



Uncovering Covered Bonds

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"Imitation is the sincerest form of flattery"

Charles Caleb Colton (1780–1832) – English cleric, writer and collector

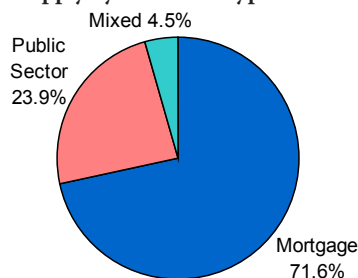
Introduction

A **cover band** is one that records songs that “were first recorded or made popular by somebody else.” The Beatles are the most covered artists in the music world. In the world of finance, it might soon be the **covered bond** market. A method of structured finance in Europe for more than 240 years, this market has the potential to become quite popular with structured investors in the U.S.

The first covered bonds originated in Germany (Prussia as it was known) in 1770. The bonds carried the name “Pfandbriefe” and were used to fund agricultural development. Since that time, nearly all European nations have adopted covered bonds as a means of financing.

In its simplest form, a covered bond is a collateralized bank obligation that is backed by a specific pool of assets, usually mortgage or public sector loans. Covered bonds have a fixed rate, a bullet maturity and are fairly liquid. The main difference between a covered bond and a securitized bond, such as a mortgage-backed or asset-backed security, is that the pool of underlying assets remains on the issuing entity’s balance sheet. This enables the investor to lay claim directly to the asset pool in the event of insolvency by the issuer. If the assets are insufficient to cover the claim, then investors have recourse to the issuer, ranking pari passu with existing senior debt. In a mortgage-backed security, the credit default risk is passed on to the purchasers, while in covered bonds, the risk remains with the issuer.

Figure 1. 2010 Supply by Collateral Type / Source: Barclays Capital



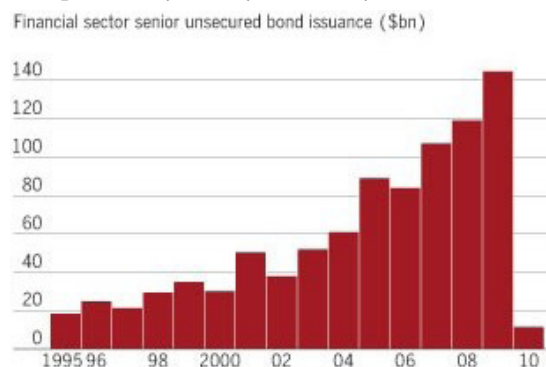
Market Growth and Performance

The market for mortgage backed covered bonds has grown substantially due to the lack of government-sponsored housing enterprises in Europe, such as the U.S. organizations Fannie Mae and Freddie Mac. Nearly 72% of 2010 issuance in Europe to date has been backed by mortgages. The total size of the covered bond market is estimated to be approximately \$2.9 trillion with more than 100 issuing banks. It is so large, in fact, that as part of their version of quantitative easing, the European Central Bank began a covered bond purchase program in May 2009.

The recent turmoil surrounding European sovereign debt and its effect on regional banks is causing issuance of covered bonds (with their collateral backing) to increase dramatically. Demand for other sectors is being crowded out as a result. Origination of senior

unsecured debt for the first six months of 2010 is at its lowest levels in more than fifteen years, as evidenced in Figure 2 below.

Figure 2. Corporate bond issuance dries up for European banks (in six week period May to early June each year) / Source: Dealogic

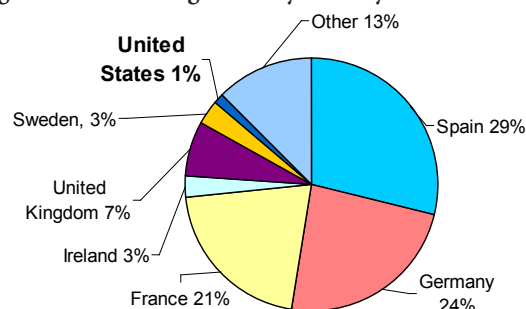


The performance of covered bonds depends upon the governing jurisdiction from which they are issued. The laws of the jurisdiction typically govern the types of assets backing the bonds, the minimum quality of the underlying assets, the loan-to-value ratio, over-collateralization levels, role of the regulator and steps taken in the event of bankruptcy. According to Bank of America, more than twenty-five countries have implemented specialized covered bond laws.

U.S. Market Poised for Growth

The market has been slow to develop in the United States due to the lack of a legal framework and the uncertainty of how covered bonds would fare in a bankruptcy situation. However, that sentiment has been evolving now that new accounting rules are forcing issuers to carry more collateral on their balance sheets. To date, there have been only two covered bond deals from U.S. domiciled banks. Washington Mutual was the first U.S. lender to issue in September of 2006 with a €4 billion deal (\$5.1 billion) while Bank of America soon followed with a \$2 billion deal in 2007.

Figure 3. Outstanding Bonds by Country / Source: Barclays Capital



In 2008, then Treasury Secretary Henry Paulson and other policy makers pushed for the creation of a covered bond market in the U.S., stating that Bank of America, Citigroup, JP Morgan and Wells Fargo were ready to begin issuing. At that time, Paulson introduced the framework for the establishment of a U.S. covered bond market.

U.S. Market will be Well-Regulated

In introducing the framework, one of the critical questions was what would happen to the bonds in the event of default. In a

bankruptcy situation, it was important that the governing body, the Federal Deposit Insurance Corporation (FDIC) not create a situation that would put depositors in conflict with investors. So, in July of 2008, the FDIC released a policy statement, created to ease uncertainty that covered bond assets would revert to FDIC in receivership.

Further refinements were made in December 2009, when Representative Scott Garrett (R-NJ) introduced a covered bond amendment to the Financial Stability Improvement Act of 2009. Garrett subsequently withdrew the amendment and reintroduced it in March 2010 as a bill (United States Covered Bond Act [USCBA] of 2010).

The USCBA of 2010 establishes the groundwork for a regulated covered bond market in the U.S. The bill covers eligible issuers, appropriate collateral and collateral enhancement requirements, testing to verify sufficient coverage, registration, reporting and default scenarios. It also provides for supervision by a regulator who will have final approval on eligible assets for covered bonds and will establish over-collateralization minimums.

The law governing covered bonds in the U.S. differs from the European legal framework. It provides for multiple asset classes in addition to mortgage and public sector loans. U.S. banks also are allowed to issue debt to provide funding for residential and commercial mortgages, as well as auto, student, credit card and small business loans.

However, we believe the most important aspect of the bill is that it allows for private funding of the consumer mortgage market. The opening of the covered bond market would free up the residential mortgage market, providing alternatives to Fannie Mae and Freddie Mac. A sizeable covered bond market will allow for an orderly wind down of Fannie or Freddie without disruption to the mortgage market.

The timing and adoption of the bill are still uncertain at this point. Once a firm legal framework is in place and the rules of the game are known, it is anticipated that several issuers will tap the market.

Benefits to the Issuer

What are the benefits to a firm issuing covered bonds versus other methods of raising capital?

- 1. Credit Ratings:**
The quality of the underlying assets and the enhancement allow for potentially higher credit ratings than those of the issuer itself.
- 2. Cheap Funding:**
Higher credit ratings equate to lower interest costs for the issuer.
- 3. Quality of Assets:**
Covered bonds provide the issuer with a stronger alternative to mortgage securitization. The underlying mortgages have higher underwriting standards since the mortgages are kept on the balance sheet.
- 4. Diversification of Financing Sources:**
Covered bond issuance gives financial entities the ability to tap another sector for funding needs. This is especially important since issuers would have access to liquidity in highly volatile markets and put less pressure on the Federal Home Loan Bank (FHLB) system for financing advances.

Advantages to the Investor

- 1. Credit Quality:**
The structure and quality of the underlying assets give most covered bonds a double or triple-A rating. Covered bonds use over-collateralization for credit enhancement.
- 2. Yield:**
While the yields on covered bonds may not be as high as unsecured corporate debt, the bonds still offer a spread pickup over government securities.

- 3. Diversification/Prepayment Protection:**
Investors leery of investing in mortgage-backed securities can get mortgage exposure with a stable cash flow and high credit ratings.
- 4. Dynamic Collateralization/Full Recourse:**
If any of the assets in the underlying pool mature or are nonperforming, the issuer must replace these assets with high quality substitutes. In addition, the issuer must pay interest and principal due regardless of how the underlying collateral performs. The issuer, in essence, has "skin in the game."
- 5. Protection in the Event of Bankruptcy:**
Investors in covered bonds have a direct claim on assets backing the covered bonds, and these assets are separated strictly for the benefit of bondholders. If the issuing bank becomes insolvent, the process for dealing with the segregated collateral is determined by laws specific to the country of origin. In the United States, according to the FDIC, there are three possible scenarios in the event of an FDIC takeover (conservatorship or receivership):
 - a. The FDIC continues to make payments on the covered bonds as scheduled (continuation)
 - b. The FDIC pays off the covered bonds in cash up to the value of the pledged collateral (repudiation)
 - c. The FDIC allows the liquidation of the pledged collateral to pay off the covered bonds (acceleration)

Conclusions

The prospects for a regulated covered bond market in the U.S. may become a reality sooner rather than later, given the legislative framework and the advantages to issuers, investors and the mortgage market. In addition, if covered bonds backed by public sector loans in the U.S. also become popular, they may find a larger audience than those investors in the municipal bond market. Deals have the potential to be larger in size and may garner a wider group of investors who may not have been able to utilize the tax-advantaged characteristics of certain municipal securities.

Although the covered bond market may never replace the securitization market, it does provide a viable alternative that benefits the financial markets. Moody's already has stated that the adoption of a formal structure for covered bonds would be a credit positive for banks.

While the financial health of the European sovereign and banking arenas remains in question, there is hope the U.S. covered bond market can continue to make inroads and learn from history. Otherwise, the covered bond market may be an idea that goes the way of the most covered Beatles song in the world: "Yesterday." ♦

Darren K. Getek, Vice President and Trader, is primarily responsible for trading short-term investments, agencies and asset-backed securities, and he acts as back-up for mortgage-backed securities and commercial mortgage-backed securities. Mr. Getek was previously a Portfolio Manager with Conning before joining the Trading Group. Prior to joining Conning in 1996, he was employed by The Hartford as a supervisor in the Annuities Division and then as an Investment Accountant in their Investments Division. Mr. Getek is a graduate of Babson College with a degree in Finance.

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