

EUROWEEK

The US Dollar Covered Bonds Roundtable

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The US Dollar Covered Bonds Roundtable 2010

COVERED BONDS have never attracted such attention in the United States as they have during 2010. Part of that is due to legislation, wending its way through Congress — and put forward by roundtable participant Representative Scott Garrett — that promises to create a domestic legal covered bond framework for the first time. With the country's housing finance system set for a shake-up, US domestic covered bonds could soon become a fixture of the country's capital markets — and that is starting to win attention from a wide variety of investors.

But 2010 hasn't only been about the potential of future supply. Perhaps partly because of the domestic agenda, this year has also seen a sustained resurgence in US investors' wider interest in the product — which Canadian and European issuers have taken advantage of, through the 144A market, to sell \$19bn of US dollar covered bonds. Many more European issuers are slated to launch 144A deals over the coming months, taking a new funding avenue in seeking to avoid congested home markets.

In this roundtable, participants shared their thoughts on the likely market impact of legislative progress, the challenges for foreign issuers and the attractiveness of the product for investors.

Participants in the roundtable, for which interviews were conducted in September, are listed below.

Ian Berry, managing director, head of funding and liquidity management, **Scotiabank**

Ben Colice, director, head of covered bond origination,

Americas, **Barclays Capital**

Paul Dudouit, managing director, head of long term funding, **Crédit Foncier**

Representative Scott Garrett (**R-NJ**)

Beth Hammack, head of US agency/sovereign/supranational/covered bond trading and syndicate, **Goldman Sachs**

Ted Lord, managing director, head of European covered bonds, **Barclays Capital**

Jerry R. Marlatt, Senior of Counsel, **Morrison & Foerster LLP**

Eldar Mezbur, head of covered bond origination, **Goldman Sachs**

David Power, vice president – corporate treasury, **Royal Bank of Canada**

Nick Jacob, contributing editor, *EuroWeek*

Derrick M. Wulf, head of interest rate positioning, **Dwight Asset Management**

Lucette Yvernault, global credit portfolio manager, **Schroders**

EUROWEEK: Congressman, could you start off by updating us on the progress of the legislation you have been pushing for and a brief outline of other regulatory developments?

Representative Scott Garrett (R-NJ): The legislation has been passed unanimously by the House Financial Services Committee and a hearing has been held in the Senate Banking Committee. We are expecting companion legislation to be introduced in the Senate in the near future.

Some of the accounting standards changes (FAS 166-167 Securitisation Accounting) have led to less capital relief for banks when they securitise. This has somewhat levelled the playing field for covered bonds because one of the biggest knocks on them was that issuers got no capital relief for them.

EUROWEEK: Why do you support covered bond legislation in the US? Will it take a similar route to European legal frameworks?

Rep. Garrett: One reason I am particularly fascinated with covered bonds is the fact that they can be a purely private means of finance — that is, without government guaran-

tees or subsidies. I believe covered bond legislation offers a way for the government to provide additional certainty to private enterprise, and generate increased liquidity through the innovation of a new marketplace.

Most importantly, we can do all this without putting the US taxpayers on the hook. The US mortgage and credit markets are much different than those in Europe. It is hard to know what exact differences there will be in

the end, but I imagine that the US market will be more closely tailored to fit the US system.

EUROWEEK: Jerry, do you think there are European models to emulate?

Jerry R. Marlatt, Morrison & Foerster: There are a lot of differences — I was going to say more differences than similarities, but that's not true. But mortgage and housing finance do just vary



US Congressman Scott Garrett

so much from country to country it's really hard, I think, to say we would emulate any country. Certainly there's a lot to be learnt by looking at the housing market in other countries and there's a hearing in Congress on the September 29, on the senate side, on exactly that: on housing markets and housing financing in other countries.

The standard mortgage here is a 30 year fixed rate mortgage that's pre-payable without penalty and in many states it's no personal recourse to the borrower, it's only recourse to the property. So the incentives in the market can be very different from any other country. But on the other hand, I would say that this legislation is kind of modelled off the traditional European structure of direct issuance out of the bank — it adopts an issuance form more like the traditional German form. Obviously, a lot of the details are different because you have to adapt it to the legal environment you have in the United States, but the broad form is like the German form, not like the UK form.

EUROWEEK: How do the bankers on the panel view current progress?

Beth Hammack, Goldman Sachs: The covered bond legislation has gotten a lot of focus and broad based support in DC. We've spent some time trying to educate interested parties about the benefits of having a covered bond market and I think many people in Washington view it as a nice complement to some of the GSE styles of housing support that we have in place in our market. And so it's a discussion topic alongside the GSE reform, because I do think that there's a role for covered bonds to play for the US in terms of trying to be more supportive of what was the private label market, the non-conforming 30 year fixed rate product. I would expect to see some of the US commercial banks using covered bonds for things that could not be wrapped by a Fannie or Freddie or successor entity and that this could help to really build the market and make the hybrid ARMs product a more affordable choice.

Ben Colice, Barclays Capital: There has been continued support across the House and Senate for covered bond legislation and so we are fairly optimistic and certainly very supportive of the work that is being done in an effort to enact legislation to facilitate a domestic market. We think that the timing of legislation remains uncertain, certainly because of the upcoming elections in the US and what those elections will bring to the House and the Senate. But regardless of what the outcome is, there remains very enthusiastic support. Representative Scott Garrett has been a staunch supporter and has garnered a great deal of support from the Republicans and Democrats alike in the House and the same can be said of the Senate. The real question is timing because it will happen at some point and will facilitate the development of domestic covered bond issuance.

Ted Lord, Barclays Capital: And just to add to what Ben is saying, we see fairly frequent pronouncements out of Washington, whether it's coming from the Congress or from the Treasury or from the Federal Reserve, that the covered bond market has got



Ben Colice,
Barclays Capital

a lot of advantages to keep a mortgage market on a fairly stable footing.

Colice, Barclays Capital: That is a good point. People view covered bonds as not the solution, *per se*, to mortgage finance in the US but they very much view it as an additional source of funding for US banks that will benefit consumers in the form of reduced costs in accessing funding. That is certainly a positive.

EUROWEEK: So covered bonds could co-exist with government-insured mortgage programmes?

Rep. Garrett: Yes, I believe they definitely could. However, Congress is also in the process of looking at how we can overhaul our entire mortgage financing sector. At the moment, we aren't even sure there will be government-insured mortgage programmes at all. Even if there are, it would be hard to say what they will look like.

EUROWEEK: Like Fannie and Freddie?

Rep. Garrett: I do not believe covered bonds could in the near term ever replace our current securitisation markets, but they could add an important additional tool to help provide funding for a variety of asset classes. I believe a US covered bond market should be able to fit into our country's mortgage system.

EUROWEEK: Congressman, what kind of private sector support is there for the initiative?

Rep. Garrett: I have formal letters of support for the US Covered Bond Act from: the National Association of Realtors, the Mortgage Bankers Association, the American Bankers Association, the National Multi-Family Housing Council, the National Apartment Association, the CRE Finance Council, the Real Estate Roundtable, the Securities Industry and Financial Markets Association, the American Securitisation Forum, the Financial Services Roundtable, and others.

EUROWEEK: In what timeframe can covered bonds become a reality in the US?

Rep. Garrett: It all really depends on when we can get the legislation passed so we can offer the certainty needed to get a market going. I'm confident we can get legislation passed by early next year and possibly sooner. There is definitely an appetite in the US for the product — no doubt about it. So far this year, \$19bn of dollar denominated deals offered by foreign banks to US investors have been done.

Marlatt, Morrison & Foerster: You know, we have an election coming up here in November so this session of Congress only runs through October 8 and then it recesses. There may be a lame duck session after the election to address important issues but I doubt that covered bonds would get picked up, and so I think the real answer is, it's likely that covered bonds are not going to be addressed till January.

EUROWEEK: So there's a real prospect that we could have something in January?

Marlatt, Morrison & Foerster: Yes, I think so. The FDIC is supportive of covered bonds — two years ago they put out a policy statement on covered bonds and I think

their position is still that covered bonds can be a very useful financing technique for banks. They're concerned about a few key provisions in their statutory powers but I think we'll come to some resolution on that and there's generally agreement. There's no opposition, nobody who thinks they're a bad idea, so I suspect sooner or later they will get approved. It's just that in the grand scale of things it's hard to move covered bonds to the top of the agenda in Washington. It just needs to move at its own pace.

EUROWEEK: What are the obstacles to covered bond legislation? And how can they be overcome?

Rep. Garrett: The FDIC has concerns about limiting their flexibility in dealing with a bank failure. As such, we have made accommodations for them in the legislation and worked to find a solution that is agreeable to all sides. I'm confident we'll not just get everyone in agreement, but enthusiastic about the future of a US covered bond market.

EUROWEEK: Did the latest Senate committee meeting live up your expectations?

Marlatt, Morrison & Foerster: In some ways it exceeded my expectations because the level of dialogue and the questions being asked by the Senators were in more depth than the hearing I'd seen in the House of Representatives. They'd obviously been well prepared for this and they understood the issues pretty well, I think. It was heartening to see that they'd spent that kind of time to come up to speed. And they really, I think, understood the key issue between protecting the maturity date on the covered bonds and the FDIC's desire to retain the flexibility to accelerate debt on an insolvency of the issuing bank.

EUROWEEK: Can that be resolved or will one side or the other have to give way?

Colice, Barclays Capital: In the Senate hearing the other day, the FDIC very plainly and clearly stated their support for covered bonds suggesting to me that the FDIC does view there to be a role for covered bonds in so much as covered bond issuance would not jeopardise the strength of the deposit insurance fund.

Hammack, Goldman Sachs: The FDIC's mission is to protect the depositors, so first and foremost that is what they're going to focus on. When you're looking at a bank that's insolvent obviously there are going to be competing interests that need to be managed. However, if we view this as a long term core product that will be supportive of our banks on an ongoing basis and hopefully keep them out of bankruptcy, then you would hope the FDIC is willing to make some concessions to allow the product to develop.

Marlatt, Morrison & Foerster: It's still possible to resolve it. And the FDIC has a number of other powers that allow them to approach this differently. For instance as a bank regulator they have a power to limit the activities of banks, for safety and soundness reasons; they have the power to change the assessment that they charge banks to support the deposit insurance fund; so there are a number of different ways to approach this. Senator Corker indicated that he had already had private meetings in his office with the United States Covered Bond Council and

the FDIC, and that he expected to hold more such meetings with the hope of resolving this point.

EUROWEEK: I'm interested in the way that regulators everywhere are putting more emphasis on resolving failing banks quickly. How well will resolution authorities be able to function when there's a significant portion of the balance sheet wrapped up in a cover pool?

Marlatt, Morrison & Foerster:

Well, as a starting point there may be limits on the amount of assets that are trapped in a cover pool. Secondly, most likely you would find another bank coming in and taking over the covered bonds and the cover pool, and that's both in the interests of the bondholders, I think, and in the interests of the FDIC, and it's the quickest resolution to the problem.



Jerry Marlatt,
Morrison & Foerster LLP

But banks also face similar problems in other areas; for example, at least in the US, most swap agreements are what are called qualified financial contracts under the Federal Deposit Insurance Act, and they are often secured under a CSA, and the counterparty to that swap, if the FDIC does not move those swaps to an assuming bank within one day, those counterparties are entitled by law to close out immediately. So, some of those issues are already on the table for banks in their swap portfolios and derivative portfolios.

EUROWEEK: Just recently there have been suggestions that in Europe, Anglo Irish covered bonds could form part of an unguaranteed run-off bank — and rating agencies downgraded the bonds after lowering expectations of timely payment.

Lord, Barclays Capital: Well there's talk about that, but we need to think about the likelihood. Anglo Irish has good assets in the cover pool.

Covered bonds have been around since 1768 with an impeccable payment record despite war, occupation, hyper-inflation, deep recession, and highly-structured derivatives.

You've had cases in many countries where you have actually had a government bond default and a covered bond has been simultaneously paid in full and on time. Denmark defaulted on government debt in 1813, whereas Danish mortgage bonds were paid in full and on time. You had a default case with Austria at the outbreak of the First World War, whereas Austrian covered bonds (then known as Fundierte Schuldverschreibungen) were fully paid at the same time. Germany defaulted on its foreign debt in 1933 whereas the holders of German Pfandbriefe at the time were fully and punctually paid.

I would like to draw people's attention to a recent case which highlights how robust covered bonds can be. Iceland recently — March 2009 — had a total meltdown of its banking system, which resulted in full nationalisation. The Icelandic government could hardly borrow locally and it was impossible for it to do so in the capital markets abroad. Throughout all this, you had two instruments that have been punctually serviced, and that's two covered bonds: one issued by Kaupthing and the other

by Glitmir. The cashflows from the assets pools of these covered bonds were of a high quality and were separated to service the covered bonds.

I've seen many cases where people have suggested there may be a problem and, needless to say, there have been some big issues, but, you know, so far, so good.

EUROWEEK: Congressman, what do you see are the advantages of the product?

Rep. Garrett: There are many potential benefits for a wide variety of interested parties that come with a US covered bond market. Consumers will experience lower loan rates because of the additional liquidity in the various asset classes and will benefit from the ease by which they can have their loans modified. In addition, investors will now have a new transparent and secure vehicle to invest in, which will allow for further diversification within their portfolios.

Of course, at the macro level, the broader financial markets will benefit by having an additional, low cost, diverse funding tool for financial institutions. Covered bonds will ensure more stable and longer term liquidity in the credit markets, which reduces refinancing risks as well as exposure to sudden changes in interest rates and investor confidence. And they will allow US financial institutions to compete more effectively against their global peers.



Eldar Mezbur,
Goldman Sachs

Eldar Mezbur, Goldman Sachs:

It is a purely private way to finance mortgages without a government guarantee and ultimately in a crisis situation, not utilising taxpayer's money so it clearly is going to benefit not only the US government but the taxpayer and ultimately the mortgage holder because of the liquidity that this product will bring back to the mortgage market.

EUROWEEK: Let's bring in the investors on our panel. What attracts you to the covered bond market?

Derrick Wulf, Dwight Asset Management: The covered bond market has been around for a very long time in Europe and has withstood numerous tests over the years. While American institutions have historically relied on the securitisation model to finance loan portfolios, we expect them to adopt the covered bond model as well in the near future in an effort to diversify their funding sources. We consider covered bonds to be an attractive complement to both unsecured bank credit and other high grade spread product, such as the debt issued by the GSEs.

Lucette Yvernault, Schroders Investment Management:

We believe the covered bond sector represents a true opportunity versus debt from large corporations which are now trading at an equivalent spread level. With the current economic backdrop, it is likely that a number of large companies will look at non-organic opportunities often including aggressive/hostile bids which in turn can shift their skinny yield profile to a wider spread level based on a massive leverage multiple. Extensive barriers prevent this appalling kind of behaviour in covered bond pools.

Moreover covered bonds seem supported by the new

set of regulations to be implemented in the foreseeable years. So far the asset class has been developed under tight regulatory frameworks which have prevented most quality migration under difficult market conditions. Furthermore, this asset class has been a permanent and viable source of funding in various northern European domestic markets throughout the financial crisis. Similar market sustainability could be replicated in the United States.

EUROWEEK: On-balance sheet cover pools are touted as a way of ensuring originator's adherence to high underwriting standards. How much comfort does that give you?

Wulf, Dwight: For us, it gives only limited comfort. We place much greater emphasis on an issuer's established lending practices and overall risk culture.

Yvernault, Schroders: Covered bond pools aren't subject to the volatility waves created upon change of management or M&A activity at a time when companies aren't delivering the kinds of returns which are going to please shareholders going forward. While these instruments aren't entirely disconnected from their sponsored entity's well being, in terms of investor sentiment, the covered bond pool should support the entire repayment of the cashflows throughout the life of the covered bond plan.

EUROWEEK: It's not just mortgages is it? There have been initiatives to include quite a wide variety of collateral in the US legislation.

Colice, Barclays Capital: That is right and I think the US focus has really been on how the concept of covered bonds, if you will, can benefit consumers and banks as broadly as possible. The idea of multiple asset classes has come up and it's something that is, quite frankly, a very interesting idea.

Hammack, Goldman Sachs: We've only talked about covered bonds in the context of a mortgage product and I do think that in the early stages the mortgage based product is really driving the market. But when you look at how the securitisation markets have dried up in the US and when you look at how some of the changes in the bank reform bill that was recently passed there will be broader applicability to use covered bonds as a general financing tool for banks beyond the mortgage space.

Marlatt, Morrison & Foerster: The legislation that was approved by the House Financial Services Committee narrowed the eligible assets quite a bit, to the point where it is right now only residential and commercial mortgage loans and public sector debt. There are still some people who would like to see a wider variety of assets but there seems to be general agreement that either covered bonds should be narrowly defined or that they should at least start off narrowly defined.

The one thing I would want to point out is that we have a lot of banks in the United States, almost 8,000, and I think, frankly, that covered bond legislation would be most beneficial to the middle-tier banks, to the 1,000 or 2,000 or 2,500 banks, that are not money-centre banks but they're fairly sizeable lending operations in their commercial mortgage business. This would give them capital markets access to finance mortgage loans, which could be really valuable.

And if that happened, it's an enormous market.

Think about 1,000 or 2,000. Let me just step back and say, frankly, I don't expect these are going to be jumbo covered bond issuers. I think what you're going to see is the development of a domestic market in covered bonds similar to what you see in Germany and France, where the smaller issuers, the smaller banks will fund themselves in covered bonds primarily in the domestic market and not in a jumbo market. And in the long run I think that may be the most beneficial effect of the covered bond legislation.



Ted Lord,
Barclays Capital

Lord, Barclays Capital:

That's certainly possible and I would also point to the fact that in the European market, there are a number of different asset types that are eligible for cover pools. As well as the traditional public sector loans, commercial mortgages, and residential mortgages, you have ship loans, in some cases you have aircraft loans and leases. So the concept of more asset classes than just mortgages is not unique

to the US. The point is that it's a very flexible asset class as long as investors really feel they have high quality assets backing the bonds and a very transparent cover pool. This sort of development is really gaining momentum, not only in North America and Europe, but even elsewhere.

EUROWEEK: Isn't that running before you can walk? It's not the natural place to start?

Hammack, Goldman Sachs: Well, mortgages are the natural place to start, they are the most liquid and I think the most well known market and I think that's why we have started there. I would not expect to see some of these other products used initially but when investors get more comfortable with the FDIC treatment of the covered bond product I think you will be able to see it come from these other assets as well.

Mezbur, Goldman Sachs: What it boils down to is that it really doesn't matter what collateral is backing the bonds as long as that collateral is on the balance sheet because it will force issuers to maintain it to the highest possible standards, unlike what you have in the ABS world where ultimately you live and die by the assets in a pool.

EUROWEEK: That meets some of the regulators' worries about 'skin in the game' doesn't it?

Hammack, Goldman Sachs: Yes, absolutely, it's a very nice complement to some of these 5% retention rules that came through in the securitisation sections.

EUROWEEK: Covered bonds have had a chequered history in the US. What lessons can be learnt from those earlier experiences?

Marlatt, Morrison & Foerster: I object to the word chequered, but I understand what you mean. I think the first lesson is to avoid financial panic — that's an experience that I'd rather not repeat.

Covered bonds had really started to flower with WaMu and Bank of America, but WaMu's insolvency was one

knock, the reputation of the entire US residential mortgage market that came out of the subprime problem was another knock, and, finally, the financial crisis was a huge knock, to the point where today I don't think it's cost-efficient for any US bank to issue covered bonds under the structure that we used in 2006 and 2007. We started issuing covered bonds and then ceased doing it.

On the other hand, from a market point of view, Canadian and European banks have increasingly been coming to the US market so on the investor side, I think covered bonds are being, I would say, pretty warmly received.

Wulf, Dwight: Chequered, perhaps, but recent history has also provided some extremely valuable lessons which have helped the industry learn, evolve, and grow. As such we feel the acceptance of covered bonds can and will grow meaningfully in the US going forward.

Without the longstanding history enjoyed by the covered bond market in Europe, we don't think the US market will likely reach quite the same proportions. Instead, we believe it will be viewed by issuers as an attractive means to diversify funding sources, and by investors as an alternative and a complement to securitised assets and other high-grade spread product.

Hammack, Goldman Sachs: We've seen some investors taking a wait and see approach over how this market develops and the liquidity that develops behind it. Some were quite disappointed with the liquidity they saw through 2008 and 2009, not just in covered bonds but across all quote, unquote, liquid products. And so they are being somewhat cautious but the market has really grown up without them and is quite vibrant and we are seeing some of those investors who were quite supportive in 2007 now starting to come back because they feel the liquidity is present in a way that they want and need it to be.

EUROWEEK: What do European issuers in the US covered bond market think will be the impact of domestic covered bond legislation in the US on their own programmes?

Paul Dudouit, Compagnie de Financement Foncier: Covered bonds should be an opportunity for the US commercial banks to diversify their funding and to have new funding tools to refinance their activity. I am sure this project will have positive feedback from the politicians and from the banking community. It's a very strong, very powerful tool.

I don't see development of covered bonds in the US to be direct competition — it's a win-win process because if investors are looking for new tools of course they will have an interest in European covered bonds and the experience we have developed in Europe. They will see in the example of CFF that for 150 years there have been no defaults and that we can show them stability, transparency and performance.

David Power, Royal Bank of Canada: The development of a US legislative framework would be a huge positive for the evolution of the market. Active participation from domestic banks would lead to maximum involvement from the US investor community and would be another boost for liquidity in the product.

EUROWEEK: Is the awareness of covered bonds increasing in the US? Are there more investors looking at the product and more banks looking to be involved?

Marlatt, Morrison & Foerster: You know, I would turn to some of the bankers on the panel to really answer that. I have to think the answer is yes, because with \$20bn of issuance this year, it can't be the same investors all the time. And having that marketing effort in the US helps to educate investors and a growing volume of issuance in the US starts to build a real secondary market. So for a number of reasons, I would say, yes, on the investor side, the awareness and the interest is going to be growing.

Hammack, Goldman Sachs: When the covered bond market started in the US in 2006 and 2007 we had really just a handful of investors that were driving it. In the deals now you're finding the order book has 70-100 lines. Investors are participating in varying sizes and to varying degrees, but you're getting a much broader scope of participation. And part of that is driven by the US discussions and about the applicability of covered bonds to our funding markets and financing markets.

Lord, Barclays Capital: What is different this time around is that investor appetite in the United States is more widespread than it was with the US dollar 144A covered bond issues that came to the market before the financial crisis. This is a reflection of, over time, increasing awareness of the covered bond asset class. There has been a lot of discussion about covered bonds in the United States, of establishing a covered bond market and covered bond legislation, as well as positive statements from Washington.

Additionally, we have witnessed a very public support from Europe with the Covered Bond Purchase Programme of the European Central Bank and the central banks of the Eurosystem. The ECB publicly stated that unless you have a good, functioning covered bond market, you cannot really have true economic recovery in Europe. The Covered Bond Purchase Programme was a very visible and very successful move by the ECB and the central banks of the Eurosystem.

Those two things are what's really created a much greater spread of different types of investors this time around in the covered bond market in North America. And what's been interesting is that the increased appetite that we've seen from the United States has actually encouraged many more non-US accounts, particularly in Europe, and also some of the central banks in Asia, to start utilising more of their dollar liquidity in the covered bond market. Before, their investments in covered bonds were mainly in the euros, Swiss francs, and Nordic currencies.



Beth Hammack,
Goldman Sachs

Hammack, Goldman Sachs:

Look, the appetite for the product is quite significant and our main limiting factor right now is issuers coming to market with supply. So, the more that we have issuers coming to market and helping to develop the market with supply the broader the investor base will get, the tighter pricing could potentially get, and the more attractive overall. There are some structural things that US legislation would

help with — things like repo eligibility at the Fed, how covered bonds are treated in various liquidity buckets,

and electronic trading. To have those things more fully developed I think is going to be necessary to get this market to the next stage.

EUROWEEK: Let's talk about the 144A issuance we've seen so far. How have those deals performed and are market conditions favourable for more issuance?

Hammack, Goldman Sachs: The current market is definitely ripe for additional issuance. Investors in the US have been quite pleased with the supply that's come to date. Obviously most of that has been in the Canadian structures, whether it's collateral with the government insurance or without and investors are quite confident in that structure and in those credits. But we've also seen success both in the CFF trades as well as the recent Barclays trade. And so I do think that there is the opportunity for new jurisdictions to come to market — US investors are very much starved for product and are very open minded about ways to increase yield in the high credit quality space.

Lord, Barclays Capital: From my point of view, it's really good that the Canadian covered bond issuers re-opened the 144A US dollar covered bond market because they are very well known to the US institutional investor base. Not only were the Canadian transactions heavily oversubscribed, but they held their spreads relatively well even when the bond markets sold off towards the middle of the year. This is important for the development of the 144A covered bond market because it has really bolstered confidence in the covered bond asset class — not only for North American investors, but for European, Middle Eastern, and Asian institutional investors with large US dollar portfolios.

Since the Canadians re-opened the market, we saw a high profile French covered bond issuer tap the US investor base in a 144A US dollar French covered bond benchmark. What was encouraging with this transaction was that it showed that even a French issuer, with a uniquely French structure, could also interest the US institutional investor base. The French issuer has subsequently done two additional US dollar covered bond benchmark transactions this year, resulting in a total of three.

Generically, the Canadian issues followed by the French issues have created an impetus for European covered bond issuers. European covered bond issuers really see the attractiveness of being able to establish a foothold and expand their investor base in the largest capital market in the world. We're heading into a virtuous cycle with this round. The world has changed a bit in the sense that the covered bond asset class is more understood and investors are looking for alternatives, especially to some of the agency debt positions they hold.

EUROWEEK: David, can you tell us when you started issuing 144A — and why?

Power, RBC: We issued our first US dollar covered bond in 144A format in April of this year. We launched our programme with a couple of euro denominated deals in late 2007 and early 2008 and followed that with two Canadian dollar deals in 2009 and 2010. Expanding into the US dollar covered bond market was a natural next step for us as part of our goal to diversify our investor base. The documentation requirements were not challenging for us, as we have been a long-time issuer in the US market and maintain our continuous disclosure filings and 10b-5 due diligence process. The real work revolved around investor

dialogue to ensure that there was a broad base of support ready to invest in the product again. Going back to mid-2009, we had made covered bonds one of our regular discussion topics in our general US marketing efforts.

Dudouit, CFF: When Compagnie de Financement Foncier started in 1999 the first element of our strategy was to develop our European investor base. Then between 2000 and 2002 we were more working on a larger investor base including the Asian market, and between 2002 and 2010 we extended our investor base including the US. With a funding target of Eu15bn-Eu20bn we definitely needed to have a large investor base, qualifying investors in the US, so in 2007 CFF started on this route to put in place the specific 144A format.

We sent an application to the SEC in 2009 to have approval to be able to be in a position to issue the 144A/RegS format. And we're now entering a powerful phase in which we are in a position to diversify our investor base from the euro market through the 144A format.

CFF is a very well known issuer with specific formats to meet investors' demand. As a strong name and a well known company, the Credit Foncier group has been issuing obligations fonciers since 1852 without a default so the image of the issuer is strong. Diversification of the products we can offer, with a very strong legal framework — the French legal framework is one of most safe in the covered bonds universe — were well perceived by the US investor base.

We are already building a year curve with two year, three year and five year benchmarks and altogether we've achieved a volume of \$4.5bn so we are very happy with the transactions in 2010.

In 2007 when we explored the 144A/RegS transactions, the issuers were talking about placing 30% in the US. But in the first two transactions in 2010 we placed more than 50% in the US and with the five year transaction at the beginning of September we placed 77% in the US, so this has been a good opportunity to diversify our investor base.

EUROWEEK: David has already hinted at the challenges for some non-US issuers of setting up issuance programmes, but Jerry can you tell us a little more about that?

Marlatt, Morrison & Foerster: The biggest challenge is meeting disclosure standards for the US market. It's a little bit like, and maybe worse than, a US bank going to Europe to issue. If you're going to list with the UKLA, you've got a lot of work to do to your prospectus.

Unfortunately, to come into the US market, even if it's not a registered offering and it's a private offering, the due diligence process is layered on top of the disclosure standards. And the due diligence, for people who are not used to it, is quite intrusive.

We review board minutes, for example, which for some European issuers is kind of an invasion of privacy. It's a costly exercise to go through due diligence the first time if it's never happened before, so that's, I think, the biggest impediment, the biggest hurdle for European issuers coming into the US for the first time.

On the other hand, having gone through it once, you've basically set yourself up to do covered bonds or medium term notes and any other kind of debt offering — it's just a question of keeping that updated. So you can amortise the upfront cost over a number of different finance programmes which helps. But there's perhaps \$100,000-\$200,000 upfront cost to do that.

Ian Berry, Scotiabank: We completed the bank's inaugural covered bond issuance in July of this year. Our three \$2.5bn year covered bond was issued under format 144A as it provided us access to the US market and enabled us to further diversify our funding sources. Earlier this year Scotiabank completed its US debt IPO which provided us with increased appreciation and understanding of the US market. We were able to leverage this experience to prepare our covered bond programme for our 144A issuance in just over a few weeks.

EUROWEEK: Paul, you've issued three deals this year — how did you decide on the timing of the issues?

Dudouit, CFF: We started a first round marketing at the end of 2009, just after we received the exemption from the SEC, and we had a very good feedback from the investors — investors were looking to view new issuers in the triple-A segment.

We went for a second round of marketing in February 2010 and after this second round we decided to enter the market with a three year transaction. The three year was a great success, it was a \$2bn transaction. At the beginning of July we went out with a two year to develop our yield curve in the US and now we've reached a new segment of investors with the five years. The rationale and strategy is to develop the investor base and to build a yield curve, and to show to the American investors that we are in this market on a regular basis, that we will provide liquidity to them, that it is much more than arbitrage in terms of currency for us and we are able to offer them at each part of the curve specific maturities to match their needs.

EUROWEEK: The basis swap is now very favourable but what will happen if it becomes less so? Will you still issue 144A?



Paul Dudouit, Crédit Foncier

Dudouit, CFF: It's definitely not just an arbitrage strategy for us. In any capital market you have different parameters. You have to measure the costs in euros but a key element as I mentioned is also the diversification of the investor base. So it's the mix in the strategy of the cost of the funding and the diversification that we will need to manage. There is no definitive position regarding the specific market, but for example for the first part of this year the US represented

a significant part of our investor base but we also had great support from Germany and France but also from Switzerland, Asia and Scandinavia. We need as an issuer with a large programme to have this diversified investor base so we are not focused on one parameter.

With these three benchmarks we were in a position to execute after-swap at better levels than we were in a position to issue in euros. All the "stars were aligned" — the need of investors to find a new triple-A asset class, a strong name with no default for 150 years, a strong legal framework, and from our side it was good timing to reach new investors under 144A format.

Power, RBC: US dollar covered bonds have evolved as a cost-efficient funding tool for banks. The relative attrac-

tiveness of this product was not as apparent during the credit crisis. Covered bonds are a strategically important funding tool for us, providing diversification into several different types of buyers. RBC has always maintained a well diversified global funding platform and covered bonds is an important complimentary part of our funding mix.

EUROWEEK: How have your deals performed and how attuned are investors to performance?

Dudouit, CFF: At CFF we have had the same approach for more than 10 years to meet the investor demand. We launch the transaction at a fair price to have investors again in our transactions.

Berry, Scotiabank: Since issuance in July, our Series 1 bond has performed well and at \$2.5bn the BNS Series 1 covered bond has been the largest US dollar covered bond issued this year. We think the performance of this bond as well as the initial and ongoing demand reflects investor support of the BNS credit and the quality of our CMHC insured collateral pool.



David Power,
RBC

Power, RBC: We were very pleased to see such strong support for our inaugural US dollar covered bond. We were able to reach a very broad base of demand from more than 70 investors across several different investor classes, with particular support from traditional agency buyers, which validated our efforts in achieving investor diversification with the product.

EUROWEEK: During the crisis in 2009, spreads on Canadian covered bonds were said to be wider at times than senior unsecured. Why did that happen, and what steps have you taken to educate investors about the quality of the collateral?

Power, RBC: Disconnects like that happen from time to time when there is very little trading taking place in the marketplace in general. We believe that investors appreciate the high quality nature of our collateral and will reflect that in the required returns they seek for our covered bonds.

EUROWEEK: What explains your choice of whether or not to include CMHC-insured mortgages for covered bond collateral? How important do US investors find the lack of CMHC insured mortgages compared to the perception of the bank overall?

Power, RBC: We have always found the Canada Mortgage Bond programme (CMB) to be a more efficient way to fund our insured mortgage book and the covered bond programme to be an important tool in funding our uninsured, low LTV book. The credit quality of our low LTV book has been exceptionally stable through the last several cycles and we believe that US investors understand and appreciate this. It is also quite evident that US investors, like Europeans, attach significant importance to the issuer's credit quality.

EUROWEEK: How important is more activity in the Canadian dollar covered bond market to raising awareness among the US investor base?

Power, RBC: This is probably not critical as part of our US covered bond activity, but the Canadian dollar covered bond market does act as another outlet for the product and has proven effective in allowing us to attract new buyers for our name at cost-efficient funding levels. We also believe the Canadian dollar market values high quality non-government triple-A assets.

EUROWEEK: Paul, how do you go about choosing the banks?

Dudouit, CFF: When you are looking at 144A you are looking for a global bank, a bank that can sell bonds in the US and also in Europe and in Asia. When we launched the first transaction at the beginning of this year, we had a competitive bidding to choose the syndicate and we had 15 banks pitching to put CFF in the 144A market. There is a lot of competition between the banks, and the issuers at the moment are in a good position to have these discussions.

EUROWEEK: So far 144A covered bond issuance has been concentrated in quite short and mid-term maturities. Do you see potential to increase tenors in this market?

Berry, Scotiabank: We think shorter dated maturities can be expected as the market develops. However, as investor comfort with the asset class continues to increase the likelihood of longer dated issuance will as well.

Dudouit, CFF: In the euro market in 2006 we reached a 50 year transaction and clearly obligations fonciers is definitely a duration product — we are able to provide long dated bonds to insurance companies and pension funds. We've done that in the euro market and of course we want to extend our yield curve in the US market, depending of course on market conditions. We can develop our yield curve to match perfectly the duration need of the investors.

Hammack, Goldman Sachs: Well, for the Canadians, it doesn't really fit their structure because their mortgage product is a five year product. The average duration for a lot of Canadian issuers tends to be well inside of 10 years, making a 10 year issuance a stretch for many of them.

Mezbur, Goldman Sachs: Covered bonds are inherently designed to enable issuers to have a long term funding tool. European mortgages are usually 25 years and in certain circumstances even go to 30 years but nevertheless in a pool the average life is anything between five to 10 years and in certain circumstances it definitely can go higher. We have even had issuance of 50 year covered bonds albeit in the good times. I think that the seven year shouldn't be seen as a long maturity. What is happening at the moment is, and I'm referring to the US market, is that investors are getting comfortable with a product in a shorter maturity and they will undoubtedly extend to the longer maturity.

We have had significant amount of issuance of 144A in 2007 and unfortunately we had had a crisis and a lot of investors that entered the market then — I'll say for the lack of a better word, they burned themselves — are coming back but they're coming back cautiously. The

shorter maturities are the way for them to do that and then they will gradually extend to the longer term maturities.

Hammack, Goldman Sachs: Yes, I mean it's always easier to blaze the market in the most liquid parts — and the deepest part of the dollar market is definitely five years, it is very much the belly and the most active part of the curve, whether that's in Treasuries or agencies or any other product. You get a good cross-section of both liquidity funds as well as insurance and pension accounts — money manager-oriented money. Obviously the liquidity funds move more quickly because they have lots of cash and lots of rollover. As you gain broader acceptance, you can start building out the curve, as Eldar said. And we have had longer deals in the past — Depfa did a 30 year deal in dollars so I don't think it's a foregone conclusion that this market needs to stay within the five year maturity and then only out to 10 years — there's definitely the potential to have more duration as investor appetite grows.

EUROWEEK: To what extent is the lack of competing issuers helping you? Would more visibility of European issuers in the US be a help?

Power, RBC: We are strong believers that the US covered bond market will continue to develop and will be here for the long run. Part of that development is an expansion of supply from a greater number of issuers from different regions. We have seen a few European issuers come already and there are more on the horizon. This expansion will get more investors engaged and will facilitate greater liquidity for the product.

Dudouit, CFF: Of course to develop the image of covered bonds we need to have other issuers. I understand that some issuers from the Nordic part of Europe or from Germany are looking at this market and this asset class will definitely be present in the future in this market.

But once again CFF has proven through our five year benchmark that we are innovative and we are very transparent in terms of strategy when we sold the bonds at the beginning of the year we said we would build a yield curve, and we did it. We presented our funding strategy to issue a significant amount off our programme in the US and we've achieved it. We will visit and revisit this market and we will be in this market in the future on a regular basis.

Berry, Scotiabank: The US covered bond market has developed significantly over the past year. This development has happened concurrently with record issuance and recently we have seen additional issuance out of Europe and we expect that new issuers will further support the development of the market and help to increase investors' understanding of the product.

Canadian banks have issued "structured" covered bonds in the US, Canada and Europe. Recently the Canadian government indicated they intend to introduce covered bond legislation as early as 2011. I would expect the introduction of legislation will enhance our and other Canadian bank's access to markets as well as increasing investor demand.



Ian Berry,
Scotiabank

Power, RBC: We have always found strong support for our Canadian product in multiple currencies and markets. Our structure is sound and is supported by well-tested insolvency

and contract law principles. But we do recognise the importance of legislation to further support and protect the product. The Canadian government has been very proactive and supportive in the development of Canadian covered bonds and is actively preparing a legislative framework which will further that development.

Lord, Barclays Capital: One thing that I picked up in the discussions that I've had with investors both in North America as well as here in Europe is that the 144A market is now starting to get to an interesting size, about \$18bn so far this year. That's a fairly significant amount of money from a standing start in 2010 and for a lot of investors, if this continues and let's say we start to have a market that is approaching \$30bn to \$35bn or even more, then it is going to be pretty hard for a lot of US institutional investors to really ignore this market in my opinion. The development which I'm sensing from more investors is that covered bonds could begin to be incorporated in the indices they track.

EUROWEEK: Even so, it will still be relatively small for a long time compared to what would be the alternatives for investors in the rates space.

Colice, Barclays Capital: Yes I think that's true, but I think you've hit on something earlier that's pretty relevant and that's that what happens as the market gets larger and more liquid, not only do you have more issuers participating but you have more investors, more broker dealers, more people making secondary markets. And that makes the market become increasingly attractive.

One of the pitfalls of the US dollar market back in 2007 was that when the market turned South there wasn't the ability for people to get in and out of positions quickly, which is a hallmark of the agency and the rates space generically. So you're right, we're certainly not to that point yet, and even at \$30bn or \$40bn of issuance we won't be there either. But hopefully it sets the right frame of mind for the market to get there and then for participants to create two-way markets and ultimately a liquid market.

EUROWEEK: Derrick, are you put off by the lack of issuers at the moment? More issuers could raise awareness of the product and widen the investor base but could too much supply become a problem in the short-term?

Wulf, Dwight: We understand and respect the desire by certain issuers to wait until the covered bond market becomes more established in the US, but believe that new supply will be very well received as issuance in other competing sectors continues to decline. With scant new issuance in non-agency mortgage backed and asset-backed securities, investors in these markets are finding it more difficult to satisfy their reinvestment needs. As the FDIC-guaranteed bank debt issued under the TLGP programme begins to roll off, these reinvestment needs will only grow. We believe that a robust covered bond market will help fill that vacuum.

EUROWEEK: Beth, can you explain a little more about what is happening to issuance in the MBS world?

Hammack, Goldman Sachs: Yes, debt outstanding in the triple-A space has been declining — both GSE debentures as well as MBS product — and with banks flush with deposits there's a greater need for new paper. So, with net issuance down this year versus prior years, there's just a real need for investors to find places to make reasonably safe investments.

Whether it's explicitly triple-A or whether it's just high quality generally, if you look across both the corporate space

as well as the GSE and SSA space there's been much less issuance this year, especially of longer duration. The agencies have been focusing the bulk of their issuance in two and three years and so there is a real hole in the longer part of the curve, namely fives and 10s. As the covered bond product increases acceptance, the longer part of the curve will be better supported.

Mezbur, Goldman Sachs: At the moment we only have about \$35bn or so outstanding of 144A covered bonds and clearly that does not represent a liquid market by any means so we can see increased issuance in this market without having to think about over-supply — which is probably what is happening in Europe at the moment.

EUROWEEK: So in the short term at least the 144A market can absorb any kind of potential issuance that you're going to get out of Scandinavia or Germany or elsewhere in Europe?

Hammack, Goldman Sachs: Yes, absolutely.

EUROWEEK: Has declining supply of agencies and concerns over their future funding programmes also prompted more interest in covered bonds from investors?

Wulf, Dwight: Somewhat, yes. The uncertainty surrounding the eventual resolution of the GSEs' future status has left many investors increasingly cautious about their exposure to the asset class, and as a result, many of these investors are now much more receptive to alternative high grade investments.

EUROWEEK: There has been a lot of dollar supply over the summer from SSA issuers — is that directly competing with dollar covered bond issuance?

Power, RBC: A segment of the covered bond buyer base participates in SSA deals, but we feel there is enough demand for the covered bond product regardless of how much supply comes from SSA borrowers. Covered bonds stand on their own as a unique asset class with an attractive risk/return profile.

Dudouit, CFF: This investor base is very deep and these investors are able to buy large tickets in SSA or in covered bonds, so there is definitely room to issue covered bonds and for other strong names from the agency world too. We are not in direct competition, we offer another stable product and it's a complementary product to the agency world that we offer with obligations foncières and covered bonds.

EUROWEEK: How many US accounts are active in the dollar covered bond market and what potential do you see for expanding the number of US investors participating in your 144A deals?

Dudouit, CFF: For the five years deal we did we had more than 30 different accounts, for the first two we had between 35 and 60 different accounts, so this investor base is very large and very diversified. We visited more than 100 different investors to prepare this 144A/RegS transaction and we plan to have regular roadshows in the US to target new investors.

Power, RBC: The US covered bond market is still in the early days of development, but we have already seen dramatic expansion and broad based support from a large number of buyers from many different investor segments. Further issuance will only increase this participation. We believe the market is here to stay.

Berry, Scotiabank: Our Series 1 bond had more than 50 investors participate. We understand that the number of investors in our transaction was higher than other recent US dollar covered bonds. This increase in investor participation in new issues combined with increased investor participation in secondary markets confirms the growing acceptance of this asset class that we expect will continue.

Colice, Barclays Capital: We are optimistic for the market's growth, but, time will tell and there are a lot of factors that will influence it, including the US legislative process. We are optimistic that the US dollar covered bond market develops as a rival source of financing for, at some point, domestic issuers and also other North American and European issuers, and we look to support that growth in any way we can.

Lord, Barclays Capital: People should really look at the cover bond asset class as much more of an established asset class that has arrived. I think one of the greatest indications of that is we now have central bank reserve managers that are actually including covered bonds in the indices for investment of their reserve portfolios.

Before, many investors bought a covered bond as an off-index investment. Now we're seeing a lot of changes in the way people invest and for some investors, if they do not purchase a covered bond, they are now actually going off their index. That is a significant change.

Ten years ago, covered bonds were heavily dominated by the German Pfandbrief market and all the other covered bond markets were more satellites to Germany. Now, the German market is still big, but percentage-wise smaller than before. This just shows how well accepted and mainstream covered bonds have become. It's not an exotic asset class by any means anymore.

Wulf, Dwight: We've only recently started to become active in the asset class, investing in some of the dollar denominated issues that have come to market this year. We manage a substantial amount of assets in both high grade credit and capital preservation strategies, so we are always on the lookout for investment opportunities that offer credit quality and income potential. Covered bonds meet both of these requirements while also allowing us to further diversify our portfolios. It's a natural fit.

EUROWEEK: So how do you evaluate covered bonds — how much is jurisdiction important to versus collateral and versus issuer credit quality?

Wulf, Dwight: Our foremost criterion for investment in covered bonds is the financial strength of the issuer. The collateral pool and jurisdiction are also important considerations, but we will only invest in covered bonds issued by entities that we are already very comfortable with from a credit standpoint.



Lucette Yvernault,
Schroders

Yvernault, Schroders: Before 2007-2008, covered bonds were often selected because of their dormant volatility profile and not for the benefit of their carefully selected profile. However at Schroders, we believe in true bottom-up analysis of the three pillars supporting every covered bond structure. Those are, one, the regulatory environment, which will dictate the basic features of the programme; two

the legal framework which will mostly dictate the format of the succession plan if the parent company is no longer running as going concern; and three, the parent company which will originate the public loans or prime mortgages in the first place. However the absolute rules surrounding the covered bond pools themselves are also analysed with particular care before investment as they ensure the stability of the plan over time. So we look at bullet structure, amortising structures of underlying mortgages, asset-liability discrepancy, high over-collateralisation, low LTV, diversification and maximum level of substitution

Berry, Scotiabank: During the process of our inaugural issuance investors focused on our CMHC insured collateral, covered bond structure and Scotiabank's credit quality — which we think is appropriate as each should be considered in valuing our covered bond programme.

Dudouit, CFF: All over the world investors are now very sophisticated and they understand quite well the different jurisdictions of covered bonds in Europe. These investors are more focused on the quality of the assets and the capacity to give them information and to communicate on a regular basis. Investors at the moment are looking at the transparency of information through the annual and semi-annual reports, and to meet once or twice a year with the issuer to make sure the strategy is what they expect from the issuer, the credit. They want to have this meeting to be sure we meet their needs.

Power, RBC: All three elements — jurisdiction, issuer credit quality and collateral — are important to US investors. We have been impressed with their level of diligence and understanding of what is still a relatively new product. We have observed in particular that bank credit quality will always be an important part of the equation for investors.

Mezbur, Goldman Sachs: Beth can probably comment on this better than I can but I think that unlike what we have seen pre-crisis, investors would pretty much look at it and ask is it triple-A or not and look at the comparables within the jurisdiction and they would just accept the pricing that was given to them on a market. Now, first of all I think they are looking for the jurisdiction that the issuers are coming from, then to their credit and then drilling into the underlying pool. So, I would say there's more work involved from the investor side than I've ever seen in over seven years being involved in covered bonds.

Hammack, Goldman Sachs: Investors, by and large, do a lot of work on the jurisdiction. For the Canadian product, some investors have done tremendous amounts of work on the Canadian structural frameworks that they've set up — but others have said 'it's government insured collateral, that's good enough for me' and they look at it as a government surrogate. But, by and large, I do think that the country level framework is a great starting point and I think people like to understand the general aspects of the collateral that are backing the programme. Most US investors like to run through the disaster scenarios — what happens in the case of liquidation or a bankruptcy at that institution, how does it get handled and walk through the worst case scenario. We do get questions about that, just so they understand if we go back through a crisis situation what that is going to look like.

EUROWEEK: How do you approach the investment case for covered bonds relative to MBS? Is the lack of pre-payment risk a benefit?

Wulf, Dwight: There is a clear and quantifiable benefit to hav-

ing greater certainty with respect to the timing of cashflows.

Certain types of investment strategies have very limited tolerance for negative convexity or prepayment risk, and for these strategies covered bonds represent a viable and attractive alternative.

Hammack, Goldman Sachs: It's a benefit. It's a different investor base that you're going after. Being able to take the prepayment risk out of the equation is a huge plus for many investors who are searching for yield enhancement in bullet securities.



Derrick Wulf,
Dwight Asset
Management

Yvernault, Schroders I.M.: Not every bank activity should be financed via the covered bond market and we welcome only covered bond pools which are as pure as possible in terms of the underlying nature of the loans. The covered bond market isn't keen, for instance, on servicing credit card, auto loans or SME lending. The nature and behaviour of the underlying assets has to be more reliable and sustainable enough in the long term. As such, investors should know the quality, risk and reward of their investment at all time. This is why it is so important to ensure that the underlying covered bond pools don't suffer from quality migration as observed over the recent years in the MBS market. The securitised nature of the instrument has to be sufficient to repay all cash-flows over the life of the instrument without having to rely on the sponsor/parent company. This is best illustrated by high quality mortgage pools with substitution rules in place instead of replenishment.

EUROWEEK: How much work do you need to do to evaluate a new jurisdiction coming online — how well understood are the subtle differences between them among the investor base?

Wulf, Dwight: We do a lot of groundwork to get to know the subtleties and distinctions between the various jurisdictions but continue to focus the bulk of our credit work on the specific issuers and their covered bond pools. We are also working with industry groups to help draft proper legislation and establish best practices for the covered bond market in the US. We believe it is in everyone's best interest to develop a framework that insures transparency, consistency, and simplicity in any new jurisdiction.

Yvernault, Schroders: Now within the financial sector, when compared, well selected secured bonds are actually better quality than most senior unsecured structures as they should be more remotely detached from increases in company tax burdens, sponsored financial institution profitability and also surrounding austerity plans as the maximum level of turnover in a covered bond pool is often extremely limited and the pool only encompass high quality and well seasoned loans.

EUROWEEK: We talked a little bit about investors being starved of product and wanting to see more European issuers come to the market. How difficult is it for US investors to have to get their heads around the legal frameworks that each different jurisdiction represents?

Hammack, Goldman Sachs: It's not that hard to do but it does take time to familiarise yourself with different jurisdictions and to learn the distinctions between them.

Mezbur, Goldman Sachs: It's essential for any European issuer that wants to come to the market to come and actually do some roadshowing, the more the better. CFF is a good example — the roadshowing that they have done is paying huge dividends. And I think their strategy has been to educate investors as much as they can and that has paid off as I said in US markets but also in European and Asian markets where they clearly have a strong investor base. Savvy issuers should really adopt similar strategy.

EUROWEEK: Are you happy with liquidity in the covered bond market? How does it stack up against liquidity in competing asset classes?

Wulf, Dwight: Liquidity in the dollar denominated covered bond markets has improved meaningfully over the past year, and we expect that to continue as the asset class becomes more established and participation within the domestic investor base continues to grow.

Colice, Barclays Capital: The amount of size that's available to move in the covered bond space is much smaller than in the rates space here domestically. That being said there's a mix of happiness levels among not only dealers but investors in terms of secondary liquidity. And one of the things that we hear over and over again is that the more people making a market and the deeper, i.e. the bigger the size that can be moved, the better. So that, to me, suggests that there's still a little bit of a ways to go but where we are compared to even the beginning of this year is a big step forward for the US dollar covered bond market.

Hammack, Goldman Sachs: Markets are changing and evolving and so any bid-offer spread will be very much cognisant of the tone in the marketplace as well, the size of any particular trade. In general, GSE markets are in the one basis point wide-type market, SSA tends to be two to three, and the covered market is probably about two to three as well at this point in time.

Lord, Barclays Capital: The markets in general have been healing. We had some problems even with some of the larger government bond markets at times. The encouraging development that I see is that we're starting to see a lot more medium-sized types of investors that are participating in the primary market. They might not be in large size, but it makes the order books more granular and that is very positive for the longer term development of the market.

EUROWEEK: Do you think covered bonds should trade as a rates product?

Colice, Barclays Capital: Well from a secondary market perspective, we do trade it off of our agency desk, so although I don't think that anybody would say it trades and performs exactly like a rates product, ourselves and other dealers are doing our best to help position it as close as is possible.

Wulf, Dwight: There is an obvious credit component to all covered bonds, so we don't think they will ever be a pure rates product. The events of recent years in particular have been a powerful reminder that the financial sector can be subject to significant idiosyncratic and systemic risk, leaving no room for complacency on the credit front.

Hammack, Goldman Sachs: We view it as a rates product, we trade it off our rates trading desk and we think as the market continues to gain acceptance it will gain broader support as a rates product rather than a credit product. Obviously the credit component is more meaningful than what you have

in GSE product right now given the current level of government support for Fannie and Freddie, but it's very similar to what you have in sovereign and supranational products which again are rates products. We expect that this will become a large, deep, liquid market which is mostly traded off the rates desk because the credit component will be much smaller and much less a driving force in the flows than the relative value or interest rate views that investors are trying to express.



Nick Jacob,
EuroWeek

EUROWEEK: But isn't it still a problem that, in crisis times, people just sell the name rather than the product?

Lord, Barclays Capital: No, the investors neither just sell the name nor the product in a time of stress. It is more complex than that.

From my perspective in Europe, when you ask an investor where a covered bond fits in a portfolio, you will get different answers depending on the investor. Some would definitely

look at it more as a rates product — as a government bond yield plus spread. But also, an increasing number of investors are now diversifying away from corporate bonds into covered bonds. This is due in large part to the tightness on spreads that they've started to see on some of the prominent corporate names.

When covered bond markets go through periods of stress, the domestic investor bases are important — there is a local bid to step in and grab value.

One thing that I've observed is that, with each 144A US dollar covered bond benchmark issue, there are new and substantial investors that are either coming into the market for the first time or switching out of an agency position or even a corporate position.

As the investor base builds, the result is more awareness and support for the asset class. Then, in times of stress, you could have a growing number of investors who will see value and support the market. That is happening now with the larger US-headquartered global fund managers and US-headquartered insurance companies. Several of the larger ones have been setting up substantial covered bond expertise in Europe complete with specialised covered bond analysts, portfolio managers, and legal experts for their operations in both Europe and North America. This should create a much more sophisticated domestic US investor bid. Then, if you do have times of stress, you could have an investor take advantage of the value opportunities. So that's very encouraging for the 144A market.

Added to that, several central banks have been seeing this development and saying 'if we are starting to see more and more domestic US investors buy covered bonds we, who have traditionally not bought covered bonds with our US dollar liquidity, are now feeling a lot more comfortable to do so'. This is also a very encouraging development.

EUROWEEK: Because these non-US investors already have experience of the various jurisdictions in Europe?

Lord, Barclays Capital: Yes. A large number of non-US investors have a very strong knowledge of the covered bond asset class and welcome the ability to actually have a very familiar asset class for their US dollar liquidity. We need to keep in mind that there are numerous non-US investors, who have substantial US dollar holdings.



