

# Increasing the attractions for Irish issuers

The Irish covered bond, introduced in 2001, has proven to be a great success with the market now worth over 20 billion, and issues on both the mortgage and public sector side. However, for residential mortgage lenders, the legislation only allows mortgages up to 75 per cent loan to value ratio to be included as collateral, which can be restrictive. But third party credit enhancement from a speciality mortgage insurer could potentially solve this limitation, TONY PORTER writes.

The recent Irish legal framework that enables the issuance of covered bonds has opened exciting new channels for banks to access capital markets. Covered bonds provide banks access to relatively cheap cash funding because these instruments are considered extremely safe by investors. Security comes from both the underlying assets, such as residential mortgages, as well as the credit of the bank in the unlikely event that excessive defaults in the portfolio result in insufficient cash flow to pay all bond obligations. For residential mortgage lenders, the Irish legislation allows mortgages up to 75 per cent loan to value (LTV) ratio to be included as collateral in these bonds. This conservative LTV limit leaves many mortgages ineligible, but third party credit enhancement could change this.

**'The problem with such a conservative approach, however, is that mortgage lenders engage in a significant share of lending over 75 per cent LTV.'**

One of the aims of the covered bond framework intends to create instruments that insulate investors from the possibility of suffering losses. This confidence in repayment enables investors to bid bond prices high enough to provide a very efficient source of funding for bank issuers. Any elements that introduce instability or risk to the market would be considered undesirable.

The problem with such a conservative approach, however, is that mortgage lenders engage in a significant share of lending over 75 per cent LTV. Particularly in housing markets that are difficult to afford, such as Dublin, borrowers have great difficulty in saving a down payment of 25 per cent. As a result, the cost for banks to do business in the high LTV sector increases further relative to low LTV loans.

Third party credit enhancement from a speciality mortgage insurer could potentially solve this limitation. The rating agencies and capital markets already recognize the value of highly rated mortgage insurers, such as PMI Europe, a double A rated entity. Mortgage insurers pay claims to lenders if foreclosures combined with house value declines result in financial losses. In American and Australian mortgage backed securities (MBS), mortgage insurance facilitates the inclusion



ANALYSIS

of high LTV mortgages. The rating agencies recognize the value of highly rated mortgage insurers who have deep capital reserves that ensure claims will be paid in severe economic scenarios.

**Third party credit enhancement from could potentially solve this limitation.**

A similar approach could work for covered bonds to give investors the confidence to invest in bonds backed by high LTV mortgages. The rating agencies already have criteria to analyse high LTV mortgages protected by mortgage insurance and these criteria could be applied to covered bond pools with high LTV mortgages. Another benefit of this approach is to reduce the amount of over-collateralisation required in structuring the bond issues in much the same way that mortgage insurance reduces the amount of subordination required in MBS. For an investor in a covered bond with high LTV mortgages to lose their investment, the mortgages would have to perform worse than allowed under severely high stress, and the issuer would have to fail its repayment obligations, and the mortgage insurer would have to fail its claim obligations. This would be an extremely unlikely combination of events, with risk not measurably higher than for investors in covered bonds with LTV limitations.

The mortgage insurance coverage could be structured with two alternative approaches. First on a portfolio basis, when an issuer has constructed a portfolio to use in a covered bond, a pool insurance policy could all mortgage exposure above 75 per cent LTV. This approach could work well for a lender constructing covered bonds from its existing loan portfolio.

Alternatively, a lender that has already issued covered bonds could insure individual mortgages for exposure above 75

per cent LTV. When the bank has accumulated enough mortgages to issue the next series of covered bonds, the bank can easily assemble its portfolio because the high LTV mortgages would already be insured. This approach would shorten the time required for the issuer to come to market.

Regulatory approval would also be necessary to enable expanded mortgage eligibility. A prudent approach would be to permit inclusion of mortgages above 75 per cent LTV if the exposure above that LTV threshold is insured by a AA or higher rated speciality mortgage insurer. The AA rating threshold would have a consistent approach with the Basel II framework which assigns maximum credit risk mitigation from AA or higher rated counterparties. The rating should be issued by major rating agencies using specialized mortgage insurer criteria. This approach could also relieve regulator worries of covered bond issuers' cherry picking their portfolios and leaving the highest risk mortgages behind in their unsecured portfolios and detracting from depositor safety. The inclusion of high LTV loans would leave the unsecured portfolio more balanced when considering LTV distributions.

**'In American and Australian MBS, mortgage insurance facilitates the inclusion of high LTV mortgages.'**

In other European markets, LTV limits similarly constrain the capital markets. In Germany, where the pfandbrief represents one of the oldest covered bond structures, mortgage eligibility is very conservatively limited to 60 per cent LTV on discounted lending value. An approach using mortgage insurance could greatly improve bank access to the capital markets. Using protection from a highly rated specialist mortgage insurer would not detract from the immaculate safety record for investors. A similar approach could apply to expand all markets with covered bond limitations for LTV eligibility. In conclusion, the covered bond is a tremendous innovation for capital markets. However, the current frameworks are limiting to the residential mortgage sector because of LTV eligibility caps. For mortgage-covered bonds, the expansion of LTV eligibility through mortgage insurance could bring benefits to issuers, investors and borrowers throughout Europe.

*Tony Porter is managing director of PMI Europe.*