1.7 COVERED BOND INVESTOR VIEW: PRIVATE BUYERS RETURN AS THE ECB STEPS BACK

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Investing in covered bond markets has been a rather challenging affair in recent years. For much of last year, we were faced with low gross and negative net issuance volumes, heavy CBPP 3 buying, poor levels of liquidity in secondary markets, tight spreads, flat spread curves and negative yields for the bulk of the market. Not exactly pleasant unless one is on the issuing side of the equation and a number of investors did indeed either temporarily focus on alternatives to covered bonds or left altogether. However, with us moving into 2022, almost all of those points have at least begun to change. Issuance volumes have surged as have re-offer yields, spreads vs EGBs and SSAs have been as high as they have been in years and with the PEPP ending net settlements at the end of March, net APP settlements coming to an end on 1 July and CBPP 3 orders dropping further to 20%, the Eurosystem's impact is also becoming less pronounced.

If there ever was a time when classic multiple choice questionnaires to get investor feedback were not fit for purpose, then it is this year. Hence, unlike in previous editions of the ECBC factbook, we have decided that we need more nuanced and detailed feedback from investors and have as a result conducted a series of interviews with around ten key covered bond investors with a wide range of backgrounds, both investor type as well as location wise.

What we want to do below is to briefly highlight what the ECBC has been doing in terms of engaging with the covered bond investor base in these tricky times. Niek Allon, the moderator of the ECBC Investor Task Force will run you through this. We then thought it is useful for Frederik Kunze to run you through a short section highlighting the evolution of classic investor distribution statistics in EUR benchmark covered bond markets. And last but not least, Florian Eichert will outline the main highlights from our interviews.

ECBC INVESTOR TASK FORCE

In 2021 the ECBC established the Investor Task Force (ITF). The reason for the establishment of the task force is to strengthen the active involvement of covered bond investors in the activities and plans of the council. As they cannot become members of the ECBC an active dialogue with a wide range of investors is crucial to get feedback on the publications issued and the activities organized by the council. The ITF has the objective to engage with investors, to build a platform for and with investors, to share information, discuss developments and requirements and to connect investors with ECBC members.

The Task Force started with a series of interviews with a group of 12 covered bond investors. The interviews presented us with a number of interesting insights:

- Investors are willing to be actively involved in ECBC activities, roundtables and discussions
- The ECBC fact book and Covered Bond Label initiative are very highly valued
- Investors use the CB Label website and Harmonized Transparency Templates (HTT) intensively for their daily activities. Some investors have automatic links from the label websites to their internal systems and reporting. In addition, investors indicated that they can not invest in covered bonds if the issuer does not publish an HTT. At the same the time the presence of an HTT allowed them to look at alternative (also non-core EU) jurisdictions and issuers.
- Going forward investors show interest being involved in the ECBC and ITF activities
- Further disclosure of date related to the EU Taxonomy, EPC indexes and other ESG topics would be appreciated.

The interviews presented the ITF with sufficient positive feedback to start building the investor platform, to continue the dialogue and conversations with investors and to organize issuer and investor events. The interviews we conducted for this article are a nice follow up and the first event will be organized around the ECBC Plenary meeting in Vienna in September 2022.

EUR BENCHMARK COVERED BOND INVESTOR DISTRIBUTION STATISTICS

Before going into the interview feedback, let's zoom out quickly and first of all take a look at distribution stats in EUR benchmark covered bond primary markets to highlight the multi-year trends that have been at play in covered bond markets.

Although the Eurosystem continues to act as a price-insensitive buyer in the primary market for covered bonds, the general market environment has changed and the asset class has become more attractive to an increasing number of investors. In particular, the return of covered bond yields to positive territory, caused mainly by the significant rise in swap rates, can be seen here as paving the way for a stronger participation of real money investors in primary market transactions.

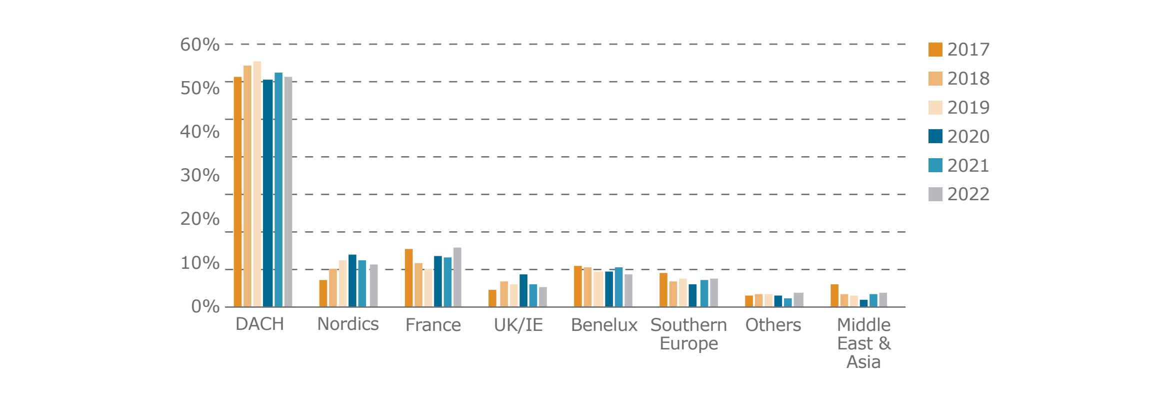
This different market environment is increasingly having an effect on the distribution statistics in primary markets. However, when comparing ytd 2022 data with 2021, the differences are not yet dramatic. One reason for this is the fact that for much of 2022, the ECB still placed significant orders in eligible new issues. Until the end of March we were still talking about 40% of the expected issue size, until the end of June 30% and since then it has been at 20%. However, central banks outside the common currency area as well as supranational investors were also active investors in the primary market, which ultimately kept the share of central banks and public institutions in the allocated bond volume at a high level even as the ECB started to reduce orders.

Having said that, similar to last year, bank treasuries continued to be the largest investor category in covered bonds. At 40.3% (2022 ytd), the share of banks is at the same level as the entire previous year (40.8%). The Central Banks/OI category now ranks second with 29.8% (previous year: 27.0%). Asset Managers & Funds have a share of 23.3%, which initially marks a decline compared to the average value for 2021 as a whole (25.9%). With regard to the Insurances & Pension Funds category, there is a discreet increase to 5.8% (2021: 5.3%). However, currently, the shares of the Insurance & Pension Funds category are higher, especially in the longer maturities (initial maturity >10y: 29%).

In terms of the geographical distributions in primary markets, allocations to the DACH region continue to dominate, with Germany again carrying the greatest weight. Similarly to the distribution by investor type, the pure statistics mask some of the underlying trends, though, as Eurosystem central bank demand from for example France is being replaced by private sector investors such as for example French insurance companies.

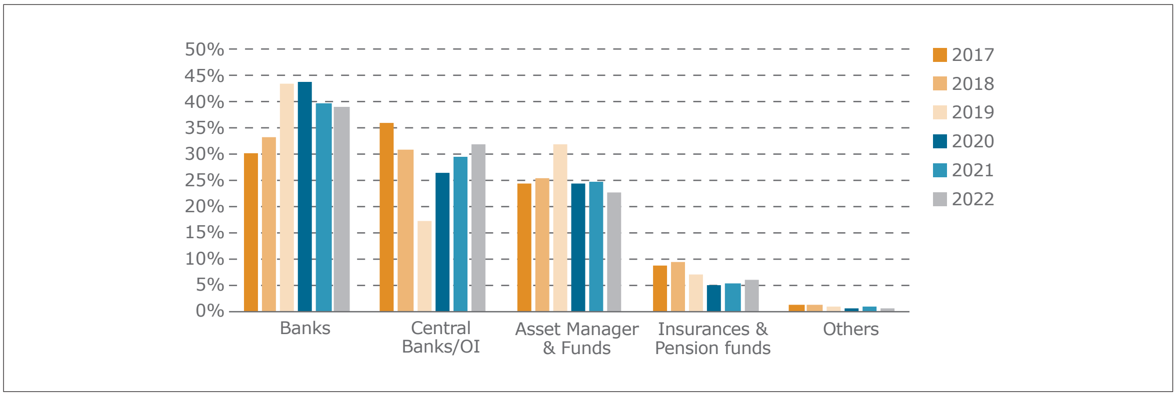
It can be assumed that with a further reduction in the ECB's activities in covered bond markets, the return of investors who had been forced out will continue to gain momentum. Additionally, the new interest rate environment together with a general shift to safer assets will bring in new demand too.

> FIGURE 1: INVESTORS FROM DACH REGION STILL DOMINATE



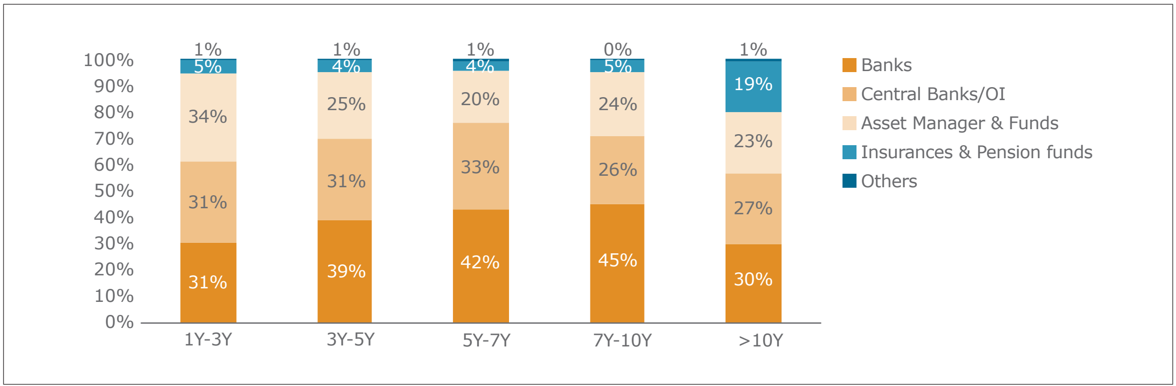
Source: Nord/LB

> FIGURE 2: BANKS STILL WITH LARGEST INVESTOR SHARE



Source: Nord/LB

> FIGURE 3: INVESTOR DISTRIBUTION BY INITIAL MATURITY BUCKET (2022YTD)



Source: Nord/LB

INTERVIEW FEEDBACK

Having gone through the deal statistics and having highlighted that they do not fully show some of the underlying trends, let's focus on the more detailed interview feedback we have gathered from our discussions.

How have investors dealt with the market until last year?

While the reaction was slightly different across investor types, responses in our survey did typically centre around investors having become somewhat less active in covered bond markets without, however, materially changing their previous approaches. Only one of those we interviewed said they had actually stepped back from covered bond markets altogether as relative value to other asset classes, tight outright spreads and low yields no longer made sense to them. Bank treasury and insurance buyers in our survey did predominantly say that they had shifted towards SSA markets while within covered bond space, portfolios were tweaked marginally to include the odd new name or jurisdiction. One bank investor for example mentioned having expanded from buying only LCR and ECB repo-eligible assets to also buying LCR but non-ECB repo-eligible ones (i.e. Australia, New Zealand). On the asset management side, we also heard of a stronger focus towards corporates or in the case of one Nordic investor a stronger push in non-EUR currencies. However, none of the investors we surveyed went for a complete strategy change by going materially longer, materially adding risk or embracing conditional pass through structures for the few extra basis points.

We did ask investors also about what they had seen as the biggest distortion in covered bond markets. While the majority view on liquidity was actually better than one could have thought (one respondent saying that bid-side liquidity has never been better), the vast majority responded that a lack of spread differentiation as well as curve flatness had been the biggest issues for them.

Have investor views changed in early 2022 and can all of this issuance be absorbed at all?

We mentioned in the intro that the start of 2022 has produced a material shift in how covered bond markets feel. The investors in our survey acknowledged this and while some said we are still in the early stages of the normalisation, the stepping back of the ECB and normalisation on the funding side has clearly refocussed attention onto covered bond markets. Investors mentioned above all the materially wider spreads vs EGBs and SSAs as well as higher absolute levels of yields as important factors. Especially for shorter dated covered bond issuances some of the asset management participants reported they had begun to receive internal interest in covered bonds from even high yield portfolios wanting to park liquidity, which comes on top of renewed interest from externally managed LCR funds as well as aggregate mandates.

On the back of this cautiously optimistic view, virtually all of the participants in our survey said that investors would be able to absorb the higher issuance volumes (with one abstention). After all, the interest has resumed across a number of investor groups with outright yield buyers back as well and even the Eurosystem staying in the market via re-investments. However, we did have some more critical voices as well highlighting the threat of too much comparable issuance taking a short-term toll on markets and valuations (as we have seen at the very end of H1) and we had some of the respondents re-stressing the fact that more spread differentiation would be needed to absorb also issuance from smaller jurisdictions and issuers.

We did also ask one question around what investors believe will be the biggest difference in a post-net APP additions world compared to the 2021 market, higher levels of liquidity, wider spreads, steeper curves and more sector and issuer differentiation. The predominant response was really all of the above. Effectively, investors expect the trend that we have started to see at the beginning of 2022 and the factors they have already highlighted above to continue. Equally to the question around the biggest distortions, changes in the level of liquidity does not really feature very prominently as a factor highlighting that covered bond markets are a long way from (and have never been close) EGB and SSA markets where a name such as the EU would these days attract a lot of short-term, trading oriented fast money flows. Covered bond investors and traders continue to not dare to go short and they still predominantly take a strategic view in primary rather than a tactical one in secondary markets.

Last but not least, we did ask a final market related question. Do investors believe covered bonds can continue to play the role of safe haven and a place to hide from volatility in EGB, SSA and credit markets even in a less ECB-supported environment. The resounding answer was yes with one investor rightfully so pointing towards this remaining valid for as long as underlying fundamentals stayed solid. Volatility may pick up also in covered bond markets, but the product would continue to be less volatile than its surrounding markets / products and hence, continue to be a good fit for long-term insurance buyers as much as an interesting asset for asset managers' aggregate portfolios and bank treasury HQLA books.

Fundamental risks, how worried are investors and how relevant is fundamental analysis?

While differences in underlying risks across issuers, cover pools and jurisdictions have not had much of an impact on spread valuations and hence made spending time on it a rather unprofitable exercise, investors have nonetheless paid attention. There was not a single investor in our survey that did not stress the need to have a clear view of the underlying risk profile of the covered bonds as well as the issuing entities. Whether we are talking about the impact of the war in the Ukraine and the geographic cover pool profile as well as general business exposure of covered bond issuers, whether we are talking about Covid and the exposure to commercial real estate assets or more recently the impact of higher rates on residential mortgage portfolios. Investors do have a strong interest and while they may not be able to arbitrage different covered bonds based on their relative fundamental qualities just yet, they can at the very least factor in fundamentals when looking at whether or not to participate in new issues. Also, while Covid and the Ukraine may have sharpened the focus on fundamentals and while higher yields and wider spreads make going into the details more worthwhile, the need to analyse has always been there, hence, it is nothing new.

Getting up-to date, harmonised and comparable information on underlying cover pools across issuers and jurisdictions has been at the centre of the ECBC covered bond label's Harmonised Transparency Template (HTT). Especially with the Covered Bond Directive (CBD) in force now, getting updated information in line with the new transparency requirements has lifted the HTT's profile even more. Hence, we simply had to ask the question if investors already use it. The short answer is the vast majority of those we interviewed do already use the HTT and the one investor who had never seen it, told us he would going forward. The responses were still not all without criticism as there is sometimes still some manual work needed by investors when running analysis and the timeliness of the publications was seen as a problem for some names and policing delays more actively was seen as a sensible thing to do to improve the overall quality and usability by investors.

Covered bond harmonisation

With the CBD having come into force on 8 July, we have certainly had our fair share of questions from investors as well as issuers around just how things will be different. In general, though, the CBD aims to raise the game of the previously weaker frameworks while leaving room for gold plating as well as national specificities. To see what investors make of it we asked them whether the CBD makes their life any easier and whether it could even have a spread impact.

The consensus across investors we surveyed was that the CBD is indeed helpful and positive. However, since important differences will remain, it does not mean the amount of work needed to analyse various covered bond products will be reduced materially. In terms of spread impact, one of the investors did mention that in times of stress, stronger frameworks do of course limit the extent of any widening. However, another actually even pointed out the short-term risks around the time of the implementation. Having for example the ECB collateral as well as purchase programme eligibility tie into CBD alignment when issuer reporting may still need some fine-tuning early on, especially for those not working with an ECBC covered bond label, can actually lead to uncertainty at first before the positive long-term impact. According to some of the investors interviewed by us, the one area that could really have a spread impact is on third country equivalence. However, with this still being years away, it is too early to focus on this at this point.

ESG in covered bond markets

Last but not least, we cannot end any survey or round of interviews without touching on the element of ESG in covered bond markets. Green, social or sustainability covered bonds are still a niche rather than mainstream as above all difficulties in identifying assets on bank balance sheets that comply with covered bond frameworks as well as the issuers' green or social bond frameworks is what has been limiting supply in covered bond markets.

First of all, we wanted to know whether investors look at the more specific ESG credentials of covered bonds or whether they take a more holistic approach focussing on the issuer. While responses varied across the investors we interviewed, we could probably sum up the answers as the assessment of the issuer is crucial and for issuers scoring very highly on ESG metrics, adding an ESG theme to a covered bond is of course positive but not crucial. However, issuers that score poorly on ESG metrics can indeed benefit from issuing green or social covered bonds. Hence, holistic approach of the issuers while bond specific considerations are above all helpful to those scoring poorly at the issuer level. Last but not least, whether or not an ESG theme at the bond level helps depends on the mandate in question. A dedicated green bond fund will not buy conventional covered bonds from an issuer with strong ESG credentials of course.

With varying standards competing for attention in ESG markets as well as the EU taxonomy and further down the line European Green Bond Standards (GBS), we also wanted to know what investors focus on in covered bond markets. Similar to the previous question, opinions differed. The majority of the investors we interviewed said that taxonomy and GBS alignment would eventually be crucial, especially the asset managers we spoke to stressed this point. However, at the same time, a bank treasury investor mentioned to us that with nuclear and gas being part of the taxonomy they will continue to focus on other, stricter standards.

Finally, there was no clear view on pricing differentials between green or social covered bonds and conventional ones.

BOTTOM LINE

2022 can certainly be characterised as a structural break for covered bond markets. With the ECB finally ending net CBPP 3 purchases and issuers finally normalising their funding away from long-term central bank liquidity, covered bond markets are finally wiggling free from years of Eurosystem-related distortions.

One big question over the past years had always been whether private sector investors would be back to take over from the Eurosystem to support banks' funding normalisation. Looking at the exceptionally high issuance volumes so far this year, the corresponding deal statistics as well as the feedback from the interviews we conducted for this article, it is fair to say that they are back or at the very least are starting to be back. The higher yields, wide spreads vs sovereign bonds and SSAs and also increasingly wider spreads vs swaps (at least in primary markets) have all contributed to this.

It is fair to say that the ECBC Investor Task Force was created just in time to accompany this trend. After all, it aims to keep an active dialogue between the ECBC and the covered bond investor community, a task that is more crucial these days than ever as we are not only talking about a different environment in the market. Despite being seen as a long-term positive by the investors we interviewed, the implementation of the Covered Bond Directive has also created short term uncertainty and the ECBC is aiming to assist investors through updated reporting templates to take into account the new requirements from Article 14 as well as updates to the ECBC comparative database to include the recent law amendments across jurisdictions.

Speaking of the investor interviews, the responses we received show how critical a role covered bonds have played and still play in many investors' portfolios. The past few years saw many of them take a step back as especially a lack of yield as well as spread differentiation made covered bonds unattractive on the back of

Eurosystem purchases and little supply. However, the moment the environment began to change, they began to come back. Looking ahead, none of the investors we interviewed see capacity constraints to absorb the increased issuance volumes. However, the vast majority said that with the ECB retreating they do see the need for more differentiation across issuers and sectors as well as steeper curves. In other words, they expect to see a more normalised market environment in which underlying fundamentals do play a role again.

For issuers this means, they will have to tread markets more carefully and be prepared to pay up to get investors to engage. However, the good news also for the issuer community is that we are talking about relative pricing and not about chasing investors that do not care to engage at all. Private sector investors are back. However, the ECB stepping back does mean that the balance of power has shifted back towards them after a number of years with issuers firmly in command.