



An introduction to covered bonds

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With issuance so far this year already at £6.7 billion - and set to grow further - compared to just £1.1 billion for the whole of 2010, the signs are that covered bonds are becoming established as a core asset class within the sterling credit market. By contrast, whilst material issuance of sterling covered bonds is a relatively new phenomenon, the sector's roots run deep in mainland Europe, where the market has well over two centuries of history and a current value of more than €820 billion.

So what are covered bonds? Covered bonds are senior, regulated debt instruments issued by banks and backed by a pool of assets, including mortgages (both residential and commercial) and public sector loans. The mortgage-backed covered bond market is the largest segment in terms of volume and geography, while the public sector loan segment is only sizeable in four markets, most notably Germany, where they are known as 'Pfandbriefe'. It is worth noting that in over 200 years there has not been a single instance of a covered bond defaulting.

In the UK, all covered bonds that have been issued recently are AAA-rated, backed by residential mortgages and are materially over-collateralised – in other words the value of the mortgages significantly outweighs the debt secured against the loans. The extent of the over-collateralisation has been driven primarily by more stringent requirements imposed on the rating agencies for providing AAA ratings in the aftermath of the credit crisis.

As well as the significant credit enhancement that over-collateralisation brings, within the UK regulated covered bond market individual eligible residential mortgage loans must all have a maximum loan-to-value level of 80% at the time of entering the pool. Furthermore, unlike RMBS (residential mortgage-backed securities) and other asset-backed deals, the mortgage assets remain on the issuing bank's balance sheet, while crucially, in the event of insolvency, holders of covered bonds have 'double recourse', to both the portfolio of eligible assets and the issuer's balance sheet, where they rank equally with other senior creditors.

Looking ahead, banks face significant funding headwinds, compounded by the regulators seeking to ensure that in times of distress the burden is shared across the whole capital structure, including equity, subordinated bonds and senior unsecured bonds. Therefore with covered bonds being viewed as more sacrosanct by the regulators, as well as being likely to receive more favourable treatment under new liquidity regimes, we think that this is an area of the UK market that will continue to grow dramatically.

We see considerable value in these instruments given their protective features, and we have participated in all recent sterling issues, including those from Lloyds and Abbey, as well as Yorkshire, Leeds, Nationwide and Coventry building societies. Our weightings have therefore broadly increased towards the 5% level. With the sector trading at a yield premium of 1.4-1.6% over government bonds, we believe

they offer considerable upside potential as the asset class becomes more developed, more widely understood and eventually re-rated, as the attractive risk-reward benefits are recognised.

Source: rlam as at 8th June 2011 unless otherwise stated.

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