



## Covered bonds and residential mortgage backed securities

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In recent years, the ability of banks to raise funds in the capital markets has been under pressure. This has encompassed both senior debt, due to increased regulatory discussion regarding possible 'bail-in' regimes and depositor preference, and subordinated debt, given significant ongoing uncertainty around the appropriateness of current hybrid structures. As such, the re-opening of the collateralised debt markets, which began in late 2009 and has gained further traction over the past 12 months, could not have arrived at a more opportune moment for banks.

There are two main forms of collateralised debt instrument available to retail banks – **Residential Mortgage Backed Securities (RMBS)** and **Covered Bonds** and in this note we outline some of the key features of these similar but subtly different securities.

Briefly, residential mortgage securitisation involves the creation of a 'ring-fenced' special purpose entity that funds the purchase of a pool of mortgage assets from the originating bank through the issue of RMBS. The role of rating agencies is pivotal in the structuring of these deals as it is their assessment of the underlying quality of the mortgages, and the stresses that the pool can endure, that determines the level of 'over-collateralisation' (OC) or credit enhancement that is required for the deal to achieve AAA ratings. In effect, the lower the quality of the assets the less debt that can be issued due to the higher amount of 'equity' the structure needs to absorb expected future losses and vice versa. This process of 'structuring' or separation of the assets from the bank is important because it de-links the rating of the RMBS and the performance of the assets from the wider performance of the originating bank. Indeed, at a time when rating volatility is increasing, the greater 'theoretical' stability of RMBS ratings has undoubtedly helped to make them more attractive to the fixed interest community.

Perhaps surprisingly, given its high profile role in the credit boom and subsequent bust, RMBS was one of the first forms of securitisation to come back to the sterling bond market when Nationwide Building Society issued a five year fixed rate bond out of its Silverstone Master Trust in late 2009. This was followed in relatively quick succession with successful deals from Lloyds and Santander. Less than two years later, the market is now functioning effectively and issuance, whilst nowhere near the levels seen leading up to 2007, is reasonably frequent, albeit largely focused on the floating rate note (FRN) market. Telling evidence of the market's continuing rehabilitation was provided in April as Northern Rock was able to securitise a pool of prime mortgages in a vehicle called Gosforth Funding.

While the availability of RMBS funding has undoubtedly been a positive for the retail banks, issuers have had to pay a considerable price to open up the market. Coupons/yields on new prime UK RMBS deals (AAA), secured on mortgage assets with average loan to values (LTV) around 50% are typically as high as 1.7-1.9% more than gilt yields. To put this into context, the relatively cyclical sterling BBB Industrials benchmark, which only includes unsecured corporate bonds, currently provides a spread of only 1.8% more than gilts.

Furthermore, this price has gone beyond the direct cost of debt. The rating agencies, stung by the criticism of alleged over-rating of previous securitisations, have reacted by demanding considerably more credit enhancement from issuers to achieve AAA ratings. By way of example, the Gosforth Funding transaction securitised £1.5bn of the highest quality prime residential mortgage assets, with a maximum LTV of 85% and an average LTV of 53%, yet was still required to include enough credit enhancement to withstand 13% of loan losses within the deal at the AAA level (which contrasts with low single digit credit enhancement pre-credit crunch). To date eligible Northern Rock mortgages have suffered zero losses and there are currently no arrears in the secured pool. In more generic terms, RLAM's

analysis of the amount of mortgage defaults such a structure could withstand and maintain full asset coverage for senior bondholders is close to 100% on the basis of a 40% haircut in the value of the repossessed properties. This underpins our belief that a combination of the highest quality mortgage assets and significantly improved credit enhancement makes the new vintage of AAA UK RMBS deals unusually robust.

Covered bonds, despite having an extremely long history in European markets, are an even more nascent form of bank funding in sterling fixed rate markets. In fact, it was the arguably unlikely name of Leeds Building Society that opened up this market with a 10 year deal yielding 1.9% more than gilts as late as November 2010. This was subsequently followed by covered bond deals from Abbey National and Lloyds, as well as Nationwide, Yorkshire and Coventry building societies.

In broad terms, covered bonds share a number of common features with RMBS – not least that they are both secured on pools of mortgage collateral (typically residential). However, there are some equally crucial differences. Most notably, covered bonds remain fundamentally ‘credit-linked’ with the issuing institution as the charged assets remain on the banks’ balance sheets - covered bondholders have both a secured claim on these assets and an unsecured claim on the bank. As a consequence, there is an inextricable link between the senior unsecured ratings of the issuer and the issuer’s covered bond rating, irrespective of the magnitude of over-collateralisation provided by the pool. In almost all the issues outlined above, senior ratings have been high enough for the covered bonds to be rated AAA, although with possible downward momentum on senior bank ratings at present, there is a risk that certain covered bonds may lose their top ratings.

UK covered bonds are regulated and legally required to maintain a minimum level of OC, which is generally c7-10%. Whilst this number is lower than the equivalent credit enhancement in recent RMBS deals, in practical terms, most covered bond issuers currently maintain OC well in excess of 20% - again largely because of more stringent rating agency requirements. In certain cases, the requirement to have OC levels that map to current rating agency methodologies is also mandated by the bond’s legal documents.

RLAM calculate that current pricing of covered bonds compared to unsecured senior bonds issued by the same institutions requires between 10-20% recovery on the underlying collateral and, by implication, yields on offer from the covered bond sector are significantly over-compensating for fundamental credit risk.

Whereas RMBS issuance has naturally settled on the shorter maturity FRN market in recent months, the more dynamic nature of covered bond assets – as maturing mortgages are replaced with newer eligible mortgages – lends itself more neatly to longer dated issuance. This provides investors with the additional benefit that they can lock in current coupons over a longer period and attain more material price upside should spreads over gilts fall to a level that we believe more appropriately reflects the credit risk.

Covered bonds and RMBS undoubtedly differ in certain regards, although the most striking feature is common to both. Quite simply, a combination of banks’ large appetite for new funding, market scepticism regarding asset-backing and dramatically increased rating agency stringency provides investors with an opportunity to buy into two low risk sectors at unusually attractive prices.

Source: rlam as at 14th June 2011 unless otherwise stated.

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