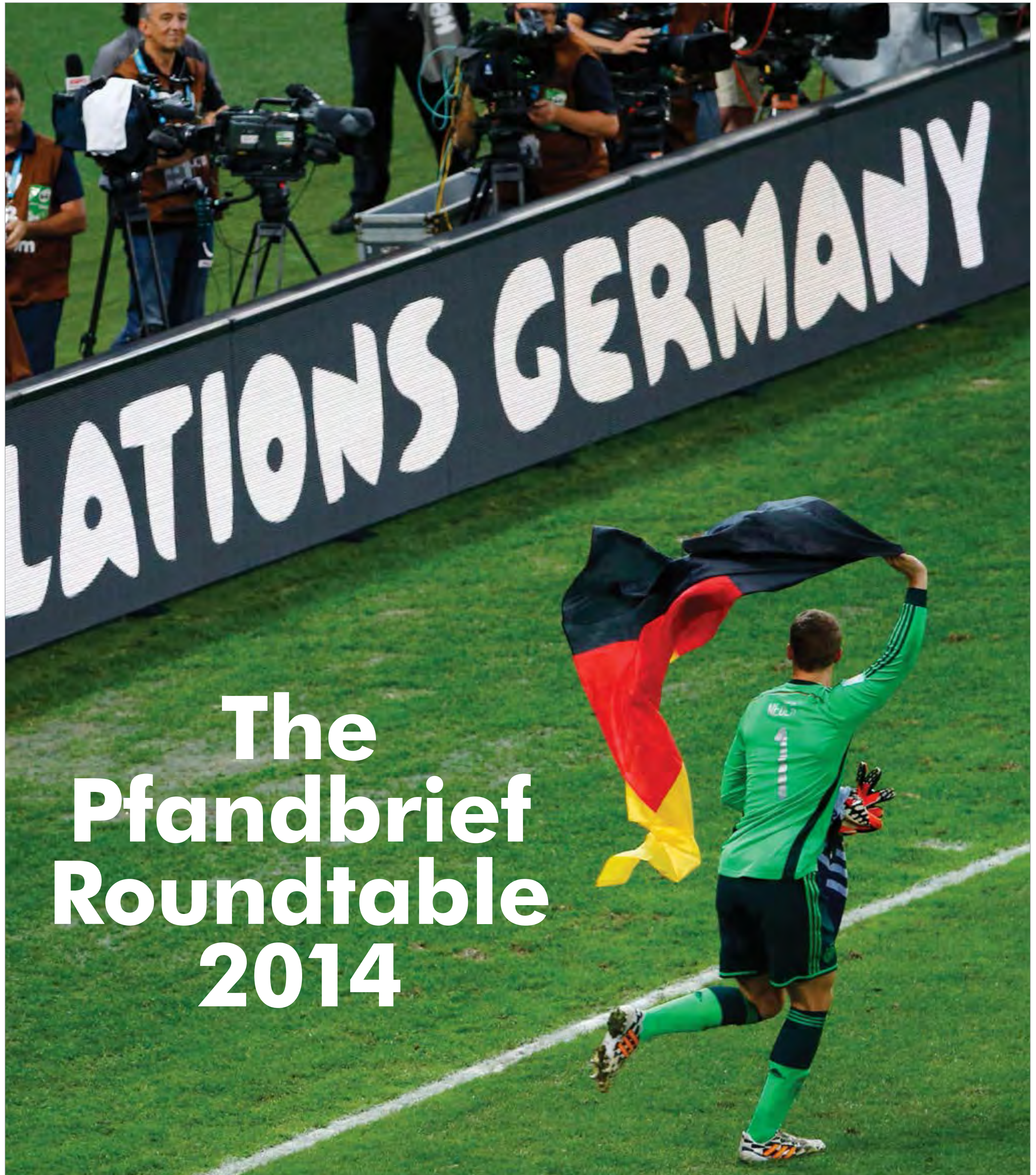
The Covered Bond Report



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The Pfandbrief Roundtable 2014

Pfandbrief issuers have enjoyed tight spreads this year, but ECB and regulatory developments have nevertheless provided food for thought on funding strategies and business models. In this roundtable sponsored by the Association of German Pfandbrief Banks (vdp), leading market participants offer their views on key issues.

Neil Day, The Covered Bond Report: How has Pfandbrief supply developed this year?

Ted Packmohr, Commerzbank: To put it in a wider perspective, we are seeing a relatively broad mix of issuance in the overall covered bond market in Europe this year. We are slightly ahead of last year's numbers and closing in on 2012's figures, which is relatively well in line with expectations, I guess.

Germany is once again contributing a large share to this. When it comes to euro-denominated benchmark issuance, Germany and France once again lead the pack. Hence, Pfandbriefe continue to live up to their leading position in the covered bond market.

Overall, however, the German market continues to be characterised by negative net issuance, as are most European covered bond segments. For the year as a whole I expect redemptions to amount to around Eu90bn for the overall Pfandbrief segment — not just including euro benchmarks, but also private placements and other smaller-scale deals. Issuance will once again not be able to live up to this number: I would be surprised if we were to hit or even surpass the Eu60bn threshold in terms of new deals. So the market will continue to shrink, probably by at least Eu35bn. Bundesbank data published in July shows that in the first five months of the year the German Pfandbrief market already declined by some Eu23bn. This should continue over the remainder of the year — with the ECB's TLTROs also probably having an impact.

Day, The CBR: What is it that is causing the decline in volumes?

Jens Tolckmitt, vdp: There are a number of reasons. Firstly, public sector issuance is subject to a changing business model — as it has been over the past 10 years — and that is continuing. There is also regulatory pressure on the public sector business and it is still not clear to what extent this business will be conducted by banks in the future. Only once these remaining regulatory questions have been answered will banks be able to properly plan for the future supply of public sector loans. This is the overarching reason for the decline.

Secondly — and this is very important for the overall loan businesses that are behind covered bonds — is the implementation of the new regulatory framework for banks. To my understanding, many banks only started to implement new regulatory frameworks once they were more or less finished, which is understandable given the fact that important changes are oftentimes included only at the last minute. What you can see now — the decline in volumes — is a result of this implementation. And this has certainly in many cases been accelerated by ECB supervision, which I would say has prompted the institutions to move more quickly towards the new regulatory framework. Whereas they had expected to have two to three years to implement their new equity ratios, for many that are now supervised by the ECB it turns out that they don't actually have so long, and that has an impact.

And finally, I would also stress that any kind of liquidity provision by the central bank offered at rates that are favourable compared even to covered funding does have an impact on issuance in the covered sector.

World Cup winner Manuel Neuer
Photo: Jamie Squire/Getty Images Sport

Day, The CBR: Are issuers rethinking their funding plans in light of the ECB's announcements?

Martin Gipp, Helaba: Yes, of course. Any decision coming out of the ECB will be closely watched because it has a potential economic impact on the business. The final TLTRO definitions are not out yet — they are due out soon — and the devil will be in the detail.

LTROs have in the past been broadly taken up and have had a positive economic impact on the rates at which banks fund themselves. The stigmatisation from using such facilities that we once saw has gone away, so I don't think we will see any stigmatisation now. It will probably therefore come down to a pure economic decision whether to use these funds or not.

And then, as Jens just pointed out, it seems that the conditions will be very favourable, even in light of covered bond funding, so I would not be surprised if funding plans are adjusted once the technical details are out — especially because it will provide the banks with a neat safety net: since the drawdowns will be in September and December, you can see how your funding goes, what kinds of rates you can achieve, and then at the end of the year you can step in and take advantage of the LTROs. So that's definitely something we are watching closely.

Götz Michl, Deutsche Pfandbriefbank (pbb): I have a similar view. At the beginning of the year you set up your funding plan. During the year and depending on market conditions and actual funding requirements you decide on the best timing, the best structure, best term, best product. We are closely observing developments and adjusting our funding plan continuously. In the end it's a question of how cheap it is in comparison to the Pfandbrief.

Volker Karioth, BayernLB: We have also not yet made any decisions regarding the LTROs. But for BayernLB in general I can say that the bank is becoming less dependent on capital market funding as it continues reducing the volume of its balance sheet. We are broadening our funding mix and a major proportion of our secured and unsecured capital

Roundtable participants:

Martin Gipp, head of funding, Helaba

Thorsten Jegodtka, senior portfolio manager, Union Investment

Volker Karioth, director, rating and investor relations, BayernLB

Götz Michl, head of funding and debt investor relations, Deutsche Pfandbriefbank (pbb)

Ted Packmohr, head of covered bond research, Commerzbank

Jens Tolckmitt, chief executive, Association of German Pfandbrief Banks (vdp)

Neil Day, managing editor, The Covered Bond Report

The roundtable — kindly hosted by Commerzbank — was held in July. Minor amendments have been made to the text to reflect subsequent developments.

Thorsten Jegodtka, Union Investment: "We have very, very tight spreads, so it doesn't make it easy for us to invest"

markets funding comes from the savings banks, which puts us in a comfortable situation, and we are overall less dependent on capital markets funding.

BayernLB will continue to issue one to two covered bond benchmark issues per year, of course, to ensure access to the capital markets, but, as I said before, no decision has been taken yet regarding the LTROs.

Day, The CBR: How has your funding developed this year, compared with what you anticipated?

Karioth, BayernLB: As in previous years, BayernLB has funding needs of around Eu7bn, and half of it will be done with secured and half with unsecured funding. We plan one to two benchmark bonds in the public covered bond sector per year, and the rest is done via private placements. We did one 10 year public sector benchmark covered bond in April, in Eu500m format, and we plan another one for this year.

Gipp, Helaba: The funding has gone very well this year. I think for most issuers the market has been very, very receptive. Our overall funding needs that we want to cover in the capital markets are Eu9.5bn, also split roughly 50% senior unsecured and 50% covered. We have done about two-thirds of that in the covered bond space so far, having issued about Eu3bn in covered bond format, so from a budgeting perspective we still have Eu1.5bn to go for the remainder of the year. But, as I said, funding plans might be revised going forward depending on what comes out of the ECB. But even if no revision is needed, it will be rather easy to get this funding done. We don't feel any pressure to rush to the market in the near future.

"The market has been very, very receptive"

Michl, pbb: The funding has gone quite well. We experienced a pretty strong private placement market in January, February and March — particularly the first two months, when we did a huge amount — and then it got a little slower. We will probably do another one to two benchmarks on the mortgage side this year.

On the public sector side, we experienced quite substantial prepayments on the assets last year and therefore we currently have no need to issue a public sector benchmark for the remainder of the year. So far the private placements are sufficient.

Day, The CBR: When you say funding conditions have been good, in what respect? Is it the maturities, the levels?

Michl, pbb: With regard to volumes. You can certainly steer it by the price and what you pay for the Pfandbriefe. But if you look at what we issued one year ago and the normal run-rate for private placements, I would say the beginning of the year was very strong for us and then it slowed down a little. The private placement market is — even for us not having a Sparkassen background — quite favourable.

Day, The CBR: Martin, when you say funding has been very good, are you talking about levels, volumes, and why do you think it is?

Gipp, Helaba: It's on both sides. We are in a spread environment with regards to Pfandbriefe that is basically unprecedented, with almost the tightest levels we have ever experienced. So from an economic perspective it has been extremely good. Pfandbrief levels are pretty stable at these tight levels, and we can do the issuance volumes we like in the maturities we like, so the market is from my perspective open to anything that issuers want to do. It's an issuer's market.

Day, The CBR: For an investor, is the situation as positive?

Thorsten Jegodtka, Union Investment: I absolutely agree we have very, very tight spreads, so it doesn't make it easy for us to invest. Nevertheless, we still invest in German Pfandbriefe because they offer a pick-up over German government bonds. But of course we also have to look at the yield of our portfolios, and it's especially difficult to get comfortable with yields in shorter maturities, while on the other hand at the long end we have very tight spreads so that's also not our favoured place. We prefer the middle part of the curve, where the curve is a little bit steeper — at the long end it is quite flat. Here, we can also benefit from the positive roll-down effect. So it makes more sense for us to be invested in the middle part of the curve, also because most of our portfolios have a duration of four to five years.

Day, The CBR: Given the tight spreads for German Pfandbriefe, are you looking at other jurisdictions, other asset classes?

Jegodtka, Union Investment: Yes, of course, it depends on the portfolio. If you are concentrated on the covered bond market, we are also looking at different jurisdictions. We have seen a lot of new jurisdictions over the last 10 years, so of course we are looking over to, for example, France, because you get more yield and you also have, from our point of view, some good laws in other countries. I think the benchmark is still the German Pfandbrief law — there's no doubt about that. We nevertheless like to invest in other countries where we get a little bit more yield. At the end of the day we have to look at both risk and return, of course, and while the German Pfandbrief is really a low risk investment, it is also a low return investment, so we have to look around.

In aggregate portfolios we are looking not only at other covered bonds, but we also invest in corporate and government bonds. In some countries it makes sense to compare the yields of government bonds with the yields of covered bonds, and in some countries, depending on the time, it makes sense to prefer government bonds over covered bonds. You have a little bit more liquidity in government bond markets and at times you get more yield.

Day, The CBR: Looking at the spread situation, Martin said it wasn't clear if things would stabilise or widen. Do you have a view on what is likely to happen to spreads going forward, in light of things like the ECB, and the supply situation?

Packmohr, Commerzbank: The ECB has obviously rekindled the overall spread compression, and we think this story is to remain intact for the time being despite other political risks. There is little to suggest that spreads will widen out or fan out again significantly towards the end of the year.

Clearly this is something that not all markets participate in equally. We can see that it is very tough for the covered bond segments that are already trading at very tight levels to tighten even further. There is something of a natural barrier for Pfandbriefe that is very difficult to push through, i.e. it is sometimes problematic to move too close to Euribor flat or into negative territory. The benefits are therefore more for the higher yielding products. So spreads are coming in for the other end of the rating scale, while they trade relatively stable at the lower end.

Götz Michl, Deutsche Pfandbriefbank (centre): "We will probably do another one to two benchmarks on the mortgage side this year"

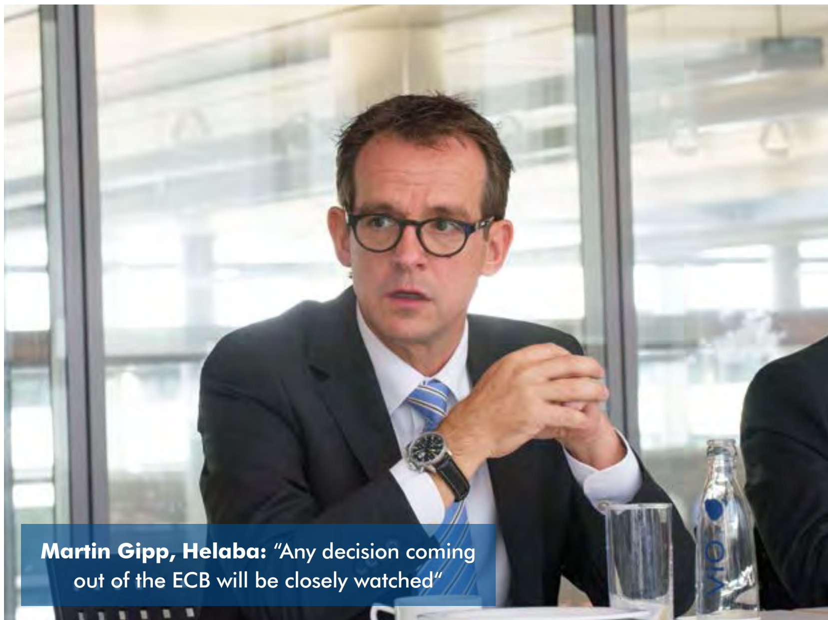
> "There is something of a natural barrier"

We have also seen some German investors — so the backbone of the Pfandbrief investor base — increasingly argue that German Pfandbriefe have become a bit too tight versus other products, such as German Länder. This trend was already underway well into last year: various smaller German investors who are perhaps diversifying into some other products for the first time are putting more weight on German Länder issuance and the like. I think that is a risk that the Pfandbrief market has been very alert to.

If you look at the placement statistics of some of the recent core deals, you see a relatively low share of asset managers. With some Canadians, for example, only 8% went to asset managers. This is similarly true of some German deals, such as Berlin Hyp, HSH, DG Hyp, or one of the Helaba tranches, for example. They all had a relatively low share of asset managers in their books. There is therefore the risk that the Pfandbrief becomes more dependent on bank demand. The latter has obviously been increasing, which is a good thing. We have seen unusually high bank demand in the 10 year tenor, for example, which typically was not really banks' favoured spot on the yield curve. But this also makes us more dependent on what is happening on the regulatory front. Should the preferential regulatory treatment of covered bonds change at some stage, the effect on spreads would be amplified the more dependent on bank demand we become. That is to some extent a risk.

Day, The CBR: Regarding the regulatory drivers of that bank demand, what is your expectation on the likely LCR result?

Tolckmitt, vdp: What we have seen recently is a bargaining debate. With regards to the LCR, it is evident from the introduction of new criteria that we have been seeing every so often, for example with issuer ratings again being discussed.



Martin Gipp, Helaba: "Any decision coming out of the ECB will be closely watched"

However, these are not yet set in stone and we are pleased that there is a chance to argue these points properly and have them removed. I am quite optimistic that we will end up with a final LCR that is pretty similar to what we discussed in late spring and earlier in the summer that is favourable for covered bonds.

Day, The CBR: That would be thinking up to 70% of LCRs, or what has been called Level 1B?

Tolckmitt, vdp: Yes.

Packmohr, Commerzbank: I fully understand the vdp's position, and I also agree that there needs to be an alignment of the regulatory treatment of covered bonds and Pfandbriefe in general across the different pieces of regulation.

Regarding the issuer rating point, however, we also have to keep in mind that whereas the risk weighting actually looks at the risk of bankruptcy and therefore of losing your money, the LCR looks at the liquidity risk. While I'd like to think that covered bond legislation is typically strict enough to delink to at least a large degree bankruptcy risk and issuer risk, there is a close linkage in terms of liquidity risk. Make no mistake, if an issuer really were to go belly up its covered bonds might retain an acceptable rating, but liquidity would still be nowhere near where we would like to see it for LCR purposes. In principle, there was therefore a reason for considering including a link to issuer creditworthiness in the LCR discussion because of the impact it has on liquidity.

Tolckmitt, vdp: I'm not sure about that. If you look at the history of particularly the Pfandbrief market over the crisis, and if you look at the discussions that we have had over the years regarding liquidity from an investor's point of view, getting in and out of positions, I am not quite sure whether the issuer rating has played a negative role in investor perception of liquidity in terms of what the LCR tries to achieve. I would even say that this could also be another argument in favour of not recognising the issuer rating.

> "There is a close linkage in terms of liquidity risk"

And my basic feeling is that this, for whatever reason, has come at a very late point and not been thought through from all these perspectives properly. My feeling is that we would not have substantially lower liquidity depending on the issuer rating, especially if you look at the specific issuer ratings that have been under discussion.

Day, The CBR: Do you have a view on this, Thorsten? To what extent do you take issuer ratings into account regarding covered bonds' credit quality and liquidity?

Jegodtka, Union Investment: We are looking at this point from two angles. One is quite simply with regard to investment guidelines. We have some investors who not only tell us to look at the credit rating of the covered bonds but who also want to see a minimum rating for the issuer, which is quite straightforward. Of course, as I said, that depends on the investor and his view on risk in his portfolio.

The second point is about how we do our research, looking at the different issuers and of course at the covered bonds. At Union Investment, our credit department looks at the senior unsecured bonds, so they are looking at the bank itself, and we take this into account for our covered bond research. In the covered bond team we are little bit more focused on the analysis of the cover pools. We then take both together.

Day, The CBR: A rating agency analyst mentioned how they themselves are delinking the issuer rating from the covered bond rating. Is that relevant?

Karioth, BayernLB: The bail-in rules definitely changed the market situation. One asset class has been the big winner and that asset class is clearly covered bonds. And concerning this liquidity discussion, covered bonds, especially German Pfandbriefe, showed in the past that they are very solid. They are bankruptcy remote and there is transparency. And in that respect I think investors — and you can see this in the market — acknowledge these facts.

With the bail-in rules having clearly set out what is bail-in-able and what is not, we clearly see that people are focusing more on the cover pools than in the past. Of course they were important in the past as well, but not as important as today, because in former times issuer ratings played a more dominant role —

that's my personal impression, at least.

Michl, pbb: I think it's a question of what the impact of the issuer rating is. Is it a matter of credit risk? If so, an investor looks into a product and simply wants to make sure that it is a safe investment. If, on the other hand, it is a question of liquidity, there is the issue of whether you can really sell the bond if the issuer is insolvent. But we are really talking about investment grade ratings for issuers here, so a sudden default is unlikely — there will firstly be a deterioration, with the impact on the covered bonds depending on the degree of delinkage.

If we were to just concentrate everything on, let's say, single-A or even double-A rated banks, you then get into the question of what is the value of covered bonds for such highly rated issuers. What is the funding difference between senior and Pfandbriefe for a double-A bank?

And then, going back to the investor side, I think it is important to have different products, with different spreads. If you just offer, let's say, triple-A covered bond products then the investor base is not really able to earn anything. That's probably why bank treasuries are looking at 10 year Pfandbriefe, simply to somehow achieve a positive spread. If bank treasuries were to buy only sovereigns, agencies, and three year triple-A Pfandbriefe — which are the optimum if you want to sell — then it comes down to the issue of profitability. If we just narrow it down to basically Bunds, then how do you build up equity in the bank?

Day, The CBR: Harmonisation has been talked about for years but looks like it could finally be coming. Is it a threat? Is it a good thing? How might it best be handled or managed?

Tolckmitt, vdp: It's a good thing, as long as you are successful in maintaining high quality standards. That is our position and we are constructively arguing to that end with the European regulators.

Secondly, it remains to be seen but I don't think that full harmonisation is anywhere on the radar screen of the European regulators. Indeed, it would be extremely difficult to have full harmonisation because of the importance of national insolvency law in covered bond laws everywhere.

Volker Karioth, BayernLB: "The bail-in rules definitely changed the market situation"

You might therefore say that harmonisation is impossible. The problem — and that is why we are repeating this — is that there have been a lot of things on the regulatory side that in the last few years we thought would be impossible but which we have seen someone try to make reality. So we can only offer these two warnings: that, firstly, it's a huge task and you have to do a lot of groundwork harmonising insolvency laws before you can harmonise special insolvency laws, i.e. covered bond laws; and, secondly, with regard to quality, our concern has always been that if you harmonise certain areas then you could have a watering down of quality, and we are not willing to accept that. One of the strengths of our product has been its strict legal framework, which has benchmark status, and we want to be able to, firstly, retain this status in the future, but also to be able to refine our product in the interest of investors under a harmonised rule. So we could agree to certain areas being harmonised — these could in our view be: transparency, asset classes, a definition of what public supervision properly means, and how investors are safeguarded in case of the insolvency of the bank — but with the possibility for each jurisdiction to actually go beyond what the European regulator stipulates in a possible harmonised legal framework, so this would mean a kind of a minimal harmonisation.

> "It is important to have diversification"

Michl, pbb: I would even say that in the capital markets it is important to have diversification, because simply from a risk point of view you then have alternatives on the investor side. The big threat would be — as seen in 2007 and 2008 — if everything were to be linked together, if everything were to be the same product. The more it gets standardised and the more it becomes the same product, the risk is too high that for whatever reason the whole system doesn't work anymore. If there is an impact on the harmonised covered bond area then nobody buys any covered bonds anymore — everyone is threatened and the whole market disappears. And therefore what we need, especially in the capital markets, is to have diversification.

Jegodtka, Union Investment: From our point of view harmonisation is definitely positive, but I absolutely agree that it is very important what the standard is. I don't think it will be possible to have the

Jens Tolckmitt, vdp: "There is an overarching interest in high quality harmonisation"

German standard for the whole EU — it won't happen — but perhaps something in the middle or that comes a little closer to the German law. For example, with regard to the 180 day liquidity buffer rule.

We need some minimum standards. Transparency is one area that, from our point of view as an investor, is really important. We want to have more transparency because it is absolutely positive for the product, it helps us to do our research and helps the issuers when markets are difficult because we are able to better assess our investments. And not only more information — it's important that we get the data on a quarterly basis.

So I think harmonisation is positive and there are certain standards we have to agree on.

Packmohr, Commerzbank: But even with these very high level harmonisation items that are being discussed we have witnessed that there is no "one size fits all". For example, with the liquidity buffer: we have soft bullets, we have conditional pass-throughs, which by definition are constructed so that they don't need special liquidity buffers. So already at this level there are problems in putting in place one rule for every product.

We have seen the European Banking Authority releasing best practice principles, and there's loads of interesting stuff in there. Some of the items are boxes that nobody can really tick at the moment. For example, when it comes to cover stress testing with regard to credit risk: while most issuers are stressing for interest rate, currency, co-mingling risks etc, credit risk is, as far as I know, usually not yet taken care of in the cover tests. This is something the rating agencies do in their stress testing to come up with their OC requirements. If this were to be included in future harmonisation standards we would already have some new rules that need to be applied.

> "Transparency is one area that is really important"

I also agree that in some areas it would probably be not only useful but vital to achieve better harmonisation, for example when it comes to oversight. There are very different standards of public oversight in the covered bond market, and I believe that for many countries investors don't have a clear feeling or guidance as to what the public authorities are actually providing to safeguard the product's creditworthiness. It would be useful to provide some common standards or some guidelines here, which would also fit the trend towards a single oversight regime in Europe. But there are of course other areas where things are more complicated.

Tolckmitt, vdp: I agree with this assessment of the EBA paper, that there are boxes that perhaps no country can tick. But this is a question of countries being asked to live up to certain standards and in that respect it is productive because it is quality-oriented. It would be worse from our point of view if it were the other way around and there were standards that were watered down to an extent that could somehow hamper or threaten to hamper the overall asset class.

And if I might underline this interest in quality: we always consider both the harmonisation issue and the preferential treatment issue, which are dealt with in two strands of work but are basically interlinked. There is an overarching interest in high quality harmonisation because I'm pretty sure that the elements that are harmonised will later on be the decisive points regarding what covered bonds will continue to be privileged in the new regime. Once the big regulatory issues are taken care of, we could face regular reviews of the treatment of covered bonds and that will be perhaps the biggest challenge for the whole industry going forward. That is more than understandable from a regulatory point of view, but it forces the industry to consider enhancing quality as one of the foremost elements of its work regarding the product.

Day, The CBR: Are there any other related developments on the horizon?

Tolckmitt, vdp: In line with the importance of further developing the covered bond product, there is another amendment of the Pfandbrief Act underway. This is coming just after the last one was finished — indeed, we have yet to receive some of the results of the last amendment on the transparency side. We expect the new amendment to be in place in November or at the end of the year at the latest.

We didn't really plan for it to come around that fast, but the real motivation — and this is something that other countries have to consider as well — is that under the new ECB supervision,

Pfandbrief and covered bond supervision will remain in the sphere of the national supervisors. And in Germany, at least, the supervisors have asked to make sure that some elements of the general banking law that have until now allowed them to do proper supervision are put into the covered bond law in order for them to be able to conduct the supervision properly in the future as well. So that was the main motivation, but there are some elements in this amendment that go beyond this pure technical issue.

Day, The CBR: Such as?

Tolckmitt, vdp: The main one is that we will have a so-called collateral add-on — we call it a collateral add-on because it is similar to what we know from general banking supervisory law as being a capital add-on. With this, the supervisor can assess the cover pools and if necessary impose a higher legal OC on individual cover pools. This is quite unique. We discussed a lot of different ways of doing this, from doing a flat increase of legal OC to the so-called collateral add-on, and we think this is the most advanced way of doing it, because it is state of the art in other areas of banking regulation, and again distinguishes Pfandbriefe from other products.

Day, The CBR: We saw NIBC with the first conditional pass-through (CPT) last year and also SME covered bonds and Goldman announced its FIGSCO structure. How do you view CPTs, SMEs, etc. in relation to more traditional covered bonds?

Jegodtka, Union Investment: What we do think as an investor about SME covered bonds? We are not really convinced that SME credits are the right assets for cover pools. Traditionally covered bonds have the advantage that we are able to do some analysis on the real estate markets and so on. When you talk about SME pools, we are not able to do analysis on the pool directly, on the specific credits, so it's difficult for us to get an insight into the loan pool. That's the disadvantage from our point of view. So we think that SMEs are something for the ABS market.

Ted Packmohr, Commerzbank: "There are problems in putting in place one rule for every product"

And with regard to CPTs, we don't like the ultra-long extensions of soft bullet maturities as you can also regard CPTs. We think the liquidity risk has to be part of the bank's pool management and not be transferred completely to the investor. We would at least like to be compensated for taking this risk. From our point of view, we still prefer hard bullet covered bonds. It's easier for us to manage our investment, especially when we look at our fixed maturity funds. It doesn't make sense to invest in a conditional pass-through as you might end up with a bond with a maturity of 32 years or thereabouts. It's difficult for us.

"SMEs are something for the ABS market"

Day, The CBR: And FIGSCO, is that on your radar at all?

Jegodtka, Union Investment: Yes, we had a look at this structure, too. But it is not a covered bond in our point of view or under UCITS and CRR. So it's something that we had a look at, but as I said, we rather prefer traditional covered bonds.

Day, The CBR: On the CPT, basically the argument seems to be that if you are buying a normal covered bond, you are anyway exposed to the same risks, but you don't know exactly what will happen when the bank defaults, and you could be faced with exactly the same situation as what NIBC's structure makes clear from the beginning in a mechanistic way, that in reality you face the same extension risk if the bank goes bust.

Jegodtka, Union Investment: In a theoretical sense, you are right. The CPT structure does give you maybe a kind of clearer guidance on what happens when a static pool does get liquidity problems. Nobody knows exactly what happens after a covered dond defaults, i.e. the bond acceleration starts and assets need to be fire-saled. CPT is a bet into the future: maybe better prices, maybe less pressure to monetise assets. We nevertheless haven't had any kind of empirical evidence of these assumptions. The more severe a house price bubble, the higher the uncertainty about the future evolution of it. We therefore have a tendency to prefer the hard bullets where we would assume a higher incentive for regulators to overcome severe stress in their covered bond markets. Covered bonds are too important for lots of banking systems.

Day, The CBR: Would BayernLB ever consider an SME covered bond?

Karioth, BayernLB: We are not planning any SME structure for the near future. However, we are of course monitoring the market closely and we don't exclude that this could change in the future.

I think SMEs in general as a new investment alternative are from an investor's point of view very interesting. What you would need, of course, would be implementation of a specific statutory framework for these instruments so that they are not mixed up with typical covered bonds. And investors would need to do some fundamental analysis in each case. But as a new alternative — especially coming back to Germany, with the great importance of the SME sector — it could be interesting.

Tolckmitt, vdp: We have always said that we are not puristic about SME covered bonds as long as they are properly delimited from the traditional product in terms of not threatening the treatment and the perception of this traditional product. I think as long as this is assured, it's perfectly OK to use elements of the traditional, very successful product for different purposes — but that has to be assured.

And from an issuer point of view, what Götz just said is extremely important. The SME covered bond was a child of a time when banks were more or less looking desperately for new forms of funding going forward, not only because of the crisis, but because the new regulatory framework basically called into question the economic sense of all types of funding except covered bonds, it sometimes seemed to me. But looking ahead, we are now back at discussions around securitisation and whether the regulatory framework for securitisation might have been a little bit overdone. I think we will get back to a situation where securitisation is potentially at least used as a form of SME funding, but that was not possible for a number of years.

> "You keep higher pricing power on your side"

The final thing I would say on this topic is that I don't necessarily think that using covered bonds or securitisations for SME funding automatically translates into favourable funding conditions for SMEs. The political discussion is always looking for solutions to SME funding and they believe that this could be one, but I doubt that. Other factors need to be looked at.

Gipp, Helaba: The same can be said of the TLTRO. It will, if nothing else, be a substitute, a kind of SME funding for lending scheme.

Day, The CBR: Turning back to market issues, Helaba has used the dual tranche structure twice for benchmark issuance. Why did you turn to it and what are the benefits?

Gipp, Helaba: As Ted said early on, the market has gone away from the old jumbo issuing format into more the benchmark issuing format, so Eu500m issues are more or less the name of the game. What we have found is that with smaller sized issues you keep higher pricing power on your side, but there are nevertheless certain times when it is rather attractive to get as much size out of the market as possible. That was the initial reason why we said at that time, let's go out with two tranches of Eu500m each to keep the pricing power on each tranche but to take out liquidity in the amount of Eu1bn.

The only thing you really need to watch out for is that you do not get cannibalisation across these two tranches, so you need to choose maturities where you can target different investor bases. We did the same thing this year with our three and seven year issue, where the allocations were at the end quite different. There was a very large non-German take-up in the shorter tranche, and a very large domestic take-up in the seven year tranche. So you can actually use your own issuing curve quite neatly through this dual tranche mechanism.

Is that something that we are going to use going forward at all times? I do not know. We have now four issues outstanding that can be tapped, to get to a size of Eu1bn. And with the smaller deal size you on the one hand keep pricing power in your hands, but also ensure a little bit of performance potential for the investor.

Day, The CBR: Would other issuers consider it?

Michl, pbb: We prefer Eu500m transactions and have an internal soft guideline not to tap higher than Eu750m simply

for the ALM profile. But I rather prefer to do the deals independently. So if we need, for example, three years and seven years or five years, then it might be a second transaction two months later or whatever. Of course then you have the uncertainty if the market is there in two months' time, but we normally just do only one. To be honest, I would be a bit afraid about the cannibalisation between the two products. Of course you have the pricing power, but then there's the question what you do if the book for one deal is more favourable than the other.

Gipp, Helaba: Of course, with every new issue you need to go out with proper marketing and a good idea of what is feasible and what isn't. It is right that you cannot squeeze out the last basis point of any issue and definitely not in a dual tranche.

Karioth, BayernLB: We have never issued a dual tranche deal and we have no intention of considering such a transaction in the foreseeable future.

Jegodtka, Union Investment: We also prefer seeing issuance spread over the year because we have cashflows over the year so for us it is easier if we get more chances to get into the market at different times. So we do not really prefer dual tranche deals.

Day, The CBR: But ultimately if one does come, I suppose you have to live with that. Do you treat it any differently?

Jegodtka, Union Investment: At the end of the day, it depends on the portfolios we are investing and also on the situation in the market, and it might happen that we sign up for both tranches.

Day, The CBR: Götz, you did some foreign currency issuance last year. Have you followed that up this year?

Michl, pbb: Last year we did sterling and Swedish kronor, two currencies in which we originate assets. We did a couple of Swedish krona deals at the beginning of this year for a total of around Skr1.2bn (Eu131m). We have an office in Stockholm and a lending operation there.

The main reason why sterling isn't currently working so well for European issuers is the quite small basis swap between sterling and euros, meaning that the spreads we can offer on sterling issues are not as competitive as in the past. However, in recent weeks the basis swap came out a little bit, so maybe something will work again.

There are two sides to the coin. On the one hand, we need to swap euros into sterling because we have more euro funding and a couple of billion of sterling assets, but the basis swap is favourable for us and we can swap rather cheaply into sterling. But on the other hand if the basis swap is larger and it is not so favourable to fund these sterling assets in euros, then it is easier to issue in sterling.

> "We are not puristic about SME covered bonds"

It's certainly quite nice to have the same currency in the cover pools, because then it's matching and you need to pay less overcollateralisation for the mismatch — we don't have derivatives in the cover pool anymore, we simplified it, so we really pay for the currency risk with overcollateralisation. And then you benefit from diversification in the investor base, which is quite positive — investors who buy sterling or Swedish kronor are perhaps not really euro investors.

Day, The CBR: Regarding collateral, are there any concerns about either the mortgage or public sector collateral backing Pfandbriefe? Moody's recently noted that some foreign collateral was performing worse.

Packmohr, Commerzbank: I don't think NPLs are currently an issue for the German Pfandbrief market. Of course we have NPLs, as every market has, but these are far away from the levels of the more problematic markets, be that Italy, Spain, etc.

It is quite natural that there is an increase in arrears for foreign assets. Many German issuers are running international pools, potentially including some Portuguese loans, some Spanish assets, etc. So the broader the spectrum of assets that you have on board, obviously, the more you will also be subject to the risks in those countries — but then only on a very small scale. This is exactly what Moody's describes.

In the German market we currently have a very strong real estate market. This is particularly true for the residential side of things, but also for the commercial segment. In combination with the strong economic backdrop, this leaves us pretty much unconcerned when it comes to NPLs of German Pfandbrief pools.

Day, The CBR: Götz, do you see a significant difference between the German portion and the foreign portion of your cover pool?

Michl, pbb: Our cover pool is 50% Germany, and the rest is diversified over Europe. But overall we have Eu4m of workout loans in the overall balance sheet. It's a very small amount.

Packmohr, Commerzbank: We have also seen some turnover again in the distressed loan markets, which is a good sign, too, as it provides issuers with a degree of flexibility over how to manage their NPL portfolios if need be.

Day, The CBR: Thorsten, do you have any concerns collateral-wise with regard to Pfandbriefe, or anything you are keeping an eye on?

Jegodtka, Union Investment: Not really with regard to the German Pfandbrief market. When we look at the German cover pools of course most of the assets are German-based — the average is around 80%.

But things are different with regard to southern Europe, where we have a closer look into the cover pools. ■

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