

The Crédit Agricole CIB covered bonds roundtable 2019

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Covered bonds grapple with QE distorted world



Navigating the covered bond market will not be without its challenges in 2020. The Targeted Longer Term Refinancing Operation (TLTRO), European Central Bank deposit tiering and the Covered Bond Purchase Programme have collectively distorted the market, but added to this concoction is the impact of negative interest rates. Against this backdrop issuers, investors and investment bankers gathered in Munich in November to discuss the outlook for covered bonds.

It is likely that new issue premiums will gradually tighten, but the path is unlikely to be smooth. January is typically the busiest month, but in 2019, issuers that funded this early paid the highest spreads. And, with the ECB expected to buy in the region of €4.5bn covered bonds a month, issuers will not feel compelled to move early. But the ECB monetary policy has unwelcome implications. Covered bonds have begun to lose value against government bonds, and this will extend if the ECB is unable to loosen restrictions on government bond purchases.

Participants in the roundtable were:

Ger Buls, manager, long term funding and capital, Rabobank

Florian Eichert, head of covered bond and SSA research, Crédit Agricole CIB, Frankfurt

Miguel Garcia De Eulate, head of treasury, Caja Rural de Navarra, Pamplona

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Timo Boehm, senior portfolio manager, Pimco, Munich

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Carlos Martins, senior portfolio manager, European Stability Mechanism, Luxembourg

Vincent Hoarau, head of FIG syndicate, Crédit Agricole CIB, London

GlobalCapital: How do you expect ECB covered bond buying to pan out over the course of 2020?

Florian Eichert, Crédit Agricole CIB: I expect net ECB purchasing of €2bn a month, plus redemptions of €2.5bn a month next year, which takes gross purchases to around €4.5bn per month. That's about twice as much as they bought up until November in 2019 and around the same volume as seen in 2017. We've already seen on the most recent new issues that the ECB's order is back to 40% of a deal's size, though allocations are slightly below 20%. With a 20%-25% overall allocation and around €100bn of eligible issuance next year, the ECB should be able to source about €20bn-€25bn from the primary covered bond market.

Timo Boehm, Pimco: An obvious outcome is that real-money investors will be slowly crowded out and the

market will become increasingly dominated by bank treasuries buying for their LCR portfolios. Since the ECB restarted buying we've already seen some quite strong tightening from initial guidance and, given questions about the limitations on the purchases of sovereign bonds, the ECB's covered bond buying could become even more intense.

GlobalCapital: Why might the ECB increase covered bond buying further?

Eichert, Crédit Agricole CIB: Unless the ECB are able to increase the purchasing limit [33% of a sovereign deal or ISIN and 50% of an agency deal] they might actually end up raising their covered bond and corporate purchases. They can probably keep going for nine to 12 months, so there's no immediate need for them to really try and get every last available SSA bond for the time being. But if they don't increase the ISIN

limit then the first reaction will, most likely, be to shift more into the private sector programmes because that's an easier thing to do — they can just do it without any trouble from the Governing Council.

The ECB would need the council's agreement to increase the ISIN limits on SSAs, and I don't know whether that's possible. Though, given the choice between more helicopter money and a higher ISIN limit, the Bundesbank would probably go for the higher ISIN limit. The ECB could also temporarily move away from the capital key without a need to announce anything.

But if the ISIN limit on SSAs and govies is not increased, it potentially means gross covered bond purchases will rise from €4.5bn to €6bn a month. Even though that doesn't really move the needle for the overall Asset Purchase Programme, it would be quite disastrous for covered bonds. Although increased ECB buying is likely to be good for investors' existing holdings, it will be bad for any new investment, and bad for new issuance. Along with negative yields, investors could possibly demand substantial new issue premiums of 15bp-20bp... I don't know. I'm really, really anxious on the ISIN limit — not in the short run, but a good three quarters down the line. In the second half of 2020, after the summer, it could get a little ugly.



Timo Boehm
Pimco

GlobalCapital: We've already seen some deals being priced flat to their curve. It feels like new issue premiums are already disappearing.

Boehm, Pimco: Everything being equal, I agree that new issue premiums will decline over time, not least because we have the TLTROs, which will prevent a rather huge wave of supply in covered bonds. However, I would argue that new issue premiums will depend on overall yields. As long as 10 year covered bond yields can just about hold above zero, there might be room to tighten new issue premiums (NIPs). But if we return to levels seen in August 2019, when the 30-year euro swap rate was at 0%, NIPs will probably need to rise.

Admittedly it was holiday season, but we only saw two new euro deals surface in August. Both were deeply negative and attracted only 30-40 investors. Under such circumstances, issuers may need to provide a bigger incentive to get investors into their deals.

Besides bank treasuries, we shouldn't forget the real-money investors, like insurance companies and pension funds, who need to earn money for their clients. If a

covered bond is priced at negative yield, then these investors need a certain degree of tightening to avoid losing money. These are precisely the companies that are going to suffer the most with the low-yield environment — so it's very important that, if rates fall back to the lows seen in August, issuers offer compensation by way of a higher new issue premium.

Nadine Fedon, Crédit Agricole: When we issued our last public sector covered bond, on September 4, yields were at their most negative, with 10 year swaps at minus 25bp, and (including the NIP) the real-offer yield on our nine year bonds was minus 0.22% — and the demand was, of course, smaller. If yields are that negative, it is only possible to issue when the differential with the domestic benchmark of the same country is significant. French covered bonds are a proxy for the domestic benchmark, so investors will buy if they really have cash to put cash to work.

Sequencing

Vincent Hoarau, Crédit Agricole CIB: Pricing flat to the curve is more likely with infrequent quality issuers where the scarcity element is well pronounced. When it comes to core national champions, new issue premiums are still requested. Supply may soon dry up, so I would expect spreads and new issue premiums to drift lower into the end of 2019. Then, depending on whether issuers decide to front-load funding in January, the direction of spreads may evolve drastically. Many borrowers were caught by surprise in January 2019 and issued at fairly elevated levels, so they may become more vigilant, in terms of sequencing issuance in 2020. The ECB is back, pressure is lower, so the supply dynamic could be different in the early part of 2020.

Ger Buls, Rabobank: We've issued eight covered bond benchmarks since May 2017 including some dual tranche deals, but going forward we plan to issue once or twice a year. Given our limited needs, we are more flexible with regard to timing. Therefore there's likely to be no urgent need to rush into the January window. I don't think there will be a massive spread tightening, but on other hand I don't see much risk of a spread widening, so there's no pressure to hit the market early.

Sami Gotrane, SFIL: We expect to carefully manage our balance sheet and optimise our P&L by paying careful attention to sequencing in 2020 to find the best funding window and reduce our liquid assets and cash equivalent. In 2019 we raised €4bn, of which €3.6bn was public, including €1.75bn of sustainable bonds. We issued €1.25bn in January, split over six and 15 years, but as we start 2020 with €4.5bn of cash equivalent, the challenge here will be to optimise our balance sheet. Obviously we'll discuss the right funding window with our banks and it's likely we'll make an appearance in the first quarter, but I'm not sure whether it will be in January. Two-thirds of our global funding is under covered bond format; within that context we intend to be flexible.

Fedon, Crédit Agricole: We have a funding plan which is set for the year and has constraints resulting

from financial communication, programme and documentation updates. But within this framework we have some flexibility regarding timing and sequencing.

We have no fixed target regarding the covered bond spread to senior preferred, nor for other instruments, but we try to optimise spreads on higher beta transactions. In January 2019, we thought senior spreads were much too high, and clearly distressed, and thought that they would tighten. Therefore we decided to go for lower beta transactions like covered bonds and short-term euros. In fact, having a funding programme of €17bn for the year means we cannot skip a window completely.

We attach great importance to diversification as well. Having done the largest part of funding in euros this year, we have issued senior preferred in Australian dollars, sterling, Swiss francs and US dollars and we've also issued a green senior non-preferred in euros. We generally want to operate in all these markets when the premium is not too high, but if the premium is reasonable.



Sami Gotrane
SFIL

There is no sense in diversifying in other currencies in covered bonds, except for Swiss francs where we have a natural interest. This year we issued covered bonds twice in Swiss francs, but next year it will be difficult because the spread differential could be higher due to the purchase programme.

Buls, Rabobank: The spread differential between covered bonds and the senior preferred markets should be meaningful to issue covered bonds. In general, covered bond issuance is in the medium to longer tenors, versus shorter tenors in the senior preferred market. With short to medium-dated funding you could question whether covered bonds are really the perfect instrument — probably not. But when you look at the differential between senior preferred and covered bonds in the 10 year, for example, it's quite meaningful.

Ideally we'd like to fund our regional branch balance sheets with senior preferred in Aussie dollars and US dollars. So if these markets are pricing relatively competitively to euros we'll enter them, but if not then we'll look for alternatives. Ultimately we monitor all the different markets and all the different products. The most important component of our funding mandate is that we need to fill the senior non-preferred part with our MREL needs and the remaining funding, which is between senior preferred and covered bonds, is relatively flexible.

Hoarau, Crédit Agricole CIB: Sequencing means it will become extremely important to take a view on the evolution of the rate-spread complex over the year and push one, or the other, part of the liability structure-curve, or just wait. Because, with a deeply negative yield, low beta issuance might not necessarily work. Despite the support of the Eurosystem, we have already seen in recent weeks that the magnitude of the demand and the quality of the order book can significantly vary, depending on the level of outright yields.

GlobalCapital: What's your view on rates?

Eichert, Crédit Agricole CIB: The house view is for another cut of 10bp in the deposit rate to minus 0.60% but that's it. The house view is that the rates market is currently at medium-term peak and that yields will start trending downward again from here.

Buying below zero

GlobalCapital: Are negative yields a deal breaker?

Carlos Martins, European Stability Mechanism:

The fact that investors are not willing to buy securities with yields below zero is understandable. However, expecting covered bonds would not trade below the 0% yield threshold could be wishful thinking. If there is a downward shift in the yield curve due to an economic downturn, or because of another ECB rate cut, all yields will structurally fall, including covered bonds. At first, when overall yields fell below 0%, SSA investors were very reluctant to invest; eventually it became structural and investors had to bite the bullet and start buying at negative yield.

Buls, Rabobank: There are some investors that simply can't accept negative yields and there are also some that are not participating in deals that price through mid-swaps, or because of the tight spread to govies. For these reasons, the number of investors in the book can be more limited, which means the size of a trade might tend to become smaller. So it won't necessarily be so easy to get benchmark executions. Obviously, if there's a reduced group of investors buying it's going to have an impact, though I expect issuers will try as much as possible to term out funding with longer deals to avoid negative yields.

GlobalCapital: There doesn't yet seem to be any sort of precedent in the covered bond market for ultra-long maturities. How far would you extend to avoid negative yields?

Boehm, Pimco: There are one or two examples of ultra-long covered bonds such as CFF's 50 year. But I would say this is a very illiquid covered bond. But if there were more issuers to come in on the ultra-long end of the curve, then it would make it much easier for investors. The curve now is flat after 23 or 24 years, which makes it very difficult to buy. We don't want to roll up the curve for no compensation, so if you come with a 30-year covered bond you would need to make sure there is sufficient new issue premium to offset the flatness of the curve in this maturity bucket.

The flattening we saw in the first half of the year was also a function of the very low yield environment. But some of our clients need to pay careful attention to their liability management, so for this reason they buy at the very long end which is much more interesting than the typical five to seven year where we see most covered bonds issued.

Martins, ESM: In practice, we mainly invest in the five to 10 year sector as it corresponds to our market risk appetite. Yet, we can theoretically invest in longer maturities. If yields are very low and the only real positive yield is on a longer part of the yield curve, we would then need to reconsider. We would need to be rewarded by some term premium but with a very flat yield curve above the 15 years, there is not much term premium left and certainly nothing above 25 years. On top of that, unless for hold-to-maturity investor types, one has to consider the potential higher volatility for such long duration positions.

Hoarau, Crédit Agricole CIB: During the summer it was all about how to avoid negative yields, but since September, we've had a dose of evidence that negative yields work. It's a relative value game in a market where cash is not an asset. Nevertheless, there is still a lot of resistance. And we acknowledge there is a strong correlation between the quality and granularity of an order book and the absolute re-offer yield. We have around this table some extremely diligent investors that have demonstrated that they can be accommodating some of the time, but at other times they can also be extremely sensitive to the spread.

Boehm, Pimco: Most real-money investors like us manage our performance against a benchmark such as the Bloomberg Euro index, which has a negative yield right now but it shows a total return in 2019 of 3.3%, which is fantastic. The total return of the Bloomberg covered bond index was also positive in 2018 and 2017, which is proof you can earn money even in a low-yielding environment.

But, what we've also seen in the past is that clients might also think about their overall asset allocation and we've already seen a trend of clients moving away from covered bonds into bonds lower down the bank capital structure, or into alternative investments like equities or real estate. And if the rates cycle changes and yields start trending higher then it's likely we'd be looking at a negative total return, in which case even more clients might be motivated to seek other investment opportunities.

Relative value

Martins, ESM: I think one alternative that we can also look at, within the covered bond space, is outside the euro area, such as issuers in Canada, Australia, New Zealand, and the Nordic countries. They trade at a small discount to euro area covered bonds but the quality of the asset pool is, generally speaking, of very similar quality.

Miguel Garcia De Eulate, Caja Rural de Navarra: But before going to real estate or other alternative assets, it's

possible investors will consider peripheral covered bonds which offer higher spread, where of course there is still a lot of room for tightening against core names. What has shocked me is that the rating difference between core and peripheral European covered bonds is only one notch — but when you look at spreads, we are still talking about a large differential of many tens of basis points between some Spanish Cédulas and core European covered bonds.



Vincent Hoarau
Crédit Agricole CIB

Hoarau, Crédit Agricole CIB: I fully agree with you. Semi-core covered bonds are still attractive, but we have not seen the full effect of the restart of the Asset Purchase Programme. When that happens, you can bet on a decent spread convergence.

When I look at the entire credit spectrum in covered bonds, I still don't understand why there are some jurisdictions and some names where convergence has not been more pronounced — particularly in Italy, where the BTP compressed nicely versus Bunds. In some specific situations, I see a 50bp differential to core names which makes me question the relevance of some levels in the secondary market where the liquidity is — by the way — sometimes non-existent.

GlobalCapital: And if yields and spreads are too low, there's always the senior unsecured market.

Hoarau, Crédit Agricole CIB: Indeed, I think there is also room for spread compression versus covered bonds before covered bonds can tighten further. We had a couple of recent senior preferred deals from DNB Nor and Helaba where bookbuilding was booming because of their substantial spread premium to covered bonds. And in recent years banks have been building their capital stacks, reinforcing the safety of the senior preferred layer.

That said, in terms of spread evolution, the outlook will strongly depend on issuers' behaviour and funding tactics, together with absolute rate levels. As history has demonstrated, a big spread driver for covered bonds is supply. What if, for example, core issuers collectively decide in January 2020 to favour MREL and TLAC issuance and they postpone covered bond issuance because they think conditions and appetite may be better later in the year?

Most bank issuers have funding needs in covered bonds, senior preferred and non-preferred, and potentially tier two or tier one. So you could have a

good part of January that is skewed towards higher-beta instruments in the core markets, which will indirectly support a relatively better performance of the covered bond sector, particularly at the long end where the curve could flatten further.

Boehm, Pimco: We look at the relative value of covered bonds versus senior preferred and if there is enough room we invest in one or the other, depending on the portfolio.

Hoarau, Crédit Agricole CIB: If you look at the recent performance of covered bond new issues since the end of the summer, everything has worked fairly well. But the performance of recent core senior non-preferred deals has been relatively weak because of the spread compression in non-preferred to preferred senior in the last six months.

Regulatory funding

GlobalCapital: How do you break down your overall funding across the capital stack?

Fedon, Crédit Agricole: We fix our funding programme yearly by looking at the expected evolution of the balance sheet, and at the medium to long-term (MLT) liquidity excess. We target an excess MLT liquidity of above €100bn to fund our High-Quality-Liquid-Asset portfolio, and that essentially defines the entire funding plan for the whole year. In our medium-term plan we also disclosed that our subordinated MREL target for the year ending 2022 is 24%-25%. That includes CET1 of 16%, AT1 of 1%, tier two of 3% and senior non-preferred of 4%-5%.

Those two targets define both the size of the funding plan, and within that, the need for capital stack, split by instruments. As an example, within our €17bn funding programme for 2019 there is €5bn-€6bn of TLAC debt – from tier two to senior non-preferred. The remaining €12bn is funded in senior preferred, covered bonds and securitization. Next year's figures are not decided.

Garcia, Caja Rural Navarra: Meeting MREL requirements has mostly been done by Spain's bigger banks, but medium-sized banks like us will probably need to think about this soon – and we expect to hear more about our MREL requirements in the next few months. Of course we remain committed to the covered bond market but MREL will be key. There is of course a spread relationship between covered bonds, senior preferred and senior non-preferred. As we build out our MREL curve we will see where spreads settle and then we can compare.

TLTRO

GlobalCapital: And when we think about the TLTRO which is the cheapest to deliver, that's also going to bring down supply, especially now it has been made more favourable in terms of lengthening the duration to three years, as opposed to two, with the option to pay back early. How does that affect your overall funding?

Buls, Rabobank: TLTRO is up to three years, so there is still a need for the alternative longer funding that covered bonds can offer. Obviously the TLTRO stands to reduce our funding need but it's not yet a given that we'll participate as we still need to make the calculation and decide whether it makes sense. After fulfilling our MREL requirements with senior non-preferred, we look at senior preferred and covered bonds. The long-dated mortgages on our balance sheet are best match-funded with long-dated covered bonds, which is a market that we are committed to maintaining a strategic presence in. We also want to keep a presence in senior unsecured in US dollars, Aussie dollars and New Zealand dollars, so if it makes sense we'll prioritise senior supply in these markets too.

Fedon, Crédit Agricole: We increased our 2019 funding programme in comparison to 2018 in order to address the repayment of TLTRO II. But now we have TLTRO III, which has been significantly improved. We expect to use it, probably in the same way as in the past, which is to fund our short-term needs and then go to the market for longer maturities. What we will not do is issue benchmark senior preferred for two or three years, which is what we had intended to do if the TLTRO had been stopped without replacement.



Miguel Garcia De Eulate
Caja Rural de Navarra

Garcia, Caja Rural de Navarra: Three year TLTRO is much cheaper than covered bonds for Spanish issuers and it means banks are not under pressure to issue. So I expect more Spanish banks to refrain from covered bonds in the next year due to the combination of TLTRO and deleveraging.

Deleveraging is key because if you really see growth in mortgage lending then banks will begin to think about covered bonds, which for most Spanish issuers are a strategic funding tool for long-term funding that does not compete with the TLTRO. The Spanish mortgage market used to be a purely floating one, but it's now half floating/half fixed, and since covered bonds are a fixed rate, they provide a natural hedge for balance sheet.

GlobalCapital: How useful is the TLTRO for Caffil?

Gotrane, Caffil: We are not a bank but an agency, so the way we use covered bonds is a bit different. We have a very conservative approach to asset liability

matching, with the average duration of our loan portfolio being around 11 years and the maximum allowable duration mismatch being around one year. We've seen a lot of municipalities and local authorities extending borrowing in 2019 to the 20 and 30 year level, where rates have become very attractive. We expect to have originated close to €5bn of new loans in a portfolio of €55bn with a small drift to increasing the maturity. For this reason the TLTRO does not fit well with our strategy.

Deposit tiering

GlobalCapital: Earlier this year the ECB introduced deposit tiering, which to my mind is an admission of the pernicious impact of negative rates. Combined with the TLTRO, it feels like the ECB's 'extraordinary measures' are becoming ordinary.

Martins, ESM: ECB deposit tiering and the TLTRO, along with the crowding-out effect of the ECB's purchase programme, should help small and medium-sized bank issuers in semi-core countries to more easily access the senior and subordinated markets to boost their capital buffers and meet the MREL requirements. Therefore, despite some recent criticism about the side-effects of negative yields, this policy should contribute to make the banking system more resilient.

Garcia, Caja rural Navarra: I had the opportunity to listen to Luis de Guindos from the ECB at a conference in Bilbao and my take was that the ECB is very concerned about the viability of the European financial sector in the negative yields environment, especially in countries where the loan book has been repriced aggressively, leading to disappearing profit margins. They know that 12 month Euribor is very important for Spanish banks. In August the 12 month Euribor rate was minus 40bp and now it's minus 30bp. That's only 10bp, which may not sound like much, but there's some research so suggest that this is the difference needed for banks to be profitable.

Eichert, Crédit Agricole CIB: If it helps you guys, that's great, but there's a whole lot of German, French and Dutch banks who have excess reserves that are 20-25 times their minimum reserve requirement (MRR). They put six times their MRR to the ECB at zero, but for the rest of their deposits it doesn't change anything.

Garcia, Caja rural Navarra: That's true but what I'm saying is that the main benefit of deposit tiering is the effect it has on 12 month rates. Tiering could in effect be used as a tool to put a floor to short end rates and in that sense the ECB has the flexibility to increase the present cap of six times MRR.

Eichert, Crédit Agricole CIB: I agree that the present deposit tiering cap of six times MRR is probably only a starting point, but it cannot go up to the point where it reduces excess liquidity in core European countries substantially. If the ECB were, for example, to increase the cap to 25 times MRR, all excess liquidity would be put to the ECB and money markets would shut down. The ECB needs to keep money markets up and running as smoothly as possible.

Fedon, Crédit Agricole: In June we disclosed that we have €75bn of excess deposits with central banks, so having a part of this charged at zero percent instead of minus 0.50% is a positive. In fact retail customers have increased their deposits with us at 0% as long-term yields have fallen. Deposit tiering goes some way towards compensating our margins. It helps the ECB to pursue a longer-term policy of negative rates, limiting the cost for the European banking sector.

Buls, Rabobank: We park quite a bit of cash at the ECB and tiering has helped dampen the cost but it doesn't have a direct impact on our funding behaviour. We try to optimise excess deposits above the tiering threshold as much as possible.

GlobalCapital: Bank investors can now put up to six times their minimum reserve requirement to the ECB at zero, rather than invest in one year covered bonds at, say, minus 30bp. Yet, am I right in thinking there are few covered bond bank investors that are in this situation, so it won't lower bank demand for covered bonds by much?

Eichert, Crédit Agricole CIB: I'd say so, yes. Quantitative easing adds €20bn every single month, and because you're adding to the ECB balance sheet, you're increasing the excess liquidity in the system.

Garcia, Caja rural Navarra: We are an issuer but also buy covered bonds from time to time. The impact of deposit tiering is not really about the overall average cost but what happens at the margin. We invest all we can in the deposit tiering up to the cap of six times our MRR. But we're generating additional excess liquidity in Spain due to deleveraging, so every euro of excess liquidity that is generated beyond that cap will need to be invested in any bonds that offers a pick-up to the ECB's deposit rate of minus 0.50%.



Carlos Martins
European Stability Mechanism

Martins, ESM: Tiering at six times the MRR was a prudent first step and the ECB probably still has room to increase the multiplier if needed. Nevertheless, if the ECB had to increase the multiplier significantly, it would be in effect a rate hike, which could be counterproductive from a monetary policy point of view and, eventually, damage the good functioning of the money market.



Florian Eichert,
Crédit Agricole CIB,

Eichert, Crédit Agricole CIB: It's an iterative process. They started at six and will assess how markets reacted. If everything is calm, they might increase it and pause to analyse the impact before possibly moving back if the reaction is too strong. But even if the threshold for deposit tiering is set at 10 times a bank's minimum reserve requirement, the German banking system will still have an additional €250bn of excess liquidity that will need to be deposited with the ECB at the lower prevailing discount rate of minus 0.50%. So, when it comes to making a decision about where to invest the next euro of excess liquidity, banks will be looking at the deposit rate and not the tiered rate of zero percent or a blended cost of the deposit rate and tiered rate.

GlobalCapital: Why not cut the deposit rate and increase the MRR multiple?

Eichert, Crédit Agricole CIB: That would be the natural thing to do. The ECB should probably try to do something that offsets the hit on banks' profitability from a further cut in the deposit rate. That could be done by increasing the tiered rate above zero or raising the MRR multiplier. They have a lot of variables to play with.

Garcia, Caja Rural Navarra: We're running an internal study in our bank to ascertain the positive impacts of deposit tiering and the TLTRO relative to the negative impact of a further 10bp cut in the deposit rate. The negative impact of a rate cut and more deeply negative yields on our loan book far outweighs the two positives.

Performance potential

GlobalCapital: The falling yield and tightening spread trend seen in covered bonds has provided investors with the best absolute returns in years. Realistically, what chance is there of repeating 2019's performance in 2020?

Martins, ESM: Tariff discussions between the US and China seem endless, while slowing Chinese growth may continue to hit German exports. There is also potential noise from trade negotiations between the European

Union and the US, while some uncertainty remains in place regarding post-Brexit reality. We have not yet seen the complete spill-over effect from Germany's slowdown to the other countries in the euro area – which may take six to 12 months. If this slowdown persists, the ECB may have to continue with its current expansionary monetary policy, implying a lower and flatter yield curve; this means we would still potentially see another positive year for fixed income assets in 2020.

Hoarau, Crédit Agricole CIB: But could credit spreads realistically resist a downturn in equities, because this is precisely what may happen if what you are describing occurs. If you are right about next year I think it should logically translate into a correction in global equities and I don't see how credit spreads cannot be affected by that.

Martins, ESM: Equity markets may be holding up in anticipation of further easing and, if that's the case, then spreads should be quite resilient, if not even tighter. Of course, in case we see a meltdown in equities, we can expect a sell-off of risky assets into safe-haven assets. The question then is to assess which assets will the market participants regard as safe-haven. Will higher rated government bonds in the euro be considered more connected to the risk-free area, or the opposite, as occurred during the euro crisis? With the current institutional framework and financial architecture deployed after the crisis – including the creation of the ESM – there is a good chance that the countries in the euro area are now far more resilient to a crisis.

GlobalCapital: Timo, what's your view on the likelihood that covered bond investors will get remotely close to matching this year's performance?

Boehm, Pimco: Our target is always to provide alpha versus the benchmark. I wouldn't go so far as to say we'll match the 3.3% total return seen this year. But what we will try to do is switch out of our existing covered bond exposure into new issues, which provide a degree of new issue premium and take more exposure to the credits we like. We will also look at the Danish covered bond market, where the yields are much higher relative to euros, as well as Swedish covered bonds. We also might look more closely into new issuers and new jurisdictions such as those in central and eastern Europe.

And what we also see right now is a new development in structured deals which are called covered bonds and included in the covered bond index, but are not backed by a covered bond law. We will try to analyse these and stress the pools to get a feeling on repayment risk. These structured deals pay a higher spread but there can be a dilution in asset quality, which is where we have to be very careful, also as an industry. We also look at special situation programmes where issuers are in run-down mode and we'll sometimes look at retained covered bonds that are brought back to the market. This is where we can add some basis points to our clients' portfolios.

Fedon, Crédit Agricole: In theory covered bond spreads to mid-swaps could potentially come back all

the way to where they were at the beginning of 2018. However the impact is going to be smaller because rates are negative. Nevertheless, investors buy covered bonds as a proxy to the domestic benchmark, so this is the relationship that's going to be key. If the domestic benchmark goes extremely negative then covered bonds will follow, but if they stay where they are the potential tightening for covered bonds is going to remain limited. In a normal rates environment the tightening could be up to 10bp from present levels but some of that has already been seen – and we are not in a normal rates environment, which leads me to think the potential tightening from current levels is going to be something closer to 5bp.

GlobalCapital: I'm struggling to see where there's any potential for sustained performance from current levels.

Eichert, Crédit Agricole CIB: You have a number of investor bases that buy irrespective of yield or spread. The euro system is there to generate volume, so they'll be buying at any level. On the asset management side you have a lot of relative value players who will buy if there's a 30bp-35bp pick-up to Bunds and a 20bp-25bp pick up over OATs. The absolute level versus swaps won't matter.

Then there's bank treasuries which of course also look at covered bonds in relative value terms across the LCR eligible universe. However, they also have an absolute spread element in their thinking. The current spread of the ECB deposit facility versus three month Euribor is a good 10 basis points and they are clearly trying to beat this level. When looking at covered bonds, banks will add a few basis points for capital cost and the LCR haircuts, but as long as they trade around three month Euribor flat, those costs are covered and there is a vast amount of liquidity that is ready to play. However, if the covered bond spreads fall below that breakeven level, banks will simply stop buying them, refocus on government bonds or SSA or simply leave the liquidity at the ECB's deposit facility or current account.

And depending on how issuers sequence their funding next year, we could potentially see the market widen 3bp-5bp, but the eventual level where I'd expect core European covered bond secondary market spreads to settle is around 5bp-7bp through swaps with primary deals pricing with one or two basis points of new issue premium. That's not going to make anyone happy, but it's a sustainable equilibrium that can work for a very, very long time.

Buls, Rabobank: I assume the ECB's order will be in for the same amount in the new year as it was in November, but this is not necessarily a given since they could just be ramping up ahead of a quiet December. But if they carry on in the same way, then this will definitely have an effect on spreads but also on the execution risks of transactions. It's clearly helpful to have a large order in the books which will help spreads a bit. The downside is that some investors that are active in this market might drop and not participate. There might therefore be a bit of an offsetting element, and because of that it's not likely spreads will tighten by too much.

Structured covered bonds

GlobalCapital: Timo mentioned that Pimco is also looking into structured covered bonds. Do they give you any cause for concern?

Martins, ESM: It only takes one default to lose a full century of reputation so I think it is very important to still define and distinguish those covered bonds that are regulated under national law from those alternative structured products.

GlobalCapital: But just because it is structured, doesn't necessarily make it less safe.

Eichert, Crédit Agricole CIB: If you look at deals issued by Deutsche Bank or SMBC they're both using traditional assets. You can find a lot worse cover pool quality in Germany than the structured covered from Deutsche which, for now at least, is almost entirely residential mortgages.

GlobalCapital: Do you think other issuers, whose senior preferred deals trade with a triple-digit premium, might also be interested in mimicking this trade, or will they prefer to rely on the ECB?

Eichert, Crédit Agricole CIB: Most banks are liquid and do not necessarily need to add yet another product to their funding stack. Deutsche Bank's senior preferred spreads are wide so it has room to issue a deal mid-way to where its Pfandbrief trade. For most other issuers, such a trade doesn't make sense because their senior preferred to covered bond spread is not sufficiently wide enough, which means it is probably going to be a niche product. I do not see a lot of issuers and I certainly don't expect new asset classes to be added.

Hoarau, Crédit Agricole CIB: Investor due diligence should preserve the quality of covered bonds, irrespective of whether they're legally-based or not. Deutsche Bank's structured covered worked because some dedicated and committed investors did the analysis and decided it was worth investing in and it's the same for SMBC. The quality of the bank sponsor also plays a key role

ESG covered bonds

GlobalCapital: Caffil has always issued hard bullet legally-based deals, but you also issue smaller deals that help cater to issuers' specific requests, don't you?

Gotrane, Caffil: We do issue what we describe as lightly structured transactions, which are obviously not the same as structured covered bonds and are for private placement only. The potential here is rather small and it's not something we've done in the last year.

It's good to have new members but at the end of the day what is also good is to keep the quality of the product and in this respect I struggle to see much credit spread differentiation. So even if you are really a bad

portfolio manager, that probably means you will be paid the same as your colleagues. Having said that, what we do clearly see is the size of the order book, which in the case of our recent inaugural green deal was four times subscribed with over 100 investors — so here we were able to price with practically no concession.

Hoarau, Crédit Agricole CIB: In this market, technicals often play a greater role than fundamentals. For example, conventional bonds and green bonds rank *pari passu*. But that is in contradiction to the fact that a green bond in primary attracts a greater investor base for the issuer, a greater level of granularity in the order book, and ultimately a more positive price traction. This is driven by the fact that there is a significant imbalance in green supply and green demand. And the higher the beta, the more pronounced this phenomenon is. In covered bonds, curves are compressed and supply is scarce, so it is difficult to illustrate what I have just said with specific examples. But if you screen the unsecured market, you will see green curves trade a few basis points tighter.

Martins, ESM: The ESG market will become increasingly relevant in years to come, as this component will gradually be incorporated into all investment decisions. However, covered bonds have so far lagged SSAs, in terms of green and social issuance, which means there is a lot of room for this market sector to catch up.

Garcia, Caja Rural Navarra: Sami and I have been engaged in this market for several years and since we issued our debut ESG covered bond in 2013 we've been able to access more and more investors from the Nordics, the Netherlands, France and Germany of course. But, that said, the covered bond market still lacks ESG supply.

Eichert, Crédit Agricole CIB: We've seen a fair amount of senior issuance but less so on covered bonds for a number of reasons. One is that issuers can get more benefit by deploying this product to the higher-spread products. Another is that there needs to be a link between what is in the pool and the issuance.

On the public sector and commercial mortgage assets it's easier to identify these assets' ESG credentials as issuers can go into every single loan almost. On the retail mortgage side, many banks still don't even have the data — for example, in terms of energy performance certificates linked to the loan. So it's still a bit of a Wild-West-type of environment in the covered bond space at the moment with different approaches being used.

Garcia, Caja Rural Navarra: I must agree with you — it's a challenge to tag each and every mortgage. However, we have been doing this since May this year and we've created four new fields including numerical and descriptive data on CO₂ emissions and kilowatt usage per square metre. These four fields are filled in for each and every mortgage, which is not easy but it can be done.

This data will help investors to accurately gauge our sustainability efforts, though whether we get a regulatory lift remains to be seen. But in any case, I'm convinced something is coming down the line, in terms of differentiating between brown and green assets, at which

point there's going to be a very compelling reason for all loans in the book to have an environmental tag.

Boehm, Pimco: Ultimately green and sustainable covered bonds should become the new normal, they shouldn't be the exception. We have clear guidelines to stick to ESG-compliant issues which shows there has already been huge transformative progress for the whole industry. It shows the ability of capital markets to force progress and bring lenders to account when it comes to funding less sustainable practices like mining, fossil fuels, weapons or slave labour.

Eichert, Crédit Agricole CIB: We've also been working at the European policy level so see whether a green supporting factor for mortgage risk weights could be something to counterbalance the increase in capital requirements likely to come from Basel IV. This is a long-term process and for new mortgage origination I'm pretty sure that every single bank is already flagging up green mortgage assets in their systems. But since this is for new origination and not existing stock it will take time.

Martin, ESM: The market is still developing so there's a fair degree of freedom. Even if you think about the proceeds of the senior unsecured part of a covered bond, that could be also used for a green project.

Hoarau, Crédit Agricole CIB: But that is where investors' diligence comes to the forefront. And I like that, particularly in the unsecured space. Some investors are already complaining that some frameworks are too weak, that they don't see any positive impact, arguing that some programmes are merely labelling 'business as usual' lending as having an ESG-related impact.

These are isolated cases, but welcome messages. It is instrumental to preserve the hard work done by pioneers to maintain high quality standards and produce positive impact bonds.

Gotrane, Caffil: We decided that all the export finance loans should be on the balance sheet of SFIL with nothing in the covered bond programme. It was a key structuring point and now we have a very loyal investment base in Germany. So when we have some turmoil in the market, and I'm convinced of that, I would say that you will attract a better bid for our green or social deals. **GC**



Bill Thornhill
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