Current and past developments in covered bond markets

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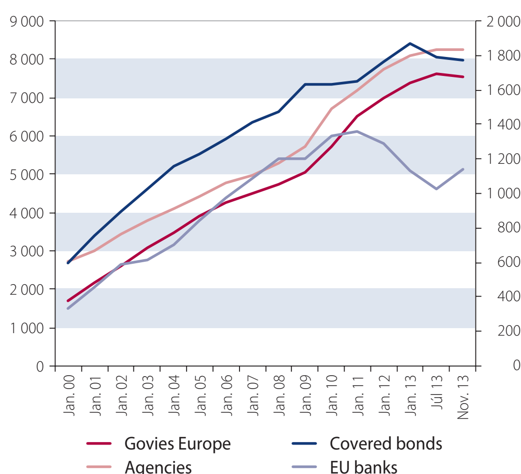
Covered bonds became an important segment of the fixed-income bond market during the last decade. This market was constantly growing till the end of 2012 and helped to fill the gap resulting from the limited use of other funding instruments of European banks. Covered bonds are a standard mean of raising capital via bonds backed by good quality assets. While covered bonds provide both safety and liquidity and higher yields for investors than more conventional triple-A securities, for issuers they provide benefits such as cost effective funding and funding diversification. The outstanding amount of covered bonds[1] issued worldwide reached €2.8 trillion in 2012, while EU-based issuers accounted for about 90% of the total amount.

The special character of covered bonds is enshrined in the 2009 Directive on Undertakings for Collective Investments in Transferable Securities (2009/65/EC, "UCITS"). Article 52(4) of this Directive defines the minimum requirements that provide the basis for privileged treatment of covered bonds in different areas of European financial market regulation. In particular, Article 52(4) requires:

- the covered bond issuer must be a credit institution;
- covered bond issuance has to be governed by a special legal framework;
- issuing institutions must be subject to special prudential public supervision;
- the set of eligible cover assets must be defined by law;
- the cover asset pool must provide sufficient collateral to cover bondholder claims throughout the whole term of the covered bond. In addition, bondholders have priority claim on the cover asset pool in case of default of the issuer.

Chart 1 Outstanding amounts by major asset class in Europe (EUR billions)



Source: Natixis Research.

COVERED BOND ISSUANCES AND OUTSTANDING AMOUNTS

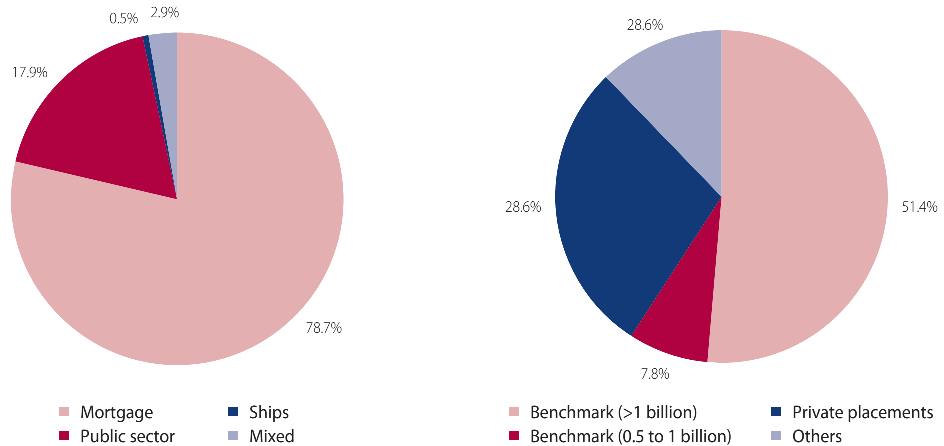
Covered bonds used to be primarily a European tool used for bank financing, in particular to refinance real estate and public loans.[2] Due to its inherent features, this funding instrument has started to become popular also outside Europe. In terms of underlying assets backing the bonds, at the end of 2012 a majority of them were mortgage assets. Nevertheless, the share of covered bonds backed by public sector loans was steadily declining over the last years. In terms of volume, jumbo issuances (above €1 billion) accounted for the largest share (see Chart 7). The share of so-called "benchmark size" or "sub-jumbo" issuances has sharply risen, with more than 60% of new primary issuance now having an issue size of €500 million. As it seems, this reflects banks´ reduced funding needs in light of on-going deleveraging.

The largest jurisdictions in which covered bonds are traded are Germany, Spain, Denmark and France; together they account for about 60% of the total outstanding amount (see Chart 3). The distribution across jurisdictions however changed over the years, which is clearly evidenced by the benchmark covered bond market (see Chart 4).

Covered bonds are often issued in non-benchmark form as private placements or in a size and currency corresponding to the issuer's funding needs and market opportunities. These factors are more important for issuers raising funds in capital markets than is building their own EUR benchmark[3] credit curves. Especially, non-euro area issuers have to consider making placements either in the local currency in which they lend money to customers or going to the Eurobond market, where the funding costs due to financing in foreign currency might be higher. An important development that had an impact on outstanding amount of benchmark covered bonds was observed in Germany. From 2000 to 2004, the market size had increased from nearly €400 billion to €949 billion. Nevertheless, it started to de-

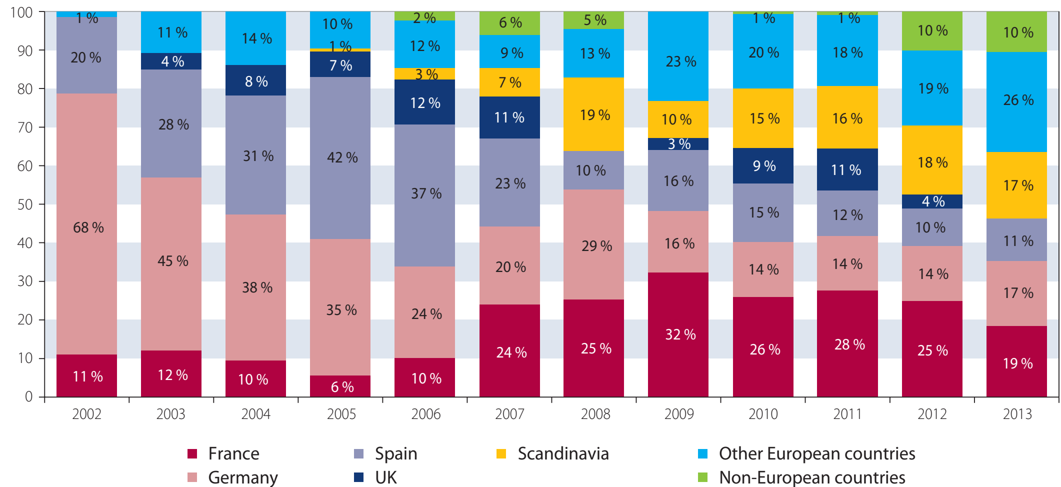
1 Outstanding amount of covered bonds refers to both private and public placements in all denominations.
2 The first German Pfandbrief was issued in 1769. Since then the covered bond market developed only modestly, with only three new legislative frameworks adopted in the following 160 years (1797 – Danish Mortgage Bond, 1899 – Austrian Pfandbriefe, 1930 – Swiss Covered Bonds).
3 An EUR benchmark bond is denominated in EUR, publicly issued and with an outstanding amount higher than €500 million.

Chart 2 Outstanding amounts of covered bonds by underlying asset class and size (2012)



Source: ECBC.

Chart 3 The EUR benchmark market (market shares of new issues)

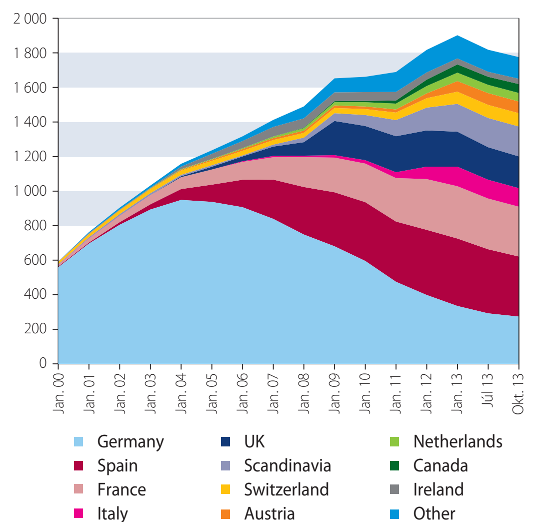


Source: DZ Bank Research.

cline thereafter, mostly due to legislative changes. In 2005, the Landesbanks and Savings Banks lost their public sector guarantees. Since most of the lending business of a typical Landesbank was done with savings banks, the Landesbanks could no longer include loans to savings banks in the pool of public sector loans, which led to lower issuance of public Pfandbriefs.

The euro area banking crisis and sovereign debt crisis had a profound impact on the covered bond market in recent years. During the peak of the debt crisis, primary markets were essentially closed to covered bond issuers in certain euro area jurisdictions. Later on, the ECB's non-standard monetary policy measures exerted important effects on covered bond markets, including the two Covered Bond Purchase Programmes (CBPP1 in 2009–2010 and CBPP2 in 2011–2012) and the three-year`s[4] carried out in late 2011 and early 2012. While particularly CBPP1 is considered to have re-opened the primary market in some jurisdictions, the impact of CBPP2 was considered to be less impor-

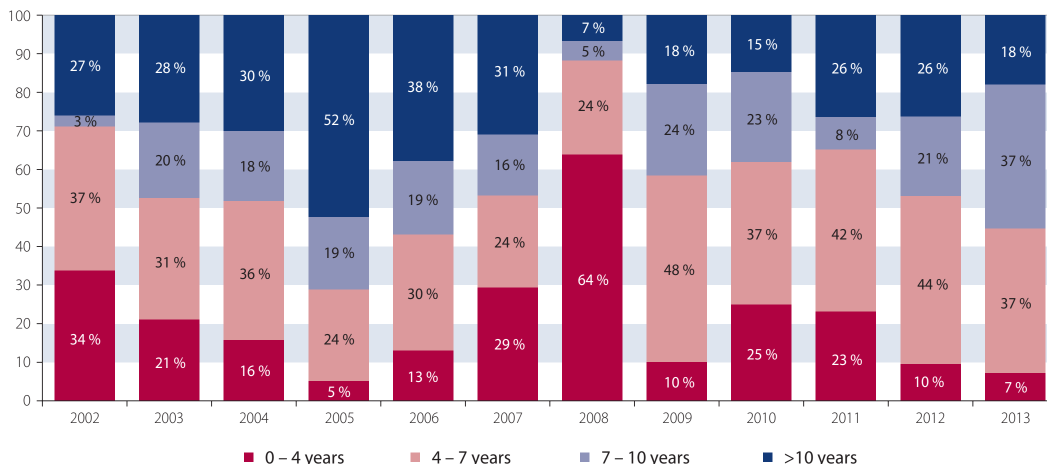
Chart 4 Outstanding amount of all publicly placed covered bonds in EUR billion equivalents



Source: Natixis Research.

4 LTRO – Long Term Refinancing Operation

Chart 5 The EUR benchmark market: new issues by maturity



Source: DZ Bank Research.

tant by many market participants. However, it has to be noted that the two 3-year LTROs were conducted during the lifetime of CBPP2 with a strong impact on funding conditions.

The observed steady decline of new issuances in combination with large amounts of maturing bonds led to net negative supply. Whereas net supply of covered bonds backed by public loans was negative in recent years, mortgage covered bonds have been facing this new challenge as late as 2013. Public issuance activity in the benchmark covered bond market has remained subdued during 2013, reaching a total volume of €91.5 billion[5], compared with €97 billion in the same period a year earlier. At the same time, the volume of maturing benchmark covered bonds amounted to €149.3 billion, which led to a negative net issuance of €57.8 billion compared with a positive net issuance of €8 billion in 2012.

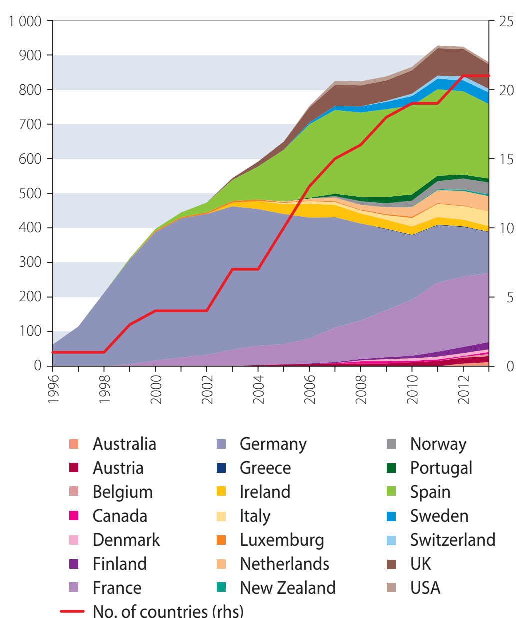
Chart 5 shows how sensitive markets are and to which extent issuers depend on risk sentiment. The debt crisis in the US, which hit Europe in 2007–2008, forced issuers to focus on short-term issuance (maturities up to four years). These maturity terms are not standard for covered bond issuances as the underlying assets have usually much longer residual maturity than the covered bonds issued. After the situation stabilized in 2009, issuers started to look at the 4-7 years maturity bucket with a share close to 50%. The ongoing sovereign debt crisis in 2010–2011 led again to an increase in short-term covered bond issuance. Nevertheless, the improved market sentiment since 2012 has resulted in an increased share of longer-term bonds.

NEW COVERED BOND FRAMEWORKS / NEW INSTRUMENTS

Implementation of and changes to legal frameworks during the last two years in North and South America and Asia-Pacific have globalized the issuer base. Indeed, as of 1996, after the first Jumbo Pfandbrief was issued, the covered bond universe broadened by approximately one to three new covered bond frameworks per year, and often immediately attracted investors looking for new diversification opportunities into top quality issuers and/or different jurisdictions.

Looking at new frameworks, New Zealand, Canadian, Swiss, Australian and Belgian covered bond markets emerged in 2010 and 2012, while Korea and the US are discussing legislative proposals. Thus, the covered bond market has become more diversified. New domestic frameworks have found their investor bases and it cannot be excluded that non-European countries will increase its share in total issuance in the future. However, potential for a growing market share is

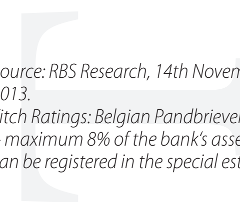
Chart 6 Outstanding amounts of EUR benchmark bonds and number of countries with covered bond frameworks as at October 2013 (EUR billions)

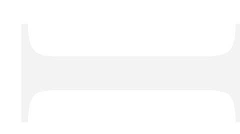


Source: BNP Research.

5 Source: RBS Research, 14th November 2013.

6 Fitch Ratings: Belgian Pandbrieven – maximum 8% of the bank's assets can be registered in the special estate.





rather limited because of framework restrictions aimed at shielding investors from various forms of unsecured debt and retail clients, for example in Australia, Belgium[6] or New Zealand. In these covered bond legislations, regulators capped covered bond issuance at a certain percentage in relation to banks' total assets which can be used in the special estate. Caps applied in some jurisdictions will also mitigate the risk of too much assets encumbered on banks' balance sheets.

Lately, some new forms of covered bond structures emerged. Structured covered bonds backed by SME loans, multi-issuer OBG[7] and conditional pass-through covered bonds are all new phenomena that are seeing daylight. Conditional pass-through covered bonds may become more popular due to the favourable regulatory treatment of covered bonds and the fact that these transactions encumber fewer assets than do the traditional covered bonds, which results in a higher rating uplift. More recently, on 1st October, the Dutch NIBC issued its initial public conditional pass-through covered bond, namely a five year €500 million deal rated AAA[8] by Fitch and S&P's. According to market participants the deal attracted higher interest from investors than expected, including that of traditional covered bond buyers, thanks to the product's regulatory endorsement by the Dutch central bank and the AAA rating achieved by the bond structure. This positive result could possibly encourage especially second row issuers from non-core jurisdictions, with legislations similar to the Dutch one, to take advantage of the favourable rating treatment and looking into setting up their own dedicated conditional pass-through covered bond programmes.

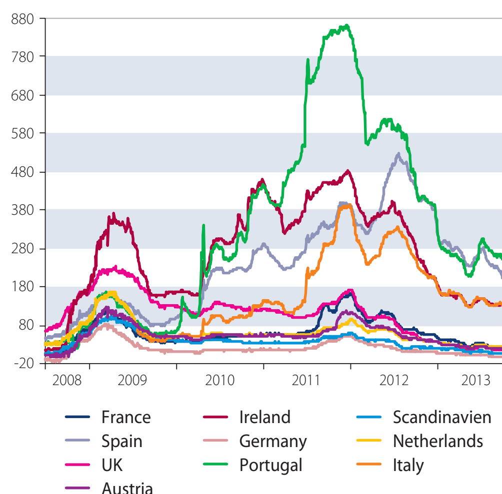
Swap spread performance of EU covered bonds

Since the beginning of 2013, covered bond spreads in core markets have narrowed further, but to a relatively small degree compared to market movements in 2012. This small move may underline the fact that scope for further tightening is limited at current spread and yield levels. These developments in spread levels have several explanations. It were mainly non-standard measures taken by the Eurosystem which supported swap spreads. CBPP1 had a strong effect and helped to stabilize the market until the positive development was counterbalanced during the escalation of the debt crisis in April 2010. The announcement effect and the impact of CBPP2 were significant. However, these effects were superseded by the stronger impact of the three-year LTROs. Markets stabilized, but the positive mood lasted only for a few months, and the situation worsened again thereafter. Nevertheless, the statement of President Mario Draghi that the ECB is ready to do whatever is needed to preserve the euro[9] and subsequently the announcement of the OMTs provided renewed confidence to the market. Indeed, these announcements changed the sentiment in Europe, and swap spreads continued to tighten until the FOMC meeting held in May 2013. At this meeting, the FOMC announced that it might reduce government bond purchases, and some analysts interpreted this as a possible ending of Quantitative Easing in the US. Covered bond markets sold off, and even if the spreads showed lower volatility compared to other asset classes, they were not able to continue the previous trend and slightly widened.

Limited reinvestment opportunities noticeably reduced covered bonds supply in 2012 and 2013[10] and investors faced difficulties to keep the same share of covered bonds in their benchmarks. Without access to the primary market, investors looking for bonds in the secondary market were forced to bid on every offer. Investors´ search for yield increased the interest in the secondary market of second row issuers, especially from Spain. This supported spread compression mainly in peripheral countries and kept swap spreads stable in core markets. The scarcity factor, which is likely to prevail due to limited supply, together with political support, strong fundamental background and legislative framework, were also supportive for covered bond spreads.

In addition, regulatory changes (e.g. bail-in of unsecured bank bonds, the Basel III Liquidity Coverage Ratio (LCR)) and other market activities (Covered bond Label) may induce higher interest for covered bonds by investors. Firstly, formal confirmation that the EU Council intends to exempt covered bonds from bail-ins is credit positive for covered bond holders. This intention should increase the spread between senior unsecured and secured bank debt from its historical lows to higher levels. The first deadline for the full bail-in implementation should have been 2018, however, it may be changed to 2015. Secondly, if covered bonds are allowed to be counted at 100% in liquidity reserve as suggested by EBA and not 85% with maximum share of 40% in High Qual-

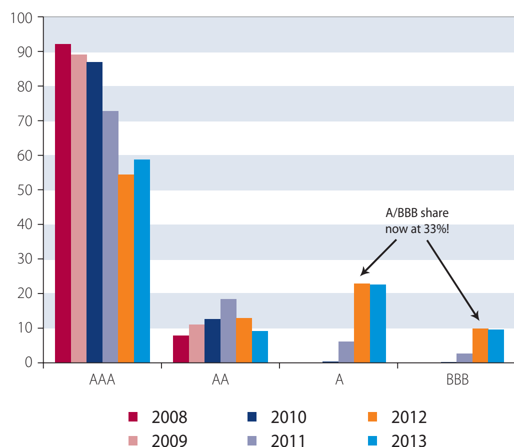
Chart 7 Asset swap spreads of selected countries since November 2010 (b. p.)



Source: BayernLB Research, iBoxx[11].

7 OBG – Obbligazioni Bancarie Garantite; i.e.Italian covered bonds.
8 Covered bonds in NIBC´s traditional covered bond programme are rated A+ by Fitch.
9 Speech by Mario Draghi, President of the ECB at the Global Investment Conference in London, 26 July 2012; http://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html
10 EUR Benchmark net supply, 2012: €-7 billion, 2013 (Nov.): €-58 billion.

Chart 8 Change in covered bond rating distribution from 2008 to 2013 (in %)



Source: BayernLB Research.

ity Liquid Assets as suggested before, it would be positive for this asset class since more investors will be looking for covered bonds to have them in their liquidity portfolios.

Covered bond ratings

Sovereign debt crisis which started in 2010 and persisting implications of US housing market crisis led to revaluation of rating criteria by all rating agencies. The outcome was reflected in lower sovereign and issuer ratings and consequently also in covered bond ratings, albeit to a lesser extent. While in 2009 iBoxx index included 92% of all AAA rated covered bonds, this proportion decreased to 54% in 2012 and slightly increased to 59% in 2013. On the other hand, the share of lower rated covered bonds increased during this period from 0% to 33%.

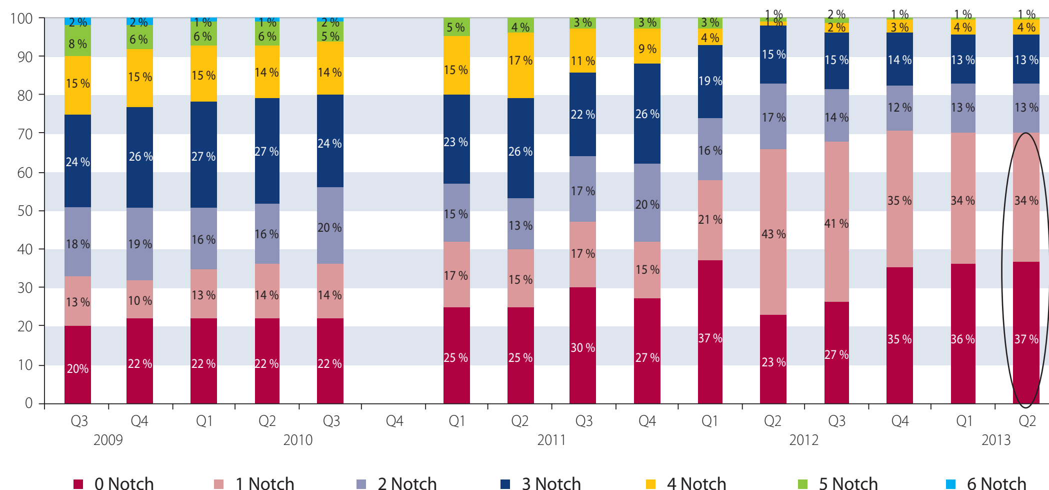
As already suggested in the previous paragraph, both issuer and sovereign ratings are important for the assessment of covered bonds since the agencies determine the final result from both of the ratings. With sovereign and bank downgrades, rating agencies started to use lower recovery and higher default assumptions in their credit reviews. With gap between 1 and 6 notches a covered bond rating could be changed depending on the number of notches which the sovereign or the bank lost. This was mainly seen in peripheral countries, where larger sovereign cuts were followed by slower cuts of covered bonds ratings backed by mortgages and core covered bonds lagged behind the respective sovereign ratings even more. On the other hand, ratings of covered bonds backed by public sector loans were more sensitive to sovereign ratings because of potential uplift of 1 notch only.

Chart 9 shows the developments in Moody's TPI Leeway[12] between the third quarter of 2009 and the second quarter of 2013. It confirms the trend observed in changes of covered bond ratings. TPI Leeway did not move much till the end of 2011, despite the fact that the rating agencies changed their methodologies already in 2009[13]. Nevertheless, the trend changed in 2012. The most important driver for changes in TPI leeway in the first quarter of 2012 were the worsening of the ratings of sovereigns and the downgrades of issuers which led to shrinking TPI leeway for issuers in peripheral countries. The TPIs were changed due to worsening economic environment and rising market risks. From the second quarter of 2012, Moody's did not rate any issuer with 5 or 6 notches uplift. This trend even worsened in the second quarter of 2013 when the best issuers had only 3 notches of rating uplift and more than two out of three covered bonds (71%) faced high downgrade risk.

Covered bond label initiative

This initiative is promoted by the European Covered Bond Council (ECBC). It is aimed at establishing a "Covered Bond Label" which will be

Chart 9 Moody's TPI Leeway distribution (in %)



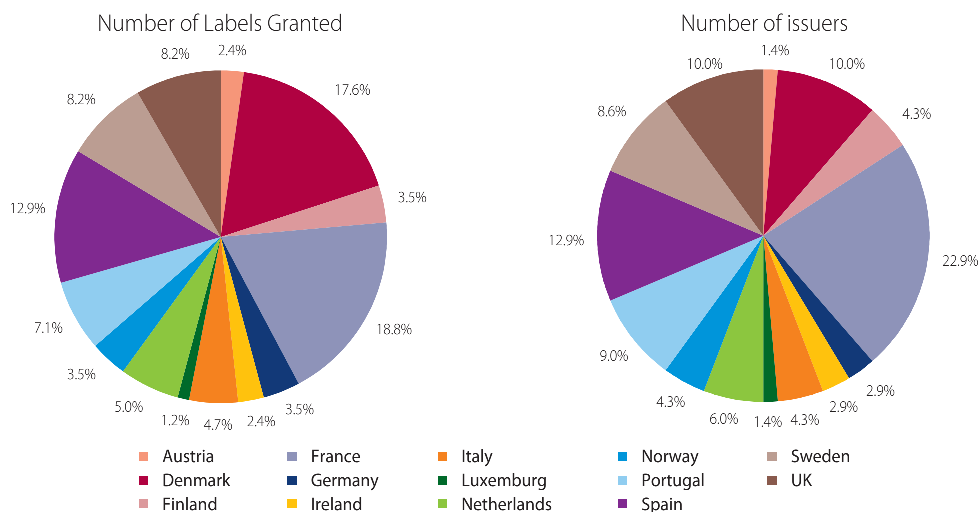
Source: BayernLB Research.

11 Remaining years to maturity: iBoxx France: 4,7, iBoxx Spain: 3,8, iBoxx Ireland: 2,5, iBoxx Germany: 3,4, iBoxx UK: 3,8, iBoxx Portugal: 2,7, iBoxx Italy: 3,9, iBoxx Scandinavia: 3,7, iBoxx Austria: 4,7, iBoxx Netherlands: 4,8.

12 TPI leeway measures the number of notches of the downgrade of issuer rating that a covered bond rating can withstand without suffering a downgrade under Moody 's TPI framework.

13 For example, Fitch updated its liquidity risk assumptions and alternative management scores in July 2009, which caused deterioration in D-factors. In December 2009, S&P completely changed its basic approach to rating criteria.

Chart 10 Covered Bond Label statistics



Source: www.coveredbondlabel.com

granted to covered bond programmes which meet specific criteria, such as a commitment by the issuer to regular and increased transparency, strong safeguards provided by dedicated national covered bond legislation, the public regulation and supervision of both the issuing credit institution and the cover pool, and compliance with the requirements of Article 52(4) of the UCITS Directive. The objectives of the initiative are the enhancement of the regulatory recognition and trust in covered bonds, the development of the existing high standards and quality of the asset class and higher transparency and liquidity of the product.

This initiative was concluded during 2012 and the Label website, where information on programmes and issuers is centralised, became fully operational in January 2013. The Label opened for registrations in mid-2013 and as of November 2013 there were a total of 85 labels (cover pools) have been granted to 70 issuers in 14 countries. The initiative has evolved significantly since its start. As a result, 4,000 bonds are now registered on the Label website amounting to more than €1.42 trillion, which represents approximately 58% of total EU-28 amount outstanding or 53% of the worldwide total. Geographical concentration is significant, as only 5 jurisdictions (Spain, Denmark, France, Sweden, the United Kingdom) account for 80% of the total labelled volume (see Chart 10).

The Label is a private initiative to protect the covered bond product against further dilution by new collateral types, new structures and jurisdictions. Nevertheless, it has to be further developed and accepted by market participants. The initiative is a first action to provide for more transparency in covered bond markets, improved market discipline for issuers and facilitating credit analysis for investors, although further work in terms of harmonization of national transparency templates seems necessary. Its self-certification feature implies that a certain time is needed for the Label to be recognized by the market, including its role as a potential pricing factor, and thus gain credibility. As a recent development, the ECBC has just proposed the Label Committee to amend the current Label Convention in order to align it with Article 129 of the Capital Requirements Directives, following the recommendations by the EBA and ECB.

Conclusion

The covered bond market is very important segment as it is used to refinance loans to private and public sectors. This crucial role was also highlighted by the European Commission in its Green paper[14] published on 25th March 2013. Deleveraging of banks and the decline in new credit agreements on the one hand, and diversification of long-term financing tools, on the other hand, were mentioned as the main points in this paper. The slump in new loans was reflected in the negative net issuance of covered bonds this year. Additionally, non-standard measures like LTRO's have provided medium-term funding at lower cost reducing the incentive to raise funds through publicly issued covered bonds. The temporary shutdown of covered bond markets in peripheral countries during the worst stage of the sovereign crisis caused an increase in the amount of covered bonds retained, but the improvement of market conditions enabled markets to reopen in 2012/13. Lower issuance[15] and sufficient ECB funding were both reflected in falling swap spreads, and with regulatory support[16] the market expects this trend to persist. A very positive signal for the covered bond market is the growing number of approved legislative frameworks and new issuers coming to the market.

14 *http://ec.europa.eu/internal_market/finances/financing-growth/long-term/index_en.htm*
15 *According to Credit Agricole, highest negative net issuance in 2014 are expected in Spain (€-34 billion), Germany (€-16,6 billion) and France (€-13,4 billion).*
16 *For example: EBA proposal to include covered bonds in the first level of assets accepted based on Liquidity Coverage Ratio, exclusion of covered bonds from bail-in and general appreciation of collateralized bonds in regulation.*