Searching for Cover
An asset class in high demand

BNP PARIBAS
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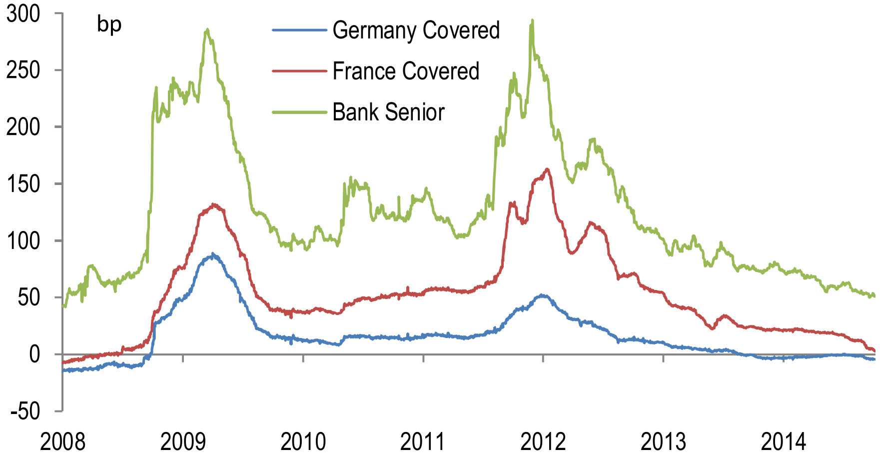
Why are covered bonds in high demand?

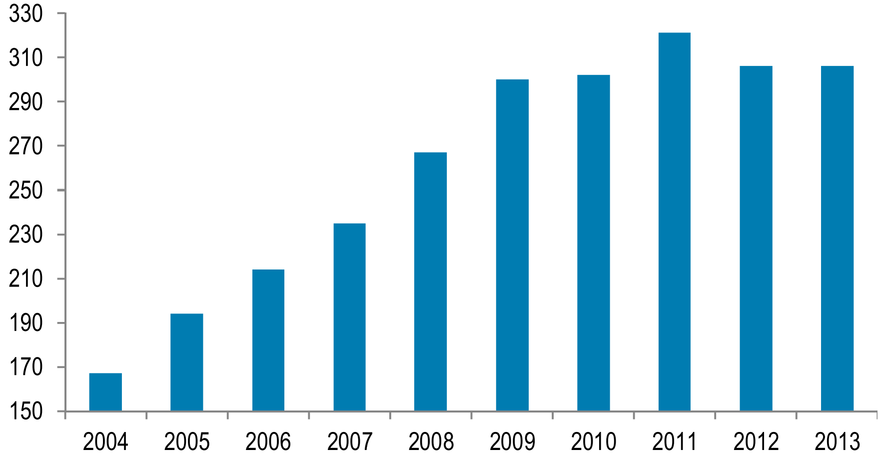
- Covered bonds showed strength and relative stability during the global financial crisis. Spread volatility, for example, was significantly lower than in other asset classes such as senior bank debt or ABS.
- Increased funding advantage and better market access for banks during the crisis resulted in a strong increase in the number of covered bond issuers in recent years.
- Regulators endorsed the relative stability that covered bonds showed during the crisis by granting preferential treatment in a number of regulatory frameworks.

Swap Spread Margin of Covered Bonds and Senior



Source: BNP Paribas, IBOXX

Number of Covered Bond issuers



Source: ECBC

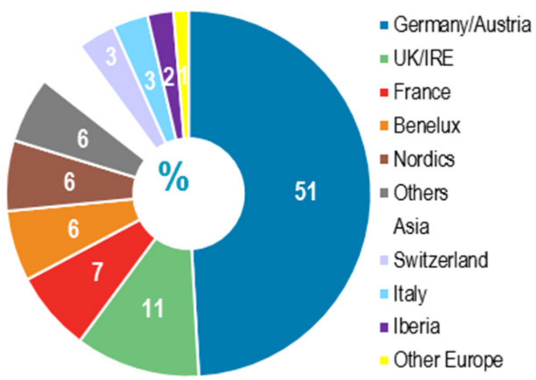
Regulatory treatment of covered bonds

- LCR eligibility: Covered bonds will be eligible as Level 1, Level 2a and Level 2b assets within the Liquidity Coverage Requirement regime.
- Solvency II: Covered bonds receive a risk weighting that is lower compared to similarly rated unsecured bonds.
- Risk weighting: A reduced risk weighting applies for covered bonds that are held by banks. The preferential capital treatment was reconfirmed on a study published earlier this year by the EBA.
- ECB repo eligibility: Covered bonds (issued by third parties as well as retained) are eligible as collateral for repo transactions with the ECB and receive lower haircuts than unsecured bank debt or ABS.
- ECB purchase programme: The ECB has announced its third purchase programme for covered bonds. While the size of the programme was not specified, the ECB noted that it will run for at least two years and will target Euro denominated covered bonds issued within the Eurozone. Purchases will take place in the primary and secondary market.

Who are the buyers of covered bonds?

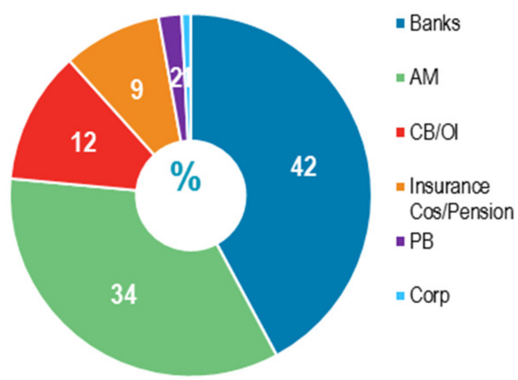
- Traditionally, the German/Austrian investor base has been the deepest in the market. Very tight Bund levels provide an expensive benchmark for German investors. Investors from outside the Eurozone/EU are likely to gain market share in the future.
- The market share of bank investors has increased noticeably since 2012, mainly as a result of the planned LCR eligibility of covered bonds. Within 2014, the market share of banks has also increased beyond maturities of 5 years.
- The upcoming ECB purchase programme could impact the composition of the investor base for covered bonds.

Average distribution of EUR Covered Bonds 2014



Source: BNP Paribas

Average distribution of EUR Covered Bonds 2014

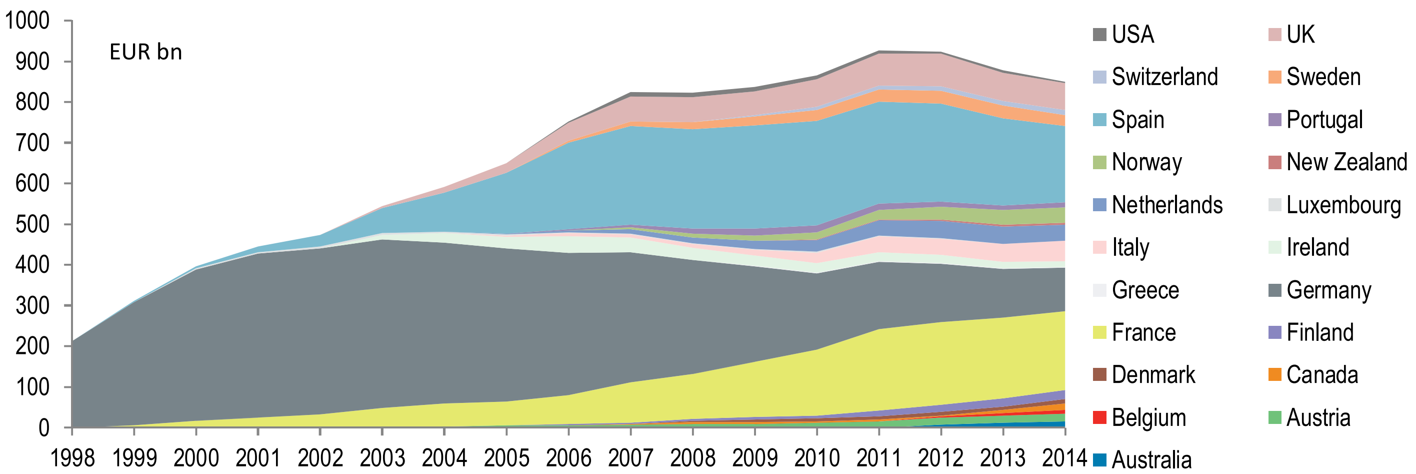


Source: BNP Paribas

The covered bond market has entered a maturing phase

- After more than a decade of strong volume growth, the covered bond market has entered a maturing phase and is now consolidating.
- The volume of maturing covered bonds is currently higher than the volume of newly issued covered bonds, which causes the market to shrink.
- Main reasons for the shrinking market size:
  - Consolidating bank balance sheets and mortgage markets
  - High reliance of peripheral banks on central bank funding (LTRO/TLTRO)

Outstanding Jumbo Covered Bonds by country

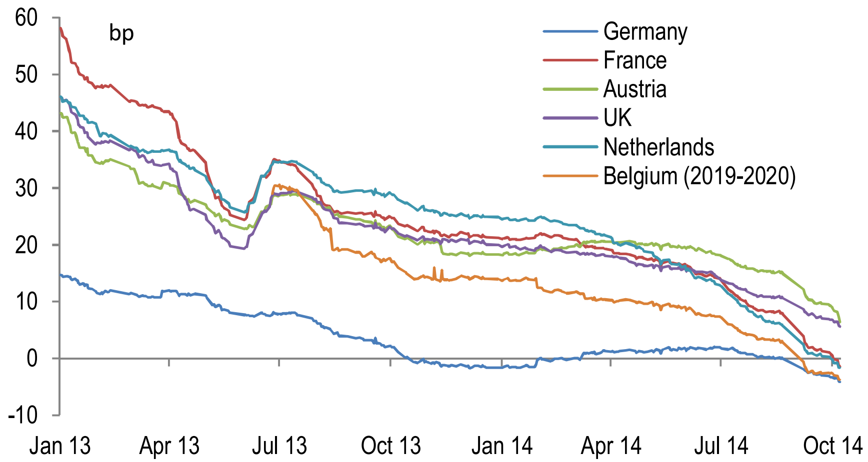


Source: BNP Paribas

Strong spread compression on the back of technical factors

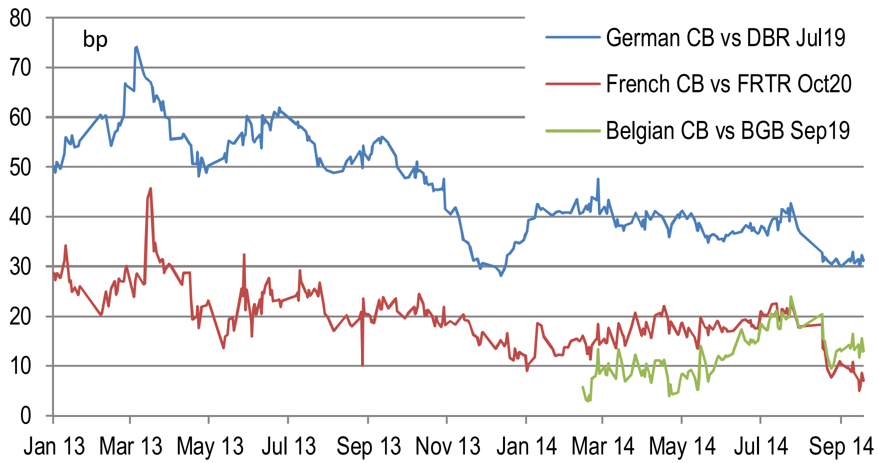
- The imbalance between high demand for and low supply of covered bonds has triggered a long development of covered bond swap spread compression.
- The announced ECB purchase programme has pushed swap spreads even tighter.
- Despite the tight spread levels, covered bonds in core markets still offer a pick up over local government bonds.
- In most peripheral markets covered bonds trade at tighter levels than local government bonds.

Average 2019-2022 euro benchmark swap spreads



Source: BNP Paribas

2019-2020 Covered Bond swap spreads vs. Govt.



Source: BNP Paribas

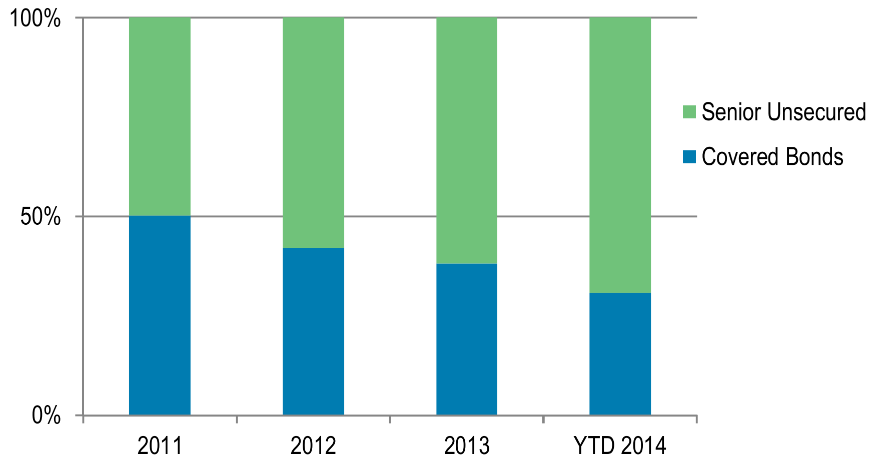
Spread differentiation between senior and covered remains low

- Despite the upcoming introduction of Bail-In regimes across Europe, the spread differentiation between covered bonds (exempt from Bail-In) and senior unsecured bonds has remained relatively low.
- Overall trend of spread compression and increasing risk appetite of investors have been the driving forces behind the tight spread differentiation.
- While the announcement of the ECB purchase programme has led to a slight increase in differentiation, it is likely that the expected strong decrease in senior unsecured supply due to the TLTROs will keep differentiation low going forward.

Spread difference senior vs. Covered Bonds

Source: BNP Paribas

European bank issuance Senior and Covered Bonds

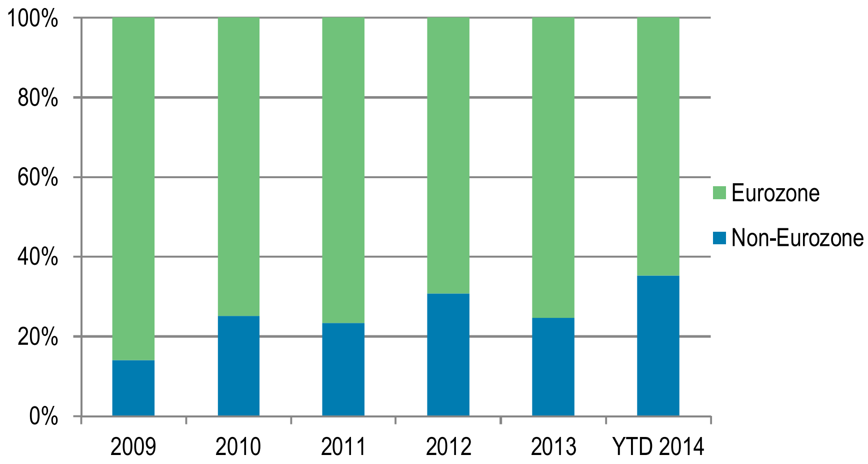


Source: BNP Paribas

Growth potential lies outside of the Eurozone

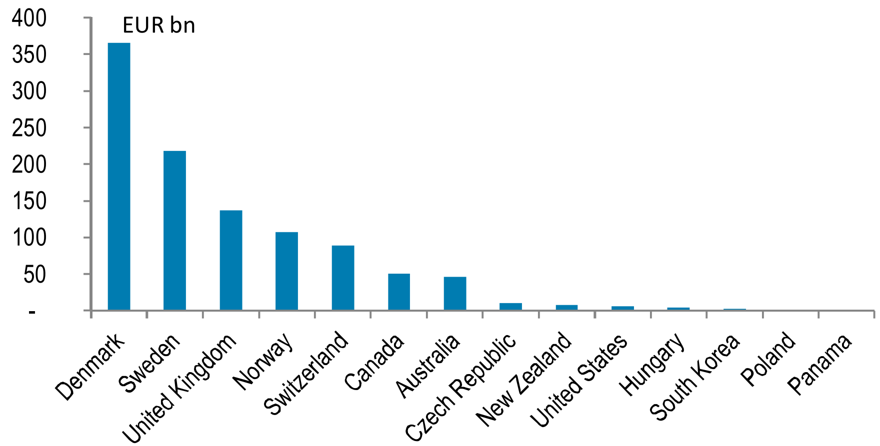
- While the Eurozone covered bond market is consolidating, we still see growth potential for countries outside the Eurozone.
- Several countries in Eastern Europe, South America and the Asian Pacific region have developed mortgage markets but only very few covered bonds outstanding.
- Investors which are getting squeezed out of core European covered bond markets are looking for investment alternatives.

Annual Jumbo Covered Bond gross supply



Source: BNP Paribas

Total outstanding Covered Bonds by country



Source: BNP Paribas, ECBC

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Recommendation System:

Type	Terminology	Horizon
Credit Trend (1) Investment Recommendation (2)	Positive/ Stable/ Negative Buy/ Add/ Hold/ Reduce/ Sell (*)	6 months Up to 6 months

(1) Credit Trend is based on underlying Credit fundamentals, business environment and industry trends;
(2) Investment Recommendations are as follows:
(*)
BUY – Maximise exposure based on improving financial profile and/or significant under-valuation.
ADD – Overweight exposure within industry sector/index, based on improving financial profile, and/or defensive characteristics and/or cheap valuation.
HOLD – Maintain position based on stable credit fundamentals and/or average expected return characteristics within peer group.
REDUCE – Underweight exposure within industry sector/index based on weakening financial profile, increased volatility and/or rich valuation.
SELL – Sell exposure/Maximise protection largely based on deteriorating credit fundamentals, negative headline/event risks and/or significant over-valuation.

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