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The Covered Bond Report

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And the winner is...

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Despite falling supply, Pfandbrief issuers are eyeing opportunities on the asset and liability sides of their business. In this roundtable, sponsored by the Association of German Pfandbrief Banks (vdp), leading market participants discussed these, as well as market and regulatory challenges.

FRANCE

38 A new vintage

French supply has lagged expectations, but a spate of deals in April put it back in pole position. Growth prospects are slim, but the responses to troubles at CIF and Dexia are among reasons for a more positive outlook. *Susanna Rust* reports.

MOROCCO

44 Africa on the horizon

Morocco is preparing for the launch of Africa's first covered bonds. Developed in conjunction with international agencies, Moroccan Obligations Sécurisées look set to be embraced by issuers and investors alike. *Chiara Francavilla* reports.

The end of the beginning

No, I'm not talking about this page of the magazine, but CRD IV, as those of you familiar with Churchill's all too famous quote might have guessed.

When MEPs on 16 April passed the version of the Capital Requirements Directive/Regulation that had finally been arrived at in the EU trilogue process, perhaps the only surprise was that it had at long last been agreed and we wouldn't have to wait any longer. Regular readers of *The Covered Bond Report* should have been all too aware of the passages detailing the favourable treatment of covered bonds for which the industry had successfully lobbied.

But well before the final document was being translated into the various languages of the EU it was becoming clear that the final CRD IV text would be no more than a staging post in the long road to a new post-crisis financial regulatory architecture.

The European Banking Authority's release on 21 February of a consultation paper on the process for defining assets eligible for liquidity buffers had already set in motion the next stage of the journey. Market participants soon queried the regulator's plans, and now have their work cut out making the case for covered bonds — again. Although some observers have suggested the outcome to be a stitch-up, with Danish and possibly Swedish covered bonds the only ones set to qualify for LCRs, comments from the EBA at the recent European Covered Bond Council plenary in Rome could be interpreted more encouragingly.

Meanwhile, the ECBC-led Covered Bond Label initiative appears to face a similar predicament: barely has the project gone live and the European Central Bank apparently raises the bar, expressing — alongside the EBA and European Commission — scepticism about its usefulness for regulatory purposes.

This shouldn't stop those whose hard work has gotten covered bonds this far from raising a toast to their achievements.

Just be prepared to roll up your sleeves again and get back to work.

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Legislation & Regulation

LCRs

Ball in EBA's court after CRD IV approved

After months of negotiation the European Parliament on 16 April approved the final text of the CRD IV package, although the fate of different covered bonds' eligibility for liquidity buffers depends in large part on the work of the EBA over the coming months.

The fourth iteration of CRD IV should be welcomed by the covered bond industry, according to Richard Kemmish, head of covered bond origination at Credit Suisse.

"It got pretty much all that it wished for," he says.

The CRD IV package affects covered bonds in various ways, including defining risk weightings — with preferential treatment having been extended to France's obligations de financement de l'habitat, for example — but perhaps the most important aspects concerns the new liquidity buffer provisions of Basel III and the treatment of covered bonds therein.

The covered bond industry has been actively lobbying for the asset class to count towards Level 1 liquid assets for the purpose of the Liquidity Coverage Ratio, and market participants have interpreted the approved CRD IV text as providing for this, at least for certain covered bonds.

For RBS analysts, the wording of the approved regulation amounts to a recommendation that covered bonds be generally regarded as Level 1 assets, citing a passage on the "broad set of quality assets" that should be taken into consideration during an initial observation period used for the development of the LCR definition:

"When making a uniform definition of liquid assets at least government bonds, and covered bonds traded on transparent markets with an ongoing turnover would be expected to be considered assets of extremely high liquidity and credit quality."

MEPs: European Parliament approved CRD IV after trilogue

Yet while the main task of the European Parliament and the Council of Ministers with respect to CRD IV has ended, the real work for the European Banking Authority (EBA) now begins, according to Luca Bertalot, head of the European Covered Bond Council and Katalin Dobransky-Bartus, acting head of economic affairs, European Mortgage Federation.

> "This to me looks brightest for Danish and Swedish"

"Some key discussions over the details of the legislation will henceforth shift to the EBA, which has delegated authority to set technical standards," they said.

The EBA has been charged with coming up with appropriate uniform definitions of high and extremely high liquidity and credit quality transferrable assets, and appropriate haircuts, to report to the European Commission by the end of this year.

To that end the EBA from 21 February to 21 March consulted on the process for defining highly liquid assets in the Liquidity Coverage Ratio on the basis of a discussion paper outlining its proposed methodology.

It said that the first step of its proposed analysis will involve an assessment of a range of asset classes against fundamental definitions of liquid assets set out in the draft Capital Requirements Regulation. It will then perform a detailed quantitative assessment of the liquidity of individual assets to produce a ranking of the relative liquidity of different asset classes. Finally, it will identify the features that are of particular importance to market liquidity, with the aim of providing definitions of the characteristics assets should have to qualify as highly or extremely highly liquid.

Based on this approach, it appears the EBA will base its decision about whether and which covered bonds could qualify as extremely high liquid assets to a large extent on quantitative trading and turnover data, says Florian Eichert, senior covered bond analyst at Crédit Agricole.

"This to me looks brightest for Danish and Swedish domestic covered bond markets simply because they offer the highest degree of transparency when it comes to trading related data," he says. ■

LATIN AMERICA

Santander to test unusual new Chilean law

Banco Santander Chile is planning to issue its first covered bond in June, after an unusual new covered bond framework was introduced in Chile in September.

The bank is planning to launch a 68bn Chilean peso ($145m, Eu11.2m) issue with a 15 year amortising maturity, according to Emiliano Muratore, manager of financial management at Banco Santander Chile. The deal is likely to be the first under the new framework.

Muratore expects covered bonds to allow the bank to save some 10bp-30bp versus senior unsecured funding. "There is no point in doing anything that would let us save less than 10bp," he told *The CBR*.

Muratore said Santander has wanted to issue covered bonds since the introduction of the new legislation. "June is the soonest that we can do as we needed to do a lot of administrative work to prepare for it," he said.

Financial instruments with a structure similar to covered bonds, Letras Hipotecarios, were issued by Chilean banks from the 1970s, but their use has been progressively abandoned, according to a 2011 report by Standard & Poor's. Muratore said that Letras Hipotecarios had a dual recourse principle like covered bonds, but unlike covered bonds a single letra was associated to a single mortgage instead of a pool of mortgages.

Banco Santander Chile
literally flying the Chilean flag

The new covered bond framework introduced a structure more similar to Europe, he said, but there are notable differences. The main one is that under the new law banks are required to issue covered bonds and then originate the mortgages that become cover pool assets in the following 18 months. Meanwhile, the cover pool should contain high quality assets, such as government and central bank securities.

If an issuer is unable to originate enough mortgages in the 18 month period after the covered bond issue it is then forced to buy back the bond, he added.

"To assure investors that we are confident we will able to originate enough mortgages we decided to include a yield penalty, so in case we needed to, we would buy the bonds back at unfavourable conditions for us," said Muratore.

Muratore said that because of the specificities of the legislation the first covered bond will mainly target domestic investors, but Santander plans to place an issue on the international markets in the future.

Mortgage origination in Chile has grown solidly in the past five years, increasing by an average of 10.3% year-on-year to reach $57bn in 2012, or 20% of the country's GDP, according to a December report by the Chilean ministry for the economy, development and tourism. ■

GLOBAL

UAE work in progress, covered on HFSC agenda

The **UAE Securities & Commodities Authority** (SCA) is working on covered bond regulations among a host of other securities markets measures, the authority's chief executive officer said at a conference in Dubai on 14 April.

CEO Abdullah Al Turifi told delegates that SCA has issued 42 regulations and resolutions, and is working on several others that are intended to have a positive impact on local securities markets, with regulations for covered bonds among the measures.

There has been no previous covered bond issuance from the Middle East. ■

The US **House Financial Services Committee** has included covered bonds on its agenda for the 113th Congress.

"The Committee will review the potential for covered bonds to increase mortgage and broader asset class financing, improve underwriting standards, and strengthen US financial institutions by providing a new funding source with greater transparency, thereby fostering increased liquidity in the capital markets," reads a committee oversight plan.

The committee will also review whether Department of the Treasury guidelines and an FDIC policy statement can foster issuance or if regulations or legislation are necessary. ■

NETHERLANDS

DNB cites transparency as encumbrance check

The Dutch central bank has identified disclosure as a means of mitigating risks associated with asset encumbrance, and said that prudential limits on covered bond issuance have helped keep Dutch encumbrance levels below the European average.

It is the latest regulator to put forward transparency as a means of tackling asset encumbrance. The Swedish financial authorities have urged issuers to take the lead on asset encumbrance by releasing relevant information and the European Banking Authority has highlighted asset encumbrance reporting as integral to regulators' supervision of the financial markets.

DNB said in a financial stability report published on 18 April that secured funding has increased in importance, with the use of covered bonds increasing in particular, although there are other sources of encumbrance, such as central bank liquidity support. The rise in secured funding can have a self-reinforcing effect, said the central bank, noting that asset encumbrance brings with it certain risks, such as pro-cyclicality and threats to deposit guarantee schemes as well as greater interconnectedness and complexity in the financial system.

It said that Dutch banks have increasingly turned to secured funding, mainly via issuance of long dated covered bonds as opposed to ECB funding. Dutch covered bonds are highly overcollateralised, leading to relatively high asset encumbrance when they are issued, DNB noted, mainly due to the interest-only profile of many Dutch mortgages backing covered bonds, with high LTV ratios also playing a role.

However, average asset encumbrance at large Dutch banks, at 14%, is below the European average of 25%, said the Dutch central bank, and is partly due to DNB setting prudential limits on the volume of covered bonds that individual institutions may issue. The Dutch central bank takes a case-by-case approach to banks' covered bond issuance.

In addition, it said that provision by banks of "sufficient information" can mitigate the risks of asset encumbrance, by helping keep encumbrance levels low and reducing the risk of surprises.

"If banks report frequently on which portion of their balance sheet is encumbered, unsecured financiers can make better risk assessments," it said. "This increases the incentives for banks to keep asset encumbrance low.

"Providing frequent information reduces the risk of surprises for investors, thus avoiding the threat of a sudden increase in risk premiums or funding risks, for example."

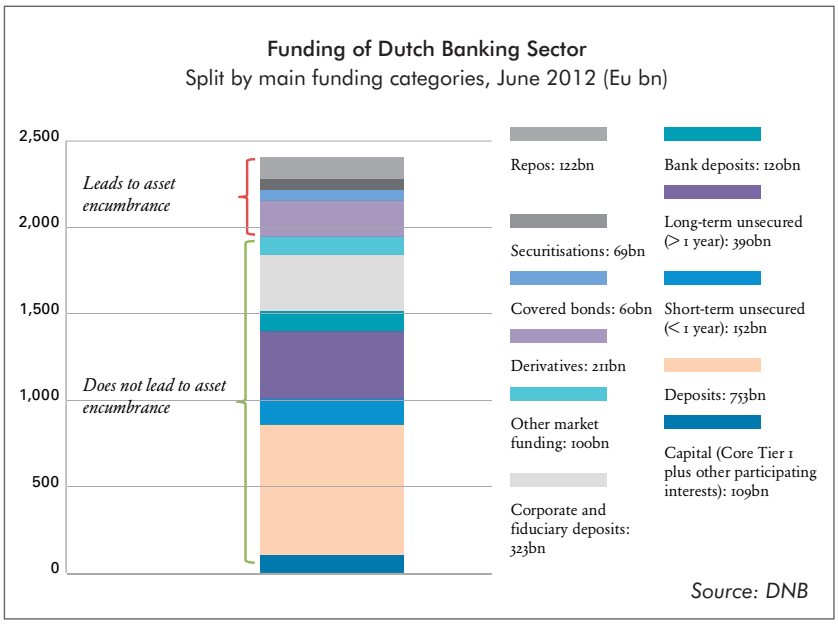
A new housing market policy in the Netherlands will also help limit asset encumbrance, said DNB. Two aspects of this, the introduction of annuity-based mortgages and the gradual imposition of a 100% LTV ratio limit, will help lower the level of overcollateralisation required in future, according to the central bank.

As concerns the risk of asset encumbrance jeopardising the stability of the broader financial system by potentially necessitating deposit insurance payments and, ultimately, a government bail-out of banks, DNB said this could be countered by pricing the risks for the deposit guarantee scheme (DGS).

"In the future ex-ante deposit guarantee scheme, which is expected to be introduced in 2015, the banks will pay a risk-based premium," said the central bank. "Making this premium partly dependent on the level of asset encumbrance will prevent banks from seeking to lower their funding costs by pushing the risks onto the DGS."

Meanwhile, a proposal for a new central Dutch institution to acquire triple-A tranches of government-insured NHG mortgages and then issue government-guaranteed bonds has been floated by a group of specialists as a means of stimulating the Dutch mortgage market, according to analysts. The proposal for the new financing instrument, "Nederlandse Hypotheek Obligaties", was put forward following a government request for specialists to explore the role of institutional investors in mortgage housing finance.

See news.coveredbondreport.com for more on this and EBA moves. ■



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EUROSYSTEM

ECB reclassifies Commerz SME as covered

An SME-backed structured covered bond issued by Commerzbank in February has been reclassified as a covered bond within the Eurosystem's collateral framework, where it was previously treated as senior unsecured debt, in a fillip to the innovative instrument.

The deal was the first covered bond backed by SME loans from a major jurisdiction and as such proved controversial, with traditionalists decrying a potential dilution of the asset class.

The Eurosystem's move — shifting Commerzbank's deal from liquidity category 4 to 3, and its reclassifying it as a "non-jumbo covered bond" — means that its haircut falls from 11% to 5% within the collateral framework.

"While this doesn't sound like much," said Florian Eichert, senior covered bond analyst at Crédit Agricole, "it essentially means the Eurosystem has reclassified the bonds from senior unsecured to non-jumbo covered bonds, which is substantial."

Some market participants resistant to the expansion of covered bonds beyond traditional parameters, fearing a dilution of the asset class, have, however, criticised the move. *(See Pfandbrief Roundtable for more.)*

In the run-up to its launch, the deal's treatment as senior unsecured debt rather than as a covered bond had been cited as a negative.

The CBR understands that the issuer had no involvement in the reclassification, but that the Luxembourg Stock Exchange was involved from a technical standpoint as the market where the bond is listed, and that the Bundesbank was consulted.

The reclassification will lend weight to arguments for Commerzbank's deal and any other SME-backed issuance that follows being treated more generally as covered bonds. Index providers have so far taken a mixed view of the new instrument, with Barclays having included Commerzbank's issue in an "other covered" classification but iBoxx having excluded it from its covered bond categories.

Members of the European Central Bank's governing council have recently given SMEs' access to finance a high profile in public statements.

Benjamin Sahel, market operations analysis at the ECB, told a European Covered Bond Council plenary meeting on 21 March that the central bank regards SMEs as "crucial" and that they are taken into consideration in monetary policy discussions of the ECB, including the funding environment they face.

He said that the launch of an SME-backed covered bond raised three issues: ABS, which traditionally have used SME loans as collateral, would "feel the heat"; traditional covered bonds could be "in some sense challenged"; and the move would point to increased asset encumbrance. ■

FINANCIAL TRANSACTION TAX

Danish fear FTT, call for exemption

The Association of Danish Mortgage Banks and the Danish central bank fear adverse effects on financial markets from an EU financial transaction tax (FTT).

The fears were raised in a submission to a consultation by the Danish ministry of taxation. Danmarks Nationalbank said that a financial transaction tax would have adverse effects on financial markets and that Denmark's capital markets would be affected even though the country is not participating in enhanced co-operation on the proposed tax.

The mortgage bank association (Realkreditrådet) said that although Denmark is not one of the 11 EU countries that will participate in enhanced co-operation on the tax, the country's mortgage model could be affected because there is a risk that Danish mortgage bonds will be affected by a tax on sales of the bonds to investors in the countries that sign up to it.

Because of the matching principle underpinning all Danish mortgage lending a tax on the sale of mortgage bonds would be directly reflected in the price of mortgages, said the association. Bonds issued to fund loans secured by real estate should be exempt from the proposed tax, it argued. If it is not possible to obtain an exemption for covered bonds then the definition of a primary market transaction, which is exempt from the proposed FTT directive, should be clarified to include the entire value chain that directly connects borrowers and investors under the Danish model, said the association.

"An exception or clarification of the scope will also help to ensure a 'level playing field' in relation to financial service providers that have access to other funding sources such as deposits, which are not subject to the FTT," it said.

Its submission to the tax ministry noted that most day-to-day financial activities relevant for citizens and businesses, such as mortgage lending, are exempt from the financial transaction tax (FTT) proposal, but that there is insufficient clarity for it to be reassured that this will become a reality for all Danish mortgages.

Around 15% of Danish mortgage bonds issued by Denmark's mortgage banks are owned by foreign investors, according to data cited by the association. ■

"The risk of something coming in out of the blue is very small" page 22

DENMARK

Danes face up to IO fears despite rejection

Denmark's mortgage banks are persevering with efforts to find a way of easing the impact on borrowers of the upcoming expiry of interest-only loan periods after having had a proposal rejected by the government in March.

Denmark allowed mortgage lending on a maximum 10 year interest-only basis in October 2003, and such loans have been very popular since then, accounting for 54% of total mortgage lending at the end of 2012. The original 10 year interest-only period expires in October this year, with the majority of such loans due to expire between 2017 and 2020, according to Standard & Poor's.

The prevalence of interest-only loans and the approach of amortisation requirements have prompted concerns about borrowers' repayment capacity in the context of high levels of household indebtedness and lower house prices and the impact this could have on the Danish mortgage system.

In a report published in January the International Monetary Fund, for example, called for "deferred amortization" mortgage loans to be limited for macroprudential reasons and said that such loans contribute to a threat of higher delinquencies given high debt levels of Danish households.

And S&P in late March said that the requirement for borrowers on interest-only loans to start amortising their debt could threaten the Danish mortgage market.

"As increasing numbers of interest-only loan periods will expire, this challenge could destabilise the Danish mortgage market as borrowers face potential dramatic increases in their instalments," said S&P credit analyst Casper Andersen. "This could in turn lead to a sharp increase in arrears and potential foreclosures."

Denmark's mortgage banks have been busy anticipating the onset of repayment obligations by exploring possible solutions for those borrowers that may have

Governor Lars Rohde spoke out against IO renewals

difficulty amortising their loans, with uncertainty over whether or not they will be able to take out a new interest-only loan at the heart of the issue.

Under Danish legislation borrowers on a loan with an interest only period cannot be granted a new such loan if LTVs are over 80%, although Danske

"The vast majority of borrowers will be able to pay"

Bank senior analyst Jan Weber Østergaard noted that this is possible on condition that "security is not hereby substantially reduced".

According to Karsten Beltoft, director at the Danish Mortgage Banks' Federation (Realkreditforeningen), the federation and the Association of Danish Mortgage Banks (Realkreditrådet) felt that they had come up with a proposal that addressed the challenge of rising mortgage payments and was in line with the legislation. This foresaw borrowers with expiring interest-only periods being allowed to renew interest-only loans for up to 80% of the property prices and only have to amortise loan amounts in excess of that level.

"The vast majority of borrowers will be able to pay instalments," he said, "but for those customers who will struggle to do so and if they have LTVs above 80% we came up with a pragmatic solution that we felt was a move in the right direction and permissible under current legislation."

However, in a meeting on 19 March the Danish ministry of business and growth rejected this plan, according to Beltoft.

"The FSA does not agree that our proposal is in line with current legislation, and we have to accept that," he told *The CBR*. "We are discussing other possibilities that we will discuss with civil servants in the next month or so."

Danish central bank governor Lars Rohde spoke out against the renewal of interest-only loan periods on 20 March.

"The security of mortgage bonds must not be open to question," he said. "If you grant the option of rolling the interest-only term, even when the property is mortgaged almost up to the roof, I believe we would be contradicting ourselves when we at the same time argue that Danish mortgage bonds should be considered as secure as government bonds.

"It is our recommendation that no changes be made to the legislation on this area."

S&P's Andersen said that overall mortgage market stability could be threatened by an increase in the percentage of borrowers with LTVs higher than 80%, although the magnitude of LTV breaches remains manageable.

"However, politicians as well as mortgage lenders should be aware that given current low interest rates, tax incentives, and Denmark's weak economy, the solution to the high LTV ratios observed isn't likely to come from borrowers as incentives to amortise remain limited," he said. ■

Ratings

AGENCIES

Germany-based Scope in bank rating push

German company Scope Ratings is planning a push into international bank ratings and has hired former Moody's and one-time DBRS European bank rating head Sam Theodore.

Scope said in mid-April that under the initiative it will rate European and global banks, and to that end it is assembling a team of analysts, initially in London.

The performance of the three major rating agencies — Moody's, Standard & Poor's and Fitch — has come under scrutiny since the onset of the financial crisis, with many market participants calling for greater competition. In the US players such as Kroll Bond Ratings have made a push into the industry, while Canada-headquartered DBRS has ramped up its activities — not least in Europe, where it launched a second attempt to establish itself in the European covered bond market in 2011.

DBRS had made an earlier move into Europe in 2007 before withdrawing in 2008. Theodore, now running Scope's initiative, also led that DBRS push, having joined the rating agency in 2005 from Moody's, where he ran European bank ratings. After DBRS he worked at the UK Financial Services Authority as a manager, banking sector, from 2008 to 2011, since when he had been working at the European Banking Authority as an analytical expert, risk assessment.

Scope said that its initiative fits well into the evolving landscape of the rating industry, given calls for more competition and a wider diversity of opinions.

"Scope aims to offer a genuine European alternative in the bank rating arena, which is currently dominated by the large North American-based rating agencies," said CEO Florian Schoeller.

"It marks the next step in Scope's strategy to become a fully-fledged rating agency across Europe, thus moving beyond its traditional German market base, where it already has a recognized position in asset-based and corporate ratings," he added.

Another German company, Feri EuroRating Services, in August 2012 announced that it was establishing a new structured finance and covered bond ratings business, having the previous year become a registered credit rating agency (CRA) under EU regulations — something Scope already is.

René Hermann, I-CV: services have gained interest since the crisis

Scope's Theodore highlighted a need for "crisp, more transparent and forward-looking methodologies more suitable to the post-crisis banking realities… free of the legacies of the past", not just for fundamental bank ratings, but also for covered bonds and capital instruments.

He also said that repeated methodology adjustments are often disruptive for issuers and investors and can distort the meaning of rating symbols.

"Senior debt investors and lately segments of depositors alike have come to recognize that the risk of loss for bank liabilities is increasingly real and no longer automatically covered on a timely basis by public support," added Theodore, saying that in this context a forward-looking assessment of the intrinsic credit strength of each bank through a mix of qualitative and quantitative factors is more essential than ever.

Meanwhile, **Independent Credit View**, a Swiss credit research boutique, has developed a covered bond rating model to cater for demand from its institutional investor clients for an independent credit risk assessment of their holdings as a complement to rating agencies' views, according to an I-CV spokesperson.

The ratings will not be made public because I-CV has for the last 10 years strictly operated an investor-pay model, said René Hermann, partner at I-CV, which is based on full insight into and continuous monitoring of its clients' positions and "does not lend itself to conflicts of interest".

Demand from large German pension funds for an independent assessment of the covered bonds in their portfolios was the main driver for I-CV to extend its services to the asset class, he told *The CBR*.

He said that I-CV is not seeking to compete with the established rating agencies, a question that is often asked, and that its services are designed as a complementary source of unbiased information and expert analysis on top of that provided by incumbent rating agencies.

"Our consultancy services have gained interest since the crisis, in particular because we were able to detect early the deteriorating credit quality of certain banks and sovereigns and position our clients well ahead of the curve," he said.

"We were approached by one of the largest pension funds in Germany and asked if we could expand our offering to cover their covered bond holdings." ■

HUNGARY

FHB currency mismatches fall 'markedly'

Hungary's FHB Mortgage Bank has significantly reduced foreign exchange exposure in its covered bond programme as a result of a sharp decline in outstanding euro denominated bonds and a focus on its domestic currency for new issuance and mortgage origination, according to Moody's.

Sizeable foreign exchange risks remain in FHB's programme, the rating agency said in mid-April, but these have fallen since the beginning of 2012. At that time, the vast majority of the issuer's cover pool comprised Hungarian forint and Swiss franc loans, while covered bonds were issued in forint and euros, leading to considerable currency mismatches.

However, over the course of 2012, FHB repurchased or redeemed euro issues while issuing forint bonds. As a result, the share of euro denominated bonds in FHB's programme fell by 63%.

At the same time, the share of Swiss franc denominated assets in the cover pool fell, by 13%, as the issuer originated new mortgage loans in forint. In addition, under a law change in September 2011 borrowers can pay back their foreign-currency denominated mortgages in forint, a move that raised concerns among some rating agencies and other analysts.

Moody's said that sizeable foreign exchange risks remain in FHB's covered bond programme, with over 40% of all assets still Swiss franc-denominated.

"If the government's decision to allow repayment of these CHF debts at a steep discount in HUF is repeated, the level of assets in the cover pool would suffer a further haircut," said Moody's.

However, the rating agency said that it expects foreign exchange risks to decline because FHB's new issuance is primarily forint-denominated and new mortgage loans are originated solely in its domestic currency. ■

ACS

Stricter Irish arrears plan positive, says Moody's

Irish proposals to strengthen lenders' ability to deal with mortgage arrears are credit positive for Irish mortgage covered bonds because they will make it easier for lenders to take action against delinquent borrowers and reduce arrears, according to Moody's.

On 13 March Ireland's Department of Finance (DoF) announced that it planned to introduce new legislation removing a legal ban on repossessions, which Moody's said would remove legal uncertainty regarding lenders' ability to repossess properties when a mortgage loan has become delinquent. Legislation was published on 28 March by the Department of Justice & Equality.

Meanwhile, Ireland's central bank is expected to publish a revised Code of Conduct on Mortgage Arrears (CCMA) by the end of May. The amendment of the CCMA is aimed at increasing lenders' powers when dealing with delinquent borrowers. The proposals include a tightening of the definition of a "co-operating" borrower, a classification that triggers a 12 month moratorium on the lender taking any action against the mortgagor. Another proposal is the removal of a cap on the number of communications that a lender can have with a borrower, currently limited to three per month, said Moody's.

"These initiatives are credit positive for mortgage backed covered bonds and RMBS in Ireland because they will enable lenders to weed out disingenuous borrowers and reduce arrears," said Moody's.

The rating agency noted that as a result of a "borrower-friendly legal and regulatory system" Ireland has one of the highest rates of residential mortgage loan arrears in Europe and a very low number of repossessions.

Mortgage arrears surpassed 12% at the end of 2012, while repossessions were practically zero as a result of a 2011 High Court ruling that, according to Moody's, "made it virtually impossible for mortgage lenders to get a court order to repossess a home if the mortgage was originated before 1 December 2009". ■

ITALY

Fitch cuts five OBGs, catches analysts out

Fitch cut the ratings of five Italian mortgage covered bond programmes on 20 March, taking by surprise analysts who had expected only a limited impact on OBGs after Italy was downgraded to BBB+ on 8 March.

The rating agency also affirmed three programmes, including UniCredit's, which had been singled out by covered bond analysts as that most likely to be lowered.

The ratings of obbligazioni bancarie garantite (OBGs) issued by the following Italian issuers were downgraded by one notch:

- Banca Carige, from A- to BBB+,
- Banca Monte Paschi di Siena, from A+ to A,
- Banca Popolare di Milano, from A to A-,
- Credito Emiliano, from AA- to A+,
- UBI Banca, from AA- to A+.

Only limited impact on Italian covered bond ratings had been forecast by analysts after Fitch cut Italy's sovereign rating from A- to BBB+ on 8 March, and Intesa Sanpaolo and UniCredit were downgraded by one notch from A- to BBB+ on 18 March.

The driver of the OBG downgrades was the lowering of the Discontinuity Cap (D-Cap) of Italian covered bond programmes, which was cut from 2 (high risk) to 1 (very high risk), said Fitch.

Jan King, covered bond analyst at RBS, said that Fitch had mentioned in its 2013 Outlook the possibility that a downgrade of the sovereign rating to triple-B territory would lead to a lowering of the D-Cap assigned to covered bond programmes.

Another covered bond analyst explained how under Fitch's methodology D-Cap scores indicate how many notches above an issuer rating covered bonds can be rated, with a D-Cap of 2 allowing

for four notches of uplift over the issuer rating and a D-Cap of 1 allowing three notches of uplift.

"So while Fitch left the issuer ratings untouched, it has lowered the maximum uplift after the sovereign downgrade, and this led to the OBGs downgrades," he said.

According to Fitch, the lowering of the D-Cap was due to an increase in its liquidity and systemic risk component from "high" to "very high" after Italy's sovereign rating was downgraded.

"The rationale is that in a systemic crisis, Fitch expects that a deterioration of the sovereign's creditworthiness would be associated with diminishing interbank liquidity," it said.

"The very high risk assessment for the liquidity gaps and systemic risk component also reflects Fitch's view that the extendible maturity feature of up to 15 months would not be sufficient to bridge maturity mismatches in a stress scenarios exceeding the issuers' rating by more than one notch."

The ratings of covered bonds issued by Banco Popolare and UniCredit were confirmed, at BBB+ and A, respectively, as they incorporate a sufficient buffer against a change in D-Cap, said Fitch.

UniCredit's programme also incorporated sufficient buffer against a downgrade of the issuer, said the rating agency. UniCredit was downgraded by Fitch from A- to BBB+ alongside seven other Italian banks on 18 March following the downgrade of the sovereign.

Fitch noted that in assessing UniCredit OBG's overcollateralisation levels (which it refers to in terms of Asset Percentage, or AP) it had given credit to the evolution of the level of OC observed over the last 12 months (March 2012-March 2013), instead of the lowest OC observed in December 2011.

"This is justified by the trend that the level of UniCredit's AP has shown since the first quarter of 2012, following a Eu5.1bn transfer of assets in March 2012," said Fitch.

An analyst, who like others had expected a UniCredit OBG downgrade, noted that before the issuer downgrade UniCredit's OBG rating was lower than Fitch's methodology could have allowed for because the lowest OC level observed in December 2011 prevented the covered bonds from achieving a full rating uplift over the issuer rating.

But since that lowest OC level is now older than 12 months, it has ceased to be a drag on UniCredit's OBG ratings, so the bank's OBG rating was maintained without the issuer making any changes in its OC commitments. ■

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PORTUGAL

Totta OH up on new Fitch time subordination

Fitch has changed the way it evaluates recovery prospects in defaulted covered bonds where there is time subordination, which is expected to lead to lower breakeven OC for affected programmes and already prompted an upgrade of Santander Totta obrigações hipotecárias.

The rating agency announced the change on 30 April, saying it will "more accurately" model stressed recoveries given default in covered bond programmes where there is time subordination.

Time subordination arises when proceeds from the cover pool in the event of it being overindebted are not allocated pro-rata across outstanding bonds but allocated sequentially in order of maturities, meaning that later maturing covered bonds are at risk of suffering a loss while an earlier series could be repaid in full.

In such cases Fitch's prevailing approach is to only recognise recovery benefit when stressed recoveries reach 100% of covered bonds deemed to be in default, including the last maturing bond.

Hélène Heberlein, managing director of Fitch's covered bonds team, told *The CBR* that this meant that the recoveries on the last maturing bond were the driver of any uplift for all the other, earlier bonds, given that the rating agency prefers to rate all covered bonds backed by a cover pool the same.

"Given this constraint we felt a need to calculate recoveries slightly differently," she said, "and the new model is more precise because we no longer assume that a fire sale is necessary, which means that you do not have to apply harsh refinancing cost assumptions as you would if there was a liquidation.

"Our overall framework for recovery uplift is not changing, but the new modelling is less conservative."

The rating agency will henceforth assume ongoing allocation of funds from the cover pool to make the payments that

become due under the covered bonds, until the maturity date of the last maturing covered bonds, when the stressed value of the remaining assets will be assessed.

> "Sometimes the last bond can be very small"

This is expected to lead to lower breakeven overcollateralisation in line with a given rating scenario for the concerned programmes, such as Portuguese and French legislative covered bonds, according to Fitch, although the OC level will still be higher than that for a programme where there is no time subordination.

Later on in the same day it outlined its new approach, Fitch upgraded Santander Totta mortgage covered bonds from BBB to BBB+. The obrigações hipotecárias had been on Rating Watch Negative. The outlook is negative.

Fitch said that the rating is based on the Portuguese issuer's default rating of BBB-, a Discontinuity Cap of 0 (full discontinuity) and 30% overcollateralisation publicly stated by the issuer in its investor reports.

"This level of OC is in line with the agency's breakeven OC and allows a two notch uplift being granted for at least 91% recoveries achieved on the longest dated bond given that all other outstanding bonds are paid in full," it said.

Fitch said that it will apply its new approach over the next six months to cases where its analysis rests on the time subordination of later maturing covered bonds, which is analysed on a jurisdiction by jurisdiction basis.

Another aspect of Fitch's revised approach is to aggregate the size of the last maturing bonds up to a certain threshold where these are not large enough to represent a significant share of the total covered bonds outstanding.

"Sometimes the last bond can be very small," said Heberlein, "and you would not want recovery prospects linked to that to be the driver of the potential recovery uplift for all bonds linked to that cover pool, so this is another change."

A covered bond analyst said that Fitch's move had opened up an important discussion, and that from an academic point of view this is to be welcomed.

"Trading-wise we do not believe that it will have much impact, however, these are the types of discussions on which the great history of covered bonds are based," he said, adding that the question of how to distribute funds was important in assessing recovery prospects.

"However, we believe that the more striking element is the question of the degree to which the cover pool administrator is put under pressure to liquidate (e.g. Spain requires a fire sale)," he said, "and the degree to which he is forced to take loss bearing measures such as selling cover assets instead of, e.g. being able to repo them with the central bank or issuing new debt, maybe even in the form of covered bonds." ■

SPAIN

Fitch easier on cédulas after reviewing law

Fitch has revised its recovery uplift assumptions for cédulas hipotecarias after reviewing Spain's covered bond framework in light of new legislative measures introduced as part of the restructuring of the country's banking sector, but no impact is expected on cédulas ratings.

Fitch said on 5 April that after reviewing a law to reform the banking system that the Spanish parliament approved in November (Law 9/2012), the rating agency now understands that the Spanish covered bond framework provides for equal credit treatment for all the cédulas of an issuer.

This means that upon an issuer default the receipts from cover pool disposals are allocated on a pro rata basis without discriminating according to bond maturity, according to the rating agency.

The new understanding has positive implications for Fitch's recovery uplift analysis for the rating of cédulas, it said, which previously had been conducted in a "conservative manner".

Previously Fitch's stressed estimate of cover pool proceeds would have had to meet 100% of the outstanding covered bonds for a maximum rating uplift to be assigned, which is the rating agency's policy regarding jurisdictions where covered bonds are subject to time subordination risk.

Now, it will grant full uplift when the overcollateralisation taken into account between the total mortgage book and outstanding cédulas is able to reach stressed recoveries of at least 91%.

> "Powers granted to the FROB... introduce uncertainty"

Fitch noted that the maximum recovery uplift assigned to Spanish programmes remains unchanged.

The rating agency said that no positive rating impact for cédulas is expected following the review of the law because its liquidity gap analysis, which is the weakest component of Fitch's cédulas continuity analysis, remain unchanged.

Fitch noted that some elements introduced by Law 9/2012 — such as early measures, restructuring and resolution processes for domestic banks — are net positive and should provide greater confidence to cédulas investors as an active management of institutions will be conducted by the Fund for Orderly Bank Restructuring (FROB) ahead of a traditional insolvency.

However, it also highlighted that the measures could lead to troubled banks not maintaining stable levels of overcollateralisation.

"We believe that the powers granted to the FROB by the new Law 9/2012, in particular relating to the transfer of assets and/or liabilities to a bridge bank or an asset management company introduce uncertainty with regards to the ability of the troubled bank to maintain a stable level of OC between the total mortgage book and outstanding cédulas hipotecarias," said Carlos Masip, director at Fitch. ■

FITCH

Cédulas cancellations mitigate Sareb OC fall

The cancellation or amortisation of cédulas by issuers that have transferred mortgages to Spain's bad bank has offset a reduction in total overcollateralisation levels, according to Fitch, meaning that investor protection has hardly diminished.

The transfer of assets to Sareb, Spain's bad bank, by issuers such as Bankia, NCG Banco and Catalunya Banc has caused total overcollateralisation of these banks' covered bonds to drop by 14% on average, according to Carlos Terre, director, structured credit at Fitch, in a report published on 24 April.

However, eligible OC has increased by 8% because issuers have amortised or cancelled some of their existing cédulas, with the retired covered bonds likely to have been those retained for use for repo with the ECB, he said.

In addition, the vast majority of mortgages that were transferred to Sareb are troubled developer loans, so that, after credit and market value stresses are applied, the cédulas offer almost the same level of protection despite the reduction in the size of the collateral available to investors, according to Terre.

"Investors remain protected because it is riskier loans that have been transferred and because banks have amortised outstanding cédulas," he said.

The rating agency has lowered estimated per cent losses for cover pools following the asset transfers and said that the larger proportion of higher credit quality residential assets that remain and a reduced refinancing rates stress also cut its loss esimates under all rating stresses.

However, it noted that it has increased market value decline assumptions to capture the challenges facing the Spanish housing market. ■

Markets

EUROS

April shower revives mart after lacklustre Q1

Euro benchmark covered bond issuance picked up in April after the market had its second quietest first quarter in a decade in terms of gross supply, with a rare deal from HSBC SFH leading what Natixis analysts described as a strong comeback by core issuers.

Benefitting in part from a rally in French government bonds that allowed for an attractive pick-up versus OATs, a Eu1.25bn 10.5 year deal from HSBC SFH on 9 April was the first new euro benchmark in just over three weeks. Its first such deal since the issuer made its debut in January 2010, the transaction met with heady demand and was priced at 35bp over mid-swaps, or 5.7bp over October 2023 OATs.

"The bookbuild was fantastic," said Neil Sankoff, head of senior funding at HSBC. "I don't think I've ever seen a book build so quickly. Given there was no pre-announcement the first the market knew of the deal was when it hit the screens and within 65 minutes we had a Eu4bn book."

The transaction was followed by a mini-surge in supply, all of which was long dated, with a concentration on the seven year maturity bracket, as market sentiment improved.

"All seems forgotten about Cyprus, Italian deadlock or European growth," said a syndicate official on a busy morning the day after HSBC SFH's deal, when BNP Paribas Home Loan SFH and Münchener Hypothekenbank were out with new issues.

Indeed five new euro benchmarks plus a tap priced that week constituted Eu4.75bn of supply — more than in the entire month of March, with syndicate bankers attributing the heightened activity in part to aggressive quantitative easing announced by the Bank of Japan and anticipation of other central banks possibly following suit.

Among that week's rush of deals was a Eu1bn seven year for Westpac Banking Corporation, the first Australian euro benchmark covered bond of the year. The issuer seized the opportunity in the euro market after having for some weeks discussed with the leads when an issuance window might open, according to a lead syndicate banker, with the fate of a deal for Sweden's Stadshypotek in the middle of March having complicated matters somewhat for low beta issuers. *(See separate article.)*


Photo: HSBC France

> "All seems forgotten about Cyprus, Italy or European growth"

"The market now looks much better," said the syndicate banker. "There has been a readjustment in relative values, particularly versus the government bond market and SSA market."

The following week Credit Mutuel CIC Home Loan SFH "joined the party" in the primary market, in the words of a syndicate banker on the deal, pricing a Eu1.25bn seven year deal without any new issue premium and also raising £250m via an inaugural sterling trade.

Austrian regional bank Hypo Vorarlberg was able to make a strong debut in the public covered bond market that week, increasing a seven year mortgage issue to Eu600m on the back of Eu2bn of orders, with pricing of 20bp over better than expected, according to Florian Gorbach, head of treasury at Vorarlberger Landes- und Hypothekenbank.

Sparkasse KölnBonn, meanwhile, returned to the benchmark covered bond market for the first time in five years on 23 April, selling a Eu500m no-grow seven year mortgage Pfandbrief that, at 9bp over, bankers said came close to Germany's tightest names.

Shortly thereafter Swedbank Mortgage sold the first Swedish euro covered bond since Stadshypotek's deal, meeting with a "mad" rush of demand for what was its first benchmark since August 2011. The deal ended up being the tightest Nordic covered bond in five years, a Eu1bn seven year priced at 13bp over mid-swaps.

March intermezzo

Back in March the turmoil around Cyprus's plans to tax and effectively haircut deposits as part of a bail-out package had spooked markets and effectively brought the first quarter's new issuance to a close some two weeks before its calendar-end after a steady, if unremarkable deal-flow.

A Eu1.25bn seven year deal for Crédit Agricole Home Loan SFH on 28 February had been the first benchmark to hit

the market after Italian elections a few days earlier had resulted in a stalemate and triggered market volatility.

Deals for HSH Nordbank and CRH followed, with supply in the week of 11 March taking in more core transactions but also two from the periphery, an almost three times subscribed Eu1bn five year deal for CaixaBank and a Eu500m five year issue for Bank of Ireland Mortgage Bank.

CaixaBank's benchmark was the first from the periphery since the Italian elections and the issuer's first this year, after it had waited longer than other Spanish issuers to come back to the cédulas market.

"We are always looking at the market but we are not in a rush to issue because we are in a comfortable liquidity position," said an official at the issuer. "At the beginning of the year market conditions did not fit in with our spread targets as much as we wanted."

Three days later Bank of Ireland attracted Eu2.5bn of demand for a Eu500m no-grow five year issue that was the issuer's second public covered bond since it reopened the Irish market in November. The deal came after a successful 10 year Irish government bond auction the week before, the first since the country's 2010 bail-out, although Darach O'Leary, head of wholesale funding at Bank of Ireland, played this down as a driver of the covered bond.

"We had been actively monitoring the market over recent weeks" he said. "Following our preliminary results on March 4, we made the decision to launch a new covered bond deal on Friday given the strong market backdrop." ■

SWEDEN

Stadshypotek hits 'brick wall' but picks itself up

Stadshypotek came up against the limits of investor appetite for low risk names at tight levels when it launched a five year issue on 12 March for which guidance had to be set considerably wider than IPTs, with the issuer, leads and others learning a lesson from the experience.

The Swedish issuer priced the Eu1bn five-and-a-quarter year deal at 14bp over mid-swaps — the tight end of guidance of the 15bp over area, but well wide of initial price thoughts (IPTs) of the high single-digits, which had failed to trigger sufficient momentum for the Eu1bn minimum benchmark-sized trade the issuer was targeting. The eventual order book was Eu1.6bn, after around Eu600m of orders had come in on the basis of IPTs.

Many market participants were understanding of the situation Stadshypotek had found itself in, despite the outcome of the initial price thoughts process clearly having shown the issuer and leads to have "got it wrong".

Outsiders noted that the right decision was taken to rescue the deal and that the issuer still ended up with a Eu1bn trade at a decent level, with a couple acknowledging that they might have ended up in the same predicament — "It could have been me," said one.

Indeed, syndicate bankers *The CBR* had spoken to on the morning of the transaction before the spread was widened did not raise the alarm, and later several said that the high single-digits was not wholly inappropriate.

One banker said that it was inevitable that as spreads ground tighter one unlucky issuer would hit a "brick wall", when some investors, particularly in Germany, would take a stand.

A banker at one of the leads — Danske Bank, Deutsche Bank, Société Générale and Svenska Handelsbanken — defended the approach to pricing and the adjustment to the spread, saying that it came down to the risk-on sentiment characterising the market at the time and that investors were focussing on other deals in the market offering higher spreads.

Bengt Edholm, head of treasury at Svenska Handelsbanken, Stadshypotek's parent, said that the transaction was prompted by the observation earlier that week that the issuer might be able to print a deal in the high single-digits and thereby, for the first time, fund itself more cheaply in euros than in Swedish kronor.

Most banks advised that the issuer could print inside 10bp over, he said, but on the day of launch competing supply, such as in the form of a new issue for Spain's CaixaBank, "took away the limelight from our very low risk offering".

With feedback surrounding the only moderate initial demand indicating that the problem lay with the spread rather than the issuer's credit, the bank decided to increase the spread, said Edholm, "and then the order books exploded in five minutes".

The eventual outcome of the transaction was satisfactory, even though the initial spread was a mistake in being too tight, he said.

"It is a lesson, and it appears we were ill-advised and that the banks misread the market," he added. "The consensus was that we could print inside 10bp over, but the conclusion we have drawn is that as long as the market is in risk-on mode as one of the safer credits you have to pay a new issue premium." ■

TURKEY

Turkish eye mortgage, international issues

Turkiye Garanti Bank is looking at issuing covered bonds, it said in early April, potentially becoming the first bank in Turkey to sell mortgage-backed covered bonds, with others also eyeing the international markets.

"T. Garanti Bankası AS Board of Directors has authorised the Head Offices to take the necessary actions, with regard to a potential covered bond issuance, to do feasibility studies regarding such potential issuance and give necessary authorisations …," the bank said.

An official at Garanti Bank told *The CBR* that Garanti is studying data to assess the feasibility of a mortgage-backed issue placed on the international market.

"We think that the international covered bond market would be interested in a Turkish issue," he said. "The project is still in its preliminary phase of feasibility and there is no plan for issuance at this stage."

Garanti could become the first Turkish bank to issue mortgage backed covered bonds under the country covered bond framework, which was established in 2007. So far, two other banks have issued covered bonds using loans to small and medium sized enterprises as collateral.

Akbank has also been said to be looking at a mortgage backed-covered bond to be sold internationally. Contacted by *The CBR*, the bank declined to comment.

Sekerbank launched the first Turkish covered bond issue, in July 2011, selling $125m equivalent of covered bonds to three investors: UniCredit, the International Finance Corporation, and Dutch development agency FMO.

Last November Sekerbank announced a European roadshow for the issuance of an internationally targeted issue that would have been the first public Turkish deal, mandating Commerzbank and UniCredit, the latter having also structured the Turkish bank's SME-backed programme.

Zeki Onder, executive vice-president, financial institutions and international funding at Sekerbank, told *The CBR* in April that the roadshow was carried out mainly to inform market participants about the structure of the programme as this was the first SME-backed covered bond presented to the global market, and to collect feedback on the feasibility of an international issue. "Investor response was really good," said Onder.

Sekerbank in the meantime also mandated for a roadshow starting on 4 April for the launch of a senior unsecured US dollar issue. However, that was postponed.

"We are now constantly watching the market to seize an opportunity to issue," said Onder. "So far the pricing that we would accept and the pricing that the market would allow us to print at have not met for the senior unsecured US dollar issue, so we are waiting for the right moment."

Onder said that both covered bond and the senior unsecured options remain open. "The covered bonds are rated A3," said Onder. "We want this to be reflected in the pricing."

DenizBank is meanwhile preparing a debut SME backed covered bond off a Eu300m equivalent programme, with the IFC set to be involved.

Yapi Kredi sold its first issue off a Eu300m SME-backed programme in mid-November. The Turkish lira-denominated bonds, equivalent to Eu200m, were split between two supranational institutions and one commercial bank, according to an official at Yapi Kredi Bank. The maturities of the bonds ranged from three to five year, he said. The pricing was not disclosed. "The issue was priced below where our senior unsecured issues are usually priced," said the official.

Yapi Kredi does not have plans for further issuance in the short term, he said. The bank would nevertheless be interested in placing an issue on the international market, he added, depending on the appetite in the market.

"However, there may not yet be the conditions for that," he said. "The Turkish economy is expanding, but Turkey's sovereign rating would need to be lifted further to attract foreign investors."

Fitch upgraded Turkey to above investment grade in November, lifting its long term foreign currency rating from BB+ to BBB-. According to the Yapi Kredi official, the sovereign upgrade encouraged Turkish banks to look at the possibility of issuing bonds on the international markets, seeing covered bonds as an opportunity to diversify their funding base.

"We expect Moody's, too, to upgrade our sovereign rating soon," he said. "After that we will see even more issuers looking at the international covered bond market." ■

"Top names are still benefitting from good market access" page 36

NEW ZEALAND

Kiwibank debuts in Swiss francs with NZ story

Kiwibank inaugurated a covered bond programme with a Sfr150m long seven year deal on 26 March that was also its first public offshore unguaranteed issue, the bank's head of funding told *The CBR*.

Leads Barclays and UBS priced the December 2020 issue at 13bp over mid-swaps, tightening the spread from initial price thoughts in the 15bp over mid-swaps area and guidance of 14bp over. The deal, rated AAA, was sized at Sfr150m (Eu123m, NZ$190m), after the transaction was announced as a Sfr100m minimum, Sfr150m maximum issue.

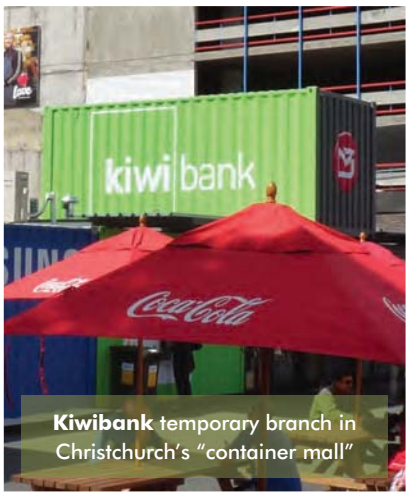
Geoff Martin, head of funding at Kiwibank, said the transaction followed positive investor feedback the bank received during a European roadshow. "The good reception on the roadshow in early March provided the impetus to proceed with a launch this week," he said.

Kiwibank decided to target the Swiss franc market for three reasons, he said. "First, there's a long history of New Zealand issuers accessing that market and therefore a good understanding among investors of the 'New Zealand story'.

"Second, the size of a liquid transaction suits Kiwibank's modest funding task, and third, funding diversification."

The transaction was Kiwibank's first offshore issuance in public markets, according to Martin, apart from an Australian dollar MTN issued in 2009 under a New Zealand government guarantee scheme.

"Kiwibank established the covered programme to build funding capacity, provide duration and diversity and provide access to debt markets in difficult times," said Martin. "From an issuer's perspective, covered bonds have performed very well during the periods of market dislocation."



Kiwibank temporary branch in Christchurch's "container mall"

Martin said that Kiwibank will continue to assess funding opportunities in senior and covered bond markets both domestically and offshore. Kiwibank's programme is structured on a contractual basis, as New Zealand covered bond legislation is still going through the country's parliament. ■

UK

Foreigners see varied attractions in sterling visits

Three foreign covered bond issuers made their debuts in an undersupplied sterling market in April, with France's CM-CIC saving costs versus euros but Pfandbrief issuers paying up for entry into what they see as a strategic market given sterling funding needs.

CM-CIC Home Loan SFH was the first to tap the market, selling a £250m (Eu295m) three year floating rate note on 15 April on the back of reverse enquiries generated during bookbuilding on a Eu1.25bn seven year euro benchmark covered bond that was priced earlier that day.

In addition to being the issuer's sterling debut, the deal was the first French floating rate covered bond in the sterling market and the first French sterling covered bond at all since 2007. Sole lead HSBC priced the FRN at 30bp over three month Libor, which a syndicate banker on the deal said represented savings of 10bp-15bp versus euros in the same maturity.

Two days later Münchener Hypothekenbank priced a £200m three year mortgage Pfandbrief FRN at 23bp over. The deal was the issuer's first public sterling covered bond, and Münchener Hyp is aiming to be a regular issuer in the currency given sterling funding needs. *(See Pfandbrief Roundtable for more.)*

With the deal being priced at 23bp over, the issuer paid up around 7bp versus euros, according to an official at the issuer.

A week later Aareal Bank tapped the currency, pricing a £200m three year FRN to kick-start use of what an official at the German bank said will be a strategic market for it.

"This isn't an opportunistic move," said Alexander Kirsch, director, capital markets at Aareal Bank. "We have a lot of sterling assets in our portfolio and from a risk management point of view, also taking into account the regulations we face, it makes sense to issue in a currency matching that of your assets."

Given the issuer's long term and strategic intentions, it is prepared to pay up to enter the sterling market, said Kirsch.

The deal was priced at 40bp over, the largest spread for a new issue in the currency this year although a lead syndicate banker said it was not cheap on a relative value basis. ■

RECOMMENDATION

Go public with tap plans, say AFME, ECBC

Issuers planning to increase outstanding euro benchmark covered bonds by way of open marketing should communicate this in advance to ensure market participants have equal access to information and avoid market distortion, the ECBC and AFME said on 18 April.

The recommendation on tap issuance by the European Covered Bond Council and the Association for Financial Markets in Europe (AFME) is intended to reduce the problem of asymmetrical information in the context of potentially market-moving transactions of which only those market participants involved in a trade are aware.

This can arise when an increase is launched that reduces technical shorts in the market, but not all market-makers are aware of the transaction so that some are left trading the bonds on the basis of the previous deal size and others on the basis of the larger volume.

Richard Kemmish, head of covered bond origination at Credit Suisse and chairman of the ECBC market related issues working group, said that the recommendation is intended to serve as a reminder to adhere to fair practice.

"This is geared mainly toward offered taps that are broadly marketed and which all market participants should know about at the same time to avoid distortion," he said.

The ECBC and AFME have proposed as a solution that issuers announce in advance that a trade is about to take place, and said that this would benefit market-makers by making them aware that an increase is imminent and allowing them to price accordingly. The recommendation is that this should apply to all euro denominated covered bonds sold internationally.

Torsten Elling, co-head of rates syndicate at Barclays, said that there have been occasions in the past when traders have been at a disadvantage because they did not know about a tap at the same time that investors did.

AFME's James Kotsomitis: confident of a warm welcome

"It's only fair that issuers make a very broad approach to the market so that liquidity providers are alerted to the fact a tap is planned," he said. "Increased transparency of this sort can only help future transactions coming to market."

James Kotsomitis, head of AFME's credit division, said that the recommendation is the outcome of efforts over the last 12-18 months.

"The consultation process, driven by AFME and the ECBC, has incorporated a comprehensive range of market participant views, particularly from the buy-side and sell-side," he said. "We are confident that this key recommendation will be warmly welcomed by the secondary market."

Issuers would not need to disclose the size of the increase but simply state that a trade is to take place, according to the industry bodies, with the timing differing depending on whether the increase is marketed or not.

In the case of a non-marketed tap, the ECBC and AFME are recommending that the issuer should announce the transaction at the time of pricing. Kemmish said that in the case of a bilateral, private trade it is not obvious when a transaction has been carried out and that from a practical standpoint pricing represents the earliest time at which it is reasonable to inform market participants that an increase has taken place.

However, when a trade is being marketed more widely through a syndicated process the announcement should be made when investors are first approached, the ECBC and AFME have recommended. This could happen via deal disclosure systems such as Reuters or Bloomberg, said the industry bodies. ■

CEE

Poland's PKO BP targets covered

PKO Bank Polski is aiming to set up a mortgage bank by next year in order to be able to issue covered bonds as a source of long term funding better matched to the maturity of the assets.

The bank said in a statement on 24 April that the plans are in response to new capital requirement regulations (CRD IV) and expectations of the Financial Supervisory Authority in Poland, and reflect the bank's aim of increasing the share of long term funding sources.

It said that the mortgage bank would issue in Polish złotny as well as foreign currencies.

Universal banks are not allowed to issue covered bonds in Poland. A PKO BP mortgage bank would be the third covered bond issuer in Poland, in addition to BRE Bank Hipoteczny and Pekao Bank Hipoteczny.

PKO BP is the largest commercial bank in Poland. ■

"We will proceed with a transaction as soon as the law is passed" page 44

DENMARK

Nykredit senior secured makeover pays off

Nykredit Realkredit built the biggest order book for a Danish senior secured bond when it launched a Eu500m five year issue on 22 April, with a shift away from the "Junior Covered Bond" name making for an easier sale, according to an official at the issuer.

Danish issuers having variously referred to the debt as Junior Covered Bonds, senior secured bonds, or Section 33e issuance, after the part of Danish legislation that governs them — although since December this has changed to §15.

The instruments have been used by Danish mortgage credit institutions to help finance overcollateralisation to meet continuous LTV requirements in the event of falling house prices, although following the December legal change they can also be used for more general OC management purposes, and can also be issued out of realkreditobligationer (RO) capital centres, which was previously not the case.

The Eu500m five year deal was Nykredit's third sale of this type of debt to euro investors, but it was the first time that it has marketed it as a senior secured bond rather than as a Junior Covered Bond. Morten Bækmand, head of investor relations at Nykredit, told *The CBR* this made a difference.

"The fact that we went out with it as senior secured bond took away some of the questions about what it is," he said. "It made things easier, as people were more comfortable they understood the nature of the debt."

Leads BNP Paribas, DZ Bank, Nykredit and UniCredit priced the bond at 102bp over mid-swaps, after having gone out with initial price thoughts of the 110bp area. Some Eu1.4bn of orders were placed for the bonds, according to Bækmand.

"The orders just came pouring in," he said. "We had Eu700m within the first hour and then ended up just shy of Eu1.5bn."

A lead syndicate banker said that the order book is the biggest ever for a Danish senior secured transaction, and that

despite some initial price sensitivity all the accounts stayed in the order book and wanted full allocation.

At 102bp over, the deal was priced in line with senior unsecured debt of other Danish issuers, according to Bækmand, and through Nykredit's implied curve.

Some 140 investors participated in the deal, up from 90 accounts in the issuer's previous senior secured transaction, and Bækmand said that this included several accounts that had never previously bought senior secured issuance from Nykredit.

"We had new jurisdictions, with Spain, Portugal and Asia involved for the first time," he said, "and also a number of investors that we had visited in the past but had not participated in our deals before."

S&P warns on legal change

A few days beforehand Standard & Poor's had said that an expansion of how senior secured bonds can be used following the December legal change could render overcollateralisation of standard covered bonds more volatile and potentially trigger negative rating changes.

Casper Rahbek Andersen, director in S&P's covered bond team, said that the greater flexibility offered by §15 could increase supply of these bonds, and lead to a more liquid market and standardised terms and conditions for an issuer insolvency situation.

However, he identified two main risks stemming from the broader scope of junior covered bond issuance: potential rating volatility affecting senior covered bonds and the potential creation of two classes of §15 bonds.

As concerns the first risk, he noted that the overcollateralisation available for covered bonds partially funded with §15 bonds may become more volatile due to their traditionally short maturities, while the cover pool includes loans and bonds that mature after 30 years.

"In our opinion, the emergence of Section 15 bonds requires investors to consider what would happen if the issuer is unable to refinance the Section 15 bonds," he said. "Although Section 15 bonds boost the available overcollateralisation for the covered bonds, they will need to be refinanced several times before the covered bonds mature."

Separately, the emergence of two-tier lending, as practiced by one Danish mortgage bank [Nykredit] and the possibility of issuing §15 bonds out of RO capital centres could create first and second tier §15 bonds, according to S&P.

"Were the borrowers to default, the issuer would need to draw on the highly rated collateral bought as part of the bond issuance, thus reducing the available overcollateralisation for the Section 15 bondholders." ■

Industry moves

NORDICS

Borgström to leave Nordea

Fanny Borgström, senior vice president and head of group funding at Nordea, is leaving the Nordic financial group in August.

Described as a "legend" by one DCM banker, Borgström has long been at the heart of the Nordic bank funding scene and more latterly the covered bond market.

She told *The Covered Bond Report* that it had been a privilege to be a part of the market. "But there is a time for everything," she added.

Borgström has held her latest position since 1997 and previously worked in treasury and funding positions in predecessor entities of the Nordea group, including Merita Bank of Finland.

She has also chaired the Association of Swedish Covered Bond Issuers and been a member of the European Covered Bond Council steering committee.

Meanwhile, Helge Stray in March retired from DNB, where he was senior vice president in the Norwegian bank's funding and investor relations team. He was also active in the Norwegian Covered Bond Council and ECBC. ■

Fanny Borgström: "Legend"

SYNDICATE

Tobin exits UBS for RBC CM

Anthony Tobin has left UBS and is understood to be joining RBC Capital Markets in London.

He worked as executive director, financial institutions group, on syndicate at UBS with Armin Peter, head of covered bond business and syndicate at the bank.

Tobin joined the Swiss bank's syndicate a year ago, having previously worked from 2010 at Bank of America Merrill Lynch and before that for seven years at HSBC.

Tobin is said to be joining RBC Capital Markets, which lost Nigel Owen from syndicate when he joined National Australia Bank in January.

The Covered Bond Report understands that UBS is moving to cover the gap left by Tobin on syndicate. ■

DEXIA

Dexia to appeal rate ruling on three CAFFIL loans

Dexia is to appeal a French court judgement under which the interest rate on three structured loans that are in the cover pool of CAFFIL would be reduced, it announced in early April.

The case involves three structured loans totalling Eu178m made to the Département de la Seine-Saint-Denis, which the Conseil Général de la Seine-Saint-Denis had argued were mis-sold by Dexia and should be cancelled, with compensation paid.

The Superior Court of Nanterre on 8 February rejected these claims, saying that: Dexia had signed loan contracts (and not financial instruments) with the Département; the loan contracts were not speculative, but lawful and compliant with regulations; the Département was competent and had full knowledge of the facts; and Dexia in no way lacked in its duty to inform and advise the Département.

However, the court ruled that because the Effective Annual Percentage Rate was missing in faxes that were sent ahead of the execution of final contracts, the legally applicable rate (the Taux Effectif Global, TEG) should prevail. According to a covered bond analyst, the interest rates payable on the loans were initially low but then rose.

This interest rate that would be applicable under the ruling is understood to be significantly lower than that hitherto charged on the loans, which are now in the cover pool of Caisse Française de Financement Local (CAFFIL), the successor entity to Dexia Municipal Agency. CAFFIL's parent is Société de Financement Local (SFIL).

"As the loans referred to in the court's decision fall within the scope of the disposal of the Société de Financement Local, and if the judgement is confirmed it will have no financial impact for the Dexia Group, as the assets sold are now carried by the Société de Financement Local," Dexia said on 4 April. "If the High Court's decisions were to be confirmed and were to become established case law, their extension to other Dexia financing is likely to introduce significant risks.

"Dexia Crédit Local SA plans to appeal these decisions," it said.

Some observers have suggested that the court's ruling was inconsistent, saying that on the one hand it found the Département to be a well informed party, but on the other applied the TEG, which is a rate designed to protect retail clients. ■

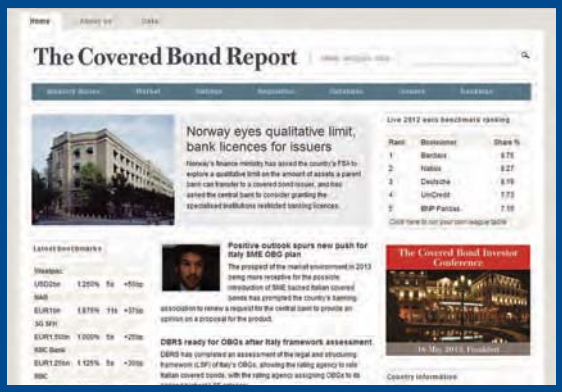
League Table

EURO BENCHMARK COVERED BOND RANKING				
1 January 2013 to 30 April 2013				
Rank	**Bookrunner**	**Deals**	**Amount Eu (m)**	**Share %**
1	Credit Agricole	20	3,555.42	9.02
2	UniCredit	22	3,458.75	8.78
3	Barclays	17	3,111.67	7.90
4	Natixis	15	2,567.92	6.52
5	BNP Paribas	11	2,316.67	5.88
6	Commerzbank	15	2,102.08	5.33
7	SG	12	2,054.17	5.21
8	Deutsche	12	1,966.67	4.99
9	RBS	11	1,575.00	4.00
10	Danske	7	1,443.75	3.66
11	Santander	7	1,431.25	3.63
12	HSBC	7	1,418.75	3.60
13	DZ	10	1,107.50	2.81
14	Credit Suisse	5	991.67	2.52
15	LBBW	7	957.50	2.43
16	UBS	5	850.00	2.16
17	Banca IMI	4	674.17	1.71
18=	Citi	4	650.00	1.65
18=	JP Morgan	4	650.00	1.65
20	BayernLB	5	625.00	1.59
21=	NordLB	5	525.00	1.33
21=	BAML	2	525.00	1.33
23	ING	3	464.58	1.18
24	Bankinter	3	350.00	0.89
25=	WGZ	3	325.00	0.82
25=	BBVA	2	325.00	0.82

Criteria: Euro denominated fixed rate syndicated covered bonds of Eu500m or greater and taps thereof. This league table is based on The Covered Bond Report's database. Please contact us at editorial@coveredbondreport.com if you have any queries.

Don't forget to visit our website at:

www.coveredbondreport.com



Natalie Portman
at the 84th Academy Awards
Photo: Kevin Winter/Getty

The Covered Bond Report

Awards for Excellence

Welcome to *The Covered Bond Report*'s inaugural Awards for Excellence. In the following pages we highlight those institutions and deals that have demonstrated the best of the covered bond market in the past year and taken it to new heights.

When we conceived our inaugural Awards for Excellence, we did so with a desire to celebrate the best of the covered bond market. After much deliberation, we have chosen 11 winners.

Notable among these are institutions that have been at the sharp end of the crisis, either directly or indirectly. As one head of covered bonds put it: "We think a deal from a peripheral country deserves the award for best deal since it's the best evidence of the beauty of the covered bond instrument. Moreover, access of peripheral issuers was *the* story of the past 12 months."

However, we would have to disagree with his follow-up: "When core issuers launch tighter or bigger deals," he added, "it's a bit like when the 100m record is improved by 0.01s."

Try telling that to US athletics legend Carl Lewis. Indeed if we are seeking those who are pushing the boundaries of the covered bond market, we must look at those who are willing to go outside their comfort zone and reach for new levels.

Meanwhile, although no-one in their right mind would have wished for the crisis that has afflicted the globe for more than five years now, the difficulties that have been faced have inspired innovations and initiatives that would otherwise not have come about, and two of these are among our winners.

Before you turn over and find out just who we have chosen (on the small chance you haven't already done so), a few words on how we arrived at our selection.

Most importantly, however much input we may have received from outside — and we did our best to hear the market's views — the final decision was ultimately ours alone.

We gave ourselves the maximum flexibility in the process with a view to letting those institutions and deals deserving of recognition drive our categories rather than vice versa. The main concrete criterion was the period under consideration: April 2012 to March 2013.

Our ultimate selection is weighted towards issuers, which we feel is valid considering their number relative to the ranks of lead managers, law firms and regulators. It is also difficult to separate out individual deals from issuers' overall strategies, which explains why more issuers than deals are recognised.

We have confined our awards to those areas where we are confident our process and ability to survey the market within our given time frame have allowed us to reach a justified and justifiable result. This explains, for example, the lack of a research award, which we feel requires a different process.

We have in some categories alongside the winners designated as "highly commended" certain institutions or deals that either might have triumphed had they not faced competition from our chosen winners, or had a sufficiently strong case that we felt they deserved to be recognised.

While we are confident that the winners are deserving recipients of our awards, we are the first to admit that there may well be others we have missed as a result of the depth and breadth of the market. Hopefully next year we will be able to uncover a broader range of winners.

In the meantime, we hope you will share in celebrating this year's winners.

Commerzbank

Award for Excellence:

Innovation

★ ★ ★

If there were an award for "Most different reasons why this deserves to win", then the SME-backed structured issue Commerzbank launched in February would win hands down. But, then again, some market participants would argue that the deal doesn't even deserve to be considered for a covered bond award.

Love it or hate it, it is hard to deny that Commerzbank's Eu500m five year was groundbreaking and it wins the Award for Excellence in innovation.

With apologies to Turkish issuers, the German bank's inclusion of SME loans in a covered bond programme broke one of the market's taboos — breaking out from traditional public sector and mortgage collateral. And it did so on a structured basis in the home of the Pfandbrief.

A full pass-through structure beyond the expected maturity date and other

structural innovations make the deal almost overqualified for even this award.

Commerzbank's deal also makes covered bonds relevant to the latest plan being pushed to save the euro-zone real economy: somebody do something about SMEs! While the ECB has called for governments, EU institutions and the ABS industry to come up with a solution to this real economy problem, only the covered bond market has delivered a potential breakthrough — small wonder that the deal won covered bond treatment from the central bank.

The debate over the deal's status will run and run, making Commerzbank's issue possibly the most influential innovation in the covered bond market since HBOS launched the first structured covered bond a decade ago, in 2003.

★ ★

Highly commended:

Global Bank (Panama)

Bank of Ireland Mortgage Bank

Award for Excellence:

Overall deal

★ ★ ★

It is not often that individual covered bond issues are highlighted by governments as milestones. But then not every covered bond issue is as notable as a Eu1bn three year deal issued by Bank of Ireland Mortgage Bank in November.

"This issuance is further evidence of the strengthening and normalisation of our banking system," said Ireland's finance minister, Michael Noonan. "It is a clear show of confidence in the restructuring of the sector and its viability into the future by international investors."

While the transaction clearly benefited from Ireland's profile as a poster boy for the EU's recovery cheerleaders, Bank of Ireland deserves credit for taking advantage of the opportunities presented it and for the way it has done so.

The November deal was the first non-government guaranteed deal for an Irish financial institution since September 2009 — when Bank of Ireland had launched its last benchmark covered bond. The Irish bank followed up the watershed deal with a Eu500m five year in March in the wake of the first Irish government benchmark since the 2010 bail-out.

Bankers pay tribute to the way in which Bank of Ireland has maintained a dialogue with potential investors even when the market was closed. *The CBR* witnessed this first hand at an LBBW covered bond conference in February 2012 when head of wholesale funding Darach O'Leary engaged with investors despite laughing off our suggestion that we might see an Irish covered bond before the year was out.

"Darach is one of the best funding officials out there, if not the best," says one syndicate official. "He pushes banks, but in the right way."

★ ★

Highly commended:

UniCredit

Eu750m 4% 2018

Royal Bank of Canada

Award for Excellence:

Deal: Dollars

★ ★ ★

A full-blown US market with domestic issuers and investors is perhaps the Holy Grail of the covered bond market. Although that remains a fantasy, the asset class took a big step forward in North America in September when Royal Bank of Canada launched the first fully SEC registered covered bond.

The $2.5bn five year issue attracted some $5.25bn of orders from more than 180 investors, and was hailed as a breakthrough, promising a broader US investor base for the asset class for index and other reasons while offering the issuer savings.

"The deal went phenomenally well," said a syndicate banker away from the leads, "and was right in line with expectations and where we had pinpointed the opportunities for them."

Much of the deal's success was down to work done before execution, with the issuer and Securities & Exchange Com-

mission getting themselves comfortable on the regulatory side.

The deal also caught the attention of those in Washington whose support is necessary for the US dream to become a reality, with Democrat Senator Kay Hagan citing it in a call for the swift passage of legislation.

★ ★

Highly commended:

CM-CIC

$1bn 1.5% 2017

Sveriges Riksbank

Award for Excellence:

Regulation

★ ★ ★

When it comes to opinions on financial authorities from market participants, negativity typically abounds. It is therefore refreshing to hear one such institution talked about consistently in a positive way, namely Sweden's Riksbank.

Issuers applaud the way in which the Financial Stability Department, led by Mattias Persson *(pictured)*, handles its responsibilities and takes a pro-active approach.

"They have a consistent dialogue with the banks regarding different issues and the risk of something coming in out of the blue is therefore very small," says one funding official. "But it's not like the

banks are dictating policy as they usually have a firm view."

The Riksbank has also engaged with the wider market on a variety of issues, whether that be in support of its local banks or to promote the debate about asset encumbrance — a topic where its joint stance with the Swedish FSA has been complimented. ■

Intesa Sanpaolo

Award for Excellence:

Issuer: Euros

★ ★ ★

Some market participants put forward Intesa Sanpaolo's Eu1bn 12 year OBG from January for a deal award. Others suggested its public into mortgage exchange last summer should be recognised. And one banker simply described them as "a great issuer".

Whichever way you look at it, that sounds like a winner.

However, the issuer faced stiff local competition, with Italian peer UniCredit also coming in for acclaim.

Among factors tilting our decision in Intesa's favour was the exchange of public sector into higher rated mortgage backed OBGs, on a par for par basis and with the same terms, that it completed in July 2012.

"That one definitely wins on my 'I wish I'd thought of that' criteria," said one covered bond banker.

Among a trio of euro benchmarks executed from September to January, Intesa Sanpaolo's 12 year in January was the longest dated OBG in two years, the only 12 year euro benchmark outside France in our qualifying period, and its longest OBG.

The Eu1bn no-grow transaction garnered Eu3.5bn of demand from over 150 accounts, with 89% placed outside Italy, and achieved pricing inside its curve and more than 100bp through BTPs.

A lead syndicate official said that Intesa was for the third time in six months confirming its high standing in the market with the 12 year deal, as well as further distancing itself from peripheral names, and "being able to enter in the elite club of issuers with the privilege to go beyond the 10 year tenor".

★ ★

Highly commended:

Belfius

Commonwealth Bank of Australia

Award for Excellence:

Overall issuer

★ ★ ★

CBA has been at the forefront of covered bond issuance despite being a relative newcomer. And, unlike some of its large peers at home and abroad, it has a track record that is hard to fault — despite an ambitious issuance programme.

Alongside deals in niche currencies — and its home Australian dollar market last year — the bank has not shied away from leading the way in euros, sterling and US dollars this past year.

In April 2012 CBA launched a Eu1.5bn 10 year deal into a challenging market, which was seen as a brave move but attracted Eu4.5bn of demand. It followed this up with a £750m 14 year issue that was the first long dated sterling benchmark from a foreign issuer since before the crisis and remains the largest, and achieved the tightest new issue spread seen in the currency. The bank then opened the US dollar market for covered bond issuance in January with a successful $2bn five year deal.

"Their issuance was very balanced over the course of the year and they very nicely accessed different parts of the curve to secure best execution in each market while ensuring outstanding ongoing investor diversification," says one banker.

Another banker describes CBA's funding team — led by Simon Maidment, head of group funding and execution — as "probably the most switched on of the Australians, if not all issuers".

★ ★

Highly commended:

Münchener Hyp, Stadshypotek

Swedbank

Award for Excellence:

Investor relations

★ ★ ★

It may seem strange that a bank that only issued one international benchmark in the period under consideration (April 2012 to March 2013) and no euro benchmarks at all wins an Award for Excellence, but Swedbank has nevertheless won over market participants and was cited for its investor relations work.

Bankers note how the Swedish issuer's spreads have improved to be on a par with the tightest of its peers.

"It has gone from the doghouse a couple of years' back to being the best positioned among the Nordic majors," says one.

Its outperformance in the covered bond market has been helped by better than expected results and positive ratings news, while as an issuer it has been active in raising senior unsecured and subordinated debt. Swedbank rounded off the year under consideration with a return to the covered bond market, selling a $1bn five year in March.

★ ★

Highly commended: **CFFL**

Allen & Overy

Award for Excellence:

Legal advisory

★ ★ ★

One respondent to our call for nominations simply put down in the legal advisory field: "No brainer." It would have been a disservice to firms such as Clifford Chance, Linklaters and Morrison Foerster if we hadn't checked that this market participant had Allen & Overy in mind, but given the strength of feeling in support of A&O it was no surprise when our suspicion was confirmed.

The firm has been at the forefront of developments in the covered bond market for at least a decade and remains there. Among partners mentioned by their supporters are Angela Clist, Sally Onions and Lawton Camp.

"The breadth and depth of their advice encompasses a number of different partners," says one structuring specialist. "We have worked with them extensively across all the major markets, and they have the ability to cross-pollinate the advice they provide."

Among A&O's contributions in the past year are involvement in the development of Belgium's covered bond market and in RBC's SEC registered covered bond. ■

Barclays

Award for Excellence:

Overall bank

★ ★ ★

Getting to the bottom of which banks really stand out in the covered bond market is no easy task, with reciprocity allegedly clouding the picture and the success of bulge bracket bond houses elsewhere making it hard to discern their expertise in the asset class.

But one name stands out as the undisputed leader: Barclays. In the UK bank's case, it appears that the league table does not lie.

"They are still a real reference point in this market," says a rival DCM banker.

A stalwart of the euro market, Barclays has now positioned itself at the front of the US dollar market.

Meanwhile, the bank remains active in bringing new jurisdictions on stream and developing new structures.

"You can't knock them for the work they do to develop the market," says a

covered bond banker at one competitor. "I wish I had the resources to throw at those obscure countries."

The bank is seen not only as strong overall but among the leaders across the variety of competences necessary for a covered bond franchise, including research, syndicate, structuring, trading and origination.

★ ★

Highly commended:

BNP Paribas

UniCredit

Award for Excellence:

Bank: Euros

★ ★ ★

Making sense of the relative merits of banks within the euro benchmark market is far from straightforward given its competitive nature. And once the testy subject of reciprocity surfaces emotion often takes over from reason.

However, a couple of deals this year already have shown that successful execution cannot be taken for granted even for top credits.

Each issuer has its own preferences, but a name that regularly crops up when issuers are asked who they can trust to help avoid any such pitfalls is UniCredit.

Rival syndicate bankers also pay tribute to the Munich-based operation, and the bank has kept pace with its strongest

competitors and led more euro benchmarks than any other over the period in question.

★ ★

Highly commended:

Deutsche Bank, Crédit Agricole

European Covered Bond Council

Award for Excellence:

Editor's award

★ ★ ★

The euro-zone crisis has shown just how difficult it is to get representatives of different countries to come together and compromise for the common good.

In the covered bond market, that unenviable task falls to the European Covered Bond Council. And history has shown that the covered bond market can be just as fractious as any EU heads of government meeting.

Against such a challenging backdrop, the successful launch of the Covered Bond Label in January deserves to be recognised as an achievement in itself.

But above and beyond that, the initiative fits perfectly into the spirit of our Awards for Excellence in driving the market forward.

The Label has gradually won around sceptics among issuers, investors and bankers, while getting the European Central Bank onside has been a key achievement.

At the same time, the ECBC has been commendably frank in its admission that the Label needs to be improved.

The Label was nominated by a variety of market participants in the field of innovation, while others proposed the ECBC — under its parent, the European Mortgage Federation — as a candidate in regulation.

We have given the institution our Editor's Award, reflecting its unique contribution and status in the market.

At the heart of the Label project has been ECBC head Luca Bertalot, whose tireless efforts and passionate arguments have won plaudits, while others pay tribute to the work of the body down from chairman Paul O'Connor to its various working groups. ■

The Pfandbrief Roundtable 2013

Despite falling supply, Pfandbrief issuers are eyeing opportunities on the asset and liability sides of their business. In this roundtable, sponsored by the Association of German Pfandbrief Banks (vdp), leading market participants discussed these, as well as market and regulatory challenges.

Neil Day, The CBR: How has Pfandbrief supply been developing this year?

Sabrina Miehs, Helaba: If you look at overall issuance, it has started slightly less positively than in 2012. In terms of benchmarks, Germany was actually better in the first quarter, when it represented one-fifth of benchmark issuance. I think this will hold steady throughout the year. Because spreads are so tight, I wouldn't expect the movement towards benchmark issuance to come down, so my expectation is that we will see Eu22bn of euro benchmark issuance of German Pfandbriefe in 2013, which would be similar to or a little bit more than last year.

Jens Tolckmitt, vdp: What we have clearly seen in recent years is a strong consolidation in public sector Pfandbriefe. It was already evident in 2012 and will occur through 2013 and beyond. This consolidation is not compensated for by a positive trend in mortgage Pfandbriefe, so you have a net consolidation of the overall market. So looking beyond the first quarter of 2013 we expect this trend to continue.

At the end of last year we made an estimate based on quotes from our member banks of an overall issuance volume of Eu60bn, but if you look at recent years and at the different developments that have driven issuance and opened or closed issuance windows, you have to be careful with these kinds of estimates. So the low level of issuance in the first quarter has to be considered taking into account the fact that in recent years we have seen issuance fluctuate strongly from one period to the other. I wouldn't necessarily take the first quarter as an indicator for the rest of the year.

Marco Bales, UniCredit: I would just add that benchmark Pfandbrief supply is in line with overall supply. Actually Pfandbriefe are holding up quite well with the new issues that we have seen so far. The total euro benchmark covered bond market is down basically 50% versus the first quarter of 2012, and if you look at the global covered bond market — i.e. including US dollars, etc — it is down even more. So there is definitely also less supply. The largest decrease has been in France, but we also haven't seen any UK covered bonds so far, and only one Australian, whereas they issued some Eu5bn in the first quarter of 2012. It seems to be a general trend that banks might be in need of less funding.

Day: What funding needs do the issuers here today have for the year, and how did you find the first quarter?

Bodo Winkler, Berlin Hyp: We calculate that we will need about Eu3bn of covered funding this year. More than one third has already been done during the first quarter. We issued a jumbo at the end of January, so Eu1bn, and private placements of approximately Eu250m so far.

Of course, if you calculate what you will need before the year starts you will always have to take into account how new business evolves during the course of the year, the development of the overall market, and to what extent you extend loans.

So from our point of view, the first quarter was more than OK. Concerning benchmarks, we always said we would do this one jumbo, which has been done, and we said

The roundtable was held at pbb's offices in Eschborn, Germany, on April 11

that depending on the development of the private placement market we might issue another benchmark later this year, but if so it will probably not be before the third quarter of the year.

Götz Michl, pbb: I agree with Bodo. Pbb had a very strong first quarter with regard to our funding activities, and we were quite happy to come to the market with several transactions in benchmark format.

Pbb's overall funding need depends on new business volumes and we see strong demand on the lending markets. Therefore — if the market environment does not change significantly — there may be even more benchmark transactions.

We have seen some public sector benchmark transactions. If this trend continues, we could tap the market with a public sector bond in addition to our mortgage bond issues.

But the key point these days is the overall market sentiment in light of the sovereign debt crisis. We will continue to seize the opportunity to issue, when there is liquidity in the market to issue, because the big concern is market volatility. It's very hard to predict whether the market will be there, whether new issues will be taken up. Of course we have a very strong product with the Pfandbrief, but nevertheless we monitor the markets closely and will use a window of opportunity rather than wait for a better opportunity which may not come

Day: Claudia, you waited ahead of the benchmark you issued yesterday. How much of an issue was the kind of volatility that Götz describes?

Claudia Bärdges-Koch, MüHyp: We initially planned to issue yesterday's bond exactly on the Monday when Cyprus was on the screen and all over the market. We saw the Bund future move 135bp, so that was definitely not the day to issue a new benchmark. So yes, there can be volatility.

When we looked at a deal at that time, long yields were at a different level and we were looking at doing an 8.5 year to reach a 1.5% coupon. That is now history, so when we came to the market this week we said it makes no sense to do a broken maturity.

Marco Bales, Global Co-Head of Capital Markets, UniCredit

Claudia Bärdges-Koch, Deputy Head of Treasury, Münchener Hypothekenbank (MüHyp)

Ralf Burmeister, Senior Portfolio Manager for Covered Bonds, Deutsche Asset & Wealth Management (DeAWM)

Götz Michl, Head of Funding, Deutsche Pfandbriefbank (pbb)

Sabrina Miehs, Covered Bond Analyst, Landesbank Hessen-Thüringen (Helaba)

Jens Tolckmitt, Chief Executive, Association of German Pfandbrief Banks (vdp)

Bodo Winkler, Head of Investor Relations, Berlin-Hannoversche Hypothekenbank (Berlin Hyp)

Neil Day, Managing Editor, The Covered Bond Report

Claudia Bärdges-Koch: "The market will determine the natural floor"

Flexibility is essential in volatile markets. A continuous investor dialogue and their feedback enables an issuer to react well and do the right deal at the right time.

Our funding needs on the covered side will be between Eu3bn and Eu4bn this year. We can issue more or less every quarter when we see demand. The focus will be on the mortgage business — the Eu1.5bn maturing on Monday was a mortgage Pfandbrief and this is our main business focus. By the end of the year a public sector benchmark is also possible.

Day: There's low supply. There's volatility. How is this affecting spreads and what are your expectations?

Ralf Burmeister, DeAWM: From the perspective of the German Pfandbrief, it's a rather easy equation, because there is such a huge negative net supply. It's the largest market in terms of redemptions, with some Eu50bn becoming due this year – and still supply isn't catching up. This is of course highly supportive of spreads.

I'm quite pleased that the issuers have learned the lesson, that they come to market when the market is there and prefund themselves rather than waiting for the possibility of issuing 2bp tighter. This also helps stabilise the market because if you have issuers having already done 50%-60% of their funding by April, it makes it quite comfortable for the overall market. Therefore in terms of supply dynamics, it is probably one of the easiest markets.

Day: Spreads have returned towards pre-crisis, Libor flat levels. Obviously that is a good thing, but does it make execution more difficult? Berlin Hyp seemed to find that an issue, for example.

Winkler: It's no secret that this was a rather difficult deal, coming in the Libor minus area.

Concerning the oft-cited "Libor flat barrier", you have to distinguish between the benchmark market and private placements. Funnily enough, issuing at Libor minus levels is not an issue in the private placement market — BHH has issued private placements between two and 12 years so far this year and none of them was in the Libor plus area.

An explanation for why the execution of benchmark deals gets more difficult in the Libor minus area seems even more difficult when I look at our latest order books: usually a maximum of 20% are asset-swappers, with most investors buying the bonds outright. Therefore it is a strange question why Libor flat should be a barrier.

In the end I think it is predominantly the low yield environment which makes it difficult. Even if you manage to print a coupon of at least one per cent in a medium maturity we are still talking about levels that are much lower than the German inflation rate. But this general situation has nothing to do with spreads 1bp or 2bp higher or lower, or minus or plus. It's a different question.

I think this "Libor flat barrier", if it is there, is something more psychological than something that can be explained logically.

Bales: Investors always look at what they view as comparables, which asset they can buy at a certain spread, and one of the main drivers — probably it still holds true for all markets — is the underlying government. Even though there are certain countries where covered bonds can now trade far through the sovereign, nonetheless the overall level where the government is does have sort of a function on where also covered bonds are priced. Last year we saw three Pfandbriefe that were priced in Libor minus territory, on the shorter part of the curve, and most of them came at a time when Bunds were trading more expensive due to the volatility in the overall euro system. So, that's one fact.

What do you compare Pfandbriefe against? Most German Pfandbriefe trade pretty much on average flat to German Länder, some even trade through the Länder. The Münchener Hypo yesterday came at plus 3bp and today there was a tap of a Land Hamburg 2022 at plus 9bp. So it's a question how far you can move away from that in a country where the government is still Aaa/AAA/AAA, and not triple-B.

So I think it has a lot to do with relative value. But clearly, as Ralf mentioned, the overall dwindling supply clearly helps. The total amount of Pfandbriefe that were around on 31 December was Eu525bn. I think we are going below Eu500bn now. That's a trend that is beginning to ease, but there is lower supply and there is still a pretty strong investor universe looking for these assets — especially Germans, but not only Germans, and including a high quality central bank, public sector bid.

Bärdges-Koch: We issued two of those double-digit minus deals and it was definitely as Marco said. With the two year, for example, there had been no supply in that area — because no-one was issuing due to the LTROs — and we were approached by investors who said, look, we aren't looking at it so much as a Pfandbrief, we are taking it for the pick-up against Bunds. That was a completely different view and at that time the coupon was not the deciding factor. I have to admit that we were completely surprised because we would have never ever looked at it, our product, in the same way. That's something that you would only learn in a dialogue.

We realised that the situation in the second half of 2012 was completely unusual. That is the reason why we could not completely give those funding levels to our lending department. The market will determine the natural floor for the German Pfandbrief. At some point investors say, it's too expensive, why should we buy it? I'll buy some government bonds or other covered bonds that are coming to the market, but Pfandbriefe are not really tempting. I think that's something we really have to be careful about, that it doesn't end up as a domestic niche product, for example.

And anyway, it's still a good product: I don't mind about plus 3bp – it's the right level this time.

Burmeister: I think there are a couple of points to mention in this regard. One thing is that as an investor you are always very happy if you get a new issue premium and if you are already issuing at minus something, in order to have a decent performance the bond must go down into the minus double-digits.

Secondly, what has changed in the investor landscape in the last couple of years is that there is much fiercer competition when it comes to cross-asset allocation and selection, also because of the volatility and absolute yield levels. Marco mentioned the Länder example, and then there are all the agencies like EFSF, ESM and so on and so forth, which offer a decent pick-up against German Pfandbriefe. It's no longer a pure German Pfandbrief play or looking at where French paper is, where German paper is, and then asking if the pick-up is enough. Your peer group has simply become larger. It's not a phenomenon of the Pfandbrief itself, I guess, it's due to the whole market. If you have a broad mandate, for example trying to replicate or being benchmarked against euro aggregate indices, you have a lot of choice so you don't depend on a rather expensive segment like the German Pfandbrief. There's a certain danger in that.

Plus, as you mentioned, in real terms if you are buying below the inflation rate, it makes it tough to have a decent weighting on that position. Sometimes for liquidity purposes, of course, you have demand for German Pfandbriefe, but we have to justify ourselves to our investors and if you go for a five year Pfandbrief, for example, and it gives you a yield of, say, 1% and inflation is 2%, it's difficult to explain the rationale behind it, to say, OK this is good for you. As a defensive move, maybe, but if you say, no, we don't expect the landscape to change dramatically over the five year tenor, it really makes it tough to justify that.

Miehs: But are the low spreads not also leading to an appetite for longer maturities, opening the possibility of tapping this part of the curve? This week we saw a lot of longer maturities, like seven, eight or 10 years. This wasn't so evident in the first quarter, but now we are starting to see a small tendency towards longer maturities. This is probably partly because there is a need on the investor side — for insurance companies, for example — but also because it is clearly good on the issuer side to have long term financing and at the moment it is very attractive.

Jens Tolckmitt: "I wouldn't necessarily take the first quarter as an indicator"

"It's no longer a pure German Pfandbrief play"

Burmeister: That is exactly what the central banks want us to do, to go out along the curve. It's as simple as that.

Day: What are the attractions of foreign currency issuance? Claudia, you did a dollar deal last year, for example.

Bärdges-Koch: We have US dollar assets and therefore have a natural need in this currency. The same is true of Swiss francs, where we have covered bonds outstanding, and we are going to look at the sterling market for this reason.

For us it's not currency arbitrage like what we have seen from the Nordics, for example, where they just use it as an additional funding source when issuing in euros and move it back into their local currency. We do have needs in those currencies and for regulatory reasons it makes sense to issue in those currencies corresponding to the assets in your cover pool.

Michl: It's the same here at pbb. We have new business predominantly in euros but also in sterling, and to a lesser extent in Swedish kronor. So we aim to get the currency on the liability side where you have the assets. Each cross-currency construction inside the cover pool is difficult and also expensive. Therefore to get funding in the right currency is helpful. And therefore we did a sterling transaction last year, £250m, and we are looking for sterling this year as well. We also did a Swedish krona transaction, Skr600m a month ago.

Day: In what way did your experience of the sterling market differ from your typical euro experience?

Michl: When you enter the market, you typically have a lead order, then you build a deal around that.

Especially in sterling it is important to be a regular issuer. It is also important to explain the German Pfandbrief in the Anglo-Saxon environment as investors are more familiar with SPV constructions which work differently. Investors also need to get comfortable with your bank rating because they see the linkage. The current environment in the UK supports our case: Due to the Funding for Lending Scheme there is no sterling covered bond supply

Bodo Winkler:
"It's an additional buffer for the investor"

from domestic issuers.

We can afford to pay a higher premium if we issue in sterling as this saves us the complexity of a swap. With CVA charges coming up and all the potentially difficult questions linked to derivatives in cover pools you can pay more for the foreign currency than for euros. And therefore it becomes a little bit more attractive for foreign investors. And there is good reason for the issuer.

Burmeister: We also like to see this from issuers. First of all, that they diversify their funding. Secondly, that they have natural matching and get around the obstacle of derivatives in the cover pool.

The next thing is, of course, that if issuers diversify out of euros in terms of their overall funding, it eases supply pressure a little. We mentioned before there is no real pressure on supply in terms of German paper, but if they diversify in other currencies, that's fine and it's also supportive of euro spreads. So I think it's good to exploit those possibilities and to place Pfandbriefe not only in continental Europe, but abroad and with a new investor base. Spreading the product can only give more stability in these turbulent times.

Michl: You really need to invest time in approaching these markets. And the intermediary needs to understand that there is probably more business to win if this is something that the issuer needs. The intermediary can add completely new value to the issuer. As you can imagine, many of the investment banks are looking for the easy euro benchmark transaction because that is the standardised product. But what an issuer really needs is foreign currencies, new investors, a little bit of a different set-up and not the standardised product.

Bärdges-Koch: I fully agree with the extension of the investor relations work you have to do.

"The intermediary can add completely new value"

On my first UK visit the second investor I saw said they were missing the page from our presentation showing the SPV structure… I just stared at him and then realised! There is no SPV — it's all on balance sheet. That way I really understood the completely different perspectives there are because noone would ask you that in Germany.

Regarding new investors you have to work out what is different or new to them, and get them somehow to understand your business and the product.

Miehs: Obviously you have to educate investors in new countries, but in those where the German Pfandbrief is already known, I imagine issuance is probably easier because of the high quality assets. So if you take the US, for example, there you have an investor base that has already invested in German Pfandbriefe and you have convinced them of the quality previously, and they are looking for high quality assets.

Day: On the asset side, how are property prices developing?

Tolckmitt: The overall development, in both the commercial and residential sectors, is very stable in Germany, with some exceptions in some of the metropolitan areas, namely Berlin, Hamburg and Munich. Where you can say there are substantial price increases is specifically in the residential real estate and more specifically in the condominium sector. The question is: is that fundamentally justified? We think that, yes, it is still fundamentally justified. So it is not what we would call a bubble but rather a development that, especially in the case of Berlin, you can show relates to the fact that Berlin was a latecomer to the property market. For a long time after reunification it was an area with very low prices. That is changing to a certain extent now, but Berlin is far from having caught up with other metropolitan areas in Germany or other metropolitan areas in Europe. So this price development is still justified and we retain the overall impression that there is a very, very stable development in the property market, in all segments. That is very important.

If prices are rising does that mean anything for the Pfandbrief? The most important thing is that we have the so-called Mortgage Lending Value, which is particular to Germany. More and more people also outside Germany now understand this valuation method and it is, interestingly, catching the attention of other countries where developments in property prices have been more substantial. They are looking for reasons why this has not been the case in Germany, and one of the reasons is the Mortgage Lending Value.

As a rule of thumb you can say that the Mortgage Lending Value is around 15% below the market value of a property. And if you look at different points in the property market cycle the more the market value of a property increases, the larger is the gap between the Mortgage Lending Value and the market value. So as the Mortgage Lending Value is the basis for including collateral in cover pools and lending up to 60% of a

property's value and refinancing that loan via Pfandbriefe, we don't see any impact from rising prices. This is actually one of the safety features of the Pfandbrief.

It is also very important to mention that loan to values granted by banks have decreased substantially since 2008 and have remained at a much lower level than before the crisis, and this also helps underline the constant safety of the product.

Winkler: This positive development of German real estate prices comes alongside consistent demand for German properties, which in return gives credit institutions the power to lend only to lower LTV levels. We have reduced the LTV levels that we are financing substantially over the last years, too; at the same time we were able to increase our margins.

Regarding the Mortgage Lending Value, under the German Pfandbrief Act we have to recalculate it at regular intervals. At Berlin Hyp we re-evaluate the properties we finance at least every second year. If the market goes down we have to decrease the MLV. If the market goes up, the Mortgage Lending Value stays exactly where it is. What this does is add additional OC to the cover pool which is not taken into account by either investors or the rating agencies. It's an additional buffer for the investor in the end. Jens spoke of this rule of thumb — we compared market values and MLVs last year for our cover pool, and it's quite close to that number that you stated. In our case it was a 17% difference over the whole cover pool — 17% additional buffer of security for investors in the end.

Burmeister: It is absolutely a part of our job to look into something like this. It is related to the seasoning of the loans, obviously, and also the area of business. One thing you have to state about the German Pfandbrief — and which makes it different to its brothers and sisters throughout Europe — is that you have a large chunk of commercial business in it, while almost all other mortgage backed European covered bonds are purely or 80%-90% residential. In Germany you have issuers that are purely focused on German residential mortgages, and then you have issuers who are almost exclusively commercial lenders across Europe, and that's a broad variety. It is exactly part of the investor job to look at the specific risk of an issuer's business model plus the risk being put in the cover pool. I therefore think it's not really fair to make statements about Germany property prices going up and that being good for the Pfandbrief — rather, it should come down to a case by case analysis, saying, OK, what's your share in country x, y or z, what's happening to property prices there, how much buffer do you have, etc.

Marco Bales: "Funding for SMEs is a huge topic"

Day: Commerzbank launched its SME backed structured covered bond in February. What do you make of this development?

Michl: We have looked at the concept of structured covered bonds — like many others did. However, we came to the conclusion that it does not fit our business model. We are a specialised mortgage lender, lending against commercial real estate at low LTVs. Therefore, most of the loans fit into the Pfandbrief. So we have no need for such a structured covered bond and there is no portfolio to produce one.

From my point of view, the deal has been over-rated. Of course it's good to see that a structured covered bond can be done — but it has to fit the portfolio.

Winkler: But it's short dated corporate loans and a medium term covered bond. I am not as relaxed towards this product as you are, to be honest. This is not because I do not like the product, as such. Of course Mittelstand is important to Germany and finding new ways to refinance your loans to the Mittelstand is valuable, but why call it a covered bond? What I don't like is the label of a covered bond in this. If any investor would lose money on this investment, he might say: Oh! This is a covered bond and it came from Germany — and then there is a very obvious linkage to the Pfandbrief.

Michl: It is not a Pfandbrief and therefore it's fine.

Winkler: But I think what most covered bonds have in common in Europe or around the world is that you put certain specified high quality assets into a cover pool and you do term funding against this.

Burmeister: And you have long term assets, that is the point. There is not a high turnover in the pool.

Bärdges-Koch: What I think is even more important is that you have a legislation behind it. And in the Commerzbank deal it is a bilateral contract. I have to admit I was surprised to see that the ECB is now putting the deal into the same haircut class as covered bonds.

Burmeister: Absolutely. Another thing I would like to add is: does the German Mittelstand have a funding problem? Or is it more the SME business in other countries? That's one thing.

Götz Michl:
"You really need to invest time in approaching these markets"

The other thing is, naming and labelling it a covered bond. The point is: you can bring it to the market – I don't mind — but where will it end up in the indices? Barclays has included it with covered bonds, but iBoxx has lumped it in a segment with a Czech energy supplier. Will I one day become a forced investor because its share gets so large, and do our clients really want to invest in these asset classes? Covered bonds is mortgages and public sector assets — apologies to the Flugzeugpfandbriefe and shipping Pfandbriefe…

Tolckmitt: They are totally different, they are long term assets and they have a safety structure.

Burmeister: And shipping Pfandbriefe so far haven't made it into the indices…

Michl: But is the name really a problem? I would expect that whoever selects the asset to go into an index will take a closer look at the transactions. Otherwise one could do an unsecured transaction and simply call it covered…

Burmeister: You are absolutely right, but then in the next step it comes down to regulation. Under current thinking the idea is that a covered bond should be exempt from any kind of bail-in. And if a deal is basically a senior unsecured note with some kind of collateral behind it, how should it be treated in case of resolution? Should it be exempted? So there is another dilemma.

Tolckmitt: I would agree that the discussion of whether or not a covered bond can be called a covered bond in English is a little esoteric. If the traditional covered bond needs to be differentiated, then please can industry differentiate it by naming it differently. 'Labelled covered bond' could be one such example if the ECBC label develops into a market standard. A name that cannot be attained by a covered bond backed by SME loans.

Having looked at developments over the last one and a half years, my view is that we have come a long way in differentiating the structured covered bond from what in Germany we would call a Pfandbrief. In the beginning, people went around and said maybe there could be an SME Pfandbrief and we said, no, there will never be an SME Pfandbrief. And I think this view has taken hold in the market.

It is important to make very clear the distinction between the traditional covered bond and this kind of structured covered bond because a big challenge in the future will be that in regulatory discussions those putting any type of asset in a structured covered bond will try to gain preferential regulatory treatment alongside traditional covered bonds. So there is a danger of a blurring of frontiers between the traditional product and these new products.

Secondly, it is not the right way to behave towards investors because under all regulations today these structured products are not treated preferentially, and you should not give the impression that they are or will be.

And, thirdly, we have achieved a lot for the traditional covered bond in the regulations that are coming out in all areas — be it fund regulation, be it insurance regulation, banking regulation, bail-in regulation — everywhere we have a justified preferential treatment for the traditional covered bond — but this preferential treatment is under very, very close scrutiny. And my biggest concern in the medium term is that if there is any impression that the universe of preferentially treated covered bonds is growing and is getting more complicated then we are really at risk of losing this preferential treatment for the traditional asset class. We don't want to end up in this situation, and that is why we have to make very clear as

Ralf Burmeister:
"Will I one day become a forced investor?"

an industry — not only the German industry — that we see a difference between the structured product and the traditional covered bond/Pfandbrief.

Bales: I tend to very much agree with you, Jens, if you look at the pure Pfandbrief and say: this is a Pfandbrief, this is the legislation, this is what the Pfandbrief is about.

Regarding the name, structured covered bond, well, it's an English description: covered bond. You have a senior bond that you cover by some assets. What else do you want to call it? The fact is, it is an SME covered bond because it is covered by assets that are SME loans.

We were on that deal and every investor knew exactly that he was not buying a Pfandbrief, every investor knew what was in there. There was also an intensive roadshow behind it and everyone was made aware of what was behind it, the assets, etc, and Commerzbank did a very good job of explaining that.

Also, if you look at the spread, the bond came at plus 47bp. I think a five year Pfandbrief of Commerzbank at that time would have come substantially tighter, probably around the plus 5bp to 10bp area. A senior unsecured obviously would have probably been roughly 40bp-50bp wider. So it was priced somewhere in between.

I think you have to go one step beyond that and look at the discussion that is currently going on among regulators, politicians but also the ECB. Funding for SMEs is a huge topic, and you currently have a

market environment where top multinational corporates can fund themselves very cheaply, even longer term in the bond markets, and for short term liquidity they get very cheap funding levels via revolving credit facilities from the banks. But as soon as you start to leave the triple-B minus sector, it gets more and more challenging. For German corporates, you still have the Schuldschein business, especially for the ones that have a decent size and good name recognition. But if you go one step beyond that, it gets challenging, and especially if you leave Germany and go to other countries, then it gets really tough. And we have to accept that the new regulatory environment for banks has made it a lot more expensive for banks which are in this business to lend at competitive "cheaper" levels.

So it is fair enough — especially if you also look at the bail-in discussion with regard to senior debt — to ask: is there a funding opportunity that banks could somehow use to have access to cheaper funding to pass on to SMEs? Because we all know that SMEs in Europe are very, very important. From a political and economic view it is just as important as giving cheap funding to home owners.

Winkler: But, Marco, nobody would deny this. For me it's just a question of marketing this special tool. Has it got to be named a covered bond? In my personal view, a covered bond is a high quality…

Bales: The Turkish legislation allows you to issue SME covered bonds.

Winkler: Yes, and you could discuss whether it should be like that or not…

As traditional mortgage lenders, we put the best assets we have into our cover pool, and then we issue high quality debentures: Pfandbriefe. In the case of the SME covered bond, the assets were not investment grade rated SMEs. If you look at the Moody's report, the pool does not contain a single loan which is investment grade. They are all Ba1 and lower. This leads to another question: If the issuer is rated A3 and all assets in the pool non-investment grade, how can this pool add quality to the unsecured claim against the bank?

Sabrina Miehs:
"Issuance is probably easier because of the high quality assets"

Tolckmitt: There is one thing that we have to be extremely careful about. I have nothing against duplicating the idea of secured funding to make SME loan financing cheaper. But is it OK that this kind of product be moved close to the traditional covered bond in order to profit from the brand? There I would really be hesitant, because you have the potential to dilute an asset class that has been extremely strong during a very difficult market. And this dilution, if it happened, would be hard to fix afterwards.

Day: Bodo, would the ECBC Label not perhaps be a useful way to delineate what is a covered bond in your eyes? I understand that you have not signed up to it.

Winkler: After what we have just heard about differentiating between SME backed structured covered bonds and traditional covered bonds, you may be right. So far most German issuers didn't sign up for the label — only two have the label for their products. The rationale behind this is that the requirements of the Pfandbrief Act are much stronger than what is asked for to obtain the ECBC Label.

For instance, increased cover pool transparency is one of the very positive outcomes of the labelling initiative so far, as it wasn't very far developed in some covered bond jurisdictions before the label started. But in Germany no increase was necessary as we already have legally defined transparency standards in the Pfandbrief Act which are subject to ongoing advancement. Another example is the special public supervision that the Pfandbrief Act requires while the label only asks for public supervision.

In my view, what would turn German issuers quite quickly towards the label would be restricting regulatory privileges for covered bonds to labelled covered bonds only.

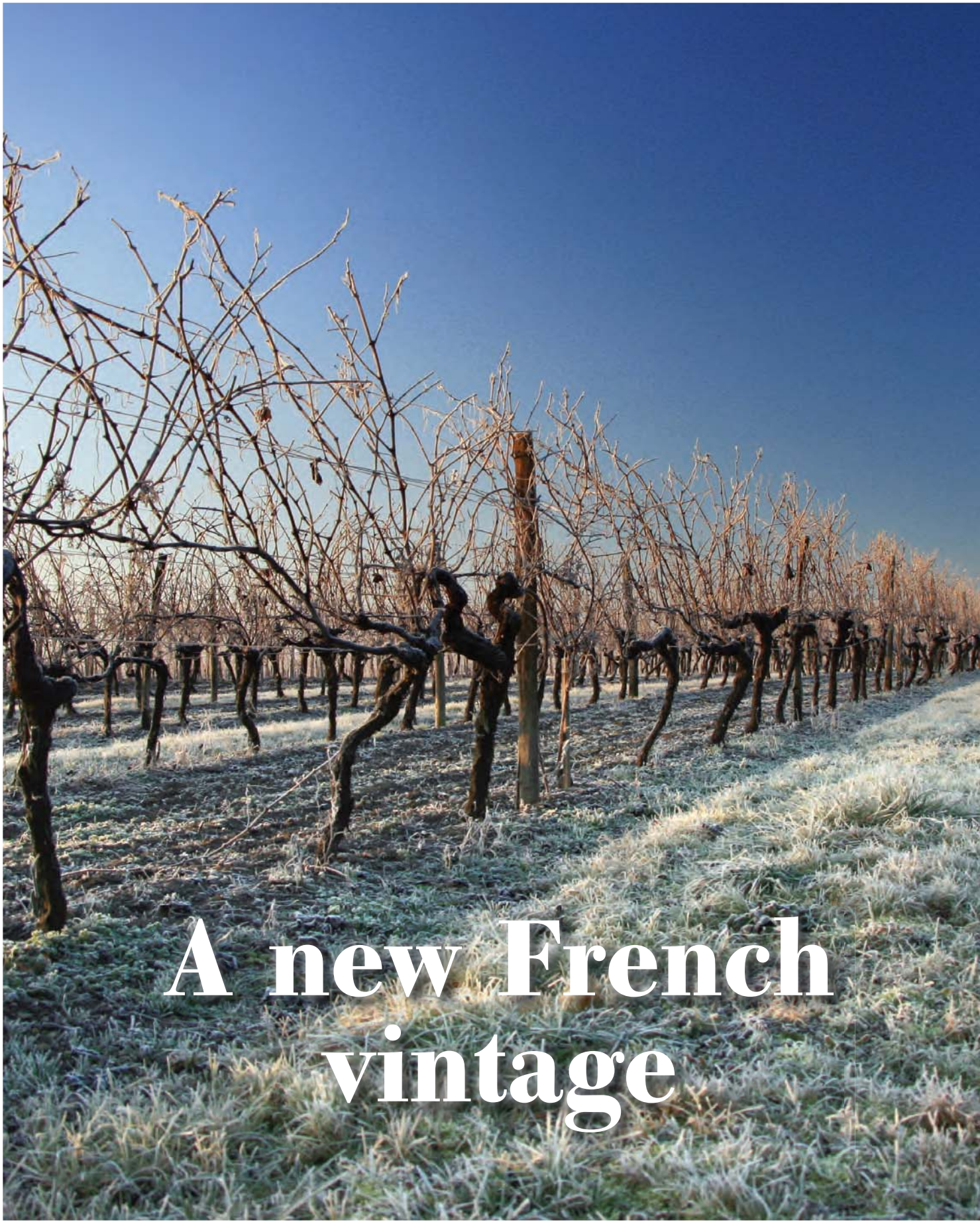
Michl: I think it may be a good idea to label European covered bonds. Still, investors need to analyse what they are buying.

Tolckmitt: I think this branding issue around the Pfandbrief is a very important reason why German issuers have been so hesitant about acquiring a label.

I also don't see any preferential treatment of labelled covered bonds at the very beginning, simply because it's a private industry initiative and it's difficult to put something like that into law. And to my understanding all the regulators who have been asked about this have clearly indicated that they don't see an immediate measurable benefit with regard to the label either.

One thing I deem to be really important, as I said before, is that going forward we will be regularly benchmarked on whether granting preferential treatment to covered bonds is still justified, and for which covered bonds. We will also face a consultation and an enquiry from the European Commission into what is a covered bond. And then we will face a discussion on whether we should harmonise covered bonds across Europe, and to what extent we should harmonise them and what should be the content of a harmonised covered bond.

In all these cases the industry issuing traditional covered bonds is well advised to ring-fence its own product, and the label can help in this ring-fencing. And although this does not have a measurable, tangible benefit now, my feeling is that it can turn into a tangible benefit quite quickly, simply because at some point we can say, look, this is the traditional covered bond that in the 1980s you granted preferential treatment to on a European level, and this is the ring-fenced one, and we ask you to continue granting preferential treatment — which might be more difficult if the universe gets more diverse than it is today. ■



A new French vintage

Vineyard on Christmas Eve, Poitou-Charentes, France
Photo: Thomas Valadon/Flickr

French euro covered bond supply has lagged expectations this year, but a spate of deals in April put the jurisdiction back in pole position. Growth prospects are slim, worrying some, but the response to troubles at CIF and the creation of a successor to Dexia MA are among reasons for a more positive outlook. *Susanna Rust* reports.

Benchmark covered bond supply has been collapsing. This reality, and its driving force — deleveraging — has been impossible to ignore and a feature of all major European markets. The shrinkage of Germany's Pfandbrief market has been underway for some time already, but more recently a lack of supply from France, the second largest market in terms of outstanding benchmark volumes after Spain, has come in for attention.

"Covered bond issuance activity by French banks has been particularly weak in the year-to-date and is unlikely to materially change this year, in our view," said Barclays analysts in early April, halving their forecast for French covered bond supply for the year from Eu30bn to Eu15bn.

Looking at gross benchmark supply in the first quarter — when issuance was at its second lowest level for a decade — French covered bond issuance accounted for 17%, according to Barclays analysts, with volumes of Eu6.2bn significantly below that of the first quarter of 2012, when Eu20bn of French covered bonds were sold.

UniCredit analysts had expected France to be the largest contributor to the covered bond market this year — as had been the case in the past four years — but instead by April supply from that jurisdiction had fallen short of their estimate by a greater margin than for any other country.

But, as everyone has learned, things can change quickly these days, and given how low overall euro benchmark volumes have been so far this year, three French deals totalling Eu3.5bn in early April were enough to move the jurisdiction into the lead in terms of issuance this year, according to *The Covered Bond Report* data, ahead of Germany and then Spain.

Derry Hubbard, head of FIG syndicate at BNP Paribas, notes that French banks have been able to achieve very good execution in the senior unsecured market this year, and have

preferred this funding route over covered bonds where possible.

"You also have consolidation going on in terms of home loan production," he says, "so rarity is the name of the game in French covered bonds."

According to Fitch, mortgage lending volumes in France were down by 35% year-on-year in the third quarter of 2012.

Bernard du Boislouveau, managing director, DCM at Crédit Agricole in Paris, also draws attention to French issuers' increasing use of unsecured funding.

"Starting last year they have been trying to maintain an equilibrium between the covered and non-covered routes, partly because encumbrance was an issue and they wanted to deal with that," he says. "Senior unsecured levels are also interesting these days on a relative basis, with bail-in risk not appearing to be fully priced in at the moment."

Caisse de Refinancement de l'Habitat (CRH) is the only French issuer to have tapped the market twice this year for new issues, and its chairman and chief executive, Henry Raymond, is comfortable with the slowdown in French issuance.

"For several reasons banks have reduced funding needs," he says, "and the asset encumbrance debate puts some pressure on covered bonds, but I'm not about to proclaim the death of the market, French or otherwise. It's normal for the market to reach a point of maturity, and settle into a more leisurely pace."

Others have some concerns, however.

"The drop in issuance in France does worry me a bit," says Ralf Grossmann, head of covered bond origination at Société Générale. "Cover pools were mobilised, for example for BNP Paribas' public sector programme, but now new asset production is very small and there is not much scope for increasing issuance.

"There is a bit of a challenge to keep investors interested, but at the same time the French market is still very visible, and other covered bond markets face similar issues."

La Banque Postale at one stage looked set to expand the French issuer line-up, having in October 2011 announced that it envisaged setting up a covered bond issuing entity to refinance home loans, but that has yet to materialise and the institution did not respond to requests for an update from *The CBR*.

OAT rally catalyses

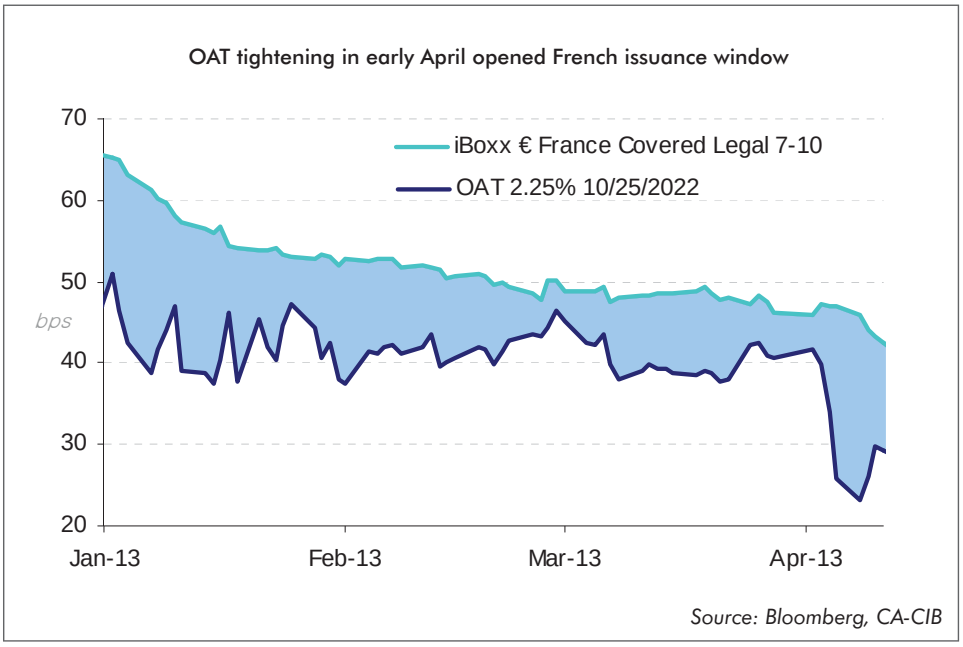
Yet it was French supply that led and stood out among a surge of benchmark covered bond supply in the week of 8 April, when five new issues plus a tap made for enough issuance (Eu4.75bn) to surpass that of the entire month of March and fall just shy of February volumes. The rush of supply marked the reopening of the FIG market following the Cyprus turmoil.

This was led by a Nordea Bank senior unsecured deal, but HSBC SFH got the ball rolling in covered bonds with a Eu1.25bn 10.5 year — only the issuer's second euro benchmark covered bond, after a debut in January 2010. In coming to the market the issuer took advantage of an outperformance of covered bonds by French government bonds that helped establish relative value for long dated supply.

> "The drop in issuance in France does worry me a bit"

"The OAT tightening opened the issuance window for French covered bonds and provided an excellent opportunity for French issuers to bring a deal with a pick-up to the sovereign," said Christian Klocke, covered bond syndicate at Commerzbank, one of the leads on HSBC's deal.

Indeed, with French investors typically needing a pick-up over government bonds to participate in a French covered bond, a strong performance against OATs by French covered bonds since July 2007 had complicated market access and pricing for French issuers.



However, CRH demonstrated that it is possible for a French issuer to come tight to its sovereign's bonds when it sold a Eu1bn 12 year deal almost flat to OATs in January, making it the tightest ever French new issue.

Raymond says that a small premium over OATs deters French accounts — although some purchase CRH bonds at tight spreads, he adds — but the pick-up

over the sovereign is not an issue for German investors, for example, which are an important part of CRH's investor base.

Nonetheless, a decent to attractive premium over OATs was a feature of all three French euro benchmarks that hit the market in early April.

In HSBC's case the pick-up was 5.7bp over October 2023 OATs, according to Mark Pearce, covered bond syndicate at HSBC, who said the differential was small but justified by a lack of supply and the rarity and quality of the issuer. Syndicate bankers away from the deal had spoken of a premium of the high single-digits to 10bp.

Neil Sankoff, head of senior funding at HSBC, told *The CBR* that HSBC France, the SFH's parent, only has modest funding needs for 2013 and that together with a Eu1bn seven year senior unsecured issue from January the covered bond helped satisfy the issuer's public term debt target for the year.

"After the senior unsecured issue it was a question of finding the right time for a covered bond," he said. "Markets have been very choppy this year. The OAT rally was definitely helpful and yesterday [Tuesday, 9 April] we decided to go ahead."

The deal was priced at 35bp over mid-swaps on the back of some Eu4bn of orders, with 160 accounts participating in the deal.

Well-received covered bond and SSA supply on top of the OAT rally also encouraged BNP Paribas Home Loan SFH to tap the market, with the issuer launching a four times subscribed Eu1bn no-grow seven year deal at 22bp over a day after HSBC SFH sold its deal. At 22bp over mid-swaps, the re-offer spread included a premium of 20bp over OATs, according to Hubbard at BNP Paribas.

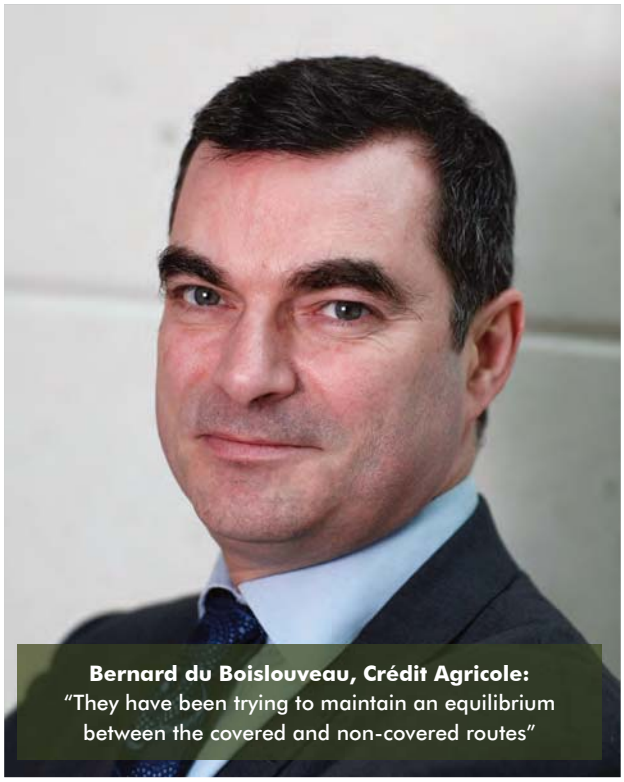
Three working days later and it was CM-CIC Home Loan SFH's turn to add more French flavour to April's issuance spurt, when it raised Eu1.25bn via a seven year euro obligations de financement de l'habitat issue. It also priced a £250m (Eu293m) three year FRN in the sterling market, the first French floating rate covered bond in sterling and the first French benchmark sterling covered bond issue since 2007.

The euro deal was the issuer's first benchmark in the currency since January 2012, and, at 23bp over, came flat to the bid side of the issuer's curve and some 25bp over OATs, according to a lead syndicate official.

According to HSBC Trinkaus analysts, asset swap spreads on French mortgage backed covered bonds have reached their tightest levels since September 2008, having ratcheted in from an average of 145bp over in December 2011 to 23bp over, now in the region of some Austrian, Dutch, or Scandinavian covered bonds.

Upheaval and resolution

Some of the biggest changes in the French covered bond market have been at an individual issuer level, as the crisis entangled specialised mortgage lender Crédit Immobilier de France and the Franco-Belgian Dexia group was broken up, affecting covered bond issuers CIF Euromortgage and Dexia Municipal Agency.



Bernard du Boislouveau, Crédit Agricole: "They have been trying to maintain an equilibrium between the covered and non-covered routes"

Market participants appear relaxed or even positive about these developments, noting that the problems affecting these issuers did not have negative knock-on effects in the rest of the French covered bond market.

"The specialised institutions have run into trouble, but the problems are being dealt with," says du Boislouveau at Crédit Agricole. "And it's good to see that despite the Dexia and CIF bumps the top names are still benefitting from good market access, with the US dollar route even having reopened for them."

> "Top names are still benefitting from good market access"

A French issuer was said to be eyeing a return to the US dollar market for a covered bond deal as *The CBR* was going to press. Any such deal would be the first from France since CM-CIC Home Loan SFH sold a $1bn (Eu767m) five year in November 2012. That was the issuer's inaugural US targeted covered bond and the first French dollar benchmark in more than 18 months.

Société Générale's Grossmann says that investors have been able to differentiate between the Dexia and CIF situations and other issuers' business models.

"The impact was quite minimal," he says. "Spreads have tightened quite a lot for CAFFIL (ex-Dexia MA) and CIF Euromortgage covered bonds, and this shows the resilience of a mature market."

Florian Hillenbrand, senior credit analyst at UniCredit,

Ralf Grossmann, SG:
"Real money investors are not that dependent on risk weightings."

says that the CIF situation is an example of a "classic problem case" in France.

"A bank runs into difficulty, in CIF's case unnecessarily in my opinion, this is followed by a few weeks of uncertainty and volatility, and then the government intervenes and all is well," he says. "Although this is not the way covered bonds are actually supposed to work, if that's your downside, you can live with that."

Furthermore, Moody's said that a December 2012 law on a government guarantee for the CIF group is credit positive not only for CIF Euromortgage obligations foncières but also for French covered bonds in general, showing the government's willingness to support French covered bonds issued under its jurisdiction.

"If that's your downside, you can live with that"

"Similar to Dexia Municipal Agency's recent restructuring, we believe that the government's enactment of the 2013 law reflects its view that the French covered bond product is an important source of funding to French banks, and that the government might extend support to other programmes, if required," the rating agency said in February.

The CIF group ran into trouble last May when, in the wake of some Moody's rating actions, questions about the viability of its wholesale funding-dependent business model came to a head and ultimately, after a temporary suspension of trading in CIF Euromortgage obligations foncières and bonds issued by Caisse Centrale du Crédit Immobilier de France (3CIF), the government stepped in with a guarantee.

This, following the approval by the European Commission of a six month guarantee in February, will allow 3CIF to return to the public markets to sell government-guaranteed bonds to pay outstanding liabilities while an orderly resolution of the group is pursued.

CIF Euromortgage, however, will no longer issue, says Géraldine Lamarque, head of long term funding at CIF. Moody's in January affirmed the covered bonds at Aa2 and Fitch in February affirmed them at AAA, on negative outlook, noting that it considers the programme to be in run-off mode. Lamarque says that the origination of new loans at CIF has sharply decreased since the second half of last year after the group tightened its lending criteria.

Fitch's affirmation came after the issuer publicly committed to maintaining a minimum overcollateralisation level of 8.3%, a decision that Lamarque says was taken for the reason of preserving the covered bonds' rating.

Bernd Volk, head of covered bond research at Deutsche Bank, welcomed the move, contrasting it with the attitude of some other issuers.

"Given that the group no longer originates new business, the OC commitment is positive and differentiates CIF Euromortgage from other wind-down issuers, such as Depfa ACS Bank or Hypothekenbank Frankfurt, which didn't commit to higher OC to support their covered bond rating," he said. "Spreads should remain well supported."

Dexia is dead! Long live SFIL!

Caisse de Financement Française Local (CFFL, or CAFFIL) is the entity succeeding Dexia MA, following the latter's sale to a new French state-owned municipal lender, Société de Financement Local (SFIL). In February Philippe Mills, chief executive officer of SFIL, said that covered bond issuance would resume in the second quarter.

Like its predecessor Dexia MA, CFFL is a société de crédit foncier and will issue obligations foncières backed by public sector assets, originated by a joint venture between La Banque Postale and Caisse de Dépôts et Consignations. Since the transfer of ownership, which was finalised at the end of January, the ex-Dexia MA covered bonds have been upgraded to or confirmed at triple-A by Fitch, Moody's and Standard & Poor's.

Volk at Deutsche Bank notes that in contrast to many other public sector covered bond issuers that are being wound down or restructured with a view to reprivatisation, in CFFL's case the government is committed to being a long term shareholder of SFIL (it has a 75% stake).

"In other words the structure is not temporary but is part of the business model, providing agency features," he said.

All is not completely settled at Dexia, however. It is appealing a French court judgement on structured loans that it granted and which are now in CFFL's cover pool, with analysts at one bank suggesting a negative ruling could have implications for other lenders.

The case involves three structured loans totalling Eu178m made to Département de la Seine-Saint-Denis, which the

Conseil Général de la Seine-Saint-Denis had argued were mis-sold by Dexia and should be cancelled, with compensation paid. The Superior Court of Nanterre on 8 February rejected these claims, but ruled that because the Effective Annual Percentage Rate was missing in faxes that were sent ahead of the execution of final contracts, the legally applicable rate (the Taux Effectif Global, TEG) should prevail. The interest rate that would be applicable under the ruling is understood to be significantly lower than that hitherto charged on the loans.

Natixis analysts highlighted the potential impact of a negative ruling.

"The loans concerned by the decision of the Tribunal are now part of the cover pool of CAFFIL, which if this decision were to be confirmed, would bear the financial impact linked to the decrease in the interest rate," they said. "If the decisions of the Tribunal de Grande Instance de Nanterre on the absence of the TEG rate were confirmed and were to become jurisprudence, they might concern other loans from potential banks active in France, including CAFFIL, and could represent significant potential risks."

"It should send a positive message to CFF and CFFL"

New rules good and bad

While the crisis has disrupted the business models of some French issuers, post-crisis regulation now being put in place — such as the EU bank recovery and resolution (bail-in) framework and CRD IV — are affecting France as much as any other market, with two recent developments either specifically or particularly relevant to French covered bonds.

One has to do with the fourth iteration of the Capital Requirements Regulation/Directive package, which was passed by the European Parliament on 16 April and under which French obligations de financement de l'habitat (OHs), backed by guaranteed home loans, have become eligible for preferential risk weighting. The impact on the French legislative covered bonds in question, however, is likely to be minimal, according to Grossmann at Société Générale.

"It's unfortunate that they were not included as eligible for preferential treatment from the beginning, but that did not have much of a market impact," he says. "Real money investors are not that dependent on risk weightings."

A second change affecting some French covered bonds is a revision to the European Central Bank's repo criteria, according to which covered bonds backed by cover pools containing external ABS will no longer be eligible for repo, effective 31 March. The change was announced in November last year, along with a grandfathering period of two years, from 3 January 2013, for already issued covered bonds that no longer meet the criteria.

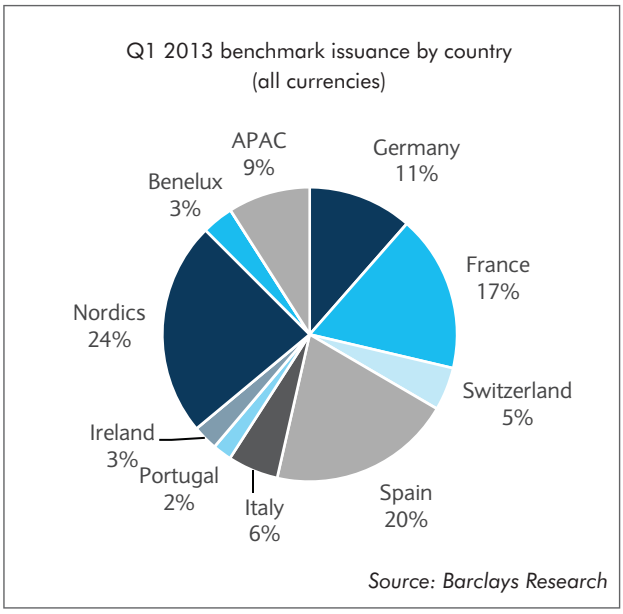
The new criteria affect in particular Compagnie de Financement Foncier (CFF), according to RBS analysts, but also CIF Euromortgage and CFFL. CFFL has external ABS tranches in its pool, in addition to securitisations originated within the Dexia group, but, without prejudice to the grandfathering period, the ECB will no longer accept for repo covered bonds backed by pools containing public sector ABS. The impact of the new eligibility criteria should be manageable for affected issuers, suggested the RBS analysts, with the two year grandfathering period a "reasonable" amount of time for issuers to remove external RMBS from their cover pools.

In addition, although new issues of covered bonds featuring external ABS as collateral will no longer be eligible for repo with the ECB, said the RBS analysts, taps of such issues that were first launched before November 2012 will benefit from the grandfathering rule.

"We contacted the ECB and they confirmed to us that tap issues of grandfathered covered bonds will remain eligible during the grandfathering period, as long as no additional ABSs, which do not comply with the additional eligibility criteria, are added to the cover pool," they said, noting that this is positive for issuers such as CFF.

And according to an investor survey carried out by Florian Eichert, senior covered bond analyst at Crédit Agricole, most investors do not consider ECB repo rule changes relevant, which is, he said, positive for issuers like CFFL and CFF. Only 9% of investors he surveyed listed ECB repo rules as an important factor. By investor type the figure was understandably low for insurance companies (13%) and asset managers (2%), according to Eichert, but somewhat surprisingly so for bank treasuries (16%).

"We are not sure yet whether the low number from bank treasuries is merely because the change affects only two issuers," he said. "However, combined with the low figures from asset managers and insurance companies, who have no access to ECB funding anyway but could have been concerned about the behaviour of bank treasuries, it should send a positive message to CFF and CFFL." ■



Moroco, seen from Tarifa, Andalusia
Photo: Gerardo Amechazurra/Flickr

Morocco: Africa on the horizon

Morocco is preparing for the launch of Africa's first covered bonds, potentially before year-end. Developed in conjunction with international agencies promoting housing finance, Moroccan Obligations Sécurisées look set to be embraced by issuers and investors alike. *Chiara Francavilla* reports.

Africa and Europe are at their closest at the Strait of Gibralter, where just 14km separates the two continuents, with Morocco visible from Spain.

It is perhaps therefore appropriate that it is in Morocco that covered bonds — perhaps the most European of financial instruments — look set to take hold for the first time in Africa.

The drafting of a covered bond framework has been carried out with the assistance of the World Bank and German development agency KfW, in an effort to promote the development of more efficient means of financing the country's housing needs and thus help tackle a 500,000-unit shortage, according to government data.

Work began in 2011 and a bill was finalised in the second half of 2012, says Nouaman Al Aissami, head of the credit division at Morocco's ministry of economy and finance.

However, the ministry in 2012 initiated the approval of several reforms of the capital markets, the insurance industry, and banking law, so the adoption of the covered bond law was postponed to 2013.

The draft proposal was then published on the website of the Secrétariat Général du Gouvernement (Government General Secretariat) this March for public consultation, and will proceed to parliament in the coming months, according to Al Aissami.

"We set ourselves the target of passing the law in 2013," he says. "The next parliamentary session has started in April and will end in August."

Talking French, walking German

While Morocco's bill has been published in the French that many Moroccans have as a second language, the covered bond framework proposed in the draft law is similar to the German Pfandbrief structure, according to Jennifer Levy, analyst at Natixis.

It envisages the introduction of two types of covered bonds, split along traditional lines.

- **Obligations Sécurisées Hypothécaires** (OSH) will be covered bonds backed by a pool of residential and commercial mortgages. An LTV below 80% will be required for residential mortgages, and below 60% for commercial.

- **Obligations Sécurisées Territoriales** (OST) will be covered bonds backed by loans to regional and local authorities.

A mandatory 5% overcollateralisation level for both covered bond types is mentioned, says Levy.

Although the draft law mirrors German legislation, there are some differences, she says. For example, the draft requires that only loans originated within Morocco can be used as cover pool assets, a geographic restriction that is not usually present in the legislations of established covered bond jurisdictions, according to Levy.

"The reason for including the criteria on the Moroccan origination of as-

Rim El Honsali:
"Safe investment opportunities during crises'"

sets may be that the government wants covered bonds to really become a tool to boost housing finance in the country," she says.

Foreign assets can nonetheless be used as substitute cover pool assets for up to 15% of outstanding bonds. Assets eligible as substitute collateral include government bonds, state-guaranteed bonds, term deposits from Morocco's central bank or any approved credit institutions, and covered bonds issued by other banks, domestic or foreign.

Another unusual element of the framework is a relatively high issuance limit, says Levy. According to the draft, banks can encumber up to 20% of their balance sheets through covered bonds, whereas in other jurisdictions with limits these have typically ranged from 4% to 8%, she says.

CIH raring to go

The issuance limit was one of the points of discussion between banks and the ministry of finance when the latter held consultations on the proposal last year, according to Lofti Sekkat, managing director at Crédit Immobilier et Hôtelier (CIH), a large retail bank in Morocco that is a subsidiary of state-owned Caisse de Depôt et de Gestion.

"We tried to push for the limit to be increased as much as possible," he says. "We argued that if the percentage was too low, it would have limited too much our possibilities as our bank is largely exposed to mortgage lending."

CIH's mortgage portfolio stands at dirham 17bn ($2bn, Eu1.6bn), according to Sekkat.

He says that he is looking forward to the approval of the law, which he hopes will happen by the end of the year. "We will proceed with a transaction as soon as the law is passed," says Sekkat.

CIH strongly supports the introduction of the new type of financial instrument. "CIH has already used most of the securitisation instruments available, and senior unsecured debt," he says, "therefore the issuance of covered bonds will allow us to expand and diversify our funding options."

Furthermore, covered bond issuance could contribute to reducing funding costs because of the lower risk profile of those financial instruments, he says.

Sekkat says that when CIH begins issuing the aim would be to launch an international transaction in dollars or euros, but he acknowledges that there would be some obstacles to international issuance. The main one would be the difficulty and the costs of putting in place measures to mitigate exchange rate risks, especially for longer maturities.

> "One of the most advanced financial markets in Africa"

"The ministry of finance is aware of this issue and it is working to provide adequate solutions," says Sekkat.

"There is no doubt we are going to issue, but we keep an open mind on the currency," he says. "If there will be the right conditions, we will go for an international transaction, if not we will go for a dirham-denominated one."

However, others suggest that the first Moroccan covered bond issue will target the domestic investor community.

"The first issuance will be denominated in Moroccan dirhams, for currency-matching reasons, as well as domestic investors' interest," says Gabriel Sensenbrenner, lead macro financial economist for the Middle East and North Africa region at the World Bank. "Foreign investors that are comfortable with managing Moroccan dirham risk would also be attracted."

Guarantees, economy supportive

According to Sekkat, some foreign investors have already expressed to him an interest in investing in Moroccan covered bonds.

"International investors will be interested in Moroccan covered bonds because of the dynamism of the Moroccan market," he says. "Moroccan covered bonds will also offer attractive yields, but in a competitive range in comparison to more mature jurisdictions because we will be able to leverage off the quality of our assets."

Sekkat says that one of the elements that contributes to the high quality of Moroccan loans is that most mortgages for low income households carry a state guarantee. These are through programmes such as a state guarantee fund, Fogarim, for example, which guarantees up to 70% of the mortgage of low and irregular income households that earn up to $66 a month.

Moroccan GDP has on average grown more than 4% year-on-year in the past five years to reach $99.2bn in 2011, according to figures from the International Monetary Fund.

The mortgage market constitutes 16.9% of the country's GDP, which is the third highest ratio in Africa after South Africa, with 26.4%, and Namibia, 19.6%, according to the Centre for Affordable Housing Finance in Africa (CAHF), a division of FinMark Trust, a non-profit trust with a mission of "making financial markets work for the poor". Moroccan non-performing loans decreased significantly over the past five years, CAHF said in a 2012 yearbook, dropping from 15%-20% before 2005 to 5% in 2011.

Mortgage lending is carried out by commercial banks such as CIH, but also by consumer credit companies, microfinance institutions, and five state state-owned housing finance institutions.

According to Sensenbrenner, besides top-rated banks with significant mort-

gage books, specialised state housing institutions will also be the best positioned to issue covered bonds.

Local investors welcoming

Morocco appears to be promising territory for the introduction of covered bonds not only on the supply side, but on the buy-side, too, according to CAHF. The volume of assets under management of insurance companies reached dirham 131bn ($15.4bn) in 2009, a figure practically equivalent to the size of the housing finance market, says CAHF, while Moroccan pension funds total the equivalent of around 20% the GDP.

The volume of assets managed by Moroccan mutual funds amounted to more than dirham 241bn ($28.4bn) in 2012, according to the Association des Sociétés de Gestion et Fonds d'Investissement Marocains (ASFIM, the professional association of Moroccan mutual fund managers).

However, CAHF notes that investments in Morocco "are now increasing and strongly biased towards stocks, partly as a result of a lack of appropriate fixed income investment opportunities".

Rim El Honsali, general manager at ASFIM, says that, in compliance with current regulations, mutual fund (OPCVM, or UCITS) assets include securities listed on the stock exchange, shares or parts of other mutual funds, venture capital funds and securitisation funds, government or corporate bonds, and all other securities approved by the Moroccan financial services authority (CDVM). She says that Moroccan investors are very interested in the possibility of investing in covered bonds and would welcome the introduction of the law.

"Every additional regulated financial instrument or product will expand the investment options available for mutual funds, and the possibility of diversifying assets will lead to a better performance of the funds," she says.

El Honsali also cites some of the features that make covered bonds attractive for investors, such as their resilience during economic downturns. "Covered bonds constitute safe investment opportunities during crises," she says.

She adds that covered bonds offer an excellent risk-return ratio. "Covered bonds will allow investors to be exposed to a risk similar to government bonds, but will offer higher yields," she says.

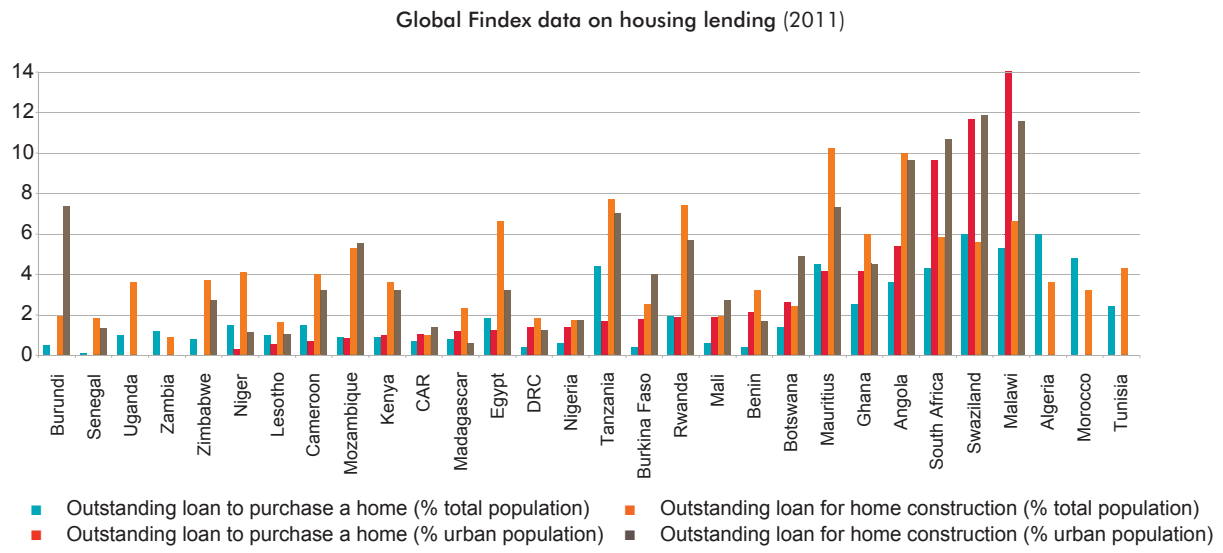
Al Aissami at the ministry of finance says he believes there is appetite for covered bonds among investors. "They will help in diversifying risks and provide the country with high quality financial instruments," he says, "filling the gap between senior issuance and government bond issuance."

Lofti Sekkat:
"We tried to push for the limit to be increased'"

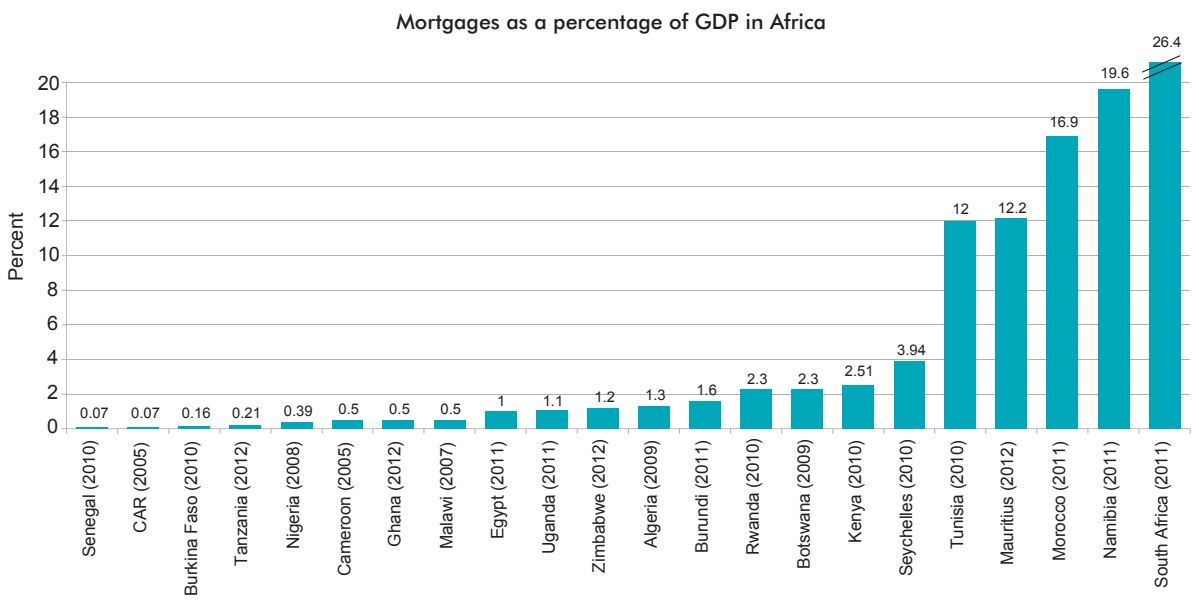
A pioneer in Africa

The Moroccan financial landscape presents fertile ground for testing the introduction of covered bonds in Africa, according to regional experts such as Josie McVitty, a housing and urban development specialist at the Affordable Housing Institute who wrote Morocco's profile for the CAHF 2012 yearbook.

"Morocco has one of the most advanced financial markets in Africa, and a relatively high mortgage to GDP ratio," says McVitty. "Non-performing loans have also decreased significantly in the past decade due to enforcement of strict-



Source: Demirguc-Kunt, Asli and Klapper, Leora, Measuring Financial Inclusion: The Global Findex. World Bank Policy Research WP 6025



Source: World Bank and others, cited in CAHF Africa Housing Finance Yearbook 2012

er loan origination processes.

"All these features make it a strong place to introduce covered bonds."

Spotting the potential of the Moroccan capital market, the World Bank decided to plant a covered bond seed in the country in 2011. The institution sees mortgage funding sources as critical for sustainable market development and mortgage covered bonds as "one of the key funding mechanisms" for this, especially in Europe and Latin America. For this reason, it said, the World Bank collaborated on the establishment of Morocco's covered bond framework.

This is the first project of its kind in Africa. "Morocco will be a pioneer in Africa in general and the Middle East-North Africa region," says the World Bank's Sensenbrenner.

"Since Morocco is the country with the most developed institutional investor base in the region, and mortgages are done largely on a fixed rate basis, there are clear advantages for both lenders and investors to develop a long term, fixed rate funding instrument," he says. "Morocco also benefits from a good legal, transactional and informational ecosystem for capital markets instruments."

The country already pioneered the introduction of securitisation in the North Africa region, in 1999, when it announced the drafting of the first securitisation law.

The law was implemented in 2002, which is also when the first transaction took place, by CIH. However, the framework only allowed for the securitisation of banks' high quality mortgages for the refinancing of the acquisition or construction of individual housing units.

Following pressure from market participants, the law was reformed in 2010 to broaden the scope of eligible assets to loans of public companies and credit institutions, and of public services and insurance companies, and it is now undergoing further amendments that would allow for the issuance of sukuk, the Islamic equivalent of bonds.

> "Clear advantages for both lenders and investors"

The introduction of covered bonds will not be through an amendment of the securitisation law, but by the establishment of a framework for the issuance of Obligations Sécurisées.

Sowing the covered seed

McVitty says that the covered bond project could be introduced elsewhere in North Africa, for example in Tunisia, which has similar challenges for financial institutions in accessing long term finance and aspirations to develop capital markets.

"However," she says, "Tunisia is currently grappling with an uncertain political situation, so it would be some time before such an initiative could be undertaken."

Another African country to have explored covered bonds is South Africa. At the beginning of 2011, the country's banking association discussed with the central bank the possible introduction of covered bonds.

However, the discussion was soon brought to an end. In May 2011 the Reserve Bank of South Africa prohibited the introduction of the financial instruments as "potentially materially" inconsistent with the mission of its bank supervision department, as they would subordinate the interest of depositors to covered bondholders.

Morocco therefore looks set to become the first African country where covered bonds are issued. The government appears committed to pass the law by the end of 2013, and Natixis analysts forecast that the first issuance will happen this year.

"As with any new product," says Sensenbrenner, "there is a need to launch and let the market learn and perfect the product for the local environment. But the odds are favourable." ■

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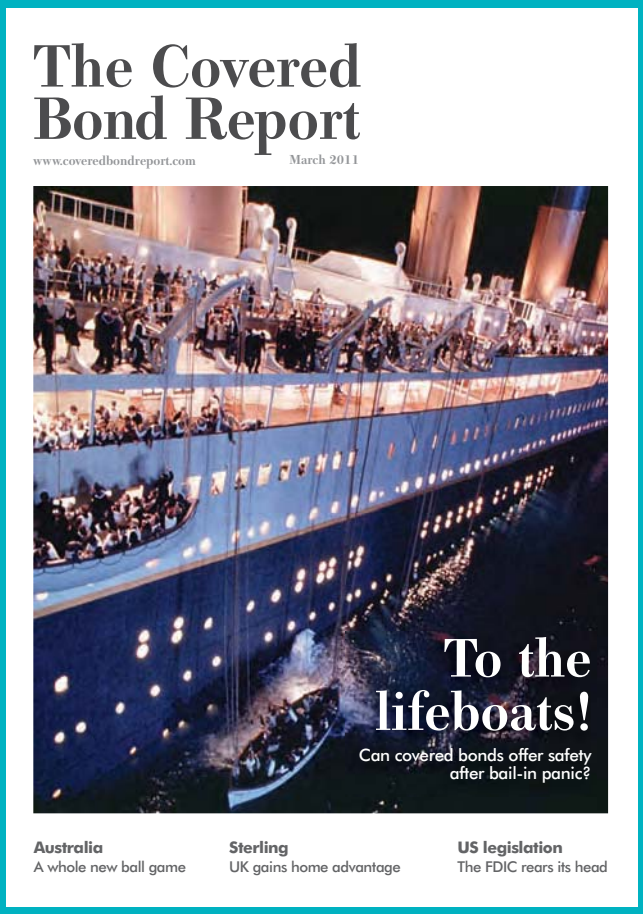
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