The Covered Bond Report

www.coveredbondreport.com

May-Jun 2014

Reasons to be cheerful?

EBA pitches in as industry positions on transparency differ

H2 upsides
TLTRO downsides

Poland
Progressive thinking

RBC
Covering all bases

Exceedingly high liquidity and credit quality

Nykredit covered bonds have offered investors excellent security and liquidity since 1851.

A strong legal framework and focus on mortgage lending in Denmark have made Nykredit the largest issuer of mortgage covered bonds in Europe.

Nykredit's covered bonds are rated AAA due to high quality mortgage assets in the cover pools, match funding and a total capital ratio of 18.9%.

Nykredit

Kalvebod Brygge 1-3 • DK-1780 Copenhagen V • nykredit.com/ir

The Covered Bond Report

CONTENTS

13

22

7

FROM THE EDITOR

3 Raising the bar

While an end-June deadline for the EC to decide on the treatment of covered bonds for LCRs has been missed, from a regulatory perspective good news was delivered courtesy of the EBA.

Monitor

MARKETS

4 Long end centre stage in busy June

Westpac NZ first • US attracts Aussies • Mediobanca signals tighter OBGs • UK names back • Danish impact 'insignificant'

LEGISLATION & REGULATION

12 EBA: tighter CRR, best practices

LCR issuer ratings concern • ECB field gives CRD verdicts • Covered LCR 2A in Canada • 'A technique, not a brand'

RATINGS

18 Moody's 'aggressive' post-HAA

Encumbrance less of a 'red flag' • Cédulas lifted • OC rise among French positives • BRRD mulled for Fitch, S&P

PEOPLE MOVES

22 ECBC-EMF merger benefits

Bertalot steps up • CS, HSBC moves • Noé exits DB

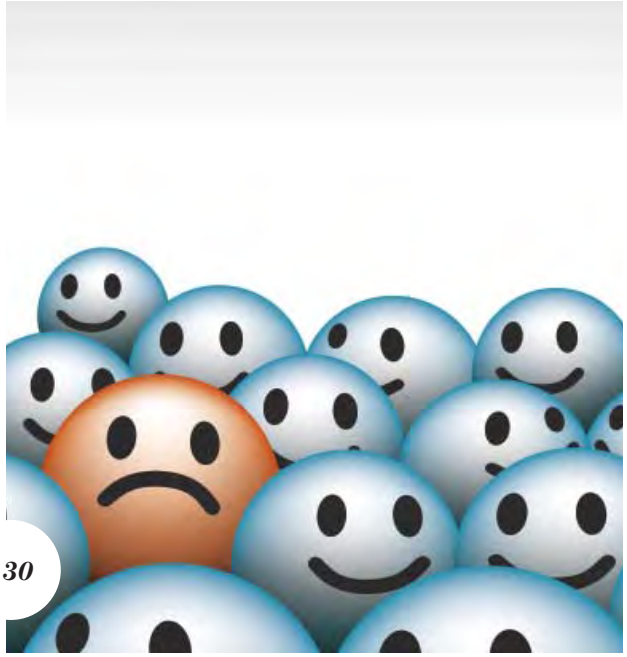
LEAGUE TABLE

23 Euro benchmark ranking

CONTENTS

The Covered Bond Report

36



30

40

Cover Story

30 Reasons to be cheerful?

The ICMA CBIC is disappointed with the response to its transparency initiative, while the ECBC argues transparency is improving under the Covered Bond Label. The EBA has looked at both, and said it's time for the next step.

FULL DISCLOSURE

24 Awards & Conference 2014

Q&A

28 RBC: Covering all bases

We recognise those deals and institutions that have demonstrated the best of the covered bond market over the past 12 months in this year's honours.

ANALYSE THIS

36 H2 upsides, TLTRO downsides

Analysts have revisited their 2014 forecasts in light of the first six months' issuance, with greater-than-expected supply from countries such as Canada having outweighed disappointing volumes from Spain. But the biggest unknown — if not totally unexpected — has proven to be new ECB LTROs.

POLAND

40 Progressive thinking

The Polish covered bond market could witness upgrades, lower funding costs and more issuance when long-awaited changes to the country's list zastawny legislation — including statutory conditional pass-throughs — are enacted.

Raising the bar

While an end-June deadline for the European Commission to decide on the treatment of covered bonds for Liquidity Coverage Ratios has been missed, from a regulatory perspective good news was delivered courtesy of the European Banking Authority.

In a final report delivering on two mandates, one from the Commission and one from the European Systemic Risk Board, the EBA identified principles of best practice in certain key areas of covered bonds and, more importantly, said that the preferential risk weight treatment assigned to qualifying covered bonds under CRR is — "in principle" — justified.

However, while Article 129 of the CRR "sufficiently elaborates on the eligibility of asset classes, it is less specific on equally relevant aspects of the safety of the covered bond" and the EBA has therefore recommended that the qualifying regime be tightened. Eligibility criteria should be added to Article 129 "to cover, at a minimum, the areas of liquidity risk mitigation, overcollateralisation and the role of the competent authority, and the further elaboration of existing requirements on disclosure to investors".

The EBA's approval thus comes with caveats and does not represent an unqualified endorsement of the status quo. The EBA has said that no single country's legal or regulatory framework meets all principles of best practice, and it has expressed support for more convergence. And in relation to transparency, the subject of our lead article, it has said more progress is needed and that it wants to set binding technical standards.

One could therefore read the EBA's recommendations on transparency as signalling that the industry's efforts are not quite up to scratch.

But that would be harsh. The EBA itself has said its pronouncements "should not be heard as criticism".

And yet there comes a point when industry has to be given a bit of a shove, or at least a helping hand in the right direction.

There is no shame in that. To the contrary — the EBA is asking for the bar to be raised, and that can only be a good thing.

Susanna Rust
Deputy 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 7267 5354
srust@coveredbondreport.com

Reporter: Alex Whiteman
+44 20 7267 8130
awhiteman@coveredbondreport.com

Fulfilment & distribution
Celeritas Solutions

Design
Garrett Fallon

Advertising & Subscriptions
Richard Buxton
+44 20 7267 4685
rbuxton@coveredbondreport.com

The Covered Bond Report is a
Newtype Media publication

Office 37
Spectrum House
32-34 Gordon House Road
London NW5 1LP
+44 20 7428 9575

Markets

EUROS

Long end moves centre stage in busy June

The euro benchmark covered bond market experienced its busiest day since the end of January in the middle of June, with a feature of that session being the launch of three 10 year deals, despite coupons falling to record lows.

Belfius, BPCE and MünchenerHyp were behind the 10 year covered bonds that, in combination with a five year for Berlin Hyp, turned Monday, 16 June into the busiest day of the year since January.

The last time four euro benchmarks were launched on the same day was 29 January when CM-CIC, Commerzbank, Intesa Sanpaolo and UBI Banca tapped the market.

The four deals priced on 16 June were followed by deals for Nationwide Building Society and Westpac New Zealand, with the former issuing a dual-tranche Eu1bn five year and Eu750m 15 year *(see separate articles)*. In total, Eu5bn of covered bonds were issued that week, across seven transactions (taking Nationwide's dual trancher as two), making it the second busiest week of the year.

Indeed, Eu13.15bn of benchmark supply in total in June meant the first half of the year finished strongly, after a measly Eu4.25bn was priced in May. A series of public holidays and peripheral weakness on the back of nervousness surrounding Greek elections were factors cited as affecting primary market activity that month.

The month of June opened strongly, however, with three deals in one day on 3 June — for Banco Santander Totta, Danske Bank and Dexia Kommunalbank Deutschland. These were followed by new issues for BBVA, OP Mortgage Bank and Yorkshire Building Society the day after, with a highly anticipated European Central Bank meeting on 5 June having influenced the timing of the deals to varying degrees. Officials at some issuers told *The CBR* they were keen to come to market before the ECB meeting

Mario Draghi, ECB

— at which president Mario Draghi announced the central bank would conduct targeted longer term refinancing operations (TLTROs) — while others played down its relevance.

"You always have news coming to the market and we knew the market was constructive, so you have to act on what you know," said Peter Holm, senior vice president, group treasury, Danske Bank, after his bank's deal, a Eu1bn seven year.

> "The markets fell back into a complacent stupor"

According to Barclays analysts, this June was the strongest since 2011, and much stronger than last year, when Eu7.2bn of covered bonds were issued.

At the close of that particularly busy week in June, Bank of America Merrill Lynch analysts said that while other markets appeared to be taking a breather the covered bond market, alongside the securitisation market, was "continuing its rally unperturbed".

"With the accommodative stance confirmed yet again, the markets fell back into a complacent stupor, oblivious to geopolitical and regional political risks, convinced that 'ECB will do whatever it takes' and unwilling to fight the central bank," they said.

A feature of the June supply was issuers' decisions to tap the long end of the curve. Of 17 new benchmarks, eight came with maturities of seven years or longer. Six were 10 year deals and one was the aforementioned 15 year for Nationwide.

"Investors' continuing hunger for yield is a weighty factor behind the flood of long dated issues," said DZ Bank analysts.

One of the three 10 year deals priced during that busy session in mid-June was a Eu500m 10 year mortgage Pfandbrief for Münchener Hypothekenbank, which featured the lowest ever coupon for a 10 year euro benchmark covered bond — 1.5%. The record had been briefly held by Deutsche Kreditbank (DKB), which had the week before priced a 10 year Pfandbrief with a coupon of 1.625%.

A syndicate official on the DKB deal had said that he was pleased with how the transaction went, noting that selling a 10 year Pfandbrief in the prevailing low yield environment is not "the obvious trade".

"But if an issuer has reasonable pricing aspirations and the syndicate takes a sensible approach in terms of guidance, it works," he said.

Barclays analysts also noted that issuance from core European jurisdictions dominated supply in June, comprising nearly two-thirds.

"As at the end of June, peripheral issuance represented 20% of the year-to-date (YTD) total, but the issuance mix has changed," they said. "Spanish issuers, which in the past have made up the bulk of peripheral issuance, have issued only Eu4.5bn of covered bonds.

"The slack has been picked up by Italian banks that have issued €8.8bn of covered bonds, representing an impressive 9% of YTD supply (up from 7% in 2013)." ■

NEW ZEALAND

Westpac gets tight level in NZ legislative first

Westpac New Zealand inaugurated the New Zealand legislative covered bond framework with a Eu750m five year issue on 18 June that was the tightest euro covered bond from the country.

The deal was Westpac NZ's second euro benchmark and came three years after a debut in June 2011 that, like all other issuance from the country until its new issue, was contractually-based. New Zealand's covered bond framework became effective in December.

Jim Reardon, treasurer at Westpac NZ, said the issuer had abstained from tapping the benchmark covered bond market for some time as investor engagement over the past year had led it to believe that it would meet with a better response if it waited to issue under the legislation, which it did after a roadshow.

"We're very pleased with the result," he said. "Out of the 85 investors in the book, almost half were either new to Westpac New Zealand or new to New Zealand from what we can gather, which indicates that there was stronger participation and as a result we got much more pricing tension."

Barclays, UBS and Westpac priced the deal at 20bp over mid-swaps, the tight end of guidance of the 22bp over area plus/minus 2bp, which followed initial price thoughts of the 25bp over area. At 20bp over, Westpac NZ came some 5bp-6bp wide of its parent, which compared with a 20bp-25bp pricing differential some 18 months ago, according to Reardon, although he acknowledged that a friendly market environment and overall spread compression also played a part in this development.

"We're pretty happy that we're pricing that tight, although I won't truly be happy until we're pricing flat," he added.

Armin Peter, head of EMEA debt capital markets syndicate at UBS, said that the deal drew some Eu1.4bn of demand, of which Eu1.25bn was good at re-offer, and that this enabled the size of the transaction to be increased from that initially targeted.

"It's difficult to say whether the covered bond legislation made a pricing difference but it seems likely judging from the feedback and the order book, and the ability to move the spread so tight and not lose much demand," he said.

A covered bond banker away from the deal said that Westpac had obtained "a fantastic result".

"And Eu750m isn't the typical New Zealand deal size, so that indicates that appetite was so enormous they couldn't resist," he added.

Westpac is the only New Zealand issuer to have a covered bond programme registered with RNBZ, having entered the central bank's registry in early April. Reardon said the registration process took around three months and was relatively straightforward.

"The legislation was very consistent with the structures of the programmes that had already been set up, so we didn't need to change the programme," he said. "Being first through the process meant it was a bit difficult in that that RBNZ was also dealing with certain things for the first time, but from my perspective the process wasn't too bad." ■

DOLLARS

CBA follows Westpac as US attracts Aussies

Australia's Westpac and Commonwealth Bank of Australia launched the only dollar benchmark covered bonds of the year in May and June, respectively, each selling five year issues at the same level for an aggregate $3bn.

Westpac Banking Corporation priced its US$1.75bn (Eu1.28bn, A$1.87bn) deal on 14 May, selling the covered bond as part of a triple-tranche transaction otherwise comprising three year senior unsecured fixed and floating rate tranches for $1.25bn each.

Leads Bank of America Merrill Lynch, Citi, JP Morgan, HSBC and Westpac priced the covered bond at 35bp over mid-swaps on the back of $2.3bn of orders, with some 65 accounts in the book, according to a syndicate banker on the deal.

The transaction was the first US-targeted covered bond since December and was launched after the issuer uncovered good demand for a covered bond tranche given the lack of supply, said the banker.

The lead syndicate official said that the 35bp over spread was equivalent to around 18bp-19bp over in euros, roughly where the issuer would come in the European market.

CBA launched its US$1.25bn five year on 4 June, with leads Barclays, CBA, Citi and RBS pricing the new deal at the same level as Westpac's on the back of some $1.5bn of orders.

"CBA saw the success of the Westpac trade and there hasn't been a ton of activity in the covered bond space," said a banker at one of CBA's leads.

"It's supportive of additional issuance," he added. "There's a view that there may be more opportunities than there was three to four months ago, although I still think that the pricing has to be a bit more compelling before you see a huge rush by any of these borrowers." ■

ITALY

Mediobanca success signals tighter OBGs

Mediobanca priced the tightest Italian covered bond in more than four years on 10 June, a Eu750m five year OBG at 51bp over mid-swaps, buoyed by a package of ECB extraordinary measures announced the previous week.

A banker on the deal said that the leads had decided from the outset "to be aggressive and announce IPTs inside fair value", adding that the final spread represented a great success, with an order book comprised of over 100 "good quality" accounts.

"The ECB announcements proved a decisive factor both in terms of pricing strategy and the decision to return to market as quickly as possible in the wake of the announcements," he said. "However, the decision to issue our second covered bond had been made prior to Thursday, but it was felt that it would be best to wait until after it."

Leads Commerzbank, Mediobanca, Natixis and Société Générale opened books on the Italian deal with initial price thoughts of the 55bp over mid-swaps area, before revising guidance to the 53bp over area. After collecting more than Eu1.5bn of orders, the leads fixed the spread at 51bp over and the size at Eu750m.

Mediobanca, Milan

A syndicate official at one of the leads said that, at 51bp over, no new issue premium was paid, with the spread having come through fair value of the mid-50s. For comparables, the leads used an Intesa Sanpaolo 2019 trading at 44bp over, a UniCredit 2019 at 48bp, and Mediobanca 2023s at 82bp over.

"This is one of the tightest Italian trades we have seen," said a syndicate official away from the leads. "It shows what Italian issuers are capable of achieving, and perhaps that they are ready to trade tighter than they have been."

Syndicate officials away from the leads felt that the pricing was appropriate, with one also noting that previous Italian issuance had perhaps been priced wider than was necessary because of weaker market conditions and that Mediobanca's pricing strategy was more in line with what could be expected from future Italian issuance.

Mediobanca wanted to return to the market with its second euro benchmark, following a Eu750m 10 year debut in October 2013, so that it could populate its covered bond curve, said the banker on the deal, who added that the timing was right as it allowed the issuer to take advantage of strong market conditions and tightening peripheral markets.

"All in all, the deal was a success, we set the size at the maximum possible and priced 7bp-8bp inside fair value," he said. "As for future issuance, the issuer has yet to decide what its 2014/2015 approach will be."

Italy was allocated 40% of the bonds, Germany and Austria 22%, UK and Ireland 9%, Iberia 8%, France 8%, the Benelux 5%, Switzerland 4%, and Asia 4%.

Banks took 38%, asset managers 35%, central banks and public institutions 21%, and insurance companies 6%. ■

ITALY

CDP mortgage-backed buys near Eu1bn

Cassa depositi e prestiti had purchased some Eu835m of Italian covered bonds and Eu120m of RMBS as of late June under a Eu3bn purchase programme launched in December.

The purchase programme was announced in November 2013 as part of an initiative to stimulate residential mortgage lending in Italy, taking in obbligazioni bancarie garantite (OBG) issues and what was described as "securities of a similar nature". A spokesperson told *The CBR* that CDP has since December subscribed to eight issues, including RMBS.

"At present, four out of eight bonds are still in CDP's portfolio," he added.

Under the scheme, CDP will only purchase OBGs in the primary market, subject to eligibility criteria being met, and its involvement is tied to issuers committing to using the proceeds to grant new residential mortgages to Italian residents. CDP's OBG purchase programme will run until the state fund's subscriptions have reached a total of Eu3bn under the scheme, according to the spokesperson.

"Banks still like CDP presence and role and ask for CDP intervention," he said when asked if any consideration had been given to ending the scheme early in light of factors such as ECB targeted longer term refinancing operations (TLTROs) and a fall in Italian banks' borrowing costs on the public bond market.

The CDP spokesperson noted that it appears residential mortgage loans will not count toward banks' borrowing allowance under TLTROs that the ECB recently announced. ■

"Bank regulations should be risk-based" page 28

UK

Yorkshire, Nationwide welcomed back

The UK's Yorkshire and Nationwide building societies returned to the euro benchmark covered bond market after absences of four and three years, respectively, in June, and found strong demand for their signatures.

The only previous UK covered bond supply this year had been a Eu1bn seven year benchmark for Lloyds on 9 April, which set the tone for its peers by achieving the tightest pricing for a UK name since September 2007, 15bp over mid-swaps.

Yorkshire Building Society drew Eu1.9bn of demand from 90 accounts on 4 June for its Eu500m comeback, a deal that Chris Parrish, group treasurer at the institution, said was mainly about reintroducing the credit to European investors. Its last euro covered bond was priced in September 2010.

Danske, DZ, JP Morgan and Natixis priced the no-grow seven year at 22bp over mid-swaps after initial price thoughts of the high 20s, which triggered indications of interest of around Eu1bn, and guidance of the 25bp over area.

"The undersupplied UK asset class was very much welcomed by asset managers, who took almost half of the issue, leaving fewer than usual bonds for banks," said a lead syndicate banker.

Parrish said the issuer was very happy with the new issue.

"It's particularly pleasing to get such a good following without having gone on a full roadshow," he added.

The issuer announced the mandate the Thursday before launch and held a few one-on-one investor calls and a global investor call over the following days, but there was no need for face-to-face meetings, according to Parrish, who pointed out that that Yorkshire did extensive investor work before a senior unsecured transaction in March and subsequently some non-deal related investor meetings.

"Our main focus was to get ahead of the ECB meeting [on 5 June] given its potential to distract, and because there wasn't any requirement for face-to-face meetings we decided to move quickly," he added.

Nationwide, Swindon: first euro benchmark since 2011

The issuer limited the deal size to Eu500m because the transaction was more about reintroducing the issuer as a credit to the European covered bond investor base than needing to secure additional funding, he added.

"We wanted to achieve benchmark status and Eu500m was sufficient to tick that box," said Parrish.

Nationwide's Eu1.75bn five year deal — which was split into five and 15 year tranches — was its first euro benchmark since October 2011 and David Wallis, head of funding at Nationwide Building Society, said that the deal was a sign of Nationwide's return to "business as usual funding flows". He said that this was due to a combination of the issuer's retail franchise performing well, several bonds coming up for maturity, and the UK Funding for Lending Scheme — which Nationwide has used — no longer being open to the country's mortgage banks.

Dual tranche structures are rare in the euro benchmark covered bond market, with Nationwide's deal only the third two-parter this year, and the 15 year tranche was also the longest dated euro covered bond to be sold since September 2013.

"Given the length of our absence from the covered bond market we wanted to try to make a franchise-positive statement," said Wallis. "One of the ways we thought we might achieve that would be via short-long dual tranche, reaching out to different investor bases."

Each tranche was well oversubscribed, with leads Barclays, Citi, UBS and UniCredit collecting Eu1.5bn of demand for a Eu750m 15 year tranche priced at 31bp over and some Eu2bn for a Eu1bn five year priced at 8bp over, each at the tight end of guidance. A Eu1bn deal was the goal from the outset for the five year tranche, according to Janusz Nelson, fixed income syndicate, FIG at Citi.

"On the 15 year, we initially envisaged printing at least Eu500m, but the demand we saw meant that we could tighten the spread and upsize," he added. "Both tranches went very well, showing the demand for UK covered bonds in general and in particular the Nationwide name."

Nationwide's deal was not the first UK dual tranche covered bond in euros, with Nationwide also having sold a five and 15 year issue in February 2007. The other two dual tranche deals this year were for Italy's UniCredit, which included a floating rate note, and Germany's Landesbank Hessen-Thüringen (Helaba). ■

INNOVATION

Goldman borrows from covered for FIGSCO

Goldman Sachs has established a Eu10bn programme for a new structured secured bond that draws on covered bonds features and which the bank hopes will provide it with cheaper funding, being backed by a range of fixed income assets and two guarantors.

The investment bank went on a one week European roadshow of the "fixed income global structured covered obligations" (FIGSCO) in late June. Barclays, Crédit Agricole, Natixis and UBS were mandated alongside Goldman Sachs.

The move to establish the programme, which carries a preliminary AAA rating from Standard & Poor's, is aimed at taking advantage of a demand overhang for triple-A supply, with the investment bank seeking to position the FIGSCO bonds as a rates product and obtain cheaper funding than that available to it in the senior unsecured market.

The FIGSCO bonds are not being marketed as covered bonds and do not carry key regulatory benefits associated with the asset class. They are, however, being described in relation to covered bonds — for example, where there are similarities and where there are differences, either as a relative strength or weakness — and Goldman is understood to be intent on positioning the FIGSCO structure closer to covered bonds than any other funding tool on the credit-rates spectrum.

Bonds issued by FIGSCO Issuer Ltd would be backed not by mortgages or public sector assets, as is typically the case in covered bonds, but by long dated fixed income assets held by Goldman, which can include senior unsecured debt, consumer ABS, and RMBS, for example. An external asset monitor would on a monthly basis check the valuation of the cover pool, which will be marked-to-market on a daily basis and topped on a daily basis if necessary.

Any shortfall from the assets in the event of an issuer default would be covered by Goldman Sachs Mitsui Marine Derivative Products (GSMMDP), which acts as a total return swap (TRS) counterparty and is joint and severally guaranteed by Goldman Sachs Group and Mitsui Sumitomo Insurance. GSMMDP is the basis of S&P's preliminary triple-A rating, which is assigned on a look-through basis.


Goldman Sachs, NY (centre)

"Investors should note that we did not give benefit to the underlying collateral or the documented collateral posting requirements in our rating analysis of the series 2014-01 notes," said S&P on 25 June. "Our rating relies solely on the obligation of the TRS counterparty to make interest payments and any shortfall in principal payments on the notes under the TRS agreement."

GSSMDP is rated AAA by S&P because of the joint guarantee provided by Goldman Sachs Group and Mitsui Sumitomo Insurance.

To make economic sense, any deal would have to come inside the senior unsecured levels, actual or assumed, of Goldman Sachs and Mitsui Sumitomo Insurance — "the ultimate port of call" for investors in the event of an issuer default — according to a banker familiar with the FIGSCO structure.

Mitsui CDS levels are considerably tighter than Goldman's and the banker said that the relationship would be similar for senior unsecured debt if Mitsui were to have a non-domestic currency unsecured curve, although it does not.

However, although Goldman would no doubt prefer it if Mitsui funding levels served as the pricing pivot, it appears that market participants are pricing a potential FIGSCO deal off Goldman senior unsecured levels.

"Mitsui is the third recourse and not the most pertinent reference point," said one banker.

Another banker said that "the link to a Japanese insurer is definitely a positive", but also thought about the pricing in relation to Goldman's senior unsecured curve.

He said that the pricing should reflect "amazing" risk dispersion and that to the extent a FIGSCO issue is priced off Goldman's senior curve rather than Mitsui it will offer "a lot of value". He highlighted the ultimate recourse to two entities in G3 countries, the longevity of GSMMDP's triple-A rating, and the risk dispersion as key strengths of the FIGSCO structure.

A banker suggested that pricing at a spread roughly 45%-50% of the level of Goldman's senior unsecured debt had been under discussion, with a seven year senior unsecured level of 85bp-90bp over being used as a reference.

The banker close to the FIGSCO project acknowledged that FIGSCO issuance would probably not achieve the same spread savings versus senior unsecured funding that the average triple-A covered bond would deliver for an issuer, given that most covered bonds are backed by legislation and the product is well-established. ■

DENMARK

Law impact 'insignificant' in Nykredit auctions

Nykredit sold some Dkr13bn (Eu1.74bn) of one year ARM bonds in the last week of May in the first such auctions to feature maturity extension triggers in accordance with new legislation, and market participants said the auctions, although small, show demand to be largely unaffected by the changes.

The Nykredit Realkredit auctions took place from Monday, 27 May, to Wednesday, 29 May, with bid-to-cover ratios stable around 3 times.

The auctions were the first since a new law to combat refinancing risk came into force on 1 April for bonds issued by mortgage credit institutions to fund one year adjustable rate mortgages (ARMs), although the issuer had already been selling bonds in accordance with the legislation since then. The bill comes into effect in January 2015 for maturities of more than 12 months and up to and including 24 months, and for mortgage bonds issued by banks.

The new legislation provides for the maturity extension of certain bonds and interest rate caps in certain circumstances: if a refinancing auction fails; if an auction leads to interest rates that are 5% higher than the level a year before the auction; or if the issuer is under administration or any other bankruptcy proceeding.

Nykredit's bonds were auctioned at yields-to-maturity of 0.26% to 0.27% and the group announced that the interest rate trigger that would lead to a maturity extension at next year's refinancing is 5.27%.

Lars Mossing Madsen, chief dealer at Nykredit Realkredit, said that although the auctions were small they indicated that demand was not weaker than for auctions of bonds that did not incorporate maturity extension triggers.

"It seems the changes are well accepted," he said. "As far as we can see there was no impact and the bid-to-covers are the same as before."

Jens Peter Sørensen, chief analyst at Danske Bank, said that demand was also in line with that at previous auctions, before the introduction of the refinancing legislation.

"It was business as usual," he said. "The new bonds came with a bit of a pick-up to the old ones without an interest rate trigger, but the pricing impact was not significant and bid-to-covers were very standard."

The auctioned bonds came at around 19bp-20bp over Cita, which was some 3bp-4bp wider than where older issues, which do not feature an interest rate trigger, were trading, according to Sørensen. ■

GERMANY

Helaba dual tranche combo 'right strategy'

Landesbank Hessen-Thüringen (Helaba) priced a Eu1bn dual tranche covered bond on 20 May and Martin Gipp, head of funding at the bank, said that the strategy helped it achieve tight funding levels.

The German bank issued a Eu500m three year at 7bp through mid-swaps and a Eu500m seven year at 3bp over via BNP Paribas, Citi, Deutsche Bank, Helaba, HSBC, Société Générale, UBS and UniCredit. The re-offer spreads were in the middle of the areas that had been set as initial price thoughts.

It is the second time in just under a year that the issuer opted for a dual tranche benchmark covered bond, after a Eu1bn fives and 10s combo in June 2013, and Gipp said that the format was beneficial in several ways.

"We thought that doing Eu1bn in a single maturity would require a much larger new issue premium than going through the route of a dual tranche, which proved to be right," he said. "We got pricing that was tight and the blended cost was even a better result than what we achieved with our five year deal earlier on in the year.

"So ultimately this strategy proved to be the right way."

A syndicate banker said that Helaba was able to price the tranches at impressive levels, coming very close to agency bonds.

Gipp acknowledged the tight levels at which German Pfandbriefe are trading and the difficulties this poses for secondary market performance, but said that these issues can be managed successfully, and contributed to the issuer's decision to opt for a three year tranche.

"The Pfandbrief is increasingly a product where you park your money or when you are really risk averse put your money, so it was very clear to us that three years, especially now in light of the possible rate cut by the ECB, might be a proper market to go to for many investors," he said.

This was borne out, according to Gipp, who pointed out that the three year deal attracted strong foreign demand, with 65% of the bonds allocated to international investors.

"That is quite unique for a Pfandbrief issue, where the domestic-take up in the past couple of years has been 50%-70% but in this tranche it proved to be quite the opposite," he said.

Total demand stood in excess of Eu1bn, with more than 80 accounts in the order book, according to a lead syndicate official. ■

Legislation & Regulation

RISK WEIGHTS

EBA recommends CRR tightening, best practices

The European Banking Authority has endorsed the preferential risk weights assigned to certain covered bonds but recommended tightening eligibility for such treatment. In a separate but related move it identified best practices toward which national frameworks should converge.

The recommendations were made in a report published on 1 July that delivers on two mandates the EBA had been given, one from the European Systemic Risk Board (ESRB) to identify principles of best practice in relation to covered bonds, and another from the European Commission to assess the appropriateness of the preferential risk weights for covered bonds and the associated qualifying criteria.

The report largely confirms the recommendations that the EBA previously told market participants it intended to make, as set out in a public hearing in London on 10 June.

The EBA's report provides a first comprehensive overview, from the regulatory and supervisory perspective, of EU national covered bond frameworks, and Iceland's and Norway's. This is how the EBA describes the report, but its view was backed up by external parties.

"One thing I can say at the very start is that anyone interested in different legal frameworks and how they deal with typical covered bond-specific risks will find this report to be an in depth source of detailed information," said an analyst.

The EBA said that it considers the preferential risk weight treatment assigned to qualifying covered bonds via Article 129 of the Capital Requirements Regulation (CRR) "to be, in principle, an appropriate prudential treatment".

However, while this article "sufficiently elaborates on the eligibility of asset classes, it is less specific on equally relevant aspects of the safety of the covered bond", said the EBA.

As a result, it is recommending that

EBA offices, London

further eligibility criteria be added "to cover, at a minimum, the areas of liquidity risk mitigation, overcollateralisation and the role of the competent authority, and the further elaboration of existing requirements on disclosure to investors".

More specifically, the recommendations are for: a minimum regulatory overcollateralisation level; a requirement to mitigate liquidity risk in a covered bond programme by means of liquid assets available at all times to cover total

> "It is less specific on equally relevant aspects"

net outflows over a certain time frame; requirements relating to the role of the competent authority in charge of special public supervision of the covered bonds; and clarification of disclosure criteria in Article 129 (7) by means of binding technical standards. *(See transparency feature for more.)*

The EBA was also asked to look into the preferential risk weight treatment of covered bonds backed by certain asset types, namely residential guaranteed loans, aircraft liens, and MBS.

The former should remain within the scope of preferential risk weight treatment, albeit subject to additional qualifying criteria, according to the EBA, while loans secured by aircraft liens should not. These recommendations are relevant to some French covered bonds and two NordLB aircraft Pfandbriefe, respectively.

A waiver on MBS in cover pools, meanwhile, should not be extended when it expires at the end of December 2017, said the EBA. This affects some French covered bonds.

The analysis that the EBA carried out of national regulatory frameworks and supervisory practices in the EU also provided the basis for the EBA to identify best practices in covered bonds.

"They cover crucial areas of covered bond regulation, from the dual recourse principle, segregation of cover assets and bankruptcy remoteness, composition of cover pools, loan-to-value (LTV) limits and measurement, overcollateralisation, liquidity buffers, stress testing, supervision and disclosure," said the EBA.

At the June public hearing Andrea Enria, chairman of the EBA, said that while the existence of some differences between national jurisdictions is not negative, there are "lessons to be learned from best practices" identified in existing frameworks. He and his colleagues made clear that the EBA would expect these principles of best practice to be adopted in changes made to national legal/regulatory covered bond frameworks. No single framework presently fully meets all of the principles of best practices, according to the EBA.

Covered bond analysts noted that the recommendations the EBA makes are not legal requirements. Under the CRR, the Commission has to report to the European Parliament on the issue of risk weights by the end of 2014, and the EBA is due to follow up on its interim report on best practices with another report for the ESRB by the end of June 2016. ■

CRR/CRD IV

LCR issuer rating criteria could cause demotions

A European Commission paper on Liquidity Coverage Ratios leaked in mid-June included new issuer rating eligibility criteria for covered bonds that, if implemented, would result in some double-A issues not being Level 1 eligible, and some single-A issues excluded entirely.

Meanwhile, the final decision on LCR rule is being delayed until after the summer. A Commission spokesperson said ahead of the previous deadline of end-June that this was unlikely to be met and further meetings were scheduled for July, with a decision in September seen as possible.

Europe Day 2014, European Commission, Brussels

The leaked document — which is understood to have been the basis for LCR discussions at the European Commission — included clauses that would require not only minimum ratings for covered bonds as a precondition for eligibility, but also minimum issuer ratings.

The clauses say that for covered bonds to be eligible for Level 1, not only do they need to be credit quality step 1 (i.e. rated Aa3 or AA- or equivalent or higher), but they also need to be from issuers that are rated at least credit quality step 2 (A3 or A- or equivalent or higher), or as the document puts it: "The issuer is assigned a credit assessment by a nominated ECAI which is at least credit quality step 2 in accordance with paragraphs (1) and (2) of Article 120 of Regulation (EU) No. 575/2013."

This would mean that double-A rated covered bonds from issuers rated Baa1 or BBB+ or equivalent or lower would be excluded from Level 1.

It is not clear just which ratings would be taken into account and exactly how, but the new criterion raises questions about the eligibility of double-A rated covered bonds from issuers such as Austria's Bawag and Kommunalkredit Austria, Germany's Deutsche Hypothekenbank and Deutsche Pfandbriefbank, and the UK's Clydesdale Bank and Yorkshire Building Society, which would otherwise be eligible for Level 1 but could be excluded because the issuers have ratings below the new cut-off.

Recent documents from the Commission have also indicated that a Basel requirement for a double-A rating for eligibility as Level 2A assets has been relaxed to single-A, but some covered bonds that would benefit from that might now miss out if the issuer rating criteria are included: not only do covered bonds have to be credit quality step 2 to be eligible for Level 2A, but issuers have to be investment grade rated (the wording is the same as for Level 1, as above, except that "step 2" is replaced by "step 3"). As a result of this, the Level 2A eligibility of the covered bonds of several issuers from peripheral jurisdictions appears to be under threat, but a greater difference between the ratings assigned by different rating agencies for such issuers and the lack of clarity on the exact criteria for defining the ratings clauses makes it difficult to pin these down.

> "It ain't over till the fat lady sings"

A market participant noted that the relaxation of the rating criteria for covered bonds had been key to winning support from a broader range of countries for covered bonds' status in LCRs, and that this might now be an issue again, while the threatened narrowing of eligibility for Level 1 could be just as sensitive a development. He said that the industry is already lobbying against the issuer criteria.

A covered bond analyst cautioned that many such details are still subject to change during the Commission's finalisation of its decision.

"It ain't over till the fat lady sings," she said.

The leaked document was more encouraging for non-EU issuers, as it includes a dedicated section in the definition of Level 2A assets regarding the inclusion of covered bonds from "third countries". This broadly reflects the Level 2A requirements for EU covered bonds, with the main difference being a clause defining legislative covered bonds without reference to EU regulations:

"They must be covered bonds in accordance with the domestic law of the third country which must define them as debt securities issued by credit institutions and secured by a cover pool of assets, in respect of which bondholders shall have direct recourse for the repayment of principal and interest on a priority basis in the event of the issuer's default." ■

ELIGIBLE ASSETS

ECB gives CRD verdicts in new data field

The European Central Bank has added a field to its eligible assets database detailing whether or not covered bonds are CRD-compliant, lending its view on a topic that has provoked debate among some market participants after transparency requirements were added under CRD IV/CRR.

The new field went live on the ECB website on 22 May, according to a document released by the central bank (which also detailed two other changes to the eligible assets list it maintains).

The covered bond field, "CRD_or_equivalent", has four options, with the ECB having detailed their meaning thus:

- **CRD_COMPL:** the covered bond is CRD-compliant.
- **EQUIVALENT:** the covered bond is not CRD-compliant but equivalent legal safeguards exist.
- **NO:** the covered bond is neither CRD-compliant nor are there any equivalent legal safeguards. Thus, the provisions as laid down in the "General framework" concerning close links do apply.
- **N/A:** covered bonds issued under non-euro area EEA legislation (e.g. Norway) and non-EEA G10 national frameworks (e.g. USA) where no legal assessment has yet been carried out will only be assessed on request following receipt of a specific legal opinion commissioned by the counterparty that intends to use the asset.

The database included at launch some apparent inconsistencies — with some BPCE SFH covered bonds being tagged as CRD-compliant and others not, for example — but appears for the most part consistent with expectations.

New ECB premises, Frankfurt

Under Article 129 of the CRR, covered bonds are eligible for preferential risk weighting treatment if investors can demonstrate that they have received certain information on covered bonds and their underlying collateral, and some market participants have suggested that the level of transparency provided by many issuers raises questions over CRD-compliance — although others have played down the issue. Meanwhile analysts have said that ambiguity over just what the regulation implies, particularly with regard to information about currency and interest rate risks, has exacerbated the problem. *(See transparency feature for more.)*

Florian Eichert, senior covered bond analyst at Crédit Agricole, said that the central bank had done the market "a major favour" by adding the field.

"Investors still have to make a case for each assets' risk weight with their individual regulator," he said Florian Eichert, "but making that case has just become a whole lot easier and straightforward in my view.

"That said, I would also think that the ECB field does not prevent investors from trying to make a case that differs from the ECB assessment (multi-cédulas are a 'no' in the ECB's eyes, for example)."

However, despite welcoming the ECB's addition of the field, DZ Bank analysts said that in their understanding the ECB categorisation does not relate to Article 129 rules that came into effect on 1 January, including the aforementioned information requirements, but only those that were previously applicable.

"When we asked the central bank about this, we were told that they are presently looking into the issue," they said. "Our contact also stressed that the ECB's classification relates solely to the treatment of covered bonds within the ECB's collateral framework and does not have a binding effect on the bonds' regulatory treatment.

"This leads us to conclude that when investors examine covered bonds' preferential capital treatment within the meaning of Article 129 CRR, they should not rely on the ECB's categorisation of a bond as CRD-compliant but only take this flag as an indicator of possible capital privileging.

Meanwhile, Luca Bertalot, head of the European Covered Bond Council, said that CRD IV/CRR-compliance is clearly the regulatory benchmark for the future.

"European regulators will use it as basis for convergence, so we are not surprised by this move," he told *The CBR*. "In 2013 the Label committee analysed and discussed this topic in depth and decided to fully align the Label to the CRR." ■

"There have to be certain safeguards" page 30

OSFI

Covered bonds Level 2A LCR-eligble in Canada

Canada's financial regulator has designated Canadian covered bonds as LCR eligible assets, with Level 2A status, a move that an analyst said could pave the way for Canadian issuance to count toward liquidity buffer requirements for European bank treasuries.

The Office of the Superintendent of Financial Institutions (OSFI) issued Liquidity Adequacy Guidelines on 30 May, in which covered bonds are identified as Level 2A assets, subject to a 15% haircut.

According to the text of the guidelines, covered bonds must satisfy the following conditions to be eligible for 2A status (Article 45 b)):

- either (i) have a long term credit rating from a recognised external credit assessment institution (ECAI) of at least AA- or in the absence of a long term rating, a short term rating equivalent in quality to the long term rating; or (ii) do not have a credit assessment by a recognised ECAI but are internally rated as having a probability of default (PD) corresponding to a credit rating of at least AA-;
- [be] traded in large, deep and active repo or cash markets characterised by a low level of concentration; and;
- have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions: i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 10%. [BCBS January 2013, para 52]

To count as Level 2A assets the covered bonds cannot be issued by the institution itself or any its affiliated entities.

OSFI said that the implementation date of the Liquidity Coverage Ratio (LCR) standard is 1 January 2015, adding that Canadian issuers will be required to have 100% of the minimum LCR requirement by that date.

"No phase-in period will be permitted," said OSFI. "OSFI believes that Canadian institutions are well positioned to the meet the proposed LCR requirement in advance of January 2015."

Canada introduced covered bond legislation in July 2012. ■

GERMANY

BaFin OC powers look good, but devil in the detail

A proposal to grant BaFin powers to set individual minimum OC levels for German Pfandbriefe may prove credit positive, but rating implications, including potential cuts of highly rated issuance, depend on important details that are as yet unknown, according to Fitch.

Fitch said in mid-May that the proposal would enable BaFin, the German financial supervisory authority, to impose minimum overcollateralisation (OC) requirements programme by programme, which it could recommend be higher than the prevailing legal minimums (0% on a nominal or 2% on a stressed net present value basis). As an administrative act, BaFin's decision would be binding on the issuer, effectively superseding the prevailing legal minimum requirement, said the rating agency.

It said that the proposal may prove credit positive by increasing compulsory protection.

"The mandatory nature of BaFin's decisions would eliminate the risk that if an issuer were facing insolvency it could remove assets from the cover pool to the new, higher minimum OC level," said Fitch.

However, it emphasised that important details remain unknown, such as how BaFin would assess credit and market risk in covered bond programmes and how frequently it would review OC levels or reflect changes in market conditions. The rating implications of the proposal are unclear, said the rating agency, citing the possibility of upgrades and downgrades.

"Existing legal minimum OCs are insufficient to withstand our stresses for a timely payment of Pfandbriefe in rating scenarios above the issuer's rating, and raising legal minimum OCs could result in upgrades," it said. "But if the proposal reduced the cover assets available to secure investor claims, the new legally required minimum OC might be incompatible with existing high ratings."

The latter relates to questions about the proposal's potential impact on asset segregation, specifically about the treatment of voluntary OC held above BaFin's required minimum, according to Fitch. It said that the excess OC may imply that a corresponding proportion of cover assets would be deemed "obviously not needed" to repay Pfandbriefe, in line with existing provisions in the Pfandbrief Act.

"This could increase the risk that, following enforcement of the recourse against the cover pool, the administrator could successfully demand the transfer of cover assets to the issuer's general insolvency estate, arguing that BaFin has set the level of OC necessary to pay back investors," said Fitch. ■

FRANCE

'Inappropriate' regs seen undermining CRH

The application of new bank regulations to Caisse de Refinancement de l'Habitat could result in a reduction in its activity and in a worst case scenario prompt its wind-down, Barclays analysts have warned, arguing that such treatment would be "inappropriate", while CRH's chairman told *The Covered Bond Report* that investors are unaffected by the matter.

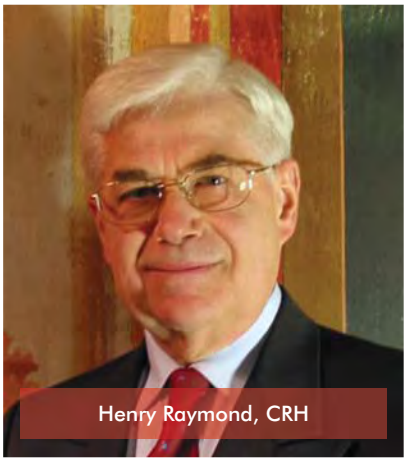
CRH issues covered bonds to raise funding on behalf of its shareholders, which are the major French banks, from whom it receives promissory notes backed by residential mortgages. It is governed by its own legislation and is the largest issuer of euro benchmark covered bonds with Eu50bn outstanding, according to Barclays research published in late May.

However, according to the analysts, it appears that the French authorities are applying standard bank regulations to CRH with respect to areas related to the ECB's comprehensive assessment and asset quality review, while the leverage ratio and large exposure limits are other issues over which there is uncertainty.

They cite, for example, a request by the French regulator (Autorité de Contrôle Prudentiel et de Résolution, ACPR) that CRH increase its Common Equity Tier 1 ratio from 5.7% to 10%, noting that the ECB will require a level of 8% in its baseline scenario. CRH has since presented to its shareholders a plan to raise up to Eu300m of extra capital.

CRH could also fall foul of leverage ratio requirements, according to the analysts, with Eu312m of equity against Eu53.1bn of assets as at 31 December 2013 giving it a (simplified) leverage ratio of 0.6% — against a target of 4%+ for most major banks in Europe on a fully-loaded CET1 basis and including Additional Tier 1 (AT1). They note that even after the planned equity increase CRH's leverage ratio would only move up slightly, to around 1%.

"In fact, in order to reach the lower limit of the 3%-4% target range of most European banks, CRH would need to further increase its capital by another Eu1bn, a level which would make funding through CRH unattractive to its stakeholders," said Barclays analysts. "The other alternative would be to more than halve its balance sheet and shrink it by about Eu35bn."


Henry Raymond, CRH

"For investors, there is no issue at all"

"According to our calculations, assuming a target return of equity of 10%, French banks may require 5.5bp-6bp of lower funding costs from CRH versus issuing covered bonds in their own name," they added. "Following the capital increase, the threshold will increase by another 4bp-4.5bp. Currently, there is hardly any spread differential between CRH bonds and covered bonds issued by its stakeholders in their own name."

Barclays analysts argue that it would be inappropriate for CRH to face such a fate.

"Beyond the pure funding costs, using CRH has some other advantages for the major banks," they said. "In particular, it allows them to diversify funding and access capital markets in difficult times without putting an additional strain on counterparty risk limits of their investors.

"CRH was the only French issuer tapping the capital market with new benchmark issues shortly after the Lehman crisis in Q4 08. Its unique business model and status is the reason why it has developed into a major contributor to the funding of the French housing market."

Indeed, they said that lawmakers and bankers from other countries have enquired about the CRH model with a view to developing similar platforms.

The analysts therefore suggest that — with full exemption from CRD IV/CRR difficult — CRH be given exemptions with respect to individual items, in particular those relating to leverage, liquidity risk and large exposures.

In the meantime, they expect the uncertainty over how CRH will be affected by regulation to continue to subdue its issuance activity and its balance sheet to shrink. CRH's last euro benchmark issuance was a Eu500m January 2025 deal in June 2013.

Henry Raymond, chairman and chief executive of CRH, acknowledged that discussions regarding the regulation of CRH are ongoing and that this explains why it has not been issuing.

However, he said that the uncertainty does not affect the quality of CRH covered bonds.

"For investors, there is no issue at all," said Raymond, "because, firstly, the CRH mechanism is a pass-through, which is to say that the servicing of our debt is done by the French banking system. Secondly, if we don't issue bonds it is no problem for us because we make no fees on the deals, so it is not necessary for us to issue to generate any margins for paying our debt.

"And thirdly, our shareholders have decided to maintain our status as a European credit institution, so there is also no issue regarding the status of our issuance as covered bonds." ■

CONFERENCE

Covered a technique, not a brand, says Haas

Covered bonds are safe and resilient instruments that play a major role in financing the real economy and this needs to be preserved, but the industry should not shy away from innovation, with covered bonds arguably best understood as a technique rather than a brand, François Haas, deputy director general operations and director of financial markets operations, Banque de France, told delegates at the ICMA CBIC-The CBR conference on 15 May.

Delivering the keynote address at the third annual Covered Bond Investor Conference, held by the ICMA Covered Bond Investor Council and The Covered Bond Report in Frankfurt, Haas said that covered bonds are "one of the major success stories" of the European financial industry and that the soundness and quality of the asset class is recognised by favourable prudential treatment. Regulation also recognises the important role they play in financing the real economy, he said, citing the Bank Recovery & Resolution Directive (BRRD) and EU Green Paper on long term financing as examples.

But while covered bonds have developed a good reputation the covered bond industry has to keep pace with market developments, said Haas, with transparency needing to improve and legal frameworks updated.

In addition, he suggested that in the context of negative net issuance and pressure on the profitability of traditional covered bond collateral, the covered bond market should be more open to innovation, and offered a new way of thinking about what defines a covered bond.

François Haas, Banque de France

"What is a covered bond?" he asked. "Is it a technique or a brand?"

Coming down on the side of technique, Haas said that in the context of challenges to banks' ability to finance the real economy and investors' search for diversification, covered bonds could have a role to play as an alternative means of financing of the real economy, with Commerzbank's SME hybrid covered bond structure such a development in the covered bond market.

> "The covered bond universe is not intangible"

The covered bond industry should not fear a loosening of the product's standard, he said, and although creating and monitoring SME cover pools requires more expertise there is scope for the covered bond technique to be applied to SME assets. The Cola (COvered bond Look-Alikes) working group of the ICMA Covered Bond Investor Council has a role to play here, said Haas.

The instrument has an important role to play in a fast moving market alongside securitisation, which is reinventing itself, according to Haas.

"The covered bond universe is not intangible", he said, and the industry "should not shy away from innovation", although it is important that certain standards be preserved and others improved, such as transparency. In this context there is scope for the ECBC Covered Bond Label initiative and ICMA CBIC transparency template initiatives to converge and ensure that covered bonds continue to play a major role as a tool for financing the real economy. ■

See pages 24-27
for photos from the
ICMA CBIC-The CBR conference
and also the winners at
The Covered Bond Report
Awards for Excellence 2014

Ratings

AUSTRIA

Moody's 'aggressive' after HAA decision

Moody's downgraded 13 Austrian banks and then three issuers' public sector covered bonds in late June because of a government decision to void a federal state guarantee of HAA subordinated debt, with an analyst seeing the rating actions as "extremely aggressive".

The covered bond downgrades came on 23 June after Moody's had a few days beforehand cut the ratings of 13 Austrian banks, which in turn followed a 11 June proposal by the Austrian government to enact legislation designed to allow the government to bail-in nationalised Hypo Alpe-Adria-Bank's (HAA) subordinated debt-holders and void a State of Carinthia deficiency guarantee on that portion of the bank's debt.

"The unprecedented nature of the government's decision to place taxpayers' interests above the rights of creditors who had previously benefited from a public sector guarantee indicates, in Moody's opinion, that Austrian authorities are now generally more willing to countenance bank resolutions in which losses may also be imposed on senior creditors," said the rating agency.

"As a result, [the] rating actions reflect Moody's decision to lower its assessment of the probability of systemic support being made available for all Austrian banks, as well as very limited value Moody's now places on deficiency guarantees for senior unsecured debt only, to ensure full and timely payment of interest and principal of related debt obligations."


Hypo-Alpe-Adria, Klagenfurt

The rating agency downgraded Hypo Alpe-Adria-Bank International guaranteed public sector covered bonds from A1 to Baa3 and unguaranteed public sector covered bonds from A3 to Baa3. It cut Hypo Tirol guaranteed public sector covered bonds from Aaa to Aa1 and unguaranteed public sector bonds from Aa1 to Aa2. Moody's also downgraded public sector-backed covered bonds issued by Kommunalkredit Austria (KA), from Aa2 to Aa3.

This followed a downgrade of the issuer's senior unsecured rating from Baa3 to Ba1, after which KA announced that it had ended all ratings for unsecured funding instruments from Moody's, only keeping its public sector covered bond rating.

The bank said that this decision had been taken due to differences in opinion between Moody's and itself regarding the propensity of the Republic of Austria to support the Austrian banking sector.

Bernd Volk, head of covered bond research at Deutsche Bank, said that HAA is a very specific case, and that the downgrades announced by Moody's "clearly lack differentiation". He added that the rating actions and tone of the Moody's announcement is "extremely aggressive". ■

GERMANY

Depfa wind-down removes downside rating risk

Soffin and the HRE Group will wind down Depfa Bank plc rather than sell it, it was announced in mid-May, a decision that led to S&P removing its rating of Depfa and its core subsidiaries from CreditWatch negative (CWN).

Depfa had been put up for sale as part of a state aid agreement with the European Commission when the HRE group was given government support at the height of the crisis.

However, with private equity houses among the leading potential acquirers there had been fears that such a sale could result in Depfa covered bonds being downgraded.

The Federal Agency for Financial Market Stabilisation (FMSA) on 13 May said that the sale had been called off and that Soffin (the Financial Market Stabilisation Fund) and the HRE group will prepare Depfa for wind-down via FMS Wertmanagement, which is the existing wind-down entity for ex-HRE assets.

Standard & Poor's reacted to the development several days later by removing its BBB rating of Depfa and its core subsidiaries from CWN and keeping it on positive outlook.

Moody's a day later upgraded public sector covered bonds issued by Depfa ACS Bank, from A1 to Aa3, but this was because it had raised the Irish country ceiling and not because of the Depfa sale having been called off. ■

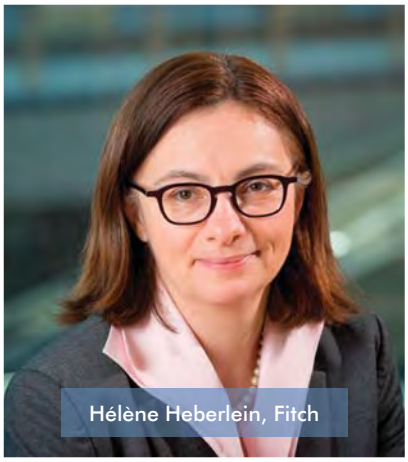
FITCH

Encumbrance stable, less of a 'red flag'

Encumbrance from cover pools has remained broadly stable over the past three years, with average levels decreasing at French, German and Spanish banks in 2013 but small increases in most other countries offsetting this, according to Fitch.

The rating agency said in its latest report on covered bond-related asset encumbrance on 12 June that cover pools alone constitute noteworthy encumbrance only for a small number of rated banks: of 142 entities in the sample, 15 have encumbrance above 50% of end-2013 adjusted assets, of which only six are above 70%. Almost 70% of issuers in the sample had a cover pool encumbrance of below 20% of adjusted assets as at the end of 2013, according to Fitch. Total outstanding covered bonds sold to the market from banks included in Fitch's report decreased by 6% in 2013, said Fitch.

Hélène Heberlein, managing director of Fitch's covered bond team, said



Hélène Heberlein, Fitch

that subdued issuance last year means the topic of asset encumbrance has been "less of a red flag" than in previous years, but that this report on banks' encumbrance levels remains popular with market participants.

"I assume users of our ratings like to reassure themselves that covered bonds are not a major source of concern from an asset encumbrance point of view!" she said.

Encumbrance remains highest at Scandinavian, German and Spanish banks, with Landshypotek, Realkredit Danmark and Nykredit Realkredit ranking highest.

"Asset encumbrance above 80% is a reflection of their business models, based on covered bond funding," said the rating agency.

Average encumbrance fell at German, French and Spanish banks in 2013, according to Fitch, reflecting deleveraging and a reduction in eligible public sector assets in Germany, a focus on senior unsecured issuance in France, and a mix of asset and liability changes in Spain. This was offset by small increases in most other countries.

"Fitch believes that covered bond funding can be a stable form of funding, particularly in markets where households invest a significant amount of their financial wealth outside the traditional banking system," added the rating agency. "This is especially the case in Scandinavia." ■

SPAIN

Sovereign, issuer moves feed cédulas upgrades

Standard & Poor's upgraded five Spanish covered bond programmes in May and June, mainly because of a chain of positive rating actions that started with an upgrade of the sovereign in late May.

S&P upgraded Spain from BBB- to BBB on 23 May and changed its outlook from negative to stable, citing improving economic growth and competitiveness as a result of the country's efforts in structural reform since 2010.

It then upgraded Banco Santander, Banco Bilbao Vizcaya Argentaria (BBVA), and Bankinter, and raised its outlook on five other Spanish financial institutions.

These actions then led to upgrades of three cédulas hipotecarias (CHs) and one cédulas territoriales (CT) programmes on 11 June. BBVA CHs and CT were upgraded from A- to A and from BBB to BBB+, respectively, while Bankinter CHs were lifted from A to A+, and Deutsche Bank SAE CHs from AA- to AA.

The outlook on CaixaBank CHs was improved from stable to positive and on Kutxabank CHs from negative to stable, in line with changes to the outlooks on the issuer ratings.

Separately, S&P also upgraded Bankia and BBVA CHs after the issuers carried out early redemptions of retained deals, which led to overcollateralisation (OC) increasing.

Bankia's mortgage covered bonds were upgraded from BBB to A-, and BBVA's from A to AA-.

Multi-cédulas also benefitted from the improvements in the Spanish economy and associated positive rating actions, with S&P upgrading 14 on 23 June. The new ratings range from BBB- to AA, after upgrades of one to two notches.

Analysts have, however, noted that S&P is working on a new sovereign ceiling methodology that could reverse some of the covered bond upgrades.

S&P cut Barclays Bank SAU covered bonds from AA- to A over the second quarter, after downgrading the issuer because S&P considers it to be of lower strategic importance for its UK parent. ■

FRANCE

OC rise among positive changes to OFs, OHs

Changes to the legal framework for obligations foncières and obligations de financement de l'habitat came into effect at the end of May and have been deemed credit positive by Fitch and Moody's, although Fitch warned that some of the decree's goals may not be fully met.

The amendments have as their overarching goal to improve the regulatory regime for secured obligations, which includes making issuers of obligations foncières (OFs) and obligations de financement de l'habitat (OHs) more resilient to an insolvency of their parent entity by limiting their exposure to the sponsor bank and reinforcing their liquidity.

The changes came into force on 28 May and Cristina Costa, senior covered bond analyst at Société Générale, said that they are as expected after they were first flagged at a European Covered Bond Council plenary in April.

"There aren't any surprises," she said.

Fitch outlined four key changes to the legislation: an increase in legal minimum overcollateralisation (OC) from 102% on a nominal basis to 105%; restrictions on asset-liability maturity mismatches; a cap on intragroup exposure; and a requirement for OF and OH issuers (sociétés de crédit foncier (SCF) and sociétés de financement de l'habitat (SFH)) to prepare living wills.

Moody's said that raising the legal minimum level of OC to 5% will probably increase the value of collateral in the event of a covered bond anchor event. It noted that while it considers sponsor ratings and contractual commitments to maintain OC, it sometimes gives limited to no value to voluntary OC that can be removed prior to an anchor event.

Moody's said that a change to the legal definition of OC relating to intra-group loans is also credit positive, as it strengthens the OC test. According to the rating agency, the new legislation states that when intra-group loans in the cover pool exceed 25% of the value of the issuer's non-privileged liabilities, a portion of such loans will be excluded for the purpose of calculating the OC test.

French Ministry of Finance, Bercy

"This adjustment is credit positive because it limits the risk that covered bond issuers rely on assets directly exposed to the credit quality of their parent or any of their affiliates," said Moody's. "Upon a covered bond anchor event, these assets are likely to have limited value because of a high default correlation within the sponsor group."

Fitch said that the higher minimum OC requirement is credit positive, but would still not cover credit losses and asset and liability mismatches in most rating scenarios.

"Our assessment will therefore continue to place more weight on commitments of issuers to maintain OC above breakeven levels, currently ranging between 5.2% and 38.9%, which Fitch deems compatible with covered bond ratings," it said.

Another change, according to Fitch, is that from 2016 the weighted average life (WAL) of assets should not exceed the WAL of liabilities by 18 months, although this provision only applies up to the minimum legal OC of 105%.

"This should result in lower asset and liability mismatches and could lead to a reduction in the level of OC compatible with the different rating scenarios," said the rating agency.

It noted that diversification would be encouraged as a result of the limit on intragroup exposure at 25% of non-privileged resources and it no longer being possible to meet an existing six month liquidity requirement with an intragroup liquidity line, but that these changes may not reduce exposure to the parent as much as intended.

"This is because it is still possible to cover a liquidity gap with secured loans or promissory notes, which are not considered as an exposure to the parent under the revised framework," said the rating agency. "In Fitch's opinion, although this would improve the recovery prospects for the SCF or SFH in a parent insolvency by making them a secured creditor, it may not provide the programme with immediate liquidity when needed, depending on the nature of the security."

The other key change, according to Fitch, is that SCFs and SFHs will have to prepare living wills that identify the employees and systems required to run the issuers on a standalone basis if the parent were insolvent. The rating agency said this could "reinforce the comfort we take from cover pool-specific alternative management provisions as a component of our Discontinuity Cap". ■

"I expect greater diversification in bank funding," page 40

BRRD

Covered resilience boosted, but IDRs weigh

Covered bond ratings are more resilient as a result of Fitch updating its criteria to take into account the asset class's treatment under the EU bail-in framework, but this does not always compensate for weakening state support, it said.

Fitch implemented updated criteria in March to take into account the exemption of covered bonds from bail-in under the Bank Recovery & Resolution Directive (BRRD), where applicable assigning additional notches of uplift to covered bonds it rates.

The rating agency on 30 May said that covered bond ratings' sensitivity to potential Issuer Default Rating downgrades declined as a direct consequence of the IDR uplifts, but that the proportion of IDRs on negative outlook has increased from 16% to 42% due to weakening state support.

Fitch said that it has incorporated an aggregate 109 notches of IDR uplift into its covered bond analysis, with 40 programmes provided with an IDR uplift of two notches, and 29 an uplift of one.

Santander: First beneficiary of Fitch criteria update

"Despite this larger cushion, the perspective for covered bond ratings has only improved modestly, with 11 ratings on positive outlook, as the potential downgrade of a support-driven IDR is not always compensated by IDR uplifts," it said.

In contrast to the positive impact for covered bond ratings under BRRD, the proportion of IDRs on negative outlook has increased from 16% earlier this year to 42%, noted Fitch, reflecting the rating agency's belief of reduced state support for banks in the event of issuer default.

An upgrade of Santander cédulas hipotecarias from A to AA- on 4 June was the first Fitch covered bond upgrade linked to the rating agency's updated criteria. ■

S&P

Change still in store despite limited bank impact

Standard & Poor's upgraded Realkredit Danmark senior secured issuance and revised the outlook on pbb covered bonds plus a non-benchmark issuer's programme on 7 May, as numerous BRRD-inspired bank rating actions — mainly negative — had only a limited knock-on effect on the covered bond market.

S&P revised the outlook and ratings of various European banking groups on 29 April following a review of its expectations for government support linked to the introduction of bail-in frameworks. S&P then in early May said that the rating actions had a limited impact on its ratings of covered bonds, with only four programmes that it rates affected.

The limited effect is either because the number of notches of rating uplift available to the covered bonds exceeds the number required for the prevailing rating level, or because the covered bonds' rating is not linked to the issuer credit rating, according to S&P.

Michael Spies, strategist at Citi, noted that S&P's "overhaul of government support assumptions" only had a limited effect on secured debt but that rating flux still lies ahead.

"Firstly, the agency has still not published the results of the attempt to introduce a sovereign cap for covered bond ratings," said Spies. "The request for comment (RFC) was published during the fourth quarter of 2013. Introducing such caps would mostly impact relatively highly rated covered bonds in Italy and Spain, including multi-cédulas."

He also noted that S&P is planning to modify its covered bond rating criteria to reflect the asset class's exemption from bail-in under the BRRD.

The covered bond rating changes resulting from S&P's European bank rating actions were outlook revisions, from stable to negative, on two Deutsche Pfandbriefbank (pbb) programmes and the covered bond programme of Crédit Foncier et Communal d'Alsace et de Lorraine Société de Crédit Foncier (CFCAL SCF), although the latter has not issued benchmark covered bonds. Realkredit Danmark section 15 bonds – senior secured issuance – were upgraded from A- to A and the outlook revised from stable to negative, with parent Danske Bank having been upgraded. ■

Industry moves

BRUSSELS

ECBC, EMF in merger, Bertalot replaces Lambert

The European Mortgage Federation and European Covered Bond Council are merging, with ECBC chairman Carsten Tirsbæk Madsen saying that the move should help their lobbying efforts by highlighting the relationship between covered bonds and mortgage borrowers.

The ECBC was created by the EMF in 2004 and the two have worked closely together in the same premises. The merger was approved by the ECBC's steering committee and the EMF's executive committee, as well as on 3 June by the EMF's general assembly.

The two "brands" of the EMF and ECBC will be retained, said Madsen, because they each have value among their respective stakeholders, but they will be run under an umbrella body, the Covered Bond & Mortgage Council (CBMC). The respective leaderships of the EMF and ECBC will remain, although the umbrella entity will have a board comprising three ECBC representatives and two EMF officials. Antonio José Béjar González, chief executive officer of Banco Bilbao Vizcaya Argentaria, is president of the EMF.

Madsen *(pictured)*, who is also CEO of BRFkredit, said that the merger will help the organisations' efforts in Brussels.

"We are bringing together the asset and liability sides because when we are lobbying, very often the best way to get in touch

with other stakeholders, and politicians in particular, is also by taking up an issue from the consumer angle, because these are their constituents," he told *The CBR*. "Our experience from Denmark and other countries where this has been done is that we are in a unique position of always being able to get air time, because when it comes to voters and their finances this is something that matters for politicians.

"And when something is hurting covered bonds, it is hurting mortgages and the borrowers or those seeking finance. The bringing together of the whole value chain therefore makes sense."

Although the joint organisation will bring together covered bonds with the lending side of the mortgage industry, it will not represent another key form of mortgage finance: securitisation.

"We will, however, have expertise in that type of financing within the organisation and be capable of participating in any debates on that topic," said Madsen.

Meanwhile, Luca Bertalot has taken over as secretary general of the EMF and ECBC, with his predecessor Annik Lambert having left at the end of June.

Bertalot has hitherto been head of the ECBC, and has also been deputy secretary general of the EMF, having joined in 2006. Before joining the ECBC, Bertalot worked as a financial analyst in Italy and Australia.

Lambert had been secretary general of the EMF-ECBC since 2005, having joined the EMF in 1992 as head of legal affairs and been appointed deputy secretary general in 1995.

"We are sorry to see Annik leave the EMF-ECBC after so many years, but we wish her every success in her future plans," said Béjar González and Madsen in a joint statement. "However, we are delighted to be able to announce Luca Bertalot as Annik's successor. With Luca's breadth of knowledge and experience of the industry, and keenness to take on this role, we are confident that he has the skills to drive the EMF-ECBC forward and face head-on the challenges of the new regulatory environment." ■

DCM

McCormick to CS, Millward steps up at HSBC - Noé exits DB

Michael McCormick is joining Credit Suisse in early July as head of origination from HSBC, which has appointed John Millward to replace him.

McCormick will report to Marcus Schulte, head of financial institutions DCM in EMEA, at Credit Suisse. McCormick was director, structured finance, and co-head of covered bonds at HSBC, where he had worked for some 10 years.

Credit Suisse's previous head of covered bond origination, Richard Kemmish, left the firm in February and is working as an independent consultant.

Following McCormick's departure, John Millward has become co-head of covered bonds alongside Hugo Moore, who already held the position. Millward, a director in structured finance at HSBC, reports to Scott Dickens, global head of structured finance. Millward joined the bank in 2006.

● Mauricio Noé has left Deutsche Bank, where he was a managing director and head of covered bonds. He joined Deutsche in 2009 from RBS, having worked at ABN Amro since 1998. Noé and Deutsche Bank declined to comment.

League Table

EURO BENCHMARK COVERED BOND RANKING*				
1 January 2014 to 30 June 2014				
Rank	**Bookrunner**	**Deals**	**Amount Eu (m)**	**Share %**
1	Natixis	30	5,592.86	8.25
2	UniCredit	36	5,241.07	7.73
3	BNP Paribas	26	4,950.00	7.30
4	Commerzbank	28	4,341.67	6.41
5	Barclays	23	4,225.00	6.23
6	Crédit Agricole	24	3,554.17	5.24
7	HSBC	21	3,333.33	4.92
8	SG	18	3,157.74	4.66
9	UBS	16	2,805.36	4.14
10	Deutsche	19	2,759.52	4.07
11	DZ	16	1,954.17	2.88
12	Danske	11	1,950.00	2.88
13	LBBW	12	1,550.00	2.29
14	RBS	8	1,462.50	2.16
15	JP Morgan	9	1,350.00	1.99
16	Credit Suisse	9	1,332.74	1.97
17	Citi	7	1,304.17	1.92
18	BayernLB	10	1,225.00	1.81
19	NordLB	10	1,041.07	1.54
20	ING	7	1,016.67	1.50
21	Nordea	6	975.00	1.44
22	ABN Amro	4	871.43	1.29
23	Nomura	6	845.83	1.25
24	Goldman Sachs	6	833.93	1.23
25	Santander	4	716.67	1.06
TOTAL			**67,775.00**	

*Criteria: euro denominated syndicated covered bonds of Eu500m or greater and taps thereof.

This league table is 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.

The CBR Awards for Excellence 2014

The Covered Bond Report held its **Awards for Excellence 2014** at MainNizza, Frankfurt on 14 May, kindly supported by sponsor Morrison & Foerster. *See box, right, for details of the winners.*

MainNizza, Frankfurt, 14 May

1: Issuer: **Helaba**
2 (left): Overall bank: **BNP Paribas**
3: Debut: **La Banque Postale**
4: Bank - Euros: **UniCredit**
5: Investor Relations: **Caffil**
6: Innovation: **NIBC Bank**
7: Deal - Ex-Europe: **CIBC**
8: Deal - Peripheral: **UBI Banca**
9: Editor's Award: **Nykredit**

The Covered Bond Investor Conference

Steigenberger Frankfurter Hof, 15 May

The Covered Bond Report and the **ICMA Covered Bond Investor Council** jointly hosted the Covered Bond Investor Conference at the Steigenberger Frankfurter Hof on 15 May

Covering all bases

Royal Bank of Canada opened the new era of legislative Canadian covered bond issuance in July 2013. On 12 June it launched its latest euro benchmark — a Eu1bn five year priced at 7bp over mid-swaps — to round off a busy 12 months that has also taken in the US and Australian markets. David Power, vice president, corporate treasury at RBC, discussed the bank's strategy and the latest regulatory developments with *The Covered Bond Report*.

***The Covered Bond Report*: You have been issuing under the new Canadian legislative framework for around a year. What are the key benefits of having this in place? Has it made a difference to how Canadian covered bonds are perceived in the market, particularly euros?**

David Power, RBC: Of course it is helpful, and the legislation aspect is now being tied to certain regulatory requirements for liquidity treatment, so we are very happy to have this in place. Legislation has helped us further strengthen our programme, for example, through the introduction of indexing requirements.

***The CBR*: What brought about your latest euro transaction?**

Power, RBC: The transaction was part of our normal funding. We are constantly monitoring the market.

The five year maturity was attractive on a dollar Libor basis, and it's a typical maturity for us. We will occasionally issue longer or shorter, but that's right in the middle of the range that we would

normally look at with our transactions.

***The CBR*: Some market participants suggested that your approach with the new issue, with regard to size and pricing, may have been influenced by the underperformance of previous transactions. Was this the case?**

Power, RBC: The broader picture is that those were very large transactions and we've just adjusted our approach to be more in line with where the market has moved. There was a time when those sized transactions were not uncommon, but the market, by virtue of how it votes through pricing, really wants transactions more in the Eu1bn range for issuers like ourselves, so we are really just adjusting to that reality.

There may be some investors who say they like the larger deals, but that's not evident through the pricing.

***The CBR*: The treatment of covered bonds in LCRs in Canada was recently decided. Are you satisfied with the outcome?**

Power, RBC: OSFI has generally followed the Basel III guidelines very closely, so there was not really much surprise from our perspective.

***The CBR*: Canadian covered bonds look set to be eligible for LCRs under CRD IV as Level 2A assets, whereas they would typically be eligible as 1B if they were from the EU and hence UCITS-compliant. What is your view on this?**

Power, RBC: First, my view is that the investors that are held to the requirements have the most relevant opinions on this topic.

My opinion on it is that bank regulations should be risk-based, rather than creating arbitrary distinctions between developed nations. For example, there generally are not different rules where if a bank makes a loan to a US-based company as opposed to Canadian-based company we are supposed to treat those differently for capital purposes.

However, the worst case scenario — of Canadian and other non-EU covered bonds being completely excluded — would have been quite bad — like the US situation, where covered bonds are not LCR eligible at all. If our bonds had suffered that fate at a time when EU covered bonds were actually being promoted into a better category, that would have been incredibly tough given that banks are about half of the investor base. So I think overall it's not such a bad outcome.

David Power, RBC: "Bank regulations should be risk-based"

"Overall it's not such a bad outcome"

***The CBR*: Are there other areas where the EU/non-EU playing field is not level? What should be done about this?**

Power, RBC: There are a number of public documents from Basel, etc, that have looked at the consistency of implementation of regulatory rules. I would refer you to those rather than make any specific comments.

***The CBR*: Is the ECBC a good/appropriate vehicle for your concerns? Is the Label initiative something that you are keen for Canadian covered bonds to be a part of?**

Power, RBC: We would potentially be interested in the Label providing it was based solely on risk-based criteria.

***The CBR*: You are among the most active issuers internationally in terms of having been active in three currencies in the past 12 months. How do you determine your strategy across currencies?**

Power, RBC: We seek to diversify our funding across markets, while considering basis swap and credit spread pricing.

***The CBR*: What made Australian dollars an appropriate market for you? Have you issued previously in senior unsecured, did you do much investor work there, and do you feel Australian domestic issuance has been an important factor in the development of that market?**

Power, RBC: We have issued benchmark funding transactions in Australia for a decade, so we are a familiar name to investors there. We occasionally do targeted investor work there, but we also have our own business presence in Sydney that keeps us close to investors.

***The CBR*: Do you see ongoing benefits from SEC registration? Do you expect the US covered bond market to develop, with other foreign issuers using the format?**

Power, RBC: That format has helped our programme and continues to make our bonds attractive there. Unfortunately, that market has been slow, especially in light of more favourable euro issuance opportunities.

***The CBR*: You have been very active in the past year. Can we expect your issuance to continue at this pace?**

Power, RBC: Our issuance volumes this year have been trending lower than last year (in part because last year we purchased Ally's Canadian business). We continue to monitor covered and unsecured markets to meet our ongoing funding requirements. ■

Transparency Reasons to be cheerful?

The ICMA Covered Bond Investor Council is disappointed with the response to its transparency initiative. The ECBC argues transparency is improving as a result of the national templates developed under the Covered Bond Label. The EBA has looked at both, and said it's time for the next step. *Susanna Rust* reports.

"A milestone in the roadmap towards a better transparency regime in Europe."

This is how the ICMA Covered Bond Investor Council (CBIC) referred to transparency standards in covered bonds when it in April 2011 released data lists detailing information it believed issuers should provide investors with.

The voluntary transparency standards set out three categories of information the CBIC expected issuers to provide and formed the basis of a consultation. That, belatedly, resulted in the investor body releasing its finalised transparency template in May 2012, on the occasion of the inaugural ICMA CBIC & The Covered Bond Report Covered Bond Investor Conference in Frankfurt.

Two years later, at the same annual event in May this year, red sad faces peppered a presentation used by Andreas Denger, acting chairman of the CBIC and senior portfolio manager and covered bond analyst at MEAG, to give a downbeat assessment of the response to the CBIC's transparency initiative.

Hardly any issuer is actively or properly using the CBIC transparency template, said Denger, even though leaving fields blank is allowed, and only three of the CBIC's "7 C-List" of key transparency requirements are being delivered on even a mediocre level (as illustrated with yellow neutral-faced emoticons).

This situation needs to improve, he said, calling on the market to work harder or risk being kicked out of the driving seat and having transparency requirements imposed that do not reflect the specificities of the asset class.

For example, the CBIC's template does not ask for loan-by-loan data, said Denger, but "talks with some regulators suggest this is not off the table".

"If it takes too long to achieve an acceptable level of transparency on a harmonised basis, covered bonds may lose the positive reputation they earned during the crisis," he further warned.

A parallel development in the field of data transparency has been the ECBC Covered Bond Label initiative, under which issuers claiming Label status must commit to disclose cover pool information in accordance with National Transparency Templates, but some investors are not that impressed by these.

Daniel Rauch, fund manager at Union Investment in Frankfurt, says that the level of transparency provided by issuers in connection with the Covered Bond Label still falls well short of investors' expectations for disclosure, as captured in the ICMA CBIC transparency template.

"If you compare the data fields in the CBIC template with the requirements under the Label, you can see that fewer data points are covered under the Label, which isn't comprehensive," he says.

The timeliness of data is another problem, according to Rauch.

"It bothers me that the cover pool data issuers have delivered to the ECBC under the Label has been up to six months old in occasional cases, depending how quickly the issuers deliver the data due to the rather voluntary character," he says, noting that at one point this was true of a Spanish issuer, for example.

Image: Yangzai/iStock

Lorena Mullor, AHE: Spanish issuers will continue to work to enhance the information provided to the market

"Even though cover pool assets are typically of high quality and don't change that dramatically," he adds, "I still think the data should be more current and it would be nice if issuers had an incentive or pressure to maintain more consistent data disclosure."

Rauch says that the focus should now be on increasing the degree of convergence between the national transparency templates under the Label and the CBIC's transparency template.

"That's a task that needs to be tackled," he says. "The market has been talking about the importance of transparency for seven years now and we have the Label, but at the end of the day it's not really all that much."

The case for the defence

But others see good reason for a positive assessment of developments on the transparency front, typically citing the ECBC Covered Bond Label initiative and the National Transparency Templates that are a part of it.

Luca Bertalot, secretary general of the European Covered Bond Council (ECBC), says that there have been clear improvements in transparency over the past few years.

"We should acknowledge that there is always room for improvement and still some significant work to be done," he says, "but at the same time we should also recognise the impressive efforts made by the covered bond community in enhancing and harmonising data disclosure policies after the crisis.

"There has been massive progress in terms of quality and comparability, especially when it comes to definitions, format and frequency of the disclosed information."

The CBIC's template is considered a benchmark when a national issuer group designs and updates its National Transparency Templates, he says, and although there is room for improvement there has been considerable progress already, particularly if one considers that before 2013 there were no agreed templates at national level.

Chris Fielding, executive director at the UK Regulated Covered Bond Council (RCBC), was at the investor conference in May and says that he listened to Denger's presentation with interest as UK issuers are keen to do their utmost to satisfy investors' expectations for transparency. He also strongly endorses the level of information available about UK covered bonds, and the industry's efforts to deliver on investor requests for transparency.

"We are looking at our national transparency template to see if there are further improvements we can make," he says, "but our starting position is that we believe the UK template provides for one of the highest degrees of transparency, even though it does not reflect everything the CBIC asks for."

It is important to distinguish between, on the one hand, the format of information, and, on the other hand, information that is simply unavailable, he adds, suggesting that rectifying the latter would be more of a priority for the UK RCBC at present than focussing on the format or layout of the information.

"There are considerable difficulties involved in just taking a report generated by others and there are legitimate questions about whose responsibility it is to get the data in the desired order or layout," says Fielding. "In our view in its entirety the information provided by UK issuers complies with regulatory requirements."

Spain has frequently been cited as a jurisdiction where disclosure has been below par, but recent efforts to improve transparency have resulted in an update of the National Transparency Templates for covered bonds carrying the Label.

Lorena Mullor, manager at the Spanish Mortgage Association (AHE), says that the Spanish National Transparency Template was modified with the initial objective of making the necessary changes to ensure it satisfies disclosure requirements under the Capital Requirements Regulation (CRR), but that the issuer body took the opportunity to voluntarily make other amendments to boost transparency and clarity of information about cédulas hipotecarias.

"The update of the national template was a pending issue for our market and, due to the deep restructuring process of the financial system and banks' integration, we had to start off with a minimum level of information that any issuer could easily deliver," she told *The Covered Bond Report*. "During the last two years Spanish banks have, for different reasons — including as a result of the sovereign financial assistance programme — got used to complying with strong information and transparency requirements.

"The new CRR requirements are minimum requirements that help to clarify by pointing out those information items that need to be disclosed, and Spanish issuers will continue to work to enhance the information provided to the market."

> "The intention is to find out what the impediments are"

CBIC reviewing initiative

For its part, the ICMA CBIC is working to review the tem-

plate initiative to make it relevant to regulatory changes and to build on the work of the National Transparency Templates, it says.

"Although this is work in progress, it is safe to say that its objectives will include better cross-border comparability of data, voluntary disclosure of relevant information over and above what is required by the National Transparency Templates and potentially the ability to perform simple portfolio analytics on cover pools," it said in a third quarter update.

Richard Kemmish, an independent covered bond consultant, is working with the investor council.

"The CBIC wants to look at what it can do to further the investor transparency agenda, starting from the premise that the Covered Bond Label and the national transparency templates are an excellent initiative because they set minimum standards," says Kemmish. "However, the intention is to find out what the impediments are to issuers aligning their disclosure more fully with the CBIC template, and to encourage issuers to use it to disclose information that is not required for the Label but could be beneficial to provide from a competitive advantage point of view.

"The CBIC has also always wanted cross-border comparable data, which by definition is not a focus for the national transparency templates."

Another way in which the CBIC believes its transparency template could gain more traction, according to Kemmish, is by issuers taking more advantage of a practice the investor council has always said would be acceptable: leaving fields blank. Indeed, the investor council has consistently and regularly acknowledged the challenge of issuers fully delivering on the CBIC transparency template, and been generous in its expectations.

For example, in April 2011, upon releasing its transparency standards, it said: "The CBIC is well aware that not all jurisdictions or issuers will be in a position to provide all of the requested data. Nonetheless, the CBIC invites all issuers to be as accurate and comprehensive as possible in filling in the data list."

"Its objectives will include better cross-border comparability"

Article 129 §7: what value?

The regulatory changes and CRR requirements referred to above represent one of the most important developments on the transparency front for covered bonds: the addition of disclosure requirements to the CRR. Article 129 §7 makes preferential risk weight treatment contingent upon, inter alia, certain information being made available to investors — although it places the onus on the buy-side to carry out due diligence.

It requires that the investing institution "can demonstrate to the competent authorities that it receives portfolio information at least on: (i) the value of the cover pool and outstanding covered bonds; (ii) the geographical distribution and type of cover assets, loan size, interest rate and currency risks; (iii) the maturity structure of cover assets and covered bonds; and (iv) the percentage of loans more than 90 days past due".

Andreas Denger, ICMA CBIC: "Hardly any issuer is actively or properly using the CBIC transparency template"

In addition, the investor must be able to demonstrate that the issuer makes available the aforementioned information at least half-yearly.

With the Covered Bond Label Committee having in October 2013 voted to make CRR-compliance a qualifying criterion for Label status, the working notion is that the National Transparency Templates linked to the Label can be held up as satisfying the new disclosure requirements in the CRR.

"The most important thing that the national transparency templates do is say that if you comply with the template it is evidence that you meet Article 129 §7," says a covered bond market participant, "although in Germany's case that box is ticked because there are strict transparency criteria in the Pfandbrief legislation."

The ECBC's Bertalot says that although the ICMA CBIC transparency template is considered a benchmark when national issuer communities design and update their Label transparency templates "the priority now is to ensure that investors have access to all the items requested in Article 129 §7 of the CRR in the Label National Transparency Templates in order to secure the preferential risk weighting under the CRR treatment".

"The Covered Bond Label remains the only source where market participants can understand if a single ISIN is CRR-compliant or not and have access to cover asset data and key data on issuer and legislative framework," he says.

But what does all this really mean for investors, especially if, as analysts and other market participants have commented, the disclosure requirements in the CRR are vague and therefore preclude a clear-cut assessment of whether they are satisfied or not?

Covered bond analysts at Barclays and UniCredit, for example, earlier this year took a closer look at the CRR transparency requirements and came up with rather contradictory assessments of whether they were being met.

Lars Overby, EBA: "We support the low risk weighting but at the same time there have to be certain safeguards"

Writing in February, the Barclays analysts said that none of the National Transparency Templates at the time fulfilled the disclosure requirements under CRR, although amendments were underway.

"Because covered bond issuers have an incentive to ensure their products fulfil the requirements of Article 129 §7, we believe that a number of the missing pieces will be addressed in the near future," they said. "Bank covered bond investors should watch this space in order to gauge the capital treatment of their covered bond holdings."

A few months later, meanwhile, Florian Hillenbrand, senior credit analyst at UniCredit, said that he does not see why some covered bonds would not be CRR-compliant, although this is largely because the disclosure requirements are too vague to allow for a clear measure of whether they are being met. This is problematic, in that it provides for a false sense of security, he said.

"It provides for a false sense of security"

"Setting up a covered bond disclosure list is actually supposed to lead investors to better understand the risk they are bearing," said Hillenbrand. "However, the regulation's current configuration turns the whole collection of facts into a meaningless exercise.

"Possible solutions for this deficit could either come in the form of an extremely detailed disclosure requirement, worked out by the European Commission, which will, sooner or later, encounter similar problems to those experienced when discussing the ECBC's national templates, or in the form of an adoption of an updated and amended form of the ECBC templates."

Both have their drawbacks, however, added Hillenbrand, arguing that only loan level data of representative portfolio samples allows investors to know the risks in a given cover pool.

"This would pass on the analytical challenge to investors — for better or for worse, but it certainly is fair," he said.

EBA pitches in

The lack of clarity surrounding the disclosure requirements in the CRR has also been noted by the European Banking Authority (EBA), which analysed the state of transparency in covered bonds as part of work it carried out to fulfil two mandates, one from the European Systemic Risk Board (ESRB) to identify principles of best practice in relation to covered bonds, and another from the European Commission to assess the appropriateness of the preferential risk weights for covered bonds and the associated qualifying criteria.

In a final report published on 1 July, the EBA said that Article 129 §7 "may leave excessive room for interpretation to both issuers and competent authorities", adding that there is also uncertainty among investors about the compliance of certain covered bond programmes with that part of the CRR.

Fourteen jurisdictions have developed National Transparency Templates under the ECBC Label and these differ substantially, according to the EBA.

This is partly a reflection of national specificities, such as the type of issuer model, the type of cover pools and covered bonds that have historically developed, and the regulatory framework in force.

The National Transparency Templates "constitute a valuable starting point for the harmonisation of covered bond disclosure standards", but there are shortcomings, said the EBA.

"The national templates differ and are not always aligned in terms of the type and amount of information disclosed, with the disclosure template elaborated by the investors' association as well as with the disclosure requirements imposed on covered bonds for the purposes of preferential risk weight treatment," it said.

"Not all the national transparency templates seem to align with the disclosure requirements provided for in Article 129 of the CRR," it added.

In addition, "very few transparency templates are particularly developed in certain areas of information disclosure," said the EBA.

Lars Overby, head of unit, regulation, at the EBA, says that raising disclosure standards in covered bonds is also important to ensure the asset class is treated roughly equivalent to securitisation, where disclosure requirements are very granular.

"Applying granular disclosure requirements to covered bonds seems like a logical next step," he says. "If we don't, there may be a skew between the two asset classes."

Overall, the banking regulator said that, in principle, the preferential risk weight treatment for covered bonds is appropriate, but recommended tightening the eligibility criteria, including with respect to disclosure.

Overby sets out the EBA's body's thinking thus: "No investor has ever lost any money on a covered bond but there have been bail-outs of covered bond issuers as documented in the report, and what we are trying to do is protect investors in the

event that an issuer fails. We support the low risk weighting for covered bonds but at the same time there have to be certain safeguards."

With respect to disclosure, the EBA has therefore recommended to the Commission that the disclosure requirements under Article 129 §7 be further clarified by means of binding technical standards — to be drawn up by the EBA — and that provision also be made for the possibility of extending the disclosure criteria under that article.

However, the EBA's disclosure recommendations "should not be heard as criticism against industry proposals", according to Overby.

"We fully praise the industry for taking the first steps to improve disclosure, but what is missing is common definitions and fully aligned templates that allow comparisons across frameworks," he says. "We believe this is the final step that needs to be taken and that is one of the reasons we have recommended that the EBA is mandated to develop technical standards in this field.

"If the Commission provides the EBA with a mandate, clearly we will look at already existing templates, such as ECBC and CBIC template initiatives, which are very useful starting points."

Time for action?

Notwithstanding the uncertainty about what any EBA technical standards on disclosure would look like, market participants have largely reacted positively to the authority's intervention.

"We consider the precise and detailed formulation of the [CRR] transparency requirements to be a vital necessity," said Thorsten Euler, covered bond analyst at DZ Bank, "since any non-compliance or misinterpretation on the part of issuers will jeopardise the capital privileging of covered bonds enjoyed by EU banking sector investors.

"Our perception is that the often very general formulation of these requirements currently leaves both issuers and investors uncertain about their implementation."

Asked to what extent the EBA's call for binding technical standards can be seen as reflection of industry transparency efforts falling short, Mullor at the Spanish Mortgage Association says that it is important for regulation or laws to set minimum standards, but that there is a role for industry initiatives, too.

"In fact, the initiatives of industry self-regulation, and especially the Covered Bond Label, have been supported by regulators, including the ECB, from the beginning," she says. "From this point of view, the EBA disclosure best practices are welcome."

Bertalot at the ECBC also welcomes the EBA's comments and recommendations, in particular what he says is the recognition of the macro-prudential role played by the asset class during the crisis and the adequacy of preferential risk weights for covered bonds.

Thorsten Euler, DZ: precise and detailed formulation "vital"

He, too, says that the disclosure requirements in the CRR are vague, and notes that the EBA's recommendations on how to address this, as well as for qualifying criteria to be added to Article 129, will be discussed at European and national level over the coming months.

"The covered bond community has been working together in order to disclose the information in the most clear and harmonised way across the different jurisdictions," says Bertalot.

"This discussion is still ongoing, therefore the ECBC believes that a dialogue between the issuers, investors, the EBA and the European Commission with regard to the next steps would be the most constructive way to move forward."

The ICMA CBIC, meanwhile, has welcomed the EBA's interest in its transparency standards.

"The EBA has noted the ECBC and CBIC efforts on transparency standards," says Nathalie Aubry-Stacey, director, market practice and regulatory policy at the International Capital Market Association, "and the CBIC hopes that investors' needs, as stated in the CBIC European Transparency standards, will be recognised, in particular concerning format standardisation and easily accessible information, and that progress will be delivered faster."

> "We believe this is the final step that needs to be taken"

No-one ever said this was going to be easy. Indeed, at an ECBC plenary in September 2011 a panellist warned that bringing the CBIC's initiative to fruition would be like turning around a supertanker.

But the EBA has delivered what must surely be the most comprehensive and definitive analysis of the state of disclosure in covered bonds and maybe, just maybe, it can help take transparency to the next level.

And turn those frowns upside down. ■

Summer solstice, Stonehenge
Photo: Taro Taylor/Flickr

H2 upsides TLTRO downsides

As the first half drew to a close, analysts revisited their 2014 forecasts in light of the first six months' issuance. Greater-than-expected supply from countries such as Canada has outweighed disappointing volumes from Spain. But the biggest unknown — if not totally unexpected — has proven to be new ECB LTROs. *Alex Whiteman* and *Neil Day* report.

That any unconventional policy measures from the European Central Bank would be a key influence on covered bond supply 2014 was apparent from the supply forecast of UniCredit analysts made at the turn of the year. They felt that the impact of central bank action was such that it was worthwhile making two forecasts: one, of Eu121bn, for a scenario in which the ECB remained on the sidelines; and another, Eu100bn, for their economist colleagues' base case scenario of new longer term refinancing operations (LTROs) being announced this year.

So when ECB president Mario Draghi on 5 June announced a package of measures including "targeted" LTROs, or TLTROs, alongside a reduction in headline policy interest rates — including a negative deposit rate — and the development of an asset purchase programme, the immediate question for analysts and other market participants was the extent to which this could affect the covered bond market.

While the market at large rallied following the announcements, the impact on covered bonds was minimal, according to syndicate bankers, with no noticeable impact on core jurisdictions and a 3bp-5bp tightening in peripheral spreads.

"There will be an impact in terms of bank funding, but this will more likely affect senior supply," said one. "I don't expect to see a decline in covered bond issuance following these announcements or following the introduction of TLTROs."

Florian Hillenbrand, senior credit analyst at UniCredit, said in the wake of the announcement that the TLTROs would have limited impact on the prevailing supply outlook given that issuance had already been subdued this year.

Joost Beaumont, fixed income strategist at ABN Amro, said that the introduction of TLTROs would probably weigh on covered bond issuance, resulting in an increase in negative net supply.

"The TLTRO will provide cheap funding for banks, limiting their funding needs," he said. "Furthermore, the ABS purchase programme can have some impact on new supply of covered bonds."

ECB's Targeted LTROs	
Start date	2 TLTROs in Sep & Dec 2014
Maturity date	Sep 2018 => c. 4 year maturity
Initial entitlement	Up to EUR400bn
Fee	Main refi rate +10bp => currently 0.25%
Early repayments	After 24 months on a 6-month basis
7% limit for LTROs	7% of total lending to euro area non-financial private sector*
Net lending limit for additional borrowing	From March 2015 to June 2016, cumulatively up to 3x net lending**
Lending requirement	If net new lending (May 2014 - April 2016) is below benchmark (May 2013 - April 2014), borrowings have to be repaid in Sep 2016
Additional assets/ credit claims	Extension of the repo-eligibility of additional assets/credit claims at least until Sep 2018

* Lending stock as of 30 April 2014; housing loans and public sector loans are excluded.

** Only to the euro area non-financial private sector; excluding loans to households for house purchase; loan sales, securitisations and write-downs do not affect the net lending measure; borrowing on quarterly basis.

Source: ECB, HSBC

Frank Will, HSBC Trinkaus: "We also believe that even the stronger euro-zone banks will participate"

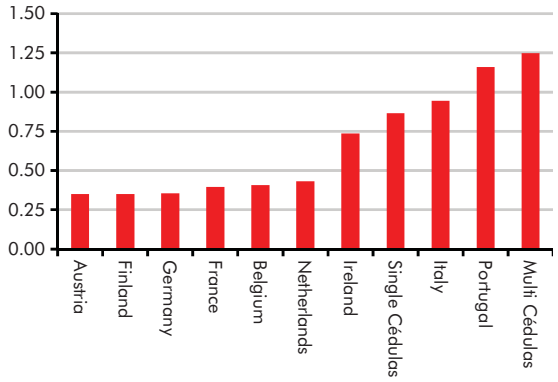
Frank Will, global head of covered bond research at HSBC Trinkaus, ran the numbers and came to a similar conclusion regarding issuance.

"We fear that the next rounds of (targeted) LTROs by the ECB will further reduce the wholesale funding needs of banks," he said.

Will said that whether this will happen will depend "at least partly" on the opportunity costs of the various funding channels.

He noted that the interest rate on TLTROs — which are being held in September and December and will have a September 2018 maturity — will be fixed at the main refinancing rate plus a fixed spread of 10bp. The average two to four year yield levels on many banks' covered bonds are close to the 0.25% the banks would have to pay for TLTRO money, he said, with only euro-zone peripheral covered bonds trading well above that threshold.

Yield levels of 2-4 year covered bonds by country (%)



Source: HSBC, Reuters, Bloomberg (as of 20 June 2014)

HSBC bank analysts estimate yield levels for stronger European banks for a four year senior unsecured bond at between 0.8% and 1.2%, and between 1.5% and 2% for weaker banks from the euro-zone periphery, he added.

"In light of those figures, we would expect a high take-up of the TLTRO money by banks out of non-core countries," said Will. "We also believe that even the stronger euro-zone banks will participate in the programme — at least to show their support of the ECB policy targeted at increasing SME lending rather than having actual funding needs."

The Funding for Lending Scheme in the UK serves as a useful guide as to what impact the TLTROs are likely to have, added Will, noting that following its introduction "covered bond issuance came almost to a complete standstill" and has only recently picked up.

Bernd Volk, head of covered bond research at Deutsche Bank, said that the introduction of TLTROs will likely result in lower overall bank bond supply and as a result "the hunt for pick-up will probably stay".

"Even in the event that covered bond supply would not be impacted," he added, "the likely lower overall bank bond supply seems supportive for covered bond spreads."

Not all negative

Stronger than expected issuance activity from corners of the covered bond market such as Canada have nevertheless led some analysts to lift their overall supply forecasts for 2014, while in some cases cédulas expectations have been lowered.

LBBW analysts have responded to primary market activity in the first half of the year by raising their forecast for full year euro benchmark issuance, from Eu92bn to Eu105bn. Positive developments in Canada and Italy prompted the analysts to lift their expectations for supply from those countries, by Eu5.5bn for Canada and by Eu5bn for Italy.

"In Spain, by contrast, we had expected far more bond issues at the start of the year," said Karsten Rühlman, credit analyst at LBBW. "The weak trend in H1 2014 has led us to lower our forecasts from the initial Eu16bn to Eu8bn."

Based on their adjusted forecast, the LBBW analysts expect total issuance of Eu40bn in the second half of the year, after benchmark supply of Eu66bn in the first six months of 2014.

Matthias Melms, covered bond analyst at NordLB, said that stronger than expected activity from Canadian and Italian issuers has led NordLB analysts to increase their supply expectations for 2014 from Eu117bn to Eu121bn.

"At the beginning of the year we were predicting significantly stronger issuance from Spain, but we were too optimistic, and Spanish issuers are Eu5bn short of where we expected they would be," said Melms. "However, Canada has exceeded expectations and is racing ahead, with Eu5bn issued in the first half and we expect Eu2bn for the second half of the year.

"The euro-US dollar basis swap has been attractive for

those issuers that do not have the euro as their home currency," he added, "but it is volatile so it remains to be seen whether conditions will change in favour of US dollars."

Jennifer Levy, analyst, covered bonds and agency markets at Natixis, told *The Covered Bond Report* that her supply forecast remains unchanged from the start of the year, with expectations for between Eu100bn and Eu110bn of supply for the year. She said that this could represent an increase of up to 15% on issuance in 2013, which reached Eu93bn.

Despite her overall forecast remaining unchanged, Levy notes that the forecast for Spanish issuance has been cut. She said that Natixis analysts had expected Eu12bn of Spanish benchmark covered bonds to be issued in 2014, but that only Eu4.5bn has been sold so far this year. Natixis analysts now estimate that cédulas issuance will add up to Eu6bn-Eu8bn in 2014.

However, Levy noted that Canadian supply has been higher than expected.

"The swap rate between euros and US dollars has driven Canadians to the euro market," she said.

Barclays covered bond analysts' prediction for full-year issuance remains unchanged at Eu130bn, although in contrast to the other analysts' figures this also captures non-euro supply. They noted that the primary market finished the first half of the year strongly, with issuance in June reaching Eu14.3bn, Eu4.3bn more than they had expected. H1 supply of Eu72.5bn, including US dollar, Swiss franc and Australian dollar deals, is 56% of their full year forecast, according to the analysts. However, they anticipate the covered bond market to be subdued in July and August.

They noted that 2014 supply has been dominated by euro issuance, representing 96% of the first half's total, up from 80% for the same period last year. US dollar supply has fallen by 11%, accounting for just 3% of total issuance for the year-to-date, according to the analysts.

Cristina Costa, senior covered bond analyst at Société Générale, said that her forecast remains unchanged, for Eu110bn of benchmark supply for the full year.

"Combined with euro covered bond redemptions of Eu155bn, this means the covered bond market should shrink for the second year in a row, by Eu45bn," said Costa. "High covered bond redemptions in Spain (Eu48bn) and Germany (Eu33bn) should support both markets."

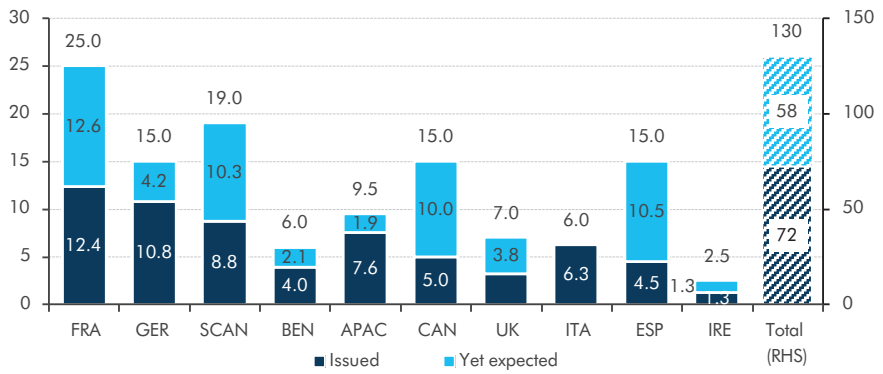
Michael Spies, strategist at Citi, has also kept his start-of-year forecast, which put full year issuance at Eu113bn. However, while the overall figure is unchanged Spies has amended its geographic composition. Most notable is a six-fold increase in full-year expectations for Portuguese covered bond issuance, from Eu500m to Eu3bn. Like other analysts, Spies has reduced his forecast for Spanish issuance, from Eu15bn to Eu9bn. Unlike some others, he has not increased his forecast for Canadian issuance, but his initial estimate was substantially higher than other analysts', at Eu10bn for the full-year.

Elsewhere, Natixis's Levy said that there is the potential for Turkish euro benchmark issuance in the second half, adding that if one Turkish bank issued there would likely be two more ready to follow. ■

Karsten Rühlman, LBBW: "In Spain, by contrast, we had expected far more bond issues at the start of the year"

"The covered bond market should shrink for the second year in a row"

More than half of Barclays' Eu130bn supply forecast was achieved in H1 14 (Eu bn)



Source: Barclays Research

Nicolaus Copernicus Monument, Warsaw
Photo: Wikimedia Commons

Poland Progressive thinking

The Polish covered bond market could witness upgrades, lower funding costs and more issuance when long-awaited changes to the country's list zastawny legislation — including statutory conditional pass-throughs — are enacted. *Alex Whiteman* reports.

Impending amendments to Polish covered bond legislation, the first to the framework since it was introduced in 1997, are expected to lead to a growth in issuance, with banks, analysts and commentators all characterising the update as the catalyst for a new era in Poland's covered bond market.

Speaking at an ICMA CBIC-The Covered Bond Report conference in Frankfurt on 15 May, Oliver Koepke, head of treasury at mBank Hipoteczny, said that covered bonds will be an important and established asset class in Poland within the next five years.

This sentiment is echoed by Matthias Melms, covered bond analyst at NordLB, who says he expects outstanding Polish covered bonds to amount to Eu10bn-Eu20bn within a five to seven year timeframe following implementation of the updates.

Such a figure greatly exceeds outstandings, which Koepke says total around 3bn zloty (Eu724m). By 2019, he expects two to three deals a year from up to five issuers.

"Covered bonds will begin to play a much bigger role in funding mortgages and real estate," says Koepke. "PKO Bank, the biggest bank in Poland, has the potential to become a huge issuer. They're intending to do a lot of refinancing through a specially created mortgage-backed covered bond bank."

PKO Bank is the largest commercial bank in Poland, with more than 100bn zloty of mortgage loans. The creation of a mortgage bank, PKO Bank Hipoteczny, would allow it to become the third covered bond issuer in the country.

Rafal Kozlowski, head of the PKO Bank Hipoteczny project, told *The Covered Bond Report* that the primary purpose of establishing the mortgage bank was for the issuance of covered bonds to provide the bank with improved ALM and a source of long term financing. He said that once the permit to develop the mortgage bank is received from the Financial Supervision Authority (Komisja Nadzoru Finansowego, or KNF), PKO Bank will begin developing its covered bond programme.

"We will then send this for final approval," added Kozlowski. "We expect the bank to begin operations in early 2015 with the first covered bonds being issued a few months afterwards."

Long overdue

A desire to improve access to long term funding has been one of the drivers of the legislative changes, according to NordLB analysts.

"The Polish Ministry of Finance is therefore concerned that long term assets are being funded on a short term basis in the local banking sector and recognises that this poses a threat to the domestic financial sector," they said. "To increase the appeal of long term funding using covered bonds, a proposal was put forward for an amendment to the existing covered bond legislation, which provides inter alia for changes to insolvency and tax law in addition to changes to covered bond legislation."

Kathleen Tyson Quah, chief executive at financial infrastructure consultancy Granularity, says that an update to Polish covered bond legislation is overdue, add-

Oliver Koepke, mBank, with Rebecca Holter, Fitch: "Our intention is that it is finalised and through the parliamentary process by the end of the year"

ing that it has come at the right time as the pressures of post-crisis reforms in Poland, Basel III, the Liquidity Coverage Ratio, and EU regulations on mortgage legislation begin to take effect.

"The regulator in Poland has taken the step of implementing an LTV cap of 85%, and restricting foreign exchange mortgage loans to borrowers who receive income in foreign currency," she says. "Before the reforms up to 80% of the wholesale mortgage market used to be financed in euros or Swiss francs and a lot of the retail market also used these currencies.

"Now the banks are being forced to lend and borrow in zloty, which is a less liquid market, and face higher interest rates for wholesale borrowing."

Tyson Quah says that while related reforms to financial infrastructure should also be focused on, the changes are on the right track.

"Let's face it, almost all financial crises start with mortgage lending as mortgage lending is the most extreme challenge of maturity transformation and faces the biggest run risk," she says. "The Polish authorities are very sensibly trying to rebalance the wholesale market to promote macro financial stability.

"Covered bonds provide the perfect vehicle for this if they get reforms right and the banks and investors come together to build a liquid market."

Koepke acknowledges that work is required if Poland wants to become a bigger player in the covered bond market, noting that the outdated nature of the country's covered bond legislation, based on a German framework in 1997, is a hurdle it is necessary to overcome.

The latest draft of the proposed amendments was published by the KNF at the end of March, according to Koepke, with a final draft expected imminently.

> "Covered bonds provide the perfect vehicle"

"It is now going through a process of being discussed by all concerned," he says. "Our intention is that it is finalised and through the parliamentary process by the end of the year."

New standards include CPTs

Under the proposals outlined in the draft legislation, issuers would be required to address overcollateralisation and liquidity issues.

NordLB analysts have noted that there is no statutory overcollateralisation under Polish legislation as it stands nor provisions for liquidity lines. The proposed amendments will require issuers to hold 10% overcollateralisation and liquidity to cover 12 months of interest payments.

Meanwhile, a loan-to-value (LTV) limit will be increased from 60% to 80% — this would bring it into line with the maximum allowed under the Capital Requirements Regulation (CRR), whereas it has hitherto matched that in German Pfandbrief legislation.

The composition of cover pools will not be affected by the proposals, with public sector debt and mortgages originated in Poland remaining the eligible assets for collateral.

But perhaps the key point is the creation in legislation of a conditional pass-through (CPT) structure. So far this has only been used within a legislative covered bond framework by the Netherlands' NIBC — twice since October 2013 — although the structure is not defined in Dutch law. Germany's Commerzbank also used a pass-through structure on a benchmark SME covered bond launched in February 2013, although that was wholly outside the country's Pfandbrief Act.

Melms says that should the Polish legislation being discussed get enacted, it would be one of the most progressive in the covered bond market.

"This draft, which is not yet in itself complete, goes much further than any other legislation I have seen," he said. "This is down to the implementation of the conditional pass-through structure."

According to NordLB analysts, the maturity of covered bonds extends by law by one year in the event of an issuer insolvency.

"As we understand it," they said, "the aim of this soft bullet structure is to avoid possible liquidity squeezes as a result of the issuer becoming insolvent. Two tests at predetermined intervals are envisaged following the issuer's insolvency.

"Firstly, checks will be carried out every six months to establish whether the collateral in the cover register is sufficient to satisfy investors' claims."

If this test is failed, they note, all covered bonds become due and the process of realising security begins.

"However, if the test is passed, a liquidity test will be applied every three months, which will check whether the interest and principal claims under the covered bonds can be serviced on time," said the analysts. "Should the liquidity test not be passed,

the payment structure of the covered bonds will be changed from a bullet to a pass-through structure.

"Payment of the nominal amount of the covered bond will then be extended until the final maturity of an item of collateral in the cover pool. At the same time, pro rata redemption on a six monthly basis is also envisaged."

Koepke says that the pass-through structure outlined in the proposals will be the mandatory structure for legislative covered bonds.

"The only option available to issuers wanting to use a hard bullet, or any different structure for that matter, would be non-legislative, structured covered bond issuance, but this would not make sense and is not our intention," he says. "We want to solely use the new legislative structure.

"What we want is some sort of transparency, so investors know that each issuer using the legislation has this structure in place."

He says that the pass-through structure will increase international investors' confidence in Polish covered bonds.

Despite Melms' praise for the progressive nature of the legislation, he says that it does not appear to go into sufficient detail.

"Take, for example, the German Pfandbrief law," he says. "This indicates, who takes control, what happens, and how it works in the case of issuer insolvency.

"These issues are not covered in detail in the draft Polish legislation."

Market moves pending

NordLB analysts noted that overall the implementation of the proposed draft legislation will result in higher issuance, with the mandatory overcollateralisation likely to help attract foreign investment.

"There is a strong willingness among all involved to get this right," says Melms. "And I think that it is certainly going to lead to an increase in issuance that will be visible within the first year of the draft's implementation."

However, Tyson Quah says that "legislation does not equal market depth or liquidity" and expects changes to market practice and infrastructure will be necessary to increase issuer and investor interest in covered bonds in Poland.

"I'm a big fan of tap issuance for providing deep liquidity," she says. "Poland is a small market with a less liquid currency. So a tap issuance structure would allow mortgage lenders to build deep liquidity in larger bond issues and increase investor confidence in the secondary market.

"That's a market rather than statutory measure, but it is probably critical for a non-euro currency, especially as Poland restricts covered bond issuance to narrow mortgage banks."

Matthias Melms, NordLB: "There is a strong willingness among all involved to get this right"

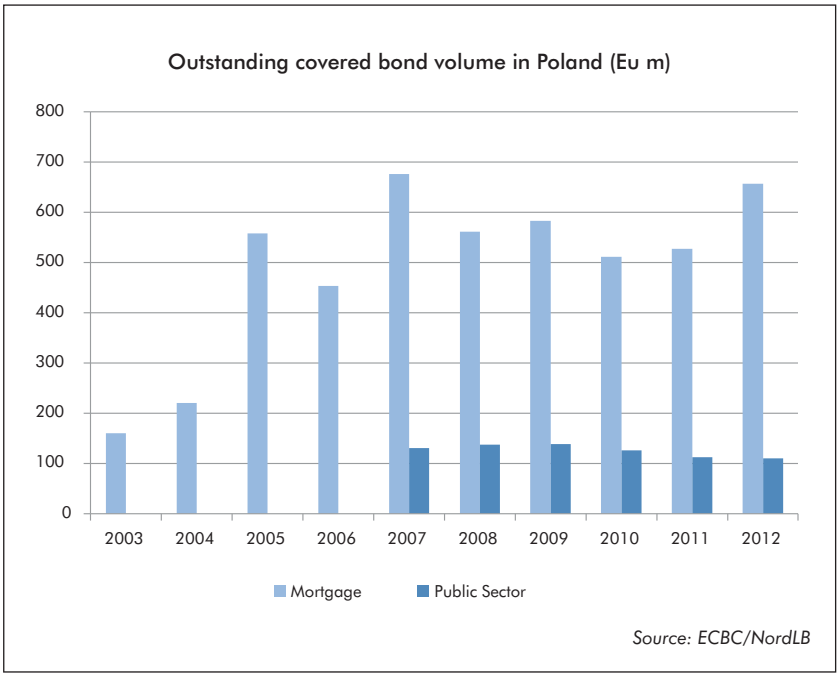
mBank has already tapped the euro market, albeit not in benchmark format but in the private placement market, where it is a regular issuer. It recently issued a Eu20m 15 year private placement, for example.

Koepke hopes that implementation of the proposed legislation should lead to a rating uplift for mBank's covered bonds *(see below for more)*, which would in turn attract greater interest from international investors. In addition, he believes the bank will eventually be able to issue larger bonds.

"The volumes in the cover pool we have are currently too low for benchmarks, so we have to acquire more loans to increase the size of it or transfer loans from mBank into the mortgage bank," he says. "So from a volume perspective we are not yet ready to issue benchmarks.

"We are not sure when this will happen. We are willing to do benchmarks in the future, both in euros and zloty, but it will take a while to get the cover pool into the necessary shape."

Alongside mBank (which was formerly BRE Bank and is part of the Commerzbank group), Pekao Bank Hipoteczny — a UniCredit group member — is an active issuer in the Polish covered bond market. Pekao Bank has sold covered bonds in euros in the private placement market, according to an official at the issuer. One such deal was for Eu15m and on several



occasions it has placed Eu4.5m deals with one investor, for example.

Recently, however, the bank has held back from issuing as it awaits the impending changes to legislation, says the official. His rationale for holding back is the rating improvements that the legislative update is expected to lead to.

"A better rating would be beneficial in two ways," says the official. "We will be able to obtain cheaper funding as a result of the rating indicating a less risky option for investors, and more investors will be interested."

Higher ratings anticipated

The Pekao Bank official expects the update to the legislation to lead to Pekao Bank covered bonds receiving an upgrade.

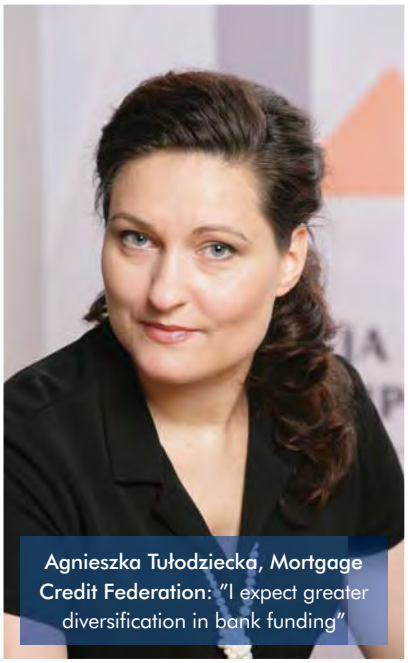
Fitch rates Pekao Bank covered bonds at A, with one notch of uplift above the issuer rating of A-, and in April the rating agency placed them on positive outlook. Under changes to its methodology to reflect the EU bail-in framework, Fitch considers Pekao Bank eligible for an extra notch of uplift for its covered bonds above the issuer default rating (IDR).

"The A/Positive rating of Pekao Bank Hipoteczny's mortgage covered bonds may be upgraded once the Bank Recovery & Resolution Directive (BRRD) is passed by the European Parliament and provided the overcollateralisation that Fitch relies upon in its analysis is commensurate with the breakeven level for the new rating," it said.

Fitch also rates mBank covered bonds at A, in line with the issuer rating of A.

Fitch assigns a Discontinuity Cap (D-Cap) of zero for covered bonds issued by Pekao Bank and mBank. The D-Cap of zero reflects its view that there is no mandatory liquidity provision in Polish covered bond legislation, combined with what it considers "insufficient marketability of the underlying assets" of the covered bonds. As a result, any downgrade of the issuer ratings would lead to a downgrade of the covered bonds.

Pekao Bank covered bonds' rating incorporates one notch of uplift for recoveries given default, which the rating agency has assessed would amount to more than 51% on the defaulted bonds, according to Rebecca Holter, senior director at Fitch.



Agnieszka Tułodziecka, Mortgage Credit Federation: "I expect greater diversification in bank funding"

"In mBank's case, the rating agency only receives limited information on the cover pool assets, precluding a full asset analysis, but tested for recovery prospects based on conservative assumptions," she says.

In May the rating agency determined that in the case of mBank, publicly committed OC of 10% did not provide sufficient stressed recoveries (of more than 51%) to support a recovery uplift.

> "We can expect more business and smaller spreads"

Agnieszka Tułodziecka, president of the Polish Mortgage Credit Foundation, says that rating agencies were not too confident of what would happen in the case of issuer insolvency under the existing framework. However, she believes that the amendments, as in the draft, would be sufficient to lead to an upgrade.

"The maximum local currency ratings of Polish covered bonds are AAA for Fitch and Aa3 for Moody's," she says. "Given the maximum rating levels available, improving the regulatory environment could raise their rating (in local currency) by six (Fitch) or two (Moody's) notches.

"This should in turn reduce the cost of loan funding by at least 50bp–60bp."

Speaking at the covered bond investor conference in May, Holter said that if Polish covered bond legislation is amended to introduce a pass-through structure and there are no other obstacles limiting the ratings, such as a lack of an interest rate reserve, Polish covered bonds ratings could potentially reach a higher uplift from the issuer rating than today.

Tułodziecka adds that she hopes Polish banks will use covered bonds as a funding tool and part of their strategy.

Hopes for the future

"If the legislation does lead to an upgrade," says the official at Pekao Bank, "we can expect more business and smaller spreads. We also offer a nice pick-up compared to others, notably mBank."

He adds that the plan will be for Pekao Bank to issue in higher volume and increase the size of the cover pool.

"As to how I will proceed, if I can wait to issue I will," he says. "But this is dependent on how long the legislator takes to put the legislation through."

Tułodziecka says that it is to assume that amendments will be greeted positively by investors and the market at large.

"Legal changes and new strategies of banking groups could finally change the share of Polish covered bonds on the market," she says. "Assuming that the current growth of residential lending will be maintained, 20% of the new mortgage production will be funded with covered bonds, and starting from 2014, three banking groups will issue covered bonds."

According to Tulodziecka, new issuance of Polish list zastawny could amount to 4bn zloty per year, which she believes could lift the share of covered bonds in residential market funding to an estimated 10% (from around 1%), and greatly improve the perception of the Polish list zastawny — from the point of view of both investors and rating agencies.

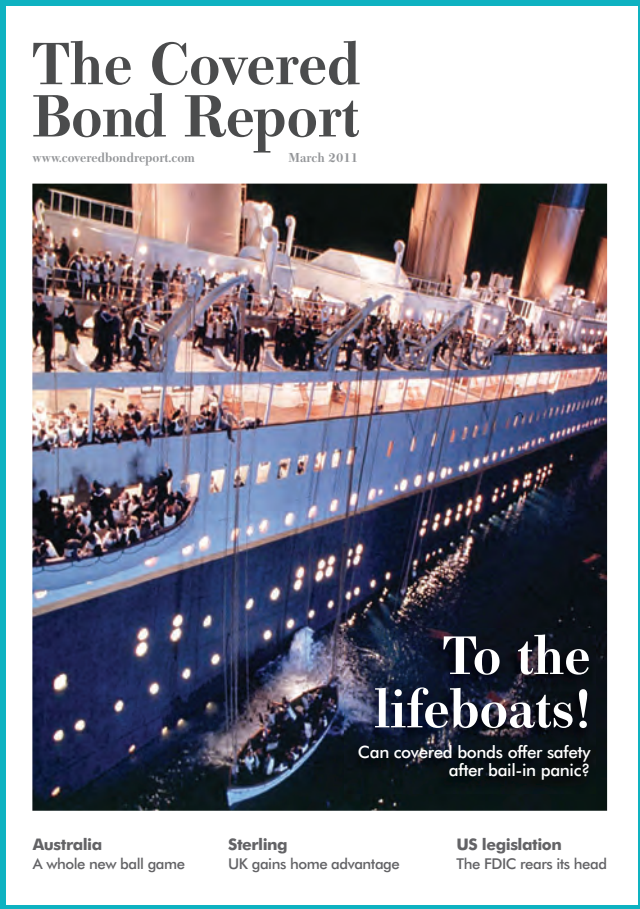
"It's a sense of perception, but investors like higher ratings and if we get these higher ratings more Polish banks may be interested in utilising the asset class as they will draw greater investor interest," she adds. "I expect greater diversification in bank funding, with covered bonds becoming a more present tool, once the legislation in place." ■

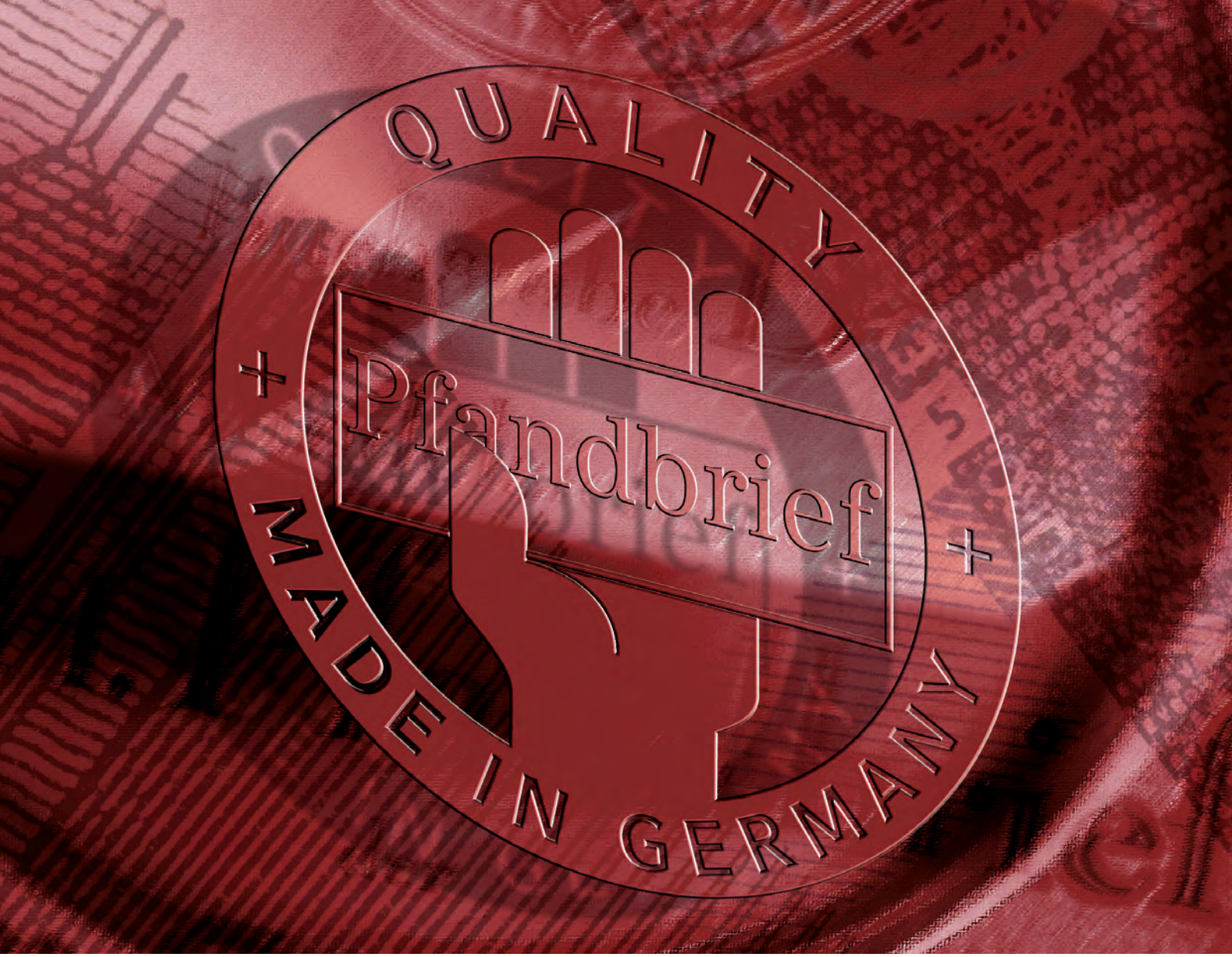
The Covered Bond Report

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

The Covered Bond Report is the first magazine dedicated to the asset class. If you are an investor or issuer with an interest in covered bonds, then you can receive issues of *The Covered Bond Report*'s magazine for free.

To ensure that you receive your copy of *The Covered Bond Report*, please send an e-mail to Neil Day, Managing Editor, at nday@coveredbondreport.com. Alternatively you can enter your details while registering for our website at news.coveredbondreport.com – and access to our online offering is completely free to qualifying investors.





QUALITY BY TRADITION: Even in troubled times, the Pfandbrief is an especially sound investment. Its first-class quality and stable returns on investment are valued by investors in Germany and abroad and, thanks in particular to the stringent German Pfandbrief Act, it will remain the benchmark in the covered bond market.

www.pfandbrief.de