Article

Covered Bonds: State of the Market (upto Q1 2014)

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Article

The covered bond market offers investors an alternative to developed country government securities. Covered bonds are debt securities backed by cash flows from mortgages or public sector loans. They are similar in many ways to asset-backed securities created in securitization, but covered bond assets remain on the issuer's consolidated balance sheet (usually with an appropriate capital charge).These bonds are one method for financial institutions to raise funds from investors. Covered bonds have emerged as an important segment of the fixed-income bond market, principally in Europe but increasingly in the U.S., Canada, and Asia-Pacific. Covered bonds are a senior secured debt instruments typically issued by a bank. This article covers the state of the market for covered bonds in 2013 and Q1 2014 and the outlook in US, Europe and Asia.

Background

The covered bond market has grown in 2012 although at a slower pace than the year before. Outstanding covered bonds worldwide grew by 5.2%to reach EUR 2.813 billion after EUR 2.674 billion in 2011.[1] The market had still been growing by 6.8% in 2011.[2] There are several factors that have contributed to this slow growth rate, such as bank deleveraging, stronger reliance on central bank funding and stable to shrinking asset markets. What however seems to have kept the market in growth territory was a significant increase in the issuance activity of non European countries such as Australia or New Zealand. At the same time, banks especially from countries like Italy or Spain used newly issued and retained covered bonds as collateral for central bank repo operations. Overall new issuance increased slightly by 1.5% to EUR 707 bn.[3] Issuance across the board from European issuers in H1 2013 is still muted and banks are still reducing balance sheet while there are still banks that continue to rely on central bank funding. At the same time banks outside of Europe are still active covered bond issuers and keep growing their respective markets. Global issuance of covered bonds has dropped 30 per cent for 2013 to $193.1bn compared with 2012. It is the lowest total figure since 2002. There has been high demand among investors but issuance has reduced significantly with banks trying to restructure and meet targets set by regulators, instead of raising more capital they have been deleveraging their balance sheets leading to less covered bonds.

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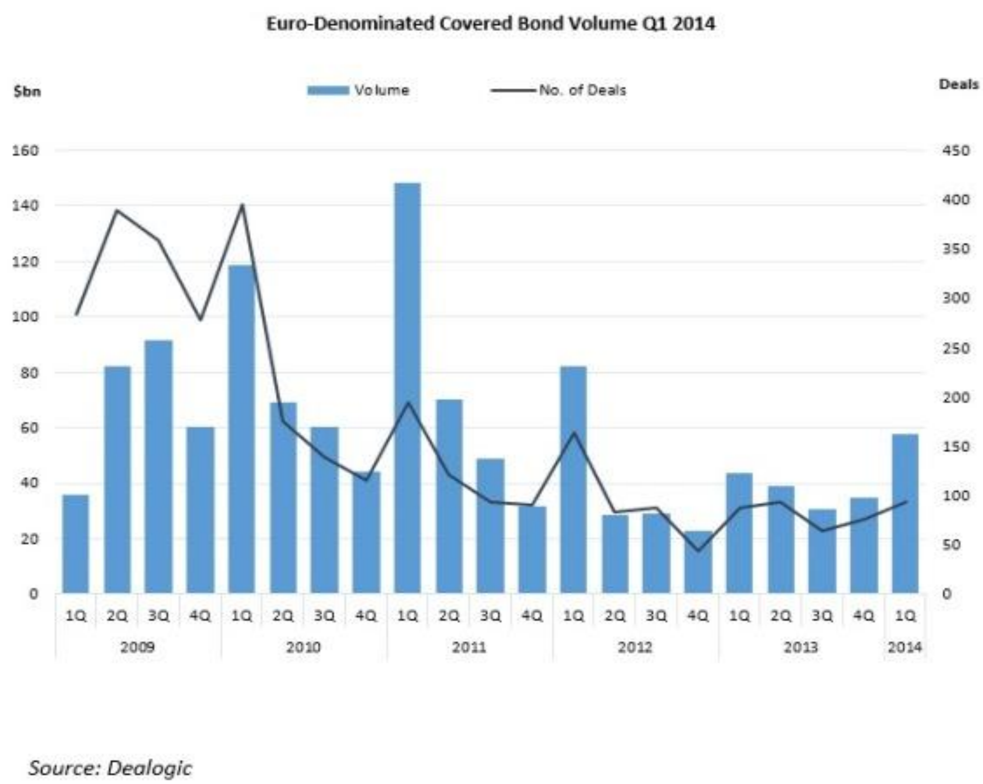
[1] See infra note 2

[2] Review of ECBC Covered Bond Statistics, http://ecbc.hypo.org/Content/default.asp?PageID=519

[3] Id.



Source: Dealogic[4]

Europe

European debt capital markets activity – issuance in all currencies by European borrowers – totalled $17bn across 41 deals by July 2013.[5] In July 2013, the ECB changed its risk control framework and increased the haircut for retained covered bonds that are rated A- or higher by 8%.[6] Haircut for bonds rated between BBB+ to BBB- was at 12%.[7] Despite this, issuers refrained from accessing public markets and remained heavily dependent on central bank liquidity. Issuers have been confronted with elevated funding costs. Compared to its performance in the last decade, European covered bond issuance fell to its lowest level in 2013, with investors increasingly prepared to lend to the region's banks on an unsecured basis in the wake of the euro-zone crisis. Since a record peak of $370bn in issuance during 2011 – when existential fears of a euro-zone break-up peaked– European covered bond issuance has fallen to $166bn for the year

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[4] http://www.icmagroup.org/resources/market-data/Market-Data-Dealogic/#14

[5] http://www.efinancialnews.com/story/2013-07-08/eurobond-volumes-hit-near-low-2013?ea9c8a2de0ee111045601ab04d673622

[6] http://www.globalcapital.com/article/kbh18qf8mcm7/covered-bonds-take-the-helm-in-italys-funding-renaissance

[7] Id.

2013, the lowest figure since 1996.[8] The main driver behind the fall in covered bonds is the shift towards senior unsecured whose spreads have rallied more relative to covered bonds. Banks have issued more senior unsecured bonds which also do not encumber assets. European banks' balance sheets also are widely perceived as still too big. As such, banks are cutting back their international networks and lending – leading to less potential collateral to issue covered bonds.

Increasing regulatory support will however strengthen the credit quality of covered bonds in Europe in the context of stabilizing sovereign credit. The draft Resolution and Recovery Directive (RRD) agreed by the Economic and Financial Affairs Council in June 2013 has increased clarity on protection for covered bonds in the context of the "bail-in" resolution tool. Covered bonds will also benefit from a more stable sovereign environment. The RRD represents an important step forward in the development of an effective EU bank resolution framework, including a credible bail-in tool for unsecured bank debt and certain deposits. If implemented as proposed, the new resolution framework will increase the probability that financial institutions will either remain going concerns or go through an orderly wind-down. The proposed bank resolution framework will benefit covered bondholders. As the draft RRD explicitly exempts covered bonds from the bail-in process, it reduces the likelihood of an issuer ceasing to perform its obligations under the covered bonds following bail-in (default) of the issuer's senior unsecured debt. Consequently, as a result of the RRD, the probability has increased that the issuer will continue to meet its debt-service obligations to covered bondholders following a senior unsecured default. As the European economy has emerged from recession and looks set for a period of somewhat greater stability over the coming 24 months, sovereign credit quality will stabilize. Notably, the pace of sovereign downgrades has tapered off and fewer sovereigns carry negative outlooks. However, challenges to issuing bank credit quality will continue to weigh on covered bonds in Europe.

United States

It appears that in the United States, some more time may be required to pass the country's covered bond legislation and hence there may be no issues in 2014. Despite attempts to introduce legislation over the past several years, it has not yet risen to the top of lawmakers' agendas to come to a vote in Congress. The United States regulators seem to be divided in opinion over the need for covered bond legislation and currently, banks have other means to finance mortgages such as Fannie and Freddie, and Federal Home Loan Bank advances. Furthermore, big banks have been content to hold on their balance sheets many jumbo loans that are ineligible for purchase by Fannie and Freddie.

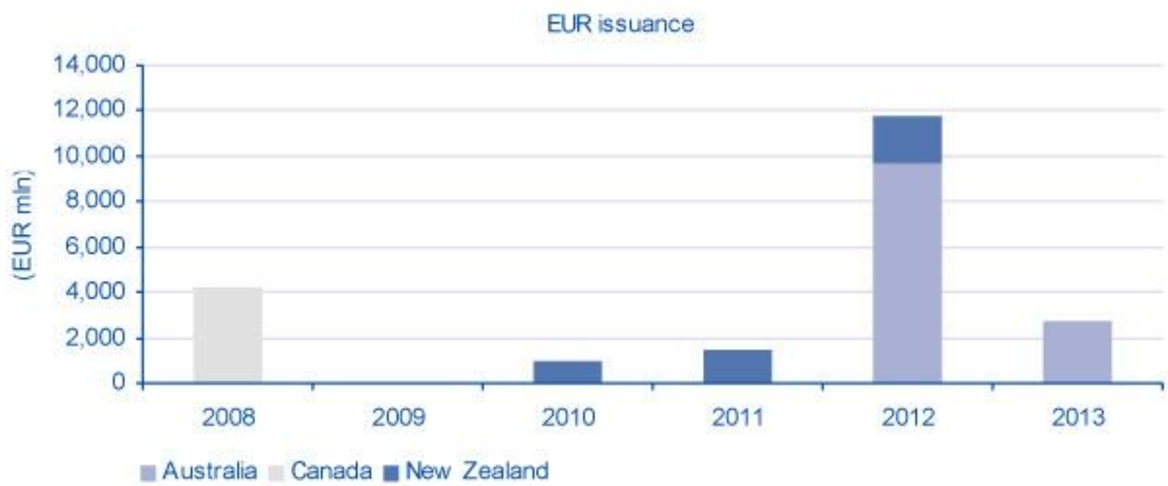
[8] Europe covered bond sales hit decade low, By Christopher Thompson, FT, Nov 26, 2013

Canada, Australia, New Zealand

Canadian covered bond legislation went effective at the end of 2012. In 2013, covered bond programmes sponsored by Royal Bank of Canada, CIBC and Bank of Nova Scotia were registered under the new law. These programmes will have stable performance, owing mainly to the strength of the Canadian banks and even if a bank deteriorates, it would be surprising if the bank chooses to increase the required over-collateralisation to maintain the strength of the programme. New issuances out of legacy programs are prohibited. All legacy programmes except that of Royal Bank of Canada will wind down because the law prohibits new issuances out of legacy programmes that are not registered. However, the issuers will still need to comply with all the requirements of the legacy programmes such as meeting the asset coverage test. However, if a bank sponsor deteriorates, there is a greater likelihood that the strength of the legacy programme will deteriorate as well. The banks will be less likely to maintain the strength of these programmes by increasing committed over-collateralisation because these programmes are no longer ongoing financing vehicles.

The law requires new programmes to be backed by uninsured mortgages. These programmes will generally have higher over-collateralisation levels than legacy programs to account for the uninsured collateral's additional credit risk. Except for Royal Bank of Canada's programme, all the legacy programmes were backed by government-insured mortgages.

New Zealand and Australian covered bonds have also moved into the regulated terrain where assets are held in separate SPVs and segregated from the issuer through a legal true sale between the issuer and the guarantor to ensure insolvency remoteness. The legal frameworks have also introduced norms on the quality and requirement of assets to be included in the cover pool and minimum over-collateralization requirements. The Australian market has benefited from a sound sovereign position, strong credit profile of its domestic credit institutions and the fact that the issuance has been based on a strong statutory and supervisory framework. The following table shows data by Dealogic on euro issuance in Australia, Canada and New Zealand:



Source: Dealogic[9]

Asia

Banks in South Korea and Singapore are being encouraged to diversify their funding through covered bonds as a result of new regulation. But given these institutions' strong credit ratings and unfettered access to the capital markets, potential supply is hard to gauge. But the market's development is far from over, with the South Korean and Singaporean regulatory authorities recently setting up frameworks that will encourage their banks to diversify their funding with covered bonds. South Korea's Covered Bonds Act came into force on December 19, 2013 and on December 31, 2013 the Monetary Authority of Singapore (MAS) set up a regulatory framework for the issuance of structured covered bonds. South Korea's covered bonds are enshrined in a specific legislation that provides a detailed outline ensuring the high quality of assets and their segregation in the event of the issuer's bankruptcy. Singapore's framework makes use of existing contract law and uses tried and tested securitization techniques that offer investors the same protection as legislative covered bonds.

Banks in these countries have strong unsecured credit ratings, generally in the double-A range, and most have good access to the capital markets at competitive funding levels. For this reason, the funding advantage of covered bond versus senior unsecured may not be compelling. Singapore's lenders could have scope to issue as much as $25 billion of covered bonds under rules that limit the amount of assets backing the debt to 4 percent of a bank's total.[10] There may be as much as S$10 billion ($7.9 billion) in covered bond

[9] http://www.icmagroup.org/resources/market-data/Market-Data-Dealogic/#14
[10] http://www.bloomberg.com/news/2014-03-14/singapore-bolstering-banks-wit-covered-bonds-plan-asean-credit.html

sales by banks in Singapore over the next three years as the world's most-expensive city prepares for tougher times.[11]

There are other longer term benefits that support Asian banks issuing their debut covered bonds in euros. Chief among these is that the first benchmark usually sets the standard against which all others reference their price. A competitively priced maiden deal should therefore help lower the cost of the ensuing funding, irrespective of whether that's in euros or dollars. Dollar covered bond investors are more likely to compare against an issuer's euro benchmark, suggesting Asian borrowers should be able to leverage the cheaper cost of euro funding with a subsequent US dollar benchmark.

Rating agency Fitch noted that the new MAS rules for covered bonds has clarified important points on liquid assets and disclosure, but further work might still be needed before the first deals emerge.[12] The absence of a dedicated covered bond law in Singapore and the flexibility that banks have to structure programmes underline Fitch's expectation that Singaporean covered bonds will be structured through contractual arrangements. However, the legal regime governing contractual issuance by special purpose vehicles (SPVs) in Singaporean securitizations has been strong and is effective in ring fencing collateral from an originator's insolvency. The updated Singaporean rules double the issuance limit to 4% of total bank assets from 2% originally. But this is still much lower than in other Asian countries. Issuers must get MAS approval to set up a covered bond programme. Eligible cover assets are only residential mortgage loans with a maximum loan to value of 80%. Banks need to implement appropriate governance arrangements, perform regular asset coverage tests and undertake regular stress tests. Banks must also establish an independent cover pool monitor, approved by MAS, and must submit an annual report to MAS and alert it to any breaches. But as most Singapore bank lending is funded by deposits, issuance from the region is likely to be less than in Korea where banks depend more on the international capital markets for funding.

Fitch has estimated that up to around $111bn of covered bonds could theoretically be issued under the Korean Act.[13] Korea's covered bond law offers investors better protection. The Korean law gives investors a priority claim over cover pools, as well as a senior unsecured claim for any shortfall if the pool is liquidated.

Conclusion

After over two centuries of use in Europe's debt markets, covered bonds have made a leap into the global debt markets in 2013 and the concept of covered bonds is now being

[11] http://www.bloomberg.com/news/2014-03-14/singapore-bolstering-banks-with-covered-bonds-plan-asean-credit.html

[12] http://www.emergingmarkets.org/Article/3336390/COVERED-BONDS-Singapore-and-Korea-to-embrace-covered-bonds.html

[13] http://www.emergingmarkets.org/Article/3336390/COVERED-BONDS-Singapore-and-Korea-to-embrace-covered-bonds.html

widely discussed and evaluated across many jurisdictions of the world. This shift has come because of a combination of a number of factors such as limited availability of long term unsecured funding and increased long term liquidity requirements under Basel III. Added to this is the fact that covered bonds are senior to other instruments and can hold their value in times of volatility. Changes in investor appetite for traditional asset backed securitisation products and the returns required to compensate investors for holding them are also key factors in driving the popularity of covered bonds across the world. Covered bonds are likely to become a new favourite asset class in countries with stable sovereign debt levels and will become a sound alternative to traditional high quality liquid assets such as government bonds.

To read more about Covered Bonds, click on: www.vinodkothari.com/cbart/