Irish covered bond consultation: belts without braces?

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On 22 June 2020 the Irish Ministry of Finance opened up its consultation on topics it might address when aligning current Irish covered bonds (Asset Covered Securities) with the European Covered Bond Directive. It is only the third consultation published to-date and highlights some challenges, even when the current legislation is already very close to what is expected for European Premium covered bonds.

The consultation runs until 17 August 2020. Scope does not expect much controversy if the changes are implemented as proposed. However, a final verdict cannot be made as the detailed proposal is not yet available. Some of the questions could indicate a watering down of what we see as some of the strengths of the current legislation.

The Irish covered bond consultation…

In our view the Irish covered bond framework is already one of the strongest. Similar to Germany, it does not use a market value concept for LTV eligibility criteria but a prudent market value, the concept of a net present value (NPV) based over-collateralisation as well as market risk stresses complemented by a unique duration-matching requirement.

With mismatch risk being the main driver for the supporting over-collateralisation, we view the matching restriction as a clear credit positive of the current Irish covered bond legislation. Even though it does not eliminate mismatches, it at least contains any mismatch risk present.

Consultation questions are limited and seem credit-neutral at first glance. However, past experience shows that the exact wording is important. As for the previous consultations in Norway and Spain (see related research) no full wording of the updated covered bond act is provided yet.

..highlights challenges for calculating winddown costs

The Irish Finance Ministry consults in Question 2 on a plain vanilla lump sum calculation of the run-down costs, which we expect to become a market standard. It also highlights that a common European interpretation of the calculation of wind down costs is desirable to avoid distortion across countries.

From a rating agency perspective, any lump sum calculation will have drawbacks as it might prove too simplistic. The expectation of an unmanaged rundown of a cover pool means that such costs should be calculated as a function of the cover pool's amortisition profile. At the same time, the sufficiency of available proceeds is also a function of the stressed scenario it should be able to support.

Irish mortgages have an average maturity between 25 and 30 years (for second and first-time home buyers, respectively). In isolation and assuming an annual servicing fee of 25bp, any lump sum could become a significant burden. Assuming a bullet maturity for all cover assets, servicing requirements could eat up to 6% of the cover pool.

However, the calculation needs to take into account the amortisation and pre-payment profile of a cover pool – both of which can significantly differ between mortgage and public sector ACS as well as issuers. Assuming a high pre-payment rate in a wind down (borrowers might want to refinance with an "active" mortgage lender in the rating scenario where the bank has defaulted) as well as amortisation, the average maturity could compress below 4-5 years and only add 1pp of over-collateralisation.

Analysts

Karlo Fuchs
+49 69 6677389 78
k.fuchs@scoperatings.com

Reber Acar
+49 69 6677389 50
r.acar@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

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Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Excess spread from mortgage loans could suffice

A lump sum calculation also should take into account the availability of excess spread. For mortgage loans, the available margin can already be sufficient to pay for the servicing and might not require any upfront provisioning for the wind down costs.

Competitive dynamics in mortgage lending will lead to differences in lending margins between issuers, which means that the above statement will not be the case for all Mortgage ACS.

That might not be the case for public-sector covered bonds

Another extreme could be for public sector ACS. Margins between the covered bond refinancing and the underlying public sector loans and bonds might even be negative. As such, wind down costs will also have to be borne by available over-collateralisation, which already needs to mitigate by the negative cost of carry.

Disapplying use of future interest could become a credit negative

Disapplying future interest might challenge the current credit-positive NPV-based tests

The consultation also asks about the ability to include future interest proceeds for coverage requirements. With the current framework's focus on NPV-based coverage, not accounting for future interest proceeds would leave investors with a nominal coverage requirement only. Disapplying the consideration of future interest would, in our view, weaken the current framework. Effectively, NPV or duration-based coverage or maintenance tests would no longer be possible: a credit-negative development.

Belts but no braces?

Extendible maturity structures (soft-bullets) are already standard in Ireland, which is a credit positive from a liquidity management perspective. As such, the question (Question 7) about whether or not extendible structures should be allowed has already been answered, in our view. With the existence of such structures, we would actually have expected a consultation on the clarity and definition of triggers.

Short-term liquidity buffer calculations based on extended maturities …

Related to the extendibility, we read consultation Question 5 as if the Irish would like to go for belts only when it comes to short-term liquidity provision within the cover pool. The Ministry asks whether liquidity tests should be based on the extended final maturity compared to the scheduled maturity.

... deprive the administrator of liquidity management options needed during wind down

In our view, the highest credit quality for a covered bond – in particular if labelled a European "Premium" covered bond – should have a strong liquidity buffer. Unless additional clarity on whether a covered bond will be able to benefit from auxiliary liquidity protection becomes available, the double safety of being able to service covered bonds coming up to maturity with ring-fenced liquidity from within the cover pool – plus the ability to extend the covered bonds thereafter – is desirable from a credit protection perspective.

With central bank liquidity currently aplenty, we hope that legislators will not water down the importance of short and medium-term liquidity. As market and liquidity risk management is one of the weak points in the harmonisation – but the area credit rating agencies typically attach most weight in determining supporting over-collateralisation – the scheduled maturity should be market standard.

... and result in only illiquid mortgage collateral

As a side effect, the need for short term liquidity coverage means that a cover pool would have to comprise substitute collateral – which is typically more liquid than the standard mortgage loan and would ease liquidity management in wind down.

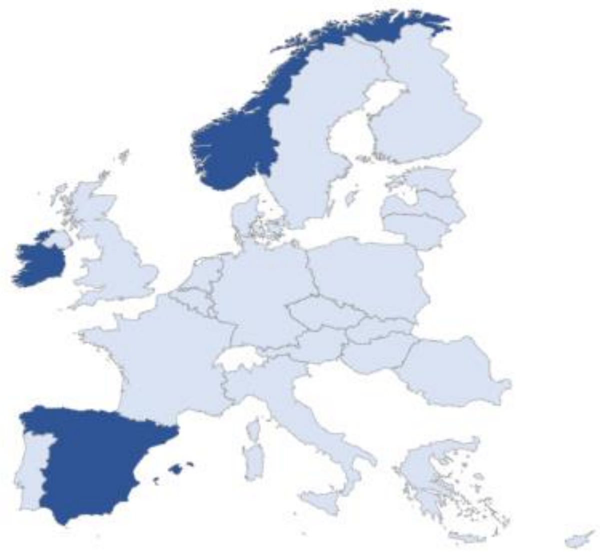
Auxiliary questions credit neutral and transition begs a common European interpretation.

The residual questions in the consultation are credit neutral but highlight that a common European interpretation of the transition into the harmonisation should be sought. The question on whether tap issuance would constitute grandfathered "old" or new covered bonds has to be seen in this context.

Further guidance on grandfathering is needed

We expect that across Europe most existing covered bond programmes will migrate into the new normal. At the same time, it begs the question of how to manage the same programme under two regimes – when bonds under the same programme legally rank pari passu.

I. Appendix. Initial consultations on the European covered bond harmonisation as of Q2 2020



Countries in dark blue have already published a consultation - Source: Scope Ratings

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

London
3rd Floor
111 Buckingham Palace Road
London SW1W 0SR

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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