields higher than European government bonds without significantly altering the risk profiles of conservative portfolios.

- **Diversification-** Covered bonds allow conservative investors to diversify into mortgage securities without diluting the credit quality of their overall portfolios. Typically, investors looking for triple-A rated investments must invest largely in sovereign and agency bonds.
- **Protection against event risk-** Covered bonds are full recourse debt instruments, meaning that holders have a preferential claim on the assets in the cover pool and the proceeds arising from them if the issuer defaults. Should an originating bank fail to make payments on a covered bond for any reason, interest payments from the underlying mortgages would go to investors.

Why Issue Covered Bonds?

Banks issue covered bonds to unlock the value of mortgage loans on their books. The money raised from the bonds' sale can be used to expand a bank's business or pay off maturing debt. However, the laws governing covered bonds require the banks to keep these mortgages on their balance sheets while the covered bonds are outstanding. Why wouldn't banks simply choose to raise money by issuing unsecured debt? Covered bonds can offer several benefits that corporate debt cannot:

- **Higher credit ratings-** The strict regulatory framework for covered bonds and the high quality of the underlying loans create high credit ratings for covered bonds. In many cases, covered bonds carry ratings higher than those of the issuers.
- **Lower cost of funding-** The high credit ratings can result in lower interest payments to investors, which reduce the cost of funding for the originator. Covered bonds also enjoy a second cost advantage: the market for them is far more liquid than it is for products like asset-backed securities in Europe. Issuers have more pricing power in liquid markets, as a function of supply and demand.
- **Diversification of refinancing sources-** Because an issuer's covered bonds usually receive higher credit ratings than its senior unsecured debt, covered bonds attract a different group of investors, which helps to broaden the issuer's funding sources.

The future of covered bonds:

In the opinion of the author, the experimentation of the covered bond structure in traditional domains of securitization implies that the market is searching for a right method of bankruptcy-protected structures. It is a pity that covered bonds, a device that comes from civil law countries which did not have the flexibility of common law, is

being tried in common law countries. The premise of isolation of assets by way of a true sale, on which securitizations are based, will increasingly prove to be too cosmetic to be real. At the same time, traditional secured financings cannot be entirely bankruptcy proof, as bankruptcy, by definition, is intended to provide an equitable distribution of assets of the bankrupt where the assets are not enough to pay everyone. Off balance sheet financing will increasingly become difficult with accounting standards trying to bring the SPVs back on the balance sheet by way of consolidation. If consolidation is the rule for books of account, it will, in long run, motivate courts also to see through the wall of separation between the seller and the SPVs. In fact, the whole device of SPVs may, at some stage, be questioned by law courts.

Therefore, legal systems need to be developed to accommodate the market's need to create asset-backed funding devices. Covered bonds do not look like an ideal solution, but surely, is a step in the search for the right solution in asset-backed funding.

Concept of Structured Bonds:

In some jurisdictions where legislation on covered bonds is absent, securitisation techniques have been applied to structure what is known as structured covered bonds. These structured covered bonds are secured against a pool of assets which have been legally separated from the issuer or originator, isolating the asset pool's exposure to default and insolvency of the issuer. This is unlike a normal secured bond whereby in the case of insolvency of the issuer, the liquidator of a borrower acts on the security in accordance to the law. In the most of the countries of Asia, there is no specific legislation on the covered bonds is in existence. So, the concept of this type of covered bond is of much relevance in the context of Asia.

Structured covered bonds are also 'dual recourse' bonds with priority of recourse to a cover pool and the issuer, as opposed to asset backed securities that are generally off-balance sheet non-recourse instruments.

Beginning of Structured Bonds:

The concept of structured bond is in the picture since 2003 through a 7-year issuance by UK-based HBOs Plc. Most recently, in June 2010, the Bank of New Zealand issued a NZD3.0 billion mortgage covered bond programme, which is the first contractual covered bond programme issued in New Zealand and the same is governed by contractual arrangements in the programme documents as there is no regulatory framework in existence there.

Mechanism:

The mechanics of a typical structured bond can be described in the following steps:

Step 1. A structured covered bond will typically have an independent special purpose vehicle (SPV) which will hold the assets, known as the cover pool, while the issuer, which is normally the originator, will issue the structured covered bond as its own direct and unconditional obligation.

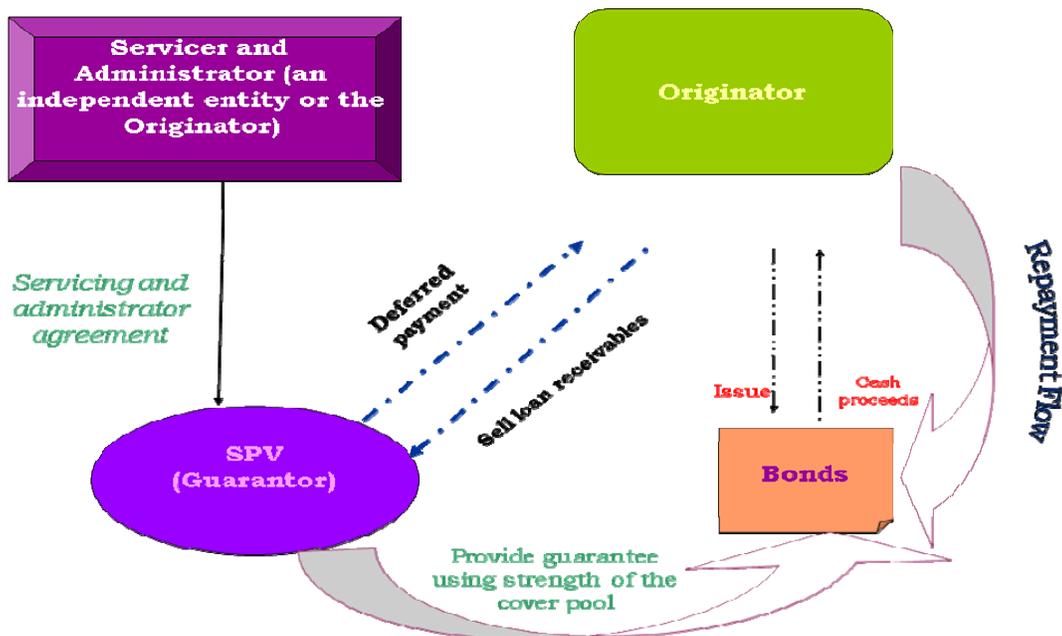
Step 2. The proceeds raised through the issue of covered bonds will be on lent to an independent SPV. In turn, the SPV will use these proceeds to purchase from the originator portfolios of eligible assets/the cover pool on a true sale basis.

2a. The SPV will repay the intercompany loan in deferred payments. The loan schedule will mirror the debt profile of the structured covered bond.

2b. The deferred payments made will be the source of repayment for the covered bonds.

Step 3. Backed by the cover pool, the SPV will provide a guarantee to covered bondholders for the payment of interest and principal on the covered bonds, which becomes enforceable if the issuer defaults. The guarantee represents an irrevocable, direct and unconditional obligation of the SPV and is secured by the cover pool.

Step 4. The originator will act as the servicer under this structure. The originator usually also provides cash management services to the SPV and monitors compliance with imposed covenants. The servicer can also be an entity that is independent.



The above diagram clearly shows the working structure of a structured covered bond.

However, in some cases, a newly created Special Purpose Company (SPC) may act as issuer. This SPC is generally wholly owned by the originator. The rest of the mechanism remains same except to the extent that The SPV will repay the intercompany loan in deferred payments. The loan schedule will mirror the debt profile of the structured covered bond. The originator will assign the deferred payments received to the SPC/SPV. The SPC/SPV will utilize the monies to repay the covered bond obligations. In this case, some functions are delegated to the SPC from the originator.

Recent issuances world wide:

Cajamar Caja Rural SC, Spain's largest rural savings bank, has issued covered bonds, due in 2014, at a record yield premium for the guaranteed notes. The bank is offering 285 basis points to 295 basis points. Since July, Spanish lenders have raised at least 10.8 billion euros (\$15 billion) from sales of covered bonds.

As per Dealogic report the volume of bond sales in Europe went down by 29% in the first half of 2010. While the sovereign bonds and corporate bonds took a plunge and the banks were unable to sell regular bank debt due to feeble investors' confidence, many issuers

turned at covered bonds which led to a 60% rise in the covered bonds issuance volumes in the first half of 2010 as compared to the same period last year.

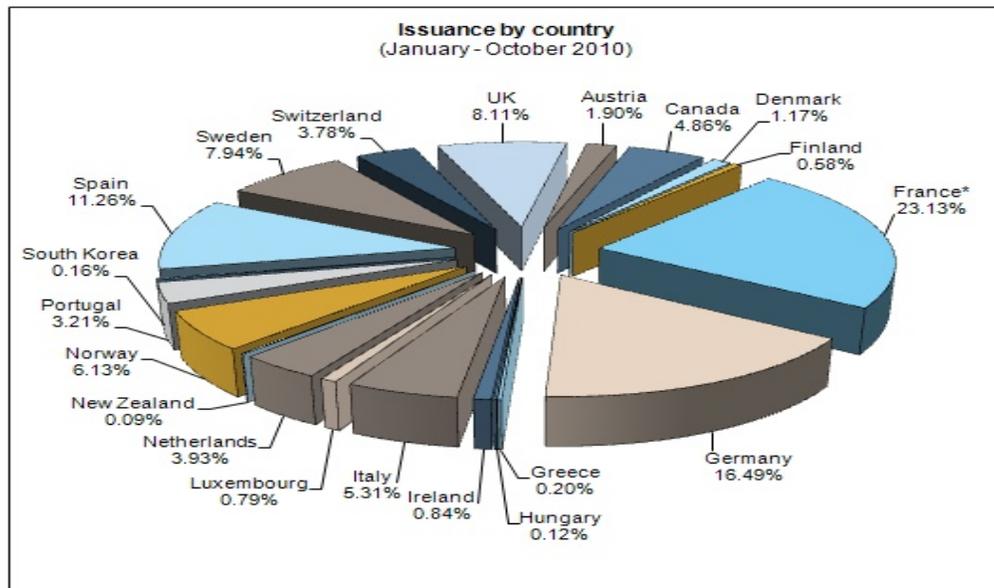
Considering the present market sentiment, especially in Europe, because the sovereign debt crisis the investors remained on sideline. Further there was volatility in the sovereign debt market in the Euro area forcing ECB to abandon its 'non-standard stimulus' measures, Greece's bailout issues, the Securities Markets Program initiated by ECB, put covered bonds in vogue.

Around EUR105 billion of new euro-denominated, benchmark covered bonds have been sold in the first half of the year--a record--with the total boosted by over EUR20 billion of new supply in June, according to figures from Deutsche Bank AG.

Bank of New Zealand has announced its first regional covered bond program in June, 2010 of NZ\$3 billion and has been secured by a pool of residential assets. The Discontinuity Factor is 22.9% and the over collateralization is enough for the bonds to attain a provisional long term rating of (P) Aaa and AAA rating from both Moody's and Fitch respectively which is one notch higher than that of BNZ's AA rating. The mortgage loans are secured by the residential properties in New Zealand with a weighted average seasoning of 25 months and a remaining term seasoning of 275 months. The weighted average LTV ration is 44.8. These covered bonds were issued in two tranches with 5 year maturity and seven year maturity. The asset percentage does not exceed 97%, 16% over collate

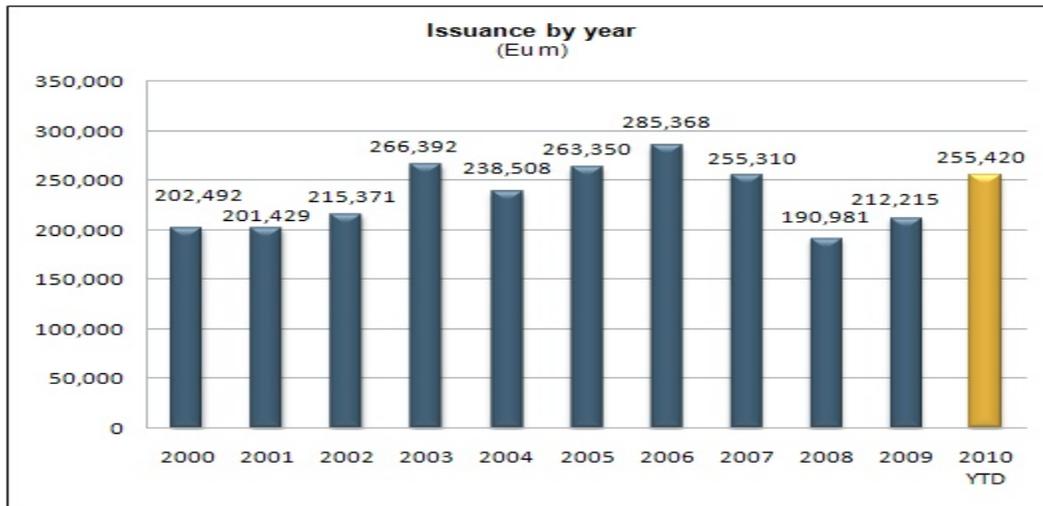
The Reserve Bank of New Zealand, the country's central bank and bank regulator, has included covered bonds in its new Liquidity Policy (BS13), classifying them with RMBS as primary liquid assets and thus can account for up to a maximum (after haircuts) of 4% of a bank's total assets. Such a classification makes covered bonds an attractive instrument for New Zealand banks to both issue and hold, particularly if they improve an individual bank's liquidity coverage ratio under the new Basel proposals.

The chart below provides an overview on covered bond issuance in different countries in the year 2010:



Sources all charts: Market Data, The Cover

The graph below provides an overview on covered bond issuance in different countries from the year 2000-2010 YTD. Though, due to collapse of market in 2008 and 2009 the volume of issue of covered bond fell, it again showing an upward trend in 2010.



Sources all charts: Market Data, The

Cover

Recent Issuance in Asia:

Asian countries like Korea are also finding the instrument attractive. In 2009 Kookmin Bank was the first to issue covered bonds worth USD 1 billion in the Asian Region having tenure of 3 and 5 yrs and then in 2010 Korea Housing Finance Corporation (KHFC) has announced its plans to issue Covered Bonds which was oversubscribed by 5.5 times. The covered bonds issued by KHFC provide unconditional, direct and unsubordinated general obligations on KHFC and priority claim on a dynamic pool of mortgage loans secured by residential real estate in Korea. There is over collate of 19% and the asset percentage in the pool is 84%. The cover pool has a weighted average screening of 12 months with a remaining term of 224 months and has been assigned a provisional long term rating of (P) Aa3 by Moody's.

In Malaysia, structured covered bond transactions have stirred some interest among prospective issuers. While rating agencies confirm that there is significant interest among issuers, transactions have still not materialized.

Covered bonds in Indonesia:

Indonesia has a regulatory structure for issue of asset backed securities. Covered bonds will NOT be covered by the regulatory guidelines for asset backed securities, as the covered bonds are like normal secured bonds. The only difference between normal

secured bonds and covered bonds is that the latter are issued by special purpose vehicles. Special purpose vehicles are possible as thinly capitalised companies under Indonesian corporate law.

Since it is an issue of a security, BAPEPAM approvals will be required, but in the view of the author, it is not necessary to await a special legislative decree for covered bonds.

Under the Insolvency law, if there has been a true sale between the originator and the SPV, the assets of the SPV will not be treated as the assets of the originator. Hence, structured covered bonds are possible under Indonesian law.