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Sterling Covered Bond Issuers Roundtable

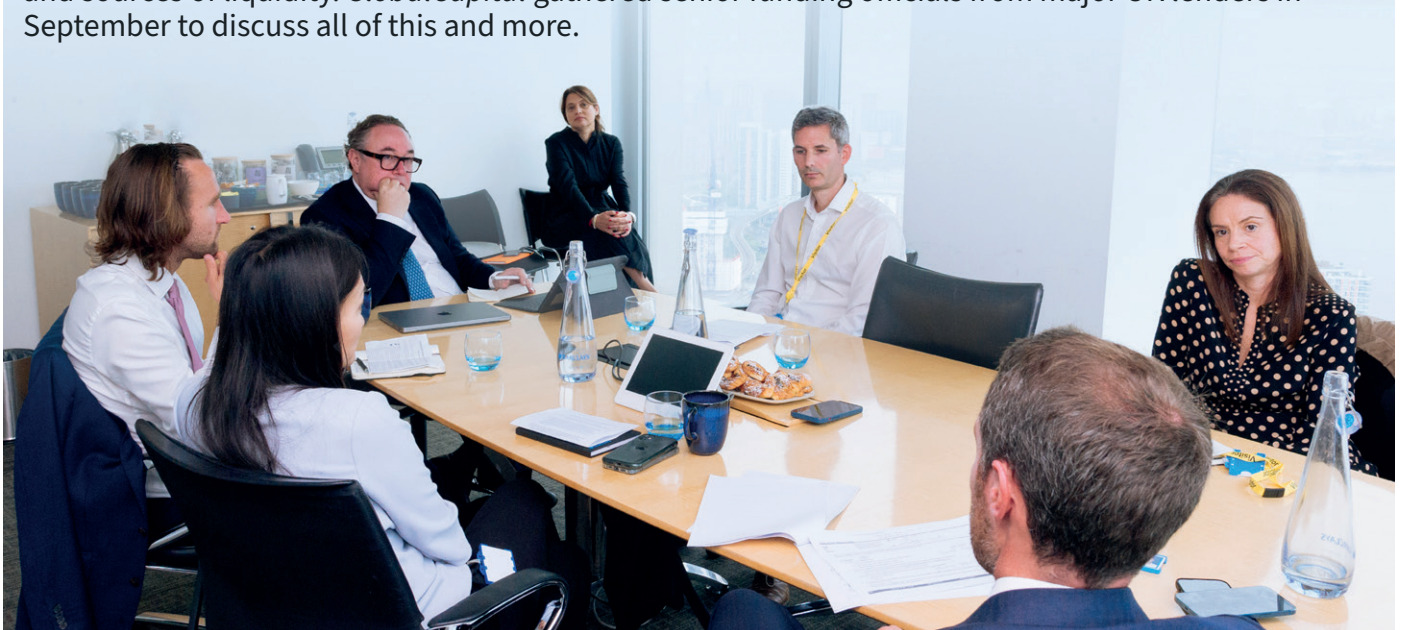
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UK covered bond issuers gear up for mortgage growth

A year filled with elections encouraged UK banks to do their covered bond funding early. The election in their own country passed without incident in July but there was still much for them to consider for the rest of the year and beyond — from fresh government policy, to rising demand for mortgages, and sources of liquidity. *GlobalCapital* gathered senior funding officials from major UK lenders in September to discuss all of this and more.



GlobalCapital: How have issuance conditions been this year? Did the parliamentary elections affect funding? What can we expect for the end of the year?

Richard Merrett, Nationwide:

Issuance has been quite favourable this year, especially in sterling as supply is considerably less than had been expected. We are at around 60% of last year's levels, so it's lower and demand is clearly there.

The UK government elections were pretty much a non-event this time because it was so well flagged who was going to win. As a result, all the policies were kind of there and unless we get any changes in the Budget we are not really expecting a huge shock — not to start with, anyway.

Kate Sinclair, TSB: The election probably just made people think a bit differently about when they were going to issue, perhaps to avoid it a bit. The Budget will cause a bit of volatility that people will avoid, but it seems like a lot of UK issuers have done the majority of their funding this year. We are always told to go quickly in the first half. I think a lot of people have opted for that approach this year.

Fiona Chan, Barclays: Issuance conditions were really supportive at the start of the year. It is worth mentioning that a lot of banks were going into Q1 thinking about Bank of England TFSME [Term Funding Scheme for SMEs] roll-off. You have a deposit trend and there were worries about whether it was going

to continue to decline or stabilise. There was a big question mark about whether mortgage growth was going to hit the target, so banks were going into the new year thinking: "We have funding to do. Let's target Q1."

Once we hit the second half, a lot of people recalibrated their funding plans and they thought: "Actually, deposits have stabilised as net lending is actually down, unfortunately," so we saw quite a lot of pull-back on funding plans. All in all, I would say it wasn't a challenging year for UK issuers. The election was almost a non-event, unlike the French, which was a surprise to us. So, we saw supply dwindle a bit in June and July, but for the UK we were not affected.

Roundtable participants



Moderator:
Toby Fildes,
managing director,
GlobalCapital

Richard Merrett,
head of secured
funding, Nationwide

Kate Sinclair,
head of wholesale
funding, TSB

Fiona Chan,
head of principal
funding and
securitization,
Barclays Bank UK Plc

Tom Burgess,
managing director,
head of UK FIG DCM,
Barclays Corporate
and Investment
Bank

Ian Perrins,
treasury debt capital
markets manager,
NatWest Group

Elena Bortolotti,
managing director,
global head of
covered bonds and
head of structured
solutions EME,
Barclays Corporate
and Investment Bank

GlobalCapital: We have the UK Budget and also US elections coming up. How do you see the rest of the year?

Chan, Barclays: Most of our funding is done on the secured funding side. I suppose the question is: Do we want to do pre-funding in November time, after the Budget in October and also the US elections?

Ian Perrins, NatWest: The main concern about the UK election was a misapprehension that it was going to be in November, at the time of the US election, or even next year. So, when it came to June it was a bit of a non-event. As Fiona says, in terms of what banks are disclosing around funding this year, most banks seem to be pretty much there now as we approach the end of Q3.

As for the Budget coming up, Labour has been quite clear in terms of being supportive of business and so on, so everyone is expecting stability. There may be some fiscal tightening, certainly, but I would be surprised if they do anything radical. Monetary policy is more a key for covered bond issuers anyway.

Tom Burgess, Barclays: Generally, people are about 75%-plus done this year. Typically, you would expect at H1 issuers to be about 50% done. There is a stat that DCM guys are trying to scare issuers about

around 60% of the world voting in the second half, so people took that into account when they built their funding plans. But, generally, conditions have been very benign.

GlobalCapital: How about maturities? Some people say that is perhaps one area that hasn't been quite as good as previously?

Burgess, Barclays: The covered bond market is typically a three to five year market and it has remained so. As a result, people have been pretty comfortable with the maturities they have been able to get.

Chan, Barclays: For our March issuance we were deciding between a three and five year maturity. Obviously, we looked at what was coming up and tried to avoid the congestion ahead of the curve. But because the spreads were so low, it made us think about going for a five year rather than the cheapest to deliver, which is usually a three year tenor. That's why we made the decision to go for fives. I think we have seen a lot more five years in sterling this year, versus threes.

Burgess, Barclays: Yes, this year has been a three to five year market in sterling. Three to five years versus seven years has been a lot more competitive. If you wanted

to do seven years or longer, you probably looked and found that the economics on offer in the euro market were a little bit more favourable, particularly as euro rates were quite volatile last year but have been quite settled this year. That encouraged investors to go a little bit further and gave issuers the confidence to go further as well.

But because credit spreads have been pretty low this year and conditions have obviously been quite favourable for issuers — and this is true across the entire capital stack — there has been a tendency to go a little bit longer.

One of the big themes, particularly in the UK banking sector, has been that deposit levels have stayed quite stable. There was a concern coming into this year, particularly with things such as quantitative tightening, that you would see some deposit erosion. We haven't actually seen that. System-wide deposit levels are 30% higher than they were before the pandemic. We are just not seeing that erosion of deposits yet. There has obviously been a bit of a change in the mix, but a lot of issuers are using wholesale markets to term out and achieve some of that maturity transformation.

Merrett, Nationwide: I did hear of some interest from asset managers for sterling fixed at seven to 10 years, but I haven't done enough due diligence or spoken to enough

people to confirm that.

Burgess, Barclays: I am old enough to remember that the sterling covered bond market began after the financial crisis as a fixed rate market — 12 to 15 year fixed trades. It was predominantly an asset manager market, then obviously it turned into the Libor market and then more recently the Sonia [Sterling Overnight Index Average] market. The composition of investors has definitely shifted from asset managers to bank treasuries.

Coming into this year, the mindset from issuers was: what was QT going to do to the demand side? People were worried about how conditions would play out in the sterling covered market and how they would have to start to price to the asset manager bid — which is typically 10bp, 15bp, 20bp wide of where bank treasuries are. So, there was definitely appetite from asset managers for fixed rate product, but at levels that were, frankly, quite uneconomic for issuers.

The reality is that none of that fearmongering has played out and there has been ample liquidity. We have actually seen an increase in the average number of investors in order books this year in sterling, predominantly from asset managers. But even the bank treasuries themselves, in many cases, have been increasing their order sizes, so there has been no shortage of liquidity in the Sonia market. I just don't think we have had to pay up for fixed rate covered bonds.

Chan, Barclays: Remember earlier this year we had discussions around the fact that asset managers would rather buy corporates than covered bonds? How has that shifted?

Burgess, Barclays: I am not sure we have ever quite moved on from the perception that corporates are a bit of an easier sleep-at-night trade than banks, if I am being perfectly honest. There is a general sense that, given the choice between a simple corporate and a financial, there tends to be a bit of a preference for the corporate. But the covered bond market benefits from being a triple-A product. It's secured, it's a really safe place to be and UK banks have never been stronger in terms of balance sheets and liquidity. The UK economy is actually faring a lot better than

people expected, the UK consumer is strong and asset quality is just absolutely benign.

GlobalCapital: Kate, going back to my question around how the investor base has evolved this year, what are your thoughts?

Sinclair, TSB: There have been a few new entrants, perhaps as they set up their own programmes.

GlobalCapital: So, bank treasuries essentially?

Sinclair, TSB: Yes. We tend to find the asset managers participate in larger volume at the beginning of the year and maybe trail off a bit at the end.

Chan, Barclays: We saw some hedge fund bids, which was quite surprising. That's a trend in quite a lot of order books in the UK — and in Europe as well. That's quite interesting because typically they don't get very much allocation, so it really makes me wonder why they keep trying. Maybe it's a case of trying and then for some issuances they do get some allocation.

Perrins, NatWest: There is a distinction between euros and sterling — it's a function of what's being issued as well. Sterling is still completely dominated by bank treasuries, whereas in euros — because it's a bigger market and there have been more issuers — you get people going longer down the curve and that brings in the asset managers or even hedge funds, as you say. So, there is a much clearer mix of an investor base in euros than currently in sterling. As Tom said,

with limited supply in sterling, there is no need for us as issuers to go further down the curve in sterling, which makes it more interesting, I guess, for different types of investors.

Burgess, Barclays: The asset manager bid in 2023 was less than 10% on average. In 2024, it has been closer to 25%. We have moved from an average number of investors in 2023 in the mid-30s to more like 50 now, so there has definitely been some growth, in terms of a few new people coming in on the bank treasury side — and on the asset management side as well.

GlobalCapital: It's hard to forecast, but are they here to stay now that they have a taste for it?

Burgess, Barclays: A lot of it will come down to what happens on fund flows on the asset manager side and liquidity in banks. It is still staggering that average Liquidity Coverage Ratios for banks in the UK are about 150%. In 2015, when the LCR came in, it was closer to 130%. So, there is a lot of liquidity still in the system and bank treasuries are still finding it very economic to deploy this in terms of their liquidity investments.

Chan, Barclays: There is one thing that I worry about, though, in the investor base, which is the way Basel treats non-UK covered bonds held by UK banks. The order book may see a shift towards more UK, rather than Europe. We haven't done a euro trade since 2012 — it has always been in sterling. But I always focus on how much of the distribution has gone into Europe because it is encouraging for me to see some



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Ian Perrins, NatWest Group



support from Europe, despite being in sterling covered bonds.

That shift under Basel — where UK banks holding non-UK covered bonds do not get level 1 treatment — will basically increase the concentration risk for UK covered bonds proportionately. So maybe it is something to watch out for.

Burgess, Barclays: We have seen euro trades going really well. Kate, you probably want to talk about this more than me.

Sinclair, TSB: It was our first ever euro and it was a €4bn book, so we were very pleased with the result — a great start to our euro issuance. We probably paid up a little bit, as you would expect on a first trade, but it puts us in a strong position for the next one, hopefully.

Perrins, NatWest: Euros is probably about as attractive as it is likely to get versus sterling at the moment. You are actually looking at well into single basis points difference on a post-swap basis, which is presumably why people such as yourselves are dipping their toes into the market. But, as you say, with the EU covered bond regime’s lack of third-party equivalence, and on the other side of the fence, the Basel III point — it does feel like that structurally your domestic market is always going to be advantaged. It is just the vagaries of the FX basis market that have made euros slightly more attractive at the moment.

Chan, Barclays: It was around May time that the euro covered bond

swap back to sterling was actually inside sterling, so there was that convergence.

Burgess, Barclays: In the three year FRN?

Chan, Barclays: Yes, the three year FRN because of where the sixes to threes were.

Merrett, Nationwide: That was us at the end of April, beginning of May. We did a three year/10 year dual tranche in euros, to take advantage of the FRN basis and the 10 year was fixed.

Burgess, Barclays: Which, I think, is the first time that we have seen euros inside sterling. I can’t remember the last time that happened.

Merrett, Nationwide: Typically, euros is cheaper for us to issue from around the seven year point. The euro market is much better for duration, and hence you can issue longer. And then, as you say, due to the basis the three year was coming underneath sterling.

GlobalCapital: Just bringing us back to the TFSME. What is the view on whether UK banks are back to their pre-pandemic funding levels? How have banks approached the increased funding volumes post-TFSME? Why have some banks chosen to return to secured funding this year?

Perrins, NatWest: Well, I can take the final question for NatWest. We did tap it for the first time in five

years. We are probably back to some degree of normalisation, not putting aside the fact that there is still a lot of TFSME outstanding. NatWest, unlike some of our peers, is much more deposit funded. Our loan/deposit ratio is low 80%, so we don’t always have a specific need for covered bonds. But in normal conditions, we like to issue fairly regularly for reasons such as diversification and keeping a foot in the market.

But it becomes a challenge to justify that when you have super-cheap funding from the bank and you are also being bombarded by deposits because no one was spending any money in lockdown, so it was a kind of a double whammy for a number of years. And, I would say, behaviourally as well. We expected those deposits that were saved up during lockdown to start to outflow much quicker than they did after things opened up again. We thought spending would pick up probably more quickly.

So, those deposit levels were maintained really until last year, when the interest rate environment started going up and people realised that they could actually earn a return on their cash and things started moving to various other products, such as Gilts. So, yes, really this is the first year that we are almost back to a normalised environment since the last time we had issued, which was in 2019. Even if we don’t specifically need the funding, I think you have seen banks return because it is good to always have access to the covered bond market.

Sinclair, TSB: We re-entered the RMBS market after eight years this year. We saw a few people follow that pattern, but we also saw the spreads inside the covered bond, so it was particularly attractive. We see it more normalised now with covered bond spreads inside RMBS.

Elena Bortolotti, Barclays: It is the only country, as far as we are aware, where we have this dynamic where RMBS is actually tighter than covered.

Burgess, Barclays: I struggle to define what normal looks like in the sense that we have not had normal for 10 years. You touched on a key point, which is that, fundamentally, post-pandemic, bank balance sheets look entirely different on a liability

side. A 30% increase in system-wide deposits. That's point number one.

So, I am not convinced, if that stays the same, that even with asset growth, which we will come on to in a second, that we will ever go back to the good old days. But when I look at the asset side, we are starting to see a normalisation.

If you look at the 10 years before the pandemic, approvals for mortgages averaged about 60,000 a month. After the mini-Budget [delivered by the UK government in September 2022 that caused a spike in Gilt yields], that fell to 39,000 because of affordability issues. Since February this year we have been at more than 60,000 — and had the highest number in two years in July, at 62,000. So, it feels like that asset-side growth, as rates normalise and affordability becomes less of an issue, should start coming through.

But the mortgage market actually shrank twice last year because, first, the volumes were just lower and it became much more of a remortgage — rather than a growing — market and, second, obviously people were using excess savings balances to pay down mortgages.

That is going to be the big driver from here rather than, for example, TFSME redemptions.

Sinclair, TSB: We had the Covid years, when we saw significant mortgage growth. You can see that when you look at UK finance, with the amount of lending in 2021 and 2022 — when people were choosing to move out of London, looking for more space and, perhaps, a garden and an office. This was driven by the stamp duty waiver — people who were considering a move in the next five years may have brought that forward. Following that, we haven't really seen more normalised annual lending yet.

Merrett, Nationwide: On that subject, there are still temporary measures at the moment, which unwind, I think, in March 2025. So that's when the levels come back down to a level that could, I guess, stagnate house prices. But it is going to be more on the Bank rate or potential future expectations of the Bank rate and where mortgage rates are. Now, they are all coming back down to 4% — just under, I think, for a few houses now — so that encourages more purchases and mortgage applications.

Perrins, NatWest: What we found really interesting, in terms of your mortgage pricing within your own bank, is how much of an increase in customer sophistication we are seeing, now that your mortgage payment is probably a bigger proportion of your general monthly outgoings.

We are seeing customers searching around for the best rate and really using that six-month window they have when they can get locked into a rate, hold on to that for six months and then wait and potentially jump away. That makes it really challenging for pricing and mortgage strategy teams in banks to price, track growth or show less appetite — or whatever your specific strategy is. It is really complicated to understand what the customer is going to do with it.

GlobalCapital: Does that have a bearing on the maturity of bond issues as well or does that not come into it? Does it make a three year better because the matching is going to be better because they are shorter-term mortgages?

Chan, Barclays: When the interest rate was high, we saw more retention because people didn't have to go through all the affordability checks again. But with rates coming down again, people are actually doing more shopping around and comparing rates, so the retention volume is actually coming down a little bit.

GlobalCapital: We have mentioned secured funding and RMBS. The spread between the two is incredibly tight. What is causing this?

Chan, Barclays: I have asked that question so many times. I don't know!

Merrett, Nationwide: It is a way for people to get a view on the UK housing market without necessarily having to have bank credit. I know they are explicitly linked but it is remote. It is a separate vehicle. If you want a view on UK housing through mortgages, you can buy an RMBS and not necessarily have to have any credit from a UK bank.

Sinclair, TSB: It's the lack of supply. We haven't seen a lot of prime RMBS in the last few years.

Burgess, Barclays: That's right. Actually, both markets are relatively liquid. There are very few people who are trading the basis, so very few people who are saying "Look, this is one where we are going to express a view", because it is quite expensive to do that from a trading perspective. Shorting is expensive.

But while there is a lot of crossover institutionally in terms of bank treasuries being able to buy both RMBS and covered bonds, for the most part they are separate desks and separate limits — and on the asset manager side there is a lot of difference between those who buy RMBS and don't buy covereds and vice versa.

Probably one of the only constants is the actual people who are issuing them. Everything else is quite different.

Perrins, NatWest: It is probably also, to some degree, a function of levels in general being just super-tight across the market. When

"With rates coming down again, people are doing more shopping around and comparing rates, so the retention volume is coming down a little bit"

Fiona Chan, Barclays Bank UK Plc



things are super-tight, everything compresses. The difference between operating company and holding company seniors is compressed. The difference between tier two and senior is compressed so, naturally, the difference between RMBS and covereds is compressed as well. That doesn't explain all of it, but it is part of it. If we make a step wider next year, you will see, I will suggest, perhaps a widening out as well.

Burgess, Barclays: Sometimes it's not a like-for-like comparison because typically the volume achievable in the covered bond market has been greater than the volume achievable in RMBS. It's not always the case — but typically.

Bortolotti, Barclays: And maybe longer duration in covered bonds compared with RMBS.

GlobalCapital: Fiona, you said you have asked that question, but do you have any theories?

Chan, Barclays: No, I don't. I think definitely supply, as Kate pointed out, and then what you said, Ian, also makes sense, when everything is so compressed.

When we did the March covered bond, we were able to price inside UK RMBS as well. That was mainly driven by the fact that we limited the print to £500m — so, to Tom's point, it was a small print size. We just didn't issue enough, so there is a scarcity value, which drives in the pricing.

The most relevant data point we can look to recently is what Santander has done. They issued a covered bond and an RMBS pretty much within two weeks of each other

and managed to price the covered bond 2bp inside, notwithstanding the print size. The covered was £1bn and the RMBS was £500m, so maybe you won't see 2bp — maybe closer to 1bp — but I think it is an encouraging sign that the covereds and RMBS differential is normalising again. I would like to see that continue.

Sinclair, TSB: Most issuers were able to issue longer tenors. A weighted average life of around five years has been achievable this year, so the maturity versus a covered bond wasn't such an issue either.

Merrett, Nationwide: You also have separate credit limits. If you are Nationwide, for example, investors are likely to have separate limits for our RMBS programme and our other programmes, depending on what investors have bought in the past or where their exposures are.

Bortolotti, Barclays: Another interesting dynamic specific to the UK is, unfortunately, that the credit enhancement levels — overcollateralisation (OC) — are actually higher in the covered market than for RMBS; usually it's the other way around. The FCA assigns you an undisclosed OC level, which tends to be significantly high. So, I think that is another anomaly of the market here in the UK. Everywhere else, RMBS for an issuer will require higher credit enhancement levels and that is why everyone is focused on the covered side rather than RMBS.

Chan, Barclays: But what is interesting is that pricing anomaly triggered a lot of issuers to open the

market with an RMBS trade instead of a covered trade. Typically, people will go for covered. We saw both Lloyds and Santander UK open this year with an RMBS trade.

GlobalCapital: Is sterling always the best option? How attractive is sterling versus euros right now? How does sterling compare with other currencies — non-core covered bond markets such as Swiss francs, Australian dollars or even US dollars?

Burgess, Barclays: The reality is that, for a considerable amount of time now, the cheapest currency for issuers to issue in — and this is excluding all of the swap costs that these guys have to pay when they are issuing in non-sterling format — has been sterling.

So, sterling has been the cheapest Libor currency. But issuers are not only motivated by price. People are willing to pay a premium in sterling to be able to diversify — not necessarily because they need the funding, because UK banks are incredibly liquid at the moment, but more because they value plurality of funding sources.

The other thing that we touched on was that the euro market and non-sterling markets can offer some different tenor choices. So, typically in the euro market, as Richard said, it is easier to go out to 10 years, even longer. You guys have done 15 year trades in the past, maybe longer.

Sinclair, TSB: We went into that market for diversification, so we didn't have to rely on the UK market for every trade. And it's a deep investor base, who are willing to invest in longer tenors too.

Perrins, NatWest: There is probably a distinction between euros and other currencies. Obviously, there is the value in having a well thought out, established euro curve. Currencies such as the Swiss franc and the US dollar to some degree are probably a more opportunistic market. Prices, as Tom says, don't have to be inside sterling necessarily, but if it is an attractive level and you have funding to do, they can offer opportunities at a specific time.

GlobalCapital: Would anyone describe dollars as a strategic market for covered bonds or not?

“In the UK, the credit enhancement levels are actually higher in the covered market than for RMBS — usually it's the other way around”

Elena Bortolotti, Barclays Corporate and Investment Bank



Chan, Barclays: We have accessed dollars in the past, but it is expensive. So, you go down the cost order — you go for sterling first and then euros and dollars or Swiss francs.

Burgess, Barclays: The dollar market in every other part of the capital structure is obviously so deep, so people would welcome the dollar market — but the reality is that it is expensive.

Perrins, NatWest: Also, the difference is you don't have a whole load of US investors buying dollar covered bonds. It will often be a similar investor base to your euro bonds but just buying different currencies. I would say it's a pure diversification trade.

Sinclair, TSB: We have a smaller funding need than some of the issuers so it's important for us to be able to return to those markets regularly before considering another market. It's unlikely we would go to the dollar market or even Swiss francs in the short term, given that we have just entered the euro.

GlobalCapital: Are our issuers worried about how rates will move over the coming months? Does the uncertainty over the pace at which they are expected to fall make your jobs harder?

Merrett, Nationwide: A shock makes being in treasury difficult. But if it is as expected, then maybe not so much. I guess to kickstart the mortgage market probably needs expectations of bank rates to go lower and, therefore, mortgage rates as well. That will probably help.

Chan, Barclays: For us on the income side, it is locked in for our structural hedge, so we are not that worried about spikes or the speed of interest rates going down.

What we are interested in looking at is where the swap rate goes and how it affects the mortgage lending market. That is probably a bigger driver of what the funding requirements will be for all of us more on the mortgage side.

Sinclair, TSB: But then that is a positive thing for the customer — so, like you say, it is likely to stimulate the market.



“Wage inflation is higher than inflation now, which is helpful. At least people are starting to recover some of the inflation costs over the past few years. And unemployment has remained low”

Richard Merrett, Nationwide

Perrins, NatWest: In terms of the instruments we issue in, I think covered bonds is my area of least concern with regard to the impact of the speed of the rate fall.

GlobalCapital: We have talked about the resilience of deposits. That resilience has been really surprising against the backdrop of the rising cost of living. But are rates lowering just in time for that resilience to be maintained?

Sinclair, TSB: It is helpful, but if you look at what all those customers would have been stressed at, it is a different market than it was 15 years ago, before the regulation we have in place now. We expect the majority of customers to be able to continue to meet their payments.

Burgess, Barclays: You can get mortgages now below 4%. In the grand scheme of things, actually that is kind of normal. We have to get out of the mindset that a 1% mortgage is normal.

Merrett, Nationwide: Isn't the average bank rate over 4%? So, if you can get a mortgage rate of 4%, that's great. Obviously, we live in different times at the moment. It's a fixed-rate market now — the majority of people like to fix and know what their payments are. Wage inflation is higher than inflation now, which is helpful. At least people are starting to recover some of the inflation costs over the past few years. And unemployment has remained low.

Chan, Barclays: Yes, wage growth is above inflation. Our credit risk team is actually quite positive about

the UK outlook. We see house prices finally increasing again after two years of decline, so I think all that is really helping the credit outlook.

Perrins, NatWest: And let's not forget the UK covered bond market benefits from being 100% residential mortgages, essentially, as opposed to [commercial real estate] or anything like that.

GlobalCapital: What are our thoughts around LCR eligibility of UK covered bonds for European investors. Fiona, you have said you are worried about that.

Chan, Barclays: It's not a real issue yet because the issuance volume in euros is not that high. If you look at the order book and demand, that lack of third-country equivalence is not really affecting the UK. But if funding requirements do go up, it will be really interesting to see how that plays out in terms of the spread that we have to pay.

Some of the European treasuries that I spoke to, although they take a view that UK covered bonds are not LCR-eligible, just create a non-LCR book to buy them. So, there are ways around the problem.

Burgess, Barclays: The composition of the investor base is slightly different. Again, since Brexit, it has been difficult. The euro market across products has been slightly more challenging for UK issuers. But that has really changed over the past few years and so there are more asset managers who aren't constrained by LCR and who are buying UK covered bonds. As Kate said earlier on, they got a €4bn book on their

inaugural euro covered bond, which speaks for that strength.

Merrett, Nationwide: It's the same if you look at the Swiss covered bond that UBS issued. I assume that it was more asset managers than bank treasuries for that very reason — it is not LCR eligible.

Burgess, Barclays: The return of that asset manager bid across all the asset classes, including covered bonds has, for the time being, outweighed the concerns around LCR. Obviously, we would all welcome clarity on that but it hasn't really constrained the ability for the UK issuers to access the market at pretty good levels.

Chan, Barclays: We are unlikely to have that clarity for a while — until the UK is willing to give some reciprocity to our European peers in covered bonds. But why should they reciprocate?

Perrins, NatWest: Initially, when the harmonisation regime came into force, they said it would be a minimum four-year window before they would even consider equivalence. We are through that now but we are still yet to hear much by way of concrete plans. We are waiting for some sort of assessment from the European Banking Authority to come out, maybe next year, but it doesn't feel likely that equivalence is something that is any way imminent.

Chan, Barclays: But yet, when the near final Basel 3.1 policy statement was published [in the UK] in September, the rules were fixed that it is only the UK-issued covered bonds or UK banks.

Perrins, NatWest: In which case that equivalence is never going to happen.

Chan, Barclays: Exactly. So, the Prudential Regulation Authority has just finalised its stance in the UK. We are waiting for the delayed announcement from the EBA. They will probably just kind of match that.

GlobalCapital: We have said how deals have been very well supported across the market. But in part that is because supply has been down year-on-year across all currencies. What happens if supply bounces back next year?

Burgess, Barclays: Spreads and general issuance conditions are exceptionally strong at the moment. Reversion would suggest that things might become slightly more difficult, but we also can't ignore the fact that inflows into credit — into fixed income — have been really strong.

We were all collectively worried about it last year. But, frankly, supply could have been higher this year and we still would be looking at really strong conditions. The things that we were worried about — liquidity in bank treasuries becoming constrained, significant volumes to be financed, TFSME — just haven't had much impact.

To put it into perspective, if you look at the covered bond issuers on an average basis, UK banks have enough surplus liquidity to repay TFSME three times over. So, there was a lot of scaremongering at the back end of last year.

But we shouldn't become complacent either because conditions are exceptionally strong. The other thing we haven't spent much time talking about — but which is something to keep an eye on — is that there is a lot of fiscal deficit funding to come through.

We are going to have a lot of US treasury issuance. The EU has €110bn of its €150bn programme done for the year, so there is going to be a lot of sovereign and SSA issuance to come through, which will definitely take some liquidity out of the market.

Merrett, Nationwide: But that all points to spreads going wider. If you have loads of SSA supply, that will mean those spreads should move cheaper, so investors are more likely to buy SSA.

Perrins, NatWest: What I have found quite interesting this year is we have had two pockets of volatility. We had the French snap election and we had a period in August when US data was weaker than expected and the market had a bit of an issue. The reaction to both of those events was kind of overdone and then quickly snapped back, probably based on the strong technical bid for bonds and people realising that actually the market is still strong. The technicals are in a strong position.

But reaction suggests to me that the market is looking for an excuse to go wider and those weren't quite the excuses, particularly with the strong technicals that we are seeing. If we do see something more material in terms of volatility next year, we could see a bit of a larger snap, wider than maybe we expect. But technicals continue to support the market.

Chan, Barclays: We also see a higher use of the one-week STR [short-term repo] by UK banks. While there is a lot of worry about TFSME rolling off — and that's why the Bank of England extended the duration again — we have actually seen a lot more usage of the Bank of England's one-week repo scheme, which has probably not been talked about.

GlobalCapital: What is behind that?

Chan, Barclays: If you don't have TFSME to use anymore, the other

"If you look at the covered bond issuers on an average basis, UK banks have enough surplus liquidity to repay TFSME three times over"

Tom Burgess, Barclays Corporate and Investment Bank



cheap funding option for banks to use is the STR. So, for balance sheet management, that is a really good source of funding.

Sinclair, TSB: Yes, the Bank of England has made it quite clear that it is there to be used.

Merrett, Nationwide: It helps because if you are trying to repo Gilts in private markets at the moment, the levels of Gilt repo are over where you can borrow via the STR, so it is by far the cheapest source of funding.

GlobalCapital: How do mergers and consolidations in the banking industry affect the covered bond market? It must be hard to work in treasury while this is all going on?

Chan, Barclays: It takes time for the combined institutions to rationalise their use of two programmes or one programme. It will be on a case-by-case basis. I can speak about our Kensington Mortgages acquisition [in 2023]. Although they didn't have a covered bond programme, they actually stopped issuing as much RMBS because one of the reasons the acquisition took place was because we had surplus liquidity. They also get to benefit from cheap deposit funding to grow the lending.

Bortolotti, Barclays: From a structuring perspective, it is a bit disappointing as there are fewer issuers. It is usually quite straightforward because what happens is that the new entity automatically becomes the issuer. But then what happens is that the bank finds itself with multiple programmes. We saw this following the merger of Banco Popolare and BPM. The new entity, Banco BPM, ended up with four covered bond programmes. Banco had two and BPM also had two. The new entity certainly didn't need to have four covered bond issuance programmes. Obviously, you want to identify which programmes are the more efficient — considering costs, asset efficiency, structure, ratings and so on — and then there are various alternatives available to optimise them.

Certainly, from a structuring perspective, some interesting considerations can come out of



“Certainly, from a structuring perspective, some interesting considerations can come out of consolidation exercises”

Elena Bortolotti, Barclays Corporate and Investment Bank

consolidation exercises. When Virgin Money merged with Clydesdale Bank a few years ago, the new entity ended up with two programmes. In their case, it worked very well because Virgin Money was the new kid on the block, the newest UK programme, aligned with the most recent rating agency methodologies — it was the first programme that was fully Sonia compliant. So, Clydesdale launched a consent solicitation exercise to partially novate its liabilities — not the cover pool assets — to the Virgin Money programme. They kept the assets separate because of IT issues.

Burgess, Barclays: To the broader point, it feels like there are more catalysts for potential inorganic combinations, whatever that might look like, than there have been over recent years. Some people just structure long liquidity and they are able to do something with that — and others perhaps don't benefit from that.

The fact is that retail banking remains a scale game, so there are some efficiencies to be had there. It is an expensive game from a regulatory perspective and that means it is the driver for a lot of the consolidation that's going on.

GlobalCapital: What about our expectations for next year?

Perrins, NatWest: I would be very surprised if supply is not higher next year. Fearmongering is probably not the right word, but expectations of early repayment of TFSME haven't necessarily arisen as yet. But next year is a huge year for actual maturities. I agree that there is a lot

of liquidity in the system and many banks won't need to do a one-for-one replacement. There are a lot of buffers there before we start to struggle.

Chan, Barclays: For us the biggest indicator is the mortgage book. We are quite confident about growth. We have seen some positive signs in the applications — so, depending on how the mortgage book evolves, that will then affect the funding.

Sinclair, TSB: For us, this year feels a bit more like steady state. So, I would expect similar for others and in turn similar issuance next year.

Bortolotti, Barclays: We're heading for around €160bn of benchmark this year, and expect a similar issuance pace next year. Hopefully, it will be another strong year, with a lot of UK issuers accessing the covered bond market.

Burgess, Barclays: UK redemptions of covered bonds in 2025 are really low for obvious reasons. Everyone wanted to avoid the competition with TFSME. We had £21bn-equivalent of covered bond redemptions this year. We have £8bn next year.

GlobalCapital: But on the other side of the balance sheet, you have five-year Covid mortgages, haven't you?

Burgess, Barclays: Well, on the other side, you have £120bn, £130bn still of TFSME to refinance. So that is why people wanted to avoid issuing in 2025 maturities. But I still like that stat about the surplus liquidity that can repay TFSME three times over. **GC**