Covered bonds in demand

Investors from around the world have been increasingly drawn to covered bonds. Many of the issues were substantially oversubscribed within a short period of time of opening the bookbuilding process. Sampo Housing Loan Bank Plc of Finland has recently issued the first Jumbo benchmark Finnish covered bond. The Aaa-rated, mortgaged-backed issue was fully subscribed within minutes of opening the books. Within one hour, the issue had acquired €5.6bn worth of customer orders from 143 institutional investors from around the world. Earlier this year, Caja Madrid, which broke new ground for the rapidly growing Spanish *cédulas* market, issued a €2bn, 20-year benchmark which was heavily oversubscribed within three hours of opening the books. The Spanish issuer AyT was able to price the largest *cédulas* ever issued (€5bn in two tranches of €3bn for 10 years and €2bn for 15 years) at a time when other prime corporate issuers were forced to withdraw their bond issues due to a weakening of market conditions. So why has the global investor embraced the covered bond market?

1) GOVERNMENT FISCAL DISCIPLINE HAS DETERIORATED. Within a short period of time, the US has moved from the largest budget surplus in its history to the largest budget deficit in its history. The cost to the US Treasury of the Iraq conflict is estimated to be in excess of $100bn a year. The rebuilding after Hurricane Katrina could cost up to $200bn. Many institutional investors are not optimistic about an improvement in the US budget deficit, especially with signs of an economic slowdown. Germany, France, Italy and Portugal continue to exceed their budget deficit/GDP ratios as set out in the Growth and Stability Pact. Economic conditions in these countries do not portend improvements in their fiscal positions. Japan's budget deficit is still high, despite recent signs of economic growth and improved corporate profitability.

Many traditional government bond investors find the covered bond asset class attractive because they achieve a pick-up in yield compared to government bonds, as well as offer a high credit rating and good liquidity through a market-making agreement among the syndicate of underwriting banks. They are also protected in many cases by a strong, covered bond legal framework. These investors also like the tight restrictions and thorough oversight to which covered bond issuers must adhere. A government may or may not live within its budgetary limitations. In contrast, a covered bond issuer must follow strict guidelines or face tough penalties (including closure) from the regulator. Covered bonds also offer a wide, diversified risk (public-sector or mortgage), versus the non-diversified risk of a government's finance policies in a government bond.

2) THE SHARE MARKETS HAVE BECOME MORE UNPREDICTABLE. Warren Buffet has stated that it is becoming increasingly difficult to find value in company balance sheets, income statements and cashflows. General Motors, a large American corporate icon, has shocked the markets with the rapid deterioration in its earnings. Continued corporate accounting and earnings scandals in the US, Europe and Asia have further cast a shadow on investor confidence.

The covered bond market, with its high credit ratings, good liquidity and solid performance in the secondary market, has been an attractive place for equity investors to place money until a good equity opportunity appears. Interestingly, a new investor, the private equity fund, has recently become active in the covered bond market.

3) SUSTAINED EURO'S STRENGTH AGAINST THE US DOLLAR. As most of the liquid, benchmark issuance in covered bonds has been in euros, the market has also profited from the funds movement from the dollar. This has occurred because of the market's increasing liquidity and good spread performance against government bonds. The most active player in this category has been the central bank reserve portfolio manager. From Barclays Capital's perspective, 77 central banks now purchase covered bonds. This is over one third of the membership of the United Nations. Recently the World Bank warned of losses on reserve positions of central banks in developing nations that have most of their reserves in US dollars. The World Bank has urged countries to take a balanced currency mix which could increase central bank buying of covered bonds in the future.

4) COVERED BOND LEGISLATION SPREADING. Once a country adopts a covered bond legislation, local investors, who may not have invested in the instrument before, begin to participate. As these local investors purchase the local brand of covered bond, they then analyse the non-local covered bond for relative value analysis. These investors generally then go on to buy the foreign variety as well. In Ireland, there was muted Irish investor interest in covered bonds before the establishment of the Irish Asset Covered Securities legislation. Now Ireland is a significant roadshow stop for Irish and non-Irish covered bond issuers alike. The first UK covered bond from HBOS opened up many traditional UK investment managers for covered bonds. With many countries looking to join the covered bond club, the amount of locally focused investors purchasing all types of covered bonds looks promising.

5) THE US AGENCY ACCOUNTING PROBLEMS HAVE ENCOURAGED TRADITIONAL AGENCY INVESTORS TO DIVERSIFY MORE INTO COVERED BONDS. The covered bond investor has a liquid instrument with a strong asset pool behind it. The covered bond investor does not need to rely on an implicit government support mechanism. Interestingly, we have seen a significant rise in North American accounts buying covered bonds as they do not see any one covered bond issuer dominating the landscape as much as the two large US Agencies.

6) THE GERMAN PFANDBRIEF LAW HAS BEEN UPDATED. On the 19th of July this year the new German *pfandbrief* law came into effect. Investor protection rights were enhanced. More banks are now able to issue *pfandbriefe* as long as they adhere to the rules. The *pfandbriefe*, the largest covered bond market in Europe, could grow even more dramatically.

With controlled issuing policies, strong asset pools backing the issues, good liquidity and yield, and more countries adopting legislation, the future for this asset class looks promising. More institutional investors from around the world are likely to participate and spread performance in the secondary market should continue parallel to the market's rapid growth into new jurisdictions.

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