The Covered Bond Report

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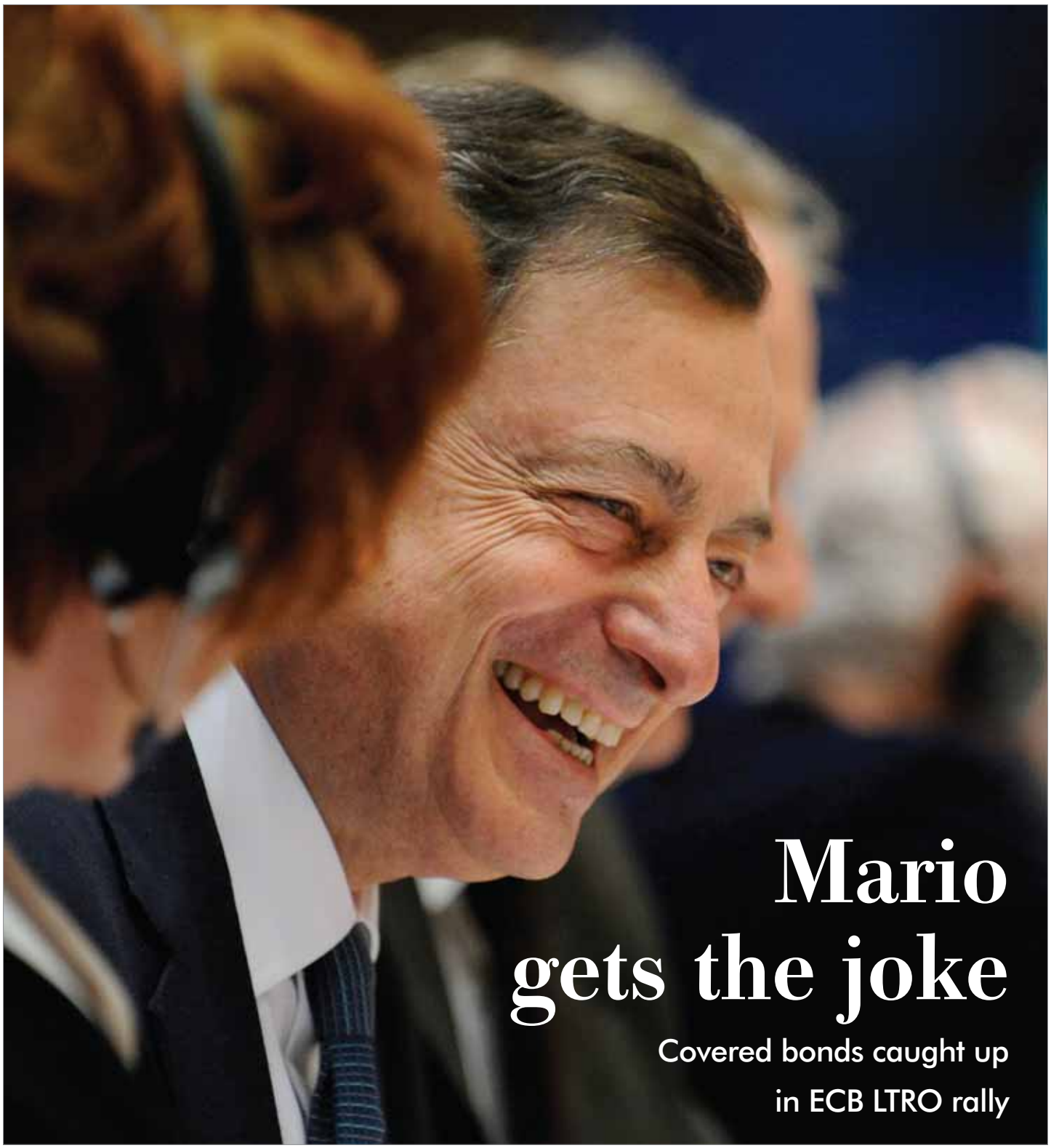

Mario gets the joke

Covered bonds caught up in ECB LTRO rally

Markets return
Aussies, Spain, sterling

Asset encumbrance
Second thoughts

The Pfandbrief
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Covered bonds have been the focus of asset encumbrance discussions, but are not the only secured borrowing on the increase. Thankfully, practitioners are increasingly realising the need for a holistic approach. *Susanna Rust* reports.

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Within just three months Australia's banks have come from nowhere to be a major feature of the covered bond market. LBBW analysts look at the legislation, issuers and collateral behind the issuance.

It's time to let go

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Canadian covered bonds have come a long way since October 2007 when the first issue from the country hit the market. Today, Canadian banks are among the most active covered bond issuers, thanks largely to their success in cracking the US dollar market since the beginning of 2010.

Indeed, their success at raising this funding in the wholesale markets from investors south of the border has been widely cited by US proponents of covered bonds keen to see their country's mortgage lenders benefit likewise.

Although covered bonds in general have been increasingly embraced by US accounts, DCM and syndicate officials in New York attribute much of the Canadians' success to the collateral backing most of their issuance being insured by Canada Mortgage & Housing Corporation, which is in turn backed by the Canadian government.

But with Canada's Department of Finance finalising the country's first legislative covered bond framework and questions being raised about CMHC's role, in light of mortgage market developments and a rapid growth in bulk insurance, the future of insured cover pools is in doubt (see page 4).

Need this be a problem?

Far from it. Canada has had a good crisis. It has not been immune (remember the Canadian ABCP Crisis of 2007, anyone?), but the country can claim to have been a safe haven amid the global financial storms — and this applies not just to the sovereign, but to its banking industry.

This is thanks mainly to behaviour not during the crisis, but beforehand. That its mortgage market did not succumb to the subprime and securitisation temptations and machinations that afflicted its US neighbour is especially impressive.

While euro investors might have been slow to understand this and undervalued Canadian covered bonds when Royal Bank of Canada pioneered the market, Canadian issuers could surely today command prices commensurate with their quality and collateral without the need for CMHC insurance. If not, US investors appear ready to oblige.

Neil Day, Managing Editor

Legislation & Regulation

CANADA

End to CMHC pools could hit covered plans

The future of Canadian issuance backed by mortgages insured by Canada Mortgage & Housing Corporation is being questioned ahead of the introduction of covered bond legislation, with CMHC nearing a C$600bn cap on bulk mortgage insurance.

A consultation paper released in May 2011 outlining legislative proposals asked if the use of uninsured collateral should be encouraged, and how this might be achieved, noting that such a move could, in the longer term, reduce reliance on government-backed mortgage insurance and also improve the liquidity of uninsured mortgages.

Market participants said that they understand Canada's department of finance to be considering preventing the use of CMHC insured mortgages as collateral for covered bonds. One said that the Canadian government is also reflecting more generally on the role of CMHC, not just in relation to covered bonds.

> "Reduced access to bulk insurance could affect future issuance"

This question has come to the fore as CMHC nears a C$600bn cap on mortgage insurance.

The Canadian crown corporation was C$59bn short of this limit as of the end of September 2011, having reached C$541bn, and although the Canadian parliament has steadily raised CMHC's capacity from C$200bn prior to 2006.

However, Fitch warned in a report in early February that further increases are not guaranteed.

"While CMHC can petition the government for another increase, an expansion of the insurer's balance sheet is unlikely as it would contradict recent steps — i.e. tightening lending standards — taken by the Minister of Finance to curb mortgage lending," said the rating agency.

According to Fitch, Canadian banks have since 2008 issued roughly C$40bn (Eu30.3bn) of covered bonds backed by CMHC insured assets, the majority of these covered by discretionary lender-paid bulk policies. The rating agency said that issuers are likely to have sufficient insured assets to cover existing covered bond obligations, but was less confident about the future.

"Reduced access to bulk insurance could potentially affect future covered bond issuance as allocations of more cost-effective NHA-MBS (National Housing Act mortgage-backed securities) become sufficient to meet banks' funding needs for diminishing amounts of insured mortgages," said Fitch. "Covered bond issuance has generally been pursued to finance insured loans after issuers have reached their limit of NHA-MBS."

The rating agency said that this could force banks to use uninsured mortgages as covered bond collateral, but that potential resistance from trustees to amending existing programmes could mean that new programmes have to be set up. The higher credit and market value risks that uninsured assets would be subject to would lead to "considerably higher" levels of overcollateralisation (OC) being necessary, said Fitch — which raises questions over a 10% OC limit floated in the Department of Finance covered bond consultation.

Six of the seven Canadian banks issuing covered bonds have cover pools that consist entirely of CMHC insured mortgages. The Covered Bond Report understands that were new legislation to prohibit the use of such mortgages, there would be grandfathering for outstanding bonds featuring CMHC insured collateral.

Royal Bank of Canada is the only Canadian bank that has not relied upon CMHC collateral. According to a syndicate official, its covered bonds in US dollars tend to trade around 5bp wider than other Canadian issuers with CMHC collateral. However, being regarded as the strongest Canadian bank, RBC typically trades tighter than its peers on a senior unsecured basis, so the difference in value between the two types of collateral is likely to be higher.

Responding to an enquiry on the potential move from The Covered Bond Report, a department of finance official was non-committal.

"Canada released a consultation paper in May 2011 which laid out a number of proposals and questions for discussion, including asking if the legislative framework should encourage the use of uninsured collateral," he said. "After receiving feedback on the consultation paper, the government will be coming forward with legislation on covered bonds in the near future." ■

CMHC, Ottawa: Fitch said "an expansion of the insurer's balance sheet is unlikely"

ICMA
International Capital Market Association

The Covered Bond Report

The ICMA Covered Bond Investor Council & The Covered Bond Report present:

The Covered Bond Investor Conference

Date: Thursday,10 May 2012 **Venue:** InterContinental Hotel, Frankfurt

On the agenda:

The ICMA CBIC transparency standards initiative

Regulatory changes including CRD IV and Solvency II

Secondary market liquidity and price transparency

Evolving covered bond structures and legislations

Primary market practices and new issue developments

"In a context of record issuance, investors are invited to many events on covered bonds but usually agendas are driven by issuers' concerns. The ICMA CBIC/Covered Bond Report event will be reviewing investors' concerns and provide them with a forum to express their views and priorities."
Claus Tofte Nielsen, Chairman of the ICMA Covered Bond Investor Council

Register via: www.icmagroup.org/events
E-mail: Suzanne.Atkins@icmagroup.org
Call: +44 20 7213 0328

The conference is free to eligible investors and ICMA members

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NEW ZEALAND

RBNZ plans 'simple, low cost' framework

The Reserve Bank of New Zealand published proposals for covered bond legislation in December, saying that existing issuance should be able to be brought under the framework easily and that the plans will clarify treatment of cover pool assets in the event of a bank failure.

"The proposed legislative framework aims to provide investors with legal certainty as to the treatment of cover pool assets in the unlikely event that the issuing bank becomes insolvent," said Reserve Bank deputy governor Grant Spencer. "Legislative frameworks exist in most other countries with covered bond markets."

The proposals follow a consultation launched in October 2010 on a framework for covered bond issuance by New Zealand banks.

"Industry responses to the consultation indicated widespread support for a legislative framework," said the Reserve Bank in the new consultation.

"The regime proposed in this document provides a simple and low cost approach to regulating covered bonds," it added.

The new consultation is open until 16 March 2012.

"The Reserve Bank considers that there are unnecessary costs involved in establishing current structures in order to provide priority for covered bond holders to cover pool assets," said the Reserve Bank in the consultation paper. "Further, some market participants appear to be uncertain as to the potential application of the statutory management regime to cover pool assets.

"The Reserve Bank considers that a statutory framework aimed at clarifying the treatment of cover pool assets in the event an issuing bank fails would be beneficial. The proposal involves two main elements: a requirement that covered bond issues are registered and a 'carve-out' of registered issues from specific parts of the statutory management and liquidation regimes." ■

Key elements of the RBNZ proposals:

- Covered bond issues must be registered with the Reserve Bank;
- The cover pool assets must be held by a special purpose vehicle;
- An asset pool monitor must also be appointed to monitor the cover pool; and
- Legislative amendment to provide that the SPV cannot be included in the statutory management of the issuing bank and that certain "moratorium provisions" of the statutory management and liquidation regimes will not prevent the SPV gaining full legal control of cover pool assets.

TRANSPARENCY

Vdp responds to CBIC, plans amendment

The Association of German Pfandbrief Banks (vdp) is pursuing an amendment to the Pfandbrief Act to expand the information issuers need to disclose under Article 28 in response to a transparency initiative of the ICMA Covered Bond Investor Council and feedback from other investors.

The association has decided to ask for Article 28 of the country's Pfandbrief legislation to be amended to require the disclosure of information about interest rate and currency risk, and the vdp said that the weighted average seasoning of real estate loans in cover pools and the share of cover assets eligible for repo with the European Central Bank (ECB) should also be disclosed thereunder.

Article 28 of the Pfandbrief Act governs transparency requirements for Pfandbriefe, setting out the information that issuers are obliged to publish on a quarterly basis. Under a transparency initiative launched in 2010 the vdp publishes Article 28 transparency reports on its website in a standard format based on a uniform interpretation of the legal requirements.

"The vdp highly appreciates CBIC's initiative to enhance transparency in the Covered Bond market as transparency is of high importance for German Pfandbrief Banks," said the vdp in a letter to the CBIC released in mid-December. "Our members have discussed your proposals in several committees very intensely and identified several useful information that you request, which go beyond the legally binding transparency requirements and which should be of interest for a wide range of investor groups."

The extension of the transparency requirements, as mentioned above, should mean that all relevant information requested by the CBIC is addressed by Article 28, said the vdp.

"On top of that, the maturity structure of Pfandbriefe and cover assets should be disclosed in more detail," it said.

The vdp expects the Pfandbrief Act to be amended in 2013.

Nathalie Aubry-Stacey, secretary of the CBIC and director, regulatory policy and market practice at the International Capital Market Association, told The Covered Bond Report that the CBIC is pleased with the vdp's move.

"This is a very positive step for us because it is a very concrete result," she said. "We look forward to more discussions with the vdp and other issuers and issuer organisations." ■

"Any access to the markets at the moment is quite expensive" page 24

INSURANCE

Lower rated gain in Solvency II draft

Draft implementing measures of the Solvency II directive circulated by the European Commission treat double-A covered bonds more favourably than earlier proposals and reduce disincentives for insurance companies to hold long dated covered bonds.

A spokesperson for the European Commission (EC) said that the Commission at the beginning of November sent to the European Parliament and Member States a draft working version of Level 2 implementing measures of the Solvency II Directive, with late spring being targeted for their adoption. The text is not a public document.

Level 2 implementing measures are those that will put into practice the Solvency II Level 1 Framework Directive, according to the European Insurance & Occupational Pensions Authority (EIOPA). Specialist insurance market Lloyd's has said that much of Solvency II's impact on insurers will come from the implementing measures rather than the directive, which in many places indicates that the EC has powers to adopt implementing measures for specified topics.

According to market participants, whereas under a previous proposal preferential treatment under a spread risk module was only given to triple-A rated covered bonds, the Level 2 implementing measures extend beneficial treatment to double-A rated covered bonds, albeit differentiating between credit quality step 1A (triple-A) and credit quality step 1B (double-A).

In addition, the implementing measures are also understood to distinguish between spread risk charges for covered bonds with a duration of up to five, and duration from five to 10, with the linear relationship between duration and spread risk capital charges being softened, thereby providing more of an incentive to invest in long dated covered bonds. An analyst said he would expect covered bond with a term to maturity longer than 10 years to also benefit from a lower spread risk factor.

EC targeting early spring adoption of latest proposals

He said that the proposed measures would reduce the additional pick-up for a double-A rated covered bond versus a government or supranational, sovereign or agency (SSA) bond in the 10 year segment from 100bp to 45bp.

"There is indeed a much stronger incentive to invest in longer dated covered bonds," he said.

Limiting preferential treatment of covered bonds in the spread risk component to only triple-A rated covered bonds and the linear relationship between duration and capital charges are two aspects of previous, or existing, Solvency II proposals that another covered bond analyst previously identified as encouraging insurance companies to focus their long dated investment exposure toward sovereign bonds and reduce the average duration of their capital intensive products, to the disadvantage of long dated covered bonds.

Insurance companies are the largest investors in Europe, holding, according to Fitch, about 44% of European investments — around Eu7tr of assets.

The rating agency on 22 November wrote about the implications of the latest European Commission proposals for longer dated unsecured corporate and financial institution bonds, saying that the proposals to lower capital charges for this type of bonds "should mitigate the capital flight from these asset classes that is a likely side-effect of Solvency II".

It said that previously proposed capital charges for long dated unsecured bonds were extremely onerous, as a result of which at best insurers were likely to switch holdings to shorter dated higher rated bonds only — potentially increasing refinancing risk for borrowers.

However, it said that the changes represent incremental progress rather than a radical change, and that holding these bonds would still be less desirable than under existing rules. ■

LEGISLATION

Belgian proposal enters politics

Belgian covered bond legislation has entered the formal political law-making process after a final draft law and royal decree was sent by the central bank to the ministry of finance in January, according to a banker familiar with the initiative.

He said that the country's banking association, Febelfin, separately sent to the ministry a draft law setting out amendments of existing law that does not concern banking legislation, which is the focus of the National Bank of Belgium (NBB).

"It is out of the hands of the banks and regulators and in the political process," he said, adding that he did not know how long this process will take.

"The new government has a lot of projects, but it is being processed." ■

ICELAND

Arion stresses 100% Kaupthing record

Arion Bank is preparing to inaugurate a new covered bond programme under Icelandic legislation, with a 100% payment record for Kaupthing contractual issuance that the bank is taking over set to prove "extremely important", according to its head of funding.

Arion is a successor to Kaupthing Bank, which was Iceland's biggest bank before the collapse of the Icelandic financial system in October 2008. It issued covered bonds between 2006 and 2008.

Arion has reached an agreement with the Kaupthing Resolution Committee on acquiring a Isk120bn (Eu750m) mortgage portfolio of Kaupthing's bankruptcy estate. At a bondholder meeting in January, Arion secured 100% agreement from holders of outstanding Kaupthing covered bonds for it to replace Kaupthing as issuer of the covered bonds (with a 75% majority having been required).

"We are replacing Kaupthing Bank, which is in a resolution process, and we are fulfilling all the obligations as set out in the original documentation," Eiríkur Magnús Jensson, head of funding at Arion Bank, told The Covered Bond Report.

He said that the bank would, for example, be adding collateral where required.

Arion has secured a licence from Iceland's Financial Supervisory Authority (FME) to issue covered bonds under legislation introduced in 2008. Eiríkur Magnús Jensson said that the bank expects to sign its new statutory programme within a few days. Barclays Capital is arranger.

Although Kaupthing's senior unsecured creditors have faced losses on their bonds, payments on its covered bonds were maintained throughout the crisis. This included a coupon payment on 10 October 2008, the day after Kaupthing collapsed.

"There was never a hiccup on the payment of the bonds," said Eiríkur Magnús Jensson. "I think this is extremely important for covered bondholders."

The first covered bonds issued under Icelandic legislation were sold by Íslandsbanki in December 2011, Isk4bn of inflation linked bonds. ■

Eiríkur Magnús Jensson: "There was never a hiccup on the payment of the bonds"

SECURITISATION

RMBS fans cite covered bond 'flaws'

Preferential regulatory treatment of covered bonds is overdone and RMBS strengths are insufficiently appreciated, potentially "setting ourselves up for a fall", according to some panellists at a Standard & Poor's covered bond event for investors in January.

During a panel discussion on "Covered bonds vs. RMBS", Neil Calder, head of the investments credit desk, European Bank for Reconstruction & Development (EBRD), and Rob Ford, partner, portfolio manager, TwentyFour Asset Management, said that they would rather hold a residential mortgage backed securitisation (RMBS) than a covered bond in the event that an issuer finds itself in financial distress or is in default.

Calder said that what he described as recent legislative developments in covered bonds showed an increasing emphasis on "almost RMBS-light" structural enhancements, such as asset coverage tests, eligibility criteria and minimum loan-to-value levels, but suggested that "hard wired" mechanisms in RMBS provide more protection for investors than covered bonds "when things don't go quite as expected". Ford agreed.

"If it was a doomsday scenario, I think I'd definitely prefer to be in the RMBS camp than in the covered bond camp," he said.

Gareth Davies, head of European ABS and global covered bond research, JP Morgan, contrasted what he said was certainty provided by documentation underpinning RMBS with the situation in covered bonds, where "you can pretty much drive a bus through the legislation". He said that in covered bonds "what really happens when something goes wrong" is less clear-cut than would be the case in the asset-backed securitisation market, likening covered bonds to "ABS 2007", when the possibility of something going wrong was not contemplated.

Regulatory support for covered bonds is leading to the asset class being "overpromoted" to the danger of the European banking system, added Davies. He said that there needs to be a diversity of funding routes available to ensure the European banking system is "as widely funded as possible".

However, not everyone agreed, with one delegate afterwards saying that he was disappointed by what he described as "the whining of the MBS issuers and investors about the unfair treatment by the regulators". ■

"The reality is that LTRO funding is much more attractive in economic terms" page 28

POLICY STATEMENT

HMT tightens RCBs, FSA goes loan level

The UK covered bond industry is hopeful that changes to covered bond legislation announced in November and December that make it more prescriptive, without placing extra burdensome demands on issuers, could win Regulated Covered Bonds (RCBs) more credit from investors, particularly those elsewhere in Europe.

HM Treasury published an amendment to covered bond legislation alongside the Chancellor's Autumn Statement in November, while the Financial Services Authority released a covered bond Policy Statement on 9 December.

The legislative amendment introduces an option for issuers to declare that their covered bonds are backed by only a single type of asset; excludes securitisation as an eligible asset; sets minimum overcollateralisation at 8%; creates a formal requirement for UK covered bond programmes to appoint an asset pool monitor; and clarifies the Financial Service Authority's (FSA's) powers to require issuers to publish information for investors. With respect to the latter, the FSA subsequently released a requirement for loan level data disclosure.

FSA aligns with Bank of England despite issuer resistance

"There are no viable alternatives to regulations, since European law and investors favour regulated covered bonds," said the Treasury. "These proposals will improve existing regulation to make sure it meets its policy objective."

Tom Ranger, head of secured funding at Santander UK, said that the Treasury's announcement did not contain any surprises.

"What was in the consultation is largely what we ended up with," he said. "The most important thing is that we have a fantastically strong legislation in the UK."

However, he said that the RCB framework does not get enough credit from market participants elsewhere in Europe, and UK RCB issuers therefore hope that the Treasury's and the FSA's work on the legislation will give it more publicity.

"Only UK issuers appreciate how hard it is to comply with the legislation, how tough and rigorous it is to qualify as an RCB issuer," said Ranger.

Bernd Volk, head of covered bond research at Deutsche Bank, welcomed the Treasury's move as "overall, a step in the right direction" by inserting more details in the legal framework instead of focussing mainly on contractual enhancements.

The Treasury said that its proposals are intended to reduce uncertainty among investors about the quality of UK covered bonds, and made what it described as a conservative estimate of 5bp as its central assumption for a reduction in spreads that could be triggered by the measures.

Jörg Homey, head of covered bond research at DZ Bank, said that the argument that any reduction in investor uncertainty brought about by the changes would lead to lower spreads is a reasonable one, but that it is very difficult to pin down a specific number to capture such savings. In addition, the Treasury appears to be making mandatory what is in many ways already best practice, he added, which means that there should not be any changes to the way in which UK covered bond programmes are set up.

The FSA's introduction of a requirement for loan level reporting will impose only minimal additional costs on most issuers, according to the authorities, given that the reporting standards the FSA will propose are similar to those developed by the Bank of England, "with which almost all issuers have indicated they are already planning to comply".

However, in a summary of responses to the joint consultation the Treasury said that most issuers opposed loan level disclosure on the grounds of cost and confidentiality, and because they believed investors did not require such a level of detail. ■

The Treasury said that its amendment will:

- Give issuers of covered bonds the option (but not the obligation) to declare that their bonds are backed by only a single type of asset.
- Exclude securitisations as eligible assets for covered bonds.
- Set a minimum level of credit protection for investors in covered bonds.
- Create a formal requirement for UK covered bond programmes to appoint an asset pool monitor.
- Clarify the FSA's powers to require issuers to publish information for investors.

The FSA Policy Statement set out the following changes to its RCB Sourcebook:

- Introduction of consistent standards of investor reporting: this will increase transparency for investors and highlight the quality of underlying assets, while the use of common standards will make it easier for investors to compare different programmes. This includes requiring issuers to provide loan level information on assets in the cover pool.
- Clarification of the role of 'Asset Pool Monitor': this codifies the existing UK practice of independent, external scrutiny of an issuer's regulated covered bond programme. Issuers will be required to provide these reports to the FSA.
- Refining of regulatory reporting: this updates and consolidates the regulatory reporting that the FSA requires when issuers apply to register with the FSA and on an ongoing basis. This information is used to assess issuers' applications and as part of the regular stress-testing the FSA conducts on regulated covered bond programmes.

Ratings

INVESTOR SURVEY

Sovereign risk dominates, demand rises

Investors identified sovereign risk as the main challenge facing the covered bond market this year in response to a Fitch survey, which also found increased appetite for covered bonds.

One hundred investors participated in the survey, which was conducted in December and released in January, with 13% of the accounts managing more than Eu20bn in covered bonds, 25% managing between Eu5bn and Eu20bn, and 62% having less than Eu5bn in their portfolios.

The number of investors who put sovereign risk as their top concern, at 59%, was up from 37% a year earlier. The health of the banking sector was the second main concern, at 21%, and underlying collateral performance was selected as their top concern by 9% of investors, down from 21% last year.

Of the respondents, 88% planned to increase their current holdings of covered bonds or maintain them within the next 12 months, up from 83% in December 2010. Ten percent expected to increase their holdings significantly, and 1% said they intended to reduce them significantly.

Fitch noted that some countries were preferred as investment opportunities, and that investors were likely to decrease their exposure to peripheral countries.

"Our survey shows that investors have a growing appetite for covered bonds, but are selective in what they buy," said Beatrice Mezza, senior director for business and relationship management at Fitch. "They expect to increase exposure to Scandinavia, Australia, UK and the Netherlands, which is where most of the supply has come from in the first weeks of 2012."

Beatrice Mezza: "Investors have a growing appetite, but are selective"

Only 10% of respondents said they are only comfortable with pools exposed to AAA countries, while 24% said they are not buying public sector covered bonds exposed to peripheral European countries, and 57% are making investment decisions on a case by case basis.

Flexibility increases

Non-AAA covered bonds could be bought by 83% of the study participants. Investors' rating limits were evenly split between AA, A, BBB, and no limit at all.

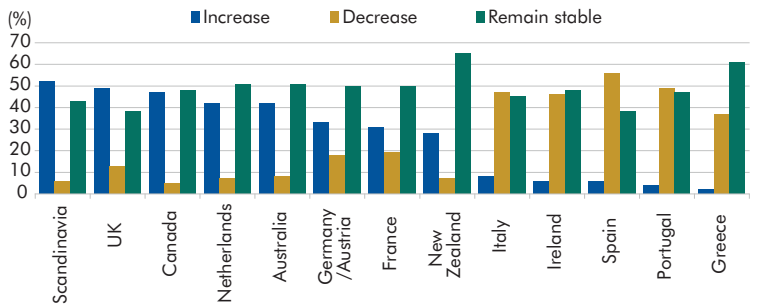
Flexibility with regard to structure was also shown in the study, with 71% of investors prepared to buy covered bonds with soft bullet maturities, compared with 62% in 2010. The percentage of participants that would only buy hard bullet covered bonds has decreased from 34% to 29%.

The survey also showed that while new countries are planning to introduce covered bond legislation in 2012, 52% of investors are active buyers of contractual programmes, with 29% of this majority requiring a higher spread than for regulated covered bonds. Some 35% were comfortable buying covered bonds secured by assets other than mortgages or public sector loans, and required a higher spread to do so.

Fitch added that when asked to list in order of priority which research investors use when monitoring their covered bond holdings, "investors said they consider rating agency credit analysis and performance reports the most relevant, followed by the issuers' own web sites and investment banks' credit research".

The majority, at 68%, of investors required at least two rating agencies to feel comfortable buying a covered bond and 26% would buy a bond with one rating. ■

In the Next 12 Months, Your Covered Bond Exposure to the Following Areas is Likely to:



Source: Fitch

MOODY'S

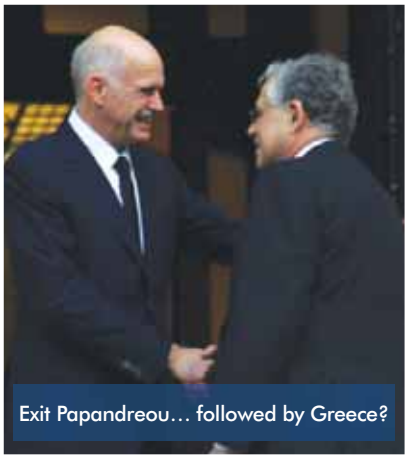
Greeks capped on 'remote' euro exit risk

Moody's said in late January that because of a "remote" risk of redenomination in Greece it was implementing a B1 ceiling on the rating of Greek covered bonds.

At the same time, it downgraded five Greek covered bonds on 24 January because of an increased likelihood and severity of Greece defaulting on its debt and the implications of such a default for Greek covered bonds.

Covered bonds issued by Alpha Bank under its direct issuance programme, mortgage bonds issued by EFG Eurobank Ergasias (EFG) off programme I, mortgage covered bonds issued under programme I of National Bank of Greece (NBG), and covered bonds issued off NBG's programme II were cut from Ba3 to B1. EFG's programme II covered bonds were cut from B1 to B2.

Moody's said that in the event of a disorderly default by Greece, "the functioning of the banking system and the state would be materially impaired, and the economy would very likely experience a further sharp contraction". It would also increase the likelihood of Greece exiting the euro area, accompanied by a return to a deeply devalued national currency, according to Moody's.



Exit Papandreou… followed by Greece?

The rating agency noted that while such an event is not its central scenario, the probability of a default occurring is rising. In that event, the ability of Greek borrowers to repay their debts would weaken significantly, beyond that already assumed. Moody's has concluded that no Greek covered bond could be rated higher than B1 even taking into account the low likelihood of this scenario.

Moody's noted that Greek covered bond documentation is governed by UK law and that in the "remote" event of a redenomination in Greece, the underlying assets backing the covered bonds could be converted into a new national currency while the rated notes remain in euros.

"In this scenario, and for a given asset performance level, notes will suffer different levels of losses arising from the redenomination risk, depending on the credit enhancement levels," said the rating agency. ■

DENMARK

End to one year ARMs floated

A phasing out of one year bullet bonds used to finance adjustable rate mortgage loans proposed by the Danish Mortgage Banks' Federation (Realkreditforeningen) would be credit positive for Danish covered bonds and Danish issuers, according to Moody's.

The Federation has called for such a move in response to regulatory pressure from domestic and international bodies — including the Danish central bank, European Commission and Moody's — but the Association of Danish Mortgage Banks (Realkreditrådet) remains committed to the instrument. The Federation's members are Danske Bank subsidiary Realkredit Danmark, Nordea Kredit and LR Realkredit, while the Association represents Nykredit, with its subsidiary Totalkredit, as well as DLR Kredit and BRFkredit.

Moody's said in a comment in January that "in the end, the positive effect of these initiatives will depend on how market participants choose to implement them". It noted that the Federation represents 43% of Danish mortgage lending and the Association 42%.

"So far," it said, "there is no market-wide consensus on which suggestions to implement."

"So far there is no market-wide consensus"

The rating agency said that the elimination of the one year covered bonds would be credit positive for the covered bonds because it would reduce their annual refinancing risk, and for Danish banks and mortgage credit institutions that widely use covered bonds for funding, investment and liquidity purposes. It noted that mortgage credit institutions have worked on several strategies to mitigate the refinancing risk, but said that these were insufficient to change its opinion.

"These include spreading the covered bond auction dates over the year and restricting the leverage of loans backing the covered bonds, which reduces credit risk and thus mitigates refinancing risk," said Alexander Zeilder, senior analyst on covered bonds at Moody's. "Several suggestions publicized so far to address refinancing risk are credit positive but are not strong enough to change our key credit assumptions because on their own these changes do not fully remove the refinancing risk inherent in one year bonds.

"Removing refinancing risk would be achieved if one year bonds were replaced by a revival of traditional Danish bonds where loan and bond amortisation as well as maturity dates are matched." ■

PERFORMANCE

Pressures rise in latest Moody's data

Moody's latest quarterly monitoring overview shows that the pressures facing covered bonds, including those of top quality issuers, are increasing, according to covered bond analysts.

The rating agency on 19 January published its monitoring overview for the third quarter of 2011, covering more than 200 issuers and providing information about five key credit measures: Timely Payment Indicator (TPI) leeways, cover pool losses, collateral scores, surplus overcollateralisation, and stressed scenarios.

Moody's said that information included in the latest monitoring overview was primarily based on Performance Overviews published for the reporting quarter ending 30 September 2011.

NordLB covered bond analyst Matthias Melms said that a worsening of general conditions for covered bonds, including systemic support, has direct consequences for the programmes monitored by Moody's.

"Rating migration in the covered bond market is continuing and claiming ever more victims," he said. "The data makes clear that pressure is increasing and that first class issuers are now also coming into focus for a possible downgrade."

As of 30 September 2011, Moody's assigned its top rating to 58% of the covered bond programmes it rates, with Natixis analysts noting that this compares with 65% at the end of the second quarter of 2011.

DZ Bank analysts said that Moody's Q3 2011 monitoring overview provides an updated snapshot of a prevailing negative ratings trend. They identified as the main points emerging from the rating agency's report that rating buffers are shrinking, market risk assumptions are increasing, and credit risk assumptions for public sector covered bonds are on the rise.

"The average rating buffer, expressed in rating steps by the TPI Leeway measure, continues to reduce," they said. "This means the pressure on covered bond ratings is increasing, as is their sensitivity to issuer rating downgrades."

Moody's report said 30% of programmes have no TPI leeway, meaning that if the issuer rating were downgraded by one notch the covered bond rating would also be cut, all else remaining equal. NordLB's Melms said this compares with 25% in Moody's Q2 2011 overview, and that the updated figure shows a clear increase in the number of programmes that are directly under threat. Spanish (13), Italian (8), and German (8) programmes are especially in danger, he added.

Risks stressed

DZ's analysts noted that Moody's is incorporating higher market risks into its stress tests, with risks for public sector covered bonds rising faster than those for mortgage-backed covered bonds.

"The biggest increases in Moody's market risk assumptions have affected Italian and Spanish public sector covered bonds and Portuguese and Danish mortgage covered bonds," they said.

Market risk and collateral risk are the two components of the cover pool losses that Moody's models into its rating approach in the event of an issuer default, which it says allows investors to take a view on Moody's loss assumptions if the issuer is removed from the rating analysis.

Natixis analysts noted that average cover pool losses of 25.8% for the period

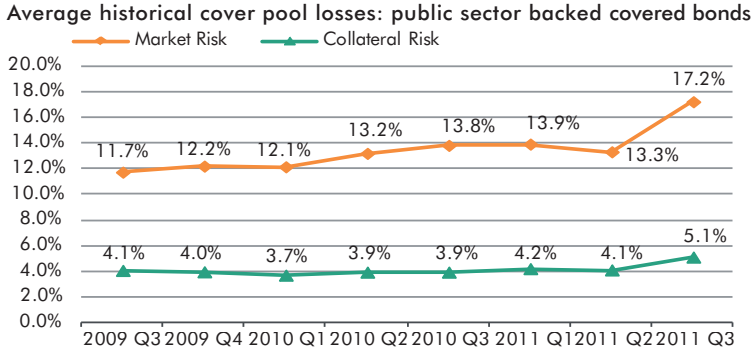
Matthias Melms: "First class issuers are now also coming into focus"

ending 30 September 2011 are higher than a 23.2% figure from Moody's preceding quarterly overview, and that the average ratio for assumed cover pool losses for mortgage backed covered bonds increased slightly year-on-year, led by a 16% increase in assumed market risk.

Moody's report also provided an overview of how it assesses the quality of collateral in a cover pool, as captured in its collateral score. DZ analysts noted that the average collateral score for mortgage covered bonds (just over 12%) has stayed very stable since the first quarter of 2010, but pointed out that the assumed credit risk for Danish mortgage covered bonds has risen, but fallen for Irish mortgage issues.

The average collateral score for public sector covered bonds, meanwhile, has risen, said the DZ analysts.

"The recent months' sovereign rating downgrades are likely to help this trend continue," they said. "The collateral scores of Spanish public sector covered bonds have risen exceptionally." ■



Source: Moody's

"How viable is the business model of public sector financing?" page 30

OUTLOOK

S&P sees 'bumpy road' for 2012

Standard & Poor's expects new issuance to be challenging in 2012 despite a good start to the year, noting that a poor economic backdrop may hurt peripheral covered bond prospects and that pricing is significantly wider than 12 months ago.

In a report released in late January the rating agency said that new issuance could be "bumpy" in 2012, despite a recent rush of supply.

"The bleak economic backdrop may hurt covered bond prospects," said Sabine Daehn, credit analyst at S&P, "especially for countries such as Spain, Greece, Portugal, and Italy, where originators will likely retain issuance for use as collateral in ECB refinancing."

The report was published ahead of the reopening of the Spanish covered bond market after eight months by Santander at the beginning of February.

About Eu100bn in benchmark covered bond issuance is set to redeem in 2012, less than last year, according to S&P. The rating agency said that even if new covered bond issuance funds all these redemptions, volumes may therefore decrease. It said overall outstanding balances globally are likely to remain broadly flat for 2012.

S&P said that it expects covered bond markets in Germany, Scandinavia, the UK, and France to be more resilient, but that spreads are likely to be higher than observed one year ago.

Germany has the largest covered bond market by outstanding balance, but 2012 could be another year where net issuance is negative. S&P anticipates that the total outstanding balances will fall, particularly on the back of shrinking public sector programmes.

"With some of the largest Pfandbrief issuers downsizing and reshaping their businesses and lending strategies, the German covered bond market is likely to shrink further," it said.

The rating agency said it is difficult to predict whether other European countries

Sabine Daehn: "Bleak economic backdrop may hurt covered bond prospects"

might pick up the slack, adding that last year's turbulence did not help new covered bond jurisdictions establish themselves.

The rating agency was also not optimistic about the chances of the US market contributing significantly to new issuance volumes in 2012 because preliminaries to the upcoming presidential election mean US lawmakers may not establish a covered bond legal framework until 2013.

> "The picture for public sector covered bonds may be a little gloomier"

It considers changes in sovereign and bank credit ratings as more likely than collateral performance to spur covered bond rating changes in the near future.

S&P's covered bond ratings are strongly linked to its issuer credit rating on the programme sponsor. The sponsor rating could be affected in the short term by a recently updated rating methodology for financial institutions, as well as by the rating agency's recent changes in sovereign ratings.

"Given the current focus on public sector indebtedness in many countries," said the rating agency, "the picture for public sector covered bonds may be a little gloomier, especially for programmes that are exposed to peripheral European countries.

"Covered bond issuers have almost completely reduced their exposure to Greek assets in public sector cover pools, but some programmes remain exposed to assets in Spain, Portugal, and Italy, as well as the issuers' home markets."

Euro-zone cuts hit covered

Downgrades of France, Italy, Portugal and Spain by S&P on 13 January as part of rating actions on 16 euro-zone sovereigns led to cuts to two Portuguese covered bond programmes, and one Italian and one Spanish programme.

On 31 January, S&P cut the ratings of mortgage covered bonds issued by Banco Santander Totta (from A to A-), and mortgage and public sector covered bonds issued by Banco BPI. BPI's mortgage covered bond (obrigações hipotecárias) programme was downgraded from A+ to A- and its public sector programme (obrigações sobre o sector public) from BBB to BB+.

The covered bond ratings were left on negative review, in line with the status of the issuer ratings. S&P said that the rating actions reflected Portugal's revised sovereign rating and the impact of the country risk exposure on the covered bond programmes. Banco BPI in January launched a covered bond and S&P said that it would also take this into account.

S&P downgraded public sector covered bonds issued by Spain's Banco Bilbao Vizcaya Argentaria (BBVA), from AA to A+, on negative outlook. This followed a two notch downgrade of the sovereign on 13 January, from AA- to A.

The rating agency downgraded mortgage covered bonds issued by UniCredit, from AAA to AA+, on negative outlook. ■

SPAIN

Cédulas redress seen unlikely in mergers

Holders of cédulas have, relative to other jurisdictions, few options to oppose anticipated mergers between Spanish banks that may affect their interests, according to Moody's.

The rating agency said at the end of January that it expects Spanish banking mergers to weaken the credit quality of the outstanding cédulas of stronger banks.

José de Leon, senior vice president at Moody's, told The Covered Bond Report that Spanish economy minister Luis de Guindos has made it clear that further consolidation is ahead, and that stronger banks are likely to merge with weaker ones.

"The Spanish banking landscape has changed dramatically over the past two years," he said, "and consolidation may intensify, with the difference between stronger and weaker entities more substantial than it has been in the past few years.

"Some covered bond investors are worried about the impact of the mergers, and raising the legitimate question about whether there is anything they can do."

Moody's said that investors in Spanish covered bonds have few legal options to oppose mergers under Spanish statutory law, which governs the terms and conditions of covered bonds.

"Spanish law for covered bonds, unlike laws for other types of bonds or other jurisdictions, does not treat the merger of a CH [cédulas hipotecarias] issuer as an early redemption event that would give investors the option of receiving their original investment in lieu of accepting a credit negative merger," it said.

The rating agency noted that according to Article 44 of Spanish Act 3/2009 on structural changes in trading companies (such as cédulas hipotecarias issuers) within a month of the merger announcement creditors that lack sufficient security can object if the merger is detrimental to their interests. In such a case, the company cannot formalise the merger until the company presents security satisfactory to the creditor.

Luis de Guindos: Spanish mergers favoured

However, Moody's said that proving that covered bondholders are insufficiently secured as a result of the merger is difficult because the entire mortgage book of the resulting entity acts as security for the investors in the cédulas hipotecarias. ■

MICH

Fitch calls for public OC promises

Spanish banks participating in multi-issuer cédulas hipotecarias (MICH) must make public commitments to overcollateralisation levels necessary to support ratings if most of the sector is not to face cuts to the single-A level, Fitch stressed in its latest OC Tracker publication at the end of January.

The rating agency will conclude a review of the sector at the end of March.

Fitch put the covered bonds on Rating Watch Negative (RWN) in December because of expected overcollateralisation (OC) volatility in the absence of OC statements by CH issuers with a low short term rating (F3 or lower), which feature in most MICH transactions. Fitch does not give credit to total overcollateralisation for such issuers because it says actions to obtain liquidity would reduce OC.

"The agency anticipates that banks under tight liquidity may see their OC ratios reduced, as they will be under pressure to issue new CHs, mortgage bonds or securitisations in order to obtain discountable assets with the ECB," said Fitch. "The weighted average OC has fallen to 144% down from 154% since the last version of this report in summer 2011."

Meanwhile, supporting overcollateralisation levels have risen and Fitch said that the average distance between total OC and supporting OC ratios has decreased from 96% in March 2011 to 55%, considering AAsf scenarios.

"The CH issuers need to decide whether they will limit the potential volatility by issuing OC statements to provide comfort that future funding decisions will not reduce OC ratios below a certain committed level," said Fitch.

> "No credit for private best-effort declarations"

The rating agency said that there is no OC statement at present for 10 CH issuers rated below F2 or rated F2 and on RWN, and for six others OC statements may have become outdated.

"The agency clarifies that no credit is now given to private best-effort declarations," added Fitch. "This follows the breach of one such statement by Banco de Valencia in summer 2011, which caused Fitch to place two MICH deals on RWN."

MICH rated by Fitch are in the AAsf category comprise 41 transactions totalling Eu94bn backed by cédulas hipotecarias issued by 24 Spanish financial institutions. ■

Market

ECB

CBPP2 path reflects primary focus

The second European Central Bank covered bond purchase programme is more focused on the primary market than the first programme was, according to Wilfried Baum, head of portfolios section at Deutsche Bundesbank.

Speaking at the Landesbank Baden-Württemberg European Covered Bond Forum in Mainz on 3 February, Baum said that there is "much more focus this time on the primary market".

During the first covered bond purchase programme the ECB released monthly reports giving, among other details, a breakdown between primary and secondary market purchases, but it is not releasing such reports for CBPP2. According to final ECB data on CBPP1, only 27% of purchases under that programme were in the primary market, against 73% in the secondary market.

The ECB had by 9 February reported total settled purchases under CBPP2 of Eu5.762bn. According to Royal Bank of Scotland analysts, this represented a Eu5.278bn lag on a theoretical run-rate necessary for the ECB to hit its Eu40bn target by the time the programme finishes at the end of October.

Baum noted that issuance of covered bonds eligible for the programme had been very low between the launch of the programme at the start of November and the end of 2011, but had picked up in January. This was matched in January by a jump in reported purchases under CBPP2 and Baum said that the focus on the primary market of the programme "also illustrates the buying activity you observe".

He said that the focus on the primary market is "to allow for the desired catalysing function in the market", which was one of the aims of the ECB in launching the second programme.

However, Baum gave little colour on how the ECB might — if at all — be weighting purchases towards peripheral countries, but did say that "we try to be as fair as possible". He said that factors that could influence the operation could be "where the need might be big" and at the same time "where the risk is within our considerations", with the "economic importance" of countries and size of covered bond markets coming into play.

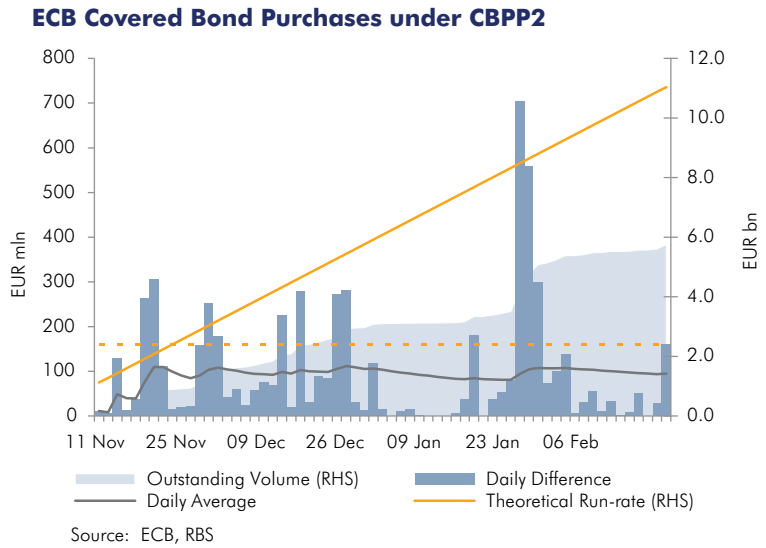
Baum had earlier noted that the "similarities are not very big" between CBPP2 and the Securities Markets Programme.

photo pg donella

Wilfried Baum: "We try to be as fair as possible"

Giving an insight into the practical operation of CBPP2, Baum said that when they are launching a new issue, issuers and lead managers can inform the national central bank (NCB) in the country of issue, and that this NCB will inform other Eurosystem members. The Eurosystem will then hold a conference call to agree how much interest there is, subject to system limits, and will enter a bid for the new issue or tap with the institution that first approached them. However, he noted that although they had been approached about new issues ahead of bookbuilding, Eurosystem members will only place orders once books are open.

Baum said that in the secondary market the Bundesbank's approach is to accept on a daily basis via e-mail lists where partners can offer excess paper. The Bundesbank will then decide where there is a need to purchase paper, and then engage in a process whereby it will ask for prices from a range of counterparties before buying. ■



CÉDULAS

Santander leads Eu4.7bn Spain comeback

Spanish issuers were able to take advantage of the risk-on mode of the capital markets to issue the first cédulas in eight months, with Santander leading the way by launching a Eu2bn three year deal on 1 February that generated Eu8.5bn of demand.

Banco de Sabadell followed with a Eu1.2bn three year deal before Banesto and CaixaBank extended the reopening along the curve with Eu500m long four year and Eu1bn five year transactions, respectively. Santander's covered bond was also only the second peripheral bond issue in the public markets of the year, after an 18 month Intesa Sanpaolo senior unsecured issue a day earlier.

Antonio Torío, director, capital markets funding at Banco Santander, told The Covered Bond Report that the issuer felt it was important for it to reopen the Spanish market after a long period without benchmark cédulas supply.

"We thought that a covered bond was the right product," he added. "It is a safe product that came with an appealing spread for investors."

Barclays Capital, Citigroup, Natixis and Santander priced the issue at 210bp over mid-swaps, 20bp tighter than initial guidance of the 230bp over area. Some 270 accounts participated in the deal, with 73% sold outside Spain.

Tim Michael, FIG syndicate at Citi, said that the level of demand exceeded expectations. He attributed the strong demand to a combination of factors including a fundamental appreciation of the credit, the lack of cédulas supply, the appeal of the spread and less than anticipated benchmark covered bond issuance in general this year.

"At the sovereign level, the peripheral region has benefitted strongly from the recent uptick in risk appetite and the positive implications of the LTRO has been evident in the bank space," he added. "The LTRO is partly responsible for supply generally being less than anticipated.

Bruce Cairnduff: CaixaBank execution demonstrated strength of name

"So there are fewer offerings, but accounts are still keen to participate in covered bonds, and all this adds up to demand for fairly priced transactions."

Second tier ahead of schedule

Banco Sabadell followed three days after Santander, with its deal attracting Eu2bn of demand and showing that the market was open to second tier Spanish names more quickly than some market participants might have imagined.

> "Nobody really expected a smaller bank like Sabadell"

"Expectations were that another top tier name would follow Santander, like BBVA or CaixaBank," said Marko Nikolic, head of covered bond origination at Nomura, joint lead with Bank of America Merrill Lynch, Deutsche, Natixis and Sabadell. "Nobody really expected a smaller bank like Sabadell to be brave enough and be the first to follow on."

The three year deal was priced at 250bp over mid-swaps, with Santander's issue having already tightened in the secondary market.

Santander subsidiary Banco Español de Crédito (Banesto) the following day extended the refreshed cédulas curve out to June 2016 with its Eu500m deal. Banesto, Citi, Crédit Agricole, Deutsche and JP Morgan took Eu1.8bn of orders and priced the issue at 235bp over mid-swaps.

CaixaBank then made it three deals in as many days and took Spanish supply to Eu4.7bn with a Eu1bn five year priced at 248bp over mid-swaps on the back of Eu2.7bn of demand from 121 investors. The pricing represented a spread of 8bp over Bonos, according to the issuer.

Demand exceeded expectations, with very strong support from domestic and international accounts, according to Bruce Cairnduff, head of financial institutions and covered bond syndicate at Crédit Agricole, which was joint lead with Barclays, CaixaBank, JP Morgan and UBS.

"This demonstrates the strength of the name, extending the maturity parameters for cédulas transactions in the current liquidity window and issuing at such a tight spread relative to the underlying government curve," he said.

A funding official at CaixaBank told The Covered Bond Report that the transaction demonstrates the bank's ability to access the public capital markets, with covered bonds representing the best product available to the issuer to do so.

"The transaction was a big success, and we are really happy to have achieved our objectives," he said. "Our objective was to make a five year deal at the right time with the right price, rather than big volume.

"The idea was to create momentum and gain traction by starting with the 260bp over area and go tighter if possible. We hit this target." ■

"They wanted to make sure that the average deposit-holder wasn't disadvantaged" page 38

BUYBACKS

Peripheral banks go for covered buybacks

Three deeply discounted cash for covered bond tender offers were launched by peripheral covered bond issuers in the first weeks of the year, illustrating the attractiveness of such liability management (LM) exercises for those seeking to bolster capital ratios and free up collateral.

A fourth buyback, for Italy's CDP, had a different rationale, while Austria's Bawag PSK was the first non-peripheral issuer to engage in a buyback (see box).

A tender offer from National Bank of Greece on 3 January is believed to be the first to target the repurchase of covered bonds for cash since 2007, and was followed by cash for covered bonds offers from Portugal's Banco BPI and then Spain's CatalunyaCaixa.

Bernd Volk, head of covered bond research at Deutsche Bank, said that covered bond cash tenders are a good solution to achieve "the perfect combination" of reducing issuer debt and freeing up collateral, while providing for truly voluntary burden-sharing and giving investors an opportunity to sell at higher prices and in size, especially in the case of covered bonds from weaker issuers.

"A high take-up of deeply discounted covered bond tenders would also confirm the macro-dimension of covered bonds," he said. "In case macro concerns dominate (and even foreign exchange concerns come into play), typical covered bond valuation models may no longer be crucial."

Florian Eichert, senior covered bond analyst at Crédit Agricole CIB, said that three year long term repo operations (LTRO) by the European Central Bank make buybacks of covered bonds for cash attractive for certain issuers. In the absence of such LTROs, he said, tendering covered bonds does not make much sense for many issuers given fairly high cash trading prices and reliance on covered bonds for funding.

"With the three year LTRO operations from the ECB entering the scene, the situation might, however, have changed a bit

CatalunyaCaixa joined National Bank of Greece, Banco BPI in tendering

for some issuers," he said. "The funding argument 'pro' covered has been eliminated at least for covered bonds with a maturity of up to three years as these tendered covered bonds can be replaced with ECB funding of the same maturity."

He said that the ideal candidate bonds

"Tendered covered bonds can be replaced with ECB funding"

for a tender offer in the prevailing market situation would come with the four following features: a maturity of up to three years to slightly longer; a low cash price; a high coupon; and a low rating, ideally close to non-investment grade status.

Banco BPI's buyback targeted a Eu1bn 3.25% January 2015 mortgage-backed issue, which was one of six bonds that Eichert had previously identified as meeting the aforementioned criteria and therefore "especially attractive" for a tender offer.

BPI follows NBG starter

The Portuguese bank launched its liability management exercise on 26 January, offering to buy back all or any of the issue for 85% of the par value, plus accrued interest in gross amount. A banker at one of the joint dealers — Banco BPI, Citigroup, and Deutsche Bank — said that the tender premium incorporated in the 85% cash price was 2.5% or 3.7%, depending on the quote.

A covered bond market participant said that he found the premium "a touch on the low side". He put the premium offered in a tender offer for National Bank of Greece at around 20%.

Some 42% of a Eu1.5bn 2016 covered bond targeted for buyback by NBG was tendered by investors, with participation in the liability management exercise by holders of NBG hybrid securities helping to generate an overall Eu302m of core tier one capital for the bank. The buyback was for an aggregate nominal amount of Eu1.88bn equivalent, with the purchase price for the covered bonds having been set at 70% of par value, and 45% for the hybrid securities. Credit Suisse, Deutsche Bank, Merrill Lynch and Morgan Stanley were the dealers.

A covered bond analyst said that holding on to the NBG covered bonds at a time when Greek 2016 sovereign bonds are quoted at 24 cash "suggests a pretty strong belief in the euro as the ongoing currency in Greece".

A banker on the tender offer said it was launched to generate core tier one capital for NBG and strengthen the quality of its capital base ahead of EU implementation of Basel III and in accordance with a Bank of Greece guideline for the country's banks to increase core tier one ratios.

"The transaction offered several important benefits to investors, including but not limited to a cash exit out of effectively illiquid instruments and a reasonable premium to current mid-market levels," he added.

Another banker said that a core tier one increase of Eu300m was a good result for the tender offer given that there are few alternative ways in which a Greek bank could raise such an amount.

Richard Kemmish, head of covered bond origination at Credit Suisse, said that the level of participation by covered bond investors was not out of line with that for other liability management exercises involving covered bonds, although NBG's was very different in that it was the first since 2007 to tender cash

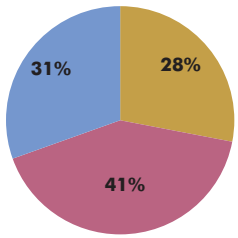
for covered bonds, the first non-extension structure and the first to offer a deep discount to par value.

"The vast majority of those investors who could participate did so," he said.

Cédulas in LM mix

Catalunya Banc followed NBG's and Banco BPI's moves by launching a tender offer on 2 February, targeting a Eu900m buyback across two covered bond issues and 34 ABS tranches of an aggregate face value of Eu7.01bn. It is the first capped covered bond tender offer this year. The covered bonds targeted by the bank, which is also known as CatalunyaCaixa, are a Eu1.5bn 4.875% June 2017 cédulas hipotecarias issue and a Eu1.75bn 3.5% March 2016 issue, also mortgage-backed.

Crédit Agricole in January asked investors: do tender offers from very distressed covered bond issuers make sense?



- No, we don't think covered bonds are the correct product for tender offers.
- Yes, if the tender price is correct, all parties can benefit from this.
- n/a

Source: Crédit Agricole CIB

Deutsche Bank, JP Morgan, and Natixis are joint dealer managers alongside Catalunya Banc. The purchase price was set at 94% for the June 2017 issue and 93% for the larger, March 2016 bond. Bankers working on CatalunyaCaixa's tender offer put the market premium incorporated in the purchase price at between 3% and 4%.

Italy's Cassa Depositi e Prestiti was seeking to buy back for cash its remaining outstanding covered bonds, Eu3bn January 2013 and ¥10bn (Eu99.7m) January 2017 issues, after having voluntarily terminated its covered bond programme in November.

The re-offer price is 99.9% plus accrued interest, with an additional 0.1% due to investors who tender their bonds by an early deadline of 10 February. Banca IMI, BNP Paribas, Deutsche Bank, Nomura and UniCredit were joint dealers. ■

AUSTRIA

Bawag's above par tender contrasts

Austria's Bawag PSK launched a tender offer to buy back up to Eu500m of a Eu1bn 4.25% 2014 covered bond on 7 February, the first cash for covered bonds buyback this year to offer a fixed spread rather than a cash purchase price and the first from a non-peripheral issuer.

The tender offer came after similar moves by National Bank of Greece, Portugal's Banco BPI, Spain's CaixaCatalunya, and Italy's CDP.

Bawag PSK, Commerzbank and Natixis were joint dealers on Bawag's buyback, which was billed as intending to optimise the maturity structure of the bank's external debt securities. Investors holding the targeted covered bond were being invited to sell it to the issuer for a fixed spread of 55bp over mid-swaps, with the buyback capped at Eu500m.

The fixed spread contrasted with a cash price on the table in the other tender offers, which, except for CDP's, came at a deep discount to par value.

A banker away from Bawag's transaction said that the premium on offer was "pretty minimal" and that it was surprising that the purchase price is so close to par. A swap spread of 55bp over equated to a cash price of around 105% on the morning the tender offer was announced

He suggested that this meant the tender offer was not aimed at generating core tier one capital, but said that a profit could also be achieved via the cancellation of swaps entered into upon issuance of the bonds.

"Their unwinding can create some profit to offset the 105 purchase price," he said.

A banker involved in the transaction said that the premium was in the high teens. A covered bond analyst saw the purchase price as offering a premium of around 20bp over secondary levels.

> "It is hardly attractive to tender Bawag covered bonds"

He said that the buy-back will generate only a small profit and that the motivation therefore seems to mainly be about balancing the issuer's maturity profile and using some of the recouped collateral for repo with the European Central Bank or for private placements beyond the ECB's three year long term repo operation (LTRO).

He said a high participation rate would be surprising given the collateral backing Bawag's covered bonds.

"We argue that given the strong demand for short dated covered bonds currently and the lack of new issuance in this maturity bracket, it is hardly attractive to tender Bawag covered bonds 2014 at 55bp over mid-swaps," he said, adding that the purchase price level is considerably wider than Austrian sovereign spreads. ■

"The factors examined here point to elevated valuations for Australian real estate" page 45

EUROS

French lead, but EZ issuers subdued

Six deals of 10 years or longer totalling Eu7.95bn helped France grab the largest share of supply in January, but elsewhere issuers from outside the euro-zone dominated when the market reopened after a quiet end to 2011.

According to Dexia research, French issuers accounted for 30% of euro benchmarks in January, but supply from other euro-zone issuers reached only 24%, with 11% from the Netherlands, 9% Finland and 4% Germany. Norway was the second most active jurisdiction, with a 16% share, while Australia took 14%, Switzerland 11%, and the UK 5%.

The historically low share from euro-zone issuers reflected lingering concerns about peripheral sovereigns, although by the start of February market sentiment had rallied sufficiently for Spanish supply to blossom (see separate article).

Caisse de Refinancement de l'Habitat opened French issuance on the first business day of the year, selling a Eu2bn 10 year at 160bp over mid-swaps, which incorporated a double-digit new issue premium typical of much of the year's early supply.

"For printing such an amount, it was useful to pay that spread," Henry Raymond, chairman and chief executive officer of CRH, told The Covered Bond Report. "We are probably supplying good performance for investors."

In common with the French long dated supply that followed, the deal enjoyed strong support from Germany, which with Austria took 53%.

ING and UBS joined CRH on the opening day, with the Dutch bank issuing a Eu1.75bn 10 year benchmark and the Swiss a Eu1.5bn five year.

Among four benchmarks the following day — the busiest so far this year — was a Eu2bn five year benchmark for DNB Boligkreditt. Terra BoligKreditt, SpareBank 1 Boligkreditt and Sparebanken Vest Boligkreditt followed to put Norway in second place in January supply.

Sparebanken Vest was able to take advantage of a market rally to sell its Eu500m five year at 66bp over mid-swaps on the last day of January, inside the 68bp re-offer spread paid at the beginning of the month by national champion DNB.

"This partly reflected the general mood in the market, with DNB having been one of the first and its deal having since tightened significantly in the secondary market," said Eeva Ketola, senior origination manager at Nordea Markets, which led the Sparebanken Vest and Terra deals. "It also reflected the positive reception enjoyed by Norwegian transactions among investors."

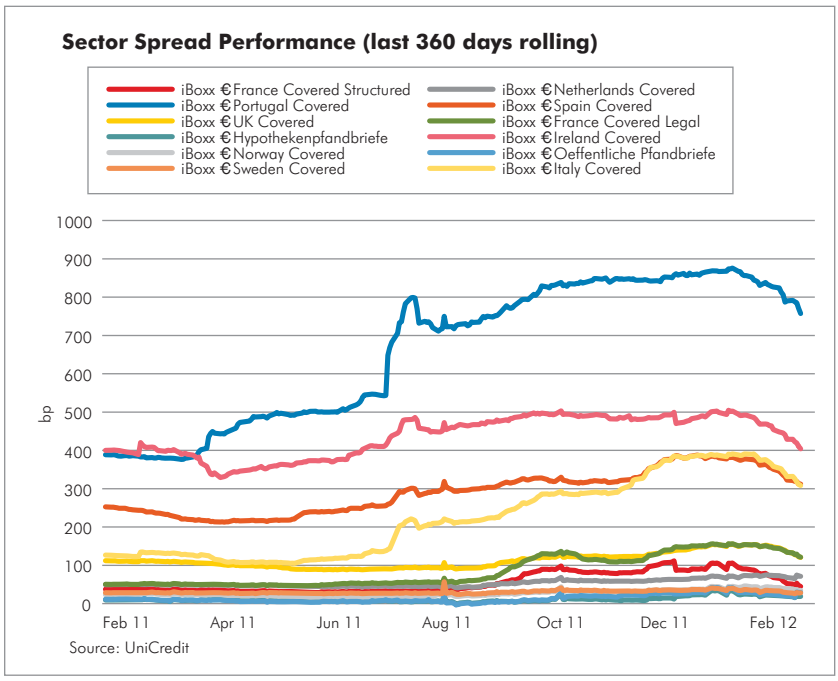
Total covered bond issuance in January, not just euros, was Eu38bn, according to Barclays Capital analysts. They said that although this was down from Eu51bn in 2011, it could nevertheless be considered a good start to the year.

"For such an amount, it was useful to pay that spread"

The euro's share of supply was 70%, down from 79%, they added, and among the non-euro supply was the first dollar benchmark covered bond issuance of 2012. Market participants were pleased to see UBS's $1.5bn (Eu1.16bn) three year issue executed successfully on 19 January. The deal was priced at 135bp over mid-swaps, equivalent to 168.5bp over Treasuries.

Syndicate officials were nevertheless unsure whether the deal would unlock further European covered bond supply in dollars, and indeed the only issuance to have followed by the time The Covered Bond Report went to press was from Canada. ■

Eeva Ketola: Norwegian transactions enjoyed a positive reception



UK

Record sterling capacity 'a massive benefit'

Sterling covered bond issuance exceeded in January supply for the whole of 2012, with an official at Abbey National Treasury Services paying testament to the market's growth after the UK Santander unit capped issuance in the currency with a £1.5bn (Eu1.8bn) dual tranche deal on 9 February.

Tom Ranger, head of secured funding at Santander UK, said that the development of the sterling covered bond market is "massively meaningful".

"Something that has been consistently pointed out to UK issuers since covered bonds were introduced here is that we don't have a domestic market," he told The Covered Bond Report. "The last 14 to 15 months have proved that to be inaccurate.

"We have a fantastic market, and a product that we can fit to meet demand. It's a massive benefit to UK issuers and sends an important message to other currency markets."

The bank's dual tranche covered bond was split into £750m tranches, a three year floating rate note priced at the tight end of guidance of 165bp-170bp and a 17 year fixed rate issue re-offered at 245bp over Gilts, the tight end of guidance of the 250bp over area. Orders exceeded £1bn for the FRN and stood at around £2.5bn for the 17 year tranche.

The deal came after the issuer in the middle of January sold the first UK residential mortgage backed securitisation of 2012, Holmes 2012-1, which included a yen denominated tranche alongside euro, dollar, and sterling tranches.

"February was our month to look at covered bonds after our results," said Ranger. "The timing worked well."

Ranger said that the pricing differential between the issuer's RMBS and covered bonds "is exactly where it should be", with the three year floating rate covered bond having been priced 10bp tighter than a three year sterling FRN tranche sold as part of Holmes 2012-1.

David Wallis: desire to develop sterling market contributed to FRN choice

The three year FRN tranche of the covered bond was the fifth deal in the format this year taking total floating rate supply to £3.15bn, and a syndicate official on Abbey's deal said it is evidence of strong demand for very short dated sterling issues. It followed deals for Barclays Bank, Nationwide Building Society and Coventry Building Society from the UK, as well as a £500m National Australia Bank issue that was the first Australian covered bond in the currency and only large deal for a non-UK issuer in sterling.

> "It sends an important message to other currency markets"

David Wallis, head of funding at Nationwide Building Society, which priced its £650m three year FRN at 165bp over Libor on 16 January, said the issuer had been looking at the floating rate market for a few months before launching its deal.

"As soon as we got to the point where we were confident the trade worked we moved to execute," he said.

He said that Nationwide had also looked at the long end in the fixed rate market, but that the pick-up over Gilts was very high.

"I didn't think we were comfortable with the absolute value either," he added. "That, along with a general desire to try and develop other parts of the sterling market, led us to think it made sense to go with a short end floater once we were confident the market was genuinely there."

RBS covered bond analysts in early February noted that the spread between covered bonds and respective Gilt benchmarks is much higher than in any other core European covered bond market. Covered bonds are on average 225bp-230bp wider than government bond spreads, they said. In addition, sterling covered bond spreads over swaps are larger than for euro denominated UK covered bonds.

The pick-up in sterling supply comes after the UK authorities late last year updated the UK covered bond framework (see separate article).

"The FSA is encouraging a big development of the covered bond market in sterling," said Lucette Yvernault, global multi-sector manager at Schroders Investment Management. "I think you've got the sponsorship of the regulator that has been very much involved, and has also developed more transparency in the market, which will also help the market developing." ■

League Table

EURO BENCHMARK COVERED BOND RANKING

1 January 2012 to 10 February 2012

Rank	Bookrunner	Deals	Amount Eu (m)	Share %
1	Barclays	12	3,837.50	10.30
2	UniCredit	14	3,576.67	9.60
3	Natixis	13	3,348.33	8.98
4	Deutsche	10	2,748.33	7.37
5	Credit Agricole	8	1,910.00	5.12
6	UBS	8	1,868.33	5.01
7	BNP Paribas	6	1,787.50	4.80
8	SG	6	1,726.67	4.63
9	Citi	4	1,437.50	3.86
10	RBS	5	1,425.00	3.82
11	JP Morgan	6	1,383.33	3.71
12	LBBW	6	1,233.33	3.31
13	HSBC	4	1,220.83	3.28
14	ING	4	1,020.83	2.74
15	Commerzbank	6	933.33	2.50
16	Danske	3	818.33	2.20
17	Nomura	3	756.67	2.03
18	Nordea	3	700.00	1.88
19	BAML	2	690.00	1.85
20	DZ	4	508.33	1.36
21	Santander	1	500.00	1.34
22	Credit Suisse	2	458.33	1.23
23	ABN Amro	2	458.33	1.23
24	Westpac	1	437.50	1.17
25	NordLB	2	420.83	1.13

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

This league table is 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.


Commonwealth Bank

CBA delivers on Aussie promise

After US dollar benchmarks from two of its peers got Australian covered bond issuance off to a disappointing start in November, Commonwealth Bank of Australia laid solid foundations in euros and then its home currency in January. The Covered Bond Report spoke with CBA group treasurer Lyn Cobley at the time of the inaugural trades.

When Australia's politicians and regulators finalised the country's new covered bond framework in October, issuance from the country looked set to be just the tonic that the market was looking for. Europe's deepening sovereign debt crisis was stymying supply from euro-zone countries, and Canadian and Norwegian issuers could only sustain the market for so long.

But when the first Australian supply emerged in the form of US dollar benchmarks for Australia & New Zealand Banking Group and Westpac Banking Corporation, a combination of questionable handling and poor market conditions conspired to produce underperforming and underwhelming deals. Expected follow-up supply from their peers then failed to emerge at the end of 2011.

Fortunately, the start to 2012 has been a happier new year for Australian covered bonds, with Commonwealth Bank of Australia at the centre of the more encouraging developments.

On the second business day of the year, the bank sold the first Australian euro benchmark, a Eu1.5bn (A$1.88bn) five year deal at 100bp over mid-swaps, in line with guidance, via leads BNP Paribas, HSBC and RBS. The final order book exceeded Eu1.7bn.

"Clearly market conditions have meant that any access to the markets at the moment is quite expensive, but we really wanted the inaugural Commonwealth Bank of Australia covered bond issue to be very successful," Lyn Cobley, group treasurer of Commonwealth Bank, told The Covered Bond Report. "My measures of success are that it was widely distributed, it's of a reasonable size, it has been well accepted by the market, the after-market trading is satisfactory, and we were oversubscribed.

"So from my point of view it was a very well received deal, and we are very pleased. We want to raise A$30bn-A$35bn under this programme and in any programme like this, in what is a new market for us, the euro covered bond market, it was important to ensure it was a success for investors as well as for us as issuer."

Euros versus dollars

The deal fulfilled a mandate that was publicly announced in October but not executed earlier given the poor market conditions. At the time of the ANZ and Westpac US benchmarks, the dollar market had offered more attractive funding, but Cobley said that the ultimate execution of the euro benchmark vindicated the issuer's strategy of opting to debut its covered bond programme in the more established marketplace.

"After the legislation was in place we decided we'd go to the European market given that it's a developed and big market," she said. "It was a little more pricey than the US market at the time, but we wanted — as I said — to get a very broadly distributed,

Lyn Cobley: "Clearly market conditions have meant that any access to the markets at the moment is quite expensive"

well received issue, and we felt the European market was going to offer that to us.

"But of course conditions deteriorated quite quickly at the end of last year and we felt, given what we were trying to achieve out of this inaugural issue, that it was better for us to wait for more constructive conditions, and I think we've been well served by waiting until this window that came up in the last couple of days."

Cobley also said that economics were no longer in favour of dollars at the time the euro benchmark was ultimately launched and questioned whether a US deal would even have been feasible.

"The advice I've received from the houses that I speak to is that the US covered bond market is effectively closed at the present time," she said. "There are a number of issues. The US covered bond market is quite a new market, it's not very deep, there are a few major investors that really can make or break a deal in that market, and unfortunately there were a few transactions that were done that didn't perform well and as a result of that, that market has effectively closed down.

"It's our hope that it will open again some time soon, but it has vindicated our decision to go to the European market because that's the one that's open now, and I suspect that any real difference that existed between those markets perhaps for a short period of time has largely gone now."

Cobley said the issuer was mindful of previous criticisms of a lack of co-ordination among Australian issuers.

"We do keep in touch with the other issuers and I think the fact that we elected at the end of last year to focus on the euro market after we'd seen two of our peers announce that they had wanted to do an issue in the US dollar market, we think is a sign of co-ordination," she said.

"I know there's a perception that the Australian issuers have been hitting markets at the same time. I think it's partly because of the timing of when the legislation came out, the fact that there was a compressed time period before the markets were going to close before the end of the year, and concerns about the markets as a whole. It was fairly natural that all the issuers wanted to get their preparations done prior to Christmas and that was what was achieved."

CBA had very early on in this preparatory process led the way among its peers by responding to investor feedback about its programme. While the Australian banks' covered bond structures are broadly similar, some elements of their documentation have varied: CBA was at one stage the only one to include ongoing indexation of the LTVs of mortgages in its cover pool — an example that was followed by its peers.

"We had seen a number of major investors in Europe and the US and asked them what they like and don't like, and we got a whole long list of what people wanted to see," said Cobley. "They had some concerns about Australian property prices and even though we are comfortable with them we were happy to address their concerns. With our background in securitisation we are also used to reporting our collateral pools and were therefore able to offer something that was regarded as top of the class.

"The response from investors to this was very, very strong and they were pleased that we had listened to what they'd said."

Home advantage?

Two weeks after opening the euro market to Australian covered bonds, CBA priced the first domestic issue in Australian dollars, a A$3.5bn (Eu2.85bn) five year dual tranche deal that was the biggest ever Australian bank bond. Cobley told The Covered Bond Report that as the largest Australian bank CBA is often the issuer that opens or reopens a market.

"It made logical sense to us given relative market availability

> "It has vindicated our decision to go to the European market"

and pricing that this was a good market to open up for covered bond issuance," she said. "Covered bonds are still very new to this market and a number of investors still need to get approval to buy covered bonds as a product."

Leads CBA, Citibank, HSBC and Westpac released an indicative price range of 180bp-190bp over BBSW the day before launch and opened books the next morning on the basis of revised guidance of 175bp-180bp, with the order books closed at around lunchtime in Sydney.

"It was a fantastic deal," said Cobley. "We attracted over A$4.4bn of demand and priced a final deal of A$3.5bn."

A fixed rate five year issue was sized at A$2bn and a floating rate note at A$1.5bn, with both tranches priced at 175bp over swaps.

"The level of demand was very strong, making it the largest ever bank bond issue done in Australia," said Cobley, "and we scaled it back so that we had a significant amount of unsatisfied demand to ensure ongoing liquidity for investors in the transaction.

"Similar to our euro deal," she added, "we wanted to ensure that the distribution of the first Aussie covered bond was as broad as possible, including institutional investors, so that we could tap this as an asset class in the future."

Some bankers away from the leads were surprised at CBA's pricing, which was wide of where the last senior unsecured deals for Australian banks had been priced. However, while a syndicate banker close to the deal said that secondary levels for a CBA Australian dollar denominated senior unsecured 2016 issue were in the range of 175bp/165bp over before the issuer's covered bond deal was announced, these levels were somewhat artificial given that traded volumes have been very low over the New Year. He said that a "sensible" new issue premium of around 25bp-35bp, in line with the tight end of ranges being paid in offshore markets for senior unsecured bank debt, would put a new major bank five year senior unsecured deal at around 200bp-plus, albeit for a modestly sized transaction.

The level could be expected to need to be set wider again to reach a A$3.5bn deal size, he added, and Cobley said that the domestic covered bond was a very efficient way of achieving a large amount of funding for the bank.

"It is a really valuable trade for us," she said. "In Australia you get the home advantage, making it somewhat cheaper than the offshore covered bond market and it's certainly much cheaper than any offshore unsecured funding that we could do."

New funding reality

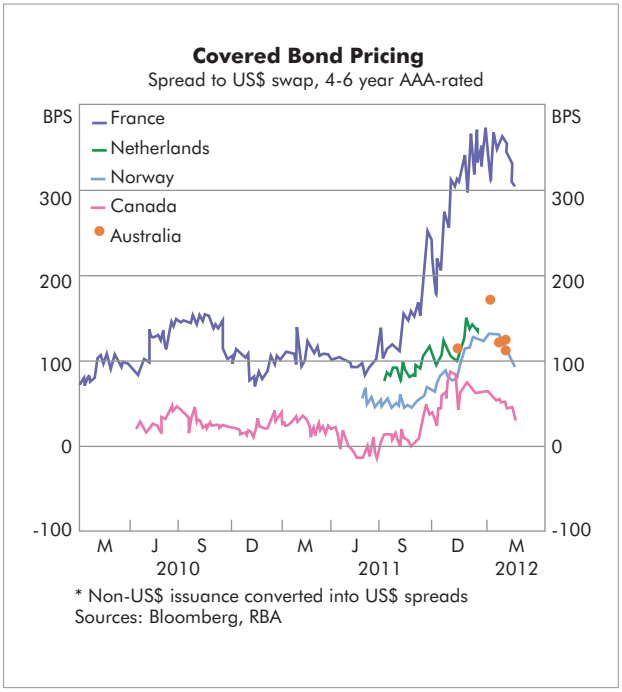
She said that the dislocation in funding markets across the world had also had an impact on the Australian domestic market, but that it is important to be pragmatic.

"I think it's fair to say that if we looked at domestic senior unsecured deals that were done six to 12 months ago, this pricing is somewhat wider," she said. "However, markets have clearly changed a lot in that time and unfortunately they have changed for the worse. At some point, you've got to accept that this is the new level.

"At the end of the day," she added, "when I look at all the potential issuance opportunities that are available to CBA across the world this domestic covered bond is still remarkably cost-efficient funding for us."

She said that once fully swapped costs are taken into account domestic covered bond funding is substantially cheaper than secured and unsecured offshore funding and "certainly cheaper than what we believe to be the realistic level for domestic unsecured funding".

Indeed this was borne out by subsequent senior unsecured supply, with Reserve Bank of Australia assistant governor (financial markets) Guy Debelle in February noting that while the spread to BBSW of domestic covered bond issuance had in January been in the region of 170bp over mid-swaps, the cost of senior unsecured had been 223bp.



"The global repricing of bank debt has clearly affected the Australian banks' wholesale funding costs," said Debelle.

Cobley also emphasised CBA's wish to achieve a broad investor distribution, and told The Covered Bond Report about the implications this had for pricing.

> "This domestic covered bond is still remarkably cost-efficient funding"

"As the markets were deteriorating going into the end of last year, we were finding that it was increasingly bank balance sheets who were buying rather than institutional investors," she said. "From our perspective, we want to see as broad a spread of institutional investors as possible, particularly in an inaugural deal such as this, and so it became clear to us that given the dislocation in the market in Europe there were investors in our own market asking to get some of the benefit of the extra amount that we have had to pay in the European market.

"As a brand new market there is also an uncertainty factor for which investors will end up charging a little bit more," she added.

Cobley said that CBA would continue gradually building up its profile in the covered bond market.

"The Australian legislation restricts the banks from issuing more than 8% of our Australian assets under a covered bond programme, so for us that means around A$30bn-A$35bn," she said. "We estimate that we'll be doing around A$5bn a year, and so it will take us a while to build up to that level of stock in the market." ■

Reporting by Neil Day and Susanna Rust

Mario gets the joke

The EU powers-that-be have been behind the curve throughout the crisis, but after its first 36 month LTRO in December, that claim can no longer be made of the ECB. It successfully unlocked bank funding markets, with the covered bond market experiencing a cascade of effects. *Neil Day* reports.

The 36 month longer term refinancing operations (LTROs) announced on 8 December were, in the words of Danske Bank analyst Søren Skov Hansen, an early Christmas present from the central bank to euro-zone banks. One with a value of Eu489bn.

"That the euro-zone banks are given virtually unlimited access — to the extent that they possess eligible collateral — to cheap funding has several positive implications," he said at the turn of the year. "First, it allows banks with funding market access issues to fund themselves — and at a very attractive rate, as the rate for the LTROs will be the average refi rate over the life of the operation, paid at the end of the period.

"Second, banks' access to liquidity may spur investors to return to the otherwise largely shut senior unsecured debt markets. As troubled banks suddenly gain access to funding at profitable levels, this may be the start of the return of investors to the bank debt markets."

And so it proved to be. While all the huffing and puffing of the euro-zone's politicians, personified by the Franco-German Merkozy chimera, was unable to prevent the painful freezing up of sovereign and bank funding markets in 2011, the European Central Bank's December move did the trick.

Reactions to political and central bank moves last year had clearly demonstrated that actions speak louder than words, when it comes to the euro-zone. A presentation by Jens Schmidt-Burgel, Fitch's managing director for Germany, in early February showed how unimpressed government bond markets were by declarations resulting from EU summits in 2010 and 2011, but responded to initiatives such as the ECB's Securities Markets Programme and the first Greek bailout *(see charts 1 and 2)*.

The full consequences of the three year LTROs that would emerge were nevertheless not fully appreciated when they were announced, with markets perhaps still focusing too much on not having received their preferred "Big Bazooka", namely an expansion of the Securities Markets Programme or similarly enlarged government bond purchases by a restructured European Financial Stability Facility. However, the "risk-on" mode of markets since the ECB's weapon of choice was first loaded up has shown the central bank to have perhaps better grasped the situation than anyone else, in that its actions balanced the needs of politicians and markets.

Taking a leap

While reducing the need for banks to raise funding in the wholesale markets, the ECB's actions at the same time made issuance easier, resulting in a complicated chain of events and knock-on effects that was still playing out well into February, with the second LTRO approaching at the end of the month.

One result was that an expected reopening of the covered bond market in January was accompanied by a resurgence of senior unsecured issuance that even after the December LTRO had seemed by no means assured.

Banks such as ABN Amro, Nordea and SEB accessed the senior unsecured market before the covered bond market, and the first benchmark bank bond for a peripheral issuer in three months came not in secured format but senior unsecured, when

Rafael Galuszkiewicz: "The reality is that LTRO funding is much more attractive in economic terms"

Intesa Sanpaolo sold a Eu1.5bn 18 month floating rate note on 31 January, a day before Santander launched the first Spanish benchmark covered bond for eight months.

The senior unsecured supply showed that in the market's post-LTRO risk-on mode some issuers and investors were ready to bypass the covered bond market, which had previously been seen a stepping stone into wholesale funding from market exile, thereby demonstrating how the market had come so far so fast.

"I would say that the strength of rally we have seen this week may point people down the senior unsecured route," said a syndicate official amid the senior unsecured issuance. "If this window remains open then a few issuers might want to go down the senior unsecured track.

"Internally, with each institution and its funding profile, it makes sense to take advantage of the senior unsecured market, and save covered bonds for a rainy day."

Danielle Boerendans, head of covered bonds at ABN Amro, told The Covered Bond Report that it had raised its Eu2.25bn of senior unsecured funding before launching a Eu1bn 10 year covered bond as it had wanted to get the more difficult transaction out of the way first.

Others have adopted a wait-and-see approach to the senior unsecured market while issuing covered bonds.

Erste Group Bank borrowed Eu3bn in the December LTRO, according to Renee Bauer, its head of group funding, and at the beginning of February sold a Eu1bn 10 year covered bond. She said the LTRO funding was also meant for Erste's savings group and its subsidiaries, meaning it still had to raise between Eu3bn-Eu3.5bn in wholesale funding, with the Eu1bn reducing its funding needs for the rest of the year. Although the issuer had in December said there was "no need" for senior unsecured benchmarks, Bauer said the issuer is still looking to the senior unsecured market.

"We can issue entirely on the back of our covered bond programme," she said. "We'll see depending on how retail runs.

"We like to issue longer tenors in covered bonds and shorter in senior unsecured," she added.

A win-win-win

Spanish supply has, meanwhile, been focused on the covered bond market, even if they have had to pay costs much higher than the 1% rate on the three year LTRO.

"We note several Spanish deals at the short end of the curve despite the availability of cheaper funding costs through the LTRO," said José Sarafana, head of covered bond strategy at Société Générale. "Spanish banks apparently wanted to demonstrate that they had market access and were ready to pay the market price."

CaixaBank approached the market in the wake of Santander's reopening to raise Eu1bn of five year funding. It did so despite having just Eu2.3bn of wholesale maturities in 2012 and, according to a spokesperson for CaixaBank, having made use of the December LTRO to the tune of Eu12.4bn.

"We used it to anticipate 2012 maturities, partially replace LCH repo funding and to provide additional liquidity cushion," he told The Covered Bond Report.

A CaixaBank funding official said that the five year maturity was chosen because it best fit with the issuer's maturity profile.

"We manage the concentration of maturities in different years, for example having planned in advance to try to avoid big redemptions in 2012," he said. "Obviously it's much easier to issue in three years, but it doesn't make sense for us to issue debt maturing before 2017-2018."

His reference to the ease of issuing in three years reflects how the LTROs have affected not only supply, but demand for covered bonds.

"The increased usage of the central bank operations has increased demand for short term ECB eligible collateral," says Frank Will, head of covered bond research at RBS. "This is reflected by the recent spread tightening at the short end of the curve."

Will also points out that non-euro-zone banks can "free-ride" on the increased liquidity for euro-zone banks by issuing short term covered bonds that could be used as collateral.

The impact of the ECB's action on demand is expected to continue through the second LTRO.

> "It makes sense to take advantage of the senior unsecured market"

"The ECB's next 36 month LTRO on February 29 will provide further support to the covered bond market as, in our view, the banking sector will continue to have a strong demand for assets to use in carry trades," says Morgan Stanley head of covered bond and SSA strategy Leef Dierks.

The LTROs have also sparked a series of covered bond buybacks, with mainly peripheral issuers tendering for outstanding issues *(see Monitor: Markets article for more)*.

Not just have-nots

The LTROs have not just changed the covered bond landscape in peripheral jurisdictions. New Pfandbrief supply from Germany comprised only two issues in January making up just Eu1bn, with Aareal Bank and Deutsche Pfandbriefbank raising Eu500m apiece. While net Pfandbrief issuance was anyway expected to be on a downward trend, LTROs have also played their part in reducing German supply.

Münchener Hypothekenbank, for example, at the end of 2011 had already made clear that it would not be issuing new Pfandbriefe up to four years given the availability of long term funding via the ECB, according to its head of treasury, Rafael Galuszkiewicz.

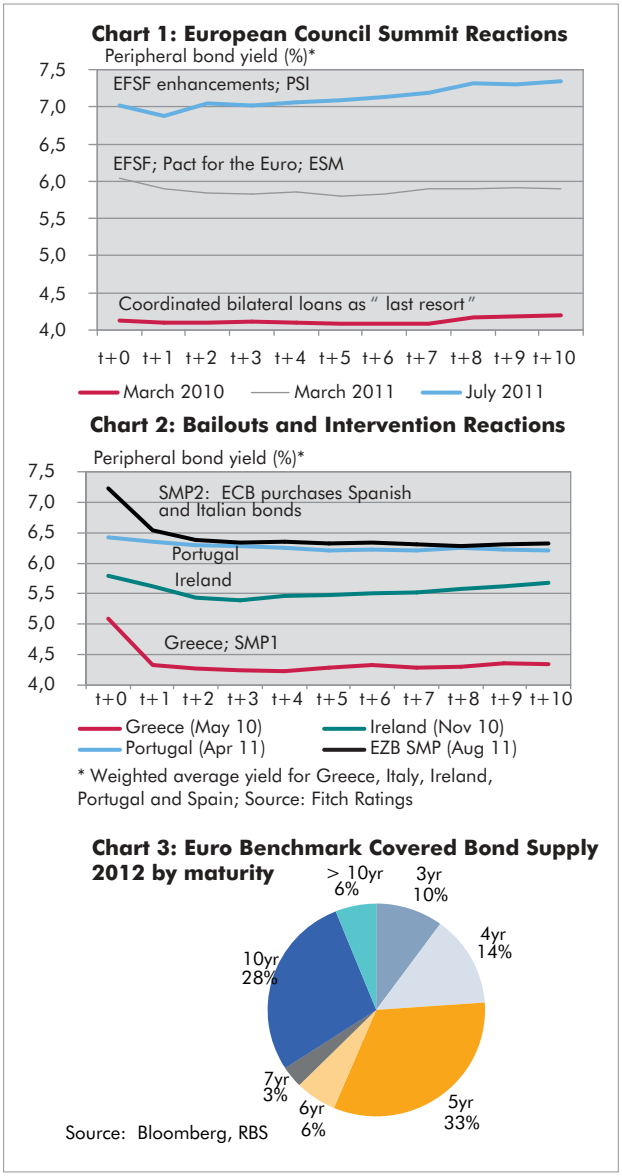
"Issuers like Münchener Hyp can access the capital markets without any problems, but the reality is that LTRO funding is much more attractive in economic terms," he says.

Benchmark supply from the issuer this year has been restricted to two Eu125m taps of a January 2016 Jumbo Pfandbrief. Galuszkiewicz says that these demonstrate Münchener Hyp's access to wholesale term funding, with increases the only way for investors to get hold of short dated benchmark supply from the issuer.

A lack of short dated supply was perhaps the most expected consequence of the LTROs on the covered bond market and apart from three year issuance from Spain only one new benchmark has emerged in the 2015 maturity, a Eu2bn deal for Compagnie de Financement Foncier, and even that was a long three year, maturing in August 2015. And the impact that the supply/demand imbalance could have on market dynamics became abundantly clear when CFF attracted some Eu7bn of orders.

"With LTROs, we don't have any short covereds anymore," said a syndicate official away from the leads, "so even given that it's a Friday and it's a bit punchy to try and push a deal through with the Greece situation, I thought it would go well."

The issuer was also able to price its transaction with no new issue concession.



Indiscriminate benefits

The indiscriminate nature of the ECB's LTROs — with good and bad banks alike finding it an offer too good to refuse — has meant that there has been no stigma attached to using it for funding. This has meant that whether or not banks have taken up the funding has had little impact on how investors have viewed their credits, but simply boosted overall risk appetite.

> "It is a huge consideration in terms of market dynamics"

"I wouldn't say we like participation in LTROs, or that it affects how we are going to invest in primary or secondary markets," says Lucette Yvernault, global multi-sector manager at Schroders Investment Management. "I would say that it is a huge consideration in terms of market dynamics."

Meanwhile Jens Schmidt-Bürgel, managing director at Fitch ratings in Germany, notes that the LTROs are only a temporary measure, and hence have no influence on how a bank is rated.

"We do recognise the strong reliance of some banks on the ECB," he says. "Banks who are in a strong position do not need to access the ECB for funding."

And some investors have argued that the ECB should be more discriminating in its support of banks. Georg Grodzki, head of credit research at Legal & General Investment Management, for example, says investors like to give money to those who do not need it.

"Banks don't really need wholesale market investors at the moment because they have a new lender of first resort called the ECB backing them, so that's comforting," he says. "But I would still wonder what is achieved if in addition to an oversized and overleveraged banking system, the balance sheet of the central bank will swell beyond healthy proportions.

"It will be a question of time before the market realises that and will ask questions about the sanity of such a development, where what is called the central bank is turning into a regional development agency and interbank clearing house in all but name, and becomes even more conflicted when setting interest rates and supply because there is so much pressure to basically keep bad banks and good banks alike going." ■

The Pfandbrief Roundtable 2012

German covered bond issuers have been shielded from the worst of the sovereign debt crisis, but nevertheless share the several challenges faced by the broader asset class. In this roundtable sponsored by the Association of German Pfandbrief Banks (vdp), leading market participants gathered in Frankfurt in mid-January to discuss how the industry is tackling issues such as transparency and liquidity, and how they see the Pfandbrief faring in the face of developments in collateral quality and regulation.

Neil Day, The Covered Bond Report: What are expectations for Pfandbrief issuance this year?

Jens Tolckmitt, vdp: The results of our annual survey of vdp members showed that they plan to issue around Eu74bn of Pfandbriefe. Most of this, about Eu43bn, will likely be mortgage Pfandbriefe, which is the continuation of a trend that we have seen for the last few years, with mortgage Pfandbriefe being the dominant part of overall Pfandbrief issuance. Eu29bn have been announced as public Pfandbriefe and Eu2bn as ship Pfandbriefe.

That Eu74bn is less than last year, when we expected Eu90bn. But due to the extremely difficult market conditions, we ended up with only Eu70bn in 2011. Based on that and the still adverse market situation in the government sector this higher estimate is quite a positive signal for the Pfandbrief market and it may even be higher if market conditions in general improve over the year.

Day: Aareal issued in the second week of January. Tammo, were you expecting to come to the market as early as that?

Tammo Diemer, Aareal: It's the first time Aareal has actually opened the Pfandbrief market. Our plans were to come pretty early in the year and it turned out to be the right decision to come with a quality product with a medium term maturity, as we had a very strong order book. We priced a Eu500m transaction and had Eu900m of honest orders, with a granular book of more than 80 different accounts. We had a strong demand from Germany and central banks.

We will have a pretty normal year regarding Pfandbrief issuance, meaning Eu1.5bn-Eu2bn of mortgage Pfandbriefe, and we will be visible with two or three Eu500m transactions, including the one we just issued.

Day: What can we expect from Helaba?

Martin Gipp, Helaba: We have been active in the public Pfandbrief market since 2010 with benchmark issues. Before that we more or less focused on the private placement market.

Our funding needs are usually in the area of Eu10bn-Eu13bn. Last year we issued about Eu12bn overall and the forecast for this year is around Eu13bn, and of that we expect to do about Eu7bn in Pfandbrief issuance. We will be active on both sides, mortgage Pfandbriefe as well as public sector Pfandbriefe. As we have pretty large cover pools and collateral available, this amount of issuance should be feasible.

In what form that will be done depends very much on market conditions. Markets have been very volatile. We are always a very price conscious house, so we are choosing the economically most sensible way for us.

But for a targeted amount of Eu7bn this year, it's fair to assume that we will be in the benchmark segment this year again at least once or twice, maybe even three times depending on market conditions.

Jörg Homey, DZ Bank: Forecasts are particularly difficult this year for several reasons. One is that banks are deleveraging, which is obviously impacting their refinancing needs. Then, secondly, universal banks in particular can refinance themselves via deposits. And ECB-supplied support via the three year refinancing tender is available if banks need liquidity and it is, let's say, not economically feasible to refinance via the markets due to high spreads. So for those reasons it's very difficult to predict a concrete number, so it could be anything between, if you are looking at benchmarks, Eu100bn-Eu200bn this year for covered bonds overall.

We have maturing Jumbo Pfandbriefe of roughly Eu42bn this year and I would expect, based on the numbers that have been cited, perhaps Eu20bn in jumbos to be a sensible estimate.

One more thing: you have mentioned mortgage, public and ship Pfandbrief — perhaps we will next see aircraft Pfandbriefe. I'm not sure if that will be a benchmark, but we will have a greater diversity of products.

Ralf Burmeister, DB Advisors: It's a little bit of a pain from the investor side when issuers are price sensitive. It is absolutely fair, but when it comes to maturity, we would love to buy longer dated paper, 10-15 years, but there is not too much issuance, especially in benchmarks: you can use private placements. The private placements are obviously targeted at a certain investor base — which is fine, it gives you a stable funding base and we love stable issuers, no doubt about that — but we tend to have some difficulties, especially at the long end of the curve, in finding good German quality.

So when you talk about Eu75bn or so, it sounds impressive, but breaking it down to new issuance in jumbos or benchmarks, it's considerably less.

Tolckmitt: It is. I would agree with Jörg's estimate that Jumbo issuance will be around Eu20bn — although that is not based on our survey. It really is a difficult number to predict. It depends a lot on the overall market conditions in the capital markets. If they are good, there will be a larger number of Jumbos. If it is difficult, it's maybe less.

If you look at last year, for example, by mid-year we had almost reached our estimate of Eu22bn and with conditions so difficult in the second half of 2011 we ended up with Eu25bn.

Day: What are expectations for the performance of Pfandbriefe?

Robin Buschmann, DB Advisors: We always look at risk-return profiles, for any bond, and in regard to Pfandbriefe, you definitely have a lower risk profile, but you also get a much lower return. The market currently focuses on the risk component

Participants:

Ralf Burmeister, senior portfolio manager, DB Advisors

Robin Buschmann, senior portfolio manager, DB Advisors

Tammo Diemer, head of treasury, Aareal Bank

Martin Gipp, head of funding, Helaba

Jörg Homey, head of covered bond research, DZ Bank

Jens Tolckmitt, chief executive, Association of German Pfandbrief Banks (vdp)

Neil Day, managing editor, The Covered Bond Report

Tolckmitt: "Higher estimate is quite a positive signal for the Pfandbrief market"

rather than the return component. From this perspective — and from our clients' perspective, too, as they are quite risk averse at the moment — Pfandbriefe are attractive investments. Compared with the overall covered bond market Pfandbriefe don't look appealing just looking at the return figures. If you consider both components, risk and return figure, they are definitely one investment that you have to have in your portfolio.

Burmeister: The other thing is tradability. Not necessarily liquidity, but we can be sure to get rid of a Pfandbrief in order to create liquidity for funds, at least at bid/offer levels which are OK and don't cause us too much pain. Obviously the further south you turn in the covered bond market, the more difficulty you may have in creating liquidity and in selling paper. Especially at the peak of the crisis. And that's another reason why you cannot be un-invested in Pfandbriefe in a normal, diversified covered bond mandate.

Day: What impact is CBPP2 having?

Diemer: The ECB covered bond programme is a very sensible tool to provide financial market stability. Pfandbriefe and covered bonds are key refinancing instruments for banks. The last covered bond purchase programme was very successful, also from the point of view of the central bank, and I predict that the second programme is going to be a similar success.

Burmeister: It's nice to have, but the question is whether the Pfandbrief in particular is in need of such additional support. Back in early 2009, right before the first programme, we had triple-digit spreads for Pfandbriefe, but even then banks could issue. It is not the case for some peripheral countries right now even if the ECB can take a part of their issue.

So, yes, it's nice to have and of course it is their mandate to ensure financial stability, but from a pure, let's say, micro perspective, they are crowding out us little covered bond investors, being a forced buyer with almost Eu3.5bn a month to spend. This is something, at least for the Pfandbrief part, which we do not really like to see, to be frank — although I understand the need for the ECB to go in and do a second round of covered bond buying for the reason of financial stability.

Gipp: It could also be seen as a catalyst for stabilisation. What we have seen is a great period of stress not only in the primary market, but also in the secondary market. I would agree with you to a certain extent that in the primary market the Pfandbrief in general is not in any great need of this support. In the secondary market, though, I think the ECB could actually play a very important role in bringing it back to life, because that has been very subdued lately. No investor, bank, whatever was able to really reinvigorate the secondary market.

But in the end, it all depends a little bit on the trust that the market needs to have in the covered bond asset class overall, not so much the Pfandbrief itself. And in that respect support from the ECB could be extremely helpful.

Tolckmitt: I would fully agree with this notion that it is a very important tool for the overall covered bond market. I would also agree with the fact that there are other countries and other covered bond jurisdictions that might need it more than the Pfandbrief, much more than the Pfandbrief.

But I think if you look at the aims that the ECB announced for the first purchase programme, they were not only to get the covered bond market going again, but to use the covered bond market as an initial market for getting the overall funding markets going again, and in the first round it worked quite well.

You can see certain limited spread reactions to the second covered bond purchase programme in the covered bond market, too. It has not spread, as far as I see it, to other markets, but I think there is one very important difference that makes it more difficult to make this programme as successful as the first one: it's a totally different macroeconomic environment.

Homey: I totally agree. The covered bond purchase programme most certainly helps support new issues over the finishing line. However, the problem is the sovereign debt crisis, and that also showed in the numbers from the first covered bond purchase programme: when the sovereign crisis kicked in with the downgrades of the sovereigns in southern parts of Europe, spreads went out again. I think it would be too much to ask for the ECB to solve the problems via a covered bond purchase programme. The problems are elsewhere.

Day: How has the sovereign debt crisis affected public sector Pfandbriefe?

Buschmann: The attitude of investors has definitely changed. Investors want to look through the investment vehicle and want to know if it is a mortgage or public sector covered bond and what exactly the distribution of countries held in the public sector cover pool looks like. The preference for mortgage covered bonds has increased throughout the last year. A mortgage covered bond is a diversifiying instrument in your portfolio, compared with a public sec-

tor covered bond where you have public exposure in the cover pool.

One point related to the purchase programme is that in 2009, when spreads had been elevated due to a general banking crisis, there was little differentiation between affected countries. Now we are in the middle of a sovereign crisis, which makes it difficult for the ECB to support one particular asset class, like covered bonds. When managers decide on allocations, the only important variable that they currently should look at is country allocation. Whether you have a covered bond or a sovereign bond is currently not so important due to the high correlations between the asset classes. Much more important is how much Spain, Portugal, Italy or Ireland you have in your portfolio. This is the decisive level of allocation right now — it's the country weighting.

Day: Have we seen issuers doing anything in response to investors' concerns?

Homey: From looking at Section 28 data on the vdp's webpage, it seems that issuers are removing Greece from cover pools. Obviously they are aware that investors are looking at the exposure to peripheral countries. But if you look at public sector Pfandbriefe, on average 80% of the assets are claims against German entities, so I think it's fair to say that most of the cover pools are genuine German risk, even if some have a larger amount of international exposure.

However, the rating agencies have reacted. First of all, the downgrades of sovereigns translate into higher credit risks which they consider in their modelling. Fitch, for example, downgraded some public sector Pfandbriefe because of that, and there are other examples outside Germany where the rating agencies have pointed out that the deteriorating credit quality of sovereigns has had an impact on the quality of cover pools.

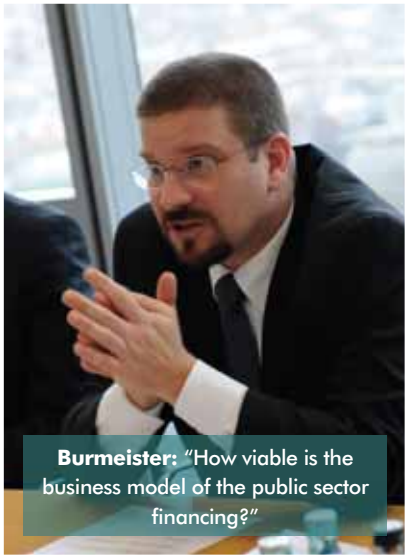
Tolckmitt: If you have an environment where sovereigns are downgraded one by one and some of them are included in cover pools, anything else would be a little bit astonishing. From some point onwards, it is certain to have an effect on the rating of Pfandbriefe or other covered bonds that are backed by such cover pools. In light of that, the Pfandbrief has held up reasonably well so far. This is, I believe, based on the fact that overall, as Jörg said, 80% on aggregate of the cover assets are German public sector exposure, which certainly helps.

Homey: Seven or so German Pfandbriefe have been downgraded recently and in the majority of cases this was due to the deterioration of the issuer rating — rating agencies keep on saying it's not about the quality of the cover pool. However, in a few cases — and that is also new — they point out that indeed the collateral quality or overcollateralisation level is not sufficient to maintain the target rating. So from that perspective the issuer rating, sovereign rating and covered bond rating are all intertwined.

Day: Does Helaba have many foreign assets in its public sector cover pool?

Gipp: No, we only have a small portion of foreign assets in our public sector cover pool and I'm grateful for that, because that subject has been an ongoing issue in our talks with investors in the last two years. We have only 7% non-German exposure, which is very small indeed, and that is something that we highlight whenever we go out to investors. That's also a key point when we talk later on about transparency: it is important that you really give investors a clear indication of where you are exposed to. We don't have any rebalancing needs because the cover pool is OK and definitely above average, but I can certainly understand any investor who is having a much more thorough look at the composition of cover pools than they have in the past.

Burmeister: Frankly, this raises a question resulting from the whole sovereign crisis: how viable is the business model of the public sector financing? If you have 80% German exposure and if you look at the spreads of Bunds, KfW and Bundesländer, it cannot be a viable business model to refinance that kind of debt through a public sector Pfandbrief, because that would be simply by playing the curve. So you need to have those higher yielding assets, which are basically foreign



Burmeister: "How viable is the business model of the public sector financing?"

assets. But on the other hand, if an issuer increases his Spanish or Italian debt — even at these levels, with a 6%-7% yield — from 2% to 4% of the overall cover pool, the issuer will get beaten up, and in the end would lose more in terms of its funding spread, because its whole curve might be affected, than it would gain on the particular investment in Spanish, Italian or whatsoever paper.

We have to ask critically how viable is that business model going forward. If you think about the large covered bond issuers that faced individual crises — Depfa and DexMA come immediately to mind — they had large public sector exposures.

Tolckmitt: That's without doubt going to be one of the big issues moving beyond the crisis. And it has been a development that has not only started in the crisis — it started in 2000. If you look at issuance or outstandings of public sector Pfandbriefe since 2000, they have been consolidating and they continue to consolidate. One of the reasons that they continue to do so now is the crisis, but it is also upcoming regulation.

We have seen difficulties well before the crisis in a certain area of public sector business, which can be called capital market based public sector business where you basically buy bonds in the capital markets and then refinance them via Pfandbriefe. As a consequence, we have for several years now been returning to smaller scale genuine public sector lending business. That is the original

idea behind the public sector Pfandbrief: to bundle the funding needs of smaller sized public entities and give them indirect capital market access through issuing Pfandbriefe and bundling them in the cover pool. We are gradually returning towards this business model, which means smaller sizes, which means we will not see the big Jumbo issues anymore that we saw before the crisis. But it's a healthy development and that is important.

I just wanted to add one important point regarding the composition of cover pools, especially public sector cover pools: it's not so long ago that rating agencies asked banks that had an 80% or 85% share of Germany in their cover pool to diversify internationally. I am happy that they have reconsidered this position, but the international exposure was a development that was to a certain extent driven by the same rating agencies that are now criticising the share of foreign assets in the same cover pools.

Day: What is the composition of Helaba's pool?

Gipp: It is granular, and very much regionally focused in Hessen and Thuringia — our home turf. And yes, a couple of years ago the rating agencies were pointing their fingers at this domestic exposure and arguing that we have a high level of concentration risk there. Now this "concentration" is proving extremely valuable.

Overall, what Jens said is very important. The business model is what is driving the strength of the product you can actually sell. We are not only selling covered bonds; we are more and more selling the entire credit story, the business model of the bank, either through a Pfandbrief or a senior unsecured issue or whatever that might be. But ultimately the investor has to look at the entire composition of your balance sheet. When you have a funding composition like us, where the Pfandbrief makes up less than 25% of our overall medium and long term funding, it provides a good indication that we have to do other profitable business in order to be able to do 75% of our funding elsewhere, and this composition and business model has to be made clear to investors. The cover pool in itself gives you a lot of indications, but it's not the full picture.

Gipp: "We are more and more selling the entire credit story"

Day: Are you supportive of the CBIC transparency standards initiative?

Burmeister: Yes, sure. A colleague of ours has been working on that, too.

The good thing about this initiative is that for the first time you have something on a European level that can make things more comparable. You have lots of different data sources — and obviously your company is offering a service as well — you have the ECBC Factbook, etc. But the real problem kicks in if you try to compare, say, a Spanish pool with a German one. Notwithstanding the time limits and frequency of data you get, sometimes you have different definitions of what is commercial, what is residential mortgages, and so forth and so on.

That's basically the reason why we absolutely like this initiative, because you have questions regarding the issuer and the bank, and about the cover pool.

I could foresee issuers having to pay up in terms of spread if they don't follow such industry standards. This is really something at the heart of what we do, which we as investors can really look at and say: OK, are they delivering? What do they deliver? With what frequency? And do we like what we see in the data we are getting?

Diemer: The German Pfandbrief legislation is leading from a European perspective when it comes to transparency. And at Aareal, we welcome further improvements. However, it is important that it is unambiguously stated how issuers should put together this data so that it is meaningful and so that investors have a clear interpretation of it.

Buschmann: The problem is rather with other jurisdictions that do not have the quality and quantity of data that is provided under the German Pfandbrief legislation.

If an investor doesn't have access to essential information, he tends to assume the worst case scenario because he thinks the issuer might hide something. This is actually the worst outcome for issuers. Hence, the transparency initiative is not only a good thing for investors but also for issuers.

Diemer: Yes, and what Martin said is that transparency is not only limited to the cover pool, but to the whole balance sheet. Aareal's mortgage pool is highly diversified from a geographic point of view: we have 20 different countries within our pool. This reflects our business model: we have been doing international commercial real estate lending for the last 20 years, and every investor is well aware that investing in Aareal paper also means engaging with this international commercial real estate lending portfolio. And therefore transparency plays an important role for our investors.

Burmeister: Just to clarify: it's a European topic and obviously Germany's Section 28 has always been good and up to date. We have some other issuers, more in the Nordic region, which also have decent transparency, and also some UK issuers, just to mention a few. But in most cases it's not a common standard and it's not enforced by law. This is why we absolutely welcome this initiative.

Tolckmitt: Providing transparency creates a win-win situation. We as Pfandbrief issuers have been committed to transparency since 2005 when we first enacted Section 28 of our law. Our aim was to make investors less reliant on rating agencies, and if you want to do that, you have to provide transparency. Going back to the figures we discussed previously: only if investors know that on average 80% of public sector cover pools are

German public sector exposure, and only if they can look at how German issuers have reduced their PIIGS exposure over time, only then will they feel comfortable with the product, and therefore may not blindly follow rating agencies' advice. That is very important and that is why we also appreciate greatly the initiative taken by the CBIC on a European level.

What is very important, though — and I think the CBIC would also acknowledge this — is that you have to differentiate with regard to the level and detail of transparency between different investor bases. Highly sophisticated international investors who are not necessarily as familiar with the Pfandbrief as a traditional German investor would ask for more cover pool data than a typical Pfandbrief investor. We review our transparency requirements regularly and our principle in approaching this is to ask every investor that we meet — and we meet a lot of investors — what they would like to add to our Section 28, and then out of all the answers we distil what a majority of the investors say and we try to put that in our legal framework. It is especially small and mid-sized investors for whom Section 28 is made, because they have to rely on a legal framework. And it is very often those investors from which you get the answer that they don't necessarily need or want more information, but perhaps more consistent or comparable information, or more timely information. And so you really have a broad range of investors with different needs, and you have to answer all their needs, not only those of investors seeking loan by loan information on the cover pool. The CBIC is representing big international investors, and they clearly have the tools necessary to analyse this and they want to know it, but it is not necessarily the case for each and every investor.

Burmeister: That is a strength of the covered bond market: you have these highly sophisticated international investors and then a second and third tier of investors. But there is a kind of free riding taking place on the investor side with smaller investors saying that if the larger players are subscribing to new issues and are fine with the name, then they can take Eu1m, Eu2m, Eu5m or whatever, too. They don't want to spend on the research capacity necessary to look at all the pool data.

Buschmann: "The transparency initiative is not only a good thing for investors but also for issuers"

Then if you look at the UK, it's the central bank demanding loan by loan data for eligibility. I'm not predicting that we will ultimately get that requirement for the whole covered bond market — indeed it's a bit of a distraction because it is moving away from the credit and the issuer itself — but it shows at least the direction we are going in and even the CBIC initiative is probably not the end of the road.

Homey: Transparency is one thing; the other thing is supervision, and the strict German supervision through BaFin and through the cover pool monitor. This adds comfort, at least from my perspective.

But if you are looking at possible improvements, investors are very interested in LTV distribution data, and also the seasoning of the loans. It should be very straightforward to provide this information, and also the maturity of assets — both the average by the time to maturity and the time to reset — and this also by interest rate type — fixed or floating rate. If you could shed a little bit more light on that, I would be delighted.

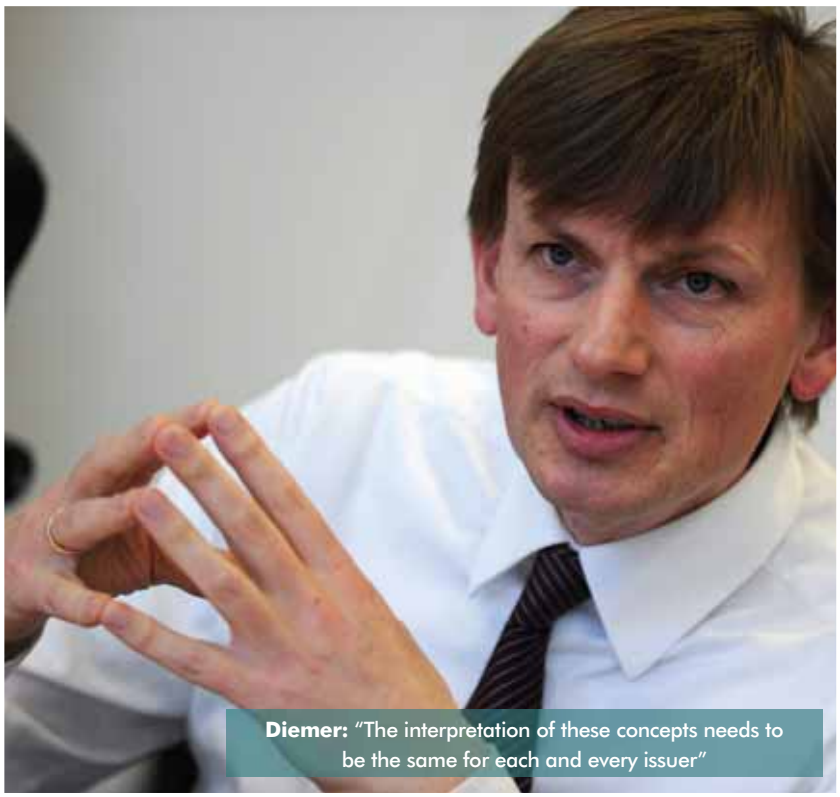
Diemer: The interpretation of these concepts needs to be the same for each and every issuer and there needs to be some sort of quality management by the vdp for German banks and the ECBC for European issuers to ensure that the data is collected in a similar way. With regard to LTVs, as a property lender I can give you five different LTV definitions right now.

Tolckmitt: We are already working on the next amendment of our law, which we hope will pass in 2013, and the majority of the issues that you just mentioned are on our agenda for inclusion in Section 28. Again, it shows that increasing transparency on a step by step basis and in discussions with investors — without a big bang as suggested by the UK government or the CBIC — is quite a promising way to do it.

Buschmann: We definitely need this transparency, not only in the covered bond market, in the Pfandbrief market; we need it in the whole banking industry. Just looking back at what happened in the past, you realise that for years there have been risks that were not adequately priced in the market because of a lack of information and a lack of transparency. What investors are doing right now is asking for more information in order to be able to build up confidence again, to regain the trust that they have lost during the crisis. If one wants to re-establish functioning markets, one needs to regain this trust. Therefore we need this transparency.

Day: The ECBC's labelling initiative — will it enter into investors' decision-making?

Burmeister: No, because we will always make up our own mind what is a covered bond and what is a covered bond we would



Diemer: "The interpretation of these concepts needs to be the same for each and every issuer"

like to be invested in. As far as I understand the label, it's a UCITS definition of a covered bond plus a certain transparency requirement. It's nice to have and if you follow that route, it might be nice to introduce it, but that is not freeing us as investors from the duty of really doing our credit work.

I don't know if they have tried to establish a link to the ECB or something like that — there were ideas to do so. It does make a difference if you say a covered bond is UCITS compliant or not, it has implications for our portfolios, whether it is CRD compliant or not. But the ECBC is not an official body.

Homey: I very much agree. Perhaps it is an attempt to establish a new brand like Pfandbrief. Everyone knows what quality a Pfandbrief is, and now they are perhaps trying to establish a new quality standard on a European basis.

Tolckmitt: In general, we welcome the idea of such a label, in such an environment. First of all, post-crisis, a number of jurisdictions are considering setting up covered bond laws that might not be the same as the classic European ones, the US in particular. And secondly, issuers of all kinds are interested in transferring the idea of covered funding to other asset classes. In such an environment a label that can ring-fence the traditional high quality asset class can be of value.

For this to be achieved, it is key that such a label has teeth. Whenever you define criteria, there has to be a certain likelihood that there will be covered bonds that will not fulfil the criteria, otherwise a label is not really of much added value. That is the challenge in the European context, finding a definition that actually fulfils this requirement.

> "And now they are perhaps trying to establish a new quality standard on a European basis."

This is important both for investors and also from a regulatory perspective. Only if you can make a convincing point to regulators that what you are defining is really a high quality asset class will you receive regulatory relief or preferential treatment. And only if you have this kind of preferential treatment will the label be widely accepted by issuers because investors are paying attention to it, and as a consequence the attractiveness of the product to a certain extent rests on regulatory implications.

In all the evolving regulatory frameworks — Basel, Solvency, bail-in, UCITS — we have a preferential treatment for covered bonds. And there are not many preferential treatments in these regulatory initiatives at all. It is clear to me that this will bring covered bonds under the scrutiny of regulators over time, asking whether they still deserve preferential treatment, especially as in the next years the covered bond universe will very likely have widened further still. Therefore it is one of the core interests of the industry, especially of the traditional covered bond industry, to work on such a differentiation, and to work on differentiation that bites.

Day: Rumour has it that German structured covered bonds are on the horizon. Would Helaba or Aareal consider structured covered bonds to be of interest?

Diemer: We offer established capital markets products. These are Pfandbriefe, senior notes, deposits and our share. There is no intention to offer anything like a structured covered bond. In our discussions with investors, it's extremely important for them that an issuer can demonstrate that it can rely on a diversified refinancing base. The role played by deposits or the role played by our footprint in the Schuldschein market is an important aspect for our investors. The current diversification we have on the liability side is sufficient for our capital markets access.

Gipp: For Helaba this product is not of any interest at all.

I think it is actually very much a function of what you want to substitute through any structured covered bond funding. I personally see it as a substitute for senior unsecured funding, also from a pricing point of view, and not for covered bond funding. So it could potentially be a valuable instrument for those banks that do not have access to the senior unsecured market, who have a very specialised business model or who do not have alternative funding possibilities. But due in particular to the three year ECB tender that was announced in December and that will be

carried out again in February, this need for alternative senior unsecured funding at attractive costs has more or less vanished, so I don't think this instrument will find very much interest.

Another point which I see as extremely crucial with regard to the use of structured covered bonds is the tranching of balance sheets, which puts the senior unsecured investor in a more and more subordinated position, and that is something that banks should be generally very, very careful with. Ultimately that could have negative effects on the rating, and would then affect your entire product offering right up to covered bonds.

Tolckmitt: If you look at the current difficult funding situation, especially in the unsecured sector, there is a certain logic in looking for other funding instruments perhaps based on the idea of covered funding, particularly given their preferential treatment. But it would be wrong to assume that any of this preferential treatment would extend to structured covered bonds. None of it will.

Furthermore, to answer a question raised in many discussions recently, covered bonds will in my view certainly not be the new unsecured. That to me is quite clear.

From an issuer's point of view, you will always look at the cost of your overall funding mix, and I am pretty convinced that a heavy use of structured covered bonds will have negative effects on unsecured funding and that, as a consequence, the overall funding costs will not necessarily be lower than without them.

Day: The vdp in January started publishing average spread data on Jumbos. How might this make a difference to the secondary market?

Burmeister: I don't want to discourage the vdp from continuing in that respect — and besides transparency to work on other things to increase the tradability of the product — but frankly speaking when it comes down to investing it's fair to say that issue size, geographic area, and underlying assets are important — you can see this reflected in where and how wide bid/offer spreads are — but in the current market environment the vdp initiative will probably not have far reaching effects. It may be a good thing going forward when we are in calmer waters, but right now it doesn't help us too much.

It comes down to the banks deleveraging and reducing the size of their trading books, whether they are willing and able to take positions.

> "Covered bonds will in my view certainly not be the new unsecured. That to me is quite clear."

Tolckmitt: It was never expected that market liquidity would increase dramatically the day we launched the initiative.

We have been looking at how to increase transparency because from an investor's point of view — and maybe not the sophisticated investors, but the overall investor base — price transparency was one of the main areas where investors were critical of the Pfandbrief market during the crisis. They said that one of the differentiating aspects of the Pfandbrief market relative to other covered bond markets was that they could always get in and out of positions in this market, even in the worst of times, but they were not satisfied with price transparency at times. And given that we know that the classic fixed bid/offer spread market-making will not return, we thought about ways of increasing this transparency and that is where this initiative should help, by giving investors an indication of where the market is.

Day: Tammo, your benchmark was Eu500m and so was the previous one. What is your view on the difference in terms of how that affects the price you get, what investors you get, and what that might reflect in terms of liquidity?

Diemer: In the last few years it has been the issuer's responsibility in particular to provide a certain backstop liquidity to the investor base and also to its market partners, the lead managers. As you mentioned, we consistently issue Eu500m transactions, and you are right, there are some large investors that cannot buy our quality product due to the fact that we just offer Eu500m transactions. We work with those investors that are ready to invest in Eu500m transactions.

Buschmann: Fact is that investors are liquidity takers and they cannot do much about improving liquidity. It's more up to the market-makers to develop more sophisticated risk management tools and free up risk budgets again for their trading books, then to apply these changes and show a commitment to the covered bond product. Then liquidity would be able to come back. Maybe not to the levels we have seen years ago, but it might come back to levels that are reasonable for investors willing to trade.

Burmeister: It perhaps also comes back to the issuers choosing syndicate banks that are providers of secondary market liquidity.

Gipp: It is not only a matter of investors asking for liquidity and of issuers providing backstop liquidity. Indeed you have to be comfortable with the syndicate you are choosing, and also you have to be very comfortable with the placement of your bonds. A strong trend that we have seen in the past couple of years is placement with more or less buy and hold investors. Not buy and hold forever, but for a longer period of time than previously, so for those investors the need for quick in-and-out trading is not as crucial as it was a couple of years ago.

The discussion about issue size is very much a matter for investors and their general investment principles. Currently the world is divided into more or less two factions, with a portion of investors being able to buy Eu500m issues and others still needing Eu1bn issues as a minimum to invest. From an asset-liability management point of view it would be desirable to have more rather than less investors who can buy smaller sized issues. That would make ALM management for banks easier. iBoxx has shown a little bit the way by now adding Eu500m issues into their benchmark, and if more and more investors follow these indices, maybe that will help to pave the way for smaller issues to be treated as being as liquid as Eu1bn issues. ■

Freeing encumbrance thinking

Covered bonds are being swept up in discussions about asset encumbrance, but they are not the only secured borrowing banks are turning to. Thankfully, after an initial knee-jerk reaction, practitioners are increasingly realising the need for a more sophisticated and holistic approach. *Susanna Rust* reports.

Fuelled by the confluence of regulatory developments set in motion in response to the 2008 financial crisis and difficulties in other funding markets, covered bonds have risen dramatically in importance. While their usefulness has been welcomed, a surge in issuance at the beginning of 2011 saw nervous regulators, legislators and other observers — who pre-crisis had failed to spot ultimately disastrous imbalances in the financial system — asking whether the development was wholly positive.

Apart from misguided comparisons with the securitisations that proved the trigger for the 2007 phase of the financial crisis, those concerns centred on asset encumbrance.

A year on, and with investors and other counterparties remaining wary of unsecured debt, financial institutions have increasingly had to pledge assets as collateral to be able to borrow money — but the development has extended well beyond covered bonds.

The International Capital Market Association (ICMA) in its first quarterly report of 2012 referred to a shortage of collateral in the financial system as a pressing issue.

"Our members are increasingly concerned at the growing scarcity of collateral, at a time when the demand for it is rising as a result of regulatory change, one-way collateral arrangements and the heightened mistrust of bank senior unsecured funding," it said. "We expect to devote more time considering these collateral issues over the next 12 months."

And regulators also have asset encumbrance on their minds and agendas, some more publicly than others.

Australian regulatory and central bank officials, for example, warned of an overreliance on secured funding at an Australian Securitisation Forum conference in Sydney in November. 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 securitisations, covered bonds (which were only green-lighted in the country in October), 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).

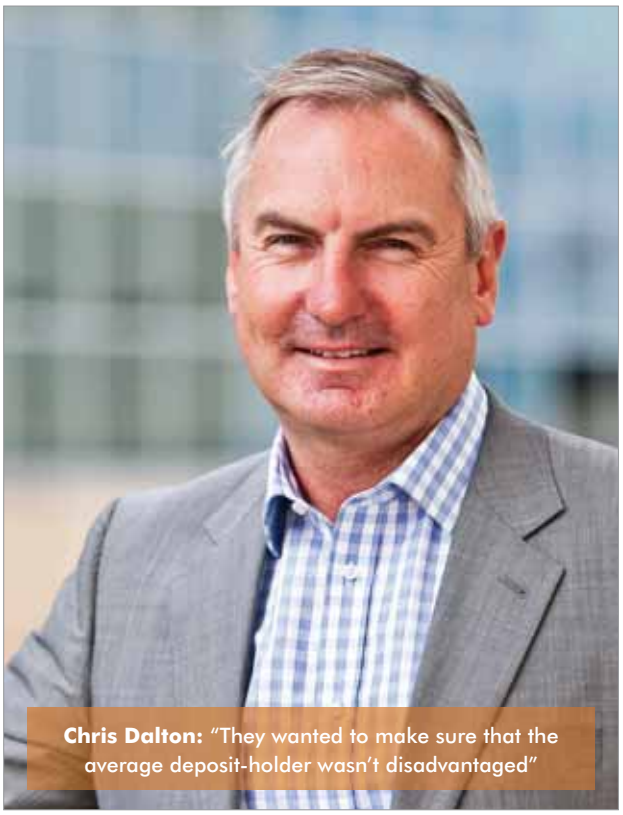
"Although each of these initiatives individually may give an ADI cheaper funding or better trading terms," he said, "a whole industry with lots of collateral pledged is most unlikely to make the remaining depositors and unsecured creditors safer.

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

The UK authorities are tackling the issue, with the Financial Services Authority (FSA) having completed a survey of major UK banks' levels of asset encumbrance, and the Bank of England in its December Financial Stability Report referring to "an increasing, and greater than planned" proportion of wholesale term debt having to be raised on a secured basis (see chart). The central bank said that higher levels of, or greater uncertainty about, encumbrance can increase the probability of a credit run, making the institution more vulnerable to liquidity risk and triggering "adverse funding feedback loops".

Speaking on the occasion of the release of the report, Andy Haldane, executive director, financial stability at the Bank of England, said that the central bank and the FSA were led to look closely at the degree of asset encumbrance at banks because some banks believe that funding will remain skewed towards the secured form in 2012.

"What the Report says is that we want to get underneath how much of the balance sheet is secured now, how much prospectively might be encumbered tomorrow, with a view to shedding a little light on that," said Haldane. "And that might in turn help reduce uncertainty and cheapen the cost of unsecured funding looking forward."



Chris Dalton: "They wanted to make sure that the average deposit-holder wasn't disadvantaged"

Other calls for a closer look at asset encumbrance include comments made to that effect by officials at the International Monetary Fund (IMF) and the Bermuda Monetary Authority in a contribution to the 2011 European Covered Bond Council (ECBC) Factbook, the first edition to feature a chapter dedicated to the subject. They wrote about the potential impact of covered bond funding on issuer balance sheets and on the efficacy of bank failure resolution frameworks and deposit guarantee schemes, arguing for an assessment of "the salience in covered bonds' rise to post-crisis prominence" to consider asset encumbrance.

Also focussing on the role of covered bonds in asset encumbrance, Bank of America Merrill Lynch analysts in September said that the increasing reliance on secured funding by banks and the related explosive growth of covered bond issuance have brought attention to the problems with asset encumbrance, "many of which are yet to be fully appreciated and adequately addressed by investors and regulators alike".

UK the first mover

While recognition of the asset encumbering effect of covered bonds is not new, the degree to which — and with what level of visibility — financial authorities have sought to deal with it — if at all — has varied.

The UK's Financial Services Authority was perhaps the first to move to directly address asset encumbrance in the context of covered bonds, when it in 2004 introduced a temporary 4% limit on covered bond issuance relative to total assets, before moving to a position where it considered 20% to be the "level of issuance above which we would be likely to consider issuance as being sufficiently material to require an increase in most banks' ICR [Individual Capital Ratio]."

These quantitative thresholds were subsequently dropped, with the FSA in October 2008 informing market participants that it would be adopting a case-by-case approach and expects issuers to set out in advance their plans for covered bond issuance "or any other significant new asset encumbrance".

It prefaced this announcement by stating that while covered bonds can pose significant risks to the claims of unsecured creditors when they are a material source of funding, other secured funding methods such as securitisation, securities financing transactions and repo financing can also present such risks.

Tim Skeet, ICMA board member and managing director, financial institutions group at Royal Bank of Scotland, says that the changes in the FSA's approach reflected a shift in understanding of the nature of asset encumbrance and how it should be handled.

"It is a very complicated topic because it cuts across so many disciplines and product lines that it is sometimes difficult to get a handle on the total picture, with even the definition of encumbrance a difficult, politically charged question," he says. "What we do know is that the FSA got the ball rolling when they brought in covered bonds in the UK and they set those limits on the amount that covered bonds could be issued in order to provide some form of protection to the unsecured creditors.

"Now I think there has been a dawning realisation that setting those limits on a relatively transparent and well understood asset class such as covered bonds is not necessarily the best way to proceed. You need actually to take a complete view of all forms of encumbrance and not hobble one which by its very nature is helpful to the long term liquidity and therefore health of a bank, but one which obviously creates additional encumbrance."

Cautious first steps

Limits are still a feature in covered bond jurisdictions, however, with newer ones in particular making clear that asset encumbrance is on their radar and setting caps on issuance based on the volume of encumbered assets in relation to an issuer's balance sheet.

The newest covered bond issuing jurisdiction, Australia, in October 2011 passed legislation that set a cap of 8% on the amount of assets that an ADI can encumber as covered bond collateral. Chris Dalton, chief executive of the Australian Securitisation Forum,

> "We expect to devote more time considering these collateral issues"

says that the question of asset encumbrance was a key consideration in discussions about the shape of the legislative framework.

"From the get-go it was always fairly obvious that both the government and certainly APRA were clear that a key part of the framework in Australia would be the cap on the overall amount of assets that could be encumbered for issuing covered bonds," he says.

Factors influencing the 8% cap included the criteria governing the cover pool eligibility of assets and the government's decision to make permanent a Financial Claims Scheme for depositors, he adds.

"Effectively this was part of moving from a unique position where the primary principle of prudential regulation in Australia up until 2011 was the protection of deposit-holders to allowing covered bonds," he says, "which the government and regulator were conscious would create a new class of creditors with a higher ranking claim on a bank's assets than unsecured creditors, including depositors.

"So in the mix of what was introduced there was a recognition by government and the regulator that they wanted to make sure that the average deposit-holder in Australian banks wasn't disadvantaged by the introduction of covered bonds."

In New Zealand the authorities also opted for a limit, 10%, based on the amount of assets allowed to be encumbered by covered bond issuance as a proportion of total assets.

"The Reserve Bank does not consider that a limit based on the face value of the bond would be appropriate as it does not address the primary prudential concern arising from the issuance of covered bonds, namely the encumbrance of assets," it said in December. "The Reserve Bank recognises that this approach places the onus on institutions to set issuance levels that include sufficient headroom to reflect the level of risk of downgrade that is inherent in their operations."

The Reserve Bank had earlier set a 5% limit, close to the UK FSA's original 4% limit. The Federal Deposit Insurance Corporation (FDIC) in the US and Canada's Office of the Superintendent of Financial Institutions (OSFI) have also previously laid out limits that, despite differing in details, had a 4% number at their heart.

Several covered bond experts have questioned just how these limits have been arrived at, given that there has been little supporting evidence for the common 4% number. Some point out that the FSA's original limit was based on the level that the now defunct Bradford & Bingley was approaching in 2004 and that the 4% limit was targeted primarily at slowing issuance from the one bank. He says that the wider adoption of a 4% limit therefore appears to be arbitrary, absurd or both.

Alternative, OC approaches

According to one covered bond expert, overcollateralisation lies at the core of the legal conflict between covered bonds and unsecured creditors. It could therefore make sense that legislators look to this in setting limits on covered bond issuance and indeed one jurisdiction is considering doing so.

As part of a consultation on covered bond legislation, the Canadian government has proposed a cap on the level of overcollateralisation (at 10%) as a means of balancing the rights of covered bondholders with those of other creditors and depositors.

However, the idea has met with resistance from many market participants. Hélène Heberlein, managing director and head of Fitch's covered bonds group, for example, acknowledged that such a limit could protect depositors and senior unsecured debtholders against excessive subordination and remove any uncertainty surrounding senior unsecured claims against OC, but said that such a cap may preclude high ratings on some covered bonds if the overcollateralisation supporting a given rate exceeds 10%.

Christoph Anhamm: "All these levels have increased quite substantially, but the most visible component is the covered bond market"

A protracted negotiation of the asset encumbrance risk posed by covered bonds that has also focused on overcollateralisation has been taking place in the US, where the FDIC and proponents of covered bonds have been at loggerheads over the treatment of covered bonds in the event of an issuer's insolvency. The FDIC is keen to cling on to its right, under an existing best practice framework, to repudiate a covered bond and claim the collateral, which many covered bond proponents see as a non-starter for investors.

Speaking at the American Securitization Forum 2012 conference in Las Vegas at the end of January, Chris Russell, senior policy advisor to Congressman Scott Garrett — the politician leading the charge for covered bond legislation in the US — told delegates that the FDIC takes a "myopic view" on its role of protecting the Deposit Insurance Fund (DIF). Its concerns are somewhat overstated, but lawmakers are trying to address them, he added, pointing out that a bill adopted by the House Financial Services Committee at the end of June included an amendment directing regulators to set an asset encumbrance cap.

Jerry Marlatt, senior of counsel at Morrison Foerster in New York, acknowledged another panellist's comment about the risk of structural subordination of senior noteholders as a result of covered bonds, but cautioned against focussing only on covered bonds, with repos and Federal Home Loan Bank (FHLB) financing also encumbering assets.

"It is a legitimate concern to worry about how much encumbrance there is," he said, "but to worry only about covered bonds and not the other piece of it seems to be misguided."

The point about thinking holistically about asset encumbrance was welcomed and taken up by Aaron Klein, deputy

James Longsdon: secured debt helping alleviate the probability of banks defaulting

assistant secretary for economic policy, US Treasury, who said that the dynamic nature of a cover pool — "one of the unique aspects of covered bonds that we have not discussed as much but I think is one of the reasons why the product is so appealing globally" — needs to be taken into account when thinking about issuance caps.

Beyond one-size-fits-all

While new covered bond jurisdictions have opted to deal with the privileged status of covered bonds by setting headline limits on asset encumbrance, there are other ways that the potential conflict between covered bonds and unsecured creditors can also be managed and this may in part depend on the covered bond model in a given country.

In a contribution to the International Union For Housing Finance's winter 2011 Housing Finance International newsletter, Otmar Stoecker, managing director at the Association of German Pfandbrief Banks (vdp), identified a range of techniques that can contribute to reducing the priority given to covered bondholders "to a fair level". These are: structuring an issuer in a way that its only funding source is (more or less) covered bonds so that a conflict between them and unsecured funding cannot arise; limiting the volume of issuance or the volume of encumbered assets in relation to the issuer's balance sheet; and/or setting strict eligibility criteria for cover assets and asset liability measures.

Sascha Kullig, head of capital markets at the vdp, says that the strict cover pool eligibility criteria set out by Germany's Pfandbrief Act limits the amount of assets that can be refinanced via Pfandbriefe, and therefore also issuance volumes, while Stoecker also noted that the legislation grants the insolvency estate an explicit right to demand that cover assets that "will obviously never be necessary" be transferred to it from the cover pool, thereby putting the burden of proof on the side of the insolvency administrator.

"The consequence is that the OC of Pfandbriefe on the one hand is not absolute," he says, "but on the other hand, only that part of the OC which is truly overstated would have to be given to the insolvency estate. In a dispute or even court trial any OC demanded by a rating agency would never be qualified as being not necessary."

Writing in the HFI newsletter, Stoecker suggested that it is important to bear in mind the characteristics of different covered bond models when considering the potential for asset encumbrance.

"It is obvious that the less specialised the covered bond issuer is," he writes, "the more detailed and complex provisions that are needed to clarify insolvency segregation and remoteness — and the more crucial is the potential conflict between covered bonds and senior unsecured creditors including depositors."

Christoph Anhamm, head of covered bond origination at Royal Bank of Scotland, says discussions about asset encumbrance are being driven by "a high degree of uncertainty" and that it is important to understand what asset encumbrance means in any given jurisdiction and how issuers' balance sheets are structured.

"In Norway, for example, there may be indirect asset encumbrance because the overcollateralisation backing a Boligkreditt's covered bonds is funded through loans or bonds issued to the holding company," he says, "but it's a completely different debate that you will have about asset encumbrance at Spanish universal banks, where everything is on the same balance sheet."

Market participants also say that discussions about asset encumbrance and its potential adverse effects for unsecured creditors need to take into account the issuer's business model. Fitch in December said that it is difficult to set a trigger point for when it would downgrade a bank's senior unsecured debt ratings on account of the level of secured funding because the amount of encumbrance a bank can bear varies widely depending on its business model and the quality of its assets.

"Banks that are purely focussed on low risk residential mortgages, for example, should be able to accommodate a higher level of encumbrance than banks with a broader range of assets with higher overall potential loss rates," it said.

James Longsdon, managing director, co-head of EMEA financial institutions at Fitch, says that it is also important to bear in mind the benefits of banks being able to raise funding via secured debt.

"You have to consider the two aspects of it," he says. "You can certainly worry about asset encumbrance, but you can't ignore the fact that banks being able to issue this stuff is probably helping alleviate the pressure on the probability of the bank defaulting."

It's not just covered bonds

Market participants also warn against focussing on covered bonds as the main driver of asset encumbrance, pointing out that banks have increasingly been turning to other types of secured borrowing, too.

"One of the complications in the discussion about asset encumbrance is when we talk about the different asset classes," says Anhamm. "It's not necessarily only covered bonds. Banks are borrowing money from the ECB — that means assets are encumbered. They also lend to each other via the repo market and collateralise derivative exposures — that is asset encumbrance. They do secured lending in all sorts of forms — that is asset encumbrance.

"All these levels have increased quite substantially over the last six, if not 12-18 months, but at the same time the most visible component is the covered bond market where cover pool data are usually frequently disclosed."

Mauricio Noé, head of covered bond and senior bond origination at Deutsche Bank in London, says asset encumbrance is undoubtedly on the rise and becoming something of a political issue, with official institutions like the European Central Bank condoning it on the one hand and regulators and deposit insurers worried about it on the other.

"We are coming into the fourth year of this financial crisis now and seeing things like the LTRO, which is the official sector encouraging banks to encumber their assets," he says. "The rationale is to stimulate the economy, or inject some inflation into it, but governments and regulators are effectively saying to banks: load the boat, back up the truck into the LTRO."

Euro-zone banks borrowed Eu489bn for three years from the ECB in a long term repo operation (LTRO) held in December, and have another opportunity to stock up on such liquidity in a second LTRO scheduled for the end of February.

"I think covered bonds get a bad rap because people don't really talk about encumbrance for any other asset class," adds Noé.

This is beginning to change, however, according to an official at a European national regulator.

"I think that since a couple of months ago people have started to realise that other funding instruments or activities of an issuer also result in asset encumbrance," he says. "This means that you should not focus only on a limit or ceiling for covered bonds because these other funding activities could also potentially damage the interests of other stakeholders, including retail deposit holders.

"So I think we are gradually broadening the discussion about asset encumbrance and about whether there should there be some sort of overall limit or just have different ceilings for different types of funding instruments."

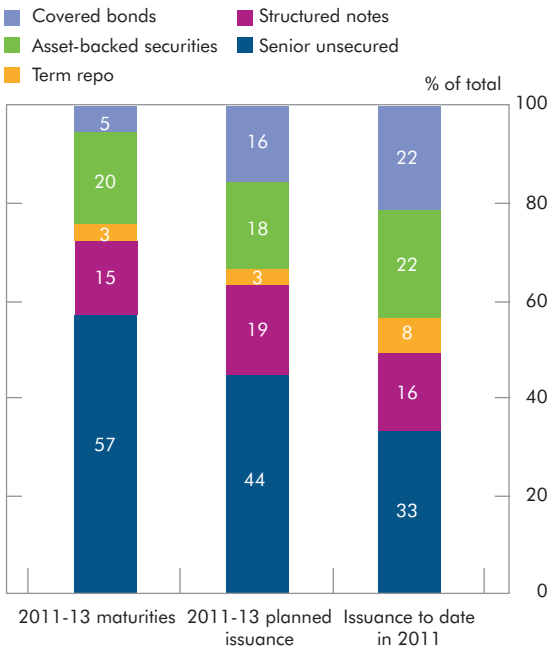
> "Overcollateralisation lies at the core of the legal conflict"

Show me the numbers

But a lack of transparency about many types of collateralised borrowing on behalf of banks means that getting to grips with asset encumbrance is no easy task.

The point was made by Fitch at the beginning of December, when it said that an increasing reliance on secured funding makes it important to improve disclosure of which of a bank's assets have been pledged as collateral and which would be available to meet claims from unsecured lenders.

The profile of the major UK banks' term debt funding



Sources: FSA, Group Treasurers and Bank calculations.

Notes:
The major UK banks here refer to Barclays, HSBC UK, LBG, Nationwide, RBS and Santander UK.
Maturing funding, planned issuance and issuance to date in 2011 include term debt issued in both public and private markets.
2011–13 maturities exclude the banks' voluntary repayment of the Special Liquidity Scheme but include debt issued under HM Treasury's Credit Guarantee Scheme.
Issuance to date in 2011 is at end-October 2011.
Funding shares may not sum to 100% because of rounding.

Longsdon at Fitch says that more information about the sources and uses of funds — "so you can marry up the two sides of the balance sheet" — would be valuable.

"I would like to see more information on what assets are encumbered and what funding is raised against those assets," he adds. "You would also very much like to understand what additional funding could be raised against the uncollateralised assets given certain levels of assumed OC-type requirements."

UK authorities have said that a better understanding of banks' balance sheets can help reduce uncertainty about asset encumbrance, and that they are confident of being able to gain such visibility.

"It's clearly an area that we both [FSA and Bank of England] need to look at closely, and the FPC [Financial Policy Committee] will engage with," said Hector Sants, chief executive of the FSA, on the occasion of the release of the Bank of England's December Financial Stability Report. "The position at the moment is we can get data, so you should be reassured that we can get visibility of the issue."

"We will be asking the banks to put work into improving their systems, improving their management information, to ensure that we can get at the data, and indeed they can get the data, and if necessary communicate it to investors in a more timely and efficient way than they currently do it." ■

Sydney opera house interior

Behind Australia's covered bonds

Within just three months Australia's banks have come from nowhere to be a major feature of the covered bond market. Here, LBBW analysts Alexandra Hauser, Andre Erdmann and Uwe Burkert look at the legislation, issuers and collateral behind the new structures.

The Australian Banking Act was amended to include provisions relating to covered bonds on 17 October 2011 after protracted discussion. The arguments cited by the covered bond opponents were that:

- the assets which were to be used exclusively as backing for covered bonds would place the Australian bank deposit customer at a disadvantage,
- residential mortgage-backed securities (RMBS) were a suitable vehicle for Australian banks to generate liquidity,

However, there were moves to render the key advantages of this funding instrument available for Australian banks.

The arguments of the covered bond advocates were that:

- it would be possible to broaden the circle of investors,
- covered bonds could be used as a possible replacement for expiring government-guaranteed bonds (GGBs) through which strong contacts had been established with risk-averse investors
- covered bonds were an efficient funding instrument even in difficult funding markets and would therefore exert a stabilising effect on the banking system.

The examples shown by Portugal and Italy demonstrate that sovereign debt crises can affect the stability of the national banking system and hence indirectly also the covered bond markets. Australia has a stable economy thanks to low public-sector debt (12%) and what is perceived to be a secure currency (as it is "backed by commodities"). This is also reflected in the AAA (Fitch) /Aaa (Moody's) /AAA (S&P) rating.

With a population of just under 23 million, the country's economy is benefiting from Southeast Asia's appetite for commodities and is increasingly placing store by the production of raw materials. The enormous importance of this sector and the resultant exposure to commodity prices is reflected in the breakdown of capital spending by sector. *(see chart 1)*

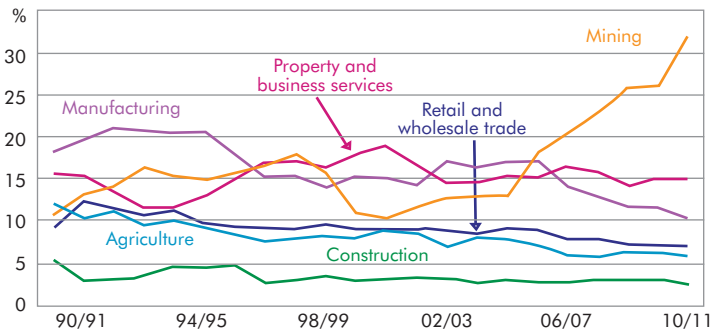
The legislation

Before an Australian covered bond can be issued, cover assets are sold to a special purpose vehicle (SPV), which guarantees the covered bond issued by the bank. No more than 8% of the bank's Australian assets may be used to back covered bonds (to protect deposit customers). Covered bonds can initially be issued by all banks with an Australian banking licence (ADIs – authorised deposit-taking institutions), although the Australian Prudential Regulation Authority (APRA) may ban an issue. An independent third party must

Alexandra Hauser

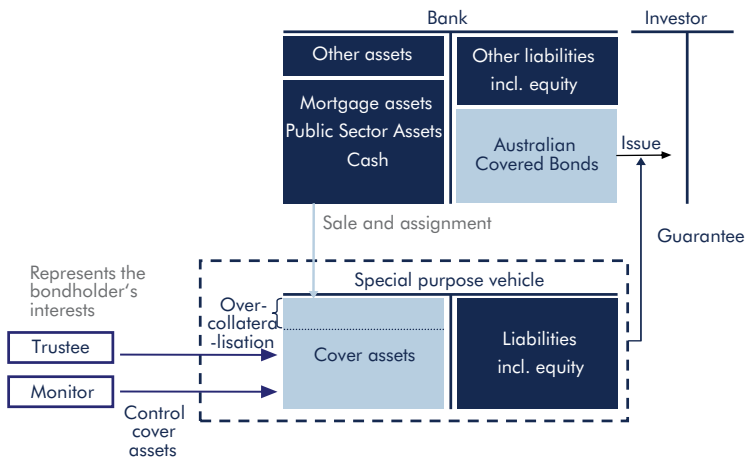
be nominated to monitor the cover assets held in the SPV. This monitor may not come from the issuer's corporate sphere and must be a registered public accountant. In addition to ensuring proper management of the cover register, s/he must prepare a report (at least once every six months) on the cover pool and submit it via the issuer to the investors. In addition, APRA forwards to the monitor any

Chart 1: Breakdown of business investments by sector



Source: Australian Bureau of Statistics

Chart 2: Structure of Australian covered bonds



Source: Banking Act of 1959, LBBW Credit Research

questions requiring answers. A 3% minimum overcollateralisation is prescribed by law. *(see chart 2)*

All eligible cover assets must be domiciled in Australia. Provided that this condition is met, the following assets are eligible without restriction:

- residential mortgages (up to a maximum of 80% of the value of the real estate, LTV limit)
- commercial mortgages (up to a maximum of 60% of the value of the real estate, LTV limit)
- bonds issued by the Australian federal, state or municipal governments
- bank deposits callable within two days
- derivatives held to protect the value of any cover assets

The following assets are also eligible for inclusion in the cover pool provided that they do not exceed 15% of its value:

- bank bills of exchange
- deposit certificates
- deposits callable at short notice.

However, these additional assets are eligible only provided that they mature within 100 days, are eligible for repurchase transactions with the Reserve Bank of Australia and have not been issued by the ADI that issued the covered bonds. The eligibility is only given for claims against Australian banks, which means only Australian assets are able to be part of the pool.

APRA may order that assets not required to secure the covered bonds be transferred back to the bank.

The 8% rule would result in a theoretical limit of A$206bn in case of cover assets and A$200bn (ca. U$213bn) for covered bonds (given the minimum overcollateralisation). Covered bond programmes with a total volume of U$90bn were already launched by the big four Australian banks. These are only refinancing instruments used for residential mortgages (total volume: A$1069bn). Theoretically, it is possible that the refinancing of commercial mortgages (total volume: A$666bn) will be managed by separate covered bond programmes. Due to the large volume of available residential mortgages, a better market acceptance and the 8% limit, the first commercial mortgage backed covered bond are likely to appear in the market, not until the segregation of high quality assets attracts the attention of senior investors.

The issuers

With preliminary preparations made even before the Australian Covered Bonds Act was enacted, a race broke out among the four major Australian banks to be the first to issue an Australian covered bond upon the act taking effect. The first covered bond under Australian law was issued in US

TABLE 1

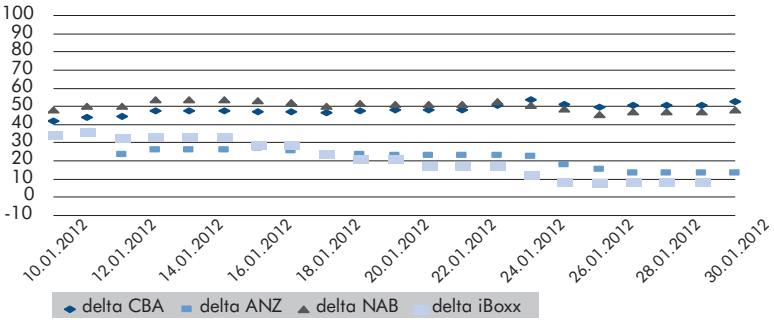
Issuer	ISIN	Issuing date	Maturity	Amount in m	ASW in bp	Currency
Australia & New Zealand Banking	US05252EAA10	23.11.2011	23.11.2016	1250	130	U$
Westpac Banking Corp	US96122WAA80	28.11.2011	28.11.2016	1000	133	U$
Commonwealth Bank of Australia	XS0729014281	12.01.2012	12.01.2017	1500	78	EUR
National Australia Bank Ltd	XS0730559894	13.01.2012	13.01.2017	1000	86	EUR
Australia & New Zealand Banking	XS0731129234	18.01.2012	18.07.2022	1000	129	EUR
Westpac Banking Corp	AU3CB0189322	06.02.2012	06.02.2017	1700	154	A$
Westpac Banking Corp	AU3FN0014874	06.02.2012	06.02.2017	1400	N/A	A$
National Australia Bank Ltd	XS0737096874	27.01.2012	27.01.2015	500	N/A	GBP

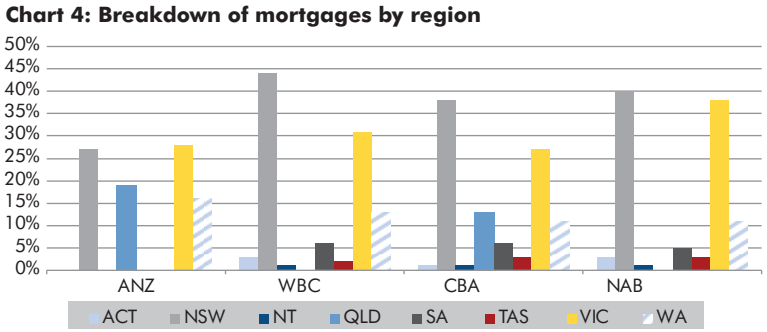
Source: Bloomberg, LBBW Credit Research

TABLE 2

Bank	Programme size	Wholesale funding	Home loans	Committed OC	Owner occupied	Var. interests
ANZ	U$20bn	30%	A$170bn	5.26%	75%	85%
WBC	U$20bn	41%	A$305bn	5,26%	83%	86%
CBA	U$30bn	36%	A$306bn	5.03%	77%	92%
NAB	U$20bn	14%	A$53bn	5,26%	91%	94%

Sources: Issuer reports, Moody's, securities prospectuses, LBBW Credit Research





dollars by Australia & New Zealand Banking Group (ANZ) on 23 November 2011. It was followed on 28 November 2011 by Westpac Banking Corporation (WBC) with a further US dollar issue. The euro issue favoured by the Commonwealth Bank of Australia (CBA) was not possible in 2011 due to sentiment in the euro covered bond market with the result that it issued the first Australian covered bond in euros at the beginning of the new year. National Australia Bank (NAB) and ANZ also quickly followed suit. All four of these banks are seeking to lower their capital market funding costs by issuing medium to long dated covered bonds. *(see table 1)*

The allocation of issues to different currencies forms part of the four major Australian banks' funding diversification strategy. In this way, they are able to resort to other markets in the event of any difficulties in a particular currency (as was recently the case in the market for euro bonds). Funding operations are customary and expected in US dollars, Australian dollars and euros. ANZ, for example, is seeking a roughly even spread across these three currencies. It plans to issue around two covered bonds per year and per currency.

The difference in the swap spreads between senior unsecured and covered bonds reflects the return which investors must forego in order to enjoy the added security of the cover pool. ANZ is currently spot on the average of the investment-grade-rated Jumbo covered bonds issued chiefly by European banks in euros. The difference at NAB and CBA is greater, something which additionally heightens the appeal of covered bond funding for these banks. The swap spreads for seniors and covereds of the Australian banks are underaverage low. The ASWs of Australian covered bonds (all triple-A rated) are around 100 bp whereas the European covered bonds have an average ASW of around 200 bp. In our opinion this is a result of the outstanding strength of the issuers. *(see table 3 and chart 3)*

TABLE 3

	S&P	Moody's	Fitch
ANZ	AA-	Aa2	AA
CBA	AA-	Aa2	AA
NAB	AA-	Aa2	AA
WBC	AA-	Aa2	AA

Source: Bloomberg, LBBW Credit Research

The cover pools comprise almost solely top-ranking residential mortgages. Only a small portion is comprised of replacement cover assets. In case of the assignment of assets to the cover pool different rules apply to the four issuers in terms of loans in arrear, advanced payments etc. Therewith, the issuer excludes the possibility transferring nonperforming loans from the beginning. Whereas CBA has launched a covered bond program worth U$30bn, its three peers have established euro programmes for Eu20bn each. Floating rate loans, which are customary in Australia, are also chiefly used for the cover pools.

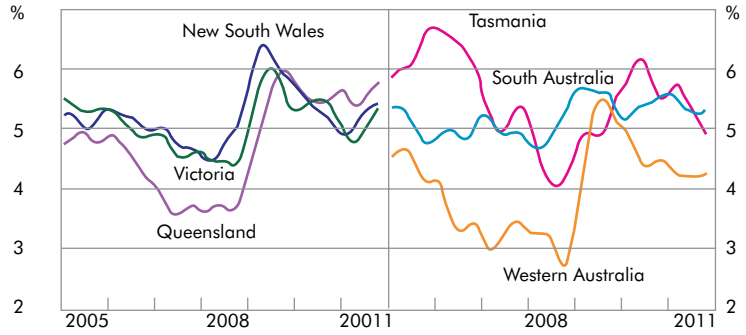
Own-home owners, who are considered to be particularly reliable borrowers, account for the bulk (75%-91%) of the mortgages held in the cover pools.

The regional breakdown of the mortgages is dominated by New South Wales (NSW, Sydney) and Victoria (VIC, Melbourne) in the case of all four banks. Western Australia (WA, Perth) and Queensland (QLD, Brisbane) have a medium weighting. South Australia (SA, Adelaide), Tasmania (TA, Hobart), the Northern Territory (NT, Darwin) and Australian Capital Territory (ACT, Canberra) are all of subordinate importance in the cover pool. *(see chart 4)*

The real estate market

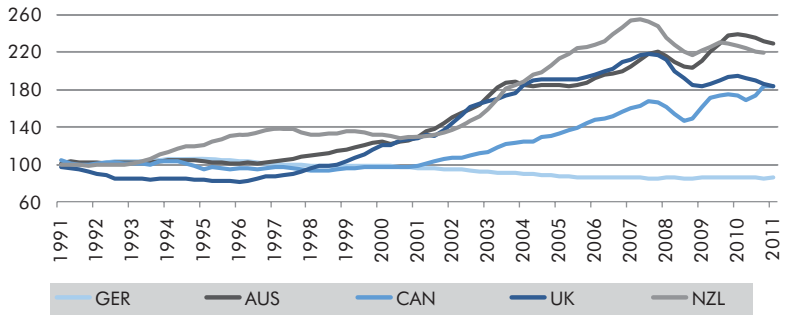
To date, the Australian covered bond programs provide for residential mort-

Chart 5: Unemployment rate by region



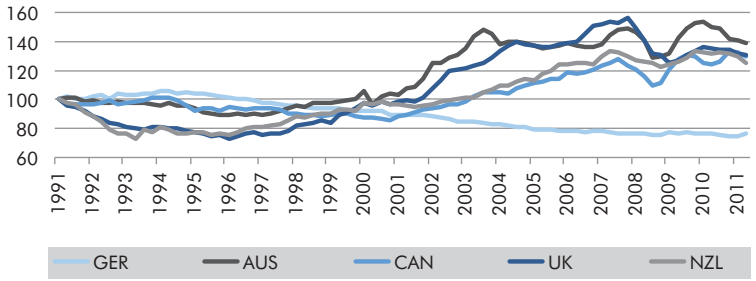
Sources: ABS, LBBW Credit Research

Chart 6: Real home prices in selected countries over the last 20 years



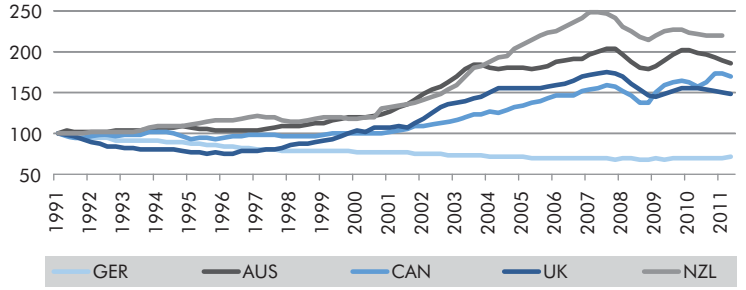
Source: OECD, LBBW Credit Research

Chart 7: trends in nominal home prices relative to incomes



Source: OECD, LBBW Credit Research

Chart 8: Trends in nominal home prices relative to rentals



Source: OECD, LBBW Credit Research

gages to be used as cover assets. The law also permits commercial mortgages to be used, although the issuers have so far ruled out this possibility so as to avoid any risk to the high reputation of their Covered bonds on account of their security. It is imagineable that there will be two covered bond programmes with one secured by commercial mortgages. In addition to borrower quality, the condition of the Australian real estate market is also of crucial importance for the quality of the cover pool.

The situation in the residential real estate market in turn hinges on conditions in the job market.

Generally speaking, Australia's robust economy is also reflected in its unemployment figures (5.3% in December 2011). By comparison, the seasonally adjusted EU-27 unemployment rate stood at 9.8% in November. The 2009 global economic crisis revealed the Australian job market's sensitivity to economic changes, with the previously very strong Western Australian job market hit particularly severely. In contrast to the other states, the recovery in the Queensland job market has been fairly tepid due to the severe flooding and also low capacity utilisation in the tourism industry as a result of the strong Aussie dollar. *(see chart 5)*

The Australian real estate market as a whole (like all the other parts of the "Commonwealth of Nations" shown here) is characterised by generally high price increases compared with Germany, although this is accompanied by heightened volatility. Over the 20-year period, prices in the Australian real estate market have performed the best out of the countries viewed here. *(see chart 6)*

Trends in home prices relative to income reveal the extent to which real estate prices have become detached from changes in income. A very high reading in this indicator points to high valuation levels in prices of homes and, hence, downside potential. Australia currently has the highest reading for this indicator, something which we see as constituting a risk to real estate price stability. *(see chart 7)*

The ratio examined here between real estate prices and rentals provides an indication of the relative appeal of buying rather than renting a home. High read-

ings indicate that it is more favourable to rent a home than to buy one. In the period under review, Australia's real estate prices rose more sharply than rentals, although the difference is not as great as in New Zealand. *(see chart 8)*

LBBW Macro Research is developing a collective indicator of valuation levels for the prices of homes comprising:

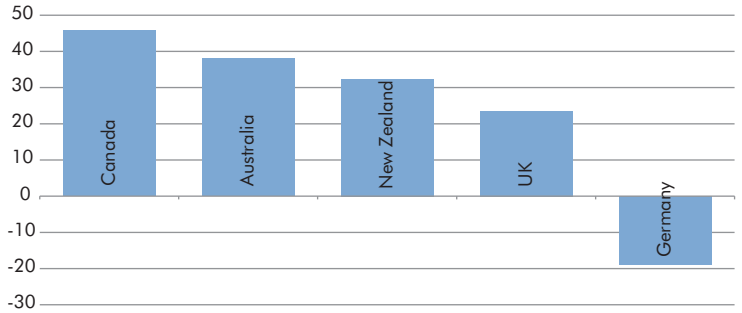
- deviation from the country's own long term average in the ratio of home prices to disposable incomes,
- deviation from the country's own long term average in the ratio of home prices to rentals and
- deviation from the country's own linear trend in home prices. *(see chart 9)*

This quantitative indicator reveals heightened levels for the Commonwealth countries, which are also analysed alongside Germany, and a low level for Germany.

The determinants examined here are not conclusive, meaning that other factors not taken into account here may also impact real estate prices. Still, we think that the factors examined here do point to elevated valuation levels for Australian real estate. However, this does not take account of the effects of changes in interest rates in Australia given that most Australian mortgage loans have floating rates. If short term interest rates drop, it is easier for loan installments to be afforded even in the case of more expensive homes assuming constant income, something which has a positive effect on demand. By the same token, rising interest rates place a damper on real estate prices. That said, we currently do not expect interest rates in Australia to rise. *(see chart 10)*

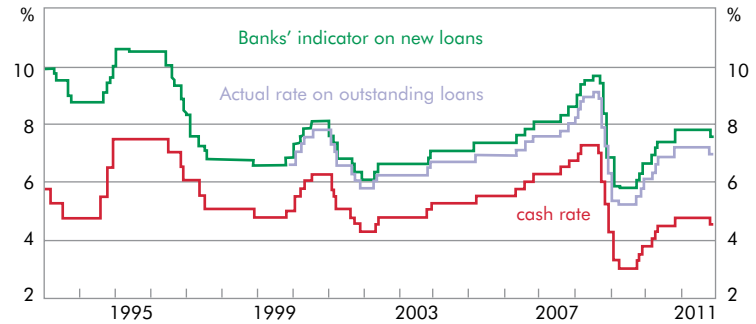
The still relatively small use made of the covered bond programmes and the strong investor interest given the youth of the market suggest that Australian covered bonds will grow in importance. Thus, 40 % of investors polled by Fitch (December 2011) said that they wanted to widen the proportion of Australian covered bonds in their portfolios.

Chart 9: Indicator of real estate valuations



Sources: OECD, LBBW Macro Research

Chart 10: Trends in interest on floating-rate mortgage loans in Australia



Sources: ABS, APRA, Perpetual, RBA

Conclusion

Australian banks, which have so far been unscathed by the turmoil afflicting the European public and banking sector, have gained in covered bonds an additional useful funding instrument. In return for collateral in the form of mortgages, they can access inexpensive funding, of which, however, they can make only limited use (8% rule). According to Moody's, this advantage will more than make up for the disadvantages for senior unsecured creditors (subordinate ranking for the proceeds from the segregated assets in the event of insolvency) thanks to the stabilising effect of the new funding instruments.

On the other hand, the Assistant Governor (Financial Markets) at APRA, sees rising funding costs for unsecured bonds, which will offset the advantages of less expensive covered bond funding. All told, he assumes that there will be no change in banks' funding costs even with covered bond issues.

No other covered bond legislation attaches such importance to balancing the interests of covered bond investors and deposit customers as in Australia. This fact places covered bond investors at a legal disadvantage compared with the status which they have in other countries.

With their investment grade ratings, the Australian banks offer covered bond investors scope for further diversification.

Australia's economic position is characterised by low public sector debt, rich reserves of raw materials, a stable currency and low unemployment. On the other hand, it is heavily exposed to volatility in commodity prices.

Given the strong investor interest and the limited utilisation to date of the large covered bond programmes, Australian covered bonds initially look set to grow in importance for the covered bond markets. As long as the Australian economy continues to benefit from the commodities boom and provided that there is no drastic slump in the prices of homes, Australian covered bonds will offer a particularly high degree of security. We consider real estate valuation levels to be high, although they began to slowly decline in 2011.

Australian covered bonds offer an attractive opportunity for investors who are sceptical about the traditional European covered bond markets on account of the debt crisis, believe in the world's continued appetite for commodities and are seeking an alternative with as little exposure to Europe as possible. ■

The Covered Bond Report

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

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

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From Brussels to Mainz … via Las Vegas

The Hotel Le Plaza Brussels plays host to the European Mortgage Federation Annual Conference 2011

Covered bonds were on the agenda at ASF 2012, ARIA Hotel, Las Vegas — reputedly the biggest capital markets conference in the world

LBBW hosted its 6th European Covered Bond Forum at the Hyatt Regency, Mainz in February, with LTROs and plans for a breakaway northern European currency provoking lively discussions

photo pg danella

Covered bonds?

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

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Figures as of 17 March 2011