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Keynote address: Harmonising European covered bond frameworks – the buyside perspective

It`s a great pleasure to talk to many of the most important representatives of the covered bond industry. There were some discussions in the market in the recent past of how real money behaves when it comes to covered bonds. Is real money still buying covered bonds or is it slowly being crowded out of the market? So let me start with a small assessment here.

Where do real money investors stay when it comes to covered bonds?

PIMCO might work here as a good example for other buy-side investors. PIMCO holds covered bonds in different currencies, EEA as well as non-EEA covered bonds. Overall around 5% of our total AUM of about €1.5 trillion are invested in covered bonds. This clearly says covered bonds remain an important part of PIMCO`s assets.

The Bloomberg Barclays **Euro Aggregate Index** includes almost 8% in covered bonds from different legislations in and outside the EU. So covered bonds remain an important and secure part of the benchmark universe. It is worth noticing that compared to AAA-rated government bonds, covered bonds remain the best performing sector this year in the Euro Aggregate benchmark. Hence real money investors will continue to invest in this asset class.

On the other side, PIMCO`s exposure to covered bonds dropped by several billions over the last few years.

It is no secret that in contrast to banks and LCR investors, new issue participation of real money investors in covered bonds decreased in recent years. Is this a question of quality, of risk? No. It is simply a question of yields. Following some spread widening this year, an average 5 year covered bond has a yield of around 0.40%, 60 basis points (bps) more than bunds. But is this sufficient? Are evaluations correct, if covered bonds can trade 200 bps inside the countries' sovereign?

Our clients need to fulfil their liabilities, they are right to expect respective returns from their investments when taking credit risk. To do so, in some cases, they do not just invest in covered bonds but move investments into other asset classes such as alternative investments, real estate or corporates that provide higher returns. Or they take prepayment risk and move into callable Danish covered bonds where they get 2% for a AAA-rated highly liquid mortgage with an 8 year duration. These yields and liquidity cannot be provided by an average euro covered bond. And yes, in some cases our clients move investments out of covered bonds into less liquid and probably higher risk assets.

Taking covered bond evaluations we **might have seen the historical tights in covered bond spreads**. Since the announced end of QE, average covered bond spreads widened by 10 bps. With a YTD covered bond supply exceeding last years supply, new issue premiums widened to 7-10 bps. For 2019 the market expects another strong covered bond supply year with €130 billion . A possible new TLTRO will remain a question mark for investors. The announcement of a new one could clearly support spreads while its absence could lead to higher supply next year. While the ECB will remain in the market (we expect a monthly new issue participation of €2 billion), the trend of wider spreads might continue. Hence better buying opportunities might occur over time.

What about **green and social covered bonds**? Can they attract real money investors to re-enter the market? Short answer, PIMCO invested in some of the green covered bond issues which came to the screens the last few years and we hope to see more issues here in the future. However we argue that the simple refinancing of existing green mortgages does not increase the green mortgage part of the issuers cover pool. It does not add more green building to the real economy. A serious green approach would include **both**: established mortgage cover assets <u>and</u> dedicated green cover pools to guarantee preferred claims on <u>green</u> assets. At least green issuers should increase the number of green assets in their cover pools over time. Simply flagging already existing mortgages as green, issuing a green covered bond thereafter and refinancing those existing green mortgages is clearly not enough.

When it comes to pricing we think green covered bonds include the same credit risk as non-green investments. Hence green and sustainable covered bonds do not need to be more expensive than ordinary bonds and could work as an attractive investment.

As most covered bonds are backed by mortgages, we should also focus on **real estate market development**. Residential real estate prices in the EU rose 4.3% in 2018 compared to 2017. Overall statistics show rising house prices in the eurozone with an increasing dynamic in the last 4 years. House price inflation and housing demand especially in urban areas remains strong. But household debt service given current yields remains low. We are not excessively concerned regarding the property market, but this can change and we think close monitoring is necessary. None of this speaks against investing in covered bonds.

From a **cyclical perspective** we think less central bank support in general is likely to lead to higher market volatility. Global trade volume is losing momentum, inflation has picked up. We expect positive but slowing growth in 2019 as well as growing dispersions between countries in the eurozone. Potential trade wars or the ongoing budget discussion in Italy are tail risks to keep in mind in portfolio construction. Hence we should not assume markets will simply mean revert.

What does it all mean for covered bonds? To make a long story short: Although we see select purchase opportunities in covered bonds, the market environment speaks to maintaining a defensive portfolio positioning.

<u>Can harmonization of European covered bonds help to turn the tide? Can harmonization make Covered Bonds great again for the buy-side?</u>

Let me be very clear. Covered bonds are and remain a great product for both issuers and investors. If we like it or not, we need to take market conditions as a given. Even more, our duty is to lead our clients through a world of negative yields, subdued growth and growing asset price inflation. Covered bonds have proved to be a safe asset even in times of financial stress.

In this context, at a time when spread differences between different covered bond legislations and structures are still at historical lows, for some market participants harmonization might look overestimated. But it is not. Harmonization will clearly pay off, when markets become driven by pure credit risks again. What is most important is to make sure the name COVERED BOND, Premium or Ordinary, European or non-European covered bonds, remains a **brand name**. As a basic requirement there should be room for new innovations in the market but it should not risk asset quality, bankruptcy remoteness or preferential claim.

From an investors point of view, harmonization should improve protection in case of issuer defaults. The proposed requirement of a cover pool monitor, a register as well as mandatory public supervision and reporting for all covered bonds covered by the directive, are prerequisite for investor security and sign of a highly developed market.

At the end harmonization of covered bond markets is designed to help develop and establish a real European capital markets union. It will clearly help to strengthen this asset class.

<u>So how do we think a European covered bond market should look</u>?

Since we invest both in **EEA and non-EEA** covered bonds and in different currencies, a covered bond directive should include both areas. Non-EEA issuers (i.e. Australia, New Zealand, Canada, Singapore and recently Japan and even a small issue in Brazil) are established and already have a 12% weight in the benchmark. It is crucial to allow existing and possible new issuers outside the EU to enter the market. First, eligible issuers outside the EU can provide innovations and second, an investment in those legislations might work as a natural hedge in case of financial stress in the eurozone.

While we support a certain degree of heterogeneity in cover pools (given this is transparent), we are defensive when it comes to a **broadening of cover assets** not eligible under CRR (with the exemption of aircraft). Public, mortgage, ship and aircraft covered bonds are established refinancing instruments. We don`t think it will help the market to build reputation if the list of eligible assets will be extended. In turn it might increase asset encumbrance and the risk for investors. Such assets should be finally refinanced by instruments not falling under the covered bond directive. European secured notes should not be called covered bonds and should not have the same risk weight treatment as covered bonds. What we hear so far from the discussion sounds promising.

We think different **maturity structures** should be possible for issuers, and we hold investments in soft bullet and CPT covereds as well. It is one of our long term requirements to make sure such extension features are not on issuers' discretion but only in case of default.

We do appreciate a strict **quarterly transparency** requirement. From what we hear so far, the council will not follow this requirement and suggests lower standard semi-annual transparency. However, as a minimum standard the well-established harmonized ECBC label template could work. For high concentration pools or used derivatives, a line by line list of cover assets should be available. Needless to say, the more frequent and extensive transparency we have, the better we can assess these risks. Regardless of what type or quality or structure, programs being an "open book" shifts the burden to investors to do their due diligence.

In general too much harmonization in terms of asset eligibility or structure would actually be a disadvantage to active managers, as differentiating and quantifying imbedded risks is how we add value. In addition as long as they are investment grade, covered bonds should be in any case eligible to be included in **benchmark indices** such as the Bloomberg Euro Aggregate or iBoxx.

Will harmonization lead to lower funding costs at all ?

Those who expect harmonization might lead to general lower funding costs could be disappointed. Covered bonds remain a credit product where the credit risk depends closely on the issuing institution. Since cover pool returns are not pass-through to the investor, even the strongest cover pool will not avoid covered bond underperformance or volatility in case of the issuer being in financial difficulty. Hence real money will continue to request premiums depending on the issuer credit quality. This is not only true for covered bonds, but also for European structured notes that consist of higher risk assets such as SME`s (small and medium enterprises).

What`s missing in the discussion?

What real money needs is a much higher degree of liquidity in covered bonds, **a topic not addressed in harmonization proposals**. Issue sizes of only €500 million, and in some cases followed by tapping outstanding issues, are not investor friendly or the lack of liquidity is currently not priced in. The duty of real money is to manage credit risk. But to do so as an active manager you need to be able to frequently switch positions. However with the exception of Denmark and Sweden, the truth is that today it can be even challenging to get a quote – bid or ask – for more than €5 million in covered bonds. Also the number of rejected broker trading requests does not speak for high liquidity. The secondary market is only hardly working and this is not just related to QE.

There is some evidence that liquidity in covered bonds can be more easily impacted if credit concerns for a specific issuer occur in the market. This shows even more the need to improve liquidity and to allow active trading. I`m sure we all agree, if covered bonds enjoy a preferential treatment under LCR, they should be liquid.

Final remarks

Regulators, issuers, investors might have different opinions and needs. But the real strength of European covered bonds is the ongoing and frequent discussion and exchange between all market participants. For the last decades this has worked exceptionally well. I remember a number of good discussions with issuers and researchers. We have regular meetings with the Association of German Pfandbrief Banks (vdp). The industry runs a number of conferences on a regular basis. I`m sure this industry wide exchange of opinions will work in the future too. Thanks to the Association for Financial Markets in Europe and the Association of German Pfandbrief Banks (vdp) for organizing this event.

I wish all of us a good conference, valuable discussions and a nice day in this great city Berlin. Thank you.