The Covered Bond Report

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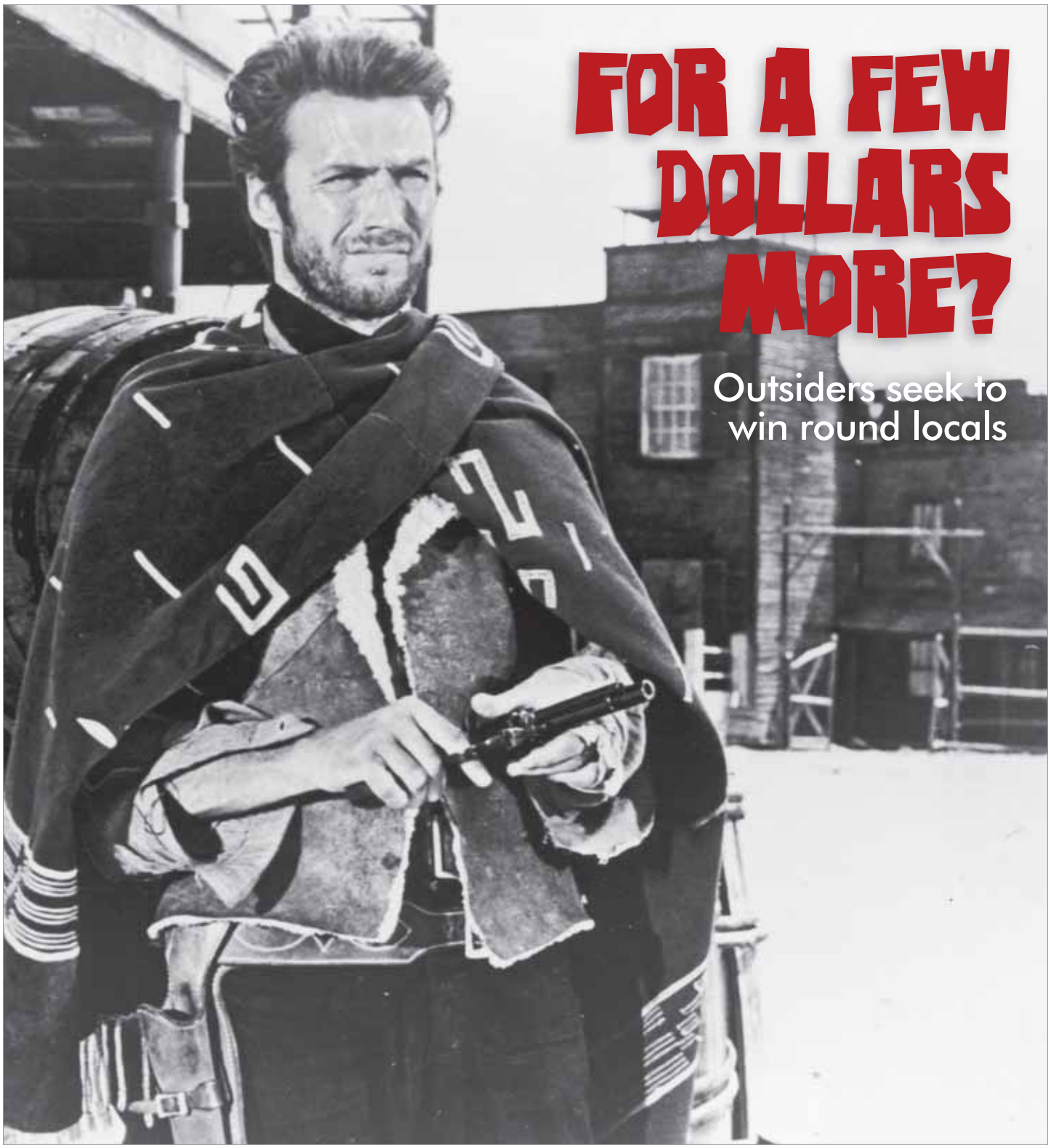

FOR A FEW DOLLARS MORE?

Outsiders seek to win round locals

Australia
Debuts under fire

CBPP2
ECB straitjacketed

CEE
Beyond the crisis

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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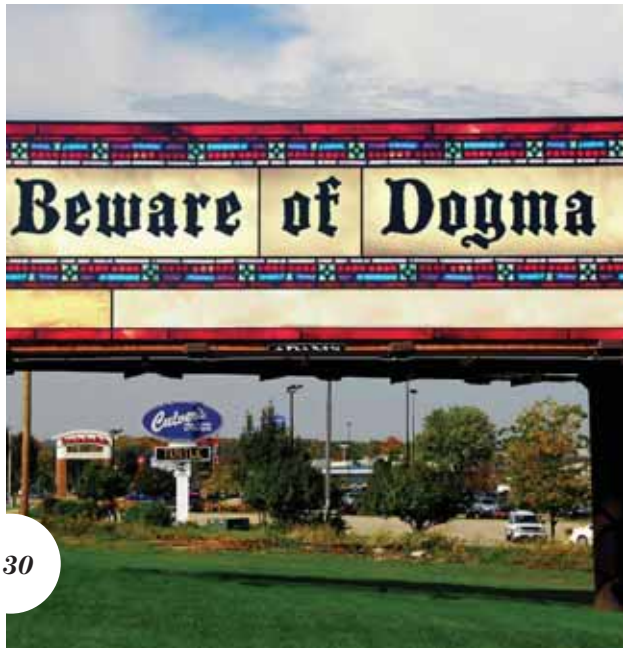

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Cover Story

Lands of opportunity

"Go West, young man, go West and grow up with the country."

This famous exhortation — widely attributed to 19th century newspaper editor Horace Greeley — has been taken up with gusto by European covered bond bankers. Seeking to grab a share of a market built on an $11tr mortgage industry, they have travelled across the pond in the hope that a US covered bond market will be born, accompanied by European issuers eager to establish a transatlantic trade.

A new Senate initiative to introduce legislation is another step towards this goal, but with a key regulator — the Federal Deposit Insurance Corporation — against it and an election year imminent, these hopes could be dashed.

Is the European industry condemned to a life of misery, its fate in the hands of euro-zone politicians prevaricating to such an extent that even a new European Central Bank covered bond purchase programme cannot rouse issuance? US targeted dollar deals will provide some business, but as disappointing Australian debuts have shown, any such relief may be fleeting.

Could developing or emerging markets provide cause for hope? Not if common reactions to such enquiries — "Pah!" or "Meh!" — are to be believed.

True, some countries will take years to generate anything like the kind of volume to get excited about in a context where Eu1bn has been a typical benchmark size. A reform of Romania's covered bond law, for example, is expected to yield — drum roll, please — perhaps Eu7bn, according to the CEO of one local bank.

But when the countries in question are Brazil or India, the calculations begin to make sense. Santander was widely scorned for the price it paid for some Latin American assets a decade or so ago, but the naysayers have since been silenced.

Of course, a sensitivity to local customs may be required in these new territories. One rating agency realised, for example, that a thorough legal analysis of foreclosure procedures in an unnamed Southeast Asian country became redundant when it emerged that it was standard practice to bribe judges.

But hopefully bankers will not need to pack one item that was standard issue for HSBC's early emerging market pioneers: a gun.

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Legislation & Regulation

HAGAN-CORKER ACT

Senate bill gives US push momentum

A bill introduced by Senators Kay Hagan and Bob Corker has been welcomed for giving renewed momentum to a push for covered bonds in the US, although market participants have warned against over-optimism, particularly in light of continued FDIC concerns.

The two introduced the United States Covered Bond Act of 2011 on 9 November with co-sponsors Democrat Chuck Schumer (NY) and Republican Mike Crapo (ID). The four Senators are members of the Senate Banking Committee, the Senate body that proponents of the asset class have been hoping would take up the covered bond cause after a similar bill was passed by the House Financial Services Committee in June. The Senate bill is aimed at creating a legislative framework for covered bonds to expand the funding options of US financial institutions.

"The US lags behind its global peers in the development of a covered bond market because we lack a legislative framework for issuers and investors," said Hagan, a member of the Senate Banking Committee. "With a legislative framework in place, US financial institutions will have a powerful tool that can be used to fund loans to small businesses and households."

Corker led a previous Senate covered bond initiative, while Schumer earlier this year said that he could introduce such a bill after seeing Republican Congressman Scott Garrett, alongside Democrat Carolyn Maloney, introduce legislation into the House of Representatives.

There had been fears that the Federal Deposit Insurance Corporation's concerns regarding covered bonds and its lobbying against Garrett's legislation might have dissuaded Senate Banking Committee members from moving forward.

Market participants said that they were pleased to see the bill being introduced.

"A few weeks ago we realised something was going to materialise in the Senate Banking Committee, but we thought that it might be a little bit of a token gesture," said Ralph Daloisio, managing director, Natixis, and a member of the American Securitisation Forum who testified at a HFSC hearing in March. "But this looks much more choreographed—very closely mirroring what came out of the House Financial Services Committee and with four sponsors, all members of the Senate Banking Committee. It sounds like [Senate Banking Committee chairman] Tim Johnson is going to have to put it on the agenda.

Kay Hagan: "The US lags behind its global peers"

"The only dark cloud is the FDIC perspective," he added. "They are not very happy it's come out in this way with the four Senators supporting it."

A covered bond analyst said he was surprised by the absence of "pro-FDIC" concessions given discouraging comments he had heard about the strength of the FDIC's lobbying in the Senate.

A Hagan staffer told The Covered Bond Report that the FDIC had neither indicated support nor opposition to the bill, saying that the FDIC is always concerned about its repudiation and the treatment of assets in the event of a bank failure. He said that the Senators would work with the FDIC going forward, as well as Senate Banking Committee chairman Johnson, with a hearing on the bill being targeted.

> "The only dark cloud is the FDIC perspective"

"Now we have legislation in both the House and Senate with wide bi-partisan support," he said. "That's a rare thing in Congress these days and a good sign for the prospects of the legislation going forward."

Bert Ely, a financial institutions and monetary policy consultant who also testified at the March HFSC hearing, said that although the Senate initiative is welcome, it might not move too quickly and further progress in the House of Representatives is probably necessary first.

"The fact that Garrett got his bill through the HFSC started to be something of an impetus to get the ball moving into the Senate," he said. "It may still have to see the House floor first and if the House passes the bill that ups the pressure on the Senate."

Fitch said that the Senate legislation "generally sticks closely" to the House legislation, aside from expanding the definition of eligible issuers and changing the proposed regulator for certain issuers. ■

NHB

India seeks covered bond road-map

India's National Housing Bank has established a working group to look at the potential for covered bonds to support the country's fast-growing housing market.

"We are looking to explore the market for covered bonds and the need for such an instrument in the industry, so we have brought together the institutional representatives to work in the Group to study the feasibility, and make recommendations on what the prospects look like and what the road-map should be," said RV Verma, chairman and managing director of the National Housing Bank, which is a subsidiary of the Reserve Bank of India responsible for supporting and regulating housing finance.

"We will be taking inputs from different players, including, of course, the government in due course, because of the legislative aspect," he told The Covered Bond Report. "Also, we are drawing on the international experience of the role played by covered bonds as an alternate instrument to MBS. And then we will see its customisability to the Indian context."

NHB has previously supported securitisation initiatives and MBS transactions, but the MBS market is subdued, said Verma, particularly in the aftermath of the sub-prime crisis.

"A number of lessons have been learnt," he told The Covered Bond Report, "and we are exploring how the market can use some variants of securitised instruments, such as covered bonds, and bring lenders/originators to bear greater responsibility, as the investors in covered bonds will have recourse to the balance sheet of the lenders. So there'll be lot more responsible origination and close supervision and monitoring by the lenders themselves."

According to Verma, mortgage lending is growing 20%-21% year-on-year, with new lending of around $30bn (INR140bn) annually and outstanding mortgages totalling about $120bn (INR564bn). This is equivalent to around 7%-8% of GDP, which Verma said "needs to be scaled up quite substantially".

National Housing Bank offices, New Dehli: housing regulator exploring covered bonds

NHB regulates specialist housing finance companies, which were historically the leaders in the housing finance industry. However, they now account for around 30% of origination, with banks — which NHB also has links with — increasing their market share, said Verma, with around 70% of new business origination and a similar proportion of outstanding mortgages. ■

SOUTH KOREA

Koreans mull legislation as Woori mandates

The Financial Services Commission is considering establishing dedicated legislation to allow South Korean banks to issue covered bonds, FSC chairman Kim Seok Dong told a parliamentary meeting on 10 October.

The FSC and Financial Supervisory Service (FSS) on 30 June issued best practice guidelines that the regulators described as intended to provide a framework for covered bond issuance to help diversify banks' financing instruments and encourage more long term and fixed rate mortgage lending.

In the absence of a covered bond framework only one Korean bank has issued a covered bond on a standalone basis — Kookmin Bank, under Korea's ABS Act — although Woori Bank in October awarded Royal Bank of Scotland the mandate to arrange a covered bond programme and Korea Housing Finance Corporation has issued covered bonds backed by pooled collateral from its member banks under an act governing KHFC.

According to FSC spokesperson Ernst Lee, the commission will review the necessity for Korean banks to issue covered bonds, and will look at making improvements to covered bond guidelines issued at the end of June.

"FSC is studying cases of other countries for covered bond issuance and will try to synchronise with market demands in terms of timing," he told The Covered Bond Report.

Moody's said in a report in October that the June guidelines are credit positive and provide the country's issuers with a "road-map" to navigate, while also benefitting investors by reducing uncertainties about the consequences of an issuer bankruptcy and establishing disclosure requirements.

"Korea is a heavily regulated civil law country and issuers are cautious to obtain regulatory blessing before issuing a new instrument in the market," said Jerome Cheng, vice president, senior credit officer at Moody's. "Although Korean banks recognise the merits of issuing covered bonds and are interested in issuing them, it is not surprising that before the regulator published the guidelines, they have taken a wait-and-see approach." ■

ECBC

Label unveiled, regulatory recognition sought

The European Covered Bond Council has released criteria — including a transparency element — that issuers will have to satisfy to be eligible for a covered bond "label" under an initiative it has been working on.

Proposals for implementation of the Covered Bond Label Convention, as it has been dubbed, will be put to an ECBC plenary in spring 2012.

"The Covered Bond Label is a key priority for the ECBC, which is developing the initiative in co-operation with issuers, investors and regulators with the aim of ensuring that the views of all stakeholders are incorporated," said the council on releasing the details in October.

The core characteristics the ECBC has drawn up and that issuers will have to satisfy are featured in the accompanying boxes.

The transparency element is introduced in the last of these. National bodies will determine what information issuers in their jurisdiction can satisfy and provide based upon guidelines listed in an annex.

"This definition of the required characteristics is complemented by a transparency tool to be developed at national level based on 'Voluntary Label Transparency Guidelines'," said the ECBC.

The labelling process will be based upon a process of self-certification, said the ECBC. The ECBC steering committee will be the decision-making and supervisory body, with market participants able to provide input through an advisory council. The practical operations of the labelling process will be run by a label secretariat.

The ECBC said that the initiative highlights to investors the value and quality of covered bonds and further enhances the recognition of and trust in the asset class.

"The label will also improve access to relevant and transparent information for investors, regulators and other market participants," it said. "The long term objective of the initiative is to promote liquidity and strengthen covered bonds' secondary market activity."

> "The long term objective of the initiative is to promote liquidity"

Speaking at an ECBC plenary in Barcelona in September, its chairman, Antonio Torío, said that the labelling initiative is a process that takes time and has necessitated "a lot of thinking to put together the pieces".

"The efforts on behalf of issuers to adhere to the label need to be recognised by regulators and we hope that if we provide enough of a solid proposal that regulators will feel compelled to treat the asset class in an enhanced way," said Torío.

Another objective is to "maintain and further develop the existing high standards of the asset class in a changing environment", said Torío, noting that covered bonds had provided European issuers with market access because the asset class had been perceived as not being "quote unquote, tainted" by the inclusion of other assets and structures that make it more complex and possibly riskier. ■

ECBC chairman Antonio Torío addresses the Barcelona plenary

I Legislation safeguards

a) The CB programme is embedded in a dedicated national CB legislation;

b) The bond is issued by — or bondholders otherwise have full recourse, direct or indirect [including pooling models consisting only of covered bonds issued by credit institutions] to — a credit institution which is subject to public regulation and supervision;

c) The obligations of the credit institution in respect of the cover pool are supervised by public supervisory authorities.

II Security features intrinsic to the CB product

a) Bondholders have a dual claim against:

- The issuing credit institution as referred at the point I b);
- A cover pool of financial assets (typically mortgage and/or public sector loans), in priority to the unsecured creditors of the credit institution; the financial assets eligible to be part of the cover pool and their characteristics such as credit quality criteria are defined in the national covered bond legislation which complies with the requirements of Article 52(4) of the UCITS Directive.

b) The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times.

c) Issuers are committed to providing regular information enabling investors to analyse the cover pool, following the guidelines developed at national level (see Annex I).

"We saw more participation from bank treasuries than we had a year ago" page 28

LETTRES DE GAGE

Luxembourg specialist bank principle could go

A draft update of Luxembourg's covered bond legislation has been circulated that The Covered Bond Report understands could remove the specialist bank principle from the country's framework.

An official at a Luxembourg issuer in early November said that the draft has been out since 28 October and had yet to be discussed by interested parties, so further details could not be released.

However, a market participant said the main change in the update will be to remove the specialist bank principle in favour of allowing universal banks to issue covered bonds.

Luxembourg's lettres de gage framework was established in 1999 and drew upon Germany's Pfandbrief market, which was centred on the specialist bank principle, whereby the activities of most issuers were restricted. However, this was removed when a new Pfandbrief Act was introduced in 2005, allowing universal banks to issue.

Bankers in the duchy have been working on possible changes to Luxembourg's legislation for some time, according to Michael Schulz, head of fixed income research at NordLB.

"They have been planning to bring in this new legislation since 2010," said, "but developing a new legislation needs time.

"I know now that the process is speeding up now."

There are five covered bond issuers in Luxembourg: Dexia LdG Banque, Eurohypo Luxembourg, NordLB Covered Finance Bank, Hypo Pfandbriefbank International (a subsidiary of Hypo Real Estate), and Erste Europäische Pfandbrief- und Kommunalkreditbank, wholly owned by Commerzbank. ■

Luxembourg's Chambre des Députés: legislative changes afoot

UK

FSA sets out compliance best practice

The UK's Financial Services Authority in November provided "thematic feedback" based on annual reviews for the first time in a letter to the country's Regulated Covered Bond issuers, with the compliance function within regulated programmes in focus.

The letter, representing "finalised guidance", was published on 2 November and set out the FSA's expectations of minimum standards that compliance functions — referred to also as "second line oversight" — should meet within regulated programmes as well as examples of good practice by RCB issuers.

John Wu, senior associate, capital markets team at the FSA, told The Covered Bond Report that the FSA's RCB team felt it would be valuable to communicate to RCB issuers some of the findings of its annual reviews, with compliance functions a "theme of interest".

"We thought it would be a good idea to communicate what good points issuers were doing and let other firms know what is indeed best practice," he said. "It doesn't reflect changes in our expectations, as we have always looked at compliance as an integral part of a programme's operation."

The letter is addressed to the signatory of the "RCB 1D Annual Attestation of Compliance" as the official responsible for ensuring that arrangements relating to the management of a programme, including governance and oversight, meet the expectations of the FSA.

"We recognise that the specific role carried out by the compliance function may vary between issuers, with certain aspects of oversight shared between other second line functions," said the FSA. "Below, we set out our expectations and provide examples of areas of good practice that we have observed.

"You should consider whether you should enhance the second line oversight of your programme in light of the examples below." ■

FSA's expectations for second line oversight include:

- Ongoing monitoring of the programme (e.g. checks accuracy of regulatory and investor reporting, aware of and monitoring breaches);
- Clear understanding of RCB requirements and the role of the compliance function in relation to the programme. Appraised of relevant regulatory developments, and able to provide advice internally as appropriate; and
- Adequate and skilled resource, with appropriate depth of expertise in covered bonds, evidence of ability to challenge management.

Examples of good practice:

- Compliance is represented as voting member on covered bond management committees and relevant steering groups with full access to relevant minutes and MI;
- Compliance undertakes regular reviews of the programme, with clear channels of escalation between i) first line and compliance function, ii) independent upwards escalation of issues from the compliance function and senior committees; and
- Compliance undertakes active "horizon scanning" and provides advice on changes in regulatory environment and is engaged in providing responses to regulatory changes.

INVESTORS

ICMA CBIC sets half-yearly standard

Half yearly reporting has been decided upon as the standard for a transparency initiative of the ICMA Covered Bond Investor Council, which has agreed what issuers need to do to be admitted to its platform.

The decisions were taken at a CBIC meeting in mid-October, following a consultation held by the investor group, which aims to finalise its transparency standards by year-end. The meeting focussed on discussing practical aspects of the investor group's transparency project, with subsequent meetings due to focus on the data fields envisaged by a draft template.

According to a statement from the CBIC, members agreed that only issuers using the group's template will be allowed to post to a dedicated CBIC webpage, a condition that Nathalie Aubry-Stacey, secretary of the CBIC and director, regulatory policy and market practice at the International Capital Market Association (ICMA), said was key.

"Having one template for all issuers is quite important for the group," she told The Covered Bond Report. "It is about ease of access via a single webpage but also the comparability of the template."

The CBIC said that while members recognise that insistence on issuers using its template "could generate additional administrative burden for issuers" they also consider it would help fuel standardisation and "be a great advantage for the European covered bond market and would eventually lower funding cost".

It was also agreed that the CBIC template — which will take into account responses from the consultation and bilateral discussions with issuers and national associations — be independent from other national templates and be presented in Excel format.

Data should be reported on a half-yearly basis shortly after issuers publish their results, according to the CBIC.

Nathalie Aubry-Stacey: "It is about ease of access but also comparability"

Aubry-Stacey said that agreement on this as the desired frequency of reporting was easily reached.

"It should be easy for issuers to do," she said, "and the emphasis is on data being published quickly after the results so that it is up-to-date.

"Issuers can always decide to publish more."

The idea of setting minimum reporting standards that issuers need to meet to be able to post to the CBIC website was also discussed, but the group decided against setting such a threshold.

"Although it was agreed that there should be a minimum of policing and that too little relevant information would not be helpful," said the CBIC, "there would not be any minimum standards."

Some market participants have noted that the range of information being sought by the CBIC is extensive, and the CBIC discussed such feedback.

"It was noted that this was expected as it represented the needs of investors and reflected the fragmentation of the European covered bond market – some investors having a focus on the cover pool, others on the general issuer section," said the CBIC. "It is for each investor to decide what analysis and focus they will take on the data received from issuers."

Some market participants have expressed concern that the CBIC is being too demanding of issuers, but Claus Tofte Nielsen, chairman of the CBIC, told The Covered Bond Report that the transparency standards were always designed to be a wishlist. He said that he realised that some issuers — in Germany, for example — might be able to rely on domestic investors who did not require so much data.

"I'm quite relaxed about that," said Nielsen.

But he said that the initiative reflected the needs of international investors and that it was up to issuers if they decided to follow it.

The investor body is also holding meetings with members and others that responded to its consultation discussions on two related areas: investors' needs and additional fields; and clarification of definitions and concepts.

> "Issuers can always decide to publish more"

The CBIC will also seek to provide clarification on some items on the data list that was consulted upon. It said that it welcomed some national issuer associations' willingness to provide their own, standardised definitions and would consider feedback on circumstances where data may or may not be appropriate to any particular jurisdiction's "national traditions".

Michel Stubbe, head of the market operations analysis division at the European Central Bank, said at a European Covered Bond Council plenary in Barcelona in September that the CBIC initiative was very important and could help reduce reliance on the rating agencies by allowing investors to make more autonomous analyses. ■

"The number of dealers that will trade covered bonds has definitely expanded" page 29

STRUCTURED BONDS

Germans consider Pfandbrief break-out

Several German financial institutions are understood to be considering the possibility of issuing structured covered bonds alongside Pfandbriefe, as they seek new ways of raising secured funding.

Deutsche Pfandbriefbank (pbb) said in a presentation in September that it is "analysing possibilities of structured covered bonds" and a market participant familiar with the discussions said that he could imagine structured covered bonds might also make sense for the likes of Eurohypo and Landesbank Baden-Württemberg. Pbb prefaced the idea by saying that "high OC requirements highlight need for alternative approaches, e.g. using non-encumbered assets".

According to analysts at UniCredit, Stefan Krauss, partner at Hengeler Mueller, presented a concept for an "unregulated" covered bond at the event where pbb discussed its thinking.

"The basic idea behind 'unregulated' covered bonds is to set up a structure comparable to what we know from UK covered bonds, i.e. a segregation of assets in a special purpose entity in combination with a senior unsecured bond issued by a bank," said UniCredit's analysts. "The special purpose entity would then guarantee the timely payment of interest and principal in addition to the unsecured claim versus the bank."

They said that although many details remained unclear, Krauss explained how this would fit with German laws and regulations to create what he said would be "quite a strong legal body". UniCredit's analysts said that the assets considered as having the most interesting potential for such a covered bond are: mortgage loans not included as Pfandbrief cover, corporate loans (SMEs and others), and consumer loans.

Bernd Volk, head of covered bond research at Deutsche Bank, highlighted concerns the financial authorities might have, while acknowledging the attractions of the project to pbb.

"We argue that a legislative decision for a specific covered bond (e.g. the German Pfandbrief) generally suggests that further contractually based covered bond structures are vulnerable from a legal point of view," he said. "On the other hand, a pure wholesale funded bank like pbb does not have to deal with subordination of depositors and actually may find ways to optimise its funding structure via introducing a further covered bond format."

Any such issuance from pbb would not, however, be without precedent, with Landesbank Berlin having launched structured covered bonds alongside Pfandbriefe, albeit in small amounts. ■

SME LOANS

Italians rule out structured, mull SMEs

Any moves in Italy to create an instrument similar to covered bonds but backed by lending to small and medium sized enterprises would need to be done through a new law, an official at the Italian Treasury told The Covered Bond Report.

Alfredo Varrati: "The way to another kind of covered bank bond would be a legislative one"

Responding to a report that the Italian government is considering structured covered bonds, Giuseppe Forese, head of prudential regulation at the Italian Treasury, said that the article was incorrect.

"The headline of the article was exactly the contrary of what I said," said Forese. "In my view, it is not possible to introduce something like that because we have in Italy two kinds of instrument: we have securitisation and we have covered bonds; we don't have something in the middle.

"So it would be very difficult to create through a private initiative something different."

Forese said that were the government to look at ways in which small and medium sized enterprises could be supported, legislation could be drawn up.

"The label OBG can be used only for specific covered bonds which are in line with the very strict criteria defined by Italian law," he said. "If we want to create some different kind of instrument — which is not named covered bonds but can be regulated by a law — in order to facilitate the access of small and medium enterprises to loans, to savings, that's another issue.

"It could be advisable that the law facilitate this process."

Alfredo Varrati, senior analyst, credit department, at the Italian Bankers' Association (ABI) said that structured covered bonds would not work in Italy.

"In Italy any covered bond issued outside Law 130 of 1999, which is our securitisation law, would definitely not be an option," he said. "There would be problems in terms of assignment of the assets to the SPV, ringfencing, clawback clauses, tax exemptions and so on.

"In other words, the way to another kind of covered bank bond would be a legislative one."

He said that the ABI is discussing with the Treasury the idea of covered bond type instruments to finance SME lending. ■

AUSTRALIA

Warning on secured, but covered boosted

Australian regulatory and central bank officials warned of an overreliance on secured funding at an Australian Securitisation Forum conference on 21 November, although APRA and RBA Basel III measures could be positive for covered bonds.

Charles Littrell, executive general manager, policy, research and statistics at the Australian Prudential Regulation Authority (APRA), said that a historic shift may be underway from banks being mainly unsecured borrowers to banks pledging "a great deal of collateral" as they turn to a mix of collateral-based funding, whether that be securitisation, covered bonds, more collateral for trading exposures, and the probable exploration of repos in the context of liquidity and other needs for authorised deposit-taking institutions (ADIs).

"Although each of these initiatives individually may give an ADI cheaper funding or better trading terms," he said, "a whole industry with lots of collateral pledged is most unlikely to make the remaining depositors and unsecured creditors safer.

"This is an issue that APRA and other regulators will need to wrestle with over the next several years."

Also speaking at the conference in Sydney, Guy Debelle, assistant governor, financial markets at the Reserve Bank of Australia (RBA), said that investors clearly prefer secured debt in the prevailing risk-averse environment, but that the trend toward predominantly secured issuance is not sustainable.

"Banks can't encumber their balance sheets through secured issuance to such an extent that unsecured issuance, and even deposit gathering, is no longer possible," he said. "Too much issuance of covered bonds and you're effectively back in the unsecured world."

Although a cap of 8% on assets encumbered by the issuance of covered bonds by Australian ADIs protects deposits, he added, the introduction of covered bonds subordinates unsecured debt holders to a degree.

"Any pricing gain obtained from issuing covered bonds is likely to be offset to some extent by a demand from unsecured debt holders for more compensation in the future," he said. "So I see the role of covered bonds as primarily broadening the potential investor base rather than a means of reducing overall funding costs for banks."

Guy Debelle: "I see the role of covered bonds as primarily broadening the potential investor base."

Debelle said that Australian banks are primarily likely to turn to covered bonds as an offshore funding source because domestic investors are more comfortable with MBS.

He questioned the extent of the differences between the various forms of bank wholesale funding, noting that they are all claims on a bank's balance sheet in one form or another, and that the main difference is the degree of credit enhancement provided by subordination in the case of RMBS or overcollateralisation (and additional recourse to the balance sheet) in the case of covered bonds.

> "Ultimately, everyone can't be at the front of the queue"

"The strong motivation for the current preference of investors for secured issuance is about repositioning themselves towards the front of the creditor queue," said Debelle. "That is the fundamental point of differentiation between the various forms of funding.

"But ultimately, everyone can't be at the front of the queue."

On 16 November APRA released a discussion paper on the Basel III liquidity framework, while RBA announced changes to its list of repo-eligible securities and margins, and released details of a committed liquidity facility (CLF) designed to help banks fulfil liquidity coverage ratio (LCR) requirements under Basel III.

Daniel Yu, analyst, financial institutions group at Moody's, told The Covered Bond Report that RBA for the first time introduced an explicit reference to covered bonds as part of the changes it announced, with there previously having been no need to do so because Australian banks only recently received regulatory approval to issue such debt (see Monitor Market for more on the first Australian covered bond issues).

Covered bonds are included in an "ADI-issued securities" category in RBA's list of eligible securities, with separate margin scales based on debt with minimum ratings of Aaa, Aa3, A3, Baa1, and "other rated". The RBA said that it will increase haircuts on securities pledged with the central bank and, with lower rated securities facing relatively larger increases in margins, covered bonds, by virtue of their high ratings, will become more attractive.

In a report, Yu and colleagues said that the favourable repo margin on covered bonds relative to unsecured bank debt will benefit Australia's major banks because it has the potential to increase demand for such securities, of which the major banks are likely to be the main issuers.

Moody's also noted that over the longer term APRA could deem covered bonds eligible for LCRs as Level 2 high quality assets, which would further raise their attractiveness for investors. ■

"The guts of both the House and Senate bills are very similar" page 30

AFRICA

Moroccan draft could herald African first

Morocco's ministry of economy and finance has been preparing covered bond legislation that could be finalised and ready to present to parliament by the end of the year, an official at the ministry told The Covered Bond Report.

No covered bond has yet been issued out of Africa, so any Moroccan deal could be the continent's first.

Nouaman Al Aissami, head of the credit division at the ministry of economy and finance, said that work on the project began more than a year ago. A draft prepared by the ministry and finalised in June is being reviewed by interested parties including the central bank.

"Our objective is to have concluded the review by the end of this year," said Al Aissami.

Morocco has elections in November and market participants hope that the legislation will be presented to parliament in 2012.

The initiative to set up a dedicated legal framework for issuance of covered bonds (obligations sécurisées) was driven by a rapid expansion of Morocco's mortgage market, according to Al Aissami, which has grown more than 20% per year over the past five years. A presentation on the draft law noted a "remarkable" development of mortgage lending, which has grown from Dh54bn in 2005 to Dh188bn (Eu16.8bn) in 2010.

Morocco has had a securitisation law in place since 2002, when the first transaction took place. The law was amended in late 2008 to broaden the range of assets that can be securitised — which had initially been restricted to residential mortgage loans — and to adopt a more secure and developed framework.

Al Aissami said that the international financial crisis had brought covered bonds to the Moroccan government's attention and prompted it to use the instrument to add to the funding sources available.

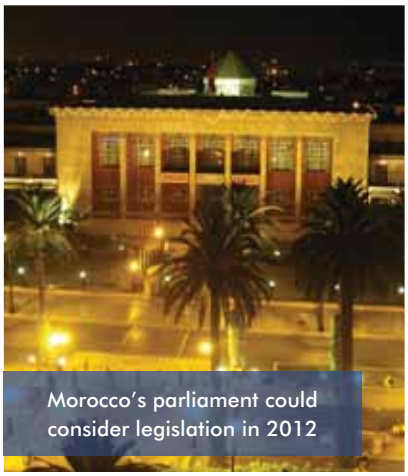
Boudewijn Dierick, head of structured covered bonds at BNP Paribas, said that the project is in the early stages and part of wider efforts to develop Morocco's finance sector.

"Covered bonds will in the first instance be an asset class for domestic investors," he said.

Al Aissami said that issuance is likely to take place primarily in the domestic market, but that there may be some issuance aimed at institutional investors. Interest in issuing covered bonds stems mainly from Morocco's largest banks, he added.

Fouad Bendi, deputy director at Maghreb Titrisation, Morocco's first securitisation company and the first in north Africa, said he sees covered bonds and securitisation as complementary funding instruments, in particular as covered bonds will only be allowed to be backed by mortgage or public sector assets.

"There are not many financing instruments in Morocco, so any additional one is a bonus," he said. ■



Morocco's parliament could consider legislation in 2012

ICELAND

Covered offer Íslandsbanki wholesale return

Íslandsbanki announced in early October that it has obtained the necessary licence from the Icelandic Financial Surveillance Authority to issue covered bonds, ahead of up to ISK5bn (Eu31m) of issuance by year-end.

An Íslandsbanki official told The Covered Bond Report that the covered bond issuance would represent the first wholesale funding by a major Icelandic financial institution since they were nationalised following their collapse.

"This is a part of the funding strategy of Íslandsbanki, which is intended to broaden the funding sources of the bank," said the bank in a statement. "Today, deposits count for up to 75% of Íslandsbanki's funding, but the future goal is to lower that ratio and make the bank less dependent on deposits as a funding source."

The Íslandsbanki official said that covered bonds would enable the bank to better match its assets and liabilities.

Íslandsbanki said that the bonds will primarily be offered to investors in Iceland and that it will thus be the first issuer of new bonds on the Nasdaq OMX Iceland Stock Exchange.

"The covered bonds are issued pursuant to Icelandic law on Covered Bonds nr. 11 from 2008, which imposes strict requirements on any issuer," said Íslandsbanki. "For example, the collateral is required to pass a weekly stress test in regards to interest rates and currency rate fluctuations.

"The Icelandic FSA will carefully monitor covered bond issuance," it added.

Íslandsbanki is not rated and its covered bonds will be unrated. ■

Ratings

S&P

Methodology part of ratings resilience

Many of Standard & Poor's covered bond ratings would be resilient to moderate stress in the shape of one to two notch issuer downgrades, according to the rating agency, which it said is partly due to overcollateralisation demands resulting from a change to its methodology in 2009.

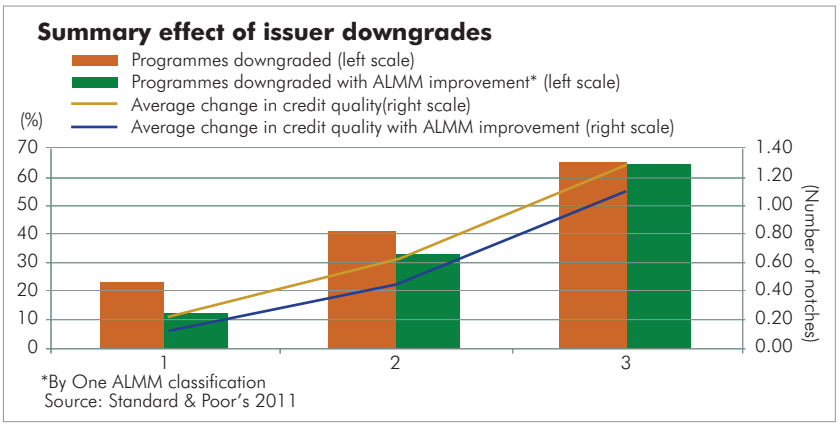
S&P looked into the availability of unused potential ratings uplift based on a sample of 87 programmes and carried out an analysis to investigate the overall sensitivity of its sample of programmes to underlying issuer downgrades. This was on the assumption that the asset-liability mismatch (ALMM) risk that helps determine the maximum potential uplift between the ICR and a covered bond rating does not change, with the analysis also leaving aside country risk, which could additionally constrain how high S&P rates a covered bond programme.

The scenario analysis, published in late October, showed that in the event of a uniform one notch lowering of all respective issuer ratings only 23% of programmes in the sample, by number, would likely have their ratings downgraded, and that the average change in credit quality would be a lowering of 0.23 notches. Assuming issuer downgrades of two to three notches 41% and 66% of covered bond programmes, respectively, would be cut, the rating agency said.

However, S&P said that the majority of programmes would remain rated double-A or triple-A even under the "relatively substantial scenarios" of issuer downgrades of up to three notches.

"For example, we currently rate 86% of programmes in our sample AAA," it said in the report. "If we downgraded all of the underlying issuer ratings by one notch, 76% of the programmes would remain rated AAA, with a further 17% rated in the AA rating category."

If all of the underlying issuer ratings were cut by three notches, 87% of the programmes in the sample would remain rated in the triple-A and double-A rating categories, it added, of which 33% of the programmes would remain rated triple-A, with a further 54% rated double-A.



Sabrina Miehs, director, covered bond ratings at S&P, said that in the rating agency's view the analysis shows that its covered bond ratings react only very marginally to a moderate hypothetical stress of a one to two notch issuer downgrade.

Andrew South, senior director, structured finance, S&P, said that the scenario analysis does not take into account the scope that issuers have to manage their programmes to lower asset liability mismatch risk.

> "When an issuer rating is lowered the target level of OC does not change"

"There is still some room for resilience that could offset issuer downgrades," he said.

S&P's report said that a reduction of ALMM risk so that a programme is classified one category better would increase by one notch the maximum potential number of uplift from an ICR, which would reduce the number of covered bond programmes whose ratings would be cut in a hypothetical case of an issuer downgrade.

The proportion of programmes downgraded would fall from 23% to 13%, from 41% to 33%, and from 66% to 64%, respectively, under the one, two, and three notch issuer downgrade scenarios mentioned above.

However, most covered bond programmes rated by S&P are already classified as having low ALMM risk, said Miehs.

S&P said that the ratings stability revealed by its scenario analysis is partly due to the rating agency only rating programmes triple-A if they are highly overcollateralised, regardless of how highly it rates the issuer.

Miehs said that this was a decision taken when the rating agency switched to its new covered bond rating criteria in 2009.

"It was very important for us not to include any benefit from the issuer rating in the calculation of target overcollateralisation levels," she said. "Our criteria are set up to size the level of overcollateralisation to address the risks in covered bonds from day one, without a link to the issuer credit rating, so that when an issuer rating is lowered the target level of OC does not change."

This approach avoids putting additional financial stress on the issuer, she added, which would otherwise find itself needing to increase overcollateralisation to maintain the covered bond rating.

In its report S&P said that this contrasts with the approach of some other rating agencies, which it said may assign their highest rating to a covered bond programme with less overcollateralisation on the basis that the issuer's credit rating is relatively high.

"Adding more collateral to the cover pool may be challenging in a financially stressed environment," it said. ■

MOODY'S

Discretion a better imparter of value

Support for covered bonds has so far outweighed credit negatives that issuers' discretion over their programmes could imply, according to a Moody's official, who also said that it is too early to determine what impact bail-ins could have on its methodology.

For a Q&A prefacing a new covered bond compendium publication produced by the rating agency, Nicholas Lindstrom, senior vice president, covered bonds, at Moody's, was asked how the rating agency takes into account the large amount of discretion issuers enjoy over the credit quality of their programmes.

"The short answer is that we penalise the programme's rating for certain actions that could be detrimental to the pool, but give limited uptake for positive actions," said Lindstrom.

He highlighted several ways in which the rating agency has to reflect worst case scenarios into its analysis and said that an issuer's discretion could therefore be seen as a credit negative.

"But an important benefit of a covered bond programme is that the issuer can support the covered bond programme if it wants to," he added. "And to date the positive credit impact of issuers adding further support to their covered bond programmes has more than outweighed any potential negative credit impact stemming from issuer discretion."

Lindstrom also addressed the question of whether bail-in frameworks being developed might make Moody's reconsider whether it is appropriate for senior unsecured ratings to be the correct reference point in determining the likelihood of investors having to rely on a cover pool to be repaid.

"The argument you're referring to is that, in a post-bail-in world, the likelihood of a default of the issuer supporting the covered bonds won't reflect the likelihood that investors will need to rely on the assets in the cover pool," he said. "This is because after a bail-in, the issuer can continue to service the covered bonds.

"This assumes that secured debtors won't be bailed in, and most of our discussions so far suggest that secured debt will be excluded from bail-ins. So it may not be right to assume that a default of the issuer supporting the covered bonds is the point at which investors have to rely on the cover pool."

But Lindstrom said that it is not yet known what the final details of all resolution regimes that incorporate burden-sharing will be.

"What's crucial is that we've seen little guidance on whether the covered bond programme of a distressed institution will be allowed to continue as part of a potentially functioning post-resolution entity," he said. "In those cases, we'd consider how to give credit for that in our analysis." ■

US

BA covered cut, lack of OC support seen

Fitch downgraded mortgage covered bonds issued by Bank of America NA from AAA to AA on 24 October, primarily due to the application of increased interest rate stresses but also because of increased loss expectations for the cover pool and a potential lack of support of the programme's asset percentage.

The covered bonds and issuer rating were left on Rating Watch Negative.

The rating agency applied increased interest rate stresses as part of its cashflow analysis, and also raised its loss expectations for the cover pool due to the risk characteristics of collateral and application of its prime residential mortgage loss model. Both meant a decrease of the asset percentage (AP) supporting a AAA rating from 78% to 69%.

An application of Fitch's counterparty criteria led to an increase in the programme's Discontinuity Factor (D-Factor) from 39.6% to 40.1%.

BA indicated unwillingness to support the asset percentage in future

The issuer's long term rating of A+, RWN, and the covered bond programme's D-Factor of 40.1% enable the mortgage covered bonds to be rated up to an unchanged level of AA on a probability of default basis (PD) provided the overcollateralisation is able to withstand Fitch's cashflow model stresses in a AA scenario, said the rating agency.

"A credit of up to two notches above the covered bonds rating on a PD basis can be applied if stressed recoveries assuming covered bond default exceed 91%," said Fitch.

The rating agency said that the programme's nominal AP is 64%, less than the 69% determined under Fitch's revised analysis, but that the issuer has indicated an unwillingness to support the AP in the future should prepayments, defaults and liquidations reduce available overcollateralisation (OC).

"Fitch does not view the potential for a lack of support as consistent with an AAA rating," it said. ■

FITCH

Italy's market access key

Fitch has said that any perceived loss of market access by Italy could lead to increased refinancing cost assumptions and therefore higher overcollateralisation supporting a given rating for Italian mortgage covered bonds and European public sector covered bonds exposed to Italian public sector debt.

It identified this and the reduction of rating uplift provided by maturity extensions as two consequences for covered bond ratings should it judge the Italian sovereign to be losing market access and cut its rating. Loss of market access is not Fitch's base case, but a risk that it highlighted in a special report, "Italy: The Challenge Ahead", on 18 November.

Fitch said Italy's near and medium term growth prospects have deteriorated

The rating agency noted that if it considers that the Italian sovereign is losing market access it will increase the stresses incorporated in its covered bond rating criteria.

Any such increase of stresses would affect covered bonds with exposure to Italian assets, such as mortgage obbligazioni bancarie garantite (OBG), and other European covered bonds secured by Italian public sector debt, such as those issued by Germany's Aareal Bank, Deutsche Pfandbriefbank (pbb), and Eurohypo.

Fitch downgraded Italy to A+, negative outlook, on 7 October, and said that since then the country's near and medium term economic growth prospects have deteriorated, with refinancing spreads for assets in Italian cover pools increasing.

The rating agency said that if Italy loses market access and the sovereign were downgraded to a low investment grade category, covered bond ratings would be affected in two ways.

Firstly, a scarcity of available liquidity for cover assets would reduce the possible rating uplift between an Italian issuer and its mortgage covered bond rating.

"It is likely that the current liquidity gap protection in the form of 12 to 15 months maturity extension for the mortgage OBG would only enable an uplift of one notch in terms of probability of default above the issuer default rating (IDR) of the issuing bank," it said, "to which a maximum two notches (or up to three notches if the rating of the covered bond on a probability of default basis is not investment grade) could be assigned to reflect recoveries in the case of default."

> "Covered bonds would be affected in two ways"

Secondly, if Fitch were to cut Italy some covered bond issuers would also be downgraded, it said, adding that the linkage between the covered bond rating and the issuer could also prompt the covered bond ratings to be lowered.

"An increase in stressed refinancing cost assumptions will lead to an increase in the percentage of overcollateralisation supporting a given rating both for mortgage OBG and European public sector covered bonds exposed to Italian public sector debt," said Fitch, noting that it expects such a rise in overcollateralisation to occur even though the mortgage covered bonds' rating would be lower than today.

Fitch placed on Rating Watch Negative (RWN) seven OBG programmes and three German public sector Pfandbriefe (see below) after downgrading the sovereign in early October. It said that existing RWNs will be resolved based mainly on the recalculation of the level of overcollateralisation supporting the rating of each programme as well as any liquidity mitigants put in place by the issuers.

Italian issuers whose OBG programmes are rated AAA, on RWN: Banca Carige, Credito Emiliano, Banca Monte dei Paschi di Siena, Banca Popolare di Milano, Banco Popolare, Unione Banche Italiane, and UniCredit.

German issuers whose public sector Pfandbriefe are rated AAA/RWN: Aareal Bank, Deutsche Pfandbriefbank and Eurohypo.

Fitch said that the ratings of German Pfandbriefe that are backed by a significant proportion of lower rated Italian public sector exposure are unlikely to be affected by liquidity concerns, but that the bonds are exposed to Italian credit risk and increased refinancing costs. ■

"Spreads should be driven by the underlying quality of the collateral pools" page 33

SPIN-OFF

Dexia MA transferred, DKD still unclear

Dexia Municipal Agency is being spun off to Caisse des Dépôts et Consignations and La Banque Postale as part of the restructuring of Dexia group, while the fate of Dexia Kommunalbank Deutschland appears to remain unclear.

An agreement between Dexia, Caisse des Dépôts and La Banque Postale, details of which were announced on 20 October, contains two main features. One is the acquisition by Caisse des Dépôts and La Banque Postale of respectively 65% and 5% of the shares in Dexia Municipal Agency, and a second is the establishment of a joint venture held by Caisse des Dépôts (35%) and La Banque Postale (65%) that will be dedicated to originating loans to French local authorities, refinanced through Dexia MA.

RBS covered bond analysts said the move was positive but raised several questions, such as what would happen to the remaining 30% stake of Dexia in Dexia MA and how strong was the willingness of Caisse des Dépôts and La Banque Postale to provide additional support for Dexia as new shareholders, if required.

Dexia said that under the agreement reached it will extend a guarantee to Dexia Municipal Agency against Eu10bn of structured loans to French local authorities as well as an indemnity against losses in excess of 10bp on all outstanding loans. Dexia will in turn benefit from a counter-guarantee from the French state on the portfolio of structured loans up to 70% of losses over and above Eu500m, subject to the approval of the European Commission.

"The counter-guarantee for Dexia is only on the Eu10bn structured loans to French entities rather than on the whole portfolio," said Frank Will, head of covered bond research at RBS. "It remains therefore even more important to what extent the cover pool structure will be altered by a possible transfer of troubled loans to a run-off entity."

Another covered bond analyst said that while the counter-guarantee was still subject to approval by the European Commission "the EU will probably not dare do anything but approve".

Dexia Banque Internationale à Luxembourg: to be sold to a group of international investors

"The future of the Pfandbrief issuer remained unclear"

A press release from 20 October setting out the decisions taken by Dexia's board of directors was silent on Dexia Kommunalbank, and RBS's Will said the future of the Pfandbrief issuer remained unclear.

"Even in this morning's press release, there has been no statement about what will happen to DKD," he said. "You can see that reflected in its spreads, which have been growing wider since September before taking a couple jumps wider in October.

"People are getting nervous," he added. "They're concerned DKD could be spun off."

Dexia held an conference call on 9 November to update analysts on the group's restructuring process and financial situation, and a covered bond analyst said that he was surprised to hear numerous questions about Dexia's financial situation rather than about the restructuring process, suggesting that "maybe the reason was that there are no news anyway in particular regarding Berlin-based Dexia Kommunalbank".

Another analyst said that the Pfandbrief issuer appears to remain a Dexia subsidiary.

Another pillar of the group's restructuring includes the sale of Dexia Bank Belgium to Société Fédérale de Participations et d'Investissement (SFPI), acting on behalf of the Belgian state.

The spin-off of Dexia Bank Belgium is seen by many market participants as having likely created a new candidate for issuance under a Belgian covered bond legislative framework that is being prepared in the country.

"It's a natural candidate," said a covered bond analyst. "It's now an isolated standalone Belgian bank with a domestic retail business."

A banker familiar with the legislative project in Belgium said that Dexia was an active participant in discussions and was "always a big fan".

"They were there from the start," he said.

Other elements of the Dexia restructuring include the targeted sale of Dexia Banque Internationale à Luxembourg to a group of international investors, with the participation of the state. ■

Market

AUSTRALIA

Aussie openers under fire

Australia & New Zealand Banking Group and Westpac launched the first ever Australian covered bonds in November, avoiding the euro-zone's troubles to tap the US dollar market, but the debuts were found wanting by some market participants who found their execution and performance disappointing.

A mandated euro covered bond for Commonwealth Bank of Australia was on hold at the time of writing, with National Australia Bank also yet to issue after having initially been considered the frontrunner.

The sudden interruption in issuance came after a frenzy of preparatory work, with Australia's major banks quick to go on roadshows once the country's parliament had approved covered bond legislation and the Australian Prudential Regulatory Authority (APRA) removed a ban on the issuance of covered bonds by authorised deposit-taking institutions (ADIs).

With roadshow mandates for NAB and CBA emerging only two days after the covered bonds bill was granted royal assent on 17 October, Australian banks moved towards covered bond issuance at an unprecedented pace.

When the bill was introduced into parliament by Treasurer Wayne Swan, a Treasury official suggested that legislation could be in place by Christmas, but ultimately it took only just over a month, with the House of Representatives and Senate passing the bill on two subsequent days in October.

"I think from first reading to speech to Royal Assent, it would have to be one of the shorter timings on any legislation that has been passed, which is one of the benefits of having bi-partisan support," said Andrew Jinks, a partner in Clayton Utz's banking and financial services team.

US and Europe-targeted roadshows, carried out by the majors, showed investors to have a preference for the use of indexation in ongoing loan-to-value (LTV) valuations, prompting those issuers that had decided to include this in their programmes to promote the feature, with NAB said to have ultimately also opted for such a feature in response to investor feedback.

ANZ: First to use Australians' new funding source

ANZ then overcame tricky market conditions to sell Australia's first covered bond on 15 November, a $1.25bn (Eu928m/A$1.24bn) five year deal at 115bp over mid-swaps led by ANZ, Citi, HSBC, Morgan Stanley, Nomura and UBS, and the result was considered respectable by others. John Needham, head of structured funding, group treasury at ANZ, said that the transaction went very well.

> "Why would such a solid jurisdiction need to rush?"

"Conditions were pretty tough in the European time zone," he told The Covered Bond Report, "but for us to bring an inaugural transaction into the US and upsize it to take $1.25bn at 115bp over mid-swaps — we're very happy with that."

Westpac launched a $1bn five year deal two days later, also at 115bp over mid-swaps, via Bank of America Merrill Lynch, Barclays Capital and Nomura, although conditions had deteriorated in the interim and ANZ's deal was said to have traded wider in the aftermarket.

Market participants away from the first Australian covered bonds were left disappointed by the jurisdiction's debuts, saying the deals had underperformed since pricing, were pitched too tightly, and were poorly co-ordinated.

"How have such a long anticipated group of such strong institutions from such a great country ended up with this result?" asked one syndicate official, with another saying that the impact on Australia's standing — and the implication for pricing in dollars for other issuers, not just from the country — was far reaching. Nordic issues also widened on the back of the Australians' underperformance.

"The question is: why would such a solid jurisdiction need to rush into the market at the wrong price?" said one. "Why risk a deal not covered at the wrong spread that is destined to widen, which it did?

"These are not one-off deals; the banks have significant funding to do in this space. It's hugely disappointing and a shame."

Bankers close to the ANZ and Westpac deals defended their execution.

"We had the ability to do a deal, investors were asking for it, ANZ had gone well, so we said: 'Let's do it.' And we got there," said one.

They also defended their execution against claims their pricing offered an insufficient premium versus outstandings, saying that a consensus had emerged from roadshows around the 110bp-115bp level at which ANZ was first whispered, ahead of 115bp area guidance.

"It is very easy to criticise the levels, but investor feedback was OK around the specific level," said one. ■

ECB

CBPP2 straitjacketed by wider crisis

The European Central Bank launched a new covered bond purchase programme at the beginning of November, but the prospect of support for the asset class failed to spark new issuance, with the euro-zone crisis undermining any recovery.

By the time The Covered Bond Report went to press, a week into reporting of purchases by the European Central Bank, no euro-zone issuers had taken advantage of the second purchase programme (CBPP2) to launch new benchmarks.

The first official details of Eurosystem buying were released on 14 November and after seven days Eu765m of purchases had been reported by the European Central Bank. Although this is below the average weekly amount that will need to be spent if the Eu40bn allocated is spread over the year the programme is in operation, it represents a faster buying rate than at the beginning of the first covered bond purchase programme, which ran from July 2009 to June 2010, despite CBPP2 being smaller than CBPP1's Eu60bn.

Market participants said that the Eurosystem is probably unwilling and unable to get new issuance flowing.

"It seems that the Eurosystem central banks do not want to intervene in large sizes in the secondary market as long as the sovereigns remain in such a distressed state and Italian and Spanish covered bonds trade well through their sovereigns," said Michael Michaelides, covered bond analyst at Royal Bank of Scotland. "The ECB and the national central banks probably want to keep their powder dry and will be more active in the primary market if and when issuance picks up again.

"A noticeable increase in the purchase volume would leave its mark in the market and could thereby have a positive effect on the currently paralysed primary market — but this is clearly not a panacea given the overarching problems at the sovereign level."

Mario Draghi: a new ECB president for a new purchase programme

The only confirmed and indeed probable primary market purchases were of two taps for Crédit Mutuel Arkéa. Central banks were allocated 20% (Eu150m) of a Eu750m April 2021 tap and 38% (Eu95m) of a Eu250m June 2015 increase. These were not necessarily all under the purchase programme, but the settlement of the trades coincided with a Eu263m increase to the ECB's CBPP2 tally and those involved in the deal confirmed that a ticket had been taken on behalf of the Eurosystem.

Thomas Guyot, financial markets, managing director at Crédit Mutuel Arkéa, told The Covered Bond Report that the purchase programme did not have a strong impact on its deal, which had already attracted good demand before the Eurosystem order was placed.

"The purchase programme is supportive of the market and demand for covered bonds in general," said Guyot, "but the specific Eurosystem participation was not decisive for our transaction.

"It was our understanding from the beginning," he added, "that the Eurosystem wants to be involved in a real transaction, in the sense that they want to support transactions that are already able to attract investors. That was the case in our deal, which was already a success when a purchase programme order was placed, although of course the programme made it possible to do a larger deal."

The European Central Bank announced the new programme on 6 October after the monthly meeting of its governing council, with further details forthcoming at its November press conference (see box for the ECB's full criteria), the first chaired by new ECB president Mario Draghi, after he took over from Jean-Claude Trichet.

Some market participants were disappointed that the ECB did not provide any clarity on how the Eu40bn would be shared between the euro-area national central banks and whether peripheral markets would be prioritised. But Vincent

Hoarau, head of covered bond syndicate at Crédit Agricole CIB, said it was naive to have expected more details from the ECB.

"It happened the same way in 2009," he said. "They're releasing no proper detail on how this money will be allocated to the different covered bond jurisdictions; we will only get the information — if we get it — when it's already trading.

"I can imagine that the allocation will be based on a kind of formula considering three things: the ECB paid-in capital share of the national central bank; the covered bond market size of that country; and hopefully the fact that some jurisdictions need more support than some others."

The first of these — money being allocated to national central banks according to the "capital key" — is understood to have been followed, but there were no signs in early secondary market buying under the programme that priority was being given to covered bonds from countries where bank funding has been most difficult — even if the ECB's criteria have been expanded to, for example, accommodate much lower rated issues than under CBPP1.

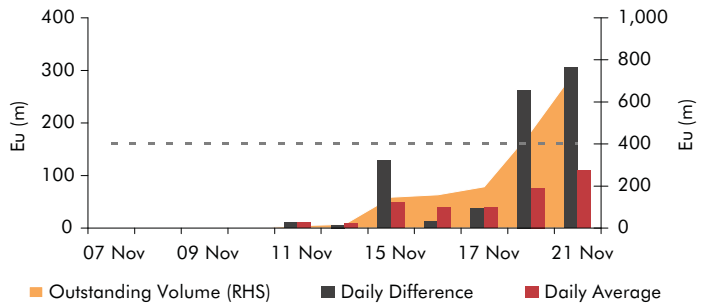
Some market participants criticised the Eurosystem's strategy.

"I am reading that the Eurosystem has purchased approx Eu100m of German Pfandbriefe and 10m of Portuguese Obrigações today," said a portfolio manager. "If this is correct, it's a waste. As if German Pfandbriefe are the most broken market..."

But others have suggested that the there are reasons for hope. A covered bond banker said that he expects central banks to be less domestically focused than previously.

"Some central banks are more open to investing in other countries than they have done before," he said. "For example, the Bundesbank will probably be a bit more open." ■

ECB Covered Bond Purchases under CBPP2



Source: ECB, RBS

In order to be qualified for purchase under the programme, covered bonds must:

- be eligible for use as collateral in Eurosystem credit operations;
- comply with the criteria set out in Article 52(4) of the Directive on undertakings for collective investment in transferable securities (UCITS) or similar safeguards for non-UCITS-compliant covered bonds, as specified in Section 6.2.3 of the General Documentation;
- have an issue volume of Eu300m or more;
- have a minimum rating of BBB- or equivalent from at least one of the major rating agencies;
- have a maximum residual maturity of 10.5 years; and
- have underlying assets that include exposure to private and/or public entities.

(Source: ECB)

"The probability of a bank going bankrupt is regarded now being much more likely" page 39

PFANDBRIEFE

Market-making 2.0 set for early 2012

The Association of German Pfandbrief Banks (vdp) is preparing to introduce a revised market-making system at the beginning of 2012 that places at its centre the quotation of covered bond prices to investors and will operate in tandem with a secondary market transparency initiative.

The vdp's former market-making system was primarily an inter-dealer quotation regime that formed part of "minimum standards" aimed at ensuring the liquidity of jumbo Pfandbriefe, with market-making in turn covered by minimum standards such as the quoting of two way prices with maximum bid-offer spreads. The system broke down in August 2007 after the onset of the financial crisis and never recovered, with the vdp since deciding to work on a successor regime that it intends to roll out early next year.

Sascha Kullig, head of capital markets at the vdp, acknowledged that the former market-making system was somewhat controversial, but said that the vdp is continuing to refer to market-making to describe the amended minimum standards.

However, the vdp is clearly distinguishing the revised regime from the former market-making system, he said, in that while the latter was focussed on inter-dealer price quotation, the new system places investors at the centre.

"It obliges market-makers to quote prices to investors," said Kullig. "If they want to provide other market-makers with quotes they can of course do so, but there is no obligation under the new minimum standards."

As under the old arrangements, the revised market-making system requires that each jumbo Pfandbrief have at least five market-makers who pledge to quote prices, although this time there is no obligation to quote two-way prices — with this instead becoming an on request service — and no maximum bid-ask spreads.

Key to the new market-making system is a secondary market transparency initiative under which the vdp will calculate and publish median spread data of jumbo Pfandbriefe on a daily basis based on spread indications provided by participating banks. This, said Kullig, is to make up for the move away from maximum bid-offer spreads under the old system.

Sascha Kullig: "It obliges market-makers to quote prices to investors"

"We needed a critical mass of data delivery"

"We have chosen to proceed with a more flexible market-making system," he said, "but to compensate for that we decided we needed to provide a minimum degree of secondary market transparency, especially for those investors who are not necessarily in the market on a daily basis."

A test phase has been running for several months, with 11 banks participating so far and the vdp in discussions with several others. The goal is to have 15 banks providing daily spread indications for jumbo Pfandbriefe with a residual maturity of at least 24 months, with the data sent to a third party that will automatically compute a median spread for eligible individual bonds.

"The technical implementation is not straightforward, which is why the test phase is taking time," said Kullig, "and we needed a critical mass of data delivery."

The vdp also wanted to verify that the spread indications provided were sufficiently in line, he added.

"We are still in the test phase," he said, "but the data delivery has stabilised to the point that we have always had sufficient data to calculate an average spread, with the spread indications such that we can do so with a good conscience."

The vdp will disclose the names of the participating banks when the secondary market data reporting initiative, in tandem with the new market-making standards, goes live — launch is targeted for the beginning of 2012 — and the median spreads will be publicly disclosed on the association's website in Excel format.

The vdp will also monitor the quality of participating banks' reporting of secondary market spread indications, although the data will for this purpose be rendered anonymous before being passed to a committee dedicated to this task.

In addition to being relevant to a new bank liquidity framework under development at the EU level, Kullig said that the new market-making standards and secondary market data reporting project were developed with the transparency agenda set out by the Markets in Financial Instruments Directive (MiFid) in mind.

"On the one hand we are trying to bridge the gap until MiFid is implemented," he said, "but on the other the secondary market data initiative complements MiFid in the sense that the spreads we will report are not necessarily based on trades, while MiFid is about post-trade transparency." ■

SCANDINAVIA

Swedes eye Aussies, Stadshypotek Nokkies

The Swedish Covered Bond Corporation and Stadshypotek have established Australian medium term note programmes and set off on roadshows, while Stadshypotek is also targeting a Norwegian krone debut for a new cover pool comprising Norwegian mortgages.

Per Tunestam, treasurer at SCBC parent SBAB, told The Covered Bond Report that the issuer is looking forward to entering the new market.

"We thought the Australian dollar covered bond market would suit us given the small size of our balance sheet and the small size of the Australian dollar market," he said. "It's a smaller market than the 144A."

Tunestam drew a comparison with the Swiss franc market, where SBAB or SCBC issues four or five public senior unsecured or covered bond deals a year, raising Sfr125m-Sfr250m (Eu100m-Eu200m/Skr924m-Skr1.85bn) per deal. Tunestam confirmed the issuer intends to launch a deal off the new Australian programme soon — if not by year-end, then in the first quarter of 2012.

"It depends on the feedback we receive on the roadshow from investors," he said.

Tunestam said it was too early to identify a size or maturity, but he expected the first transaction would be in the region of A$500m (Eu370m). He said that Australian investors might be more interested in covered bonds now that Australian banks are active in the asset class.

"I understand that interest has risen as a result of Australian issuers," he said, "as well as the Australian Prudential Regulation Authority now legitimising the market by introducing regulations.

"I think the US also needs this to make their market better," he added.

Tunestam said even the whole documentation process had been smoother and less cumbersome than what he understand to be the case with 144A.

Thomas Åhman, deputy head of treasury at Handelsbanken, Stadshypotek's parent, told The Covered Bond Report that the issuer had been considering approaching the Australian market since the beginning of the year.

"For us, it is another building block in our long term strategy," he said, "to help make sure that we have a more and more diverse investor base over time.

As well as having been active in euros, the Swedish issuer entered the US dollar market in September 2010. However, Åhman said that the Swedish market — the fourth largest domestic covered bond market — will remain the main reference for Stadshypotek.

"We could refinance 100% of our needs in the domestic market if we wanted to, so if we are issuing internationally, it's for long term diversification reasons," he said. "And if we issue in euros, dollars or other currencies, it is important for us that the all-in cost is as close as possible to what we could achieve in the domestic market."

However, the Norwegian krone market will be the focus for a new Stadshypotek programme backed by Norwegian mortgage loans but under Swedish covered bond legislation.

"It's a natural step," said Åhman. "We have had our business in Norway for some time now and have set up the Norwegian cover pool now that we have reached a critical mass."

Moody's put the size of the cover pool at Nkr26.3bn (Eu3.4bn) in a rating release on the programme but Åhman said that it is around Nkr30bn (Eu3.87bn). He said that the Norwegian krone market would be a good fit for issuance backed by the new cover pool.

"The Handelsbanken brand is well known," said Åhman, "and it is just a matter of talking to investors and giving them a view of our mortgage portfolio there."

He said that while the issuer would be open to the idea of euro issuance backed by the pool in the future, it would restrict Swedish krona issuance to that backed by its Swedish cover pool.

Per Tunestam: "Interest has risen as a result of Australian issuers"

Bigger issuers including DNB Boligkreditt and SpareBank 1 Boligkreditt have split issuance backed by residential mortgages and by commercial mortgages into separate cover pools and programmes. Stadshypotek's Nowegian cover pool will comprise 5% multi-family loans to commercial and housing association landlords, according to Moody's, and Åhman said that the small volume of such loans explains why they will be in the same pool as other residential mortgage loans that make up the vast majority of the cover pool. ■

"The option of broadening the investor base to include US investors is attractive" page 43

AUCTIONS

Danes confident despite uncertainties

Realkredit Danmark kicked off a Dkr460bn (Eu62bn) Danish auction season on 21 November, with Danish market participants confident that the impact of the financial turmoil on pricing would be limited and disagreements with Moody's a side issue.

"The most astonishing thing about this is that, although it's not a record high, it's still a lot of bonds that we need to sell in euroland, but there is no debate on risk, or refinancing risk, or anything that Moody's talked about," Danske Bank chief analyst Jens Peter Sorensen told The Covered Bond Report. "Everything is relaxed and calm, and there is a lot of focus on Denmark for being outside the euro."

Danske subsidiary Realkredit Danmark is selling Dkr140bn (Eu18bn) in Danish krone denominated non-callable bonds and Eu4bn (Dkr31bn) in euro denominated covered bonds over two weeks, auctioning mortgage covered bonds maturing from 2013 to 2017.

Sorensen at Danske expects only a modest increase in spreads this December, with a level of between 45bp and 50bp over mid-swaps.

"Usually we do around 30bp-35bp in December," he said, adding that in the September auctions the spread was down to a mere 25bp over. You get a little bit extra premium – but not much."

Nykredit group, comprising Nykredit Realkredit and Totalkredit, which will enter the market on 29 November, also expects a spread difference of around 10bp from last year, putting the pricing for its bonds this year at about 50bp over.

Nykredit will auction a total of Dkr136bn (Eu18.3bn) between 29 November and 14 December. The auctions will refinance Dkr72bn (Eu9.7bn) of Nykredit Realkredit's and Totalkredit's adjustable rate mortgages (ARMs) as well as refinancing Dkr22bn (Eu3bn) of Nykredit's Cibor and Euribor linked loans and Totalkredit's BoligXlåns. The equivalent of Dkr42bn (Eu3bn) will be sold in euro denominated notes.

Nykredit is offering about Dkr25bn (Eu3.3bn) less than in the last December auction, reflecting it having spread out its auctions from last year.

"This time we're going to issue notes in Danish kroner and euros, some of which are going to expire in July 2013," said Madsen, "which means the next time they will be auctioned is July, not December. We still want to spread out our auctions further."

Nordea Kredit plans to sell Dkr75.825bn (Eu10.19bn) of Danish krone bonds and

Jacob Skinhøj, Nordea Markets: expects higher international investor demand this year

Dkr22.478 (Eu3bn) in euro denominated notes from 28 November to 9 December. It anticipates the lowest spread of the three mortgage banks, at 45bp over.

Jacob Skinhøj, chief analyst at Nordea Markets, said he expects Nordea to trade about 5bp more expensively than Realkredit Danmark and 10bp more expensively than Nykredit. He anticipated higher international investor demand in this year's auction.

BRFkredit announced that it will be selling non-callable bullet bonds between 24 November and 7 December to refinance adjustable rate mortgage loans, comprising an expected Dkr51bn and up to Eu300m (Dkr2.23bn). ■

FRANCE

Issuer line-up to expand

La Banque Postale intends to establish a covered bond issuing entity to refinance home loans, while Crédit Agricole has set up a société de credit foncier for the issuance of covered bonds secured on loans backed by export credit agencies.

France's Autorité de Contrôle Prudential (ACP), has licensed Crédit Agricole Export Credit Agencies SCF, according to ACP's website. Crédit Agricole already issues mortgage backed covered bonds off a Home Loan SFH programme.

Loans guaranteed by export credit agencies are already present in cover pools of BNP Paribas and Société Générale SCFs, although The Covered Bond Report understands that export credit agency-guaranteed loans are likely to form a greater part, if not all, of Crédit Agricole's SCF cover pool.

La Banque Postale said in October that, as part of its strategic plan for 2011-2015, it wants to develop its home loan offering for retail clients and that it also envisages creating a société de financement de l'habitat (SFH) exclusively for the refinancing of such loans.

The announcement came as La Banque Postale said that with regard to the financing of loans to local authorities it is not working on the establishment of a société de credit foncier (SCF) but is considering using the public sector lending structure of Dexia Municipal Agency, which Caisse des Dépôts et Consignations (CDC) will control and in which La Banque Postale will have a 5% stake as part of the restructuring of the Dexia group. ■

STERLING

Co-op debuts at home amid UK changes

A preference for a long term maturity prompted the UK's Co-operative Bank to turn to the sterling market in early November to launch its first benchmark covered bond and the first in the currency for six months.

The UK Regulated Covered Bond issuer sold a £600m (Eu700m) 10 year issue at 250bp over Gilts, equivalent to around 215bp over mid-swaps, on the back of an order book of £1bn, with more than 70 accounts participating.

"The maturity preference was for a longer deal and given that we felt a euro transaction was most likely to be there in the short to intermediate maturity we opted for a sterling trade," said Jez Walsh, global head of covered bond syndicate at RBS, which was joint lead alongside Barclays Capital, HSBC, JP Morgan and UBS.

He said that while euro investors were reluctant to invest in long dated issuance from issuers with lower ratings, the UK investor base was open to such supply even in difficult market conditions. Co-operative Bank is rated A3/A-/A (Moody's/Fitch/DBRS).

However, Walsh said that with the issuer having done a UK and European roadshow a euro deal is likely to be part of the issuer's future considerations, with feedback from the UK roadshow indicating there would be leftover demand from some domestic accounts for short dated euro issuance.

> "The maturity preference was for a longer deal"

UK investors took 99% of the bonds, with funds allocated 50%, insurance companies 40%, banks 4%, corporates 2%, private banks 1%, and others 3%.

The deal was issued off a newly established covered bond programme (Moorland), with the issuer having terminated another programme (Pioneer) that was set up to access the Bank of England's Special Liquidity Scheme (SLS). Co-operative Bank merged with Britannia Building Society in 2009 and the LLP and other Moorland entities used in the ongoing programme's structure are those that were used in a programme Britannia had previously established (they have been renamed).

Around the time of Co-operative's deal, Fitch said that some UK lenders' use of covered bonds as a source of funding is decreasing with the end of the SLS on 30 January 2012, but that a recent increase in supply from large institutions can offset the contraction of the size of the UK market caused by the end of the SLS. Fitch also noted that in some cases rather than winding down covered bond programmes UK lenders are restructuring them for market issuance, citing Co-op's Moorland programme in this respect.

"Examples of restructuring include shifting from a partial pass-through structure in retained deals swapped at the SLS, to hard or soft bullet repayments in deals that will be sold to private investors," said the rating agency. ■

FLUGZEUGPFANDBRIEF

NordLB targets early 2012 for aircraft first

NordLB is aiming to launch an inaugural aircraft Pfandbrief in the first quarter of 2012, market conditions permitting, according to an official at the issuer. Any such deal could be the first benchmark aircraft Pfandbrief.

Aircraft Pfandbriefe (Flugzeugpfandbriefe) are a fourth type of Pfandbrief permitted under Germany's Pfandbrief Act, as per a 2009 amendment of the legislation. NordLB in 2010 became the first German bank to receive an issuance licence for aircraft Pfandbriefe.

"The programme is ready, the documentation is ready and the cover pool has been set up," Thomas Cohrs, head of syndicate and origination, financial institutions and SSAs, at NordLB, told The Covered Bond Report.

The programme has yet to be rated, but Cohrs said that the issuer expects a Aa2 rating from Moody's to be forthcoming in December. The issuer will then be in a position to tap the market with a planned Eu500m transaction in the first quarter of 2012, subject to market conditions, he said.

However, The Covered Bond Report understands that before launching the aircraft Pfandbrief, the issuer hopes to make its debut in the US dollar covered bond market with a benchmark backed by more traditional collateral. ■

Airbus 320-200: an example of an aircraft that meets Flugzeugpfandbrief criteria

League Tables

EURO BENCHMARK COVERED BOND RANKING

1 January 2011 to 31 October 2011

Rank	Bookrunner	Deals	Amount (Eu m)	Share %
1	BNP Paribas	55	14,222.50	8.04
2	Natixis	64	13,747.50	7.77
3	UniCredit	56	11,701.19	6.61
4	Credit Agricole	46	11,508.33	6.50
5	Barclays	44	11,450.83	6.47
6	HSBC	49	10,922.86	6.17
7	Deutsche	40	10,491.19	5.93
8	UBS	38	8,817.08	4.98
9	SG	32	8,020.83	4.53
10	RBS	27	6,877.50	3.89
11	DZ	28	5,965.36	3.37
12	Commerzbank	31	5,862.92	3.31
13	Danske	18	4,795.83	2.71
14	LBBW	25	4,435.00	2.51
15	ING	16	4,087.50	2.31
16	Citi	16	4,018.75	2.27
17	BayernLB	15	3,084.52	1.74
18	Goldman Sachs	11	3,066.67	1.73
19	BBVA	11	2,945.83	1.66
20	Santander	12	2,792.50	1.58
21	Nomura	14	2,791.67	1.58
22	NordLB	13	2,525.00	1.43
23	Credit Suisse	13	2,466.67	1.39
24	JP Morgan	12	2,383.33	1.35
25	Banca IMI	6	1,683.33	0.95

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 October 2011

Rank	Bookrunner	Deals	Amount (Eu m)	Share %
1	Barclays	63	16,801.38	7.85
2	BNP Paribas	62	15,884.81	7.42
3	Natixis	65	13,928.33	6.51
4	HSBC	60	13,621.89	6.36
5	Deutsche	45	11,877.58	5.55
6	UniCredit	56	11,701.19	5.47
7	Credit Agricole	46	11,508.33	5.38
8	UBS	44	10,802.00	5.05
9	RBS	38	10,483.83	4.90
10	SG	33	8,239.96	3.85
11	Commerzbank	32	6,043.75	2.82
12	DZ	28	5,965.36	2.79
13	Citi	21	5,005.92	2.34
14	Danske	18	4,795.83	2.24
15	JP Morgan	21	4,788.98	2.24
16	LBBW	25	4,435.00	2.07
17	ING	16	4,087.50	1.91
18	Santander	14	3,446.01	1.61
19	BAML	15	3,384.09	1.58
20	BayernLB	15	3,084.52	1.44
21	Goldman Sachs	11	3,066.67	1.43
22	BBVA	11	2,945.83	1.38
23	Credit Suisse	16	2,926.82	1.37
24	Nomura	15	2,910.33	1.36
25	NordLB	13	2,525.00	1.18

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.

For a few dollars more?

European issuers heading across the pond in search of dollars have not found the US as welcoming as anticipated. But with a covered bond bill being introduced in the Senate, Australian supply potentially complementing Canadian success, and index-eligible issuance being explored, issuers could yet reap the rewards of going west. *Susanna Rust* reports.

The US dollar covered bond market sprang into life in 2010 after three years without issuance and hopes were high that it would this year be able to continue and build on the revival.

But despite setting a new record, volumes have fallen short of some market participants' initial expectations. At the time of writing supply amounted to just over $37bn, more than 2010 volumes but down on some forecasts of between $70bn and $80bn.

Market participants are quick to attribute this in no small part to the volatility triggered by the euro-zone sovereign debt crisis rather than linking it to problems specific to the US dollar covered bond market.

"Volumes are not where we predicted they would be by this time of the year," says Mike Banchik, managing director, debt capital markets syndicate at HSBC in New York, "because the extent of the European crisis was not anticipated.

"Without US legislation, European issuers have been a key part in the market along with Canada, so it is not surprising that, with the sovereign debt crisis and wider spreads, volumes have been less than anticipated."

Another New York banker says that while the US dollar covered bond market has been "chugging along" this year, the list of issuers that have access is finite.

"Since the dollar market is less developed and has less of a history than the euro market certain issuers get painted with a broad brush of Europe," he says, "and with less differentiation than you may see in the European market this benefits certain names, like the Canadians, and hurts others."

Indeed, Canadian banks have been driving supply this year, with Toronto Dominion Bank, for example, in September pricing a dual tranche $5bn deal that is the largest ever US dollar covered bond and gives a taste of the reception Canadian deals have enjoyed.

At the time of writing these comprised more than half of supply, with Nordic issues representing the next largest share, and then debuts from Credit Suisse and HSBC, a couple of French issues and a lone deal from Korea Housing Finance Corp making up the balance.

Market participants have been looking forward to volumes being boosted before year-end by issuance from Australia's major banks, after the country's parliament in October passed legislation allowing the sale of covered bonds. ANZ was launching the inaugural deal in the dollar market as The Covered Bond Report was going to press (see Monitor, Market section for more).

For John Cerra, portfolio manager at TIAA-CREF in New York, Canadian banks' covered bond issuance has played an important role in the helping the development of the US market.

"I think it's forced a lot of people to look at this because they're all issuers that US institutional investors know well," he says. "They have done a favour to all those people who want to see the US covered bond market grow by the issuance they have brought and by bringing collateral that is insured by Canada Mortgage and Housing Corp."

Handle with care

While Canadian covered bonds have not been immune from spread widening, European borrowers' access to the US market has been most affected by protracted volatility, which a New York-based banker says prompted liquidity to "freeze up".

"We saw that throughout the summer months when there could have been a number of other transactions to hit the market — whether for the French banks, the UK banks — but they were shut out," she says.

German issuers, meanwhile, have not issued a US dollar covered bond since July 2010, when LBBW sold a $500m three year deal. However, at least a couple have since then explored the possibility of tapping the US market and in October the Association of German Pfandbrief Banks (vdp) went on its first US roadshow in several years in response to interest in dollar funding among its members, according to Jens Tolckmitt, chief executive of the vdp.

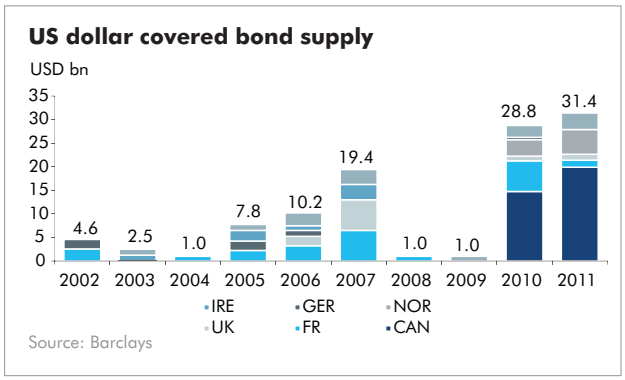
"Issuers get painted with a broad brush of Europe"

He says that one of the reasons that German Pfandbrief banks have not been as active in the US market as Nordic issuers and some of the French is because the euro market has been able to meet their needs.

"I think maybe our issuers have not started this as early as other foreign issuers because contrary to, for example, French issuers they are not as dependent on overseas funding," he says.

In addition, he says that German issuers typically have a different motivation to turn to the US market.

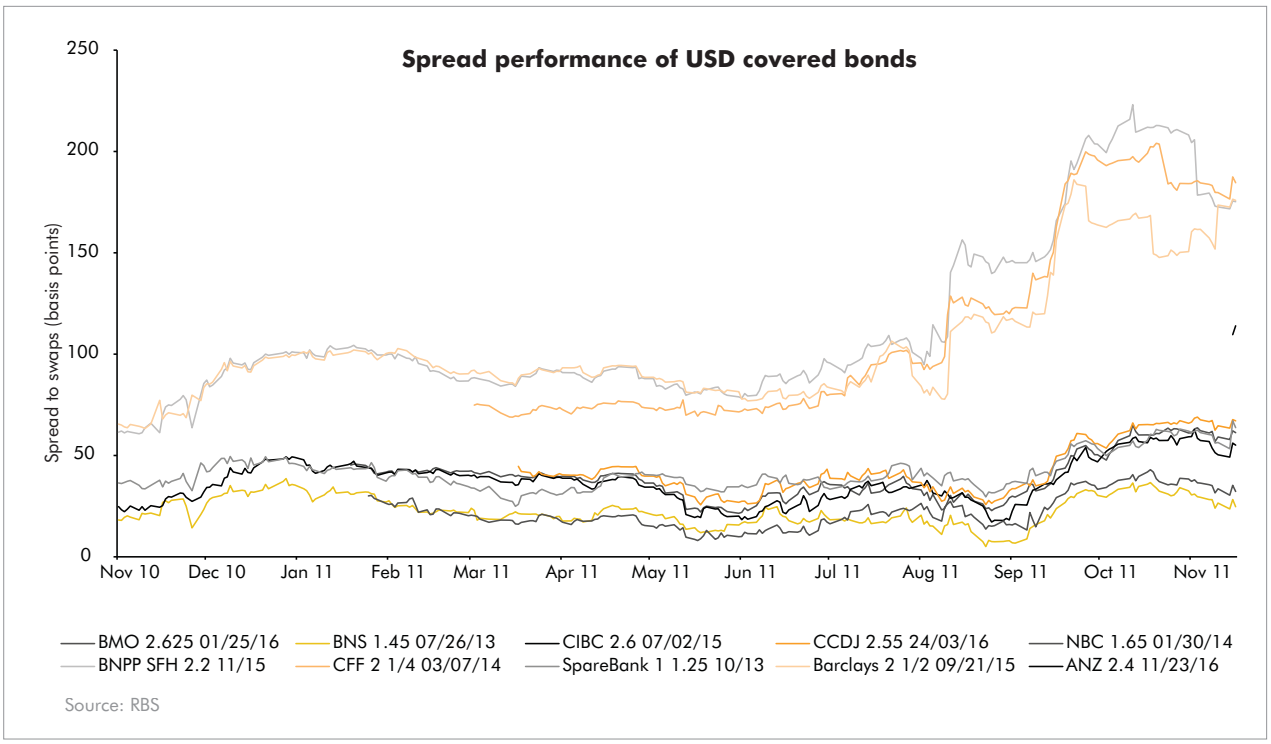
"The traditional way is for German Pfandbrief banks to look for US dollar funding if they have substantial US dollar assets," he says. "If there is no traditional US dollar asset base in the cover pool they would not feel inclined to actually issue US dollar Pfandbriefe, which is different from the Scandinavian issuers and also from the French."



The last US dollar covered bond from a European issuer was a $1bn five year deal for Norway's Nordea Eiendomskreditt on 15 September, with other European issuers who were said to have been considering tapping the dollar market instead opting for euro issuance.

"Finding dollar investors to buy European bank debt is slightly difficult these days," said a London-based syndicate official in September, at a later date noting that while the US market "provided some relief to Canadian and Nordic issuers […] that proved short-lived as poor placement sent most of those deals gapping wider post-launch."

Nordea's transaction illustrated some of the challenges posed by the US dollar market, according to market participants. A New York based banker suggests its execution had perhaps been handled too casually, with insufficient regard for US investors' sensitivity to European developments, while a Europe-based syndicate banker says Nordea's deal showed that there is



a lack of granularity in the US investor base, with a handful of large accounts able to drive pricing action. He adds that US accounts are aware of and able to limit the dollar/euro arbitrage that European issuers seek to take advantage of.

Another market participant picks up the point, saying that some recent widening in US dollar covered bonds was "probably more than you should see" and showed that liquidity was a problem.

"If a few of the big investors decide to rebalance their portfolios and sell covered bonds you're going to see greater widening than you would in a deeper market," he says, "and I think those are the challenges we have right now."

No rush to judgement

But market participants say that challenges such as these must be kept in perspective, and that there are positive developments to be pointed at and to look forward to.

Asked whether covered bonds are a niche product in the US, Richard Gustard, head of SSA origination and trading at JP Morgan in London, says he would not opt for such a description because the asset class appeals to a genuinely broad base of investors.

"It could benefit from deeper penetration into each of these individual client categories, but no, I would not say it is a niche product," he says. "I would describe it as a young market."

Peter Walker, associate vice president, treasury and balance sheet management at Toronto Dominion Bank, says that the bank's US senior unsecured deals could involve double the number of accounts participating in its US dollar covered bond issues, but that the latter have attracted new investors.

"Our two tranche deal in September got a very positive reception and managed to get over 80 investors to participate, 10 of which we think were new to US dollar covered bonds," he says. "We also saw more participation from bank treasuries than we had a year ago."

HSBC's Banchik believes that covered bonds have found a home as a rates product but that they are increasingly attracting credit buyers.

"They are not the biggest group of investors, but their involvement is growing," he says. "More and more customers are looking to get involved and are getting educated about the product. Accounts who may have only had approval for Canada are getting other jurisdictions approved, so the investor base is growing."

In acknowledgement of increased interest in covered bonds among credit investors Barclays Capital in October announced that it will be launching a new family of global and regional corporate bond indices that blend covered bonds and unsecured corporate bonds.

Julia Hoggett, managing director, head of covered bonds and FIG flow financing for EMEA at Bank of America Merrill Lynch, says that it is important to recognise that market participants, in their efforts to develop the US dollar covered bond market, are dealing with an unusual challenge.

"The market has moved forward and will continue to do so," she says, "but what is being done is fairly new. Although we are more towards the credit end of the spectrum, we are trying to create a rates product (in terms of investor ticket sizes and secondary market liquidity expectations) in the 144A private placement market and that presents its own challenges and constraints."

Peter Walker, TD Bank: "Our two tranche deal in September got a very positive reception"

And Ben Colice, head of covered bond origination at RBC Capital Markets, says that he remains broadly optimistic about the future of the US dollar covered bond market, but that it is faced with headwinds, such as uncertainty surrounding Europe and the lack of US covered bond legislation.

Cerra also refers to headwinds to describe the context in which the US market is attempting to expand.

"The market is trying to grow at a time when stress and fractures throughout the economic world are very apparent," he says. "You're definitely growing into a headwinds period and I think the fact that it has been able to take hold and make small, but noticeable incremental steps to progress is a good thing and tells you an awful lot about the product."

He believes that US dollar covered bond investors are better supported than in the past.

"We've been looking at European covered bonds on and off since 2006 and at that point the bonds traded by appointment," he says. "Today there is a developing infrastructure that operates in a way that meets the needs of US investors.

"The number of dealers that will trade covered bonds has definitely expanded, and you can electronically trade all the Canadian covered bonds and the larger, more recent European issues."

A greater number of investors are participating in the market and are able and willing to write good sized tickets, he adds, with improved price transparency also a welcome development.

"Price information used to be patchy," he says, "but now every single day a number of dealers are showing two sided markets on Bloomberg.

John Cerra, TIAA-CREF: "Every single day a number of dealers are showing two sided markets"

"When you go to look at a bond and you are getting several appraisals and as a result can see the bid and the ask converging into an institutional market that can give you more confidence executing a trade, and that's huge."

Beyond a foreign, 144A market

Signs of progress notwithstanding, covered bonds represent a fledgling market in the US, paling into insignificance compared with the dollar unsecured and ABS markets, and of course, the euro covered bond market. But such comparisons are in many ways unfair given the relatively recent arrival of the asset class in the US, market participants suggest, and the constraints under which it is seeking to develop, such as the lack of covered bond legislation to support homegrown issuance.

"My own personal opinion is that the US investor base would like to see US issuers adopt the product to validate it as a real live, legitimate asset class," says a New York-based banker. "I don't believe there is going to be a huge market out of the gates, but legislation would be a boon for the covered bond market in general although for now it seems like it's a very long ways away."

These comments were made before a bipartisan group of Senators on 10 November introduced a covered bond bill, giving renewed momentum to a push for covered bonds in the US. For the first time a covered bond legislative proposal is in both the Senate and House of Representatives.

Howard Goldwasser, partner at K&L Gates in New York, said that the bill in question — the US Covered Bond Bill 2011 (or Hagan-Corker Act) — is remarkably similar to its namesake in the House, and that this was to be welcomed.

"The guts of both the House and Senate bills are very similar, and I think that this is positive from the perspective of those in the industry that would like the bill to be able to move forward pretty quickly — it means they can be harmonised more expeditiously."

Meanwhile, market participants say that enhancing the repo eligibility of dollar denominated covered bonds, both at the hands of the Federal Reserve discount window and in the context of bilateral or tri-party repo, could provide a boost to the US dollar covered bond market.

"Most covered bonds from non-domestic issuers are not Fed eligible so you haven't seen a huge amount of US bank treasuries get involved," says a New York based banker, contrasting this with the greater involvement of bank treasuries in the euro market.

She also identifies the repo eligibility of covered bonds in inter-bank lending as an important consideration, with haircuts higher on covered bonds than on other triple-A rated asset classes. While both are important, eligibility as collateral for repo with the Federal Reserve would have a greater impact, she says.

Hoggett says that enhancing the eligibility of covered bonds in the context of tri-party or bilateral repo would enable traders to borrow the bonds and trade them in a manner than generates greater liquidity, with another banker saying that banks do not feel able to sell covered bonds short.

The Federal Reserve in August 2009 assigned US covered bonds their own bucket at its discount window, with German jumbo Pfandbriefe the only other type of covered bond eligible to be pledged as collateral under its guidelines. However, European and Canadian issuers are said to have been lobbying the Fed to sign off on eligibility of their covered bonds.

The limits of 144A

In the absence of homegrown issuance perhaps the biggest and most imminent development that could expand the US investor base in covered bonds is the sale of index eligible covered bonds, which currently seems most likely to be achieved via issuance under a format other than SEC rule 144A.

With no new domestic issuance since 2007 (and even then there was only one issue, for Bank of America), all US-targeted benchmark covered bonds have since then come in the 144A private placement format, meaning that only qualified institutional buyers (QIBs) can be approached, who may also have limits on their exposure to non-fully SEC registered bonds. JP Morgan's Gustard brings up the issue of there being a limit to the volume of 144A deals that the buy-side can absorb.

"No-one has really considered what the maximum capacity for that documentation is," he says, "and although at the moment we haven't reached that point, I do wonder if at some point we will have to address that."

Compagnie de Financement Foncier was a frequent issuer in the US dollar covered bond market in 2010, selling three benchmarks, and returned to the market with a $1.5bn three year 144A/Reg S issue in March 2011.

"It helps us to reach and respond to the demands of a large investor base," says Paul Dudouit, head of medium and long term funding at CFF, of the 144A format. "We have been able to sell syndicated benchmark deals on the basis of 144A docu-

mentation, but also to respond to reverse enquiries."

Another banker says that while a large number of 144A deals are being executed in a relatively new market, a large investor base remains untapped.

"A lot of funds can't buy the 144A format, and a lot of money managers like the product but are limited to where they can put it," he says. "A lot of accounts don't meet QIB status so even though it's a large sector it is dwarfed by what is available in other funds."

In addition, 144A covered bonds are not eligible for the Barclays Capital US Aggregate Index. They are tracked by other indices, such as a new US dollar covered bond index launched by BNP Paribas in August "in response to demand from clients who wanted a tool to track this emerging asset class and compare its returns to other investment options" and by Barclays Capital's Global Aggregate Index, but market pariticpants say that the US Aggregate is the index in which covered bonds' inclusion would have the most dramatic impact on expanding the US investor base for the asset class.

"The 3(a)(2) format is being looked at very carefully"

Market participants look forward to the sale of index-eligible covered bonds.

"It's something the market would love to see," says RBC's Colice. "Creating a product that qualifies for indices and the like will be nothing but positive, and we are optimistic that it can happen.

"With index eligible covered bonds you would instantly have a broader base of investors who are always going to be looking at the issuance."

Hoggett says that the eligibility of covered bonds for any index with a large following would boost traders' and investors' confidence in the nascent US market.

"As an investor you have more confidence that there is a rump of the account base that could be on the bid side come rain or shine rather than just come shine," she says, "because these investors have to be tracking the index or at least taking a clear view if they are not doing so. And as a trader you have more confidence about which calls to make to move positions on."

Index eligibility on the horizon?

A development that addresses the constraints of 144A issuance could soon be in reach, however, as issuers explore documentation options that could give them access to a broader investor base, with the focus being on a format referred to as 3(a)(2).

This refers to the relevant section of the Securities Act and represents an exemption from full SEC registration that stems from, in the case of foreign issuers, using a US branch or agency to issue or guarantee a debt security (see Legal Brief for more).

"The 3(a)(2) format is being looked at very carefully by a lot of people, but it is hard to judge when we will see such a deal," says HSBC's Banchik. "The pros are that you have a much bigger investor base and that the bonds are index eligible, so some investors will naturally fall into place as a result."

Howard Goldwasser, K&L Gates: "The guts of the House and Senate bills are very similar"

BAML's Hoggett says that the size and scalability of an issuer's US operation directly shapes the cohort of those who could execute a 3(a)(2) issue, adding that bonds issued under the format would have the benefit of their trading information being published under TRACE. The Trade Reporting And Compliance Engine (TRACE) is a price reporting mechanism for fixed income securities operated by the Financial Industry Regulatory Authority (FINRA).

Walker says that TD Bank has done some preliminary investigation into the 3(a)(2) format.

"There are a number of things involved," he says, "such as working through the legal issues and assessing the due diligence burden. We continue to assess this as an option."

A New York based banker points out that some foreign banks, such as Rabobank and Svenska Handelsbanken, have set up programmes for senior unsecured issuance based on the 3(a)(2) exemption. Handelsbanken in July became the first Nordic issuer to sell a 3(a)(2) deal, a $1.25bn five year that it said enabled it to gain "an even broader investor base in the US".

Cerra in New York says that a 3(a)(2) deal could be launched soon, and that the event would be a turning point for the US dollar covered bond market because the bond, if it meets the maturity and minimum size requirements, would be included in Barclays Capital's US Aggregate Index.

"That brings out a whole new series of investors," he says. "The first ones might be the institutions that don't have the resources to bridge the gap from a publicly registered deal to a 144A, and then you bring the indexers.

"That will be the next level and it will be a day for the covered bond market in the US, a coming of age." ■


Beware of Do
Culver's
TURTLE

Sovereign **belief** undermined

Rates investors are increasingly viewing European government bonds as an unsecured credit, with covered bonds trading tighter than sovereign debt in countries such as Austria and Italy. Morgan Stanley's *Leef Dierks* and *Jason Somerville* explore the evolving distortions and opportunities these have thrown up.

Following the recent weeks' continuously mounting widening pressures on certain European sovereign debt markets, typical rates investors have increasingly reclassified government bonds as an unsecured credit. Due to their dual claim against the issuing bank and the mandatory overcollateralisation, covered bonds, in contrast, benefit from being perceived as a secured credit.

On several occasions, this development has caused the previously relatively stable spread margin between covered bonds and government bonds to collapse. While government bond spreads considerably widened versus swaps and Bunds, covered bond spreads were less affected (see chart 1).

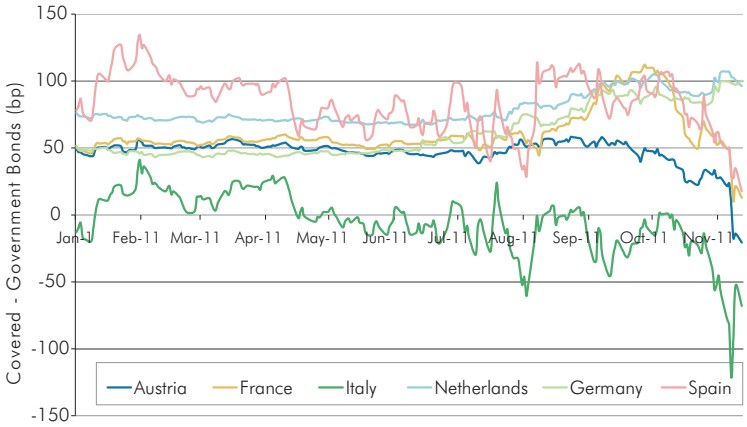
The development described above was most pronounced in the Italian market. After trading around parity until mid-October, BTPs recently experienced marked widening pressures versus swaps and cheapened by up to 100bp versus obbligazioni bancarie garantite (OBGs) before gradually recovering. A similar phenomenon could be observed in the French and Spanish markets.

> "Only the German and Dutch markets have remained unaffected"

Between early October and the time of writing, the margin between covered bond and government bond spreads contracted by 75bp. This caused covered bonds to trade within 25bp of government bonds with a comparable term-to-maturity. The latest market to be affected was Austria. Since November 8, the average margin between the iBoxx Euro Austria and the iBoxx Euro covered Austria has fallen sharply, by 45bp.

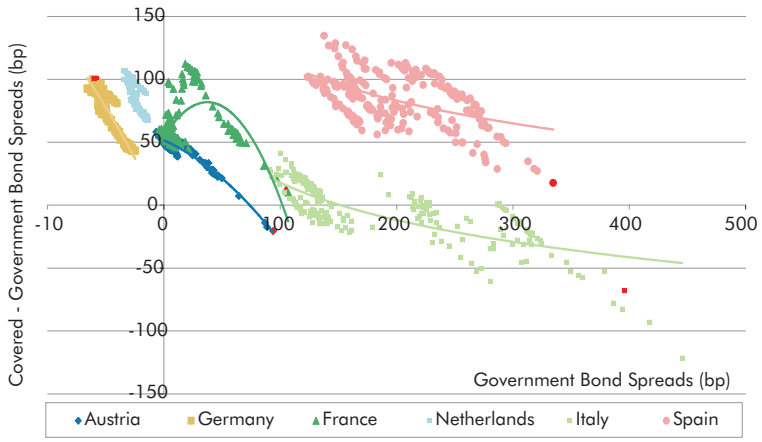
At the time of writing, Austrian and Italian covered bonds trade tighter than the respective government bonds, thereby emphasizing the currently prevailing

Chart 1: Government Bonds Cheapened vs. Covered Bonds



Source: Markit, Morgan Stanley Research

Chart 2: Spanish and Italian Covered Bonds Look Expensive



Note: red dots refer to the most recent data points. Source: Markit, Morgan Stanley Research

TABLE 1: COEFFICIENT OF CORRELATION: MARGIN BETWEEN COVERED AND GOVERNMENT BONDS VERSUS GOVERNMENT BONDS

	FY 2011	H1 2011	H2 2011
Austria	-0.94	-0.67	-0.96
Germany	-0.95	-0.93	-0.79
France	0.01	-0.85	-0.32
Netherlands	*-0.84*	*-0.89*	*-0.66*
Italy	-0.78	-0.71	-0.75
Spain	-0.54	-0.49	-0.78
Ireland	-0.94	-0.96	-0.99
Portugal*	-0.89	-0.97	-0.46

Note: There is no iBoxx € Portugal data after 1 August 2011. Source: Markit, Morgan Stanley Research

market distortions. So far, only the German and Dutch markets have remained unaffected. Spurred by an ongoing flight-to-quality, government bonds have become better bid and trade at a premium of around 100bp over the respective covered bonds, which, in contrast, have not benefitted from this development (see chart 2).

Any such elevated premium, in our view, is excessive. Despite the respective papers not strongly deviating from the fair level suggested by our model, we recommend selling the respective government bond versus buying the covered bond as we expect, ceteris paribus, the margin between the asset classes to contract in the medium term.

> "A disconnect between fundamental collateral pool analysis and covered bond spreads has emerged"

According to our model, Italian and Spanish covered bonds, in contrast, trade comparatively expensive versus government bonds. Whereas on average Spanish covered bonds exhibit a discount of only 17bp to government bonds, Italian covered bonds feature an unusually high premium of 65bp to Italian government bonds. We consider these spread moves to be largely exhausted and struggle to see how much further covered bond spreads could decouple themselves from the underlying government bonds. Therefore we recommend switching out of the covered bonds and into the government paper, particularly as we can show that the margin between covered and government bonds has steadily narrowed while government spreads widened versus swaps (see table 1).

Despite the fact that the Eurosystem's CBPP2 has recently become operational and that the first secondary covered bond market purchases have been confirmed by the ECB Irish asset covered securities (ACS), which trade at a pre-

mium of 60bp to Irish sovereign debt, have only a moderate potential to further tighten versus government bonds in the short term. Whereas the respective margin stood at 500bp in an environment characterised by poor liquidity in mid-July, it has meanwhile fallen sharply as Irish government bonds became better bid.

In a second step, we have refined the analysis by limiting ourselves to the national markets' most liquid covered bonds. Using a simple average of the bonds in each country with approximately five years to maturity we have repeated our analysis. Aggregating and restricting our sample to the most liquid and highest quality names in the German, French, Spanish, Italian and Dutch market, we again observe that German and Dutch covered bonds look cheap relative to their respective sovereign counterparts, while French, Spanish and Italian covered bonds look rich relative to sovereign equivalents (see chart 3).

The Sum versus the Parts

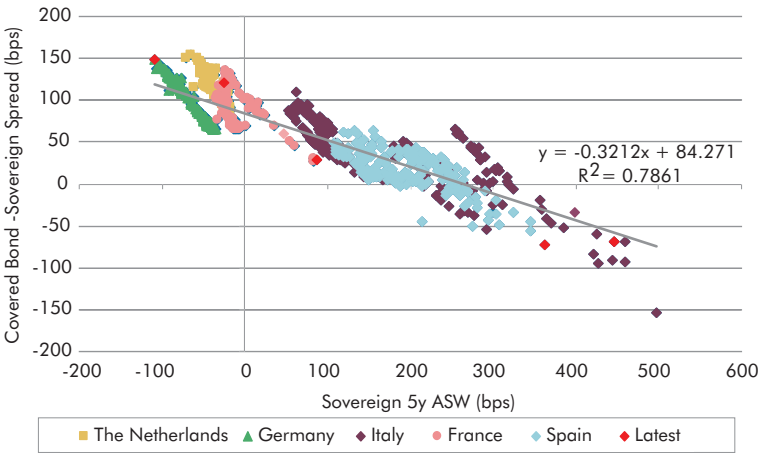
Theoretically, covered bond spreads should be driven by the underlying quality of the collateral pools and the level of overcollateralisation. If so, then the aggregate analysis presented above provides a decent indication of the richness/cheapness of covered bonds. However, a disconnect between fundamental collateral pool analysis and covered bond spreads has emerged over the past year.

Therefore, while such aggregate measures are useful, more realistically there are distinct regional factors driving covered bond spreads across the European market. If we treat each market separately, the conviction for some recommendations is not as strong.

For example, looking at Germany and the Netherlands, the explanatory power of the model (as measured by the R^2) is, not surprisingly, significantly higher (see chart 4). However, German covered bonds look fair value based on this analysis. This can be attributed to the addition of higher yielding names in the German composite index, which in our opinion makes German covered bonds more at-

Leef Dierks: "There are distinct regional factors driving covered bond spreads"

Chart 3: German & Dutch Covered Bonds cheap vs Sovereign



Source: Morgan Stanley Research, Bloomberg

tractive on an aggregate basis. Dutch covered bonds are equally attractive on this metric, while French covered bonds are still expensive.

Our sell recommendations, namely on Spanish and Italian covered bonds versus their respective sovereigns when analysed on a regional basis are broadly consistent (see chart 5). However, the conviction is lower in the case of Italian covered bonds.

Irish covered bonds are still trading cheap based on regional data. This is not surprising given the recent rally in Irish government bonds. However, despite ECB intervention in this market, covered bonds have lagged their sovereign equivalents. In Portugal, our model suggests that covered bonds trade cheap versus government bonds (see chart 6). Moreover, given the small size and illiquid nature of the Portuguese market, any activity from the ECB could bring the covered bond to sovereign spread in line rapidly.

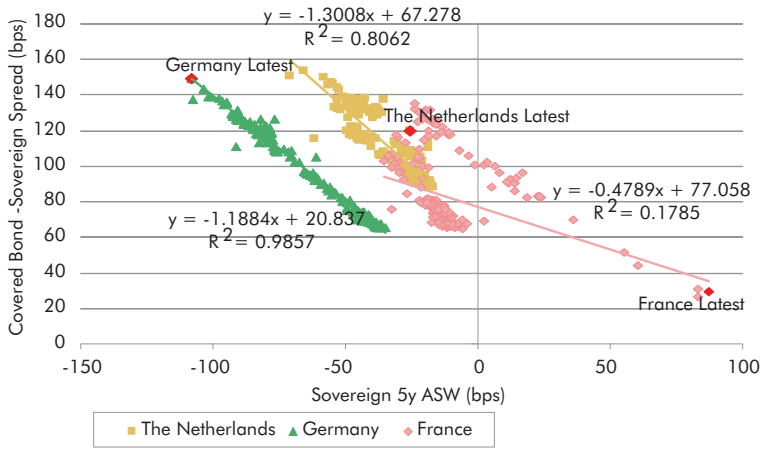
Conclusion

Taking into account both the aggregate data and the more liquid high quality issuers, we conclude that Dutch covered bonds are trading cheap relative to their sovereign benchmarks. German covered bonds are cheap on an aggregate basis, but high quality issuers are trading around fair value.

In contrast, Spanish, French and Italian covered bonds look rich in comparison to government bonds on both metrics, though conviction is lower in the case of Italy. Portuguese and Irish covered bonds continue to trade at very cheap levels relative to their sovereign and offer a significant pick up in yield on both measures.

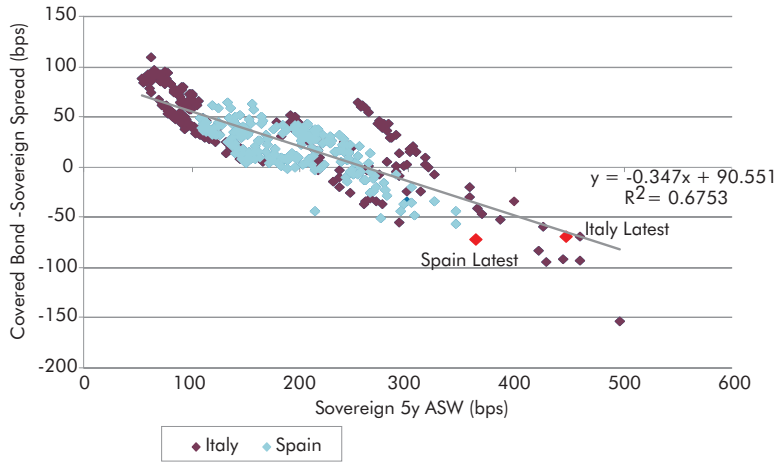
Admittedly, the above recommendations do not entirely reflect the potential transition from an unsecured to a secured credit. Despite this becoming increasingly questionable, we believe that most investors will continue to sustain the dogma of sovereign debt being by definition the potentially safest asset class. Spread moves in the European government bond market suggest otherwise. ■

Chart 4: German Covered Bonds Less Attractive From High Quality Perspective



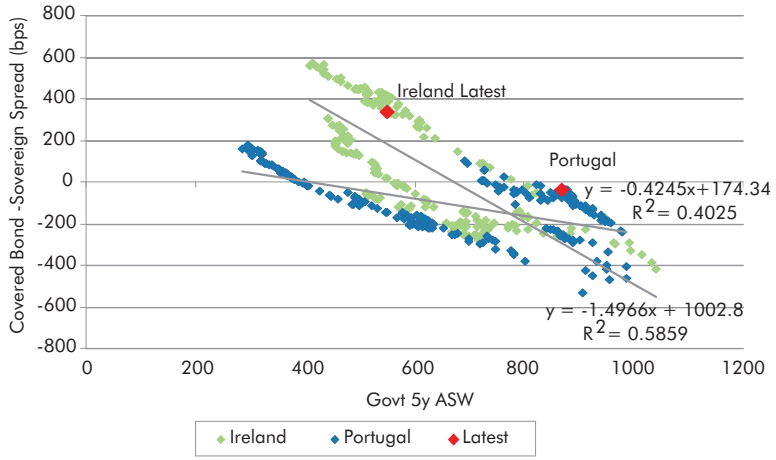
Source: Morgan Stanley Research, Bloomberg

Chart 5: Spanish and Italian Covered Bonds Look Expensive



Source: Morgan Stanley Research, Bloomberg

Chart 6: Irish & Portuguese Covered Bonds Cheap



Source: Morgan Stanley Research, Bloomberg

The Covered Bond Report

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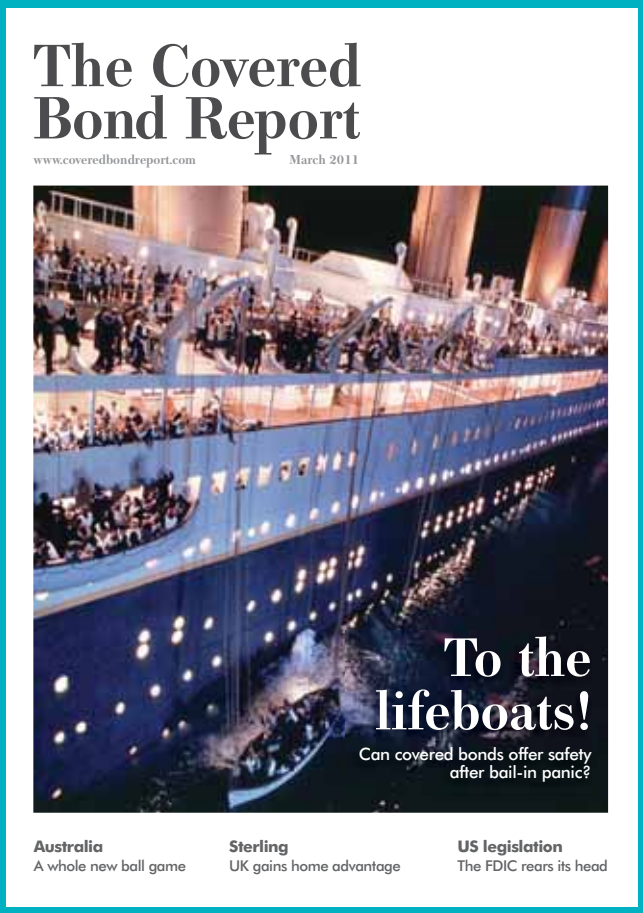


CEE beyond the crisis

A populist Hungarian law has threatened long term consequences for covered bonds, but elsewhere in central and eastern Europe constructive rather than controversial amendments are pending. Indeed breakthrough issues from the Czech Republic, Romania and Slovenia could make 2012 a banner year for the region. *Maiya Keidan* reports.

The Hungarian government gave the covered bond market a shock on 19 September when it introduced a law allowing certain foreign currency mortgages to be repaid in forints at a discount of up to 22%, thereby potentially hitting the value of collateral in Hungarian cover pools.

Moody's reacted by warning that the law could be credit negative for covered bonds and that it raised the possibility of event risk, while Fitch said the law set "a dangerous precedent".

Hungarian borrowers had before the financial crisis taken out foreign currency mortgages in Swiss francs and euros, but these were hit hard by rises in the two currencies against the Hungarian forint to all time highs, making it difficult for borrowers to meet monthly repayments. It was against this backdrop that the government communicated that it was committed to resolving the problems Hungarian households were facing and the September law was the result of that.

"The announcement shocked the Hungarian banking sector and came as a complete surprise to Hungarian mortgage lenders, particularly as all costs and losses resulting from this prepayment option and the conversion of FX loans into HUF loans would have to be borne by the lenders," wrote András Botos, secretary general of the Association of Hungarian Mortgage Banks, in the October edition of the European Mortgage Federation's Mortgage Info publication.

The introduction of the law not only raised concern about cover pools of Hungarian covered bonds (jelzáloglevél), but more generally undermined Hungarian banks. Moody's placed seven Hungarian banks on negative review at the beginning of October, while Fitch estimated that the Hungarian banking sector will have to absorb approximately 1.5% of tier one capital as a result of the law, based on a 25% take-up rate. Fitch said that most banks should be able to sustain such a hit to their capital, but "there are considerable differences in tier one ratios and exposure to foreign currency mortgages between banks, and so some institutions could take larger hits to capital than this aggregate calculation suggests".

Fitch also said that the law will only temporarily provide relief for borrowers, without materially reducing their indebtedness or their foreign currency exposure, while the Hungarian Banking Association's board has stressed that the enactment of the legislation would seriously damage the operation of the economy as a whole.

"This may adversely affect millions of Hungarian corporate and retail debtors with forint loans," it said.

Indeed the Hungarian government rode roughshod over objections from many interested parties, not least the National Bank of Hungary, which had pointed out the negative effects of the law.

A lasting impact

HSBC Trinkaus head of covered bond research Johannes Rudolph reacted to the law by saying it could have a "huge impact" on Hungarian covered bonds.

"Due to the fixed exchange rates, Hungarian banks are at risk of realising a loss of 10%-13% of their Huf5,400bn (as of July 2011 according to central bank data, equal to around Eu21bn) foreign exchange household loan portfolio," he said. "For covered bonds, there is a certain risk of under-collateralisation, should all borrowers execute their option."

However, representatives of issuers OTP Mortgage Bank and FHB Mortgage Bank told The Covered Bond Report that the credit quality of their covered bonds was unlikely to suffer directly from the law. Máriás György, head of treasury at OTP Mortgage Bank said the politicians had forecast a take-up rate of only 10%.

The banks said any resulting reduction in the cover pool could be compensated in two ways.

Within the collateral are mortgage loans and substitute collat-

András Botos: "The announcement shocked the Hungarian banking sector"

eral, which comprise cash and/or government bonds. The level of substitute collateral cannot exceed 20%. FHB and OTP have zero and almost zero substitute collateral, respectively, in their cover pools, so they have an accessible way to add collateral.

The banks can also repurchase outstanding covered bonds, a tactic that György and János Szuda, managing director, head of treasury and capital markets at FHB, confirmed was feasible.

And in spite of its warnings, Moody's noted that borrower credit quality may improve if borrowers refinance onto lower LTV loans that are not subject to currency fluctuations.

Moody's added that while the value of mortgage loans will be reduced under the new law, as foreign loans are replaced with forint denominated mortgage loans, the impact is mitigated in cover pools. The rating agency said this is because "whilst issuers remain performing, the covered bond law offers protection through the asset-coverage tests that require issuers to ensure that the value of assets exceeds the value of liabilities".

Market participants nevertheless remain concerned that the Hungarian government's move could have longer term implications for the way in which Hungarian covered bonds are viewed. Moody's, for example, said that having decided to implement the law, the Hungarian legislators may now be pre-disposed to make further changes reducing the value of mortgage loans as security for covered bonds.

"The fact that Hungarian legislators have chosen to alter contractual rights to reduce the value of mortgage loans as security may lead to 'event risk', whereby actual or potential future legal changes would need to be factored into assessments of collateral value," said the rating agency.

Moody's AVP analyst, covered bonds, Patrick Widmayer said it would particularly affect refinancing risk if it reduces the future sale value of the mortgage loans.

"The perception that such changes are now more likely may be enough to increase the risk premium on these assets as market participants become concerned that future changes in law may impact the value of the assets," he said, adding that this may make it more difficult and expensive to raise cash against the assets in the cover pool to repay outstanding covered bonds.

"The law change may also increase the risk of currency mismatches following issuer default and negatively impact bank credit quality by exposing banks to additional capital costs," he said.

Fitch said more generally that the move "sets a dangerous precedent for other central and eastern European countries with high foreign currency lending". Richard Kemmish, head of covered bond origination at Credit Suisse, also noted that the Hungarian move may have broader consequences.

> "A first Czech euro issue could hit the market as early as March 2012"

"If you're in a world where governments can step into private sector contracts and set them aside because they're unfair to somebody else," he said, "then maybe governments can do other things, which can be extremely difficult to quantify in a rating."

As Bernd Volk, head of covered bond research at Deutsche Bank, noted on hearing news of the Hungarian law: "There is a reason for the term 'sovereign'."

However, Kemmish added that he did not think the government would ever dream of enacting this law if it was going to bring down a bank, and ultimately the problem would be solved by adding more collateral.

"So, yes, the assets in the cover pool are a little bit worse off than they used to be, and yes, this has established a precedent that they might get worse again," he said, "But Moody's and whoever else rates them will ask for more collateral to be thrown at the problem, which will solve the problem — though it's not exactly an elegant solution."

Specialist reservations

Hungary decided against another potentially controversial change to legislation after debating the merits of moving away from a specialist bank principle for issuing covered bonds to allowing universal banks to issue, something Poland had also debated.

Until 2005, Germany's legislative covered bond framework placed restrictions on the breadth of most Pfandbrief issuers' activities. But while this model proved the basis for several of the covered bond frameworks established in central and eastern Europe as the asset class expanded in the 1990s and the last decade, Germany did away with the specialist bank principle with the introduction of the Pfandbrief Act in 2005.

Moody's in January noted that the Union of Polish Banks had lobbied to extend the legal right to issue covered bonds to universal banks, saying that it viewed the proposed amendment as broadly positive in that it would improve access to medium term funding for banks and deepen the covered bond market.

However, the Polish regulators decided against pursuing

such a change and Otmar Stöcker, managing director of the Association of German Pfandbrief Banks, says such a fundamental change as abolishing the specialist bank principle must be treated very carefully during a financial crisis.

"The probability of a bank going bankrupt is regarded now being much more likely than it was eight years ago when we had these discussions in Germany — that's a big difference," he says, "so therefore any deep change to an existing covered bond law has to address the legal issues that are related to the insolvency of the issuer — including the globally discussed question of how to decide on the conflict between covered bond holders and depositors."

Stöcker notes that in discussions regarding abolishing the specialist bank principle there is sometimes even a tendency to water down eligibility criteria to fit the needs of the existing portfolios of universal banks.

"To do that in a financial crisis situation can absolutely not be recommended," he says.

"The name of the game really is funding diversification"

He adds that the issue of ringfencing must also be tackled — today on a much higher level than it was discussed in public many years ago.

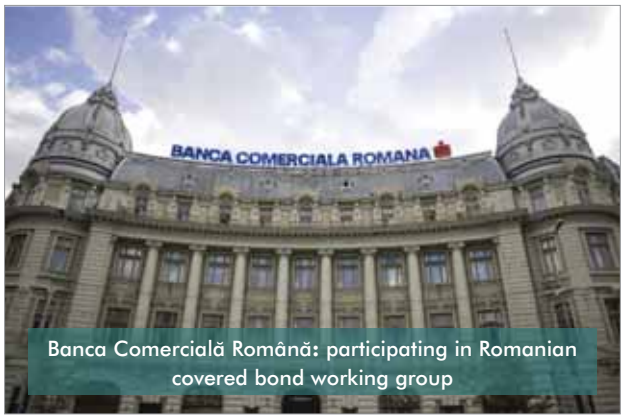
"As long as you have very specialised banks then internal ringfencing is less important," he says. "But once you lose the specialist bank principle, then ringfencing is at the core of the whole structure, and there is no proposal so far on how to regulate that in detail in Poland."

Otmar Stöcker: "Once you lose the specialist bank principle, then ringfencing is at the core of the whole structure"

Romanians fix unused law

Romania could have an amended covered bond law by early 2012, potentially kick-starting issuance in a country where there has been none despite legislation having been in place since 2006, according to members of a working group.

A covered bond law has been in place in Romania since March 2006, but there has been no issuance because the law is not fully aligned with international standards, according to bankers in the country, and a lack of interest because of alternative investments for local funds. But market participants established a working group in the first half of 2010 to improve the legal framework for issuing covered bonds after an overhauled pension system had begun to pave the way for private pension funds in Romania to start investing more.



Banca Comercială Română: participating in Romanian covered bond working group

"Until now, pension funds had various investment alternatives and they were mainly looking for higher yields," says Irina Neacsu, head of debt capital markets at Banca Comercială Română and a member of the working group. "At the moment, given the current market conditions, the safety of the investment is of utmost importance.

"Therefore, secured bonds are becoming more appealing."

The working group — comprising local banks and their respective parent companies, the Romanian Banking Association, the National Bank of Romania, and the Romanian National Securities Commission — identified covered bonds as a viable alternative for bank refinancing.

"The overarching aim of this initiative is to develop the local capital market and create investments for local investors," says Neacsu, "and to diversify the funding sources for banks, given that they have a critical mass of assets (mortgage loans and public sector loans), which could be refinanced through covered bonds."

The existing legislation was a roadblock, according to the working group, because it was inconsistent with international standards because each bond issue had to be backed by its own dedicated set of loans, as opposed to one cover pool allowing for multiple issues, and a static cover pool, with administrators only replacing mortgages included in the cover pool if they no longer comply with the eligibility criteria. In addition, the law does not allow for issuance of public sector backed covered bonds.

Neacsu said the group is upgrading the legal framework, using the German Pfandbrief legislation as a benchmark. The improved framework will consist of an amendment to the 2006 law as well as secondary legislation. The amendment will provide for:

- The establishment of two cover pools, one for mortgage and housing loans and one for public sector loans, with an active and dynamic administration
- 2% minimum overcollateralisation
- A split of responsibilities/roles between the relevant competent authorities (central bank, securities commission)
- Active management of cover pools

- The establishment of the institution of trustee
- Internal registries and transparency obligations of the issuer
- Special provisions regarding the bankruptcy of issuers and the enforcement of cover pools (role of the cover pool manager, servicing of pools, enforcement of cover pools)

Secondary covered bond legislation will be related to the agent, the portfolio structure, internal registry, and stress tests on the cover pools.

"In general the maximum limit allowed for supplying the pool and for the substitution of receivables in the relevant cover pool with supplementary assets should not exceed 20% of the cover pool value," adds Neacsu.

Adrian Sacalschi, deputy head of branch, Frankfurt, at FHB, which has assets in Romania, also sits on the working group, and said that he expects the law to go through parliament at the beginning of next year.

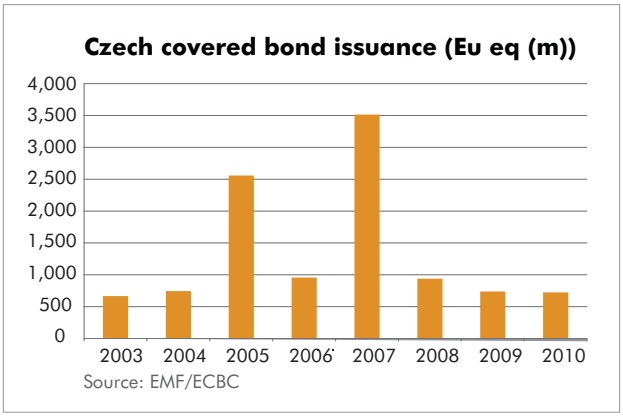
"If the Ministry of Finance gives it the OK then the approval process should go pretty quick," he said, "and we hope to have something for next year."

Czech euro, Slovenian firsts eyed

A legislative amendment is underway in the Czech Republic, The Covered Bond Report has learned, which could open the door to the first Czech issue in euros.

The legislation in question is not the country's 1995 Covered Bond Act — which governs issuance of mortgage backed covered bonds (hypnoteční zástavní list) — but the general Czech Bond Act of 2004. This stipulates that bonds issued under the act be first registered to an investor securities account in the

Nova Ljubljanska Banka: could launch first Slovenian covered bond



Czech Republic. While this has not caused problems for senior unsecured issuance from Czech banks, according to a market participant, it has been a barrier to covered bond issuance.

The amendment proposes scrapping this geographical requirement, which the market participant described as "a major breakthrough for covered bonds".

The Czech government passed the proposed amendment on 25 October, according to Eva Svobodová, partner at White & Case in Prague, although it still needs to pass through several steps in parliament before being presented to the President to be signed into law. If the law is passed by year-end, then a first Czech euro issue could hit the market as early as March 2012.

There were eight Czech covered bond issuers by the end of 2010, according to data from the European Covered Bond Council, which issued between Eu500m-Eu1bn equivalent between 2008 and 2010, after having issued Eu3.5bn in 2007.

In Slovenia, Nova Ljubljanska Banka (NLB) is in the preliminary stages of issuing the first Slovenian covered bond, which could help it refinance outstanding government guaranteed debt, according to Fitch.

Fitch reported in June that NLB was considering a debut covered bond programme backed by public sector loans of up to Eu600m as part of the bank's refinancing plans. Officials at the bank confirmed to The Covered Bond Report that NLB is planning to issue a covered bond, but declined to comment further.

Fitch noted that NLB has a Eu1.5bn government guaranteed bond maturing in July 2012. According to Lindsey Liddell, credit analyst at Fitch, NLB had prepaid some of the government guaranteed bond, but still had about Eu1.1bn left.

"That's clearly a very large sum for a single Slovenian bank to refinance at any one time, particularly given the difficult operating environment at present," she says.

Launching a covered bond was said to be one of the ways in which to refinance this sum.

"We understand the covered bond is one of the ways that they are looking to manage their refinancing spike," says Liddell.

"Given what's going on generally in the market," she adds, "the name of the game really is funding diversification, by both source and tenor of funding, so that would be a motivation for NLB to look into issuing a covered bond."

Liddell says that given that this would be Slovenia's first covered bond, it seemed sensible that one of the larger state owned

The Covered Bond Report

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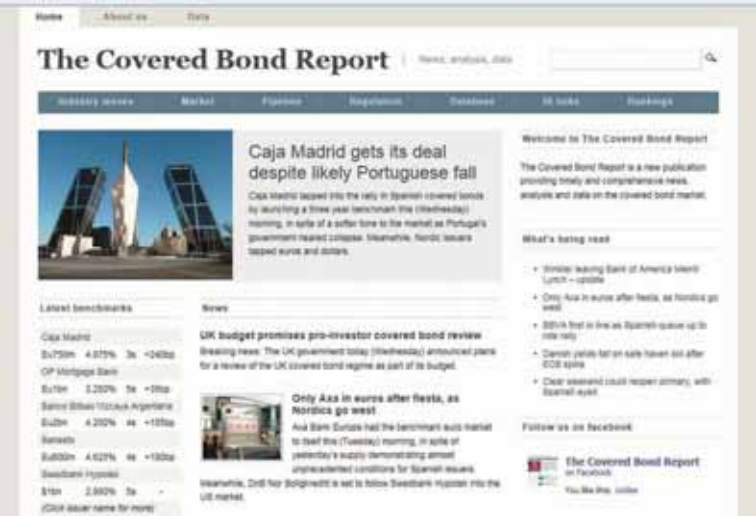


Ellis Island, New York: immigrants had to make sure their papers were in order

Papers, please

While the US is regarded as a land of opportunity by many non-US issuers, documentation requirements have caused hesitation. Here, Jerry Marlatt, senior of counsel at Morrison & Foerster, details the options and steps necessary for a successful introduction into the US.

We are often asked what documents and process are required for a non-US bank to issue US dollar covered bonds in the US.

With the heavy reliance by European banks on covered bonds for funding, the option of broadening the investor base to include US investors is attractive. The US market saw $30bn of issuance in 2010 and through October 2011 there has been about $34bn of covered bonds issued by non-US banks. And the pricing has been attractive: in September, for example, TD Bank issued a $3bn five year covered bond at 26bp over mid-swaps. So the combination of the turmoil in European markets and attractive pricing in the US market suggest that we will see more non-US banks issuing US dollar covered bonds.

The two threshold concerns for a non-US bank considering issuing US dollar covered bonds are documentation and process; in particular, what are the disclosure burdens and how intrusive is the diligence process. We have brought a number of non-US banks into the US dollar covered bond market who have not found the requirements or the experience to be difficult.

144A and 3(a)(2)

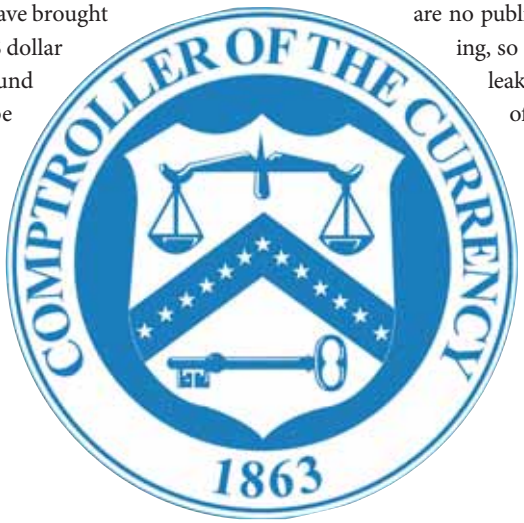
Generally, non-US banks use one of two routes under US law to issue debt securities in the US: Rule 144A and Section 3(a)(2) under the Securities Act of 1933.

An offering under Rule 144A is a private offering and, while there are no express regulatory disclosure requirements, the disclosure documents are usually similar to prospectuses used in public offerings. A security issued under Rule 144A is a "restricted security" under the 33 Act rules and some investors have a limited ability to purchase restricted securities.

An offering under Section 3(a)(2) is not restricted, but must be issued through or guaranteed by a US branch or agency of a non-US bank. Involvement of a branch or agency may require holding additional capital at the branch or agency, the amount of which will be determined by the regulatory authority in the jurisdiction that licenses the branch or agency.

The advantages of using Section 3(a)(2) are several. First, a security issued under Section 3(a)(2) is not a restricted security, so investors generally do not face limits on the ability to purchase 3(a)(2) securities. Second, unlike 144A securities, 3(a)(2) securities are eligible for the bond indices. This has the effect of both expanding the investor base and improving the secondary market in the securities. The investor base expands because those bond funds that are index funds need to buy bonds in the indices. Third, there are no publicity limitations around a 3(a)(2) offering, so there is less concern about information leaking into the market in advance of the offering. In contrast, in a Rule 144A offering very tight controls must be maintained over contact with journalists. Advance publicity about a Rule 144A offering can result in the offering being pulled from the market for up to 60 days.

Both types of offerings will generally require the same documentation and diligence process. A 3(a)(2) offering, however, will require some additional documentation in order for the branch to issue or guarantee the securities and some additional disclosure about the branch and the role of the branch in the transaction.



The OCC's rules are very similar to those applied by the SEC

The primary regulator for a US branch or agency of a non-US bank is the banking regulator in the US jurisdiction granting the banking licence for the branch or agency. A licence may be granted either by the US Office of the Comptroller of the Currency (OCC), which grants a federal licence, or by state banking authorities in the state where the branch or agency is located. Most of the older branches or agencies located in New York are licensed by the New York State Banking Department.

Only the OCC has specific disclosure rules for securities offered in the US by a branch of agency regulated by the OCC. Banking regulators other than the OCC do not have specific offering disclosure rules. The OCC's rules are very similar to the rules applied by the Securities & Exchange Commission (SEC) for securities offered by bank holding companies and, accordingly, are quite detailed. Nevertheless, for a non-US bank that can deliver the information required by SEC Rule 12g3-2(b), the OCC's detailed disclosure rules do not apply to investment quality non-convertible debt securities offered only to "accredited investors" with minimum denominations of $250,000 or more. At the same time, banking regulators expect offering disclosure of US branches and agencies to be complete and accurate, with no material misstatements or omissions.

Documentation

Prospectus. In our experience, covered bond prospectuses that are listed on the UK Listing Authority (UKLA) or Luxembourg Stock Exchange for European covered bond programmes generally provide sufficient disclosure about the issuing bank and the covered bond programme when taken together with the financial data posted with the listing authority and incorporated by reference into the prospectus and the periodic reports on the cover pool available to investors. In the cover pool reports we would expect to see reasonably complete statistical data on the cover pool, including statistics on dwelling type, geographical location, loan amount, loan balance, remaining term, credit score, interest rate, occupancy, and loan-to-value ratio. These reports usually are not posted with the listing authority, but rather are available on the issuer's website. There is, however, a growing trend in both US and European markets for investors to seek more transparency on the cover pool.

Certain additional prospectus disclosure is necessary for a US offering. This would generally include US tax disclosure, ERISA (Employee Retirement Income Security Act) disclosure, disclosure on the DTC (Depository Trust Company) clearing system and delays in transfers to transferees holding through Euroclear or Clearstream, identity of the US paying agent, selling restrictions and transfer restrictions in the case of Rule 144A offerings, disclosure of the role of the branch in offerings, and financial data on the branch in the case of 3(a)(2) offerings.

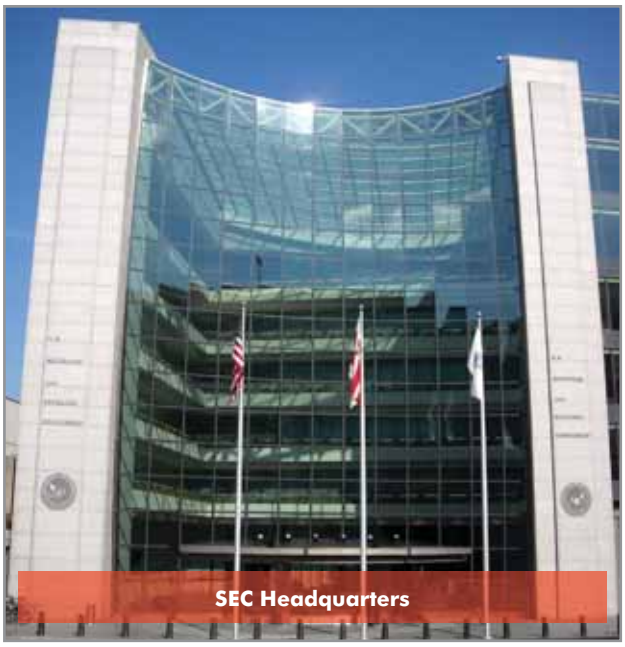
Programme Agreements. Generally there are very few changes required of the agreements for an existing covered bond programme. There is no requirement that the agreements be governed by US law, so the existing agreements will be largely unchanged.

Two changes will be necessary, however. It will be necessary to appoint a co-issuing agent under the existing Agency Agreement (or other agreement that provides for the issuance of securities) to provide for issuance and payment of the bonds. This is often accomplished by notice, without the need to amend the agreement. Also, under DTC's requirements, the global bonds must be issued in the name of DTC's nominee, Cede & Co, and physically held in the possession of the US issuing agent[1] . This may require a change to the Agency Agreement to enable the issuance of securities in registered form.

> "The two threshold concerns for a non-US bank are documentation and process"

The other necessary change is to amend the Programme Agreement or other agreement governing the offering and distribution of the covered bonds. This can often be accomplished through the Subscription Agreement or similar agreement drafted for the series of covered bonds being offered. The Subscription Agreement must include: the representations, warranties and covenants typical for a US private placement in the case of a Rule 144A offering, or typical of an offering of securities issued through or guaranteed by a US branch or agency in the case of a 3(a)(2) offering; selling restrictions and transfer restrictions in the case of a Rule 144A offering; US-style indemnification for a false or misleading prospectus; typical market-out provisions; and a requirement for an SAS 72 comfort letter and an agreed upon procedures letter regarding the cover pool, both from the issuer's auditor.

Documents for Branch Issuance or Guarantee. In the case of an offering under Section 3(a)(2), steps must be taken to effect the issuance of the bonds through the US branch or agency or for the branch or agency to guarantee the covered bonds issued by the bank from its home jurisdiction. In the case of an issuance



SEC Headquarters

of the bonds through the branch or agency, the Final Terms and Subscription Agreement or other documents that need to be executed to effect the issuance of a new series of bonds must be executed by the bank "acting through the branch [agency]" and the global bonds issued to DTC should show the bank "acting through the branch [agency]" as the obligor on the bonds. In the case of a guarantee by the branch, the bank "acting through the branch [agency]" would execute the Final Terms and the Subscription Agreement as guarantor of the bonds issued. While this may appear nonsensical at first for one office of an entity to guarantee an obligation of the entity, it has significant meaning because the branch or agency is separately regulated by a US banking regulator, the branch or agency must often maintain separate capital in the jurisdiction of the branch. In the case of the insolvency of the branch of agency, the US banking regulator will marshal the assets of the branch or agency in the jurisdiction and apply those assets to repayment of claims against the branch before releasing assets to the home office of the branch or agency or to the insolvency proceeding in the home jurisdiction of the bank[2].

10b-5 Letters. There are several significant documents generally delivered at closing, including an auditor comfort letter, a pool audit letter (agreed upon procedures letter) and a 10b-5 letter. Comfort letters and pool audit letters will be familiar to most non-US bank issuers, but it is probably worthwhile to spend a little time on 10b-5 letters.

In a Rule 144A offering and in a 3(a)(2) offering, an underwriter (or dealer) is subject to liability under Rule 10b-5 under the Securities Exchange Act of 1934. Rule 10b-5 provides in part that "It shall be unlawful for any person… to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading… in connection with the purchase or sale of any security". Generally, however, the underwriter will not be liable if it can establish that it did not know and in the exercise of reasonable care could not have known of such untruth or omission[3]. This is the so-called due diligence defence.

"While this may appear nonsensical at first… it has significant meaning"

One accepted element of establishing the defence is for the underwriter to obtain from issuer's counsel (and usually underwriter's counsel as well) a letter delivered at closing stating that the firm is unaware of any untrue statement of a material fact or omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading in the prospectus and the other offering materials. This is the 10b-5 letter.

In order to deliver the letter, counsel will conduct a due diligence inquiry involving discussions with management of the issuer, review of board minutes and material contracts, review of mortgage business policies and procedures, and possibly an interview with outside counsel to the issuer. Some non-US issuers find this inquiry offensive and intrusive. In some foreign jurisdictions it is the practice to include in board minutes, for example, a great deal more personal and sensitive information than would be common at a US issuer. In any event, it is the 10b-5 due diligence process that is to some non-US issuers the most off-putting part of a US issuance. In truth it can sometimes be an adversarial process, but it need not be. It can be handled diplomatically and it is possible to establish procedures to safeguard confidential and sensitive information. And for a senior debt offering by a regulated financial institution with publicly available financial data it should not be a lengthy process. For a regulated financial institution a great deal of information about the institution is publicly available for review. Discussions with management should take hours not days. And the review of agreements, board minutes and other documents should take three or four days for the initial due diligence inquiry, not weeks.

Jerry Marlatt, Morrison Foerster: The advantages of using Section 3(a)(2) are several

Naturally, the first time diligence is conducted it is more time

consuming than it is for subsequent offerings. For subsequent offerings, only new material agreements and new board minutes would be reviewed. And if the subsequent offering follows closely after a prior offering, the questions for management may simply be a few "bring down" questions asking if there is any change in the answers previously given in the earlier diligence.

"Some non-US issuers find this inquiry offensive and intrusive"

It should also be noted that diligence conducted, for example, for a covered bond programme can also be used in connection with other debt offerings in the US, such as MTN offerings. So once the initial diligence is completed the issuer has the option of expanding its debt offerings in the US without having to suffer through the initial diligence exercise again. This assumes of course that the same US law firms are involved in the additional offering programmes.

Process

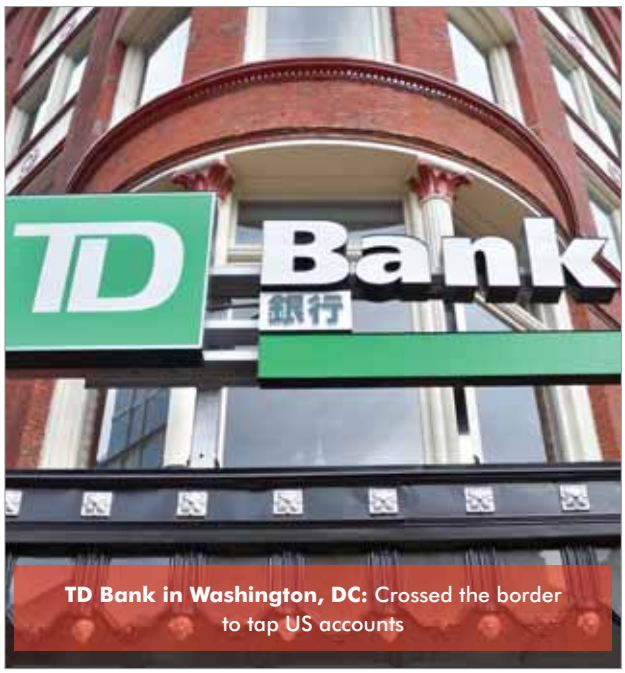
The process of preparing for an offering and conducting an offering should generally be familiar to a European issuer, although on the initial US offering there will be some changes to the programme documents as discussed. After selection of the arranger for a US offering, the offering process would typically involve the following steps:

(1) review of the existing programme agreements,
(2) amendment of the programme agreements as necessary,
(3) drafting the Final Terms and Subscription Agreement for the offering,
(4) in the case of a 3(a)(2) offering, discussions with interested US banking regulators,
(5) due diligence document review and discussions with management,
(6) development of flip-book materials and a roadshow with potential investors,
(7) selection of co-managers for the offering,
(8) bring down diligence and launch of the offering,
(9) pricing, and
(10) bring down diligence and closing.

Note that items (1), (2) and (4) would usually only be necessary for the initial US offering.

For a 3(a)(2) offering, the local US banking regulator for the branch or agency should be consulted. Covered bonds may not be familiar instruments to many state regulators and an effort should be made to explain to the regulator the role of the branch or agency and features of a covered bond. In general, reliance on Section 3(a)(2) for a debt offering will be familiar to most regulators as there are about 10 non-US bank senior debt programmes issuing in the US under Section 3(a)(2).

Generally, launch of the offering and pricing will occur on the same day. So that would mean two diligence sessions for the bank on the same day. In each case, however, the bring down diligence is typically accomplished in five minutes or so and involves only a handful of questions for management and the auditor asking whether there are any changes to answers previously provided and whether the auditor is prepared to deliver its comfort letter. Note that delivery of a comfort letter will be required both at pricing and at closing.



TD Bank in Washington, DC: Crossed the border to tap US accounts

For programmes listed on the UKLA or other European exchanges, the Final Terms would typically be filed with the listing exchange.

Some portion of the offering may be offered outside the US pursuant to Regulation S, although the Regulation S portion of offerings has typically been quite small as almost all of the offerings have been placed with US investors.

For an initial offering into the US the process described above may take up to three months, although it is certainly possible to move more quickly. Subsequent offerings may be done on as little as one or two days' notice, depending on the lapse of time from the previous offering. ■

[1] *It may also be possible to issue bonds through Euroclear or Clearstream that settle into the DTC account at Euroclear or Clearstream. US purchasers would hold the bonds through their DTC participants. To use this option, special steps must be taken to satisfy US tax requirements applicable to bearer securities sold to US persons.*

[2] *In the case of the small number of US branches that are insured by the Federal Deposit Insurance Corporation (FDIC), the FDIC will have receivership authority over the branch.*

[3] *Actually, this is the express defence available to an action brought under Section 12(2) of the 33 Act. Section 12(2) is not applicable to a Rule 144A or Section 3(a)(2) offering. However, there is general agreement that a defence adequate under Section 12(2) would also be sufficient under a Rule 10b-5 claim.*

ABI-AFME, ECBC, vdp cordially invite ...

ABI-AFME conference in Milan featuring a gala dinner in the Ristorana Ratanà with chef Cesare Battisti.

The CosmoCaixa science museum in Barcelona plays host to the European Covered Bond Council Plenary in September.




Photos from the Association of German Pfandbrief Banks (vdp) Forum held in Frankfurt's east end at Klassikstadt, a venue dedicated to classic cars.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