GlobalCapital

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Covered Bonds
Special Report 2023

INSIDE

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The Covered Bonds Report 2023

Central bank exit gives covered bonds new lease of life

The pivotal contribution of covered bonds to banks' funding plans was re-emphasised in a report by the European Banking Authority (EBA) in July.

This forecast that among EU banks alone, covered bond issuance will reach €254bn in 2023, rising to €263bn in 2024 and €250bn in 2025, compared with about €123bn in 2022. Much of this will be driven by a high volume of covered bond maturities over the next three years.

But the EBA predicts that new issuance volumes will comfortably outpace maturities, suggesting that banks are committed to replacing high volumes of maturing central bank funding with covered bonds. "Such plans would also reflect observations that covered bonds issuance can offer a cheaper source of funding than unsecured funding," says the EBA.

Issuers in non-EU European economies, as well as Canada, are also expected to increase covered bond issuance in the coming years. This will give the market an opportunity to cement its credentials as an indispensable component of banks' funding toolkits.

It might also expose issuers and investors to headwinds ranging from stubbornly high inflation to falling house prices and declining affordability. All of these may exert pressure on the over-collateralisation (OC) levels that are fundamental to covered bonds' robust credit profiles.

In this roundtable, which took place at the end of August, a panel of issuers, investors and intermediaries discuss the opportunities and challenges lying in wait for euro covered bonds.

Roundtable participants

Kristian André, head of funding, SBAB

Heiko Langer, senior analyst, covereds and financials, Erste Bank

Arve Austestad, CEO, SpareBank 1 Boligkreditt and chairman, Norwegian Covered Bond Council

Christoph Pramhofer, head of capital markets, Volksbank Wien

Mladen Djurdjevic, head of FIG syndicate, Erste Bank

Daniel Rauch, senior portfolio manager, fixed income, Union Investment

Cameron Joynt, head of funding and capital, Toronto Dominion Bank

Henrik Stille, portfolio manager, Nordea Investment Management

Richard Kosecky, head of balance sheet management, Slovenska Sporitelna

Moderated by **Phil Moore**, contributing editor, *GlobalCapital*

***GlobalCapital*: Let's start by discussing banks' funding plans for the next few years, and the role that covered bonds are projected to play as a key source of long-term secured funding. Perhaps we can start with the Nordic region.**

Arve Austestad, SpareBank 1: In Norway, covered bonds are issued by specialist entities rather than direct from banks' balance sheets, so we don't have a full overview of the latest developments in terms of deposits in real time.

But the high-level factors that influence our funding needs are the organic growth in mortgage origination and the relative pricing levels of senior and covered bonds. Most banks have been actively working to adapt to the new regulatory requirements regarding MREL. That's now out of the way and we anticipate that the funding volumes we've been bringing to the Euro market in the last few years will continue at the same pace. So I don't see any structural changes in the balance between senior and covered bonds over the next two to three years, although that may change from time to time when the senior market becomes less accessible.

***GlobalCapital*: Staying in the Nordic region, what about SBAB? Or more specifically, what are the plans of SBAB's covered bond issuing subsidiary, SCBC?**

Kristian André, SBAB: I don't expect much change from previous years. It will ultimately come down to what our lending operations look like over the next two to three years. New lending combined with redemptions will dictate our covered bond issuance over the next few years. Money needs to go out for us to fund in covered bonds, and that in turn will be dictated by the mortgage market.

If anything, I'd say that in the past we probably differed a little bit from some of the other Swedish issuers in the sense that we haven't had a very large focus on deposits in the last few years. Now that rates have risen the economics of deposits as a funding source have improved. So for about the last 18 months there's been an internal push on increasing deposits. And as long as we don't move into a negative rate environment, I'd say this will remain our focus.

Our deposit to loan ratio is substantially lower than some of the other Swedish issuers. We're aiming to increase the ratio a little, and that probably means that from an economic standpoint we issue covered bonds at a slightly slower pace.

Right now, deposits are clearly the cheapest funding source for us, and when times get a little rocky, the more options you have, the better. Looking back a few years, we were very heavily reliant on the wholesale funding market, which meant that if the market took a turn for the worse, we'd still have to carry on funding regardless. But stronger deposit inflows decrease our exposure to market risk from a funding perspective.

***GlobalCapital*: Does that previous dependence on wholesale funding mean you have a large redemption schedule coming up?**

André, SBAB: In the next couple of years we will certainly have quite large redemptions of bonds in general. That is already part of our planning. But if we see deposits continuing to come in, we'll be able to take a small step back.

From an economic standpoint, if we feel that deposits are a cheaper funding source, we will of course

prioritise that side of the market, while always maintaining a balance with wholesale funding.

But in terms of redemptions, the Swedish market works slightly differently to the euro market, which will give us the opportunity to decrease our stock of Swedish covered bonds coming up for redemption. So we're not concerned about our redemption schedule.

***GlobalCapital*: Moving further south, volumes in the Austrian covered bond market were up very strongly last year. How does Volksbank Wien see its funding balance evolving over the next three years?**

Christoph Pramhofer, Volksbank Wien: We returned to the covered bond market at the end of August after an absence of four years. We were happy to be back in the market and we plan to return within the next few months and to become a more frequent issuer.

Why do we see this growth? It's simple. We're seeing an increase in our risk-weighted assets and in mortgage lending, but we're also seeing fairly constant deposit inflows. At the same time, high inflation is reducing the value of our customers' savings. This is a trend we're seeing across the whole of the Austrian market, which of course leads to increased activity in capital market funding.

Also, the share of capital market funding in our overall mix is very low. We are aiming to increase this and bring up our loan-to-deposit ratio, so I anticipate that there will be a new covered bond in the market from us once a year from now on.

***GlobalCapital*: Richard, just to complete the European picture, Slovesnka Sporitelna is a good proxy for the Slovakian banking system, accounting for about a quarter of all deposits and loans. How do you see your funding programme developing over the next few years?**

Richard Kosecky, Slovenska Sporitelna: The issuance of covered bonds will remain an important component of our funding strategy over the next three years. Based on our current plans we expect to be in the market with a benchmark deal at least once a year.

Of course, the final decision on whether we go for one or two benchmark transactions a year, as already happened in 2022 and 2023, will depend mainly on the development of our loan-to-deposit ratio and the maturity profile of our long-term funding.

***GlobalCapital*: Cameron, Toronto-Dominion has been very active in the covered bond market this year. What is the outlook for your funding programme in the next few years?**

Cameron Joynt, Toronto-Dominion: Funding needs are generally growing across the Canadian banking industry, just as they are in a number of jurisdictions, because of quantitative tightening. We're seeing some reduction in deposits, but we still have loan growth we need to fund.

We start with about C$30bn ($22bn) of maturities each year, on top of which we need to finance our balance sheet growth. This has been elevated over the last two years and will remain high next year because of quantitative tightening in Canada.

So I would expect that you can expect to see more of the same from Canadian banks, which are major overseas issuers in the Euro covered bond market. We are a global relative value issuer, so we will take that C$30bn-plus of maturing bonds and spread it across markets around the world, issuing where we see the greatest value while still meeting our TLAC [total loss-absorbing capacity] needs.

Right now, we see a lot of value in the European markets. They are central to the covered bond market globally and in our case the differential between senior and covered bonds are at their wides. So we find the European market very appealing right now, as you've seen from the €5bn dual tranche deal we did earlier this year.

***GlobalCapital*: How do the funding plans of banks in other core markets compare with those of the borrowers represented around the table?**

Mladen Djurdjevic, Erste Bank: I think these issuers' programmes are a pretty good reflection of what we see in most of the major markets.

It's been a busy year. Most banks that wanted to come to the market have already issued. A few of them which in the past may have issued only once a year have already issued twice in 2023.

It has been a year when there have not been too many tenors open to issuers. Everything has been focused in the three-to-five-year maturity range and there have been very few windows open to issuers wanting to tap anything longer.

So if something should open up longer than five years later over the next few months we may see issuers taking advantage of these opportunistic windows.

Heiko Langer, Erste Bank: I can confirm that there has been a fluctuating picture on the deposit side. But at the same time we have seen quite a sharp fall in new mortgage lending in several markets. It's hard at the moment to assess what impact this is going to have on supply, because many banks still have unused collateral which they could either use as a buffer or as cover for new issuance. But these are two forces that work against each other, and it remains to be seen how this will play out.

***GlobalCapital*: Let's move on to trends in housing and residential mortgage markets, which might be a good time to bring in the investors on the panel. Scope Ratings published a report a couple of months ago which said that "spoiled by years of growth, the party is over for homeowners, borrowers and lenders alike". Is this an exaggeration? Should investors in covered bonds be concerned about declining house prices, rising mortgage rates and pressures on affordability?**

Henrik Stille, Nordea Investment Management: I'm not too concerned on an aggregate level. There could be parts of the real estate market that run into difficulties. But the environment of high inflation rates that we've had for the last year is not unusually associated with declining nominal real estate prices.

Of course, in real terms prices have gone down, but high inflation rates simply mean that it is more expensive to build new houses. The factors that have made housing construction more expensive over the last few years won't go away. Pay levels are up and the inputs on the construction side aren't expected to decline materially. But in nominal terms I don't see why house prices should fall too far because it would mean that the prices between new and existing homes would be moving in opposite directions. This imbalance would automatically be corrected by the market.

As long as we don't run into a very hard recession I'm not too worried based on today's macroeconomic indicators, although things might look a bit different six months from now. There may also be some specific sectors which are over-leveraged, or where there may be some negative structural changes.

***GlobalCapital*: Are you talking about the pan-European housing market or a specific region?**

Stille, Nordea Investment Management: I mean the western world as a whole, where all economies are being driven by the same factors.

Daniel Rauch, Union Investment: I'd largely echo what Henrik said about housing markets. Additionally, I'd like to mention a couple of other reasons why, as covered bond investors, we are relaxed about the credit quality of cover pools.

First, we're generally talking about prime residential lending, which is the segment of the real estate market that is the healthiest. If you look at NPL [non-performing loan] ratios globally or on a pan-European basis, and take into account so-called unused over-collateralisation and current loan-to-value ratios, there is a huge buffer in breakeven calculations of how far house prices can fall. That's the main reason why we're relaxed.

Of course, there are some specific German, Spanish or Austrian pools containing a higher share of commercial real estate, which means some higher risks.

"I don't see any structural changes in the balance between senior and covered bonds over the next two to three years, although that may change."

Arve Austestad, Sparebank 1

However, we are currently focusing much more on tenors and on supply than on fears of what the future may bring in terms of the housing market. Supply is the main factor that is driving spreads from a pure credit point of view.

***GlobalCapital*: Are the issuers around the table equally relaxed? Are over-collateralisation levels still sufficiently robust to withstand these adverse conditions in housing markets?**

André, SBAB: Yes. I don't have a crystal ball, but I'm relaxed. Our internal view is that we will continue to see a drop in prices of about 20% from the peak that we saw in March 2022. We haven't yet reached the bottom, but we are confident that our over-collateralisation levels would be sufficient to withstand a substantial drop in house prices.

One factor that may have gone slightly under the radar is that turnover has been very limited in Sweden in the first half of this year, but prices have started to increase once again, which is hard to understand. We're not putting too much stock into this, because we do believe prices will start to come down. But it has been an interesting development this year.

By now you would have expected to see a lot of borrowers with mortgages starting to feel the effects of higher rates, so it's strange that prices are going up. I think the most plausible explanation is that turnover is very low and the only houses or apartments that are being sold are the highly attractive ones. It's only the top-of-the-class properties that can still find buyers.

Joynt, Toronto-Dominion: I think Henrik and Daniel were right to say that there plenty of global factors which are very consistent across the western world. But there are also potentially some local factors worth mentioning.

An important one of these is the impact that demographics can have on supply-demand dynamics in the housing market. In the case of Canada, high immigration levels and population growth are very supportive of housing prices in general.

***GlobalCapital*: Nevertheless, are you unnerved by some of the comments raised about the housing market in the Bank of Canada's latest macroeconomic update? This said that "in light of higher borrowing costs, the Bank of Canada is more concerned than it was last year about the ability of households to service their debt. More households are expected to face financial pressure in the coming years as their mortgages are renewed. The decline in house prices has also reduced homeowner equity, and some signs of financial stress — particularly among recent homebuyers — are beginning to appear."**
You've mentioned demographics, but are there other features of the Canadian housing market at the moment which may make the issue of affordability more troublesome than it is in many major Western European markets?

Joynt, Toronto-Dominion: If you take a longer term view and look at the relationship between mortgage payments and household income over time, the market isn't too elevated relative to historical trends. There may be a slight concern about where rates will be when people roll over their mortgages, but this happens in a slow-moving fashion over several years.

We are fairly conservative in how we evaluate customers' ability to refinance, which in Canada is dictated by regulatory guidelines. This forces us to stress-test borrowers' ability to repay at a level which is 200bp or 300bp higher than the terms of their original mortgage. So we feel pretty comfortable overall with our customers' ability to refinance.

I always tell investors that it is the Canadian unsecured lending market rather than secured real estate lending that is the most exposed to any stress among Canadian consumers. In Canada, mortgage lending is a recourse product. You can't just mail in your keys and disappear, US-style. You don't see any kind of voluntary delinquency in the Canadian market and housing loans tend to be the last thing that consumers stop paying. They'll prioritise their home loan over other payments because there's no way out of the loan other than bankruptcy.

Obviously, we watch the trends the Bank of Canada has been talking about very carefully, but right now delinquency levels remain quite low and loan to value ratios are still quite favourable as far as covered bond investors are concerned.

***GlobalCapital*: Without going in too much depth into the structure of individual housing markets in Europe, would other panellists like to comment on any idiosyncrasies or peculiarities in their residential markets which may have an impact on covered bond markets?**

Pramhofer, Volksbank Wien: I'd just add that in Austria, over-collateralisation levels are very high, at above 100% in our case, and LTVs are very low. Another feature we see in Austria is that the seasoning of loans is very high, and that loans which have been printed in recent months or years have mostly been done at very low fixed rate levels. So

"I would personally expect that next year it won't all be about three to five years, and we'll start to see more supply in the seven to 10 year buckets."

Mladen Djurdjevic, Erste Bank

we're also relaxed about the market overall and don't see any huge problems round the corner.

Kosecky, Slovenska Sporitelna: I don't see any big impact on the covered bond market in Slovakia. As an issuer we maintain over-collateralisation levels that are above the market standard, which we think is one of our main advantages. Our current OC level is above 50%, which we believe should give sufficient confidence to our current and future investors.

I don't think there will be any significant deterioration in the fundamentals. But I believe it will become more and more important for investors to look on a more granular basis into issuers' cover pools and differentiate more between transactions based on the type of assets within those pools.

***GlobalCapital*: Do others agree that some investors aren't looking carefully enough into cover pools?**

Rauch, Union Investment: I agree with Richard's point. And for us at least this is to some degree good news.

I wish that investors would start to look more granularly at cover pools, because as of now I don't see this as a major driver of spreads. This may be a function of the way the market has developed over the last 10 years.

We have the impression that at least some parts of the investor community still don't really look into the specifics of cover pools as much as we do. If they did their homework they'd see that issuers in some southern European jurisdictions for example have cleaned up their portfolios by increasing the share of fixed rate loans and reducing their commercial real estate exposure. It's worth analysing what this improvement is worth in terms of basis points.

***GlobalCapital*: This suggests that there should still be some tremendous relative value opportunities for investors willing to do the necessary analysis.**

Stille, Nordea Investment Management: I agree. The impact of the large interest rate increases we've seen over the last year has, of course, been very different on cover pools with a lot of fixed rate mortgages compared to those with mainly variable rate loans.

The European covered market is still not at all homogenous. We still have large differences from country to country as well as from issuer to issuer. This is the foundation of our investment decisions, but it is important to recognize that these differences might not have an immediate impact on spreads. It may take six months or a year before there is any impact.

Instead, it feels to me that in the short term the most important driver of spreads is supply technicals. The market is very focused on supply, and it is this, rather than credit fundamentals, that will probably continue to drive spreads in the short term.

There are also differences in supply patterns from country to country. The Canadian issuers, for example, have the choice of issuing in euros or other currencies, which can impact overall supply.

The banks also always have a choice between issuing covered bonds and senior debt. Western European banks have opted to issue more covered bonds than usual this year, which has also been a driver of relative pricing between different countries and different issuers.

Kosecky, Slovenska Sporitelna: I agree with Henrik that in the short run the main driver of spreads will be supply/demand dynamics.

However, the main influence over the longer run will be how monetary policy tightening impacts the economy. At this stage, this is still very hard to predict. So far, based on the jobs data and on what's happening in equity markets, it looks as though we might avoid a hard landing. But if you look for example at the latest PMI numbers from big economies like Germany and France, the outlook seems to be less positive.

***GlobalCapital*: Moving on to the recent experience of borrowers this year, the primary market seems to have remained remarkably resilient in the face of several headwinds. Cameron, your huge dual-tranche deal in March was well timed because it came four days or so before the Silicon Valley Bank collapse. Can you talk us through that transaction?**

Joynt, Toronto-Dominion: Sure. First of all, if you're talking about the resilience of the market, covered bonds are awesome. They're a great product which have shown so much resilience to so many different negative market conditions.

Talking more specifically about our €5bn deal, we got it away just before SVB. That was lucky timing, but it was a very interesting deal. It came at a time when investors' lines were becoming open for Canadian issuers in some maturities, and we were happy to help them recycle some of that cash.

I also think that overseas issuers such as the Canadian banks are benefiting from wide differentials compared to core jurisdictions which make them attractive on a relative basis to the European investor base. That was supportive of a deal of the size we did in March. We did not originally plan a deal of that size, but we generated a much better response than we were hoping for, which was fabulous.

So I'd say the response was reflective of good timing and favourable relative value dynamics across the various options that investors had access to, combined with continued support for the Canadian jurisdiction.

***GlobalCapital*: 'Awesome' is a striking description of the covered bond market. Have other borrowers around the table found covered bonds to be an equally awesome, cost-effective and dependable source of funding this year?**

Austestad, SpareBank 1: For us at Sparebank and for other Norwegian issuers the Euro market is the prime source of longer dated funding. It has not been easy to access longer maturities this year, so we are aware of the need to monitor the market for opportunities longer than five years. That market has not been open every day this year, so in that sense we can't describe it as a super-liquid market.

***GlobalCapital*: Richard, as a relative newcomer to the euro covered bond market, how has Slovenska Sporitelna's benchmark programme been developing?**

Kosecky, Slovenska Sporitelna: We launched our first benchmark transaction in 2019. Then we were out of the market for some time, returning in 2022 with two benchmark issues. This year we have also issued two covered bond benchmarks.

We've been very satisfied with the outcomes of all these issues. But basically our experience has been the same as it has been for borrowers across Europe, where covered bonds have remained in high focus among issuers and investors. This has been due mainly to quantitative tightening, rising interest rates and strong supply in the market. This has led to shorter dated deals starting to dominate in response to stronger investor preference at the short end of the curve.

As for investor allocations, since the withdrawal from the market of the ECB, we have seen more and more real money investors participating in our transactions, which has been very encouraging.

***GlobalCapital*: We've touched here on a couple of important trends in the covered bond market, namely the concentration of demand at the short end, the withdrawal of the ECB, and the rising participation of more real money investors in the market.**
What are the implications of these trends for supply going forward? One banker told *GlobalCapital* a few weeks ago that the covered bond market — which he said was usually regarded as "boring" — was set to become "very interesting" in the next couple of months. Would panellists agree? And if so, will more opportunities start to emerge at the longer end, or are we going to remain stuck in the three to five year range?

Djurdjevic, Erste Bank: I agree with the forecast that the market is going to get a lot more interesting over the next few months.

I would say that what we have lost in terms of demand for euros from Central Banks and the ECB in particular is being compensated for by bank treasuries. To me, it does not feel as though asset managers, pension funds and insurance companies have necessarily stepped up dramatically compared to previous years, even though spread levels are much more attractive than they used to be.

With regard to tenors, it feels as though there has been too much supply within a very narrow maturity range. We're starting to get comments from a few investors saying that issuers are stepping on each other's toes because everything is coming in the three to five year range.

We do see increasing demand from issuers for something longer than five years, and I am hopeful that as we move towards the peak of the tightening cycle the curve will flatten and we'll see a re-emergence of opportunities for longer dated tenors.

I don't have a crystal ball, but I would personally expect that next year it won't all be about three to five years, and we'll start to see more supply in the seven to 10 year buckets. If you look at how the euro swap curve developed in the summer, at the beginning of July the 10-year inversion was about 90bp. It is now around minus 55bp to minus 60bp. And this also applies in the five to 10 year inversion which has gone from minus 25bp or minus 30bp to minus 10bp. Between seven and 10 years the curve is now almost flat. So although some of the indicators we've seen recently have been feeding the narrative of higher for longer, my feeling is that heading into next year we're going to see the duration bid increase again.

***GlobalCapital*: That sounds encouraging. Do investors agree about the prospects for curve flattening? Is their appetite for longer dated product increasing?**

Stille, Nordea Investment Management: For us, it has always been a question of spreads relative to swaps.

I know there are plenty of investors who are reluctant to buy longer dated issues because the yield curve is inverted. But we don't mind buying the longer bonds if issuers pay a higher spread. At the moment I don't think they're prepared to compensate investors for the inversion of the yield curve with a steeper spread. As long as that's the case, we will also prefer to buy the shorter issues.

Rauch, Union Investment: We have the same approach. We focus pretty much on a comparison with risk-free assets, which are German bunds. The focus on absolute yield is why we're still seeing demand from investors that would not normally buy covered bonds, such as some dedicated corporate bond and even high yield funds.

I've been quoted several times as saying that I regard the credit curve as being too flat. There is still some way to go, especially in the curve beyond five years. The problem is that we have had some issuers that have been brave enough to test the market and failed.

Everyone is wondering who will be brave enough to test the longer end next. We're unlikely to see a huge wave of new supply in these tenors this year. But at some point issuers are going to have to start coming to the market with longer tenors and in the first half of next year we'll have a better idea of where spreads in this term segment will end up. Until then, we will still focus very much on the shorter maturities.

Looking at the latest deals we've seen in the four-to-five-year segment ahead of the expected wave of issuance in September, I have the feeling that bid-to-cover ratios or oversubscription levels haven't been as impressive as they should be at this time of year. This may be a signal that there has been too much supply or too few investors.

***GlobalCapital*: Do the borrowers around the table have the same feeling? What trends are you seeing in terms of book sizes and price talk, and what are the implications for new issue pricing? And do any of the borrowers represented here today yet feel brave enough to step further down the curve?**

Austestad, SpareBank 1: Developments in new issue premiums and so on are very much driven by supply patterns. Investors may ask to be compensated more, but in my view spreads are at quite a decent levels compared based on long term averages compared with most alternatives.

So, the issue for the covered bond market and the reason why book sizes aren't super large is due to record supply and limited new demand.

The question is, what will supply be? We don't know enough about likely total market supply. We do know that Norwegian supply will be limited, and I also think that there may be a little less supply from some of the markets that were very active in the first half of the year.

But we are still in record territory when it comes to covered bond issuance, which implies higher new issue concessions. You'll have to ask bankers like Mladen and Heiko whether that will continue.

***GlobalCapital*: Mladen and Heiko, what do you see as the outlook for book sizes and new issue premiums?**

Langer, Erste Bank: In terms of overall supply, I'd expect that next year we'll see some normalisation. We mustn't forget that this year's record supply has been partially driven by several extraordinary factors, such as a big wave of TLTRO [Taregted Longer-Term Refinancing Operations] repayments [to the ECB], expectations of higher interest rates and anticipation of the end of the ECB's Asset Purchase Programme. All of these factors fell into the first half of this year, and I don't foresee any special drivers of a similar magnitude in 2024.

Looking back, issuers that grasped the opportunity to issue earlier in the year are probably much happier that those that chose to wait.

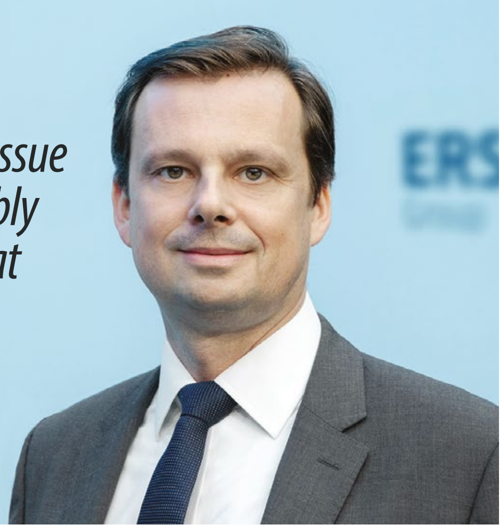
But Mladen, perhaps you can comment on the impact that normalisation of issuance volumes are likely to have on book sizes and the supply/demand equilibrium?

Djurdjevic, Erste: If supply decreases in the upcoming years then we should obviously see new issue premiums coming down again and spreads normalising, although they probably won't go back to the levels we had a couple of years ago. But the widening we've seen in some jurisdictions has been quite dramatic. For example, in Austria we're talking about a movement in covered bond spreads of roughly 30bp on average over the last 18 months.

As to new issue premiums, I don't see any catalyst for them to decline over the rest of this year because year-to-date we have seen an oversupply. A lot of investors have already filled up their covered bond books. You see that on the bank treasury side and among asset managers and insurance companies. They're telling us they'd like to participate but that they're struggling a bit with limits. They also say it's difficult to dispose of old low-coupon bonds because liquidity in the secondary market is poor and the Street feels fairly long.

"Looking back, issuers that grasped the opportunity to issue earlier in the year are probably much happier that those that chose to wait."

Heiko Langer, Erste Bank



As for next year, if there is a big decrease in supply and investors' cash positions stay high, we might see a slight decline in new issue premiums.

***GlobalCapital*: We've spoken about investor types and demand trends among real money accounts. What about the geographical distribution of investor demand? I'll never forget being proudly told by one well-known practitioner 10 or 15 years ago that he had just become the first European banker to sell a covered bond to an institution in Guam. Has the global diversification potential of the investor base for covered bonds been more or less exhausted? Or are there pockets of new demand in some regions that issuers can still explore?**

Pramhofer, Volksbank Wien: Maybe as we've been in the market recently this is a question I can answer. What we have seen is that it is very difficult for Austrian issuers to place large quantities of covered bonds in Germany. But having spent two days in the Nordic region just prior to our recent transaction it became very clear to us that there was the potential to tap into new investor demand there.

This led to Nordic investors taking a share of 30% of our deal. This was encouraging because it's essential for Austrian issuers to diversify their investor base by looking beyond the Dach region. There is probably an opportunity for us to find new investors in Italy, Benelux and of course the Nordic region, which we will have to do as we become a more frequent issuer.

***GlobalCapital*: Was the Volksbank Wien name completely new to these buyers in the Nordic region in senior as well as covered bonds?**

Pramhofer, Volksbank Wien: Yes. We were very happy to have them on board and we hope we can continue to build relationships with them.

***GlobalCapital*: Kristian, what about SCBC's investor base? I think you aim to do one euro benchmark a year, which means you retain some scarcity value. Are you aiming to diversity your investor base further?**

André, SBAB: We're always striving to encourage more lines to be opened for our name, but I wouldn't say we're seeing any great change in the geographical distribution of our order books. This year we did a five-year benchmark which is slightly shorter than what we usually try to issue in the euro covered bond space. That part of the curve is normally where we are active in the domestic market. We try to extend where we can, but overall market conditions tend to make decisions on maturities for us.

In terms of the order book, we were happy with the overall size of the issue, but the German-speaking region is definitely the bread and butter of demand for us, with French and Nordic investors also important. We haven't seen any big changes in demand, but we're continuously doing investor work and we're happy to speak to anyone who's interested in buying our bonds.

***GlobalCapital*: Even if they're in Guam?**

André, SBAB: Absolutely. The more the merrier!

***GlobalCapital*: Richard, is Slovenska Sporitelna still broadening the reach of its investor base?**

Kosecky, Slovenska Sporitelna: Because we've only been in the market for four years, I consider us to be a relatively new issuer. So I can't say that we've yet seen any big change in the geographical distribution of demand.

***GlobalCapital*: Cameron, can you give us a Canadian perspective? What sort of differences, if any, are there in the feedback you get from European investors compared to those in North America?**

Joynt, Toronto-Dominion: That's an interesting question. I'd say there's not that much difference.

If you're asking me how our investor base has changed, at the margin there has been some expansion. But most of our European demand comes from the same countries as it has in the past. I'd echo Kristian's comment that, as a borrower, you're always working to expand your reach and get new lines open, but the broad strokes are fairly consistent.

Your specific question was how investor feedback varies in different locations. The first question we always get asked by investors, no matter where we are and irrespective of whether they're looking at unsecured debt or covered bonds, is about the status of the Canadian housing market and the Canadian consumer. The questions we get are fairly consistent, although investor receptivity is sometimes a little different in Asia where some accounts can be more yield focused. But it's marginal because even in unsecured markets we're seen as a fairly low beta issuer.

***GlobalCapital*: It's interesting that Cameron mentioned Asia.**

"We have the impression that at least some parts of the investor community still don't really look into the specifics of cover pools as much as we do."

Daniel Rauch, Union Investment

Are European covered bond issuers seeing any uptick in demand from there?

Austestad, SpareBank 1: Our core demand is clearly from Europe. There is some sporadic interest from Asia, but it's not picking up meaningfully. It's probably at the same level as it was 10 years ago.

***GlobalCapital*: We've been chatting for over an hour and there has been no mention of green bonds, which is unusual in today's market.**
How important is structural innovation in the covered bond market? Will green covered bonds position themselves as a viable and scalable funding source? Do issuers have sufficient eligible green assets? Is there any pricing advantage or a so-called greenium in covered bonds? And would rising supply of green covered bonds open a new source of investor demand for issuers?
Can I start with you, Arve, because I believe SpareBank has now done three euro green covered bonds and one in Swedish kronor. What has your experience been in this market?

Austestad, SpareBank 1: We did the first ever green covered bond with residential mortgages which created a kind of blueprint for the market. I guess that gave us access to some more investors at the margin. It also attracted many of the same investors with different pockets that have specific internal green mandates. A lot of green bond investors are bank treasuries with a mandate to allocate a portion of their liquidity to green instruments.

For us, issuing a green covered bond triggered several new internal processes about how we originate mortgages, and it led to some changes in the way we evaluate our strategic goals within the bank. So it acted more as an internal catalyst for green banking than as a way of generating an issuance greenium or attracting new investors.

***GlobalCapital*: Kristian, I think SBAB has done nine green bonds since 2016 but only one green covered bond, which was an Skr6bn ($540m) issue in 2019. Why is that? Is there a shortage of assets you can refinance using green or sustainable-labelled instruments?**

André, SBAB: As you said, we were early into the market issuing our first green covered bond in 2016 under our old framework. We updated this in 2019 to the framework we are using today. We'll probably look to update this again in the near future to reflect how quickly things are developing in sustainable finance.

You're right to say we've only done one green covered bond so far, which was in the domestic market. In euros we've decided to focus on senior preferred and senior non-preferred in the green market, which are slightly more challenging projects for us.

We haven't ruled out doing green covered bonds in euros by any means and we definitely hope to offer one at some point in time. But as you mentioned, the green assets we can use are limited. Right now, we have north of Skr50bn in green assets which has allowed us to issue over Skr40bn in green bonds, and we have to operate with a buffer so we don't overextend our green assets. But the redemptions we have coming up next year include our Skr6bn green covered bond, which we'll look to refinance in some way.

***GlobalCapital*: Would you echo Arve's view that there isn't necessarily a pricing or investor diversification argument for issuing green covered bonds and that there may be more significant internal reasons for exploring this market?**

André, SBAB: We are aware of the potential greenium, and if this is going to be most efficiently used in senior preferred or senior non-preferred there is a stronger case for issuing green unsecured bonds. But we wish we could issue more green bonds in general and it would be amazing if we could offer a green euro bond to our loyal covered bond investors.

***GlobalCapital*: Christoph, Volksbank Wien published its Sustainability Bond Framework earlier this year and issued a debut €500m green senior preferred bond in March. Do you have any plans or sufficient eligible assets to issue green covered bonds?**

Pramhofer, Volksbank Wien: Having sufficient collateral or green material is definitely the main challenge here, so we think we'll use our green loans for senior rather than covered bonds.

What we have heard from investors is that green bonds themselves aren't that important to them. They are more interested in an issuer's overall sustainability story and sustainability ratings. So you will probably see us issuing green senior bonds rather than green covered instruments.

***GlobalCapital*: Canada seems to be a very green society. Would Toronto-Dominion consider issuing a green covered bond?**

Joynt, Toronto-Dominion: We've issued a few senior unsecured green bonds, but we haven't yet issued a green covered bond. It is certainly something that is of interest to us, but as a jurisdiction we've never been able to get across the line in terms of establishing a framework defining what would qualify as a green residential asset.

We have our own internal data issues that we would need to work through before we could classify these assets within our system.

While a green covered bond is of interest, we are conscious of some of the counterpoints that other panellists have raised in terms of limited greenium opportunities relative to senior unsecured, and in terms of genuine investor diversification.

***GlobalCapital*: And Richard, do you have any comments on the potential for green covered bond issuance in Slovakia?**

Kosecky, Slovenska Sporitelna: We issued our first and so far our only green covered bond last year. I must admit that I see limited potential for further large green covered bond issuance in the foreseeable future. This is due mainly to our conservative approach with regard to the definition of green assets. So I'd agree with previous speakers that the scarcity of green assets will limit green covered bond issuance.

As to innovations in green covered bonds, I don't expect to see many changes. But with respect to sustainable financing in general, we believe we will see a greater focus on other types of green assets such as clean transportation and renewable energy. These aren't eligible for green covered bond pools, but they are very important for green senior bonds.

***GlobalCapital*: Would investors like to see more diversity of supply in green covered bonds?**

Stille, Nordea Investment Management: Our internal framework is tilted more in the direction of looking at the sustainability of the whole cover. Our investors don't tell us to buy green bonds. They want us to buy covered bonds from issuers with sustainability characteristics that are stronger than the market average.

What we have implemented so far is a framework on a country level, and gradually as we get better data from the issuers — which we expect to receive over the coming years — it will also be possible to extend this to the individual issuer level. Our clients are expecting us to do much more sophisticated sustainability analysis of the whole cover with respect to energy efficiency and so on.

***GlobalCapital*: As our hosts, perhaps Mladen and Heiko can provide some concluding comment.**
We've spoken about the concentration at the shorter and of the curve and about the impact that supply/demand dynamics may have on spreads. Excluding these factors and external economic influences, is there anything else on the horizon from a structural, regulatory or legislative perspective that might keep covered bond issuers, investors or intermediaries awake at night?

Langer, Erste Bank: I sleep fairly well these days when it comes to covered bonds. We now have the big project of EU harmonisation of covered bond frameworks behind us. Even though that settled on the lowest common denominator and some countries took longer with the implementation than others, I think that was a successful project.

I don't see anything else on the regulatory side that worries me at the moment. It is a product where demand is driven by preferential regulatory treatment and as long as that remains in place, I don't see any threats to the market from a regulatory standpoint.

Djurdjevic, Erste Bank: I also sleep well. Given that we have seen so many changes in the market from the macro side, with liquidity diminishing it hasn't been an easy market and it is obviously more expensive than it used to be. But it's still functioning well. It still provides issuers with access to funding.

I believe it will continue to function well. If we see a slide into recession, an increase in NPLs and a significant repricing in real estate markets, we will see more differentiation between cover pools and between issuers. But up to now the challenges created on the macro side have been digested very well by the market.

André, SBAB: I'm not too worried either, although I'm curious to see how soon the longer end of the curve will be back in business. We have a domestic covered bond market that is functioning very well and is a dependable source of funding at the shorter end of the curve.

So we're usually looking to extend our maturity profile in the euro space. We can afford to be patient, but hopefully within the next few months we'll have a much clearer picture of how the market will look in 2024 and beyond.

Joynt, Toronto-Dominion: As I said earlier, I think covered bonds are awesome, so the market does not keep me awake at night. But looking forward I'm very interested in how the pullback of central bank buying is going to affect European covered bonds. My view is that it will create more spread differentiation between core euro and peripheral issuers, which will be an interesting dynamic to watch. GC

"The European covered market is still not at all homogenous. We still have large differences from country to country as well as from issuer to issuer."

Henrik Stille, Nordea IM

GlobalCapital Covered Bond Awards: the shortlist

The best banks, issuers, platform providers and deals of 2023 will be announced at a gala industry dinner in Munich on September 14

The *GlobalCapital* Covered Bond Awards celebrate the most notable market achievements in the period between August 2022 and July 2023.

Four new categories were added for 2023, recognising the Best Tech Provider, Best Bank for Digitalisation, Best Electronic Trading Platform and Best Trustee.

The shortlists were chosen through a market consultation, which took place in June. Market participants were invited to share their recommendations of the transactions, borrowers, investment banks and people that had stood out during the review period. Based on this feedback, shortlists were drawn up in each category. As ever, this was a competitive process and congratulations go to all of this year's nominees.

These shortlists were opened to a market vote, which took place during July. Those active in the covered bond market were invited to have their say on the leading names in each category. Votes were received from over 360 covered bond professionals, including 90 issuers, 100 investors and 125 lead managers.

The winners of the awards will be announced at a gala dinner on September 14, following the Euromoney/ECBC Covered Bond conference in Munich. They will be available to view on the *GlobalCapital* website on September 15. GC

DEALS

Best pioneering deal

Credit Suisse, €750m December 2025

Deutsche Kreditbank, €500m 3% January 2035 social

KEB Hana, €600m 3.75% May 2026 SME empowerment social

Landsbankinn, €300m 4.25% March 2028

Santander, 3.25% €500m February 2028 Cédulas de internacionalización

UniCredit, €1.75bn 3.375% January 2027 & €1.25bn 3.5% July 2030

Best ESG deal

Berlin Hyp, €500m 3% May 2026 social & €500m 3% January 2033 green

Deutsche Kreditbank, €500m 3% January 2035 social

Crédit Agricole, €1.25bn 3.25% June 2033 social

Caffil, €750m 3.125% November 2027 green

Caja Rural Navarra, €500m 3% April 2027 green

Stadshypotek, €1bn 3.125% April 2028 green

Best debut deal

Credit Suisse, €750m December 2025

HSBC, £500m August 2027

Macquarie, €600m 2.574% September 2027

Santander €2.5bn 3.375% January 2026 & €1bn 3.375% January 2030

Santander, €500m 3.25% February 2028 export finance

Slovenská sporiteľňa, €500m 3.5% March 2028

UniCredit €1.75bn 3.375% January 2027 & €1.25bn 3.5% July 2030

Best Swiss franc deal

CBA Sfr300m 1.94% June 2030

CCDJ Sfr325m 1.735% January 2028 (January 2023)

Credit Suisse Sfr500m 2.459% November 2024

KHFC Sfr160m 2.155% October 2025 and Sfr140m 2.465% October 2027

Nationwide Sfr315m 1.758% Jan 2026 and a SFr170m 2.013% Jan 2030

Best sterling deal

Bank of Nova Scotia £1.25bn September 2027

National Australia Bank £1.25bn June 2026

Nationwide £750m June 2028

Santander UK £1.5bn January 28

TSB £1bn February 2027

Best dollar deal

CCDJ $1bn 4.85% October 2025

CIBC $1.75bn 4.414% June 2028

National Australia Bank $1.65bn, 4.628% November 2027

Westpac $1.75bn 4.185% May 2028,

Best euro deal

Deutsche Bank €500m 3.125% October 2026 & €500m 3.125% May 2033

Deutsche Kreditbank €500m 3% January 2035 social

Santander €2.5bn 3.375% January 2026 & €1bn 3.375% January 2030

Toronto Dominion €3.5bn 3.879% March 2026 & €1.5bn 3.715% March 2030

UniCredit €1.75bn 3.375% January 2027 & €1.25bn 3.5% July 2030

Deal of the year

BNP Paribas €1.5bn 3% May 2028

ING €2bn 3% February 2033 & €2bn 3% February 2027

Santander €2.5bn 3.375% January 2026 & €1bn 3.375% January 2030

Toronto Dominion €3.5bn 3.879% March 2026 & €1.5bn 3.715% March 2030

UniCredit €1.75bn 3.375% January 2027 & €1.25bn 3.5% July 2030

ISSUERS

Best ESG Issuer

Berlin Hyp
Caffil
KHFC
Spabol
UniCredit

Best euro issuer

BPCE
ING
Santander
Toronto Dominion
UniCredit

Issuer of the year

Bank of Montreal
BPCE
Crédit Agricole
Santander
Toronto Dominion

LEAD MANAGERS

Best bank for distribution

BayernLB
Danske Bank
Erste Group
Helaba
NordLB

Best bank for structuring & ALM

Barclays
BNP Paribas
HSBC
NatWest

Best bank for ESG issuers

ABN Amro
BNP Paribas
Crédit Agricole
ING
NatWest Markets

Best bank for inaugural issuers

Barclays
BNP Paribas
Erste Group
ING
UniCredit

Best syndicate bank

Deutsche Bank
DZ Bank
Erste Group
NatWest Markets
RBC Capital Markets
Société Générale
UniCredit

Best sterling lead manager

Barclays
Lloyds
NatWest Markets
Nomura
RBC Capital Markets

Best dollar lead manager

Citi
HSBC
Lloyds
RBC Capital Markets
TD Securities

Best euro lead manager

Commerzbank
Crédit Agricole
LBBW
Natixis
UniCredit

Covered bond house of the year

Barclays
Crédit Agricole
HSBC
LBBW
UniCredit

PEOPLE

Best syndicate banker

Mladen Djurdjevic, Erste Groupe
Edouard Freton, Société Générale
Vincent Hoarau, Crédit Agricole
Ken Loesken, ING
Mark Pearce, HSBC
Anthony Tobin, RBC Capital Markets
Alex Trulli, Natixis
Alberto Villa, UniCredit

PLATFORM SERVICE PROVIDERS

Investor of the year

Commerzbank Treasury
Intesa Sanpaolo
KfW
Nordea IM
Norges
Rentenbank
Union Invest

Best ESG rating agency

Fitch
ISS ESG
Moody's
S&P Global Ratings
Sustainalytics

Best law firm

Allen & Overy
Clifford Chance
Linklaters
Mayer Brown
White & Case

Best tech provider

Econans
EIB Green eligibility Checker
Evitec
Harley & Dikkinson
Kestrix

Best bank for digitalisation

DZ Bank
Santander
Société Générale

Best electronic trading platforms

Interactive Brokers
MarketAxess
MTS BondVision
Tradeweb

Best corporate trust providers

BNP Paribas Securities Services
BNY Mellon Corporate Trustee Services Limited
Citi Issuer Services
Deutsche Bank Trust and Agency Services
HSBC Issuer Services
Perpetual Corporate Trust

The evolution of the post-ECB covered bond market

The withdrawal of the central bank from the covered bond market was 'a game changer' which has shaped 2023 into a potential second year of record issuance. But can the virtuous circle brought on by higher spreads and yields last? **Atanas Dinov** investigates.

In July, for the first time in eight and a half years, the European Central Bank stepped out of the covered bond market. With its gradual reduction of buying in the primary market, from its initial order of 40% of an eligible deal, the ECB withdrew first from buying new euro covered bonds at the end of February to, by the summer, ceasing secondary market purchases too.

The withdrawal from both primary and secondary markets formed part of the ECB's fight against inflation. This departure of the single biggest investor in the asset class has transformed the market.

"The ECB had a strong impact on the market — its withdrawal was a game changer as the market dynamics have completely changed," says Tarek Petzold, head of debt syndicate and private placements at LBBW in Stuttgart.

Bodo Winkler-Viti, Berlin Hyp's (BHH) head of funding and investor relations in Berlin, says: "For issuers, the most visible aspect of the post-ECB market is the central bank's absence in primary orders."

The ECB's withdrawal as a buyer of covered bonds coincided with and amplified the effects of the approaching end of its Targeted Longer-Term Refinancing Operations (TLTRO). The expiry of this cheap central bank funding, which was extended to eurozone banks in 2019 and then sweetened further during the Covid-19 pandemic, meant banks had to refinance it elsehwere. Meanwhile, banks outside the eurozone have also started to repay similar programmes offered by their central banks.

The disappearance of this cheap cash has propelled covered bonds to the top of the menu as one of the most cost effective funding tools for all banks.

"Covered bonds, among others [products], seem to be gaining in importance again for the refinancing of banks," DZ Bank said at the end of July. "The cheap TLTRO III loans still have to be repaid until 2024, so that bank funding via the central bank will become less and less important in the coming months."

Therefore, it was no surprise that last year was such a busy one for covered bond issuance as the end of TLTRO approached.

Public covered bond issuance breached €200bn for the first time last year, ending at a record of around €204bn. Market participants predict this year could finish with a similar volume. LBBW tracked around €150bn of public deals issued in 2023 by August 23. It expects another €50bn-€55bn more by the year end.

This high volume – which some also expect in 2024 as well – together with the cycle of major central banks' shrinking balance sheets and their aggressive tightening of monetary conditions has raised an uncomfortable question, however.

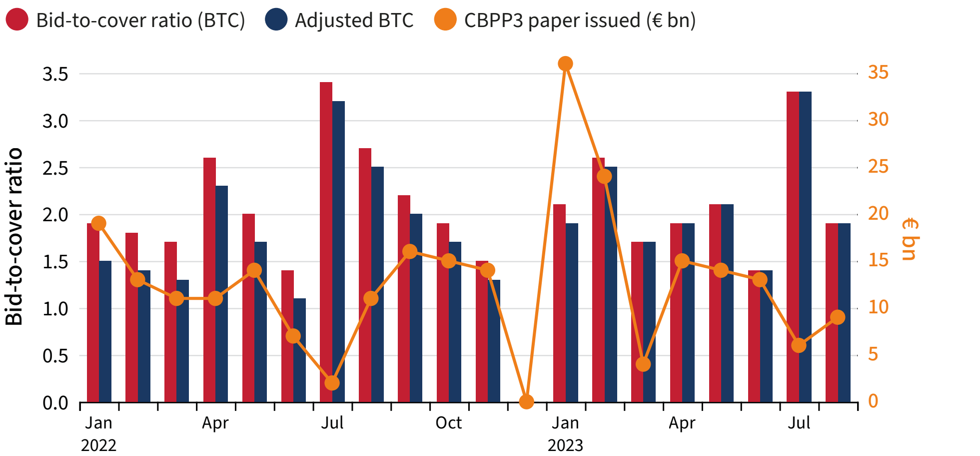
"How can this new volume of covered bonds best be absorbed?" asks Iason Ioannidis, FIG syndicate at ABN Amro in Amsterdam, echoing other European syndicate desks.

"So far private investors have taken [this huge volume] well because of the higher spreads," he says. "However, there may arrive a point at which spreads alone might not be convincing for investors to keep on buying."

Another syndicate manager at a different European bank says that "the question of how much supply we will be seeing may lead to a point when investors will simply say: 'OK I had enough and I'm not interested anymore at any spread'. Should we reach such a point, investors will be spooked and we will get into a vicious circle that can only get worse."

The seemingly unabating supply has had an impact on banks' cost

Demand for CBPP3 eligible covered bonds, including and excluding the order from the Eurosystem



Source: ABN Amro via ECB, Bloomberg

> *"There may arrive a point at which spreads alone might not be convincing for investors to keep on buying"*
>
> *– Iason Ioannidis, FIG syndicate at ABN Amro*

of funding. The iBoxx € Covered Bond Index ended the week of August 14 at 22bp — just 3bp higher than the start of the year. However, this was already 19bp above where the index opened trading at the start of 2022 — a whopping 630% rise over this 19 month period.

Petzold says: "While I'm not too worried about valuation at the moment, the high supply of this and next year is the big question mark hanging over the state of the market."

Record breaking transition

The transition to higher spreads from 2022 to 2023 was not purely the result of the supply deluge. Spreads have been heavily influenced by central banks' rapid interest rate increases.

Consequently, however, these higher spreads, as well as yields on newly issued covered bonds, have worked in favour of issuers and investors.

Wide Bund/swap spreads and the relative value resulting from the repricing of the asset class have benefitted new deals. Investors have become more eager to buy at these new valuations.

Moreover, for the foreseeable future, investors are expected to be heavily invested in fixed income because of the higher yields, according to analysts. "This doesn't necessarily mean they will stay in covered bonds," says Ioannidis. But the asset class is likely to remain attractive, because even "expensive tier one German covered bonds are offering a pick-up versus SSAs", he says.

Investors have embraced this year's spread widening of covered bonds, as peak inflation and the end of the rate rising cycle are seemingly approaching.

In 2023, "everybody had expected the ECB's exit from reinvesting the proceeds of covered bond maturities, but so far there hasn't been a real, meaningful widening because every single smaller widening brought new and more investors to the covered bond asset class," says Ioannidis.

Indeed, these higher spreads have resulted in a juicy pick-up over many other high-grade assets. "The relative value of covereds versus SSAs is huge," says one syndicate manager at a French bank.

Assuming that a core French five year covered bond might have been sold around 22bp-25bp over-mid swaps in mid-August, he says this would have resulted in yields around 60bp higher than five year French government bonds.

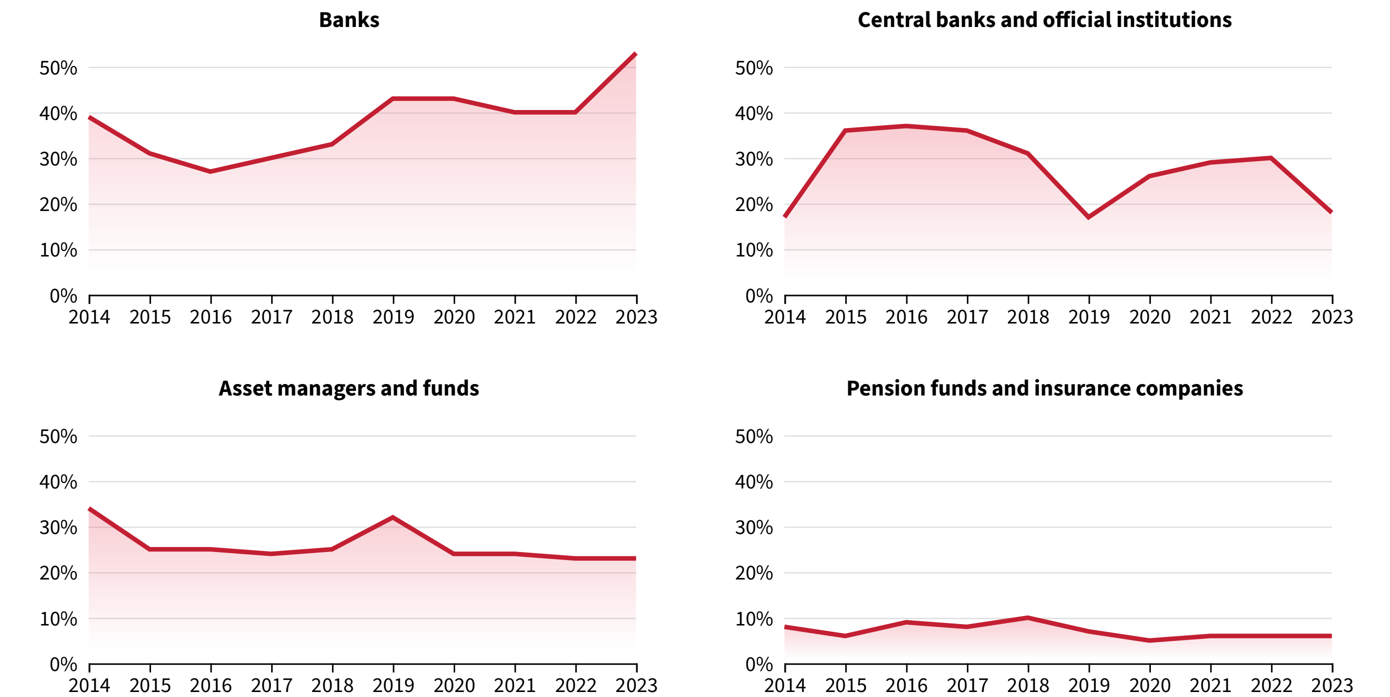
"They are not the same risk — a sovereign and a covered bond — or the same risk weighting, but we are still talking here of a triple-A risk with a huge 60bp pick-up," says the banker. "After all, relative value and risk sentiment matter."

Sentiment and relative value

Due to an already wide gap between SSA and covered bond spreads, the syndicator at the French bank does not think that "covereds will widen by anything as much as 20bp-25bp by the year end".

This kind of a widening will create an even bigger gap that "will make them too cheap versus SSAs

Breakdown of allocations of newly issued CBPP3-eligible euro benchmark covered bonds by investor type*



* The data for 2023 is up until the end of August

Source: ABN Amro via ECB, Bloomberg

> *"We have now reached a different equilibrium after one big buyer is gone. Yet, now it's easier to understand which pricings and new issue premiums work for deals."*
>
> *— Tarek Petzold, head of debt syndicate and private placements at LBBW*

and senior preferred debt," says the banker.

However, given that there is "at least €200bn of volume expected for the full year," BHH's Winkler-Viti thinks "there is not too much of a potential for spread tightening ... especially for the more expensive products".

Still, he also sees only a "limited" widening of a few basis points by the year end, and he anticipates "no need for excess widening".

"Even with the 0bp-5bp spread widening that ABN Amro expects by the year end, based on our investor survey across all covered bond jurisdictions, we expect this relative value pick-up to remain an attractive proposition for investors," adds Ioannidis.

Investor interest sharply increased just before the summer when concessions "sky-rocketed to 7bp-10bp", says Ioannidis.

"That saw second rank [covered bond] issuers like PBB (Deutsche Pfandbriefbank) and Aareal attract a lot of demand for their deals on the back of the higher premiums they paid," he says.

On July 6, despite concerns about the commercial real estate sector to which PBB is heavily exposed, investors placed €1.1bn of orders for its €500m 3.625% October 2026 deal. The bank paid a premium of 8bp.

Demand was stronger just five days later, when another real estate lender Aareal Bank paid a 10bp concession to achieve its largest Pfandbrief order book, attracting €3bn demand for its €500m 3.875% May 2026 deal.

This strong interest then is noteworthy as there were hiccups in the market not long before that. For the first time in the covered bond market a deal was pulled after its final terms were set. In the second part of June Bausparkasse Schwäbisch Hall attempted to print a €500m no-grow 10 year mortgage Pfandbrief. The pricing implied what had until then been considered a reasonable concession of 5bp-6bp. However, finding lukewarm interest for its long dated deal, the issuer opted to pull the trade.

Fast or real

Investor sentiment has shifted since the ECB's exit, making pricing, fair value discovery, and book building more challenging.

This is because investors have become "more selective in this post-ECB windows market," says Marc Just, FIG and SSA origination at LBBW in Stuttgart. When the ECB was actively buying, premiums were "for sure" lower and now "that [absence] has made it, at times, more challenging for issuers to meet investors' higher request for premiums," he says.

LBBW's Petzold says: "After the ECB's withdrawal, investors have started to behave more tactically. They have become more hesitant to put their orders and, consequently, the order book development has been much slower."

This phenomenon is due to the so-called fast money accounts that have largely stopped buying covered bonds as they have become unable to sell their paper to the ECB.

"For fast money, the free lunch is over," says Just. "They knew this would come as the ECB's withdrawal from the secondary market approached. Then after February you could say there were digital books: fast money was in on some trades and not in many others."

Instead, the increased investor interest is coming from real money accounts, says Petzold. Moreover, "some asset managers and insurance companies that have been dormant during the negative and zero yield days are back now in the asset class," he adds.

Real money buyers have created something of a compensation for fast money orders that have largely disappeared.

"But what's clear is that definitely the momentum behind covered bond deals is completely different than what we saw last year," says Petzold. "That's why many issuers pre-announce their deals [a trading day before pricing] to get a sense of what investors are thinking."

The new normal

BHH, a respected name in the covered bond market, illustrates the changes since the ECB's withdrawal.

Every year since 2019, the lender has reopened the market after the summer lull. In both 2022 and 2023 it issued on August 16.

"For both 2022 and 2023 deals, the market conditions were good for us to issue," says Winkler-Viti. "But then and now it was a different market. Last year we had a ridiculous €6bn book for a three year bond that was €1bn in size. The book included investors that are not known as covered bond investors."

This year's €500m 3.375% five year social bond attracted a formidable book of €1.6bn while offering 4bp of premium. But thanks to fast money demand the €1bn 1.25% three year green deal in 2022 had an unmatched subscription ratio even when it offered a concession of just 1bp.

"What I want to see in my order book is true interest from investors – a more honest interest in my bonds from investors that will stay for the long term and not people waiting for a few basis points of performance and then sell a week later," says Winkler-Viti, referring to fast money investors' tactic of reselling primary paper to the ECB.

"An issuer would prefer to place its bond with real money, buy-and-hold investors," says Just. "However, fast money investors help a deal as they tend to come at the beginning of the bookbuilding and they can contribute towards the momentum building of a deal."

However, a bigger book naturally provides bigger pricing power. Because of the larger books, "last year's tightening in price guidance of 5bp, 6bp or 7bp happened quite regularly," says Winkler-Viti, "whereas now a 5bp tightening is rather the exception".

The smaller books are a function of the ECB's withdrawal and form part of a new differentiation process between issuers and jurisdictions.

"We have now reached a different equilibrium after one big buyer is gone," says Petzold. "Yet, now it's easier to understand which pricings and new issue premiums work for deals."

BHH's funding head agrees: "You could say that we are now back to a normal market — a market where prices are determined by what's on offer, its quality and investors' demand." GC

Asia puts the tiger into covered bonds

A rising population and expanding middle class give Asian covered bond market the chance to grow, writes **Bill Thornhill**

Banks in Singapore, South Korea and Japan have become regular covered bond issuers and they are expected to maintain a consistent presence in the market. Among these three, Japanese issuers have the biggest potential for growth, given the country has one of the largest mortgage markets in the world but only two covered bond issuers. Several other Asian countries, most notably China, are monitoring developments and should emerge as sources of covered bonds.

Singapore is perhaps the most well-known Asian hub of covered bond issuers, reflecting the sovereign's triple-A credit rating, a trusted legal framework based on English law, and its status an advanced financial centre with three, soon to be four, sophisticated issuers.

However, unlike for many European banks, the need for wholesale refinancing after the pandemic didn't rise as much in Singapore, according to Colin Chen, co-head of financial institutions and structured products at DBS Bank.

DBS, United Overseas Bank and Oversea-Chinese Banking Corp (OCBC) have established programmes and have been active since 2015, with DBS and UOB issuing at least one euro benchmark a year.

Although all three issuers are well funded with deposits and do not require much market funding, Chen says "they do have a strategic need for liquidity".

This trio have tended to be less prolific issuers than their European peers, which could be considered a sign of strength, says Patrick Seifert, head of primary markets and global syndicate at LBBW. "The question is, 'will this change?' and the short answer is: 'yes'," he says.

The drivers for change relate to the escalating cost of funding and the demise of Silicon Valley Bank, which highlighted growing concern at the quality of deposits, something that Seifert says global regulators "are taking a closer look into".

Deposits used to be viewed as the cheapest, most available, funding source, but Chris Teck Hooi, head of group funding at DBS, says this has begun to change.

"If overlaid with potential outflows from a behavioural and regulatory standpoint," says Hooi, then deposits may not necessarily be the cheapest source of funding. Most banks outside the US, he says, do not have the competitive advantage of being able to raise "sticky dollar deposits," with the Federal Reserve acting as the lender of last resort.

Cause for optimism

For these reasons, Seifert is optimistic about volume growth in the Singaporean market and says there is the potential for three or four deals over the next six months, "possibly including [from] a new name," although he concedes that this will entail some work.

Standard Chartered Bank in Singapore has been touted as a possible fourth Singaporean issuer.

But the established banks are also expected to become more frequent issuers. DBS doubled its covered bond programme size to $20bn earlier this year and built in capacity for its overseas branches to issue deals all guaranteed by the cover pool under the same programme, says Hooi.

DBS's most recent AS$1.5bn ($960m) four year, launched in August, was its first overseas branch issuance, priced "on the cuff of obtaining regulatory clarity" from the Monetary Authority of Singapore, says Hooi. The Monetary Authority of Singapore was "very supportive," of these structural changes to its programme, he says, and the Aussie dollar deal "marked another key milestone in the development of the Singaporean covered bond market".

Alongside DBS, UOB has been active across a number of currencies, most notably euros, sterling and dollars. "We are mindful of the need to engage the markets regularly to ensure we continue to be in front of our global investors, says Chin Chin Koh, head of group central treasury at UOB.

The three to five year area of the curve is "the sweet spot for matching our assets," she adds, but typically UOB sticks to the five year area, where it identifies "the critical mass of investor demand," in normal times.

However, when European rates became negative, UOB had the flexibility to extend out to eight years, enabling it to lock in lower spreads for longer and fit investors' desire for longer durations, which at that time offered higher spreads.

Singaporean banks are well known for offering some of the best prepared transactions of any issuers, says Marco da Silva, NordLB's DCM head of origination for Asia Pacific.

He says Singaporean lenders typically begin the process weeks before they expect to issue, setting up one-on-one meetings with investors and roadshows to gain a thorough understanding of pricing in specific tenors.

Singaporean banks are among the "most sophisticated" in Asia, according to LBBW's head of DCM origination for Asia Pacific, Linfei Han. He says issuers have a strong focus on maintaining a low cost of funding and the best way to achieve that is with covered bonds.

These banks typically compare the cost of funding to the dollar equivalent as they often swap proceeds back to dollars. Hooi says DBS does not always swap back to dollars, having previously kept euro issuance in euros, "but if the cost of dollar swap is compelling, we won't rule out swapping back to dollars".

UOB has always "kept a lookout across currency markets for opportunistic savings," says Koh, though she emphasises that the bank's issuance will still be in the core funding markets in which UOB regularly issues.

Euro covered bonds are widely seen as offering the deepest pool of liquidity and, from a pricing perspective, Singaporean deals achieve similar traction to Australian deals, which also are not eligible for repo with the European Central Bank.

Unlike Canada, Singapore and Australia are not part of the G10 group of industrialised nations, which means the ECB does not accept covered bonds from those countries for repo. This is "definitely a no-go" for some large investors, says da Silva, "but Singapore has a clear advantage in terms of scarcity of supply."

Korea's different approach

The approach that Singapore's banks take is different to that followed by those in South Korea, a group which da Silva describes as "practical and adaptable". Korean banks often use the full gamut of deal features to ensure "the best possible outcome" for their transactions.

This usually means limiting deal size to €500m, issuing in the short to medium part of the curve, where most of the demand sits, and focusing on bonds that investors with an environmental, social and governance mandate want to buy.

The main issuers are Korea Housing-Finance Corp, Kookmin Bank and KEB Hana Bank, and they mostly bring deals with a social label that finance houses for low income borrowers.

But, because South Korea has a double-A rating — lower than Singapore's — is less well understood as a financial centre, and has a less familiar legal system, its deals attract "a more defined niche" of investors than Singapore, says da Silva.

With less investor traction, Korean deals tend to price around 15bp-20bp wider than those from Singapore.

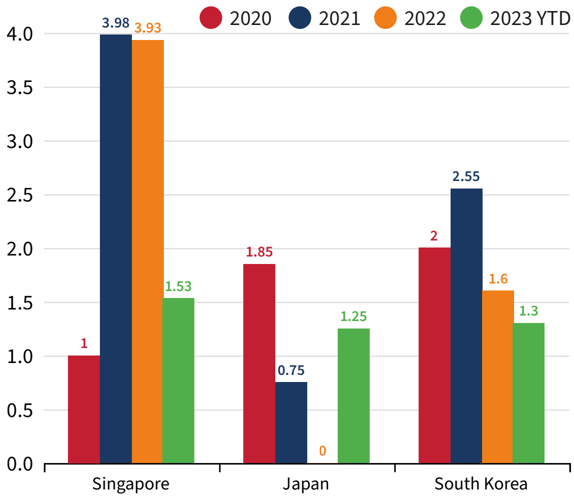
Japan's pioneers

In Japan, there are only two covered bond issuers: Sumitomo Mitsui Banking Corp and Sumitomo Mitsui Trust Bank.

Chen says Japan's issuers and the Financial Services Agency are looking at setting up a regulatory covered bond framework but he concedes that "due to issues and complexities the journey from conception to presentation will take time to build".

Although Japan is a member of G10, its structured deals are secured on RMBS collateral, which is not considered an eligible asset under the Capital Requirement Regulation

Asian covered bond supply across currencies (€bn)



Source: Primary Market Monitor/Dealogic

and would not therefore qualify for repo with the ECB. In that sense, deals from Japan issued under a legal framework could be considered on a regulatory par with Singapore and Australia.

The two active Japanese issuers are considered pioneers but with the implementation of a legal framework "I'd expect new issuers to show up," says Frederik Kunze, covered bond analyst at NordLB research.

Investors that NordLB has spoken to think covered bond regulation in Japan could result in a 5bp-7bp tightening in the paper, "which will bring them closer to Singapore," says da Silva.

This could be incentive enough to cajole Japan's two other mega-banks, Mizuho Financial Group and Mitsubishi UFJ Financial Group, to consider issuing. Several other medium sized financial institutions are also understood to be eyeing covered bond issues but would not be persuaded to do so without a law.

But, if that were to happen, Japan would undoubtedly have the most growth potential, underscored by its enormous mortgage market, which at $1.5tr as of 2021, dwarfed Singapore's market of just $45bn. Perhaps not surprisingly, Kunze says Japan has "much bigger issuance potential than Singapore".

A range of Asian emerging markets are also monitoring developments and might set up covered bond regimes. But whether they would naturally deploy mortgages as the most fitting asset remains to be seen.

For some developing markets, funnelling funding into small and medium sized enterprises could be the most pressing concern. And for this, the European Secured Note (ESN) would provide the most natural fit says Chen at DBS.

"If we want to preserve the regulatory position of covered bonds under Basel rules and national laws, then having an ESN applicable global framework for emerging market jurisdictions may make sense as issuers in these regions may not necessarily want to use mortgage collateral," he says.

ESN investors have recourse to a broader pool of asset types that are not eligible under the CRR definition of a covered bond.

Siefert agrees that emerging market central banks and regulatory authorities may see the benefit of dual recourse instruments, even if it is only used for central bank funding retained on an issuer's balance sheet and used as a precautionary liquidity backstop.

Having the covered bond programmes and financial architecture in place would also be good for borrowers and in the long run as they could eventually deploy issuance "into the capital markets when the economics make sense," says Seifert.

China's opportunity

Provided there is a clear benefit for banks and other stakeholders, LBBW's Han expects China to set up a regulatory regime for covered bonds and ESNs. These funding tools may offer Chinese banks "a unique opportunity to further expand and develop in the future," he says.

But Han is less optimistic about the prospects for Malaysia, which has a strong Sukuk market in ringit that delivers cheaper funding than offshore issuance. Although Malaysian banks have been considering covered bonds for some time, there has been no result so far.

India has also developed a budding market for dual recourse instruments, which in many cases have been secured auto loans and are not therefore covered bonds under the all-important CRR definition. And with a triple-B sovereign rating, it is hard for investors to buy into India's credit story immediately.

Nonetheless, with a strong and growing economy, India can be expected to develop and become more sophisticated "suggesting covered bonds and ESNs will be strong candidates for further discussion," says Han. GC

Pfandbriefe cushioned from commercial property repricing

Investors focus more on capital than covered bonds, writes **Bill Thornhill**.

German Pfandbriefe offer greater investor protection than any other covered bond regime, so despite their heavy exposure to commercial real estate, where prices are expected to fall further, the bonds are unlikely to suffer.

At the end of the first quarter, German commercial property prices were down 8.3% from the same period in 2022, according to data from the Association of German Pfandbrief Banks (vdp). Prices in the retail sector were down by 10.5%, outpacing the 7.5% year-on-year price fall in office properties.

Around one quarter of Germany's 30-odd Pfandbrief issuers have exposure to the commercial real estate market, amounting to around 75% or more of their cover pools.

Among these, Aareal Bank and Deutsche Pfandbriefbank (PBB) have the highest exposures to countries outside Europe, principally in the US, where CRE prices have fallen the most.

However, Pfandbriefe offer investors plenty of protection, insist market insiders. "Pfandbrief is really something that funds through the cycle as haircuts [of the loans that go into the cover pool] can be up to 80%, depending on what's being financed," says Frank Finger, Aareal Bank's head of treasury, in Dusseldorf.

On average, there is a 30% difference between the market value of a commercial property and its mortgage lending value (MLV), which is prescribed under Pfandbrief law. Furthermore, only 60% of the MLV can be put into the cover pool.

If property prices go up during the term of the loan, issuers cannot revalue the cover pool at a higher level to take out more debt. When a loan is refinanced at the end of its term, the originating bank can use a higher MLV if prices have risen.

Collectively, these mechanisms give investors a lot of protection, thought to be the highest of any covered bond regime.

The average LTV of Aareal's loan portfolio was 55% at the end of March and its NPL ratio was 3.4%. In PBB's case, the weighted average whole loan to value of its portfolio was 51%, its NPL ratio was 1.6% and its weighted average interest cover ratio was 300%, as of the end of March.

The two issuers' portfolios contrasted with Berlin Hyp's, which largely comprises mortgages on German and Dutch commercial properties. At the end of March, its portfolio had a similar LTV of 54%, but thanks to its more conservative underwriting standards and early focus on green buildings, the NPL ratio was just 0.4%. Within BHH's loan portfolio of offices, half the loans are green, which differentiates it from other lenders.

No equilibrium yet

But the question for many people is where the CRE market is heading and what the impact will be on mortgage lenders' portfolios.

Sascha Kullig, a member of the management board of the Association of German Pfandbrief Banks (vdp) in Berlin, says there have been comparatively few commercial loan transactions in Europe, making it difficult to estimate the impact on cover pools.

"People who want to sell are unwilling to accept large price declines and companies with interest to buy are hoping for a more substantial discount," he says. "As such, a price equilibrium has not yet been reached and this explains why there's been so few deals."

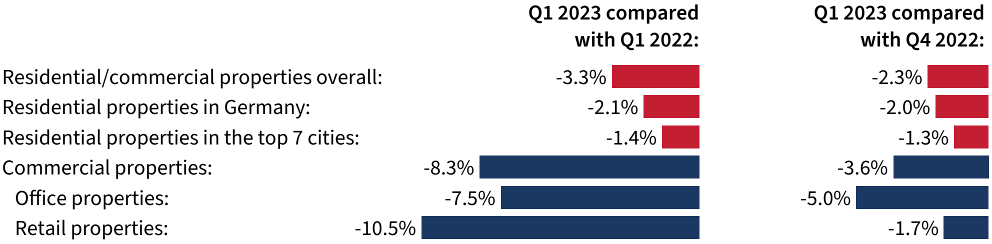
Finger says a repricing of commercial property is not far off but it has not happened yet. "I don't expect interest rates to go much higher and, before long, they will plateau and we'll see a period of [rates] stability which should help to catalyse new deals and a new level of [loan] pricing," he says.

Even so, Bodo Winkler-Viti, BHH's head of funding and investor relations in Berlin, says there is still "a high level of uncertainty" about where prices and rates will go, He thinks transaction volumes will only begin to grow after prices have been recalibrated.

Kullig agrees with this view and draws attention to the ambiguous economic backdrop for inflation and the economy, which makes it "difficult to predict how markets will react".

Despite this, Kullig is optimistic about German commercial property income. "The good news is that rents have increased by 4.7% year on year and vacancy rates are still low," he says.

Year-on-year and quarter-on-quarter change in prices



Source: vdp

Property valuations can also vary depending on their use. One of the most pertinent factors is how the structural shift in working from home arrangements has taken hold since the pandemic.

Kullig says people are clearly working fewer days in the office but this trend might be offset by other factors, such as the need for more space, higher quality buildings and better locations.

More desirable, energy efficient buildings are one example. Conversely, incoming regulations on the sustainability of older buildings raise the risk that "investors are left holding stranded properties" in some grade 'B' office assets located in less popular locations, says Antonio Farina, a Madrid-based director at S&P, in charge of its sustainable covered bonds business.

Another Pfandbrief funding official, who prefers to remain anonymous, backs up this view and says that office prices have become a "big discussion point", particularly in the US where a repricing has already taken place. He says the US CRE market is "brutal" and anticipates a wave of loan restructurings.

The funding official says the biggest risk that lenders face is "exit risk" — that a borrower cannot refinance a loan due to higher rates, or cannot sell a property without taking a loss.

For this reason, Finger says it is critical to maintain close contact with loan borrowers or sponsors. A sponsor's commitment is a key determinant of a loan's performance, he says.

In challenging times, three fundamental factors must be assessed, says Finger. "That's location, the quality and attractiveness of the building, as well as the professionalism of the customers to adapt real estate to new demands of the market."

Winkler-Viti agrees that modern, energy efficient buildings are likely to be much easier to manage than buildings needing investment.

Rolling over

Stuck with falling prices and an inability to sell, sponsors tend to roll over and extend their loans. The Pfandbrief funding official says his firm has seen a big uptake in loan extensions. This involves borrowers taking out a shorter duration loan on less attractive terms in the hope that market conditions improve by the time it matures.

Due to these problems, one German investor buying Pfandbriefe for his bank's liquidity coverage ratio portfolio says he has been taking a much keener interest in the mortgage portfolios of Pfandbriefe.

He says the 10bp-20bp additional spread that Aareal and PBB's Pfandbriefe pay over stronger credits is warranted for the additional risk of their loan portfolios.

"The pick-up is what I expect and I ask the issuer to pay for the risk I'm taking in their CRE cover pools," he says. "And even though they have low NPLs, I'm taking a closer look, as they can only get worse.

"Ultimately, it is a question of how much capital and other income these banks have to cope with losses, and from that perspective I think they are well capitalised and well-funded."

As of June 2023, PBB reported total assets of €49.8bn, a common equity tier one ratio of 16% and net income of €69m. PBB group reported aggregate losses of €5m from operation risks during the first half of 2023.

In the same month, Aareal reported second quarter total assets of €49bn, a CET1 ratio of 19.4% and consolidated net income of €58m. Aareal said its loss allowance was likely to be in the range of €270m-€330m, up from a forecast range of €170m-€210m, largely due to the US office property market. The bank expects to make an operating profit of €240m-€280m, up from €239m in 2022.

The same investor expressed confidence in Pfandbriefe but acknowledged that senior unsecured notes were likely to become more vulnerable to a CRE repricing.

S&P's Farina expects European banks' funding costs to rise over the rest of the year and next, as deposit availability is expected to decrease as central banks accelerate their balance sheet reduction. "Banks are generally well funded and capitalised and have capacity to increase exposure," he says. "[But their] willingness to [increase exposure] is problematic."

He thinks banks are more willing to help existing clients than take on new risk, despite the fact that opportunities are starting to appear.

The Pfandbrief funding official says borrower access to funding has become more restricted. "They don't get funding, but on the other hand, there are huge opportunities for new business with low LTVs and high margins as there's less competition," he says.

OC and risk planning

NordLB and Aareal Bank have both increased their CRE exposure by 10%-15% from last year, while Aareal has increased its exposure to multi-family housing by almost 30% from 2022, according to S&P.

As of December 2022, Aareal's €15.1bn Pfandbrief cover pool contained 491 commercial loans with a value of about €14bn, of which about half were in euros, 27% in dollars and 15% in sterling with a weighted average LTV of 55.8%, says Moody's.

Aareal's overcollateralisation (OC) ratio was 20.7%, only slightly above the 17.7% required for a Aaa rating from Moody's.

Deutsche Pfandbriefbank's €19.3bn cover pool contained 1,487 commercial loans worth €18.7bn as of March. Of those, 70% were denominated in euros, 17.7% in dollars and 8.4% in sterling with a current weighted average LTV of 47.3%, said Moody's.

Its OC ratio was 31.2%, well above the 12.5% needed for its Aa1 rating from Moody's.

Excess OC, above the amount required for an issuer's Pfandbrief rating, averages around 25pp across the Pfandbrief sector, according to Commerzbank. As such, Aareal's excess of 3% is conspicuous for being by far the lowest.

Other issuers "could thus still draw on this leeway, at least in part, without jeopardising their credit rating," says Ted Packmohr, head of covered bond and financials research at Commerzbank in Frankfurt, who adds that prudent management of OC is a natural part of banks' issuance planning.

"Maintaining a high level of rating stability is part of good practice in the covered bond market, not only in Germany," he says. "We therefore assume that the banks will tailor their issuing activity to their OC capacity without this resulting in substantial credit risks."

Aareal has visited the covered bond market three times this year, raising a total of €2bn, and has issued €2.65bn in benchmark format over the last year. Deutsche Pfandbriefbank has visited the covered bond market twice this year, raising €1bn in total and €2.25bn since July 2022. GC

For a few basis points more: covered borrowers go niche

Non-core currency markets can offer covered bond borrowers a key source of funding diversity as banks return to wholesale issuance. With funding conditions normalising, their importance will continue to grow, writes **Frank Jackman**.

Banks have turned to the covered bond market as they wean themselves off years of cheap central bank liquidity. In 2022, firms raised €284bn equivalent across all currencies and had placed €209bn equivalent by the end of August this year, data from Dealogic shows.

And although the bulk of this funding was raised in euros, niche markets — like the Swiss franc and Australian dollar — have given issuers a necessary and useful alternative outlet.

"We've seen through the course of the year that some trades in G3 [markets], from the higher frequency issuers, have been constrained by line capacity," says Thomas Lowe, head of FIG DCM for UK, Ireland and Canada, at Nomura in London.

"Given the increasing volume banks are needing to do, with central bank funding schemes rolling off, issuers need to supplement this with demand from elsewhere," says Lowe. "Even if it does cost a few basis points more than core G3 [currencies], issuers are willing to pay to secure genuine diversification."

For Wojtek Niebrzydowski, vice-president of global term funding at Canadian Imperial Bank of Commerce (CIBC) in Toronto, the principal reason for accessing non-core markets is funding diversification. "Of course, we can sometimes realise some arbitrage, but this is not an overriding factor," he says.

Yassir Berbiche, head of treasury at Fédération des Caisses Desjardins du Québec (CCDJ), says funding diversity "is key for us this year". His firm sold its first Swiss franc and sterling covered bonds — as well as its debut unsecured senior yen trade — this year and is looking to branch out into other markets.

The ever-popular Australian dollar is the next market in CCDJ's sights. "We roadshowed in Australia last year and might return in the winter with a deal," says Berbiche. "The Australian and Canadian economies have a lot in common and investors there understand us. Issuing in Australian dollars is also a good way for us to gain exposure to a new investor base in Asia."

Nomura's Lowe reinforces this point when he says: "There are certain investors who only buy Aussie dollar assets, so if you want true diversification as an issuer then it's a good proposition."

He adds that "the local banks have LCR (liquidity coverage ratio) portfolios to maintain and there's also a sizeable domestic asset manager community who participate in triple-A transactions. On top of this you also have Asian money from banks in China, Hong Kong and Singapore looking to manage their own LCR portfolios, as well as a pool of asset managers across the region."

These "LCR portfolios have consistently grown in tandem with bank balance sheets," says Lowe. "This pick-up in demand has been met by the pick-up in supply."

Niche markets will "never be the cornerstone of any funding programme, but there is genuine diversification available and meaningful size," he adds.

On average, offshore banks have raised just over Sfr250m ($283m) in a single Swissie tranche and A$764m ($495m) in a single Australian dollar tranche so far this year, according to data from *GlobalCapital*'s Primary Market Monitor.

ECB's shadow retreats

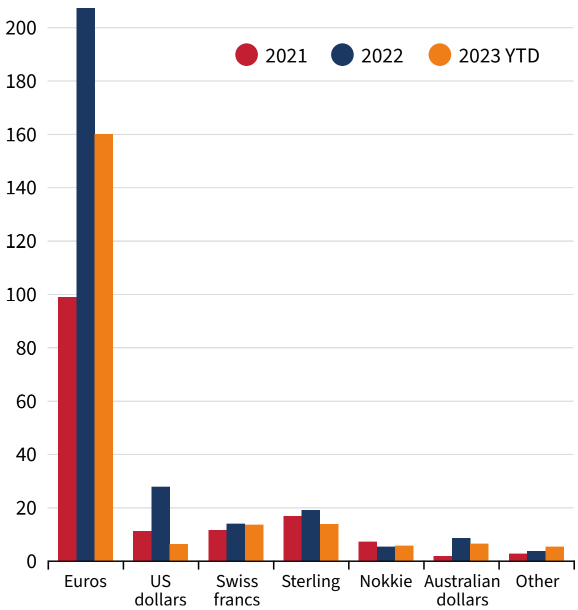
But it is not just diversification that is driving borrowers to tap niche currency markets. After years of central bank supported issuance in the eurozone, the end of quantitative easing has made niche markets an attractive funding proposition again.

"During QE, Swiss supply was not competitive versus euros for most issuers given the combination of negative rates and strong euro market dynamics," says one Zurich-based syndicate banker. "Since QE in Europe faded out and spreads normalised, the Swiss market gained in relative attractiveness."

Offshore banks have raised Sfr4.8bn so far in 2023, making it already the busiest year for the market since 2012.

On top of this, the return of positive underlying rates in the Swiss

All syndicated covered bonds broken down by currency (€bn)



Source: Primary Market Monitor/Dealogic

franc market last year has ushered in a raft of covered bond supply.

"When issuing in Swiss francs we used to aim for a minimum yield of 1%, but after rates went negative, the challenge switched to getting a positive yield," says Niebrzydowski.

"From what we understood, during this time there was a finite amount of funds available for low yielding triple-A paper. But now [rates are positive again], investors are reallocating assets back into fixed income and as a result we are seeing more demand, more issuers, and occasionally larger deals."

The Swiss franc's seven year dalliance with a negative policy rate ended in September last year. The Swiss National Bank rate first dipped below zero in January 2015, when it dropped to minus 25bp, before later being slashed even further, to minus 75bp.

This negative rate era is now over, with a succession of increases taking the policy rate up to the giddy heights of 1.75%, as of August.

"With the higher absolute rates, investors now can be a bit more flexible when it comes to spread levels," says the Zurich-based banker.

The average yield for an offshore covered bond has climbed dramatically in the Swiss franc market over the last few years, rising from 0.1% in 2020 to 0.2% in 2021, 1.07% in 2022 and 1.89% so far this year.

"The market will continue to remain supportive as long as we have higher positive rates," says the Zurich-based banker. "Swiss francs will enjoy further inflows thanks to the relative attractiveness of the currency compared to others."

This support is evident in the size available in the Swiss franc market, with funders finding opportunities to bring benchmark sized deals. Lloyds Bank dipped into the market for the first time to raise Sfr440m on August 9.

Large offshore deals followed from Santander UK and Toronto Dominion, which respectively raised Sfr385m and Sfr500m. The latter sale was the largest foreign trade in the format since Nationwide's triple trancher in 2019, Dealogic data shows. However, unlike Nationwide, Toronto-Dominion achieved its size across only two legs.

Niche frontiers

Although covered bonds are already a firmly established product for offshore borrowers in the Swiss franc and Australian dollar markets, they are yet to take off in other key non-core currency markets.

▲ Thomas Lowe, head of FIG DCM for UK, Ireland and Canada, Nomura

"There is technically a market in Canadian dollars, but covered bonds are not a traditional fixed income product in Canada," says CIBC's Niebrzydowski. "The question for us as an issuer is to what degree issuance of covered bonds would cannibalise the demand for senior unsecured paper in a market that, most of the time, is the cheapest to issue in on the senior side."

Only two Canadian dollar covered bonds have been issued in the last three years, according to Dealogic. Laurentian Bank raised C$250m ($185m) of five year paper in April 2021, with the next offering following two years later when Toronto-Dominion priced a C$1.25bn three year floater.

No foreign funder has issued Canadian dollar covered debt since Dexia in May 2007.

A potential Canadian dollar-denominated covered bond would be repo-eligible with the Bank of Canada, and as a result "there is demand from Canadian bank treasuries looking for their HQLA portfolios," says Niebrzydowski.

However, although "this demand is arguably over and above the demand from real money accounts, access to that market is very sporadic," he says. "We haven't issued a public Canadian dollar covered bond but have issued self-retained deals. Although we wouldn't consider the market, at this time, for meaningful issuance, that doesn't mean it's not an option for foreign issuers."

And although there is a clear bid for Australian dollar covered paper out of Asia, this demand does not translate into home currency interest.

Niebrzydowski says CIBC does "occasionally speak to some of our Japanese coverage banks about yen [covered bonds] but the response we get is that the likelihood of that market developing is next to zero".

Nomura's Lowe agrees, saying: "There's not the same market for covered bonds in yen. There are a handful of investors that can buy the product but because of the low yield environment in Japan the focus is on higher beta senior products where the pick-up is greater."

The last yen covered bond was issued in 2007, again by Dexia, according to Dealogic.

Meanwhile, Niebrzydowski says CIBC has "also looked at Singapore dollars, but it seems the demand there is for capital products that command a much wider credit spread".

Issuance in this market "is driven by private banks and high net worth investors — and this demand is for wider spread and higher yielding products than triple-A assets," adds Lowe.

Banks have had a great time raising capital paper in Singapore dollars this year, placing S$3.65bn ($2.7bn) across seven deals. However, no firm has ever issued senior secured paper in the currency.

Keeping up appearances

But for many bank funders, issuing a niche currency covered bond is not a 'one and done' exercise. Many hope to return repeatedly to these markets, drawing upon a recently or newly established investor base.

"You cannot spread your funding around different markets and not commit to returning," says Berbiche. "Investors don't like to open and follow a name if you only issue occasionally. When we decide to issue in a new currency, we commit to returning and building out a liquid curve."

For nascent and returning international funders like CCDJ, covered bonds are the perfect instrument to reintroduce or introduce a name to new investors. "We've been advised to open new markets first with a covered bond before looking for opportunities to issue unsecured paper," says Berbiche.

Although non-core currency covered bonds make up a small portion of the overall market, their importance will continue to be felt and these smaller niche markets will persist as a key part of a bank's multicurrency programme.

"Issuers have committed to the market, now have a decent amount outstanding, and will continue to use it as part of their global funding mix," says Lowe. GC

Public market blooms as ECB shadow shrinks

The ECB's withdrawal — both as investor and lender — from the bank bond market has rippled through covered bonds over the last 18 months, according to data from *GlobalCapital*'s Primary Market Monitor, which tracks syndicated benchmarks across asset classes in major currencies. **Frank Jackman** reports.

Banks raced out of the blocks in the first few months of 2023, maintaining last year's pace of bond issuance. In the first half of this year, €131.4bn was issued in covered format, following the €207bn raised in 2022. Eurozone banks, in particular, made a rampant start as they sought to secure what remained of the ECB bid.

"Euro area issuers closely watched the ECB's behaviour early this year, anticipating that it would reduce its primary purchases to zero," says Joost Beaumont, head of bank research at ABN Amro in Amsterdam.

Rumours circulated in January that the ECB would wind down primary market purchases under the third Covered Bond Purchase Programme (CBPP3), first with a cut from 20% to 10% of a deal's size. This, in part, helped to spur a rapid start, as eurozone banks issued just over €23bn.

Issuers rushed to secure the ECB's bid, with a number of those that priced bonds late in January doing so with shortened settlement periods to make sure the bonds were issued before the start of February, the time from which the ECB's order shrunk.

The much-heralded ECB cut duly arrived. It ceased primary market purchases altogether the following month.

Eurozone banks issued just under €23bn again in February but supply from the bloc fell sharply in March, to only €3bn. It was left to non-eurozone borrowers to pick up the slack and these banks contributed €16bn of supply in March, up from €3.75bn in February and €4.25bn in January.

"The end of QE led [eurozone] issuers to come to the market," says Beaumont. "We saw issuers last year increase their deal sizes, in part for higher liquidity, but I suspect also to allow for a greater allocation to the ECB."

On average, eurozone borrowers raised €827.5m in single tranches during the first half of the year, compared to €751.6m in 2022 and €639.2m in 2021, according to PMM and Dealogic data. The average size of their non-eurozone counterparts' sales remained more stable at €1.08bn during the first half of 2023, compared to €1.06bn last year.

For whom the TLTROs

Repayments under the ECB's latest Targeted Longer-Term Refinancing Operations (TLTRO) end in December 2024, meanwhile UK banks will have to pay back their Term Funding Scheme with additional incentives for SMEs (TFSME) borrowing from the Bank of England over the coming years.

Many banks are choosing to finance these repayments by drawing down on their abundant liquidity coverage ratios. Liquidity levels swelled during the Coronavirus pandemic as a reams of cheap central bank liquidity and surplus deposits flowed into banks' coffers.

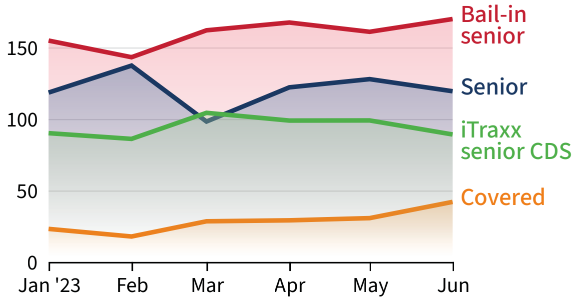
Eurozone bank liquidity coverage ratios peaked at an average of 173.81% in the second quarter of 2021, according to ECB data. This has since fallen to 161.46% at the end of 2022 — but banks still have a way to go before they return to their pre-Covid levels of around 140%.

Although this liquidity will provide the bulk of TLTRO repayments, banks are also leaning again on the wholesale market — with an emphasis on covered bonds, their cheapest source of funding — to support this refinancing.

"An increase in issuance activity was expected, given funding schemes such as TLTRO and TFSME are now being refinanced," says Peter Green, head of senior funding and covered bonds and debt investor relations at Lloyds Banking Group in London.

Beaumont agrees, saying: "Banks need to rely more on wholesale funding again [after the winddown of the TLTRO]. TLTRO repayments explain some of the large volumes as euro area banks rush to repay the quite substantial amount of loans they had outstanding."

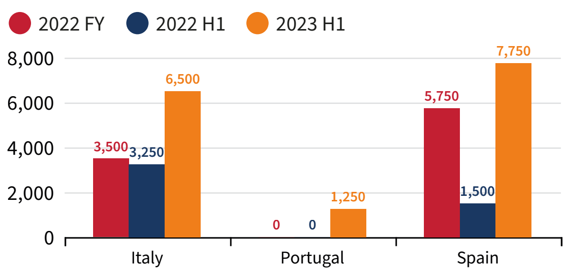
Average monthly covered vs senior new issue spreads YTD (bp)



Source: Primary Market Monitor/iTraxx

2023 H1 supply compared to H1 2022 and FY 2022 (in euros) — select jurisdictions

€m syndicated covered bonds



Source: Primary Market Monitor

He adds that the step up in supply from Austria over the last 18 months — rising from €4.85bn in 2021 to €15bn in 2022 and €11.4bn in the first half of this year — is "is partly related to the TLTRO".

In fact, the €11.4bn raised by Austrian banks in the first half of the year far exceeds the €1.75bn of redemptions expected throughout 2023.

Eurozone banks have just under €600bn of outstanding TLTRO loans — split across six tranches — they need to repay before the end of next year.

This need has driven an increase in funding from the eurozone periphery. Italian, Portuguese and Spanish supply this year, for instance, has already outstripped the total raised in 2022.

Italian firms placed €6.5bn in the first half of this year, close to double the €3.5bn raised in 2022. Meanwhile, Spanish banks issued €7.75bn in the first half, up from €5.75bn last year. No Portuguese banks tapped the market in 2022. The two Portuguese deals totalling €1.25bn from Banco Santander Totta and Banco BPI issued this year were the first from the country since July 2019, four months after the ECB launched its third TLTRO scheme.

The return of these eurozone periphery issuers "is clearly related to TLTRO repayments," says Beaumont.

Investors in control

Issuers paid higher new issue concessions in early 2023 compared to the final months of 2022 as banks flocked to the covered bond market. As the ECB left the market, those investors which stepped in to fill the void demanded more spread to compensate.

"Because of the large volumes issued, the balance in the market has gradually shifted to the investors," says Beaumont. "Banks could rely on the ECB bid for years, but now that's gone they must rely on public investors again — and these investors can be quite selective."

A new issue premium of 5.9bp was needed on average for the €27.6bn of paper placed in January, compared to the 5.1bp needed for the €18.6bn issued last November. On average banks had to offer 5.4bp of premium during the first half of the year.

Only one deal landed through its issuer's outstanding curve, PMM data shows. DekaBank achieved this feat in January, pricing a €250m two year note at 11bp through mid-swaps, 1bp tighter than fair value. Demand for this deal peaked at €1.7bn.

Less popular or riskier deals needed larger concessions. For instance, Slovakia's Slovenská Sporitelna had to offer a 15bp concession on its January visit. Raiffeisen Austria needed 11bp to secure €500m of long four year funding in May, off the back of a €700m book. Bankers away from the deal said the firm's exposure to Russia and the high level of Austrian supply this year led to lower credit line availability among investors.

"From an investors' perspective, issuers now must pay up," says Beaumont. "Although the increase in premium is marginal, it shows the move towards an investor focussed market."

However, although covered bonds require lower premiums compared to senior paper — often in the low single digits of basis points — their overall tight headline spreads mean that the concessions offered make up a far higher share of the overall cost. In June, new issue premiums made up 38.8% of the final spread needed for euro covered bonds, a far cry from the 12.5% needed for a senior preferred trade.

Despite having widened almost 20bp since the start of the year, the average monthly new issue spread to mid-swaps for a euro covered bond was only 41.95bp in July this year — a far cry from the 119.28bp and 169.75bp required for new senior preferred and non-preferred deals that same month.

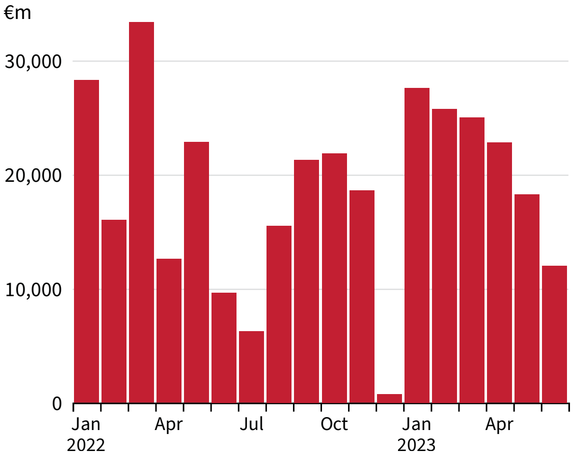
"Investor appetite for the product is quite strong thanks to the rise in rates," says Beaumont. "But at the same time, covered bonds are still the cheapest funding tool for banks. For banks facing rising funding costs, covered bonds are an attractive way to limit this rise."

Green at Lloyds says: "Supply year to date seems to have been well received, with more traditional investors returning to the product."

Banks raised €132.7bn in covered format during the first half of the year and are well on track to come close to — if not exceed — last year's record. At the same point in 2022, banks had pushed €122.73bn through the market on their way to a record €206.95bn final total. GC

"Banks could rely on the ECB bid for years, but now that's gone they must rely on public investors again — and these investors can be quite selective."

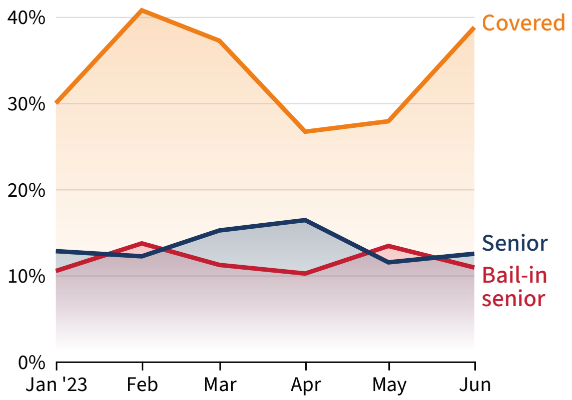
Month by month syndicated covered bond issuance in euros



Source: Primary Market Monitor/Dealogic

Covered bond premiums make up a higher percentage of the overall spread

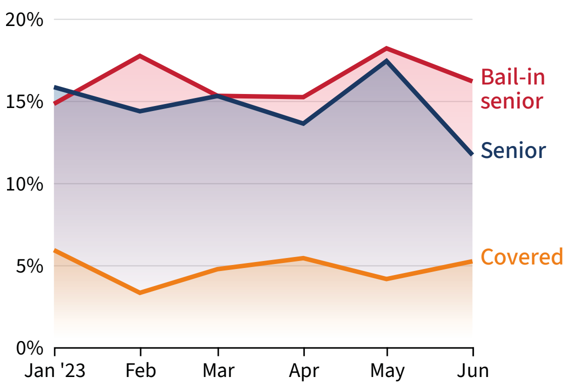
NIP as a percent of the overall spread to mid-swaps on euro bank bonds (%)



Source: Primary Market Monitor

Covered NIPs are optically smaller compared to unsecured bonds

Average monthly new issue premium for senior, bail-in senior and covered bonds priced over mid-swaps (bp)



Source: Primary Market Monitor

Trust. Growth. Success.

The Euro Covered Bond market has experienced significant growth in recent years, presenting an array of opportunities for investors and issuers alike. Erste Group play a leading role in this market and have executed 57 successful EUR deals in 2023ytd.

A selection of deals across jurisdictions is depicted below:

August 2023
Toronto-Dominion
EUR 750,000,000 3y FRN & EUR 1,500,000,000 3y & EUR 1,000,000,000 8y Mortgage Covered Bond
Joint Bookrunner

August 2023
Danske Mortgage Bank
EUR 1,000,000,000 5.4y Mortgage Covered Bond
Joint Bookrunner

July 2023
RLB Oberösterreich
EUR 500,000,000 4.4y Mortgage Covered Bond
Joint Bookrunner

June 2023
Intesa Sanpaolo
EUR 1,250,000,000 5y Mortgage Covered Bond
Joint Bookrunner

June 2023
Hamburg Commercial Bank
EUR 500,000,000 4.6y Mortgage Covered Bond
Joint Bookrunner

June 2023
RLB Steiermark
EUR 500,000,000 3y Mortgage Covered Bond
Joint Bookrunner

June 2023
EIKA Boligkreditt
EUR 500,000,000 10y Mortgage Covered Bond
Joint Bookrunner

June 2023
UniCredit Bank CZ/SK
EUR 500,000,000 5y Green Mortgage Covered Bond
Joint Bookrunner

June 2023
UniCredit
EUR 1,750,000,000 3y & EUR 1,250,000,000 7y Mortgage Covered Bond
Joint Bookrunner

May 2023
Credit Agricole Home Loan SFH
EUR 1,250,000,000 10y Social Mortgage Covered Bond
Joint Bookrunner

May 2023
DZ HYP
EUR 500,000,000 10y Mortgage Covered Bond
Joint Bookrunner

May 2023
Aktia Bank
EUR 500,000,000 4y Mortgage Covered Bond
Joint Bookrunner

May 2023
Bank für Tirol und Vorarlberg
EUR 250,000,000 4y Mortgage Covered Bond
Global Coordinator & Joint Bookrunner

May 2023
Hypo Vorarlberg
EUR 500,000,000 4y Mortgage Covered Bond
Joint Bookrunner

April 2023
Hypo Niederoesterreich
EUR 500,000,000 5y Public Sector Covered Bond
Joint Bookrunner

April 2023
BAWAG P.S.K
EUR 750,000,000 3y Mortgage Covered Bond
Joint Bookrunner

April 2023
BPCE SFH
EUR 2,000,000,000 5y Mortgage Covered Bond
Joint Bookrunner

April 2023
VUB Banka
EUR 500,000,000 3.5y Mortgage Covered Bond
Joint Bookrunner

February 2023
Oberbank
EUR 250,000,000 7.5y Mortgage Covered Bond
Joint Bookrunner

February 2023
ING Bank
2,000,000,000 3y & EUR 2,000,000,000 10y Mortgage Covered Bond
Joint Bookrunner

February 2023
Societe Generale SFH
EUR 750,000,000 3y & EUR 1,500,000,000 9y Mortgage Covered Bond
Joint Bookrunner

January 2023
Commerzbank
EUR 1,000,000,000 3.25y Mortgage Covered Bond
Joint Bookrunner

January 2023
Hypo Oberösterreich
250,000,000 4.5y Mortgage Covered Bond
Joint Bookrunner

January 2023
Hypo Tirol
EUR 300,000,000 5y Green Mortgage Covered Bond
Joint Bookrunner

January 2023
Berlin Hyp
EUR 1,000,000,000 3y Social & 10y Green Mortgage Covered Bond
Joint Bookrunner

January 2023
RLB Vorarlberg
EUR 300,000,000 4y Mortgage Covered Bond
Joint Bookrunner

January 2023
Sparkasse Pforzheim Calw
EUR 500,000,000 4y Mortgage Covered Bond
Joint Bookrunner

January 2023
The Bank of Nova Scotia
EUR 1,750,000,000 5y Mortgage Covered Bond
Joint Bookrunner

Erste Group's remarkable growth in market share reflects the **confidence and trust clients** repeatedly place in the bank's execution expertise and placement capabilities.
With a strong Central European network comprised of motivated origination, syndicate, sales and research teams as well as a proven track record of successful transactions, Erste Group have solidified their position as preferred partner for investors and issuers in the Euro Covered Bond market.

ERSTE Group