The first quarter of 2011 saw record rates of covered bond (CB) issuance. Outstanding euro-denominated CBs (based on the Bank of America Merrill Lynch EMU Broad Market Index) totaled more than €900 billion at quarter-end. We are following this market closely, looking for investment opportunities in the sector and assessing its impact on other areas of bank capital structures.

**What is a Covered Bond?**

CBs are sponsored by a bank that is responsible for interest and principal payments on the CBs. A ‘cover pool’ collateralises the CBs and is available to CB holders in the event that the bank defaults. In such a scenario, the CBs remain outstanding and due for payment in accordance with their documented terms. The CBs are not accelerated unless the bank specifically defaults on a CB payment (or fails to maintain the cover pool in line with the programme terms). To the extent that CB liabilities cannot be satisfied out of the proceeds of the cover pool, the CB holders have a claim against the wider balance sheet of the bank (typically ranking pari passu with, or equivalent to, senior unsecured debt).

The key difference between a securitisation and a CB is that CB holders enjoy full recourse to the wider bank balance sheet; securitised bondholders’ recourse is usually limited to the specific assets within the securitisation transaction.

The cover pool must contain sufficient eligible assets to satisfy CB holders at all times.

Before investing in a CB, investors need to be comfortable with the following: the sovereign, given the direct impact on CB spreads; the issuing bank, particularly if there are concerns about CB rating downgrades; the legislative and contractual terms applicable to the programme; and the quality of the cover pool (keeping in mind that it can change over time).

**Covered Bond Structures**

The long-established German Pfandbriefe market has been used as a template for CB structures globally. A number of jurisdictions have introduced specific CB legislation in recent years. CB structures can be established via contract law, although regulatory treatment is less favourable in this case.

Cover pool assets are usually limited to mortgages (both residential and commercial) and public-sector loans. Some cover pools feature all three asset types, while other programmes are limited to a single asset type. We prefer CBs that are based on pure residential mortgage collateral pools, and this paper concentrates on that preferred subsector. We believe that this market subsector is characterised by better cover pool disclosure and minimal cross-border exposure within the cover pools.

The cover pool assets need to be ring-fenced such that the CB priority claim is respected in any insolvency process.
• Cover mortgages can remain on the universal (deposit-taking) bank balance sheet if the prevailing legislation includes a cover pool register concept and a specific carve-out for cover pool assets during insolvency proceedings.

• Alternatively, the cover mortgages are sold into a special purpose vehicle (SPV). CBs are issued by the sponsor bank on a senior unsecured basis, while the SPV provides CB holders with a guarantee that is secured by its assets. This is the structure used in the UK and Italy.

• Cover mortgages can also be transferred into, or originated by, a specialist bank (a non-deposit-taking subsidiary), which is predominantly funded by the issuance of CBs. Austria, France and Ireland use this structure. In this case, the recourse of CB holders is restricted to the specialist bank, without any form of guarantee or recourse to the parent universal bank.

Mortgage eligibility tests are primarily loan-to-value (LTV) based, with the upper limit usually set at 80% for residential mortgages. For commercial mortgages, this limit is usually 60%. Depending on the jurisdiction, mortgages that breach this test are either totally excluded from the pool or split into eligible and ineligible portions (with the ineligible portion ignored for cover pool calculations). The excess-value portion of the mortgage may be included in the pool calculations if a suitable insurance policy is in place. This eligibility test is relatively weak in those jurisdictions that use a ‘mortgage value’ concept (in which mortgage eligibility is determined on a one-off basis according to the LTV at origination) as opposed to those jurisdictions that update property values (and hence LTVs) on a frequent basis using suitable house price indices.

Many jurisdictions do not explicitly exclude mortgages in arrears from the cover pool, although programmes that feature an asset coverage test typically do provide protection in this regard. UK transactions are a good example of this, restricting the amount included in the cover pool to a maximum of 40% of the associated property value for those mortgages that are more than three months in arrears. This strong investor protection exists for UK deals because this was a CB market that initially developed under contract law rather than via primary legislation (and needed to compete with legislative CBs from established jurisdictions).

**Ratings and Overcollateralisation**

CBs were traditionally considered an AAA asset class, with the cover pool assumed to be sufficient to ensure that CB investors would receive full interest and principal payments in the event of sponsor default.

While we did not see CB defaults during the credit crisis, this period proved that the historical assumptions regarding the cover pool were optimistic. The ability to monetise cover pool assets at a price sufficient to service CBs and/or roll over maturing CBs did not exist during that period; this has had a number of significant consequences.

• CB ratings are now linked to the unsecured rating of the issuer bank, irrespective of the extent of OC. Hence, it is nearly impossible for a BBB rated bank to achieve an AAA rating on CBs.

• To achieve an AAA CB rating, those banks rated above BBB now need to provide significantly higher OC than they did historically.

• CB structures are now being modified to reduce the risk that cover assets would need to be sold quickly following issuer default. For example, the modification could pass extension risk to CB holders.
Significantly, the amounts of OC that rating agencies require for an AAA rating typically greatly exceed those mandated in CB legislation. Excess levels of OC can be viewed as subordinating deposit holders and thus (in the extreme) the taxpayer in a scenario in which deposit protection mechanisms have kicked in. To our mind, this introduces the risk that excess OC could be seen as voluntary (having been introduced for rating purposes) and thus could be challenged via the legal process or otherwise removed from the cover pool as the issuing bank nears default—exactly the time when CB holders want a high level of OC available.

**Risks**

Many CB structures have not been tested during formal insolvency processes. Long-established CB markets, such as that in Germany, typically have organised rescue attempts: for example, the transfer of CBs and related cover pool assets to a stronger entity prior to formal insolvency proceedings involving the failing institution. In the UK, CBs issued by the failed Northern Rock plc were placed into the ‘bad bank’ but are explicitly guaranteed by the UK government. Such actions can be seen as a positive, with regulatory authorities acting to protect CB holders. But such supportive behaviour cannot be assumed to continue in an environment in which sovereign balance sheets (and entire banking systems) are under pressure.

Resolution regimes designed to rescue a bank quickly (bail-in, ‘good bank/bad bank’ split) seem incompatible with the longer time scales for extracting value from a CB pool. While CBs are currently excluded from such discussions, the value of the CB claim to the wider bank balance sheet might well be damaged during such a rescue (and clearly is damaged to the extent that senior unsecured bondholder claims are becoming subordinated behind deposit holders/deposit protection schemes). CB holders should not assume that they will remain within the ‘good bank’.

Cover pool quality might be weaker than expected. We avoid transactions with poor-quality/infrequent cover pool disclosure, preferring instead to invest in transactions based on pure residential mortgage pools. Commercial mortgages are more volatile, while public-sector loans often introduce cross-border exposure (in the form of public-sector loans to the eurozone periphery). When looking at residential mortgage pools, we prefer those jurisdictions in which property values are regularly indexed, such as the UK. Other jurisdictions, including France, Germany and Spain, use only the initial mortgage lending valuation to test the LTV eligibility criteria.

As outlined above, we do have some concerns about the permanence of the current elevated levels of OC and the CB holders’ ability to access this excess OC in a default scenario. Importantly, programme swap and hedge counterparties usually also have access to the cover pool on an equal basis with CBs. This can be difficult to quantify but can reduce the OC available in practice to CB holders.

Rating downgrades may lead to forced selling by rating-sensitive investors (this remains a predominantly AAA asset class). The closer linkage between CB ratings and bank ratings will also likely make it more difficult for weaker banks to access central bank funding or repo facilities and make it more difficult to roll over maturing CBs.

**Covered Bond Market Size**

Based on the Bank of America Merrill Lynch EMU Broad Market Index, at the end of 1Q11, Spain represented almost 30% of the euro-denominated CB universe, with €275 billion in CBs outstanding. Germany and France were the other big jurisdictions, with €166 billion and €196 billion, respectively, outstanding. (In each case, the actual amount is higher, given non-Index-eligible bonds, such as those with maturities of less than one year.)
The German market is shrinking, while the markets in Spain and France continue to grow rapidly (each had over €40 billion of issuance in 2010). We expect further significant issuance from the newer UK and Italian markets and out of Scandinavia. Estimates for 2011 CB issuance are in the €200–250 billion range, though we believe that actual supply will exceed these amounts, given the rate of issuance to date (January 2011 was the biggest-ever month and 1Q11 was a record quarter).

The upcoming redemption schedules are, in our opinion, manageable to the extent that the CB market is open. Individual issuers that do not realistically have access to the public markets (such as smaller Spanish cajas) will need to use highly rated CBs to fund themselves via central bank mechanisms.

**Spread History**

CB spreads are generally tighter than the spread on a senior unsecured bond from the sponsor bank, given the covered bond’s higher rating, extra rating stability and higher expected recoveries on a default. The relevant sovereign spread effectively provides a floor for CB spreads, although this relationship breaks down as the market starts to contemplate sovereign haircuts (when the strongest institutions can trade inside the sovereign).

The extreme widening experienced by the Irish, Portuguese and Spanish sovereigns is clearly reflected in the CB spreads, as seen in Exhibit 2. German CBs continue to trade at very tight levels, reflecting the large, established investor base, with both a strong technical demand and a shrinking market size.
Conclusions
Before investing in a CB, investors need to be comfortable with the following:
• The sovereign, given the direct impact on CB spreads.
• The issuing bank, particularly if there are concerns about CB rating downgrades.
• The legislative and contractual terms applicable to the programme.
• The quality of the cover pool (keeping in mind that it can change over time).

Areas where we currently look for investment opportunities are:
• Issuance of long-dated, (15+ years maturity) sterling CBs from UK banks. We particularly like the cover pool discipline and the regularly indexed house prices in UK structures.
• Issuance of euro-denominated CBs from UK banks, as continental investors are perhaps less familiar with the issuers and UK structure.
• For rating-sensitive investors, CBs issued by strong French and Scandinavian banks.
• On a more opportunistic basis, Spanish CBs from the large banking groups (Santander, BBVA, La Caixa). These bonds provide investors with significant protection against collateral claw-back risk in a default scenario, given the high level of legally mandated OC (at least 25%) and the unusually wide, priority recourse they have over the entire mortgage book.
• Mis-pricings, which can be identified by the spread between senior unsecured bonds and CBs from the same issuer, allowing us to switch from a senior unsecured bond into a CB without giving up too much spread.

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