



The European covered bond market: Too big to ignore

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The covered bond market was created and has long been dominated by German issuers. The 1995 launch of jumbo pfandbriefe further solidified their position. As the graph below shows, Germany is still the main European covered bond issuer.

The emergence of EMU prompted most European countries to modify their legislation governing capital markets, which aimed at laying down a strong basis for financial innovation and disintermediation. In the wake of these reforms, the adoption of Basel II's capital adequacy requirements will further boost bond markets. In this light, the European covered bond market will benefit most from these developments in the near future, and continue its impressive issuance growth.

A legislation driven boom...

Contrary to expectations, covered bonds have greatly benefited from legislation both at the national and European level; at the EU level, indirectly, as the legislative push prior to 1999 and the subsequent attempt to complete the single market for financial services opened up previously closed markets to competition from new products, emerging innovation, widening and deepening capital markets. Legislation at the national level further fostered the expansion of covered bonds, because new legislation created new asset classes.

The central legislative element around covered bonds is UCITS Directive². Its article 22(4)³ defined the eligibility criteria for privileged treatment of covered bonds, i.e. a 10% risk weighting, but left out a precise definition of the loan types that could be used as cover assets.

The shortcomings of UCITS were partly addressed in the capital adequacy rules adopted in September 2005, which can be considered as the first explicit EU-wide legislation on covered bonds. It specified the types of assets as well as the credit quality necessary to qualify for the privileged treatment of covered bonds. Public-sector covered bonds can be covered by any EU-asset or any non EU-asset provided that at least 80% of them are AAA or AA- rated. The remaining 20% can be A-rated bonds. Mortgage-covered bonds can be covered by any residential asset, but each will be subject to a cap (a percentage of the value of the pledged property).

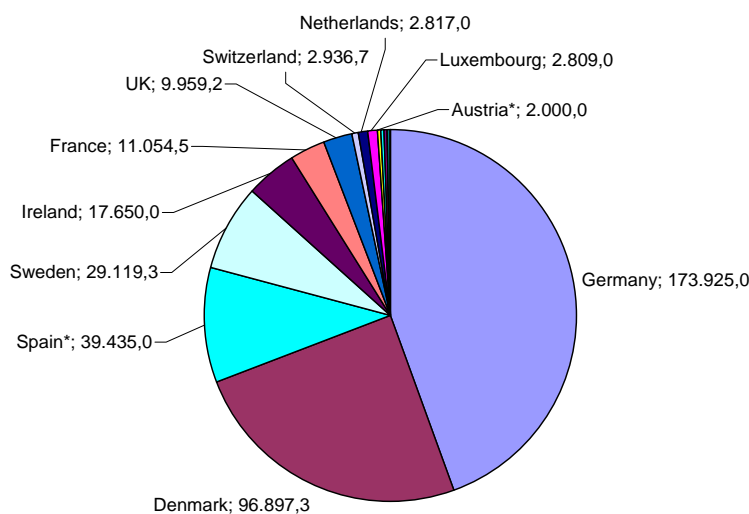
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² Undertakings for Collective Investment in Transferable Securities

³ Art. 22(4) of Directive 85/611/EEC UCITS:

- The covered bond issuance must be governed by a special legal framework.
- The covered bond issuer must be a credit institution.
- Bondholders must have priority claim on the cover asset pool in case of issuer default.
- The cover asset pool must provide sufficient collateral to cover bondholder's claims throughout the whole term of the covered bond.
- The set of eligible cover assets must be defined by law.
- The covered bond issuance must be subject to special prudential public supervision.

Total covered bonds issued by country, 2004 (€million)



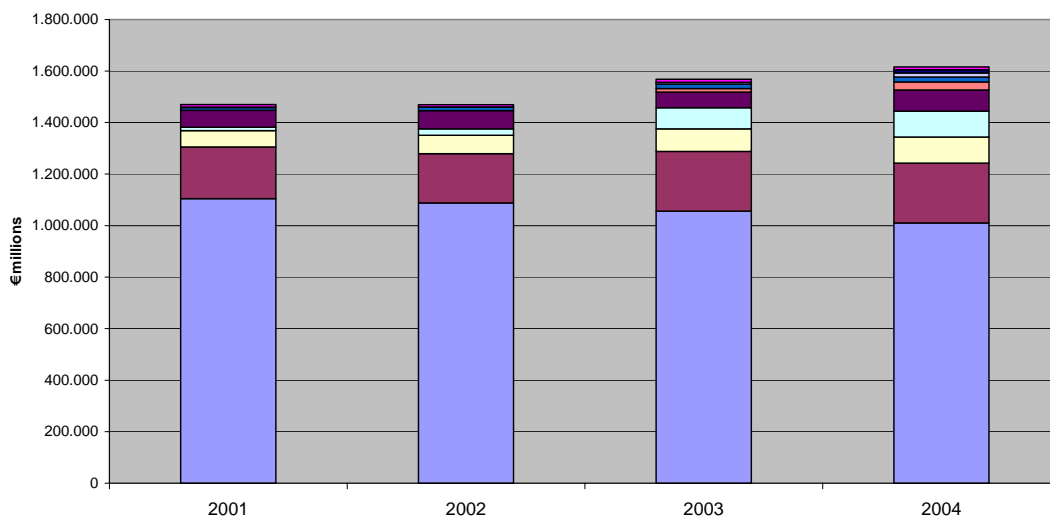
*preliminary data

Source: European Covered Bond Council

The Market Abuse Directive additionally motivated the development of covered bond markets in accepting market-making in the jumbo covered bond market. Such measure assured liquidity, efficient price formation and gave investors confidence in this new funding instrument.

Additionally, Germany was forced in July 2005 by the EU to give up their unconditional guarantee for Landesbanken, which have in the past been the biggest issuers of public covered bonds. The removal of German monopoly position was achieved by EU, fostering cross border competition in investment services: even though Germany issued 2/3 of outstanding covered bonds in 2004, diversification of covered bond supply is on the way, as the graph plotting the evolution and decomposition of outstanding European covered bonds shows.

European Covered Bond Market (outstanding volume)



Source: European Covered Bond Council

Legend: Germany (blue), Denmark (maroon), France (yellow), Spain (cyan), Sweden (dark red), Ireland (orange), Luxembourg (dark blue), UK (light blue), Netherlands (purple), others (pink)



...leads to defining covered bonds on European Markets.

Hence, the EU has achieved an equal treatment of covered bonds and has also diversified the array of covered bonds available on the European market. More importantly, however, is the fact that Europe's legislative action provided a clear definition of what constituted a covered bond. Achieving a strong legislative basis has been the outset for the recent upsurge in European covered bond issuance.

Finally, the legislative driver behind the expansion of the covered bond market is also the current low-yield environment in worldwide capital markets. Jumbo covered bonds provide an attractive alternative to government bonds, because they offer a spread pick-up over government bonds while at the same time enjoying greater liquidity. Such alternatives are more than welcome for investors, especially in the wake of global excess liquidity. Consequently, such an innovative instrument will soon find its place in each investor's portfolio.

Hence, the combination of legislative forces and structural economic trends are bringing the covered bond market to the forefront of European finance. Yet the full potential of funding through covered bonds is likely to be unleashed only when pan-European legislation is adopted. In fact the lack of unified pan-European legislation on covered bonds deprives smaller countries of the opportunity to exploit covered bonds as a financing tool.

Prospects

Market participants offer the counter-argument that cross border lending remains very small and that the benefits from a legislative push will remain modest. In fact, the law of one price seems to apply to the European mortgage market, as the cost of the same mortgage product is just above 50 basis points on the comparable interest rate⁴, which suggests that covered bond markets are already well integrated. Market participants are thus urging policy-makers not to take burdensome legislative measures.

Furthermore, despite the favourable developments in covered bond markets, market participants are unhappy with the capital requirement's directive on Residential Mortgage Backed Securities. The limited presence of RMBS (20%) in covered pools leaves practitioners perplexed. Although the limit is to be addressed in 2010, practitioners believe such a lengthy procedure might compromise the gains from covered bond market development, and still wonder about the pertinence of such legislation.

Market actors believe that goes through fostering the development of covered bond market and defining an internal market for mortgages. The securitization issue and the debate around the 26th regime are on the agenda of the Commissioner for Internal Market and Services and are to be addressed soon; an advisory expert group has been constituted on the promotion of a pan-European mortgage funding market. In fact securitization facilitates cross border funding, especially for mortgage-backed securities. Thus, the framework around covered bonds is not yet fully addressed, and to assure its prospects, its weaknesses should be addressed soon.

⁴ Mercer Oliver Wyman (2003): Study on the financial integration of European mortgage markets, report published by the European Mortgage Federation.