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Western Europe

Euro SSA and Covered Bond Monthly

German Länder, post-Fed relative value and the spread outlook

- **Assessing relative value in German Länder:** We assess relative value within the German Länder sector and detail the market structure (€300bn in debt outstanding). Länder can provide interesting spread-pick up opportunities and offer diversification for investors in core EMU bond markets. Credit strengths include the loyalty principle (Bundestreue), the Equalisation Scheme, the debt brake and Stability Council.

- **Deutschland bonds:** Germany has now issued its inaugural Deutschland bond in a joint issue involving both the Federal Republic and the Länder. Rating agencies have been generally supportive. In general, such bonds serve to enhance investor choice within highly rated SSA sectors, offering diversified exposure to German credit quality.

- **SSA relative value:** The EU is no longer expected to issue euro benchmarks this year and has penciled in €2.6bn in 1Q 2014 and €2.1bn in 2Q 2014. We would maintain EU longs vs other supras. We also see relative value in core agencies vs the EFSF.

- **SSA spread outlook:** Spreads remain relatively soft compared with core EMU governments and yields are certainly not immune to higher UST levels. However, ASW levels remain less volatile and we would expect this to continue in the near term.

- **Covered bond opportunities:** The sell-off also has opened up some opportunities to re-enter certain covered bond segments at cheaper levels [e.g. certain Cédulas] in the short term. Moreover, recent primary deals indicate a return to a "buyer market" to some extent. We expect this to continue unless new supportive measures from the ECB changes market direction.

- **Covered bond outlook:** Redemptions should outweigh new issuance while volatility may well be higher in H2 relative to H2. Moreover, market participants might need some time to digest the new resolution regime proposed by European authorities. We also detail the Irish and German covered bond markets and USD covered bonds in light of the Fed-inspired back-up in core yields.

- **June supply**: Euro-denominated agency and supranational supply totaled ~€14bn in June and stands at around €120bn YTD. Covered bond issuance in June was €7bn and stands at €56bn YTD.

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German Länder in Focus

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The German Länder market comprises the debt of the 16 regional states that make up the German federation. In this article we detail this SSA segment, analysing:

- Market structure
- Fundamental characteristics
- Secondary market relative value

Länder can present interesting diversification strategies

Our core message is that German Länder benefit from the underlying credit quality and haven status of the German sovereign (albeit ratings are not always normalised, allowing for fundamental variation). The Länder can therefore provide interesting spread pick-ups to Bunds as a diversification strategy for long-term investors in the German market. This opportunity has been enhanced further with the recent introduction of "Deutschland bonds" (detailed in the SSA Strategy section on page 16). We also asses relative value of the Länder vs German agencies and covered bonds (Pfandbriefe).

Market Structure – over €300bn in debt outstanding

Over €300bn in bond debt outstanding

Total bond debt outstanding of the German Länder is around €313bn (including debt issued jointly under the Gemeinsame Deutsche Bundeslaender)[1]. This compares to the German sovereign debt market of €992bn, the German agency market of €720bn and the German pfandbrief market of €524bn (*Euro SSA and Covered Bond Strategy - Overview and opportunities: German agency and covered bonds*). Full details of debt outstanding by individual Länder and recent bond issuance can be found in Figure 1 below.

Figure 1. German Länder debt details

Länder Name	Ticker	Bond debt outstanding (€bn)	Weighted average maturity (years)	2012 Issuance (€bn)
North Rhine-Westphalia	NRW	88.7	4.2	17.1
Berlin	BERGER	36.6	3.5	4.5
Lower-Saxony	NIESA	33.2	3.3	4.4
Hesse	HESSEN	28.3	4.1	4.4
Gemeinsame Deutsche Bundeslaender	LANDER	23.2	3.6	4.7
Rhineland-Palatinate	RHIPAL	21.9	3.9	6.1
Baden-Wurttemberg	BADWUR	17.2	4.1	2.2
Saxony-Anhalt	SACHAN	10.9	4.1	0.6
Brandenburg	BRABUR	10.5	3.9	1.7
Schleswig-Holstein	SCHHOL	9.4	3.2	1.4
Bremen	BREMEN	8.6	2.5	2.2
Bavaria	BAYERN	8.2	3.9	0.8
Hamburg	HAMBRG	7.9	4.1	2.1
Thuringia	THRGN	3.6	4.1	0.4
Saarland	SAARLD	2.9	3.9	0.6
Mecklenburg-Western Pomerania	MECVOR	1.2	6.9	0.1
Saxony	SAXONY	0.6	3.6	0.0
	Total	**312.7**		**53.2**

Source: Citi Research, Bloomberg, DCM Dealogic Analytics

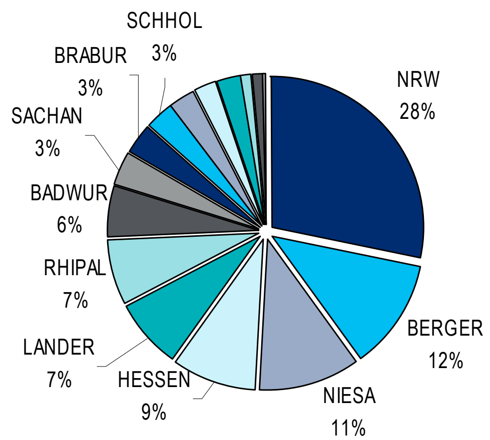
[1] According to Bloomberg

In terms of the debt distribution, NRW (North Rhine-Westphalia) has the largest amount of bond debt outstanding at €89bn, representing just over a quarter of all the Länder debt. This is followed by BERGER (Berlin) at €36.6bn and then NIESA (Lower-Saxony) at €33.2bn.

Largest issuer is North Rhine-Westphalia

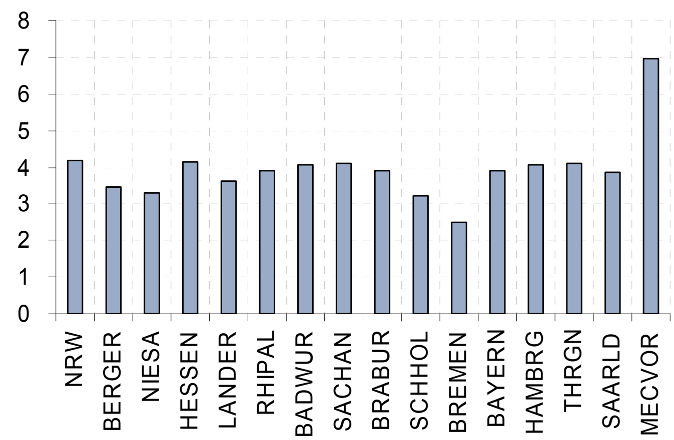
The make-up of the debt distribution is shown in Figure 2. Weighted average maturities tend to be around 4yrs (Figure 3). Note Mecklenburg-Western Pomerania (MECVOR) only has €1.2bn in debt outstanding across 6 bonds (the largest of which is €500mn maturing in Jan23).

Figure 2. Debt outstanding proportions (€bn)



Source: Citi Research, Bloomberg

Figure 3. Weighted average maturity of Länder debt (years)



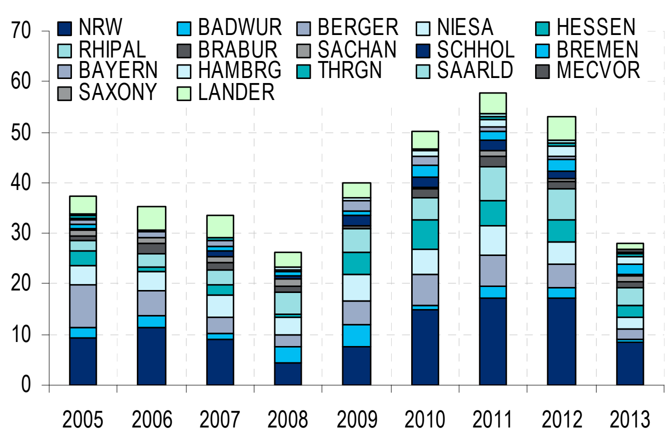
Source: Citi Research, Bloomberg

Total bond issuance last year was €53bn

Total bond issuance last year totaled around €53bn (Figure 4). Much of this came in the first quarter of the year, in line with the trend of front-loading. The largest issuer is typically NRW (€17bn) and other frequent issuers include BERGER (€4bn), NIESA (€4bn), HESSEN (€4bn) and RHIPAL (€6bn). Joint issuance under the Landergemeinschaft programme (LANDER) was around €4.7bn.

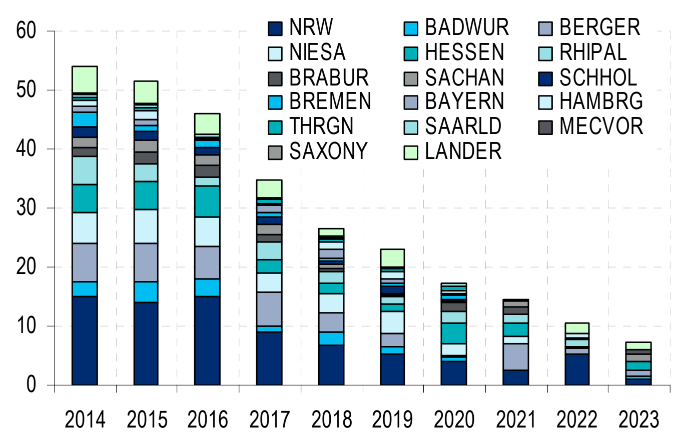
The maturity profile is shown in Figure 5. Next year, total bond redemptions total €54bn and in 2015, total redemptions are similar at €52bn.

Figure 4. Gross bond issuance (€bn)



Source: Citi Research, Bloomberg

Figure 5. Bond maturity profile (€bn)



Source: Citi Research, Bloomberg

Fundamentals and key issuers

Three of 16 Länder are city states

Germany is comprised of 16 different federal states (Länder): 13 of which are defined as territorial states and 3 are city states (Berlin, Bremen, Hamburg). This also reflects Germany's relatively decentralised structure in contrast to other European countries such as the unitary system in the UK. This decentralisation in Germany is reflected in Länder economic strength, the political decision making process of Germany, but also in the procedure of tax collection (see below).

Solidarity and independence are the two antipoles…

The relationship between the federation, the Länder and the municipalities is mainly defined by the German constitution (both horizontally and especially vertically). Here, the idea of the "state solidarity principle" plays an important role in understanding the relationship between the central government and the Länder. State finances are framed by the constitution, an equalisation system within the Länder on the one hand and a stability council, which has been introduced in 2010, on the other hand. One of the most important principles is the general principle of allegiance to the federal government (Bundestreue). Furthermore, the rising debt burden over recent years has seen the introduction of a "debt brake" (Schuldenbremse). This was even written into the constitution and will be effective as of 2016 for the German sovereign.

Figure 6. The German Länder in comparison

							GDP, yoy, %		
Land	Ticker	Rating (Moodys/S&P/ Fitch)	Share of GDP (Germany)	Interest / Tax quota	Dept per Capita (2012, €)	Unemployment (May 2013)	2010	2011	2012
Baden-Wurttemberg	BADWUR	Aaa/AAA/--	15%	6.8%	3918	3.7%	7.0	4.8	0.6
Bavaria	BAYERN	Aaa/AAA/--	18%	3.3%	2513	4.0%	4.6	4.6	0.7
Berlin	BERGER	Aa1/--/AAA	4%	14.5%	17958	11.8%	2.3	2.0	1.2
Brandenburg	BRABUR	Aa1/--/--	2%	10.6%	7282	9.8%	3.9	2.0	0.5
Bremen	BREMEN	--/--/--	1%	20.7%	28565	11.1%	5.5	1.0	1.2
Hamburg	HAMBRG	--/--/AAA	4%	10.8%	14000	7.3%	1.7	0.3	1.2
Hesse	HESSEN	--/AA/--	9%	9.5%	6666	5.8%	2.7	3.3	0.9
Mecklenburg-Lower Pomerania	MECVOR	--/--/--	1%	8.7%	5902	11.4%	0.4	0.6	1.9
Lower Saxony	NIESA	--/--/AAA	9%	11.3%	7227	6.5%	4.7	2.5	0.9
North Rhine-Westphalia	NRW	Aa1/AA-/AAA	22%	9.3%	7319	8.3%	3.8	2.1	0.4
Rhineland-Palatinate	RHIPAL	--/--/AAA	4%	10.7%	7572	5.4%	4.6	2.7	0.9
Saarland	SAARLD	--/--/--	1%	20.4%	11951	7.4%	5.4	5.0	-0.4
Saxony	SAXONY	--/AAA/--	4%	5.3%	1934	9.4%	2.9	2.4	-0.3
Saxony-Anhalt	SACHAN	Aa1/AA+/AAA	2%	11.1%	8896	11.2%	4.1	-0.1	0.5
Schleswig-Holstein	SCHHOL	--/--/AAA	3%	15.3%	9733	6.7%	0.7	2.6	0.9
Thuringia	THRGN	--/--/AAA	2%	11.1%	7313	8.3%	4.7	3.1	-0.3

Source: Bloomberg, Statistisches Bundesamt, Citi Research

… which can again be found in the constitution

The foundation of a decentralised state of several federal states is set in the German constitution. On the one hand the constitution clarifies that, in general, the regulatory and administrative power is located at the Länder level as long unless stated otherwise (Art. 30 GG). However, it should also be acknowledged that Art.31 GG puts the Bund in a position that can supersede Länder with central laws. On the other hand, the constitution also clarifies competences with respect to the state budget, tax collections and fiscal policy. Below we outline some of the main mechanics of the regional system in Germany, together with the layers of credit protection the Länder enjoy.

(1) Bundestreue - Solidarity principle

The solidarity principle has always been defended by the constitutional court

Bundestreue can be defined as an economic approach to behave in solidarity towards the federal state. On the hand, this represents a federal principle and one of the main characteristics of the German constitutional law. On the other hand, there have been cases and discussions which have sought to remove this principle of Bundestreue. However, German legal experts, as well as the constitutional court, have made it clear on several occasions that the solidarity principle is part of Germany's constitutional order and a permanent feature of Germany's economic landscape.

The common interest plays a determining role…

The core characteristics of the solidarity principle are that federal states as well as the central government are obliged to take into account the common interest of the federation when exercising individual sovereign power. This also implies that the German sovereign and the federal states should act together to fulfill common and individual responsibilities.

… which is found again in public finance

Translated into public finances, this means that the federal states are in a network of joint support if one member struggles with its own state financings. This brand of federalism is clear again when discussing financial support within the federal network. Art. 104a (4) GG gives the federation a clear boundary regarding its scope to force Länder to render services which might negatively affect the Land's budget. Separately, if a Land is in a budgetary emergency, the federation and the federal states are obliged to provide support. This can be found in Art. 107(2) GG.

Solidarity should decrease individual default risk substantially

The implication of this mechanism is the general idiom that determines the relationship. Independence should be maintained as far as possible, but solidarity is mandatory and legally binding. The consequence for an individual Land is that its default risk becomes more of an issue when other federal states as well as the central government are not capable of providing support. While this financial assistance is the "solution of last resort", the German federal state system has further mechanisms which help alleviate financial differences within Länder. The equalisation scheme is one such mechanism which tries to reduce such differences annually.

(2) The Federal Financial Equalisation System in Germany

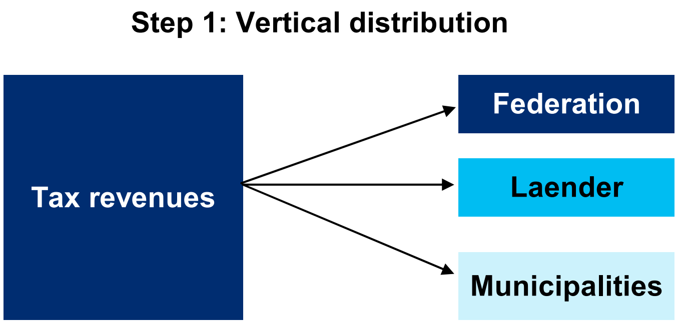
Tax income is generated on all government levels

The German tax system and its respective transfer payments and support mechanisms reflect the nature of the special relationship between the central government and the 16 Länder and the relationship between the federal states themselves. Taxes are generated on four different levels. While there are taxes which are shared among the three levels of government — the central government, the federal states and the municipalities (VAT, income tax, corporate tax, import sales tax and many others) — the respective governments also have their own tax income. For the central government, the most important own taxes are the inheritance tax and the real property transfer tax. By far the most important own generated tax income for Germany's federal states is the commercial tax. Municipalities mostly rely on their excise taxes, trade taxes and a real property taxes.

Equalisation payments follow four different steps

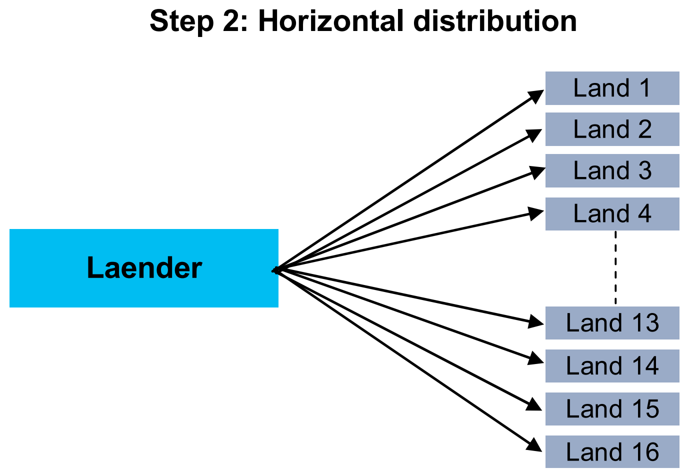
The equalisation system can be analysed in four different steps. First, there is the vertical distribution whereby tax revenues are divided and distributed to the three different government levels. Here, most of the joint tax revenues are transferred to the Federation (42.5% of income tax, 50% of corporation tax and 53% of VAT) and the Länder (42.5% of income tax, 50% of corporation tax and 45% of VAT) and to a much lesser degree to municipalities (15% of income tax and 2% of VAT).

Figure 7. First step



Source: Ministry of Finance, Citi Research

Figure 8. Second step

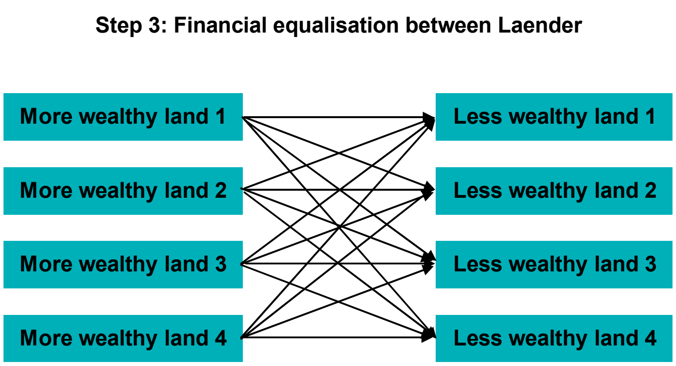


Source: Ministry of Finance, Citi Research

Horizontal distribution on step two

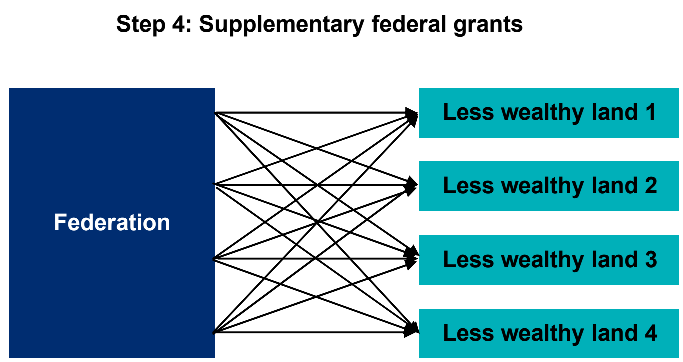
The second step involves horizontal distribution among the individual Länder. This is done following the principle of local revenue, i.e. Länder are in principle entitled to the tax revenue which has been collected on their territory. Then some corrections are undertaken within the allotment of VAT which has an equalising effect. Those areas whose sum of revenues from income tax, corporation tax and land taxes per capita is not higher than the per capita average of all Länder receive supplementary portions. This means that already on stage two, there is a degree of equalisation.

Figure 9. Third step



Source: Ministry of Finance, Citi Research

Figure 10. Fourth step



Source: Ministry of Finance, Citi Research

Equalisation payments on step three

The third step involves the financial transfer between the wealthy and the less wealthy Länder. This needs to happen against the backdrop of Länder fiscal autonomy and sovereignty which implies that a reduction of fiscal deficits can only happen partially. In order to determine the amount of transfer payments, the average financial capacity per capita from each Land is determined by taking into account tax revenues from the Lands' respective municipalities as well as the Länder share of joint taxes and the tax revenues from the Länder. Each Land's per capita financial capacity is then compared to the average fiscal capacity per inhabitant. However, for the city-states this assumption is not seen as appropriate. Therefore, their populations are increased artificially by 35%. For Länder with more strained finances, a slight increase is undertaken as well. This results in payments from financially stronger Länder to financially weaker Länder on an economically

adjusted basis (e.g. financial capacity per capita of 70%/120% of the average before financial equalisation leads to the financial strength after financial equalisation of 91%/106.5%.)

Figure 11. Financial capacity before and after equalisation payments

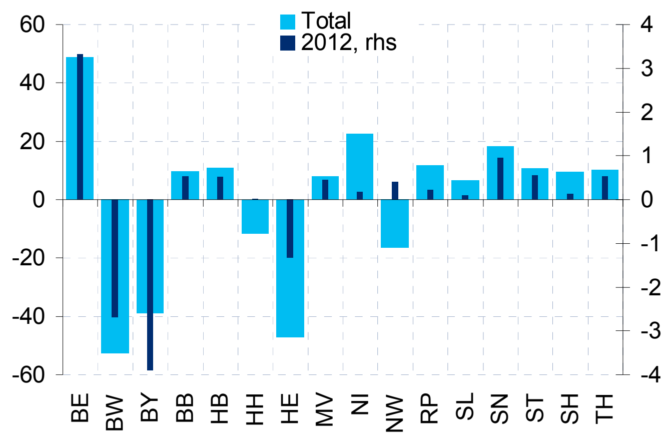
Financial capacity per inhabitant before equalization	Financial capacity per inhabitant after equalization	Financial capacity per inhabitant after equalization and federal grants
70	91	97.5
80	93.5	98
90	96	98.5
100	100	
110	104	
120	106.5	
130	109	

Source: Ministry of Finance

Supplementary grants at step four

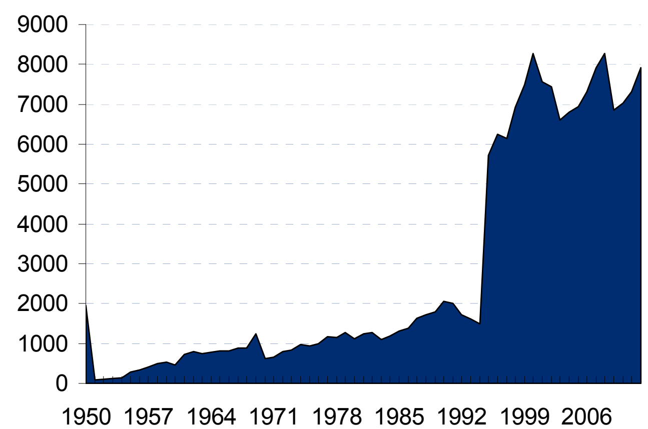
Within the last step, further grants are made to the less wealthy Länder from the central government itself. This is to help smooth out remaining financial variation. Some grants can be committed for specific purposes. One example includes the supplementary grants to Eastern German Länder and Berlin of €105bn until 2019 to build infrastructure. Generally, these grants are given if the financial capacity per inhabitant is less than 99.5%.

Figure 12. Equalisation payments, 1950-2012, EURbn



Source: Ministry of Finance

Figure 13. Average volume of equalisation payments, EURmn



Source: Ministry of Finance

What happens after 2019?

The financial equalisation payments started in 1950. After the reunification of Germany it lasted until 1995 after which the Eastern German Länder became part of equalisation payments. This mechanism can sometimes be controversial. For example, only this year, two of the biggest net payers — Bavaria and Hesse — brought their case to the German constitutional court. Their key concern regards the treatment of the city states and, in very general terms, the potential moral hazard which an equalisation scheme entails.

This judicial action should however be seen in the context of federal elections in Bavaria in September and note the equalisation scheme will be ending in 2019 (which has been decided upon in 1999). At current stages, the federal states are searching for a solution for solidarity payments after 2019.

While Bundestreue and the equalisation scheme are both mechanisms which help alleviate financial differences, Germany also has an increasing debt burden which resulted in a debt/GDP ratio of 82.4% in 2012 at the sovereign level. The increasing debt burden was one of the main reasons why German politicians decided to implement a debt brake (Schuldenbremse) which will be effective as of 2016.

(3) The debt brake – Schuldenbremse

A debt brake with some loopholes

The main pillars of the debt brake agreed upon in 2009 and being effective starting from 2016 are several. In principle, budgets need to be balanced. Moreover, there will be a structural leeway for further indebtedness which can be used in well defined exceptions. The debt calculation should be adjusted by financial transactions and cyclical influences to the public sector. Until 2016, an interim arrangement is put into place for the central government. For the Länder, the transition process is prolonged to 2020.

The central government can still rely on a structural component

As of 2016, the structural component and target for the fiscal balance for the German sovereign is 0.35% of nominal GDP (cyclically adjusted). The structural component can be used for several purposes, as flexibility is given. However, this tool should only be available for the central government and not for the federal states. They cannot rely on this. Apart form the structural component, there is also a cyclical component. This should help politicians to react with fiscal stimulus to recessions (automatic fiscal stabilisers). Yet, more importantly, this cyclical component means that in times of an economic boom, politicians are obliged to save more and hence reduce the cyclical deficit which emerged during recessions. In order to be responsive, the cyclical state of “normal times” needs to be defined. For this, the economy’s output gap and the potential output should be used as main indicators. If the central government defies the law, there is no immediate punitive fee. Instead, a control account is introduced where surplus borrowings but also less than expected borrowings are booked. If a pre-determined threshold is exceeded, repayments have to be done in keeping with the needs of the economy.

Some exceptions for certain cases

However, there still remain some exceptions regarding the debt brake. In case of natural catastrophes and extraordinary emergency situations which the state cannot control, the debt brake doesn’t apply. However, even this situation asks for an amortisation schedule of the surplus amount of debt which has been taken. Although these rules have already been decided upon in 2011, the central government needs to comply with these as of 2016.

Länder have a longer transition period

Länder are equally affected by these new regulations. Article 109 GG states that surplus debt is not allowed in times of normal economic conditions. Länder have a longer transition period and have the new rules to be implemented as of 2020. However, note that while the federal government can draw on a structural component, the Länder cannot. Apart from that, in case of natural catastrophes and extraordinary emergency situations which the state cannot control, the debt brake doesn’t apply. Also, federal states can rely on a cyclical component. The states which already receive consolidation support (i.e. Berlin, Bremen, Saarland, Saxony, Saxony-Anhalt and Schleswig-Holstein) have tighter conditions and have already begun consolidation programmes in preparation for the 2020 targets. Such consolidation is conditional on receiving financial assistance.

No punitive fees in case of violations

One main weakness of the debt brake is that neither the federal government nor the federal states are punished if they are in violation of the debt brake (apart from the potentially removed consolidation support). The long term goal of the debt reduction is that Germany complies with the rules set out in the Stability and Growth Pact which sets the 60% debt/GDP as a maximum ratio of indebtedness.

(4) The Stability Council

One of the main tasks is to monitor budget balancing

Amid the debt brake discussions following the financial crisis in 2010, the central government and the Länder agreed to introduce a Stability Council (Stabilitätsrat) as the successor of the budget council (Finanzplanungsrat). This was enshrined in law with an additional article in the constitution (Art. 109a GG). The council is composed of the respective Finance Ministers of each federal state, the German Minister of Finance and the Minister of Economics meeting at least twice a year. Decisions have to be based upon a two/third majority and the vote of the central government. If decisions are made upon one federal state, the respective state does not have the right to join the ballot. The council is headed by the German Minister of Finance and the Chairman of the Länder's Ministry of Finance conference.

Monitoring is mainly done by checking some key figures

The main purpose of the stability council is to ensure that the debt brake targets are held and that fiscal management is monitored. Thereby the public finances of the Bund and the federal states are observed. This is done by regular supervision of four different key metrics. Central government and the federal states have to inform the Stability Council until the end of September about the key figures and the mid-term household developments (over a period of seven years) based on coherent assumptions. The four key criteria are the following:

- **Structural net borrowing:** Net borrowing is adjusted by the balance of financial transactions and cyclical developments. Art.115 GG prescribes that structural net borrowing is to be decreased steadily over the next years. For every year the decreased net borrowing is defined following the steady decrease of this path. The threshold is set as the current year's figure plus €50 per capita. In case of the Länder, the Länder average plus €200 per capita must not be exceeded.

- **Net borrowing as % of expenditure**: For the central government, the threshold value is the 5y moving average plus 8pp. The threshold value for the current year is taken for the time frame of budget planning. For Länder, the threshold is derived from the Länder average plus 3pp. For the planning period, the threshold is derived from the current year's value plus 4pp.

- **Interest as % of tax revenue:** Tax revenue is adjusted by equalisation payments (received or paid), supplementary federal grants, support fees and car tax compensation. The threshold value is the 5y moving average plus 8pp. The threshold value for the current year is taken for the time frame of budget planning. For Länder, the threshold is derived from the Länder average. The value is exceeded if interest as % of tax revenue is 150% (140%) of the Länder average for city states (all other Länder).

- **Total debt level:** For the central government, debt is put into relation to GDP. The threshold value is the 5y moving average plus 8pp. The threshold value of for the current year is taken for the time frame of budget planning. For Länder, debt per capita is monitored. The threshold is exceeded if debt/capita > 130% of the average of all Länder except the city states and if debt/capita > 220% of the Länder average for city states.

The first federal states are already monitored

In general, a Land is seen in danger of a budget emergency if three of the four key metrics exceed the respective thresholds within one observation period. Although the Stability Council has limited enforcement powers, the development of this monitoring system and rigorous ratios analysis is a credit positive as an early detection system of financial health. The main role of the Stability Council is to act as a watchdog. In 2011, Berlin, Schlweswig-Holstein, Bremen and Saarland were deemed to have weakening financial indicators. The Stability Council subsequently agreed upon development measures between 2012 and 2016.

Figure 14. The four key metrics, 2012

	Structural net borrowing	Net borrowing as % of expenditure	Interest as % of tax revenue	Total debt level
Bund	-237	9.6%	13.0%	40.9%
BW	-87	-1.2%	6.8%	3,918
BY	-16	-2.6%	3.3%	2,513
BB	-95	2.2%	10.6%	7,282
HE	-233	5.9%	9.5%	6,666
MV	-63	-0.2%	8.7%	5,902
NI	-263	4.6%	11.3%	7,227
NW	-180	5.4%	9.3%	7,319
RP	-175	4.6%	10.7%	7,572
SL	-777	22.0%	20.4%	11,951
SN	194	-4.6%	5.3%	1,934
ST	-4	0.4%	11.1%	8,896
SH	-289	9.6%	15.3%	9,733
TH	-3	-0.1%	11.1%	7,313
BE	-191	4.2%	14.5%	17,958
HB	-1.281	18.6%	20.7%	28,565
HH	-447	4.6%	10.8%	14
Ø	-147	2.8%	9.2%	6,742
Threshold	-347	5.8%	12.9%	8,764
Threshold city states	--	--	13.8%	14,832

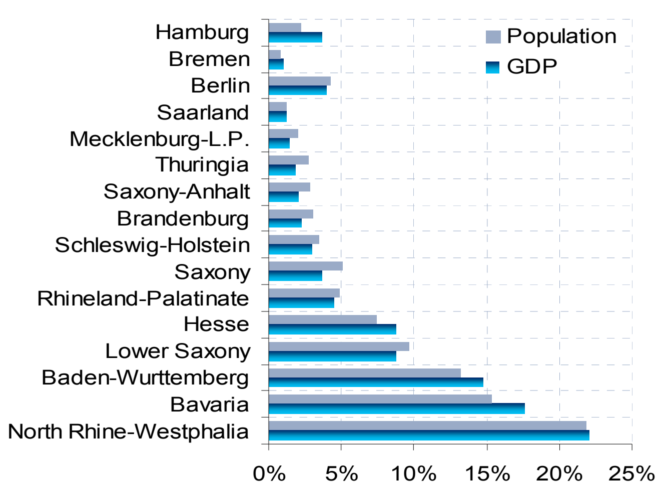
Source: Stabilitätsrat, Citi Research

(5) The macro and fiscal situation in Germany

Regional differences are sometimes substantially

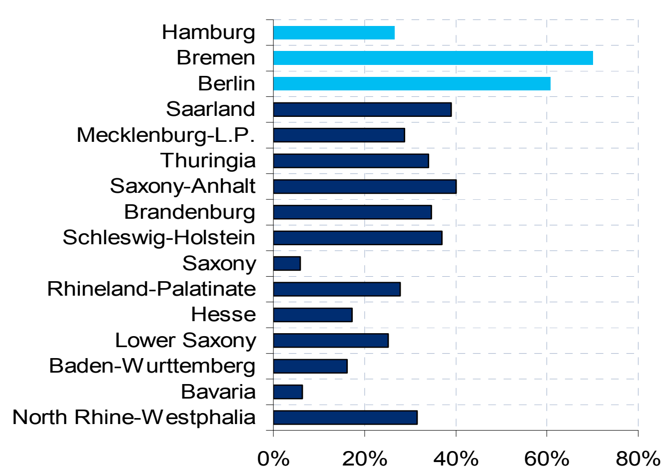
The multi-year ongoing EMU financial and political crisis put Germany into Europe's driving seat. One main reason was — and is — the economic health of the sovereign although new GDP projections also reflect how exports are influenced by weaknesses in neighboring economies. However, although Germany is generally seen as economically strong (see also our Global Economic Outlook and Strategy, as of June 2013), this must be seen in the context of substantial regional variation.

Figure 15. Share of German GDP in 2012 and share of German population, %



Source: Statistisches Bundesamt

Figure 16. Debt/GDP ratios, 2011



Source: Statista, Statistisches Bundesamt, Citi Research;

On the one hand, after more than twenty years since reunification, Eastern German Länder are still perceived to be weaker with respect to infrastructure and the labour market compared with most of its Western peers. On the other hand, the German city-states of Berlin, Bremen and Hamburg take a special role. As in any other bigger city in Germany, employees often prefer to live in the suburbs. For city states,

this often means that potential tax revenues (especially VAT and wage tax) are received by the neighbouring Länder while the former have to provide high quality infrastructure to ease commuting. This relative disadvantage is one Germany's equalisation scheme seeks to address.

Berlin has been developing more stable

Absolute debt figures would show that North Rhine-Westphalia is the most indebted federal state taking more than 25% of all federal states' debt. Putting the numbers into context, debt/GDP ratios draw a different picture putting the city states of Bremen and Berlin to figures above average. That said, the latter had much more stable growth over the last ten years. One main reason for this is the high concentration of public administration which was constantly growing after the reunification of the city.

…while the Southern German states are still the power house

The southern German states Bavaria and Baden Württemberg are the strong Länder in many respects. These federal states display lowest dept per capita figures while being one of the most productive federal states. The main relative advantages they have is that many large corporations are located in this region (BMW, Siemens, Audi in Bavaria; Daimler, IBM, Porsche, SAP in Baden-Württemberg) while they can also rely on medium-sized companies which provide a strong mix for an export oriented country.

These differences can partly explain secondary market differences as well

All in all, Länder fundamental and economic variation can be a source of secondary market differentiation. This can provide investors opportunities in terms of spread-pick-ups to Bunds, agencies and covereds which is where our attention now turns.

Relative value

i) Länder vs Germany and among the Länder

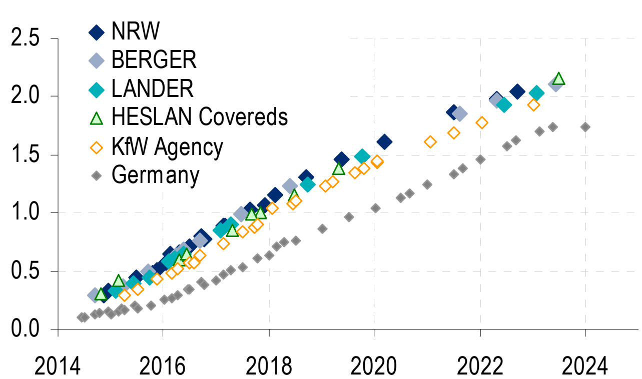
Not all Länder are rated the same

Although there are strong credit supports for the Länder (such as the equalisation scheme, the loyalty principle and the debt brake), there are of course fundamental differences as described. The strength of underlying support from the German sovereign means that all Länder are highly rated, but economic variation is enough to allow for rating differentials according the criteria of Moody's and S&P.

Technical drivers can be just as important as fundamental ones

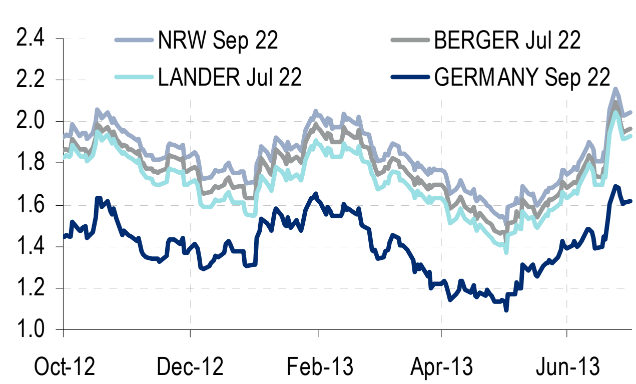
Spreads, in part, reflect such differences, but the drivers of spreads can often be more technical (reflecting supply pressures, positioning and liquidity) than they are fundamental. This means that relative value and the possibility to achieve spread pick-ups to Bunds, agencies and other Länder are important motivations for investors, who typically have buy-and-hold, long-term investor strategies.

Figure 17. Select German Länder , KfW, Pfrandbriefe and Bunds (%)



Source: Citi Research

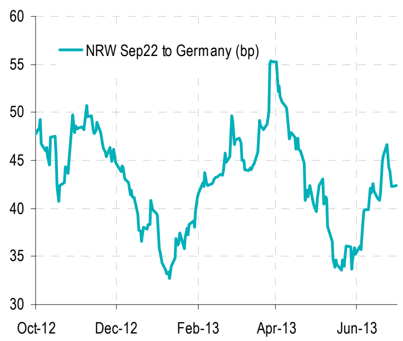
Figure 18. Select Länder and German Yield History, 9yr sector.



Source: Citi Research

The current yield curves of select German Länder are depicted in Figure 17. As shown, investors can achieve pick-ups not only to Bunds, but also to core German agencies such as KfW. Unsurprisingly, the strong connection to the German Republic and economic interconnectedness means that yields are highly correlated to Bunds (Figure 18). Spreads tend to trade in ranges (Figure 19) and are often driven by the Bund leg. The lower beta nature of German regional debt can make for interesting opportunities for dip-buying strategies when Bund yields rally sharply.

Figure 19. 10yr NRW to Germany (bp) is largely being driven by swap spreads



Source: Citi Research

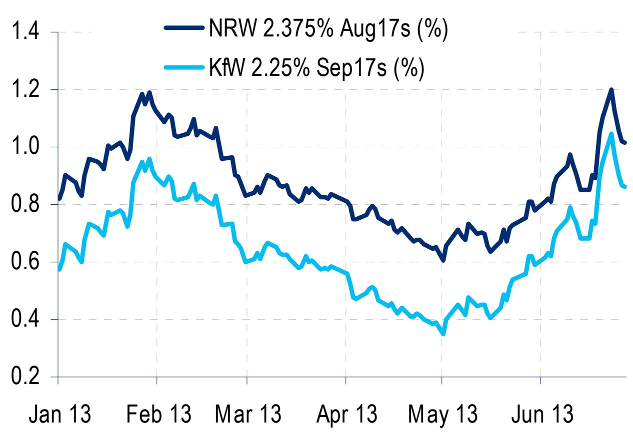
Swap spreads are also a key driver: in the current context, ASW levels are not moving so much as spreads to Germany, reflecting the move in swap spreads. In this sense, the current moves reflect less a credit story (as reflected in spreads to swaps) but more a duration dynamic (as reflected in higher core yields). The move in swap spreads is therefore providing interesting pick-ups once again between the Länder and underlying German sovereign debt.

More broadly, this particular segment of the SSA universe was one of the key outperformers throughout the volatility of 2011-2012: whereas ASWs in EIB and KFW widened, ASW spreads in the Länder outperformed.

ii) Länder vs agencies

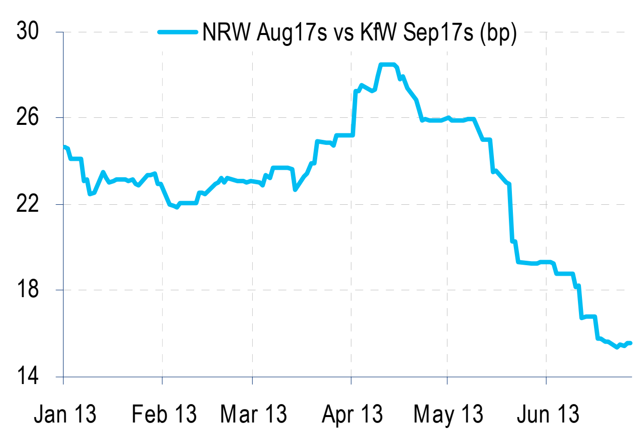
In the current context, the mover high in core yields has dragged KfW yields higher too. KfW's ASW levels may be little changed, but its relatively high beta to some of the Länder has driven considerable spread tightening between the two SSA segments. We would therefore increasingly see the current environment as an opportunity to step up in quality: as an example, the spread between KfW Sep 17s (AAA/Aaa) and NRW Aug17s (AA-, Aa1) is near historically tight levels meaning the spread give up has rarely been lower (Figure 20, Figure 21).

Figure 20. NRW vs KFW



Source: Citi Research

Figure 21. Higher beta KfW has cheapened to the Länder (bp)



Source: Citi Research

iii) Relative value – Länder vs pfandbriefe

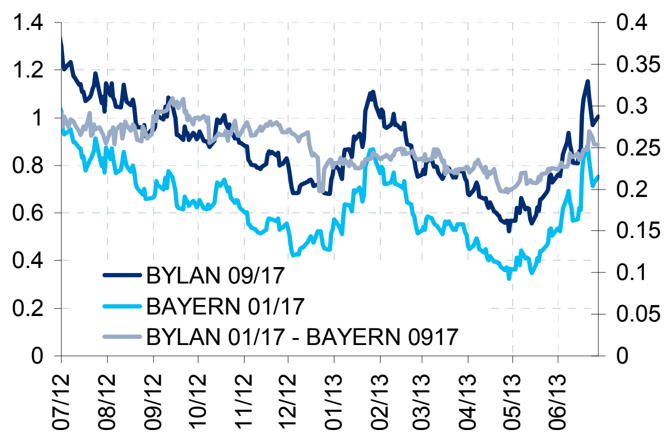
Pfandbriefe are less correlated to Bunds when compared with Länder or agencies

Pfandbriefe are less correlated to Bunds than Länder or German agencies. Nevertheless, the recent sell-off has also resulted in a re-pricing of German pfandbriefe. At the index level, German covered bonds have widened by 3bp since end of May (when historically low yields were achieved). As shown below, pfandbriefe and Länder are trading very tight to each other whereas agencies and bunds usually trade at richer levels

Step up in quality trades in covereds

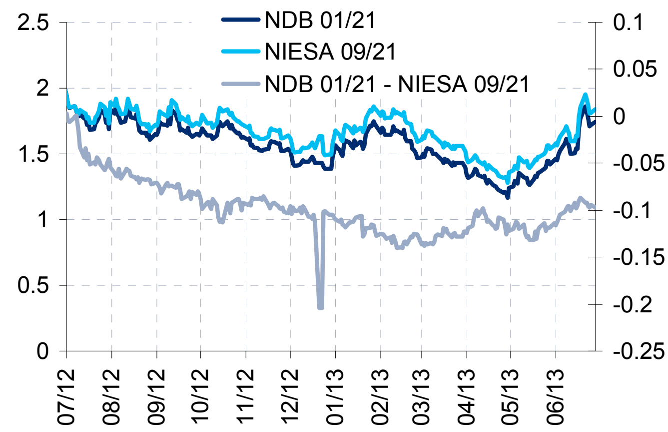
Generally, we would see it as an opportunity to step up in quality if public sector covered bonds trade very tight to sovereign debt. While there has been the opportunity to step up in quality between some agencies and KfW, we don't see this opportunity given in the relationship between pfandbriefe and Länder at the current stage. We think this is also the case for BAYERN vs BYLAN as well as NIESA vs NDB.

Figure 22. BAYERN vs BYLAN, %



Source: Bloomberg, Citi Research

Figure 23. NIESA vs NDB, %



Source: Bloomberg, Citi Research

Conclusion - credit supports and good performance

The German Länder represents another core segment of the German debt market (which also includes agency debt and covered bonds). The various credit protections — noted also by the rating agencies — which include the equalisation sheme, the loyalty principle and the Stability Council, all help explain secondary market performance and underlying fundamental strength. In general, the Länder often provide interesting pick-ups to Bunds as a diversification strategy for long-term investors in the German market, especially in terms of market stress. Going forward, the newest entrant to this market is the "Deutschland" bond (further details overleaf) and we will track issuance of this new security to better analyse relative value within the various SSA sectors.

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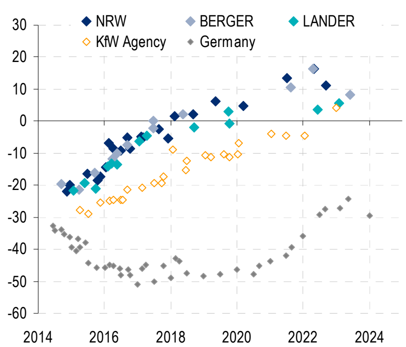
Euro SSA Strategy

1) Strategy views

Deutschland bonds have arrived

Deutschland bonds: In a widely anticipated transaction, Germany has issued its inaugural Deutschland bond: a joint issue between 10 Länder and the Federal Republic (13.5% if the issue). The €3bn 7yr benchmark transaction priced at mid-swaps +1bp, not too far away from the existing LANDER curve (Figure 24). This suggests that a higher participation rate of the Federal Republic is perhaps needed for for Deutschland bonds to trade significantly tighter than existing LANDER bonds (where the Republic is not part of the joint structure). As S&P notes[2] this joint bond has no impact on ratings for either Germany or the Länder.

Figure 24. ASW Curves of Länder and Peers



Source: Citi Research. Bloomberg

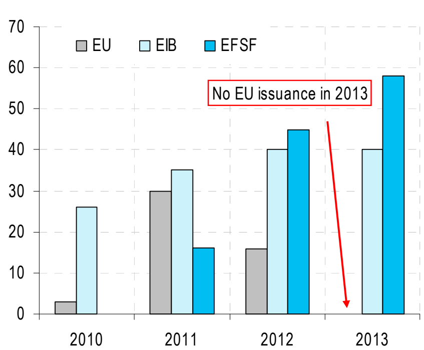
Not euro bonds: Furthermore, we would agree with S&P that such bonds do not constitute (and are not a precursor for) "euro bonds". Firstly, the regional states as detailed above are highly economically connected with various legal mechanisms to enhance fiscal consolidation. Secondly, although there is some degree of market differentiation among the states, spread differences tend to be in the single digits (as opposed to yield differences of Austria and Greece for example). This makes the German Länder market much more homogenous and viable for Deutschland bonds and renders comparisons with the "states" of Europe somewhat spurious.

Diversification for investors: In our view, Deutschland bonds represent yet another example of SSA market evolution. The involvement of the German Republic in such bonds provides investors another opportunity to gain exposure to a diversified pool of German credit quality. Liquidity of such issues should also be enhanced if issued in size and opportunities are probably best sought in the primary market. Overall though, German related debt remains the bedrock of European bond markets and fundamentally, Deutschland bonds serve to enhance investor choice within the highly rated SSA universe.

EU issuance – no benchmarks this year, remain long vs other supras

Au revoir, not adieu: The EU has recently indicated[3] it will not issue any euro benchmark bonds this year and instead, it has shifted its issuance plans into 2014 (€2.6bn in Q1, and €2.1bn in Q2). The EU still has €4.7bn left in EFSM issuance concerning the bailout programmes for Ireland and Portugal.

Figure 25. EUR Supra issuance (€bn)



Source: Citi Research, EU, EFSF, EIB

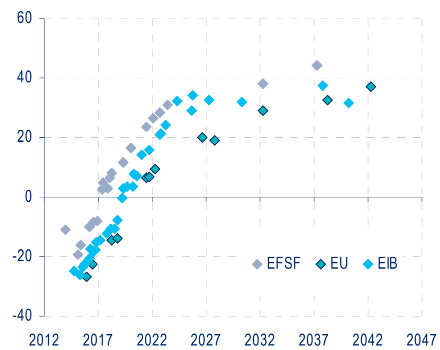
The EU (and EFSF) will continue to issue: EFSM loans to Ireland and Portugal have been increased from an average maturity of 12.5yrs to 19.5yrs which essentially means that the EU will be an active benchmark issuer in the years ahead (as is the case for the EFSF, (*European Rates Weekly; EFSF in June 2013, au revoir not adieu*). Hence, although the ESM now takes on the role of being the permanent stability mechanism (the "excess" €11.5bn capacity of the EU's EFSm is unlikely to be used), the EU and EFSFwill still refi debt until all loans are repaid.

Long EU vs other supras: The relative supply pipelines continues to support the case for being long the EU vs other supras. EU still trades at lower yield and ASW levels (Figure 26) than other supras and we would expect this trend to continue. Over recent weeks, EIB has underperformed slightly and we would not fade the move (Figure 27).

[2] S&P Ratings Direct: "*Germany's Proposed Joint Federal And State Bond Issue Has No Rating Impact*" S&P, 25th June 2013

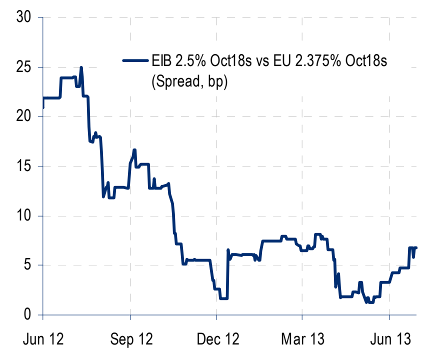
[3] EU Investor Presentation 18th June 2013

Figure 26. EFSF, EU, EIB ASW Curves



Source: Citi Research, Bloomberg

Figure 27. 5yr EIB vs 5yr EU (bp)



Source: Citi Research, Bloomberg

Long core agencies vs EFSF

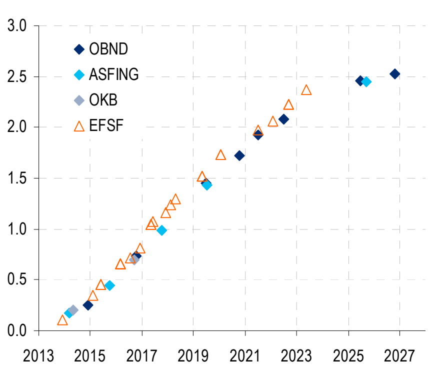
The EFSF has outperformed many supras and core agencies in the sell off

The volatility in core EMU markets has driven various SSA relationships to historically extreme levels. On various metrics, the EFSF has outperformed the move higher in yields. This is true when looking at spreads vs France, EIB and core agencies. One striking example is the underperformance of Austrian agencies such as ASFING (further details of which can be found in our *Euro SSA and Covered Bond Monthly - The Dutch and Austrian markets in focus*). Contributing factors to this move include positioning and supply (ASFING recently issued in June and the EFSF can't tap bonds issued pre-Cyprus). However, where possible, we would hunt for relative value switch opportunities, liquidity permitting.

Relative value in core agencies vs EFSF

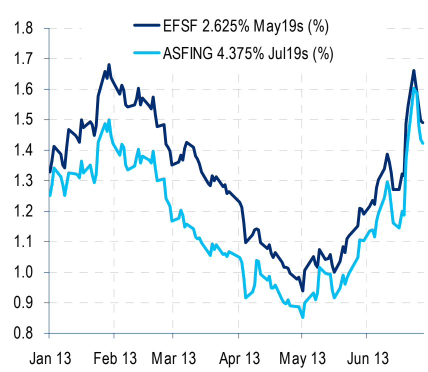
In this example, the spread between EFSF May19s (AA+/Aa1) and ASFING Jul19s (AA+/Aaa) has moved from over 25bp to under 10bp over recent months (Figure 29, Figure 30). The most recent move saw the spread hit around 6bp-7bp. Historically, this level doesn't represent an axiomatic floor, but it has proved a reliable point to fade the richness of EFSF; differentials between the two have tended to stay in single digits for relatively short periods. We would therefore expect to see buying interest in core agencies such as KfW and ASFING relative to the EFSF and spreads to normalise to average levels.

Figure 28. Austrian Agency & EFSF Yields (%)



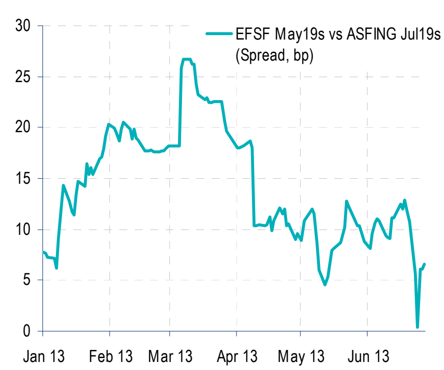
Source: Citi Research, Bloomberg

Figure 29. 6yr EFSF and ASFING Yields (%)



Source: Citi Research, Bloomberg

Figure 30. EFSF May19s vs ASFING Jul19s (bp)



Source: Citi Research, Bloomberg

(2) Primary market activity

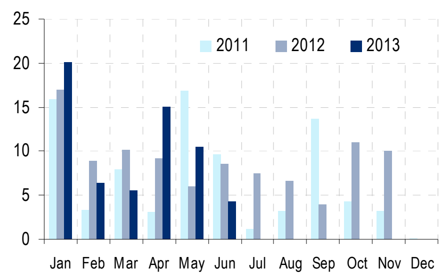
We detail European SSA supply data, including the key transactions of June, and provide completion rates for core issuers as well as upcoming cash flows.

Going forward, SSA supply in July is typically light

Supranationals: Euro-denominated supranational supply in June was €4.25bn (Figure 31). The main benchmark was €3bn EIB 2% Apr23s which was later tapped for €1bn. There was no sterling denominated supra issuance in June.

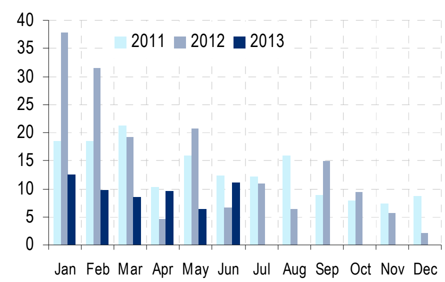
Agencies: Euro agency supply was around €10bn in June (Figure 32). Benchmark supply came from WIBANK, ASFING, CADES, KFW, RENTEN and FMSWER.

Figure 31. EUR Supranational Issuance (€bn)



Source: Citi Research, Dealogic DCM Analytics

Figure 32. Non-US Agency EUR Supply (€bn)



Source: Citi Research, Dealogic DCM Analytics

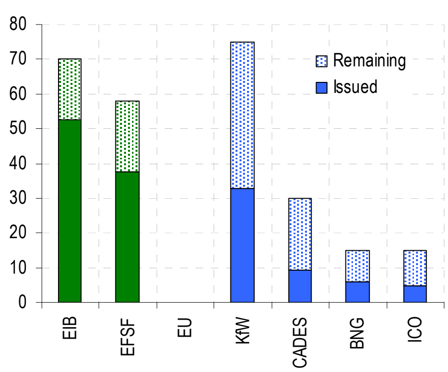
Many supras are making good progress in terms of their supply pipelines

Completion rates: Aggregating across currencies (Figure 33), many supranationals have issued over half of their 2013 supply targets (EIB 75%, EFSF 65%). Figure 34 and Figure 35 show monthly € supply for EIB and KfW.

Upcoming € cash flows in July: There are the following key cash flows in July:

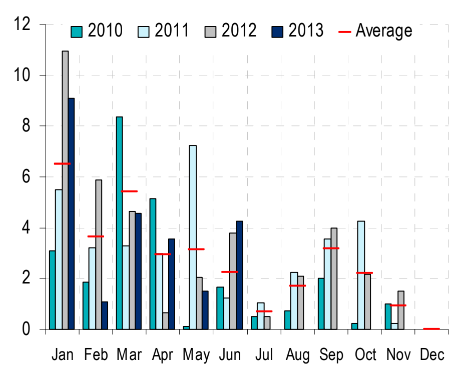
- €5bn redemption from KfW on 4th July (KfW 3.875% Jul13s)
- €1bn redemption from BNG on 4th July (BNG 4.375% Jul13s)
- €2.3bn redemption from ICO on 14th July (ICO 3.75% Jul17s)

Figure 33. European SSA Issuance Completion Rates, All Currencies, (€bn)



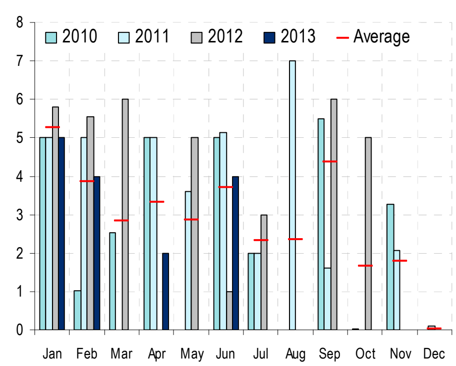
Source: Citi Research, Dealogic DCM Analytics, Issuers

Figure 34. EIB EUR Supply by month with average levels over recent years (€(€bn)



Source: Citi Research, EIB, Dealogic DCM Analytics

Figure 35. KfW EUR Supply by month with average levels over recent years (€bn)



Source: Citi Research, Dealogic DCM Analytics, KfW

(3) Secondary market performance

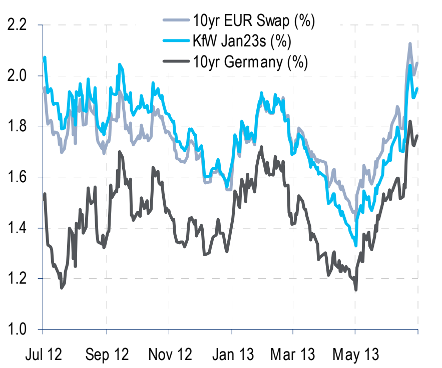
In the secondary market, SSA yields sold off given the back up in German yields over June. However, on a relative basis, spreads to swaps have been less violent.

May total returns
€ iBoxx Supranationals -1.29%
€ iBoxx Agencies -0.99%

Returns in June: The back up in core EMU yields drove most of the total return for € agencies and supras over June (10yr Bunds sold off from 1.5% to over 1.75%). Returns for € iBoxx Supranationals and € iBoxx Agencies over June were -1.29% and -0.99% respectively.

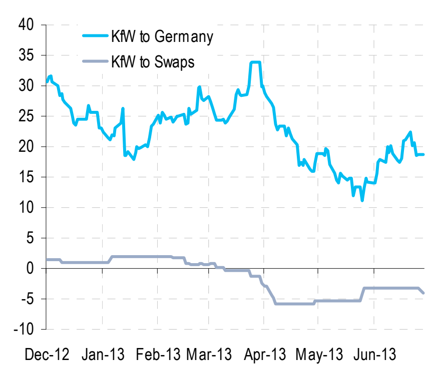
Spreads given the Fed: SSA yields are clearly not immune to the rise in core yields (Figure 36). However, on a relative basis, spreads to Germany rose largely due to movements in swap spreads, especially in agencies: KfW ASW were largely unchanged in June (Figure 37). EIB underperformed both vs swaps (slightly) and compared with German yields (Figure 38). We expect this soft tone to continue in the near-term and note that spreads are widening from levels that represent year-to-date lows following healthy buying earlier in the year.

Figure 36. 10yr KfW, EIB, Germany and € Swap



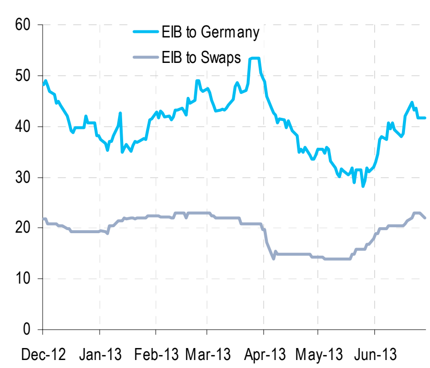
Source: Citi Research

Figure 37. 10yr KfW Spreads (bp)



Source: Citi Research

Figure 38. 10yr EIB Spreads (bp)



Source: Citi Research

June moves: Over June, core yields increased around 20b[-25bp (Figure 39). ASW spreads were slightly. Spreads to Germany widened around 5bp-10bp depending on the issue.

Figure 39. Select 10yr Core SSA Bonds, Details and Performance in June

					Yield		Spreads to Swaps		Spreads to Germany	
Issuer	Issue Date	Select Bond	Maturity	Amt Outstanding (€bn)	Level (%)	June Change (bp)	Level (bp)	June Change (bp)	Level (bp)	June Change (bp)
EIB	04-Jun-13	EIB 2% Apr23	14-Jul-13	4.00	2.24	22	26	0	52	6
EU	25-Apr-12	EU 2.75% Apr22	04-Apr-22	2.70	1.91	24	7	1	20	7
EFSF	28-Aug-12	EFSF 2.25% Sep22	05-Sep-22	3.97	2.19	23	28	0	47	6
KfW	09-Oct-07	KFW 4.625 Jan23	04-Jan-23	3.00	1.91	22	-4	-1	19	5
CADES	11-Apr-11	CADES 4.125% Apr23	25-Apr-23	5.02	2.34	22	35	0	62	5
BNG	19-May-11	BNG 3.875% May23	26-May-23	1.50	2.22	26	23	4	51	9
iBoxx Index		€ iBoxx Agencies			1.74	23	47	3		
iBoxx Index		€ iBoxx Supranationals			1.96	21	29	3		

Source: Citi Research, Bloomberg

Covered Bond Strategy

(1) Strategy views

The information provided below should be seen as a weighting recommendation of covered bond segments in order to outperform the iBoxx covered bond index in the medium term.

While still we are sticking to our general weighting recommendations in core markets, a more defensive stance on peripheral EGBs (European Rates Weekly), has led to changes in the related covered bond markets below.

Figure 40. Covered Bond Segments

Covered Bond Segment	Recommendation	Environment
Australia	Neutral	Non-Euro diversification, strong banking system, highly correlated to China
Austria	Overweight	Fiscal and economic situation, rather positive development of RAGB
Belgium	Neutral	Diversification, but rich versus other covered bond segments
Denmark	Neutral	Weak property sector, strong sovereign
Finland	Overweight	Strong sovereign, high quality cover pools
France	Overweight	Attractive demand-supply pattern, latest cheapening
Germany	Neutral	Safe haven bid, very attractive demand-supply pattern, trading very expensive
Ireland	Neutral	Easing situation on property market and the economy, correlation to peripheral countries
Italy	Underweight	Generally weak capitalised banks, Headline risk
Netherlands	Neutral	Deteriorating housing market, deteriorating macro outlook, attractive demand-supply pattern
New Zealand	Overweight	Non-Euro diversification
Norway	Overweight	Strong sovereign, decreasing new issuance pressure
Portugal	Underweight	Headline risk, contagion risk, relatively high quality cover pools
Spain	Underweight	Weak housing market, attractive demand-supply pattern
Sweden	Neutral	Trading rich to historical levels, favourable demand-supply pattern
Switzerland	Neutral	Overheating property market, strong sovereign
UK	Neutral	Non-Euro diversification, demand-supply pattern, slower than expected economic recovery

Source: Citi Research

Figure 41. Specific recommendations

Country	Recommendation	Environment
France	Prefer CIFEUR:pick-up versus French peers	Issuer in wind-down while still supported by liquidity of 3CIF
France	Prefer BPCE to the company's other covered bond issuer if trading at same levels	Higher quality of BPCE's cover pool
France	Prefer covered bonds to OAT	Different demand-supply pattern
Ireland	Prefer Irish ACS to Irish government bonds	Different demand-supply pattern
Italy	Prefer covered bonds to senior bonds from Tier 2 banks	Recent discussions on resolution regimes
Spain	Prefer covered bonds to senior bonds from Tier 2 banks	Recent discussions on resolution regimes
Portugal	Prefer covered bonds to senior bonds from Tier 2 banks	Recent discussions on resolution regimes
Norway	Prefer the highest yielding covered bond issuer EIKBOL	Best cover pool; rating differential is the main reason for higher yield
Finland	Prefer the highest yielding covered bond issuer AKTIA	New pool received Aaa
Netherlands	Prefer SNS to other Dutch covered bonds	High-quality cover pool, state owned and still offering >30bp pick-up
Spain	Prefer BKTSM to POPSM	Rating pressure on POPSM covered bonds by two rating agencies
Spain	Prefer Cedulas to Bonos	Recent underperformance of Cedulas vs Bonos provide new entry opportunities

Source: Citi Research

(2) Primary market: development and outlook

Are we back in a buyer's market?

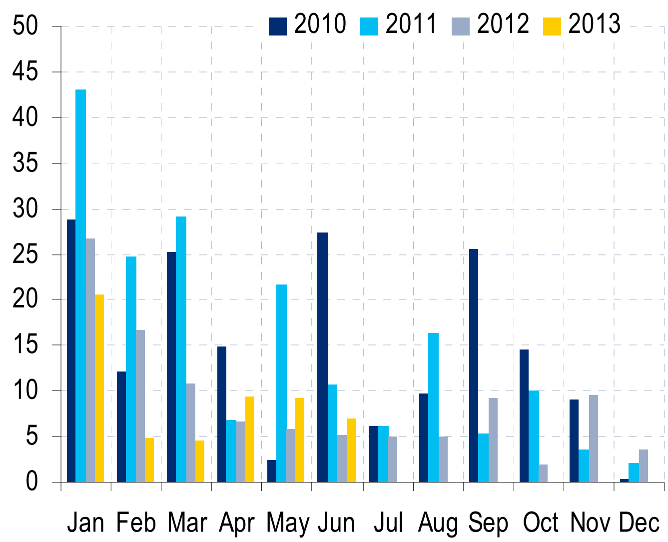
What a difference some weeks and one speech make. Over the last two weeks the covered bond primary market has been characterised by patterns not seen since the days before the first LTRO was announced. It is mainly consensus that volatility is back in markets after the compression effects of Draghi's speech in June 2012 have faded. The secondary market volatility is the main factor why the primary market might be characterised by "stop and go" activity over the next weeks. Issuance opportunities are not always given, but the existing ones will be challenged by more than just one issuer. The other aspect that will probably find increasing acceptance is a more generous stance of issuers for their deals on the primary market. This should provide investors a new issue premium to ensure the successful placement of the respective bond.

New issue premiums will probably find their way back

This could all be perfectly observed over the last week of June, when the first days of the week were still affected by Bernanke's speech. After an easing of the secondary market sell-off and partly a rebound over the middle of the week, three issuers decided to become active one the same day. What that all had in common was satisfying demand on the longer end of the curves. While CRH only tapped a 12y bond, CMARK debuted for this year with its residential mortgage backed Obligation à l'Habitat, focusing on the 10y tenor. MUNHYP, meanwhile, doubled the maturity of their first deal in April and provided the market with a 15y running mortgage pfandbrief.

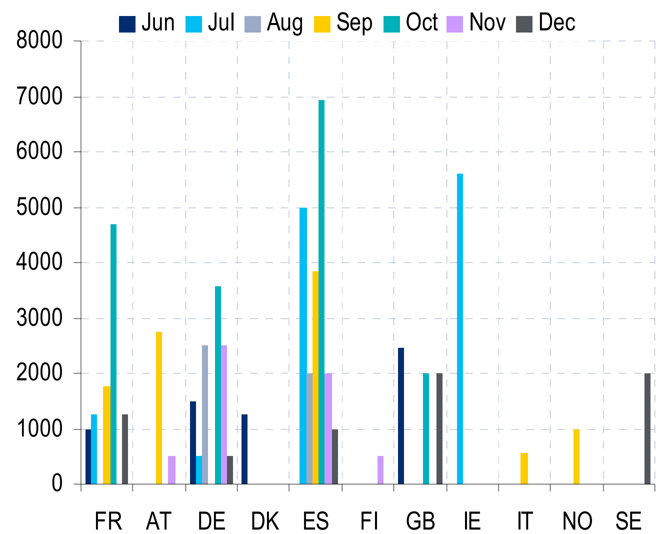
However, this is where similarities ended. CRH provided investors with a generous premium to the secondary levels which helped the issuer to tap the outstanding bond with the top end of the expected volume. This was less of a case in the other deals which were issuing without new issue premiums and therefore could not build on equally strong demand.

Figure 42. Historical gross issuance per month, EURbn



Source: Citi Research

Figure 43. Redemptions for 2H13



Source: Citi Research

Shrinkage will continue in 2H13

Although overall issuance in June was more than a year before, ytd issuance volume of EUR57bn is still lagging expectations. Over the next six months, nearly the same amount will mature (EUR56bn) as can be seen above. The bulk of these redemptions will be in October (EUR17bn) followed by July (EUR12bn). In terms of

redemptions by country, Spain (EUR21bn), Germany (EUR11bn) and France (EUR10bn) have the biggest share of total redemptions. In none of these countries we expect new issuance activities to outweigh redemptions. Therefore, shrinkage should be expected in the three most important covered bond segments whereas it should be most pronounced in the Spanish covered bond market. In general, our quite optimistic issuance expectation of EUR100bn of the beginning of the year for FY2013 would imply that the potential upcoming issuance activity would not outweigh the upcoming amount of redemptions.

A comeback and an inaugural deal to be expected from France

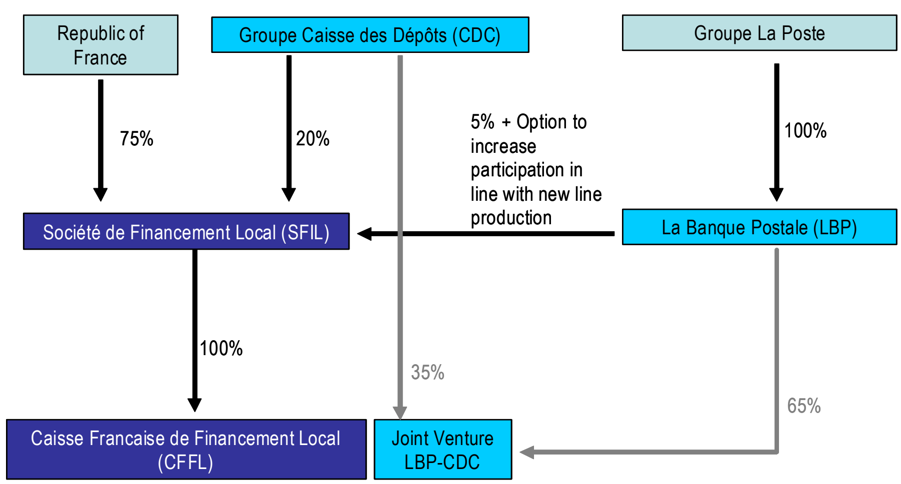
Apart from this rather pessimistic outlook, further deals can be expected in the near future. While some issuers from peripheral countries probably have to postpone their planned comebacks or inaugural deals, the issuance situation eased for many core covered bond segments. However, RLB NOE Wien recently announced to postpone their road show. Having said that, two French issuers could soon bring bonds to the market: CAFFIL and LBP. While the former should be active within the next days, the latter will probably have to do some investor relations business before its inaugural issuance comes to the market.

CAFFIL: The successor of Dexia Municipal Agency (DexMA)

The long awaited return of CAFFIL…

More than one year ago, Dexia Group agreed on several restructuring measures after the group was exposed to serious financial stress. Due to the high importance for the funding of local authorities it became clear that Dexia Municipal Agency (DexMA) as one of the most important institutions within this segment would not be part of any wind-down scenario or sale. Instead, the state-owned CDC (Caisse des Dépôts et Consignations) and La Banque Postale (LBP) should play an important role by giving support to the issuer of Obligations Foncières (OF). At the end of January, the transfer of the recently built CAFFIL — the official successor of DexMA — to their new holding company Société de Financement Local (SFIL) was finished after the European Commission approved this at the beginning of the year. Due to the high importance of local public sector funding, the French state is going to act as reference shareholder.

Figure 44. CAFFIL: New ownership structure



Source: CAFFIL, Citi Research

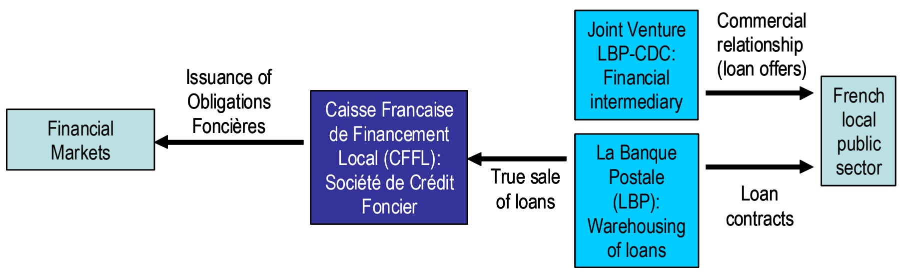
…with a 100% state dominated ownership structure

CAFFIL will be the new Société de Crédit Foncier (SCF) with its aim to refinance loans to the French public sector by issuing Obligations Foncières. SFIL is the 100% shareholder of CAFFIL. As Groupe Caisse des Dépots (CDC) as well as La Banque Postale (LBP) are state-owned, SFIL is 100% owned by public

shareholders. SFIL's goal is not only to refinance loans that are originated by LBP via the issuance of Obligations Foncières by its subsidiary CAFFIL. It also provides a range of services to LBP, CAFFIL and the joint venture between LBP and CDC (e.g. back office, risk management, ALM, controlling and execution of supply). Moreover, it provides liquidity (overcollateralisation) to CAFFIL as well as to derivative counterparties (cash collateral). Currently, this liquidity is made available mainly by CDC as key liquidity provider. However, for new activities LBP is mainly responsible for liquidity (65%) and CDC steps back (35%, capped at €12.5bn). If required, the Republic of France could also step in and make liquidity available.

The joint venture acts as a financial intermediary. It is in charge of the commercial relationship which includes loan offers. These loans are financed only by LBP. Therefore, collateral for the issuance of new covered bonds will be originated by LBP. Additionally, it will warehouse the loans before they are transferred to CAFFIL via true sale. All loans need a credit approval by LBP and CAFFIL.

Figure 45. The new transactions structure



Source: CAFFIL, Citi Research

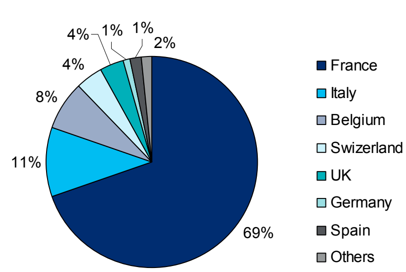
Figure 46. Main key figures to CAFFIL cover pool

Outstanding assets (EURbn)	66.6
Outstanding liabilities (EURbn)	54.1
Current OC	23.3%
Committed OC	2.0%
Moody's Key Figures	
Collateral Score	6.2%
Collateral Risk	3.4%
Market Risk	10.8%
Cover Pool Losses	14.3%
TPI Leeway	4
Maximum Mismatch	21.8%
Other Key Figures	
Main asset class: Public sector loans	100%
Fixed rate assets (cover pool)	50.1%
Fixed rate covered bonds	77.0%
WAL (covered bonds)	5.8 years
WAL (cover pool)	9.6 years
WA remaining term (months)	172
Number of borrowers	20408
Number of loans/bonds	78399
Exposure to ten largest borrowers	12.5%
Repo eligible loans/bonds	72.7%

Source: Moody's

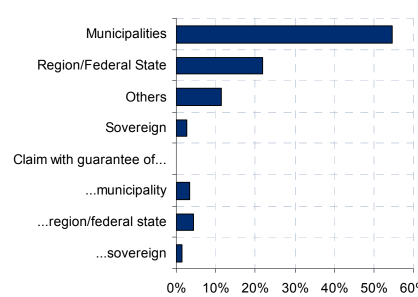
According to CAFFIL, €3bn-€5bn of benchmark covered bonds is planned for 2013. The first deal should come within the next few days. For the following years, we think that new issuance volume should be around €5bn. The new issuer will have outstanding liabilities of €54bn which were backed by €66.6bn as of 1Q13.
Due to the close link to the French state, SFIL (Aa2/AA+/AA+) is rated similar to the sovereign (Aa1/AA+/AAA). However, OF regained AAA ratings of all three agencies after DexMA was partially downgraded last year. However, for all three agencies the outlook for France and SFIL is negative. The following graphs show the cover pool composition as of 1Q13. Still, the pool is comprised by loans to the public sector or guaranteed by these entities. Over the course of time, the share of French assets is going to increase as the new lending business will be limited to the French local public sector. External ABS, which would have prevented the newly issued bonds from being ECB eligible, have been removed over the last weeks.

Figure 47. CAFFIL: Regional Distribution



Source: CAFFIL, Citi Research

Figure 48. CAFFIL: Borrower distribution, %



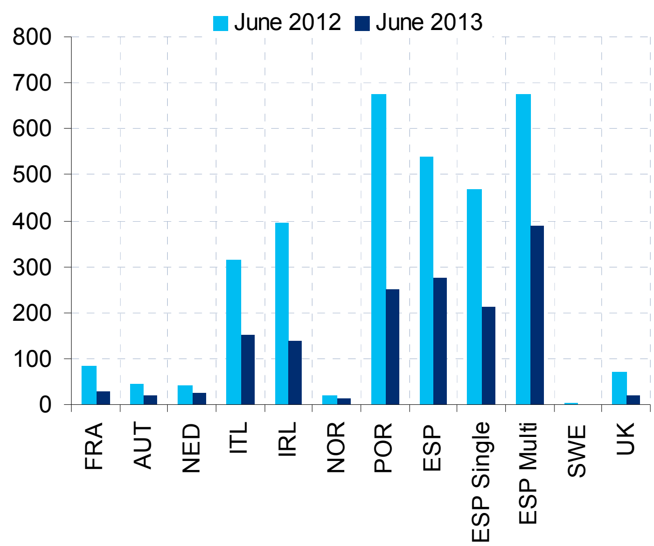
Source: CAFFIL, Citi Research

(3) Secondary market: post-FOMC developments

The effects of the „Draghi-put“ were substantial…

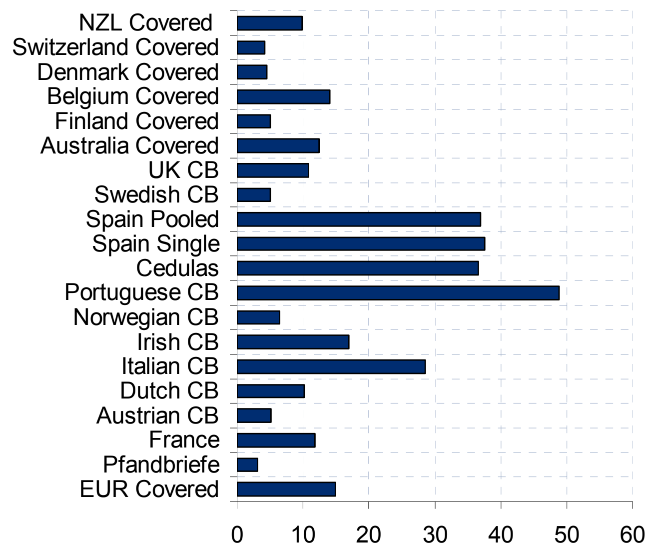
Since July 2012 the covered bond market has rallied impressively. It was especially the higher yielding bonds from peripheral countries which were sought. This led to a remarkable yield compression between but also within segments.

Figure 49. Spread over Pfandbriefe, ASW, bp



Source: Markit, Citi Research

Figure 50. Spread widening since End of May 2013, ASW-Spread, bp



Source: Markit, Citi Research

… but vanished while risk aversion bounced back

As shown in the graphs above, the compression in covered bond markets has been significant. However, this theme is over for now. In many covered bond segments, spreads to swaps have reached their 4y low over the last weeks. This implies that there has rarely been a better opportunity over the last four years to step up in quality while accepting a little give-up or none at all.

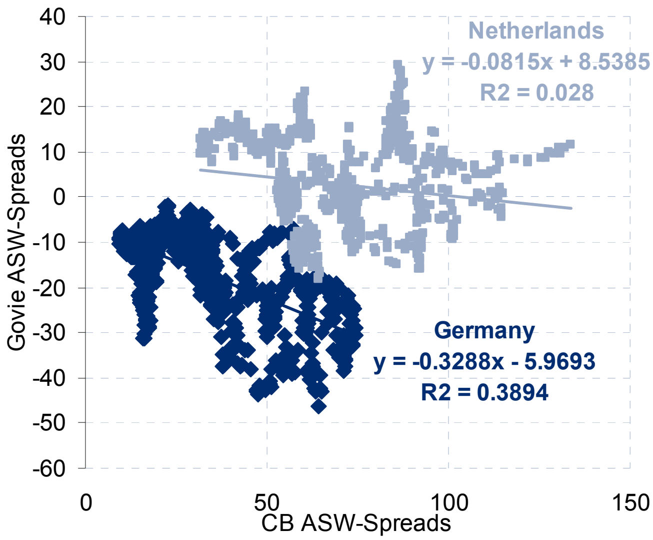
After the long rally stepping up in quality has become very attractive

During the whole month of June, spreads to swaps have widened in all covered bond segments. The reaction to comments about the end of quantitative easing reflects a new risk perception in capital markets. The increasing risk aversion could also be seen in EGB space with swap spreads widening in most of the segments. Consequences of a general higher risk aversion were also reflected in the covered bond primary market.

Higher peripheral EBG yields will lead to higher peripheral covered bond yields

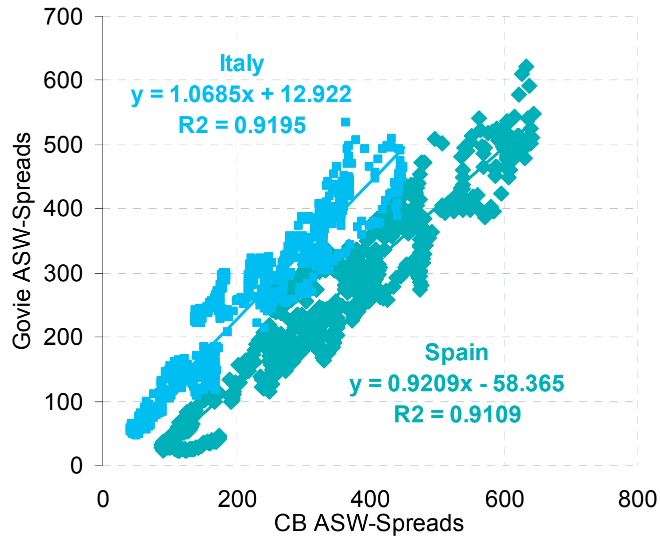
As mentioned in the monthly forecast update in one of our recent weeklies (see here: *European Rates Weekly - After the Fed – where next for European rates*?), we have lifted our projections for peripheral EGB yields while forecasting only marginally higher Bund yields. This has several implications for the covered bond space in our view. Still, the covered bond segment is affected by some idiosyncratic factors. On the one hand, the regulatory bid will be ongoing. The positive outcome of the discussions on resolution regimes for European banks and potential preferential treatment of covered bonds within LCR might even support further regulatory driven demand. On the other hand, the shrinkage of the covered bond market continues (redemptions in 2H13: €56bn) and has implications on the secondary market, especially when comparing covered bonds to sovereign bonds. Nevertheless, the main driver of secondary market levels is the correlation to the respective sovereign market. This is particularly high in peripheral covered bond markets. The uplift of peripheral EGB yields will lead logically to swap spreads widening in these covered bond segments.

Figure 51. 4y correlation between covered bonds and sovereign bonds



Source: Markit, Citi Research

Figure 52. 4y correlation between covered bonds and sovereign bonds



Source: Markit, Citi Research

Short-term volatility should be expected, mid-term outlook changed slightly

As we expect that the "lower for longer" theme will continue to hold, we would change our mid-term recommendation only slightly for some covered bond segments. Fed policy actions should play a minor role for covered bond markets when compared to sovereign and SSA debt. Instead, regulatory driven demand hitting a shrinking market will be more important factors for secured paper. Over the near term, we expect some tightening of covered bonds following the recent bounce back in many EGB markets. However, the scope of tightening should be lower and the prospect of similar outperformance of peripheral covered bonds like in the first months of the year should not be expected.

The big picture will determine covered bond performance

Over the next weeks, the main driver for covered bonds will be similar to those driving the EGB market, i.e. central bank meetings/decisions as well as headline data published. The effect should be most pronounced in the high beta segment, i.e. multi-cédulas and peripheral covered bonds from Tier-2 banks. In the mid-term we opine that most covered bond markets will be range trading. However, the latest market disruption showed that market participants became more sensitive to negative news, which should increase volatility in general.

Moreover, spreads of peripheral covered bonds over swap could widen further in the mid-term given our expectations on the peripheral EGB market. Apart from that, we think that the summer brake will be another factor which could support indecisive range trading before spread movements are led to a higher extent by idiosyncratic themes. When it comes to relative value between sovereign bonds and covered bonds, we continue to see it as justified to see covered bonds trading through government bonds in peripheral markets. This should not be affected by the absolute yield levels. However, we think that the all-time lows of March 2013 are difficult to reach again in the near-term. For France we continue to expect covered bonds trading through OAT in the long term, solely driven by different demand/supply dynamics.

Figure 53. Spread performance table

	Current	EUR	PB	M PB	PS PB	OF	OH	FRA CB	AUT CB	NL CB	ITL CB	IRL CB	CAN CB	NOR CB	POR CB	ES CB	ESS CB	ESM CB	SWE CB	UK CB	AUS CB	FIN CB	BEL CB	DEN CB	SUI CB	NZL CB	LUX CB
EUR	99	7	77	77	77	50	54	52	59	56	-65	-56	83	65	-153	-186	-124	-298	76	62	56	71	55	63	72	70	-22
PB	18	82	2	0	0	-26	-22	-25	-18	-21	-142	-132	6	-12	-229	-263	-200	-374	0	-14	-21	-5	-22	-14	-4	-7	-99
M PB	18	82	0	2	0	-26	-22	-25	-18	-21	-142	-133	6	-12	-229	-263	-200	-374	-1	-14	-21	-6	-22	-14	-4	-7	-99
PS PB	18	82	0	0	2	-26	-22	-25	-18	-21	-142	-132	6	-12	-229	-263	-200	-374	-1	-14	-21	-5	-22	-14	-4	-7	-99
OF	48	51	-30	-30	-30	6	4	2	8	5	-115	-106	32	14	-203	-237	-174	-348	26	12	6	21	5	12	22	19	-73
OH	43	56	-25	-25	-25	5	5	-3	4	1	-119	-110	28	10	-207	-241	-178	-352	22	8	1	17	0	8	18	15	-77
FRA CB	46	53	-28	-28	-29	2	-3	5	7	4	-117	-108	31	13	-204	-238	-175	-350	24	11	4	19	3	11	21	18	-74
AUT CB	38	61	-20	-21	-21	10	5	8	4	-3	-124	-114	24	6	-211	-245	-182	-356	17	4	-3	13	-4	4	14	11	-81
NL CB	43	57	-25	-25	-25	5	0	3	-5	6	-121	-112	27	9	-208	-242	-179	-353	20	7	0	15	-1	7	17	14	-78
ITL CB	168	-68	-150	-150	-150	-119	-125	-121	-129	-125	10	9	148	130	-88	-121	-59	-233	141	127	121	136	120	128	137	135	43
IRL CB	156	-56	-138	-138	-138	-108	-113	-110	-118	-113	12	7	139	121	-97	-131	-68	-242	132	118	112	127	111	118	128	125	34
CAN CB	12	87	6	6	6	36	31	34	26	31	155	144	2	-18	-235	-269	-206	-380	-7	-20	-27	-12	-28	-20	-10	-13	-105
NOR CB	32	68	-14	-14	-14	16	11	14	7	11	136	124	-20	4	-217	-251	-188	-362	11	-2	-9	7	-10	-2	8	5	-87
POR CB	267	-168	-249	-249	-250	-219	-224	-221	-229	-224	-100	-111	-255	-235	22	-34	29	-145	229	215	209	224	208	215	225	222	130
ES CB	293	-194	-275	-276	-276	-245	-250	-247	-255	-250	-126	-137	-281	-262	-26	14	63	-111	262	249	242	258	241	249	259	256	164
ESS CB	230	-130	-212	-212	-212	-182	-187	-184	-192	-187	-62	-74	-218	-198	37	63	14	-174	200	186	179	195	178	186	196	193	101
ESM CB	406	-307	-388	-388	-388	-358	-363	-360	-368	-363	-239	-250	-394	-374	-139	-113	-176	16	374	360	354	369	353	360	370	367	275
SWE CB	19	80	-1	-1	-1	29	24	27	19	24	148	137	-7	13	248	274	211	387	3	-14	-20	-5	-21	-14	-4	-7	-98
UK CB	36	63	-18	-18	-18	12	7	10	2	7	132	120	-24	-4	231	257	194	370	-17	6	-7	9	-8	0	10	7	-85
AUS CB	43	57	-25	-25	-25	5	0	3	-5	0	125	113	-31	-11	224	250	187	363	-24	-7	6	15	-1	7	17	14	-78
FIN CB	24	75	-6	-7	-7	24	19	22	14	19	143	132	-12	8	243	269	206	382	-5	12	19	3	-16	-9	1	-2	-93
BEL CB	46	54	-28	-28	-28	2	-3	0	-7	-3	122	110	-34	-14	222	248	184	360	-27	-10	-3	-21	8	8	18	15	-77
DEN CB	32	67	-14	-15	-15	16	11	14	6	11	135	124	-20	-1	235	261	198	374	-13	4	11	-8	13	2	10	7	-85
SUI CB	22	77	-4	-4	-4	26	21	24	16	21	145	134	-10	10	245	271	208	384	-3	14	21	2	24	10	2	-3	-95
NZL CB	28	71	-11	-11	-11	20	14	18	10	14	139	127	-16	3	239	265	201	378	-9	8	14	-4	17	4	-6	5	-92
LUX CB	117	-18	-99	-99	-99	-69	-74	-71	-79	-74	50	39	-105	-85	150	176	113	289	-98	-81	-74	-93	-71	-85	-95	-89	2

Source: Markit, Citi Research; Orange: Current ASW-Spread; Light blue: ASW-Spread between the two segments; dark blue: ASW-Spread performance of the segment over the last two weeks; light grey: ASW-spread between two segments two weeks ago; abbreviations: EUR = EUR covered bond index, PB = Pfandbrief index, MPB = mortgage pfandbrief index, PSPB = Public sector pfandbrief index, OF = Obligations Foncières, OH = Obligations à l'Habitat, FRA CB = French covered bond index, AUT CB = Austrian covered bond index, NL CB = Dutch covered bond index, ITL CB = Italian covered bond index, IRL CB = Irish covered bond index, CAN CB = Canadian covered bond index, NOR CB = Norwegian covered bond index, ES CB = Spanish covered bond index, ESS CB = Spain Single covered bond index, ESM CB = Spain Multi covered bond index, SWE CB = Swedish covered bond index, UK CB = UK covered bond index, AUS CB = Australian covered bond index, FIN CB = Finnish covered bond index, BEL CB = Belgium covered bond index, DEN CB = Danish covered bond index, SUI CB = Swiss covered bond index, NZL CB = New Zealand covered bond index, LUX CB = Luxemburg covered bond index

(4) Market developments

Irish and German covered bonds – the better value?

Figure 54. Definition of the PMVC and a simplifying example

The Prudent market value of a mortgage is the nominal value of the mortgage capped at 75% of the indexed property valuation. Indexed LTV levels for loans in the cover pool can exceed the 75% threshold; however, the balance of the loan above the 75%, while remaining in the cover pool, is disregarded for legislative or contractual OC calculation purposes.

Loan	100,000
Indexed Valuation	100,000
	i.e. 100% LTV
Prudent market value cap at 75%	75,000
	100,000*75%/100%
Bonds can be issued up to (min. 5% OC)	71,400

Source: Irish covered bond act, Moody's, BoI

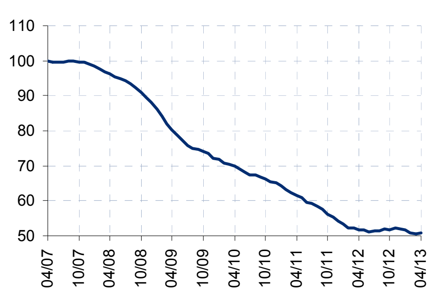
Last week, Moody's adverted to a special feature of the Irish covered bond law. It can draw on certain characteristics which are very special in the covered bond regulatory universe. Moreover, these helped to make the cover pool quality staying quite constant although Irish property prices suffered the most severe correction over the last years.

In its report, Moody's refers to the Prudent Market Value Concept (PMVC). This demands issuers to mark down property values by using a property index (since 2010 Irish issuers use the CSO index). In times of property price deterioration, this leads to the necessity that the covered bond programs have to be managed very actively. While there is the option to reduce covered bond issuance, there is also the possibility of adding eligible collateral to the cover pool or cancel retained covered bonds which would free up collateral that has been pledged to the central bank.

In any case, issuers have to manage a prudent market valuation cap of 75%. This again is a supportive factor for the cover pool quality. The consequence of declining property prices, against the backdrop of such valuation, is that the amount of ineligible OC has been constantly growing. This is because PMVC valuations demanded an increase in cover pool volume to have enough assets to fulfill OC requirements. Apart form the legal framework, Irish ACS issuers committed within their T&C to also to fulfill minimum OC of 5% on a PMV basis. Over the last years, issuers have always complied with this.

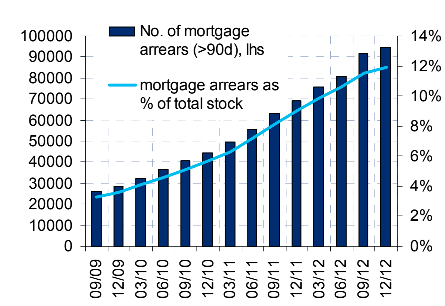
Moody's also points out that this regulatory feature had several implications against the backdrop of house prices falling to around 50 (indexed at September 2007 =100). On the one hand, the amount of assets transferred to the pool was constantly rising. The covered bond law states that although the amount of the loans exceeding the 75% threshold loses eligibility for overcollateralisation calculations, they remain in the cover pool. And this can clearly be seen as a further support for covered bond investors. On the other hand, the gap between nominal OC and PMV OC has constantly become bigger over the last years. Apart from this very useful feature within the covered bond law, there is another supportive contractual element which both Irish MACS (residential mortgage covered bond) issuers BKIR and AIB have implemented. Loans that are in arrears more than one quarter or one month, respectively, are treated as ineligible and will be removed from the cover pool.

Figure 55. Irish house price development, 2007=100



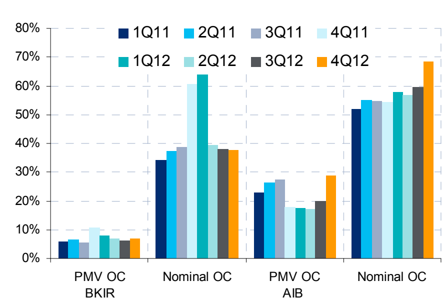
Source: Central Statistics Office Ireland

Figure 56. Loans in arrears increase on a lower pace



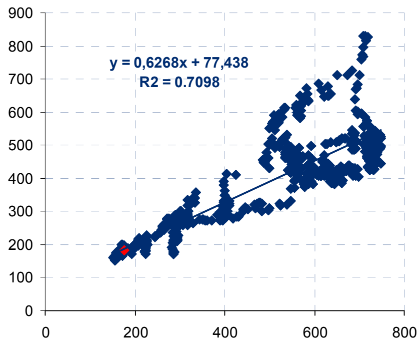
Source: Central Bank of Ireland

Figure 57. The gap between nominal OC and PMV OC has been widening



Source: Moody's, Issuers

Figure 58. AIB 06/17 vs IRISH 10/18: 3y correlation

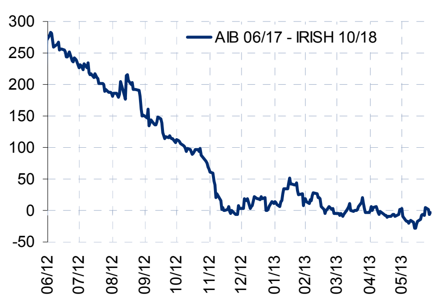


Source: Citi Research; red dot = now

In spite of the legal and contractual safeguards, we think a further support for Irish MACS may come from the rating side. Currently, Moody's is the only rating agency which still rates the Irish sovereign to sub-investment class. Citi economists continue to believe that economic and market evens may prompt Moody's to restore Ireland's investment grade rating in the quarters ahead (*European Economic Forecast Highlights - May 2013*). This would have implications on the ratings of Irish mortgage covered bonds. AIB and BKIR were downgraded in 02/11: the last time when additional government's willingness to support the Irish banks was put into question. However, this indirectly shows that the tie to the sovereign — albeit a lower assumed willingness to support — is given. This is why a sovereign comeback to investment grade could lead to the upgrade of the MACS issuers and covered bonds as well. Apart from the rating improvement our economists expect that Ireland's path back to fiscal sustainability will probably remain vulnerable to further shocks and could longer than expected. Given the high correlation between govies and MACS, higher volatility can also be expected in the covered bond segment.

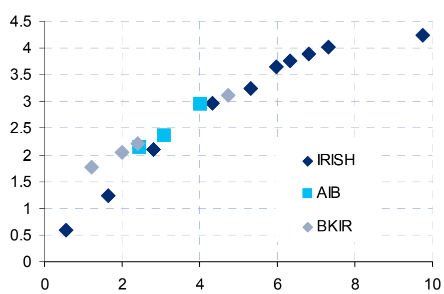
On the market side, a further shrinkage of the ACS market (only BKIR and AIB left as active issuers) is likely, while public sector covered bond issuance cannot be expected in the short and mid term. Both public sector covered bond programs are in a wind-down scenario. Therefore, redemptions of €8.8bn until end 2014 will not be outweighed with new issuance of MACS. The shrinkage of the market should also be a supportive factor for secondary market levels of the covered bonds outstanding.

Figure 59. Outperformance of AIB slowed down, ASW-Spreads, bp



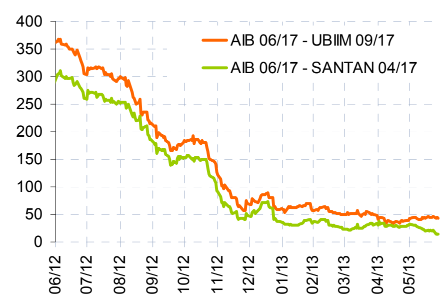
Source: Citi Research

Figure 60. Yield differentials are low in the belly of the curve, %



Source: Citi Research

Figure 61. AIB offers pick-up versus selected Italian and Spanish covered bonds, ASW, bp



Source: Citi Research

We became more defensive on Irish mortgage covered bonds

Moody's latest report pointed out the high quality of the Irish ACS law. However, in most cases, the quality of the legal framework is not the main driver for secondary market movements. For MACS, it is still the high correlation to the sovereign which mostly determines secondary market pricing. This is the main reason why we recently became a bit more defensive on peripheral covered bonds. As we expect peripheral sovereign bonds widening vs bunds over the next months, the same pattern will probably be observable for the covered bonds. However, this doesn't mean that we have changed our standpoint on the relative value between MACS and IRISH. We would continue to prefer the secured paper (by residential assets), especially given the fact that the "trading through the sovereign" pattern couldn't be observed steadily in the Irish market compared to other peripheral segments.

Mortgage lending value in Germany – more of the better

LTV of 60% for all loans is stronger than average

While the Irish covered bond issuers use prudent market valuations for the OC calculations and issuance capacity, German Pfandbrief issuers rely on the mortgage lending value and further measures which should avoid spill-overs from rising property prices. Moody's recently summarised these measures and points out the higher standard compared to other covered bond jurisdictions:

- Residential loans are capped at a loan to value of 60%. This is lower than in many other jurisdictions where the LTV cap for residential assets is at 75% or 80%.
- Valuation is based on mortgage lending value. This is the prudently calculated value of a property. It represents the value which throughout the entire life of the loan can probably be achieved for a property that is sold on the free market – irrespective of temporary (for example, economically-induced) value fluctuations in the respective property market. This requirement serves to eliminate speculative influences. In many other segments, valuation is made by indexation which leads to higher issuance capacity in times of rising property prices. In Germany, upward valuation can only be done if it is made sure that the quality of the property has been improved in a significant way.

This leads to positive side effects and to higher recovery rates

The two following examples show the relative advantage of these measures in the German Pfandbrief Act which is the steady amount of issuance capacity in times of rising property prices on the one hand and higher recovery rates in case of an issuer default on the other hand. The first example assumes that issuance capacity is derived from the original property value where no credit is given to house price increases. Therefore it is around 60% (not exactly, given legal OC requirements). This implies that in case of an issuer default and the necessity to sell assets under stress, full recovery can be achieved if the transaction price is at 40% of the market value. In the second example where issuance capacity is derived from current property valuations, the threshold price for full recovery is much higher and would stand at 60% of the current property value. This also means that in the first example a house price decrease of more than 60% could be withstood while in the second example the buffer for a house price decrease would be at 40%.

Figure 62. Consequences of different valuation methods

Assumptions		Example 1		Example 2	
Loan amount	€ 90	Maximum issuance capacity	~ € 60	Maximum issuance capacity	€ 90
LTV threshold	60%	*LTV threshold x original property value*		*LTV threshold x current property value*	
Original property value	€ 100	Threshold price fo full recovery	40% of market price	Threshold price fo full recovery	60% of market price
Current property value	€ 150	*Maximum issuance capacity / current property value*		*Maximum issuance capacity / current property value*	

Source: Moody's, Citi Research

We stay neutral on German pfandbriefe

We can only join Moody's stance on the Pfandbrief law which — in comparison to some other jurisdictions — tries to provide legal clarity as far as possible for situations of going concern and gone concern. German pfandbriefe have reacted similarly to all other interest bearing securities after the FOMC. However, volatility was much lower causing the Pfandbrief segment to outperform all other covered bond segments based on credit spreads to swaps. Although we think that market volatility may increase over the rest of the year than over the first six months, we expect Pfandbriefe to trade sideways. We therefore continue to be neutral on German pfandbriefe.

Agreement on bail-in rules: covereds are treated as expected, but still uncertainties – will rating agencies have to rethink?

The general result looks very good for covered bonds…

Last Thursday, the European council agreed on a common position to establish a framework for the recovery and resolution of credit institutions. Now, negotiations will start with the European parliament. The council's goal is to have the first reading in the parliament before the end of the year. The main outcome is a consensus of two diametrically opposed positions before the meeting. While sticking to a rather predictable implementation of the bail-in rules, there's still enough flexibility in the regime to act differently on a national level. It is planned that these rules come into force in 2018. For covered bonds, the result has been generally positive.

The most important resolution measures the council agreed upon are the following:

- Parts of the business will have to be sold
- Separation of good assets from bad assets whereas the former will be transferred to bridge institution (the latter to a bad bank)
- the usage of bail-in measures

Moreover, the council agreed upon a ranking of creditors and some exclusion in case of restructuring a bank:

Figure 63. The bail-in pecking order and exclusions

The bail-in ranking	The exclusions
Shareholder	Covered deposits
Unsecured bondholder	Secured liabilites including **covered bonds**
Large depositors (i.e. >100k)	Liabilities to employees Fixed salary Pension benefits
Eligible Deposits - from natural persons - micro enterprises - small and medium sized entities - liabilities to the European Investment Bank	Commercial claims for daily functioning of the institution Inter-bank liabilities with an original maturity of less than 7 days

Source: European Council, Citi Research

… but flexibility makes predictability harder

Apart from these bail-in rules, a resolution fund has been agreed upon. Moreover, it was decided that national authorities can ask for support through the resolution fund. This however can only be done if a minimum loss of 8% of total liabilities has been wiped out. As mentioned above, flexibility is given on a national level. This means that national regulators have the power to (partially) exclude liabilities if

- these cannot be bailed in within a reasonable time
- the continuity of critical functions needs to be ensured
- contagion has to be avoided
- the bail-in would lead to losses borne by other creditors

However, senior bonds might be hit hardest within the new regime

The positive is that the introduction date of 2018 seems to be set which helps to get a clearer picture for senior bonds maturing until then. However, the power of national regulators as described above remains a challenge to evaluate support for senior bonds. However, senior bonds in general could be seen as the hardest-hit asset class. Although it became clear quite early that bail-in procedures will also affect senior bonds, the preferential treatment of natural persons, micro enterprises and SMEs will probably negatively affect recovery rates of senior unsecured bonds more than originally expected. That said it should also be mentioned that the current configuration gives a high level of national leeway which might lead to different outcomes with respect to burden sharing.

But what happens to voluntary OC and the residual claim of covered bondholders?

Apart from that, some blurredness also remains for covered bonds. While it is clearly stated that covered bonds are excluded from the bail-in tools, residual risks are still given. As we outlined in previous monthlies/weeklies there is further uncertainty on the treatment of the residual claim of covered bondholders. Although we understand this to be a rather theoretical question, further clarity would be desirable. This goes in hand with the treatment of voluntary overcollateralisation. Former position papers of the different bodies interfered when the treatment of OC was discussed. On the one hand, it was supported that the whole product as itself (including voluntary OC) were not part of bail-in procedures. On the other hand, this hasn't been stated so clearly. National regulators could easily mitigate investors' concerns by introducing/increasing legal OC given the fact that most issuers have higher OC anyway.

Senior-covered spreads should widen for specific names

As stated above, the new decision on the resolution regime might put senior bondholders into the situation where lower recovery rates need to be expected given the better treatment of depositors and SME. Therefore, as already mentioned in earlier publications, the spread between senior and covered bonds should rise, however differing substantially on a single-name basis and mainly derived from the issuer's country of origin and the respective configuration of resolution implementation. Moreover, when things hopefully become clearer, 2018 should be the most important date for maturities with earlier maturing bonds being issued under the former regime and bonds maturing after 2018 with a potentially different pecking order.

Has the reference point senior rating served its time for covered bond ratings?

Moreover, the results might have substantial effects to the covered bond space from a different direction. Usually, rating agencies link the covered bond rating directly to the issuers' senior debt rating. As one might expect these ratings to get under increasing pressure given lower recovery rates, covered bond ratings would follow irrespective from their special treatment in times of bank restructuring. In its outlook for the covered bond market in 2013, Moody's mentioned in case "of the existence of a bail-in regime […] the actual or perceived likelihood of losses being forced on senior unsecured bondholders [would increase] to a greater extent than has been seen historically. Covered bonds would then be negatively affected as our expected loss analysis typically uses the issuer's senior debt rating when calculating the expected loss on the covered bonds. Furthermore, our TPI framework also relies on the issuer's senior debt rating to indicate the maximum covered bond rating achievable."[4] We would see it as appropriate to see some adjustments to their rating methodology.

[4] Moody's: „Global covered bonds: 2013 Outlook", as of December 2012

USD Covered bonds and the yield spike post FOMC

US covered bond market – low prospect…

Last week, some US senators released a plan to liquidate the government sponsored entities (GSE) Fannie Mae and Freddie Mac over the next five years. The main goal of this legislation is to privatise the US housing finance market that has so far been a market that was nearly exclusively dominated by government backed institutions (90%, according to Bloomberg). If covered bond market participants now hope that a European style covered bond market is about to be introduced to fill the upcoming gap, might be disappointed. The proposed legislation wants to replace such GSE with a Federal Mortgage Insurance Corporation (FMIC). This will continue to back the mortgages if 10% of the underlying securities that have been sold to private investors have been wiped out (first loss position). Moreover, FMIC could be the main platform for the creation of securitisations to ease market presence for small lenders.

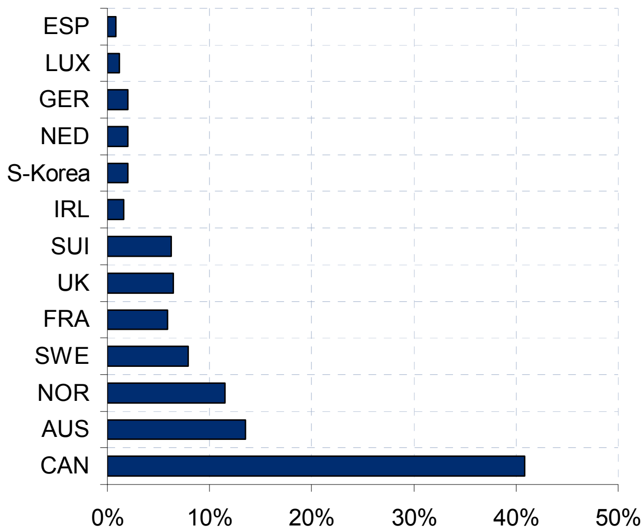
… but with hopeful developments

So far, this plan is a legislative proposal (there is still a proposal called "US Covered bond act" from 2011, too). However, we think that the prospect of a developing US covered bond market increases the more the country guides its mortgage market to privatisation. Therefore, although the new law proposal does not explicitly mention covered bonds as a tool for a more privatised US mortgage market the probability of the implementation of a covered bond market might have risen. Meanwhile, investors need to be content with USD covered bonds issued by non-US banks.

USD covered bonds – already present…

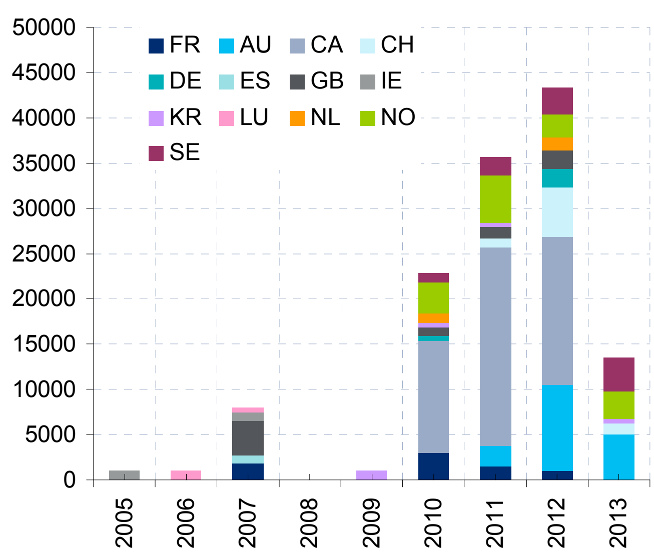
This predominantly means that it is Canadian covered bonds which investors can rely on. Currently, their market share is more than 40% (of USD126bn) if concentrating only on USD benchmark covered bonds followed by Australia and Norway. The USD covered bond market could not only withstand any spill-over effects of the European debt crisis and its consequences for the EUR covered bond market but could also grow because the EUR covered bond market suffered higher turbulence. However, this year, growth has been lagging last years' path as fundamental changes to the Canadian covered bond law forced these issuers to remain absent from covered bond markets.

Figure 64. Share on USD covered bond market by country



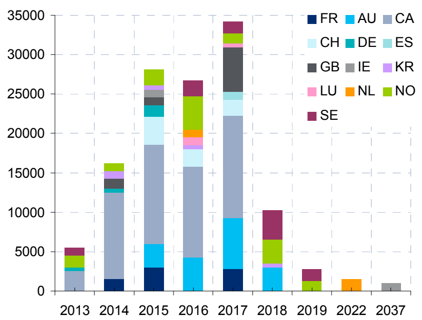
Source: Bloomberg, Citi Research

Figure 65. Development of the USD benchmark covered bond market



Source: Bloomberg, Citi Research

Figure 66. Redemptions, EURmn



Source: Bloomberg, Citi Research

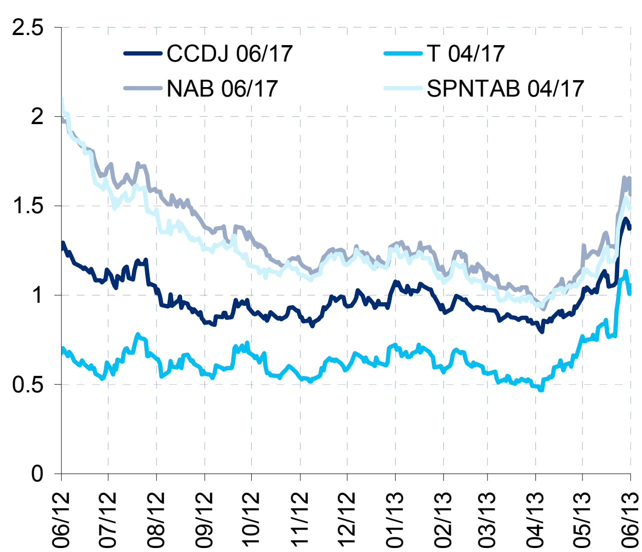
Norwegian, Swedish and Australian covered bond issuers are very flexible with respect to the currency in which they issue covered bonds. While the former can rely on a very strong domestic market, the Australian issuers started to build their domestic market in 2012. The USD market is seen as a diversification possibility within their funding process (as the EUR market).

Over the coming years, the future of the USD covered bond market will probably continue with the absence of domestic issuers. Therefore, future growth mainly relies on the comeback of Canadian banks which have to stem the bulk of redemptions over the next four years. We are quite optimistic that the issuers become active again once the new adjustments to the cover pool are finished. The fact that only uninsured mortgage loans are eligible since the inception of the covered bond law led to the need for asset changes in nearly all covered bond programs. It was only Royal Bank of Canada whose covered bonds have been backed by uninsured mortgages already before the law was introduced. But the issuer has also been pioneer by issuing a SEC registered covered bond last year. Before, all USD issuances were in the format of 144A private placements. In the beginning of June, BNS followed its peer and received the “no-action” letter from SEC giving them the right to issue SEC registered covered bonds. The big advantage of the latter is the broader investor base that can be reached. Most of the other Canadian covered bond issuers are likely to follow.

…and highly correlated to US-T

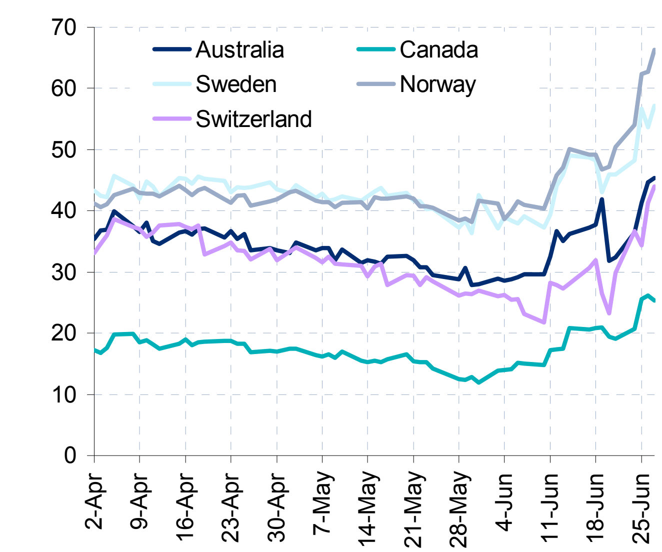
In the secondary market, the relative yield levels are fairly similar to the EUR covered bond market apart from the fact that Australian covered bonds trade relatively more expensive to Scandinavian secured paper. This is not the case in the EUR denominated covered bond market. Apart from that, USD covered bonds also reacted quite severely after FOMC

Figure 67. The FOMC shock in USD covered bond markets, yields (%)



Source: Bloomberg, Citi Research

Figure 68. FOMC effects were also seen on index level, ASW-Spread, bp



Source: Markit, Citi Research

Covered Bond Rating Overview

Figure 69. Ratings of selected covered bond issuers

Australia	S&P/Moody's/Fitch	DGHYP	AAA/--/--	New Zealand	S&P/Moody's/Fitch
ANZ	--/Aaa/AAA	DHY	--/Aa2/--	ANZNZ	--/Aaa/AAA
CBAAU	--/Aaa/AAA	DKRED	--/Aa2/--	ASBBNK	--/Aaa/AAA
NAB	--/Aaa/AAA	PBBGR	AA+/Aa2/--	BZLNZ	--/Aaa/AAA
WSTP	--/Aaa/AAA	DPB	--/Aaa/AAA	WSTP	--/Aaa/AAA
Austria	S&P/Moody's/Fitch	HSHN	--/Aa1 /*-/--	Norway	S&P/Moody's/Fitch
BACA	--/Aaa/--	HYPFRA	--/Aa3/--	DNBNO	AAA/Aaa/AAA
BAWAG	--/Aa1/--	INGDIB	--/Aaa/--	EIKBOL	--/Aa2/--
ERSTBK	--/Aaa/--	LBBW	--/Aaa/--	SPABOL	--/Aaa/AAA
HYNOE	--/Aaa/--	HESLAN	--/--/AAA	SVEGNO	--/Aaa/AAA
KA	--/Aa2/--	MUNHYP	--/Aaa/--	Portugal	S&P/Moody's/Fitch
RFLBNI	--/Aaa/--	SPKKB	--/Aaa/--	BCPPL	--/Ba1/BBB-
RFLBST	--/Aaa/--	HVB	--/Aa1/AAA	BESPL	--/Baa3/--
VORHYP	--/Aaa/--	WLBANK	AAA/--/--	BPIPL	A-/Baa3/BBB
Belgium	S&P/Moody's/Fitch	Germany (ps)	S&P/Moody's/Fitch	CXGD	--/Baa3/BBB-
KBC	--/Aaa/AAA	HVB	AAA/Aaa/--	SANTAN (PT)	BBB/Baa3/BBB+
CCBGBB	AAA/--/AAA	BYLAN	--/Aaa/AAA	Spain	S&P/Moody's/Fitch
Denmark	S&P/Moody's/Fitch	BHH	--/Aa1/AA-	BBVASM	A-/A3/--
DANBNK	AAA/--/AAA	DGHYP	AAA/--/--	BKIASM	BBB/Baa1 /*/--
Finland	S&P/Moody's/Fitch	DKRED	--/Aa1/--	BKTSM	A/A3/--
AKTIA	--/Aa3/--	PBBGR	AA+/Aa1/AA+e	CABKSM	AA-/A3/--
AKTIA	--/Aaa/--	DPB	--/Aaa/AAA	CAIXAC	BBB/Ba1 /*-/--
NDASS	--/Aaa/--	DEXGRP	A/--/--	CAZAR	A/Baa1 /*-/--
POHBK	AAA/Aaa/--	HSHN	--/Aa1 /*-/--	KUTXAB	AA-/A3/--
SAMBNK	--/Aaa/--	PBBGR	AA+/Aa1/AA+e	NOVAGA	BBB+/Ba1 /*-/BBB+ /*-
France	S&P/Moody's/Fitch	HYPFRA	--/Aa2/--	POPSM	--/A3 /*-/--
ACACB	AAA/Aaa/AAA	LBBW	--/Aaa/AAA	SABSM	--/A3/--
ACASCF	AAA/Aaa/--	HESLAN	--/Aaa/--	SANTAN	--/A3/A
AXASA	--/Aaa/AAA	MUNHYP	--/Aaa/--	Sweden	S&P/Moody's/Fitch
BNPPCB	AAA/Aaa/AAA	NDB	--/Aaa/AAA	LANSBK	AAA/Aaa/--
BNPSCF	AAA/Aaa/AAA	WLBANK	AAA/--/--	NDASS	--/Aaa/--
BPCECB	AAA/Aaa/--	Ireland	S&P/Moody's/Fitch	SBAB	AAA/Aaa/--
BPCOV	AAA/--/--	AIB	A/Baa3/A	SEB	--/Aaa/--
CAFFIL	AAA/Aaa/AAA	BKIR	--/Baa3/--	SHBASS	--/Aaa/--
CDEE	AAA/Aaa/--	DEPFA	BBB/A3/A	SPNTAB	AAA/Aaa/--
CFF	AAA/Aaa/AAA	ERSTAA	--/A3/--	Switzerland	S&P/Moody's/Fitch
CIFEUR	--/Aa2/AAA	Italy	S&P/Moody's/Fitch	UBS	--/Aaa/AAA
CMARK	AAA/Aaa/--	BANCAR	--/Baa1 /*-/BBB+	CS	--/Aaa/AAA
CMCICB	AAA/Aaa/AAA	BPIM	--/A2 /*-/BBB+	United Kingdom	S&P/Moody's/Fitch
CRH	--/Aaa/AAA	CRDEM	--/A2/A+	ABBEY	AAA/Aaa/AAA
GE	AAA/Aaa/--	ISPIM	--/A2/--	BACR	AAA/Aaa/AAA
HSBC	AAA/Aaa/--	MONTE	--/Ba1/A	COVBS	--/Aaa/AAA
SOCSCF	AAA/Aaa/--	PMIIM	--/Baa2 /*-/A-	LLOYDS	AAA/Aaa/AAA
SOCSFH	--/Aaa/AAA	UBIIM	--/A2/A+	NRKLN	AAA/Aaa/AAA
Germany (m.)	S&P/Moody's/Fitch	UCGIM	AA+/A2/A	NWIDE	AAA/Aaa/AAA
AARB	--/--/AAA	Netherlands	S&P/Moody's/Fitch	RBS	--/Aaa/AAA
HVB	--/Aa1/AAA	ABNANV	AAA/Aaa/AAA	USA	S&P/Moody's/Fitch
BHH	--/Aa1/AA+	ACHMEA	--/Aa2/AAA	BAC	A+/A1/AA-
DB	AAA/Aaa/--	INTNED	AAA/Aaa/AAA	JPM	A+/--/AA-
		SNSSNS	--/A1 /*-/AA+ /*		

Source: Bloomberg, Citi Research; m.=mortgage, ps = public sector

Covered Bond Rating Overview – Multi Cédulas

Figure 70. Ratings of selected Multi-Cédulas

AYTCED	ISIN	S&P/Moody's/Fitch
AYTCED 4.75 04.12.2018	ES0370148019	A+/A3 /*-/BBB
AYTCED 4.5 04.12.2013	ES0370148001	AA-/A3 /*-/BBB
AYTCED 4 07.04.2014	ES0312360003	A+/Baa1 /*/BBB
AYTCED 4 07.04.2014	ES0312360011	A+/Baa1 /*/BBB
AYTCED 4 18.11.2014	ES0312362009	A+/A3 /*-/BBB
AYTCED 4.25 18.11.2019	ES0312362017	A-/A3 /*-/BBB
AYTCED 3.75 31.03.2015	ES0312358007	BBB/Baa1 /*-/BBB
AYTCED 4 31.03.2020	ES0312358015	BBB/Baa1 /*-/BBB
AYTCED 3.75 30.06.2025	ES0312342019	BBB/Baa1 /*-/BB+
AYTCED 3.5 14.03.2016	ES0312298013	BBB/A3 /*-/BBB
AYTCED 3.75 14.12.2022	ES0312298021	BBB-/Baa1 /*-/BBB
AYTCED 4 24.03.2021	ES0312298054	BBB/Baa1 /*/BBB
AYTCED 4.25 14.06.2018	ES0312298070	BB+/Baa1 /*-/BB+
AYTCED 4.25 25.10.2023	ES0312298096	BBB-/A3 /*-/BBB
AYTCED 3.75 25.10.2013	ES0312298088	A+/Baa1 /*-/BBB
AYTCED 4 20.12.2016	ES0312298104	A-/A3 /*-/BBB
AYTCED 4 21.03.2017	ES0312298112	BBB-/A3 /*-/BBB
AYTCED 4.75 25.05.2027	ES0312298120	BB+/Baa1 /*-/BBB
AYTCED 4.75 15.06.2016	ES0312298229	AA-/--/--
AYTCED 4.25 29.07.2014	ES0312298237	A+/Baa1 /*-/--
AYTCED 4.5 02.12.2019	ES0312298245	A/Baa2 /*-/--
AYTCED 3.75 25.05.2015	ES0312298252	AA-/Baa2 /*-/--

CEDTDA	ISIN	S&P/Moody's/Fitch
CEDTDA 4.5 26.11.2013	ES0317019000	A/Baa1 /*-/BBB
CEDTDA 4.375 03.03.2016	ES0317043000	A-/A3 /*-/BBB
CEDTDA 4.125 29.11.2019	ES0317045005	BBB/Baa1 /*-/BBB
CEDTDA 3.875 23.05.2025	ES0317046003	BBB-/Baa1 /*-/BBB
CEDTDA 3.5 20.06.2017	ES0317047001	BB+/Baa1 /*-/BB+
CEDTDA 4.25 10.04.2031	ES0371622020	BBB-/Baa1 /*-/BBB
CEDTDA 4.125 10.04.2021	ES0371622012	BBB-/Baa1 /*-/BBB
CEDTDA 4 23.10.2018	ES0371622038	A-/A3 /*-/BBB
CEDTDA 4.25 28.03.2027	ES0371622046	BBB-/A3 /*-/BBB

IM CEDULAS	ISIN	S&P/Moody's/Fitch
IMCEDI 4.5 11.06.2014	ES0347859003	--/Baa1 /*/BBB
IMCEDI 4 19.11.2014	ES0347852008	A-/WR/--
IMCEDI 3.75 11.03.2015	ES0347848006	BBB/Baa3 /*/--
IMCEDI 3.5 15.06.2020	ES0347849004	BB+/--/--
IMCEDI 3.5 02.12.2015	ES0362859003	BBB-/Baa1 /*-/--
IMCEDI 4 31.03.2021	ES0347784003	--/A3 /*-/BBB
IMCEDI 4.25 09.06.2016	ES0347785000	--/Baa1 /*-/BB+
IMCEDI 4.5 21.02.2022	ES0349045007	--/Baa1 /*-/BBB

PITCH	ISIN	S&P/Moody's/Fitch
PITCH 5.125 20.07.2022	ES0334699008	A-/A3 /*-/--

Source: Citi Research

Covered Bond Rating Actions June 2013

Figure 71. Rating actions in the covered bond universe

Issuer	Program	Country	Agency	From	To	Reason
AyT Cédulas Cajas Global, FTA - Series VIII	Mortgage	Spain	Fitch	BBB	BB+ (neg)	Increased obligor concentrations and lower credit quality of Cedula issuers increase liquidity risk which is not compatible with investment grade
AyT Cédulas Cajas X, FTA - Class B	Mortgage	Spain	Fitch	BBB	BB+ (neg)	
Cedulas TDA 7, FTA, Class A	Mortgage	Spain	Fitch	BBB	BB+ (neg)	
IM Cedulas 9, FTA	Mortgage	Spain	Fitch	BBB	BB+ (sta)	
Bankinter	Mortgage	Spain	S&P	A-	A	Covered bond has been upgraded after a reduction of asset-liability mismatch risk
Moorland Covered Bonds	Mortgage	UK	Moody's	Baa1*-	Baa3	The parent company Co-operative Bank has been downgraded to Caa1 from Ba3
Co-operative Bank	Mortgage	UK	Fitch	AA-	A-	The issuer Co-operative Bank has been downgraded to BB- from BBB+

Source: Bloomberg. Citi Research

Redemptions July 2013

Figure 72. Redemption payments: July 2013

Issuer Name	Ticker	Coupon	Maturity	Announce	Amount (EURmn)	Country
Banco Bilbao Vizcaya Argentaria SA	BBVASM	3.5	26.07.2013	19.07.2010	2000	ES
Bank of Ireland Mortgage Bank	BKIR	4	05.07.2013	21.06.2006	2100	IE
BNP Paribas Home Loan SFH	BNPPCB	3	23.07.2013	16.07.2009	1250	FR
Depfa ACS Bank	DEPFA	3.875	15.07.2013	22.05.2003	3500	IE
HSH Nordbank AG	HSHN	1.75	05.07.2013	28.06.2010	500	DE
Banco Espanol de Credito SA	SANTAN	4.25	12.07.2013	05.07.2006	1000	ES
Banco Santander SA	SANTAN	4	08.07.2013	30.06.2003	2000	ES

Source: Citi Research

Covered Bond Performance

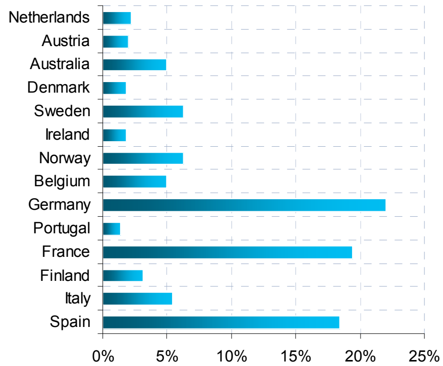
Figure 73. iBoxx Covered Bond Indices: Total Return in June 2013, %

Segment	Absolute	Δ 1m	Δ ytd	Δ 1y
Australian Covered Bonds	97.09	-1.2%	--	--
Austrian Covered Bonds	134.60	-1.2%	0.0%	3.6%
Belgian Covered Bonds	96.78	-1.4%	--	--
Canadadian Covered Bonds	124.88	-1.0%	0.2%	4.4%
Danish Covered Bonds	98.26	-0.6%	--	--
Dutch Covered Bonds	142.80	-1.4%	-0.2%	4.4%
EUR Covered	192.83	-1.4%	1.4%	8.1%
Finnish Covered Bonds	98.70	-0.4%	--	--
French Covered Bonds	208.14	-1.6%	0.3%	6.5%
Irish Covered Bonds	141.91	-0.7%	2.0%	12.6%
Italian Covered Bonds	125.47	-1.8%	2.0%	11.5%
Luxembourg Covered Bonds	98.63	-0.5%	--	--
Mortgage Pfandbriefe	190.72	-0.7%	-0.3%	2.3%
New Zealand Covered Bonds	98.79	-0.5%	--	--
Norwegian Covered Bonds	134.37	-1.2%	-0.2%	3.8%
Obligations à l'Habitat	129.16	-0.3%	0.3%	2.6%
Obligations Foncières	141.49	-1.6%	0.5%	7.0%
Pfandbriefe	185.10	-0.7%	-0.2%	2.3%
Portuguese Covered Bonds	141.30	-1.5%	4.8%	20.0%
Public Sector Pfandbriefe	183.50	-0.5%	0.0%	2.3%
Spanish Covered Bonds	189.69	-2.0%	5.3%	17.5%
Spanish Multi Covered Bonds	129.85	-2.6%	7.6%	23.3%
Spanish Single Covered Bonds	125.96	-1.7%	4.4%	15.1%
Swedish Covered Bonds	131.41	-0.6%	-0.2%	2.2%
Swiss Covered Bonds	98.64	-0.4%	--	--
UK Covered Bonds	142.69	-1.1%	0.2%	5.6%

Source: Markit, Citi Research

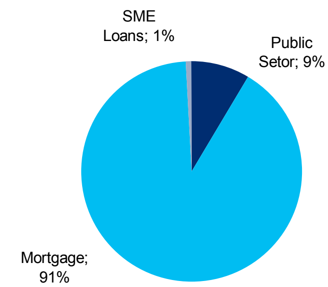
Primary Market 2013

Figure 74. EUR Benchmark covered bonds: Geographical distribution, %



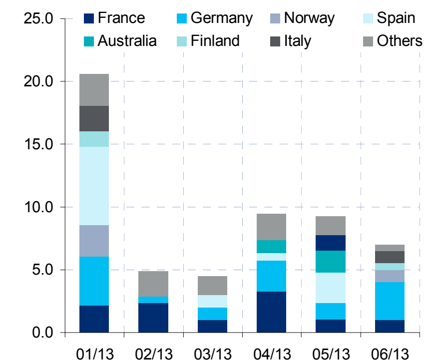
Source: Citi Research

Figure 75. EUR Benchmark covered bonds: Distribution by Collateral, %



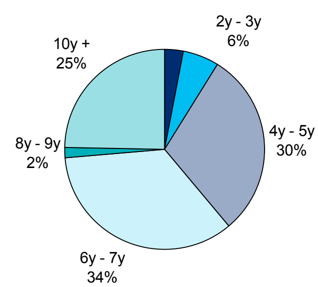
Source: Citi Research

Figure 76. EUR Benchmark covered bonds: Issuance by month



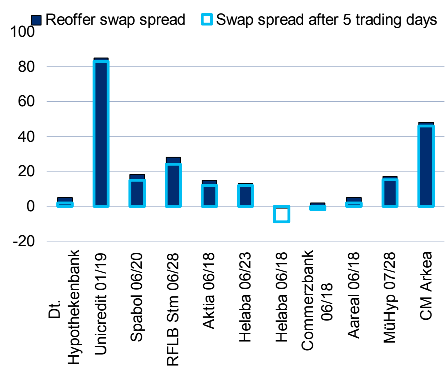
Source: Citi Research

Figure 77. EUR Benchmark covered bonds: Issuance by maturity, %



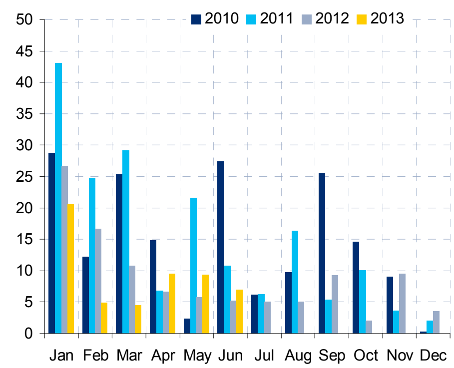
Source: Citi Research

Figure 78. Selection of June's deals' performance after five trading days



Source: Citi Research;

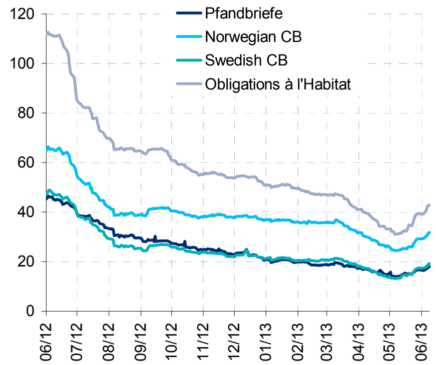
Figure 79. Historical new issuance, EURbn



Source: Citi Research

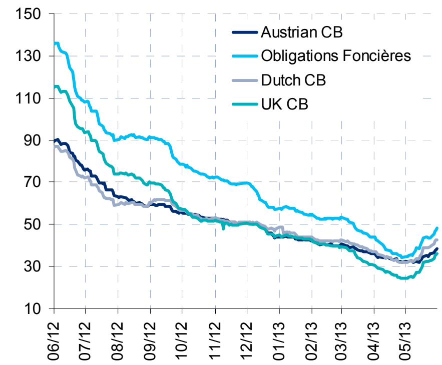
Secondary Market 2013

Figure 80. Secondary Market Performance, ASW-Spreads, bp



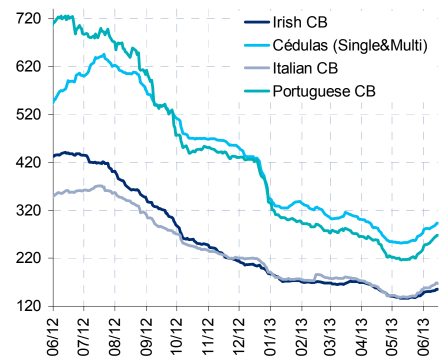
Source: Citi Research, Markit

Figure 81. Secondary Market Performance, ASW-Spreads, bp



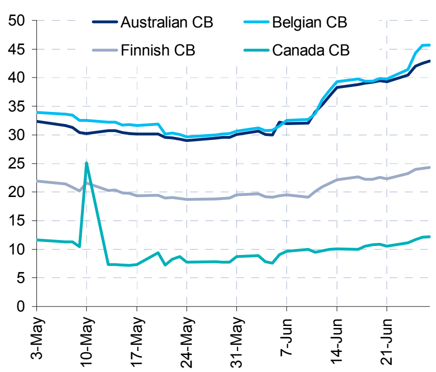
Source: Citi Research, Markit

Figure 82. Secondary Market Performance, ASW-Spreads, bp



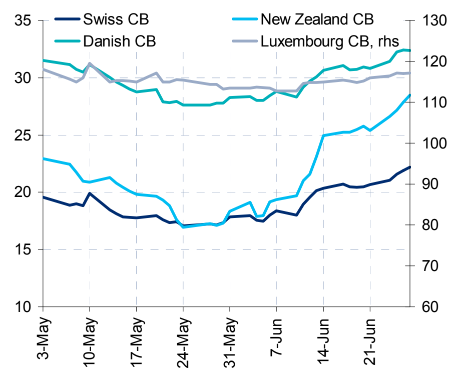
Source: Citi Research, Markit

Figure 83. Secondary Market Performance, ASW-Spreads, bp



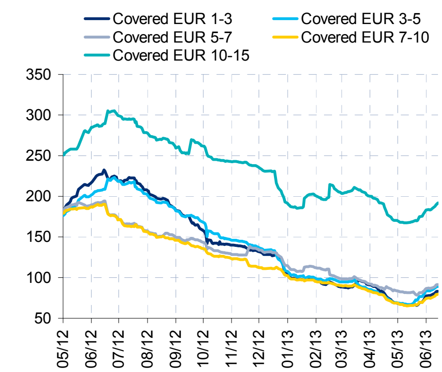
Source: Citi Research, Markit

Figure 84. Secondary Market Performance, ASW-Spreads, bp



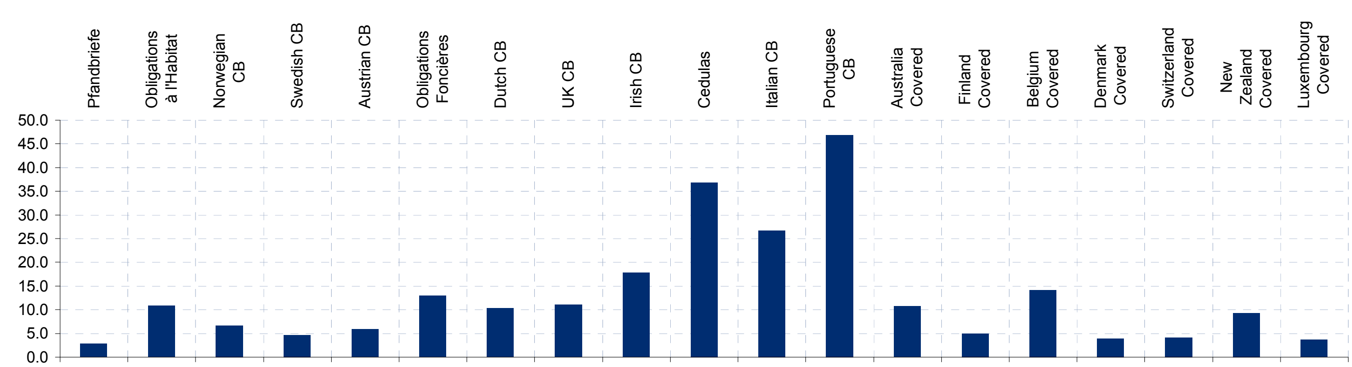
Source: Citi Research, Markit

Figure 85. Secondary Market Performance, ASW-Spreads, bp



Source: Citi Research, Markit

Figure 86. Spread performance over the last month



Source: Markit, Citi Research

Notes

Notes

Appendix A-1

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