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Bond Basics: Covered Bonds

Covered bonds are securities created from either mortgage loans or public sector loans and make up one of the oldest and largest sectors of the European bond market. In the past few years, covered bonds have enjoyed a resurgence as investors search for high quality investments with attractive yields and European banks look to finance the growth in mortgage lending.

This article will explain the fundamentals of covered bonds and why they are increasingly popular among both investors and issuers.

What Are Covered Bonds?

Covered bonds are securities issued by a bank and backed by a dedicated group of loans known as a “cover pool”. There are two different types of covered bonds: those backed by high-quality mortgage loans and those backed by public sector loans. If the issuing bank becomes insolvent, the assets in the cover pool are separated from the issuer’s other assets solely for the benefit of the covered bondholders. Asset eligibility for the cover pool and the process in the event of an issuer insolvency are determined by laws specific to each country.

Based on the high quality of the loans in the cover pool and the strength of the issuing banks, most covered bonds receive high credit ratings of double- or triple-A. In general, their maturities range from two to 10 years, although there is a recent trend toward long-term securities greater than 10 years.

Covered bonds are similar in many ways to mortgage- and asset-backed securities with one major difference: the loans backing a covered bond remain on the balance sheet of the issuing bank. The bonds are therefore obligations of the issuing bank, and the issuer retains control over the assets. It can change the make-up of the loan pool to maintain its credit quality, which can benefit investors, and it can also change the terms of the loans. By contrast, mortgage- and asset-backed securities are typically off-balance-sheet transactions in which lenders sell loans to special purpose vehicles that issue bonds, thus removing the loans—and the risk associated with those loans—from the lenders’ balance sheets.

Germany introduced covered bonds, known as *Pfandbriefe*, in 1770 to finance public works projects. Since then, 24 other countries in Europe have adopted the covered bond structure, each with its own unique laws. In Spain, for example, covered bonds backed by mortgages, known as *Cédulas Hipotecarias*, were created by a special law in 1981, while in France, covered bonds, known as *obligations foncières*, can be traced as far back as 1852, with the establishment of the first mortgage bank, *Credit Foncier de France*. All countries with covered bond laws now allow for bonds backed by mortgages, while only a few allow covered bonds backed by public sector loans: Germany, France, Austria and Spain. In Denmark and Germany, covered bonds may also be secured by ship loans.

Publication

December 2006

Originally, only specialised mortgage and public sector banks could issue covered bonds in Germany, but new laws in 2005 expanded the universe of potential issuers to include all credit institutions that meet certain credit quality requirements and obtain a license. Many other countries have also made the covered bond market accessible to more lenders, but some, including Denmark and France, still require that covered bond issuers limit their business to making high quality loans in specific areas, such as mortgages.

Today covered bond laws in Europe typically address:

- what assets are eligible to back covered bonds;
- the minimum quality requirements for those assets, such as loan-to-value ratios;
- the amount of assets needed to cover the bonds while the bonds are outstanding;
- how the asset pool will be monitored;
- and perhaps most important, how investors will be protected if the issuing bank goes bankrupt.

In an attempt to unify the various covered bond systems, the European Union (EU) set up guidelines for covered bonds in 1988 through the Directive on Undertakings for Collective Investments in Transferable Securities (UCITS); if these criteria are met, investment funds and insurance companies may invest up to 25% and 40% of their assets, respectively, in covered bonds from a single issuer, a significant easing from the usual 10% limit. In 2006, new bank capital requirements also took effect so that banks investing in covered bonds may be able to hold less capital in reserve against the bonds (a 10% risk weighting instead of 20% for unsecured bank debt) if the bonds meet the EU criteria and are backed by specific, high-quality asset types, including mortgages, public sector loans and mortgage-backed securities.

Why Invest in Covered Bonds?

In addition to the EU's favourable regulations on investing in covered bonds, several inherent characteristics make the asset class attractive to investors, including:

- **High credit quality.** The major credit rating agencies have slightly different approaches to rating covered bonds, but all focus on the structure of the cover pool and the quality of the mortgages. To a lesser degree they factor in the issuer's rating. Most covered bonds carry ratings of double- or triple-A.
- **Yield.** Covered bonds can potentially offer investors yields higher than European government bonds without significantly altering the risk profiles of conservative portfolios.
- **Diversification.** Covered bonds allow conservative investors to diversify into mortgage securities without diluting the credit quality of their overall portfolios. Typically, investors looking for triple-A rated investments must invest largely in sovereign and agency bonds.

Publication

December 2006

- **Protection against event risk.** Covered bonds are full recourse debt instruments, meaning that holders have a preferential claim on the assets in the cover pool and the proceeds arising from them if the issuer defaults. Should an originating bank fail to make payments on a covered bond for any reason, interest payments from the underlying mortgages would go to investors.

Why Issue Covered Bonds?

Banks issue covered bonds to unlock the value of mortgage loans on their books. The money raised from the bonds' sale can be used to expand a bank's business or pay off maturing debt. However, the laws governing covered bonds require the banks to keep these mortgages on their balance sheets while the covered bonds are outstanding. Why wouldn't banks simply choose to raise money by issuing unsecured debt? Covered bonds can offer several benefits that corporate debt cannot:

- **Higher credit ratings.** The strict regulatory framework for covered bonds and the high quality of the underlying loans create high credit ratings for covered bonds. In many cases, covered bonds carry ratings higher than those of the issuers.
- **Lower cost of funding.** The high credit ratings can result in lower interest payments to investors, which reduce the cost of funding for the originator. Covered bonds also enjoy a second cost advantage: the market for them is far more liquid than it is for products like asset-backed securities in Europe. Issuers have more pricing power in liquid markets, as a function of supply and demand.
- **Diversification of refinancing sources.** Because an issuer's covered bonds usually receive higher credit ratings than its senior unsecured debt, covered bonds attract a different group of investors, which helps to broaden the issuer's funding sources.

Growth of the Covered Bond Market

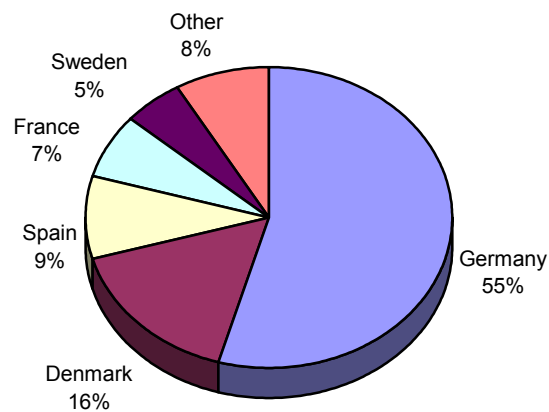
Covered bonds are the second largest segment of the European bond market, after government bonds, with €1.8 trillion outstanding at the end of 2005, an increase of 8% from 2004. Total new issuance has averaged €220 billion annually in recent years, about 15% of the euro-denominated bond market, according to the European Central Bank.

In terms of outstanding bonds, Germany is still the market leader, as shown in the chart below, but Germany's share of the market has dropped from 95% in 1999 as other countries created or expanded their covered bond legislation, and that trend is expected to continue. With a new law enacted in 2006, Portugal has become an active participant in the European covered bond market recently, and Italy is expected to follow soon. The Netherlands and the U.K., which have domestic covered bond markets, are working on the introduction of covered bond laws that will meet the EU guidelines and thus attract more investors across Europe, according to the European Covered Bond Council.

Publication

December 2006

Covered Bond Volume Outstanding by Country As of 31 December 2005



Total = €1.8 trillion

Source: European Covered Bond Council

Issuance should also increase from several other countries that need to finance their fast-growing mortgage markets. The European mortgage market has expanded at an annual rate of more than 8% for the past 10 years, with the highest growth recently in Central and Eastern Europe, as well as Spain, Ireland and Greece. Mortgage debt in Europe accounts for only 40% of EU GDP, compared with more than 60% in the U.S., and as a result, many believe there is potential for significant growth in Europe's covered bond market.

Issuers can obtain very favourable financing rates in the current market because demand continues to rise. Declining government bond yields in recent years have prompted new demand for covered bonds as a source of extra return. Two developments over the last decade or so have also made covered bonds more attractive to investors. First, in 1995, an inter-bank agreement in Germany created Jumbo *Pfandbriefe*, covered bond transactions totaling €1 billion or more that meet certain structural requirements, including market making commitment and electronic trading systems. Because of their greater liquidity, Jumbo *Pfandbriefe* have drawn institutional investors and pension funds into the covered bond market in large numbers. Other countries now allow similar large, standardised transactions, often referred to as benchmark covered bonds.

Second, in 1999, the introduction of Euro-denominated securities and in 2001, the introduction of Europe's common currency led to further expansion of the covered bond

Publication

December 2006

market. For European investors outside of Germany, the euro eliminated the currency risk of investing in *Pfandbriefe*.

Demand for covered bonds has proved so strong that U.S. mortgage lenders, which have access to the large and liquid mortgage-backed securities market in the U.S., are eyeing the covered bond market for financing. Washington Mutual Inc., the largest U.S. savings and loan institution, became the first U.S. lender to tap the covered bond market in September 2006, issuing more than €4 billion.

Conclusion

Covered bonds can play an important role in a portfolio, offering investors credit quality similar to many European government securities as well as enhanced return potential. Because they are based on high-quality mortgage loans and public sector debt, covered bonds can allow conservative investors to diversify their holdings without significantly increasing risk. Originally led by German banks, the covered bond market is increasingly popular among issuers in many countries that need to finance their growing mortgage markets.

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Publication

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