4 May 2020

Covered Bonds

Covered Bond Quarterly: the curse of liquidity support

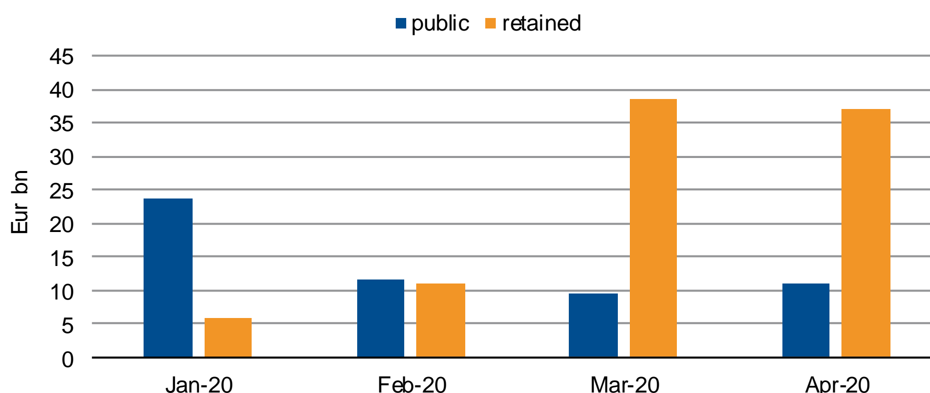
Scope's latest covered bond quarterly wraps up key market developments in the first quarter of 2020, provides a summary of covered bond rating coverage, including recent rating actions, highlights Scope research relevant to the credit quality of covered bonds, plus an update on EU covered bond harmonisation.

Q1: strong issuance activity – mostly retained

2020 remains a story with two chapters for covered bonds. January held up to its promise as one of the most active for issuance. EUR 24bn of issuance held up well against the previous year; ditto February. Issuance in both months was only EUR 5bn short of the numbers observed in previous years. This was not surprising given the low interest-rate environment and with only the ECB and bank treasuries as buyers for negative-yielding covered bonds.

However, Covid-19 started to take its toll in the public markets in March. Benchmark-sized covered bond issuance did emerge but issuers encountered a rocky market. At the same time, issuance of retained covered bonds started to soar. With about EUR 39bn in March and another EUR 38bn to mid-April, retained covered bond issuance has started to dwarf public issuance. Of the approx. EUR 150bn of covered bonds issued 2020 YTD, we estimate that more than 62% has been retained issues.

Figure 1: Covered bond issuance 2020 YTD



Source: Thomson Reuters, Scope Ratings

Treasurers and controllers need collateral to tap into the TLTRO

Banks need to fund expanding balance sheets reflecting government guarantees for corporates and SMEs to help mitigate first-round effects of the Covid-19 pandemic. As a substitute to functioning capital markets and to benefit from ultra-low refinancing costs, banks need collateral to tap into central bank repo facilities.

Retained covered bonds are among the most efficient instruments to get access to those repo facilities. Eligible collateral is already on the balance sheet and it only needs to be encumbered into the cover pool to create tailor-made issuance.

In February, banks started to increase the use of covered bonds. With about 40% or EUR 4.6bn, Italian banks issued the lion's share of retained covered bonds. In March and following the spread of the pandemic well beyond the Italian border, German issuers took the helm. The similar 40% share of retained issuance had by then reached EUR 16bn out of a total EUR 39bn for March.

Dutch issuers are now carrying the torch: EUR 18bn or 49% of the April month-to-date issuance volume of retained covered bonds came from the Netherlands.

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Related Research

Covered Bond Outlook 2020
28 November 2019

Covid-19: CBs holding steady
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Covid-19: acid test for European banks' de-risking strategies
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Retained issuance can be a blessing for issuers but a curse for investors

Asset-quality problems are the root cause of most problems for banks. But banks only become subject to regulatory intervention if they also run into liquidity problems. This is where covered bonds can provide a lifeline and where the ability to use self-issued covered bonds becomes an advantage.

This time it's different[1], however. Banks are not in the eye of the storm but are seen as one of the key transmission mechanisms to mitigate the coronavirus impact on the wider economy.

Covered bonds are the most actively used ECB collateral

Banks have no challenges accessing liquidity and it is rather the more competitive funding costs that are key to increased retained issuance activity. Not surprisingly, the highest share of collateral deposited with the ECB consists of covered bonds, accounting for a quarter of collateral used whereas sovereign bonds only account for 16%.

Retained covered bond issuance is positive for issuers but needs to be monitored by investors. Without lengthy placement processes and limited transparency, retained issuance can quickly erode available over-collateralisation and deprive investors of expected protection.

Retained CBs can more swiftly alter a CB's risk profile

Compared to the rather gradual erosion of asset quality, swift issuance can also change the risk profile of a covered bond programme. As most retained bonds are issued under existing programmes, changes to market and liquidity risk profile matter to investors.

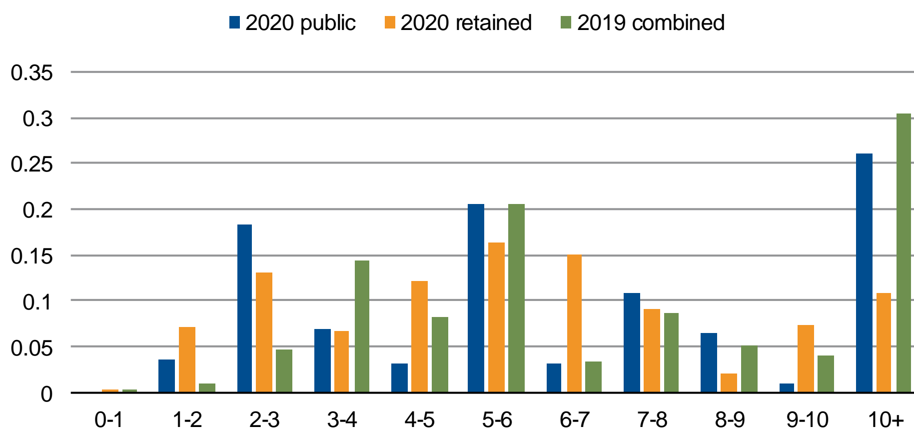
Distribution of 2020 retained covered bonds better managed?

2011/12 retained CBs mostly short dated, increasing ALM risk

During the 2011/ 2012 crisis, retained issuance caused investors to raise eyebrows. Issuance was mostly geared towards short-dated covered bonds. Even though they rank pari passu, existing investors suddenly and swiftly became subordinated in time. They suddenly had access to lower amounts of over-collateralisation. In 2011, two thirds of retained covered bonds were issued with tenors up to four years; 2012 showed a similar pattern. About 50% then were issued in the 0-4 year maturity bucket. Only 20% or so were issued with maturities beyond 10 years – where they created less of a risk for existing investors.

The structure of 2020 retained issuance to-date is more similar to the structure observed for public issuance in 2019 and 2020.

Figure 2: Maturity distribution of covered bond issuance



Source: Scope, Thomson Reuters

[1] See COVID-19 impacts on European banks: pre-existing financial health matters available here

The only marked difference is in the 10+ year maturity bucket, which given the higher haircuts for longer-dated covered bonds it is not surprising.

Maturity and size structure of retained issuance matters

At first glance, retained issuance has not increased asset-liability mismatch risk to the extent seen in the 2011/12 crisis. However, a detailed issuer-by-issuer and programme-by-programme analysis is warranted, since there are marked differences between the maturity management of retained issuance.

High volume of retained CBs need to be monitored

In the Netherlands, for example, banks have opted for retained issuance as high as EUR 5bn-EUR 6bn per issue. Existing transparency might not allow investors to spot such concentration risk – in particular if bonds can be cloaked in already sizable covered bond programmes.

Maturities far out into the future and the ability to redeem retained bonds more easily than publicly-placed issuance suggest that risks appear manageable. However, even treasurers of adequately rated and functioning banks will hold their breath when they have to ramp up liquidity to repay EUR 5bn in a single day.

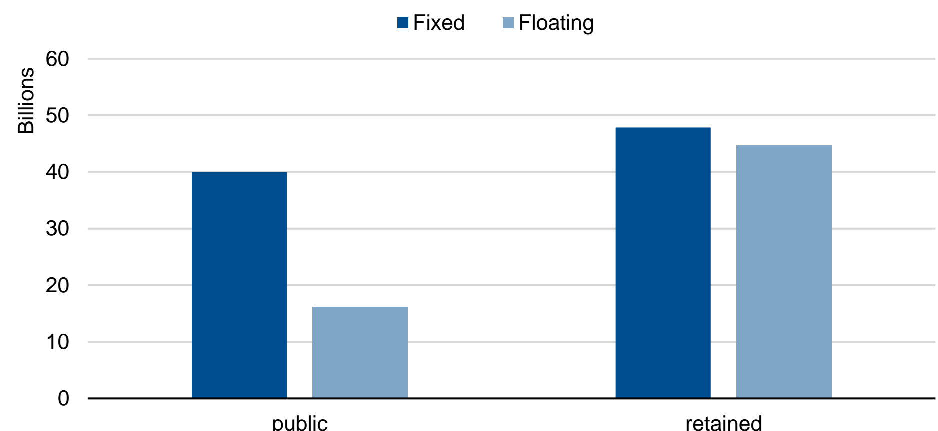
As they can become a problem for a stand-alone cover pool

Risks from massive retained issuance requires special care – in particular when a programme is facing the ultimate test of wind-down. Insufficient accumulated asset redemptions will force managers to sell additional cover assets to meet the upcoming redemption and will further exacerbate the situation. With the clock to maturity ticking, the manager might have to accept fire-sale prices which can be to the disadvantage of investors in covered bonds maturing later.

Market risk within a programme can swiftly change

Based on issuance statistics from the European Covered Bond Council, between 20% and 30% of annual covered bond issuance references floating rates. This pattern only broke in 2012 when about 62% floating-rate covered bonds were issued.

Figure 3: 2020 covered bond issuance – by interest reference



Source: Scope, Thomson Reuters

Floating-rate covered bonds are more efficient as ECB collateral

The 2020 public issuance pattern falls with the range and at 28% of floating-rates issues is fully in line with standard ranges of previous years. However, retained issuance differs and is almost equally split between fixed and floating-rate issuance. This is not surprising as floaters provide higher collateral efficiency, in particular when combined with longer-dated issuance. For mortgage markets where fixed-rate lending prevails, floating-rate covered bonds introduce another layer of risk. Higher interest-rate mismatches need to be watched as they might need to be protected by higher levels of over-collateralisation.

Retained issuance matters for credit quality

The sharp increase in retained issuance should remind investors that covered bonds are a credit product with multiple dimensions of risks. Covered bond credit quality can reach the highest rating levels but this is always the result of a dynamic interplay between different pockets of risks and the ultimate protection of over-collateralisation.

It highlights that risks need to be actively monitored and that the rating supporting over-collateralisation is dynamic, unlike the static, regulatory required over-collateralisation.

Transparency on retained CBs is not available timely…

Cover-pool transparency is a lagging indicator. It is provided on a quarterly basis and thanks to the ECB's requirements, investors receive such information 'already' eight weeks after the end of the quarter.

Effectively, Q1 2020 retained issuance and its impact on individual covered bond risk structures is not yet available for most participants. April issuance (and what will come thereafter) will only become visible in August.

Ad hoc disclosure requirements for retained issuance needed…

Consistent with other material information, we believe investors should be made aware of sizable retained covered bond issuance. Significant levels of retained issuance deprive investors of over-collateralisation. Previous levels that supported its credit quality might not be sufficient because of changed risk profiles.

… and not even mandatory

Unlike the credit quality focused eligibility criteria for cover assets, there is no minimum protection against market or liquidity risk. Unfortunately, not even the upcoming European covered bond harmonisation will change this.

…Or will the ECB through in its weight ?

Covered bond purchase programmes have made the ECB the largest covered bond investor, eventually amassing up to 50% of iBoxx eligible covered bonds in the course of 2020. Even though not a regulator, the ability to carve eligibility criteria makes the ECB just as powerful.

ECB as quasi regulator has increased timely reporting…

Whereas eligibility (or not) of conditional pass-through covered bonds can be heavily debated, the disciplinary effect of their 2016 mandatory disclosure requirements has made cover-pool transparency information available[2] in a timelier manner.

The recent ECB working paper "Risk characteristics of covered bonds: monitoring beyond ratings" highlights the obvious. As discussed above, a rating is not only a function of the issuer rating but also the interplay of risks in the cover pool. It highlights that it might be helpful to monitor over-collateralisation and cover pool (credit) risk, but also the mismatch and maturity type. All of these factors are an integral part of the rating analysis and are ultimately reflected in the ratings.

…..and could help to enhance transparency for retained CBs

If these factors are important to a covered bond's risk assessment, extraordinary disclosures might eventually be needed. The ECB has such information early on as they need to register retained covered bonds in the list of marketable assets to make them eligible. To avoid information asymmetries and taking into account that there is another sizeable (but diminishing) investor base, the ECB could easily stipulate additional disclosure requirements in case an issuer ramps up a significant amount of new retained issuance. Or at least amend already-existing disclosures with such information.

[2] To remain eligible for monetary operations rating agencies need to disclose latest eight weeks after the quarter a detailed set of data points. For more information see here.

Scope's covered bond ratings information

As of Q1 2020, Scope rates 39 programmes from 25 issuers in 10 countries[3]. We provide a comprehensive overview including: i) key rating metrices and ii) references to commentaries on the issuer and its covered bonds in an easy-to-use Excel format that can be downloaded here.

Q1 2020: continued covered bond rating stability

Stable bank ratings continue to be supportive of the stability of Scope's covered bond ratings, all of which are rated AAA with stable outlooks. The most resilient covered bond ratings remain those in Finland, France, the Netherlands and Sweden. This primarily reflects the fact that average bank ratings within Scope's coverage are highest. Consequently, the covered bonds rated in those countries have the highest resilience against changes of the issuer rating (see Figure 5 below). The highest covered bond ratings in those countries are achieved just by taking into account fundamental credit support.

At the same time, the dual recourse of covered bonds also allows issuers to support highest ratings on the basis of cover pool support. Notably, we see that covered bonds in Austria and Norway achieve AAA ratings with the help of this rating driver.

High bank ratings coupled with supportive legal and resolution frameworks (see Figure 6) provide 82% of covered bond programmes rated by Scope with sufficient support to reach the highest ratings. Most of these ratings are very resilient against issuer downgrades. Cover-pool support is only a secondary rating driver, but the strength of the cover pool can provide additional rating stability.

Only 18% of Scope-rated covered bond programmes are reliant on additional cover pool uplift to achieve the highest rating. The buffer against issuer downgrades is lower for such programmes, but the strong cover pool support can in most cases still mitigate a downgrade of the issuer rating.

Figure 5: Covered bond rating stability

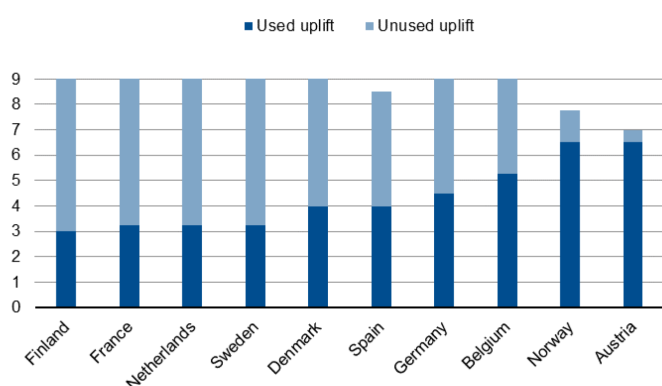
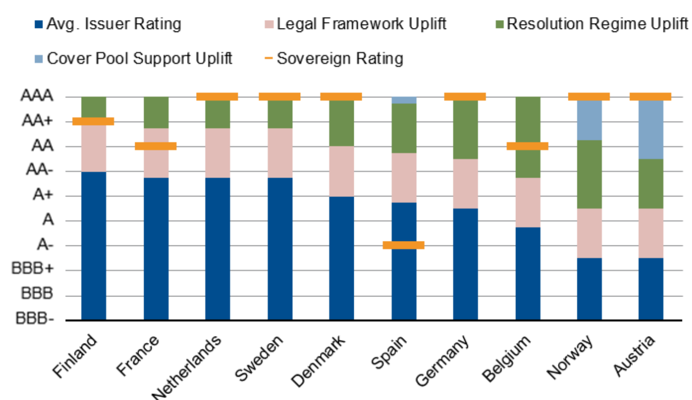


Figure 6: Covered bond rating composition



Source: Scope Ratings

[3] The majority of bank and covered bond ratings are only available via Scope Ratings credit intelligence platform ScopeOne. Interested investors can sign up for this service by contacting the ScopeOne Service Centre servicecentre@scopegroup.com.

Q1 2020: Scope rating monitoring notes

20 March 2020 – Scope affirms at AAA/Stable mortgage-covered bonds issued by Landkreditt Boligkreditt AS

On 20 March, Landkreditt Boligkreditt's covered bond ratings were affirmed. Ratings continue to reflect the sound credit quality of the issuer and its parent, including an unchanged view on cover pool support. Landkreditt's residential, low-LTV and fully domestic cover pool is resilient against high credit stresses. The covered bond programme shows a stable risk profile with maturity mismatches remaining the largest but well buffered risk contributor.

Click here to download the rating affirmation and here to access the performance update with key programme information.

09 April 202 – Scope affirms at AAA/Stable French covered bonds issued by Compagnie de Financement Foncier

On 9 April, French covered bonds (obligations foncières) issued by Compagnie de Financement Foncier S.A. (CoFF) were affirmed. Ratings reflect the sound credit quality of CoFF (AA-/ Stable), and its ultimate parent Groupe BPCE. Ratings are already achieved by the fundamental credit support available from the sound legal framework and the resolution and systemic importance considerations applicable to the French covered bonds in general and CoFF's covered bonds in particular. Scope has also performed a cover pool analysis to identify the additional credit support the cover pool could provide.

Click here to download the rating affirmation and here to access the performance update with key programme information.

Q1 2020: Relevant bank and covered bond related research

Sweden's house price correction shouldn't lead to looser policy measures: The Swedish residential mortgage market stands out as having the strongest growth rates in Europe in the last decade. 'Unsustainable', 'overheated' and 'bubble' are buzzwords that have gone along with any comment on the Swedish mortgage market. The low interest-rate environment could be the right time to introduce structural changes. Click here to download the full research report.

Growth in German house prices to shift to more sustainable levels: The 10-year house price boom in Germany appears to have ended. In Scope's view, residential prices in Germany have become elevated but they are not significantly over-valued. We do not expect a slump but rather for growth rates to revert to a more sustainable level. Housing is still affordable, indebtedness is low, and the credit quality of borrowers will continue to benefit from longer fixed-rate mortgages. Click here to download the full research report.

Phase 2 of the Supervisory Diamond will increase resilience of Danish homeowners: Stricter underwriting standards for interest-only and variable-rate mortgages will further increase the resilience of Danish homeowners and improve financial stability. As there is a significant risk cluster from households exposed to interest-rate and refinancing risk, however, we see the further tightening as credit positive. Click here to download the full research report.

Slovakian regulators step on the brakes to curb excessive house price growth: Slovakian households have become more highly leveraged than those in other CEE countries. Indebtedness has soared on the back of house-price growth over the last decade. To curb further growth and contain financial stability risks, existing minimum equity requirements are now aided by tighter income-based macroprudential measures.

This will ultimately increase the resilience of Slovakian homeowners in an economic downturn. Click here to download the full research report.

Norwegian banks well placed to deal with twin challenge of Covid-19 and falling oil prices: With their solid profitability and sound solvency positions Norwegian banks have capacity to absorb higher loan losses and compare well to European peers in this regard. Click here to download the full research report.

Covid-19: covered bonds holding steady: Since the onset of the Covid-19 crisis covered bonds have, once again in a crisis, become a preferred funding product for banks. Strong covered bond ratings coupled with the ECB backstop are allowing banks to access funding if they need it. Bank credit fundamentals and the credit quality of cover pools could weaken over time, but available buffers will generally support strong ratings. Click here to download the full research report.

Covid-19: an acid test for European banks' diversification and de-risking strategies: The impact of the crisis on bank credit quality needs to be assessed on a case-by-case basis, taking due account of the different starting position and franchise value of each bank at the outset of the crisis. A temporary dip in earnings does not necessarily lead to increased credit risk. Although policy makers and regulators are supporting banks as shock absorbers and part of the effort to mitigate the economic impact of the pandemic, our ratings view continues to be biased to the downside. Click here to download the full research report.

Appendix I: What's new in the covered bond harmonisation

The Covered bond harmonisation clock has been ticking since publication of the harmonisation directive in December 2020.

Figure 4: Covered bond harmonisation timeline

Source: Scope Ratings, European Commission

Awaiting further national translations

The Norwegian FSA presented its harmonisation proposal in January and Spanish regulators followed suit in March. Since then there has been silence. Covid-19 has taken full control, and no additional proposals are expected at this time. Work is progressing behind the scenes in some countries, but we also understand that in others work on amending the proposals have been put on the backburner.

The European commission will be interested to kickstart the economy once the pandemic can be more reliably managed. As such it is not likely that they will come down heavily on countries that have not managed to translate the covered bond harmonisation directive in a timely fashion.

Scope plans to comment on the national translations once they have been published. The inaugural comments can be found below:

Norway first out of the blocks to align with EU covered bond directive: On 13 January 2020, the Norwegian FSA published a proposal on the Norwegian translation of the directive. The proposal will allow for new covered bond types, equalise eligible LTVs to the European level, and increase mandatory over-collateralisation. It will introduce mandatory transparency standards and proposes a belt-and-braces approach by introducing a 180-day liquidity buffer on top of the existing soft-bullets, which are the market standard in Norway. Click here to download the full research report.

Spain plans its route to premium covered bonds with Cédulas 2.0: On 4 March 2020, the Spanish Treasury opened up a consultation on the highly anticipated amendment of the existing Spanish covered bond framework. It provides early indications as to how the country plans to harmonise its covered bond framework. The way the questions are drafted suggests they might move away from the current on-balance sheet set-up. Click here to download the full research report.

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