NEW COVERED BOND MARKETS IN THE SPOTLIGHT

Thanks to its resilience and reliability in turbulent times, covered bonds spread quickly all around the world in the aftermath of the global financial crisis. The authors take a close look at how these relatively new covered bond markets are currently progressing. They expect the approval of the EU directive and regulation for the harmonization of covered bond legislation to support the introduction or update of local legal frameworks, especially in Central and Eastern Europe. In Asia, Singapore and South Korea should remain the biggest markets, but Japan has the potential to grow quickly. Moreover, they identify chances for the markets in Latin America due to the recent legislative developments in Brazil. Red.

Covered bonds represent a 2.5 trillion Euro global asset class. Initially dominated by European issuers, the product is becoming increasingly relevant in many other markets, such as Australia, Canada, Singapore and South Korea. The global financial crisis proved that covered bonds can be a resilient source of funding in times of wider market turmoil. Even in the European countries most affected by the crisis, such as Italy and Spain, banks were able to tap the covered bond market despite other sources of wholesale funding evaporating.

Issuers and regulators outside the traditional European markets duly noted banks' ability to issue covered bonds in time of stress, and expedited the approval or the amendment of legislation governing the issuance of covered bonds. Covered bond issuance picked up quickly in most of these countries once the dedicated legislation was approved (see chart).

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Favorable market conditions should remain

Market conditions should remain favorable for covered bond issuance in new markets in 2019, backed by positive, albeit softening, global economic growth and a more dovish stance from the Federal Reserve and the European Central Bank. A key development this year has been the finalization of the harmonized covered bond legislative framework proposed by the European Commission, European Parliament, and European Council, which the Parliament has approved in April.

The legislative package provides a common definition of covered bonds, defines the product's structural features, and clarifies the responsibilities for supervising the product. It also amends the Capital Requirements Regulation with the aim of strengthening the conditions for granting preferential capital treatment.

Harmonized framework to boost alignment

A harmonized framework should boost development of covered bonds in Europe by raising the standards for asset quality, disclosure, and supervision, particularly in some Central and Eastern European jurisdictions. At the same time, the European benchmark should encourage legislators and regulators in other regions to align their frameworks to the same standards.

In this article*), we take a closer look at the key characteristics of emerging covered bond frameworks in new markets, focusing on regulation, as this theme is likely to dominate throughout 2019.

Continuing expansion in Central and Eastern Europe

Covered bonds are expanding in Central and Eastern Europe, with increased volumes, notably in Poland, and improvements in some of the legislative frameworks. We expect this trend to continue in the near future, with new issuers accessing the market for the first time and further enhancements to some of the local frameworks.

Issuers in the region have traditionally funded themselves with customer deposits. In a few countries, banks had been reliant on parent support from foreign banks to meet their funding needs. However, following changes in banks' business structures and regulatory initiatives in recent years, banks primarily need to finance loan growth with domestic funding sources. At the same time, we expect solid growth in mortgage lending in the region. When mortgage lending growth outpaces customer deposits, lenders typically access the wholesale funding market and can use mortgage loans as collateral for issuing covered bonds.

Pan-Baltic legal framework in progress

Several countries have also recently amended or approved covered bond legislation. The Slovak parliament has amended its existing framework to align it with the European Banking Authority's (EBA) best practice recommendations. The new law became effective on January 1st, 2018, and we expect that it will spur the issuance of covered bonds in the country. Likewise, the Estonian parliament approved a covered bond legislation in February 2019, allowing local banks to issue covered bonds starting from October.

Estonia is also working with Lithuania and Latvia to create a pan-Baltic legal framework for the issuance of covered bonds. We expect the European Commission's recent legislative initiative on European covered bond harmonization to further encourage local legislators to amend or approve frameworks aligned to best practices in established markets.

Relevant alternative funding for Polish banks

The covered bond framework in Polan was amended on January 1st, 2016 to align it with other established European markets. Customer deposits represent the main source of funding for domestic banks. However, some lenders have decided to issue covered bonds to reduce the structural mismatch between long-term mortgage assets and short-term liabilities. Moreover, some subsidiaries of Western European banking groups have historically relied on cross-border parental funding. As Polish banks are increasingly financing their operations themselves, we believe that covered bonds will become a more relevant alternative funding source for mortgage lenders.

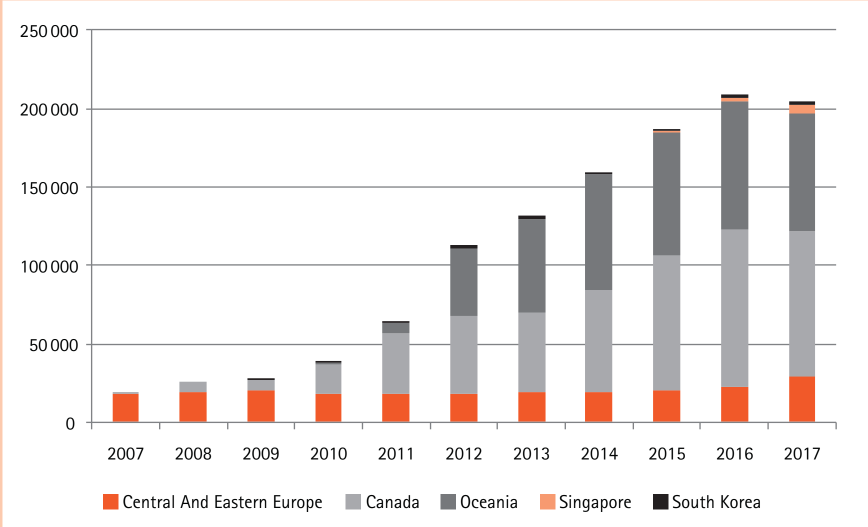
Powszechna Kasa Oszczednosci Bank Polski S.A. sold its first euro-denominated benchmark covered bond notes in 2016 and remains the only Polish issuer to have sold euro benchmarks. It has also diversified its funding basis with a zloty-denominated covered bond issuance. In July 2016, mBank established a 3 billion euro international program and issued its inaugural euro-denominated covered bond in April 2018. We understand that other lenders, including local subsidiaries of foreign banks, are also setting up local mortgage banks to issue covered bonds.

Czech Republic: updated Bonds Act

On January 4th, 2019, an update to the Czech Republic's Bonds Act (No. 190/2004 Coll., on Bonds; as amended by Act No. 307/2018 Coll.) became effective. The Czech banking sector is mainly funded through customer deposits, which provide a competitive and stable funding source for banks. As a result, Czech banks have limited incentive to diversify into more expensive funding sources such as lon-gerterm debt issuance. However, within wholesale funding, mortgage bonds are dominating.

The Bonds Act amendment of August 2012 allowing Czech banks to issue mortgage bonds governed by a foreign law opened the market to foreign investors, and since then various Czech banks (including UniCredit Bank Czech Republic A.S. and Raiffeisenbank A.S.) have placed euro-denominated mortgage bonds with investors.

Development of new covered bonds markets between 2007 and 2017
(Outstanding amounts in million euro)



Source: European Covered Bond Council

We believe that the January 4th, 2019, amendments to the Bonds Act, which addressed certain shortcomings of the previous legal framework, such as the automatic acceleration of the covered bonds following issuer bankruptcy, will further promote the relative attractiveness of the Czech covered bond market.

Hungarian market recovers well

The issuance of mortgage covered bonds in Hungary is governed by Act No. XXX of 1997 on Mortgage Banks and Mortgage Bonds (Mortgage Bank Act). In Hungary, the largest portion of mortgage loans is deposit-funded, but covered bonds are increasingly used as a source of mortgage finance. After a slump following the 2008 crisis, the Hungarian mortgage bond market is recovering with increased issuances over the past two years. We attribute this to the mortgage funding adequacy ratio (MFAR) requirement introduced by the Central Bank of Hungary (Magyar Nemzeti Bank; MNB), which demands that banks finance at least 20 per cent of outstanding household mortgage loans with mortgage-backed bonds, and the MNB's mortgage bond purchase program introduced in 2017 until the end of 2018.

In addition, the credit quality of mortgage assets originated in the current credit cycle has improved because of tighter lending and underwriting standards, including loan-to-value and payment-to-income (PTI) caps. Contrary to pre-crisis mortgage loans, loans in the current credit cycle are almost exclusively in Hungarian Forint (HUF) with an increasing share having fixed rates and longer terms. The share of outstanding residential loans compared to GDP in Hungary is still relatively low compared to other European countries. Therefore there is further growth potential in residential mortgage lending and consequently mortgage bond issuance, both of which should be further supported by the Hungarian economy's continued recovery.

Challenging environment in Turkey

In September 2014, the Capital Markets Board of Turkey amended its covered bonds communiqué, paving the way for the first issuance of mortgage covered bonds in February 2015. Turkey has generally low household and residential mortgage debt, and we expect to see sustained loan growth once the economy recovers from the recent slump. This will increase the pool of assets that issuers could use as collateral for covered bonds. However, market volatility and political uncertainty has slowed down the development of a covered bond market.

Despite several Turkish banks establishing covered bond programs after the revision of the legal framework, so far only Turkiye Vakiflar Bankasi TAO (Vakifbank) has issued euro-denominated mortgage-backed covered bond benchmarks, in April 2016. In 2017, Vakifbank also placed the first Turkish lira-denominated covered bond away from development banks, which has opened the market for privately placed covered bonds in local currency. Other issuers have placed their issuances with supranationals and development agencies that can invest in bonds denominated in Turkish lira.

Funding diversification for Asian banks

South Korea and Singapore pioneered covered bond issuance in Asia. As local banks have ample liquidity, their primary motivation in establishing covered bond capabilities was to have another risk management tool, rather than funding. Other Asian countries could benefit from funding diversification through covered bonds. While issuers in certain countries will wait for the approval of a dedicated covered bond legal framework, we believe that in other jurisdictions covered bonds will be at least initially issued under a general-law framework with an appropriate supportive regulatory framework.

For example, Sumimoto Mitsui Banking Corp. (SMBC) issued the first Japanese covered bond in November 2018. Because there is no dedicated covered bond legislation, SMBC based its program on a contractual structure. We believe that other lenders may follow suit due to the Japanese mortgage market's size and local lenders' funding needs in foreign currencies.

Established markets in Singapore and South Korea

The regulatory framework for the issuance of covered bonds by banks incorporated in Singapore was established on December 31st, 2013, and refined on June 4th, 2015, through the Monetary Authority of Singapore (MAS)'s Notice 648. With the legislative framework in place, the three major domestic banks have already set up their programs and issued cumulatively the equivalent of 8.46 billion euro as of the end of 2018. A few larger foreign banks are also considering the product, so more covered bond programs may be set up in the near future. However, the overall supply will likely be limited because banks in Singapore are mostly funded by depositors and because of the regulatory limit for cover pool assets that may amount to more than 4 per cent of the issuer's total assets.

Covered bonds in South Korea can be issued through the Covered Bond Act and the Korea Housing Finance Corp. Act. For South Korean banks, customer deposits remain the main funding source, and currently there are only two active covered bond issuers: Kookmin Bank and the Korean Housing Finance Corp., which last year issued the first social covered bond from Asia and the first Korean euro-denominated covered bond. However, the Korean Financial Services Commission has recently adopted a number of measures to encourage covered bond issuance, including reduced registration fees for bond issuances and lower capital requirements for covered bond investors. While such measures prove the regulatory support for the product, we nonetheless expect covered bond issuance from South Korean banks to be limited and opportunistic.

Increased interest in Greater China

Issuers and regulators in Greater China have increased their interest in dual-recourse issuance in the past few years. Larger banks in the Greater China area benefit from abundant liquidity and strong deposit bases. Therefore, the appetites and market trials for covered bonds issuance in this region mainly reflect increasing risk awareness – specifically, the importance of having alternative tools for banks to plan for rainy day funding, rather than current funding needs.

All three markets in Greater China have regulations on the protection of deposit holders, and the arrangement to ringfence specific banks' assets to benefit covered bondholders could be complicated without a dedicated legal framework. Moreover, legally, deposit holders enjoy a very high ranking in the allocation waterfall after banks' liquidation in the region. Because these assets' ringfencing and deposit ranking relate to the sovereign banking laws, regulators may find it difficult to have flexibility, even if they support the development of covered bond issuance.

India: regulators' guidance is needed

India has a significant shortage in affordable housing and a young and growing population. Moreover, household debt as a percentage of GDP is below that of other emerging markets. These factors suggest there could be significant growth in the housing finance sector in the future. Currently, customer deposits predominantly fund banks in India, but issuers and regulators are considering alternative sources of wholesale funding, including covered bonds. We anticipate that covered bonds in India may at least initially be issued under a general-law framework with an appropriate supportive regulatory framework.

Structured covered bonds may be issued without European-style special covered bond legislation, but regulators' guidance is likely to be needed. In our view, key clarifications required will include whether the issuance of covered bonds is permitted under Indian legislation generally, whether existing securitization guidelines can be applied to covered bonds, how asset segregation can be achieved, the treatment of assets in an issuer insolvency scenario, and whether there are any challenges from a tax perspective, including stamp duty and withholding tax.

Covered bonds in Latin America have a short and limited track record. Panama was the first country to see a covered bond issuance in October 2012, now matured. Panama does not have a specific legal framework for covered bonds, and covered bonds are based on contractual agreements. Chile is the other only covered bond market in the region, with a limited and locally distributed covered bond issuance. One factor preventing financial institutions in the region from issuing covered bonds is the lack of a dedicated legal framework. However, things may change thanks to the legislative developments in Brazil. If covered bonds prove successful there, we may see other countries in the region follow its lead.

Latin America: much hope is placed in Brazil

In October 2014, Brazil enacted Provisional Measure No. 656, which outlined a framework for Brazilian local covered bonds („letra imobiliária garantida"; LIGs), and which became Law No. 13,097 in January 2015. Although Brazil's National Congress passed a dedicated covered bond legislation in 2015 and related regulation was approved by the central bank in 2017, banks only began testing this new instrument after the 2018 presidential election, with private domestic placements. Santander was the first bank to issue LIGs in November 2018, followed by Banco Itau S.A., Bradesco, and Banco Inter.

We believe that banks are willing to issue cross-border covered bonds targeting dedicated European investors. However, the market is still waiting for legal and regulatory clarification on how these issuances could be done. Once this clarification is obtained, we believe that Brazilian banks will try to issue LIGs offshore targeting foreign investors.

*) For further information on our covered bond research, please visit **www.spratings.com/coveredbonds.**