PFANDBRIEFE UND COVERED BONDS

THE NORMALISATION PROCESS IN COVERED BOND MARKETS HAS BEGUN (FINALLY)

"The Times They Are A-Changin'": The title of this Bob Dylan classic certainly goes well with many current developments in the world. The covered bond market is definitely one of them: After years of low action and high predictability, since the start of 2022 the tide has turned. The following article provides a in-depth analysis of recent trends and moreover attempts an outlook. Considering the highly volatile times, the latter is unsurprisingly difficult. Yet the author does come up with some clear-cut messages. Red.

In recent years, covered bond markets have been impacted by heavy ECB buying, a drop in issuance volumes, negative rates, tight secondary spreads and poor liquidity. As a result, many traditional covered bond investors took a temporary step back from the market to move into higher risk assets, tenors that were well beyond anything covered bond markets can offer (ie, 100 year NRW for example) or in the case of banks focussed more on SSAs such as the EU. 2022 has, however, seen almost all of these themes reverse with Bund and especially swap rates shooting higher, covered bond issuance volumes surging and a number of investors coming back to the market while the ECB in turn has started to scale back covered bond purchases with lower primary market orders starting from April and a second drop expected for settlements from 2 July.

Interesting times to say the least and a good moment to take a step back and reflect on these various drivers and their impact on the market.

Up to end-2021: no liquidity, little issuance, a lot of ECB

As mentioned above, covered bond markets until the end of 2021 were a rather difficult place to enjoy oneself unless one was in the business of issuing covered bonds. With the ever more expansive monetary policy by the ECB post Covid, covered bond markets were ultimately squeezed from two sides.

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Despite the introduction of the pandemic emergency purchase programme (PEPP) not having a direct impact on covered bonds (the bulk of bonds purchased by this programme were from the public sector), the exceptionally large volumes taken out from the market across EGB, SSA and covered bond markets did lead to spread compression and spread curve flattening also in covered bond markets. At the same time, a surge in retail and wholesale deposits due to Covid restrictions as well as the introduction of the targeted long-term liquidity operations (TLTRO III) led to banks all of a sudden having a cost efficient and execution risk-free alternative to covered bond wholesale funding markets.

Covered bond issuance did not drop all the way down to zero. After all, there were covered bond programmes the ECB did not buy (those from non-Eurozone countries as well as those issued with very long maturity extensions).

Also, not all covered bond issuers had access to TLTRO III liquidity as for example public sector lending on bank balance sheets did not qualify to access the scheme. Issuers such as CAFFIL from France, had to remain active in covered bond markets. Last but not least, a number of issuers were not comfortable refinancing long-end lending with only three-year ECB money and hence, opportunistically accessed the long end of the curve in covered bond markets.

Nonetheless, in 2020 and 2021, we had to weather two of the lowest volume years in Euro benchmark covered bond markets in well over a decade with Euro benchmark covered bond issuance staying below the 100 billion Euro mark. With heavy redemptions in those two years, net issuance was materially negative, something made even worse by net ECB buying. Effectively, the tradeable free float fell and with the ECB owning close to 50 percent of the eligible benchmark universe, trading activity in secondary markets dropped with liquidity really only existing in new issues and even for those only around the time of issuance with activity dropping quickly a few days post issuance.

No wonder, most of our discussions with investors shifted to talking about the SSA markets and the European Union's new lending programmes SURE and NGEU.

It's a different world

With loan growth especially buoyant in mortgage lending and TLTRO III redemptions getting ever closer, it was only a question of time until banks started to re-engage with wholesale markets. However, what started slowly but gradually towards the end of last year was then given a new sense of urgency as the war in Ukraine further added to a surge in inflation, which in turn led to a shift in monetary policy.

The result of this is that by mid-May, we had already seen more issuance in Euro benchmark covered bond markets than in all of 2020 or 2021. Jurisdictions such as Canada have even seen more issuance in the first five months than in any preceding calendar year since the creation of this market. At the time of writing, Euro benchmark covered bond issuance stands at close to 110 billion Euros and net issuance close to a positive 30 billion Euros (see figure 1). Fortunately for covered bond markets, movements in rates and above all swap markets have put the sector in a strong position to deal with this turbo-charged level of activity. After all, with 10 year swap spreads shooting all the way into the high 80 basis points range and covered bonds not able to follow sovereign bonds and SSAs to valuations well below swaps, investors were able to pick up covered bonds at spreads versus Bunds or SSAs that were exceptionally wide, especially in shorter tenors.

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The last time Pfandbriefe traded at more than 75basis points above Bunds we were talking about confidence in banks being a major issue, something that cannot exactly be said these days with high capital levels, still strong loan loss provisioning, high liquidity levels and the higher yields also structurally positive for bank profitability (see figure 2).

Material uptick in the investors' interest

We have thus seen a material uptick in the interest from investors for covered bonds. The higher re-offer yields and wide spreads versus EGBs and SSAs have supported demand from central bank buyers outside the Eurosystem for tenors out to five to seven years and the same angle has worked for many asset management buyers. Banks in turn cared less about the higher yields but came back in size for covered bonds with tenors out to seven to ten years at spreads positive to swaps to lock in the material pick-up over EGBs and SSAs.

The one area that has been trickier for issuers to navigate is the long end starting from ten years. Central bank buyers typically focus on shorter tenors while bank treasuries are often limited to maturities of up to ten years in covered bond markets. This leaves asset managers and insurance companies/pension funds and while the latter two have become slightly more active in 2022 at the higher yields, the former have remained cautious on adding duration for much of this year. Hence, as issuers reacted to these demand dynamics, average tenors on offer by issuers have fallen compared to 2020/2021 and order books have been stronger the shorter the tenor.

In these fairly hectic and volatile times, it is exceptionally difficult to predict developments even just a few weeks ahead. However, for covered bond markets there are a number of themes that are bound to play out in a certain way and this in turn will have an impact on covered bond valuations. First of all, banks will continue to normalise their funding structures as central banks wind down stimulus measures and long-term liquidity schemes. With the ECB deposit rate set to at least move back to zero by September, many banks will in our opinion very likely choose not to early repay their TLTRO III liquidity this year but to hold on to it for longer.

However, while funding normalisation is already well underway, banks will in our view be inclined to above all maintain their profitability trades for longer now (take TLTRO III liquidity and either post it back into the ECB deposit facility or buy short-end, low risk securities for the carry), which means the impact on covered bond primary markets should not be dramatic for the time being.

Staying with the ECB for one moment, with the APP ending net settlements as of 1 July, we expect primary orders to drop once more from the current 30 to 20 percent. Overall, covered bond buying will remain sizeable and the redemption reinvestments in the high 30 billion Euros range also in 2023 will provide covered bond markets with support.

Primary markets are likely to calm down

However, issuers will have to replace the CBPP 3 orders with private sector demand in primary markets and we have previously seen issuers try to bring transactions to the market just before an expected drop in CBPP 3 orders. With Euro benchmark issuance at close to 110 billion Euro year to date already, the second half of the year should nonetheless be considerably calmer in covered bond primary markets. We believe that we will likely see some pre-funding towards the end of 2022 and should senior markets remain as tricky as they have been recently, some deals that were planned as senior preferred or non-preferred could well be switched into covered bond markets. Nonetheless, a number of issuers will already be close to done with their secured funding plans in 2022.

Looking further ahead and into 2023, funding needs may be driven by an additional factor other than refinancing long-term central bank liquidity schemes. In fact, we may see a phenomenon become more wide-spread that we have already started to see in Canada – negative growth in client deposits.

Negative growth in client deposits

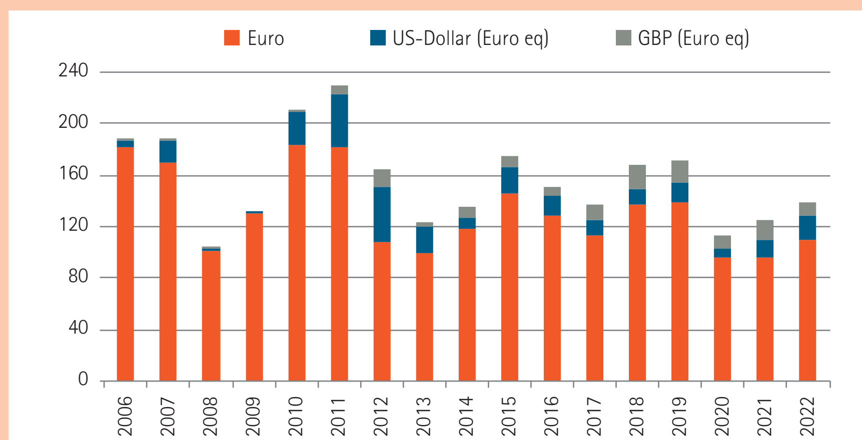
With inflation exceptionally high across the globe, retail clients will ultimately utilise their deposits to pay for their daily spending while the tighter monetary policy and less asset purchases by central banks will lead to wholesale deposits at the very least no longer growing.

With total lending still on the up in most areas, less deposits in turn mean more wholesale funding needs and with senior unsecured spreads materially wider than covered bonds at present, the latter are and will continue to be the product of choice for issuers in our view. Covered bond markets will then also finally see activity from countries such as Spain or Portugal.

With Euro benchmark redemptions falling from close to 140 billion Euros in 2022 to around 125 billion Euros in 2023, net issuance will be noticeably positive and with ECB covered bond net settlements at zero, even the free-float will grow for the first time in years. Secondary market liquidity is unlikely to rebound across the market. After all, the ECB still owns close to half of older vintage bonds. However, for more recent new issues, trade-ability has already improved.

With excess liquidity in the Eurozone still exceptionally high, we do not think that we are faced with investor constraints and question marks around absorption capacity

Figure 1: Euro, US-Dollar and GBP benchmark covered bond issuance volumes per year and currency (in billion Euros equivalent)



Source: Bloomberg, Crédit Agricole CIB

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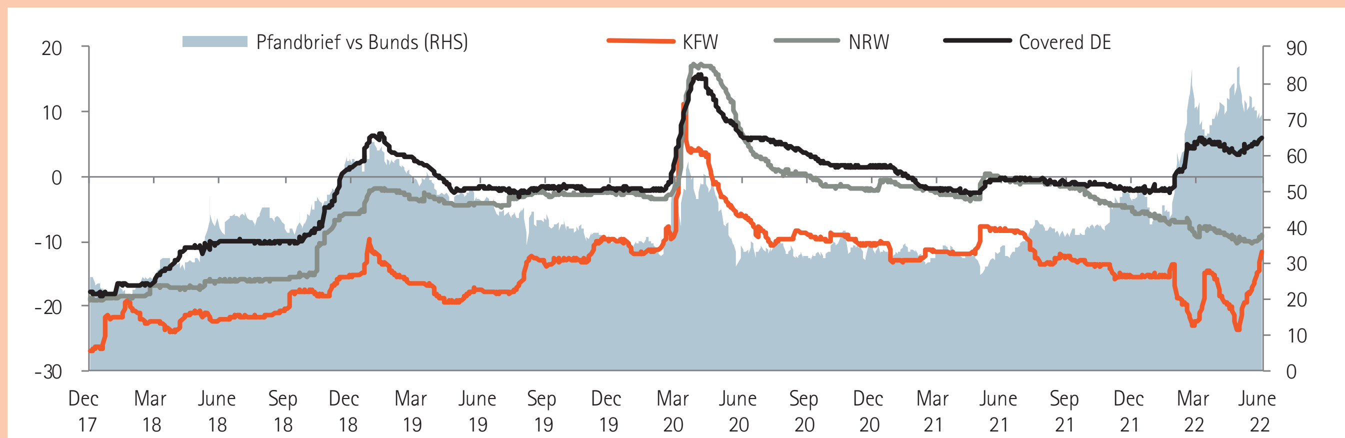
Figure 2: 10 year ASW spread evolution (in basis points)



Source: Bloomberg, Crédit Agricole CIB

as long as markets are priced fairly. For covered bond markets, this means they will in our view first of all have to continue to offer noticeably pick-up over EGBs and SSAs. Even should swap spreads tighten in the coming months, spreads versus EGBs will continue to be sufficiently wide in our view. With the EU 10 year approaching swaps flat these days, though, covered bonds especially in longer tenors no longer look as attractive versus SSAs as they have for much of this year. The less busy covered bond primary market in second half of 2022 should be supportive.

Nonetheless, with the EU expected to become meaningfully more active in the upcoming months, SSA valuations could very well lead to steeper covered bond curves. Higher yields and more supply have also led to investors having more choice. They have thus been under less pressure to chase carry in smaller segments/issuers. While this has yet to fully show in secondary markets, we do expect to see more spread differentiation between segments and issuers going forward.

Last but not least, let us take a quick look at topics away from spread valuations and issuance volumes – rising yields and mortgage markets, the regulatory landscape as well as ESG. We have begun to receive an increasing number of questions on the impact of higher rates on mortgage and thus ultimately on covered bond markets. To us, increasingly stretched affordability from higher mortgage rates will have little impact on cover pools while banks seem to still be well provisioned from the early Covid days.

Hence, the most relevant impact could be a lower number of transactions, less new origination and ultimately less funding needs, especially for the more specialised mortgage banks out there.

On the regulatory landscape, we have an important date coming up in the next few weeks. On 8 July, the Covered Bond Directive (CBD) and adjusted Article 129 CRR will go live. The combination of CBD and Article 129 CRR replaces the old UCITS (52(4) / Article 129 CRR. While the regulatory treatment of covered bonds remains broadly unchanged for now (10 percent risk weight is still possible, covered bonds can be level 1 LCR assets, they are Solvency II preferred), the minimum standards to reach this treatment have been raised.

This in turn has led to national covered bond laws across Europe being updated or in some cases entirely new frameworks being put in place. For investors, disruptions should be minimal. While the existing stock of covered bonds will benefit from extensive grandfathering rules, the development is positive from a fundamental risk angle going forward.

ESG – yet to take off on a larger scale

Last but not least, we cannot end this article without mentioning another big theme in capital markets these past few years – ESG. In covered bond markets, sustainable issuance has yet to take off on a larger scale. We have seen sustainable covered bond issuance grow in recent years with issuers such as Berlin Hyp being a pioneer in the field.

However, in many cases, data availability on the underlying mortgages has meant that eligible assets were limited to begin with and then often also used to back green or social bond issuances further down the capital structure (senior or even subordinated debt). With very low overall volumes last year, ESG covered bonds represented a little more than 15 percent of the total. However, with volumes surging this year, the share has dropped to below 10 percent again.

Recent market conditions that have also been tricky in covered bond markets have led issuers to re-focus on the ESG theme with the share in May closer to 20 percent. Nonetheless, it will be a gradual and slow process for ESG issuance to take hold in covered bond markets more meaningfully rather than something that will happen overnight. Covered bonds are designed as a work horse of banks' wholesale funding. They are low-risk funding instruments that can provide banks with long-end funding and market access even in hectic times that see their access vanish in other funding products.

After a number of years of central bank policies reducing the level of market activity in a very meaningful way, we are finally seeing things normalise. Yes, this has meant that spreads have already widened and we are most likely not yet at the end of this trend. However, rather than a major shift wider from here, we are talking about some more steepening and sector/issuer differentiation and the extent of the expected moves will be a fraction of other markets.

With the Pfandbrief having just celebrated its 250th anniversary in 2019, the product will continue to do what it was designed to do. With funding volumes structurally higher again going forward, it will re-enter the spotlight across many jurisdictions globally as far as issuance is concerned while we are confident that the structural demand will be there too.

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