The Covered Bond Report

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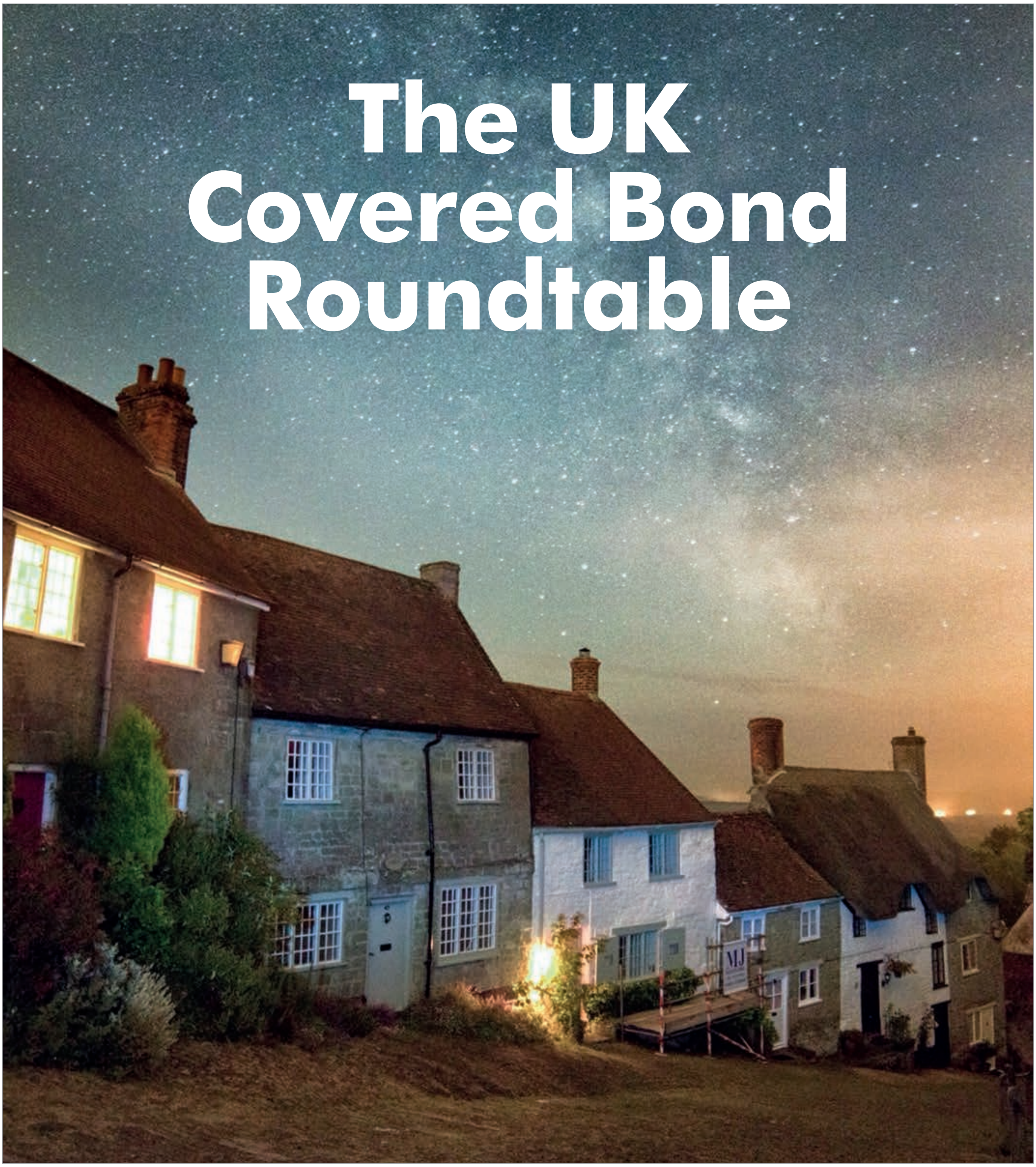

The UK Covered Bond Roundtable

NORD/LB

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A compelling sterling market and the resurgence of RMBS have provided stiff competition to euro benchmark issuance for UK financial institutions in the past 12 months. In this roundtable sponsored by NORD/LB, issuer, investor and rating agency representatives discuss the dynamics shaping issuance as well as the mortgage market and regulatory outlook.

Neil Day, The Covered Bond Report: Frederik, we're at the end of another busy year in the euro covered bond market. What's have been the key dynamics and how has the UK fared in this?

Frederik Kunze, NORD/LB: We have not really been surprised at the volume of euro benchmark issuance, more so how this evolved over time. It sometimes felt a little bit like a "stop and go" market. We saw less than expected from Canada, for example, while we saw a little more from other jurisdictions, such as Austria. One of the strongest trends was how many short dated covered bonds we saw, with factors on both the supply and demand side explaining why we rarely saw a 10 year benchmark. But overall we can acknowledge that covered bonds once again earned their keep in the funding mix of issuers, while investors were willing to absorb the supply.

We faced a new situation with the ECB pulling the plug on primary purchases and then quite quickly secondary market buying. For UK euro benchmarks, this does not have a direct impact, of course, but there have been substantial second round effects, and more generally the change in the monetary policy environment led to spread widening, also for UK covered bonds. This can nevertheless carry some good news for UK names, because when spreads widen, investors tend to become more selective — even more so when liquidity is not so abundant anymore — and favour those issues of high credit quality, particularly when they again offer some kind of spread pick-up against, for example, Pfandbriefe. This would very much apply to UK covered bonds.

In terms of volumes, we had forecast around €4bn of UK euro benchmarks, and we saw €3.5bn. This is similar to 2022 but well above the preceding years around the pandemic. So while there are good reasons why euro covered bonds are not the first port of call for UK issuers — notably the attractiveness of sterling, which I'm sure we'll hear more about — UK covered are still on the menu for euro benchmark investors.

Ana Cortés González, JP Morgan AM: We finished 2022 with historically high euro benchmark covered bond supply of €200bn and expectations for 2023 were around €170bn, but we have reached €190bn, so a little bit more than anticipated. This extra amount was somewhat driven by SVB and Credit Suisse, which meant the market for financials was closed for some time. If an issuer wanted to come to market, the only option was a covered bond, in the sense of having low execution risk and a sensible spread, and indeed the market was reopened with a covered bond. So this uncertainty maybe led some issuers to come with more covered bonds than they had planned.

Regarding the UK, there were only a few euro benchmarks, with the bulk of covered bond issuance in sterling. I can see how that makes sense from the issuers' perspective and all the deals went very well — there has certainly been demand for UK covered bonds, as well as UK prime RMBS, in sterling — while they may face costs associated with euro issuance. I like UK covered bonds and have no problem investing in sterling, while I will also look at any euro issuance — it's always a question of relative value, taking into account the structure, the collateral quality and the spreads.

Day, The CBR: Krishan, how have you found market conditions?

Krishan Hirani, Nationwide Building Society: The market has been increasingly

Participants in the roundtable, hosted by NORD/LB in London on 7 December *(left to right):*

Krishan Hirani, head of secured funding, Nationwide Building Society

Pascale Dorey, debt investor relations and senior funding, Lloyds Banking Group

Paul Millon, AVP analyst – covered bonds, Moody's

Neil Day, managing editor, The Covered Bond Report, and moderator

Philip Hemsley, head of capital markets, Coventry Building Society

Parul Pujara, wholesale funding manager, TSB Bank

Ana Cortés González, portfolio manager, JP Morgan Asset Management *(not pictured)*

Frederik Kunze, floor analyst covered bonds/ financials, NORD/LB Floor Research *(not pictured)*

challenging as we've gone through the year. The market was strong at the beginning of the year, which was a perfect backdrop for our €1bn five year deal in March. That was at mid-swaps plus 24bp with a negative new issue premium. You then compare that to our €1bn five year last month at 41bp, where we paid the going rate of 3bp-4bp of premium in addition to the widening in spreads we have all experienced through the year. That just gives you a sense of how conditions have changed.

It's been a year dominated by central bank policy and rate expectations, and issuers have above all had to navigate that. There have been periods where the markets have needed time to digest supply and adjust to new rate forecasts, so issuers have had to bide their time, take a view on how things are going to play out, and then decide how to proceed.

That said, markets, and in particular covered bonds, have been surprisingly resilient to geopolitical developments such as the two wars underway. The news flow from these regions has been terrible but it hasn't had much impact on the functioning of wholesale markets, and we've experienced this with other shock events in recent years such as the pandemic and Brexit.

Day, The CBR: Pascale, Lloyds was the first UK issuer into the euro market, with a €1bn (£860m) three year in January. What's been behind your funding strategy this year and how successful has your issuance been?

Pascale Dorey, Lloyds: We were able to achieve what we planned and complete our 2023 funding plan. On the unsecured side, we issued capital in Q1 and, looking back, that was a great decision, even if there was an element of luck about it. Issuance conditions in the first quarter were clearly strong and we decided to issue then even if we didn't really need to given the levels we were running at. That put us in a good position for the year, especially as the AT1 market effectively closed for a couple of months afterwards.

On the secured side it's been an interesting year. Levels were very tight and so although sterling was tighter than euros, we were able to issue in euros probably around 12bp tighter than where we would issue in euros today even if in January there were

Pascale Dorey, Lloyds: 'RMBS spreads have been extremely tight, almost inside covereds at some point'

still technical questions around LCR eligibility, which seem to have faded further into the background now.

But what's been most interesting for us this year is the resumption of RMBS, which we hadn't issued for some time. RMBS spreads have been extremely tight, almost inside covereds at some point, which makes it really attractive for us and other issuers. So we've issued almost as much RMBS as covereds this year, whereas you would typically see more of a skew towards covereds.

In total, we've issued about £15bn this year, which is close to where we were pre-pandemic, pre-TFSME. Our run rate would typically be £15bn-£20bn, and in 2024 we're looking at closer to £20bn, so really back to pre-pandemic volumes. That takes into account TFSME repayments, where we have maturities in late 2025 onwards.

Day, The CBR: Phil, perhaps we can look back a little further, since your last euro was in September 2022 — how has your activity developed since then?

Philip Hemsley, Coventry Building Society: 2022 was an unusually quiet year for us. We did the €500m deal, which we spent a lot of time and diligence on, making ourselves comfortable there was going to be demand, because the LCR discussion was very much live at that time. It went very well and the reception was probably better than we expected — we'd been anticipating a book of perhaps €750m and it reached €1.3bn. It wasn't the cheapest trade on earth at the time, but the way the world's moved since then, we're glad to have got the euro under our belt.

That set us up nicely for this year, when we've been able to focus on sterling. We did have a euro in the plan at various points, but the strength and cost-effectiveness of the sterling market has simply kept us away from that. We did a £500m covered bond and a sterling RMBS in the first quarter, and they were both very well received. We then came back with another RMBS, which chimes with what Pascale was saying about the differential between RMBS and covereds — by some measures, our RMBS was flat to a three year covered. So overall the sterling market has just been super-supportive.

The backdrop to our funding need has been a slower mortgage market and a pretty buoyant savings market, so given that we are mainly retail-funded and only do mortgage lending, what we need to do from a wholesale funding point of view has been squeezed — further explaining why any thoughts of a euro covered fell away.

Besides the secured funding, our most strategic trade was our £400m senior non-preferred deal, which gets us ahead of the future MREL need we'll face when we go past £50bn of deposits. Again, we got really good support from the sterling market.

Day, The CBR: Parul, how does TSB's experience compare?

Parul Pujara, TSB Bank: It's been a relatively busy year for us. We stood back from the covered bond market in 2022, so effectively made up for that in 2023. We issued £1bn in the first quarter because, as mentioned, markets were quite constructive back then, though admittedly very crowded. The timing of our results actually work in our favour because we don't immediately rush out of the doors in January when it's already busy and there's so much competing supply on screens. We typically wait until February, which worked well for us this year as conditions were still supportive at this point. January's trade was actually our largest ever covered bond: our trades are normally a maximum of £500m in size, but demand in Q1 was strong and we saw that there was an opportunity to upsize to £1bn, so we took advantage of that and took the additional funding whilst it was there. We then accessed the market a second time this year, printing £750m in September, which was another upsized transaction. We also did a liability management exercise alongside this new issue, which was a great way of de-risking the execution by freeing up investor lines. Investors were very receptive to the buyback as it gave them the opportunity to offload their Feb 24s and participate in the new deal, so it worked well for everyone.

Overall, we've been broadly on plan with what we had set out for the year, which was to do around two or three trades. We've also been monitoring the euro market, but for the reasons already mentioned, that hasn't really been favourable, so for the time being it's made the most sense to keep to sterling, whilst levels have remained relatively tight. We'll continue to monitor that space and hope to issue in euros in 2024.

Day, The CBR: Last, but not least, Krishan, Nationwide has been very active this year across a variety of markets and formats. You mentioned earlier that markets have been increasingly challenging — what has been your strategy this year?

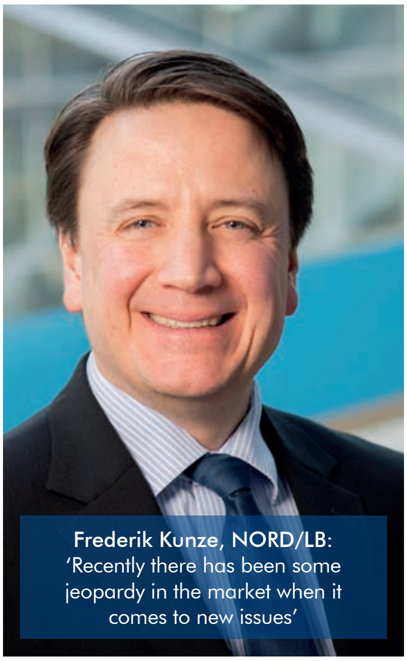
Hirani, Nationwide: We've issued more than £5bn of covered bond funding in the calendar year, including five benchmarks and across five currencies, and are on track to meet our funding requirement for the financial year to 4 April. Diversification has been important to us to be able to achieve these volumes. I completely agree with the sterling comments — the sterling market has been fantastic in terms of cost — but if you've got aspirations to do five or six billion of secured funding in a year, you can't do that in a single currency, and especially not in sterling. That's why we have put a lot of emphasis on not only sterling and euros, but also dollars, Swiss francs, and Norwegian kroner, which have all been interesting at various points of the year and have given us options to access certain markets when others may have been more difficult. It's been particularly helpful to be able to navigate the challenges I highlighted earlier.

Some of our recent increased level of activity in recent months is explained by our expectations for 2024: we think the trajectory of spreads and overall market backdrop will continue, with potentially more headwinds in the coming year. The rates headlines will continue in 2024 and in addition to that you have central bank refinancing, elections and further geopolitical risks. The impact of all of this combined on both retail and wholesale markets is uncertain and so we have tried to position ourselves for this and frontloaded some of our funding into the last couple of months of this calendar year. Saying that, we expect to still have a similar volume of funding to get through in our next financial year, so we'll be busy again and expect to access a similar array of markets and currencies.

Day, The CBR: Frederik noted earlier the prevalence of short dated issuance this year in euros — Nationwide has been particularly active at the long end in past years, so how have you coped on that front?

Hirani, Nationwide: Indeed, the headwinds I mentioned have had not only had an impact on spreads and the market windows we've had to navigate, but crucially they have had an impact on the availability of duration, particularly in covered bonds. Nationwide historically — and hopefully going forward, too — has seen covered bonds as an opportunity to extend the duration of our wholesale funding base, which is why in the past we've done trades like 10 year sterling, and 20 and 15 year euros. We like having those options and we try to use them when appropriate, but this year none of them have been on the table; most of the funding we've done has had to be short or mid-dated. We did try to extend to the extent that we could: on that first euro trade we pushed to get the five year tenor, and for the sterling trade we did a month ago, seven years was something that hadn't been tested for a while so getting that done was fantastic.

I think duration in euros has been the underwhelming story of the year, as Frederik already mentioned. It's rate volatility that has really killed that market: it's not so much that rates are rising — higher rates are good for investors, they're getting much more yield as they extend along the curve; what investors don't like is the volatility, the risk that they invest in a trade in the morning at an expected yield of x, and then by the end of the day or by the end of the second or third day, the market has completely moved. What we are hoping for next year is stability in rates, which should open up the longer end.



Frederik Kunze, NORD/LB: 'Recently there has been some jeopardy in the market when it comes to new issues'

Cortés González, JP Morgan AM: I guess issuers in general would love to print longer-dated covered bonds, because we've only seen very strong short term issuance, and this is normally a product used for seven, 10 years and longer funding. But it's highly dependent on how the market looks. In 2023 there were only very few opportunities for issuers to go longer at a reasonable spread, and I'm not sure whether we will see more long-dated supply, either in sterling or euros.

The sterling market has developed very nicely in three and five years for some time now, but seven years is still not a maturity that is used very often. And from an investor perspective, if you go into maturities where there is not much enough, liquidity can be quite challenging. I would tend to prefer issues in three or five years — assuming I like the relative value in general — simply because market depth is better. If issuers want to go out to seven years, they might have to do more to develop this part of the curve to make it more attractive.

Kunze, NORD/LB: Recently there has been some jeopardy in the market when it comes to new issues, and the longer end of the curve is exactly where we could see a mistake, because it's really difficult to find the right price when there has been so little supply — the only comparables are lower coupon deals from past years and the situation is now completely different. Meanwhile, it's not clear how much issuers are willing to pay to extend along the curve. There may be some issuers willing to test the long end at the very beginning of the year, but the appetite is not so high so timing will be crucial. Later in the year, when, hopefully, the swap curve is no longer negative-sloping, the situation could be quite different and we could see more and more longer dated deals. Our economists currently expect the curve to change thus at the end of the third quarter, but you never know — we have renewed volatility when it comes to the question of what the ECB will do. Anyway, if there is little pressure to extend duration, it might not be the best strategy to go to the long end for now.

However, the topic of ALM mismatches is coming back to the surface. We haven't heard much so far from the rating agencies about what risks these might hold for ratings or overcollateralisation requirements. But if this becomes pressing, some issuers might be willing to take a hit in terms of spread.

Paul Millon, Moody's: The short term maturities are clearly something we've seen from the UK, but also in pretty much every market in 2023. This doesn't impact our analysis, per se. Although short term issuances increase the maturity mismatch with the assets, in our model we already typically assume that at least 50% of cover pool assets will need to be refinanced following issuer default. So we don't adjust our modelling in response to real time fluctuations in new issuance maturities.

Day, The CBR: Pascale, how important are duration and the euro market

for Lloyds when it comes to covered bonds?

Dorey, Lloyds: Investor diversification is key for us. As mentioned, the sterling market has been extremely strong recently, but it's really the UK bank treasuries that have supported the market and we're quite conscious that relying on them is not going to be sustainable in the long run, so there's definitely a focus on diversifying away from that one investor base. At the same time, it has been a very good market in terms of pricing and overall conditions, which is why we issued two sterling covered bonds this year and only one euro covered bond.

In terms of tenors, we are inclined to issue shorter dated covered bonds given the kind of duration of our assets — that three to five year bracket actually works pretty well. To the extent that we get diversification with longer dated issuance, we'd definitely consider that. But in terms of asset and liability matching, for us the natural issuance would be around five years, and then we get a bit more extension in wholesale funding via other products — at the HoldCo, senior, capital would typically be a bit longer dated.

Day, The CBR: Talking about diversification, is dollars — which Lloyds has used for other formats — something that is of interest for covered bonds?

Dorey, Lloyds: We issue in dollars at the HoldCo, but haven't done dollars at the OpCo for a long time. Clearly you pay more, while investor diversification is there but only to an extent — you can be selling bonds at a higher spread to the same investors who would buy you in sterling. And we haven't really needed to go beyond cheapest-to-deliver sterling in issuing £2.5bn of covereds this year — except a Swiss franc issue, but that was inside sterling, and we'd probably look at other currencies like that before dollars because of the aforementioned limitations.

Hirani, Nationwide: Indeed, when it comes to currency diversification, it all depends on the quantum of requirement. Like I said, you cannot do more than a certain amount in sterling even though we'd all love to. Saying that, given our experience in the three markets we accessed in the past month, I do think there is diversification there, and a significant amount of it. You cannot stop investors who have multi-currency capabilities playing in all the trades — they will, and on one level that's good, as it helps your transaction; what you can do is allocate bonds to the target market that you're looking to look issue into. Our US dollar transaction had 40% non-European participation and to me that is significant — it was the rationale for doing that. Within the 60% that went to Europe, split across UK and other European investors, yes, there is some crossover with not only sterling, but also euros as well. But the diversification we achieved into North America was the purpose of the transaction.

Philip Hemsley, Coventry: 'The two things we like from euros are the diversification and the fact that you could take a little bit more duration'

Day, The CBR: Parul, the same question for you on the importance of duration and euros.

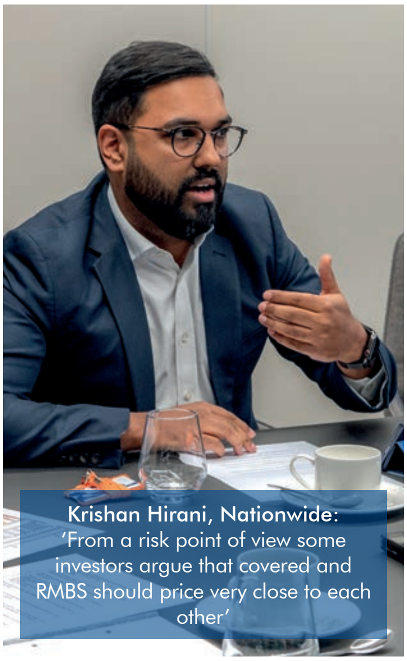
Pujara, TSB: I would echo much of Pascale's comments. The three to five year bucket has worked well for us too this year, and it's what investors have wanted, so it ticks both boxes.

As I mentioned previously, we have been monitoring the euro market for some time now. When we do decide to tap the euro market, we're conscious that it will be our debut trade, so timing and pricing will be crucial. We accept it will be expensive relative to sterling — given it'll be TSB's first, we also need to factor in an inaugural issue premium on top of that sterling-euro differential — and we expect to see a lot of the UK buyers of our sterling bonds in the orderbook, given the attractive pick-up, so the first trade will be less about diversification and more about establishing a presence in the euro market. But we're mindful that the sterling market is small and credit lines get used up really quickly, so the diversification into euros is important.

Day, The CBR: Phil, you mentioned that you will keep an eye out for euros next year — how important is that and duration?

Hemsley, Coventry: The two things we like from euros are the diversification and the fact that you could take a little bit more duration. The two three year trades and the five year we've done in the secured world this year work fine, but the preference is more that five to 10 year bucket. Apart from the last euro, in 2022, where the market wasn't there for a seven year, every euro trade we've done has been seven years — it falls quite nicely into that bucket and you're getting genuine diversification in terms of investors. And the duration is a bit further than you could generally do in sterling. So yes, euros is a key market for us.

To an extent, it plays into what Krishan said about how diverse you need to be depending on the quantum of what you've got to do. After 2022, 2023 has been a more typical year for us, and if you're doing one covered bond and maybe one or two RMBS, then you can probably get away with just playing in sterling. We're looking at dollars for RMBS and euros for covered bonds, and in the fullness of time could look at other currencies, but for the time being, if we've got one deal to do, it's natural to look at the cheapest to deliver. Next year we expect to do one euro and one sterling, just to be active in both currencies where we have established a presence, but it all depends on demand on the retail side, too. If there isn't much more mortgage growth and retail savings keep performing well, then one of those could get squeezed, and there's always a chance that's going to be the euro if that's the most expensive option.


Krishan Hirani, Nationwide: 'From a risk point of view some investors argue that covered and RMBS should price very close to each other'

Day, The CBR: Let's focus a bit more on RMBS now. That's something I believe you are all interested in as an option and now seems to be on the table at levels roughly flat to covered bonds in sterling. What are the dynamics behind that, do they make sense, and are they sustainable?

Hirani, Nationwide: Both markets are important. They coexist, albeit there is some overlap in the investor base. However, there is also a significant portion of the investor base that is bespoke to each asset class or will have specific cash for each product, so you are achieving diversification.

Am I surprised that they are pricing so close to each other at the moment? A little bit. Historically, the average differential between the two markets has been anywhere between 5bp and 15bp, so to see them essentially on top of each other is unusual. However, if you think about the technical side of it, the covered bond market is a lot more supplied than the RMBS market, and it's supply that's been the biggest driver of that narrowing differential. As long as that dynamic is broadly there, I think the situation will persist — investors are clearly getting comfortable with buying one close to or on top of the other.

We've always argued internally that the assets are the same — both are triple-A rated products — and from a risk point of view some investors argue that they should price very close to each other. So you're really drilling into some of the structural, technical differences if you want to apply a material differential.

We do expect RMBS supply to pick up next year. TFSME refinancing is going to be a big factor in that. There are a vast amount of TFMSE drawings in the UK, and although it feels like a lot of that can be repaid without too much trouble if you look at LCR ratios, if you look at the list in a granular way, there are a number of borrowers who potentially only have RMBS to go into to be able to fund their repayments. So you should expect to see more supply, which may have an impact on that RMBS-covered differential next year. But we shall see.

Dorey, Lloyds: I would echo those thoughts. They are indeed very close to each other. There are reasons both on the issuer side and the investor side that would argue for RMBS to be slightly more expensive, so as an issuer it makes sense to make the most out of these pricing conditions. As Krishan mentioned, supply is likely to increase. You're probably not going to get to that 10bp-15bp kind of differential, but you will probably see a bit more differential over the next year or so.

Day, The CBR: Phil, you mentioned dollars as an option on the RMBS side.

Hemsley, Coventry: An expensive option, at the moment.

Day, The CBR: Expensive just because sterling is so good, or actually kind of in itself?

Hemsley, Coventry: A combination of the two. Sterling being so good is definitely a driver. But also the US investors have a huge array of products they can buy, and therefore to look at UK issuers and UK RMBS, they will expect a bit of a premium. It's an option in the long run and certainly our RMBS platform was set up to ensure we can do dollars when it was established in 2020. Again, it comes down to the quantum of requirement.

On the pricing difference between RMBS and covereds, I remember getting told not so long ago it was 10bp as if that was almost set in stone. Then people seemed to say, oh, it's 5bp to 10bp. And obviously that's all gotten thrown out the window. I think there'll be more issuance on the prime side and that will probably see pricing drift wider and some of that differential reappear. But this year we've certainly encountered plenty of demand when we've issued, and there's just not the supply.

It feels logical that covered should be tighter than RMBS because there's the dual recourse, but the other side of that coin is that with RMBS you're a bit more isolated from the from the originator, the sponsor, and you're just looking at the loan book. UK mortgage quality has managed to stay pretty robust and in a world where things can happen to the sponsor bank, maybe just having exposure to the portfolio isn't a bad thing.

Dorey, Lloyds: You also have extension risk with RMBS.

There's typically the argument that with a covered bond, you can move a lot more quickly, and that has really made it attractive for issuers, in that you can be more reactive to market conditions. But then again, we've now seen Nationwide's innovative "stock and drop" RMBS, so that's could be changing, and maybe you will be able to come to market a lot quicker next year.

Hirani, Nationwide: One of the biggest issues with RMBS has always been how long it takes between making a decision to do a transaction to being in the market and able to execute it. A lot of work and process needs to go into it and you can't avoid that, but it can up to eight to 12 weeks. This means that we as funding officials can't take a view on the market or be nimble to take advantage of opportunities.

So essentially the idea is, you do all of this work once a year, and then you self-issue an amount of bonds, which we're calling the "stock", that is reflective of your upcoming year's expected funding programme requirement. So Nationwide holds these bonds, but they are real, they're fully documented, all of the diligence and structuring has been done, and they're ready to be sold. So if and when you decide that you want to

Paul Millon, Moody's: 'Loan resets will be a key theme next year. We expect a little bit of a pick-up in arrears, but nothing significant'

come to market with a transaction, you can do so within days of making that decision. Previously, if we were discussing what our funding options are and what markets are open to us over the coming days and weeks, our Silverstone RMBS programme was never a part of that conversation. Now it is very much part of that conversation alongside covered bonds, alongside senior funding, which puts it on a level playing field. We can use it in a lot more agile, reactive way to market dynamics and conditions, which is hopefully going to be positive for us, mainly, but also for investors, because they'll probably see more of it from us and benefit from the liquidity.

Day, The CBR: Paul, what's the view from a rating agency perspective?

Millon, Moody's: I agree with what Krishan was saying about the assets being basically the same when it comes to prime RMBS and covered bonds. And in fact, we do analyse these in exactly the same way, with the same model and methodology. We do then give some benefits to covered bonds because of not only the dual recourse, but regulations as well, and we expect that in a stress scenario — where in an RMBS the assets are deteriorating — issuers of covered bonds will probably clean the cover pool to maintain their ratings. So investors get some benefit, and from a pure credit standpoint, you wouldn't expect an RMBS to be priced inside a covered bond. So I would agree that supply and demand is the main factor.

Day, The CBR: Ana, how do RMBS and covered bonds compare from your point of view on the buyside?

Cortés González, JP Morgan AM: I cover RMBS and covered bonds and I'm a big fan of both products. UK RMBS went through the entire financial crisis and, apart from one hiccup, the large UK master trusts behaved exactly how they should have done and emerged pretty much unscathed. So from a structural point of view, I've never really doubted this product — it is as sound as it can be. Furthermore, structures have improved since the financial crisis. But then after the financial crisis this floating covered bond market suddenly appeared in the UK, with three and five year issuance, and it has developed since then.

Historically, RMBS traded at a pick-up of roughly 10bp-15bp over the respective covered bond; now, we are seeing RMBS trading more or less in line with the covered bonds. It is true that RMBS has returned this year after there was hardly any supply in the prior two years, as banks did not need the funding. While there is an overlap in the investor bases, with some buying RMBS as well as covered bonds, some do not. This has contributed to all the UK prime RMBS deals going very well.

In terms of the credit quality, there's not much of a difference between the collateral, especially in prime RMBS. When you go into other RMBS sectors, it's different, but when you look into the same issuer's covered bond pool and RMBS pool, there may be differences, but they are only minor, and it's very hard to put a number on what this might be worth in terms of basis points. And yes, you can argue that from a structural standpoint the RMBS might have more extension risk, and it's important to acknowledge that these differences are there and can be important, but at this point in time, it's hard to say from an investor perspective that an RMBS should be paying, say, 5bp more. That could change, but it's reasonable for RMBS and covered to be trading roughly in line for now.

Kunze, NORD/LB: The UK is quite a good example of a well-functioning blended market, where you have both means of funding.

In general, I would say that covered bonds are for technical reasons more secure for investors, because in a very severe scenario you have various kinds of protection — the exemption from bail-in, for example. And if this plays out differently in the market — as is evident from other comparisons, such as covered bonds and sovereign spreads — it is a question of liquidity, or the desire for diversification, or supply and demand. There could also be an element of the dynamic nature of cover pools being more demanding to monitor than RMBS assets if they are actively managed, for example checking when new loans could be coming into the pool with lower mortgage rates than the interest paid on the covered bonds.

Investors could currently see some kind of appeal in UK covered bonds, with the strong focus on residential mortgages, when cover pools in some other countries like Germany are so dominated by commercial real estate. But then we should perhaps discuss what is on the cards for UK covered bonds with the higher interest rates. We haven't yet seen all the pain from this yet in the UK. On the other hand, while many households still have large amounts outstanding on their mortgages, it's not so much when compared with the value of the property. Meanwhile, banks currently have higher profitability thanks to higher interest rates, although when higher risk weights kick in due to the economic cycle, the profitability of banks may not be as strong anymore.

So investors should be doing their homework to understand what's behind the instrument they are buying, whether it's a UK covered bond or a Pfandbrief.

Day, The CBR: Let's stay on that topic of credit quality. We've already heard some encouraging words about how the housing and mortgage markets have performed so far, but there have been headlines about "mortgage timebombs" from upcoming resets at higher rates. Is there pain to come?

Millon, Moody's: These loan resets will be a key theme next year. We expect a little bit of a pick-up in arrears, but nothing significant. For us, the main thing is that unemployment with remain fairly low. As long as you have a job, you pay your mortgage. Unemployment has been low for a while and we expect it to stay low next year too, even if it goes up a bit.

In UK cover pools, most of the loans are short term fixed rate, up to five years. We looked at the fixed rate loans in cover pools, and the average interest rate paid on them has only slightly increased since the end of 2021, by just 60bp, while new fixed rates have rocketed by over 3%. So we estimate that only 20% of the increase in rates has so far been transmitted to fixed rate cover pool loans. 80% of cover pool borrowers have short term fixed loans and many of them are going to be hit by the higher interest rates in the near future. But again, with continuing low unemployment, borrowers will generally be able to tolerate higher mortgage payments, so we expect a moderate increase in arrears rather than a big spike.

In terms of the new borrowers, several factors have so far offset the impact of interest rate hikes. The decrease of the affordability stress from 3% to 1% has helped, while the spread between mortgage rates and benchmark yields has contracted by around 2.5% since 2020, which has softened the impact of higher rates on borrowers. We've also seen a steady increase in the duration of new mortgages, with the share of 30-plus year terms increasing from 20% a few years ago to close to 35% of originations, which reduces payments for borrowers. The downside is that longer terms result in higher debt burdens and slower amortisation, which is negative from a credit perspective.

Covered bonds are well placed, as Frederik mentioned. There is a lot of OC in the cover pools, much more than we require for our ratings, and we know the FCA is kind of encouraging issuers to maintain high levels of OC. LTVs are very low. We've seen house prices decline recently, but if you look back just a little, even between Covid and last year, house price increases greatly exceed the slight decrease that we've seen this year. So a lot of equity has been built up in the pools. Yes, house prices might decline a bit more in 2024, but we did an exercise where we calculated what we call the breakeven house price decline — by how much house prices have to decline before the value of properties is less than the covered bonds that have to be repaid. Accounting for LTVs and OC, the average breakeven decline for UK cover pools is 70%. So there are a lot of structural protections for covered bonds against any potential weakening in the housing market.


Parul Pujara, TSB:
'Lending criteria have been strong in the UK for a number of years now'

Day, The CBR: What are the issuers seeing in their loan books and what are your expectations for the overall market?

Pujara, TSB: Lending criteria have been strong in the UK for a number of years now, helped by a number of regulations, so asset quality has held up well, and that is common to all UK covered bond programmes. The fact that not many borrowers are taking out the provisions of the recent Mortgage Charter evidences that, which is encouraging to see. We could also see more regulations coming in or more support for struggling borrowers from the government, driven by the cost of living.

Dorey, Lloyds: Most of our book is fixed, with about a quarter rolling off every year, and then we have the floating rates as well. We've seen over half the book reprice now onto the higher rates, and in terms of cost of risk, we're still guiding for very low levels, below 30bp, which is around where we used to be in a fairly benign year pre-pandemic. A lot of factors are helping, but clearly the fact that wage growth has been quite significant has helped offset some of the pressures. And when we look ahead, inflation is starting to come down. Famous last words, but I think peak mortgage rates are behind us, and we didn't see a huge level of activity when mortgage rates were 6%, 6.5%, obviously, because they weren't attractive to borrowers. So whilst we're never really going to go back to the ultra-low mortgage rates you had in the pandemic, we are looking at potentially improved conditions into next year, with lower mortgage rates. We still forecast a small decrease in house prices, but that probably makes the market slightly more attractive for first time buyers, and you should hopefully see a pick-up in that activity, while, as Paul mentioned, unemployment remains low and supports repayment ability.

Hemsley, Coventry: Arrears-wise, we're seeing an increase, but it's not at all dramatic. We are tracking back to the kind of levels we saw in the early 2010s, which was a relatively benign time. We're not seeing any higher incidence of arrears in customers that have come off one rate and gone onto a higher rate. The calls that we get in our collections department are still the same flavour they've always been: divorce, bereavement, injury, unemployment, the latter being key. They're not getting a huge incidence of people who are still in their job but are facing problems because everything's now costing more. About 92% of our book is now post-2014 mortgage market review loans and we have less than 20 repossessions in that part of our book — it does feel like that potentially made the UK mortgage market a lot safer for lenders and we are seeing the benefits of that now.

Day, The CBR: Ana, do you have any concerns regarding UK collateral?

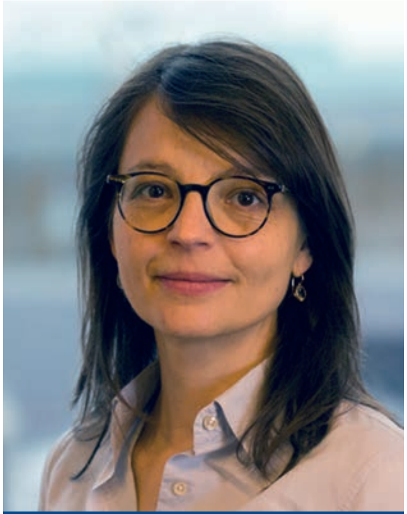
Cortés González, JP Morgan AM: I don't have any particular concerns, as such, but I'm always vigilant. I would agree with some of the points already made. I look at the RMBS investor reports to get a picture on the covered bond side, too, and they all show very stable performance. I would expect that as people refinance into higher rates, there might be a bit of an uptick in arrears, and potentially a bit of a decline in CPRs, but this is coming from very low levels.

I would echo the point on unemployment, which is the most important aspect. Looking at the period during and after the financial crisis, the performance in UK prime RMBS pools was very good, and a lot has happened since then: banks having tightened their underwriting criteria and met new regulatory requirements. So overall collateral quality has improved and certain products are not available anymore. Additionally, people have jobs. I've seen charts showing a strong correlation between the UK unemployment rate and delinquencies, and there is of course a strong link: if you have a job and can pay your mortgage, you pay your mortgage, because it's the roof over your head — this is not speculation — and once you default, it's not so easy to get back on your feet, so you only go down that route if there's literally no other option. But we are talking prime borrowers here.

So net-net, although it's always worth keeping track of how the situation is evolving, I don't foresee a significant deterioration of the overall performance.

Day, The CBR: Going back to the LCR issue that was mentioned a couple of times earlier, how has that played out?

Hirani, Nationwide: Pascale mentioned earlier that it's not really a hot topic anymore and I would agree. We've seen proof of that in the four UK euro trades this year — all have had very healthy participation from European bank treasuries, which are the LCR buyers in question. More was made out of the issue than it actually was, and quite positively over the last few months one or two of the investors who may have been the more vocal from the start have revised their internal positions. Only one or two investors — and small ones, at that — mentioned regulatory uncertainty as a reason not to participate



Ana Cortés González, JP Morgan AM: 'Overall collateral quality has improved and certain products are not available anymore'

on our euro deal last month, so I'd like to think we're 95% there on the LCR issue so have moved on from it — which is great, because we can focus on other matters and look forward to achieving third-country status under the new directive in the future.

Kunze, NORD/LB: The issue arose from there having been no clear answer from any authority on whether the UK is equivalent in its supervisory regime and other aspects — the answer was that it's a case by case basis matter. We might get some help on this from future EU or Basel measures, but I'm not 100% certain that any EU bank treasury will get a definite yes when asked if they can treat UK covered bonds as LCR-eligible — this is what we hear from the investors. They need to prove it, and while Canadian and APAC names are on a list, the UK isn't. However, this has been overcome by many market participants because the LCR treatment is not the only relevant investment factor; it's more a cosmetic aspect for many, but investors will buy UK covered bonds for other reasons.

Hirani, Nationwide: Yes, when the concerns were initially raised, the solution in the eyes of investors was to seek an official list with the UK on it. It then took some education from a lot of people, including those around this table, explaining to the investors that we're not going to get a list, that's not how this is going to work. Therefore, we explained how on a fundamental basis the UK framework is equivalent. Firstly it hasn't changed from two years ago, but secondly, it is equivalent, if not stronger, than both the existing and the new directive. Finally, investors needed to be aware that they could individually make their mind up, and not have to wait for something official and speak to their regulator. Once investors understood this, that opened the gates.

Cortés González, JP Morgan AM: LCR treatment is not a consideration for us. If we look into a UK covered bond, whether or not we participate is entirely driven by our credit as well as our relative value view. I do monitor the situation, and I can understand how it can be more important for a bank treasurer, and hence that third country equivalence could be beneficial for the issuers. But for me what is important is to understand the structure, the collateral, and the relative value at the point in time if and when a covered bond comes.

Day, The CBR: Fred noted that there could be forthcoming EU moves related to the treatment of UK covered bonds. What are expectations regarding third country equivalence pursuant to the covered bond directive?

Millon, Moody's: We would definitely it see as a good thing were the UK to be recognised as a third country under the EU directive. But it's a long way away. It keeps being postponed and the new target date for the EBA to give their feedback to the Commission is June 2025. And then after that, everything needs to be put in place from a legislation standpoint, so it will be a number of years before we see any third country equivalence. The Commission hasn't even produced a framework of how they are going to look at equivalence. We don't think it will be necessary for the UK regulations to match the EU directive line by line, but it's likely that some changes to the regulations will be needed to qualify for equivalence. Then there is the question of reciprocity, that is whether the Commission would ask the UK to recognise EU covered bonds the same way as they will be recognising UK covered bonds.

That isn't the case today so the UK would probably have to change that if it wants equivalence. Ultimately they could then achieve favourable treatment for NSFR, LCRs, under CRR, etc, which would be beneficial among investors.

We did a deep dive into the covered bond laws for all key third countries. We found that UK regulations are more or less aligned with 75% of the directive, second only to Canada. Looking at the implementation of the directive in the EU, some countries took the opportunity to remove aspects of their national laws that exceeded the minimum required standards. In Portugal, for example, they had a strong law and aligning with the directive reduced some benefits. If the UK chooses to do the same, there are areas where we could see a loosening, like the 8% OC requirement that might come down to 5%, for example, while the treatment of exposures to credit institutions is quite strong in the current regulations, so could be softened to be aligned with the directive.

Day, The CBR: Looking again at the year ahead, how would issuers sum up their expectations for 2024 — including potential Pfandbrief issuance when it comes to Lloyds?

Dorey, Lloyds: The German entity has Dutch mortgages and has done securitisations on those, and will potentially look at covered bond issuance next year. That will add to the funding diversification goal we were talking about.

Although there are naturally a number of considerations regarding asset and liability growth to factor in, overall for Lloyds you'll more or less see a balance sheet in a year's time that doesn't look that dissimilar to today — roughly flat on assets, roughly flat on deposits. There'll be a funding gap coming from TFSME repayments that we are looking at, with a late 2025 maturity for part of the loans and the balance being in 2027. So we expect to be more active than this year — probably stable at the HoldCo level but an increase at the OpCo level, really to pre-pandemic levels. That will mean more covered bonds and us being more active in the funding market overall. As I said, that could be impacted in movements in assets or liabilities, but that's roughly what we're anticipating.

Pujara, TSB: Next year will probably be about the same on the covered side. As Pascale said, we are not expecting dramatic change in the balance sheet or funding plan as it's looking at the moment. The slight nuance is that we've got our TFSME repayments as well, and to help support those we would like to be active in RMBS so we don't have to rely solely on the covered bond market. We've not been active in public RMBS since 2016, so it will be good to restart issuance there. There are also some unknowns on the mortgage side that could affect our funding plan next year. The mortgage market is of course very competitive and given some of the macro themes that have already been mentioned, activity could be quite muted next year, but we do have plans to maintain, if not grow, our market share. So we think next year's funding plans won't be too dissimilar to this year's, albeit with some diversification into euro covered bonds and RMBS.

'There are investors keen to be able to diversify a little bit'

Hemsley, Coventry: We expect to grow the mortgage book next year, but not dramatically, and we've got some TFSME to pay off — although we've already done a bit of the heavy-lifting in paying some off this year, and we're going into next year with quite a lot of cash on the balance sheet with the deposit growth. So after having done a covered, two RMBS and a senior non-preferred this year, there'll be a little more SNP to make sure that we meet the forthcoming MREL need, and I imagine we'll be active in our RMBS again, because the plan is pretty much to crank that handle and use it every year. And then at the moment we envisage two covered, one euro and one sterling, but if we get a little more deposits than expected, one of those could get squeezed out of the plan. So overall next year will feel a lot more like a typical year, and certainly so if both covereds stay in.

Hirani, Nationwide: We expect it to be another challenging year in terms of markets. TFSME is not going to be the driver of volumes for us — we've either already repaid it or it's been pre-funded and is being held as excess liquidity at the moment. Therefore, it's going to be the retail market that's going to drive the funding requirement. I agree with most of the comments, in terms of broadly stable mortgages, but it's deposits, as I mentioned earlier, that could be the big delta next year and we'll see how it plays out. That should all lead to a broadly similar funding requirement. The only difference you'll see is more RMBS in the mix — we've already told the market what that number might look like — and therefore probably as an overall mix, slightly less covered and slightly less senior preferred.

Day, The CBR: How do the issuers' plans fit in with expectations for overall UK and euro benchmark activity in 2024?

Kunze, NORD/LB: We expect €168bn of euro benchmark issuance overall in 2024, with €5.5bn forecast from the UK. There are €8.5bn of maturities next year in the euro benchmark segment from the UK, quite a bit, which means the UK will be one of the very rare markets with negative net supply, minus €3bn. This should support UK spreads relative to other jurisdictions.

I understand why some other currencies are more interesting, but we would not be unhappy to see more from the UK. Despite all the LCR discussion, I think there are investors keen to be able to diversify a little bit away from Austria, Canada, France and Germany, so more UK issuance could be good news for some investors, too.

Cortés González, JP Morgan AM: I would like to see strong supply in general coming into the market again in 2024. We had a couple of years where supply was muted, and — using an analogy from European ABS — there's always this risk that if you don't have enough supply, more and more investors will turn away, towards markets with more supply. So the more supply we see in covered bonds, the better it is for issuers, for investors, for the entire market community. ■