

A Quick Guide To Covered Bonds

Summary

- On 17 October 2011, legislation came into force allowing Australian banks to issue covered bonds.
- Covered bonds offer an appealing bank funding option—if properly structured, they should help banks lower their funding costs, easing the pressure on profit margins.
- They allow Australian banks to access a larger investor pool, especially in Europe where covered bonds are popular investments.
- They also offer investors another range of high-quality credit investments.
- However, investors should be mindful of the risks they entail—they are still bank debt and not a direct substitute for government-guaranteed bank debt.

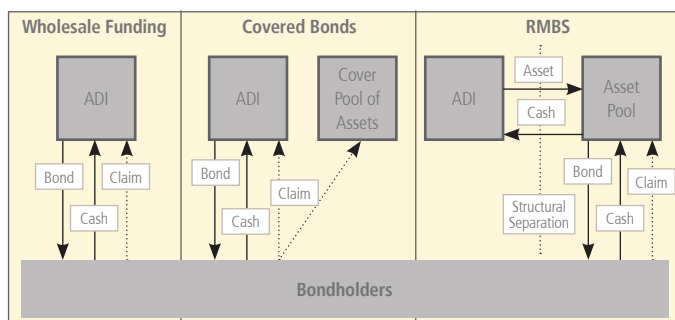
What is a covered bond?

It 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 cash flows are funded by the bank and not by the cash flows of the pool of assets. Hence, a covered bond has regular payments and no prepayment, thereby resembling a traditional bond issue.

The key feature of covered bonds is that investors have *dual recourse to the bank and to the collateral*. Senior bank investors can only claim on the bank and residential mortgage-backed securities (RMBS) investors can only claim on the collateral. Unlike an RMBS, covered bond collateral is normally refreshed regularly to maintain the pool’s quality.

Note: the assets used to provide the cover must be assigned unambiguously to the covered bond issue so there is a reduction in the amount of assets available to other unsecured lenders.

Covered Bonds Provide Investors With Dual Recourse



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 another option in a bank’s funding mix. They are targeted to replace government-guaranteed bank paper issued during the height of credit crisis which is starting to mature at the end of the year. They may enable mandate-constrained investors in guaranteed bank debt to continue sourcing AAA-rated debt of Australian banks. However, it must be stressed that government-guaranteed bank debt is an exposure to the sovereign.

Larger investor pool

Senior debt of the Australian major banks has long been supported by international investors. 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—the introduction of a covered bond market will put the major banks on a level playing field with their offshore counterparts.

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. In the current circumstances, covered bond programs benefit major banks more than the non-majors.

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. Ability to access the covered bond market is a credit positive for bank ratings. But it may be a negative for the rating on its 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 with unsecured senior bank debt.

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. Rating agencies have recently considered as a positive a bank’s ability to maintain a longer maturity profile.

A Quick Guide To Covered Bonds

Fact Sheet

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. They can potentially offer an alternative to supras or government-guaranteed debt. However, in Australia, the liquidity of these bonds is still reasonably uncharted and may limit interest.

Inter-bank buying

For Australian banks, covered bonds could potentially help address the problem of liquidity assets shortfall under Basel III, which indicates that covered bonds will be a level 2 asset, provided they hold a credit rating of at least AA-. As such, covered bond holdings will be limited to 40% of total liquid assets and subject to a 20% discount in their face value to account for the higher risk. Given the lack of qualifying liquid assets under Basel III in Australia, it may be appealing for bank treasuries to buy covered bonds as part of their liquidity strategy.

Secured debt status

The secured nature of covered bonds attracts different types of investors, particularly Europeans who understand covered bonds and have a long history of investing in them. The new law provides the opportunity for Australian bank covered bonds to tap into the European covered bond market, which is large and deep.

Considerations and risks for investing in covered bonds

Correlation risk with bank senior risk

Covered bonds are inherently linked to the credit risks of the issuing bank. If an issuer has been generating weak assets then it will suffer and the credit quality of the cover pool may also be tainted.

From a portfolio investment and management perspective, Tyndall treats covered bonds as part of its exposure to the issuer and not as a separate new credit. We will manage covered bonds according to our credit policy on individual bank name risk and don't regard covered bonds as a different asset class.

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. Although with a cap of 8% of total assets, Australia's covered bond program should have very limited impact on senior debt.

Conclusion

Covered bonds could help mitigate some imminent problems facing domestic banks by broadening issuing options. For investors, covered bonds offer another range of high-quality credit investments but they are still bank debt. As investors, Tyndall will consider covered bonds based on whether their price reflects the correct compensation for credit risk and liquidity.

For a full and detailed description of covered bonds and their relative risks and benefits, please refer to our April 2011 article titled "Are covered bonds the solution?", available at www.tyndall.com.au or by contacting us.

Prepared by Tyndall Investment Management Limited
October 2011

For further information please contact:

John Sorrell
Head of Credit
john.sorrell@tyndall.com.au
02 8072 6357

or

Ileria Chan
Senior Credit Analyst
ileria.chan@tyndall.com.au
02 8072 6351

Disclaimer

This document was prepared and issued by Tyndall Investment Management Limited ABN 99 003 376 252 AFSL No: 237563 ("TIML"). The Tyndall managed funds are issued by Tasman Asset Management Limited ABN 34 002 542 038 AFSL No: 229664 ("TAML"). The information contained in this document is of a general nature only and is not personal advice. It is for the use of researchers, licensed financial advisers and their authorised representatives. It does not take into account the objectives, financial situation or needs of any individual. Investors should consult a financial adviser before acting on the information contained in this document. Investment decisions should be made on information contained in the current Tyndall Fixed Interest Product Disclosure Statement ("PDS") and its Supplementary PDS ("SPDS") available at www.tyndall.com.au. Applications will only be accepted if made on an application form attached to the current SPDS. Past performance is no guarantee of future performance. TIML and TAML are subsidiaries of Nikko Asset Management Co., Ltd. (Nikko AM).