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Risks involved in using public-sector debt as collateral for covered bonds

Ted Packmohr | Central European Covered Bond Conference - Budapest | November 2011

Sovereign risk remains a critical factor for covered bonds as well

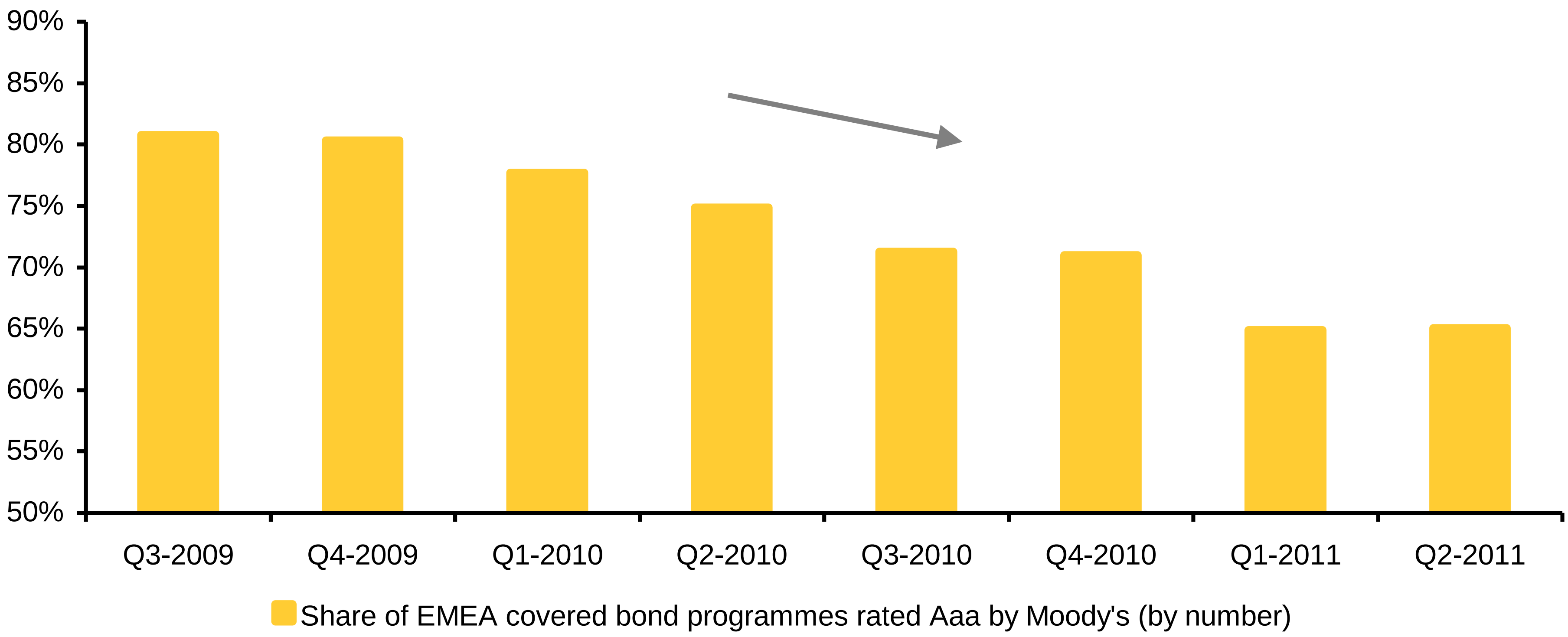
A ranking of factors impacting covered bond evaluations

Trend

1. Sovereign creditworthiness — ?
2. Issuer creditworthiness (incl. systemic bank support) — ↘
3. Quality of legal/structural framework (incl. systemic product support) — ↗
4. Cover pool quality — ↘

The result: Covered bond ratings on a downtrend

The example of Moody’s



Source: Moody’s

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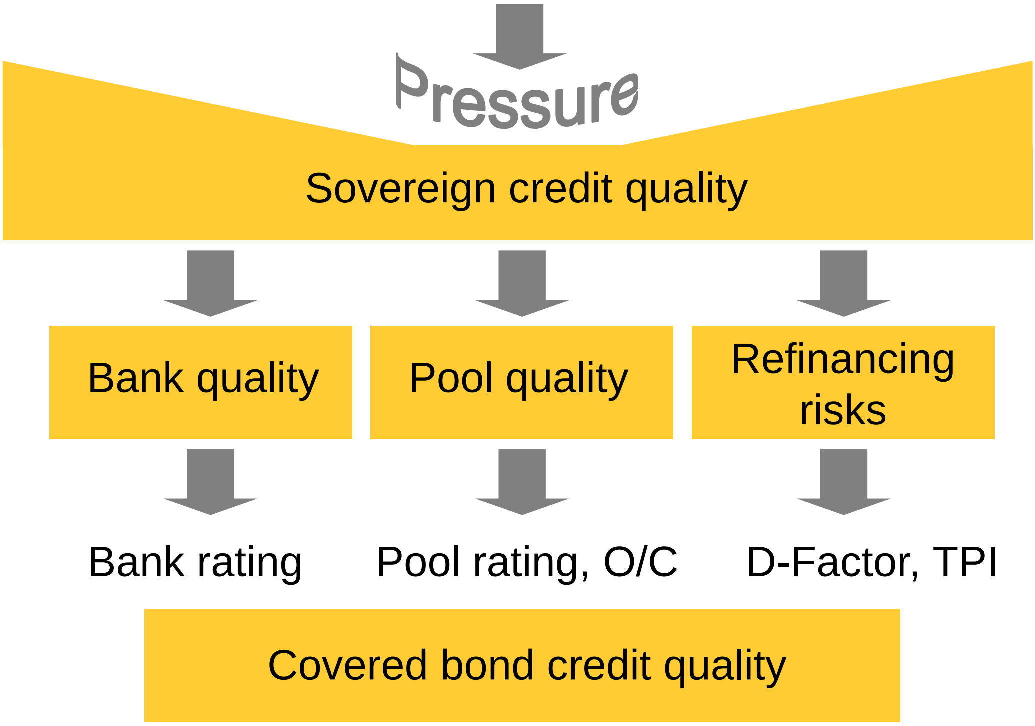
An interlinked network

Sovereign credit pressure affects covered bonds through various channels



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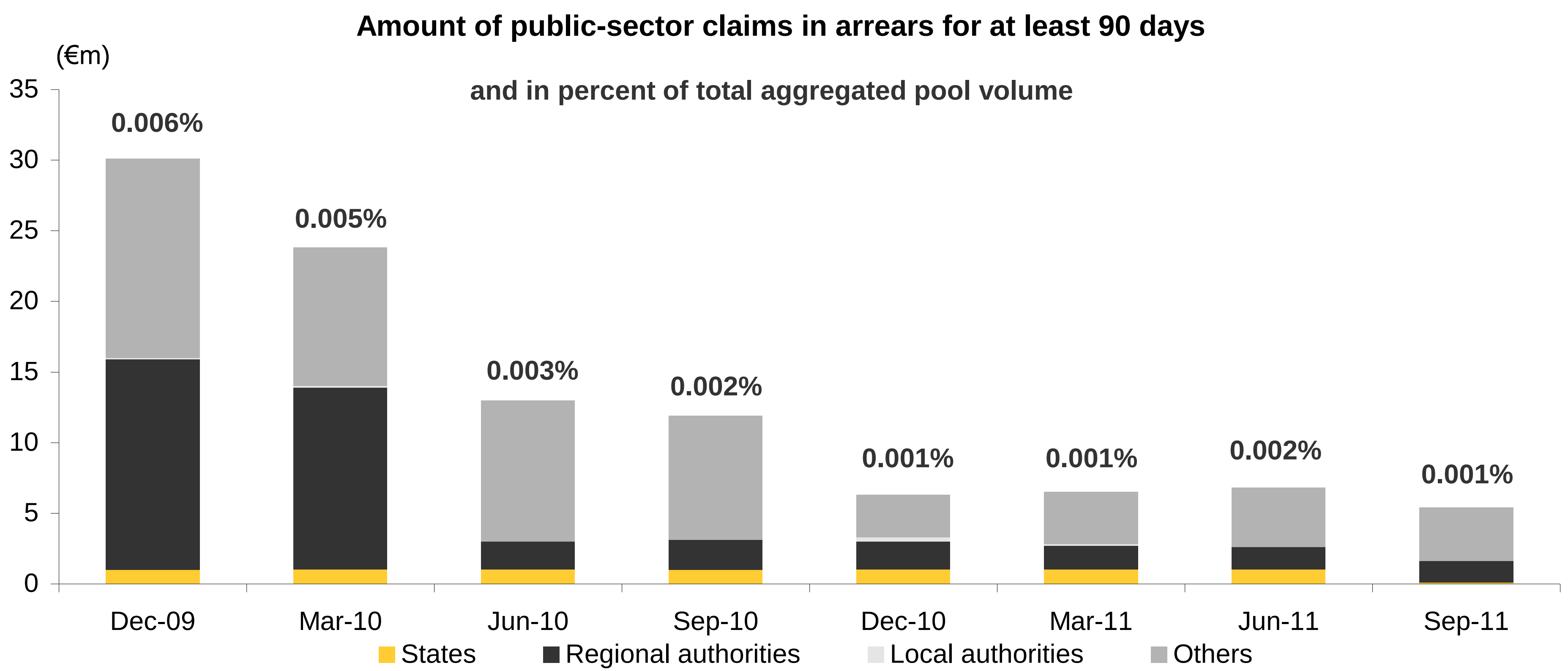
Public-sector credit risk has never been zero

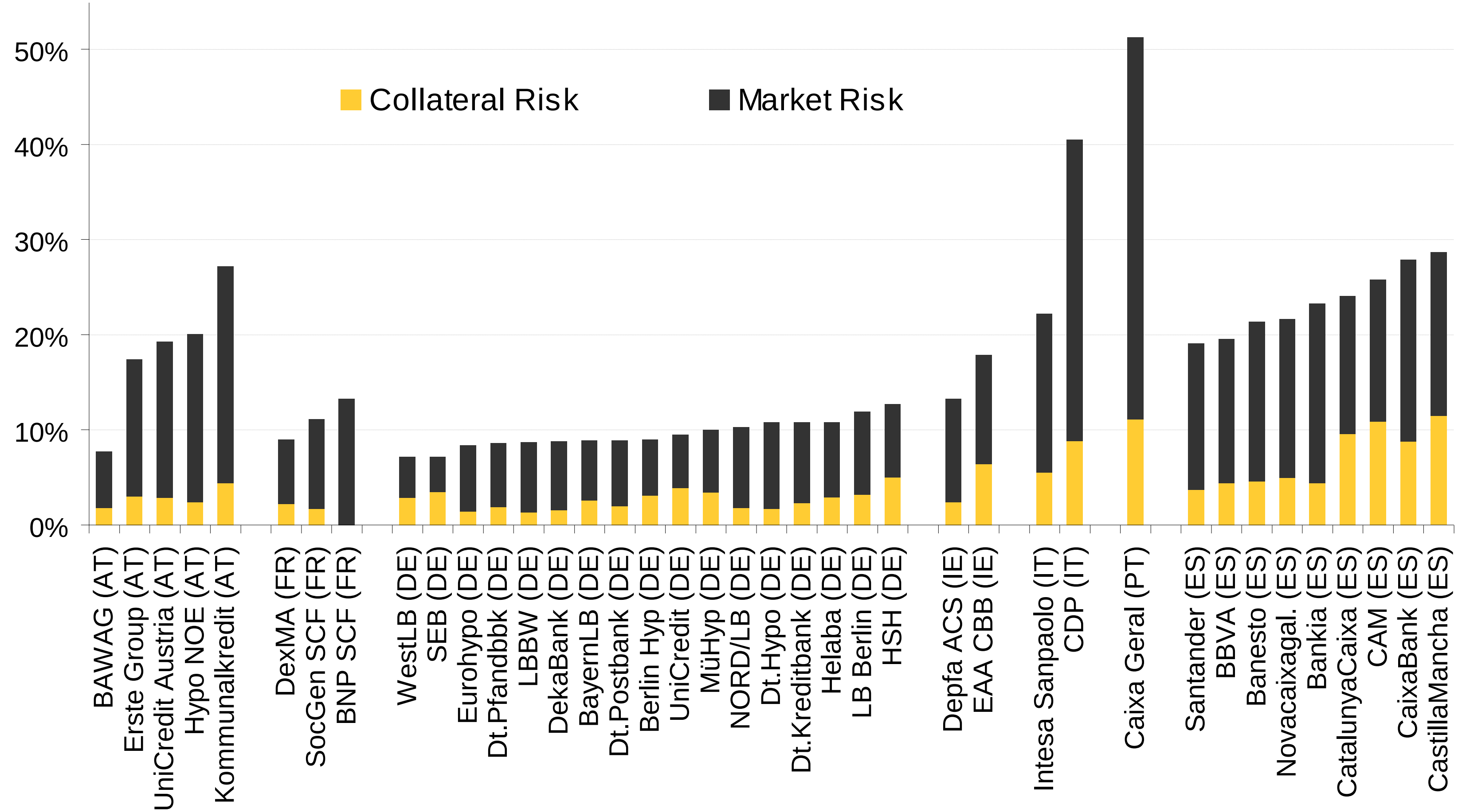
Aggregated pool statistics of vdp member banks



Source: vdp

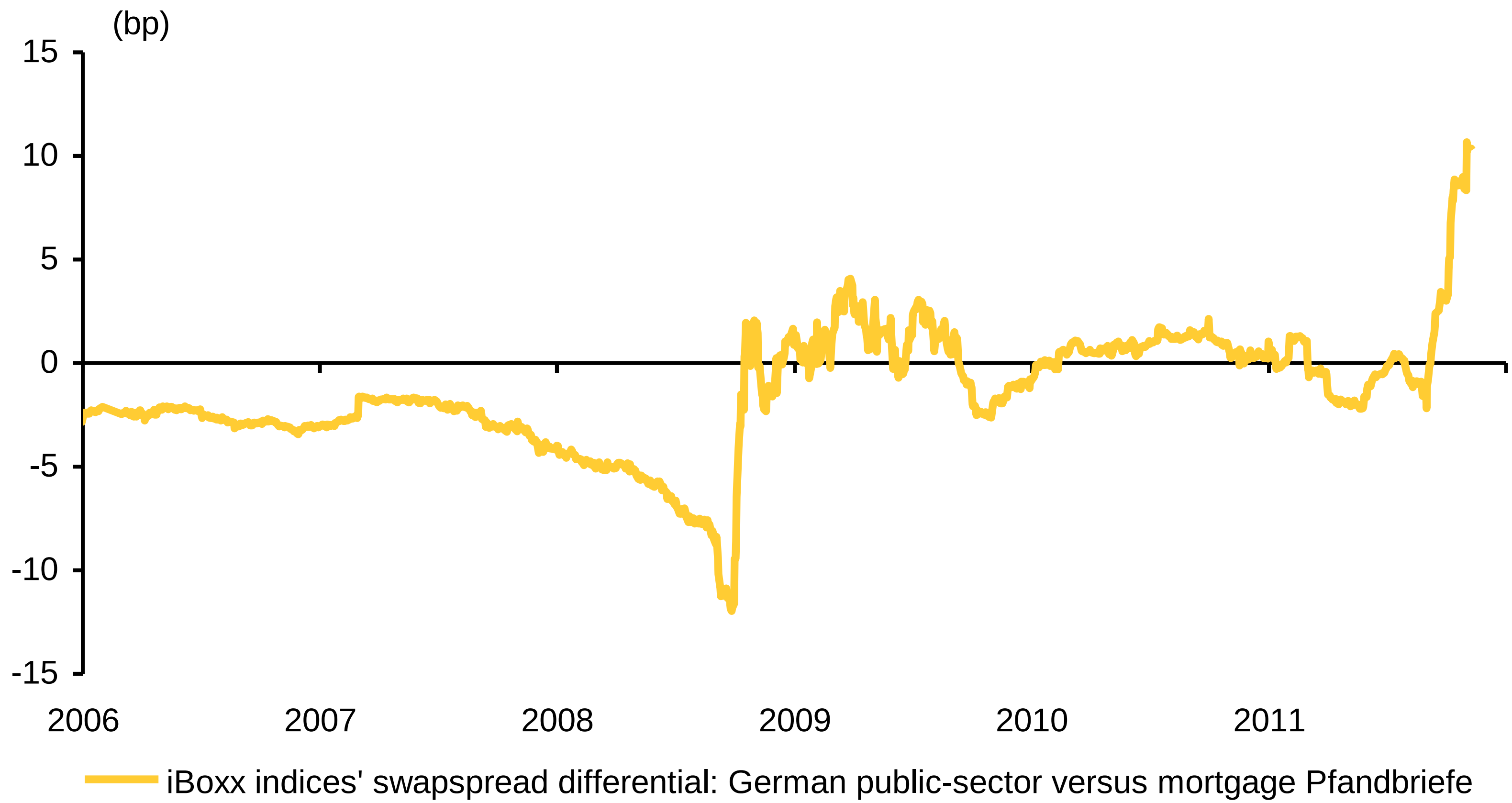
Credit risks vs. refinancing risks

Moody's modelled pool losses for public-sector covered bonds as at Q2 2011



A paradigm shift

Public-sector covered bonds have fallen victim to the crisis



Source: Commerzbank Research

Public-sector covered bonds

Domestic versus international pools: concentration versus diversification risks

<u>Mainly domestic pools, e.g.</u>

- BAWAG, Erste Group, UniCredit, Hypo NOE
- Intesa Sanpaolo, CDP
- Santander, BBVA, CaixaBank
- KLP
- BRE Bank
- Caixa Geral
- LB Berlin, LBBW, UniCredit

<u>Mainly international pools, e.g.</u>

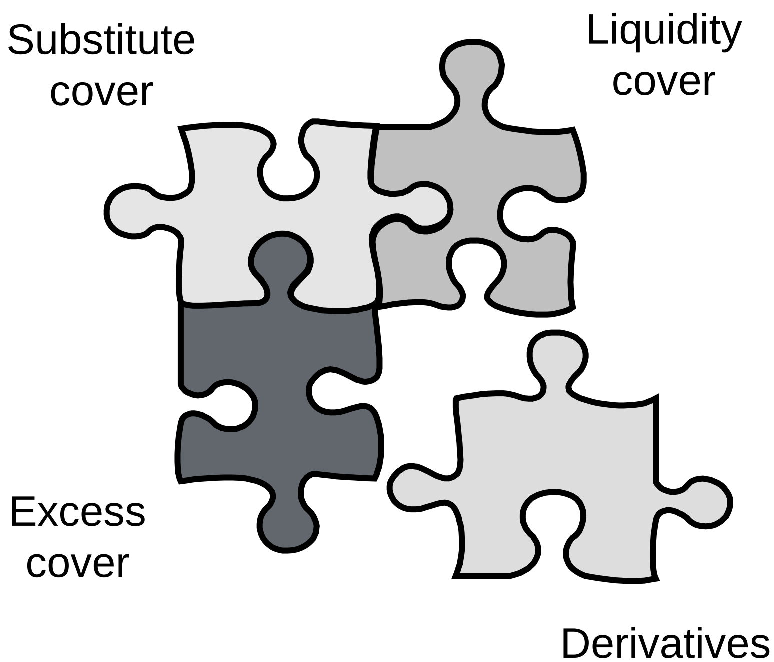
- Eurohypo, pbb, Dexia, DG Hyp, DüssHyp, HSH, Postbank, MüHyp etc.
- DEPFA, EAA
- DexMA, CFF, BNP
- Eurohypo, EEPK, NORD/LB, HPBI

Mortgage covered bonds

Hidden risks in German Mortgage Pfandbriefe?

Cover pool	Transparency
Additional cover assets	-
Mortgages	✓

Components



What kind of assets qualify for these supplementary cover categories?

Public-sector bonds and bank bonds included

	Substitute cover: Mortgage Pfandb.	Substitute cover: Pub.-sec. Pfandb.	Excess cover	Liquidity cover
1) Debt instruments of the German Bund, its special funds, a German state, an EEA country, Switzld., USA, Canada, Japan or certain internat. develop. banks (incl. guartd debt)	✓		✓	✓
2) Deposits with the ECB and EU central banks			✓	✓
3) Claims against the ECB and EU central banks	✓			
4) Non-subordinated deposits at suitable credit institutions			✓	✓
5) Claims against suitable credit institutions (max. per institution: 2% of the respective Pfandbriefe outstanding)	✓	✓		
6) Other regular cover assets of public-sector Pfandbriefe (but: bonds only)	✓			
7) Equalization claims converted into bearer bonds	✓	✓		
8) Other cover assets eligible as ECB repo collateral				✓
Legal basis (PfandBG)	§19(1)	§20(2)	§4(1)	§4(1a)
Volume limit	1)+3)+5): max. 10% of mtg. Pfandb.; 1)+3)+5)+6): max. 20% of mtg. Pfandb.	5): max. 10% of outstanding public-sector Pfandbriefe	1)+2)+4): at least 2% O/C on present value basis	1)+2)+4)+8): at least 180-day buffer

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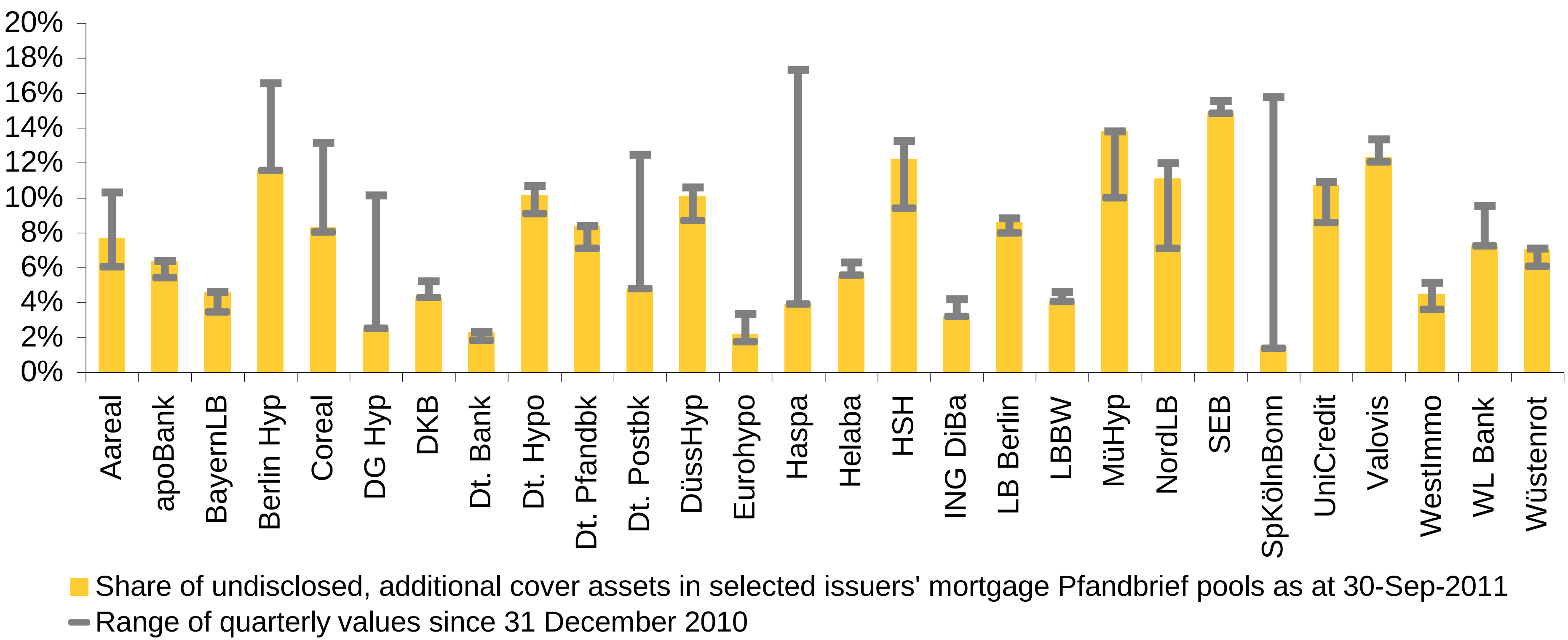
Additional cover assets can represent large and volatile pool shares

Larger fluctuations should be mainly due to 180-day liquidity coverage requirement



Source: Banks, vdp, Commerzbank Research

Topical issues

What is allowed to go into the pool?

- Eligibility of EU sovereign debt is typically solely tied to a **regional definition:**
  - No link to creditworthiness
  - No exclusion of countries subject to default / restructuring.

How are the pool assets accounted for?

- The fluctuations in market price and liquidity of government bonds are not reflected within the typical **cover calculations:**
  - Nominal coverage
  - (Artificial) present-value coverage.

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Potential alternatives (1)

Introducing rating triggers

- **Rating requirements** could help safeguarding a **minimum quality** of public-sector cover pools
  - Minimum rating per asset
  - Partial accounting depending on rating thresholds (see e.g. ABS haircuts in France)
  - Limiting the pool share of assets of certain rating classes overall.
- Issues to discuss:
  - Would the **legislators** want to stipulate a credit differentiation among European sovereigns while several other regulatory frameworks still treat them on equal terms?
  - Should we increasing the **influence of rating agencies** further? Problem of cyclicality.
  - There are **plans to forbid the publication of ratings** for countries under the bail-out scheme. How to deal with such a scenario?
  - How should sub-sovereign debt be accounted for, which holds **no rating** at all?

Potential alternatives (2)

Adjusting cover calculations

- Closer **alignment of cover calculations with market movements / risks**
  - Introducing tighter limits on asset/liability mismatches
  - Moving from artificial present-value cover calculations towards market prices
  - VAR limit
- Issues to discuss:
  - Collateral requirements would become more **volatile**, tying more capacity in pool management and surveillance (trustee)
  - Probably additional safety cushion in the form of **higher over-collateralisation** required
  - Determining **fair market prices** may not always be straightforward (depending on asset liquidity)
  - In line with the general **covered bond concept**? (cover pool = buy-and-hold portfolio)

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Today's panellists

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- **Reinolf Dibus**
  Managing Director, Eurohypo Luxembourg
- **Michel Stubbe**
  Head of Financial Operations Services Division, ECB
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