Credit

Are covered bonds the solution?

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Tyndall INVESTMENTS

Summary

- Covered bonds offer an appealing funding option for banks and while there is a place for them in the investment universe, investors need to be mindful of the risks they entail, especially given the geographic differences between issuers and the untested nature of having to rely on the collateral.
- Covered bonds offer investors another range of high-quality credit investments but they are still bank debt and are not a direct substitute for government-guaranteed bank debt.
- Despite the government's intention, the introduction of covered bonds in Australia may weaken rather than enhance competition in the banking sector - they could in fact potentially further widen the gap of funding access between the majors and the second tier banks.
- Covered bonds may also cause consequences for senior debt holders and bank depositors that could lead to potential conflicts and regulatory risk.
- Domestically, the size of Australian issuance will be constrained by investors' existing senior debt exposures and so for most Australian portfolios, offshore issuers of covered bonds in the Australian market will probably be of more interest.
- Tyndall will consider covered bonds as a potential sector for investment depending upon pricing and liquidity. Exposures to an issuer's covered bonds will be included in the exposure to an issuer.

Introduction

Covered bonds have become a hot topic after the Australian Treasury included them as an important component in a recent proposal on the banking system. Australia is one of the last developed countries to introduce covered bonds, and as they generally represent an alternative funding source for issuers, there has been considerable interest by local banks in this 'new' issuance structure.

This paper examines these bonds and considers why they are being introduced, who will buy them and what risks they entail. We find that these securities have a place in the investment universe but care needs to be taken to ensure the finer points are understood - and these points differ across geographies. Their introduction in Australia is a strong positive for the major banks but may in fact weaken rather than enhance competition in the market. Moreover, the introduction of covered bonds unless controlled, has consequences for senior debt and depositors that could lead to potential conflicts and regulatory risk in the future.

Background

On 12 December 2010, Australian Treasury released the Federal Government's proposals for a "Competitive and Sustainable Banking System". These proposals attempt to address a range of issues, including bank competitiveness and a sustainable banking system. The introduction of covered bonds forms part of the proposal to create an additional AAA-rated funding source, with the aim of lowering bank funding costs, creating competition in the bank lending market and addressing the issue of the liquid assets requirement in Basel III, by meeting demand by bank balance sheets for repo-eligible assets (i.e. on the eligible security list).

The proposed covered bonds issuance reversed the long-standing opposition by the Australian Prudential Regulation Authority (APRA) to covered bonds. The Federal Government released the Exposure Draft on covered bonds legislation in March 2011. Comments are due by 22 April 2011 and the Bill will be tabled in Parliament thereafter.

Before looking at what covered bonds mean for issuers and investors and what are the associated risks, a definition of a covered bond is needed.

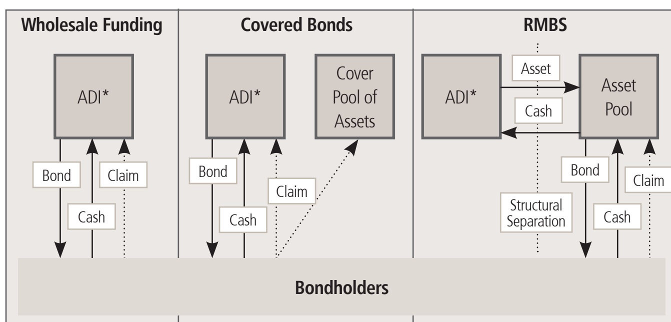
What is a covered bond?

A covered bond is a security issued by a bank with assets (usually mortgages, but sometimes other loans) assigned to provide security for the debt. Typically the size of the asset pool (or 'cover pool') is larger than the bond issue. The excess assets are referred to as "over-collateralisation". Unlike a residential mortgage-backed security (RMBS), the cashflows are funded by the financial institution and not by the cashflows of the pool of assets. Hence, a covered bond has regular payments and no prepayment, thereby more resembling a traditional bond issue.

The important feature of covered bonds is that investors have **dual recourse** to the bank and to the collateral while senior bank investors can only claim on the bank and RMBS investors can only claim on the collateral (as illustrated in chart 1 below). Unlike an RMBS, in normal operation of the issue, the collateral will be refreshed regularly and the quality of the pool maintained.

It is important to note that the assets used to provide the cover must be assigned unambiguously to the covered bond issue and hence there is a reduction to the amount of assets available to other unsecured lenders including depositors.

Chart 1: Covered bonds provide investors with dual recourse



ADI = Authorised Deposit-taking Institution, which includes banks, credit unions and building societies

Source: The Parliament of the Commonwealth of Australia "Exposure Draft – Banking Amendment (Covered Bonds) Bill 2011

Why issue covered bonds?

Diversification of funding

The ability to issue covered bonds provides an alternative option in a bank's funding mix. In Europe, covered bonds form a deep and mature market. European experience showed that covered bonds were one of the first asset classes to recover and provide liquidity during the credit crisis.[1] Their strength was due to the high quality of the asset pools, dual recourse to both the collateral and the issuing banks and the support of the European Central Bank (ECB) for repurchase agreements.

In Australia, covered bonds are targeted to replace government-guaranteed bank paper issued during the height of the credit crisis which is starting to roll off at the end of this year. The ability to issue covered bonds may enable mandate-constrained investors in guaranteed bank debt to continue sourcing AAA-rated debt of Australian banks. However, it must be stressed that **covered bonds are not an exposure to the sovereign.**

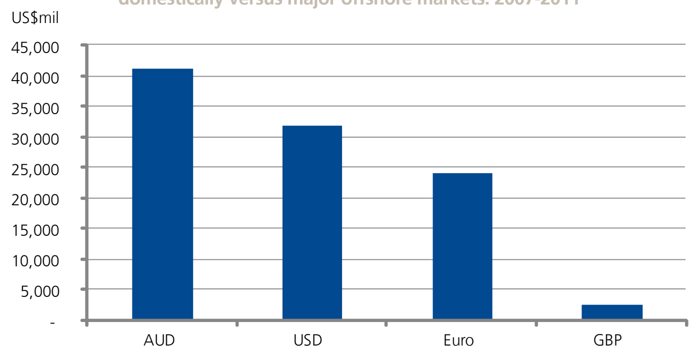
[1] Australian experience with covered bonds has been less happy in that the issues in Australia were often from some of the more challenging and obscure European issuers such as Hypo Real Estate Bank or Hypothekenbank in Essen. These issues became exceedingly illiquid during the aftermath of the Lehman's collapse although they remained highly rated and at no time were they expected to default.

Competition with offshore banks for international funding

As mentioned, this asset class has been long recognised and utilised by European investors. Canadian banks have also started to access this market and, closer to home, Bank of New Zealand (BNZ) recently had an inaugural covered bond issue. Debate is currently underway in the US about creating its own covered bond market.

Senior debt of the Australian major banks has been supported by international investors as evidenced by the benchmark issues of Australian banks offshore in chart 2. However, the covered bond market is becoming a key competitor for funds from many investors nervous about the volatile regulatory environment and seeking to decrease risk. Australian issuers are keen to be able to compete for this money.

Chart 2: Issuance by Australian major banks
Australian major banks benchmark senior unsecured issuance domestically versus major offshore markets: 2007-2011



Source: Dealogic, Nomura

Accordingly, the introduction of a covered bond market is a major win for the major banks as it provides a level playing field relative to their offshore counterparts. Based upon the response to the €1 billion issue by BNZ in November 2010, there is reasonable expectation for the demand of Australian-originated covered bonds.

Less beneficial to second tier banks

Benefits for second tier banks are less certain. Due to their lower credit ratings, their associated covered bonds may not be able to achieve AAA ratings. In addition, the smaller size of the non-major banks means that they may not be able to reach the critical mass for a covered bond issue. With specific legislation, a pooling structure for non-major banks could potentially be a solution that enables these issuers to access the market.

In the current circumstances, covered bond programs thus benefit major banks as an alternative funding source, more than they do the non-majors. Accordingly, the covered bond initiative may not achieve the desired goal of facilitating alternative funding for second tier banks and could, in fact, potentially further widen the gap of funding access between the majors and the second tier banks. As part of the banking competitiveness initiatives, the effectiveness of covered bonds in assisting funding profiles of second tier banks is yet to be seen.

Positive rating agency perspective

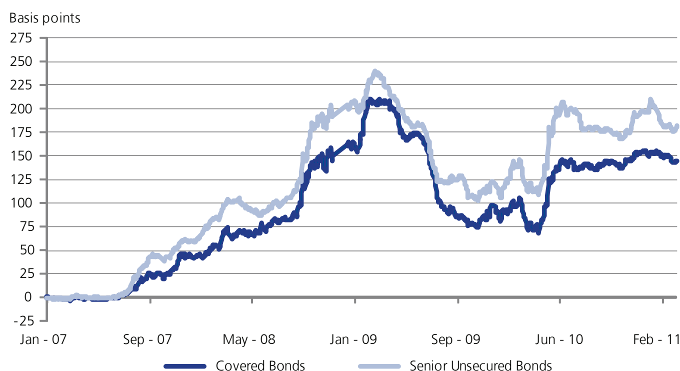
Rating agencies consider covered bonds as an alternative funding source which improves the banks' funding profile, investor base diversification and liquidity position. Being able to access the covered bond market is therefore a credit positive for the rating of a bank. (Although as discussed later it may be a negative for the rating of senior debt.)

Attractive financing terms

Accessing the covered bond market should allow banks to achieve lower funding costs, longer-term financing and larger volume.

Due to their dual recourse and other structural features, covered bonds are considered a better credit risk compared to unsecured senior bank debt. The certainty of payments and the support of the bank also make them a preferred asset over most RMBS. Hence, covered bonds typically trade at tighter spreads than these other forms of debt and provide better funding levels for their issuers. For example, among euro-denominated bonds, when the BNZ 3.125% November 2017 covered bond was marked at a spread of 56 basis points over the swap rate, the slightly shorter-dated BNZ 4% March 2017 senior bond was marked at a 125 basis point spread. Chart 3 illustrates the relative spreads of covered bonds to senior bonds. Recently, with rising concerns about potential regulatory risk for senior unsecured debt in Europe, the spread between senior and covered bonds has widened.

Chart 3: Comparison of covered and senior unsecured bonds
Relative performance of covered bonds and senior unsecured bonds in iBoxx



Source: iBoxx, Goldman Sachs

Due to the ability of issuers of covered bonds to substitute collateral, covered bonds can be issued with longer terms to maturity of well over 10 years, thereby reducing the refinancing risk. In recent times, the ability to maintain a longer maturity profile has been an important positive in considerations by the ratings agencies.

The issuance of covered bonds under a single program allows banks to issue more frequently. The established framework enables low issuing costs and preparation. This allows large volume issuance on a low cost basis.

One caveat to this view of cheap financing is that it ignores the cost of maintaining the collateral pool and more particularly the cost of over-collateralisation.

Why buy covered bonds?

AAA investors

Covered bonds are well suited to the needs of investors who can only invest in AAA-rated securities (i.e. sovereign funds) or have a minimum allocation to AAA-rated assets. Covered bonds can potentially offer an alternative to supranationals or government-guaranteed debt. However in the Australian context, the liquidity of these bonds is still reasonably uncharted and may limit interest.

For investors who are able to invest in senior bank paper and have comfort with the issuer's name, covered bonds may be less appealing since they can use up limits on exposures to these names with lower yielding investments. Hence, Canadian investors have preferred senior debt to covered bonds for their banks and Canadian banks have issued their covered bonds outside their borders. Australian banks may, likewise, find more acceptance for their covered bond issues offshore rather than domestically with the possible exception of bank balance sheets which are focused on liquidity requirements.

For issuers, it may also be preferable to issue offshore since it is important for them to try and avoid reducing demand for senior paper by having holdings in senior paper replaced with holdings in covered bonds. This "cannibalisation" has been a concern in Europe of late as debt investors shun senior debt due to regulatory concerns and replace their holdings with covered bonds.

Inter-bank buying

For Australian banks, covered bonds could potentially assist in addressing the problem of liquidity assets shortfall under Basel III. Basel III indicated that covered bonds will be a level 2 asset, provided they hold a credit rating of at least AA-. As a level 2 asset, holdings in covered bonds will be limited to 40% of total liquid assets and will be subject to a 20% haircut (i.e. a discount in their face value to account for the higher risk). Given the lack of qualifying liquid assets under Basel III in Australia and their relative yield pick-up against other AAA-rated bonds, it may be appealing for bank treasuries to buy covered bonds as part of their liquidity strategy.

At the very least, covered bonds are expected to be repo-eligible with the Reserve Bank of Australia (RBA). They should, therefore, qualify for the recently announced liquidity facility by the RBA which enables domestic banks to meet the Basel III liquidity requirement.

It is, however, less than clear that systemic banking risk is reduced if banks are holding each other's debt - a fact that is in the minds of regulators worldwide as they review the aftermath of the financial crisis.

Considerations and risks when investing in covered bonds

While covered bonds are high-quality credit instruments, there are some important considerations to be factored in:

- Geographic idiosyncrasies in covered bond structures and legislation
- Correlation risk between assets and issuers
- Legal and regulatory risks
- Liquidity
- Pool quality reporting.

Geographic idiosyncrasies

The actual program structures for covered bonds vary substantially between different jurisdictions, with some having clearly defined legal structures and others being more informal. In Canada, the structures are well defined and covered bonds are currently limited to 4% of total assets (although it is proposed to increase this limit to 10%). In Australia, the Federal Government has proposed a limit of 8%. In New Zealand, legislation is being finalised at the time of writing. In Europe, the structures of covered bonds vary considerably between countries and sometimes even within countries.

These differences can become quite technical. For example, in France there are now two types of covered bonds (Obligations Foncières and Obligations à l'Habitat) which vary primarily upon the assignment of the mortgage between the issuing entity.

Very significantly, the limits on the percentage of total assets that can be pledged to support covered bonds varies substantially between countries. Some countries like Canada and the proposed Australian scheme have strict limits while many European countries have no explicit limits and in some cases, such as Denmark, almost all mortgages are funded through covered bonds.

The divergence of structures doesn't mean that the market is flawed but it does place an imperative to examine all covered bond issues carefully and be aware that not all issues are equal. Investors need to study the nuances.

Correlation risk with bank senior risk

The credit risk on covered bonds can be viewed as the combination of the credit risks of RMBS and of bank debt. The dual recourse to the underlying collateral and the issuing banks means that the probability of default and expected recovery levels for covered bonds is a function of the likelihood of the issuing bank and the cover pool both becoming insolvent.

It is important to note that the cover pool and the issuer are not independent - in fact they are strongly correlated. One of the flaws in analysing wrapped bonds was the assumption of independence between the monoline and the wrapped assets. Some analysis of covered bonds falls into exactly the same trap between issuer and assets for covered bonds.

If an issuer has been generating weak assets then it will suffer and the credit quality of the cover pool may also be tainted.

Moreover, covered bonds remain as a liability on the issuing bank's balance sheet. The cover pools of covered bonds are structured as an open-end pool which has ongoing asset demands based upon the qualifying criteria of the collateral. It is the issuing bank's obligation to maintain the performance and quality of the cover pools to certain levels, as evidenced by the issuing bank's capability to substitute assets in cover pools and maintain its performance management and servicing. If qualifying assets are not available, this places stress not only on the cover pool but also on the issuer.

In the event of default of an issuing bank, to the extent that the cover pools are insufficient to fully satisfy claims, unsatisfied claims will turn into unsecured claims and will rank equally with other senior unsecured claims on the issuing bank. In most cases, the ability to claim on the cover pool will result in a far superior recovery level than for senior unsecured debt.

Covered bonds are therefore inherently linked to the credit risks of the issuing bank. Tyndall, from a portfolio investment and management perspective therefore treats covered bonds as part of its exposure to the issuer and not as a separate new credit. Covered bonds will be managed according to Tyndall's credit policy on individual bank name risk and it does not regard covered bonds as a different asset class – they are just one part of its exposure to the banking sector.

Tension with senior debt and retail depositors

The secured claim of covered bond holders reduces the claimable bank assets for senior unsecured bond investors and for retail depositors. As mentioned earlier, caps on covered bond issuance vary substantially between different jurisdictions. If the cap is too high then the assets available for non-secured investors may be inadequate and this could cause a credit downgrade for senior bonds and, in theory, for retail deposits.[2] With a cap of 8% of total assets, Australia's proposed covered bond program should have very limited impact on senior debt. In fact, Moody's has already stated that under this cap, the program will not affect a bank's standalone rating.

[2] This dilution of available assets can also occur if RMBS issuance is too high.

For bond investors, the current European Union proposal to share the burden of bank failure with bank senior bond holders has been troubling and has driven investors to covered bonds rather than more "equity-like" senior debt. This has driven a large amount of covered bond issuance by European banks pushing to maximise the issuance limit. If this were to continue, unsecured bonds may virtually become subordinated debt and highly unfavourable.

Combined with probable preferential treatment for retail depositors, we are cautious of the implication for senior bank debt holders in the event of a bank's bankruptcy. It is uncertain how senior bank debt pricing may need to change to reflect this risk and hence adequately compensate senior bank debt investors.

From what we have observed during the credit crisis, governments around the world tend to protect the interests of retail depositors. This is not surprising, given that alienating retail depositors creates considerable political risk. It is still a matter of conjecture on how a government might handle balancing the interests of retail depositors and of covered bond investors in an event of bank bankruptcy, but investors in covered bonds need to appreciate the political risk in such a circumstance.

Untested law of the covered bonds concept

The risk of a conflict of interest between retail depositors and covered bond investors means that it is critical to understand, and have complete confidence in, the strength of the assignment of assets in the cover pool. The method of assignment and the strength of the claim will be very dependent upon local legal systems and so an understanding of the jurisdiction is important.

The concept and legal framework of covered bonds has never been tested as there has not been a case involving a default of a covered bond in the last 100 years. This is partly a sign of the success of the structure, but also it has been assisted by there being no situations in which retail depositors have been made to forego parts of their deposits to pay out covered bonds.

There have been cases where banks have failed but covered bonds are repaid - for example, Northern Rock in the UK - but these cases have been resolved without challenging the legal strength of the claims of the covered bonds. If the conflict is however with retail depositors, legal challenges are more likely.

Moreover, the case where a claim upon the assets is actually made has not been tested. In this case, assuming the claim is successful, the holder of a covered bond is now the owner of a pool of long-dated assets. The difference in tenor between the bonds and the collateral could create the risk that the time to recovery of money is considerably delayed unless the assets can be transferred to a third party in which case the transfer price is critical to ensure payment in full on the bonds.

Liquidity

Currently, the domestic covered bond market is small with only a few offshore issuers. This is a big contrast with the RMBS market, which the Federal Government has also committed to supporting. The covered bond market will take a long time to develop into a deep and mature market and in the meantime liquidity could be challenging.

Reporting: underlying collateral performance disclosure

RMBS reporting has been well developed in most countries and investors are usually provided with regular and reasonable consistent collateral performance disclosure. This has yet to be developed in the covered bond market partly because the collateral pool is more dynamic.

Conclusion

Covered bonds could potentially help mitigate some imminent problems facing domestic banks by broadening issuing options. Further work is needed in order for non-major banks to benefit from this concept. For investors, covered bonds offer another range of high-quality credit investments but they are still bank debt. As investors, Tyndall will consider them based upon whether their price reflects the correct compensation for credit risk and liquidity.

Australian issuers will be constrained domestically by existing senior debt exposures and so for most Australian portfolios, offshore issuers of covered bonds in the Australian market will probably be of more interest.

Prepared by Tyndall Investment Management Limited
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For further information please contact:

John Sorrell	Ileria Chan
Head of Credit	Senior Credit Analyst
Ph: 02 8275 6650	Ph: 02 8275 3563

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