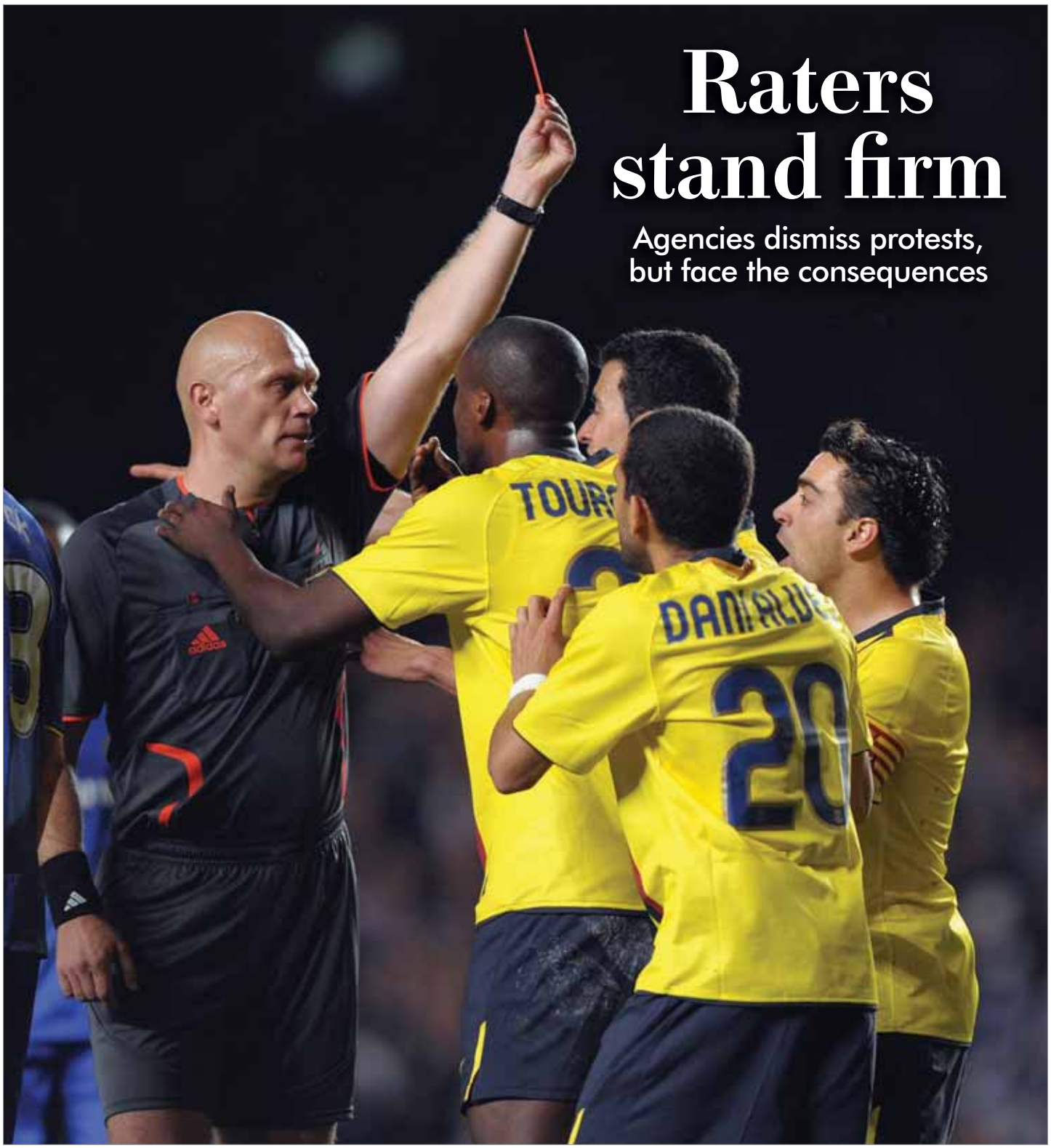
The Covered Bond Report

www.coveredbondreport.com September 2011



Raters stand firm

Agencies dismiss protests, but face the consequences

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Northern light

UniCredit
More than covered

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The Covered Bond Report

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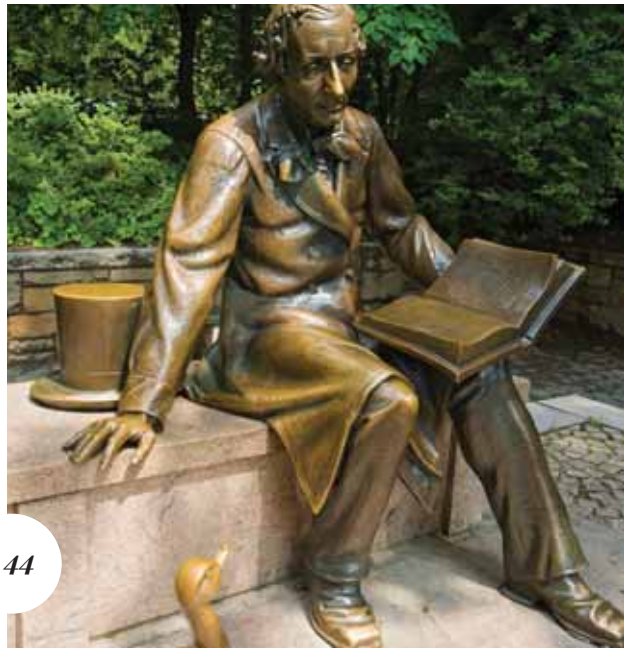

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Thanks, but no thanks

Guarantees for covered bonds? We've heard this one before.

Morgan Stanley bank analyst Huw van Steenis did, however, bring a new twist to the proposal with a widely discussed paper in mid-August: that guarantees come not from individual sovereigns but from the European Financial Stability Facility (EFSF).

Van Steenis sensibly suggests that were the EFSF to go about guaranteeing bank debt, covered bonds might be more politically acceptable given that economic risks could be reduced.

As with all good things in the covered bond market, the idea of governmental guarantees brings to mind a German expression: doppelt gemoppelt. Covered bonds are already guaranteed — effectively senior bank debt with a guarantee from the cover pool.

For proponents of covered bonds, any sovereign or supranational guarantees would be a retrograde step.

In the wake of the collapse of Lehman Brothers European countries set up schemes for their banks to issue government guaranteed debt. Only in Sweden was the standard template pioneered by the UK extended to include covered bonds, but no one used the facility.

True, it took European Central Bank support to help the market to its feet with a covered bond purchase programme after senior debt had already started flowing. But since this prop was removed last year the asset class has surpassed expectations.

This is partly thanks to regulatory initiatives such as Basel III supporting covered bonds and bail-in fears hitting senior unsecured levels, but the fundamental strengths of covered bonds have been key to the asset class's success. Witness a Eu1bn 10 year UniCredit obbligazioni bancarie garantite issue backed by Italian residential mortgages at the end of August, which was priced flat to an Italian government bond curve being supported by the ECB.

Guaranteeing covered bonds would also have the perverse effect of weakening the arguments of those lobbying in favour of the asset class around the world, not least in the US, where the merest whiff of taxpayers' money being necessary is used as a counter-argument. Turning to guarantees could also lessen the impact of their impressive performance in Europe, where covered bonds have been a rare source of encouragement.

Regulators, politicians and others would do better to focus on the root causes of the crisis. Covered bonds alone won't save the world. But guarantees could prevent them from playing their full role in the recovery.

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Legislation & Regulation

ICMA

ECB hails CBIC transparency push

Disclosure on an electronic platform as envisaged in a transparency initiative by the ICMA Covered Bond Investor Council is of "utmost importance", according to the ECB, which said that the CBIC's work should help inform industry efforts to establish a covered bond label.

The European Central Bank's comments were made in a response to a consultation on the CBIC's proposed transparency standards and were just one of several to emphasise a need for greater clarity and standardisation of definitions and concepts included in the CBIC's template. Francesco Papadia, director general of market operations at the ECB, said that this was important to help foster the objectives of a better functioning market and greater integration.

The ECB's feedback also pointed to a need for a balance to be struck between providing "comparable, timely, frequent and easy to access data" and limiting issuers' administrative burden.

"The electronic platform accessible to all (investors, issuers, rating agencies, market analysts, academics, and commercial data providers) envisaged in the CBIC's consultation paper is therefore of utmost importance," said Papadia.

He referred to the commercial paper market's Short Term Paper Market in Europe (STEP) project and a recent ABS loan level data initiative, saying that the ECB would be pleased to share its experience "on a catalytic basis". The Covered Bond Report understands that the STEP project is being looked at as an example of a successful labelling initiative by the ECBC, which is leading the covered bond market's efforts.

"Against this background," said Papadia, "I would regard it useful if the CBIC and the ECBC would join forces both from a conceptual and a technical point of view in order to achieve and maintain a meaningful transparency pillar of the prospective covered bond label."

In its response to the CBIC consultation the ECBC described the introduction of a label for covered bonds as its main focus, adding that transparency will form a key element of the label.

ECB calls for CBIC and ECBC to join forces

"The label transparency component is the result of a detailed ongoing reflection conducted by the ECBC that was launched in late 2009," it said.

> "The final product should allow flexibility"

Nathalie Aubry-Stacey, director, regulatory policy and market practice at the International Capital Market Association, told The Covered Bond Report that half a dozen investors responded to the CBIC's consultation "in addition to many investor comments received as the template was drafted".

"We will be publishing a reviewed template in September/October and look forward to working with the ECBC and national associations," she said.

The only buy-side feedback published on the CBIC's website was from Pioneer Investments, whose letter assessed the data in the template thus: "Pretty extensive and should cover most of the information requirements."

However, 12 investors are named on the CBIC's website as "supporting enhanced transparency standards in the European Covered bond market", including Allianz GI, Generali Investments, Legal & General, and Schroders.

The UK Financial Services Authority, HM Treasury and Bank of England said that the CBIC's transparency template should extend to require loan-level data in addition to the stratification tables proposed. However, the UK Regulated Covered Bond Council (RCBC) set out a preference — in line with the CBIC's — for aggregate cover pool rather than loan-level data.

The UK RCBC listed several ways in which it felt the CBIC's template could be improved, for example by better defining or describing certain requirements referred to in the proposed standards.

"In the absence of clarification, the goal of establishing a consistent and harmonised standard will not be achieved as issuers may report certain information on a different basis," it said.

The UK RCBC also drew attention to the existence of other covered bond transparency initiatives put forward by different industry organisations and different regulators, calling for a joint approach to be adopted where possible.

"In general, we consider that further work may be required in order to establish a suitable benchmark for all, to avoid certain potential unintended consequences and to strike an appropriate balance from a cost-benefit perspective," it said. "This work should not be rushed and the final product should allow flexibility for further market development." ■

AUSTRALIA

Aussie law could be done by Christmas

Australian covered bond legislation could be in place by Christmas, according to a Treasury official, laying the foundations for the first issuance from the country in 2012.

Speaking at a conference in mid-August, John Lonsdale, general manager, financial system division, markets group, at the Treasury, said that the department is working towards giving Treasurer (and deputy prime minister) Wayne Swan the option of introducing a bill into parliament early in the Spring session, which started in August.

That could allow passage of the bill by the time the session ends in late November, with Royal Assent being given by Christmas. Lonsdale said that alternatively the legislation would probably be passed in early 2012, after which it would be up to industry to progress.

Lonsdale said that the Australian Prudential Regulation Authority (APRA) will revise some of its prudential standards to facilitate covered bond issuance and that he expects the regulator to consult on these in the coming months.

The Treasury released proposals for covered bond legislation in March and the subsequent consultation finished in April.

"We have listened closely to the views of stakeholders"

Lonsdale said that while "the devil is in the detail" when it comes to such legislation, he could not discuss the final wording of the bill that will be introduced to parliament. He nevertheless gave some insights into the Australian government's thinking.

"Although the draft legislation attempts to obtain international best practice, it does not simply replicate the European framework, which in general is highly prescriptive, and is adapted for the Australian context," said Lonsdale. "One benefit of the diversity in offshore jurisdictions is that we can observe how these frameworks operate in practice, allowing us to pick and choose those features that seem to work best."

Parliament could see bill in spring session

Crisis lessons heeded

Lonsdale said that the issue of asset encumbrance that comes with covered bond issuance and how this affects unsecured creditors had come to the fore in light of the financial crisis.

"The proposed legislative cap of 8% on covered bond issuance by ADIs seeks to address any asset encumbrance concerns, while also meeting regulatory best practice," he said. "As well as looking at offshore best practice, we have listened closely to the views of stakeholders on how the new Australian legislative framework should be designed."

He said that, alongside the introduction of a permanent financial claims scheme, measures proposed under the legislation would maintain depositor protection even if the introduction of covered bonds might breach the previous "depositor preference" concept hitherto enshrined in the Banking Act.

Lonsdale expanded upon APRA's oversight of covered bonds under the proposed legislation, saying that it will have the power to prevent authorised deposit-taking institutions (ADIs) from issuing or topping up covered bonds under certain circumstances, "such as the ADI experiencing severe financial stress or breaching the requirements of the Banking Act 1959". However, he noted that APRA has no power over assets providing security to covered bondholders once they have been transferred to a cover pool.

Expectations of pooled covered bond issuance from smaller Australian financial institutions were dampened by Lonsdale when he said that "an aggregation model is not likely to be used in the period immediately after the covered bond bill becomes law". However, he said that the possibility of aggregation models should provide opportunities in the medium to longer term.

"The government is interested in providing a mechanism to allow smaller ADIs to issue covered bonds into the Australian market in particular," he said.

Lonsdale said that during the consultation process investors had requested regulatory disclosure requirements for covered bonds, and that he expects the Australian Securitisation Forum to work to develop such a framework, similar to one developed for residential mortgage backed securities (RMBS). ■

FEBELFIN

Belgian pandbrieven come into view

Statue in grounds of National Bank – movement awaited

Belgian bankers are waiting for the country's central bank to release a draft covered bond law that, according to Dexia analysts, could be in place by year-end.

Concrete discussions about a framework have been taking place between Belgian banks, the National Bank of Belgium (NBB), the Belgian financial supervisory authority (FSMA), and law firms since at least 2009.

"Belgium is currently one of the few European countries that has no dedicated legal framework in place," said Dexia's analysts. "However, it should not take too long anymore before Belgian credit institutions can use covered bonds as an alternative funding tool knowing that the covered bond fundamentals are laid down in a draft legislation."

The country's banks will then be able to issue bonds designated "pandbrieven" or "lettres de gage" in the draft.

The country's banks have submitted — via a working group operating under the auspices of the Belgian banking association (Febelfin) — comments on the draft to NBB, which has yet to return a reviewed version to the working group.

"There is no confirmed timeline, but the central bank had indicated that it would probably not revert before the end of the summer," said an official at one Belgian bank. "We hope that it will revert by late August/early September."

The Covered Bond Report understands that in its feedback the Febelfin working group suggested only minor changes to the proposed law, on which there is general agreement.

Once the NBB gets back to the banks with a reviewed version of the law it will be sent to the finance ministry and the European Central Bank, and thereafter to Belgium's parliament. The supreme administrative court (Conseil d'État/Raad van State) will also need to pass judgement on the law.

Sounds like Pfandbrief?

In its prevailing form, which Dexia's analysts noted may change, the draft framework provides for a structure based on issuance by universal credit institutions that will need to be licensed as covered bond banks by the NBB, as will be the case for individual programmes, too.

A cap on issuance does not appear to have been set, with Dexia's analysts only referring to the possibility that the NBB might decide a limit on a case-by-case basis. An official at one of the Belgian banks confirmed that the NBB would have full discretion in this context.

The draft law also provides for the segregation of assets into two separate estates for covered bond issuers, with a general one containing assets of the issuer to which all creditors have direct recourse, and a segregated estate comprising the cover pool. Any initiation of insolvency proceeding will not affect the assets recorded in the segregated legal estate, according to the Dexia analysts.

They noted that the draft law is inspired by the German Pfandbrief Act, with common elements including direct issuance from the balance sheet, a cover asset register, a 180 day liquidity rule, and a separate programme for different asset classes.

However, in contrast to the Pfandbrief Act, the draft Belgian legislation accepts securitisations as cover pool assets under certain conditions, such as 90% of the pool underlying the securitisation being directly eligible for covered bonds and originated by a group-related entity of the issuer.

In addition, while Germany's Pfandbrief banks do not have to set up separate programmes for commercial and residential mortgages, the draft Belgian legislation foresees this being the case for Belgian banks.

Another aspect of the draft legislation highlighted by Dexia's analysts is that it provides for covered bonds being compliant with Ucits 52 (4) and the Capital Requirements Directive. However, they note that a distinction is made at programme level between CRD-compliant covered bonds, i.e. Belgian pandbrieven/lettres de gage, and non CRD-compliant covered bonds, simply called Belgian covered bonds.

"The denomination of both terms [pandbrieven/lettres de gage and covered bonds] is protected by law," said the analysts. "These distinct types of covered bonds will appear on two separate lists. However the way that the law and the Royal Decree are stipulated, assures that in practice the Belgian credit institutions will only be able to issue CRD-compliant covered bonds." ■

"Changes have clarified a few issues that were not in the original legislation" page 42

LATIN AMERICA

Banks lobby for Brazilian LFIs

The Brazilian Association of Real Estate Loans & Savings Companies (Abecip) in late July presented a proposal to the country's central bank for a Brazilian version of covered bonds, in a bid to create a long term funding instrument that can support a fast growing real estate financing market, according to Moody's.

Savings deposits have been the primary source of mortgage financing in Brazil, with the country's banks mandated to invest at least 65% of these into real estate lending, but this funding source is dwindling and "could soon constrain further expansion of mortgage financing", said the rating agency.

Moody's said that the introduction of Brazilian covered bonds, to be called Letras Financeira Imobiliarias (LFI), is a credit positive for the country's banks because it provides for an alternative long term funding instrument that will allow Brazilian banks to serve growing housing demand.

LFIs are structured as debt securities that will be guaranteed by the issuing banks and a pool of assets. The rating agency said that the proposed format calls for tax exemption on investments in longer maturity papers, primary those with five to 10 year tenors, aimed at creating additional incentives for investors.

Moody's noted that the country's banks have no incentive to securitise their mortgage portfolios because they are required to invest in real estate, therefore making that funding source unattractive.

Mortgage loans have been growing at an annual average rate of 45% since 2007 — in contrast to an 18% increase in savings deposits, with Brazil's largest banks standing to benefit the most from the introduction of covered bonds, said Moody's. These are: Banco Santander (Brasil), Banco Bradesco, Itaú Unibanco, and Banco do Brasil. Caixa Economica Federal, with a 60% market share, is the largest player in this market, said Moody's. ■

Banco Central do Brasil: received Abecip proposal

FSA

Encumbrance on new UK Forum agenda

The UK Financial Services Authority is working on updating its asset encumbrance policy, according to the minutes of the first meeting of a new body, the UK Covered Bond Forum

A review of the UK Regulated Covered Bond framework, transparency standards, and ratings were also discussed at the first forum, which took place in June, according to recently released minutes.

The FSA was asked for an update on asset encumbrance policy – a topic that has come to the fore in the wake of the financial crisis and that has been debated in countries that are introducing covered bond legislation, such as Australia.

According to the minutes, Lara Joseph of the FSA's capital markets team "explained that a survey has been sent out to firms by the FSA, and work is ongoing to update policy in this area".

"Work is ongoing to update policy in this area"

Suggestions for future topics of discussion included the implications of Solvency II, CRD IV and retail ring-fencing proposals being developed by the Commission for Banking, which is reviewing the UK banking industry.

The new body takes on a role previously played by the FSA's Covered Bond Standing Group (CBSG), which broke up as issuance of covered bonds in the public markets dried up after the onset of the financial crisis.

John Wu, senior associate, capital markets team at the FSA, told The Covered Bond Report that the UK Covered Bond Forum has a similar mission to that of the CBSG in that it is meant to be a group where market participants can air their views on market developments and regulations. The FSA intends for the forum to meet at least twice a year.

"It should be frequently enough so that there is a continuous dialogue, but with sufficient time in between for there to be substantial issues to discuss," said Wu.

The forum differs from the standing group in that the membership is broader, extending to investors and trade associations, according to Wu, while the CBSG only comprised the tripartite authorities and issuers. ■

ASIA

Japanese law planned with a public face

A push for covered bond legislation in Japan has been spurred in part by a desire to keep up with developments elsewhere, but its goal contrasts with that of many other countries, according to a banker familiar with the initiative.

Japan has yet to join the ranks of covered bond jurisdictions, with Shinsei Bank having in 2008 aborted a structured, mortgage backed deal on account of the financial crisis and no issuance having been attempted since.

The government-owned Development Bank of Japan (DBJ) is now spearheading a push for covered bond legislation in Japan. It is leading a study group that on 7 July published a report setting out a range of considerations raised by its members — representatives from major banks, securities firms, rating agencies and the Bank of Japan; academics, lawyers, and institutional investors.

Yukio Egawa, chief strategist, head of research division at Shinsei Securities in Tokyo and a member of the study group, told The Covered Bond Report that covered bond legislation has only recently become the focus of market participants' efforts, and that DBJ has been leading the initiative as it considers ways to diversify its funding sources.

"Another reason for the timing of these efforts is the spreading of covered bond legal frameworks across the world, including in Australia, Canada, Korea and other non-European nations," he said. "If the trend continues and we do not introduce our own framework then Japanese institutions will be at a disadvantage from a competitive viewpoint compared with European and North American institutions."

But while developments in new jurisdictions have tended towards mortgage finance, Japanese market participants are eyeing the asset class in the first instance primarily as a tool to raise medium to long term funding for public finance, private finance initiative (PFI), social infrastructure and industrial lending.

Yukio Egawa, Shinsei: Covered bonds unlikely to be used for housing finance

"It is very unlikely that covered bonds will be used for housing finance (residential mortgages) for the time being," said Egawa. "Public finance, PFI, loans to railway and other infrastructures are more likely to form cover pool collateral."

He identified two reasons for the public sector focus: as the main driver behind the initiative, DBJ, does not lend to consumers; and financing of residential mortgages in Japan is generally well provided for by the Japan Housing Finance Agency, which purchases fixed rate mortgages from originators and securitises them.

Breadth could influence timing

According to Egawa, covered bond proponents are aiming for legislation to be introduced within the first half of next year, and that the first issuance – initially domestic – would also take place in 2012.

The ease, or otherwise, with which legislation might receive political approval could depend on the scope of the proposed framework and how it can be squared with concerns about structural subordination.

"If the legislation limits the number of eligible issuers, in an extreme case only to DBJ or to DBJ plus the three largest private banks, then it may not be that difficult to pass legislation," said Egawa. "But if we try to expand the scope of the law it may take more time and effort to persuade the banking regulators."

According to Egawa the study group has already envisaged ways in which covered bond issuance could be structured to avoid a conflict with Japan's existing bankruptcy laws, under which deposit taking banks can be placed under legal bankruptcy procedures.

Also under discussion are the maturities the study group envisages the first Japanese covered bonds could feature, which, at 10 years or longer, would be quite different from the average tenor of recent dollar and euro benchmark supply.

"The terms of social infrastructure, PFI and local government loans, which we are looking at covered bonds financing, tend to have very long maturities, of 20 years or more," said Egawa. "In addition both private sector banks and DBJ have been able to raise funding of up to 10 years at very tight credit spreads in the unsecured market."

> "Public sector loans tend to have very long maturities"

It is not clear what the next steps are after the study group published its report in July. Egawa said that the group is agreed on the need for a legal framework and standardisation, but that many points are still open as various alternatives are pursued. ■

The Covered Bond Report

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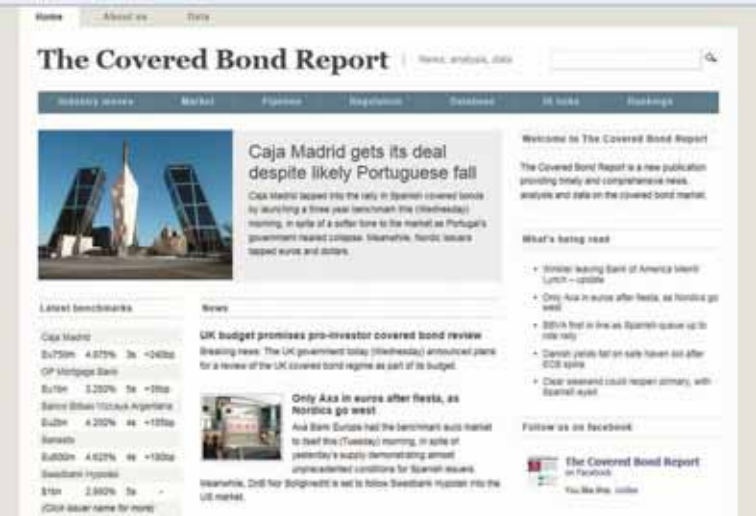


Ratings

SPAIN

Severe S&P multi-cédulas cuts criticised

Standard & Poor's downgraded 46 multi-cédulas between one and nine notches on 1 August, surprising market participants by the severity of its actions, with analysts disagreeing with the rating agency's view on concentration risk in particular.

The rating agency removed the multi-cédulas, totalling some Eu103bn, from CreditWatch negative. They were put on review in September 2010. Only two issues that were subject to the review retained their AAA ratings.

> "S&P usually comes around with the toughest calls"

"People are surprised that we saw as much as a nine notch downgrade," said Frank Will, senior analyst at RBS. "I did not expect a downgrade to BBB- of some of the transactions. I thought maybe we'd see a downgrade to single-A, but not so close to junk.

"It's clear that there is something wrong with S&P's approach if you have downgrades of this extreme."

Two transactions, for example an AyT Cédulas deal launched in March 2007, fell to BBB-.

"It was issued based on our perfect world environment we had back then," said Florian Hillenbrand, senior analyst at UniCredit. "Going from as high as AAA to BBB- is tough, but rating agencies tend to do tough calls these days and S&P usually comes around with the toughest calls since they base their assessments on Probability of Default rather than on expected loss."

S&P cited deterioration in the credit quality of the financial institutions behind the multi-cédulas between 2008 and 2011 as the main reason for the downgrades. In 2008 71.93% of issuers were rated higher than bbb/BBB (credit estimate or rating), but by 2011 the number in that category had dropped to 27.27% (see table below for more details).

Along with an amplified credit risk, the rating agency said a consolidation within the Spanish savings banks sector had heightened concentration risk of the multi-cédulas and increased the impact of an individual financial institution on the corresponding multi-cédulas.

Analysts found fault with this reasoning, saying the merger of banks that had occurred in Spain had likely done more good than harm.

"They didn't take into account the medium to long term benefits of the mergers," said Will at RBS. "I can't understand the reasoning behind S&P's views."

Dries Janssens, fixed income strategist at Dexia Capital Markets, agreed that the merger of the institutions was more likely to have enhanced credit quality than negatively affected it.

"The S&P report seems to put more emphasis on the deterioration of the creditworthiness of the cajas, than on the positive effects of consolidation and recapitalisation," he said.

Will added that S&P had not taken into account the "massive" overcollateralisation levels on the multi-cédulas.

> "Consolidation has heightened concentration risk"

The rating actions also came as a result of the adoption of an updated version of S&P's credit risk model, which addresses updated default rate stresses, correlation assumptions, concentration risks, and model risk.

S&P said the credit enhancement to cover possible interest shortfalls in 46 of the 48 transactions analysed "would not be sufficient to pay interest on all bonds to a AAA rating level if a cédulas defaults". ■

CHANGE IN CREDIT QUALITY OF MULTI-CÉDULAS PARTICIPANTS 2008-2011

	2008		2011	
Credit estimate/rating	% of entities	Number of entities	% of entities	Number of entities
aa-/AA- or higher	7.02	4	11.36	5
a+/A+	12.28	7	0	0
a/A	15.79	9	6.82	3
a-/A-	14.04	8	6.82	3
bbb+/BBB+	22.81	13	2.27	1
bbb/BBB	17.54	10	18.18	8
bbb-/BBB-	1.75	1	36.36	16
bb+/BB+ or lower	8.77	5	18.18	8
Total		57		44

Source: Standard & Poor's

"Norway's economy is more sheltered from abroad" page 34

ECB REPO

Greeks tweak to avoid Fitch junking

Greek banks have restructured their covered bond programmes in successful bids to stave off downgrades below investment grade by Fitch, keen to keep investment grade ratings necessary for continued repo eligibility with the European Central Bank.

Greek banks have had to take action as their issuer ratings faced pressure in spite of the second rescue package for their sovereign, and particularly with Moody's having already stripped their covered bonds of investment grade ratings.

At the end of July Fitch confirmed that structural changes have been made to covered bond programmes of four Greek banks that it had said were necessary to avoid downgrades.

The BBB- ratings of the four programmes were left on Rating Watch Negative. The rating agency said that its continuing review "reflects the adverse economic conditions and heightened uncertainty surrounding recent developments in Greece", and the RWN status of the four banks' issuer ratings.

Alpha Bank, Eurobank EFG, National Bank of Greece and Piraeus Bank completed structural adjustments to transform the liability profiles of covered bond programmes in line with a release by Fitch on 14 July, which had said that the changes were expected by 29 July and that the ratings would be cut were the restructurings not implemented by then. NBG's changes are to its Programme II.

Fitch said structural amendments to the four covered bond programmes have changed their liability profile from soft bullet redemption to partial pass through amortisation. The rating agency said that this transformation mitigates refinancing risk after an issuer default by eliminating maturity mismatches between the cover assets and the covered bonds.

The issuers have revised their programmes so that the maximum Asset Percentage commitment is contractually undertaken. Fitch said a contractual Asset Percentage clause offers more protection to bondholders than a public commitment and was a credit positive for the covered bonds.

Greeks under pressure

Fitch added that it expected Greek issuers to demonstrate an ability to replenish their cover pools on a regular basis by maintaining assets over and above the volume of assets required to meet their contractual Asset Percentage commitments. ■

COLLATERAL ANALYSIS

Moody's covered-RMBS checks differ

Moody's relies far less on double-checking of loan-by-loan data for covered bonds than for residential mortgage backed securities given the on-balance sheet nature of covered bonds and the lower importance of collateral analysis as a factor when rating them.

In an August report, "Identifying key aspects of pool AUP reports in EMEA structured finance and covered bond transactions", the rating agency discussed how it ensures the integrity of data through reports provided by originators and arrangers.

"Third parties usually conduct these data checks on a sample of the underlying asset pool and in compliance with agreed-upon procedures (AUP)," said Moody's.

The AUP reports assess the integrity of loan-by-loan data provided by originators.

The rating agency said that as loan-by-loan data is the basis for its analysis of the credit quality of portfolios underlying RMBS, "the accuracy and veracity of the information relating to the main risk drivers is vital". It therefore expects independent third parties to have assessed factual information provided by issuers and their agents that is key to determining ratings.

But Moody's said that it does not routinely receive pool AUP reports for covered bond transactions. It cited two reasons for this; firstly, the on-balance sheet nature of covered bonds.

"In covered bond transactions, the loans that secure the covered bonds are normally originated by the issuer group and remain on the issuer's balance sheet," said the rating agency. "The expectation is that issuers, as regulated and supervised financial institutions, will maintain high standards of quality control over all their loan operations, regardless of whether the loans are in the cover pool or not."

The second reason relates to the importance of factors aside from collateral quality in Moody's covered bond rating methodology.

"The amount of losses we model for covered bond transactions are only partly (currently about one-third) derived from the collateral analysis," said the rating agency. "The remainder are due to market risks that arise due to refinancing risk and interest rate and currency mismatches."

Moody's said that it would not expect a pool AUP report to have a "material" impact on its analysis of the majority of covered bond transactions. However, it said that it may consider AUP reports in certain cases and if the issuer is lowly rated or unregulated. ■

FITCH

Downgrade rate doubles on sovereign woes

Fitch downgraded as many covered bond programmes in the first half of the year as it did in all of 2010, reflecting the damage the euro-zone debt crisis has caused the asset class.

The 33 downgrades made by Fitch were confined to Portuguese, Greek, Spanish, Irish and Cypriot financial institutions or their affiliates, said the rating agency in an EMEA structured finance snapshot report released in early April.

"The vast majority resulted from sovereign rating downgrades and/or downgrades of the relevant issuer default ratings," said Hélène Heberlein, managing director of covered bonds at Fitch. "In fewer cases, the decision was motivated by insufficient overcollateralisation, liquidity and comingling issues."

And she said that the unfolding sovereign crisis is obstructing access to the capital markets for covered bonds from those countries affected.

However, the doubling in the rate of downgrades did not stop covered bonds from achieving a record breaking year, hitting Eu215bn of new issuance in the first half of 2011, according to the rating agency.

Heberlein highlighted the attractions for issuers and investors that have been driving the supply surge.

"A competitive cost of funding would certainly be the first argument cited by bank treasurers," she said. "Although covered bond spreads rose substantially since the onset of the global financial crisis, they were on average subject to lower spikes than those witnessed in the senior unsecured debt and securitisation markets.

> "Disagreement persists on allocation of overcollateralisation"

"On the other hand, investors' appetite is fuelled by risk aversion and regulatory incentives. Historically, legislative covered bonds have attracted a low capital charge at EU investing banks. Also preferential eligibility criteria as well as haircuts have been applied for central bank repo operations. Additionally, some covered bonds qualify for banks' future mandatory liquidity coverage ratios, and the debt instrument is widely expected to be exempted from banks resolution regimes."

She added that the rest of the year could be quieter given that some issuers took advantage of the buoyant first half to meet their funding needs "to a large extent".

Regulation de rigueur

Fitch highlighted a trend towards covered bonds based upon dedicated legislative frameworks rather than contractual issuance, noting that whereas two-thirds of the programmes it rated were legislative based in 2009, three-quarters are today. Among developments contributing to this was the introduction of obligations de financement de l'habitat in France in March.

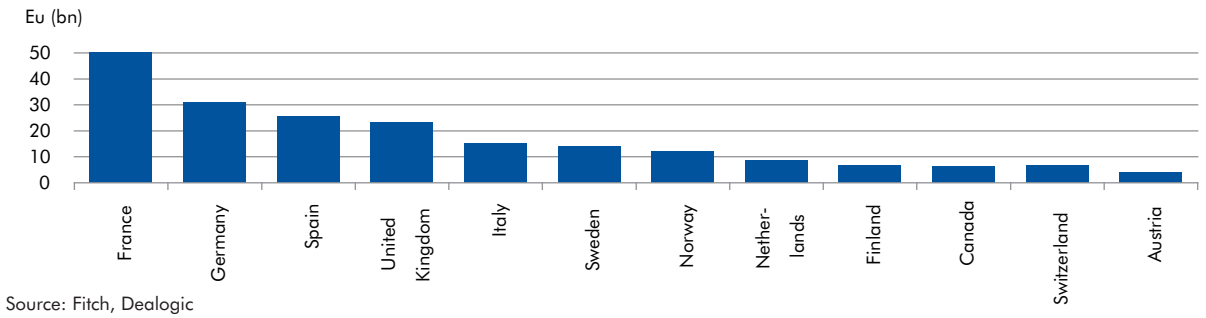
The rating agency noted that Canada and New Zealand, where issuance is already established on a contractual basis, have launched consultations regarding introducing legislative frameworks — but that in some of these younger jurisdictions regulators were also looking more closely at the wider impact of covered bond issuance. Fitch pointed out that the Reserve Bank of New Zealand has set a 10% limit on the amount of assets that can be encumbered by covered bond issuance, while Canada's Department of Finance has proposed a maximum overcollateralisation level of 10%.

But while Heberlein noted further developments in Australia, for example, she was cautious about prospects in the US.

"Disagreement between stakeholders persists on the allocation of overcollateralisation in the event of an issuer default," she said.

The Federal Deposit Insurance Corporation continues to have objections to an initiative to introduce covered bonds by Republican Congressman Scott Garrett, who nevertheless saw the United States Covered Bond Act of 2011 passed by the House Financial Services Committee in June. ■

Top 12 countries by covered bond issuance H1 2011



Source: Fitch, Dealogic

"There is so much more rating shopping going on" page 31

US

WaMu covered fall on collateral deterioration

Fitch cut the rating of mortgage covered bonds issued off a former Washington Mutual programme to one notch above the rating of the programme sponsor, JP Morgan Chase Bank, because of a deterioration in collateral quality.

The rating agency downgraded the covered bonds at the beginning of August from AA+ to AA, one notch above a AA- long term issuer default rating of the sponsor bank.

"The rating downgrade is driven by increased loss expectations assessed on the cover pool assets on account of the deterioration in observed performance of US payment-option and interest-only hybrid adjustable rate mortgages," said Fitch. "As a result, the level of overcollateralisation in the programme is no longer sufficient to provide expected recoveries above 91% on defaulted covered bonds in an AA+ stress scenario."

In addition to the rating of JP Morgan Chase, the rating of the covered bonds is based on a Discontinuity Factor (D-Factor) of 100%, which captures Fitch's assessment that the bonds' probability of default is aligned with that of the sponsor bank. However, Fitch said that a contractual maximum asset percentage (AP) of 67% is commensurate with a AA stress scenario on a recovery basis.

The rating agency has assigned the 100% D-Factor to the WM Covered Bond Program because it believes that potential asset and liability mismatches after an issuer default cannot be bridged. This is because as an institution insured by the Federal Deposit Insurance (FDIC) Act, JP Morgan Chase is subject to a 90 day automatic stay period upon insolvency, while two of three outstanding series of soft bullet covered bonds issued off the programme only provide for an extension period of 60 days. This does not give the mortgage bond indenture trustee sufficient time to enforce its security over the cover pool and liquidate the portfolio prior to covered bond redemption, said Fitch. ■

HM TREASURY

UK misfits shrug off guarantee differences

Covered bonds issued by the government owned rumps of Bradford & Bingley and Northern Rock have been affirmed at AAA by Fitch, in spite of the rating agency taking different attitudes to government support for the programmes, while Standard & Poor's upped B&B's to AAA.

Fitch in mid-August affirmed covered bonds issued by Northern Rock Asset Management at AAA, although — unlike a Bradford & Bingley affirmation two weeks earlier — it gave no credit to an HM Treasury guarantee because of differences between the two support arrangements.

Fitch said that it does not give credit to the guarantee provided to NRAM's covered bonds because it can be removed with at least three months' notice.

"The agency is not comfortable giving credit to a short term guarantee to support its long term rating on the covered bonds as it does not consider there is sufficient protection to support the covered bond rating upon withdrawal of the guarantee," it said.

Fitch had in late July affirmed at AAA covered bonds issued by Bradford & Bingley based on an HM Treasury guarantee, even though the rating agency said that in that case it made an exception to its standard criteria for analysing such support, which focus on their irrevocability. Fitch said that the B&B guarantee does not contain language describing it as "irrevocable" but that it made an exception to its standard criteria for analysing guarantees because it considers that governments do not make such guarantee commitments lightly.

S&P in late July raised the ratings on B&B's mortgage covered bonds from AA to AAA — without giving any credit to the guarantee because it had "not received comfort that the guarantee arrangements meet our sovereign guaranteed debt criteria for rating substitution". S&P said that it had reduced its asset-liability mismatch classification of B&B's programme from "moderate" to "low". ■

TREUHÄNDER & CO

Active or passive? S&P examines trustees

Covered bond trustee roles vary widely from country to country, said Standard & Poor's in a report focussing on trustee-like roles in the five largest markets released in late August, reaffirming the rating agency's view that not all covered bonds are created equal.

While all covered bond programmes benefit from trustees, or trustee-like entities, the names, nature and scope of those appointed to safeguard bondholders' interests vary significantly by jurisdiction, said S&P. Their roles range from rather passive to highly active depending on the country, said the rating agency.

"The trustee roles differ significantly in different countries," said Sabine Daehn, credit analyst at S&P, in a podcast that accompanied the release of the report, "as we, for example, look at the powers trustees have in various jurisdictions.

"You have countries like the UK or Germany where trustee-like entities have a much more active role within covered bond programmes."

For example, in both Germany and the UK, trustees must sign off on new issuance — in Germany's case it is the cover pool monitor (Treuhänder) and in the UK it is the bond trustee and security trustee who act together.

S&P said that in addition to signing off on new issues the Treuhänder supervises the portfolio to ensure that it complies with covered bond regulations and that overcollateralisation levels are commensurate with the regulatory overcollateralisation requirements.

Sabine Daehn: "You have countries where trustee-like entities have a much more active role."

The Treuhänder has the power to request and check all information required to review the eligibility of the programme, and remove or cancel assets from the cover pool accordingly.

In the UK, the bond trustee and security trustee approve amendments or corrections to transaction documents and bond terms, as well as authorise the termination and appointment of agents and servicers.

"When we, however, look at a country like Spain and the cédulas programmes there," added Daehn, "as long as the bank itself is solvent there is not really a trustee employed."

The report said different covered bond programmes in Spain use different approaches but cédulas hipotecarias and cédulas terrioriales, for example, do not employ trustees when solvent, but rather the issuer itself manages the cover pool, supervised by the Spanish regulator.

The trustee role also varies after a default, said S&P, with Daehn, however, identifying as a common theme that "trustee-like entities have more power than before in that usually new entities enter the scheme or enter for the first time."

For example, in Spain and Denmark, a trustee-like entity — which enters for the first time at the point of insolvency — examines the cover pool, she said.

"Depending on the jurisdiction, they might have sole responsibility for managing the cover pool, the cover programme, like for example in Denmark," she added.

According to the S&P report, during insolvency proceedings Finanstilsynet, the Danish financial supervisory authority, appoints a trustee to manage the cover pool and provide it with quarterly reports. In the case of a mortgage bank, the Finanstilsynet appoints a liquidator (Kurator) who administers the cover pool and has the same rights over the mortgage loans as the insolvent bank would have had. ■

METHODOLOGY UPDATE

October at the earliest for S&P counterparty finale

Standard & Poor's does not expect to publish updated counterparty criteria for covered bonds before October, the rating agency announced in mid-August.

It said that it is "giving due consideration to the opinions expressed" during a consultation period that ended on 4 May and yielded "significant" levels of feedback.

S&P at the beginning of June reported on the comments it received on its proposals.

Karlo Fuchs, analytical manager for covered bond ratings at S&P, told The Covered Bond Report that for internal reasons the rating agency had not been able to advance as quickly as originally intended.

The rating agency had been receiving questions from market participants about whether finalised criteria would be released before a possible wave of benchmark supply, and so wanted to provide an update about the timing, he added. ■

Market

EUROS

ING leads covered rush as senior swoons

European banks raised close to Eu20bn of funding through benchmark covered bonds in seven business days at the end of August as the asset class left the senior unsecured market trailing.

Ballooning spreads on senior unsecured debt meant that market was yet to reopen post-summer as The Covered Bond Report was going to press, and covered bonds were the only game in town.

The Netherlands' ING reopened the market on 24 August with the first benchmark since 5 July, issuing a Eu1.25bn 10 year at 80bp over mid-swaps. Martin Nijboer, head of long term funding at ING, told The Covered Bond Report that the bank had felt a sense of responsibility in reopening the market.

"You want to do a good, successful transaction that means the market remains open for others," he said. "If you go out with a 10 year you should show leadership and be strong."

Issuers that followed paid tribute to the Dutch bank.

"ING gave us a lot of confidence that the market had opened," said John Paul Coleman, head of capital raising and term funding at RBS, which tapped the market a week later. "It was an excellent deal and the catalyst for all this issuance."

The reopening expanded quickly, with UniCredit selling the first OBG benchmark since Italy was drawn towards the centre of the euro-zone sovereign debt crisis in mid-July (*see Q&A with UniCredit's Philipp Waldstein for more*).

"Everyone was expecting a short dated deal from a German or Scandi issuer to reopen the market," said a syndicate official, "but it was a 10 year, and then you've got all these other things coming out like a 10 year OBG. It does show quite a strong reopening for the market."

Deals for Eurohypo, UBS and Nordea Bank Finland also came that week, but with Abbey National Treasury Services, Barclays Bank, BPCE SFH, Caisse de Refinancement de l'Habitat, Crédit Agricole Home Loan SFH, Erste Group Bank, RBS, SpareBank 1 Boligkreditt and Swedbank Mortgage all following, overall demand eased. Orders for a Eu1bn 10 year transaction for Norway's SpareBank 1 Boligkreditt, for example, came in slower than expected and guidance was revised to reflect the worsening market conditions.

"We felt that the low 60s was a fair starting point but the revision of the guidance was a reflection of market conditions – a combination of heavy supply and a shakier credit market overall," said Arve Austestad, chief executive at SpareBank 1 Boligkreditt.

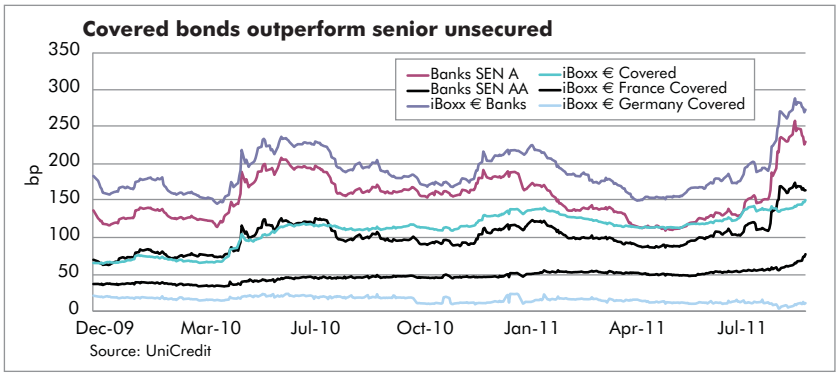
Secondary spreads came under pressure — particularly with new issue premiums on the supply being high. A portfolio manager said the new issue premium on ING's reopener — put at 15bp by several market participants — was scary and that secondary market spreads were widening by 70%-80% of new issue premiums.

"How long can this continue with wide primary issues?" he asked. "All the curves are going wider."

However, although sympathetic to concerns about secondary spreads, a syndicate official said that issuers and his peers should be less worried about where exactly new issue premiums were coming in at.

"If you look at the moves in sovereigns or in senior unsecured," he said, "these bizarre discussions around new issue premiums seem to be very misguided. The questions are not relevant, especially when seeing such high unsecured levels and sovereigns.

"We've seen a lot of different deals," he added, "which have been bought up with many different types of investors, so what this really shows is that it is a really strong market in horrific conditions." ■



The Covered Bond Report

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DOLLARS

Swedbank a euro opt-out in US

Swedbank Mortgage launched the first dollar benchmark covered bond in a month on 24 August, achieving cheaper funding than available in Swedish kronor or euros.

Leads Bank of America Merrill Lynch, Barclays Capital, Credit Suisse and JP Morgan gave initial price talk in the high 70s over mid-swaps for the five year deal, and priced a $1bn issue at 82bp over.

The Swedish issuer last sold a dollar deal in March, a $2bn transaction split into fixed and floating rate tranches of $1bn each. The three year FRN was priced at 45bp over three month Libor and the five year fixed rate piece at 71bp over mid-swaps.

Although the funding levels for the latest transaction were a little higher, Martin Rydin, head of long term funding at Swedbank, told The Covered Bond Report that this was to be expected given the challenging market conditions and given that the transaction heralded the reopening of the dollar covered bond market.

Rydin added that the bank had obtained funding that was around 10bp cheaper than in the euro benchmark market, and also inside levels in the domestic market.

"The dollar market was by far the most cost efficient," he said.

As well as the dollar market being cheaper, Rydin said the issuer expected to have a first mover advantage.

"I think we were one of the first banks to update our 144A covered bond programme following our Q2 results, so I guess we were one of the first who actually were able to issue," he said. "One reason for us to move was that we thought we'd be the one only ones looking at the dollar market, while the euro market might be quite crowded."

Coming from a financially sound jurisdiction also helped, said Rydin.

"Sweden in general has good and sound finances, which means that there is a safe haven bid regarding Sweden," he said, "and it's probably also a positive factor that Sweden is not a part of the euro-zone area."

The last prior dollar benchmark was a $2bn five year for Canada's Bank of Nova Scotia at 42bp over mid-swaps on 26 July. ■

SWISS FRANCS

Swissies offer growing respite

The Swiss franc market has provided covered bond issuers with greater volumes of funding this year, offering welcome respite from the euro-zone's problems.

Foreign covered bond issuance in the second quarter rose from Sfr1.625bn in 2010 to Sfr2.125bn (Eu1.92bn) this year, and from Sfr1.175 in 2009. Supply in the year to the beginning of August increased from Sfr6.6bn in the same period of 2010 to Sfr7.2bn, according to figures from Credit Suisse.

This made Swiss francs the fourth largest currency for international covered bond issuance after euros, dollars and sterling. In the first seven months of the year, 15 issuers from 10 countries tapped the currency with either new issues or reopenings.

"Whenever we've seen difficult times in Europe," says Andre Schmid, head of Swiss franc syndicate at Credit Suisse, "the Swiss market has been open for top quality issues. As an issuer you can use the Swiss market as a strategic market, but you have to be aware that average transaction sizes are smaller.

"But compared to euro deals, you get more interesting levels," he added.

Maturities in the Swiss market have varied from five to 10 years in 2011, said market participants. Schmid said the "sweet spot" for broadly distributed issues was between four and six years.

Despite Royal Bank of Canada having launched the tightest transaction of the year, the Swiss franc market has been dominated by core issuers from Scandinavia and France. That it is not to say the market is not open to other jurisdictions, according to UBS Swiss syndicate official Fabian Welandagoda, who said that German risk would also have been welcomed, but was too expensive on a swapped basis.

"We believe the market is open for other jurisdictions, too," he said, "but professional investors increasingly do look at the rating/credit metrics of the underlying credit as well and expect a higher spread even if the cover pool consists of high quality assets." ■

SECURITISATION

RMBS pick-up more molehill than mountain

Market participants have cautioned against reading too much into a pick-up in European RMBS issuance in the first half of the year, suggesting that tough conditions, regulatory disincentives and the attractions of covered bonds could stymie any continued recovery.

Standard & Poor's in mid-August noted that European issuance of residential mortgage backed securities, excluding retained deals, neared Eu30bn in the first half of 2011, 20% more than in the first half of 2010. The rating agency said improving collateral performance and recovering investor sentiment could be partly responsible for the moderate revival.

"As RMBS issuance has slowly returned, there has been some shift in post-crisis transaction structures," said S&P, using the example of standalone transactions, which it said have gained traction.

However, market participants noted that the increase was from a low base. Boudewijn Dierick, head of structured covered bonds at BNP Paribas, for example, was more sceptical about the return of the RMBS market.

"Because the amount of issues in H1 2010 was relatively small, it does not need a huge amount of deals more to get a 20% increase," he said, "but it is indeed a good sign."

"The Dutch and UK markets are still the only active RMBS markets," he added.

S&P acknowledged any recovery was limited to the UK and the Netherlands, which together accounted for 95% of placed RMBS issuance in H1 of 2011. S&P expects this trend to continue into next year.

Dierick contrasted the recovery in the UK and the Netherlands with Italy and Spain — the two other European markets that were the most active pre-crisis.

"The big difference is that, for example, we have seen one or two Italian deals but that's it," he said, "while pre-crisis Italy was quite important.

"Spanish RMBS was also really big and we haven't seen those either, although that's more linked to the sovereign problems and the state of the housing market in Spain, for example."

"Not expecting that under current conditions issuance will improve"

Paolo Binarelli, CDO portfolio manager at P&G SGR Alternative Investments, said the Italian RMBS market is currently illiquid.

"It hasn't been a very liquid market since a couple years ago, as the bulk of outstanding bonds is made of legacy paper and the number of new issues has been very limited since the end of 2010," he said. "I'm not expecting that under current conditions issuance will improve, though of course anything could happen.

> "Netherlands and UK still the only active RMBS markets"

"I think eventually they will probably try a non-public way of issuing — probably through finding funding with the ECB."

Binarelli added that covered bonds were more viable because issuers could access the market more swiftly, thus enabling them to act during a brief market upturn, and because their investor base included international and domestic investors.

Market participants have complained about regulatory bias in favour of covered bonds and said that better treatment for RMBS would lead to an improved outlook.

"CRD IV indicated favourable treatment for covered bonds," Simon Collingridge, managing director, structured finance, at S&P, told The Covered Bond Report, "whereas structured finance seems to be quite heavily treated in things like Solvency II. I think investors forget that not all covered bonds are created equally and that there is actually a higher degree of transparency with RMBS."

Of 70 respondents to a poll on The Covered Bond Report website, 39 said that there is an unjustified regulatory bias in favour of covered bonds over ABS while 31 disagreed — although The Covered Bond Report's readership might be more inclined to considering any favourable covered bond treatment appropriate.

BNP Paribas' Dierick said it is very difficult to get investors to acknowledge RMBS because of the regulatory treatment they face.

"Not necessarily for insurers or pension funds," he said, "but for bank investors, in all their investments they take into account whether it counts as liquid assets."

The European Securitisation Forum (ESF) and lobbyists have approached the European Banking Authority (EBA) seeking better treatment for the asset class. ■

League Tables

EURO BENCHMARK COVERED BOND RANKING

1 January 2011 to 31 August 2011

Rank	Bookrunner	Deals	Amount (Eu m)	Share %
1	BNP Paribas	49	12,789.17	7.93
2	Natixis	55	12,343.33	7.65
3	Crédit Agricole	41	10,550.00	6.54
4	UniCredit	48	10,517.86	6.52
5	HSBC	46	10,152.02	6.29
6	Barclays	39	10,096.67	6.26
7	Deutsche	36	9,724.52	6.03
8	UBS	36	8,492.08	5.26
9	Société Générale	30	7,412.50	4.60
10	RBS	23	5,902.50	3.66
11	Commerzbank	28	5,454.58	3.38
12	DZ	24	5,390.36	3.34
13	Danske	14	4,166.67	2.58
14	ING	16	4,087.50	2.53
15	LBBW	22	4,047.50	2.51
16	Citi	14	3,710.42	2.30
17	BayernLB	14	2,876.19	1.78
18	Nomura	14	2,791.67	1.73
19	Goldman Sachs	10	2,566.67	1.59
20	BBVA	9	2,550.00	1.58
21	Santander	10	2,525.83	1.57
22	NordLB	11	2,216.67	1.37
23	JP Morgan	11	2,150.00	1.33
24	Credit Suisse	9	1,904.17	1.18
25	Banca IMI	6	1,683.33	1.04

Criteria: Euro denominated fixed rate syndicated covered bonds of Eu500m or greater, including taps

MULTI-CURRENCY BENCHMARK COVERED BOND RANKING

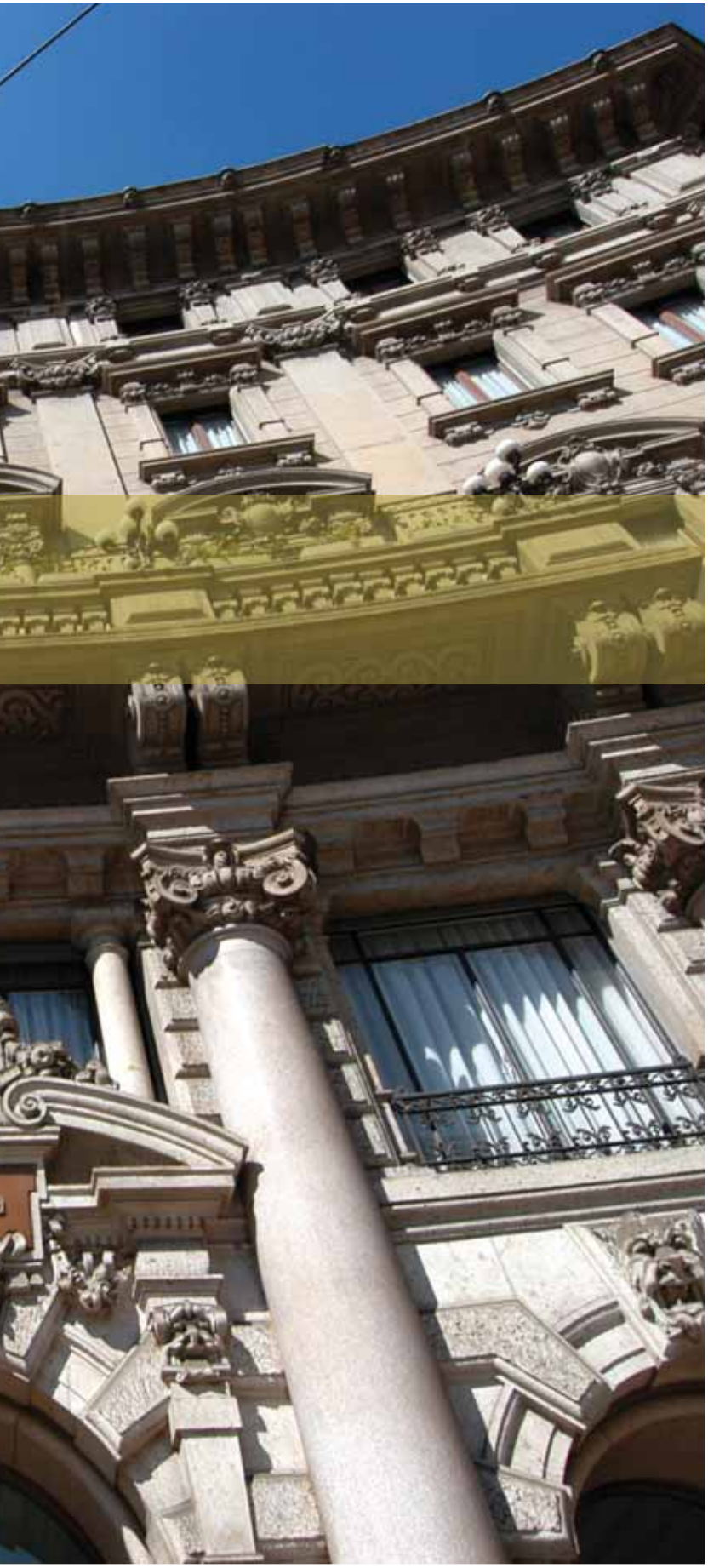
1 January 2011 to 31 August 2011

Rank	Bookrunner	Deals	Amount (Eu m)	Share %
1	BNP Paribas	56	14,451.48	7.81
2	Barclays	53	13,660.90	7.38
3	Natixis	56	12,524.17	6.77
4	HSBC	55	12,339.64	6.67
5	Crédit Agricole	41	10,550.00	5.70
6	UniCredit	48	10,517.86	5.68
7	Deutsche	39	10,220.34	5.52
8	UBS	41	10,194.51	5.51
9	RBS	30	7,892.82	4.27
10	Société Générale	31	7,631.63	4.12
11	Commerzbank	29	5,635.42	3.05
12	DZ	24	5,390.36	2.91
13	Citi	17	4,298.36	2.32
14	Danske	14	4,166.67	2.25
15	ING	16	4,087.50	2.21
16	LBBW	22	4,047.50	2.19
17	JP Morgan	17	3,685.22	1.99
18	Santander	12	3,179.35	1.72
19	Nomura	15	2,910.33	1.57
20	BayernLB	14	2,876.19	1.55
21	BAML	12	2,794.12	1.51
22	Goldman Sachs	10	2,566.67	1.39
23	BBVA	9	2,550.00	1.38
24	Credit Suisse	11	2,219.34	1.20
25	NordLB	11	2,216.67	1.20

Criteria: Fixed rate syndicated covered bonds of 500m or greater, including taps, in euros, dollars and sterling

These league tables are based on The Covered Bond Report's database of benchmark covered bonds. For further details visit our website at news.coveredbondreport.com. Please contact Neil Day on +44 20 7415 7185 or nday@coveredbondreport.com if you have any queries.

UniCredit: More than covered



A successful OBG issue in late August allowed UniCredit market access in the wake of Italy being drawn into the crisis. But although UniCredit is keen to establish further covered bond platforms, Philipp Waldstein, head of group strategic funding and portfolio at UniCredit, says that privileged treatment of the asset class should not be to the detriment of others, such as RMBS. He shared his views with *Neil Day*.

Q At the end of August UniCredit was able to sell a Eu1bn 10 year obbligazioni bancarie garantite issue, only a few weeks after bail-out fears caused panic in the Italian government bond market. Are you surprised how soon afterwards you were able to come to market?

A I have been on the road a lot, especially in 2011, continuously discussing with various investors the Italian covered bond pool in particular, and I've always noted that the impression they have of the Italian collateral is extremely high — and it has always been extremely high.

Now, I was assuming that because of the crisis people would have been put off. But in fact it turned out that they hadn't been put off, and that their positive appreciation of the Italian collateral has remained, even when the level of the crisis has increased. That's been to me the surprise: that the vast majority of the investors I have been in contact with maintained a positive spin towards us.

"If we privilege covered bonds too much, other asset classes will suffer even more"

However, it has always been clear that there is a broad range of investors out there doing a fundamental qualitative analysis, and obviously that hasn't changed. It might have even increased, because relative to other asset classes the cover pool has become even more interesting. Even in comparison to the sovereigns, it has become more interesting, because what we've seen is a sovereign crisis, not a mortgage crisis. The fact that we have been able to price the bond flat to BTPs demonstrates that in relative terms people appreciate it even more.

Furthermore, an investor called me up and said, look, it's even more impressive when you consider that if the ECB were not there for BTPs then they would be much higher, so some would consider that the deal effectively even came through BTPs if looking at the pure market level.

Philipp Waldstein: "ABS has suffered unfairly"

Q You focused there on the collateral and I guess that does reflect the way that investors are looking because — although this is a sovereign crisis — fears about Italian banks increased with the sovereign volatility, hitting their share prices and senior unsecured spreads…

A The lower share prices are, in my view, due to the sovereign exposure that the banking industry has. And in that respect it is directly correlated again to the sovereign risk. So whether you have BTPs or you have senior bonds, in the end you are exposed to the sovereign risk. If you have a residential mortgage bond, yes, the bank might default, but the underlying collateral will persist.

Q You clearly retained confidence that you would be able to do something in covered bonds. It was nevertheless quite a surprise to many people last week when you did come out with a deal only one day after the market reopened and that it did go so well. Would you have gone ahead if ING hadn't done its deal to reopen the market day before?

A I think it helped, no doubt. As I said, I stayed in contact with investors and we knew that some of them would come in. But then of course the best case is that you go on to achieve broad distribution, which we ultimately managed to get.

I think it's always a fine psychological line and obviously the fact that there has been another issue before us was a help to us. And we had no plan at all to be first. That's not the point here. Even to be second is to be in a very nice position. And so we were quite grateful, and I take my hat off to ING that they moved first. I think that was a bold move and they deserve credit for that.

Q How big a role have covered bonds played in your funding this year?

A Covered bonds to us are very strategic. We take them very seriously and we believe that covered bonds are, and will be even more so in the future a key anchor of our funding strategy.

So this year, when our funding plan is Eu32bn, we have around about 30% of our funding in covered bonds. We want to grow that to as large as 40% — we believe that is a good mix that we will achieve in the medium term.

Q Is RMBS an option for UniCredit this year?

A I don't think it's going to be an option this year. It could be next year. We believe that there is room for both segments, for covered bonds and ABS.

The ABS market has more of a branding issue than an issue of substance. Performances in Europe are very good. You find problems in the States, but European ABS is performing very well. It's more a branding issue.

Within the context of regulatory discussions ABS has suffered unfairly. My impression is that the regulatory sector is thinking of giving a reassurance in terms of regulatory signalling to the market. I think the regulator deems it necessary that ABS exists and wants to support it. They acknowledge the fact that signalling has so far not been given.

UniCredit is also working with the banking industry bodies to reposition ABS through initiatives such as Prime Collateral Securities (PCS), and I hope and expect that the regulatory side will respond to such an initiative should it prove successful.

Q In covered bonds there is the labelling initiative. Do you think this will help the asset class? If so, how?

A Labelling is an important step because at some point we need to define — from, to start with, a European perspective — what is a covered bond. That is undoubtedly a question that the investor base has. I believe the regulator is thinking about that as well. And, looking ahead, at some point there will be a legislative definition from the regulatory side. But in preparation for that, labelling, driven by the market side, is an important step to achieve ultimately a legislative branding definition, too.

Q The European Banking Authority has been charged with coming up with the criteria for defining which assets should be included in liquidity buffers. What's your view on the way in which the Basel Committee proposed that covered bonds be treated in the Liquidity Coverage Ra-

tio (LCR)? Do you think that CRD IV treatment might be more favourable?

A There is no doubt that the covered bond is the supreme asset class. However, should the other components remain unchanged, personally I believe that the current favouring of the covered bond sector is sufficient.

Should we improve the treatment of covered bonds? We can partially improve it, but if we go too far we risk affecting other asset classes. If we privilege covered bonds too much, then other asset classes will suffer even more. So — as much as I am convinced that covered bonds are the supreme asset class — we also need to be aware what is happening to senior debt, what is happening to ABS, and what is happening to government debt.

> "Wherever possible we will also set up covered bond platforms"

I understand that the covered bond industry as such is pushing forward, but I think at the end let's not forget there is already a privilege embedded — and rightly so — which is in broad terms OK.

Personally I believe that a limited portion of ABS should be included. It is a non-correlated asset class.

The prospect of ABS being included in liquidity buffers has been raised by some market participants, including a Basel Committee member. But it's hard to get a handle on whether there is a realistic prospect of that happening or if it is just wishful thinking.

It is at an early stage and it is very difficult to judge. But there is still a long way to go before we will find out the final version of the Liquidity Coverage Ratio.

And, as you say, there are clearly two lessons that have been learned: government bonds are not without risk — that is a lesson learned the hard way; and the other is that non-correlated assets, like ABS, for example, provide from a credit perspective a diversification. The liquidity component of ABS is less developed — we need to work on that — but at least from a credit perspective they merit a positive consideration.

Q The explicit link between bank ratings and the ratings of their covered bonds in rating agency methodologies ties in a correlation between the two. Are you satisfied overall with the way the rating agencies look at covered bonds and how they handle changes to their methodologies?

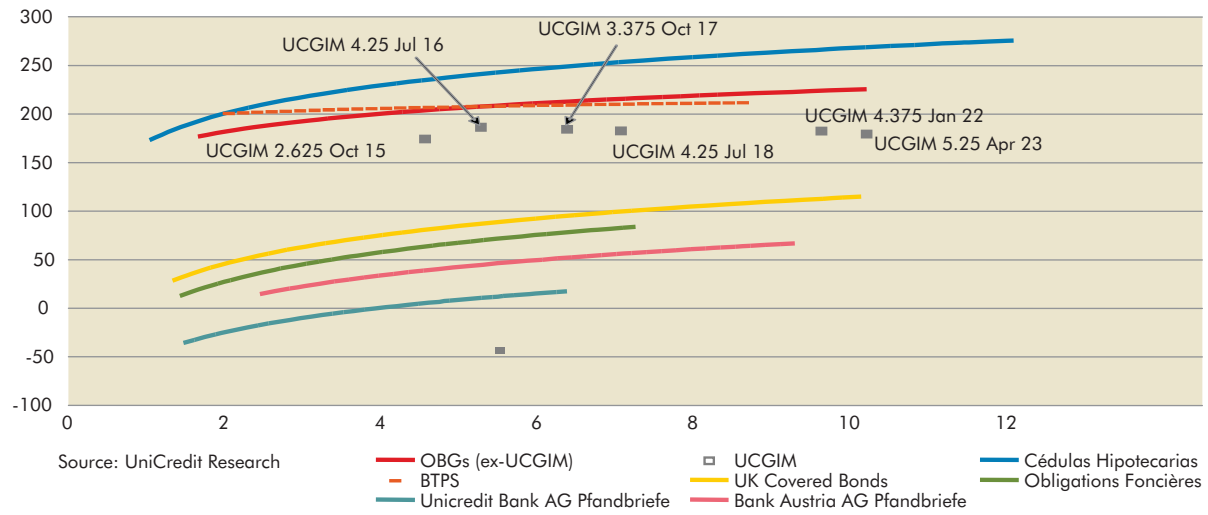
A The way that covered bonds are assessed by the rating agencies, even within Europe, needs harmonisation. Because covered bonds in Germany and in Italy are assessed a little differently in a way. So I appreciate that the rating agencies are readdressing their methodologies. Are changes always handled in the best way? I'm sure there's room for improvement. Overall I expect the agencies to conclude their work in 2012.

Q It is quite rare for one banking group to have as many different issuers as UniCredit, with entities in Italy, Germany, Austria and even Russia. Is that an advantage for you or does it pose any particular challenges?

A That is clearly a double advantage that we have. As an overall group we profit from the fact that we are partially a German bank, partially an Austrian bank, and partially an Italian bank. So from an overall funding point of view we profit from that, because we have access to all these markets and we are a credit in all these markets.

On top of that, we have the advantage of diversified covered bond access, and it is a clear competitive advantage. We are trying to maintain this and, as you say, we are gradually stretching this out across the group and wherever possible we will also set up covered bond platforms. That's not going to be in the same amount that we have seen in established markets — Austria, Germany and Italy will always be the key platforms — but you will see other ones that then operate in the local market or do smaller amounts, private placements — that is definitely a strategy that we are pursuing. ■

UniCredit OBG curve versus peers as of 18 August 2011



Raters feel the heat

With temperatures running high, rating agencies have needed to keep a cool head and stand by their decisions in the face of pressure from issuers. But could the prospect of rating agencies themselves being red carded lead to rating shopping? *Neil Day* spoke to the arbiters of credit quality.

"Rating agency bashing appears to have become a modern-day sport."

Even those who — like UniCredit analysts when they made this statement — have no grudge against the rating agencies cannot fail to have noticed how credit ratings have come to the fore in the wake of the financial crisis, often as the subject of criticism.

But whereas in several asset classes such as sovereigns and securitisation, rating agencies have been blamed for being too lenient, the loudest complaints in the covered bond market have come from issuers protesting too strict criteria in the post-crisis era.

The worsening of the sovereign debt crisis this year has only exacerbated the situation. The number of covered bond programme downgrades made by Fitch, for example, doubled from the first half of 2010 to the first half of this year as euro-zone sovereigns weakened, and rating agencies have been faced with unprecedented and unimagined scenarios (see Ratings section for more).

Rating agencies say that they are just reflecting the new reality.

"Our original covered bonds rating criteria were developed at a time of mostly — at least in Europe — stable sovereign risks," says Hélène Heberlein, managing director of covered bonds at Fitch. "But now we have to deal with a different environment in terms of sovereign credit ratings, and that has been a novel thing.

"The regulators chose to give external ratings importance"

"If you were coming from an emerging market context, maybe that would have been different, but covered bonds have been used mostly in Western Europe. We were not used to thinking about what would happen if a country were downgraded severely, for example."

The changes in ratings and methodologies that have resulted from the crisis are seen as unavoidable by the rating agencies.

"Many people obviously prefer ratings and methodologies not to change," says Karlo Fuchs, analytical manager for covered bonds at Standard & Poor's. "But a rating and the underlying criteria have to be current — that is also enshrined in regulations these days. Naturally that means that criteria might evolve over time — even if the changes might not be as significant as with the introduction of our ALMM methodology in 2009.

"Most people recognize that the environment has changed significantly over the last few years, not least with the evaporation of asset-based lending. We have to take account of these changes and of new risks that have emerged by reflecting them in our new criteria. If we had stuck with our previous way of looking at risk, we would probably been accused of fair-weather rating."

And while Moody's says that the last major review of its covered bond methodology, incorporating a more detailed cover pool analysis, occurred as far back as 2005 — and which it says

Helene Heberlein: "Now we have to deal with a different environment"

did not affect the stability of covered bond ratings — it is ready to move again should that prove necessary.

"In line with our ongoing efforts to strengthen analytical quality, when credit conditions warrant, we may revise our methodologies to capture the relevant risks," says Juan Pablo Soriano, managing director, structured finance, at Moody's.

Straight talking

Nowhere was the sport of rating agency bashing played more vigorously than when S&P revised its methodology to introduce its asset liability mismatch (ALMM) risk criteria, which introduced a formal explicit link between the rating of an issuer and its covered bonds. The rating agency must have been prepared for a rough ride — when announcing its plans it said that as many as 60% of covered bond programmes could face downgrades — but the reaction S&P's covered bond team faced clearly still smarts today.

"We understand that issuers feel strongly about the changes, but as a rating agency we have to do what we believe is right — and we have to invest time in explaining our views," says Fuchs. "We aim to be transparent to the issuers and to equip investors with the information they need in order to assess our analysis and if necessary to draw their own conclusions.

"If the changes result in an issuer cancelling its rating contract, that is something we live with."

At the heart of many complaints about S&P's methodology was a ranking of countries that affects the rating ultimately achievable by an issuer.

"You are almost stepping on the pride of certain countries when they suddenly find themselves in a category that they don't think they belong to," says Fuchs. "In challenging the classification of certain countries, we were questioning something that people have taken for granted. Emotions can run high.

"But the AAA rating is our highest rating and you have to deserve it. That is why we make sure that we are as transparent as possible about our criteria for achieving it."

Fuchs says that although S&P's classification of Sweden in its second highest category was initially seen as "totally out of whack", subsequent discussions proved constructive, Sweden's law was changed, and the country won promotion into category one.

"Superficially, covered bonds can be seen as very straightforward and simple" says Fuchs, "but as soon as you start to drill down and look into things in detail, suddenly some aspects might come up that you might not be aware of.

"So you can well argue that a disagreement is actually almost what we would like to see because a disagreement actually prompts people to think, to basically accustom themselves with what we are doing, and why we are doing something, and then they can form their own opinions."

However, S&P did not win everybody around and Fuchs acknowledges that the rating agency has been dropped by issuers as a result of its change in methodology.

Regulation agencies

Issuers might be more relaxed about ratings were some regulatory initiatives not putting even more importance on the views of the agencies. Most dramatically, Solvency II, which will affect the relative attractiveness of different assets for insurance companies in the European Union, puts not just covered bonds, and not just highly rated covered bonds, but specifically triple-A rated covered bonds in a privileged position. Similar, although less restrictive, rating categorisations are set to be embedded in the Basel III framework, too.

The rating agencies each point out that they did not ask to be put in such a pivotal position in the markets but have argued against it.

> "We understand that issuers feel strongly about the changes"

"Moody's Investors Service has long supported the objective of reducing regulatory overreliance on ratings," says Soriano. "By encouraging a diversity of credit risk measures and modifying their use in the oversight regime, we believe regulators could ensure that no individual opinion or measure causes excessive market reaction while also encouraging competition in the market for credit risk analysis."

Krishnan Ramadurai, a managing director in Fitch's credit policy group, says that the Basel II framework heralded the arrival of rating agencies at the centre of regulations in 1999.

"The regulators chose to give external ratings importance un-

der the standardised approach," he says. "It's fair to say that none of the rating agencies lobbied for that or were happy with that.

"And unfortunately, as events have shown, some institutions placed an excessive reliance on these ratings either to determine capital requirements or to use them as triggers to decide on collateral requirements in derivatives transactions."

Fuchs at S&P says that this can result in rating agency opinions having unintended consequences.

"Clearly we want to be a relevant opinion in the market — don't get us wrong," he says. "On the other hand, what we do not want is — and we say this on each and every rating letter — a rating to become a recommendation to sell or to purchase a security."

Fitch's Ramadurai welcomes initiatives among regulators, under Dodd Frank as well as in the EU, to move away from such a reliance.

Heberlein cites as an example of this trend a consultation paper released by Canada's Department of Finance in May on a proposed covered bond framework. In a section on back-up swap and service providers, the Canadian government asked: "Is there an alternative trigger for the establishment of back-up swap and service providers that does not rely on credit ratings?"

Unfortunately, when applied to the financial markets in general, the answer to this question appears to be no — or, at least: "Not yet."

"The alternative is internal ratings," says Ramadurai, "and it's fair to say, looking at the performance of these over the crisis, that there have been some issues with these. While some banks have done well, some banks have not done so well.

"So in the absence of any independent alternative, the process of moving away from a reliance on credit ratings will take time."

> "The AAA rating is our highest rating and you have to deserve it"

In the meantime, rating agencies have launched initiatives to put more of the detail of their ratings into the public domain, while their methodologies have become more explicit and transparent.

"In accordance with Moody's ongoing efforts to strengthen the transparency of the rationale supporting our credit opinion," says Soriano at Moody's, "we have introduced Moody's specific credit indicators, which provide deeper information on the key fundamentals of our ratings on covered bonds (i.e. collateral score, Timely Payment Indicator (TPI), cover pool

DBRS targets Europe — again

Undeterred by the experiences in the covered bond market of the three established rating agencies, DBRS is planning to hire analysts to help it win a share of European covered bond ratings and is hopeful that it could have rated its first programme by the end of the year.

The Toronto-headquartered rating agency released a publication, "Rating European Covered Bonds", in August that updated its methodology. Keith Gorman, senior vice president, US and European structured finance at DBRS, says that this comes as part of a push by the firm into the covered bond market.

"DBRS has established itself back in the European RMBS market and the ABS market over the last 12 months, particularly with the ECB second ratings requirement for repo eligibility," he says. "We've rated more RMBS, ABS, and SME CLO deals, particularly in Spain, Portugal and the Netherlands.

"And with this development of the platform in London, getting back into the covered bond space is just a natural progression. Most issuers we've been working with and that we've provided some credit analysis for over the last 12 months, they've shown a keen interest in us providing a covered bond rating as well."

DBRS previously started a push into the covered bond market in autumn 2007, announcing its methodology and taking on staff, but the team was disbanded with the deepening of the financial crisis. The rating agency has since then, however, rated all Canadian covered bond programmes.

Gorman, based in New York, is leading European covered bond ratings for DBRS but says that the rating agency is looking to build a team in London. He says that he expects the firm to have begun rating European covered bonds by the end of the year.

Karlo Fuchs, analytical manager for covered bonds at Standard & Poor's, says that S&P welcomes DBRS's move.

"We encourage free and fair competition because it allows investors to get different views on the same risk and enables them to determine which ratings are credible and useful," he says.

DBRS's Gorman says that the methodology update did not contain any major changes.

The rating agency previously assigned jurisdictions to different buckets as part of its rating methodology. Gorman says that the rating agency decided not to publish a new ranking in its update.

"We're probably going to publish that on a transaction by transaction basis initially, with the expectation of updating our criteria to generalise all of the jurisdictions," he says. "Because we don't have the back-testing of the outstanding ratings, we didn't feel that we wanted to initially bucket the jurisdictional assignments.

"We'd rather see how things progress, see if maybe there are any programmes within a jurisdiction that might have some strengths above the established law and if the law does develop then obviously that's an input that could change over time."

Juan Pablo Soriano: "When credit conditions warrant, we may revise our methodologies"

losses). Aggregating this data every quarter by country and per issuer outlines to investors the sensitivity of covered bond ratings, changes in the issuer rating and the loss assumptions Moody's assigns to cover pool assets."

Rating swapping

A very public falling-out between an issuer and one of its rating agencies occurred when Realkredit Danmark said in June that it would no longer work with Moody's because of fundamental disagreements over the rating agency's analysis of refinancing risk resulting from adjustable rate mortgages and hence demands for more overcollateralisation.

"The decision was taken because Moody's, as a result of its model calculations, demanded that Realkredit Danmark provide an additional excess cover of Dkr32.5bn (Eu4.36bn) if it wanted to keep its current Aaa rating," said the Danish issuer. "Realkredit Danmark has discussed the fundamentals of the matter with Moody's in order to understand the rationale behind its rating model, but has concluded that the parties disagree about the fundamentals."

Although complaints about Moody's view were widespread across the Danish mortgage industry, Realkredit Danmark's move was a more extreme action than any of its peers. BRFkredit, for example — despite facing more severe rating actions and being "surprised and confused" by Moody's — is soliciting a rating from S&P,

> "Moody's believes that rating shopping is a harmful practice"

but maintained its relationship with Moody's. Realkredit Danmark has meanwhile been reported to be considering hiring Fitch to rate its covered bonds instead — S&P already rated its issues, triple-A.

While nobody has argued against an issuer's right to choose its rating agencies, the prospect of covered bond issuers switching from one rating agency to another where they are more favourably treated raises the spectre of ratings shopping, which has haunted the securitisation market since it fell from grace. There, allegations of ratings shopping — the practice whereby ABS arrangers would solicit a rating from the agency affording it them the loosest terms — continue to stymie a recovery.

But while the threat of lawsuits and regulation — not to mention the slow pace of issuance — might have lessened ratings shopping in the US securitisation market, Fuchs at S&P says that it is becoming more prevalent in covered bonds.

"There is so much more rating shopping going on," he says. "From an issuer's perspective, why should you penalise yourself if you can achieve a higher rating somewhere else and investors do not appreciate the difference?"

Relationship counselling

Fitch's Heberlein says that it is nevertheless important to understand that issuers' relationships with rating agencies are more complex than being based solely on the rating that is ultimately awarded.

"Issuers are regularly upset by their rating agencies," she says, "but we cannot draw general conclusions every time one issuer decides not to go along with a particular rating agency after they have been rated. Obviously it's because they were not happy with something, but you cannot infer from that that they are taking another rating agency simply because they could have a higher rating or lower overcollateralisation supporting the covered bonds rating."

Heberlein says that the change could be relationship or communication driven.

"How our opinion is formed and how we explain it is probably even more important to issuers than the final rating outcome," she says.

New arrival DBRS could nevertheless find itself in the po-

sition to benefit from any dissatisfaction with the three established players. However, Keith Gorman, senior vice president, US and European structured finance at DBRS plays this down as a factor in the firm's move.

"DBRS views itself as another service provider to investors and other market participants by providing a transparent ratings approach," he said.

However, a market participant says that any new entrant into the market could face a tough time, having to choose between adopting a rigorous approach that could put off issuers and a more lenient approach that risked being viewed as a "me too" opinion.

> "DBRS views itself as another service provider to investors"

HSBC Trinkaus analysts have suggested that lower rated issuers, such as some in Portugal and Spain, might benefit from turning to DBRS. They said that while triple-B issuers might not be able to reach triple-A ratings for their covered bonds, those that are only just sub-investment grade rated could hope to achieve single-A ratings for their covered bonds.

Investors the ultimate arbiter

As an ex-auditor, S&P's Fuchs cites the example of Enron accountant Arthur Andersen, which collapsed with its reputation in tatters, as a warning to any independent arbiter of quality that puts business before integrity. In this respect, the fall-out from S&P's change of methodology is something of a badge of pride for the rating agency.

"We had a quite lengthy request for comment process and people were clearly threatening us with withdrawing their business and in the end also did so," he says, "so the fact that we were willing to actually move forward with those criteria is something that shows we didn't take that side into account in our decision.

"Our key constituency are the investors," he adds. "The issuers pay us, but we are only accepted by the market if we remain independent. Being independent, really having integrity — that is really what we are keen to do and that is what we have done."

However, Soriano at Moody's warns that developments in investors' attitudes could raise the risk of ratings shopping.

"Moody's believes that rating shopping is a harmful practice that can exacerbate the potential conflicts that credit rating agencies face as a result of being paid to provide credit ratings," he says. "A recent survey suggests that the covered bond market is becoming a one rating agency market, with approximately 70% of the investor base being satisfied with only one credit rating for a covered bond programme.

"In order to mitigate the potential for rating shopping in such an environment, extensive and widely disseminated disclosure of information is important so that investors and other market participants are placed in a position to form their own opinions and also facilitate unsolicited ratings."

Karlo Fuchs: "There is so much more rating shopping going on"

But another trend among investors cited by Soriano offers hope that issuers may feel less desperate about doing everything they can to achieve the Holy Grail of ratings. He says that according to recent surveys, approximately 30% of the covered bond investor base requires a triple-A rating, meaning that 70% can manage without the highest ratings.

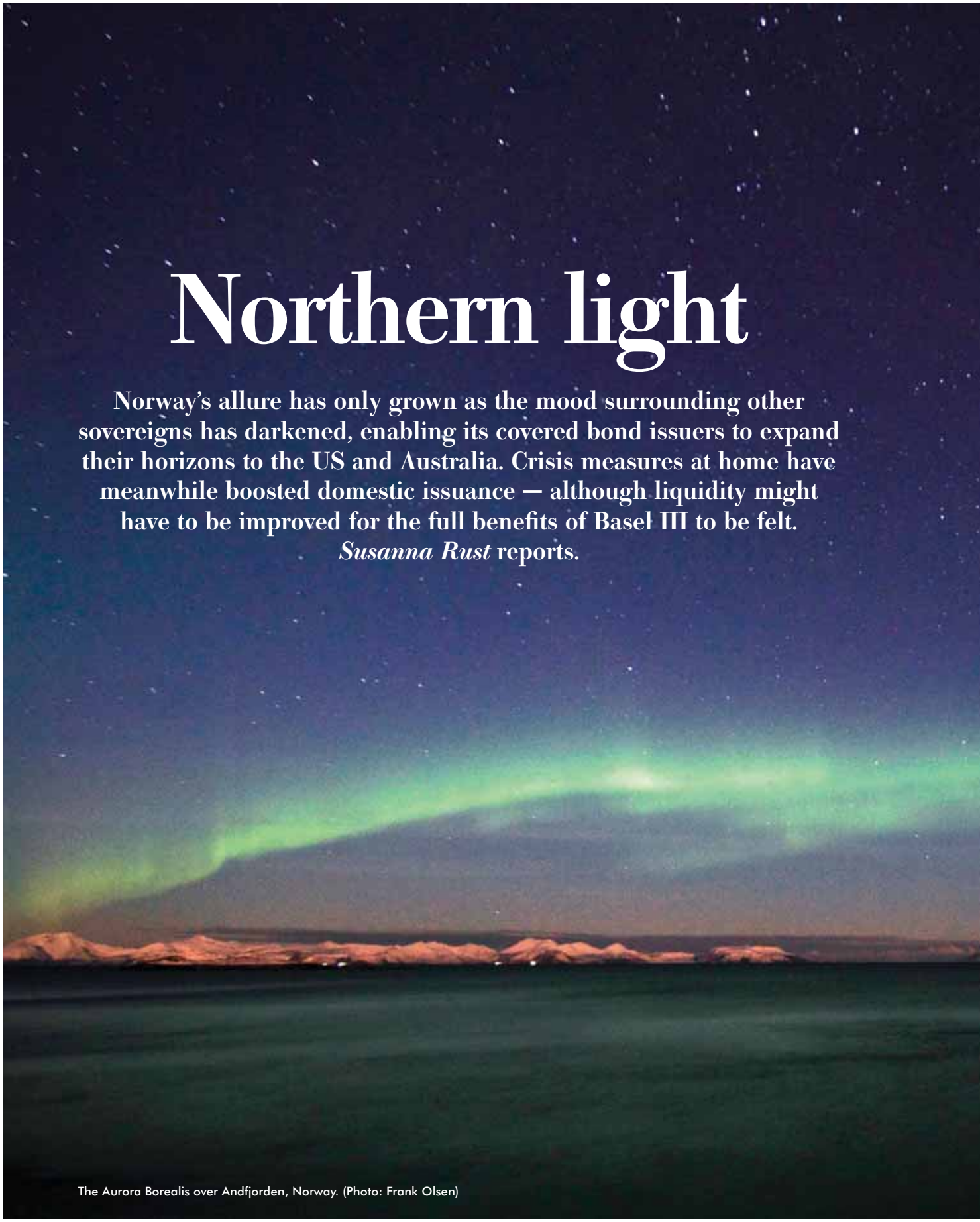
Fuchs at S&P also expects more comfort with lower ratings.

"Whereas in the past it was predominantly a triple-A product, going forward it will no longer be so," he says. "There is quite a wide rating spectrum within investment grade and that's something people might get more accustomed to.

"Double-A is still a solid investment grade rating." ■

Northern light

Norway's allure has only grown as the mood surrounding other sovereigns has darkened, enabling its covered bond issuers to expand their horizons to the US and Australia. Crisis measures at home have meanwhile boosted domestic issuance — although liquidity might have to be improved for the full benefits of Basel III to be felt. *Susanna Rust* reports.



The Aurora Borealis over Andfjorden, Norway. (Photo: Frank Olsen)

It is perhaps difficult to imagine that in 2007, when Norway became a covered bond issuing jurisdiction, some investors questioned whether it was worth opening a credit line to the country.

This was based not on a particular reluctance or concern about the quality of debt stemming from the country, but on an assessment of whether a limited supply of Norwegian debt was worth the time, effort and resources necessary to open and maintain a line.

"At the beginning, Norway was not interesting enough for some investors because we are a small country and not in the EU," says Thor Tellefsen, senior vice president and head of long term funding at DnB Nor, parent of Norway's largest covered bond issuer, DnB Nor Boligkreditt.

But the factors that might previously have caused investors to question the value of opening credit lines are the very ones that have of late appealed to accounts seeking refuge from the eurozone sovereign debt crisis and global economic uncertainty.

"All this is now in our favour," says Tellefsen.

He contrasts Norway's budget surplus with the budget deficits of other European countries in 2010, highlighting net government wealth of around 160% of GDP — thanks largely to the country's oil — and low unemployment, of around 3%.

"We've been filling our boots with the stuff."

Erica Blomgren, chief strategist, Norway at SEB in Oslo, says that the Norwegian economy and housing market are key elements supporting the country's covered bonds, especially given the state of the global economy.

"Norway has much better prospects of good growth in that you have a whole different situation in terms of the possibilities of stimulating the economy, both via interest rates but also fiscal policy," she says. "Norway is dependent on the global outlook, but arguably less so than other countries because its economy is more sheltered from abroad, with non-oil exports constituting less than 20% of mainland GDP."

Julia Hoggett, managing director, head of covered bonds and FIG flow financing for EMEA at Bank of America Merrill Lynch, identifies strong macroeconomic fundamentals, currency independence, and balance sheet strength as three main reasons why the Nordic area, in particular Sweden and Norway, is benefiting from a safe haven bid.

"There has been a step change in what markets focus on over the summer," she says. "One of the biggest is realising that we will be in a slow growth/no growth environment for some time and that we will not be able to reinflate our way out of the economic downturn quickly.

"That leads to people being exceptionally focused on balance sheet strength, including in the context of a potential downturn. It doesn't matter if you are a sovereign, a corporate or financial — it's your balance sheet that matters."

In this context investors will perceive Norway's currency independence and consequent discretion about any contribution

Erica Blomgren, SEB: "Norway's economy is more sheltered from abroad"

to assistance for distressed euro-zone sovereigns, and its positive overall balance position as strengths, she says.

Indeed, according to SEB Norwegian fixed income research the flight to safety has pushed Norwegian yields to levels where banks receive a better return by depositing money overnight at the central bank than buying government bonds with maturities of up to eight years.

Arve Austestad, chief executive of covered bond issuer SpareBank 1 Boligkreditt, says the pricing of Norwegian government debt is "abnormal", and that there is a differential of more than 150bp between government bonds and covered bonds.

"I don't think you will find many other countries where this is the case," he says.

Michael Riddell, retail fixed income fund manager at M&G Investments, provided an investor's perspective on the prevailing flight to quality bid in a Bond Vigilantes blog post at the end of July. The "quest" for a safe haven in which to park funds is "propelled by an imploding euro-zone and US politicians that are seemingly looking to bring its $14tr poker game to a spectacular finale by committing collective hara-kiri", he wrote.

Credit default swap levels indicated Norway to be the safest sovereign in the world, he noted, describing the strong bid for Norwegian government bonds, alongside German and Swedish government debt, as justified.

"Indeed, we've been filling our boots with the stuff over the past few months," he said, "and given our well documented ongoing nervousness regarding a number of sovereign states' creditworthiness, we think that there's still significant value in the safest AAA markets."

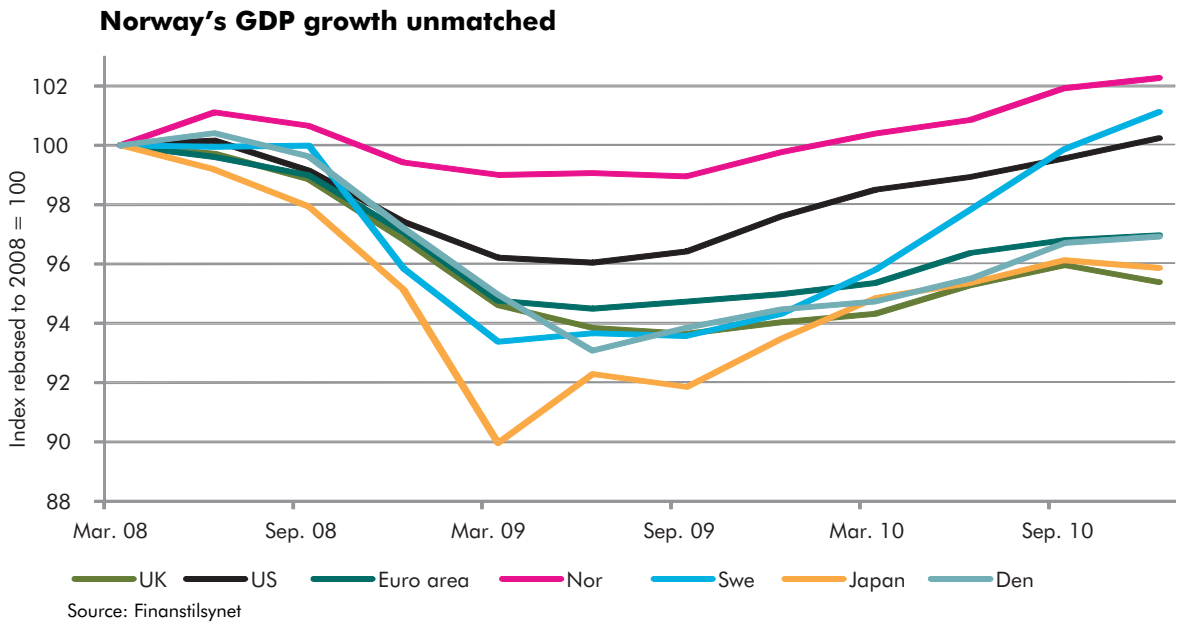
Neither US nor euro risks

The perceived low sovereign risk and strength of the Norwegian economy are also very much at the front of covered bond market participants' minds.

"The sovereign situation should not be underestimated," says Fritz Engelhard, German head of strategy at Barclays Capital in Frankfurt, pointing to the stability of Norwegian covered bond spreads in US dollars in support of this.

"Dollar denominated Norwegian covered bonds only widened by around 1bp-3bp, while French names for example all widened substantially in dollars," he says. "This shows that investors appreciate that Norway is separate from the turmoil in the euro-zone."

Three Norwegian covered bond issuers have tapped the dollar market: DnB Nor Boligkreditt, Nordea Eiendomskreditt and SpareBank 1 Boligkreditt. DnB Nor was the first to launch a



dollar transaction, in October 2010, and was followed by SpareBank 1 two weeks later. Both have since returned to the US market, in March and May this year, respectively.

SpareBank 1's Austestad says that strong financials in the underlying banks and the strength of the sovereign's balance sheet meant that when they were first launched Norwegian covered bonds "fell into the same bracket price-wise" as other Scandinavian covered bonds.

"Throughout and since the financial crisis Norwegian covered bonds have been pretty stable, and especially in this market that is attractive for many investors," he says.

While the pricing of Norwegian covered bonds has been fairly stable since 2010 in absolute terms, adds Austestad, since the spring of 2010 they have traded tighter than French covered bonds, whose spreads have widened, with the differential to Germany's Pfandbriefe narrowing.

He says that the strength of the sovereign as something of a unique selling point amid concerns over the sustainability of several euro-zone sovereigns' debt levels eased SpareBank 1's access to the US market.

"The sovereign situation helped us to exploit other markets where we would not have had the same comparative advantage, and helps us to stand out from our competition," he says. "In this environment it is more about picking the best credit exposure and at the moment Norway is in a comparatively strong position.

"Of course it is easier to get our message across now than before, and to a larger extent a distinction is now being drawn between Norway and other Scandinavian countries, while when we started issuing most investment bank analysts looked at Scandinavia as one."

Tellefsen says that DnB Nor's venture into the US required it to explain to investors that the Norwegian residential mortgage market is the "very opposite" of the subprime market in the US, but that accounts were all "very impressed" with the Norwegian economy and Norwegian issuers.

"European investors have always been interested in Norway, but for investors further away it is very helpful that Norway is so outside the euro-zone problems," he says.

"The sovereign situation helped us to exploit other markets"

This isolation also played a part in helping DnB Nor access the Australian market, according to Tellefsen. DnB Nor launched its first Australian dollar issue in May, a A$600m (Eu446m) five year deal that was also the first Australian dollar benchmark covered bond from a European issuer since the onset of the financial crisis.

"It was easier for us to go to Australia now than it would have been three years ago," says Tellefsen.

Hoggett says that Norwegian covered bonds appeal to US accounts seeking access to mortgage markets they see as correlated to the performance of economies with which they are comfortable.

"The view of Norway as one of the strongest covered bond jurisdictions is increasingly growing in the US and is cemented in Europe," she says.

Thor Tellefsen, DnB Nor: "It is very helpful that Norway is so outside the euro-zone problems"

Housing market heats up

If the case for Norwegian covered bonds, at least from a fundamental credit perspective, seems rather one-sided, then this boils down to their strengths outweighing their weaknesses, according to market participants.

A research piece on Norwegian covered bonds published by Barclays Capital lists among relative weaknesses an absence of mandatory overcollateralisation in the Norwegian framework and a lack of transparency rules. But Jussi Harju, vice president, covered bond analyst at Barclays Capital, says that these weaknesses veer towards being academic, and are in practice often mitigated. So while the Norwegian legislation does not include transparency rules, Norwegian issuers in practice provide good disclosure, with the website of the Norwegian Covered Bond Council also useful in this regard.

And while some analysts have argued that investors holding Norwegian covered bonds do not have recourse to the larger, parent banks of an issuer because the latter is a specialist entity, Harju says that this is more of a theoretical concern.

"Given that the mortgage business is the core business of the parent bank there is a pretty low chance of it walking away from the covered bond issuing entity in times of stress given that it provides the bulk of funding for its core mortgage

Arve Austestad, SpareBank 1: "It is easier to get our message across now than before"

business," he says. "The incentive to step back from the programme is rather marginal."

SEB's Blomgren says that the stability in house prices in Norway over the past years could raise the question of whether this lack of a correction could be a risk for the covered bond market, but that the answer would be negative on account of healthy overcollateralisation levels and prevailing loan-to-value ratios, and the options available to policymakers to prevent a collapse in house prices should the need to do so arise.

Property prices in Norway have been rising. In a presentation on supervision and macroeconomic surveillance in Norway delivered in July, Emil Steffensen, deputy director general at Finanstilsynet, said: "House price inflation and household indebtedness in the current low interest and low unemployment environment is the most important financial stability issue in Norway, besides challenges related to the sovereign debt problems in Europe."

Blomgren says that the rise in house prices has so far been addressed by Finanstilsynet at the beginning of 2010 introducing guidelines that mortgage financing should not exceed a loan-to-value of 90%.

"This is one way to control the rise," she says, "in additional to hiking interest rates, which are very low at the moment."

According to Steffensen's presentation, the results of a survey of mortgage financing and LTV guideline compliance scheduled for August would be followed by a decision about whether stricter regulation or tighter guidelines are necessary.

Barclays' Engelhard notes that the housing market could be the source of some concern about a potential overheating, but says that in his view there is no imbalance to be worried about.

"Norges Bank has already started to increase interest rates to deal with the situation of too cheap funding, but overall we do not think there is a real disequilibrium," he says. "The rise in prices reflects some scarcity, and that the Norwegian economy is pretty isolated from the heavy ups and downs of the global economy.

"It's really difficult to find any serious weak-spots," he adds, "and that's what makes Norwegian covered bonds so attractive."

Hoggett at Bank of America Merrill Lynch says that the overall picture for Norwegian covered bonds is positive.

"In the context of a slowing global economy the performance of Norwegian mortgage assets is very good," she says. "Their nature and behaviour seems to be relatively stable so I don't see a reason to think of Norway as anything other than a very good place on which to be focussed."

Domestics boosted post-swap scheme

According to Kristian Fiskerstrand, funding and risk management at Terra BoligKreditt, the biggest developments in Norwegian covered bonds over the four years since the legislative framework was launched have arguably taken place in the domestic market.

"On the international level, especially in Germany, investors were already familiar with covered bonds, but in Norway it was a completely new market," he says. "There are more investors in the product now than a few years ago, and, with the Basel III regulations, banks that used to buy senior unsecured debt are now buying covered bonds instead, so that is providing more liquidity to the market."

Terra, for example, has in the past year been able to issue domestic covered bonds in larger sizes than previously, and has been taking advantage of this, says Fiskerstrand.

"We have raised Nkr5.9bn (Eu760m) in the domestic market so far this year, including one five year issue of Nkr3bn, with this issuance replacing our euro market activity for the first half of the year," he says.

SpareBank 1 has also been more active domestically, according to Austestad.

"Since August-September 2010, volumes have been picking up," he says.

Key to the development of the domestic covered bond market was a swap scheme introduced by the central bank, Norges Bank, in October 2008. This allowed covered bonds (obligasjoner med fortrinnrett, OMFs) to be exchanged for Treasury bills in a bid to alleviate liquidity problems facing Norwegian banks at the time.

A Norges Bank Economic Bulletin from November 2010 said that the arrangement "greatly increased" covered bond issuance, boosting the growth in the number of specialist mortgage companies authorised to issue the product. Before the scheme was introduced there were seven such entities; now there are 24 covered bond issuers registered with Finanstilsynet.

SEB's Blomgren says that the arrangement was essential in kicking off the domestic Norwegian covered bond market, with

around Nkr230bn of a possible Nkr350bn issued under the scheme.

And DnB Nor's Tellefsen says that the size of the swap scheme, at around Eu45bn equivalent, compares favourably with a Eu60bn covered bond purchase programme launched by the European Central Bank in July 2009, in that it shows "the willingness and ability of the central bank to buy Norwegian covered bonds".

The last auction under the swap arrangement took place in October 2009, as improved market conditions and increased minimum prices for participating in the swap scheme made it cheaper for issuers to return to the public markets. The swap scheme will be fully phased out in September 2014 by the latest, with around Nkr180bn of covered bonds up for redemption by then, mostly in 2013 and 2014, according to Blomgren.

The phasing out of the swap scheme is likely to take place smoothly, according to market participants. Barclay's Harju says that the central bank is addressing refinancing risk stemming from the end of swap periods by introducing early termination options for participants to entice them to exit the scheme gradually.

"So far there seems to be rather good take-up of this option," he says. "We don't expect a massive avalanche of supply to come along."

SEB's Blomgren expects that most of the covered bonds coming up for redemption under the swap arrangement will be refinanced in covered bonds, with the focus mainly on the domestic market, which will be able to absorb the supply. She also expects a shift away from floating rate covered bonds — which represent 60% of the total outstanding stock due to the format being eligible for the Norges Bank swap scheme — to fixed rate issuance, a development also noted in the Norges Bank Economic Bulletin report.

The central bank noted that, according to market participants, it has been difficult to issue floating rate Norwegian krone covered bonds with a maturity longer than five years, with key investor groups such as pension funds and life insurers preferring to invest in bonds with long maturities and fixed coupons.

> "Issues of fixed rate NOK denominated OMFs will become more common in the future"

"This may mean that issues of fixed rate NOK denominated OMFs will become more common in the future," it said.

Larger Norwegian issuers may also turn to the international market to refinance covered bonds maturing under the swap scheme, according to market participants. The Norges Bank report said that a "substantial proportion" of the covered bonds used in the swap arrangement are expected to be refinanced in a foreign currency, with Blomgren and Fiskerstand also saying they expect bigger issuers to tap the foreign markets.

Market participants say the outlook for the domestic Norwegian covered bond market is good, supported by increased demand triggered by discussions about making senior unsecured debtholders shoulder part of the cost of rescuing distressed banks, and a decision by Norway's central bank to no longer accept senior unsecured bank debt as collateral for repo from February 2012, with covered bonds remaining eligible.

Jussi Harju, Barclays Capital: "There is a pretty low chance of the parent bank walking away"

Liquidity improvement plans

Also relevant to the future of Norwegian krone covered bonds is how they will be treated under liquidity buffer rules in the Capital Requirements Directive (CRD) IV, which will implement Basel III regulations. Although outside the European Union, Norway, as a member of the European Economic Area, is obliged to implement all financial directives and regulations in line with implementation in EU member states.

Under CRD IV proposals released by the European Commission in July, the European Banking Authority (EBA) will have final say over which asset classes will be eligible as level one assets —facing no limits or haircuts — and level two assets — which will only be able to comprise up to 40% of a bank's liquidity buffer and face haircuts of at least 15%.

The decision is particularly important given the low volumes in Norway of government debt, which under the Basel Committee's framework are the main level one liquid asset. Indeed, Finance Norway (FNO), a Norwegian banking association, in autumn 2010 put its name to a proposal drawn up by Danish and German banking associations that would remove a cap on covered bonds in liquidity buffers and lower haircuts for some

Julia Hoggett, Bank of America Merrill Lynch: "The performance of Norwegian mortgage assets is very good"

parts of the asset class.

However, the Norwegian central bank has discussed the possibility that Norwegian covered bonds might not even qualify as level two assets.

"For Norwegian OMF covered bonds to be included as Level 2 assets, the Norwegian covered bond market needs to become more liquid," said Norges Bank in a Financial Stability Report in May. "Measures by both market participants and the authorities can help to bring this about."

The Norwegian Covered Bond Council is very focussed on improving liquidity in the domestic market, according to Helge Stray, chairman of the council and director, rating and funding, at DnB Nor Boligkreditt.

"Discussions are somewhat premature, but the first step is to obtain a more liquid market, more Norwegian krone issuance," he says. "Both Norwegian krone domestic issuance and secondary trading in NOK covered bonds have increased significantly in the last year, but there is still room for further growth.

"A second step would be to discuss market-making agreements, etc, but for the moment we are waiting for volumes to increase further."

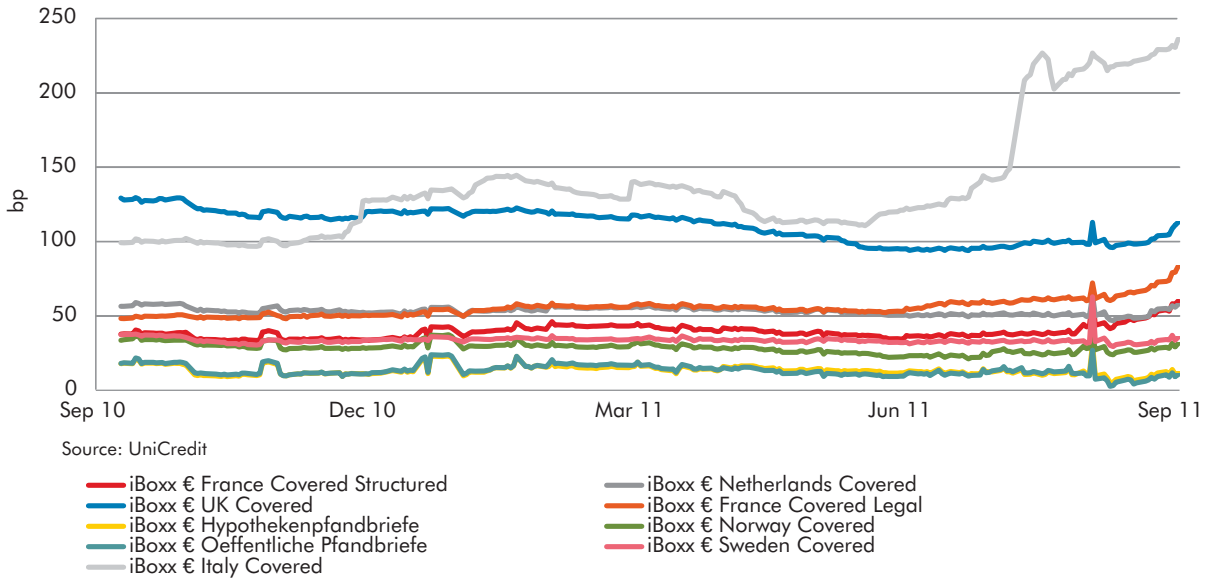
Other measures identified in the Norges Bank report as potentially contributing to greater liquidity include issuers seeking to increase the volume of individual bonds, and the relevant authorities repealing a regulation (Issue Regulation) that the report describes as placing certain limitations on the issuance of bonds at a discount.

"When market rates rise, this may prevent issuers from extending existing bond series, preventing the bond issuers from becoming large enough to be attractive for trading in the secondary market," it said.

While any improvements in liquidity may contribute to a more favourable assessment of Norwegian krone covered bonds by the EBA in its work on liquid assets, the Norges Bank report also refers to Basel III regulations proposing alternative treatment for financial institutions in jurisdictions with an insufficient supply of liquid assets in their domestic currency.

"It is reasonable to assume that Norway will be eligible for alternative treatment," it said, pointing out that outstanding government securities, excluding the amount of T-bills in the swap arrangement, stood at around 14% of GDP in 2010. ■

Norway's spread performance versus peers



The Covered Bond Report

The Covered Bond Report is not only a magazine, but also a website providing news, analysis and data on the market.

The Covered Bond Report is the first magazine dedicated to the asset class. If you are an investor or issuer with an interest in covered bonds, then your subscription to *The Covered Bond Report*'s magazine is free.

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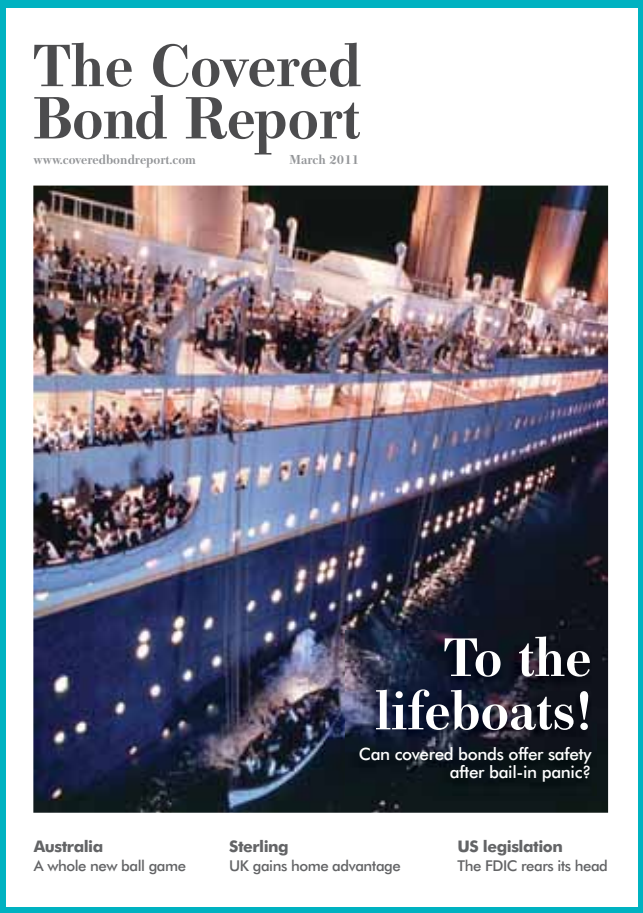
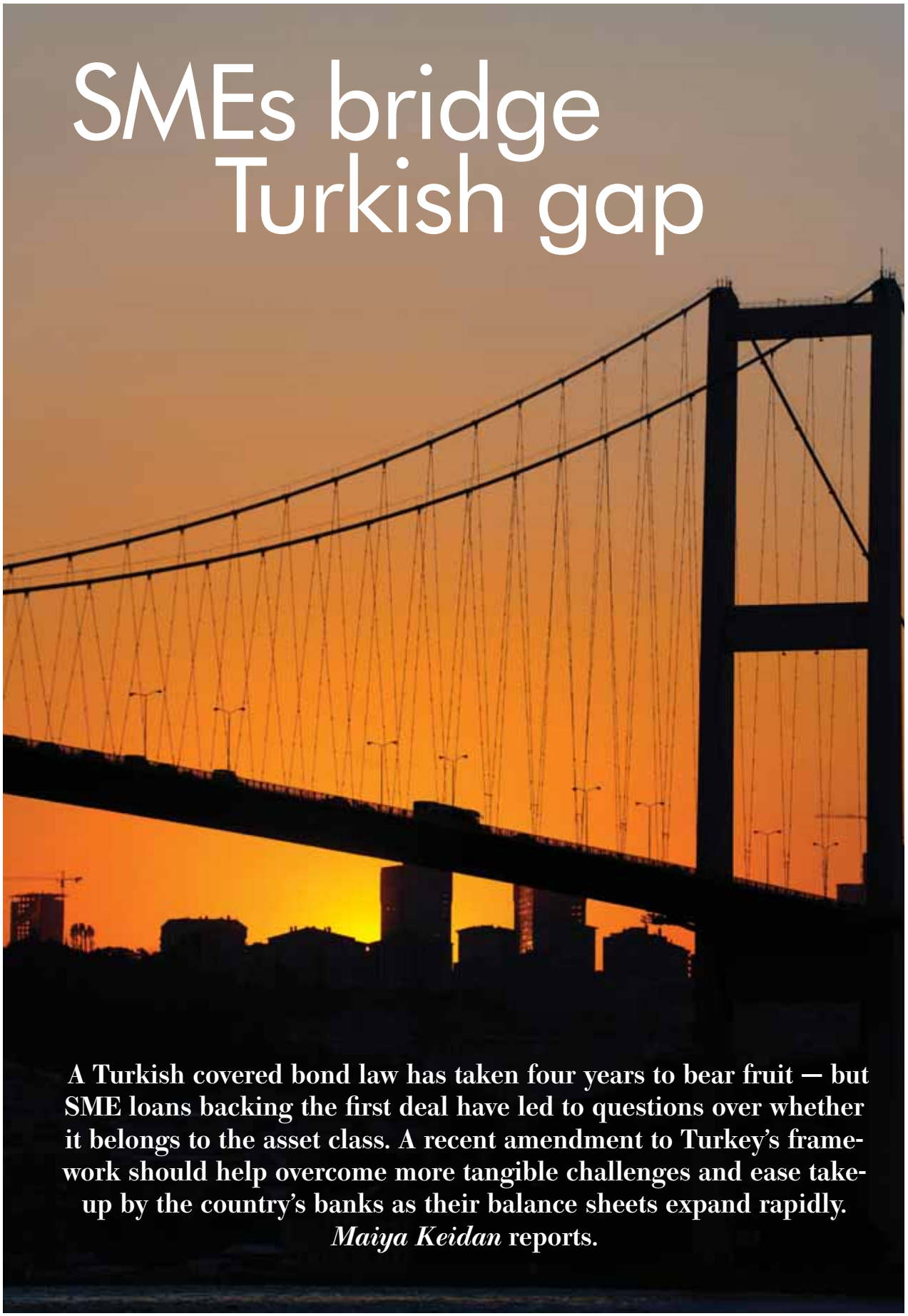


SMEs bridge Turkish gap



A Turkish covered bond law has taken four years to bear fruit — but SME loans backing the first deal have led to questions over whether it belongs to the asset class. A recent amendment to Turkey's framework should help overcome more tangible challenges and ease take-up by the country's banks as their balance sheets expand rapidly. *Maiya Keidan* reports.

Turkey rolled out covered bond legislation four years ago, but those awaiting a first issue have had to be patient, with the debut Turkish covered bond not having been launched until this July. However, they might not have to wait long for a second.

Şekerbank inaugurated the asset class by selling covered bonds totalling around $125m equivalent to three international investors. The bank aims to follow this up with a second tranche of issuance in the autumn off a TL800m ($473m/Eu327m) programme.

Ali Küçükcan, vice president in the financial institutions department at Şekerbank, says that the bank plans to sell a second issue, of around TL400m, comprising around three to four series, in September or October, and aims to place that trade with more international financial institutions. Separate series of bonds will be again issued for each investor under the main programme structure, he says.

The first trade went as expected, says Küçükcan.

"It was parallel to our plans," he says. "We are happy to sign the issuance for the first tranche as planned."

Three investors bought the first series — arranger UniCredit, the International Finance Corporation, and Dutch development agency FMO. The bonds were priced at between 200bp and 250bp over Libor/Euribor and the maturity varied from one to five years, depending on the investor.

David Barwise, partner at White & Case, says one of the reasons why it took so long for a first Turkish covered bond to come to market was the question of how to deal with currency exposure.

"International investors like to be paid in euros or dollars," he says. "Obviously, a Turkish lira denominated transaction was not going to appeal to everyone.

"Şekerbank was the first issuer to market for this type of issuance, so other banks now have a precedent as to how particular things are done," he adds.

Moody's assigned the covered bonds a rating of A3, which Şekerbank's Küçükcan says is the highest rating awarded any structured transaction from Turkey.

With its debut, Şekerbank took advantage of a near four year old law that provides for two separate regulations, one for asset backed covered bonds (ACBs) and one for mortgage covered bonds. Şekerbank's programme falls into the asset backed category.

But is it a covered bond?

While Şekerbank's deal showed that asset backed covered bonds are viable, it prompted some market participants to call into question whether the debt instrument deserved to belong to the covered bond asset class.

The first aspect of the covered bond that was called into question was the cover pool, which comprises loans to small and medium sized enterprises.

"Any small and medium sized enterprise loan backed covered bond is not a traditional covered bond," says a covered bond analyst. "Traditional assets are mortgages, public sector loans, maybe shipping, but not small and medium sized loans.

"I'm not sure that's a covered bond."

Leef Dierks, head of covered bond strategy at Morgan Stanley, also says that there have been doubts over the categorisation of Şekerbank's deal as a covered bond.

"The market purists would definitely say it is not a covered bond," he says. "The collateral pool is not what the typical covered bond investor sees as attractive."

However, José de León, senior vice president at Moody's, says Şekerbank's issue was easily identifiable as a covered bond.

"It was very easy to define," he says. "The notes issued by the bank are on balance sheet, they have full recourse to the issuer, and they are secured by a pool of SME loans."

De León says that he has had trouble understanding why the deal's status has been called into question, particularly given that the deal is governed by the Turkish covered bond law.

"Şekerbank decided, because they wanted to refinance their SME loan portfolio, to use the law that is in place for asset covered loans," he says. "In most jurisdictions you have only two possibilities — either mortgage loans or public sector loans — backing your covered bonds, so it's good for Şekerbank that it has another opportunity to refinance its portfolio."

Despite the ongoing debate over whether the traditional covered bond label should be applied, market participants were positive about the Turkish development.

> "The market purists would definitely say it is not a covered bond"

"From what I can tell, this is a very encouraging sign," says Dierks at Morgan Stanley. "What I like is that we see an ongoing shift toward newer legislation in places like Canada, New Zealand and Turkey.

"It's clear the Turkish covered bonds do not compete with the Pfandbrief, but you still get a sense that covered bonds are gaining ground around the world."

Tweak lifts funding promise

And — like them or not — more ACBs could be on their way due to recent amendments to the Turkish covered bond framework that have eased the way for Turkish issuers. According to Turkish law firm Eryürekli Law Office, the amendment, published in the government's official gazette dated July 20, has diversified the potential issuer base for ACBs and brought in new investor protection measures.

A specialist at the Capital Markets Board (CMB) of Turkey, Eser Şagar, is positive that the amendment could help the market develop further.

"I think interest in covered bonds is not dependent on the recent amendment," he says, "though it has dealt with some of the problems that hindered the growth of covered bond issuance.

"It has mainly made issuance clearer, so it may have a positive effect — but the main factors driving issuance are the state of the economy and interest rates."

Key aspects of the CMB amendment:

- Factoring companies are included in the list of entities that may issue ACBs and thus, have obtained an additional funding option for their activities. In line with the above, receivables arising from all type of factoring transactions has been classified as cover assets for ACB offerings conducted by factoring companies.

- The Amendment has envisaged that cash flows arising from redemption of cover assets shall be deposited in the name of the investors with a separate bank account in case the issuer violates cover matching principles or fails to fulfill its obligations arising from ACBs. The principle stating that the net present value (the "NPV") of cover assets must at all times be at least 2% more than the NPV of the ACBs has been revised to reflect the risk of different types of cover assets. Under the new framework, the minimum positive difference between the NPVs of cover assets and of the ACBs has been increased to a range up to 8%-46% depending on the type of cover assets. The Amendment also authorises the CMB to revise these percentages where it deems necessary and thus create flexibility for adaptation to the changes in economic conditions.

- The Amendment has paved way for the issuer to use cash derived from the redemption of cover assets, provided that the redeemed assets are replaced with new assets, cover matching principles are in no way violated and the issuer is not in failure to fulfill its obligations arising from ACBs.

- The CMB is entitled to authorise Investor Protection Fund for conducting an administrative liquidation process (i.e. an accelerated and cost efficient way of liquidation) for a cover pool in the event that (i) the issuer fails to fulfill its obligations on due date, (ii) the value of issuer's liabilities exceeds the value of issuer's assets, (iii) the management control of the issuer is transferred to governmental authorities, (iv) operation license of the issuer is revoked, or (v) the issuer is suffering from bankruptcy.

- The Amendment, in line with the above defined revisions, have attributed new responsibilities to the cover monitor (i.e. independent audit company) which shall be appointed for the supervision of the cover register and cover pool.

Source: Eryürekli Law Office

Wasif Kazi: "Changes have clarified a few issues that were not in the original legislation"

Şagar says that the CMB has heard via advisory firms of further interest in the issuance of asset covered bonds. However, there have not yet been further applications to issue.

Rapid growth in Turkey's banking system might suggest that the country's banks would be keen to develop the new funding source. In the first six months of this year alone lending by Turkey's banks grew by 18%, according to data from the country's Banking Regulation & Supervsion Agency (BDDK) (see chart).

And when the amendments to Turkey's legislation were published, Moody's commended them for helping to diversify banks' funding sources.

"As issuance of covered bonds in Turkey is in its infancy, the legal amendments are a favourable development for the banking system's funding profile, which consists primarily of short term deposits," it said.

Moody's noted that these deposits, which account for 56% of balance sheets and with 85% maturing within three months as of the first half of 2011, constrain the development of longer term loans and their affordability.

> "Issuance of covered bonds in Turkey is in its infancy"

"Further diversification into longer term funding sources will reduce the maturity mismatch between short term liabilities and long term assets," said the rating agency. "Additionally, the reliance of covered bonds on on-balance sheet assets, for which credit risk remains with the issuing bank, encourages the banks to maintain sound risk management and lending practices as banks grow their loan books."

Moody's said that the amendments are credit positive because they raise minimum overcollateralisation levels and mitigate commingling risk and a risk of servicing disruptions. Under the new rules, the minimum overcollateralisation was raised from a statutory obligation of 2% to 8%-46%, depending on the asset class.

"The new rule mitigates the risks that overcollateralisation levels will decline without remedy and that the issuer commingles the covered assets' cashflows with its other assets," said Moody's.

(See box for a fuller list of amendments.)

Wasif Kazi, director, structured capital markets at UniCredit, says the amendment had clarified several issues that arose during Şekerbank's transaction. UniCredit was arranger and an investor in the issue.

"One of the changes, which is helpful in the amended legislation, is that it clarifies that the CMB would have the right to appoint a servicer specifically for the asset pool in the event of issuer bankruptcy," he says, "which should be helpful with the rating of future covered bonds.

"We did have a long dialogue with the CMB and these changes have clarified a few issues that were not in the original legislation."

While mortgage lending in Turkey has grown strongly, an issuer has yet to launch a mortgage backed covered bond. Şagar, suggests that while mortgage covered bonds are more in line with traditional standards, they may be harder to issue than ACBs.

"The mortgage backed covered bond legislation is much stricter," he says. "I think the issuers have to create strict portfolios and that will take time."

No guarantee of follow-up

Batuhan Tufan, vice president of Garanti Bank, welcomed Şekerbank's transaction but says his bank will not be following Şekerbank's lead anytime soon.

"We've been having discussions for a very long time," he says. "We know the product very well and the feedback we've learned from the market is that investors would still price a Turkish covered bond wide of the Turkish sovereign.

"Garanti has had several preparations internally but the ultimate conclusion is — given the uncertainty of the ratings, lack of local investor demand, proper commercial investor demand, and the uncertainty in the financing cost — we will probably keep this project running in the background but we will not be taking action sometime soon."

Ali Küçükcan: "It was parallel to our plans"

Tufan says he knows of other banks preparing for covered bond issuance behind the scenes, but questioned whether they could come to the market.

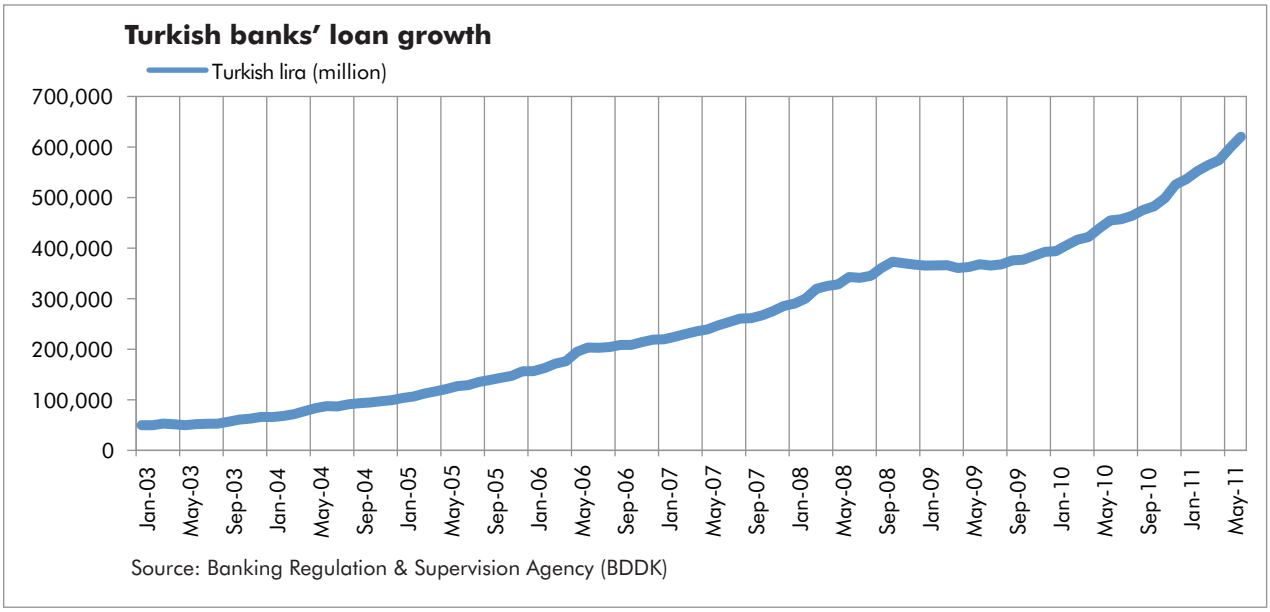
"I think banks will still choose to go on the unsecured financing market before actually looking at the covered bond space.

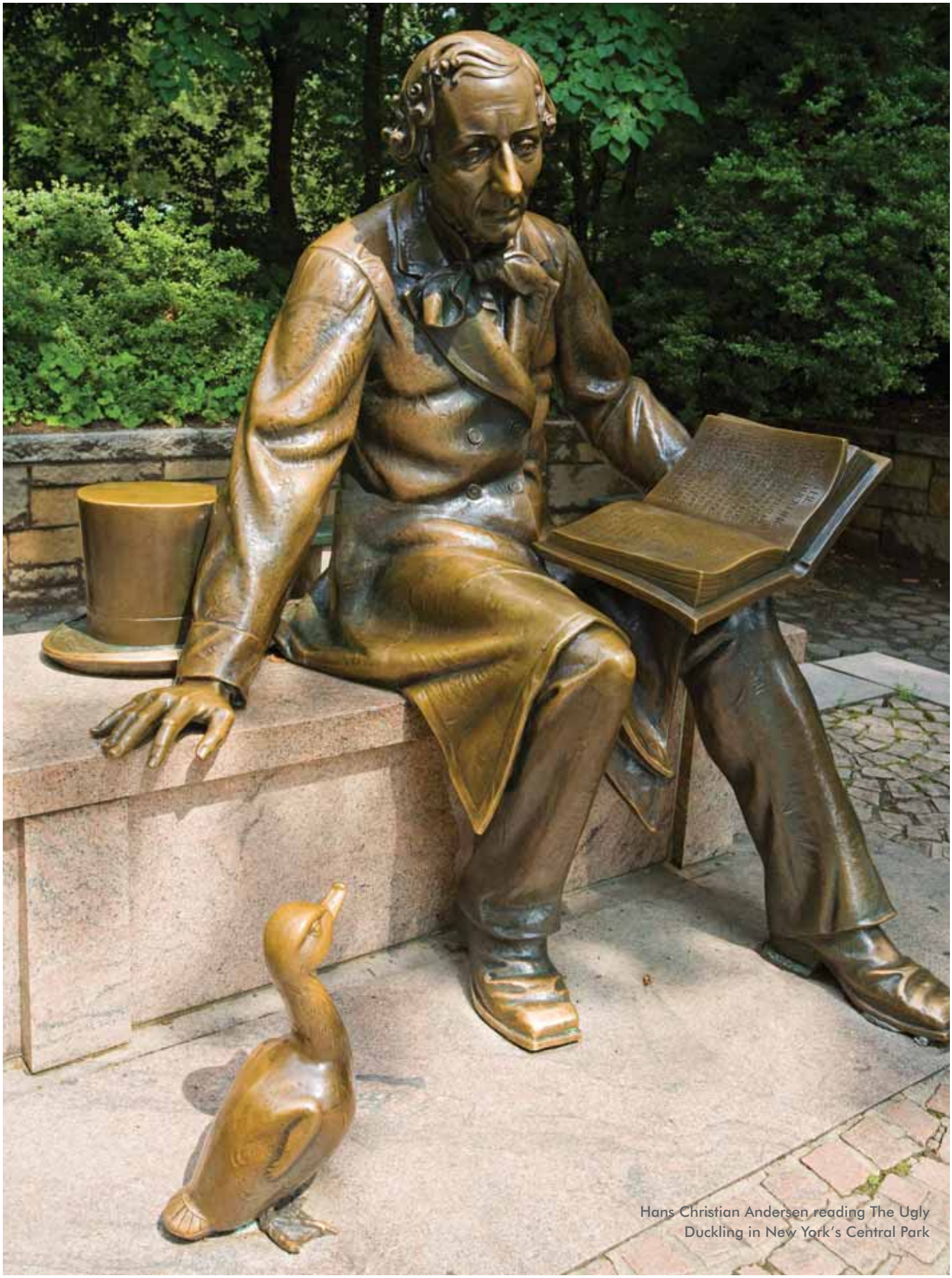
Other market participants were more positive about the potential for further issuance.

Asked whether he believed more issuance would be forthcoming, Fazel Ahmed, managing director, structured capital markets at UniCredit, replies: "An emphatic yes."

He does not expect Şekerbank to be a one-off, with other potential issuers also looking into the product.

"Over time," says Ahmed, "it is likely that the market will develop a multitude of issuers." ■





Hans Christian Andersen reading The Ugly Duckling in New York's Central Park

Has the market got Denmark wrong?

A tough Danish stance on bail-ins in the midst of a banking crisis has had unintended consequences for Denmark's covered bond issuers. But RBS senior analyst Frank Will argues that the doomsday scenario some market participants are painting is overdone — as long as the Danes can rise to the challenge.

Over the last few months, there has been an awful lot of negative news surrounding the Danish banking sector: the bail-in discussion after the default of Amagerbanken and Fjordbank Mors; Standard & Poor's saying that another 15 Danish banks could default; Moody's downgrades of several Danish banks and its tougher stance on refinancing margins; concerns about the state of the Danish economy and the stability of its housing market; plus regulatory concerns. The latter point includes questions about the eligibility of Danish covered bonds under CRD IV if house prices fall, as well as issues surrounding the high share of adjustable rate mortgages, which would become problematic under new Basel III liquidity rules. To make things worse, investors are concerned about the periphery exposure of issuers such as Danske Bank.

Does this mean investors should avoid Danish covered bonds at all costs?

Given the list of problems, there is no doubt that investors need to be cautious, but we think that the market is probably too negative on the sector, painting a doomsday scenario for Denmark.

Investors should take into account that the Danish banks benefit from exceptionally strong domestic demand and a unique mortgage market model. The government has approved the new Bank Package IV, which will offer alternatives to the infamous haircuts of senior unsecured debt when a bank becomes insolvent. Moreover, the Danish regulator has made clear that under its insolvency rules, secured investors, including covered bonds and junior covered bondholders, would not be subject to any regulatory writedowns. And even Moody's has recently reiterated that Denmark continues to have "one of the strongest covered bond frameworks in Europe".

> "One of the strongest covered bond frameworks in Europe"

A brief history

The Danish covered bond market is one of the largest in Europe, second only to the huge (but shrinking) German Pfandbrief market. The origins of Danish covered bonds date back to the Copenhagen Fire of 1795. The total outstanding amount is around Eu340bn equivalent. The vast majority of Danish covered bonds are denominated in Danish kroner and only a small portion is issued in other currencies.

Until the implementation of the Danish Act of 2007, only mortgage banks were allowed to issue mortgage bonds/covered bonds. The new law was designed with the twin objective of enabling commercial banks to issue covered bonds to fund mortgage loans and ensuring that all Danish banks could issue bonds that fulfil the requirements of the new EU Capital Requirement Directive (CRD). Due to these regulatory changes, there are now three different types of mortgage bonds in Denmark: RO, SDRO and SDO (see table 1).

Bail-ins and rating pressure

One of the main reasons for negative investor sentiment towards Danish banks has been a much discussed new bank resolution scheme in Denmark also known as "Bank Package III".

The Bank Package III came into force in September 2010 when a full guarantee on Danish bank deposits and senior debt expired. Since then, "at the point of insolvency" a bank can decide to use either a new Orderly Liquidation Framework or existing legal framework for insolvency. If the ailing bank chooses to use the Orderly Liquidation Framework, then assets and liabilities are transferred to Finansiel Stabilitet, a subsidiary of the Financial Stability Company. Senior unsecured investors and depositors (beyond a Dkr750,000 threshold) could then become subject to debt writedowns.

Importantly, mortgage and covered bond investors are explicitly excluded from such debt haircuts.

In February 2011, Amagerbanken was the first bank to use the Orderly Liquidation Framework. The senior unsecured debt holders and depositors (beyond the Dkr750,000 threshold) of the small Danish lender suffered a 41% write-down. In June 2011, Fjordbank Mors became the second Danish bank to choose the "bail-in" framework rather than use the insolvency law. Senior unsecured creditors and unguaranteed deposits were subject to a 26% haircut. In both cases covered bond and mortgage bond investors were not impacted.

The rating agencies responded by reducing their government support assumptions for Danish banks.

In May 2011, Moody's downgraded six Danish banks, citing a reduced expectation of systemic support in the aftermath of the default of Amagerbanken and the subsequent losses for senior unsecured investors. The systemic uplift for the smaller banks was removed, whilst the rating uplift for larger players such as Danske Bank, Jyske Bank and Sydbank was reduced to one notch.

> "In S&P's opinion, Denmark's banking crisis is not over yet"

Moody's also increased refinancing margins and lowered the timely payment indicator (TPI) from "very high" to "high" for many Danish covered bond programmes. In addition, the agency took negative rating actions on covered bonds issued by two Danish banks and withdrew the ratings on one programme. Nykredit Realkredit's Capital Centre D was downgraded and three of BRFkredit's programmes were placed on review for downgrade. Moody's also withdrew its rating on Realkredit Denmark's covered bonds.

At the end of August, the government announced that it will identify those Danish banks that are of systemic importance. The list should, in our view, include at least Danske Bank, Nykredit, Jyske Bank and Sydbank. Moody's has already stated that this will not change its view on the likelihood of systemic support, but the announcement should have a positive effect on the standalone strength of systemically important banks.

Government backs down

At the end of July, S&P stated that it is gradually becoming apprehensive about the riskiness of Danish banks. In S&P's opinion, Denmark's banking crisis is not over yet and around 15 banks could default, due to boom year loans made to the commercial property and farm sectors. Since the financial crisis started in 2008, 11 banks have already defaulted. S&P believes that the gross losses due to additional bankruptcies of Danish banks could reach up to Dkr12bn (c. Eu1.6bn) over a three year period. While the number of banks at risk looks scary, S&P's estimate of potential losses underlines that only tiny banks are at risk.

However, S&P made it clear that it would reassess its ratings on individual Danish banks if the losses are larger than expected. All Danish banks currently rated by S&P are regarded by the agency to be systemically important. S&P expects that those banks may therefore "receive extraordinary government support, beyond that defined in the country's established bank resolution scheme". Here, we agree with S&P and believe that large players such as Danske Bank and Nykredit would be treated differently to the likes of Amagerbanken and Fjordbank Mors.

In response to the concerns of both investors and rating agencies, the Danish government has somewhat softened its previous tough stance and set up a new Bank Package IV. The package has been agreed by the major political parties in Denmark but awaits passage into law, which is not envisaged before a general election on 15 September.

Key features of the package include the possibility of stronger banks taking over ailing banks, thereby avoiding writedowns of senior debt and unguaranteed deposits, as seen in the cases of Amagerbanken and Fjordbank Mors. The government would support such mergers by allowing: (i) the replacement of senior unsecured debt by up to Dkr10bn of new government guaranteed debt; ii) an extension of up to three years of up to

TABLE 1: COVERED BOND TYPES IN DENMARK

Instrument	Description	UCITS Compliant?	CRD compliant?
RO (Realkredit-obligationer)	The traditional mortgage bonds issued by mortgage banks	Yes	No
SDRO (Saerligt Daekkede Realkreditobligationer)	Covered mortgage bonds issued by mortgage banks, fulfilling the former as well as the new legal requirements	Yes	Yes
SDO (Saerligt Daekkede Obligationer)	The new covered bonds issued by commercial or mortgage banks	Yes	Yes

Source: Nykredit, RBS

Note: In addition, all ROs issued before 1 January 2008 maintain their covered bond status in accordance with the grandfathering option under the CRD. The new legislation also allows for joint funding, i.e. two or more institutions can jointly issue covered bonds in order to achieve larger issues.

Dkr40bn of existing government guaranteed debt; and (iii) the split of an ailing bank into a good and a bad bank. In such a scenario, the Danish government might take over the bad bank to avoid haircuts for senior debt holders and unguaranteed deposits.

The package is a partial retreat by the Danish government after it realised that previous regulation was too tough and significantly increased the funding costs of Danish banks in the international capital markets. Moody's responded by saying that it views the new Danish Bank Package IV as credit positive for Danish banks.

Adjustable rate mortgage challenge

Traditionally, the Danish mortgage market has consisted of 30 year callable fixed rate annuity bonds. Over the last few years, Adjustable Rate Mortgages (ARMs) have significantly gained in importance and now represent a large proportion of the market. In Denmark, the underlying interest rate of an ARM is typically reset every year through the issuance of new bonds (usually through a large auction in December).

Based on figures from the Danish central bank, the outstanding volume of bonds for financing ARM loans more than doubled between 2008 and 2011 from Dkr636bn to Dkr1,217bn. In its recent Financial Stability Report 2011, the Danish central bank highlighted the challenge ARM loans represent for mortgage banks given that these instruments fund long term loans by way of short term bonds.

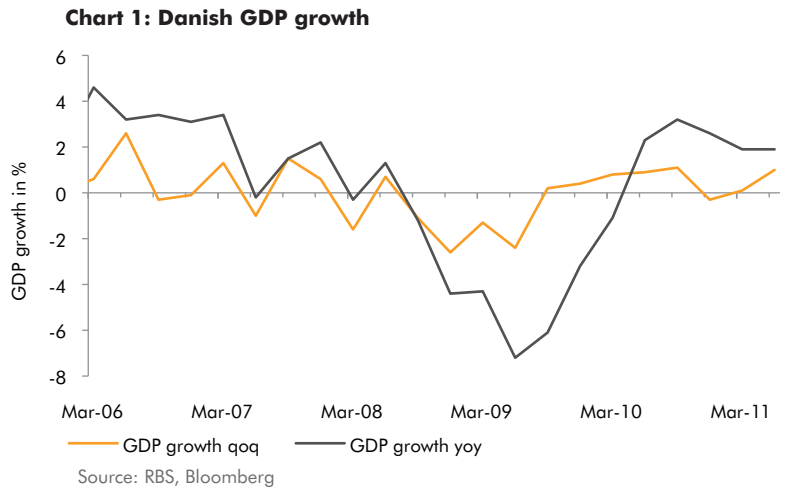
The upcoming "one year liquidity rule" of the Net Stable Funding Ratio (NSFR) will target this very type of refinancing risk and will require banks issuing such bonds to hold an amount equivalent to 65% of a loan until the customer's loan is refinanced. Even though the new rules will have generous phase-in periods — the NSFR is not due to be implemented before 2018 — the Danish central bank recommended that already "the mortgage credit institutes should seek inspiration in the new requirements and move towards more stable funding".

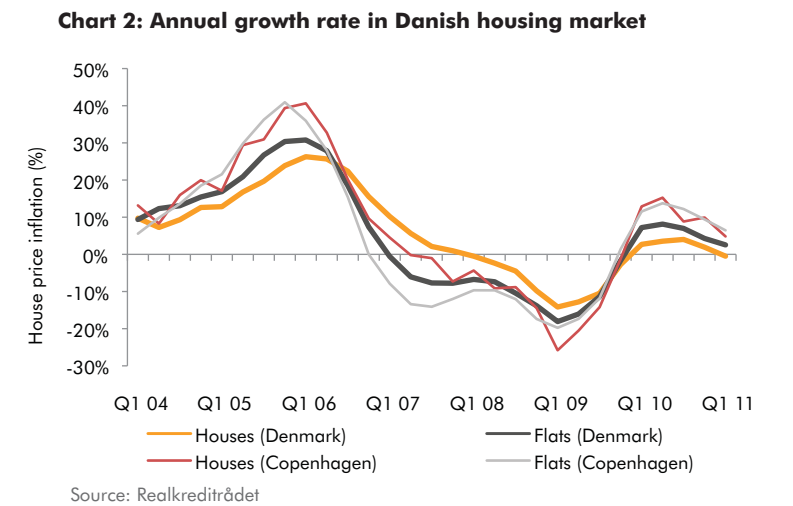
Frank Will: "The market is probably too negative on the sector"

The Danish banks argue that Danish ARMs are not comparable to variable rate housing loans in other European countries. Danish ARMs benefit from the balance principle, which means that there is a match between loans on the one hand and bonds funding the loans on the other. As the interest rate of ARMs is reset typically every year, the balance principle ensures that interest rate hikes are directly passed on to borrowers when loans are refinanced, thereby removing any liquidity risk from the banks.

However, the rating agencies are concerned about the mismatch between the underlying loan term and the term of the covered bond refinancing the loan that results in refinancing risk, and increased reliance of the issuers on regular market access to issue covered bonds given the fast growing volume of ARM loans.

In order to reduce this refinancing risk, Nykredit Realkredit, in particular, has spread its refinancing over the year so that much of it now takes now place at other times than in December, but other mortgage banks have done so only to a limited extent. However, as highlighted by the Danish central bank in its Financial Stability Report, spreading the





refinancing requirement evenly over the year is not sufficient to resolve the refinancing issue.

JCBs need a track record

Another issue for Danish banks are CRD requirements. Banks issuing covered bonds (SDOs and SDROs) have to fulfil the minimum requirements of the CRD on an ongoing basis. If house prices fall, the value of the collateral deteriorates and the loan-to-value ratio of some mortgage loans may exceed the 80% threshold. In that case, the credit institutes might have to issue new debt in form of junior covered bonds (JCBs) to finance the top-up collateral.

Based on a sample of mortgage loans and house values of Danish households, the Danish central bank estimates that the aggregate need for top-up collateral would be more than Dkr100bn if house prices fell by 10%. These figures are considerably higher than in 2008. However, so far only Nykredit has issued junior covered bonds and initial demand for such bonds has been lukewarm. The central bank recommends that the mortgage credit institutes hold sufficient buffers by selling JCBs in advance, by reducing the mortgaging ratio, or by restricting access to deferred amortisation.

Economy, housing face slow recovery

The difficult economic situation in Denmark, as well as the state of the housing market, are not providing any relief from the aforementioned problems, but are instead further fuelling investor concerns.

The Danish economy was in recession in 2008 and 2009, but started to recover in 2010. However, quarter-on-quarter growth was again anaemic in Q4 10 and Q1 11 (see chart 1). Growth in Q2 11 was better than expected, at 1.0% quarter-on-quarter, indicating that there might be some light at the end of the tunnel. But it takes more than one swallow to make a summer and the market will doubtless monitor closely further economic developments in Denmark.

Following boom years in 2005 and 2006, Danish house prices fell significantly over the three year period from 2007 to 2009. Housing market sentiment improved in 2010, with positive house price growth, but has cooled down again this year. According to the Association of Danish Mortgage Banks (Realkreditrådet), house prices receded towards the end of 2010 in all regions except the capital, but the uncertainty has now also spread to the Greater Copenhagen area. In Q1 2011, house prices declined by 1.9% quarter-on-quarter at national level and 1.8% in the capital (see chart 2).

The housing market in Denmark currently faces an unholy combination of falling prices, record large supply, and relatively long times-on-market. According to the mortgage association, detached and terraced houses sold in the first quarter of 2011 had typically been for sale for nearly seven months, while the time-on-market was six months for owner occupied flats and nearly 11 months for holiday homes. Detached and terraced houses were sold at a 11% discount on the initial asking price. For an average house of 140 square metres, this corresponds to a price reduction of around Dkr200,000. The price reductions for owner occupied flats and holiday homes were 8.5% and 15%, respectively.

Given the lacklustre economic outlook for Denmark and the rest of Europe, a quick recovery of the housing market in Denmark appears quite unlikely.

Euro spread performance mixed

So far, only Danske Bank has issued euro denominated covered bonds in benchmark size. Danske Bank's euro benchmark covered bonds (SDOs) are backed by Norwegian or Swedish mortgage assets and are issued either out of Cover Pool I — which includes only residential mortgage loans — or out of Cover

Table 2: Outstanding euro-denominated Danish covered bonds in benchmark size

Issue	Size (€bn)	Cover Pool	Property Type	Geographical Location
DANSKE 3.75% 23/09/2011	1.0	Sampo	Residential	Finland
DANSKE 4.875% 11/06/2013	1.25	Cover Pool I	Residential	Sweden/Norway
DANSKE 3.25% 07/10/2015	1.25	Cover Pool I	Residential	Sweden/Norway
DANSKE 2.625% 02/12/2015	1.0	Sampo	Residential	Finland
DANSKE 3.25% 09/03/2016	1.0	Cover Pool C	Residential/Commercial	Sweden/Norway*
DANSKE 4.5% 01/07/2016	1.25	Cover Pool I	Residential	Sweden/Norway
DANSKE 3.5% 16/04/2018	1.25	Cover Pool I	Residential	Sweden/Norway
DANSKE 4.125% 26/11/2019	1.25	Cover Pool I	Residential	Sweden/Norway
DANSKE 3.875% 21/06/2021	1.0	Sampo	Residential	Finland
DANSKE 3.75% 23/06/2022	1.0	Cover Pool I	Residential	Sweden/Norway
*Note: currently only Sweden				
Source: RBS, Danske Bank				

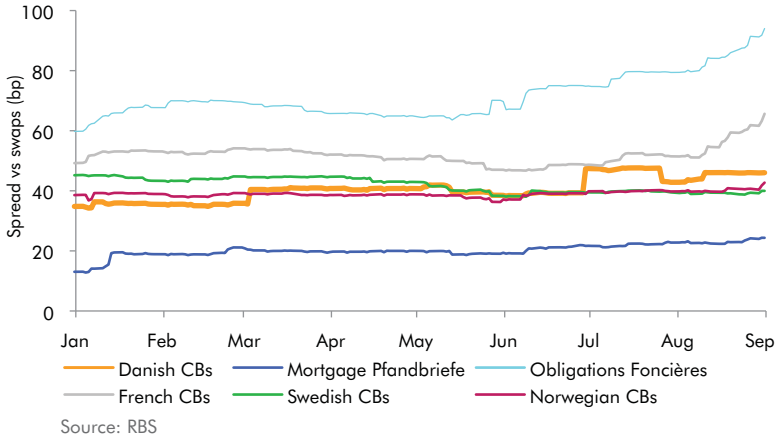
Pool C — which is a combined pool of residential and commercial real estate assets. Danske Bank can also issue covered bonds backed by Danish residential loans (Cover Pool D). Moreover, its Finnish arm, Sampo, issues covered bonds backed by Finnish mortgages.

At the beginning of this year, RBS's five year Danish euro covered bond index was trading slightly inside of those of Sweden and Norway. Since then Danish covered bonds have cheapened a bit and now trade wider than their Scandinavian peers.

However, the widening of covered bonds has been far less severe than the movements in CDS spreads. Danske Bank's five year CDS spreads more than doubled from around 110bp in April to 230bp at the beginning of September, reflecting increased concerns in the market. Moreover, over the last couple of months, Danish covered bonds have clearly outperformed French covered bonds (see chart 3).

We remain cautious regarding the future secondary market performance of Danish covered bonds and believe that the market would require a decent new issue premium from any Danish issuer wishing to come to market. Turnover in Danish covered bonds has historically been low, reflecting the high share of buy-and-hold investors. This means that even limited selling from investors switching in to new issues could trigger a considerable widening of secondary market spreads.

Chart 3: Five year index spread performance of market segments



Source: RBS

Danish banks must tackle headwinds

The Danish banking sector faces an uphill struggle and is under a lot of domestic and international regulatory pressure. Market sentiment towards Danish banks remains very negative as highlighted by the wide CDS spreads. The recent rating actions and comments from S&P and Moody's added fuel to this fire. We remain cautious and see risks that covered bond spreads will widen further.

However, the Danish government has softened its harsh stance regarding haircuts for senior unsecured investors in a wind-down scenario and is now trying to support the banking sector. Danish banks and their regulators are lobbying hard with the EU authorities to ensure that upcoming liquidity rules and CRD IV will take into account the unique character of the Danish mortgage market. Issuers such as Nykredit have already started to spread the refinancing risk resulting from the large ARMs auctions in December more evenly over the year. Moreover, the NSFR does not need to be implemented before 2018 giving the issuers some time to adjust to the new world.

But it is also clear that Danish banks will have to work hard on all these fronts to regain investor confidence and that the market will demand evidence that Danish banks will be able to cope with the broad range of problems they face. ■

Note: Sigmund is on holiday

Covered bonds?

- Highly rated covered bonds backed by mortgages
- Average LTV of 60.5%
- Match-funded structure
- Core capital ratio of 18.6%
- Largest mortgage bond issuer in Europe

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Figures as of 17 March 2011