1.10 EXTENDABLE MATURITY COVERED BONDS: A NEW ERA ON THE HORIZON

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Over a decade ago, extendable maturity covered bond structures emerged as an alternative response to an intrinsic shortcoming of traditional hard bullet covered bond maturities: refinancing risk and liquidity risk. The risk of cover pool sale proceeds being insufficient to repay matured covered bonds that the issuer was unable to refinance was only partly addressed by soft bullet maturities. In effect, the typical 12-month extension of their expected maturities, aiming at a timelier liquidation of the cover pool assets in the event of non-payment or issuer insolvency, may still prove short in an illiquid market.

Rating agencies reflect this in both credit ratings and required levels of overcollateralisation (OC). These in turn drive costs of funding and how efficiently mortgage portfolios are used. This became particularly burdensome when the 2007-8 financial crisis morphed into the subsequent liquidity crisis. Lowered covered bond ratings, sometimes as a consequence of lowered country ceilings, translated into higher funding costs and, as ratings dropped below required minimums, increased difficulty in utilizing covered bonds as collateral for ECB funding.

Taking a page of the securitisation book, the first conditional pass-through programme emerged in 2013. Keeping the same fundamental principles such as the double recourse, upon insolvency or non-payment, maturities could now be extended for much longer periods. During these periods, due interest and principal amounts would be paid out of cover pool cash flows, passed through to the covered bond holders, thus eliminating completely the asset-liability mismatch adversely treated by rating agencies. In a liquidity-stricken continent, this proved crucial to lower the costs, or even accessing, both capital markets and ECB funding, with an instrument benefiting now from a multi-notch rating uplift.

However, the disparate nature of triggers causing the extension and the consequences of such extension, across jurisdictions soon became apparent. Also, investors showed reservations regarding the uncertainty surrounding bond duration. The need for harmonization across jurisdictions merited a special section of the new Covered Bond Directive (CBD). Article 17 requires Member States to introduce clear conditions for extendable maturity structures, with maturity extension only being allowed as long as it is subject to objective triggers specified in the Member States national legislation, and not at the discretion of the credit institution issuing the covered bonds. These triggers need to be specified in the terms and conditions of the covered bonds and, alongside the consequences of extension and the role of supervising authorities, be part of the information disclosed to investors. Addressing duration uncertainty, the final maturity of the covered bonds needs to be determinable at all times. All this while the initial sequencing and ranking of the covered bonds of the initial maturity schedule remains unchanged and the double recourse and bankruptcy remoteness is unaffected.

Below, we provide an in-depth overview of the various extension formats; we then take a closer look at how Member States have transposed Art.17 of the CBD and at market developments related to extendable maturities. Finally, we examine the motives of issuers on the one hand and the reactions of investors on the other as well as issuance trends.

What are the main difference between the covered bond redemption formats?

The most fundamental idea of covered bonds is safeguarding a full and timely repayment even in the case of an issuer default. Once the issuer ceases to exist, the cash flow stemming from a separate portfolio of assets is used to cover all claims due to bondholders. The two most significant sources of risk threatening the ability to satisfy the claims are (i) credit default risk, which potentially leads to an overly impaired cover pool and (ii) market risk – first and foremost in the form of liquidity risk – which potentially leads to a sufficiently large cover pool, which, however, is no longer able to satisfy claims due to illiquidity.

In the past, the rating agencies and other market participants assumed that, following an issuer default, the cover pool administrator could easily monetise the assets in the cover pool either by disposing parts of the cover assets or in an indirect way, i.e. by bundling them into an asset-backed security (ABS) or – if applicable – by using the refinancing register. Some covered bond structures may also be able to raise new debt either in a technically "unsecured" way or in the form of covered bonds. In particular, against the backdrop of uncertainty regarding the functionality and the efficiency of these tools, it is particularly important that the cover pool administrator is equipped with a broad set of instruments, so he is free to pick the most efficient one.

In cases involving hard bullet structures, issuers tried to enhance the effectiveness of the tools by regularly calculating pre-maturity tests or by maintaining a certain amount of liquid assets in the cover pool – a costly exercise for issuers since liquid assets usually come with a negative carry. By extending the maturity, the liquidity challenge is handled differently. This was achieved by either using soft bullet structures or pass-through structures. Soft bullet structures have a limited extension period of usually one year. However, since the soft bullet timeframe might still turn out to be too short, the idea of pass-through aimed at completely eliminating any refinancing risk by eliminating pressure to sell assets at the expense of a maximum timeframe for the payment deferral.

There is no regulatory definition of the various covered bond extension formats but the convention is to refer to covered bonds as hard, soft or conditional pass-through. The ECBC and its members have agreed on a set of definitions (available on their website) with the intention to give market participants a guideline when using each term[1].

> **Hard bullet covered bonds**: are repaid on the scheduled maturity date. Neither the documentation nor the legal framework contain provisions for a maturity extension. Failure to repay the final redemption amount of a hard bullet covered bond on the scheduled maturity date could trigger the default of the relevant covered bonds and, possibly, the liquidation of the cover pool depending on the respective national insolvency rules.

> **Soft bullet covered bonds**: Soft bullet covered bonds have a scheduled maturity date (SMD) and an extended maturity date (EMD). If objective, predefined, and transparent criteria have been met, the maturity of a soft bullet covered bond can, and in some cases, will automatically, be prolonged up to the EMD. During the extension period, the covered bond may be redeemed using cover pool proceeds. Failure to repay a covered bond on the EMD triggers the default of the relevant extended covered bonds (unless multiple extensions are allowed).

> **Conditional pass-through covered bonds (CPTCB)**: Conditional pass-through covered bonds have a scheduled maturity date and an extension mechanism. By itself, the failure to repay the CPTCB on the scheduled maturity date does not lead to an acceleration of the covered bond but to an extension of the maturity date of this and potentially other relevant covered bonds. The extension requires that objective, predefined and transparent criteria are met. In such circumstances the maturity of a CPTCB can be prolonged to the EMD, which is typically linked to the maximum legal maturity of the underlying assets. During the exten-sion period, cash flows received or generated from the cover assets will be distributed to the covered bond investors. Regular attempts are in general made to sell the cover pool assets to redeem the covered bonds. Such sales are subject to predefined criteria intended to protect the interests of all investors under the same programme. In certain jurisdictions and programmes, CPTCB may feature an initial soft bullet extension.

1 The definitions do not reflect the transposition of the Covered Bond Harmonisation Package.

Conditions for extendable maturity structures

As part of the harmonisation effort, the CBD introduced for the first time the concept of extendable maturities and in particular the need to harmonise the various extension options that many covered bond programmes had contractually introduced. To assure investor protection, Art.17 of the CBD clearly outlines the requirements issuers need to meet to be able to issue covered bonds with extendable maturities. Namely, the CBD requires Member States to include objective triggers specified in national law and not at the discretion of the issuer, that will cause the covered bonds to extend.

As Member States have been transposing the CBD, we have seen how they have decided to satisfy this requirement. In particular, we can group the triggers into two main groups: (i) countries where the extension is a tool available for the covered pool administrator to avoid/delay the insolvency of the issuing entity and/or (ii) countries where the extension can occur prior to the insolvency of the issuing bank and will be triggered simply via non-payment of principal or interest on the covered bonds. It is not surprising that each Member State has identified slightly different triggers; finding *one solution fits all* would have been arduous mainly due to the fact that across Member States we have at least three covered bond issuance models: ring-fencing on balance sheet, specialist banking model and SPV guarantor structure.

The below table summarises the objective triggers that have been introduced by Member States who have fully transposed the CBD at the time of writing.

Jurisdiction	Conditions for extension
Germany	The cover pool administrator may only extend the maturity up to 12 months, at the maturity date, if: 1) the extension is necessary to avoid the imminent insolvency of the Pfandbrief bank with limited business activity, and 2) the Pfandbrief bank with limited business activity is not overindebted, and 3) there is reason to believe that the Pfandbrief bank with limited business activity will be able to meet its liabilities then due after the expiry of the maximum possible extension date, taking into account further possibilities for extension.
France	The maturity date of a covered bond may be extended, if: 1) the issuer or sponsor bank falls into insolvency or resolution, or 2) subject to the decision of the French prudential regulation authority (ACPR), the issuer breaches the 180-day liquidity coverage requirement
Spain	The issuer or the administrator may seek permission with the Central Bank to extend the maturity date of a covered bond, under certain circumstances: 1) clear risk of failing to make payments on the covered bonds due to liquidity problems in the cover pool or the issuer, or 2) issuer bankruptcy or insolvency, or 3) resolution of the issuer, i.e., issuer is declared inviable according to Art. 8 Law 11/2015, or 4) severe market disturbances (as acknowledged by AMCESFI via a formal communication).
Austria	Following the insolvency of the credit institution, the insolvency administrator may trigger a postponement of maturity provided that, at the time of the postponement of maturity, the insolvency administrator is convinced that the liabilities can be serviced in full on the extended maturity date.
Estonia	Any suspensive condition included in the terms and conditions of covered bonds which, when fulfilled, will extend the maturity of the payment obligation arising from a covered bond, shall be void unless both of the following requirements are met: 1) the suspensive condition does not allow the issuer to extend the maturity of the payment obligation at its discretion, 2) it is possible to unambiguously determine the new maturity of the payment obligation on the basis of the terms and conditions of the covered bonds.
Hungary	A mortgage credit institution may issue a mortgage certificate with an extendable maturity structure if: (a) the triggering events that allow for the extension are objective conditions, independent of the mortgage credit institution's discretion, pre-determined at the time of the issue, through which the mortgage credit institution seeks to prevent default, in particular by addressing liquidity shortages, market failures or market disturbances, (b) the conditions allowing for the extension of the maturity as set out in point (a) are included in the terms and conditions of the mortgage certificate, (c) the information provided to investors on the maturity structure describes the risks of the mortgage bonds and includes a detailed description. In the event of the insolvency or resolution of the mortgage credit institution issuing the mortgage certificate, the extension of the maturity date does not affect the order of the holders of the mortgage certificate or reverse the order of the original maturity schedule of the mortgage certificate scheme. The mortgage bonds may be extended once and may not exceed 12 months.

Jurisdiction	Conditions for extension
Latvia	The special administrator has the right to use the extendable maturity structure if it is so provided for in the covered bond programme in conformity with the following conditions: 1) both events causing the extension of the maturity have occurred: a) the declaration of the insolvency proceedings or liquidation of the issuer, the application of resolution or reorganisation measures; b) the circumstances that give reason to believe that it will not be possible for the issuer to make current payments to investors within the time periods provided for; 2) the information provided to investors on the extendable maturity structure is sufficient to be able to assess the risks related to the fulfilment of the covered bond liabilities and the information shall include a description of the following: a) the events causing extension of the maturity; b) the consequences of the declaration of the insolvency proceedings or liquidation of the issuer, the imposition of resolution or reorganisation measures on the extension of the maturity of the covered bonds.
Luxembourg	The cover pool administrator may extend a covered bond's maturity for up to 12 months if: 1) the maturity extension is necessary to avoid the issuer's insolvency, and 2) there are objective factors upon which it is reasonable to assume that the maturity extension will allow to meet the extended deadline.
Belgium	The issuer or the cover pool administrator may extend the maturity date of a covered bond by up to a year (or more if a waiver is granted by the Central Bank) if: 1) there is the incapability, on the issuer's part, of meeting the payment on the covered bond as and when due, or 2) there is an issuer insolvency or resolution. In the case of liquidation/resolution procedures, the extension is decided by the cover pool administrator.
Cyprus	The issuer or the covered bond monitor may extend the maturity date of a covered bond if 1) the choice not to extend will bear an impact on the issuer, or 2) there is the inability, on the issuer's part, to issue a new covered bond on same or better terms, or to make a payment at maturity, or 3) there is an issuer insolvency.
Italy	Covered bond programmes may entail automatic maturity extension in the following instances: 1) failure to pay by the issuer, or 2) issuer insolvency, or 3) activation of early intervention measures or resolution procedures against the issuer.
Portugal	Maturity extensions must be approved by the CMVM, under certain conditions: 1) the issuer's authorisation as credit institution is revoked, or 2) there is a prospective or actual non-payment of principal or interest under the covered bonds at the initial maturity date. The issuer shall notify the CMVM of the extension and its grounds 10 days in advance of the extension (or as soon as possible, if such 10 days advance notice is not possible). CMVM can then oppose to such extension within 10 days.
Ireland	The maturity of a covered bond may only be extended by the issuer if: 1) the issuer fails to pay the principal due on the scheduled maturity date (as extended by any applicable grace period), or 2) the Authority or manager directs the issuer to extend the maturity of the securities.
Netherlands	The maturity date of a covered bond may be extended, if: 1) there is an issuer default (failure to pay) or if the issuer is in liquidation, insolvency or resolution, and 2) the CBC has insufficient means to repay the principal amount of the bond at the SMD, or cannot fulfill the OC requirement.

Source: National covered bond frameworks

Conditional pass-through structures becoming even more of a niche

It has been almost ten years since the first conditional pass-through structures was introduced in the covered bond benchmark universe. NIBC was the pioneer issuing a EUR 500mn 5Y benchmark covered bond in October 2013, although it was in 2015 that this redemption format started to gain momentum. Additional issuers took the conditional pass-through path with UniCredit SpA, Van Lanschot Bankiers and Aegon Bank entering this market. Meanwhile, Banca Monte dei Paschi di Siena converted its programme from soft bullet to conditional pass-through and Banca Carige followed in 2016 with a new CPT programme. CPT programmes can also be found in Portugal (Novo Banco and Caixa Económica Montepio Geral), in Austria (Anadi Bank), Germany (a structured covered bond programme of Deutsche Bank), and in Australia with Bank of Queensland. In 2017, the Greek Banks also started issuing covered bonds off their CPT programmes. However, most CPTCBs have been used for retained issuance rather than being sold publicly. In June 2022, 21 CPTCBs were included in the iBoxx EUR Covered Index, with a total amount of EUR 13bn (1.6% of the total index). This was roughly half of the amount of CPTCB outstanding at the end of 2021. This, in turn, is mainly related to all Dutch CPTCB issuers having switched to soft bullet programmes. Key reasons for the change have been the introduction of harsher haircuts by the ECB for CPT covered bonds as well as their non-eligibility for the third covered bond purchase programme (CBPP3), while Dutch issuers also wanted to have more flexibility in terms of issuance tenors (i.e. Dutch issuers prefer issuance at the very long end of the curve, which for CPTs implies a higher execution risk). Overall, there are today still circa 20 covered bond programmes, across jurisdictions, structured in conditional pass-through format.

In CPTCB programmes in general, following an issuer default, a particular covered bond will only become pass-through once a covered bond reaches its SMD and the available cash is insufficient to fully redeem the bond. Other outstanding covered bonds will not turn into pass-through covered bonds as long as they are paid as scheduled. It goes without saying, that the switch to pass-through on the SMD does not prevent the cover pool administrator from trying to sell assets in order to improve the liquidity of the cover pool and, in doing so, making the switch to pass-through less likely. The maturity extension and switch to pass-through aims to reduce refinancing risk, i.e. the risk of losses resulting from cover pool fire-sales. In order to generate sufficient cash flows to repay the covered bonds due, the cover pool administrator is empowered to sell a randomly selected part of the asset portfolio as long as the conditions of the amortisation test are met.

Following issuer default, the amortisation test has to be passed. The amortisation test is designed to ensure that cover assets are sufficient to repay the outstanding covered bonds. Key aspects in that respect are the level of OC in the programme as well as provisions to address transactions risks like servicing. If the test is failed, the commonly used structure is that all covered bonds become pass-through. In this case, the covered bond company will be required to use all funds available to redeem all covered bonds on a pro rata basis, while interest continues to accrue on the unpaid part of the covered bonds.

An important feature in the CPTCB is the minimum OC, which is needed to allow for the programme to switch to pass-through. Shortage of collateral, which could arise from paying administrative costs as well as covering potential credit losses, would otherwise instantly trigger a failure of the amortisation test and an acceleration of payments to bondholders. This is the reflection of the fact that cover pool credit risk is the key remaining source of loss in the cover pool asset-liability management. In order to eliminate market risk completely, the legal final maturity is extended to beyond the maximum maturity date of the cover pool assets. The extension period usually ranges from 31 years to 38 years, depending on the respective programme documentation.

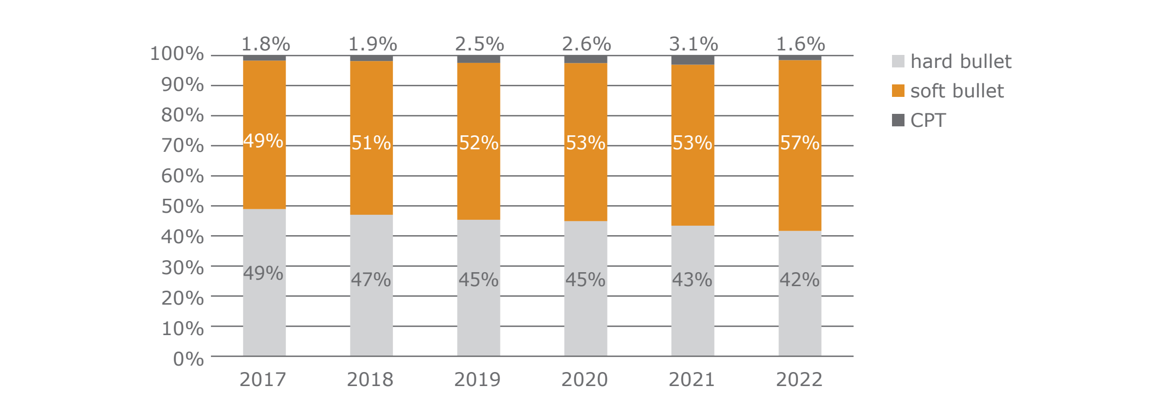
The increased number of CPT programmes in the past few years has led to a relatively broad diversity of structures, for example showing different extension triggers and procedures following the failure of the amortisation test. While within countries like the Netherlands, CPT structures are relatively homogenous, they are less homogenous in Italy, Greece and Portugal and differ quite substantially between countries. Hopefully, the transposition of the CBD will address the lack of standardised structures in the market.

Soft bullet covered bonds keep dominant position in covered bond market

In June 2022, 25 jurisdictions had covered bonds with extendable maturity structures outstanding in the iBoxx EUR Covered Index. The total amount of soft bullet and conditional pass-through covered bonds outstanding in those countries was EUR 466bn as of June 2022, up from EUR 400bn five years ago.

Soft bullet covered bonds became the dominant structure in the euro benchmark covered bond market in 2018 and have expanded their dominance ever since. The share of soft bullet covered bonds in the iBoxx index rose to 57% in June 2022, up from 53% at the end of 2021. In volume terms, the June 2022 index comprised EUR 453bn of soft bullet covered bonds, up from EUR 386bn at the end of 2017. Meanwhile, the share of conditional pass-through covered bonds (CPTCB) was 3.1% at the end of 2021, but it had already dropped to 1.6% in the first half of 2022. Finally, the share of hard bullet covered bonds declined to 42% (or EUR 334bn) in June 2022, down from 43% and 49% at the end of 2021 and 2017, respectively.

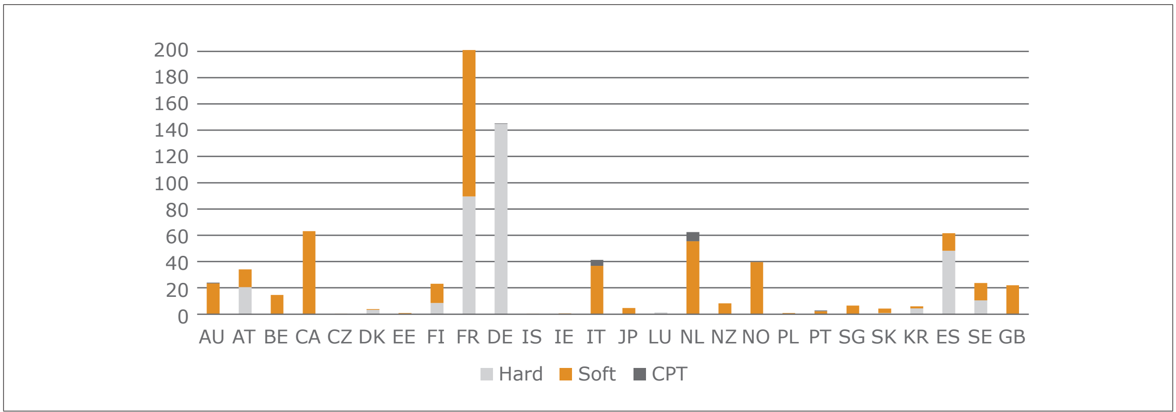
> Figure 1: Outstanding covered bonds in iBoxx EUR covered bond index by maturity structure (%, with labels showing amounts in EUR bn, June 2022 index)



Source: Bloomberg, ABN AMRO

A breakdown by country shows that Germany and Luxembourg are the only countries with pure hard bullet covered bonds, although there is one structured CPTCB in Germany. Meanwhile, hard bullet covered bonds also still have a share of more than 50% of the total amount of euro benchmark covered bonds in Denmark (88%), Spain (78%), South Korea (76%), and Austria (61%). However, more countries are likely to see a rise of covered bonds with extendable maturity structures now that the CBD has become effective. Therefore, covered bonds with extendable maturity structures are set to expand their dominance in coming years.

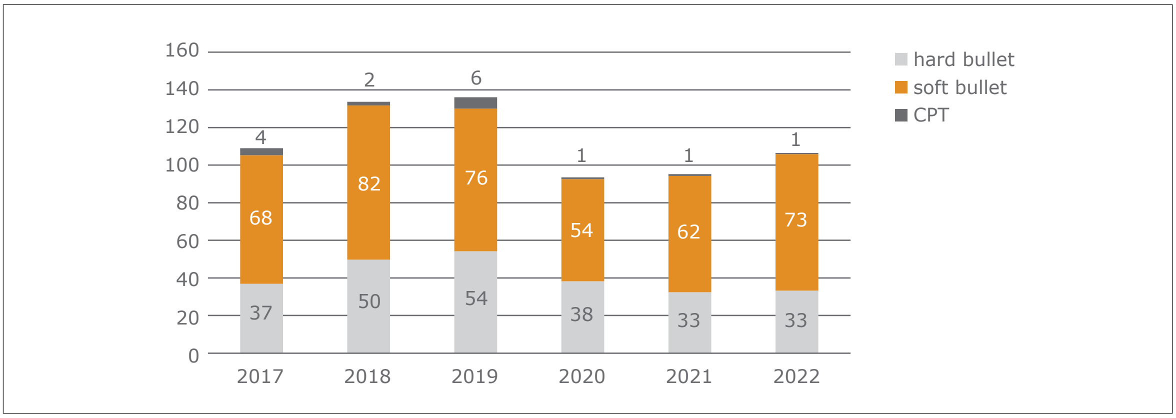
> Figure 2: Volume of outstanding covered bonds in the iBoxx index by country and maturity structure (EUR bn, June 2022 index)



Source: Bloomberg, ABN AMRO

Turning to new issuance of euro benchmark covered bonds, the share of covered bonds with extendable maturities had risen to 69% in 2022 at the time of writing, well above the 63% average seen in the past five years. The majority (68%) consists of soft bullet covered bonds, as CPTCB issuance has been on a declining trend. As said, this largely reflects developments in the Netherlands where all CPTCB issuers have switched to soft bullet programmes, with NN Bank even having successfully asked investor consent to switch outstanding CPTCB into soft bullets. As a result, it is likely that no new Dutch CPTCB will be issued, while the outstanding amount of CPTCB will probably also decline if more issuers ask investor consent to switch to soft bullet structures. The only CPTCB issued so far was from Bank of Queensland.

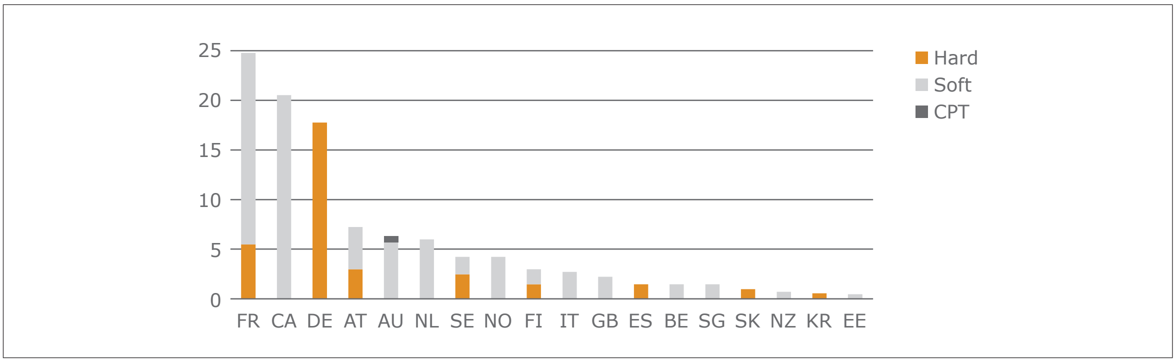
> Figure 3: New issuance of EUR benchmark covered bonds by maturity structure (%, with labels showing amounts in EUR bn)



Source: Bloomberg, ABN AMRO - as of 6 June 2022

The rise in the share of soft bullet covered bonds mainly stems from relatively large issuance volumes of Canadian issuers, which are all in soft bullet format. This has not been offset by larger issuance volumes of German and French hard bullet covered bond issuers. Looking forward, it will be interesting to see if issuers will stick to hard bullet format now that soft bullet structures will be an option for almost all issuers in all countries. As such, it is expected that the share of soft bullets in new issuance will rise strongly in the coming years.

> Figure 4: New issuance of EUR benchmark covered bonds by country and maturity structure in 2022, EUR bn



Source: Bloomberg, ABN AMRO - as of 6 June 2022

Conclusion

Only a few years ago, extendable maturity covered bond structures were the exception rather than the rule. Today, their market share has steadily risen, with extendable maturity covered bonds now being the majority in covered bond indices. The CBD has solved the issue of fragmentation in extension triggers across countries and programmes. Moreover, more and more countries have embraced the maturity extension structure when transposing the CBD into national law. As a result, soft bullet covered bonds will further enlarge their footprint, with CPTCB slowly disappearing. This will also likely lead to greater investor acceptance, although the vast majority of investors is already able to invest in covered bonds with maturity extension features.