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The covered bond asset class: an attractive investment compared to other high-quality liquid assets

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- **Covered bonds are an essential financing instrument for banks in the euro area.**
- **ECB monetary tightening affects the covered bond market directly with the unwinding of CBPP3[1] holdings and indirectly with the TLTRO[2] repayment (freeing covered bond collateral).**
- **Mortgage loans are the main collateral for covered bonds. Housing has been hit by higher rates so that bank lending to households for house purchase shrunk.**
- **Covered bond supply should slow reflecting declining lending flows.**
- **Covered bond spreads tend to compare favorably to other similarly low-risk asset classes.**

[1] CBPP3: Third covered bond purchase programme conducted by the ECB
[2] TLTRO : targeted longer-term refinancing operations of the BCE towards banks

Covered bonds are an essential funding tool for banks. Covered bond supply has been strong in recent years as banks seek refinancing to repay TLTRO-III loans. However, ECB monetary tightening took a toll on residential investment and mortgage loan demand. Supply could slow going forward and help shrink CB asset swap spreads which currently trade around 30 bps. The covered bond asset class offer attractive value compared to other high quality liquid assets.

Covered bonds in a nutshell

Covered bonds (CB) are debt obligations issued by credit institutions which offer a so-called double-recourse protection to bondholders: if the issuer fails, the bondholder has a direct and preferential claim against certain segregated assets (mortgage loans or public-sector loans) and an ordinary claim against the issuer's remaining assets.

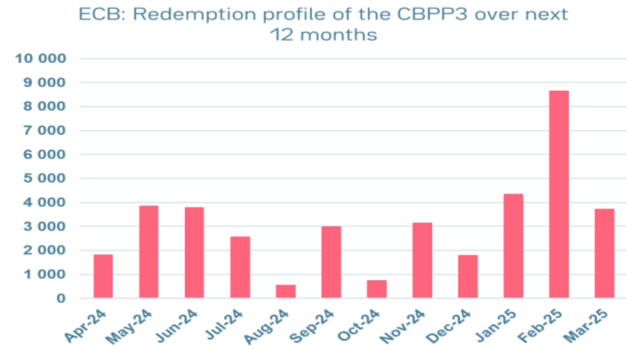
While securitization transfers some credit risk relating to the assets from the bank to the investor, covered bonds don't transfer the risk of the assets. The bonds usually pay down when the assets pay down. National regulatory regimes may vary in terms of supervision and composition of the cover pool.

The impact of ECB policy tightening

Covered bonds have been an essential funding instrument for banks. Covered bond shave been sold to the market or posted as collateral by institutions seeking long-term funding at the ECB. Indeed, collateral against TLTRO-III loans represented as much as 717 billion euros in haircut-adjusted value at the end of 2021. Covered bonds are category II assets or second-best after government bonds and similar low-risk assets. Applicable haircuts depend on the maturity, credit quality (steps 1, 2 or 3) and the structure of the bonds (soft bullet or pass-through for instance) and whether the covered bond collateral is for the own use of the issuers.

The ECB has a considerable footprint in the covered bond market via three covered bond purchase programs since 2011 or the collateral received against TLTRO loans. Remaining holdings in the CBPP 3 portfolio amount to 274.5 billion euros (March 2024) whilst CB collateral was valued at 463 billion euros at the end of 2023. Both asset holdings and loans are winding down. Maturities of the CBPP3 will amount to 37.8 billion euros in the twelve months to March 2025.

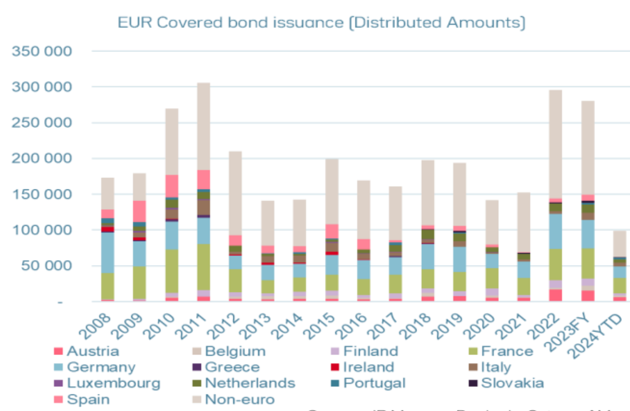
As the ECB's presence in the CB market declines, opportunities will arise for investors.



Source: ECB, Ostrum AM

Strong issuance backdrop

As the ECB takes a step back from CB markets, the issuance of covered bonds has picked up noticeably since 2022. The total borrowed by euro area financial institutions hit 200 billion euros last year whilst gross issuance already totals 62 billion in the first quarter of 2024.



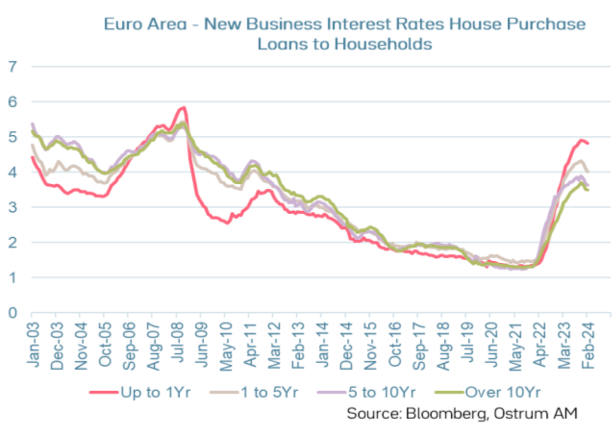
Source: JP Morgan, Dealogic, Ostrum AM

Non-euro issuers have increased their presence in primary bond markets. Institutions from Anglo-Saxon economies (Canada, Australia), Scandinavia (Norway, Sweden) and Asia (South Korea, Singapore) have issued a total of 131 billion euros last year.

Is the worst over for housing markets?

The collateral of covered bonds is mainly residential mortgages[3]. As such, a covered bond investment is a claim on the underlying loans secured by homes. Mortgage origination is therefore a good proxy for potential future supply of covered bonds, although there are limits to how much bank assets can be encumbered.

Euro area housing markets have gone through a soft patch as the ECB raised interest rates. Home prices only started to stabilize recently about 3 % below their 2022 peak. However, the stabilization of prices in aggregate masks considerable discrepancies in the region. The worst-performing housing market has been Germany, where home prices are down by 12.5% from their 2022 peak. On the contrary, prices in Portugal have increased continuously through the pandemic and the ECB's monetary tightening cycle. Home prices in Portugal have indeed doubled since 2015. Foreign investment has been very strong and is causing concern among the population as household income fail to keep up with housing costs.

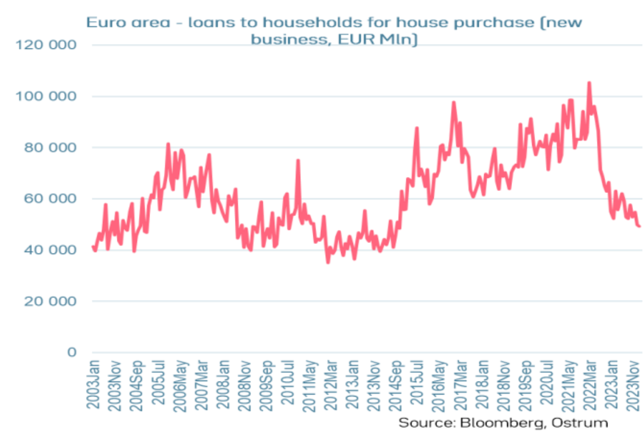


Mortgage borrowing costs have nearly quadrupled from pandemic lows in most countries. Besides higher mortgage interest rates, banks have tightened credit conditions through the third quarter of 2023 largely due to their low risk tolerance and their housing outlook. According to the ECB bank lending survey, the net share of rejected loan applications has indeed increased every quarter since the start of the ECB policy rate hikes in July 2022. In the fourth quarter of 2023, banks reported a further net increase in the share of rejected applications for housing loans (net percentage of 6%) but the increase was lower than in the previous quarter (12%).

Still, there may be light at the end of the tunnel. In the fourth quarter of 2023, banks reported no further tightening of mortgage credit standards in the four largest economies of the European monetary union. On the demand side, banks now face less negative demand conditions. Low household confidence and high interest rates still impact loan demand negatively but to a lesser degree. As the ECB begins cutting interest rates later this year, demand for house purchase loans should pick up.

Supply picture is mixed as mortgage loan origination plummets

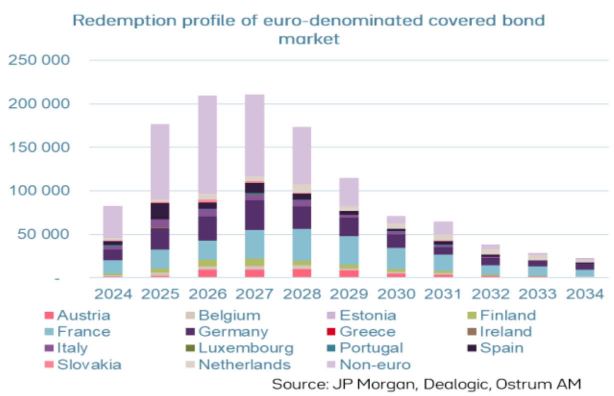
Though the outstanding amount of mortgage loans on bank balance sheets is just 0.5% below the peak, new loans to households for house purchase has plunged. Tight credit standards, less housing transactions and weaker home prices all weighed on bank lending activity.



New loans indeed slowed from 92 billion euros on average in the first half of 2022 to just 49 billion euros in February 2024. Net of monthly repayments, lending flows only rose by 8 billion euros last year and are down 26 billion euros in the first two months of 2024. Moreover, the average maturity of new loans has been reduced. Floating-rate loans have been in relatively higher demand than fixed-rate deals as borrowers expect the ECB to start cutting rates this year.

[3] NB: in this piece, we will leave out other collateral including public-sector loans and commercial real estate aside for the sake of simplicity.

Lower mortgage origination should weigh on the net supply of covered bonds in the years to come. Gross issuance will nevertheless remain high given the redemption profile of the asset class. As can be seen in the next chart, refinancing needs will rise to 200 billion per annum in 2025 and 2026 (half that amount will come from non-euro issuers). As per the main euro area economies, the maturity wall is somewhat closer in Italy and Spain (2025-2026) than in France and Germany (2027-2028).



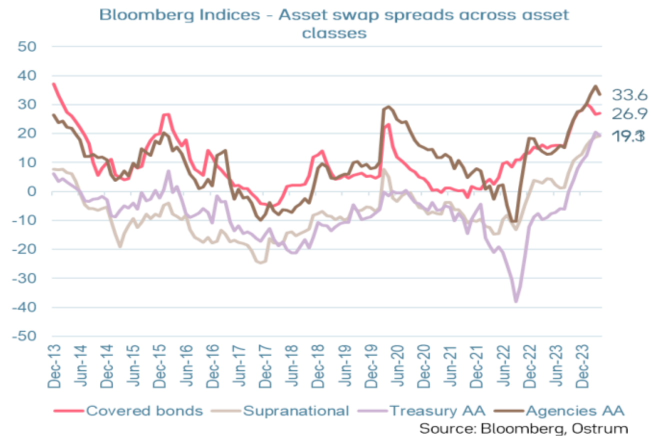
It is worth keeping in mind that covered bonds posted as collateral with the ECB will be redeemed by banks upon TLTRO-III repayment. These securities could either be canceled or sold to the market, potentially adding to supply.

Covered bonds compared with similar asset classes

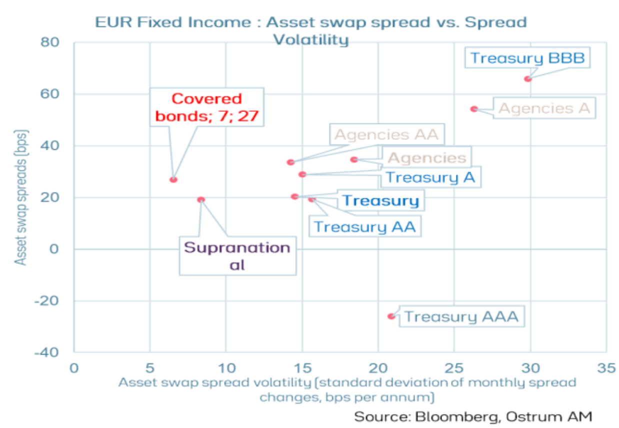
Covered bonds are a low-risk asset class priced off the interest rate swap curve. As such, the asset class competes with sovereign and quasi-sovereign issuers (agencies, supranational bonds) of similar high credit quality.

The euro covered bond market universe is quite deep with 1,500 securities and 1,2 trillion euros in market value. The average yield to maturity is currently hovering about 3% with average maturity just under 5 years. The average rating is AAA/AA1.

As most fixed income asset classes, covered bonds have underperformed swaps since 2021. Asset swap spreads on covered bonds have risen to around 27 bps from sub-0 bp levels in October 2021. Current covered bond valuations compare favorably to that on sovereign and supranational debt with similar high credit quality. Agency bond spreads however trade slightly wider but covered bonds may offer more security for investors with the double-recourse structure whereas government guarantees on agency bonds are not always explicit.



Furthermore, covered bond spreads appear less volatile than comparable asset classes. The chart below shows current spreads vs. annualized spread volatility using a 3-year window for different fixed income markets. On this measure, covered bonds seem to offer better value with low levels of spread volatility.



Banking institutions hold some covered bonds for regulatory liquidity purposes. Covered bonds are not as liquid as core sovereign bonds, but good enough. On ECB supervisory data for the 4th quarter of 2023, euro area bank holdings of Extremely High Quality Covered Bonds (EHQCB) sum up to 221 billion euros, a mere 4.5% of aggregate LCR assets for the euro area banking sector. There may be scope for larger investments in covered bonds by liquidity buffer managers given attractive spread levels.

Conclusion

Covered bonds are an attractive low-risk asset class. Spreads currently hover around 30bps vs. swaps as strong supply since 2021 contributed to a widening in spreads. Indeed, euro area banks used covered bond issuance to refinance TLTRO-III maturities. However, higher ECB rates weighed on housing loan demand and home prices. The contraction in new loans should cap issuance in years to come. Covered bonds used as TLTRO collateral could still add to supply, but the risk-reward trade-off on CB compares favorably with other high credit quality assets.

Additional notes

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