An Examination of Covered Bonds

Bachelor Thesis in Banking and Finance

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Executive Summary

Problem

Covered Bonds are one of the most important refinancing instruments for banks in Europe and the respective market is one of the biggest private debt markets. Nevertheless, there is very little academic research on this topic. Since each country has adopted its own Covered Bond legislation, Covered Bonds might be treated very strict in one country but very limp in an other. Therefore, this paper compares several legal frameworks and overviews the Covered Bond topic from a theoretical perspective. Additionally, we analytically investigate the historical development of the Covered Bond market in terms of outstanding amount and riskiness.

Method

This thesis is split into three parts. The first part is based theoretical literature such as the Covered Bond Fact Book provided by the European Covered Bond Council (2011). In a first step, we propose a definition for Covered Bonds, then we introduce different issuance structures applied in different countries. Afterwards, based on existing literature, we state differences and convergences between Covered Bonds and mortgage-backed securities (MBS). In the last section we compare different legislations or contractual frameworks. In the second part, we compare the rating methodologies of the three big agencies Fitch, Moody's and Standard & Poor's and discuss the single procedures in detail. The last part of the thesis provides a market overview for Covered Bonds. In a first step, we analyze the outstanding amounts of Covered Bonds. Secondly, we analytically compare the development of average weekly Covered Bond prices and yield spreads for three different sub-samples: (i) by country, (ii) by country and collateral type and (iii) over all countries by collateral type. We examine data on 23,363 Covered Bonds which stem from Bloomberg and Datastream over a period from January 2005 until May 2012.

Results

In the first part, the developed definition consists of a list of requirements for Covered Bonds. We conclude, that a Covered Bond needs to be issued by a credit institution and that the size of the dynamic and monitored cover pool has to fit at least the outstanding bonds. Furthermore, the investors have a double recourse and their claims are ensured by protection mechanisms. Then, we inaugurate four different ways to issue Covered Bonds. The four structures are the *Direct Issuance*, the *Pooling Model*, the *Issance by a specialized Funding Institution* and the *Issuance using a SPV*. We do not find one structure superseding all other since we see advantages and disadvantages in every model. In the next section, we compare Covered Bonds and MBS. We state that MBS benefit from the independence of the issuer, the high transparency of the cover pool and lower market risk. Otherwise, Covered Bonds gain from the strict legislation, the higher quality of the cover pool and the double recourse. When comparing the legal frameworks, we find great distinctions between

the Anglo-Saxon countries and traditional European Covered Bond markets. Moreover, we observe clear distinctions between all legislations.
We find some convergences when analyzing the methodologies of the rating agencies. All rating agencies rate Covered Bonds on a joint-default basis meaning that the issuer rating is both, the starting position and the lowest achievable rating. The uplift above the issuer rating is calculated differently. Fitch investigates the indipendence of the cover pool from the issuer. Moody's focuses its analysis on the expected loss and on the probability of timely payments continuing after an issuer's default and S&P's approach is to analyze asset-liability mismatches.
The first section of the last part examines the outstanding amount of Covered Bonds denominated in euros. Our investigation shows, that the outstanding amount of Covered Bonds backed by public sector loans has declined. The main driver behind that trend is Germany, where several legal amendments reduced the attractiveness to issue public Covered Bonds. On the other hand, the amount of outstanding mortgage Covered Bonds has increased in the last years. This trend is caused by the exploitation of new Covered Bond markets and the expanding amount of mortgage Covered Bonds in the established countries. The second purpose of the last part of the thesis is to explore the performance and the riskiness of the Covered Bond market. We find higher yield spreads for the U.S., Britain and Ireland immediately after the Lehman collapse compared to the other countries. With the beginning of the debt crisis, the spreads for countries deep in debt increased dramatically. For five countries we investigate differences between the certainty of public Covered Bonds and mortgage Covered Bonds. We find obvious differences only in countries which are struggling because of either a debt or a mortgage crisis. Additionally, for the differences of mortgage and public Covered Bonds we make a comparison over all countries. We find slightly higher spreads for mortgage Covered Bonds during the subprime crisis. With the beginning of the debt crisis we cannot observe any obvious differences.

Evaluation

When comparing the legal frameworks, we focus on the, in our view, most relevant criteria. We believe that the main differences between the legislation is caused by those properties. But there may be other differences not considered in this thesis which have a big influence as well. We discuss the procedures of the rating agencies in detail. But even after this study, the transparency of the methods is not fully assured. By making use of an application example, we realize that the assignment of a rating is not fully comprehensible. Since our analysis of the market development is based on analytical methods or descriptive statistics, our findings could be revised by statistical models.