Covered bond issuance and the implications for bank ratings

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Neben Staatsanleihen gilt der Pfandbrief als Premium-Produkt des Kapitalmarktes. Entsprechend zahlreich sind die Nachahmer: Bereits 27 Länder haben Covered-Bond-Gesetze. Die hohe Produktqualität bietet den Investoren Sicherheit und den Emittenten eine günstige Refinanzierung. Doch kann es zuviel des Guten geben? Durchaus! Zumindest meint das der Autor. Ein breiter Refinanzierungsmix, der auch unbesicherte Anleihen einschließt, senkt die Liquiditätsrisiken und erhöht die Handlungsfreiheit der Bank bei Marktveränderungen, begründet er. Letztlich wirkt sich diese Flexibilität auch auf das Rating aus. (Red.)

Since the authorisation of Pfandbrief issuance by Frederick II of Prussia in 1769, covered bonds have grown to become one of the largest asset classes in the European bond market, with outstanding issuance exceeding 1.9 trillion euros in 2007. They now constitute a major source of funding for mortgage finance. Although initially dominated by the German domestic Pfandbrief, the covered bond market has seen significant geographical expansion and diversification of issuance patterns, centred mainly in Western Europe, during the past ten years. Currently, more than 27 countries have implemented special covered bonds legislation, recent examples being Greece, Italy (2007), the UK and the Netherlands (2008).

Dual nature of the protection

Covered bonds were initially introduced to provide funding for long-term investment projects such as residential, commercial or agricultural properties as well as for public sector financing such as infrastructure development. The instrument has traditionally been regarded as a high-grade and liquid asset, a perception underpinned by the generally higher quality assets contained in the cover pools supporting issuance. An additional defining element is the dual nature of the protection offered. Investors have recourse both to the issuing institution and to a dedicated pool of collateral generally prime mortgages or public sector loans on which investors have a priority claim.

In most European jurisdictions, legislative frameworks are in place designed to adhere to the Capital Requirements Directive (CRD), which, among other things, limits the range of acceptable collateral to be included in the pool (thereby helping to preserve its underlying quality) and imposes a degree of regulatory oversight.

The dual nature of the protection offered by covered bonds sets them apart from both senior unsecured debt and asset-backed securities such as residential mortgage-backed securities (RMBS). The pool of collateral for covered bonds is regarded as a credit enhancement feature rather than a way to gain exposure to the underlying assets it contains. As a result of these features, covered bonds were seen as a higher-yielding alternative to government bonds rather than credit products and, until recently, this was reflected in typically narrow spreads, particularly in the more established markets such as Germany.

Re-evaluation the funding strategies

Recent dislocations in wholesale money markets have led banks to re-evaluate their funding strategies. Although margin pressure has been eased by greater flexibility in loan pricing and, to some extent, an increase in comparatively cheaper retail funding sources for several lenders, an important aim remains the provision of cheaper wholesale funding and the ability to diversify maturity profiles. With the current closure of the securitisation markets as a major funding vehicle, attention has turned towards covered bonds issuance, both as an alternative source of wholesale funds predominantly in the form of private placements and, increasingly, to bolster shorter term liquidity in the form of repo transactions with central banks.

Current market conditions have stemmed the flow of new public issuance for the time being, but a high number of first-time issuers are awaiting an improvement in market sentiment before joining the league. Although it may be some time before issuance volume regains the double digit growth momentum experienced between 2004 and 2006, steady growth is expected in the medium term. Compared with alternative funding instruments several characteristics can be highlighted.

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Cheaper funding

Covered bonds provide a relatively cheaper source of longer term funding. Their use, for example, reduces the need for potentially more costly true sale securitisation structures. They generally help issuing banks to lengthen their maturity profiles. In addition, they offer issuing banks the opportunity to tap into another investor base, thereby helping to diversify funding sources and ultimately providing increased funding stability.

However, excessive issuance of covered bonds can lead to risk concentration on both the asset and liability side of the issuer's balance sheet. In the case of the latter this can be particularly significant if the covered bonds displace retail funding in the overall funding mix. It can also have negative implications for the issuer's unsecured or subordinated debt ratings as the level of unencumbered assets available to cover these obligations declines.

There are various ways to form an opinion of what constitutes "excessive" issuance. Particularly in the newer covered bond markets, regulators have an interest in defining such levels. To date no real consensus has emerged from this perspective, as can be seen in the range of views from "no limit", for example in Germany and France, to an effective limit of zero, such as in Australia. From a rating agency's perspective the question of "excessive" needs to be examined from two distinct but complementary perspectives:

● Firstly, a major change in the funding mix of a bank, especially if it is at the expense of retail funding, could result in downward pressure on the bank's Issuer Default Rating (IDR). As a guiding principle, Fitch maintains that an increase in the use of covered bonds to more than 25 percent of total funding would result in an increased level of scrutiny of the overall funding mix of the bank in question. Of particular concern would be the displacement by covered bonds of retail funding. The displacement of other sources of wholesale funding would be less concerning.

● Secondly, there is a potential impact on the rating of senior unsecured obligations because of the reduced level of unencumbered assets available to cover senior unsecured obligations. This proportion will necessarily need to be considered on a case-by-case basis, using the Fitch recovery rating methodology. In some special cases, an institution could even have covered bonds funding up to 60 to 70 percent of total liabilities before this subordination effect puts pressure on the senior unsecured rating.

So far, the observed figures suggest that there is still significant capacity for further issues, particularly in countries like the UK. As expected, the proportion of covered bonds funding in Germany is much larger on average than in the rest of Europe because it is a far more mature and well-established market and has proportionately more specialised mortgage banks with long-term funding strategies specifically designed to support this business. However, the outstanding volume is declining in Germany due to a steady and ongoing decrease in public sector net issuance volumes.

In total, Fitch maintains ratings on 89 covered bond programs in 15 jurisdictions. The text is based on an extract from the study: "The impact of covered bonds issuance on bank ratings", 29 September 2008, available for free at www.fitchratings.com.