Covered bonds – resilience in times of uncertainty

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WHILE COVERED BONDS STILL PROVE TO BE A RELIABLE INSTRUMENT TO OBTAIN FUNDING, EVEN IN TIMES OF UNCERTAINTY AND GLOBAL FINANCIAL DISTRESS, THEY ARE NONETHELESS STILL APPROACHED WITH SOME TREPIDATION, LARGELY DUE TO THE CURRENT SUSPICION SURROUNDING ALL ASPECTS OF THE FINANCIAL WORLD. DESPITE SOME EFFORTS SPECIFICALLY DIRECTED AT SUPPORTING THIS STRUCTURED DEBT SEGMENT, THE COVERED BONDS MARKET HAS NOT QUITE MANAGED TO ENTIRELY ESCAPE THE CRISIS.

Since the inaugural 'Portuguese Covered Bond' issue was completed in late 2006 by Caixa Geral de Depósitos, S.A., a major Portuguese commercial bank fully owned by the Portuguese Republic, the Portuguese covered bond market has experienced different trends, but it is fair to say that covered bonds have consistently been viewed by market players – including regulatory entities – as a very robust instrument. This mainly derives from the fact that covered bonds benefit from a legal and regulatory framework that in essence allows the detachment of valuable assets from a bank's overall estate and the allocation thereof to a segregated and independently audited pool, ring-fenced for the benefit of the holders of covered bonds.

Therefore, despite the permanent challenge that placing debt constitutes nowadays (particularly when issued outside of a Euro area periphery country), the attractiveness of this particular debt instrument has not completely faded, and the six banks that have established covered bonds programmes since 2006 were joined by another two in 2010 and 2011.

To a great extent this attractiveness arises from the specific framework governing covered bonds: the ring-fencing of the assets, and the fact that covered bonds are otherwise ordinary corporate bonds – therefore allowing ultimate recourse to the remainder assets of the relevant issuer – have historically justified the assignment to covered bonds of significantly higher ratings than those of the issuer of the instruments, and in most cases also above the sovereign rating of the country out of which the bonds are issued – although this may not continue to be true for much longer.


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In a context where the banking sector is struggling for liquidity, the possibility of obtaining funding using the banks' own assets – which for all purposes remain in the banks' balance sheet – to collateralise the issue of a (highly) rated instrument seems to be the perfect deal.

A further advantage that this instrument presents, especially when considering the current limited market funding alternatives, is the fact that covered bonds are considered 'Eurosystem eligible', thus enabling the relevant issuers to use them as collateral for the European Central Bank (ECB) repo transactions. In fact, it can be said that, at present, covered bonds together with securitisation appear to be the most readily available sources of funding for banks in Portugal.

Following the advice of the generality of banking regulators for banks in the European economic area to diversify sources of funding among private market players, as a way of progressively abandoning ECB dependency for liquidity purposes, another tendency has arisen in recent times: the issue of covered bonds has began to appear as a useful tool in transactions between financial institutions, in which this instrument can be used as collateral, in the form of repos, securities lending deals or similar structures.

As a way of stimulating this structured debt segment, in June 2009 the ECB announced that it would establish a programme for the acquisition of covered bonds, both in the primary and secondary markets, with the goal of providing liquidity to this particular market.

The programme was implemented between July 2009 and June 2010 and many Portuguese covered bonds issuers resorted to it, even if there were a number of eligibility requirements which had to be complied with. In fact, the ECB was willing to purchase only covered bonds rated at least 'AA' (or equivalent) by one of the major rating agencies, and the bonds had to be simultaneously eligible for Eurosystem operations.

The stimulus resulting from the ECB acquisition programme may have been the cause for 2010 beginning with significant issues of covered bonds by Portuguese issuers, even though it is not possible to categorically state whether or not it worked as a true incentive to this market in Portugal, as the effects of its closing down are not immediately perceptible.

Alongside these stimulation measures, some not-so-beneficial-events have occurred and significantly impacted Portuguese covered bonds. 2010 was an active year in terms of ratings downgrading action over the Portuguese Republic, which inevitably also impacted the ratings assigned to Portuguese banks. This fact, along with the general sentiment of uncertainty which stemmed from the rescue schemes put in place in Greece first and then Ireland – with many betting Portugal as the next natural candidate – may have been a key factor in the development of a new trend of suspicion on the part of rating agencies as far as covered bonds rating rules are concerned.

As a natural development of the above, Standard and Poor's decided to re-evaluate the rating criteria applicable to covered bonds, proposing a tighter linkage between the rating assigned to the instruments and that of the relevant issuer.

Until then, mainstream understanding indicated that covered bonds represent an instrument essentially supported by underlying valuable assets, since the mortgage credits forming part of the cover pool are required to comply with strict loan-to-value (LTV) and performance requirements. In addition, by law covered bonds are mandatorily segregated from the remainder of the issuer's estate, and are therefore unable to meet the claims of creditors of the issuer, other than the holders of the covered bonds. Even the legally established, and for some time now unquestioned, principle that in the event of an insolvency of the issuer the mortgage credits included in the cover pool would be taken out of the issuer's control and placed, by the Bank of Portugal, with another credit institution in financial health, who would then manage the pool and make the required payments to the holders of covered bonds, ceased to be a good enough argument from the rating agencies' perspective.

Standard and Poor's unprecedented approach was shortly followed by Moody's and then by Fitch, who also followed the route of reassessing the criteria used to evaluate covered bonds issuances, showing wider and more diversified concerns in respect of the structures which had been in place for a considerable amount of time.

As such, variables like the refinancing cost of the relevant issuer and the risk of the lack of liquidity available to make interest payments on covered bonds on the due dates in case of the issuer's downgrade turned into actual concerns for rating agencies, with correspondent mitigant devices are being put in place across covered bonds programmes as a way to give comfort to raters.

As a result of the new approach adopted by rating agencies, a number of issues of Portuguese covered bonds were downgraded in July 2010, after having been placed on negative watch for re-evaluation. The main reason presented for this downgrading action was the rating downgrade of the corresponding issuers and of the Portuguese Republic, which impacted the expected loss evaluation criteria, although the perception that refinancing margins in Portugal were progressively escalating was also viewed as a negative factor. All in all, the level of overcollateralisation for the issues under the covered bonds programmes at stake were found to be insufficient when considering the expected loss levels calculated in accordance with the approved criteria.

The criteria adopted by rating agencies are undoubtedly a result of a more cautious approach and naturally seem to be less favourable for this instrument, in terms of result, than the ones previously in place. Although this may come without surprise considering the context in which we presently live, the truth is that covered bonds in Portugal are a strongly robust instrument and continue to present many advantages, especially when compared to other debt instruments.

As far as the robustness of covered bonds issued under Portuguese law is concerned, it should be highlighted that not only are the requirements – in terms of LTV and overcollateralisation established in Decree-Law 59/2006 of March 20, 2006 (the 'Covered Bonds Law') and in the Bank of Portugal regulations – extremely demanding, but also the very quality of the assets included in the cover pool shall not be underestimated. When considering asset performance, the fact that, in general, the so-called 'sub-prime' mortgage loans effect associated with the financial crisis (mainly in the US), did not actually have a significant expression in the Portuguese mortgage market is of prime importance. It is widely thought that Portuguese mortgage lending commercial banks have always had a relatively conservative approach to mortgage credit granting, with adequate and thorough evaluation of the assets as the rule of thumb.

Furthermore, the 'Covered Bonds Law' also established a number of different devices designed to ensure that the segregation and overcollateralisation principles from which the creditors of covered bonds benefit in respect of the assets are observed. As such, all assets comprised in the cover pool (including collections) are required to be adequately registered in segregated accounts of the issuer and to be identifiable as pertaining to the cover pool at all times.

The register in segregated accounts is in fact the key factor in terms of setting the boundaries of the estate allocated to the issues of covered bonds, considering that the special creditors' privilege is not subject to public registration (or registration with the real estate registry office where the mortgaged properties securing the credits are registered). And as a result the legal effect of such security entitlement derives strictly from the 'Covered Bonds Law' and is proven by the register of such assets in the segregated accounts of the issuer.

A further characteristic which provides additional assurance in respect of the structure underlying Portuguese covered bonds programmes is that the fulfilment, by issuers, of the obligation to comply with the aforementioned segregation principle is closely monitored by the Bank of Portugal and by the cover pool monitor – an independent auditor legally and contractually obliged to analyse and evaluate the pool of assets allocated to the issues of covered bonds. In fact, issuers are required to report information to the Bank of Portugal on a monthly basis while the cover pool monitor submits an annual report in relation to the assets to both the issuer and the

Bank of Portugal, including thorough information on such assets and their performance.

Ultimately, when considering the aforementioned features together with the fact that, on the one hand, the nominal principal amount of covered bonds outstanding cannot exceed 95% of the outstanding underlying mortgage credits and, on the other, the amount of interest payable on the covered bonds is also closely linked to that due under the segregated mortgage credits, one is forced to conclude that covered bonds still appear as a highly reliable financial instrument which we believe will continue to play a crucial role in Portuguese banks' ability to raise the necessary levels of funding.

As a final word, it should be mentioned here that the shape of banks designed under Basel III heralds a further important role for covered bonds (rated AA- or better for which there is an established liquid market) as they may qualify as a high-quality liquid asset for the purposes of calculation of the new liquidity coverage ratio.

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