GlobalCapital

ASIAN COVERED BOND ROADSHOW SPECIAL REPORT

April 2023

Sponsor:

DZ BANK

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The diversification imperative: analysing the growth of covered bonds outside the eurozone

In March, Euromoney Conferences held its annual Asian Covered Bond Roadshow event in Singapore. Among many topics discussed by participants on multiple expert panels, the growth of covered bond issuance outside of Europe and in Asia specifically was one of the most important.

The following insight is an edited version of the panel discussion – sponsored by DZ BANK – on this topic, and covered some of the key points below:

- Understanding the greater role for US dollars and sterling in issuance in 2022
- Domestic currency vs international: Pros, cons and regulations
- Untapped potential: which currencies need covered bond issuance (but don't know it yet)?
- How can the global covered bond industry jointly develop the global investor base?

Participants in the roundtable were:

Friedrich Luithlen, head of debt capital markets, DZ BANK

Matthias Melms, head of syndicate and origination, financial institutions and SSA, Helaba

Chris Ngooi, head of wholesale funding, DBS Bank

John Pang, head of portfolio management, group corporate treasury, Maybank

Guy Volpicella, managing director and head of structured funding and capital, Westpac

Richard Kemmish, moderator

GlobalCapital: We have seen a massive uptick in issuance in covered bonds in the Eurozone recently, to some extent this has been mirrored outside the eurozone but there is a little bit of me that is pessimistic that it isn't a real development in the non-Eurozone investor base, it's just a safety valve because Euro supply has been so great. Do you think that is the case Matthias?

Matthias Melms, Helaba: We have seen the largest issuance volume ever in the euro market last year, there is definitely the need for diversification. The investor base in euro is not unlimited so €210bn of issuance last year was really a huge volume, so we are seeing more issuers looking at opportunities in other markets for diversification of the investor base. Covered bonds are the right instrument for that diversification. We have seen $30bn in USD denominated issuance last year, £20bn in sterling and this has not only come from domestic issuers who use the opportunity to fund themselves where they have natural need, but its also other issuers that look for diversification in non-euro currencies. The market was supporting this supply. What is highly important – as the covered bond is not only a product for bad weather – is that we see diversification in regulatory treatment outside the euro.

There are some good reasons why the euro is the largest covered bond market worldwide, one of them is regulatory treatment: HQLA eligibility, central bank repo eligibility, etc. One of the largest investor groups in the market are bank treasuries because of this regulatory treatment. It's important for markets outside the euro that we get a similar regime in these markets as well, not only to bring asset managers to the product but also to offer banks the possibility to use them as high quality liquidity assets. Its good to understand that Singapore is at the forefront in introducing this regulation and I'm really excited about that. I'm convinced that will open the door for much more issuance here.

GlobalCapital: Fritz, you have this vast, hungry sales force desperate for euro supply. Are we really

reaching limits? Or are they more specific: they are full of European covered bonds?

Friedrich Luithlen, DZ BANK: I don't think we are reaching any limits. We've done nearly €200bn in euro covered bonds last year. We are seeing that the Canadians, for example, are still doing large transactions – just this week Toronto Dominion launched a two tranche €5bn transaction.

What we see is this: The share of bank treasuries buying euro covered bonds has increased to about 50%. This is a clear function of the improvement in the spreads. Also, bank treasuries are not constrained in terms of liquidity as real money investors are.

When we look at the investors, we don't see much regional diversification of the investor base. So, when you look at US dollar denominated covered bond issuance, you sell about only up to a third of the trade into the US, 10% of the trade goes into Asia, with the balance going to Europe. European bank treasury books – including DZ's – buy US dollar covered bonds. The current cross currency arbitrage target is around 10 basis points. Same for sterling. If you have lines for the credit the currency is not a problem.

The regional distribution of investors committing to a euro denominated covered bond is also pretty static. Half of a transaction typically goes to the Germany/Austria region, with investors in the Nordics and the UK taking a good chunk. Non-European investors take less than 5%, and that hasn't changed. But that change is something that we would like to see. For instance, I'd like to see Singaporean dollar denominated covered bonds. It would take some volume away from us in euros where we earn our fees, but it would showcase that local investors are increasingly engaging the product.

However, the obstacle here is not so much the product as the currency. The euro is not an interesting currency to invest in in an Asian context. This is beginning to change, though.

GlobalCapital: **Guy, when you speak to investors about issuing in various currencies, is this to fulfil a natural funding need or arbitrage? How much of this is swap comparison driven?**

Guy Volpicella, Westpac: There are so many things in play in terms of what you think about at the time. The number one priority that you think about from a funding perspective is building a large sustainable platform for your funding. That's the key theme. Then you look at what that means for all of the trades.

For Westpac, we have been pretty consistent in terms of the amount of wholesale funding and in terms of the amount of covered bond funding that we have done and the jurisdictions that we've gone into. I first started issuing covered bonds back in 2010. We said at the time that we were going to do about A$30-40bn of aggregate wholesale funding and about A$6-8bn of that would be covered bonds. We'd be targeting at least one deal in

Guy Volpicella
Westpac

euros, one deal in US dollars and three deals in total, which is pretty much what we did. And we'd look at other currencies as well, such as sterling and Swiss francs.

Fast forward to where we are today and other than the term funding facility that we had access to during Covid, what did we do last year? A$8bn of covered bonds, A$40bn of term wholesale funding, a Swiss franc trade, and a sterling trade. We are kind of boring in the sense that we are doing consistently the same thing time and time again. Some of it is driven by price but not all of it – its driven by diversification, by building our funding base.

What does issuing covered bonds do for Westpac? It allows us to broaden our investor base. But it's not just the number of investors. It's also tenor. One of the things that we like about the European market is that we can actually increase our tenor; we've issued five year, seven year, 10 year and benchmark trades up to 15 years. This is different to the Australian dollar market, which is a three to five year market. In the US, we've issued in US dollars slightly wider than in euros, and we do that because it tends to be a five-year market and that's the tenor that we are trying to achieve.

So there are several factors in play here when we consider what currencies to issue in. Worth adding that Australia is unique in that triple-A rated covered bonds are repo eligible. Interestingly, they don't get the LCR treatment, but they are repo eligible. That's the same for Canadian dollar covered bonds.

GlobalCapital: **Chris, you don't have as big a funding need. Do you agree with Guy about the decision making? Or are there different factors?**

Chris Ngooi, DBS Bank: Not that much different from what Guy just said. In terms of the wholesale funding needs in general, Singaporean banks are generally deposit funded. The whole genesis of the establishment of a covered bond a couple of years ago was to diversify our funding sources.

Other than Singapore dollars, US dollars are the second biggest currency on our book, so naturally we have a need for US dollars. When we look at various types of funding sources, whether it is senior, or covered, and what kind of currency we look at on a relative value basis, we ask which one is more attractive? That helps guide our decision making but we always have to start from a need basis. Do we have a need for it? If so, how do we then construct a case as to which market to go to, what does that look like on a swapped basis, in terms of credit spreads? So it's a dynamic discussion.

GlobalCapital: John, are we going to see the development of domestic investors? Are they interested in covered bonds?

John Pang, Maybank: From Maybank's perspective, we are a potential issuer in Singapore dollars. We are actually looking at both the Malaysian and Singaporean market. Luckily for us, we have mortgages in both markets.

Let's look at Singaporean dollar first. Our experience there is more in securitization; we have looked at securitization for many years. Unfortunately, the Singapore securitization market hasn't developed very well over the last twenty years. There is no real Singapore dollar bond market for structured finance or securitizations. So when we start issuing covered bonds, with more issuers coming now from Singapore, the first thing we will look at is what is the nearest benchmark. What is sellable or acceptable from a European investor point of view? Most likely, we will look at euros in something like five years, rather than doing something in Singapore dollars. So there's no plan to go into domestic currency yet.

GlobalCapital: To Guy's point about the domestic investor base, do you keep it separate for senior unsecured funding, for bail-inable debt? Is it purely a cost consideration?

Volpicella, Westpac: If we were to start issuing covered bonds more frequently in Australian dollars we'd be simply replacing covered bonds with senior unsecured. But when we issue covered bonds in Europe we are expanding our funding base, so it actually compliments what we do, and doesn't replace it.

We always look at the swap pricing, and when we issue five year covered bonds in euros its often actually more expensive than doing a senior five year trade in Australian dollars. We just suck it up, though. At the end of the day we are doing it for diversification. Creating a sustainable funding platform is key. For me it's all about creating that platform, so we will pay up if it makes sense for the diversification.

To the point about investors being more currency agnostic these days, that's a good thing. We used to do trades back in 2010 and 2011 when you had a discrete group that could buy dollars and a discrete group that could buy euros.

Luithlen, DZ BANK: Let's compare three markets: Germany, the US, and UK.
In Germany, of course, covered bonds are a 250 year old product. It's very much engrained in investment culture.

In the US, if you go there with a credit product, 80% of it goes to US investors. If it's a covered bond, an absolute maximum of 30% of it goes to US-based investors. They don't have that covered bond gene in their investment culture.

Friedrich Luithlen
DZ BANK

And then we look at the UK market. Around 80% of sterling covered bonds are bought by investors in the UK. That shows that in order to develop the investor base and its understanding of the product you don't need 250 years. The first UK covered bonds in euros were issued in 2003, so there is a good scope of developing that investor culture and it can be helped by regulation as Matthias pointed out.

Melms, Helaba: As we are discussing funding opportunities for covered bonds in non-euro currencies, to bring that into perspective, if we look at the US market it is only around 7% of the size of the global covered bond market. That shows how difficult it is to establish investor demand for covered bonds.

As Fritz pointed out correctly, it is a product, and you have the credit risk, but you don't get any spread for that. It's complicated to understand that you have assets behind it but in most cases the assets are on the balance sheet and not in a SPV that is completely delinked from the issuer. The investment culture is highly important. You have to convince the investor to buy such a distinctive product, especially if it is issued by a not so well-rated German bank.

Volpicella, Westpac: One thing to bear in mind, is that when I talk to US investors, they say "I get it, I like it," but I'm comfortable with the Westpac credit, so I'd rather buy something that gives me a higher yield so I'll buy senior instead. From my point of view that's a good thing. That's why we always say its complimentary to what we do.

Pang, Maybank: I want to make a point about 30% of covered bonds in the US going to US investors. In Singapore, if you ask the syndicate desk, probably under 5% of any euro denominated issuance goes to local investors. So if a foreign, European bank issues covered bonds, less than 5% would go to the local investor. And so if you're a decision maker here, would you even try to do a local currency issue? It's just very difficult, you can't justify the risk in doing so.

Ngooi, DBS Bank: It is not always restricted to geographic boundaries. Speaking of Australian dollars, for example, we have sold an Australian dollar transaction into Asia. I think for certain currencies it maybe domestic driven – like Swiss francs – simply because of how the whole framework and regulatory regime works, which is tailor made for Swiss franc investors. But other than that, for some of the more international currencies, it is quite free-flowing, and the important thing is that as much it is about what we want as issuers, we can provide something that investors want, too. To Fritz's point about investors buying euros or dollars and swapping it back, why would you want to swap it back if I can give you direct exposure?

Melms, Helaba: One important point in this discussion is that we should also look at traditional non-euro covered bond markets in Europe, and draw some conclusions from that. One of the oldest developed covered bond markets is Denmark, where we have seen a large volume of issuance primarily from domestic issuers using this market. Although we have really deep liquidity and a deep investor base, there is really no issuer outside of Denmark issuing in the Danish krone market. The same is true for the Swedish market where there is one hundred year history of issuance activity in covered bonds. It is a domestic market in the end.

Matthias Melms
Helaba

Having said that, issuers are tapping that market for specific reasons, where there is a need for domestic currency exposure. However, issuer always want to swap it back into their own currency and there is limited capacity. Indeed, even for larger markets, there is limited capacity in the swap market. This is one of the reasons why you are concentrated in the euro market because in euros there is a deep swap market. That's not the case for smaller currencies.

GlobalCapital: So what's the difference between krone, where there is no or negligible foreign issuance, and Swiss francs? It is also well established, its also engrained in the system but loads of people issue into Switzerland?

Melms, Helaba: When you look at the Swiss covered bond market you have two issuers there. Because of the regulation, banks can't set up their own issuers. That's why, for example, Credit Suisse created their own structured covered bond programme not under Swiss covered bond law.

The Swiss investor base is used to this product, but the market is not as deep as other markets. For Credit Suisse's structured covered bonds, beside the credit on the issuer, there is an excellent quality of mortgage pool. However, the bank pays mid-swaps plus 73 basis points, which is around 60 basis points over what other issuers have to pay.

This is because of the regulatory treatment of the product; it does not qualify for HQLA, or for ECB, because of the structured part. As long as you don't have regulatory benefits, there is not so much a natural need to buy covered instead of the senior. When the investor is comfortable with the credit then they buy senior and get the spread. The reason you buy covered bonds is not because of the spread – obviously not – but because you get regulatory treatment.

Luithlen, DZ BANK: One point about the regulatory benefits. We were involved in the first trade for Credit Suisse and SMBC. Both trades showed quite nicely that, as much as I have a limited capacity to like regulation, there is enough investor culture away from regulation to get those trades through the door.

Asset managers – our own included – were carrying both of these transactions. LCR books, of course, were less keen. Multi-asset investment mandates really liked these trades because, in both cases, the mortgage markets provide high quality diversification and with no regulatory bid distorting the price, spreads are very attractive.

Volpicella, Westpac: If our regulator for the first time ever was to say that covered bonds should be LCR eligible, I'd say prove it. I want to see the liquidity in this product in times of stress.

GlobalCapital: One of the requirements of equivalence might be reciprocal treatment. Euro issuers get nice treatment for LCR or risk weighting. Are we going to get these in the non-EU jurisdictions, a) because we win the argument and its actually valid treatment or b) because we have to in order to get reciprocal treatment?

John Pang
Maybank

Pang, Maybank: As Guy said, the product has to survive on its own fundamentals. The regulatory treatment on the balance sheet is complimentary. It does help. In an ideal world, if you have a universal treatment of the product that's good for the investors and good for the issuers as well. But that type of conversation takes time. I believe each country has their own objectives and priorities.

GlobalCapital: But isn't the point to them: "Our issuers can get better funding if we prioritise this treatment".

Melms, Helaba: We can't, from a European perspective, just say we get the best treatment, but you can't. You get different treatment just for being part of a different continent. The next thing that we have to do – this is not a policy thing – is the same treatment by the central banks. I can't use Singaporean covered bonds for collateral at the ECB just because its not G10.

Volpicella, Westpac: We are G13 so we just miss out! I come back to the investor side. That's what I think the regulator needs to focus on. What do investors really want to see here? Do they want a scenario where their ability to diversify their portfolio, to buy these products, gets stifled because of that treatment? If you are a regulator saying I want my banks to hold liquid assets for times of stress, do I want that to all be euro-centric or do I want that portfolio to be diversified?

Pang, Maybank: When you look at things like that you cannot be overly idealistic about it. You get different treatment from different jurisdictions. At the end of the day, you look at it from a pricing point of view. Let's say one issuer has a different regulatory treatment, the other will say why will I issue a triple-A rated trade at a higher spread than another the other issuer's triple-A rated trades? That's the reality.

Ngooi, DBS Bank: The whole regulatory discussion around equality and all that is mainly for only a certain part of the investor base – the banks. You also have central banks and official institutions that are big buyers of covered bonds. You also have multi-asset managers who obviously like the product, particularly for their high grade portfolios.

Chris Ngooi
DBS Bank

GlobalCapital: I agree that it is mainly about the banks and the most important thing is LCR. Its not just about credit, its about liquidity too. Equities are the most liquid product in the world and they aren't triple-A.

Volpicella, Westpac: The main fundamental point is making sure that if the bank is invested in liquid assets, and the mud hits the fan, they can trade those assets. Assets that perform better in those environments are those that are not going to pay you back. Covered bonds have traded well at times of crisis.

Question from an audience member:
I heard that the reason why covered bonds are such a well performing robust product is that over the past 250 years, there has never been a case when the cover pool has actually been utilised. Is that truth or myth?

Luithlen, DZ BANK: I don't think we have had a proper default. That's why when you hear Luca's speeches and when we talk about alternative assets and extensions of the covered bond product, everybody is always very careful not to dilute this brand and have more esoteric asset classes available as a dual recourse instrument. For those of us who live and breathe the covered bond product, this goes without saying. We are very careful when we, as a covered bond industry, discuss new asset classes or formats and it is why we tend to give them different labels such as "European secured notes".

Melms, Helaba: I'm not so sure this is completely correct. I would say that there has not been a default since at least World War 2. But there were covered bonds in parts of Germany that were no longer part of Germany after the war. I don't know if the investors got their money back or not. Technically, though, there was no default.

Pang, Maybank: Is there any portfolio that has been liquidated to save a bond?

GlobalCapital: Pools have been put in run down in failed banks, like Northern Rock Asset Management in the UK, which went into run down.

Pang, Maybank: The issuer defaulted and they liquidated the portfolio to pay the investors to avoid default.

Comment from an audience member
This is very academic. There have been no defaults. There were cases where the regulator didn't like the idea and stepped in before the default.

GlobalCapital: I think that's the important point for exactly that reason: systemic importance, the German regulator would never let it happen. I looked into this, I found twenty two covered bond issuers have failed on which twelve defaulted on their senior unsecured bonds but none on their covered bonds. That was for a variety of reasons, some because the regulator stepped in, some because – like Washington Mutual in the US – the portfolio was sold off but there it did use the cover pool. They were able to sell it for at least as much as the liabilities. So no, they didn't rely on the cover pool in the sense of using cashflows but for the value of the assets. There are two or three cases like that.

Volpicella, Westpac: The important thing is that legislation is in place, so the cover pool is not subject to bail-in. The pool is ringfenced. If that was to default, no one can touch those assets. They are there for the investor.

Comment from an audience member
Sounds like there is determination to keep it that way as well. GC