

Covered Bonds and RMBS in Europe

A view from the front line

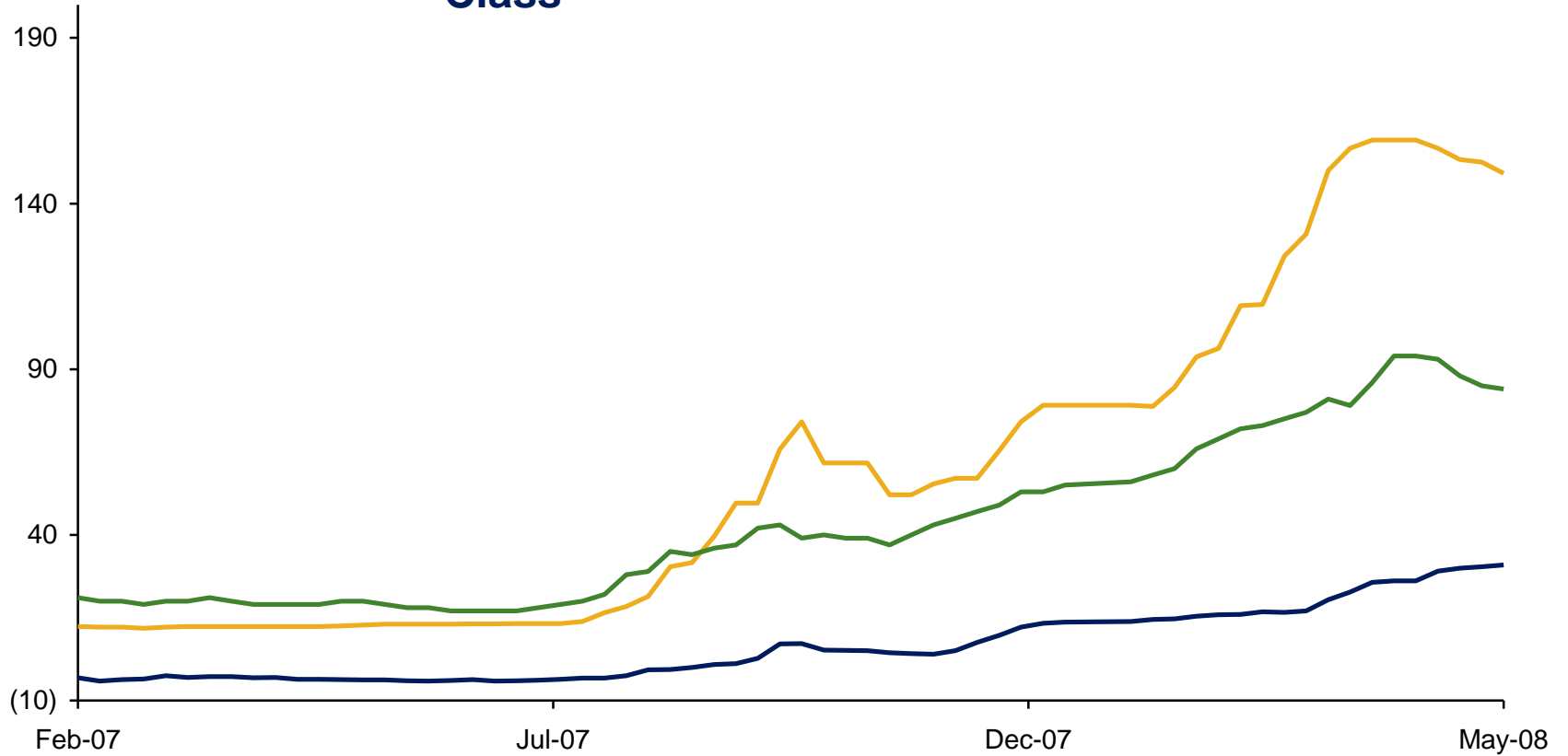
The liquidity crunch: Why, Whence and Whither?

Tim Skeet

What happened in September 2007 in the trading rooms across the markets?

- Traders were no longer in the driving seat
- Positions were being marked up and down by reference to external indices/derivatives
- The volatility was turbo-charged by the effects of leverage in the system
 - Bank prop trading
 - Hedge funds beyond regulatory reach
 - 'SIV's outside the supervisory limits

Aggregate Spreads By Asset Class



■ Senior ■ CB ■ RMBS

What have been the consequences?

Financial companies have taken more than **\$300bn** in write-downs and

.....raised some **\$260bn** of fresh capital

.. And a shortage of liquidity across the markets

The drying up of trading markets is due to:

- Mistrust of ratings and fair value notions
- Investors now have to do more homework themselves
- Collapse in confidence in the market mechanisms and counterparties
- Headline risks
- Investors have lost all sense of 'relative value' or 'fair value'
- Primary markets are re-pricing the secondary markets...
- Volatility compounded by mark to market

Mark-to-Market

- The write-downs required under current interpretations (of the rules) may be substantially in excess of any reasonably probable loss on many instruments.
 - The requirement to mark the value of assets to the market price creates a vicious cycle of excessive losses, capital depletion and forced asset sales
 - IIF Paper: “ Often dramatic write-downs of sound investments required under the current fair-value accounting adversely affect market sentiment in turn leading to further write-downs”
- “There needs to be acceptance that volatility is an economic reality. There is no point in hiding, smoothing or disguising it.”
- Ian Mackintosh, Chairman of the UK’s Accounting Standards Board

Other factors that have impacted trading:

- Cost of capital has soared
- Cost of liquidity has increased significantly

- Therefore 'ageing periods' for inventory are shortened
- Financing costs for all positions are much higher
- Trading limits have been squeezed

Even the fabled 'market making' in the covered bond sector ground to an inelegant halt despite all efforts to keep it on a life support mechanism

Where were the Regulators?

- Regulators had set out to regulate for credit risk and solvency. Liquidity was taken for granted
- Markets and regulators have learned the old lesson- it is not a lack of profit or even capital that cause companies or banks to fail- it is a lack of liquidity
- RMBS and covered bonds were regarded as key sources of market liquidity with specific defensive qualities that provided for a measure of certainty of liquidity in times of stress, especially where a specific institution suffered credit concerns

Where were the Regulators?

“We’ve also found other regulatory gaps.. We have discovered a host of perverse incentives in the securitisation process, only a small portion of which are the responsibility of securities regulators”- Christopher Cox, Chairman, SEC

The SEC has recently been granted regulatory authority over credit rating agencies

...Moody’s suffered a ‘bug in its computer models’

Headline Risk

Investors report that they are trying to deal with excessive volatility but also significant 'headline risk'.

'If it bleeds, it leads'

The press have had a great time: and there has been much blood on the street

The UK Case:

- Dramatic headlines suggesting UK mortgage market would follow the US model-
- Excess sub-prime exposure
- Rising default rates, negative equity, failing underwriting criteria
- Macro economic concerns- slowing economy, inflationary pressures
- Concerns over UK mortgage market and regulation- and over UK covered bond structures

This led to:

Collapse of the RMBS sector gives rise to concerns over volume that needed to be financed from other markets:

UK RMBS issuance

2006	\$136bn
2007	\$131bn

UK Covered Bonds

2006	\$20bn
2007	\$17bn

...and the same fears applied also to Spain...

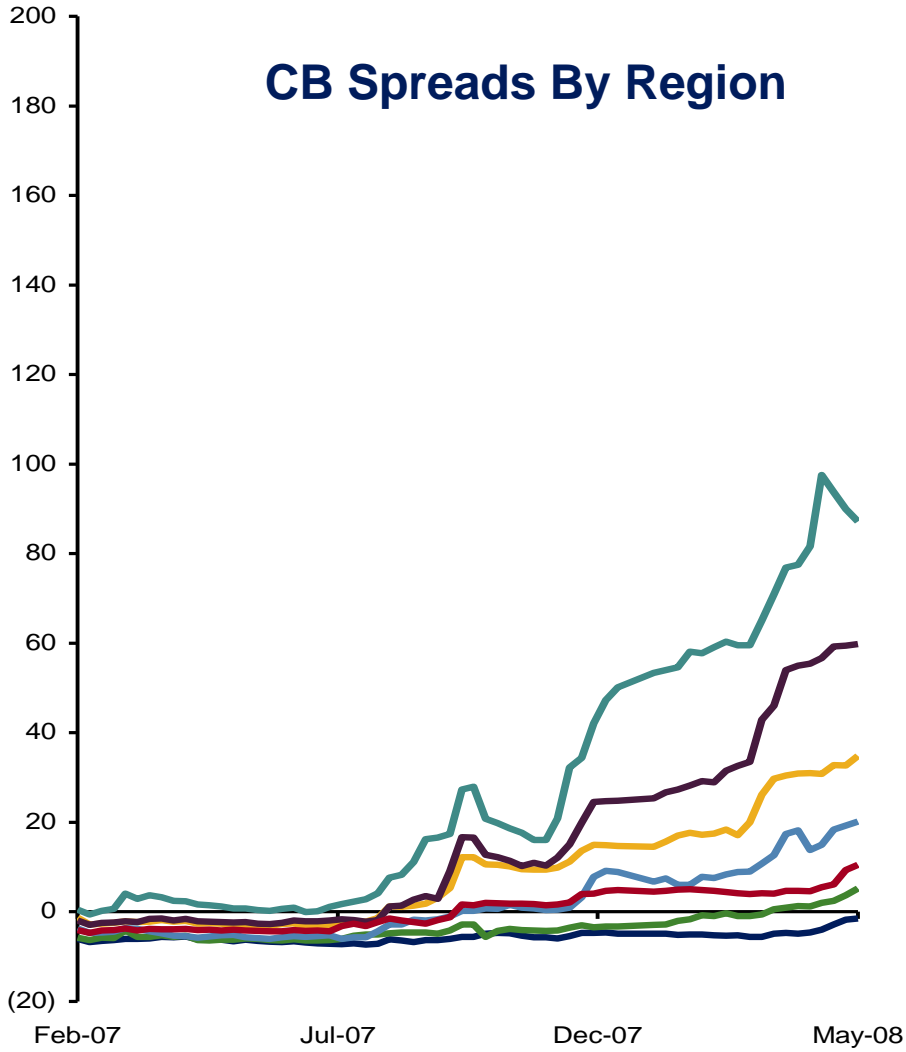
Spanish RMBS Issuance

2006	\$36bn
2007	\$53bn

Spanish Covered Bonds

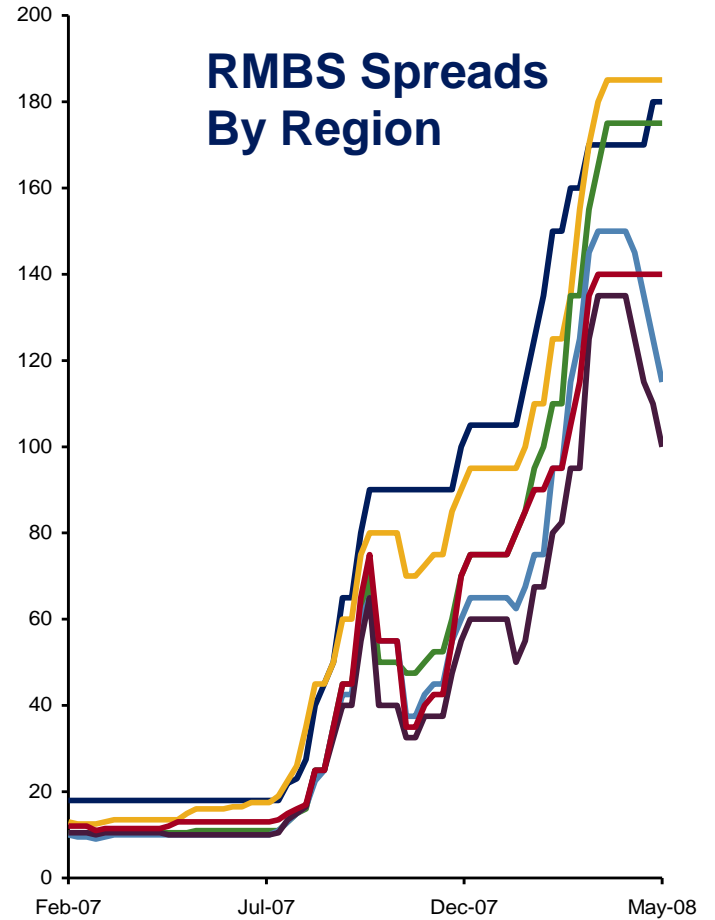
2006	\$65bn
2007	\$36bn

CB Spreads By Region



- German Pfandbriefe
- Spanish Cédulas
- French Obligations Foncières
- Irish credit covered securities
- UK covered bonds
- Swedish covered bonds
- US covered bonds

RMBS Spreads By Region

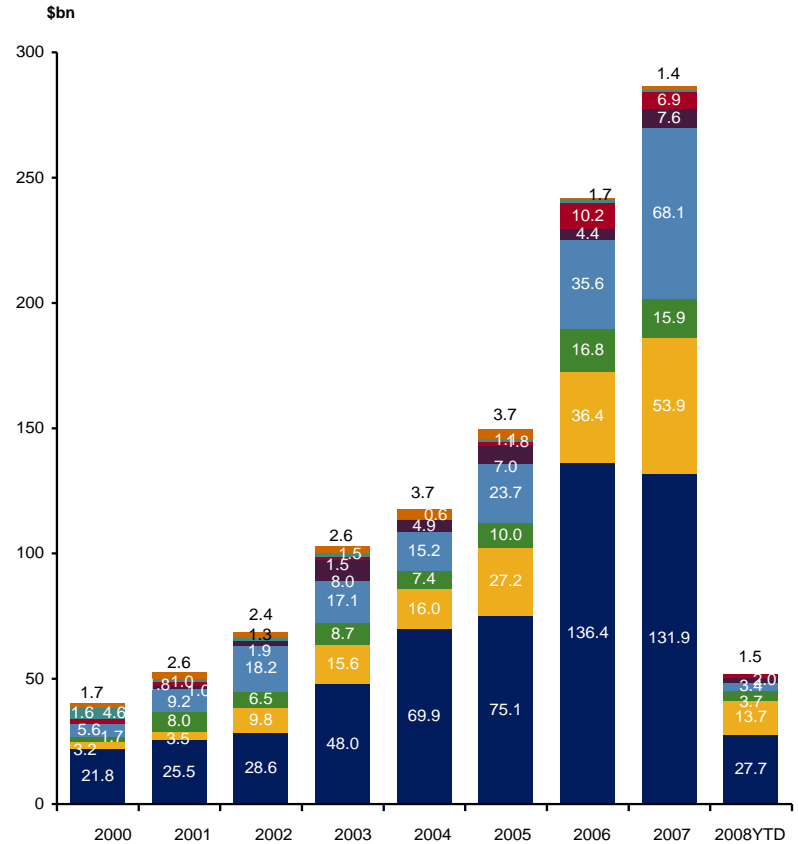
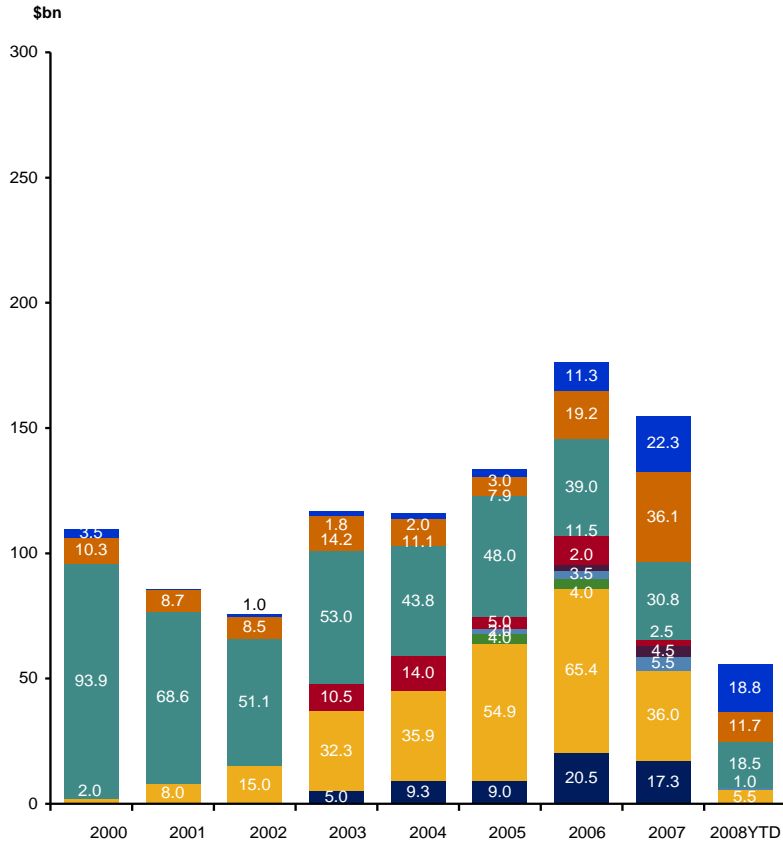


- Germany 5y AAA RMBS H
- Spain 5y AAA RMBS
- Ireland 5y AAA RMBS
- UK 5y AAA RMBS
- Netherlands 5y AAA RMBS
- Italy 5y AAA RMBS

CB vs. RMBS Market Supply

CB Supply By Year

RMBS Supply By Year



What have the authorities done?

Tighter regulatory regime

Bank of England term repo facility

Covered bond law to make UK covered bonds UCITS compliant

The Covered bond market has split into:

- Core
- Peripheral

- Covered bonds governed by a law
- Covered bonds relying on commercial contract

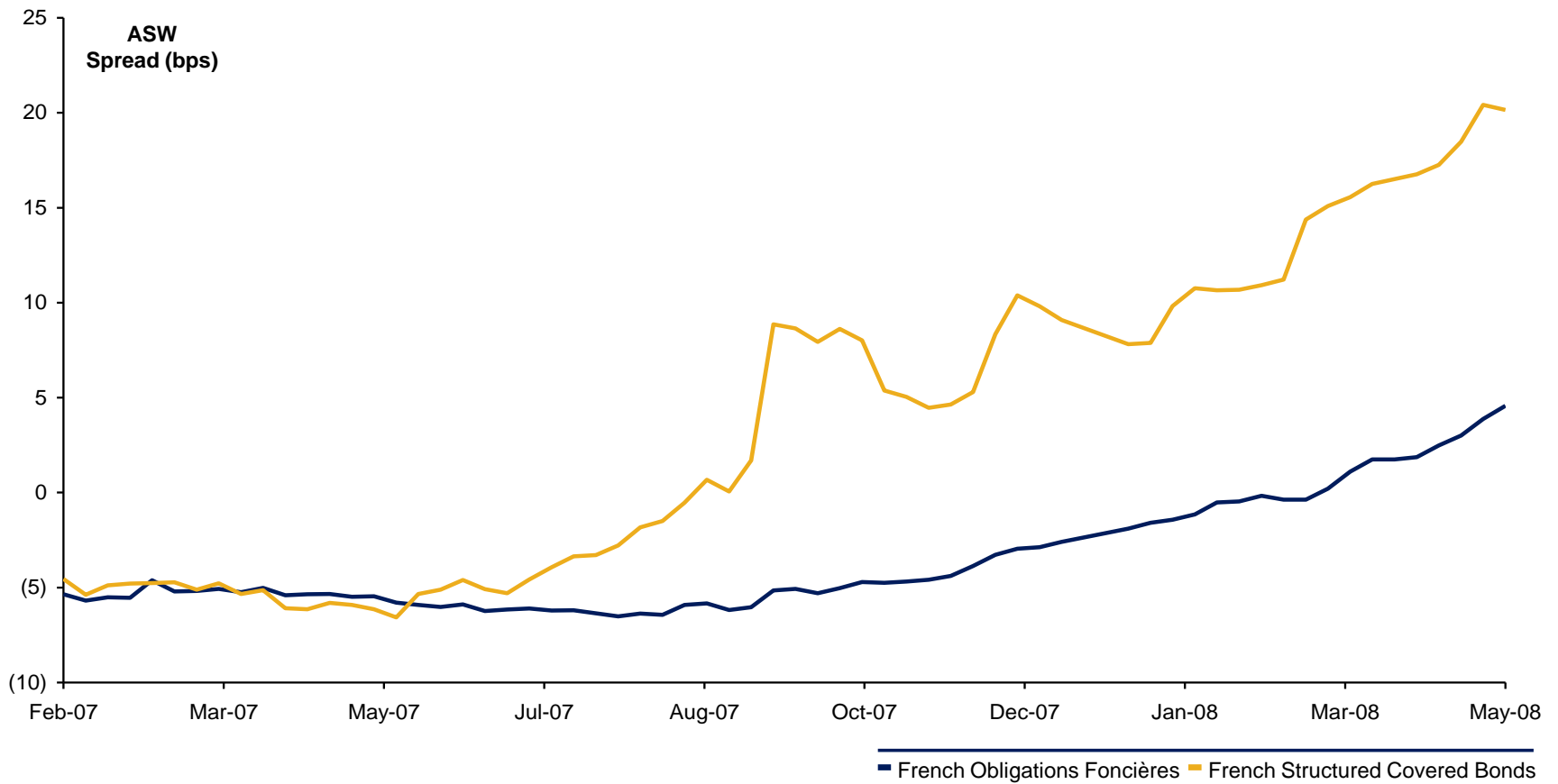
The UK is ranked- 'peripheral'

There have been no issues from the UK this year

France has split in two- 'core' and 'second tier core'

OF and more recent structured covered bonds no longer trade together

French Structured CB Spread Performance vs Obligations Foncières



A few thoughts for the near term in Covered Bonds:

- The market is now well engaged in the re-pricing of the curve- issues are being executed but at a price
- Soft market conditions expected to run into the summer. Tightening of the senior curve will flow through into the covered market as investors focus on relative value. Some investors have migrated to the 'credit' side
- Overall covered bonds remain a rates product, but one that is heavily coloured by 'credit' considerations in the short term. We expect this trend to start to reverse somewhat after the summer, when volume supply concerns will predominate

A few thoughts for the near term in Covered Bonds:

- Investors are now expected to do more homework and due diligence on individual issuers. This includes credit work.
- Assuming that there is no fresh trauma in the financial institution market, we should expect some stability in Q3 post the summer break. This will feed through into a more stable spread environment with possibly a slight tightening trend.
- Market should resume trading with a transparent screen based service that will allow issuers to monitor volumes and prices, and investors will have access to reliable data and prices for valuation and trade purposes.

..And the US is learning something from Europe...

Given the subprime crisis, and investor concern about "securitizations", the covered bond market may prove to be an alternative means of financing for depository institutions. The covered bond market has flourished in Europe for centuries, but is new to U.S. depository institutions and institutional investors. Recently, the Chairman of the FDIC stated that U.S. regulators were working on ways to help the covered bond market's development in the U.S. Similarly, Treasury Secretary Paulson has expressed his support for the growth of the market in the U.S.

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