Feature

COVERED BOND **SAFE HAVEN**

Events over the European summer gave covered bond issuers from some countries the chance to prove the relative safety of their products even in times of extreme volatility. However, the performance of covered bonds was not even, with some – particularly those from France and Germany – clearly outperforming covered bonds from issuers based in the US, the UK and Spain. And events in the primary market at the beginning of September show that even this asset class has not been completely immune from the sub-prime fallout.

No asset class was safe from the fallout produced by the US sub-prime disaster during the European summer months. However, outside the safest haven of them all – sovereign, supranational and agency bonds – both primary issuance and secondary performance levels reveal that investors in covered bonds got less nasty surprises than those with exposure to residential mortgage-backed securities (RMBS) and corporate senior unsecured bonds.

COVERED BONDS VS RMBS

As Christoph Anhamm, head of ABS and covered bond research at ABN AMRO in Frankfurt, explains: "Before the summer five-year prime euro RMBS was trading at around 10 to 11.5 basis points over mid-swap. By the end of the first week in September, these levels had blown out to 40 and over, depending on the geographical location of the issuer." In contrast, he says, while before a five-year euro covered bond product was trading at around three to five basis points through mid-swap, the average on screens in the first week of September was around one basis point over mid-swap.

However, to be fair, the widening of covered bond spreads of issuers from some countries is comparable with RMBS spread movements during the summer. As Laurence Ribot on the syndicate desk at IXIS Corporate and Investment Bank (IXIS) in Paris, points out: "Nationwide issued a five-year covered bond at the beginning of September at 15 basis points over mid-swap – which is three to four times the spread they could have issued at before the summer. Even a slight movement in spread to swap in the covered bond world can be quite dramatic, so while in general covered bonds have widened less, by proportion the most volatile segments of this market have widened in relative terms the same as RMBS."

HIERARCHY OF PERFORMERS

One result of the summer's credit crunch has been to increase the differentiation between covered bond issuers from different jurisdictions. The European covered bond market has grown to €1.8 trillion (US$2.5 trillion) of outstandings and is second in size only to the government bond market in Europe. And part of the growth has been due to the emergence of new players in covered bonds in the last few years, as different countries in Europe complete the process of phasing in covered bond legislation.

It is generally agreed that at the top of the hierarchy of performers sit the issuers from France (which issue *obligations foncières*) and Germany (which issue Pfandbriefe). In the middle

are the Scandinavian – in particular Swedish – covered bond issuers. And below are UK, Spanish and US covered bonds.

FRENCH & GERMAN PRODUCTS STAND OUT

Some say the difference in performance reflects the strength of covered bonds issued under legislative regimes and those – like the existing UK covered bonds – that are issued as structured covered bonds, without specific legislation. But this is too simplistic an explanation, says Lorenz Altenburg, syndicate manager at SG Corporate and Investment Banking in Paris. He points out that until recently UK structured covered bonds traded tighter than *cédulas* from Spain, which operate under a legal framework.

"French covered bonds have been the best performers," says one banker, "because there has been very little bad news on French banks during the summer."

In contrast, in Germany there was quite a bit of upskittling news over the summer – particularly the bailouts of IKB Deutsche Industriebank and SachsenLB (see feature p14). "In the few weeks up to mid-September," says Altenburg, "spreads on *obligations foncières* moved out only one to two basis points. But some Pfandbrief moved five to 10 basis points wider, depending on the credit."

Altenburg says the performance of German and French covered bonds during July, August and September this year proves that issuers from these countries – which have worked hard to convince investors around the world of the relative safety of their products – have not been simply banging their own drum while delivering this message. "You cannot exaggerate the relative safety of covered bonds," he says. "They have 60 to 75 per cent loan-to-value ratio, they offer overcollateralisation, and the cover pool is dynamic so if there is any problem, the assets can be changed."

Ribot at IXIS says one reason covered bonds from issuers in France and Germany have performed so strongly is their historical presence in the market. "Some of these issuers have been in the market for more than 10 years, so they have very deep investor bases," she comments. "And unlike some of the newer covered bond issuers, both French and German issuers of covered bonds have very strong domestic investor bases, which gives them more stability."

In addition, Ribot points out that the German issuers have not been that active in the last two years, while the French issuers have issued on average three benchmark-sized deals – generally in the region of €1 billion. "This is contrary to the big and frequent volume of some of the Spanish issuers," she says, adding that the newer and bigger-volume deals have greater liquidity, which in a bear market does not bode so well for their relative performance.

ABN AMRO's Anhamm adds that the way in which the French and German issuers continued to access the market reveals a key difference in strategy. "These issuers were testing the market over the summer," he says, "but in a different way." Unlike the UK issuers, for example – with the big HBOS and Nationwide deals issued at the beginning of September – the issuers from Germany and France were issuing via private placements, in small taps, to specific demand for high-quality paper. "So smaller *obligations foncières* and Pfandbrief deals were being done, at relatively tight spreads compared with other deals in the market," he comments.

Anhamm says French and German covered bond issuers have always tended to use times of tight spreads to tap bonds. "On the one hand you could say this is opportunistic, but on the other you may say that others should take a close look at this strategy of building up issuance volume slowly by tapping in smaller lines."

COVERED BOND INVESTOR BASE CHANGES

Another impact of the credit crunch on the covered bond world has been a shift in the traditional investor base of European covered bonds. As one banker explains: "Banks have historically been one of the strongest investor group for covered bonds, particularly the German banks. Over the summer, the German bank bid all but vanished." Anhamm confirms that since January 2005 45 per cent of Pfandbrief investors have been banks, which also make up 46 per cent for all other jumbo covered bond products.

Ribot adds: "If before we could rely on German bank investors buying 40 per cent on average of European covered bonds, and annual volumes are around €180 billion, you can see the impact the loss of this investor group could have on primary volumes going forward." Even if new deals can be brought at high volumes, she adds, it is likely issuers will have to pay more of a premium to attract new investors to the product.

This loss of a core investor group has not led to a complete halt on primary deals. ABN AMRO was one of the leads on the HBOS deal and Anhamm says although bank investors did not play a big part in the primary deal – 77 per cent of the bonds went to non-bank investors – the deal was "well oversubscribed". Says Anhamm: "In the current turmoil real money accounts will be the ones guiding us out of the crisis and these are the accounts that have started to cautiously put their fresh money to work in the secondary market."

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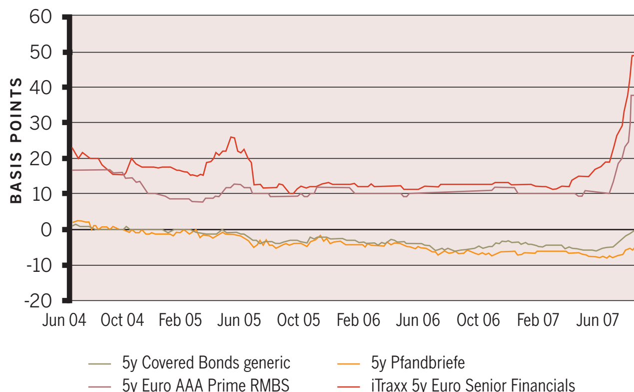
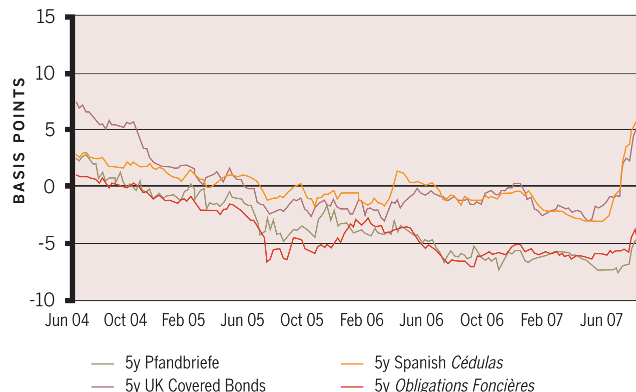
LORENZ ALTENBURG SG CORPORATE & INVESTMENT BANKING

COVERED BONDS VS RMBS AND FINANCIALS



SOURCE: ABN AMRO SEPTEMBER 7 2007

COVERED BOND PERFORMANCE



SOURCE: ABN AMRO SEPTEMBER 7 2007

MARKET-MAKING UNDER FIRE

One aspect of the jumbo covered bond market that is likely to change, however, is the formal (inter-dealer) market-making agreements in place – until now one of the biggest selling points of this market.

As liquidity evaporated in Europe over August and September, the most liquid products – among them covered bonds – were punished as banks across Europe looked for the easiest products to sell in their bid to shore up cash. By early September it became apparent that forcing market-makers in jumbo covered bonds to continue the established practice of trading bonds with each other at a fixed bid-offer spread, depending on maturity, was leading to some intense bad blood among some issuers and their dealers. Many market-makers started to call for a stop to the practice, accusing issuers of not understanding the situation.

As one banker says: "People have realised that market-making is fine when things are running smoothly. But it also provides anyone with a means of selling risk. Liquidity exaggerates the movements because if you are long UK RMBS and these products have gapped out 30 to 40 basis points, while UK covered bonds have remained relatively stable, you will hammer the UK covered bonds."

"Issuers have held a gun to our heads," says another banker, "and forced us to honour the commitment to make a price, albeit at three times the usual prices. Issuers are not at the front line, they don't realise what is happening – which is that these agreements give people an instrument to hedge and then the logical movements of widening or tightening get radically exaggerated."

The banker adds: "No-one has been duped into believing that market-making functions normally. Issuers have wanted to maintain the fiction of covered bond market-making and liquidity, which has cost the market-makers tens of millions of euros in the last few weeks. And all the issuers have done is shot-kicked their own goal. There is now a very bitter feeling in the market."

Ribot says what happened was a snowball effect, which resulted in even more volatility. "It drew attention to the flows between the market-makers, which did not reflect properly the value of credits. No-one would argue that the market needs to reprice. But the place to do this is in the primary market, not the secondary market, and particularly not when the trades in the secondary market between market-makers are so small," she comments.

ABN AMRO's Anhamm agrees. He says a substantial amount of the widening seen in the covered bond product over the summer – around 60 per cent – was due to the market-making commitments in place. "It has become obvious that the system set up for covered bonds is not working well in a time of a severe liquidity crunch," he comments.

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CHRISTOPH ANHAMM ABN AMRO

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LAURENCE RIBOT IXIS CORPORATE AND INVESTMENT BANK

PRIMARY MARKET ROUT IN UK

The situation with regard to market-making was one reason for events in the primary market in the week beginning September 3, say market participants. Two UK-based issuers dipped their toe in the benchmark covered bond market during this week. At the same time, rumours were circulating in the market that some market-makers, in a bid to loosen the bid-offer spread commitment, were lobbying to split the market by differentiating between 'core' covered bonds (from Germany, Austria, France, Luxembourg and Depfa Bank) which would be traded at twice the normal bid-offer spreads; and 'non-core' covered bonds which would trade at three times the normal spread. Although this move was nipped in the bud, it certainly caused further volatility in an already fragile market.

On September 4 HBOS priced a three-year €2 billion UK structured covered bond at five basis points over mid-swap, followed the same day by Nationwide's €1 billion five-year structured covered bond, marketed at 11 to 12 basis points over mid-swap and priced at 15 basis points over mid-swap.

What was thought to be a ground-breaking deal in opening up the primary benchmark market for covered bonds backfired horribly for HBOS and its leads in the ensuing turmoil. Many bankers will not comment on the record about what happened, but sources at two of the lead managers on the HBOS deal say the Nationwide transaction, which came on screens half an hour before HBOS priced, caught the market by surprise. They claim that while the HBOS deal had been through a few days of pre-sounding the market before being announced on screens and priced the following day, there was little information before the Nationwide deal was announced.

Says one banker: "It is true that HBOS was issuing into a weak market. But when Nationwide came on the screens offering plus 11 or 12 over mid-swaps for a five-year deal, investors started wondering what was next. It smacked of desperation on Nationwide's part – especially when the deal priced at 15 basis points over mid-swaps."

But Armin Peter, director and head of covered bond syndicate at UBS in London – one of the leads on the Nationwide deal – strongly disputes this claim. According to Peter, the rout that followed the pricing of these two deals had more to do with the confusion caused by the ACI to discuss a split of covered bond markets into 'core' and 'non-core' than with the timing of the Nationwide deal. And, agreeing with Ribot's earlier comment, he adds that it was always going to be the primary market to lead a repricing of secondary markets, which was not an easy exercise in the midst of such volatility and uncertainty.

REPRICING THE MARKET

We had over €1 billion of interest in our pre-sounding," says Peter. "Of course we knew that HBOS was in the market (and others intended to issue as well) with a three-year deal, while investors indicated an interest in a five-year Nationwide transaction to give a further indication of repricing of the credit curve." He adds that the marketing range was reasonable considering the longer maturity and the differences between the Nationwide and HBOS credits.

That the Nationwide deal priced at 15 basis points over swap is purely an indication of investor demand, says Peter. As the leads went back to investors to confirm their orders, Peter says there was a mixed reaction. "All but two accounts reconfirmed their orders," he comments. "And a third – cornerstone – investor said they would buy the bonds, but at a higher spread to mid-swaps although in line with the continued repricing seen in the secondary market at that time."

At this stage, the issuer had two choices, says Peter. "Nationwide could have opted to pull the deal, which would have created even more volatility. Or it could do the deal at the higher price – where real investor demand was."

Unfortunately, these two deals were followed by extreme volatility in the UK mortgage bank sector – first, when Victoria Mortgages, a small sub-prime lender owned by Venturion Capital, a US private equity group, became the first UK casualty of the sub-prime crisis after a lack of funding forced the company into administration. This was followed by news that Northern Rock, one of the biggest UK-based mortgage banks, announced it had gone cap-in-hand to the Bank of England for emergency funding, on September 13 (see KangaTrends p6).

By September 17 the European covered bond market was still in recovery stage from these events, with most bankers predicting a few weeks of stabilising before the primary market opens once more. •

Editor's note: HBOS plc debuted in the Kangaroo bond market in April 2007 with a A$200 million (US$168 million) fixed rate and A$400 million floating rate 10 non-call five deal. Nationwide has issued once in the Kangaroo bond market, bringing A$380 million of fixed rate and A$120 million of floating rate three-year notes in February 2001.