

1.8 COVERED BOND MARKETS AND CENTRAL BANK POLICY IN THE LIGHT OF THE COVID-19 CRISIS

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INTRODUCTION

With regard to the international covered bond markets, a formative influence was exerted in particular by monetary policy, but also by the fiscal impulses in the course of the pandemic development. The aim of this article is to give the reader an overview of the implications of these measures while focusing on monetary policy. To this end, we first present a recap of the decisive policy responses to COVID-19 and then go into the effect of crisis intervention on banks and cover pools. We then discuss in detail the monetary policy related changes in market dynamics emphasizing supply-side effects, give an assessment of the demand-side effects and spread developments, and conclude with the question of how unwinding of monetary-policy support measures evolve.

A RECAP OF THE DECISIVE POLICY RESPONSES TO COVID-19

The **targeted longer-term refinancing operations (TLTRO)-III** were one of the most important measures used by the European Central Bank (ECB) to ease the impact of the pandemic. TLTRO-III gave banks access to an unprecedented amount of 3yr liquidity. The ECB also offered banks access to liquidity via its non-targeted pandemic emergency longer-term refinancing operations (PELTROs). Eurozone banks borrowed only EUR 30 bn under the PELTROs. Instead, banks borrowed EUR 2.3 tn under the TLTRO-III, up from EUR 740 bn under the TLTRO-II operations.

When the pandemic reared its ugly head, the ECB stepped up its asset purchases. Most purchases were made through the **pandemic emergency purchase programme (PEPP)**. This programme included all the assets eligible under the asset purchase programme (APP), plus non-financial commercial paper. However, it mainly focussed on buying public sector assets. The ECB ended its net purchases under the PEPP in March 2022, when the programme had a size of EUR 1,718 bn, of which EUR 6 bn covered bonds. The net APP purchases were halted per July 2022. By the end of June 2022 the APP had a EUR 3,265 bn size of which EUR 302 bn in covered bonds (CBPP3). The ECB will reinvest redemptions under the APP until well after its first rate hike which took place 21 July 2022. The ECB also adopted **temporary collateral easing measures**, to facilitate the participation in liquidity operations and to support bank lending. These measures will be phased out or are already phased out gradually again per 8 July 2022. In June 2023 the collateral valuation haircuts will be fully normalised, while in March 2024 the remaining pandemic collateral easing measures will be phased out (for details please refer to the table below).

> TABLE 1: ECB MONETARY POLICY MEASURES EASED OR INTRODUCED IN LIGHT OF THE COVID-19 PANDEMIC

Asset purchases		Start	End*	Holdings end June '22 (EUR bn)	Reinvestments until
<i>Asset purchase programmes</i>	Covered bonds	20-Oct-14	30-Jun-22	302	Well beyond first rate hike
	Asset backed	21-Nov-14	30-Jun-22	25	Well beyond first rate hike
	Public sector	09-Mar-15	30-Jun-22	2,593	Well beyond first rate hike
	Corporates	08-Jun-16	30-Jun-22	345	Well beyond first rate hike
TOTAL				3,265	
<i>Pandemic emergency purchases</i>	Covered bonds	18-Mar-20	31-Mar-22	6	At least end 2024
	Asset backed	18-Mar-20	31-Mar-22	-	At least end 2024
	Public sector	18-Mar-20	31-Mar-22	1,644	At least end 2024
	Corporates	18-Mar-20	31-Mar-22	42	At least end 2024
	Commercial paper	18-Mar-20	31-Mar-22	4	At least end 2024
TOTAL				1,696	

TLTRO-III operations	Tranche	Settlement date	Maturity	Drawings (EUR bn)	Repaid by end June '22 (EUR bn)
	III.1	25-Sep-19	28-Sep-22	3	2
	III.2	18-Dec-19	21-Dec-22	98	34
	III.3	25-Mar-20	29-Mar-23	115	27
	III.4	24-Jun-20	28-Jun-23	1,308	110
	III.5	30-Sep-20	27-Sep-23	174	15
	III.6	15-Dec-20	20-Dec-23	50	2
	III.7	24-Mar-21	27-Mar-24	331	6
	III.8	24-Jun-21	26-Jun-24	110	12
	III.9	29-Sep-21	25-Sep-24	98	3
	III.10	22-Dec-21	18-Dec-24	52	5
TOTAL				2,339	215
Collateral rules		Easing	Phasing out (1) 8-Jul-22	Phasing out (2) Jun-23	Phasing out (3) Mar-24
Temporary reduction collateral valuation haircut		20%	10%	0%	
-covered, ABS, senior bonds used in reverse transactions		4.0%	4.5%	5.0%	
-own use covered bonds CQS 1 & 2		6.4%	7.2%	8.0%	
-own use covered bonds CQS 3		9.6%	10.8%	12.0%	
Higher usage limit for senior unsecured instruments		10%	2.5%		
Removal EUR 25,000 non-uniform minimum size limit domestic credit claims					X
Eligibility marketable assets downgraded < rating threshold after 7-Apr-20			X		
Eased eligibility additional credit claims (ACC)					
-frequency of loan level reporting			X		
-acceptance requirements banks' own credit assessments (IRB systems)			X		
-eased requirements on public sector guaranteed loans to corporates					X

* Net asset purchases were also halted from 1 January 2019 until 31 October 2019

Source: ECB, ING

Also other central banks responded to the pandemic, albeit not necessarily all in the same way. In the UK, Australia and Denmark, central banks provided banks with access to cheap funding facilities. In the case of Australia and the UK, these were longer-term facilities of respectively 3yr (last expiration date June 2024) and 4yr (with an option to extent some advances up to 10 years). The Norwegian and Canadian central banks made temporary adjustments to their collateral eligibility criteria, including for covered bonds, to give banks the opportunity to post sufficient collateral to attract central bank funding. These measures were phased out in 2021. In Sweden, the Riksbank opted for asset purchases, which included sovereign bonds, municipalities, covered bonds and corporate bonds. Albeit less than during the crisis, the Riksbank was still buying bonds in 2H 2022. The UK, Canadian and Australian central banks also bought sovereign and corporate bonds in response to the crisis, but never covered bonds.

> TABLE 2: SUMMARY OVERVIEW OF CENTRAL BANK MEASURES ON THE BACK OF THE COVID-19 PANDEMIC

Region	Liquidity	Collateral eligibility	Asset purchases
Eurozone	✓	✓	✓
Sweden			✓
Norway		✓	
Denmark	✓		
United Kingdom	✓		✓*
Australia	✓		✓**
Canada		✓	✓*

Source: Central bank information, * no covered bonds, ** no corporate and covered bonds

NON-MONETARY POLICY MEASURES

Alongside liquidity measures, regulators also allowed banks to operate at lower capital levels. In Europe for instance, banks were given room to temporarily run below the Pillar 2 guidance, the capital conservation buffer and the liquidity coverage ratio requirements. Counter-cyclical capital buffer requirements were also relaxed. Meanwhile, the option for banks to meet part of their Pillar 2 requirements with AT1 and T2 instruments (instead of only CET1 capital) was moved forward. Besides, to improve their loss absorption capacity and support lending, banks were recommended not to pay dividends during the crisis. Regulatory authorities also gave banks a break on their loan loss provisioning, by being more lenient on the classification of moratoria as forbearances or past due loans as defaulted. Furthermore, they allowed banks to temporarily deduct central bank exposures from the leverage ratio total exposure measure, to offer them space to attract central bank liquidity.

Also public sector authorities gave it their best effort to reduce the implications of the pandemic. This stretched beyond measures taken to ensure good access to health services. Think for instance of the facilitation of working hour reductions to avoid layoffs, the offering of income support to households and businesses affected by the pandemic, state guarantee schemes supporting the financing of companies, and of the tax relief measures for companies and households. These measures have all been of utmost importance, not only from a broader economic and bank fundamental perspective, but also in terms of preserving the strong quality of covered bonds, as we will discuss in the next paragraph.

POSITIVE SIDE EFFECTS AND CRISIS PREVENTION

The dual economic shock of the COVID19-crisis, also came with risks regarding the credit quality of covered bonds. This was due to the fact that at the outbreak, uncertainties with regard to the short-, medium- and long-term consequences were extremely high. With regard to covered bonds, there was thus, among other things, the risk of a negative impact on the credit quality of issuers. In addition, there was a risk to the value of bank assets that a sustained economic shock with lower economic activity and rapidly rising unemployment would have a massive impact on the solvency of borrowers.

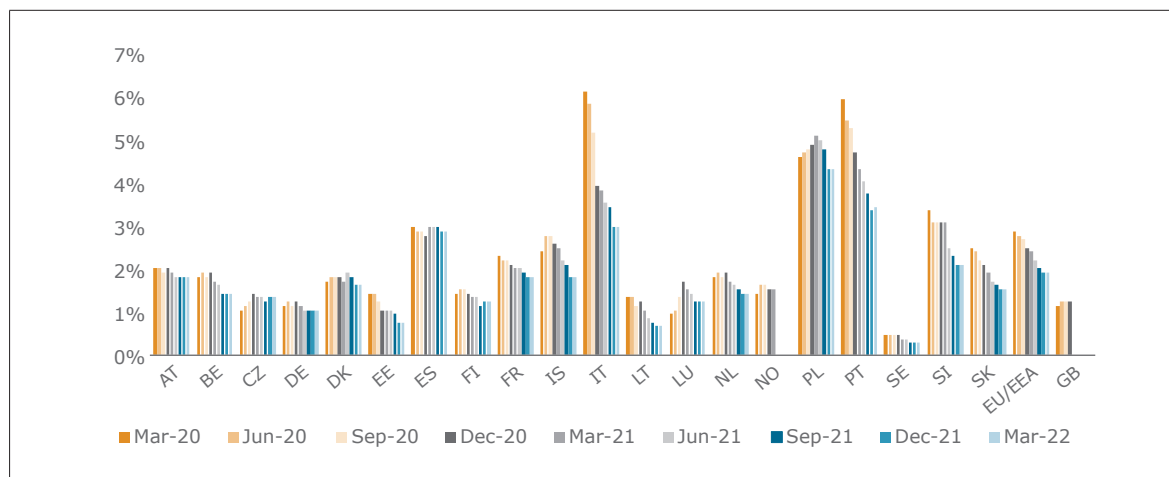
In view of the possible consequences for cover pools, these developments were also associated with a high loss potential. This is true at least subject to the theoretical implications of rampant unemployment, significant setbacks in real estate prices, but also in the event of general distortions on the capital markets, which could have drastically reduced the cash flows of the cover assets and thus the liquidity of the cover pools. Even if the management of cover pools enables or requires the replacement of non-performing or persistently delinquent receivables, a broad and deep crisis could have narrowed the scope for issuers to act. This risk was initially conceivable for mortgage pools and could have materialized especially for those characterized by a high proportion of commercial real estate mortgages.

In fact, the described interventions averted a deep, broad and, in particular, sustained crisis. With regard to fundamentals of covered bonds, one should think here in particular of those measures, which have averted liquidity tensions. Additionally, a rapid and sustained rise in unemployment has been averted and temporary easing of capital requirements for banks has strengthened their ability to lend and at the same time made it easier to comply with the required capital ratios.

The success of the interventions depended both on the short reaction time of the decision makers and on the size and scope of the steps decided upon. As mentioned above, central banks acted shortly after the potential extent of the crisis began to reveal itself. Liquidity tensions could thus be averted. Legal requirements, for example on payment moratoria for private households and for companies, were also regulated quickly – also in the spring of 2020. Particularly on the public sector side, the aggregate scope of support measures is revealed by the designs of special budgets.

Focusing on covered bonds the crisis prevention yielded primarily to the observed stability in the financial sector also shown by rare downgrades for issuers. The monetary policy measures prevented liquidity crunches and supported to a large extent the property prices and, together with moratoria and employment protection schemes, prevented delinquencies or defaults on the mortgage side. To sum up the positive side effects of the crisis prevention measures we use data from the latest EBA risk dashboard. The data reveal decent capitalization of banks together with shrinking NPL-quotas and comfortable liquidity positions.

> FIGURE 1: NPL DATA OF EEA BANKS



Source: OECD, NORD/LB Floor Research

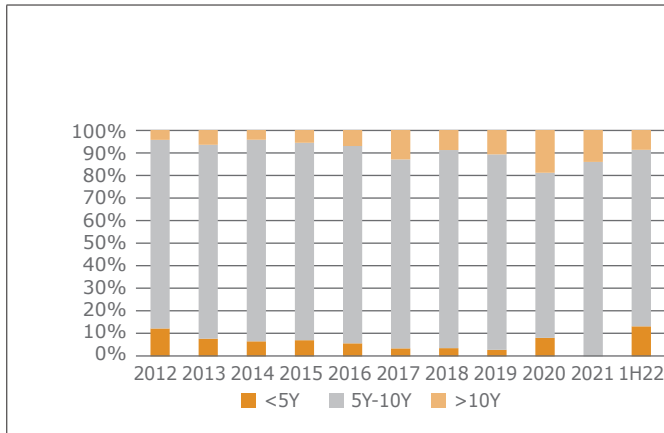
IMPLICATIONS OF MONETARY POLICY MEASURES ON COVERED BONDS

Focusing on the underlying factors for the market dynamics for covered bonds, especially the monetary policy measures outlined above brought forth significant structural changes. We will discuss these changes focusing on the impact on tenors and especially the supply and demand side of the covered bond market.

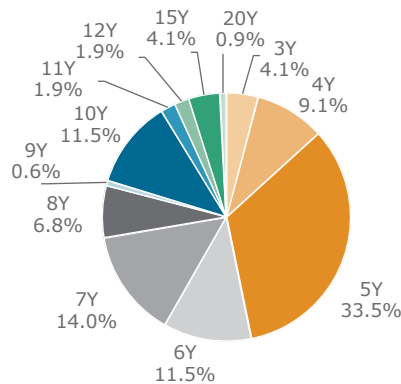
IMPACT ON TENORS

As regards tenors the yield environment as a consequence of the ECB’s monetary policy altered substantially. Over the past decade, tenors of publicly placed bonds have gradually increased. Besides the low yield environment, one of the drivers was that especially shorter maturities up to five years faced strong competition from funding opportunities in the context of central bank measures. As a consequence, the tenor of publicly placed covered bonds was extended. While in 2012 around 12% of publicly placed EUR benchmark covered bonds had a tenor of below five years, this share dropped to 8% in 2020 and to 0% in 2021. At the same time, the share of long-dated covered bonds (>10y) increased from 4% in 2012 to 14% in 2022. In 1H/22, this trend has reverted with the share of shorter dated covered bonds increasing considerably and the share of long-dated paper declining (see following figures).

> FIGURE 2: PAST DECADE MATURITY SPLIT OF EUR BENCHMARK COVERED BONDS



> FIGURE 3: 1H22 MATURITY SPLIT OF EUR BENCHMARK COVERED BONDS

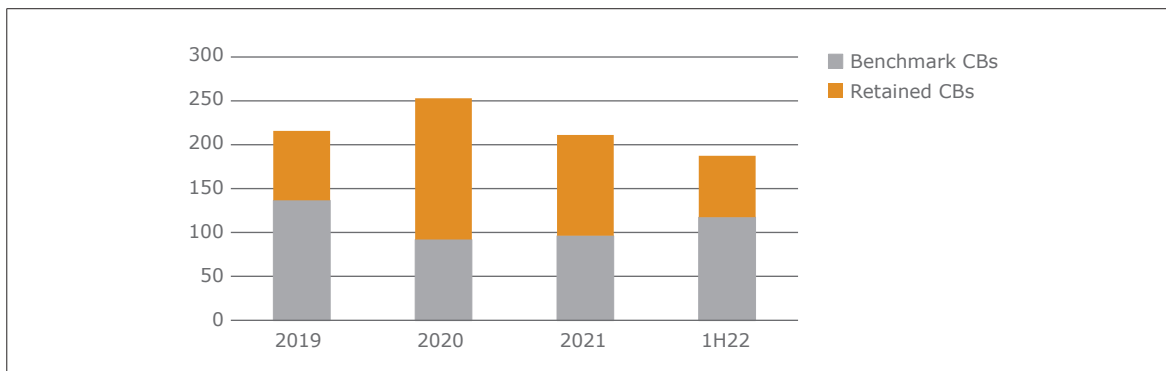


Source: Bloomberg, UniCredit Research

SUPPLY IMPLICATIONS

Much more striking and long lasting effects have materialized themselves on the supply side. Especially the TLTRO-III conditions had a strong effect on supply in 2020 and 2021. Irrespective of the before mentioned record low yields, gathering TLTRO-III funding was a very attractive option for banks. The consequence was a shift from publicly placed covered bonds towards retained issues (see figure below). Banks decided to issue large amounts of retained covered bonds in order to place them as collateral. According to the ECB between Q1/20 and Q1/22, the covered bond volume posted as collateral for ECB transactions had risen by almost 90% to more than EUR700 bn, while the eligible covered bond universe had increased by only 7%.

> FIGURE 4: COVERED BOND SUPPLY – BENCHMARK VS. RETAINED COVERED BONDS



Source: ECB, UniCredit Research

Therefore, the volume of retained covered bonds exceeded the amount of publicly placed covered bonds significantly. In 2021, around EUR 114 bn of retained covered bonds have been issued, following EUR 161 bn in 2020. These large volumes are comparable to levels seen only in 2011/2012. However, in contrast to the past, the highest volumes were generated by banks from markets such as the Netherlands, Germany or France and not from countries like Spain or Italy. While in 2019 the share of publicly placed benchmark covered bonds was 63%, this share dropped to 36% in 2020.

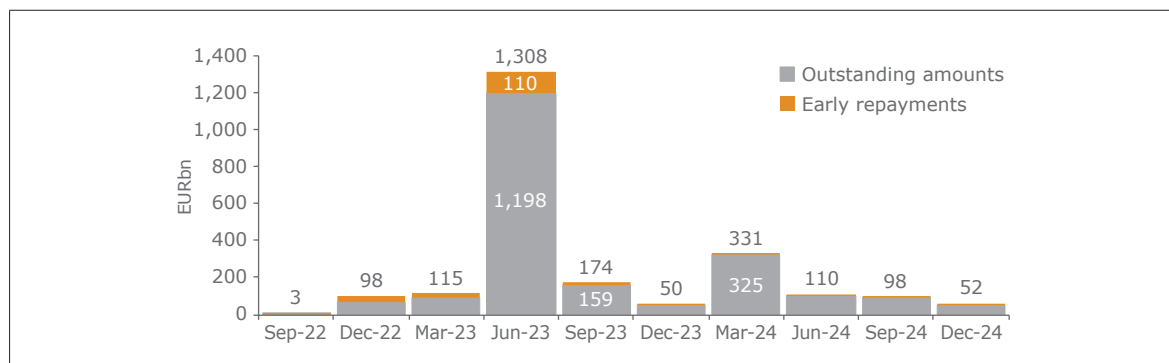
Nevertheless, compared to the peak in 2020, the proportion of retained covered bonds in relation to publicly placed covered bonds declined to 46% in 2021. This trend continued in the first half of 2022 and reached levels comparable to those in 2019. Due to the reduced issuance of publicly placed benchmarks, the net supply in 2020 and 2021 was negative, which compares to a positive net supply in 2019. Also this trend has reversed in the first half of 2022.

HOW WILL TLTRO-III COME TO AN END FOR COVERED BONDS?

As outlined above banks have borrowed more than EUR 2.3 tn under TLTRO-III. Despite early repayments since September 2021, the size of the TLTRO-III programme remains at a staggering residual volume of more than EUR 2.1 tn. Between September 2022 when the first of the ten tranches matures and June 2023 (which is the maturity date of the large fourth tranche, see table above and chart below), the outstanding scheduled redemption volume amounts to more than EUR 1.35 tn. While some banks might have used the TLTRO-III for carry trades which do not trigger any funding needs if unwound, other banks have to refinance the maturing ECB funding in one form or another. Many of the latter banks will probably use covered bonds as a funding source then.

On 23 June 2022, the 50bp special rate discount ended, which increased borrowing costs for banks, and on paper, reduces the incentives for banks to use TLTRO funding. However, for banks that have met the various ECB lending benchmarks, the TLTRO-III interest rate from 24 June 2022 is calculated as the average deposit facility rate over the life of the respective tranche. Depending on the hike expectations, this still provides banks with an arbitrage opportunity until the end of the term of the respective tranches and lowers the incentives for banks to make use of early repayment options.

> FIGURE 5: MATURITY AND OUTSTANDING AMOUNTS OF THE TEN TLTRO-III TRANCHES



Source: HSBC, ECB, Bloomberg (as of August 2022)

The end of the TLTRO-III programme over the next two and a half years means banks will need less collateral for ECB repo transactions. Moreover, in the case of retained covered bonds, they might increase their covered bond issuance to repay their ECB funding. This means that when TLTRO-III runs out, there could be less bank treasury demand for covered bonds and potentially even higher covered bond supply volumes in the primary and secondary market. Importantly, the ECB stresses that it monitors the bank funding conditions and that it will ensure the maturing of TLTRO-III does not hamper the smooth transmission of its monetary policy (ECB, 21 July 2022).

Having said that, in the first half of 2022, many issuers took advantage of the favourable sentiment towards covered bonds to get funding, also under the aspect of the fading of TLTRO III and, focusing on the demand-side developments, expectedly lower ECB participation in the primary market, with shares of the ECB of around 40% at the beginning of the year gradually declining to around 30% and around 20% in mid-2022. In addition, the overall higher yield levels made covered bonds more attractive. Supply volumes of publicly placed covered bonds have thus again significantly increased compared to previous years.

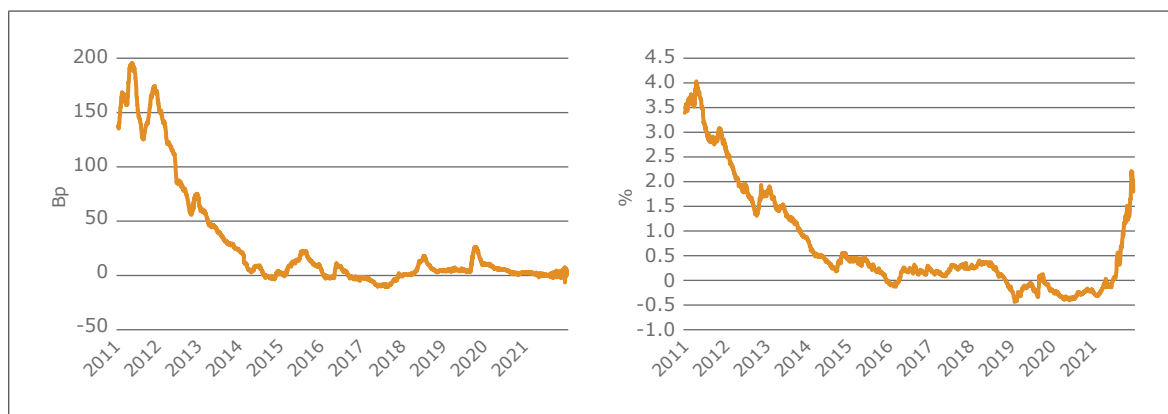
SECONDARY MARKET PERFORMANCE AND SPREAD SUPPORT OF CBPP3

The unprecedented measures taken by central banks have proven to be extremely effective in terms of easing the impact on performance. Nonetheless, not even the significant drop in covered bond supply due to the cheap central bank liquidity offered, has managed to maneuver covered bond spreads back to the negative levels seen last in 2018. However, the low supply of covered bonds in combination with continued strong demand from investors and the ECB kept asset-swap-spreads steady at levels of around 0bp for the *iBoxx EUR Covered*.

The primary market purchases allowed issuers to price the CBPP3 eligible new issues at tighter spread levels as they could rely on the price-inelastic ECB demand. The secondary market purchases have impacted spreads in two ways: directly as they increased the actual demand and indirectly as they provided some form of back-stop bid for traders as they typically were able to sell the bonds to the ECB as the largest buyer. The running out of the net purchases has resulted in an increase in risk premiums as investors distinguish more between the credit quality of their covered bond investments.

> FIGURE 6: ASSET-SWAP SPREADS OF IBOXX COVERED BONDS

FIGURE 7: YIELDS OF IBOXX COVERED BONDS



Source: Bloomberg, UniCredit Research

GENERAL CROWDING OUT

The less price-sensitive ECB purchases resulted in tighter spreads and lower yield levels. The latter were of course also driven by other ECB measures such as various key policy rate cuts, the TLTRO programme, other APP purchases and the PEPP. As a result, many real money investors had been crowded out over the past few years and focused on higher yield alternatives such as unsecured bank debt and corporate bonds. Particularly pension funds and insurance companies reduced their participation levels as covered bond yields were just too low for many of them. Bank treasuries on the other hand continued to be an important investor class as many Eurozone treasuries used ECB-eligible covered bonds as collateral for TLTRO-III and other repo operations.

EFFECTS OF ECB TIERING ON DEMAND

In September 2019, the ECB Governing Council introduced a two-tier system for reserve remuneration. Since 30 October 2019, a certain amount of the banks' excess reserve holdings* were exempted from remuneration at the deposit rate and were remunerated at 0% instead. This allowance is calculated as a multiple of an individual bank's minimum reserve requirements and is the same for all institutions. The ECB stated set the initial multiplier at six.

The two-tier system led to a redistribution of liquidity and prompted some banks to increase their central bank balances in order to take full advantage of their own exemption allowances. According to the Bundesbank,

the resulting redistribution of liquidity between banks began as soon as the two-tier system was introduced and took place largely via the money market. Redistribution could be observed both domestically and within banking groups as well as across national borders, and it enabled almost all euro area banks to make full use of their allowances resulting in exemption allowances being very largely used up (Bundesbank, January 2021).

One of the drivers of the decision to introduce the two-tier system were concerns by the ECB that a long-lasting environment of low or even negative interest rates could hurt lending. Particularly given that the non-standard liquidity-providing monetary policy measures further increased the excess liquidity holdings of Eurozone banks. Under the two-tier system, banks are no longer required to pay the Eurosystem negative interest on a certain portion of the excess holdings which reduce their interest expenditure. Moreover, banks were even able to generate additional interest income by borrowing funds at negative interest rates and depositing them in their central bank account at the zero interest rate. As regards covered bonds, the two-tier system might have had its impact on the demand side for covered bonds. However, this has been rather a theoretical issue for the times of negative yielding covered bonds, which might have been less attractive than the rate for excess liquidity within the exempted amount.

**Excess reserves are the amount a bank holds on current accounts with the central bank which exceeds its minimum reserve requirements. Excess reserves do not include the deposit facility.*

CONCLUSION – READY FOR THE NEXT CRISIS TO COME?

Financial markets barely moved on from the COVID-19 pandemic, or the next crisis presented itself: the war between Russia and Ukraine. While a decade of low inflation helped central banks offering full monetary accommodation, including at the highs of the COVID-19 crisis, times changed rapidly this year on the back of accelerating energy prices and rising inflation. Central banks across the globe are not merely looking anymore at a tapering of the quantitative easing put in place during the pandemic, they are on full alert to act on inflation. However, one thing is sure: if it had not been for the decisive reaction of policy makers to the pandemic, bank and covered bond fundamentals would have been in worse shape today when facing the new inflation and geopolitical uncertainties. However, the unwinding of these measures is needed and already underway. Albeit rather slowly one might say when looking at the still existing influence of the ECB on the covered bond market. But with an end to net purchases and TLTRO III-maturities soon underway the clock is ticking.