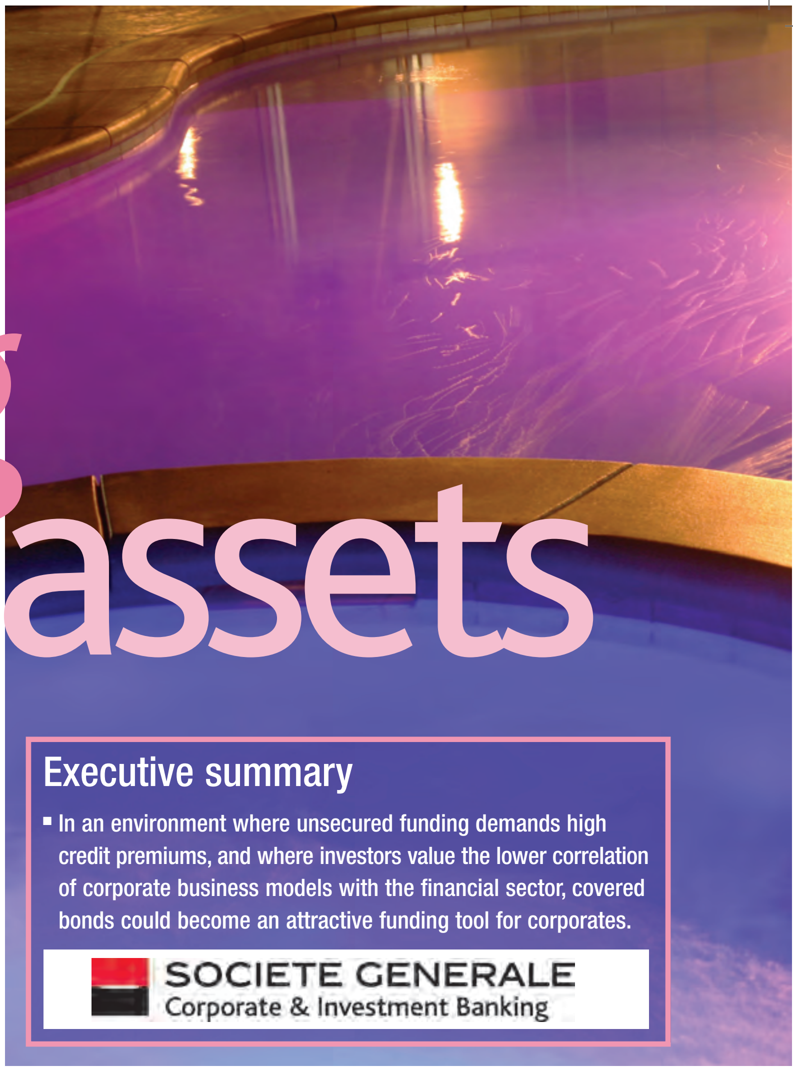
corporate finance
COVERED BONDS

Pooling your assets



Executive summary

- In an environment where unsecured funding demands high credit premiums, and where investors value the lower correlation of corporate business models with the financial sector, covered bonds could become an attractive funding tool for corporates.

SOCIETE GENERALE
Corporate & Investment Banking

Over the past 15 years, the covered bond market has developed into the most important segment of privately issued bonds on Europe's debt capital markets, with an outstanding volume of over €2,000bn at the end of 2007. Today, there are active covered bond markets in about 20 different European countries and issuers from the US and Canada have also joined the market. The market is strongly expected to attract new issuers and countries, especially since the securitisation market is in gridlock and senior unsecured funding costs have soared (see *Figure 1*).

A LONG-ESTABLISHED HISTORY Covered bonds are bonds secured by a collateral pool of financial assets, mainly public sector debt and/or mortgage loans. They have a long tradition in Europe and both bonds and collateral have developed since the covered bond concept was invented over 230 years ago.

Covered bonds offer high investor protection combined with little or no exposure to credit risk. Holders have a preferential claim against the collateral pool. Issuers have the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times, and their cover pool obligations in general are supervised by public or independent bodies. The dynamic collateral pool distinguishes covered bonds from securitisations, where investors have recourse to a static cover pool only, and could therefore face losses if asset defaults exceed expectations.

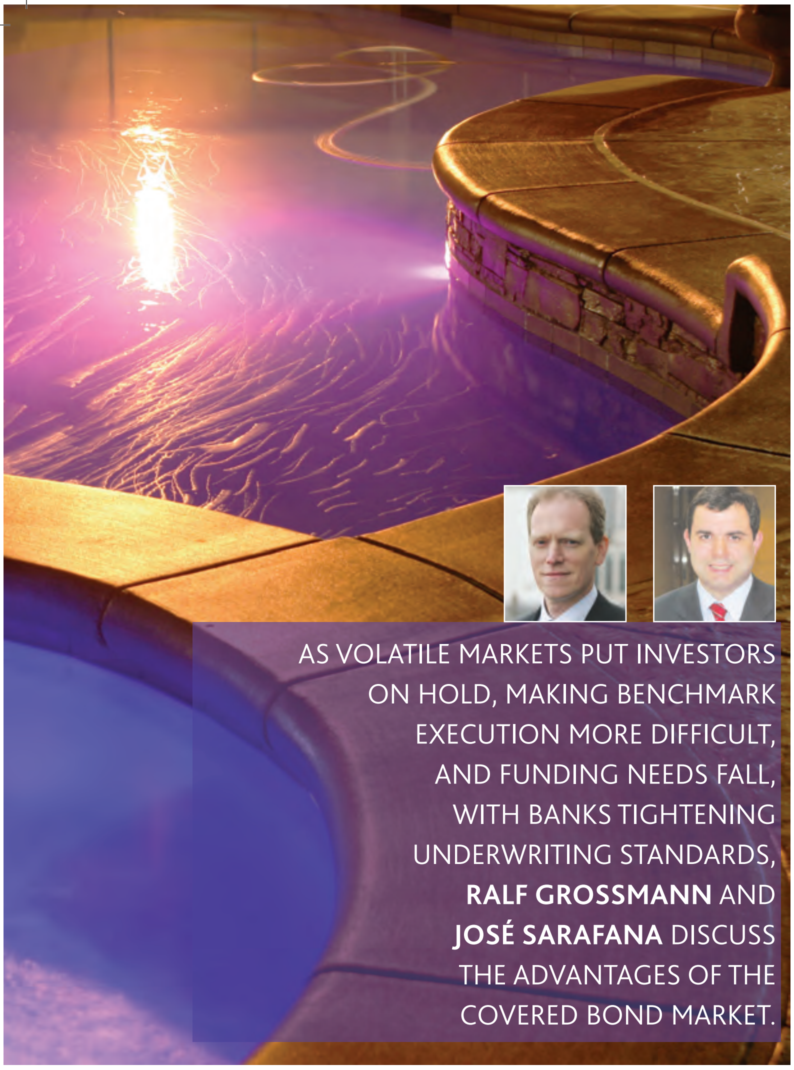
In most countries, covered bond issuance is regulated by a special legal framework, although in a few places the legal basis for covered bonds is provided by general insolvency law combined with contractual arrangements. Should the issuer default, covered bonds and the corresponding collateral pool are bankruptcy-remote. Payments to investors are made out of the collateral pool, in full and in due time. Most covered bonds have AAA ratings. Given compliance with special requirements, covered bonds can enjoy privileged treatment under EU financial investment regulations.

Investors perceive covered bonds as much safer than senior unsecured notes and will pay a higher price for them. Per-Âke Nyberg, Treasurer of Sveriges Bostadsfinansieringsaktiebolag (SBAB), a leading Swedish mortgage loan provider and frequent issuer of covered bonds through subsidiary SCBC, points out: "Investors in our covered bonds appreciate the Swedish covered bond law, which is one of the strongest in Europe, and that Sweden is one of the most solid economies in Europe with a healthy underlying mortgage market. Swedish issuers also benefit from a very strong domestic Swedish krona covered bond market with a solid domestic investor base, the fourth largest in Europe."

Table 1: Past and expected issuance (in €bn)

	2004	2005	2006	2007	2008e
Germany	48	48	42	33	37
Spain	36	52	65	36	15
France	11	8	18.5	43	42
Ireland	12	6	9.5	2.5	5
UK	9	12	20	16	10
Austria	2	3	1	1	2
Luxembourg	1	0	0	0.25	2
US	0	0	6	7.5	5
Sweden	0	0	6	4.75	10
Norway	0	0	0	4.75	6
Italy	0	4	4	0	10
Netherlands	0	0	4	5.5	10
Portugal	0	0	2	4.5	7
Finland	0	0	1	1	1
Denmark	0	0	0	0	5
Canada				2	8
Greece					8
Total	**119**	**133**	**179**	**162**	**175**

LONG-TERM EFFICIENCY Financing public sector, housing and other real estate activities usually requires long-term lending. Based on their own creditworthiness, credit institutions can generally obtain short-term resources (deposits, short-term bonds, and so on) much more easily than long-term resources to fund their lending activities in those areas. Covered bonds offer lenders an efficient long-term funding instrument for their long-term lending activities. The combination of covered bonds with specific lending (the mortgage or



AS VOLATILE MARKETS PUT INVESTORS ON HOLD, MAKING BENCHMARK EXECUTION MORE DIFFICULT, AND FUNDING NEEDS FALL, WITH BANKS TIGHTENING UNDERWRITING STANDARDS, **RALF GROSSMANN** AND **JOSÉ SARAFANA** DISCUSS THE ADVANTAGES OF THE COVERED BOND MARKET.

public sector loans that constitute the cover pool) allows the issuer to exploit more efficiently the characteristics of the lending (higher creditworthiness, long maturities, and so on) and to reduce mismatching of assets and liabilities.

Nyberg highlights another advantage: "Funding through covered bonds offers the investor diversification, both in terms of geography and investor category, and in the end lower funding cost and funding cost volatility."

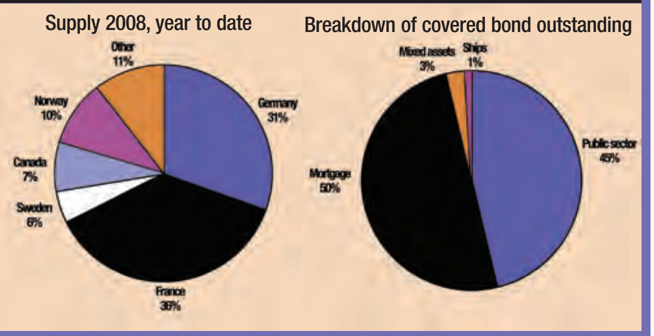
In the current debt capital market, with extremely large spreads for senior unsecured funding, covered bonds offer an attractive funding alternative at reasonable spreads at the short end. For example, the five-year senior unsecured credit default swaps (CDS) of French banks currently trade at 100-150bp over Euribor, whereas they would have to pay 10-30bp over Euribor for five-year funding through French covered bonds.

THE EURO JUMBO MARKET The most visible market area is the euro benchmark or jumbo covered bond market. The jumbo covered bond has a minimum volume of €1bn, with market making provided by investment banks and fixed-coupon standard bonds. The euro jumbo covered bond market has experienced tremendous growth over the past few years and has reached a total outstanding of more than €800bn. It offers issuers the possibility of raising large volumes of funding (bond size between €1bn and €3bn) at regular intervals.

However, private placements and currency diversification also play an important role in the covered bond market. As Nyberg explains: "We are one of Sweden's frontrunners in the covered bond market. In the jumbo market, SCBC has four outstanding euro benchmarks with a total volume of €4.3bn."

In the secondary market, covered bonds have experienced some volatility as a result of the credit market turmoil. Compared with strongly performing euro zone core government bonds (such as Bunds and OATs), covered bonds have underperformed, with noticeably stronger spread differentiation between the different bond segments. This has led to substantial spread premiums over swap rates, penalising Spanish and UK covered bonds in particular. As a result of these extreme market conditions, secondary market trading in jumbo covered bonds has run dry.

Figure 1: Covered bond market



The primary market for jumbo covered bonds has performed better. In 2008, issuance has been concentrated in the most stable sections of the covered bond market, short maturities out of Germany, France and the Nordics. Issuance volume in the year to date stands at €31bn compared to €51bn for the same period in 2007.

Société Générale expects total jumbo covered bond issuance volume for 2008 to reach €175bn, 8% higher than in 2007 but falling short of the record level of €179bn in 2006 (see *Table 1*). The current volatile market environment has put investors on hold, making benchmark execution more difficult. Moreover, funding needs are tending to decrease in some areas as banks tighten underwriting standards. The most affected market segments are Spain, the UK and the US. In contrast, conditions are more favourable in Germany, France, Sweden, Norway, Portugal, Canada and the Netherlands. Italy and Greece are likely to become new covered bond countries.

So far, only credit institutions have issued covered bonds, but French utility Véolia plans to set up a small French covered bond bank and issue covered bonds backed by public sector assets. Véolia has the necessary public collateral, while remaining within the predominant classes of cover assets: public sector credit, mortgage loans and most recently ship loans.

An expansion into other asset classes also seems feasible. From a technical standpoint, cover pools could be constituted of asset types such as auto loans, consumer loans or trade receivables, and still comply with covered bond requirements. In an environment where unsecured funding demands high credit premiums, and where investors value the lower correlation of corporate business models with the financial sector, covered bonds could become an attractive funding tool for corporates.

Ralf Grossmann is Head of Covered Bond Origination at Société Générale Corporate & Investment Banking.
ralf.grossmann@sgcib.com

José Sarafana is Head of Covered Bond Strategy at Société Générale Corporate & Investment Banking.
jose.sarafana@sgcib.com
www.sgcib.com

SOCIETE GENERALE
Corporate & Investment Banking