

MARC ANALYTICAL INSIGHTS

FREQUENTLY ASKED QUESTIONS ON COVERED BONDS



OVERVIEW

The covered bond industry has come a long way since the first issuance in Germany in 1769. The first issuance in Denmark happened in 1797 after the fire of Copenhagen in 1795. Although covered bonds have been in existence for centuries, both the issuance and amount outstanding of covered bonds have grown considerably only since the mid-1990s. Announced issuance of covered bonds has increased from less than €100 billion in the mid-1990s to over €350 billion in 2006. In mid-2007, the outstanding amount of covered bonds was at least €1.7 trillion. This expansion has coincided with dedicated covered bond legislation being enacted in quite a few countries to facilitate the growth of the covered bond market and also the use of structuring techniques to issue covered bonds without the need for special legislation.

There are at least 19 countries in Europe as of now with enacted legislations and 9 more countries where legislations are under consideration. Recently there was a move to introduce a covered bond act in the United States. Closer to home, Kookmin Bank of Korea issued covered bonds worth USD1 billion in May 2009.

MARC is currently evaluating several covered bond transactions. This paper is an attempt to answer the most frequently asked questions about covered bonds.

Contacts:

Sandeep Bhattacharya
Vice President, Ratings
sandeep@marc.com.my

Nadia Edmaz Abdul Hadi
Senior Analyst, Ratings
nadia@marc.com.my

+603 2092 5398
www.marc.com.my

MALAYSIAN RATING CORPORATION BERHAD

5th Floor, Bangunan Malaysian Re,
No. 17, Lorong Dungun,
Damansara Heights,
50490 Kuala Lumpur,
Malaysia.

PART 1 - OVERVIEW

What is a covered bond?

A covered bond is a debt security usually issued by an institution and backed by an identifiable pool of loans over which the covered bond holders have recourse. In the event of the insolvency of the issuing institution, the pool of mortgage loans, or "cover pool" serves to satisfy the covered bond debt, and is separate and distinct from the issuer's other assets.

How is a covered bond different from a secured bond?

In a secured bond, the assets against which the bond is secured form a part of the insolvency estate of the borrower. Thus, in case of the insolvency of the issuer, the liquidator of the borrower acts on the security as per the law.

In a covered bond, there is legislation that insulates the "cover pool" from the insolvency of the issuer; however, in structured covered bonds this is achieved through the normal contract laws and techniques that are used in structured finance to isolate the assets from the borrower.

How is the cover pool different from a pool that has been charged to a bond?

A pool that is "secured" is a part of the insolvency estate of the issuer. Thus the liquidator has the right to dispose the pool as per the provisions under the general law.

In a covered bond, either through structuring techniques or through legislative provisions, the pool is isolated from the normal winding up proceedings.

Why do we need an SPV for this issuance?

In countries where there is legislation, the role of the SPV is defined by the relevant legislation. The function of this SPV varies from country to country, in some cases forming an official issuance vehicle and in some cases, it isolates the cover pool from the issuer.

In the case of a structured covered bond, the SPV isolates the cover pool from the insolvency of the issuer and thus needs to be "bankruptcy remote" from the issuer.

How is a covered bond different from an ABS?

Asset backed securities (ABS) are generally off-balance sheet non-recourse instruments. A covered bond is usually an instrument that the issuer has to account for. The details of the differences are as per the following table:

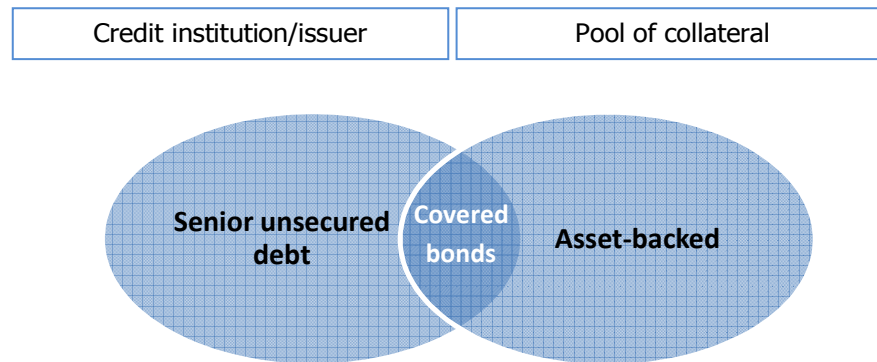
	Covered bonds	Asset-backed securities
Motivation of issuer	Funding.	Risk reduction, regulatory arbitrage, funding.
Issuer	Generally the originator of the assets.	Special purpose vehicle/entity.
Recourse to originator	Yes.	No in most cases.
Structure	Assets generally remain on the balance sheet of the originator/issuer but are identified as belonging to the cover pool for the benefit of covered bond investors. In structured covered bond transactions, the assets are often sold to the SPV to create legal isolation. However, they usually remain on the issuer's balance sheet for accounting purposes.	True sale of assets to a distinct entity to satisfy legal, accounting and regulatory overview. Bankruptcy remoteness is achieved through isolation of assets.
Impact on issuer's capital requirements	None.	Reduced.
Legal restrictions on issuer or eligible collateral	Yes, if the covered bond is issued in countries that have legislation and regulatory framework on covered bonds. Among others, regulators impose restrictions on the issuance size, level of over-collateralisation and types of assets.	Generally none. Some regulatory restrictions on the nature of the SPV may exist.
Nature of asset pool	Collateral is generally dynamic. Non-performing or prepaying assets in the cover pool must be substituted.	Collateral is predominantly static.
Transparency of asset pool to investors	Limited (but quality regularly controlled by trustees or rating agencies).	
Exposure to prepayment risk	Covered bonds are structured to avoid prepayment.	ABS investors are exposed to prepayment risk.
Tranching	None.	Common.

What motivates an entity to raise funds through covered bonds rather than senior unsecured bonds or ABS?

Off-balance sheet and capital relief are usually the most significant drivers for ABS. The most significant motivations for covered bonds are usually to lower the cost of debt and to diversify their funding sources.

A senior unsecured bond will generally entail higher borrowing costs compared to covered bonds. However, a senior unsecured bond is usually less tedious to structure. The relative features of a covered bond, ABS and senior unsecured bond are illustrated in the following chart:

SECURITIES REPRESENTING A CLAIM AGAINST

**Why are there legislations on covered bonds?**

Covered bond legislations usually separate a pool from the bankruptcy estate of the issuer. There are at least 19 countries with legislation to cater to covered bonds. There are legislations that have norms on the eligibility criteria of the cover pool. Issuing under relevant legislation often gives favourable risk-weighting status to the bonds. The presence of legislation comforts investors, and low risk weightage results in lower costs of borrowing for the issuer.

Can we issue covered bonds without an enabling legislation? In what countries has this been done?

Yes, covered bond can be issued in countries where there is no supporting legislation. In countries such as UK, Canada, the US, Korea and New Zealand where there are no enabling legislations, structured covered bonds can be issued to achieve the same purpose of granting investors a security interest over the cover pool.

MARC believes that given the absence of dedicated covered bond legislation in Malaysia, the first covered bonds to be issued in the domestic market would likely be structured covered bonds. Malaysia's general legal framework should provide adequate support for the issuance of structured covered bonds.

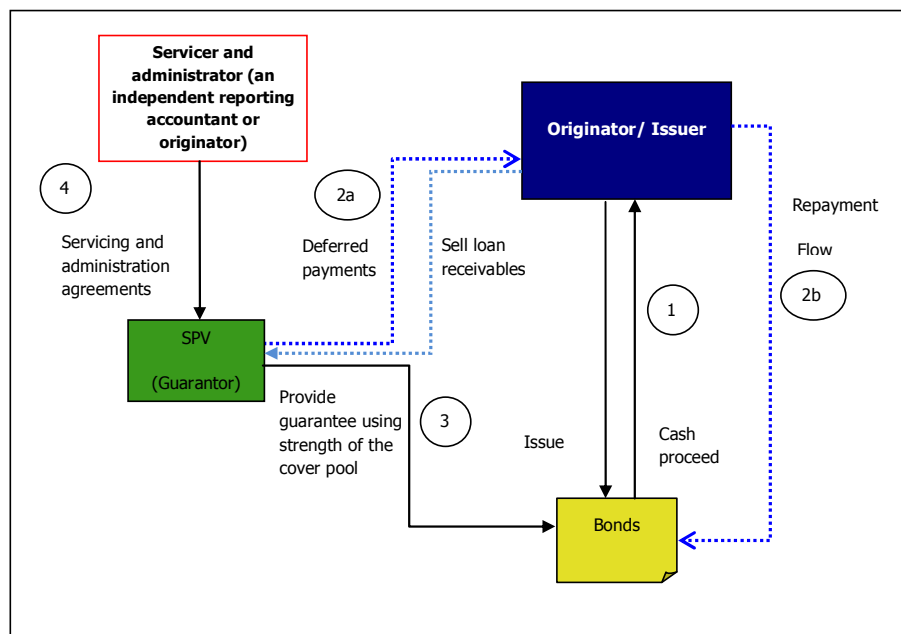
What is the difference between a covered bond and a structured covered bond?

The main differences are illustrated in this table.

	Traditional covered bond	Structured covered bond
Issuer	Banks/financial institutions or specialist covered bond issuer.	Banks/financial institutions.
Segregation	By legislation segregated on the balance sheet.	Assets are transferred to a SPV.
Asset types	Public sector, residential and commercial mortgages.	No restrictions.
Asset-liability management	Legislation prescribes market risk parameters; only Denmark focuses on liquidity.	Market risks generally fully hedged; liquidity risks mitigated.
Counterparty	Financial institutions.	Mitigated through triggers.

What is the typical working mechanism of a structured covered bond?

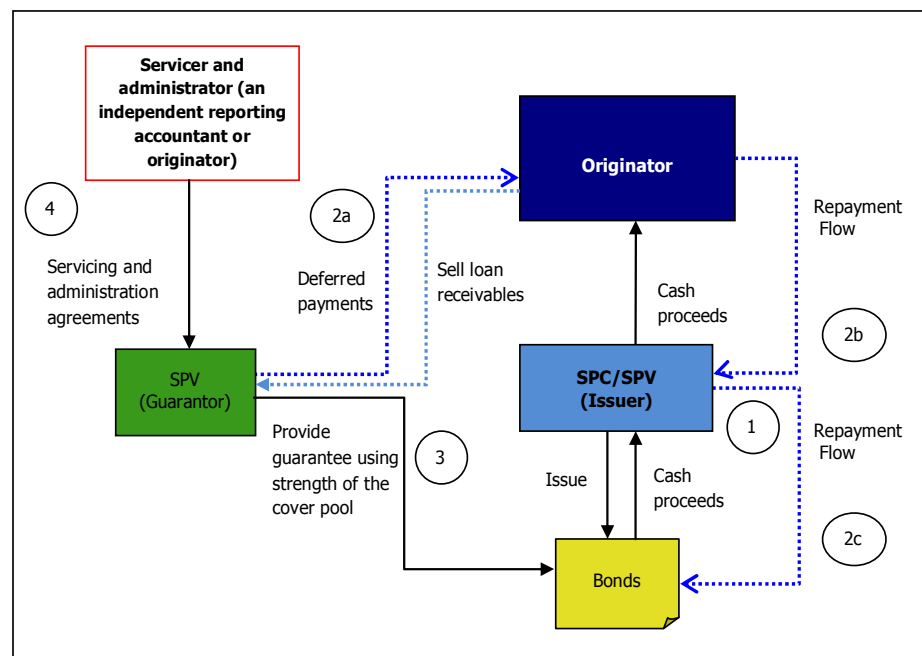
The typical transaction structure can be represented by the following diagram:



The mechanics can be described in the following steps:

- Step 1.** The originator/issuer issues covered bonds as its direct and unconditional obligations.
- Step 2.** The proceeds raised through the issue of covered bonds will be lent to an independent SPV. In turn, the SPV will use these proceeds to purchase from the originator portfolios of eligible assets/the cover pool.
- 2a.** The SPV will repay the intercompany loan in deferred payments.
- 2b.** The deferred payments made will be the source of repayment for the covered bonds.
- Step 3.** The SPV will provide a guarantee to covered bondholders for the payment of interest and principal on the covered bonds, which becomes enforceable if the issuer defaults. The guarantee represents an irrevocable, direct and unconditional obligation of the SPV and is secured by the cover pool.
- Step 4.** The originator will act as the servicer under this structure. The originator usually also provides cash management services to the SPV and monitors compliance with imposed covenants. However, in some cases, an independent reporting accountant is appointed.

Alternatively, to overcome certain constraints, a newly created special purpose company may act as the issuer. This is illustrated in the following diagram:



There are only slight variations on this structure under Step 1 and Step 2. Step 3 and Step 4 of this variant are similar to the earlier structure. The mechanics for the first two steps are as follows:

- Step 1.** The special purpose company (SPC) or an SPV issues covered bonds as its direct and unconditional obligations. This SPC or SPV is often wholly-owned by the originator.
- Step 2.** The proceeds raised through the issue of covered bonds will be onlent to an independent SPV. In turn, the SPV will use these proceeds to purchase from the originator portfolios of eligible assets/the cover pool.
 - 2a.** The SPV will repay the intercompany loan in deferred payments.
 - 2b.** The originator will assign the deferred payments received to the SPC/SPV.
 - 2c.** The SPC/SPV will utilise the monies to repay the covered bond obligations.

When did the covered bond market begin and when did structured covered bonds begin?

Covered bonds started in 1769 in Germany while structured covered bonds started in 2003 through a 7-year issuance by UK-based HBOs Plc. Most recently, in June 2010, the Bank of New Zealand issued a NZD3.0 billion mortgage covered bond programme, which is the first contractual covered bond programme issued in New Zealand. Similar to the UK, there is no covered bond regulatory framework in New Zealand, so the covered bond programme is governed by contractual arrangements in the programme documents.

When was the first covered bond transaction done in Asia?

Kookmin Bank of Korea issued covered bonds worth USD1 billion in May 2009. Besides being the first in Asia, this transaction was another "first" in the sense that credit card receivables were used as a part of the cover pool. The cover pool was a mixture of mortgage and credit card receivables. The issuance had two different tenures of 3 years and 5 years.

PART 2- CREDIT-RELATED QUESTIONS

What asset classes are suitable for this kind of transaction? Do the assets need to be liquid (or easily tradable) to be qualified?

Traditionally, low-risk assets like mortgage and public sector loans have been used as cover pools. However, in the Kookmin Bank transaction, the pool was a mixture of mortgage and credit card assets. As long as there is a demonstration of the fact that the bondholders are secured, there should not be issues about the kind and nature of the cover pool.

There are provisions in some transactions that state that a cover pool can be sold to be able to repay the bondholder. For these transactions, it is necessary that the cover pool be easily tradable. However, not all transactions are structured this way and thus in such transactions, the tradability of the pool is not consequential.

In Malaysia, trading of loans pools is uncommon. Thus transaction structures need to be designed in a manner that reflects this.

What will be the main source of repayment if the issuer remains solvent?

In a traditional covered bond that is governed by legislation, payments are met from the issuer's cash flow and the cover pool acts as a "security". Thus pool redemption does not have to mirror the bond redemption profile.

In the structured covered bonds, the source of repayment is often the cash from the cover pool itself.

What will be the main source of repayment if the issuer becomes insolvent?

In the case of issuer insolvency, the source of payment is the cover pool.

Will the issuer's standalone rating affect the overall rating of the transaction?

There is a link to the issuer's rating. However, the transaction's rating can be higher than the issuer's rating in the case of structured covered bonds where structuring is used to reduce the link between the two ratings. The strength of the cover pool will be the primary focus of MARC's credit analysis when rating structured covered bonds. Isolation of the cover pool from the operations of the issuer/originator may be a challenge in less creditor-friendly jurisdictions.

What kind of liquidity features are possible and how do they enhance credit protection to the bondholders?

Cash in the SPV, standby liquidity facilities, etc. are possible to structure liquidity needs of the bondholders.

OTHER QUESTIONS**What role does a regulator play in this issuance?**

Regulators play a variety of roles that can become relevant to the covered bond. They play a role in ensuring the stability of the financial system and thus have a direct effect on the stability of the issuer. In certain cases, the assets used in the cover pool can be "re-pledged" with the regulator, thus easing any possible liquidity concerns about the cover pool.

How will locally issued covered bonds differ from covered bonds issued in countries with a developed capital market?

Since there is no legislation yet, MARC anticipates the initial issuances to be "structured covered bond" transactions as opposed to traditional covered bonds.

Given that there is no secondary market for loan pools locally, one distinct difference will be that there cannot be any sale of pool to a third party to redeem the bond.

Since any issuance is likely to be originated and placed in ringgit, cross-currency swaps may not be needed. Also, if both the bond and the cover pool are at a fixed interest rate, there should not be any need for interest rate swaps.

Is tranching a feature of a covered bond?

No.

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MALAYSIAN RATING CORPORATION BERHAD (Company No. : 364803 V)
5th Floor, Bangunan Malaysian Re, No 17 Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel: (603) 2092 5398 Fax: (603) 2094 9397 E-mail: marc@marc.com.my
H-page : www.marc.com.my