

Enhancing Europe's Covered Bond Programs

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Covered bonds pervade Europe. The grandfather of all covered bond programs is the German *pfandbriefe* established in 1899. Today thirteen other countries across Europe have established their own *pfandbriefe*. According to the European Mortgage Federation at the end of 2001, outstanding covered bonds totalled €613 billion, equivalent to 16% of all mortgages outstanding. Deposits still dominate residential mortgage funding, but covered bonds are in undisputed second place.

What is a covered bond? A covered or mortgage bond is an on-balance sheet obligation of the issuing institution. The legal structure, the issuer's backing, and the pledge of quality assets should the issuer fail make for a highly rated bond - typically AAA. Triple-A funding is the cheapest of capital markets funds and, therefore, dictates much of the attractiveness of the instrument.

Adding to this appeal are the relative difficulties of its off-balance sheet alternative, securitization. Though securitization has distinct capital management advantages, it suffers from:

- A required high level of transparency and data quality

- Invasive reviews by investment banks, rating agencies, and investors
- Regular issuance of large volumes to minimize funding costs
- Careful structuring to maximize bond pricing and produce "true sale" treatment and capital savings
- Sophisticated, specialized systems and procedures
- Potential legal and other difficulties, e.g., borrower notifications, recording costs, etc.

Covered bonds are much more simply produced.

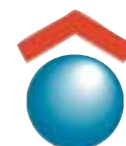
The high ratings of these instruments derive from the issuers' promise to pay and, failing that, the investors' preferred rights to the underlying collateral, stipulated to be of a high quality (i.e., a low loan-to-value). Each jurisdiction has placed an LTV limit on acceptable mortgage loans that can back a covered bond. (See Table 1) It is worth noting that at least in the case of Germany, conservatism reigns. Germany determines its loan-to-value using a "mortgagable value." In practice this value discounts the sales price some 10%

Table 1
General Residential Loan-to-Value Limits in Selected Covered Bond Programs

Country	Program Name	LTV Limit
Germany	<i>Pfandbriefe</i>	60%
Denmark	<i>Realkreditobligationer</i>	80%
France	<i>Obligations foncières</i>	60/80%*
Switzerland	<i>Pfandbriefe</i>	75%
Spain	<i>Cedulas hipotecarias</i>	80%
Luxembourg	<i>Lettres de gage hypothécaires</i>	60%
Ireland	<i>Mortgage cover assets securities</i>	75%
Finland	<i>Kiintesisövakuudellinen joukkovelkakirja</i>	60%
Latvia	<i>Kilu zime</i>	75%

Source: Moody's, "European Covered Bonds" (September 2002)

* France's LTV limit varies with the lender's exclusivity to mortgage lending.



so the LTV limit is actually around 54%. Moreover, non-pfandbriefe eligible collateral may constitute only 20% of lending for a “pure” German mortgage bank.

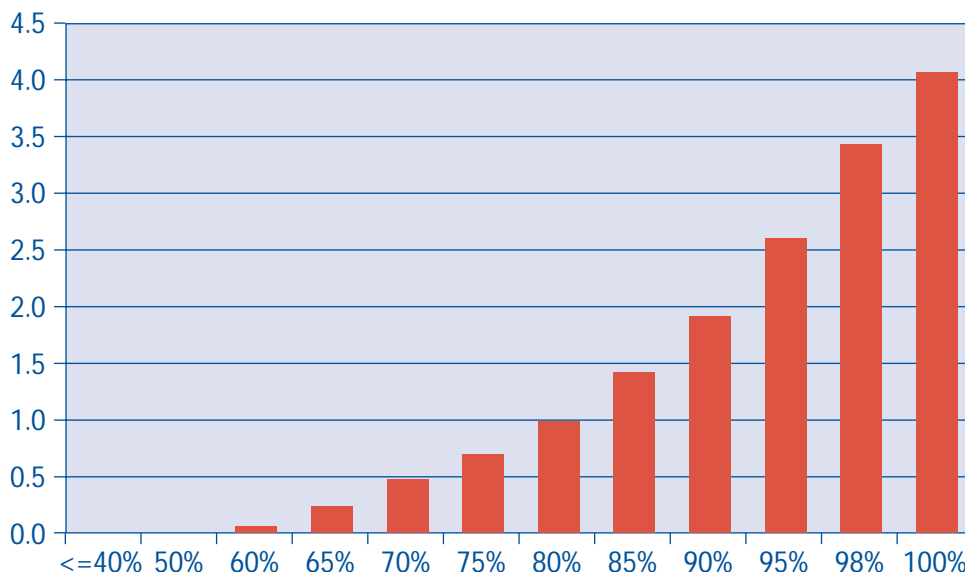
Clearly these LTV limits do not nearly represent the totality of lenders’ mortgage lending activities. A significant portion of most lenders’ originations include LTV’s well above these limits. This reality points to two aspects of covered bond programs that bear examination:

1. How can covered bond programs be safely extended to embrace more of the lending actually done?

2. How is higher LTV lending being accomplished today?

The answer to Question 1 is that covered bond programs can be expanded safely. Generally, the LTV limits in the various covered bond programs have been selected at points where losses are thought to be less likely. Without a doubt, LTV’s above the 60-80% points display an accelerating probability of default. (Chart 1)

Chart 1
Relative BBB Expected Losses by LTV averaged For Six Selected Countries



Source: Fitch Ratings, Residential Mortgage Default Models
(Australia, Germany, Holland, Spain, UK, and US)

Note: Expected losses calculated relative to LTV’s 75.01 to 80.00%

These higher LTV, higher risk loans, however, can be protected from loss by highly-rated, specialized insurance companies. For example, my institution, PMI Europe, is a AA-rated residential mortgage insurer that provides protection for credit-related losses up to 95% LTV (and sometimes beyond). These loans can be covered for losses up to a selected percentage. The result is that high LTV loans will display no greater losses to mortgage holders than lower LTV loans.

The further benefit to bondholders is that the guidelines for the origination, underwriting, and servicing of these loans will be carefully crafted between the lender/issuer and the insurance company. The insurer has a vested interest in the performance of these loans and will therefore demand a certain standard of care and quality. Furthermore, institutions providing this sort of protection are generally multinational organizations that diversify their credit risk-taking

activities in a way local lenders/issuers typically cannot.

Question 2, stated earlier, points to the fact that higher LTV loans are already likely in covered bond pools. How? Though the specific loans that back covered bonds are limited in loan-to-value, other secured loans can still be made to borrowers. In continental Europe “top up” loans are common. These are secured or unsecured loans that fill the gap between the covered bond funding limit and the borrowers’ available or preferred down payment. For example, a German borrower may have a 60% first “covered bond” loan and a 30% second lien, forming a 90% loan.

From an investor’s perspective, the probability of this borrower defaulting is akin to any other 90% LTV borrower. Should a default occur the quality of the asset relies upon the preferred position of the loan, that is, the 60% LTV first lien loan.

The proposal to insure higher LTV loans merely substitutes an insurance company’s rated promise (contract) for the equity that is hopefully between the property value and the covered bond LTV limit today. More simply: if they’re both in effect 90% LTV’s, can insurance replace equity yet retain the soundness of the covered bond idea? A long-lived, global mortgage insurance industry says that it can.

The conclusion is that such enhancement could accomplish a number of worthy goals:

- High LTV lending would be simplified by the elimination of “top up” loans.
- Bonds would be backed by (1) the issuer’s promise, (2) the quality of the collateral, and (3) a highly-rated “guarantor.”
- Advantageous residential mortgage funding could be extended to the low downpayment borrower: the first time homebuyer, the lower income borrower, those with little equity on which to advance a “trade-up” purchase, etc.
- Greater leverage could be provided to the housing market that brings disenfranchised homeowners to the market, supports housing values, and fosters economic growth.
- Covered bond programs, quickly expanding across Europe, could be further qualified and monitored by institutions financially vested in the outcome.

Much work has gone into establishing covered bond programs in numerous countries. Covered bonds are already Europe’s preferred method of capital markets funding. Maximizing the success and usefulness of these programs will not be a wasted effort!

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