Box 9

DEVELOPMENTS IN THE EURO AREA COVERED BOND MARKET

Before the eruption of the crisis, euro area financial institutions had been relying heavily on covered bonds to fund an important part of the increase in residential mortgage and public sector lending. This box describes the main developments in the euro area covered bond market during the crisis and reports on some of the effects of the covered bond purchase programme (CBPP) that was announced on 7 May 2009 and that constitutes an integral part of the enhanced credit support measures initiated and implemented by the Eurosystem.

Given its size, both in absolute and in relative terms, the euro area covered bond market represents a very important funding channel for various financial institutions, foremost among them banks. At the end of 2008, the nominal value of outstanding euro area covered bonds amounted to over €1.6 trillion. This represented about 15% of all assets eligible for Eurosystem credit operations. Although covered bonds issued in the euro area accounted for only about 3.6% of all debt securities issued by euro area monetary financial institutions (MFIs), the outstanding volume of residential mortgage-backed covered bonds (€740 billion at the end of 2008) represented about 21% of total outstanding loans for house purchase by euro area MFIs.

The financial crisis had a material impact on covered bond spreads and issuance volumes, as well as on the maturity of new issues. Based on Markit's iBoxx euro covered bond index, spreads against mid-swaps widened from 6-7 basis points before August 2007 to as high as 185 basis points in April 2009 amid distressed sales and the uncertainty surrounding possible changes in associated credit rating methodologies. In addition, when deleveraging, investors preferred to sell covered bonds, rather than ABSs, since the former were more liquid. Total euro area jumbo covered bond issuance volume declined by €19 billion in 2007 and €46 billion in 2008, whereas they had increased by €14-16 billion in both 2005 and 2006.[1] While original maturities of ten or more years were common up to the outbreak of the turmoil, few covered bonds with maturities beyond seven years have been issued since August 2007.

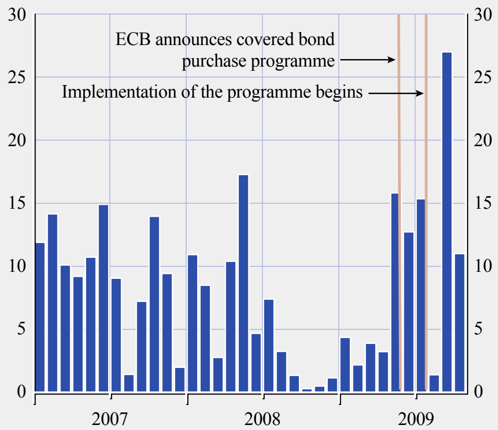
In the context of a depressed situation in the euro area covered bond market, the announcement and subsequent implementation of the €60 billion CBPP had a very positive impact. The impact of the CBPP can be divided into three distinct phases: (i) the announcement of the CBPP on 7 May 2009 itself contributed to the tightening of spreads, while (ii) the presentation of the specifications in June 2009 and (iii) the start of the implementation phase in July 2009 spurred and coincided with an increase in primary market activity (see Chart A). It should be noted, however, that it is difficult to disentangle the pure impact of the CBPP from the influence of the improvements in the broader macro-financial environment as, for example, covered bond spreads, as well as senior bank debt spreads, were already tightening before the announcement of the CBPP.

According to most private sector analysts, the CBPP has been particularly beneficial for the primary market, although monthly Eurosystem purchases of new covered bond issues have accounted for, on average, less than a quarter of the total CBPP purchases since July 2009. The amount of new jumbo covered bond issues increased from just €3 billion in April 2009 to more than €15 billion in May 2009, even before the actual purchases by the Eurosystem began in July 2009. In September 2009, jumbo covered bond issuance reached €27 billion, which was the second highest issuance volume in the history of the euro area covered bond market (see Chart A). At the same time, the maturities of newly issued covered bonds started to lengthen to up to 7-10 years.

In the secondary market, the average spread of covered bonds against mid-swaps has tightened by around 100 basis points (based on the Markit iBoxx index) since the CBPP was announced in early May 2009, but in late November 2009 it still remained above the pre-crisis levels

Chart A Monthly issuance of euro-denominated jumbo covered bonds

(Jan. 2007 – Oct. 2009; EUR billions)

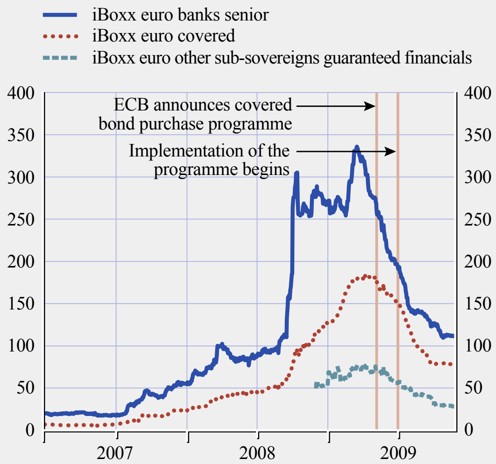


Source: Dealogic.

1 Jumbo covered bonds are plain-vanilla covered bonds denominated in euro with a minimum issue size of €1 billion.

Chart B Spreads of covered bonds and other bank bonds against swaps

(Jan. 2007 – Nov. 2009; basis points)



Source: Markit.

(see Chart B). Covered bond spreads have reached levels where, for most banks, it has become cheaper to fund themselves through the issuance of covered bonds than through the issuance of government-guaranteed bonds, once one takes into account the fees that banks have to pay for those state guarantees.

Despite the important improvements, liquidity in the secondary market remained weak between May and September 2009, although there has been some improvement since October 2009. During the crisis and before the CBPP was announced, the market was often characterised by market participants as a "sellers-only" market. However, after the announcement of the CBPP, most investors became unwilling to sell, since they were expecting a further tightening of spreads. Consequently, bid-offer spreads remained wide, there were very few firm offers and usually for small transactions only, and price transparency was lacking. Many banks no longer had sufficient balance sheet capacity to support their market-making activities in the open market, although they still tried to indicate two-way prices for their own clients internally. On 20 July 2009, Eurex launched a secondary market auction platform for covered and government-guaranteed bank bonds, with the aim of supporting price transparency and market liquidity, but the average trading volume has remained very small so far. Since October 2009, however, liquidity and the availability of offers in the secondary market have started to improve, largely because of investors' perceptions that further rapid spread tightening was increasingly less likely.

The introduction and implementation of the CBPP has proved successful in alleviating tensions in the euro area covered bond market, although this took place against the background of improvements in the broader macro-financial outlook, which may also have helped. The CBPP has also facilitated the issuance of covered bonds that are not eligible for the CBPP. Moreover, the tightening of covered bond spreads since the announcement of the CBPP has significantly improved funding conditions for euro area banks.