Why covered bond spreads are not always stubbornly stable

Even covered bonds occasionally see notable swings in credit spreads. So, let's point out some of the important metrics against the recent backdrop of spread volatility seen in the covered bonds from a major German issuer

It has not even been a year since the European Central Bank fully pulled its purchase support for the covered bond market, or the market was shaken up by a new challenge story. Last week, the covered bond spread levels of one of Germany's major covered bond issuers shot wider after the bank gave its second loan loss provisions guidance in four months for the unforeseen deterioration in its commercial real estate portfolio, particularly in the US.

The subsequent almost 40bp spread widening in this bank's covered bond spreads couldn't contrast more sharply with the extraordinarily low and boringly stable spread developments of the covered bond market during the height of central bank support. Though a relatively isolated incident, it is a significant one for a bond product that has historically never experienced a single default event.

About covered bonds

Covered bonds are generally seen as a low-risk bank bond product. Not only because of their systemic importance in Europe as a funding instrument for banks for housing market financing purposes but also because of the regulatory certainty offered to investors through strict legal frameworks for the issuance of covered bonds. The latter forms an important reason for the privileged regulatory treatment provided to covered bonds in Europe for risk weights, liquidity coverage ratio and central bank collateral purposes.

Covered bonds are mostly issued under a dedicated legal framework. They are subject to special supervision ensuring that the legal requirements for covered bond issuance are always met. The bonds are dual recourse instruments offering investors a preferential claim to a collateral pool of high-quality assets if the issuing institution fails to meet its payment obligations to the covered bondholders. Even if this cover pool proves insufficient to meet all repayment obligations, the bondholders still have a claim on the remaining assets of the issuing bank, ranking pari-passu to ordinary unsecured debtholders.

The assets included in the cover pool are subject to strict eligibility criteria and to regular monitoring and valuation provisions when the cover assets are mortgage loans. Commercial real estate assets for example, only count as eligible collateral up to a loan-to-value (LTV) ratio of 60%, while defaulted exposures would not count as cover assets at all. The actual LTV levels are often even lower than that, offering a decent cushion against real estate value declines in the event a property has to be sold to recover a loan. Finally, issuers must, by law, make sure that covered bonds are secured by sufficient collateral.

So why the concern then?

Refinancing risk concerns

It is important to bear in mind that covered bonds are generally secured by residential and commercial real estate loans that have a longer maturity than the covered bonds themselves. This maturity mismatch between the assets and the liabilities exposes the holders of covered bonds to refinancing risks. If the issuing bank is no longer able to meet its payment obligations, the bondholders become fully reliant on the payments made on the underlying pool of mortgage loans for full and timely repayment.

This exposes investors to the risk that, for timely payment, the assets from the cover pool might have to be sold at below-market-value fire sale prices. At the current higher interest rate levels, this would possibly add to the general market value declines of longer-term fixed-rate mortgage loans originated in the low-interest rate years.

The alternative for a full or better recovery from the collateral pool would then be that investors wait longer for the mortgages to gradually be paid off over time. This has the consequential side effect that investors may not be able to reinvest these repayments at a time when interest rates and market circumstances are more favourable to do so.

Several legal safeguards mitigate the refinancing risks related to these asset and liability maturity mismatches. Most covered bonds have soft bullet twelve-month extension features. Subject to strict conditions, the repayment on a covered bond can be postponed by twelve months if the issuer is not able to redeem the bond on its scheduled maturity date. This allows for extra time to sell mortgage assets to make the repayment without having to accept substantial 'fire sale' haircuts.

The majority of the covered bonds in Europe nowadays also benefit from a 180-day liquidity buffer requirement, obliging issuers to set aside sufficient liquid assets to cover their interest and redemption payments due over the next 180 days. The liquidity available for redemption payments may be dependent, however, on whether the national covered bond law requires banks to make such reservations with reference to the scheduled intended maturity date of the covered bond or with reference to its twelve-month extended final maturity date.

Cover pool quality concerns

While very important, these refinancing risk mitigants do not address the possibility of a significant deterioration of the quality of the collateral pool. Cover pools might, for instance, be exposed to a more rapid performance deterioration if they have a higher borrower concentration or have more loans included in the pool that are up for nearer-term repayment or refinancing under more challenging conditions and at lower property values.

A significant rise in non-performing loans or a notable increase in loan-to-value ratios due to property value declines could reduce the collateralisation levels protecting the covered bondholders. An important cushion against this risk is that covered bond regulations always require sufficient coverage by high-quality eligible cover assets. This means that non-performing loans must be replaced and/or would no longer count towards the coverage requirement.

Smaller-size issuers that already pledged most of their eligible assets as collateral for covered bond issuance may have fewer options, though, to replace non-performing assets with other eligible performing assets. This might constrain the possibilities of the bank to refinance maturing covered bonds with new covered bonds and could force them towards the more expensive senior unsecured segment for stable funding purposes.

In summary

Despite the solid regulatory protection features in place to secure covered bonds, these are factors that covered bond investors do become nervous about when they start feeling more uncertain about a bank. While not very common, they do explain why even covered bonds may occasionally see a notable swing in credit spreads.

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