The Covered Bond Report

www.coveredbondreport.com May-Jun 2013

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Correctly priced?

Portugal
On the edge

Schroders
Tough talk

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The Covered Bond Report

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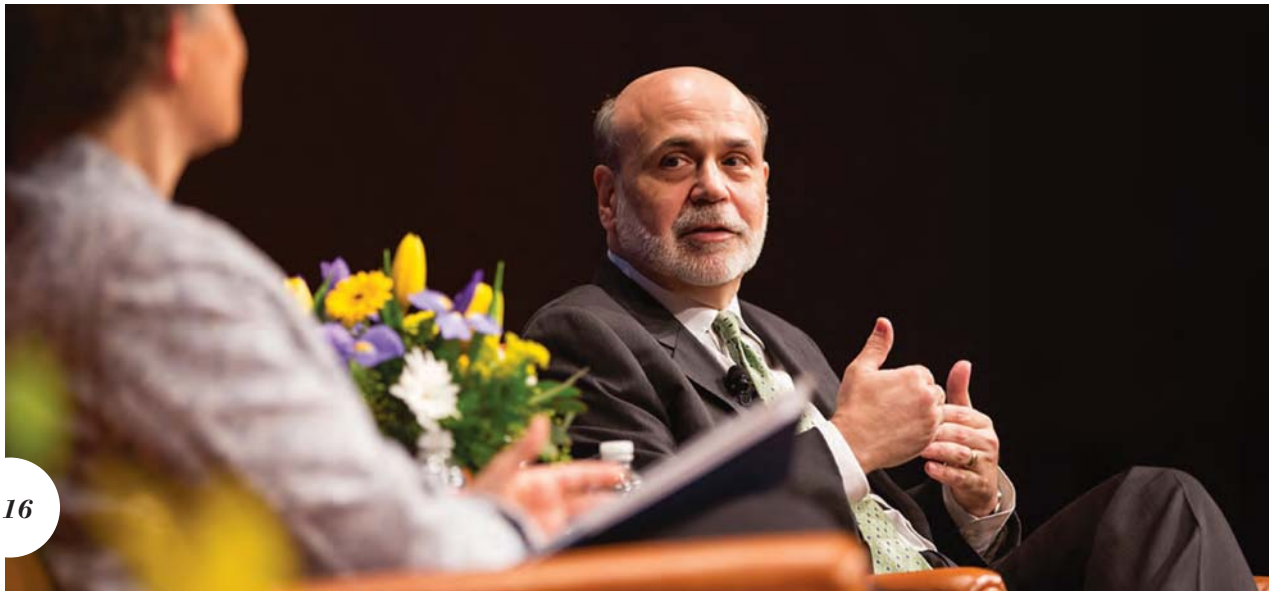

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Pandora's Box

In July 2003 HBOS launched arguably the most important covered bond since the asset class's emergence in the 18th century.

I remember it well. At the time I was writing about covered bonds for *EuroWeek*. Like other institutions, we had to decide whether the covered bond specialist (yours truly) or structured finance bod would handle it. Ultimately I focused on deal execution while he got his head around the structure.

Not everybody arrived at such a happy compromise.

The deal sparked a clash of civilisations between the traditionalists of Louis Hagen's vdp and Anglo-Saxon invaders often represented by Robert Plehn (admittedly the differences in style often overshadowed questions of substance).

Did either side "win"? That's a tough one.

HBOS as an issuer was, of course, a victim of the crisis, while the UK introduced covered bond legislation five years later.

But perhaps HBOS had the last laugh with the launch of Commerzbank's SME backed structured programme in February. Maybe FJK took in more than we realised when sitting quietly next to Boz on all those conference panels.

Indeed, if ever there were a Pandora's Box in the covered bond market, it was HBOS's covered bond. The debate over the union of covered bonds and structured finance techniques has continued to this day.

Standard & Poor's, for example, recently declared that the increasing similarities between covered bonds and asset backed securities might add benefits. The question is: cui bono?

There is a clamour for the use of covered bonds to be expanded, with the purported justification that this will help the real economy. But surely this can only be done by sticking with the qualities of covered bonds that have ensured that they are valued by investors and regulators — otherwise, why use them?

So by all means borrow from the ABS world as HBOS did. But do so only if it will make a covered bond more like a covered bond, not more like an asset backed security.

Neil Day, Managing Editor

The Covered Bond Report

www.coveredbondreport.com

Editorial
Managing Editor: Neil Day
+44 20 7428 9575
nday@coveredbondreport.com

Deputy Editor: Susanna Rust
+44 20 7485 4909
srust@coveredbondreport.com

Design
Garrett Fallon

Printing
Bishops

Advertising Sales
ads@coveredbondreport.com

Subscriber Services
subs@coveredbondreport.com

The Covered Bond Report is a
Newtype Media publication

Office 12
19 Greenwood Place
London NW5 1LB
+44 20 7428 9575

Legislation & Regulation

CONSULTATION

ECBC decries hard encumbrance limits to EBA

A one-size-fits-all approach to the "mythical" issue of asset encumbrance is not supported by research and any absolute encumbrance limit would "catastrophically" impact dedicated covered bond banks, the European Covered Bond Council has argued in its response to an EBA consultation on asset encumbrance reporting.

The ECBC said the asset encumbrance issue needs to be addressed through a holistic and gradual approach, taking into consideration all sources of encumbrance.

"The ECBC believes that establishing hard limits on covered bond issuance would be a short term and one-size-fits-all solution," it said in its 24 June submission. "These limits would be detrimental for this essential asset class and, therefore, for the European banking industry as a whole."

The ECBC argues that a large part of encumbrance is hard to measure and that this can lead to a focus on the most visible part of encumbrance, such as covered bonds, resulting in biased conclusions.

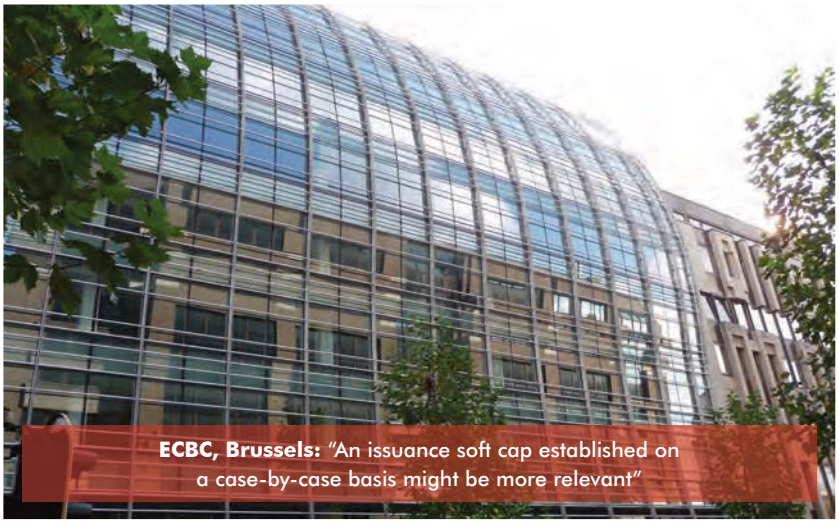
It says there is no evidence of correlation between the covered bond encumbrance of a bank and its senior unsecured spread levels.

"The existence of different business models implies in our view a case by case interpretation of the level of asset encumbrance," says the ECBC. "For specialised issuers for instance, the level of encumbrance — given a broad definition — is close to 100%.

"For those financial institutions which do not take any deposits, all senior investors are institutional investors who are well aware of their position in the priority ranking in case of insolvency. For such institutions, the high level of encumbrance is only a consequence of their business model and cannot be interpreted differently."

The ECBC says an absolute limit would endanger existing stable business models in traditional covered bond markets.

"There are long established covered bond markets in several countries including Denmark, France, Germany and Sweden," it says. "In these jurisdictions, dedicated covered bond banks often exist that do not take in retail deposits and that provide a key service to the economy, but which would be catastrophically impacted by any absolute encumbrance limit.



ECBC, Brussels: "An issuance soft cap established on a case-by-case basis might be more relevant"

"Therefore, we consider that an issuance soft cap established on a case-by-case basis might be more relevant in this area, especially as this could be easily implemented thanks to the licence systems already in place in several jurisdictions. Such a system is already in place in the Netherlands. The breach of a soft cap should result in an increase in incremental capital required rather than a strict ban to issue new covered bonds."

> "A short term and one-size-fits-all solution"

The ECBC further argues that specialised issuers that do not take deposits should be exempt from the more burdensome reporting requirements proposed by the EBA. It also says that institutions should only be requested to report on covered bonds if their asset encumbrance level triggered by covered bonds is equal to or larger than a 5% threshold put forward by the EBA.

Regarding what the appropriate asset encumbrance ratio should be, the ECBC argues that most important to senior unsecured creditors is the ratio of unencumbered assets to unsecured liabilities, rather than the share of encumbered assets to total assets, which it says has been more commonly cited.

"In particular for specialised institutions, as is the case for many covered bond issuers, the ratio of unencumbered assets to unsecured liabilities provides a fairer picture than the pure encumbrance ratio (encumbered assets/total assets), which is usually very high for such issuers," it says. "Instead, their lower dependence on unsecured funding corresponds to a high ratio of unencumbered assets to unsecured liabilities, indicating a comfortable level of protection for senior unsecured bondholders."

Given the challenge of coming up with an appropriate regulatory response to asset encumbrance, the ECBC argues that a straightforward way to increase market discipline and lower excessive encumbrance is by enhancing transparency, and it cites its Covered Bond Label initiative in this regard. ■

LUXEMBOURG

DZ seen as leading candidate for co-op LdGs

Luxembourg's covered bond law has been amended as of 1 July with a key change being the introduction of a type of co-operative covered bond, with DZ Privatbank cited as the leading candidate to take advantage of the new instrument.

DZ Privatbank is the Luxembourg-based centre for private banking of Germany's co-operative banking group. A spokesperson for DZ Privatbank told *The CBR* she was unable to comment at this juncture because the bank is currently considering the topic of lettres de gage (LdG) mutuelles, or Verbundpfandbriefe, as the new co-operative covered bonds have been dubbed.

Lettres de gage mutuelles are foreseen as covered bonds backed by loans to or guaranteed by credit institutions that are members of an "institutional guarantee system". The bill specifies 10 conditions that such a network must fulfil to qualify as an "institutional guarantee system", with the Luxembourg financial supervisory authority, CSSF — drawing on the opinion of the country's central bank — needing to approve a system as such.

HSBC Trinkaus analysts have said that the new framework for lettres de gage mutuelles could encourage banks from countries with a co-operative network — such as Austria, Finland, France, and Germany — to set up subsidiaries in Luxembourg.

A banker familiar with the changes to the law said there was some opposition to harbouring this asset class under the lettre de gage legal framework, due to questions about whether it should be considered as a covered bond and out of concerns it would harm the lettres de gage product. However, the supervisory authority was in favour, according to the banker.

He said that DZ Privatbank was involved in the move to add the new class of lettres de gage, which resemble DZ Bank Briefe. These are a special form of German covered bonds and are governed

DZ, Frankfurt: New LdGs like DZ Bank Briefe

by the DG Bank Transformation Act and only issued by DZ Bank.

According to Fitch, they are similar to German Pfandbriefe with respect to legal provisions regarding an issuer's bankruptcy. However, in addition to assets also eligible for public sector Pfandbriefe, the DZ Bank Brief cover pool can contain debt against German co-operative credit institutions, loans secured on liens, and mortgage as well as public sector Pfandbriefe.

> "This amendment could introduce new risks"

Standard & Poor's said that the amendments to Luxembourg's covered bond law are credit neutral, but will strengthen the framework by clarifying the consequences of insolvency of an issuing bank and enhancing disclosure requirements.

S&P said that the amendment clarifies how an issuing bank would be split into two entities upon insolvency: an insolvent entity that would enter a moratorium and liquidation process; and a separate entity that would be excluded from this process and hold the assets registered in the cover pool(s), managing them for the benefit of LdG holders and making payments to them.

S&P also noted that the law states explicitly that the entity managing the cover pool would retain its banking license. However, the rating agency said that the amendment does not fully exclude comingling risk and that the degree of such risk will depend on the operational set-up of individual LdG programmes.

Previously only assets located in European Economic Area and OECD countries were eligible as collateral for LdGs, but the amendment expands this to include assets originated in any country with a high sovereign rating, according to S&P, up to an amount that is dependent on the sovereign rating. Up to 50% is allowed if the sovereign rating is "first credit quality step" (equivalent to an S&P rating of AA- or higher) or 10% if "second credit quality step" (at least A-).

"In our view, the expansion of the geographic spectrum will give issuers increased flexibility regarding the assets they can use to maintain overcollateralisation over time, and provides a more risk-based assessment framework for the inclusion of assets from new jurisdictions," said S&P. "In some cases, this amendment could introduce new risks to the cover pool."

The amendment also clarifies the conditions for the inclusion of securitisations, said S&P, which can be included if their rating is credit quality step 1 and if a portion of the underlying assets would themselves be eligible, with this portion having to be 50% if securitisations make up less than 20% of the cover pool and 90% if not.

The rating agency said the amendments provide for a regulatory disclosure requirement, which it understands aims to enhance the transparency of cover pool information, in particular within the context of the European Covered Bond Council's Covered Bond Label project. ■

TAX

FTT exemption for LCR assets urged by ECBC

The European Covered Bond Council has called for all LCR-eligible assets to be exempt from a proposed Financial Transactions Tax, arguing that implementation of the tax could otherwise lead to a collapse in covered bond liquidity.

The industry body said in a position paper published on 24 June that while it agrees that financial institutions should make a fair and substantial contribution to public revenues and in particular the costs of the crisis, the FTT, which is due to be implemented in January 2014, has unintended consequences that conflict with other regulatory initiatives aimed at stabilising the banking sector, such as CRD IV.

The ECBC says that the tax could result in "a potential collapse in liquidity of the covered bond market and a consequent misallocation of resources as well as higher costs, which would ultimately be borne by end investors and retail consumers".

As envisaged in a European Commission proposal published in February, a 0.1% tax will be imposed on all securities traded, with carve-outs for primary and retail markets. Each party to a transaction is subject to the tax if at least one of them is established in the FTT member states or if the financial instrument is issued in the FTT member states.

The ECBC says that for intermediated trades, the tax would amount to 0.4%-0.1% each for the end-seller and end-buyer, and 0.2% for the intermediary, who trades with both sides.

"The proposed tax, being magnitudes greater than the average fee earned intermediating these trades for end investors, will either be fully passed on to end investors or the market intermediaries will be forced to pull out of market making of these instruments all together," says the industry body. "Given the current low yield environment, this represents a very significant tax on their total income."

The ECBC says that liquidity in the secondary markets will dry up if the tax is implemented on a wide range of financial transactions.

EC proposal could result in "a potential collapse in liquidity"

"With transaction costs so high in real terms, it will almost never be economically worthwhile for an investor to sell a security, even if it no longer meets its needs or if the investor has a negative view of its creditworthiness," it says. "This will considerably lower the ability for investors to reallocate efficiently their assets, to react to credit news such as, for example, a credit downgrade and avoid potentially catastrophic credit losses. This will also impede the capacity of European issuers to buy back their own bonds, for either market making purposes or bond cancellation, and to adapt their bond outstanding to current market conditions.

"More specifically, against a backdrop of low yields and short duration, it appears economically irrational in many cases for investors and for banks to trade on secondary markets as the new tax would significantly decrease the expected return to the investor."

The ECBC cites the example of a Pfandbrief with a yield of 45bp and a remaining life of three years, saying that a one-off 0.1% tax represents nearly 15% of the total return to the investor over the life of the security, or a "massive" 44% of the total return to the investor this year.

The FTT proposal's potential impact on liquidity is at odds with other regulatory initiatives, according to the ECBC. It points to CRD IV, with banks having to hold large stocks of liquid assets of high credit quality, including covered bonds, that can be liquidated as and when needed in a crisis.

"Therefore, we believe that the European Commission should remain coherent in this respect and avoid any measures that could impede the capacity of banks to sell these assets under a stress scenario," says the ECBC. "Thus, we recommend to exempt assets eligible for banks' liquidity buffers from the tax."

The ECBC also argues that the FTT would significantly hit banks' funding costs at a time when the European Commission, with the publication of a green paper in March, is discussing how to foster the supply of long term finance to the economy. The FTT would also lead to market fragmentation and discourage some form of hedging activity, it adds.

Exemption is also sought for transactions between a parent bank and its covered bond vehicle or guarantor SPV, which the ECBC says would be consistent with other regulatory measures such as EMIR and CRD IV, where such transactions are exempt from clearing and CVA charges. ■

"Cutting out the middleman would be just fine in my book" page 24

GREEN PAPER

Harmonisation vs. expansion: tensions exposed

There is a tension between the desire to use covered bonds to help boost the long term lending capacity of the banking sector and the value that would come from greater harmonisation of the asset class, the European Covered Bond Council has told the European Commission.

The ECBC made its comments in a response on 24 June to a green paper on the long term financing of the European economy published by the EC in March.

The ECBC notes how covered bonds have played a central role in banks' funding strategies even amid the volatility of the crisis, and how this has attracted the attention of regulators and market participants worldwide. Given the need to provide lenders with long term financing tools, this could result in greater use of covered bonds in sectors "that are not traditionally addressed under the current 'covered bond' concept", says the ECBC.

"However, enlarging the use and the scope of the covered bond structures to different asset, maturity and risk profiles could increase the degree of heterogeneity in the covered bond arena," it warns. "This could lead to a significant fragmentation of the covered bond market and could jeopardise the quality features and regulatory recognitions that currently characterise this asset class."

> "This could lead to a significant fragmentation of the covered bond market"

This tension is brought to the fore in the ECBC's discussion of covered bonds backed by SMEs — an area of the real economy highlighted in the EC's green paper. The ECBC says it backs SME covered bonds — which made a breakthrough with the launch of a Commerzbank deal in February — but also advises caution.

"The ECBC believes that covered bond techniques — in particularly the dual recourse character of the instrument — could be used by banks for the refinancing of SME loans, as we have already seen in Germany and in Turkey (where SME backed bank bond is due to be issued)," it says. "The ECBC, as the think-tank of the industry, supports the development of this market segment as long as the fundamental differences between the two products — particularly in terms of recovery values — between mortgage or public sector backed covered bonds on the one hand and dual recourse instruments backed by SME loans on the other hand — lead to a clear differentiation between the classical product and these new types of secured bonds."

It adds that while some of the long term funding techniques characterising the product could potentially be adapted and integrated in other funding tools, transforming the covered bond asset class into "a new all-purpose form of collateralised funding" is not the best way forward.

Scope for progress in three areas

Addressing the more general questions posed by the EC green paper, the ECBC says that harmonisation is already being enhanced and the asset class ring-fenced through the Covered Bond Label initiative, while the industry is continuously fine tuning best practices resulting in a process of convergence.

However, the industry body notes that minimum standards also take into consideration different market conditions and practices that are not linked to the covered bond product per se, such as insolvency laws or structural differences in mortgage markets.

It nevertheless cites three key areas that offer scope for further harmonisation: special public supervision, transparency, and bankruptcy remoteness.

Implementation of special public supervision varies across jurisdictions, so a decent level of harmonisation could be conceived at a European level, says the ECBC.

Regarding transparency, it points to progress made under National Transparency Templates within the Label initiative, and says that this is ongoing.

The ECBC says that given that the diversity of national covered bond regimes makes harmonisation of technical aspects of asset segregation mechanisms and the preferential treatment of bondholders in insolvency proceedings unworkable, a debate about some common principles underlying the security concept of covered bonds appears more sensible.

"These principles could relate to the relationship between the general insolvency estate of the bank and the cover pool, as well as their respective administrators," it says. "A common European approach could also address the criteria triggering the over-indebtedness and liquidity of cover pools and the proceedings to be applied post-insolvency."

Other areas the ECBC mentions as possibly offering scope for further harmonisation are: asset and liability management; minimum legal requirements for overcollateralisation levels; licence systems; cover pool disclosures; and asset monitors. ■

FRANKFURTER HOF

Pros and cons weighed at ICMA/CBR conference

Covered bonds' possible role in stoking house price inflation came under scrutiny at The Covered Bond Report's joint conference with the ICMA Covered Bond Investor Council in Frankfurt on 16 May.

In the opening panel, investors and a representative of the European Banking Authority (EBA) discussed covered bonds' position in macroprudential regulation.

Citing Ireland and Spain as examples, Georg Grodzki, head of pan-European credit research at Legal & General Investment Management, said that overuse of covered bonds can fuel a rise in property prices and that it is important to be honest about this. Regulatory authorities are entitled to monitor overall leverage in an economy, and, as a funding tool contributing to this, covered bonds would legitimately come under their focus.

"There should not be a ban on lateral thinking" about the big picture implications of use of an asset class that has many strengths and weaknesses, said Grodzki.

"If there is a property bubble it won't be covered bonds' fault," he added, "but covered bonds are not a guarantee that things will remain under control."

Claus Tofte Nielsen, head of position management allocation strategies at Norges Bank Investment Management, said that investors should be "relaxed" about the possibility of regulators turning to covered bonds in a bid to try to dampen house prices. However, he noted that politics can also influence how regulators go about tackling overheating property markets and said that investors should be mindful of this, as well as the role played by the availability of sources of cheap funding. He gave as an example the introduction of legislation in Denmark that allowed interest-only mortgages, which, he added, some would say turned out to be a mistake.

See Full Disclosure for conference photos

Other panellists pointed out that covered bonds are only one piece of the puzzle. Christian Moor, policy advisor, securitisation and covered bonds at the European Banking Authority, said that loose underwriting standards and poor risk management are other contributing factors.

Mónica Trastoy, senior credit analyst at Santander Asset Management, noted that several factors were behind the property bubble in Spain, such as a growing population, high employment and high per capita salaries, and that the growth of the cédulas market only came later.

> "There should not be a ban on lateral thinking"

Meanwhile, Morten Bækmand, head of investor relations at Nykredit Realkredit, gave a mixed prognosis on the wider regulatory front. He said that whereas a previous examination of pending regulations had thrown up 10 potential ways for the group to be put out of business, recent encouraging developments suggested that "we can only be killed three or four times".

Florian Eichert, senior covered bond analyst at Crédit Agricole CIB, said that regulation remained uppermost among issues that investors are grappling with based on his conversations with them. And Jens Tolckmitt, chief executive of the Association of German Pfandbrief Banks (vdp), noted that the regulatory scene was developing.

"Some of the big elephants are out of the room," he said. "Others are coming."

Bækmand noted that a key decision would be the final outcome of what assets are eligible as top level LCR assets after the EBA has completed its work on this. Bækmand was optimistic about Danish covered bonds' fate, noting that the industry had a lot of data to back up its case.

Tolckmitt said that a major issue that needs to be tackled is the way in which European-level regulatory initiatives can be contradictory, and he called for greater examination of the interaction between different regulations. In particular, he said that were covered bonds to become subject to haircuts in the event of a bail-in this would "kill" the idea of covered bonds.

Nykredit's Bækmand agreed with this, citing two examples: he said that CRD IV induces banks to raise more

"A good means of regaining access to the wholesale markets" page 21

longer term funding, but that Solvency II penalises insurance companies buying long term assets; and that the authorities want liquid markets but are introducing the Financial Transactions Tax (FTT), which Bækmand said "will kill liquid markets".

A trader in the conference audience took the opportunity to ask Ulrich Bindseil, director general, market operations, at the European Central Bank and one of the keynote speakers, for the ECB's views on the FTT proposal. Bindseil said the transaction tax needed to be thought about very carefully, and that, as currently proposed, it risks undermining liquidity in the bond markets, including in covered bonds.

Nykredit's Bækmand warned that such muddled banking regulation would "sow the seed for the next piece of trouble", which he said was likely to be activity being driven into the shadow banking sector.

Investors also had warnings for regulators. Grodzki criticised a trend of political interventionism and regulatory overreach and inconsistency, saying that this undermines investors' trust, and that regulators and politicians were playing into the hands of old-fashioned securitisation.

"Regulators should rein in their ambitions to fix the world," he said. "They are not wiser than the markets."

Another topic on the investor-driven conference agenda was asset encumbrance, and whether covered bonds were being unfairly singled out as a contributor.

"Regulators are not wiser than the markets"

Bindseil at the ECB said that covered bonds have not been a driving factor of intensifying asset encumbrance, but that the issue will become more relevant for the market because of a general trend toward collateralised transactions, in part due to regulatory drivers. There needs to be scope for collateralised and unsecured bank liabilities, he said.

For L&G's Grodzki, senior unsecured investors should be more worried about depositor preference than asset encumbrance via covered bonds when it comes to their spot in the payback queue and recovery prospects.

And Moor at the EBA defended the way covered bonds were dealt with in the EBA's asset encumbrance reporting consultation, saying that the asset class was not singled out and that the proposed data reporting requirement is "quite reasonable".

It is right that regulators pay attention to asset encumbrance — which has increased over the years, he added — to determine to what extent it is a real problem or not.

When an investor warned of the implications of changes recently put forward to the proposed EU bail-in framework, Moor said that uncertainty about the fate of covered bonds in a bail-in situation should not be exaggerated, questioning how certain investors can really be about how covered bonds would ultimately fare in an insolvency situation under national covered bond laws. ■

TALKING POINT

SMEs unavoidable

The conference would not have been complete without a discussion of SME backed covered bonds, as controversially spearheaded by Commerzbank via the launch of the first such deal at the end of February, with use of the "covered bond" term being a major concern for several large investors.

Rainer Mastenbroek, head of covered bond funding at Commerzbank, was once again pressed to explain why the issuer introduced the SME backed programme and why it referred to it as a covered bond.

"We chose the covered bond brand because that it is how people referred to it during the preparation and because it has typical covered bond features," he said. "It was the natural thing to do to call it a covered bond, and I don't think the name affected the pricing."

The latter point was an answer to a question posed by Andreas Denger, senior portfolio manager at MEAG, about how much pricing power could be attributed to the deal being called a covered bond, as opposed to a collateralised SME bond, for example.

He welcomed the innovation and SME funding tool, but said that it is missing traditional covered bond assets as collateral and that is one of the reasons he believes it should not be referred to as a covered bond.

Thorsten Jegodtka, portfolio manager at Union Investment, said that the Commerzbank SME bond came under the remit of the ABS team at Union Investment, and criticised the use of the covered bond term in connection with the deal, saying that it amounted to abuse of a good name for the product.

Mastenbroek played down the take-up of covered bonds backed by alternative assets on a bank's balance sheet. He said that the SME programme made sense for Commerzbank because it corresponded to one of the bank's core business areas, and that the issuer wanted all of these to have access to covered bond financing. ■

Ratings

UK

Co-Op covered slashed, but TPI eases pain

Covered bonds issued by The Co-Operative Bank were cut from Aaa to Baa1 on 10 May after the UK bank acknowledged problems that ultimately necessitated a rescue package.

Jan King, senior covered bond analyst at RBS, said that the downgrade of seven notches is one of the sharpest ever in covered bonds, with the covered bonds' fate made even more exceptional by the issuance falling from a triple-A rating.

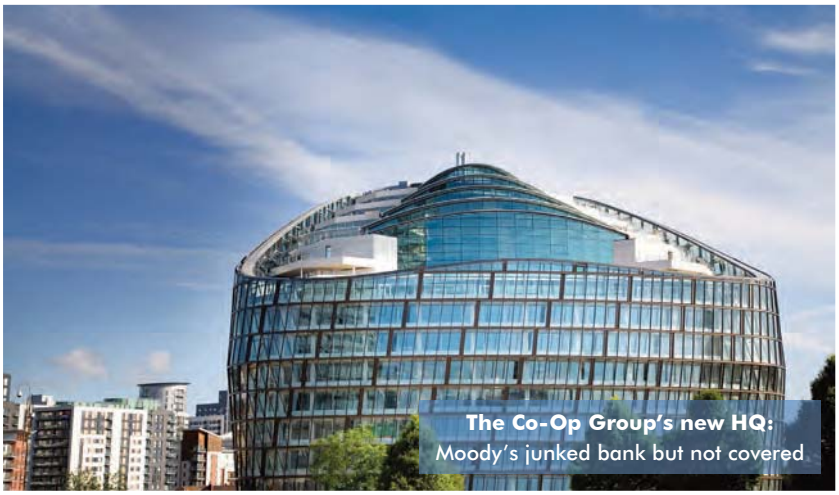
Co-Op has only one benchmark covered bond outstanding, a £600m November 2021 issue launched in November 2011. After the initial downgrade of Co-Op this widened some 35bp to around 160bp over swaps, according to a banker.

Downgrading the issuer to Baa1, Moody's cited potential further substantial losses, particularly from Co-Op's commercial real estate exposure, which could exert pressure on capital ratios that are already relatively low, as well as vulnerability to losses heightened by low levels of provisions, and slow progress in realising benefits related to its merger with Britannia.

The covered bonds were downgraded to Baa1 because the combination of the new Ba3 issuer rating and a programme Timely Payment Indicator of "probable" constrain the rating at that level. A covered bond analyst had suggested that under Moody's methodology they could have been cut as low as Baa3.

The Co-Operative Banking Group's chief executive, Barry Tootell, resigned in the wake of the downgrade of the bank, which went on to put together a rescue package announced on 17 June, including a bail-in of subordinated bondholders. Moody's then cut Co-Op further, to Caa1.

However, its covered bonds enjoyed a measure of relief a week later when Moody's cut the covered bonds again. Analysts had expected a downgrade to sub-investment grade — in the Ba or single-B area, according to RBS, for example — given a combination of the Caa1 issuer rating and a Timely Payment Indicator (TPI) of "probable". But Moody's improved the TPI to "probable-high", resulting in a Baa3 rating for the covered bonds.



The Co-Op Group's new HQ: Moody's junked bank but not covered

The rating agency cited three factors in the change of TPI: the high credit strength indicated by its expected loss analysis, consistent with a single-A rating; a high level of overcollateralisation, with 29% committed OC and total OC of over 180% at the last reporting date; and the time remaining until the next principal payment — Moody's said it understands this to be eight years away and Co-Op to have no plans to issue further covered bonds in the near term.

> "We were surprised that the TPI was raised"

RBS analysts said that the TPI move was unexpected.

"We were surprised that the TPI was raised one level against the backdrop of a deterioration at the bank level (as evidenced by the senior unsecured rating downgrade) and no observable changes in the structure of the cover pool or the outstanding covered bonds respectively since the last rating decision in May," they said.

Fitch also downgraded the issuer and its covered bonds in late June, cutting Co-Op from BBB- to BB- on 20 June and the covered bonds from AA- to A- four days later, directly reflecting the lowering of the bank's rating.

The A- covered bond rating is based on Co-Op's BB- rating, a Discontinuity Cap (D-Cap) of 4 (moderate risk), and an asset percentage (AP) of 77.5%. The AP of 77.5% allows for a rating of BBB on a probability of default basis and an A- rating considering recoveries given default, as it is lower than the breakeven AP for that rating level, which is 90%, said Fitch.

The rating agency said that any rating action on Co-Op is likely to translate into a rating action of the same magnitude for the covered bonds, all else being equal.

Fitch noted that according to Co-Op's programme documentation, the issuer has to use reasonable endeavours to enter, within 60 days, into a back-up servicing agreement with a third party as appropriate, because of the downgrade of the issuer below BBB-.

"Also, a suitable back-up cash manager should be appointed within 60 days, on a best effort basis," it said. "Fitch will closely monitor any remedial action put in place by the issuer and review the rating accordingly." ■

FITCH

Demand loans seen spreading outside Europe

Demand loans can help address asset encumbrance and are likely to be taken up by new covered bond issuers in jurisdictions outside Europe, such as those due to emerge in Asia, according to Fitch.

In non-European covered bond jurisdictions, such as in Australia, Canada and New Zealand, demand loans are used to fund cover pool assets in excess of the minimum amount contractually allocated to covered bond investors, it said.

"Because the issuer can be repaid on demand, it can seamlessly reduce the size of the cover pool available to investors," said Fitch. "This leaves issuers better able to limit the extent of unsecured creditor subordination, although it can reduce priority access to assets by covered bond investors, who in most cases do not have access to this excess amount of assets."

According to Fitch the removal of excess overcollateralisation (OC) by repayment of the demand loan is allowable, provided that upon repayment, there is no breach in the contractual amount of OC required by the programme.

"In a period of market stress, when issuers generally utilise more of their excess assets for funding, the reduction in OC could well be faster in programmes with a demand loan," said the rating agency, "leaving only the minimum level of OC available to covered bond investors."

New Zealand parliament: Flying the demand loan flag

Although the terms and conditions of demand loans differ from country to country, in most countries the demand loan repayment ranks senior in repayment to covered bond investors, noted Fitch.

The method of repayment of the demand loan — in kind with mortgage assets or with cash — can make a significant difference to liquidity risk, it highlighted. In contrast to Australia and New Zealand, for example, in Canada repayment in kind is not explicitly required, it said. This means that, in the event of issuer insolvency, any cash available in the programme could be used to repay the demand loan first, thereby reducing the liquidity available in the programme and increasing the refinancing risk to maturing covered bonds.

In cases where the demand loan ranks senior in repayment to covered bond investors, the rating agency said that it would expect refinancing risks to be mitigated via structural provisions such as repayment of the demand loan in kind with cover assets following issuer insolvency, as is the case in Australia and New Zealand covered bond programmes. ■

ASIA-PACIFIC

Fitch cites Australasian covered bond positives

Covered bonds are an important tool and a "mild credit positive" for Australian and New Zealand banks, Fitch said in mid-June, although it does not expect many further issuers to emerge from the region.

The rating agency noted that the funding instrument allows them to access new investors, longer issuance duration, and a diversification of funding tools, with this being particularly important for banks in the two countries given their reliance on wholesale funding, particularly offshore.

Fitch noted that Bank of New Zealand is an outlier in its use of its potential covered bond capacity, having issued about 70% of the amount it is permitted to, with other major Australian and New Zealand banks having each used about one-third of their available capacity — Australian banks' cover pools are limited to 8% of domestic assets, and New Zealand banks have a limit of 10% of total assets, with the need for overcollateralisation effectively lowering issuance capacity further. The extent to which they maintain issuance capacity within limits is key to the extent to which covered bonds are a benefit, the rating agency said.

Fitch expects few new issuers to emerge from the two countries given the regulatory limits and that smaller banks that have not issued covered bonds would find it difficult to achieve high ratings. It also said that asset encumbrance resulting from covered bond issuance is likely to remain low due to issuance limits. ■

ENCUMBRANCE

Depositor preference the bigger risk to senior

Depositor preference remains a far greater subordination risk to senior unsecured creditors than balance sheet encumbrance, according to Fitch, with encumbrance resulting from cover pools broadly stable from 2011 to 2012 and disclosure better.

The rating agency's comments about the risk posed by depositor preference were made in late May in response to a bank recovery and resolution framework proposal from the European Union Economic & Monetary Affairs Committee (ECON) the week before, under which depositors would be ranked ahead of senior unsecured creditors. The proposal also introduced the possibility of covered bondholders' residual claim being bailed-in, although market participants appear hopeful that this will not feature in the final directive. It was, however, included in the EU Council's version of the proposed directive, agreed upon at the end of June.

Depositor preference has a far greater influence on subordination risk than balance sheet encumbrance, said Bridget Gandy, managing director, financial institutions at Fitch *(pictured)*.

A preference for retail depositors over senior unsecured bondholders could substantially increase subordination risks for senior creditors in the — very rare — event of a bank default or resolution, she said, pointing to figures released by the Bank for International Settlements. According to these, the introduction of depositor preference can raise the median asset encumbrance ratio for European banks by about three times, noted Gandy.

"This is consistent with our findings last year that deposits raise the median encumbrance of funded banking assets to around 72% compared to 28% when only secured funding is included," she said. "This shows how the relative size of a bank's deposit base compared to other funding sources could limit recoveries for senior unsecured bondholders."

However, policymakers' views on which deposit categories should come under protection are likely to vary, said Gandy, especially because the definition of a deposit can include instruments that resemble capital markets investments.

A narrow application would have a less marked impact on the encumbrance ratio.

> "This is consistent with our findings last year"

Asset encumbrance could also increase if banks use more long term secured funding to comply with the Basel III net stable funding ratio, with regulatory reforms and market pressure adding to momentum for banks to increase balance sheet encumbrance. Collateral for OTC derivatives, for example, is increasing.

"However, these factors are unlikely to have as great an impact on subordination risks compared to depositor preference," said Gandy. "In any case, they are being at least partly offset by a receding euro-zone sovereign crisis, collateral optimisation and enhanced capital buffers and liquidity."

"Weaker European banks that are able to restructure and improve their financial profile will see balance-sheet encumbrance decline if their need for central bank funding reduces."

Fitch found asset encumbrance resulting from cover pools to have been broadly stable from 2011 to 2012, according to a June update, and said that disclosure has improved.

The rating agency's survey took in 135 entities (101 banking groups) that it rates.

For the first time the ranking in Fitch's report was based on cover pool size, rather than covered bond funding, as a proportion of a bank's assets, which the rating agency said was possible given better disclosure. It noted that initiatives are underway to improve encumbrance disclosure further.

Cover pool encumbrance was broadly stable from 2011 to 2012, averaging 10% last year, according to Fitch. It said that trend drivers vary.

"Growing use of covered bond funding for some banks is based on necessity, borne from limited access to unsecured funding," said Fitch in early June. "More stable use comes from banks in countries where covered bonds have accounted for a large share of financing for a long time."

The rating agency highlighted developments such as the cancellation of securitisations leading to higher encumbrance in Spain, and deleveraging in Germany including cover pools, often leading to slight decreases in encumbrance.

Newly opened markets are unlikely to witness high levels of encumbrance resulting from covered bonds given issuance limits, said Fitch.

"Banking authorities in countries that have adopted covered bonds more recently have put in place regulatory limits on cover pool size or covered bond issuance," it said. "Covered bond issuers in these countries unsurprisingly remained in the lowest bucket (0%-10%)."

For example, Fitch noted that in Australia legislation introduced in late 2011 specifies that assets in the cover pool cannot exceed 8% of domestic assets. ■

"There is a higher risk that voluntarily held OC may be more volatile" page 30

S&P

Ratings in 'fragile equilibrium'

Covered bond ratings are characterised by a high degree of stability but nearly one-third face an automatic downgrade if Standard & Poor's cuts the issuer, the rating agency said in mid-May.

In its latest quarterly report on covered bonds S&P said the number of covered bond rating changes over the preceding quarter was at its lowest since it started publishing metrics in 2010.

"Indeed, most of our covered bond ratings have shown a high degree of stability, and two-thirds are still at AAA," it said. "That's because issuers have managed overcollateralisation levels or amended the terms of their programmes, such as regarding swap counterparties considerations."

Most of the downgrades of covered bond ratings in 2012 reflected a change in S&P's view on country risk in Europe, according to the rating agency.

However, it said covered bond ratings are in a "fragile equilibrium" because many financial institutions face challenges in transitioning to more sustainable balance sheets, and that the stability of its ratings on European banks and therefore their covered bonds remains delicate.

"Following consecutive rating actions on various European sovereigns throughout 2012, and the impact on our bank ratings, the share of covered bonds without unused notches of uplift has increased," said S&P. "A downgrade of an issuing or sponsoring bank would therefore directly result in a downgrade of the covered bond."

The average issuer credit rating on covered bond issuers is still high, at A-, according to S&P, so only 29% of its covered bond ratings carry negative outlooks or are on CreditWatch with negative implications, signalling that a downgrade of the issuer would automatically lead to a cut of the covered bond programme.

S&P pointed to credit risk information available in its Global Covered Bond Characteristics report, noting that it is important for investors to be able to gauge the level of this risk and that it varies widely across Europe.

It noted that its figures show Spain and Ireland as the countries where credit risks to asset pools for rated mortgage covered bonds are highest, and suggested that Italy and Portugal were often incorrectly associated with this group.

"Our credit risk estimate for mortgage covered bonds in Italy is relatively low, as it is in Portugal," it said. "Notably, both figures are lower than the median for all covered bond programmes, as well as those for Germany, Denmark, and the UK."

Asset-liability mismatch (ALMM) risk is a key component in S&P's rating approach, and S&P noted that for the mortgage covered bonds it rates the median target credit enhancement to offset credit risk was 4.62%, but five times higher, at 24.62%, including ALMM risk.

"Depending on where a programme was issued, however, absolute amounts of credit enhancement to support a covered bond rating can also differ: from 6.8% for the two Canadian programmes we rate, to about 78.4% (more than three times the median) for rated Spanish programmes," said S&P. "At the same time, the lowest target credit enhancement for a Spanish programme was 47.6% and the highest 88.2%, which also demonstrates the effect of variances among covered bond risk characteristics within a country." ■

SPAIN

Loan reclassification seen lifting transparency

Stricter loan reclassification rules approved by the Bank of Spain will allow covered bond investors to better assess credit quality of cédulas cover pools, but will not reduce overcollateralisation, according to Moody's.

Under new rules approved by the Bank of Spain on 30 April Spanish banks have to reclassify the status of refinanced loans and increase provisioning for them to better reflect the credit risks associated with the loans, said the rating agency. Because banks have not been including the majority of forbearance loans in disclosed non-performing loan (NPL) figures the credit risks in covered bond cover pools have been masked, Moody's said. It expects the new rules to push most refinanced mortgage loans into riskier loan categories and thereby lead to higher NPL figures.

However, it sees the new provisioning rules as positive for investors in Spanish covered bonds because they will help reveal the true credit risk in cover pools, which has been masked by loan restructurings.

In addition, the new rules will not reduce overcollateralisation levels, said Moody's.

"Issuers will only classify refinanced and restructured loans for provisioning purposes and will not write-off the loans," it said. "Therefore, the refinanced and restructured loans will still form part of the total cover pool and not be removed in part or in full."

Fitch also noted that comparability of asset quality would be enhanced, but highlighted that additional loan impairment charges could further dent "already feeble" earnings and that this could ultimately filter through to capital, leaving some thinly capitalised banks vulnerable to downward ratings pressure. ■

METHODOLOGY

Moody's notes upside for future SME growth

SME backed covered bond usage is set to expand and become a feature of markets such as Italy, Spain and France, according to Moody's, which noted that the new instruments carry some advantages over traditional ones and will not necessarily be assigned worse scores in its rating analyses.

"Covered bonds backed by loans to small and medium-sized enterprises (SMEs) are gaining traction as a new funding tool for European banks," the rating agency said in a report in early June. "In our view, the reasons are (1) the need of SMEs to find alternative funding sources, especially given the lack of bank financing and the current relatively low level of investor demand for SME asset-backed securities (ABS); (2) the apparent current market preference towards secured debt instruments; and (3) the favourable regulatory treatment of covered bonds."

Moody's noted trends that have recently been highlighted by policy-makers across the European Union, particularly the European Central Bank, showing the challenges faced by SMEs.

"The lack of credit availability has been a key factor affecting SMEs' weak performance since the beginning of the economic crisis in 2008, especially in the most troubled economies, combined with increased funding costs and the tightening of the associated lending conditions," said the rating agency. "SMEs in stressed countries face worse borrowing conditions than similarly risky competitors in non-stressed countries, given the fragmentation amongst euro area countries."

Moody's said that several countries have introduced measures to help SMEs and that the European Investment Bank has increased its lending capacity, but it also highlighted how outstanding volumes of SME ABS have fallen progressively since a peak in the first quarter of 2009.

Covered bonds have meanwhile come into favour among investors and enjoyed regulatory support, said Moody's, with investors possibly preferring the dual recourse nature of covered bonds while policy-makers are potentially exempting covered bonds from bail-ins and central banks are treating them favourably as collateral, for example.

"In the SME space, the ECB's recent categorisation of Commerzbank's SME CBs as assets within the Eurosystem's collateral framework leads to a more favourable treatment of SME CBs relative to senior unsecured debt and ABS, which could provide further momentum for developments in other euro area countries," added Moody's.

> "Lack of credit availability has been a key factor"

Three types of SME covered bonds have thus far been issued, according to Moody's: law-based SME covered bonds, for example out of Turkey since 2011; contractual-based issuance, namely a Commerzbank deal in February; and covered bonds where SME loan receivables are guaranteed by a public sector entity to make the collateral eligible to back public sector covered bonds, a method used by HSH Nordbank via a guarantee from KfW.

Differences between SME covered bonds and more traditional versions of the asset class are addressed in three ways during Moody's analysis, it said: by determining the collateral score of the cover pool; by assessing refinancing risk; and by reviewing interest rate and currency mismatches, cash commingling and set-off risks influencing expected loss.

Moody's said that collateral scores for SME portfolios tend to be higher than for mortgage portfolios in the same country, reflecting lower credit quality. It said the main reasons for this are that: the security provided by residential properties in mortgage portfolios is typically higher than in SME portfolios where portions might have no or lower quality collateral; residential mortgage pools are more highly diversified and granular; and households are typically more resistant to a credit crisis relative to SME credits.

However, the rating agency noted SME covered bonds are not necessarily riskier since the level of protection available — such as overcollateralisation and other risk mitigants — also has to be considered.

Regarding refinancing risk, Moody's said that in transactions it has rated so far (from Turkey and Germany), this has been well mitigated because of long extension maturities and pass-through structures that avoid the forced sale of assets.

"The refinancing risks observed in SME covered bonds could be even lower than in traditional covered bonds depending on the structure decided by the issuer," it said.

Moody's said that, based on three major components that determine refinancing risk, the level of refinancing risk in an SME cover pool can be characterised thus: the average life of the refinancing risk is shorter, because SME loan receivables usually have a shorter duration than traditional residential mortgage loans (although this could lead to reinvestment or replenishment risk); refinancing margins are higher, because SME loan receivables offer less protection than mortgage loans in terms of security and their performance is highly correlated to the country's economy; and a smaller cover pool portion is exposed to refinancing risk.

Moody's said that it rates the effectiveness of credit protections irrespective of whether they are added through law or contract. However, it said that it considers that recognition of SME covered bonds within a specific legal framework could strengthen the debt instrument's systemic importance and thus improve their refinancing potential. ■

"The result is significant: covered bond ratings will be protected" page 42

STRUCTURED FINANCE

S&P blesses marriage of covered and ABS

Covered bonds could do with adopting elements of structured finance, according to Standard & Poor's, which identified the practice as an emerging trend and one that can bring a range of benefits despite the complexity of covered bonds increasing as a result.

"While some covered bond investors see the replication of covered bonds with features of securitisation as a threat to the existing market, we believe structurally enhanced covered bonds can reduce risks that would otherwise be present," the rating agency said in a report in mid-June.

It said that "marrying securitisations with covered bonds" could enhance the benefits of the latter for issuers — such as relatively low funding costs — and reduce the number of "risk variables" investors are exposed to. Ratings volatility could also fall as a result of an integration of securitisation features, said S&P.

It contextualised such developments by pointing to a desire among policymakers to develop instruments and schemes capable of financing the real economy, which could lead to policy-led government guarantees bringing about new asset types. These could slow the decline of the public sector covered bond market, said S&P, but will require investors to take a fresh look at risk mitigation features, particularly over the long term.

The nature of banks' public sector loan assets, and consequently their covered bond structures, is likely to change, it said, adding that "already, the distinction between pure public sector and private assets has started to blur".

As policymakers seek to foster economic growth, public sector entities will increasingly provide more guarantees for loans that banks would otherwise not be willing to grant, said S&P. As cover pools increasingly comprise assets not owned by public sector entities, the need to analyse such structures differently arises, possibly using techniques similar to those applied for structured finance transactions or collateralised debt obligations (CDOs), it said.

In addition, the more public sector guarantees make their way into asset cover pools, the more valuable issuers' self-imposed restrictions will become to investors, according to S&P.

"We believe investors will likely become more discerning about their choice of covered bond, compared with the traditional approach of trusting issuers to maintain low risk cover pools," it said. "This can change the way that issuers manage the cover pools."

There is a case to be made for structured finance techniques in the context of cashflow structures, too, said S&P. It noted that although the covered bond market generally seems to prefer bullet structures, pass-through structures, typical for structured finance transactions, can help reduce risks and thereby add to the stability of S&P's covered bond ratings.

"Until recently banks have mostly used pass-through covered bonds for sale and repurchase transactions with central banks," said the rating agency. "But we believe the issuance of this type of covered bond, and its acceptance by investors, will increase."

Benefits include lowering default risk and hence the level of overcollateralisation required, which would also entail less balance sheet encumbrance, according to S&P. ■

GERMANY

Updated Pfandbrief Act has positives, says S&P

Amendments to the Pfandbrief Act passed by Germany's parliament on 16 May are generally ratings-neutral but will strengthen the country's covered bond framework, improve clarity for investors, and enhance the quality of Pfandbriefe, according to Standard & Poor's.

In a report at the end of May, S&P focussed on an amendment that for the first time makes explicit the cover pool eligibility of claims against the Deutsche Bundesbank, which S&P credit analyst Ioan Isopel said could lead to wider use of central bank accounts by issuers as a tool to mitigate commingling and account bank risk.

The rating agency said that it would generally link its covered bond ratings to the rating of the account bank to reflect bank account risk and that although Deutsche Bundesbank is not rated, S&P considers it highly unlikely that a sovereign would exit the euro-zone. As a result, it aligns a euro-zone country's central bank with that of the European Central Bank (unsolicited ratings, AAA/Stable/A-1+).

S&P highlighted some other amendments to the German Pfandbrief law, such as clarification for the statement of collateral purpose (Sicherheitszweckerklärung) with regard to land charges and foreign security interests; greater transparency about the loan-to-value ratio of loans in the cover pool and arrears levels; and further clarification of the engagement of the cover pool administrator (Sachwalter).

"Although we believe these changes will improve the quality of information available to market participants, we consider them broadly credit neutral under our ratings criteria," said Isopel.

The updates come into effect 1 January 2014, noted S&P. ■

Markets

2013

H1 supply sharply down, market shrinks

Issuance volumes in the second quarter exceed the same period of 2012, but after a very weak first quarter gross covered bond supply in the first half of the year was the second lowest in a decade, according to Barclays analysts.

They put gross covered bond issuance in the first half of this year at Eu69.5bn, 40% below that of H1 2012. Only in 2009 did the first half of a year produce less gross supply, with issuance then totalling Eu52.6bn, according to the analysts.

Redemptions amounted to Eu102.1bn in H1 2013, which means that the market shrank by nearly Eu33bn. The trend is set to continue, said Barclays' analysts, and based on a full-year supply forecast of Eu110bn they expect the benchmark covered bond market to shrink by around Eu55bn this year.

"Ongoing deleveraging of euro area banks, the drive to increase deposit funding and lower mortgage production in many jurisdictions have substantially reduced banks' funding needs," they said. "This, combined with the relative cheapness of senior unsecured funding cost versus covered bonds for many issuers, has substantially dampened benchmark covered bond supply."

A "very weak" first quarter this year accounted for much of the reduction in supply, according to the analysts, with monthly issuance in the second quarter exceeding the same period in 2012.

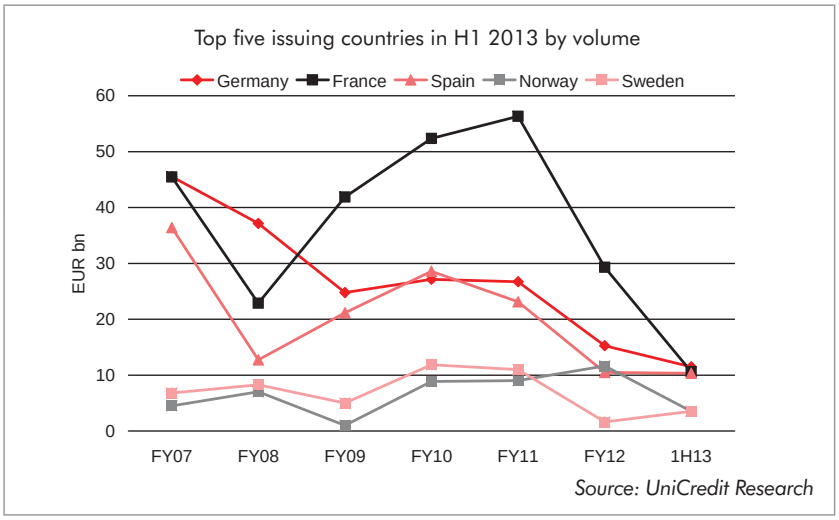
The comparatively low issuance volumes in the first half of the year moved ING analysts to revise their 2013 supply estimate, lowering it by Eu15bn to Eu95bn. This takes into account that the first half of a year has typically accounted for two-thirds of annual euro benchmark supply.

"In particular, our forecasts for French covered bond issuance were lowered, from Eu29bn to Eu20bn," said the ING analysts, "following the slow supply from this jurisdiction in 1H13.

"Supply has not managed to exceed coupon and redemption payments during one single month this year," they added.

Focussing on the euro benchmark covered bond market, UniCredit analysts said that nearly 25% less supply hit the market in the first half of this year compared with H1 2012 — Eu56bn (including taps) versus Eu75bn.

France, Germany, and Spain were the most active jurisdictions, but a fall in supply from these markets nonetheless accounts for much of the reduction in overall euro benchmark issuance compared with last year, according to the analysts, with UK issuers' absence from the market so far this year also an important factor.



Germany was the most active jurisdiction, with Eu11.5bn of supply via 20 benchmarks, followed by France with Eu11.6bn via nine benchmarks, and Spain with Eu10.3bn via 10 benchmarks. The five issuers with the largest volume among the 55 that printed euro benchmarks in H1 2013 were Caisse de Refinancement de l'Habitat (CRH), CaixaBank, Banco Santander, UniCredit SpA, and KBC, according to the analysts, who said that new markets such as Australia or Belgium were unable to compensate for the relative lack of supply from the traditionally more active jurisdictions.

NordLB analysts noted that in the first half of this year Germany took over pole position from France, which had in the previous two years accounted for the lion's share of euro benchmark supply.

Re-offer spreads over mid-swaps are in most jurisdictions lower than the levels achieved in 2011, added the analysts, with Portugal at the wide end of spreads and German Pfandbriefe, followed by Swedish and Finnish covered bonds, at the tight end.

Most issuers tended toward longer dated issuance, added the NordLB analysts, given a context of improving market conditions and falling risk premia, which they attributed inter alia to expansive monetary policy and a supply/demand imbalance. The maturity of new issuance in H1 2013 was on average 7.2 years, compared with 5.9 years in H1 2011, they noted.

Barclays' analysts linked spread tightening to more cautious issuance activity, with many issuers having opted for smaller deal sizes to ensure smooth execution. The average size of a new euro benchmark covered bond decreased from around Eu1.2bn at the beginning of 2012 to around Eu800m as at the end of June this year. ■

DOLLARS

SEB debuts in US after Stadshypotek

SEB made its US dollar covered bond debut on 21 May, pricing a $1.5bn (Eu1.16bn) five year deal on the back of strong demand after fellow Swede Stadshypotek tapped the market a week earlier.

The deal came two months after Skandinaviska Enskilda Banken sold its first senior unsecured deal in US dollars, and had been planned for a while as part of the issuer's long term diversification strategy, according to John Arne Wang, head of treasury management at SEB *(pictured)*.

"It wasn't an opportunistic trade," he told *The CBR*. "Euros have been our main diversification market but we wanted to add dollars to further strengthen that and bolster our investor reach."

Bank of America Merrill Lynch, Barclays, Deutsche Bank, Goldman Sachs and SEB priced the deal at 43bp over mid-swaps on the back of some $2bn of orders, following a roadshow.

"The deal was priced at more or less the same level at which SEB could issue in euros and secured our access to the

Yankee market," added Wang. "We had received very positive feedback so in that sense I am not surprised by the outcome but we are very happy with it."

The issuer paid up versus its domestic market, but not significantly so, he added.

According to a banker at one of the leads, the deal had the highest number of investors ever in a Scandinavian US dollar covered bond, 68, and relied the least on the top five to 10 accounts.

The deal came amid a flurry of dollar activity, with Australia's Westpac Banking Corporation the next day launching a $1.25bn five year and Stadshypotek having sold a $1.25bn five year the previous week.

Stadshypotek attracted some $1.7bn of demand to price its covered bond at 42bp over. At that level, the deal was the tightest Nordic US dollar covered bond ever, so the pricing was fair, according to Thomas Åhman, deputy head of treasury at Svenska Handelsbanken, Stadshypotek's parent. At 42bp over the pricing was arguably a few basis points inside where the issuer would fund in the euro benchmark covered bond market, he added, but its main focus is diversification.

"Over time it is important for us keep working on long term diversification," said Åhman, "and when you see markets offering fair pricing you need to take the opportunity. The reception was really good and the dollar market is slowly developing in the right direction." ■

ITALY

UniCredit OBG gets 'landmark' BTP pricing

A Eu1bn long five year obbligazioni bancarie garantite benchmark for UniCredit on 4 June was a "landmark" transaction, coming with the largest spread discount ever to the host government curve, Waleed El Amir, head of strategic funding and portfolio at UniCredit told *The CBR*.

BayernLB, Commerzbank, Crédit Agricole, ING and Société Générale priced the OBG at 85bp over mid-swaps, equivalent to 120bp through the 4.25% February 2019 BTP. More than Eu1.6bn of orders were placed by over 130 investors.

A banker away from the leads said that it was the first peripheral covered bond since August 2010 to have come with a double-digit rather than triple-digit spread over mid-swaps.

Italy's UniCredit became the first issuer to price a benchmark covered bond substantially through its sovereign's curve when it sold a Eu750m long five year in August 2012, and the feat has been repeated since then by several issuers. However, pricing of 120bp through BTPs on yesterday's deal for UniCredit represents the largest spread discount versus the respective government curve ever, according to the issuer.

"It was a landmark transaction in terms of the pricing that was achieved," said Waleed El Amir, head of strategic funding and portfolio at UniCredit, "and a vote of confidence in the Italian real estate sector. The deal broke a psychological barrier by coming more than 100bp through the sovereign."

He noted the deal came with a coupon of less than 2% (1.875%) and said that the pricing was tight. This meant that the issuer lost some accounts who flagged a triple-digit spread over mid-swaps as a minimum requirement, added El Amir, although several accounts new to UniCredit OBGs participated.

"We had several smaller investors in the book that we hadn't seen before, which is heartening," he said. "They came in and in size."

He attributed the successful outcome of the transaction to improved perception of the issuer's credit, its cover pool and the Italian real estate sector, and the economic and political situation in Italy, plus hard work in investor relations. ■

PRIMARY MARKET

QE fears hit June after May upside surprise

Primary market activity in euro benchmarks unfolded at a decent clip in May despite the disruption of several public holidays, but by the end of June tapering fears had made for more challenging issuance conditions.

The change in sentiment in late June was illustrated by Raiffeisenlandesbank Niederösterreich-Wien (RLB NÖ-Wien) deciding to postpone a roadshow that was due to start on 27 June, with syndicate bankers at the time also seeing chances of a restart to primary market activity as low in the wake of tapering fears.

RLB NÖ-Wien had announced its roadshow plans on 18 June, in the middle of three days of issuance before US Federal Reserve chairman Ben Bernanke *(pictured)* indicated the beginning of the end of quantitative easing, a move which threw markets off balance.

"Everybody is adjusting to the new world in terms of rates," said a syndicate banker at the time, "and before we see some stabilisation I wouldn't expect to see much happening.

Another syndicate official said that investors "don't want to catch a falling knife".

Two days after RLB NÖ-Wien announced that it was postponing its roadshow a trio of issuers took advantage of an early recovery in sentiment to add new supply, but the deals suggested investors were still nervous about rates.

Caisse de Refinancement de l'Habitat was able to hit the top end of its targeted size range at the tight end of guidance for a Eu500m tap of a Eu1bn January 2025 deal, but a Crédit Mutuel Arkéa 10 year deal was limited to Eu500m, after having been pitched as a Eu700m no-grow, and at 48bp over mid-swaps after guidance of the mid to high 40s. Münchener Hypothekenbank sized a 15 year mortgage Pfandbrief at the stated Eu500m, re-offering the issue at the wide end of guidance of 15bp-17bp over.

This had led some market participants to question how well the German deal had gone, but Rafael Scholz, head of treasury at Münchener Hyp, said that the pricing at 17bp had been decided upon by the issuer even though 16bp was possible. He said that the idea of launching a 15 year transaction was initially conceived in January, but it was decided to wait until a 2.5% yield was possible.

A syndicate official at one of the Arkéa leads said that although the back-up in rates had moved them to levels where certain investors' yield bogeys would be hit, accounts turned out to have been "somewhat distracted" by the recent volatility and were unsure how to proceed.

In total, June benchmark supply amounted to Eu7bn, including deals such as an inaugural transaction off an Aktia Bank programme after the Finnish group's move away from issuance via the Real Estate Mortgage Bank, and a Commerzbank Pfandbrief debut, in the public sector backed format *(see separate articles)*.

Issuance in May came in slightly higher than June's, at Eu8.275bn, and Barclays analysts said this was slightly more than expected and a positive surprise.

"Overall, the relatively good issuance activity in May was a pleasant continuation of the slightly stronger issuance sentiment that began in April," they said. "The strength of the May supply was also very positive given the multiple public holidays in Europe during the month (four in Germany alone)."

Australia's ANZ kicked off issuance on 2 May by pricing its first euro benchmark since January 2012, with at least three new issues hitting the market every week that followed in May. Supply included inaugural deals for Cajas Rurales Unidades and Caja Rural de Navarra (*see separate articles*) and the first Dutch benchmark of the year, a Eu1.25bn 10 year for ING Bank that came at 26bp over mid-swaps on 15 May.

By the end of the month, though, the market was less buoyant than it had been in preceding weeks

"Things this week have been less bright than in the previous two weeks," said a syndicate official.

However, a flurry of primary market-related activity in early June, with deals for issuers such as Deutsche Hypothekenbank and SpareBank 1 Boligkreditt, and others on or planning roadshows, went on to show that the market was capable of absorbing new issues, albeit with lower levels of oversubscription and a somewhat more cautious and generous approach to pricing amid more fragile global market conditions. ■

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FINLAND

Aktia makes happy return in new guise

Aktia Bank has launched the first deal off a new programme the Finnish group set up to replace the Aktia Real Estate Mortgage Bank issuer it previously used, selling a Eu500m five year deal on 17 June.

Timo Ruotsalainen, managing director, Aktia Real Estate Mortgage Bank (Aktia REMB), said that everything from the roadshow that preceded the deal through to execution went smoothly, despite the deal coming in between periods of market volatility.

"Of course, as everybody has pointed out, maybe a few weeks ago it would have been even easier than it was now, but we are certainly very, very happy with how it went," he told *The CBR*. "And having almost twice as many orders than the amount we said we would issue shows both the good quality of our operations but certainly also that the Finnish reputation is there even in weeks when everywhere else people have had to take a step back."

Leads Crédit Agricole, JP Morgan,

Nordea and UniCredit priced Aktia's Eu500m no-grow five year at 15bp over mid-swaps, following initial price thoughts of the high teens and guidance of 17bp plus/minus 2bp. A lead syndicate official said that the pricing compared with a level of 10bp-12bp over mid-swaps that a new Nordea Bank Finland issue might come at. Ruotsalainen said that Aktia left some basis points on the table for investors given that it was an inaugural transaction.

"Certainly from a credit quality perspective we don't have any reason to believe we couldn't trade more parallel with the benchmark issuers from Finland," he said. "But then again we have to remember that we can't be as liquid as them and so at the end of the day we have to recognise that there will be a little bit of a difference.

Ruotsalainen said that the Aaa rating of Aktia Bank's covered bonds helped attract investors relative to the lower rating of Aktia REMB issuance, particularly central banks and SSAs, but that it was not a crucial factor.

"During the roadshow we met a lot of investors who had already bought Aktia REMB issues and everybody was very calm about the ratings, even with all the turbulence that we had last year."

He added that investors also focused on more general questions, for example Finland's position in the euro-zone. ■

GERMANY

ECAs find Pfandbrief home in Commerz debut

Commerzbank sold the first deal off a new public sector Pfandbrief programme on 18 June, a successful Eu500m five year deal backed by assets including loans backed by sovereign-guaranteed export credit agencies (ECAs).

ECA loans are a relatively new collateral type in covered bonds, with French banks having made increasing use of them.

"Although it is a regular Pfandbrief from a legal perspective, it is not an old-style public sector Pfandbrief," Rainer Mastenbroek, head of covered bond funding at Commerzbank told *The CBR*. "We have a higher share of ECA assets in the pool which is a new development for a public sector Pfandbrief. But when we spoke to investors, there was no doubt that this is a real Pfandbrief. Of course, it was something that we had to explain, but investors understood the structure.

"We have our Mittelstandsbank that does this kind of business. So it was easy to get across that we will be using the public sector Pfandbrief to finance our MSB in future, i.e. a core business. And the good thing about these loans is that we have the Euler Hermes coverage which provides us with a 100% guarantee of the Federal Republic of Germany, and that made the explanation pretty simple."

Mastenbroek said that the outcome showed how the programme had been accepted. Crédit Agricole, BNP Paribas, Commerzbank and Deutsche Bank priced the deal at 2bp over mid-swaps after building a book of around Eu1bn

"It was priced as a normal public sector Pfandbrief," he said. "We are very happy with the pricing and how the transaction went. The distribution was also very Pfandbrief-like — we had the most demand from Germany and from banks, which you would expect when you issue a Pfandbrief."

Commerzbank in February launched its high profile new structured SME covered bond programme, and is also working on a new mortgage backed covered bond programme.

"The most important thing is that we have now established two out of three instruments that we wanted to put in place in order to be able to issue them when we think it is a good time and we need it from an overall funding perspective," said Mastenbroek. ■

"Issuers are relatively liquid and deleveraging is still a key feature" page 36

SPAIN

CRU, Caja Rural de Navarra open door

Cajas Rurales Unidas (CRU) and Caja Rural de Navarra hope to establish a regular presence in the covered bond market after having issued Eu500m cédulas debuts in May.

CRU sold a Eu500m three year cédulas hiporecarias at 290bp over mid-swaps on 7 May via Crédit Agricole, Nomura, Santander and Société Générale, while Caja Rural de Navarra launched a Eu500m five year at 200bp over mid-swaps on 29 May, with the two Spanish deals coming before market conditions deteriorated through June.

More than 100 accounts participated in CRU's transaction, placing Eu900m of orders, and Miguel Gadea Martin, head of investor relations at Cajas Rurales Unidas, told *The CBR* that the outcome exceeded expectations.

"We were impressed by the number and the amount of orders that the deal managed to attract," he said.

At 290bp over mid-swaps, the deal was priced at 110bp over Bonos, according to Gadea Martin.

Contributing to the positive outcome of the deal were the supportive market conditions and investor work carried out in early April, when the issuer engaged in a European roadshow, said Gadea Martin. The deal was CRU's first transaction since the merger between Cajamar and Ruralcaja that led to its creation in November, and the first issue from a Spanish co-operative bank since 2010.

"One of the aims of the deal was to present ourselves to the market," said Gadea Martin. "We want to become a regular issuer."

According to Gadea Martin, the three year maturity was targeted because it fit the issuer's maturity profile and following the investor feedback received during the April roadshow.

"It also let the company diversify its funding sources for the next years," said Gadea Martin. "A deal with a longer tenor wouldn't have been so attractive to the market."

Miguel García de Eulate Martín-Moro, Caja Rural de Navarra: "Deal got a very good reception"

After the roadshow, CRU waited for the best market conditions to launch its inaugural cédulas deal. "We wanted to tap the market this week because of the strong backdrop," he said.

"We want to become a regular issuer"

Caja Rural de Navarra decided to turn to the asset class to "open doors" to the capital markets again, Miguel García de Eulate Martín-Moro, head of treasury and capital markets at Caja Rural de Navarra, told *The CBR*.

Its Eu500m no-grow five year transaction attracted Eu1.1bn of orders and was priced at 200bp over mid-swaps. A syndicate official away from the leads said the deal came 25bp though Bonos, which he suggested was an impressive result for an inaugural deal.

"We are really happy with the results, which exceeded our expectations," said García de Eulate. "The deal got a very good reception. The feedback from our roadshow last week was good, but you never know until you open the books."

The issuer is a regional co-operative bank focussed on retail banking in the Navarre and Basque regions and is mainly financed via retail deposits, which García de Eulate says distinguishes it from many other Spanish banks.

"At a time when others are trying to reduce their exposure to the capital markets and increase their deposit base we are doing this to diversify our funding base," he said. "It's a qualitative approach of opening doors."

The issuer is not without capital markets experience, however, he noted, having sold a five year senior unsecured floating rate note in 2006, and issued securitisations, for example.

"We have been very happy with our deposit base, but felt that covered bonds are a good means of regaining access to the wholesale markets," said García de Eulate. "As a product they have been more resilient to the financial crisis, in terms of confidence at least."

He pointed out that Caja Rural de Navarra's issuer and covered bond ratings are at the same level as Spanish banks such as BBVA. Caja Rural de Navarra is rated BBB by Fitch and Baa3 by Moody's, in line with the Spanish sovereign, and its covered bonds are rated A3 by Moody's.

"Even with a better cover pool we couldn't get a higher covered bond rating because of the sovereign cap," added García de Eulate.

The issuer does not intend to be a frequent borrower in the covered bond market, but is encouraged by the success of its debut and may return to the market depending on its balance sheet growth and financing needs, he said. ■

Industry moves

ICMA CBIC

Chairman Nielsen steps down

Claus Tofte Nielsen has stepped down as chair of the ICMA Covered Bond Investor Council, it was announced at the ICMA CBIC & The Covered Bond Report Investor Conference in Frankfurt on 16 May.

Nielsen was one of the founding members of the investor council and had chaired it since its inception in 2009. Martin Scheck, chief executive of the International Capital Market Association, announced the move in a welcome address at the conference, thanking Nielsen for his work.

Andreas Denger, senior portfolio manager at MEAG Munich ERGO Asset Management, has hitherto been vice chairman of the CBIC and since Nielsen's departure has been acting chairman.

Nielsen told *The Covered Bond Report* that the time had come to step down after several years at the helm of the investor body, and said that the synergies between the work of the CBIC and his recent responsibilities at Norges Bank Investment Management (NBIM) had become less obvious.

Since being founded in 2009 the ICMA CBIC has been pushing for better transparency in covered bonds, and has developed a transparency template that it is encouraging issuers to use as the basis for national transparency templates.

The investor council's transparency working group is chaired by Denger, while Nielsen was chair of an ICMA CBIC liquidity working group. ■

STRUCTURER

Verbeek exits BNPP

The Covered Bond Report understands that Arjan Verbeek, head of flow ABS and covered bond structuring at BNP Paribas, has left the bank.

Verbeek joined BNP Paribas in September 2006, having previously worked at Barclays Capital. Prior to that he worked at Moody's Investors Services, and before that, until 2000, at Royal Bank of Canada.

In his role at Moody's Verbeek worked on the first structured covered bond, for HBOS in 2003, and he went on to be involved in the structuring of many new covered bond programmes at Barclays and BNP Paribas.

The CBR understands that Verbeek is set to leave the industry.

Rudolph leaving HSBC Trinkaus

HSBC Trinkaus is losing its incumbent head of covered bond research, Johannes Rudolph, *The CBR* understands.

Rudolph is due to be leaving the bank to take up a position elsewhere. He has been at HSBC Trinkaus & Burkhardt for 13 years, having joined in 2000. ■

INDICES

Markit expands country indices, disbands "other"

Markit has launched seven new country-specific indices, which an analyst said means that every country with a covered bond benchmark will have its own index, increasing visibility for issuance from these seven jurisdictions.

The countries for which the new indices are being launched are Australia, Belgium, Denmark, Finland, Luxembourg and New Zealand, taking to 20 the total number of countries with dedicated indices.

The indices take in all the covered bonds in Markit's iBoxx EUR Benchmark index that are classified as "other covered", and this sub-index was discontinued on 30 April, when the new indices were launched.

In total there are 28 new Bid and Mid price indices, one each for Markit's Total Return and Clean Price indices.

Markit will review the covered bond universe on a quarterly basis and will create a country covered index if a covered bond is issued in an additional country.

A covered bond analyst said that he welcomes the new indices for accommodating the strongly increased regional diversity of the covered bond market.

"The new scheme will increase market visibility of the covered bonds from their respective countries and will also be positive for investment considerations from a relative value perspective," he said.

He flagged some shortcomings, such as that there are some indices consisting of only one issuer (Denmark) or just one bond (Canada, Luxembourg), and said that the conclusions that can be drawn from such indices are therefore negligible, but said that the indices are aimed at investment professionals who are aware of the weaknesses and that there were uncertainties under the old index rules, too. ■

League Tables

EURO BENCHMARK COVERED BOND RANKING*

1 January 2013 to 30 June 2013

Rank	Bookrunner	Deals	Amount Eu (m)	Share %
1	Credit Agricole	30	4788.75	8.76
2	UniCredit	30	4353.19	7.96
3	Barclays	21	3774.17	6.90
4	Commerzbank	25	3413.19	6.24
5	BNP Paribas	18	3350.00	6.13
6	SG	20	2948.61	5.39
7	Natixis	17	2942.92	5.38
8	Deutsche	19	2916.67	5.33
9	DZ	22	2243.61	4.10
10	HSBC	14	2167.36	3.96
11	LBBW	17	2132.50	3.90
12	RBS	14	1936.11	3.54
13	Santander	8	1556.25	2.85
14	Danske	9	1554.86	2.84
15	BayernLB	10	1241.67	2.27
16	UBS	7	1200.00	2.19
17	Credit Suisse	6	1091.67	2.00
18	ING	5	943.75	1.73
19	JP Morgan	6	875.00	1.60
20	Citi	6	761.11	1.39
21	NordLB	8	750.00	1.37
22	Banca IMI	4	674.17	1.23
23	BAML	3	625.00	1.14
24	WGZ	6	533.33	0.98
25	BBVA	3	491.67	0.90

US DOLLAR BENCHMARK COVERED BOND RANKING**

1 January 2013 to 30 June 2013

Rank	Bookrunner	Deals	Amount US$ (m)	Share %
1	Barclays	6	2025.00	15.00
2	RBC	5	1787.50	13.24
3	JP Morgan	5	1562.50	11.57
4	BAML	4	1400.00	10.37
5	Goldman Sachs	3	1112.50	8.24
6	Deutsche	3	800.00	5.93
7	CBA	1	666.67	4.94
8	HSBC	2	600.00	4.44
9	Morgan Stanley	1	500.00	3.70
10	Citi	2	416.67	3.09

*Criteria: Euro denominated fixed rate syndicated covered bonds of Eu500m or greater and taps thereof.

**Criteria: Dollar denominated syndicated covered bonds of US$500m or greater and taps thereof.

These league tables are based on The Covered Bond Report's database of benchmark covered bonds.

For further details visit our website at news.coveredbondreport.com.

Please contact Neil Day if you have any queries on +44 20 7428 9575 or nday@coveredbondreport.com

Tough talk from Schroders

Schroders covered bond duo Lucette Yvernault, portfolio manager, and Roger Doig, credit analyst, take time out on a Friday afternoon to talk to *Susanna Rust* about asset encumbrance, transparency and the death of market-making, and to disagree — with each other — on SME covered bonds.

Sue Rust, The CBR: Spreads have tightened dramatically over the past year or so — where do you see value in covered bonds, if you see any at all?

Lucette Yvernault, Schroders: The market has tightened significantly over the last year and even more significantly since the beginning of the year. We currently have valuations that are probably similar to August 2007, just before the inter-bank trading in the Pfandbrief market was suspended.

Does this represent great value for investors? Well, it depends on what your alternatives are. If your alternative is the money market and you want to hold an instrument that is not government bonds then yes, go ahead and buy covered bonds. If you have the luxury to have access to the credit markets and you don't want to touch very high quality industrials then yes, but if your alternative is the world of credit all the way to CCC and all the way to LatAm, Australia and so on, do covered bonds represent as nice an alternative as they used to? No.

Roger has been speaking internally about the potential delay to the European bank resolution regime and I think if you're scared to invest in senior bank paper but you have appetite to invest in senior something then I think covered bonds are better than senior while there is still uncertainty about the resolution regime.

Roger Doig, Schroders: If we look at senior bank spreads then we also have a situation where there is very little spread available and I think we would argue that in particular in northern European countries you're not even being paid for credit risk in senior unsecured. You're essentially getting paid for taking duration, for taking some liquidity risk in buying the bank paper, but you're not really getting paid for taking any material credit risk. Obviously with covered bonds you're getting even less spread. You are paying a premium, if you like, for having a triple-A stamp on the paper with covered bonds, but unlike two to three years ago where there was an element of credit risk being priced into covered bonds that is all gone now.

Rust: How have your covered bond allocations changed as a result of what you were describing?

Yvernault: We can't disclose what the allocations used to look like and what they look like now, but what I would say is that for certain portfolios including the Short Term portfolio that we've been managing, covered bonds are still part of the investment opportunity set. For more global portfolios where we saw opportunity for spread contraction at some point in time and when we came to be a bit more cautious about European banks then covered bonds are not so much the asset allocation of the day.

Schroders, London
Photo: David Churchill

We still look at deals that are coming, maybe in new markets or alternative markets where we see a bit more room for spread compression. We also still look at deals that are further along the curve because of the nature of what we believe should be in our portfolio, but more often than not it falls short of being attractive from a spread perspective, as Roger just mentioned.

Doig: We have had some interest outside of euro denominated issues. For example, some of the recent short dated sterling issues have met some of our portfolio requirements quite nicely, and in the US we're still looking at dollar issues from European covered bond programmes. They are attractive alternatives given the lack of other triple-A assets. We've seen some issues which we participated in in that market, from some Scandinavian issuers in particular.

Rust: You mentioned new and alternative markets. The Commerzbank SME backed deal was one of the big events in the covered bond market this year. Lucette, you've spoken critically in the past about it being labelled as a covered bond. What are your views on the product and whether it should carry the term covered bond?

Yvernault: Actually I have changed my view in that as long as we are talking about a pure SME pool and nothing in between or mixed I don't mind if other banks use a similar funding scheme. I strongly believe that the covered bond label should ensure, especially in new markets like Italy and others, that the issuer is responsible for the quality of the covered bond pool and that the investor doesn't have to do a great deal of monitoring. So that in my view is what should happen if this is to be labelled a covered bond.

For any further SME programmes there has to be something that behaves more like a covered bond pool and not so much like an ABS. I do believe that a number of banks around Europe today have a lack of financing solution for their SME loan book for reasons that we know — no ratings, quite obscure assets, no real transparency of what is there — and as long as we can get information in a standardised way I think it could represent value. But the caveat is we don't want to spend our time monitoring for potential degradation of the quality over time, so if an SME loan is changing buckets it should be kicked out. Substitution as opposed to replenishment has to be in order.

The ECB's backing of the Commerzbank deal, which was the piece I didn't have last time I commented, would be a great sponsorship of SME covered bonds going forward. But the caveat is that the issuer will maintain the quality. The Commerzbank deal is now trading rather tight, I would say, pretty much in between what would be a covered bond and a senior unsecured and that

Roger Doig, Schroders:
"SMEs don't need more debt"

doesn't leave you much room for any loan depreciation let alone delinquency in the foreseeable future. Otherwise I would be quite happy to see the market developing further.

Doig: I remain quite sceptical about it. The underlying loans are pretty low grade. On their own internal rating scales most of these would be high yield, which is a very different prospect from what you see with mortgage loans and public sector loans that typically back covered bonds. And the other thing about the underlying SME loans is that they're pretty short duration. You've got an unusual circumstance in which you've got bonds which can be issued with a five, seven, or 10 year maturity, but being backed by a revolving pool with very short tenor underlying loans. The way this programme works is rather different from the way your typical mortgage covered bond would work. I find it difficult to see how we can really label this a covered bond. It seems to be much more of a hybrid kind of asset backed security.

Rust: Lucette, you mentioned a lack of SME financing in Europe. Does a funding tool like SME backed covered bonds potentially give you comfort that banks have a way of profitably funding SME business?

Yvernault: The potential solution for the financial system is twofold. Either there is a natural pick-up in the economy and naturally bank balance sheet quality would improve dramatically giving banks more flexibility to carry on business and being less stretched in terms of where they need to cut back. Or we could also adopt what we've seen in the UK where the Bank of England guaranteed that SME loans going forward are supported by the central bank facility, which means that they can be refinanced at extremely low rates. But otherwise I don't see how, in the current market given the instruments we have available, you would develop a functional banking system quickly in Europe.

Doig: The Bank of England's Funding for Lending scheme also aims to cheapen the cost of funding to SMEs. But what is actually happening with the FLS is that SME lending continues to contract even though they've changed the terms of the FLS to make it incredibly attractive to have net positive lending. And that tells you two things. It tells you that the SMEs that are out there have got too much debt currently and are trying to pay that debt down, and that they need equity. They don't need more debt and so having something which cheapens the cost of debt will only have a pretty marginal impact.

And the other thing which is an issue for banks' ability to provide this kind of lending is the capital side of the equation. And the fact is that the risk weight on SME lending versus, say, mortgage lending or lending directly to a government is extremely high, so unless the authorities come in and change the risk weight for SME lending or find some way around that it's pretty unlikely that this kind of lending is going to look attractive for the banks versus mortgage lending. And that is exactly what you see in the UK. The discussion of whether covered bond programmes backed by SME loans would help SME lending is missing the point. I think it's pretty clear that it's the risk weights and the actual requirements of SMEs for equity rather than debt which are really causing the problem. Lowering the cost is pretty marginal.

Rust: Jumping to a different topic and back to covered bonds more directly, how do you perceive secondary market liquidity?

Yvernault: To be honest, there is absolutely zero liquidity whatsoever in the entire European market. We thought that a year ago it was appalling but I think the recent sell-off proved that there is absolutely no market-maker left at all in the entire street of London or Europe. Absolutely not a single one. Nobody has got a balance sheet. A year ago maybe some Asian investment banks had some kind of flexibility, but this time nobody does.

I certainly would be in favour of switching rather hastily to a model where we can buy and sell bonds through a clearinghouse to one of our competitors, because there is absolutely nobody left in between to provide anything. And I think if any issuer is lured by any investment bank into paying "making-market fees" then surely the issuer is highly gullible and I wouldn't want to lend this issuer any of my client's money.

In terms of the number of securities available in some issuers' curves, I already made the comment a long time ago that I don't understand why we have so many benchmarks around, sometimes two to three a year. That clearly is quite detrimental because if we would all be trading the same bond it would be half the maintenance we have at the moment on our internal database, and probably half the amount of effort for daily analysis. But that's the reality. One benchmark a year is more than enough. I don't think most issuers have much visibility beyond 10-12 years on who is going to prepay their mortgages and when and so on. Any issuer paying for a liquidity facility going forward will

get a bad mark in my book because they must be extremely gullible to pay an investment bank for liquidity where clearly there is absolutely zero liquidity.

A model where you trade electronically with competitors and cut out the middleman would be just fine in my book. They do it in the equity market and I still don't understand why we are so prehistoric in the bond market.

Rust: Roger, are you happy with the level of disclosure in the covered bond market? Are there any jurisdictions that are leading the way?

Doig: The disclosure that is given for the cover pools per se is reasonably good. In most jurisdictions we look at we get monthly or quarterly reports in a very standard format, and all the key information regarding LTVs, delinquencies, etc is there. I'm generally quite comfortable with the level of disclosure for the cover pools per se.

There is a medium term issue, which relates to the disclosure of the sponsor banks more generally about asset encumbrance, because the disclosure there is extremely poor. And if you think that one of the consequences of depositor preference and hence the subordination of senior unsecured debt is likely to be an increased issuance in secured formats then I think it's quite important that we get to a standardised and understandable degree of disclosure around the level of asset encumbrance banks face. Not least because we know that rating agencies will be looking at it and the subordination of senior unsecured debt will take down the unsecured ratings and because of the methodologies they apply to covered bonds it's likely at the margin to have an impact on the covered bond ratings, which I think is something we still need to watch given that so much of the market remains a triple-A market.

Rust: Before we go further into the asset encumbrance topic that you just touched on, a brief question about the ICMA CBIC transparency initiative, given that the investor group is pushing for better disclosure, including at the issuer level. To what extent do you support the initiative?

Yvernault: We definitely support the ICMA CBIC encumbrance disclosure work. It's an ongoing discussion about what should count towards encumbrance and what is really necessary in terms of transparency. It's a huge topic obviously, and is relevant for covered bond and other bank investors. We come on both fronts. Going forward it's more a matter of covering which information we really need as opposed to which formula is going to be used to assess the level of encumbrance, because obviously different companies tend to classify different parts of their balance sheet with very false disclaimers that we tend to come across too often. The committee is still working on what the level of information is that we need to be able to assess the level of asset encumbrance as opposed to what is yet again another ratio given to us by the banks.

Doig: I'm jumping forward to the regulatory issues here, but I

Lucette Yvernault, Schroders:
"Cutting out the middleman would be just fine"

think that as we move to a situation where senior unsecured is a bail-inable instrument the disclosure by the banks of exactly how a bail-in might occur, exactly which entities would be affected etc, and disclosure on how subordinated senior unsecured actually is — there'll be a lot of demand from senior unsecured investors for that. There'll be pressure from below as well as at the covered bond level for improved disclosure.

Rust: Sticking to the covered bond angle, how important is disclosure about asset encumbrance levels?

Yvernault: I think it is very important because in the case of a regulatory write-down, for example, you need to know how much the depositors and any entity ahead of you will be taking out of the balance sheet even before you potentially get to the covered bond pool. Overcollateralisation levels are currently extremely good, but let's say in a deteriorating market or in a situation where a bank failed to meet its regulatory requirements more likely than not then the covered bond pool might not suffice for the final repayment of all outstanding liabilities. So I think at least in the recent iteration of bank deterioration as over the past couple of years you definitely want to know who's ahead in terms of priority even before the covered bond investors get their repayment.

Doig: Also because as a covered bond investor you're dealing with a dynamic pool and should you face the situation at some point that the collateral begins to deteriorate quite significantly you need to have some kind of assurance that the sponsor bank is going to be in a position to provide additional collateral as required.

Yvernault: You also have to think about the structure of the issuer.

Among the new jurisdictions in Europe where legislation has been drafted most of the issuing entities are quite closely directly linked to the sponsor bank as opposed to being a specialist issuer. In that case the level of encumbrance on the balance sheet is more important than if you would have a pure covered bond issuer.

Rust: Are you worried about asset encumbrance and what do you make of how covered bonds are being addressed in the encumbrance debate?

Doig: To be fair, asset encumbrance is probably the greater issue at the senior unsecured level because that's where you're having a significant change of the subordination of the instrument. Asset encumbrance is more of a concern at the senior unsecured level because you are first of all more likely to see more secured format issuance but also because of depositor preference. If they come in with a broad preference which seems to be suggested — so not just insured depositors but also uninsured retail and SME depositors — that will change senior unsecured's position in the capital structure. The fact is that going forward senior unsecured is seen as an at risk or bail-inable instrument so it is important therefore to understand where you are in the capital structure and how much of the balance sheet is encumbered above you.

Rust: Are you following the regulatory developments affecting the status of covered bonds in a bail-in situation and do you have any concerns in this regard?

Yvernault: To be honest at the moment the spreads at which covered bonds are trading don't really allow any buffer for a bail-inable kind of situation. If going forward the regulator believes the residual claim should be bail-inable like senior then the instrument ought to widen a bit because we don't really have any compensation for this kind of risk at the moment.

Doig: The key issue in the event that there is a bail-in of senior unsecured debt is whether that knocks out the sponsor guarantee and therefore forces a separation of the cover pool automatically or whether it stays distinct, i.e. whether in the event that senior unsecured gets bailed in and the sponsor bank gets recapitalised whether the cover pool continues as part of the successor bank's grouping with a new guarantee from that successor bank post the bail-in. That will be subject to legislation but I don't know what the status is of that discussion.

Rust: So a key question from your perspective is what kind of event a bail-in of senior unsecured debt is deemed to constitute and the implications for whether the cover pool stays tied to the sponsor bank or not?

Doig: Exactly. There are a number of bail-in tools which are given to the authorities, one of which is the senior bail-in, and if they use the senior bail-in tool does that automatically mean the cover pool is separated from the sponsor bank or does it remain within a recapitalised "new bank" if you like, which is the successor bank of the bank that had its senior debt bailed-in? The legislation as it's been drafted at the moment gives authorities quite significant discretion to trigger a restructuring of a bank so they may use bail-in quite early and if that's the case you don't necessarily want full separation of the cover pool.

Rust: In some Nordic countries covered bonds have come in for focus as contributing to rising property prices — do you think they play a role in this regard?

Doig: I think if they do contribute it's extremely minor. Property price bubbles are caused by low interest rates and that's to do with the central bank and not really the fault of covered bonds. It's also driven by things like high LTV lending or significant interest-only lending. Property price bubbles are also fuelled by the very low risk weights that are applied to mortgages, which is a structural issue and incentivises lending for residential mortgages rather than to SMEs. Covered bonds only play a very minor part. To the extent that covered bond investors are willing to accept high LTV loans within a pool or significant amount of interest-only mortgages within a portfolio then at the margin they could help fuel this trend, but the big things, I think, are the risk weights and interest rates.

Yvernault: I don't think we should confuse the Spanish situation. It was the biggest covered bond market and then the housing market crumbled and is facing a lot of stress, but obviously it's not because it was the biggest covered bond market that property prices have gone down significantly. It's probably more because of the standard of lending that was being operated.

Rust: What do you make of the level of issuance we've seen this year in covered bonds?

Yvernault: The level of issuance this year has been extremely slim. There was a ramping up of issuance from new issuers a couple of years ago but the need to replace some of the recent vintage is not here yet. And then the volume of new mortgages being generated in Europe has dropped considerably so I'm not so surprised issuance levels have been so slim. At the moment we've seen some of the frequent issuers still coming to the market but some of the smaller or newer issuers don't seem to have a growing book of mortgages that would support further issuance. So until the bonds mature they are probably unfortunately not going to be issuing much more volume compared with when they were first time issuers.

I think the authorities should make efforts now to standardise the market. The regulator should push to standardise things like asset encumbrance and so on and for there to be more information rather than less. Now that the market has been well established in a number of countries for up to two years it's time to push market participants to give all the information required as opposed to wait for the next crisis. I would not take a breather. I would encourage regulators to push forward and achieve more standardisation across the market. ■

The Covered Bond Report

The Covered Bond Report is not only a magazine, but also a website providing news, analysis and data on the market.

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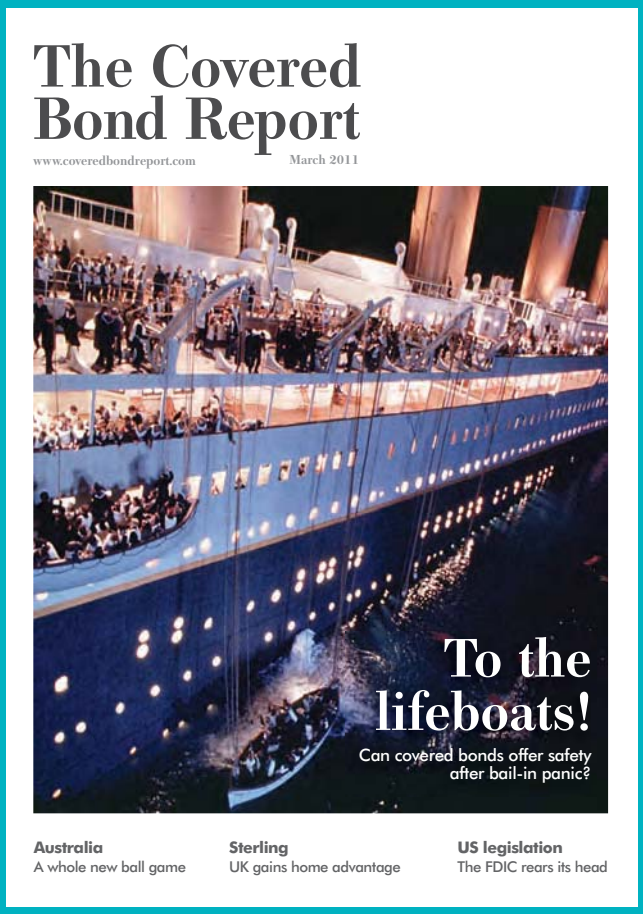


Janet Leigh, from Alfred Hitchcock's *Psycho*, 1960
Photo: Paramount/The Kobal Collection

EXPECT THE WORST!?!

Overcollateralisation can be a key risk mitigant for covered bonds, but with issuers free to reduce levels, the extent to which it can be relied on is unclear. Some issuers have used this discretion to support ratings, but with an increasing number unable or unwilling to do so, should investors prepare for the worst? Neil Day **reports.**

The issue of overcollateralisation (OC) has risen to prominence as banks have been downgraded during the crisis, putting pressure on their covered bond ratings and posing the question whether or not they should add OC to support these.

And even issuers who have remained reasonably highly rated have been faced with the issue, with changes to rating methodologies having resulted in an increase in the levels of OC commensurate with given rating levels.

Investors, meanwhile, have struggled to make sense of the evolution of overcollateralisation and hence how it should be analysed.

"It's the most talked about feature when you talk to new investors, especially those who are coming from the credit side," says Karlo Fuchs, senior director for covered bonds at Standard & Poor's. "They clearly can't understand how it can be that you can give benefit to something that is not contractually committed when rating a covered bond.

"And I think most investors aren't too conscious that, by buying a bond where there is no contractual OC commitment, they are giving the issuer the option to manage the covered bond risks at their own discretion."

So what should investors and other market participants read into overcollateralisation levels?

Jörg Homey, covered bond analyst at DZ Bank, says that events have shown that current overcollateralisation is not a good guide when it comes to assessing the creditworthiness of covered bonds.

"In the event of doubt, overcollateralisation is likely to be reduced to the statutory minimum if there is a crisis, as the example of Spain has shown over the past few years," he says.

Homey says that when considering the issue of overcollateralisation and covered bonds investors should bear in mind one of the lessons of the financial crisis: "Although you can hope for the best, you should always expect the worst."

The extent to which rating agencies follow this maxim in their rating methodologies varies. S&P takes arguably the most generous approach, giving credit to current OC unless there is evidence that it might not be of permanence.

"We try to form an opinion whether the issuer really has the ability and the willingness to maintain the OC and in most cases we therefore give benefit to the OC that is currently available," says Fuchs.

Moody's leans more towards Homey's advice, but Volker Gulde, vice president and senior credit analyst at the rating agency, says that experience has shown that with respect to OC issuers should be given some credit for how they have used the discretion they have.

"On the one hand we continue to highlight the negative elements of issuer discretion: that issuers can reduce OC, that they can change assets, that they can make the credit profile of the programme worse if they want to," he says, "which is undisputed. And it is right to focus on this and take it into account in our modelling.

"Having said that, the overwhelming majority of issuers,

Susanne Matern, Fitch: "Before making such a statement a bank would give it careful consideration"

particularly in highly rated countries, are supporting their programmes, they do not reduce OC — quite the contrary. Most choose to increase OC where this will support the existing rating, and some even commit OC."

Gulde nevertheless notes that recently Moody's has observed that levels of support are gradually being reduced, with issuers less prepared to increase OC or less able to. "This trend is more marked in lower rated countries," he says.

At the same time, since the onset of the financial crisis a new category of issuer has emerged, namely those covered bond issuers — in some cases previously high profile ones — that are in wind-down mode.

"There's clearly a kind of game-changer because in the past, prior to 2007, most of the issuers really were extremely supportive and always provided the OC that was required," says Fuchs at S&P. "Some banks are no longer in the shape that they were before because they have been forced to wind down by the EC, and they are no longer in a position to do the utmost to support their covered bond programmes because they are restricted in what they can do."

He cites the example of the former Eurohypo, now Hypothekenbank Frankfurt. The Commerzbank subsidiary is being wound down as part of the EC's approval of state aid for the German banking group, which is now issuing covered bonds directly.

"They have to shrink their balance sheet and the parent has decided to start issuing by itself, so in our view the incentive to remain supportive of the old covered bond programmes has reduced because they may no longer tap the markets," says Fuchs. "They will maintain the programme and remain within regulatory requirements, but the incentive to support it at its highest rating has waned."

When Fitch updated its methodology in September 2012, moving from a previous framework of Discontinuity Factors to Discontinuity Caps (D-Caps), it responded to this trend by introducing an additional criterion.

"For programmes we believe to be in wind-down or dormant, we do not give credit to the lowest OC of the last 12 months but only to contractual or public statements or to the legal minimum," says Susanne Matern, senior director at Fitch. "This is because if the business strategy has changed and the programme is not being actively managed anymore, there is a higher risk that voluntarily held OC may be more volatile or withdrawn at some point in time."

And she notes that issuers have generally managed OC much more consciously. "This is also why some of the Fitch-rated programmes that could theoretically achieve a triple-A rating are managed at the double-A level because issuers want to save OC, if you like," says Matern.

S&P's Fuchs says that this fits into wider trends in the market.

"Let's face it: there is a growing acceptance among investors and issuers that there is something other than a triple-A that can be attached to a covered bond," he says. "So the willingness of issuers to always support the highest rating is no longer as pronounced, and if there is a criteria change from a rating agency, some might become agnostic on that and decide no longer to do what you have expected in the past, which was to do the utmost to maintain the rating.

"And this is an area where more scrutiny needs to be done by investors to form their own opinion," he adds. "Maintenance of OC has always been an integral and important aspect of the analysis of covered bonds, and particularly in the past two years it has become even more important because of the challenges the issuers are facing: deleveraging, restructuring, encumbrance — all of those are not necessarily supportive to the maintenance of high OC."

"THIS IS AN AREA WHERE MORE SCRUTINY NEEDS TO BE DONE"

Now you see it, now you don't

Non-statutory OC is generally considered to be more at risk the lower a bank's rating.

Fitch, for example, typically takes into account in its analysis the lowest level of voluntarily held OC of the past 12 months when it is looking at higher rated banks, but for issuers with a short term rating of F3 or lower, it only takes into account legally required OC — unless the issuer has declared in a public statement it will maintain a higher level.

The value of such public statements has nevertheless been questioned.

Most recently Düsseldorfer Hypothekenbank on 17 May announced that it was revoking, effective 14 June, a public statement made to its public sector covered bondholders in August 2010 that it would voluntarily maintain nominal overcollater-

alisation of 13.2%. This complied with its original statement, which afforded it the option of revoking the commitment with four weeks' notice.

"Owing to the extensive provisions and minimum requirements particularly of the German Pfandbrief Act as well as the Pfandbrief Net Present Value Regulation, both of which serve to protect creditors of public sector Pfandbriefe, the Management Board no longer considers it necessary to uphold the Commitment," it said. "By maintaining responsible and anticipatory risk policies, the Bank will continue to ensure the quality of the cover pool for its public sector Pfandbriefe."

Taken over by US fund Lone Star in December 2010 after having had to be rescued by the Association of German Banks (BdB) in April 2008, Düsseldorfer Hypothekenbank had only Eu3.74bn of public sector Pfandbriefe outstanding as of 31 March, according to its Section 28 reporting, against a cover pool of Eu4.42bn, equating to OC of 18%, according to Bernd Volk, head of covered bond research at Deutsche Bank. He says that an outstanding issue in Swiss francs maturing in 2015 looks attractive, even though it matures beyond the expiry of the commitment — it had already been trading some 100bp wider than other Pfandbriefe in the currency largely because it lacks a rating.

"While we remain confident regarding full and timely payment of Düsseldorfer Hypothekenbank Pfandbriefe, the withdrawal of the OC commitment seems to confirm that the value of OC commitments is very low," adds Volk.

The public statement had originally been made for the benefit of Fitch, which took it into account until it withdrew its rating of Düsseldorfer Hypothekenbank's Pfandbriefe last September, after downgrading them from AA- to BBB+. The issuer was one of only two to have in place such a public statement for Fitch's benefit, the other being Corealcredit (also owned by Lone Star).

"Typically we give more credit to such statements because they are made public to investors and our view is that a bank wouldn't do this if it had plans to withdraw it in the short term," says Fitch's Matern. "Obviously it's true that they could revoke it after a notice period, but I think that before making such a statement a bank would give it careful consideration because if they withdrew it or if it looked somewhat volatile neither investors nor the rating agencies would give credit to it.

"But so far our experience from German issuers has been that it was handled carefully. Even Düsseldorfer Hypothekenbank only withdrew it about nine months after we removed our rating."

Commitment issues

The treatment of OC as issuers slide down the rating scale has also been an issue in relation to Moody's.

BayernLB faced losing the triple-A rating of its mortgage and public sector covered bonds when they were put on review for downgrade by Moody's alongside the issuer in July 2011 — on the same day the bank was planning a new jumbo, unfortunately — with the German bank being cut to Baa1 in November that year. According to Moody's Gulde, although the Baa1 rating meant that under the rating agency's Timely Payment Indicator (TPI) framework a Aaa rating was still achievable, at that issuer rating level Moody's will only rate the covered bonds Aaa if the OC being used to reach the maximum uplift is committed rather than voluntary. The reason for this, he says, is that under the TPI framework a further downgrade of an issuer, to Baa2 or lower, would make a Aaa rating unachievable and this carries the risk that the covered bond rating may then fall by more than only one notch.

Karlo Fuchs, S&P: "The willingness of issuers to always support the highest rating is no longer as pronounced"

"THE VALUE OF OC COMMITMENTS IS VERY LOW"

"All of a sudden there is a scenario where the issuer may think: I'm Baa2 now, I cannot reach Aaa anymore, so everything that I was holding voluntarily until now I can just take out or issue against," says Gulde. "But if they were to reduce the OC level, and they technically could go down to 2% NPV OC, the rating of the covered bonds would fall by several notches.

"So we would be in a scenario where a Aaa would be very unstable. That's why at some point we're saying we will only give credit for this OC in our analysis if it is committed, with 'committed' really meaning you can't just unilaterally take it out later either."

BayernLB decided to put in place a commitment that satisfied Moody's and thereby had its Aaa covered bond ratings affirmed in October last year. The bank chose to formulate a commitment whereby it will hold whatever level of OC Moody's considers necessary to achieve a Aaa rating, subject to caps of

25% for its mortgage Pfandbriefe and 15% for its public sector covered bonds on an unstressed NPV basis (versus required OC levels of 18.5% and 10.5%, respectively, commensurate with Aaa Moody's ratings at the time of the affirmation).

Furthermore, if the covered bonds are downgraded below Aaa — because of an issuer downgrade to Baa2 or lower, for example — BayernLB has undertaken to maintain the last OC level consistent with a Aaa rating published by Moody's before the downgrade.

"The commitment BayernLB undertook states that for as long as a bond that was bought at the Aaa level is outstanding it will maintain this OC level," says Gulde. "As an investor, you benefit from the commitment and the higher rating.

"BayernLB is not the only Baa1 rated issuer in Germany," he adds, "but they are the only Baa1 rated issuer with Aaa covered bonds, because they were the only ones deciding to commit to the OC level to maintain the Aaa rating. The other issuers made the choice not to do that. It really is a question of what the issuers decide to do."

"YOU BENEFIT FROM THE COMMITMENT AND THE HIGHER RATING"

However, while BayernLB's commitment was aimed at underpinning its Aaa Moody's ratings, Fitch in February responded to the mechanism by highlighting the OC caps. It said that rather than the lowest level of OC observed in the preceding 12 months, it would now use the contractually committed maximum OC level as the input for its rating analysis. It noted that the AAA breakeven OC levels were lower than these, and affirmed the programmes' top ratings, but also said that in future it would give no credit to OC higher than the contractually committed maximum level.

"Although BayernLB's short term Issuer Default Rating is currently F1+, the agency sees the contractual commitment to a maximum OC as a binding reference for the cover pool monitor should excess cover assets be removed from the cover pool in the run-up to an issuer's insolvency," it said.

Down by law

However, while non-statutory OC requirements may be of dubious value and/or have unintended consequences, minimum OC requirements enshrined in legislation have rarely been sufficiently high to support the high ratings issuers typically target. When Fitch published a special report on the German covered bond legislative framework in early June, for example, one of the only blemishes on the somewhat glowing report was its comment on the low headline number for the minimum overcollateralisation level in the Pfandbrief Act.

"Fitch considers the mandatory 2% OC insufficient to withstand stress scenarios above the issuer's rating applied to both the cover pool's credit risk and mismatches between cover assets and covered bonds," it said, noting that the OC level is calculated on a stressed net present value basis taking into account predetermined interest rate and currency stresses and has to be held in liquid assets.

The rating agency's view was publicly demonstrated in August 2012 in its rating of public sector Pfandbriefe issued by Berlin-Hannoversche Hypothekenbank (Berlin Hyp). After the issuer said that it would not commit to any OC above the legal minimum, Fitch lowered its rating of the public sector Pfandbriefe from AAA to AA-, one notch above the German bank's issuer default rating of A+, with the uplift granted for superior recoveries in event of default on the bonds.

Moody's also cut the public sector covered bonds, to Aa1, but it was the costs of meeting OC required by Fitch to attain a AAA rating that had prompted a buy-back by Berlin Hyp given that it is phasing out its public sector lending activities and focusing on its real estate business. Conscious that its move would result in the downgrades, it offered holders of the bonds an exchange into its mortgage Pfandbriefe, which were rated Aa1/AA+.

"Mortgage Pfandbriefe are our most important refinancing instrument, and we are committed to supporting their rating, but overcollateralisation costs money," said Bodo Winkler, head of investor relations at Berlin Hyp at the time. "Reducing the overcollateralisation of the public sector Pfandbriefe compensates for the negative impact on our P+L that comes from the OC requirements for the mortgage Pfandbriefe."

Fitch's highlighting of Germany's 2% level (on a stressed NPV basis) as a negative aspect of the country's covered bond legislation contrasted with a Moody's view on Spain's covered bond framework published later in June, in which legal minimum OC levels were cited as a strength. "Minimum OC levels for Spanish programmes are well above the typical legal minimum," it said, noting a requirement of 25% on a nominal basis for mortgage covered bonds and 42.9% for public sector covered bonds.

According to one covered bond banker, recent developments in Germany, with several issuers reducing OC, have led to renewed discussions between market participants and the regulatory authorities as to whether the 2% headline number should be raised.

However, one issuer representative says that discussions about raising the minimum OC come up every year and that such a move has rather become more difficult because of concerns about asset encumbrance.

"That's why it hasn't happened yet," he says. "And then there are questions about how high the OC level should be, and what its scope should be. There is no consensus among vdp members and other stakeholders."

When the UK authorities tightened the UK Regulated Covered Bond regime in November 2011, they introduced a minimum OC level against the background of a developed market where individual programmes already had contractual OC levels in place. The 8% number that it arrived at was "around the midpoint" of submissions made during a consultation, according to HM Treasury.

BayernLB, Munich: the only Baa1 German issuer with Aaa Pfandbriefe

Hard numbers 'a fig leaf'

Although the rating agencies may cite higher statutory numbers as positive, coming up with an appropriate number is by no means easy given all the variables that are also a factor when considering creditworthiness.

"Any hard number that you put forward is only a fig leaf," says Fuchs at S&P, "because it might help you to support the rating, but without any additional boundaries it doesn't tell you anything. If you say you will maintain, say, 10% OC, and you have a public sector cover pool that is very well diversified, that might be OK, but if you then suddenly start to issue very short dated paper and back that with long term Greek exposures, it might not be adequate for the risks you are then incurring."

He cites the example of Allgemeine HypothekenBank Rheinboden (AHBR), which went from being a leading covered bond issuer with a mortgage cover pool comprising a mix of commercial and residential assets to becoming Corealcredit, a "minor boutique issuer" with a wholly commercial real estate cover pool.

"Permanence of OC can only be adequately discussed if you also talk about the permanence of the risk protections," says Fuchs. "The external boundaries laid down by covered bond laws can still allow you to incur risks that render redundant any OC that is in there."

In Norway's covered bond legislation there is no minimum overcollateralisation level. According to a funding official at a Norwegian issuer, this is because Norway took several years to produce its legislation and during this time rating agency overcollateralisation requirements and treatment changed so many times that any figure would end up appearing arbitrary.

DZ's Homey says that this is a sensible approach.

"From my point of view some sensible level of overcollateralisation in the law is fine," he says, "but if issuers want to commit to a certain level of overcollateralisation — due to discussions with investors or with rating agencies — then they can by all means do this through the programme documentation.

"It's perfectly viable and legitimate to do it like this."

But Homey adds a caveat that applies to public statements as well as committed OC: "We are also increasingly sceptical about public statements or contractual regulations. This is because issuers can use buyback programmes at any time to try to wrest back from covered bondholders the approval of changes to earlier promises or make the withdrawal of public commitments acceptable."

S&P nevertheless forecast in a report in mid-June that contractual OC commitments could be on the rise.

"We anticipate that issuers may use mitigation mechanisms, such as those typically seen in structured finance transactions, more frequently to maintain the current credit quality of their covered bonds," the rating agency said in a report discussing convergence between covered bonds and ABS. "One of the more pressing, but still unanswered, questions on investors' agenda is how to ensure the ongoing buffering of risks in a covered bond to support credit quality.

"We understand, for example, that some investors have been showing interest in features that prevent issuers from reducing overcollateralisation to the legal minimums, which could happen if a bank issued additional covered bonds without replenishing the collateral value in the cover pool."

However, analysts note that ultimately, investors should bear in mind that withdrawal of OC is by no means always a bad thing.

"There's the general point that even though withdrawal of OC could be negatively interpreted," says Deutsche's Volk, "if the issuer is withdrawing it to support the bank, as a covered bondholder you should be happy about that if it helps withstand temporary stress." ■

On the edge but on the lookout

A Caixa Geral de Depósitos deal in January is the only Portuguese covered bond benchmark to have been launched since 2010. Faced with a choice between expensive wholesale funding and cheaper ECB liquidity to satisfy shrinking funding needs, they have eschewed the former — but remain open to opportunities. *Susanna Rust* reports.

On 11 January, Caixa Geral de Depósitos (CGD) sold the first Portuguese benchmark covered bond in almost three years, a Eu750m five year mortgage backed deal that attracted nearly Eu4bn of demand, the vast majority of which came from international investors.

With the last deal from the country having come in March 2010, the benchmark covered bond was also the first from Portugal since the bail-out of the sovereign in May 2011.

In reopening the jurisdiction after more than two years without benchmark covered bond supply, CGD's deal was a similar landmark to that for another peripheral, with Bank of Ireland Mortgage Bank having in November 2012 sold a Eu1bn three covered bond that marked a similar comeback for Ireland.

But unlike their Irish peers, Portuguese issuers decided to follow the unsecured funding route back to market before moving to secured; Banco Espírito Santo (BES) reopened the Portuguese FIG market in October 2012 when it sold a Eu750m three year senior unsecured deal. CGD followed suit, selling a Eu500m three year trade in November, and BES then sold another senior unsecured deal, a six-times oversubscribed Eu500m five year issue in January.

Paulo Ferreira, head of funding at BES, explains why the issuer opted for a senior unsecured deal over a covered bond on both occasions.

"The spread differential between senior unsecured and covered bonds in our view did not reflect the quality of our cover pool," he says, "so we decided to follow the probably less obvious route and go for the senior, even though by then we had been asked by several investment banks to issue a covered bond.

"At the beginning of the year we completed our yield curve with another senior deal and that was for the same reason," he adds.

After BES's ice-breaker in October, CGD wanted to prove that it, too, had market access, says Bruno Costa, head of funding at Caixa Geral de Depósitos, and, after weighing up launching a new senior unsecured deal versus a new covered bond, it opted for the former.

"A covered bond would come at a lower price, but at the time, in November, we were not sure if the typical covered bond investors were ready to invest in Portuguese covered bonds," he says. "But we knew hedge funds or credit funds would play a greater role than in the past due to the higher yields, and that this would act as a catalyst for other investors to come in.

"The senior unsecured deal went very well and created awareness and reverse enquiries, so in January we felt there were good conditions to go ahead with a covered bond, which was also a success."

Sidelined?

Speaking at the time of CGD's covered bond, João Nuno Palma, chief financial officer at Caixa Geral de Depósitos, told *The Covered Bond Report* that the positive outcome of the deal showed re-

The lighthouse of Cape St Vincent, Portugal
Photo: Peter Guyan/Flickr

Sebastien Domanico, SG:
"Issuers are relatively liquid and deleveraging is still a key feature"

gained market confidence in the issuer, in Portugal, and in the Portuguese mortgage market.

He noted that placing a five year transaction meant that CGD was able to borrow funds maturing three years beyond the end of funding under the European Central Bank's (ECB's) longer term refinancing operation (LTRO), and beyond the end of the Portuguese bailout programme.

"We were able to use our collateral on the market again," said Palma. "This is impressive."

And yet, despite its success the deal remains the only Portuguese covered bond to have come to market this year.

CGD's Costa gives his explanation why this is the case.

"There are two reasons," he says. "Wholesale funding needs are shrinking because new lending activity is not replacing amortising assets and deposits have been stable, and then you also have cheaper funding available via the ECB.

"Portuguese banks would like to issue covered bonds, but there is little incentive to reduce exposure to central bank funding now if you compare the cost of accessing the market versus the ECB."

This is something that the market understands well, according to Sebastien Domanico, global head of FI DCM at Société Générale.

"It hasn't been a question of the market being closed for Portuguese issuers," he says, "but that cost is an important consideration for them. The issuers are relatively liquid and deleveraging is still a key feature.

"They took out a sizeable amount from the LTRO and haven't reimbursed all that much, and it's still a cheap source of funding for them."

Profitability is a key concern for Portuguese issuers, says another banker.

"They don't want to be paying a large net interest margin," he says, "but they are not originating a lot of new mortgages so they are living off cover pools that contain older mortgages with much higher interest rates.

"So in terms of funding, it doesn't make economic sense to do the five, seven or 10 year type of trade that they should theoretically consider doing."

And while launching deals to prove market access is valuable, he adds, there is a limit to how many transactions an issuer will want to execute for "signalling effect" when the economics are not compelling.

Sell-off shows vulnerability

Portuguese issuers also have to contend with their links to a sovereign that the market still judges as being high risk, although the bank deals that have been priced show that that they are able to overcome this obstacle, says Richard Kemmish, head of covered bond origination at Credit Suisse.

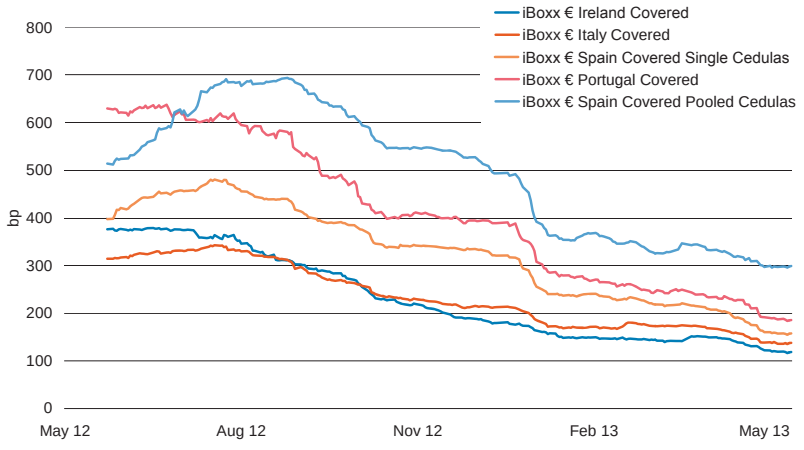
He draws attention to a difference between Ireland and Portugal, noting that while in Ireland "covered bonds can come to market because the government curve has recovered, in Portugal covered bonds allow the issuers to recover ahead of the government".

"The price for Portuguese risk generically has come down, but Portugal is still the widest major government in Europe," he adds, "and Portuguese bank deals have achieved reasonably tight levels despite the government still trading at relatively inflated levels."

SG's Domanico says that the sell-off in June showed the relative fragility of the market's perception of Portugal.

"It's true that investors are looking for yield and would be keen to buy Portuguese covered bonds as they offer a good premium versus Italian or Spanish covered bonds, for example," he says, "but the sell-off shows that every time the market gets more nervous it affects Portugal more than some other peripherals."

Portuguese government bonds were hit hard by the downturn in sentiment prompted by US tapering fears, and, according to Alessandro Giansanti, rates strategist at ING, it triggered talk of the ECB activating its Outright Monetary Transactions (OMT) programme for Portugal.



Source: UniCredit Research

"The level of Portuguese yields is incorporating too negative a scenario in our opinion," he said in the middle of June. "The 10 year PGB yield at 6.40% is in line with a B+ credit rating, which is two notches below the current BB level at S&P."

Portuguese covered bond swap spreads widened by 17bp over a two week period leading up to 13 June, according to DZ Bank analysts, based on Markit iBoxx data.

However, they expect Portuguese covered bonds, along with Irish, Italian and Spanish paper, to once again outperform the iBoxx Euro Covered Bond Index as a whole, and said that investors should take advantage of wider spreads to build positions in these categories.

Portuguese covered bond issuers could have sold deals in the weeks prior to the sell-off, says Dhiren Shah, FIG syndicate at Credit Suisse, but the picture changed as a result of the weaker tone in June.

"You need to see more stability on the sovereign," he says. "The markets have turned and the Portuguese need to wait for the market to come back to them, which will probably take longer than just a week or two."

Banco Espírito Santo will probably begin to think about next year's refinancing after the summer

Wanted: a better economy

At 285bp over mid-swaps, CGD's covered bond in January was priced some 125bp inside Portuguese government bond spreads. Further issuance should also be able to come at a discount versus the sovereign, says SG's Domanico, but issuers will still be looking for a tightening of their government's bond curve before coming to market again.

"You may not be under pressure to issue, but at the same time you want to issue at the tightest levels and use the momentum you would get from a rally in govvies," he says.

So what will it take for the reopening of the Portuguese market to extend beyond CGD's lone deal?

BES will probably begin to think about next year's refinancing after the summer, says Ferreira. The bank has already redeemed some Eu2.3bn of bonds in 2013, and expects cash inflows until the end of the year as its balance sheet continues to deleverage.

"In terms of protecting profitability deleveraging will help to finance the balance sheet and to reduce gradually central bank dependence," he says, "and if we were to see a window of opportunity at fair spreads we would tackle the market, probably with a covered bond."

> "We would gradually like to replace ECB funding"

CGD's Costa identifies two conditions that would ideally need to be fulfilled for the issuer to return to the market.

"We would like to see a pick-up in our loan concession activity, which would be a catalyst for us to think that our funding needs will increase," he says, "and, if credit spreads contract then we would gradually like to replace ECB funding with market funding."

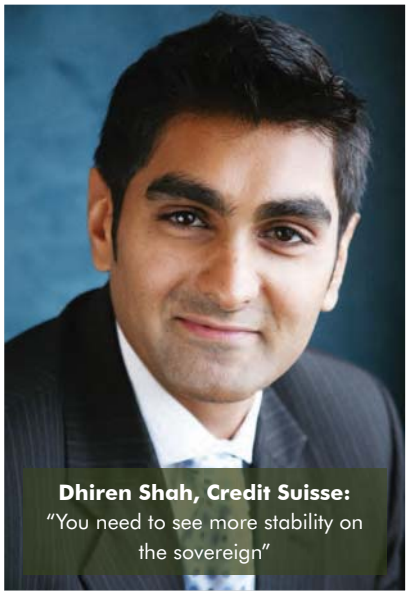
However, the combination of these two factors would ultimately reflect an improvement in the Portuguese economy, the prospects of which are still very uncertain, he adds.

'A bad neighbourhood'

Indeed, the economic outlook for Portugal remains "sombre", according to the International Monetary Fund (IMF). This and other assessments were made in a June report setting out the fund's latest review of the country's progress against targets, which ultimately led it to approve the next tranche of Portuguese bail-out funds, for some Eu657m.

It noted positives such as a sharp reduction in the current account deficit and the sovereign's return to the international bond market in January — it sold a Eu2.5bn five year bond, its first with that maturity in nearly two years — but said that strong export growth has recently started to decrease and that the labour market situation remains "extremely difficult". The fund revised downwards its growth projection for 2013, by 1.25 percentage points to minus 2.25%.

For DBRS, the extended economic downturn in Portugal is behind its negative view on the country's banking sector. It rates four Portuguese banks at BBB (low), with a negative trend, mirroring the status of DBRS's rating of the sovereign, and also rates Banco Santander Totta, at BBB (high), negative trend.



Dhiren Shah, Credit Suisse: "You need to see more stability on the sovereign"

"We don't see light at the end of the tunnel at the moment but a slow deterioration," says Lisa Kwasnowski, vice president, financial institutions group at DBRS. "There was a steady but slow decline in credit quality until 2010, but since then we have seen the pace of deterioration accelerate."

This is having an impact on banks' earnings, which in the past year began to be surpassed by provisions for deteriorating credit, she adds.

"In contrast to Ireland, where the banks were the source of the problem, in Portugal the economy is the driver," she says. "Portuguese banks are a good house in a bad neighbourhood."

However, she notes that it is corporate loans rather than residential mortgages that are declining in credit quality. Banco Popular Portugal is the only covered bond issuer that has some commercial mortgages in its cover pool, notes Vito Natale, senior vice president, EU covered bonds, at DBRS.

He says that the Portuguese residential mortgage market has experienced a slight increase in non-performing loans, but that the development is not dramatic and therefore ultimately encouraging given the overall economic conditions.

"There is a downside risk from the austerity measures, but so far the performance in the residential mortgage market has held up quite well, and it doesn't raise any specific concerns," he says. "Issuers have been willing to increase overcollateralisation to support ratings and they are managing the shrinking of cover pools in advance."

Portugal was DBRS's gateway into the European covered bond market, which it entered in December 2011 when it rated the obrigações hipotecárias programme of Caixa Económica Montepio Geral (Montepio). It now rates seven Portuguese programmes, with a DBRS rating in at least one case safeguarding ECB repo access.

Banco Popular Portugal obtained a BBB rating of its obrigações hipotecárias from DBRS in August 2012, one month before Fitch downgraded the covered bonds to BB and then withdrew the rating. With an investment grade rating of the covered bonds from DBRS, the bonds maintained their eligibility for use in repo operations with the ECB.

And maintaining a buffer against potential loss of ECB repo access was behind Montepio's move to obtain a rating of its covered bonds from DBRS, an official at the bank previously told *The CBR*.

"We have decided to sign a deal with DBRS for a rating of our covered bond programme to have one additional rating agency in our programme," said Fernando Teixeira, deputy director, funding, at Montepio, back in December 2011, "because our programme was already rated by two rating agencies, but both of them were at the minimum acceptable level in order to discount the covered bonds with the ECB."

When Montepio obtained the rating — A (low) — of its covered bonds from DBRS in December 2011 the obrigações hipotecárias were on the cusp of junk at Moody's (Baa3) and Fitch (BBB-).

Sitting tight, hoping for a break

There have been several opportunities for Portuguese covered bond issuers to tap the market in the first half of this year, says Ralf Grossmann, head of covered bond origination at Société Générale, and although the spread widening in June is a step backwards the medium term outlook is fairly constructive.

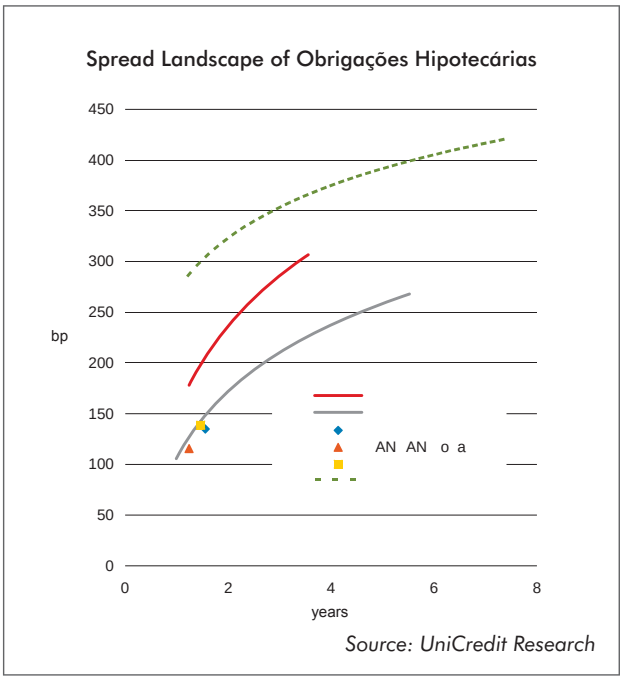
"We are currently away from Portuguese issuers' target spreads," he says, "but they are not in a hurry anyway, so let's see how the market looks after the summer break and after the elections in Germany in September.

"I think that there will be some positive developments and that the issuers will look to have another go at the market. If you look at the Caixa Geral issue from January, that is still trading tighter than where it was launched."

The new issue was priced at 285bp over mid-swaps, and was trading at around 250bp over in the middle of June, according to Grossmann.

Costa sums up the state of affairs for Portuguese covered bond issuers on a fairly optimistic note.

"Time is on our side," he says. "The Portuguese market is healthy. It exists although it is not visible, and that is more a question of choice by the issuers rather than a restriction from the market." ■



Source: UniCredit Research

The Covered Bond Report

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EC president José Manuel Barroso and European Council president Herman Van Rompuy at the EU meeting where bail-in compromise was reached
Photo: European Council

Is the market pricing **bail-in risk** correctly?

The pending finalisation of a bail-in framework has refocussed attention on the topic. Here, *Jean-David Cirotteau, head of strategy in covered bonds and SSAs at Societe Generale CIB,* asks whether spreads between senior unsecured and covered bonds are pricing in risks correctly.

Introduction

Here we look at how bail-ins should hit covered bonds. We find evidence that in many core jurisdictions the market has been pricing the exclusion of covered bonds from bail-ins — a positive for the asset class. As such, in terms of our modelling, most covered bonds are pricing near fair value (based on six months of history, thus fully capturing the non-bail-inable element).

Moody's has confirmed that it is less likely to use senior unsecured (SU) ratings as the anchor point to rate covered bonds from issuers in core countries. This will limit the impact of any SU downgrades following the Ecofin draft decision on the new resolution regime. Unlike last year when Moody's modified the TPI table for SU ratings at Ba and lower, this new approach should not change the TPI table for Baa-ratings and above to allow for the new resolution regime.

We find that the UK, French, Dutch and Nordic markets price the covered bond bail-in exclusion well — as they should. In contrast, the non-bail-inable advantage does not seem to have changed the fair value of German Pfandbriefe — most likely because the credit risk is seen as low. The French long term curve looks cheap, the medium part of the Dutch covered bond curve offers value, as does the short term Swedish curve.

Market impact of the banking resolution regime

Further comments from counterparties, in particular rating agencies, further highlighted the benefits for covered bonds of being deemed not bail-inable by Ecofin.

Jean-David Cirotteau, SG CIB:
"Covered bond markets have become strategically important in all jurisdictions in Europe"

Nonetheless, we wonder whether there will be any impact from the link between senior unsecured (SU) and covered bond ratings. Part of this link is due to Moody's TPI (Timely Payment Indicator), which was previously amended in July 2012 at the double-B level and below *(see changes in the lower box of the right-hand table below)*.

As shown in the tables below, the Moody's changes made in July 2012 had the effect of increasing the upper limit of covered bond ratings in relation to SU ratings at the Ba level or lower. We wonder if similar changes could occur for SU ratings in the Baa category once the new resolution regime is agreed on 20 July. Many of the largest banks in Europe are rated at SU level in this category with some of them having limited TPI leeway between the covered bond and their SU rating.

The charts on the opposite page show the distribution of TPIs as of 28 June. We split the market into three categories: core/Nordics and Switzerland/peripherals. The latter is obviously skewed towards the lower TPIs (Improbable and Very improbable).

Moody's comments in its 2013 outlook

In its 2013 "Covered Bond Outlook", Moody's made some interesting comments regarding the way it would address the consequences of the banking resolution regime if it was confirmed:

Point 1: *"**Use of powers is more likely to benefit covered bonds in core jurisdictions.** Resolution powers (1) to (4) will be more beneficial for covered bonds in core jurisdictions where covered bonds are seen as a key funding source."*

Our understanding of this paragraph is that covered bond markets, should they require support from authorities, are more likely to be supported in core jurisdictions simply due to the fact that core countries have more financial capacity than peripherals. But in our view, covered bond markets have become strategically important in all jurisdictions in Europe.

Point 2: Of course, their exclusion from bail-inable instruments is very positive for covered bonds. In contrast, senior unsecured bonds can be bailed in. As a result, rating agencies will surely lower senior unsecured ratings following the implementation of the resolution regime. But the big question is this: **Is the senior unsecured rating then still the right anchor level from which to rate the covered bond programme?** Moody's answer is the following.

"If issuer ratings are downgraded as a consequence of bail-in risk then, all other variables being equal, this is negative for covered bonds. … Covered bonds would then be negatively af-

TPI table before Jul 2012
(Maximum CB rating achievable before 7/12)

	Very Improbable	Improbable	Probable	Probable-High	High	Very High
A1	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa
A2	Aa1	Aa1	Aaa	Aaa	Aaa	Aaa
A3	Aa2	Aa2	Aaa	Aaa	Aaa	Aaa
Baa1	Aa3	Aa3	Aa1	Aa1	Aaa	Aaa
Baa2	A1	A1	Aa2	Aa2	Aa1	Aaa
Baa3	A3	A2	A1	Aa3	Aa2	Aa1
Ba1	Baa3	Baa2	Baa1	A3	A2	A1
Ba2	Baa3	Baa2	Baa1	A3	A2	A1
Ba3	Baa3	Baa2	Baa1	A3	A2	A1
B1	Ba3	Ba2	Ba1	Baa3	Baa2	Baa1
B2	Ba3	Ba2	Ba1	Baa3	Baa2	Baa1
B3	Ba3	Ba2	Ba1	Baa3	Baa2	Baa1

Note: If it is classified as 'very improbable', it is very improbable that bond holder will get timely payments on the covered pool in the event the issuer goes bankrupt

Current TPI table
(Maximum CB rating achievable after 7/12)

	Very Improbable	Improbable	Probable	Probable-High	High	Very High
A1	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa
A2	Aa1	Aa1	Aaa	Aaa	Aaa	Aaa
A3	Aa2	Aa2	Aaa	Aaa	Aaa	Aaa
Baa1	Aa3	Aa3	Aa1	Aa1	Aaa	Aaa
Baa2	A1	A1	Aa2	Aa2	Aa1	Aaa
Baa3	A3	A2	A1	Aa3	Aa2	Aa1
Ba1	Baa1-Baa3	A3-Baa2	A2-Baa1	A1-A3	Aa3-A2	Aa2-A1
Ba2	Baa2-Ba1	Baa1-Baa2	A3-Baa2	A2-Baa1	A1-A3	Aa3-A2
Ba3	Baa3-Ba2	Baa2-Baa3	Baa1-Baa3	A3-Baa2	A2-Baa1	A1-A3
B1	Ba1-Ba3	Ba1-Ba2	Baa3-Ba2	Baa1-Baa3	A3-Baa2	A2-Baa1
B2	Ba2-B1	Ba1-Ba3	Ba1-Ba3	Baa2-Ba1	Baa1-Baa3	A3-Baa2
B3	Ba3-B2	Ba2-B1	Ba1-Ba3	Baa3-Ba2	Baa2-Ba1	Baa1-Baa3

Note: If the SU rating is for example Baa2, and the TPI is probable, then the maximum rating on the covered bond is Aa2.

Source: SG Cross Asset Research/Rates, Moody's

fected as our expected loss analysis typically uses the issuer's senior debt rating when calculating the expected loss on the covered bonds. Furthermore, our TPI framework also relies on the issuer's senior debt rating to indicate the maximum covered bond rating achievable."

"… the covered bond programme would be (re-)housed within a functioning and solvent entity. ***For core jurisdictions****, therefore, we may review our typical assumption that "default" on the senior unsecured debt will mean investors are then left relying primarily on the value generated by the cover pool. In core jurisdictions, where we would expect regulators to use resolution powers to benefit covered bonds, the likelihood that covered bonds will continue to be part of a "going concern issuer" following the use of resolution powers means* ***the issuer's senior debt rating may no longer be the most appropriate reference point for "issuer default"****.*

*"****In non-core jurisdictions****, issuers' senior debt ratings are more likely to continue being the correct reference point for issuer default. In non-core jurisdictions, however, we are less likely to revise our assumptions around issuer default. We will continue to expect support for covered bonds to be less certain, and dependent on idiosyncratic factors and circumstances at the relevant time. On this basis, bail-in of an issuer's senior debt will more likely lead to, or be contemporaneous with, covered bond investors having to rely primarily on the cover pool collateral for future payments on the covered bonds."*

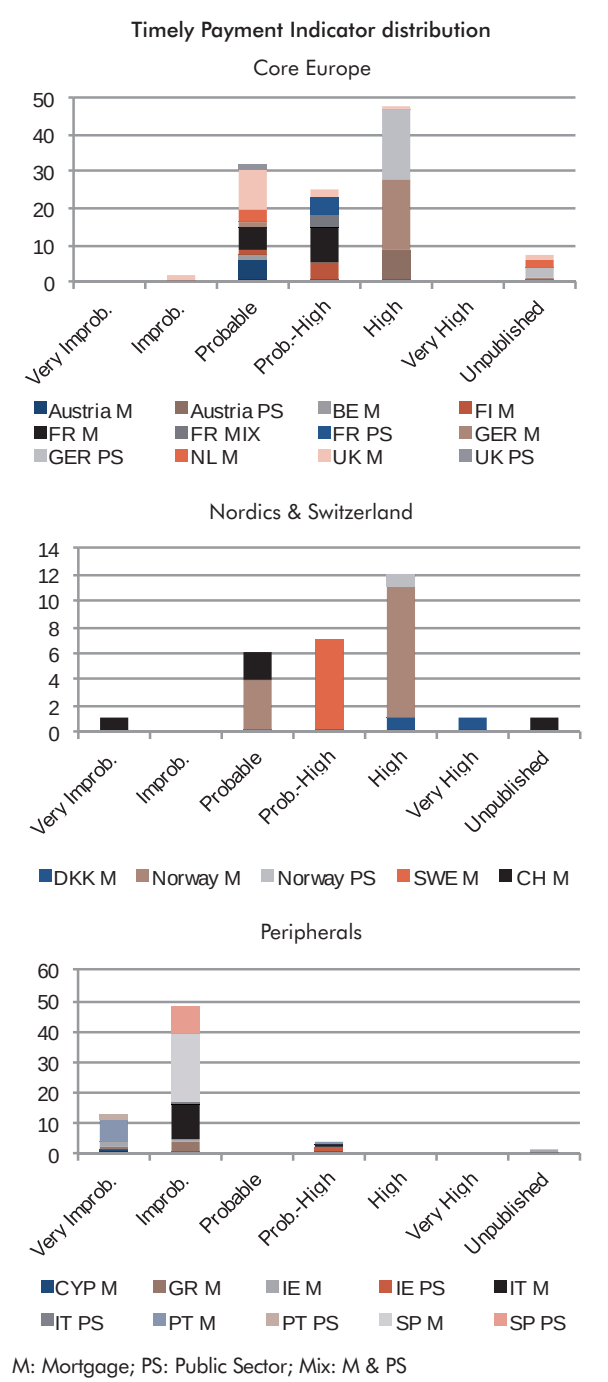
We understand that Moody's is concerned about its methodology. Its answer is to differentiate between core and peripheral markets based on considerations we do not necessarily find accurate. Nonetheless, the result is logical to us, as it somewhat de-links the covered bond rating from the senior unsecured rating for banks in core markets. The result is significant: covered bond ratings will be protected.

We expect Moody's to release its Q113 covered bond overview soon. The table should provide some indication as to the changes in TPI leeway for each individual issuer.

How the market is capturing the non-bail-inable component of covered bonds

Below we provide a set of charts showing the evolution of covered bond ASW spreads versus our fair value model. The model combines SU bonds and sovereign (SOV) bonds. The data can be monitored from our webpage. We calculate a fair value spread based on two sets of data calibration — six months and two years of history.

The model, based on just six months of history, includes data when the market had a good understanding of the non-bail-inable characteristics of the covered bond. The 2Y model doesn't take into account (or does only partially) the non-bail-inable component of covered bonds. **Should FVs from the two models be significantly different, we will assume that the market has priced the non-bail-inable characteristic of covered bonds.**



M: Mortgage; PS: Public Sector; Mix: M & PS

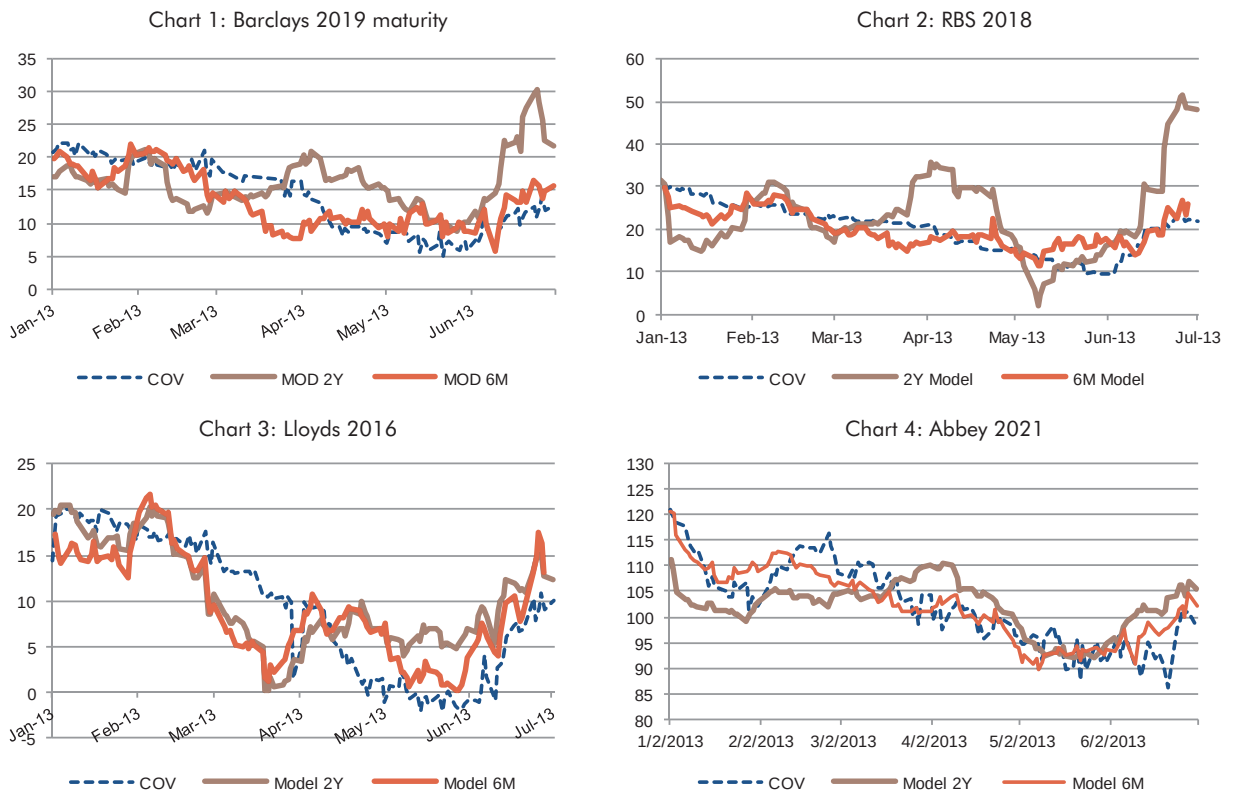
Source: SG Cross Asset Research/Rates, Moody's

Examples in the UK market

The differentiation between both models is quite clear in charts 1 and 2 below. We would expect the 6M model FV to be lower than the 2Y FV as is the case in the 2021 maturity.

The 6M vs 2Y model for Barclays 2019 and RBS 2018 is correctly pricing the non bail-in characteristic of covered bonds. The current level of these bonds is at FV as it is close to the fair value of the 6M model.

We look at other maturities in the UK covered bond market. For both maturities, either short term (three years) or long term (eight years) the pricing of the non-bail-in characteristic is



Source: Source: SG Cross Asset Research/Rates

less striking. Regarding the three year maturity, the models are close, although this may be a temporary phenomenon. Current market value is rich versus the 6M model.

The impact on Dutch covered bonds.

Market differentiation is very clear in the case of the ABN 2018 maturity, but less clear in the case of ING, at least for the last month of data.

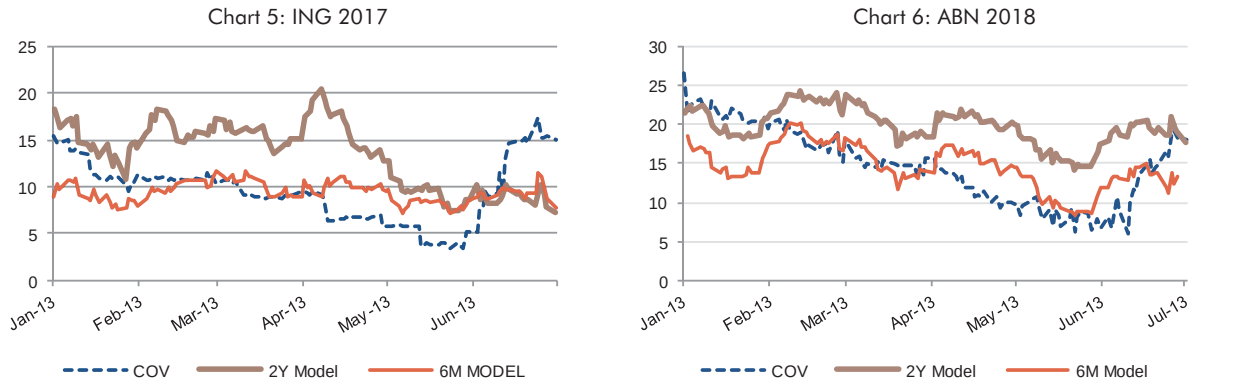
Both covered bonds, however, have underperformed significantly relative to both models and in our view are offering good value all else being equal. We explain part of the relative underperformance of the bonds vs the models from the fact that SG models are using 2015 SU maturities, as they are the only available and are slightly shorter than the covered bond maturity. The relative underperformance should therefore be slightly adjusted from the curve effect.

Some examples in the French curve

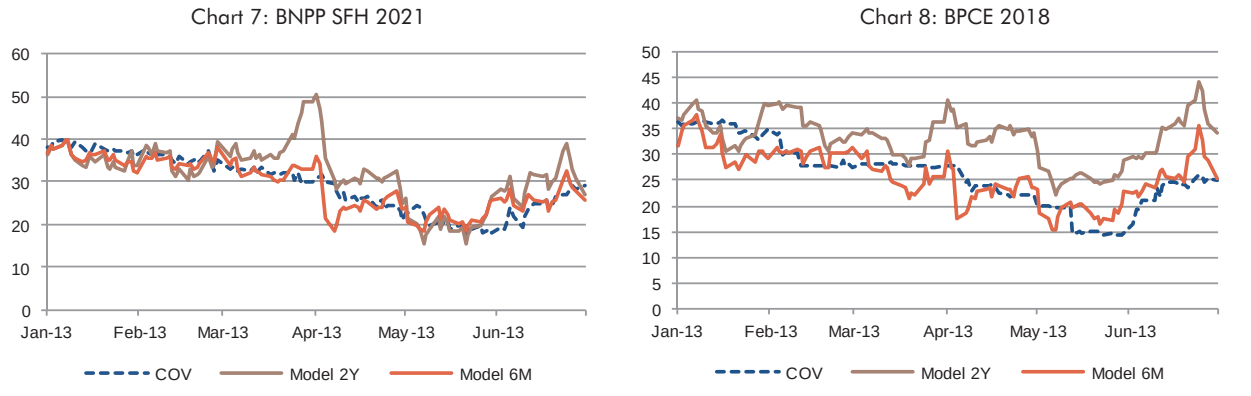
Similar to the two previous markets, French curves are showing some differentiation depending on the maturity. This is most evident for the five year area. The covered bonds are priced at their FV vs the 6M model.

The differentiation between the models for long term bonds is much less evident. Besides, the covered bond paper is clearly wider than its FV spreads. This offers a buying opportunity in our view.

We explain the current underperformance of long term cov-



Source: Source: SG Cross Asset Research/Rates



Source: Source: SG Cross Asset Research/Rates

ered bonds because of the reluctance on the part of a number of investors, who are mainly investing for liquidity purposes — such as bank treasuries who are focusing on the LCR constraints and still want to benefit from the pick-up of covered bonds over sovereign bonds. This segment of the market will continue to be cautious until the outlook for interest rates in general becomes clearer. They are confident in the strong credit protection provided by covered bonds in core jurisdictions. They are sensitive to any deterioration of prices, i.e. in the event of interest rates moving higher. This highlights the fact that covered bond instruments are clearly favoured for a number of accounts as a liquidity instrument. They will be very cautious to invest at proper interest rate levels.

Examples in the German Pfandbrief market

The differentiation between the two models in the German market is not that clear from the two examples below in charts 9 and 10. The behaviour of German Pfanbrief instruments is essentially explained by liquidity aspects. The market is not worried about asset quality for this market (hence few bail-in considerations).

German paper in general is pricing at very rich levels (in the case of BYLAN 2016 between -12 and -14bps in ASW). Investors positioning for liquidity purposes seem to have reallocated elsewhere in anticipation of higher yields, and from the moment risk-on mode is intact.

Conclusion

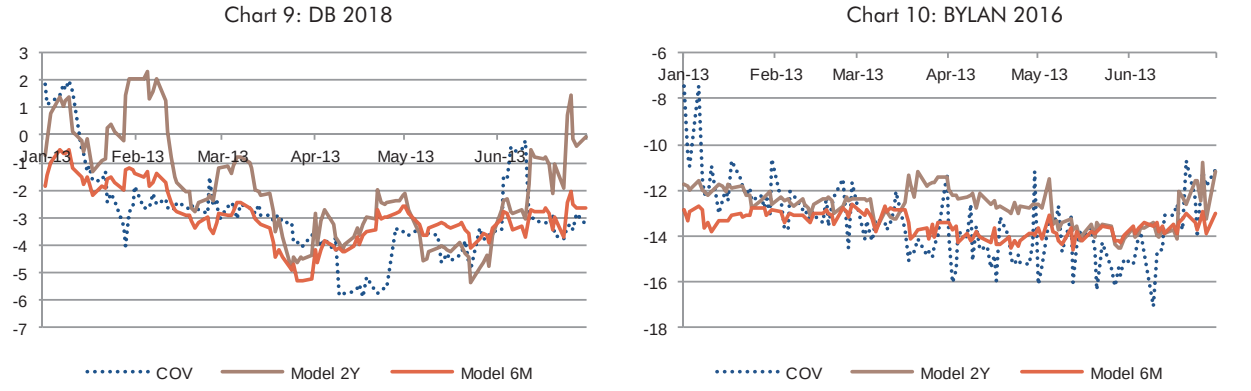
In most cases, the non-bail-inable characteristics of covered bonds are priced by the market, particularly for medium term maturities in the five year area. From our discussion with Moody's and its comments in its 2013 covered bond outlook published in December 2012, we are comforted that covered bond ratings in core jurisdictions will not be downgraded should SU ratings be lowered due to the new resolution regime.

We see some value in markets where models are not well differentiated (i.e. non-bail-inable characteristics are insufficiently priced).

In the current period of repositioning, covered bond paper, which has attracted a great number of investors for liquidity purposes, is suffering the most in long term maturities. This will continue until the market has reached a consensus on what the level of interest rates will be over the next six to 12 months.

Our conclusion is that the market is right in pricing a covered bond premium to our long term model (calibrated over a two year history). Yet some parts of the covered bond market have been more driven by liquidity aspects and some maturities have underperformed in the current environment. This phenomenon should fade once the interest rate outlook becomes clearer. ■

This piece is an extract from the research document "Covered Bond flash: Is the market correctly pricing the Bail-in exclusion?" published on 4 July 2013 which can be found on Societe Generale Cross Asset Research website: www.sgresearch.com.



Source: Source: SG Cross Asset Research/Rates

The Covered Bond Investor Conference

The ICMA Covered Bond Investor Council and The Covered Bond Report hosted The Covered Bond Investor Conference 2013 at the Steigenberger Frankfurter Hof on 16 May, preceded by an evening reception at Villa Kennedy.

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