Article

Conditional Pass-Through Covered Bonds: A New Innovation

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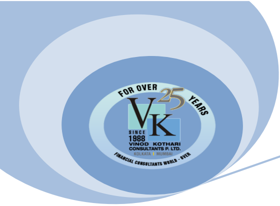

Conditional Pass-Through Covered Bonds: A New Innovation

Conditional Pass-Through Covered Bond (CPTCB) is a new innovation in the covered bond market. Its structure is different from that of traditional covered bond. It comes with the feature of maturity extension in case the issuer of the bond defaults on repayment. Interesting to note is that if the structure of CPTCB is sufficiently robust, it can overcome the risk of fire-sale[1] of the cover pool assets thus achieving a rating which is independent from the rating of the issuer, a feature which puts it in a very advantageous position as compared to a traditional covered bond.

CPTCBs and Traditional Covered Bonds: the Differences

In a CPTCB structure when an issuer of the CPTCB defaults to make payment on the date of maturity and such date falls before the date of maturity of the cover pool of assets, then the maturity of the CPTCB can be extended, thus postponing repayment without having to right away sell or pledge the cover pool. On the contrary, such is not the case in a traditional covered bond structure. In case the issuer of traditional covered bond defaults on the date of maturity of the bond and such date falls before the date of maturity of cover pool of assets, the date of maturity of the bond is not permitted to be extended. Payment is made to the bondholders through sale of the cover pool assets.

Further, the market risk that a traditional covered bond is exposed to, due to the potential fire sale of the cover pool of assets, is higher than in the case of CPTCBs.

Furthermore, rating of a traditional covered bond is generally dependent on the rating of the issuer, mainly because the issuer plays a significant role in the structure, however, on the other hand if credit risks related to the role of the issuer is removed or protected against, the credit quality of CPTCB can be made entirely independent from the credit quality of the issuer.

However, a CPTCB structure entails a greater extension risk to investors than a traditional covered bond since the CPTCB's maturity can be extended in certain situations to the scheduled maturity of the cover pool of assets.

Issuance of both the bonds under the same programme

A traditional covered bond and CPTCB cannot be issued under the same covered bond programme. This in turn creates transparency for covered bond investors as they would be aware of the risks they would be facing.

Let us now discuss the structure of CPTCBs in detail.

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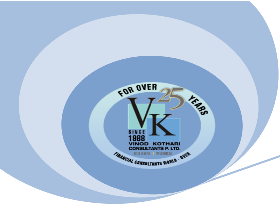
[1] Fire Sale is the sale of assets at heavily discounted price in the event of bankru, .



What is CPTCB?

CPTCBs, are covered bonds whose maturity extends if there is inadequate cash to repay them. The extension period is the maximum term by which the contractual payment obligations under CPTCB can be delayed. As long as the issuer of the CPTCB is performing, CPTCB can bank on the issuer to meet the payment obligations, however in situations where the issuer turns non-performing and the proceeds from the cover pool are inadequate to redeem the CPTCBs, then the maturity date of the bond gets extended.

Low risk of an asset Fire-Sale

Due to the maturity extensions CPTCBs are at a less risky position as compared to a bond which falls due before the maturity of the underlying assets, since the probability of a fire sale of the underlying assets is extremely low. The maturity extension allows for the orderly wind down of the cover pool and thus there is no need to sell or refinance cover pool assets at a high discount.

Credit quality of CPTCB less dependent on the creditworthiness of the Issuer

An important feature of CPTCBs is that removal of the risk related to fire sale causes the credit quality of the CPTCBs to be much less dependent on the creditworthiness of the issuer. Further if other credit risks related to the role of the issuer, discussed later in this article, is removed or protected against, the credit quality of CPTCB can be made entirely independent from the credit quality of the issuer. Furthermore, Moody's Investor Service is of the opinion that *"CPTCB whose credit quality is dependent on the issuer will have ratings which are inhibited by their timely payment indicator (TPI) framework. However, the rating of the CPTBC may be higher than that of an equivalent "hard bullet" or "soft bullet"*[2] *bond where the maturity date falls before the cover pool assets' scheduled maturity"*[3].

CPTCB Structure should be robust

The use of maturity extension CTPCBs can remove the risk of fire sale only if the structure of the CPTCB is robust[4]. Thus while assessing the effectiveness of the structure following considerations are to be made:

1. **Adequacy of the level of Over-Collateralisation (OC) existing to cover losses that may occur due to a default of the issuer of the covered bonds** – Absence of adequate OC may lead to fire sale of the cover pool. Under individual covered bond laws there are certain contractual and legal tests that the issuer of the CPTCB must perform pertaining to the cover pool and which will be applicable even after the issuer has defaulted on its payment obligations. In an event where the issuer breaches the test, the cover pool would

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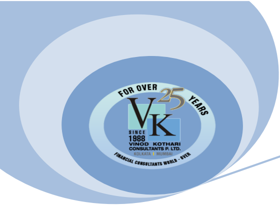
[2]Hard bullet bond ensures that the principal is paid on the expected maturity date and soft bullet bond has a fixed maturity date that may be extended for a limited period, typically 12 months.

[3] Moody's Invest Service, SPECIAL COMMENT: CONDITIONAL PASS-THROUGH COVERED BONDS: RATINGS CAN BE INDEPENDENT OF SUPPORTING BANK'S RATING, APRIL 28, 2014

[4] https://www.moodys.com/research/Moodys-Conditional-Pass-Through-Covered-Bonds-Ratings-Can-Be-Independent--PR_297963



become insolvent and would be required to be realized by the issuer. This happening can be evaded only if proper OC is in place to cover the risk of test breach. Further adequate OC in place would enable the CTPCB to achieve a rating that is independent from the rating of the issuer.

2. **Measures and safeguards in place to guard against transaction risks that may give rise to losses** –Under the CPTCB programme there are risks around the performance of services to the transaction, risk of default by contractual counterparties and uncertainties in legal enforcement. Fire sale risk may materialize if adequate protections are not in place to cover the abovementioned risks ensuing a default of the issuer of the CPTCB. Protections like provision for appointment of back up services, holding of liquid funds, use of swap criteria to assess the limit of exposure to swap counterparty risks, use of set-off reserve to protect against set-off risk and segregation of cover-pool assets from issuers other assets are few examples that address these risks.

Rating of Robust CPTCB Structure can be Independent from the Rating of the Issuer

Rating of covered bonds generally depend on the rating of the issuer mainly because the issuer plays a significant role in the structure. If credit risks related to the role of the issuer is removed or protected against, the credit quality of CPTCB can be made entirely independent from the credit quality of the issuer.

Limitations on the role of the Issuer

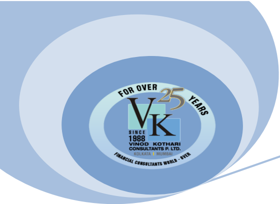
Before the issuer has defaulted, the issuer has the power to materially alter the nature of covered bonds thereby affecting the rating of the cover pool and the risks of fire-sale of asset and interest-rate and currency mismatches. In order to confine the role of the issuer in the structure, its power to introduce new credit risks can be limited and adequate OC can be put in place to protect against the new credit risks introduced, if any.

Limitations to issuers role can be put by imposing restrictions on it on issuing further bonds which negatively impact the credit quality of existing structure and also by obtaining a commitment from it that it would ensure that any material changes or any addition of new assets to the programme do not negatively affect the credit quality and that the cover pool maintains the credit quality parameters at all times.

Is CPTCB a big Rage?

The format of CPTCB is a new format and as discussed earlier, is very different from the format of a traditional covered bond. NIBC bank (NIBC) had launched the CPTCB programme[5] for the first time in October, 2013 followed by a successive transaction in April 2014. NIBC gained

[5] https://www.nibc.com/media-relations/news/nibc-successfully-launches-second-eur-500-million-aaa-rated-conditional-pass-through-covered-bond.html



global recognition for this new innovative product. Following NIBCs' lead UniCredit Italy[6] has also recently launched its first bond from its new conditional pass-through Obbligazioni Bancarie Garantite (OBC) programme. According to International Financing Review (IFR)[7] the format of CPTCB is *"relatively untested in public benchmark format, with only NIBC preceding UniCredit"*. Only time will tell whether this innovation will be a hit or a flop.

Also see our other related write-ups: http://vinodkothari.com/cbart/

[6] https://www.unicreditgroup.eu/en/pressandmedia/pressreleases-price-sensitive/2015/unicredit-emette-obbligazioni-bancarie-garantite-a-10-anni-per-1.html

[7] http://www.ifre.com/unicredit-testing-new-covered-structure-free-content/21187040.article