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Morocco covered bonds project

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Morocco began planning for the introduction of covered bonds, in 2010. This article presents the rationale for introducing covered bonds into the Moroccan market, describes how the project was managed and gives an overview of the main characteristics of the draft covered bonds law.

Rationale for introducing covered bonds in Morocco

The Moroccan financial sector has grown strongly over the last decade with financial assets exceeding 200 per cent of gross domestic product (GDP) in 2008 and is steadily increasing. This has been allowed by the supportive economic environment in a sound macroeconomic framework combined with comprehensive financial sector reforms.

On the one hand, economic growth increased steadily from a medium GDP growth of 3.2 per cent in 1998–2000, to reach 4.4 per cent in 2002–05 and 5 per cent in 2006–11 despite the negative impact of the international financial and economic crisis. This growth was achieved in the context of long term sustainable inflation with, on average, a low inflation rate of 1.8 per cent over the last 16 years (0.9 per cent in 2011) compared with a medium inflation rate of 6.2 per cent during 1990-95.

On the other hand, the government has carried out a comprehensive set of financial sector reforms over the last two decades. These reforms encompassed consolidating the banking sector, improving financial regulation and supervision, which included banking, capital markets and insurance, and deepening capital markets. As a result, the financial sector is strongly regulated and endowed with the main actors and instruments.

The continuous reform efforts are currently primarily dedicated to consolidating financial regulation and supervision, improving access to finance mainly for low income households and micro, small and medium-sized enterprises (MSMEs), and completing capital market instruments by introducing a new generation of financial instruments. The latter includes setting up a legal and regulatory framework for the issuance of covered bonds.

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The banking sector has experienced a rapid and strong growth over the last few years, with total bank assets reaching 129.4 per cent of GDP in 2011 compared with 102.4 per cent in 2006. Bank lending to households and corporations has increased by 50 per cent in five years reaching 84.8 per cent of GDP in 2011 against 56.4 per cent in 2006. Mortgage lending has been one of the main drivers of this increase with total mortgage loans doubling to 25.4 per cent of GDP in 2011 from 12.6 per cent in 2006. Housing loans represent two-thirds of mortgage lending, that is, 17 per cent of GDP.

The growth of mortgage loans was especially strong in 2005-08 with an average annual progress of more than 35 per cent followed by a healthy decrease in the period 2009-11 to an average annual progress of almost 11 per cent. This was driven by a strong demand for housing combined with an improved offer notably in social housing, thanks to supportive government policies and the emergence of large real estate developers.

This strong increase in mortgage lending has exacerbated interest rate and liquidity risks due to the fact that a large proportion of mortgage loans are fixed-rate (almost 70 per cent) and due to maturity mismatches between increasingly long-term loans, with mortgage loans average maturity being more than 18 years and their funding coming mainly from short term deposits. The need for long term resources is also driven by a more general gap between the increase in customer deposits and that of credit, with a ratio of customer loans to deposits that had lately reached and exceeded 100 per cent.

Given this situation, the Moroccan banks have successfully issued private medium to long-term debt, mainly certificates of deposits and subordinated debts, which have found a demand from a large base of local institutional investors. On the other hand, the Central Bank has progressively adjusted reserve requirements from a high rate of 16.5 per cent up to January 2008 to 4 per cent in September 2012. Nevertheless, it was felt that more needed to be done to tackle the risks created by this ever-growing mortgage loans portfolio in the Moroccan banks.

Overview of the objectives and main characteristics of the draft covered bond law

Based on the European covered bond industry success story, in the second half of 2010 the Moroccan Ministry of Economy and Finance launched a project for establishing a legal and regulatory framework for covered bonds with the main objective of addressing these issues and specifically:

- allowing banks to further offer mortgage loans at affordable rates
- reducing banks' maturity mismatch and interest rate risks
- providing institutional investors, notably insurance companies and pension funds, with a new class of long-term, high-quality private debt to reduce their term gaps

Covered bonds also have a positive collateral impact in promoting sound loan origination given that the loans eligible as cover assets have to meet high quality eligibility criteria on an ongoing basis.

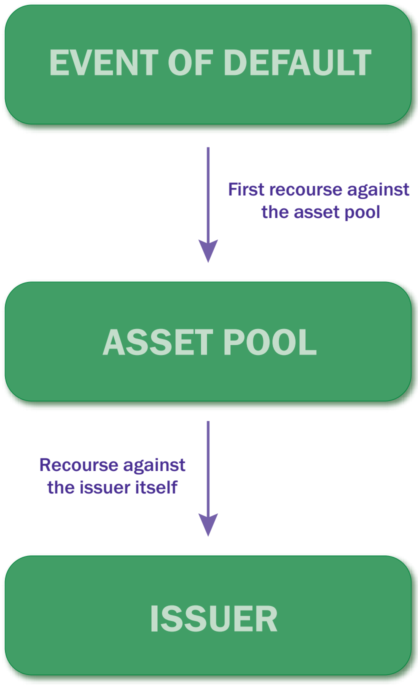
The most significant characteristics of the Moroccan covered bonds draft law may be summarised as follows:

- **Issuance structure.** There are typically three types of CB issuance structures, all associated with the cover pool of assets: it can be transferred to a special purpose vehicle (SPV), a specialised bank (as mainly used in the French system) or the assets can be kept within the bank balance sheet. There is no perfect choice, each of these structures having its own advantages and disadvantages. In Morocco, the choice went to the direct issuance by the bank, which is the most common structure internationally, as it seemed the simplest and most appropriate to the nature of the bonds as senior bonds and the ongoing flows between the cover pool assets and the other bank assets.

- **Issuer and supervisory system.** Based on international benchmarks, the issuers will be banks that will have received a specific licence granted by the Central Bank on the basis of their capacities and the specific

Two constraints have to be resolved: the first is that the quality level of eligible assets must be high enough to ensure the international standards of covered bond quality, and the second, the existence of a significant pool of eligible assets

Chart 1
Recourse the bondholder has against the assets and the issuer



covered bond management system put in place. These conditions have to be maintained on an ongoing basis. Regarding supervision and prudential regulations, the Moroccan system is to treat the cover pool almost like a small bank. Hence, the draft law provides for specific supervision of the covered bonds activity by the Central Bank, monitoring of the cover pool by an independent comptroller and implementation of specific prudential regulations on the cover pool (internal audit, risk management, liquidity obligations, and so on).

- **Eligible assets.** Two constraints have to be resolved: the first is that the quality level of eligible assets must be high enough to ensure the international standards of CB quality, and the second, the existence of a significant pool of eligible assets. If it is not possible to optimise the two constraints, this means that the market is not yet ready for covered bonds. In Morocco, the draft law has established two kinds of bonds, Mortgage CB (MCB) and Public CB (PCB).

Eligible assets for MCB are primary mortgage loans with a loan to value (LTV) ratio of less than 80 per cent for residential loans and 60 per cent for commercial loans. Mortgage loans had reached MAD 218.6 billion in September 2012, from which MAD 147.5 billion corresponds to housing loans. It is estimated that around 40 per cent of the housing loans may presently fulfil sufficient quality criteria to be eligible as a cover asset. Currently this corresponds to total assets of MAD 60 billion (around US$ 7 billion), increasing annually by more than 10 per cent, to which a proportion of other mortgage loans could be added.

Eligible assets to PCB are loans to local government that meet certain financial conditions, and loans to public corporations guaranteed by the government. Loans to local government currently exceed MAD 11 billion. It should be noted that local government debts are strongly regulated in Morocco and mainly granted by a specialised bank *("Fonds d'Equipement Communal")*. The

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local government delinquency rate is less than one per cent and largely corresponds to delays in repayment due to expenditure processes that are generally regulated. The inclusion of PCB is aimed at allowing a new class of assets for investors and is expected to gain importance in the medium to long term, thanks notably to the regionalisation process currently ongoing in Morocco.

- **Cover pool.** It is important to emphasise that there is a unique cover pool for all issued MCB and a unique one for PCB. The law provides that the bank has the ongoing obligation to maintain sufficient eligible assets in the cover pool that allow coverage of issued covered bonds both in stocks and flows. To this end, the Central Bank enacts specific and prudent valuation techniques of the cover pool assets. Any asset that loses quality criteria or is prepaid has to be replaced by other eligible assets. There is also a minimum legal over-collateralisation of at least five per cent that can be set to a higher level in the regulatory framework, by using substitution high quality assets listed in the law, notably government bonds. Specifically for MCB, mortgage commercial loans cannot exceed a small percentage of the cover pool (10 per cent).

- **Customer deposits protection.** The recurrent question arising from the introduction of covered bonds, and answered differently from one country to another, is that too high a level of protection for CB holders may be to the detriment of customer deposits in the case of the issuer's bankruptcy. Covered bond supporters would respond that by allowing banks to issue CB, the system is promoting their financial soundness. In Morocco, the risk of depositors was not deemed to be a major issue in an emerging market. Yet, it was judged prudent to include in the law the provision that the issuance is limited to a share of the issuer's total assets to be set in the regulatory framework (at present, 20 per cent) and more stringent limits can be set by the Central Bank, notably in the case of banks with a specific risk profile.

- **Bankruptcy remoteness.** The law must provide effective protection for covered bond holders. This includes ensuring the effectiveness of the priority ranking of CB holders to the cover pool and the bankruptcy remoteness of the cover pool combined with its capacity to survive the bank. The law states that a specific cover pool manager will be designated in case of bankruptcy and given sufficient power and tools to continue the management of the cover pool or to transfer it to another bank. It is also important to underline that the law explicitly enacts the principle of asset continuation in case of bankruptcy.

Covered bonds objectives and project management

The CB project was part of a broader financial sector reform accompanied by the World Bank. It has benefited during its different stages from specific technical assistance funded by the "First Initiative" trust fund. This technical assistance allowed the mobilising of high level experts to assess the prerequisites and rationales for introducing covered bonds in Morocco and to comment on the draft law.

First of all, it is important to note that prerequisites for implementing CB are the existence of a comprehensive financial infrastructure and of a strong financial supervisory framework, especially in the banking sector (the central bank). The steps already taken in Morocco to implement covered bonds are as follows:

1. The first step was to clearly identify the need for covered bonds on the issuer side and the appetite of investors for such instruments. These needs, which were described in the above section, are mainly that there is a large pool of potential eligible assets comprising notably of housing mortgage loans and a large base of institutional investors comprised mainly of insurance companies, pension funds and mutual investment funds (banks may also be one of the main CB investors) A covered bond workshop was organised in November 2010 for all market players and supported by senior international experts who could share their experience in developing such a reform and implementing it. Meetings were also organised between the main financial market actors, supervisory agencies and potential issuers and investors.

2. As a second step, a very first draft law was prepared internally by the Ministry of Economy and Finance (Directorate of Treasury and External Financing) based on benchmarks drawn mainly from the German *Pfandbrief* legislation, one of the most developed covered bond legal frameworks.

3. As a third step, the draft law was submitted in April 2011 to a technical committee comprising all the main market players, including the Central Bank, the Moroccan capital markets authority, major banks, a securitisation company, a law firm, and an accountancy firm. The technical committee refined and finalised the draft law that was submitted in September 2011 to all market players for comments.

4. The fourth step was, once all the comments had been received which took more than two months, to prepare a final draft law taking into account market comments. The draft law was submitted in late June 2012 to the formal approval process, which includes adoption by the government and the parliament with the objective of implementing the law in late 2013. The draft law is currently under legal review.

The preparation of technical and operational regulations, including prudential regulations, has already begun with comprehensive technical assistance from KfW Bankengruppe in the context of bilateral cooperation. This technical assistance has allowed in its first stages a review of the draft law. The target is to have all the operational regulations ready before the draft law is finally adopted.

Conclusion

Establishing the covered bonds legal framework is a long and complex process that has to be managed efficiently. It is important to this end to follow a structured process involving all market participants and to benefit from international experience and expertise.

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