1 August 2013 | 44 pages

Global

European SSA and Covered Bond Monthly

Sterling SSA and UK Covered bond markets in focus

- **Sterling SSA:** We detail the key characteristics of the sterling SSA market. Total bond debt is around £140bn, dominated by the top three issuers. In general, liquidity and technical factors can play a key role in explaining secondary curves. The recent market tone has been constructive and we see curves continuing to flatten in this environment.
- **UK Covered bonds:** Outperformance of the UK sector within the broader covered bond universe has stalled over recent weeks. However, the lack of issuance – probably lasting into 2014 – should support secondary market levels going forward.
- **Euro SSA strategy:** The steady performance of some core agency sectors is increasingly providing opportunities to step up in quality as yields compress. Regarding supras, we would perhaps wait for better entry levels before going long vs EMU soft core sovereigns at this juncture. We also detail the good performance of the Deutschland bond which is now trading inside the LANDER curve in ASW.
- **Euro SSA performance and outlook:** Both euro agency and supranational bonds performed relative to swaps and EMU governments over July. The tone remains constructive and supply is expected to be low in August which should help spreads grind in further.
- **Covered bond opportunities:** Over recent weeks, covered bond issuance has only come from the Canadian sector. The relative cheapening in certain segments of covered bonds versus government has opened up some opportunities to prefer covered bonds to the underlying government debt in our view.
- **Covered bond outlook:** YTD, the covered bond market has shrunk by €7.4bn on average per month. Over the next five months, we expect around €40bn in new supply. Apart from the inaugural issuance of La Banque Postale, the market will probably also see the first conditional pass-through covered bond that will be publicly placed and issued within a legal framework.
- **July supply:** Euro denominated agency and supranational supply totaled ~€13bn in July and stands at around €135bn YTD. Covered bond issuance in July was €5bn and stands at €61bn YTD.

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Contents

Contents 3
The £ SSA and UK Covered Bond Market 4
Market structure – around £140bn in debt outstanding 4
Key issuer characteristics 6
Secondary market and relative value 7
£ SSA Conclusion – liquidity centered in the key issuers 8
Conclusion - lack of UK covered bond supply is beneficial 13
Euro SSA Strategy 14
(2) Primary market activity 16
(3) Secondary market performance 17
€ Supranational Yield and ASW MoM Changes 18
€ Agency Yield and ASW MoM Changes 19
Covered Bond Strategy 20
Covered Bond Strategy 20
(1) Strategy views 20
Appendix A-1 41

The £ SSA and UK Covered Bond Market

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Following our recent publications on German, French, Dutch and Austrian SSA and covered bond markets, we provide a market overview of the UK sector. In general, we find that liquidity differences and technical factors can play just as an important role as fundamental ones. Performance has been relatively healthy for both the SSA and covered bond market, especially in light of the UK's safe haven status and the recent market tone has been constructive. For UK covered bonds, significant further performance might be limited given the extent of the rally, but the lack of supply going forward should generally be supportive in our view.

(1) The £ SSA Market

Sterling market is relatively small in terms of debt outstanding

The £ SSA market represents around £145bn in bond debt outstanding. This compares to the conventional UK government bond market of about £1tn. Across the wider SSA space, (as in the corporate sector) the sterling market is smaller than the euro market: the German agency market alone is around €700bn whereas the French agency market is over €240bn. Liquidity considerations can therefore be a key factor in understanding secondary market performance and relative value within the broader universe.

Technical factors can be important

Of course, the direction of £ SSA yields will be largely dictated by underlying fixed income drivers such as inflation, MPC policy and UK economic growth. Spreads to governments and to swaps reflect in part the perceived credit quality of the issuer, together with the strong technical drivers of supply and demand in this market. However, spreads will largely not stray too far from the sovereign given how the main UK issuer, UKRAIL, has a direct and explicit government guarantee.

Market structure – around £140bn in debt outstanding

Top three issuers dominate the market

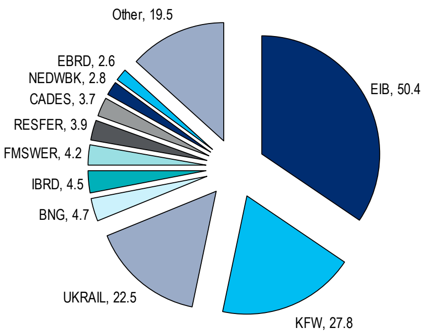
The sterling supranational and agency market represents around £145bn in bond debt outstanding. The market structure is heavily dominated by the top three issuers: EIB (£50bn), KfW (£28bn) and UKRAIL (£22) in terms of sterling bonds outstanding. Key characteristics of these issuers can be found below. Both UKRAIL and KfW have ratings normalized to that of the underling sovereign given the explicit government guarantee.

Figure 1. Top three £ SSA issuers

Ticker	Issuer	Issuer Type	Established	Ownership structure	Moody's	S&P	Total Assets	Total Bond Issuance 2012	% GBP	Bond Debt Outstanding	% GBP
UKRAIL	Network Rail Infrastructure Finance	Issuing vehicle for Network Rail Infrastructure Ltd. responsible for the UK rail infrastructure	Active in capital markets since 2004	Private company, direct and explicit UK government guarantee (financial indemnity)	Aa1 (Stable)	AAA (Neg)	£52.6bn	£5bn	48%	£29bn	77%
EIB	European Investment Bank	European supranational focused on project finance	1958	All 28 EU member states have subscribed capital and must ensure the EU budget is in balance. EIB Statues lay down governance and capital structure	Aaa (Neg)	AAA (Neg)	€567.8bn	€71.3bn	9%	€427bn	14%
KFW	Kreditanstalf für Wiederaufbau	Germany's leading development bank	1948	80% Federal Republic of Germany, 20% German Federal States. Explicit Guarantee by Germany since 1998	Aaa (Neg)	AAA (Stable)	€511.6bn	€78.7bn	7%	€358bn	9%

Source: Citi Research, UKRAIL, EIB, KFW, S&P, Moody's, Bloomberg

Figure 2. £ SSA Bonds Outstanding (£bn)



Source: Citi Research, Bloomberg

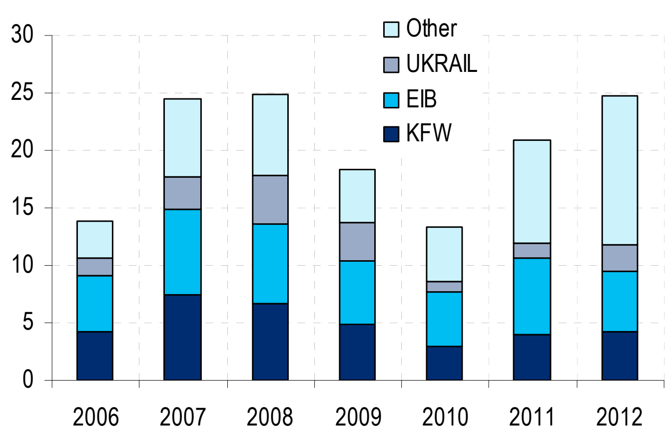
Debt outstanding: Across the wider sterling supras and agency sector, total £ debt outstanding is about £145bn in total. In supras, EIB is the largest contributor to the market structure with about £50bn in GBP bonds outstanding. The next largest supra in terms of GBP outstanding is the IBRD with £4.5bn in the market illustrating just how dominant EIB is within this sector. Within the agency sector, KfW has around £27.7bn in GBP bonds outstanding and UKRAIL has £22.5bn in GBP bonds outstanding making them the largest contributor to the market structure.

Top three issuers dominate: Aggregating across agencies and supras, the top three issuers (EIB, KfW and UKRAIL) clearly dominate the market, accounting for nearly 70% of all £ supra and agency debt outstanding (Figure 2). The remaining £45bn is spread across 29 other issuers in a very skewed distribution.

Annual supply: Detailing sterling bond supply by the top issuers, £ supply has varied by around £15bn-£25bn each year depending on issuers' funding requirements (Figure 3). Again, the top three issuers (UKRAIL, KFW, EIB) account for anywhere between 50%-75% of sterling SSA issuance each year. The exact proportion will largely depend on refi requirements, market conditions and investor appetite. We drill deeper into issuer level detail below.

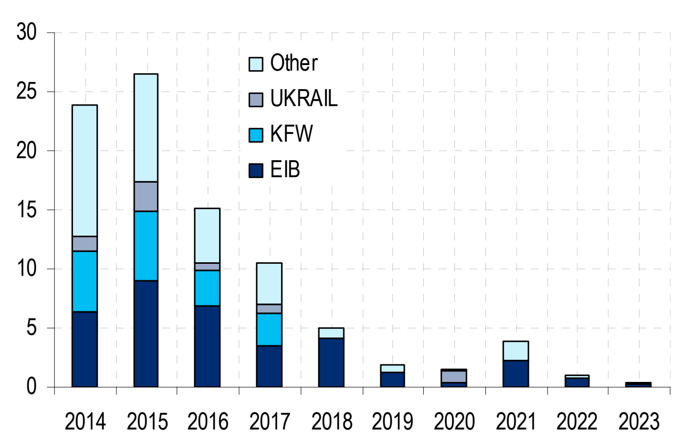
Maturity profile: In terms of the maturity profile, total redemptions next year total nearly £24bn, and around £26.5bn in 2015 (Figure 4). The distribution might resemble typical debt distribution, but this figure masks the fact that 35% of bonds mature in 2024 and beyond meaning that the sterling market has a relatively large weighted average maturity (WAM). The WAM for £ UKRAIL is around 18yrs and for £ KFW and £ EIB it is 6yrs and 8.4yrs respectively. The WAM for € KFW bonds and € EIB bonds is 4yrs and 6.5yrs respectively.

Figure 3. Gross Issuance of £ Supras and Agencies Bonds (£bn)



Source: BNG, NEDWBK, NEDFIN, Dealogic, Citi.

Figure 4. Maturity Profile for £ Supra and Agency Bond Debt (£bn)



Source: Bloomberg, BNG, NEDWBK, NEDFIN, Dealogic, Citi.

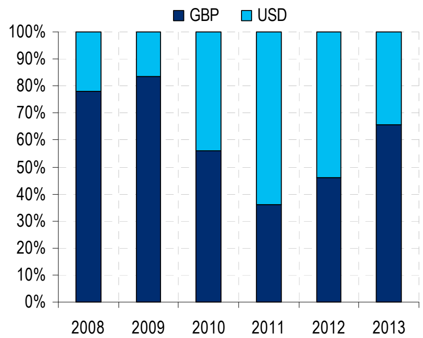
Investor distribution: As with much of the wider SSA market, key investors include central banks, asset managers, banks and insurance/pension founds. Using data from UKRAIL as a proxy, issuance from 2009 to date has had the following distribution: central banks 47%, asset managers 27%, banks 15% and insurance/pension funds 7%.

Key issuer characteristics

We outline key fundamental and market characteristics of the top three issuers within the £ SSA sector: UKRAIL, KfW and EIB. Further details for KfW and EIB can be found in our *Euro SSA Strategy - Introduction to Core European SSA Issuers*.

UKRAIL – UK rail network (AAA/Aa1)

Figure 5. UKRAIL Issuance by Currency (%)



Source: Citi Research, UKRAIL, Dealogic

Network Rail Infrastructure Finance (NRIF, ticker *UKRAIL*) is the issuing vehicle for Network Rail Infrastructure Ltd (NRIL) which is responsible for running, maintaining and developing the British railway network. This is not a profit maximizing entity, but a limited company (£52bn in total assets) with strong links to the government whose profits are reinvested. Much of its revenue is fixed (around 85%) with other funds coming from customer charges. From a credit perspective, there is a financial indemnity (entered in 2004) which essentially means that note holders have a direct and explicit UK government guarantee. Moody's and S&P therefore normalize the rating on the £40bn debt programme to Aa1/AAA in line with the UK.

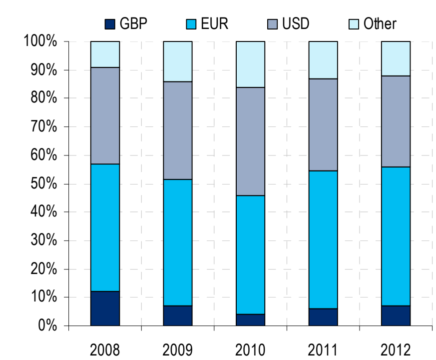
KfW – Leading German development bank (AAA/Aaa)

Kreditanstalt fuer Wiederaufbau (KfW) is Germany's leading and largest development bank founded in 1948 as a public law institution. Its assets are in excess of €500bn. Typically, KfW raises funds in the capital markets and then "on-lends" funds through the banking sector for some development objective. Specific functions are documented in the "Law concerning KfW" and allow for, inter alia, promotional finance in sectors ranging from small and medium sized enterprises (SMEs), housing, infrastructure, technological progress and internationally agreed promotional programmes. Since April 1998, there has been an unconditional and explicit guarantee of KfW's liabilities by the Federal Republic of Germany. Moody's and S&P both rate KfW at Aaa/AAA in line with Germany. Bond issuance is around €70bn-€80bn a year of which 5%-10% tends to be in sterling (Figure 6). For 2013, KfW recently reduced its funding needs to €65bn-€70bn.

EIB – European supranational for EU project finance (AAA/Aaa)

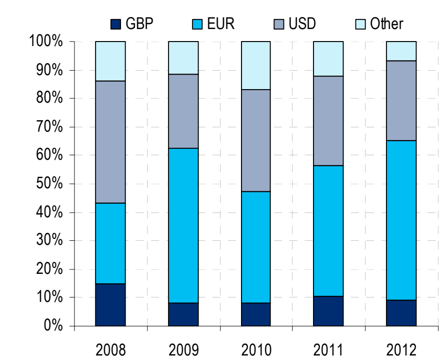
The European Investment Bank, founded in 1958 (Treaty of Rome) is the bank of the 28 EU Member States primarily focused on project finance. It was recently incorporated within the EU Treaty (Article 308 and Article 309). Total assets exceed €550bn and paid in capital totals €21.6bn. The EIB benefits from good asset quality and a strong established franchise: both Moody's and S&P rate EIB Aaa/AAA. Annual supply has recently been around €70bn-€80bn, roughly 10% of which has come in sterling (Figure 7).

Figure 6. KfW Issuance by Currency (%)



Source: Citi Research, KfW, Dealogic

Figure 7. EIB Issuance by Currency (%)



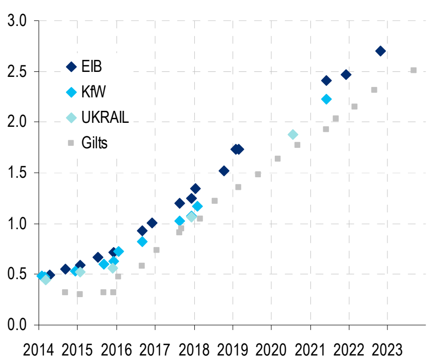
Source: Citi Research, EIB, Dealogic

Secondary market and relative value

Secondary market trading behaviour

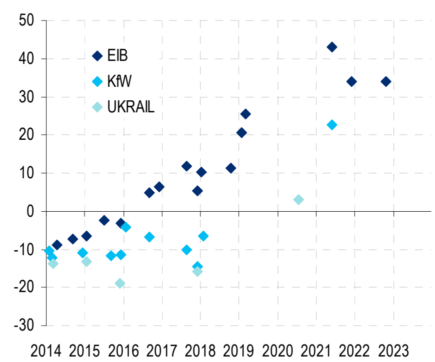
Technicals in the sterling market can be a large part of assessing secondary market performance. The lack of depth, compared to the euro market, makes liquidity differences important as can demand segmentation along the curve. Liquidity in sterling curves (Figure 8, Figure 9) tends to be deeper sub 10yrs where real money is more active. At the very long-end (10yr-30yr) where supply is much more scarce, bonds can be tightly held and ASW spreads are often structurally expensive. In general, UKRAIL tends to trade tighter than KfW which in turn trades tighter than EIB – which has cheapened recently to peers in £ ASW (Figure 10).

Figure 8. Yield Curves (%)



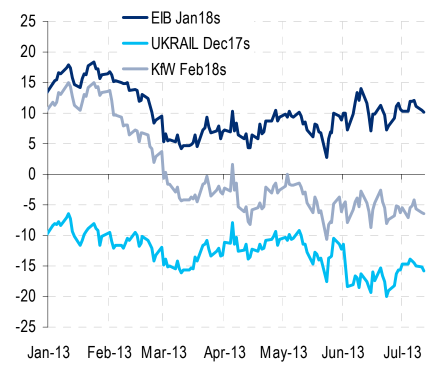
Source: Citi Research, Bloomberg

Figure 9. ASW Curves (bp)



Source: Citi Research, Bloomberg

Figure 10. ASW performance (bp)



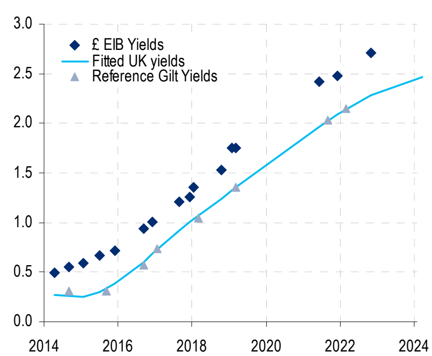
Source: Citi Research, Bloomberg

Watch your spread

Look at relative value and use spreads to a fitted curve

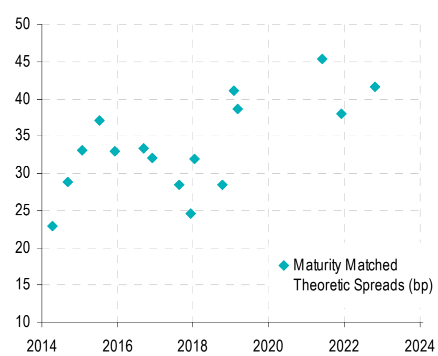
Sterling SSA bonds tend to be associated with a "reference" underlying gilt which often doesn't change as and when more and more gilts are issued. Reference gilts and the current £ EIB yield curve are shown in Figure 11. We would always prefer to look at cash spreads between £ EIB and the maturity matched point on a fitted cash curve (Figure 12). Such spreads perhaps portray a better reflection of relative value than mere "headline" spreads to the reference gilt whose maturity could be several months away from the maturity of the £ EIB bond itself.

Figure 11. £ EIB Yields and UK Gilt Curve (%)



Source: Citi Research, Bloomberg

Figure 12. £ EIB spreads to fitted UK curve



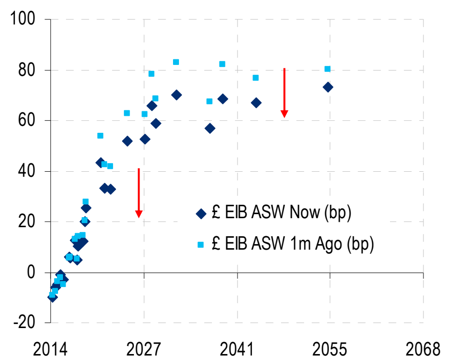
Source: Citi Research

Tone is constructive and curves continue to flatten

Curves can probably flatten further

The tone in the sterling SSA market at present is relatively constructive, with curves bull flattening as accounts look to extend on the curve. As ever in this market, activity is centered on where liquidity is greatest and in this sense, EIB provides a good example of secondary market behaviour (Figure 13). For investors who are still interested in extending on the curve, switches are still possible that look historically attractive such as the spread between £ EIB Jun21s and £ EIB Oct18s (Figure 14, Figure 15).

Figure 13. £ EIB ASW Curves (bp)

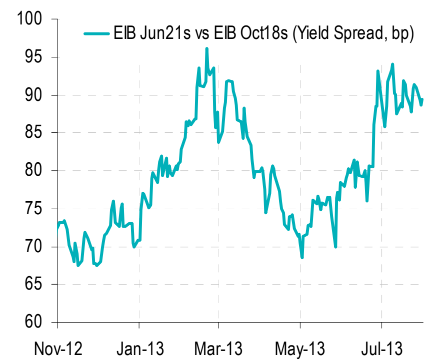


Source: Citi Research, Bloomberg

Figure 14. £ EIB Oct18s and £ EIB Jun21s (%)

Source: Citi Research, Bloomberg

Figure 15. EIB Jun21s vs EIB Oct18s (bp)



Source: Citi Research, Bloomberg

£ SSA Conclusion – liquidity centered in the key issuers

We see the sterling SSA market as an important segment of the overall universe of supranational and agency debt. The lack of market depth relative to other sectors can help explain secondary market term structures, with the need to take liquidity differences into account. That said, opportunities can be found in the top issuers and the relatively constructive tone at present is likely to see curves flatten further and spreads grind in.

(2) The UK Covered bond market

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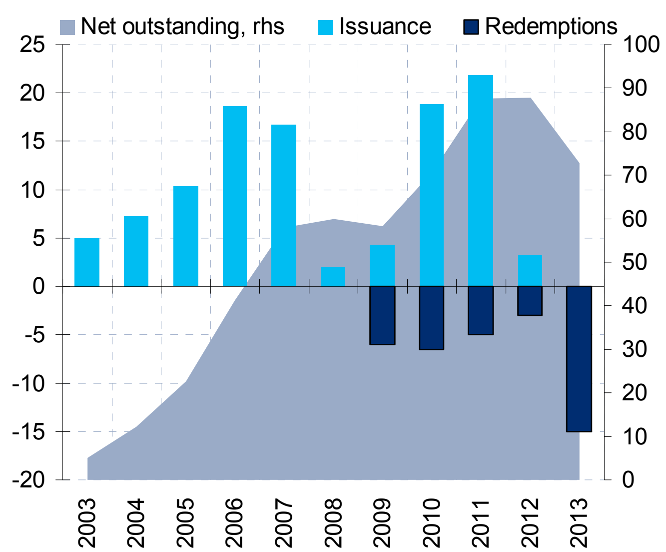
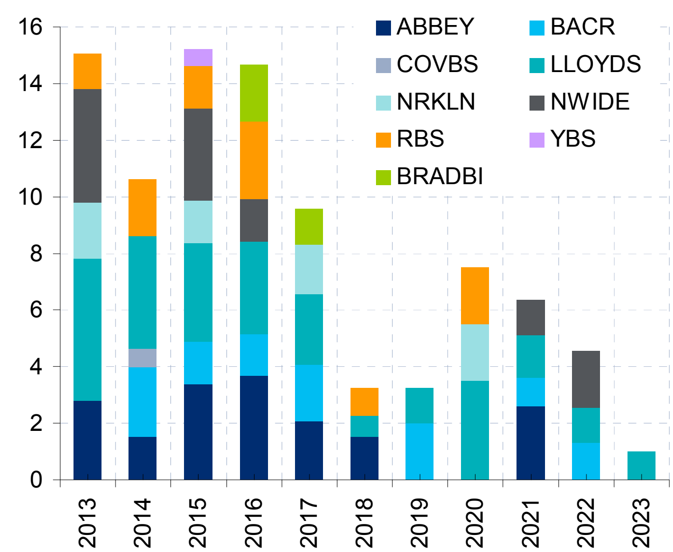
When discussing net negative issuance and a shrinking covered bond market, one European segment certainly comes to mind. The UK covered bond market has never been in severe distress nor is it now. Instead, funding levels have been decreasing constantly since 2008 and reached historic lows last May. Nevertheless, the UK covered bond market lacks € covered bond issuance since February 2012. Also, the growth of the very young sterling covered bond market came to a halt in May 2012. In our view, this can mainly be traced back to the effects of the Funding for Lending Scheme that was introduced in 2012 by the Bank of England and has been extended by the central bank until the beginning of 2015. This is why the UK market is shrinking substantially this year after a small drop in 2009. After lower redemptions in 2014, a record volume of €15.2bn will be maturing in 2015.

Figure 16. Net outstanding volume € benchmark covered bonds, EURbn



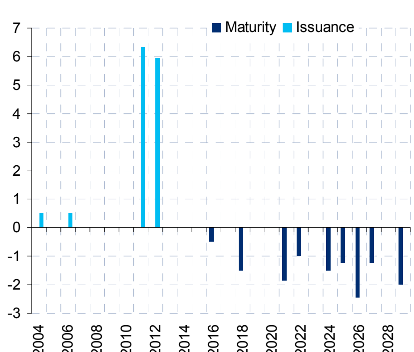
Source: Bloomberg, Citi Research

Figure 17. Redemption profile UK € benchmark covered bonds, EURbn



Source: Bloomberg, Citi Research

Figure 18. Issuance and redemption GBP benchmark covered bonds, £bn

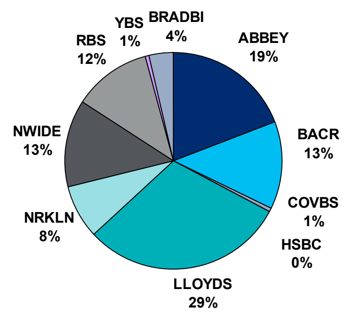


Source: Bloomberg, Citi Research

The GBP benchmark covered bond market is much younger than the euro covered bond market. UK banks started issuing actively in 2011. Apart from one Sterling bond that was issued by CBA, the market is exclusively composed of UK banks. Strikingly, while the average maturity of all EUR UK covered bonds that were issued over the last years is 7.3 years, the average GBP covered bond maturity is 12.9 years. Within the GBP market, LLOYDS and ABBEY have the highest amount of outstanding Sterling covered bonds (£4.75bn and £3.0bn, respectively, resulting in market shares of 36% and 23%).

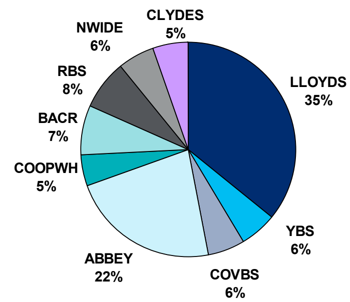
The dominance of these issuers is similar in the euro market while NWIDE is the third biggest euro covered bond issuer and the most active building society in the UK. Apart from the NWIDE and YBS, COVBS is a further covered bond issuer who is active in the covered bond market. Under the name of LLOYDS, there are a total of three different programs: the Lloyds global covered bond program, the Bank of Scotland Social Housing covered bond program and the Bank of Scotland Residential mortgage covered bond program. The last issuance activity of the latter two programs date back to 2006 and 2010, respectively.

Figure 19. Market share, € UK issuers benchmark covered bonds, %



Source: Bloomberg, Citi Research

Figure 20. Market share, £ UK issuers benchmark covered bonds, %

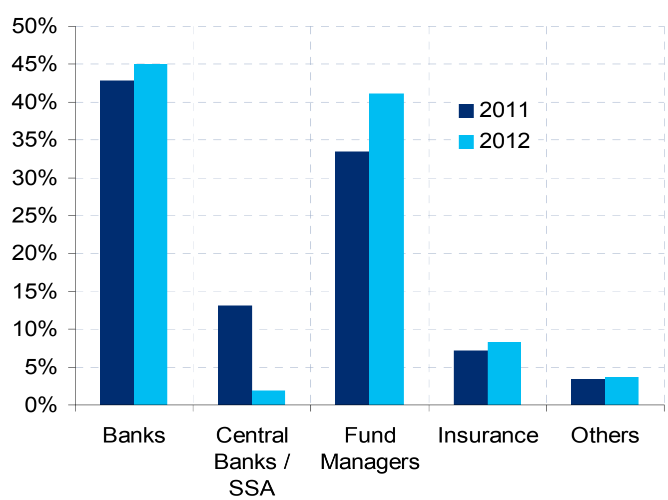


Source: Bloomberg, Citi Research

Domestic investor base is more concentrated to the GBP market

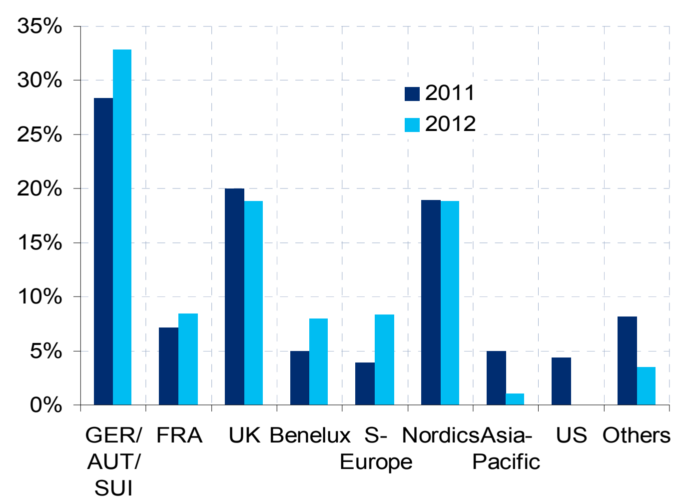
The investor basis in UK covered bonds in the primary market is dominated by investors from Germany (plus Austria and Switzerland). However, their share is relatively small compared to other segments (average in 2012 was 49%) with only 33% in 2012. However it increased from 28% in 2011. The domestic investor base is rather small but this is not altogether surprising as the Sterling market started developing rapidly in 2011. Moreover, Nordic investors have been active in the UK market seeing this segment as non-euro risk with yield pick-up to their domestic segments. The investor base is dominated by bank treasuries and fund managers whereas the share of the latter increased in 2012 taking over a big share from central banks and sovereign related entities which decreased their share from 13% to 2%. Compared to other covered bond segments, the high share of bank treasuries (average 34%) and low share of insurance companies (average 15%) leap to the eye. The latter, however, can be partly explained by the diverging average maturities (7.4 years vs 6.1 years) and long maturities in the GBP covered bond market.

Figure 21. Investor distribution by investor (%)



Source: CBR, The Cover, Citi Research

Figure 22. Investor distribution by investor base (%)



Source: CBR, The Cover, Citi Research

FLS will continue to hamper covered bond issuance

Prospects for the primary market are rather bleak in our view. While general deleveraging is a topic for UK banks as well (but lesser than for European banks, see UK Banks: An Eventful Summer Ahead - Leverage, Share Placing & Bad Banks - UK Big Picture: Summer Trends) the prolongation of the central bank's Funding for Lending Scheme is the main driver for issuance activity next year in our eyes. BoE cannot be satisfied with the usage of FLS so far (see also UK - Funding For Not Lending). The positive impact on covered bond issuance activity could come from the revival of the UK housing market and the economy which could be recorded recently. However, as FLS will be terminated in January 2015. Next year issuance should again be disappointing, although we would not expect zero issuance like recorded year to date.

Domestic assets dominate UK cover pools

Loans in UK cover pools are exclusively domestic risk. All actively managed covered bond programs with public issuance are backed by residential mortgages. At current stages, there are two outliers. On the one hand, BACR set up a program for the Special Liquidity Scheme (SLS) with covered bonds backed by public sector loans. Moreover, under the umbrella of Lloyds, the Bank of Scotland plc Social Housing loan covered bond program can still be found. However, issuance was only done in £ and was stopped in 2006. Nevertheless, the last bond matures in 2024.

The UK covered bond market is still AAA dominated

Apart form YBS, the UK covered bonds are still comprised exclusively by AAA rated securities. However, if RBS were to be downgraded by Moody's soon, the covered bonds would lose their Aaa. That aside, short-term pressure on ratings is not given in the case of Moody's. The majority of these bonds can display a rating buffer of one notch (TPI Leeway) while all other issuers whose covered bond rating buffers are exhausted, can present stable outlooks.

Figure 23. Main covered bond issuers (EUR benchmark covered bonds)

	ABBEY	BACR	BRADBI	COVBS	LLOYDS	NRKLN	NWIDE	RBS	YBS
Issuer rating	A2/--/A	A2/A/A	A1/--/--	A3/--/A	A2/A/A	A1/A/--	A2/A+/A+	A3*-/A/A	Baa2/--/BBB+
Covered bond rating	Aaa/AAA/AAA	Aaa/AAA/AAA	Aa1/AAA/AA+	Aaa/--/AAA	Aaa/--/AAA	Aaa/AAA/AAA	Aaa/AAA/AAA	AAA*-/--/AAA	Aa2/--/AA+
Moody's key figures									
Collateral Score	6.9%	5.0%	16.0%	5.0%	6.9%	18.5%	5.0%	5.0%	5.0%
Market Risk	15.4%	16.3%	20.1%	14.5%	13.5%	18.4%	13.5%	20.6%	16.9%
Collateral Risk	4.6%	3.4%	10.7%	3.3%	4.6%	12.4%	3.4%	3.4%	3.4%
Cover Pool Losses	20.0%	19.7%	30.9%	17.8%	18.1%	30.8%	16.8%	24.0%	20.3%
Maximum Mismatch	49.3%	39.9%	60.7%	n/a	28.5%	77.8%	18.2%	51.8%	79.0%
TPI	Probable	Probable	Improbable	Probable	Probable	Improbable	Probable	Probable	Probable
TPI Leeway	1 notch	1 notch	1 notch	0 notches	1 notch	0 notches	1 notch	0 notches	0 notches
Committed OC (rating)	17.0%	37.4%	20.5%	27.6%	17.0%	31.5%	18.3%	34.5%	22.5%
Cover pool data									
Assets, GBPbn	29.688	24.784	8.898	4.529	32.401	8.786	21.951	15.978	3.268
Liabilities, GBPbn	20.186	16.035	3.338	3.22	21.913	4.322	14.928	10.011	1.756
Current OC, %	47.1%	54.6%	166.6%	40.7%	47.9%	103.3%	47.0%	59.6%	86.1%
Average original LTV	63.4%	61.3%	78.1%	54.4%	68.2%	82.4%	56.7%	63.0%	63.2%
Indexed LTV	64.9%	65.3%	84.6%	54.3%	67.3%	94.6%	55.7%	63.3%	61.2%
WA Seasoning (months)	64	48	85	39	63	77	84	29	70
WA remaining term (mon.)	204.87	192	182	203	189	18	196	232	211
Concentration to London	6.7%	12.7%	28.0%	14.5%	15.3%	12.4%	12.5%	12.0%	12.3%
Loans in arrears (> 2m)	0.4%	0.2%	1.8%	0.0%	1.4%	8.3%	0.6%	0.2%	0.5%
Fixed rate assets	29.2%	21.3%	1.4%	49.2%	7.7%	5.1%	20.0%	61.6%	56.5%
Fixed rate liabilities	89.7%	88.2%	100.0%	41.0%	62.0%	100.0%	62.9%	100.0%	71.5%
WA Life (covered bonds)	5.7	5	4.4	3.3	15.3	4.7	7.2	4.1	3.7
WA Life (cover pool)	11.2	11.4	n/a	n/a	7.5	17	16.4	10.4	11.8

Source: Moody's, issuers, Citi Research

BRADBI and NRKLN have lower than average cover pool quality

Within the UK segment, there is a clear distinction in cover pool quality. This is nicely illustrated by the different collateral scores which are marked to the programs by Moody's. More than half of the issuers display the best reachable number (5.0% ceiling due to systemic risk assumed by the agency). BRADBI and NRKLN break out of the column. In case of the former, this can mainly be reasoned by the high amount of buy-to-let and interest-only loans, according to Moody's. Apart from these reasons, the high amount of limited income-verified loans is a further point which the agency points out in case of NRKLN.

New rules have been introduced this year

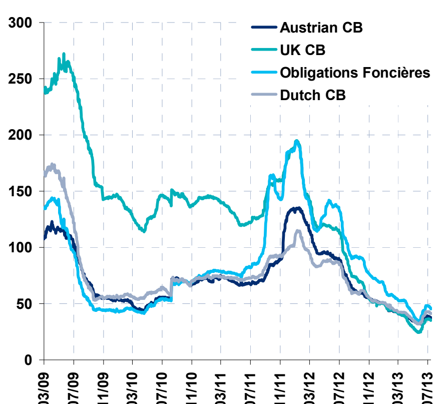
Since January 2013, UK issuers have to cope with new rules for their covered bond programs. Most importantly, the FSA introduced a legal overcollateralization of 8% and the role of an asset pool monitor. Moreover, securitizations have become non-eligible as assets within the cover pools. In order to reduce substitution risk, issuers have to put their own programs within classes. These are "public sector & liquid assets", "commercial & liquid assets" and "residential & liquid assets". After the classification, other assets are not eligible to add. Regarding transparency, UK issuers have already been exemplary before the new amendments were introduced. Since January, however, market participants can study loan-by-loan data which can be found on the website of Bank of England.

Secondary market

A long lasting outperformance is over

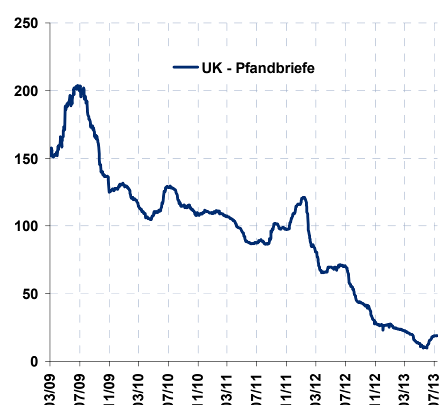
In the secondary market, UK covered bonds rallied steadily and have been the best performing core covered bond segment over the last five years. Currently, UK covered bonds are trading more expensive than Austrian, Dutch and French covered bonds. Spreads over pfandbriefe came down from 200bp in July 2009 to find its lowest levels in May at 10bp followed by a rebound to 20bp at current stages.

Figure 24. Comparison to peer segments, ASW-Spread, bp



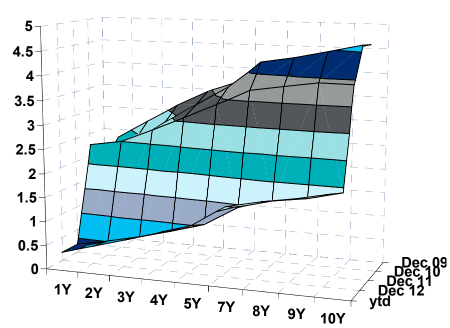
Source: Markit, Citi Research

Figure 25. Spreads over pfandbriefe, ASW-Spread, bp



Source: Markit, Citi Research

Figure 26. Yield curve development, %



Source: Markit, Citi Research

BARCL is the benchmark in the UK covered bond space

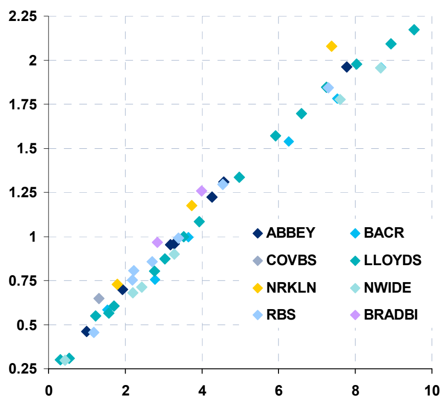
At the issuer level, market participants still make a clear distinction between BARCL and NWIDE which are seen as the strongest names and BRADBI and NRKLN which yield highest among the UK covered bond segment. Back in 2008, BRADBI retail business was taken over by ABBEY while the rest of the lender was taken over from HM Treasury (HMT). In September 2008, HMT announced to guarantee the issuer's obligations. However, it is not stated if it guarantees timely payment or payments if losses occur. Moreover, the guarantee is revocable (albeit this is perhaps unlikely).

Meanwhile, NRKLN was divided into a good bank and a bad bank in 2009. Northern Rock Asset Management and BRADBI are now both part of UK Asset Resolution Ltd. However, their guarantees are reading differently. NRKLN are guaranteed as well. However, HM Treasury can remove its guarantee with a notice of three months. Nevertheless, it should be emphasized that HM Treasury said it would ensure credit ratings are sustained and supported.

Senior-Covered spread is at historical lows

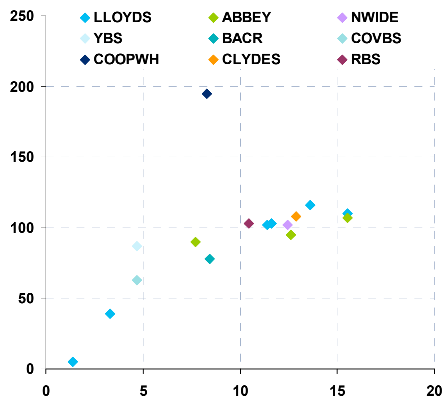
The spread between covered bonds and senior unsecured bonds has been quite stable for the strongest issuers over the last nine months. Currently, this spread is around 50bp. Less strong names have had a more volatile spread development at the same time. However, this volatility has been mainly led by the senior leg. On a long-term basis, the senior-covered spread in the UK is at historical low levels making the secured segment still an interesting pick within the intra-country choice over unsecured bonds. This pattern can be equally found in the GBP market where senior bonds trade at relatively tight levels to covered bonds. This spread should also be seen against the background that the UK already made it clear in 2011 that regulated covered bonds should be exempt from any bail-ins in case of a default of a bank.

Figure 27. Yield universe, EUR Benchmark covered bonds, %



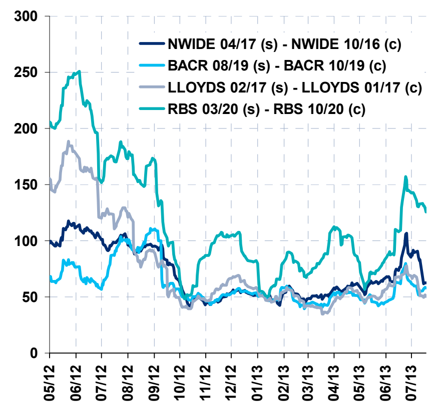
Source: Citi Research

Figure 28. Z-Spread universe, GBP Benchmark covered bonds, %



Source: Citi Research

Figure 29. Senior vs Covered, ASW-Spread, bp



Source: Citi Research

Conclusion - lack of UK covered bond supply is beneficial

Extremely low issuance expected for the medium term

We think UK covered bonds are recognized as a very important funding tool for UK banks by the regulators. The latest changes to the law reflect this. Unintended consequences of accommodative measures drawn out by the central bank however mean that the development of the domestic GBP covered bond market was stopped abruptly. The lack of issuance was/is supportive for the secondary market. For the rest of the year and beginning of 2014 we would expect to see this drought continuing given the prolongation of the FLS scheme. While displaying a supportive demand/supply pattern, further significance outperformance of UK covered bonds is perhaps going to be limited given the level of compression already achieved. However, we think UK covered bonds are attractive compared to the senior bonds given the historic low spread between both asset classes.

Euro SSA Strategy

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(1) Strategy views

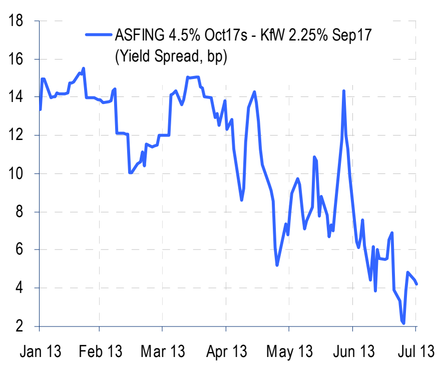
Market outlook: Notwithstanding the various political headline risk from the periphery EMU markets, the underlying tone in European SSA markets in recent weeks has been positive. Secondary cash spreads continue to tighten and the market remains resilient in the face of supply (note the €9bn from the EFSF in two benchmark deals this month). Our sense is that that the near-term bias remains for spreads to continue to grind in which can open up opportunities for relative value trades, especially for those looking to move up in quality. We detail our most recent trading themes and views regarding the most recent SSA market topics below.

Fade the performance of Austrian agencies

Good performance of Austrian agencies

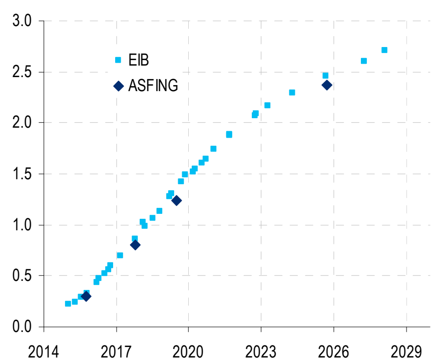
The steady performance of Austrian agencies, such as ASFING (Aaa/AA+), has driven spreads to core Aaa/AAA SSAs to low single digits. Yields have converged to KfW (Figure 30) and we would take such yield compression as an opportunity to fade the performance. In many cases, ASFING yields are now inside AAA/Aaa EIB yields (Figure 31). The example in the 4yr sector illustrates the extent to which positive spread pick-ups are possible (Figure 32).

Figure 30. ASFING Oct17s – KfW Sep17s (bp)



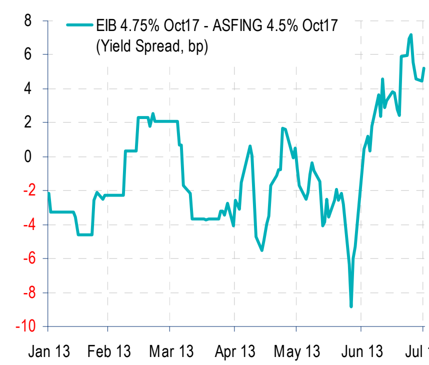
Source: Citi Research

Figure 31. EIB and ASFING Yield Curves (%)



Source: Citi Research

Figure 32. EIB Oct17s – ASFING Oct17s (bp)



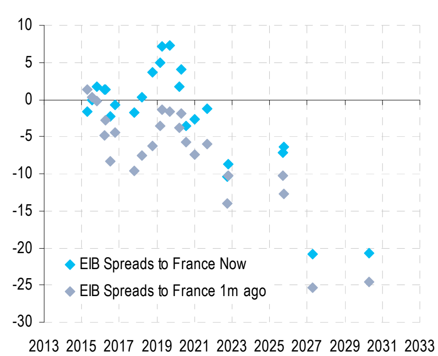
Source: Citi Research

Supras cheapening…but spreads not quite at extremes of ranges

Wait for better entry points for going long supras vs France

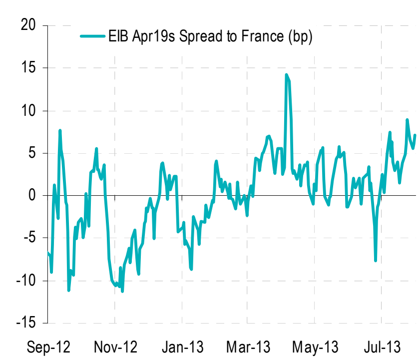
EIB also looks relatively too cheap to France given the recent bid for EMU soft core. Spreads are around 5bp to OATs in the 6yy-8yr sector (Figure 33), but better entry points have been possible historically for relative value trades (Figure 34).

Figure 33. EIB Spreads to France (bp)



Source: Citi Research, Bloomberg

Figure 34. EIB Apr19s to France (bp)



Source: Citi Research, Bloomberg

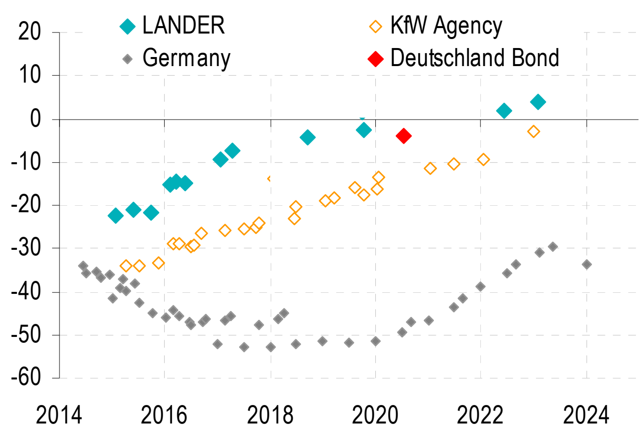
For example, the yield differential between EIB Apr19s and France has cheapened to around 6bp, but has approached 15bp earlier in the year. We therefore suspect spreads may need to widen a little further for dip buyers to show significant interest. A similar picture is evident when looking at EFSF spreads to France, but again we would probably look for better entry points to go long here. The total absence of OAT supply in September might be one factor in French yields outperforming further in the coming weeks.

Deutschland bond performance

Good performance of the Deutschland bond

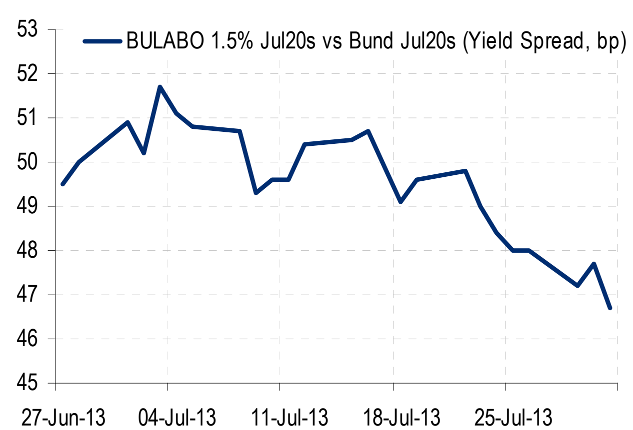
Germany issued its inaugural "Deutschland bond" in late June in a widely anticipated transaction. The German Republic issued 13.5% jointly with the German Länder. The €3bn 7yr bond was priced at mid-swaps +1 roughly in line with the LANDER curve at the time. Since then we have seen good performance of the bond which is now trading inside the LANDER curve in ASW and spreads to Germany have also tightened (Figure 35, Figure 36). We continue to see such bonds enhancing investor choice in providing another alternative for accounts wishing to gain exposure to a diversified pool of German credit quality. Further details regarding German Länder can be found in our recent *Euro SSA and Covered Bond Monthly - German Länder, post-Fed relative value and the spread outlook*).

Figure 35. ASW Curves of LANDER and peers (bp)



Source: Citi Research, Bloomberg

Figure 36. Deutschland bonds vs Germany (Yield Difference, bp)



Source: Citi Research, Bloomberg

ESM and the banking resolution regime

ESM functions continue to evolve

Since we last published, ECOFIN announced (late June) principles regarding the new banking resolution regime. This includes use of the ESM which is to earmark €60bn for bank recapitalization purposes. However, to the benefit of the ESM, the use of such a facility is strictly conditional. It can only be considered after a bail-in of shareholders/bondholders and after national governments have also provided support.

Full details of our views regarding this topic can be found in our *European Rates Weekly – SSA Strategy 5hth July.*

(2) Primary market activity

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

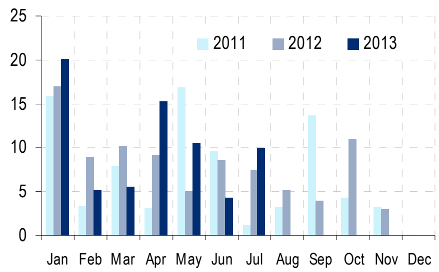
Going forward, SSA supply in August is typically light

Supranationals: Euro-denominated suprantioanal supply in July was €10bn (Figure 37). The main benchmarks were €5bn EFSF 1.625% Jul20s and €4bn EFSF 1.25% Jul18s. EIB performed three taps in the 6yr and 12yr sectors totaling over €1bn.

Dollar market more active in July

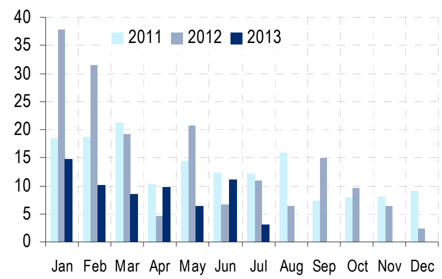
Agencies: Euro agency supply totaled nearly €3bn in July (Figure 38) with much more agency supply coming in dollars (for example, there was no euro KfW supply in June, but two dollar benchmarks totaling $6bn). Euro benchmark supply came from NEDWBK and BNG. CADES tapped the 12yr sector for €0.6bn.

Figure 37. EUR Supranational Issuance (€bn)



Source: Citi Research, Dealogic DCM Analytics

Figure 38. Non-US Agency EUR Supply (€bn)



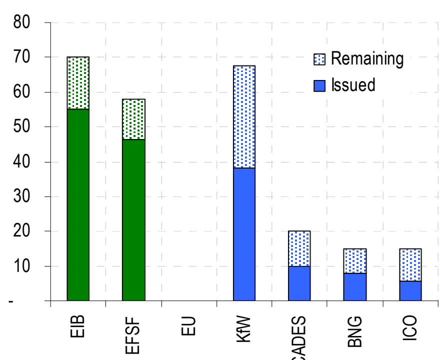
Source: Citi Research, Dealogic DCM Analytics

Many supras have now completed around 80% of their 2013 supply pipelines

Completion rates: Aggregating across currencies (Figure 39), many supranationals have issued around 80% of their 2013 supply targets (EIB 79%, EFSF 80%). Figure 40 and Figure 41 show monthly € supply for EIB and KfW which suggest August is a very light move for euro issuance. Note KfW recently reduced its funding requirement and now expects total issuance in 2013 of €65bn-€70bn.

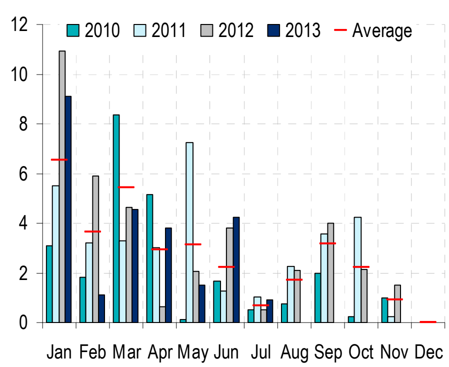
Upcoming € cash flows in August: There are no significant upcoming coupon or redemption payments from the core SSA sector in August.

Figure 39. European SSA Issuance Completion Rates, All Currencies, (€bn)



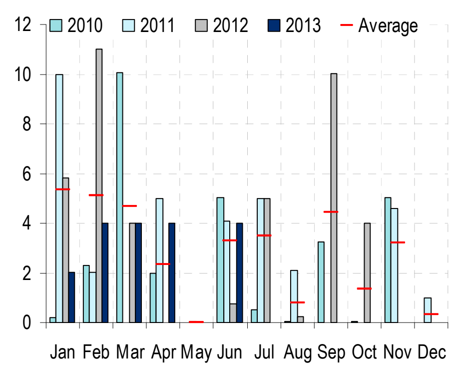
Source: Citi Research, Dealogic DCM Analytics, Issuers

Figure 40. EIB EUR Supply by month with average levels over recent years (€bn)



Source: Citi Research, EIB, Dealogic DCM Analytics

Figure 41. KfW EUR Supply by month with average levels over recent years (€bn)



Source: Citi Research, Dealogic DCM Analytics, KfW

(3) Secondary market performance

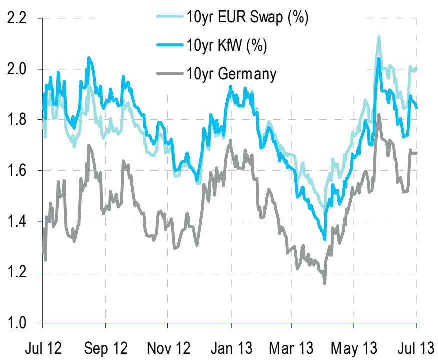
In the secondary market, SSA yields have rallied and spreads to both governments and swaps have tightened in a month where the tone has generally been constructive.

July total returns
€ iBoxx Supranationals 0.15%
€ iBoxx Agencies 0.41%

Returns in July: Returns for € iBoxx Supranationals and € iBoxx Agencies over July were 0.15% and 0.41% respectively.

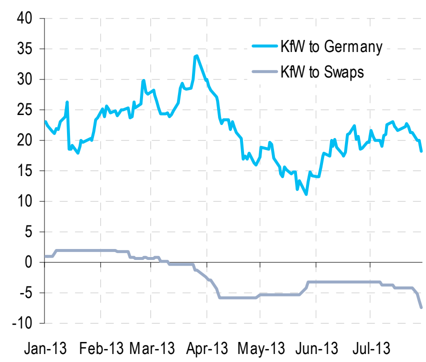
Spreads grinding tighter: SSA yields generally finished lower over the course of July with noted outperformance vs both governments and swaps. Yields for 10yr KfW, Germany and EUR swap are shown in (Figure 42). 10yr KfW continues to trade well in ASW where levels are now at the lows of -7.5bp (Figure 43). Spreads to Germany are also tightening and we had previously noted the scope for such mean reversion (*European Rates Weekly – SSA Strategy, 18th July*). The picture is similar regarding EIB (Figure 44).

Figure 42. 10yr KfW, Germany and € Swap



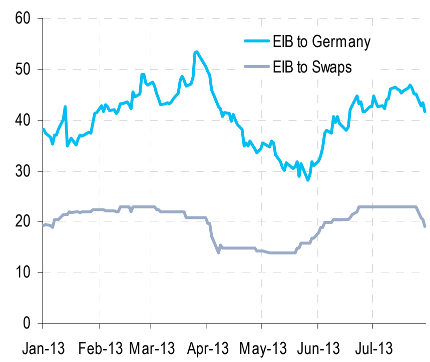
Source: Citi Research

Figure 43. 10yr KfW Spreads (bp)



Source: Citi Research

Figure 44. 10yr EIB Spreads (bp)



Source: Citi Research

July moves: Over July, core SSA yields rallied around 7bp-9bp (Figure 45). ASW spreads tightened by around 5bp and spreads to Germany also ground in.

See our new issuer specific performance charts overleaf: We include issuer specific month-on-month changes in both yield and ASW levels for core SSAs.

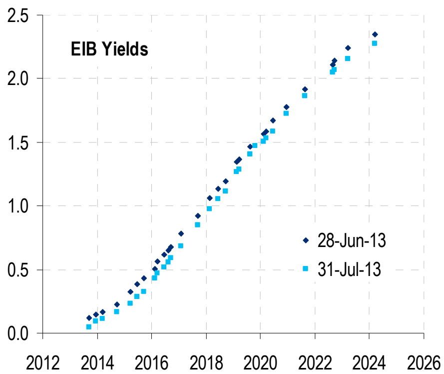
Figure 45. Select 10yr Core SSA Bonds, Details and Performance in July

					Yield		Spreads to Swaps		Spreads to Germany	
Issuer	Issue Date	Select Bond	Maturity	Amt Outstanding (€bn)	Level (%)	MoM Change (bp)	Level (bp)	MoM Change (bp)	Level (bp)	MoM Change (bp)
EIB	04-Jun-13	EIB 2% Apr23	14-Jul-13	4.00	2.16	-9	21	-6	50	-3
EU	25-Apr-12	EU 2.75% Apr22	04-Apr-22	2.70	1.88	-4	7	0	22	2
EFSF	28-Aug-12	EFSF 2.25% Sep22	05-Sep-22	3.97	2.11	-8	24	-5	45	-2
KfW	09-Oct-07	KFW 4.625 Jan23	04-Jan-23	3.00	1.84	-7	-7	-4	18	-1
CADES	11-Apr-11	CADES 4.125% Apr23	25-Apr-23	5.02	2.28	-8	33	-5	62	-1
BNG	19-May-11	BNG 3.875% May23	26-May-23	1.50	2.18	-5	22	-2	53	1
iBoxx Index		€ iBoxx Agencies			1.65	-8	40	-7		
iBoxx Index		€ iBoxx Supranationals			1.93	-4	25	-4		

Source: Citi Research, Bloomberg

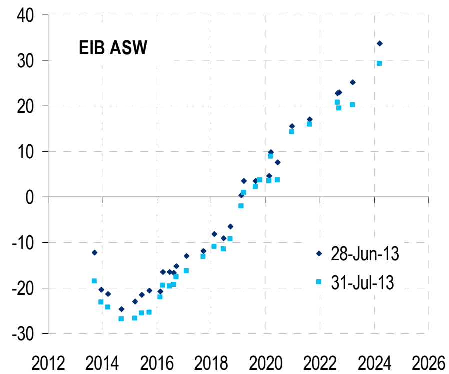
€ Supranational Yield and ASW MoM Changes

Figure 46. EIB Yield Curve, Now and 1m Ago



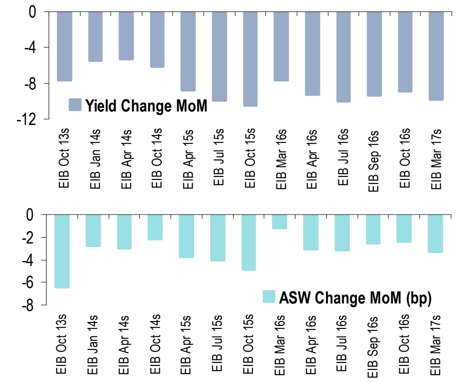
Source: Citi Research

Figure 47. EIB ASW Curve, Now and 1m Ago



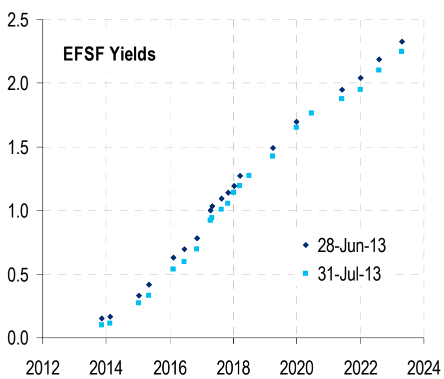
Source: Citi Research

Figure 48. MoM Yield and ASW Changes (bp)



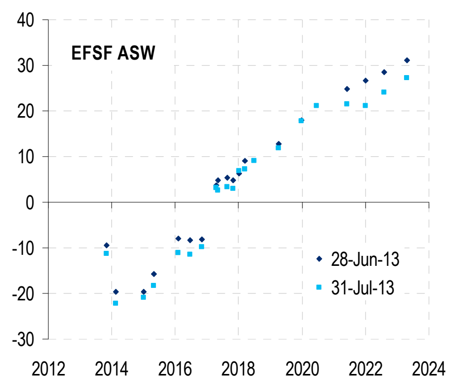
Source: Citi Research

Figure 49. EFSF Yield Curve, Now and 1m Ago



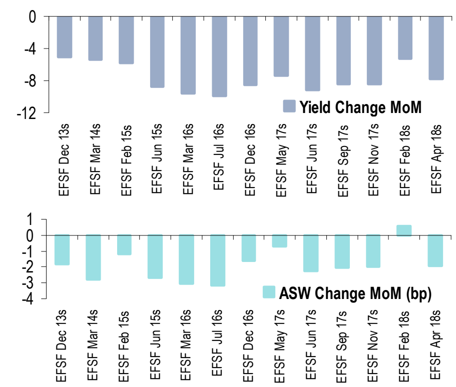
Source: Citi Research

Figure 50. EFSF ASW Curve, Now and 1m Ago



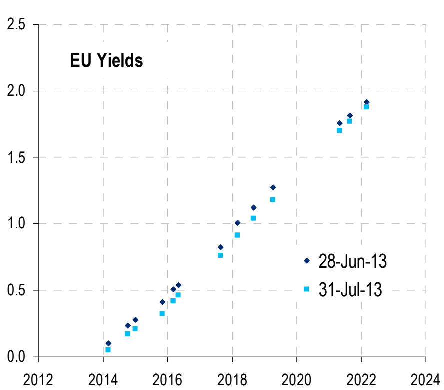
Source: Citi Research

Figure 51. MoM Yield and ASW Changes (bp)



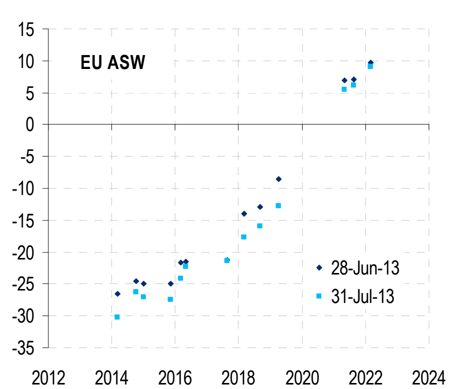
Source: Citi Research

Figure 52. EU Yield Curve, Now and 1m Ago



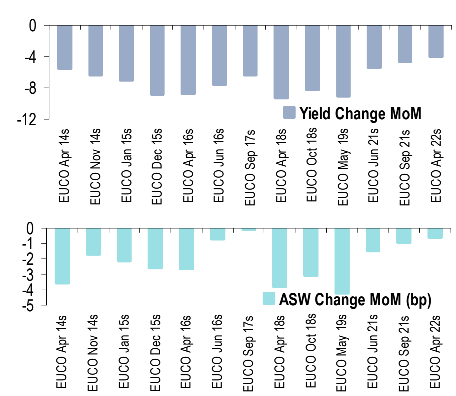
Source: Citi Research

Figure 53. EU ASW Curve, Now and 1m Ago



Source: Citi Research

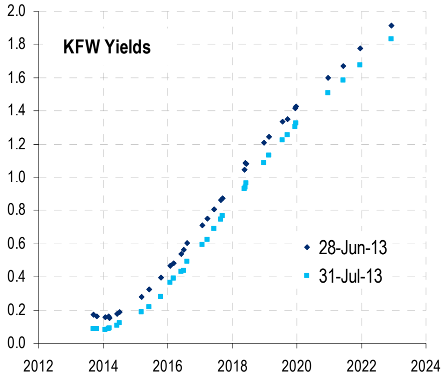
Figure 54. MoM Yield and ASW Changes (b)p



Source: Citi Research

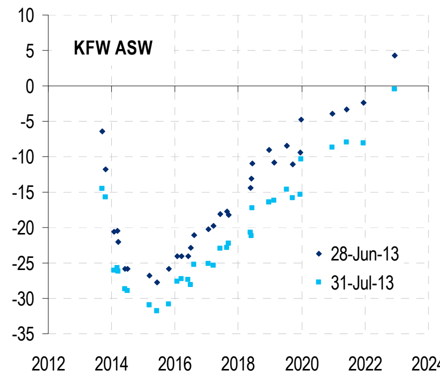
€ Agency Yield and ASW MoM Changes

Figure 55. KfW Yield Curve, Now and 1m Ago



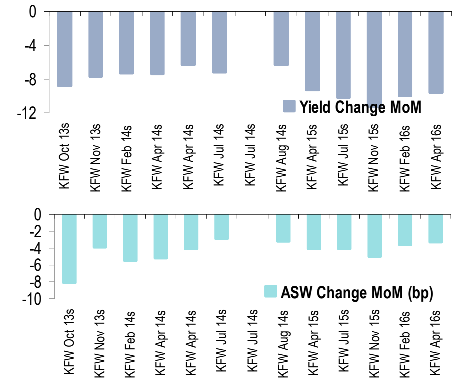
Source: Citi Research

Figure 56. KfW ASW Curve, Now and 1m Ago



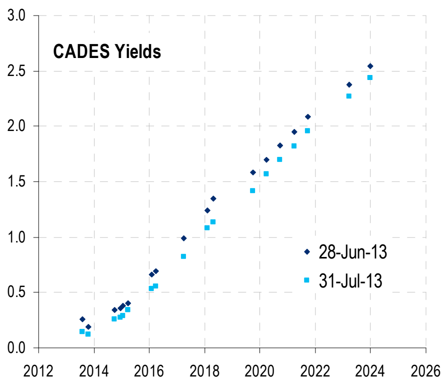
Source: Citi Research

Figure 57. MoM Yield and ASW Changes (bp)



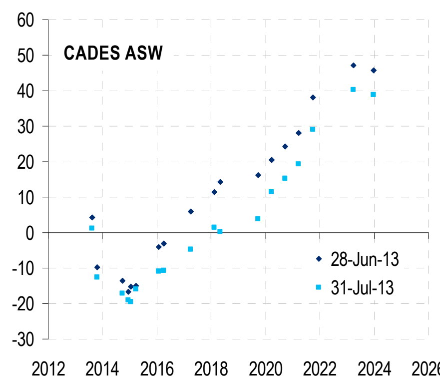
Source: Citi Research

Figure 58. CADES Yield Curve, Now & 1m Ago



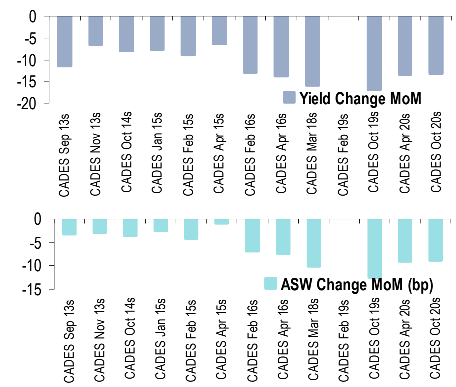
Source: Citi Research

Figure 59. CADES ASW Curve, Now & 1m Ago



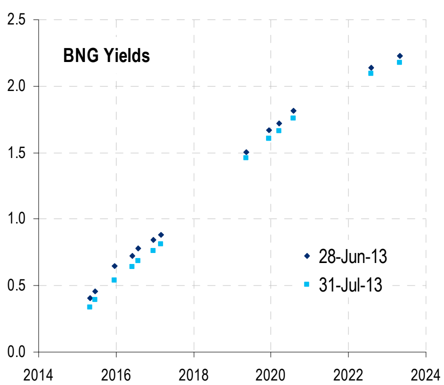
Source: Citi Research

Figure 60. MoM Yield and ASW Changes (bp)



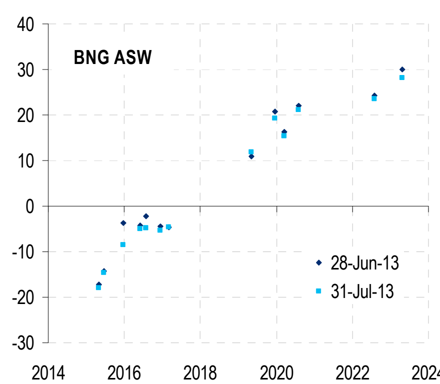
Source: Citi Research

Figure 61. BNG Yield Curve, Now and 1m Ago



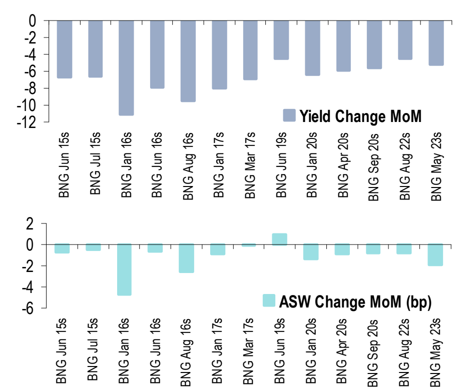
Source: Citi Research

Figure 62. BNG ASW Curve, Now and 1m Ago



Source: Citi Research

Figure 63. BNG Yield and ASW Changes (b)p



Source: Citi Research

Covered Bond Strategy

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(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 we are sticking to a more defensive tone on peripheral covered bonds, we slightly adjust our general weighting recommendations in core markets. Moreover, we include the Canadian covered bond segment.

Figure 64. 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
Canada	Overweight	Highly rated, healthy sovereign, still more attractive than safe haven peers
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 65. 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	Latest chepaning and long-term prospect due to different demand-supply patterns
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 CAJARU, BKTSM and KUTXAB to other Tier-2 issuers	Yield pick-up to Tier-1 issuers but higher cover pool quality
Spain	Prefer Cedulas to Bonos	Recent underperformance of Cedulas vs Bonos provide new entry opportunities

Source: Citi Research

(2) Primary market activity

Canadian covered bonds – the next one is standing ready

CIBC followed RY's multi-currency activity

In our last Weekly (*European Rates Weekly - Value in the soft core*), we provided a brief introduction of the Canadian covered bond law and summarized the cover pool of RY, backing the first EUR covered bond issuance from Canada for more than five years. This time we want to present a further issuer which has already been on road-show and has been active this week. In mid of July, RY re-opened the USD market for Canadian covered bonds followed by its debut in Euro last week and in the AUD market as well. The $1.75bn bond has been placed 35bp over mid-swaps and 51bp over US-T. The issuer again preferred to issue a SEC registered bond, hence opening it to a bigger investor base than with the 144/A format. The EUR covered bond came 16bp above mid-swpas in the seven year range. Further issuance can be expected soon, probably in the USD market: Bank of Nova Scotia also has the SEC approval and received the issuance license of CMHC at the beginning of last week. For more details on the USD covered bond market, see also our last *Euro SSA and Covered Bond Monthly.*

CIBC preferred EUR covered bond issuance first

Euro covered bond investors have already been fed with another Canadian covered bond. CIBC has been on a road-show through Europe in mid of July. Execution has been this week as the soon coming blackout period would have postponed the deal even longer. Nonetheless, we want to present the issuer and its cover pool in the following. The source of the cover pool data and the cover pool information is Moody's. In order get a picture of the issuer within the Canadian banking sector, please have a look at CIBC (CM.TO) as of May 30th and a very broad view on Canadian Banks as of February 27th.

Figure 66. Cover pool key figures

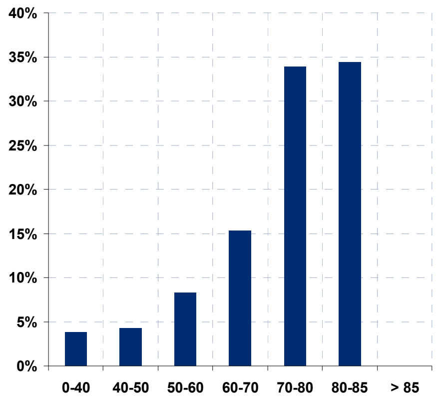
Cover pool assets (CADbn)	6.056
Fixed rate assets	100%
Average loan balance, CAD	275,155
Number of loans (=borrowers)	22,008
Loans in arrears	0.00%
WA remaining term (months)	35.2
WA seasoning (months)	14.3
WA current LTV	68.8%
Moody's Collateral Score	7.0%
Moody's Timely Payment Indicator	Probable
Rating buffer (TPI Leeway)	3 Notches

Source: Moody's, Citi Research

New covered bonds won't be issued out of the former structural covered bond program backed by insured mortgages. This will be wound down in the future while new covered bond issuance will solely come from the CMHC approved program. For this, Moody's already assigned a provisional Aaa rating. Although a covered bond law is generally credit supportive, Moody's also sees higher credit risk, mainly given the lack of governmental insurance for mortgages but also higher market risks. Moreover, the agency (and we) see it as a major weakness that in case of an event of default excess overcollateralization will not stay with the covered bond program. Therefore, the agency only gives credit to the committed OC in the terms and conditions which is 7%. Concerning refinancing risk, the covered bond program incorporates several structural features which should reduce this. On the one hand, soft bullet covered bonds (maturity extension by twelve months) are allowed to issue while on the other hand the issuer has the obligation to run a pre-maturity test if it prefers to issue hard bullet covered bonds.

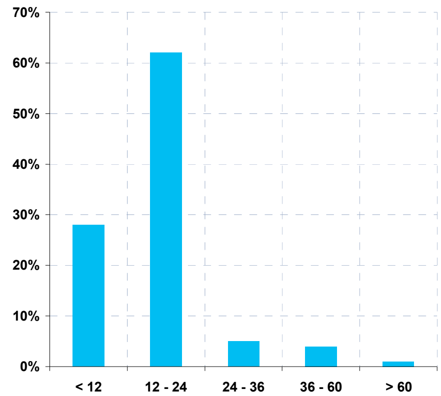
Moreover, Moody's assumes that loans that have to be sold will find willing buyers (i.e. the other covered bond issuers) as this is often seen as an entry point for more business with specific clients. A negative however is that the covered bond law defines substitute assets quite narrowly, thereby excluding cash. Interest-rate risk should be a lower problem as all assets are paying fixed rate while the bulk of covered bonds should be expected to be fixed rate either. Moreover, the issuer is allowed to use derivatives to hedge interest rate and currency risks. The fact that the issuer is mostly its own counterparty displays a risk which should however be mitigated by collateral postings and rating triggers.

Figure 67. LTV distribution, %



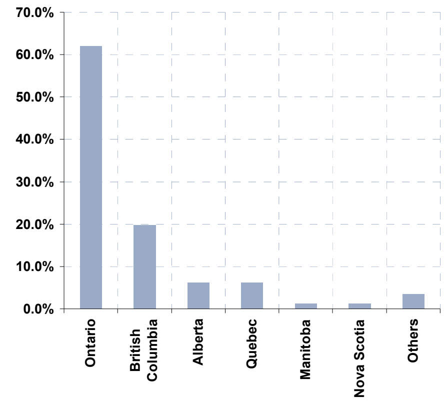
Source: Moody's, Citi Research

Figure 68. Seasoning in months



Source: Moody's, Citi Research

Figure 69. Geographical distribution



Source: Moody's, Citi Research

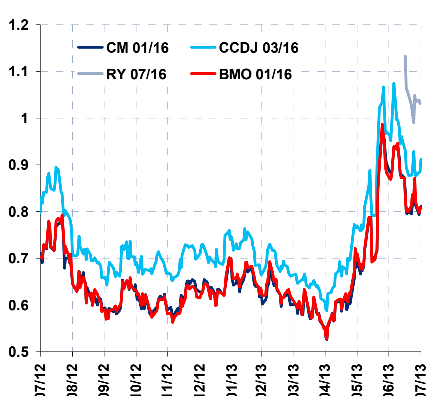
87% of the pool consists of single family properties

The pool exclusively consists of Canadian exposure to the residential market. Loans are only eligible if the volume is lower than CAD3mn, has a first priority lien, relates to a mortgaged property in Canada and is current on payments with its first payments made. More positively is the fact that only 13% of the cover pool are not single family properties.

Pricing of CIBC has been less attractive than in case of RY the week ago…

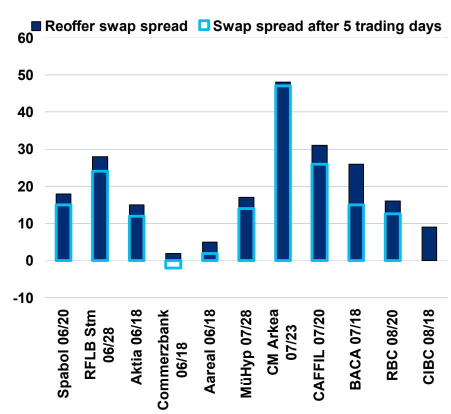
The secondary market in USD covered bonds has so far been differentiating between bonds backed by government insured mortgages and uninsured collateral (i.e. RY covered bonds). This should now come to an end. While refinancing levels have been higher for the latter over the last years given the lack of federal insurance, we see their bonds as one of the main reference points for the pricing of new USD covered bonds. In the Euro market, both covered bonds outstanding have been issued by RY and have probably been the benchmark for CIBC's first EUR deal this week. This 5y bond was priced 9bp above mid-swaps.

Figure 70. Canadian USD covered bonds, yield, %



Source: Bloomberg, Citi Research

Figure 71. CIBC's issuance vs peers, mid-swap



Source: Bloomberg, Citi Research

Figure 72. RY EUR covered bond in comparison, ASW-spread

Source: Bloomberg, Citi Research

…but seems in line with safe haven peers

The left hand graph above shows the price differentiation and RY's latest USD covered bond pricing cheaper than its peers although it was the first law based covered bond. The different structure of the new cover pools make comparisons to already outstanding covered bonds rather difficult. The two other graphs show the risk perception on EUR Canadian covered bonds. RY has been performing

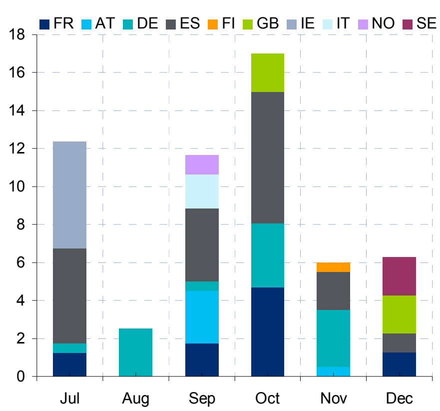
impressively over the last months. The already longer outstanding RY covered bond which is going to mature in 4.5 years reached ASW-levels of Swedish and German covered bonds over the last months and developed similar since then. The latest issued bond by RY was cheap in our opinion. This week's CIBC covered bond program which was priced 9bp above mid-swaps in the belly of the curve seemed to be on fair value compared to the Canadian peers and the Swedish and German segment.

Primary market in slow mode

July issuance has been very low again…

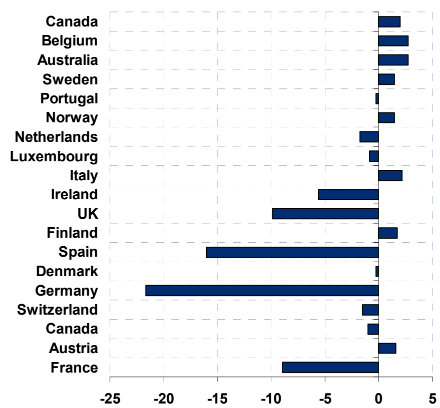
While CIBC's was expected to come, many other deals should not be expected as the covered bond primary market is still in summer mode. It doesn't come as a surprise that issuance in July (€5bn) has nearly been lowest ytd. And it fits perfectly to the broader picture for covered bond markets in 2013 that the monthly issuance volume has been lowest compared to the last years' volumes as well (see appendix). Year to date, average net negative issuance per month was EUR7.4bn with only month displaying positive net supply. On a country basis, the main drop in net supply can be reported for the traditional covered bond markets Germany, Spain, UK, France and Ireland.

Figure 73. Redemptions 2013, EURmn



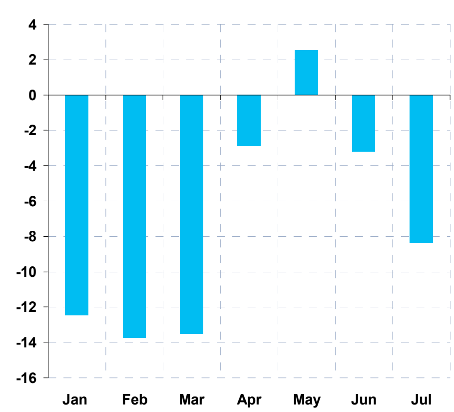
Source: Citi Research

Figure 74. Net supply, ytd, EURbn



Source: Citi Research

Figure 75. Net supply per month, ytd, EURbn



Source: Citi Research

…but might be better in August

Although August tends to be a light month in terms of supply, volumes tend to be higher when compared to July. However, last year, August has been even weaker. And so far, primary market activity drew more similarities to last year. However, some issuers already announced its plan to return in 2H13 or do the inaugural issuance. One of these entities is the French La Banque Postale (LBP).

One more French issuer works on a new covered bond program

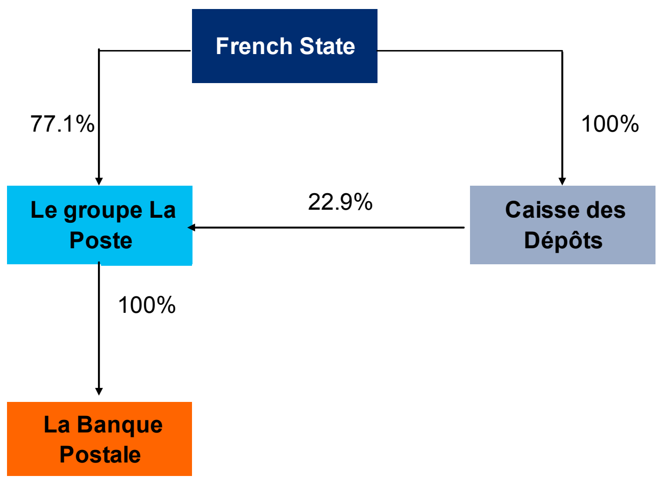
The affiliate of the French La Poste (LP), La Banque Postale, is working on a SFH program, allowing them to issue obligations à l'habitat in the future. Back in 2011, the entity announced that a part of the bank's strategic plan would be the creation of a covered bond issuing entity until 2015. The name might be familiar to covered bond market participants. LBP has a decisive role in the business structure of CAFFIL which issued its first deal under the new name recently (more information on the ownership structure, see also Euro SSA and Covered Bond Monthly). On June 24th, LBP already received its issuing license by the French Autorité de contrôle prudentiel (ACP, the French prudential authority).

The French state is again involved heavily

LBP is a wholly owned entity of LP which is legally bound to keep a majority stake in LBP. LP itself is controlled by the French state who is the main stakeholder, directly and indirectly via Caisse des Dépôts (29.1%). S&P thinks that "there is a very high

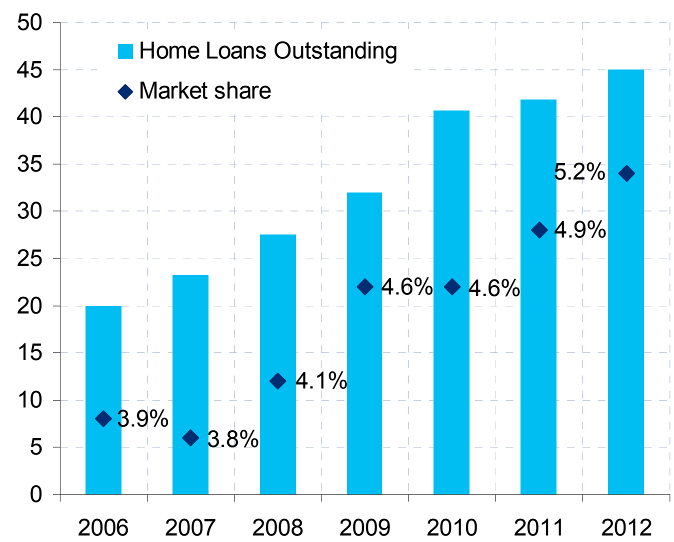
likelihood that the Republic of France would provide timely and sufficient extraordinary support to LP [La Poste] in the event of financial distress. "[1] However, although LP's role for the French government is seen as very important, the public company gets a rating deduction and is not rated in line with the French government. While France is currently rated Aaa/AA+/AA+, LP displays --/A/AA- and its affiliate, LBP is rated --/A+/A+.

Figure 76. Ownership structure



Source: LBP, Citi Research

Figure 77. Home loan business (€bn) and market share (%)



Source: LBP, Citi Research

The following points are key strengths and weaknesses which S&P points out in its credit analysis:

Strengths:

- Implicit support from the Republic of France
- Strong franchise and critical market share in French household banking
- Above-average funding profile and strong liquidity position

Weaknesses:

- Spread risk generated by large portfolios of securities
- Structural interest-rate exposure
- Concentration of the loan book

So far, we didn't have information on the issuer's cover pool as neither rating reports nor investor reports have been published. We will come back to this topic when we receive further information on the cover pool.

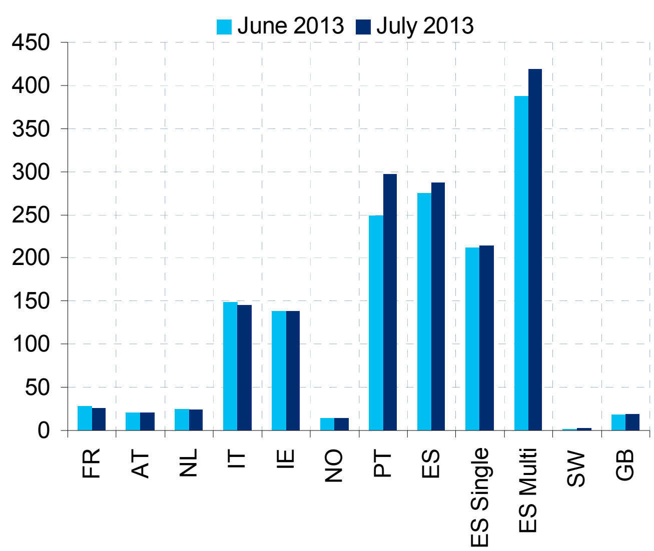
[1] S&P: La Poste, 05.11.2012

(3) Secondary market activity

First bids for Spanish covered bonds have come back

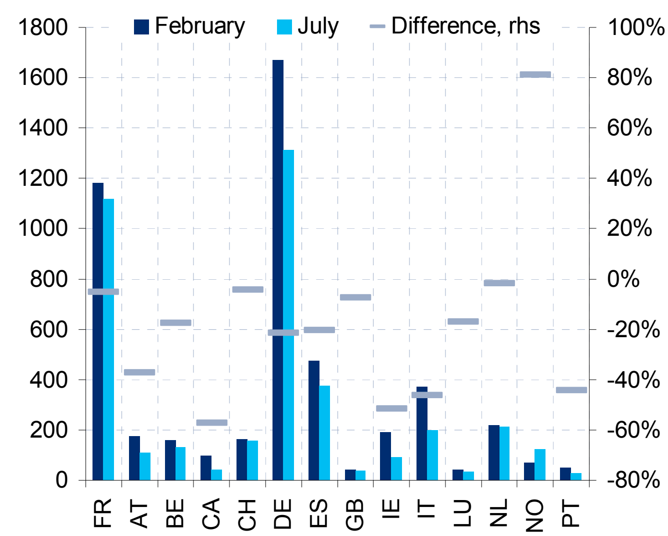
After two months of spread divergence in the covered bond space, first bids for lower yielding segments came back in the mid of the month. Over the last week, demand was also attracted by higher yielding covered bond segments. So far, however, in these segments the main demand was concentrated to the Tier 1 issuers. Nevertheless, demand also started to trickle down to Tier 2 issuers and multi-structures. Spreads over pfandbriefe have been widening on a 4 weeks basis in the Southern European covered bond segments while, overall, movements have been relatively low. This should also be seen against the fact that markets are still in summer break and trading volume is relatively low compared to earlier months of the year. The right graph below shows trading activity measured by the number of tickets (buy and sell) within the 100 most actively traded covered bonds via Bloomberg in the month of February and July, respectively. Apart from higher trading activity in Norwegian covered bonds, it is in general lower within each segment.

Figure 78. Spread over German pfandbriefe, end of each month



Source: Markit, Citi Research

Figure 79. Trading activity (number of tickets) within the 100 most actively traded covered bonds on Bloomberg



Source: Bloomberg, Citi Research

Figure 80. Yield difference between French covered bonds and OAT, %

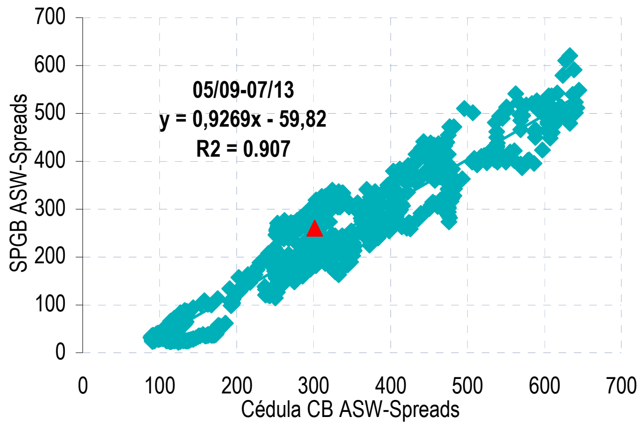
Source: Bloomberg, Citi Research

The main demand within the non-peripheral covered bond space was found for French covered bonds which have been widening more severe in the aftermath of the FOMC speech, followed by Belgium. After FOMC, French secured paper has been underperforming OATs after having been trading flat or even through government bonds (especially on the long end of the curve). Given this relative cheapening of covered bonds we think that French covered bonds look attractive again versus OAT. For the long term we are still convinced that French covered bonds can follow the pattern of Southern European covered bond markets implying selected covered bonds trading more expensive than government bonds. The only segment which has been widening (by 1bp) is the Canadian covered bond market. However, this should be seen against the latest issuance of EUR2bn by the RY and the follow-up deal of CIBC which are not part of the index so far.

In the peripheral covered bond space, an interesting decoupling of the segments has been taking place. While the general re-pricing of risk in the aftermath of the tapering debate has been most pronounced in the peripheral covered bond

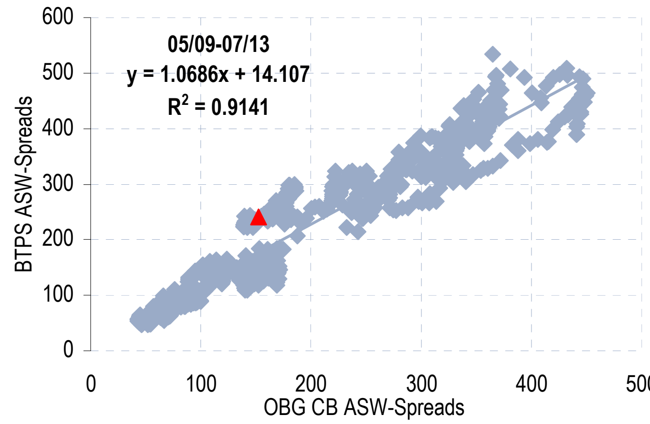
segments in general, the volatility in Irish and Italian covered bond segments has been much lower than in Portuguese and Spanish covered bonds (see appendix for the respective graphs). While we see the decoupling justified for Irish ACS issuers, we think that high short-term political risk is given for Italy. Moreover, some Italian banks have been downgraded in a similar manner like some of its Spanish peers. Especially the macro outlook and political uncertainty in both countries, Spain and Italy, lead to our forecast of wider spreads over bunds for both countries in the same range (please see Global Economic Outlook and Strategy). Therefore, we think that a more similar movement should also be expected in the covered bond segments of these countries.

Figure 81. Relative attractiveness of Spanish covered bonds vs. SPGB



Source: Markit, Citi Research; red point: current spread

Figure 82. Relative richness of Italian covered bonds vs. SPGB



Source: Markit, Citi Research; red point: current spread

Spanish cédulas look attractive versus Bonos at current stage

Given the lower sensitivity in Italian covered bonds that was recorded over the last weeks, Italian covered bonds haven't been cheapening to their underlying sovereign than in case of Spain compared to historical levels. While the govie-covered spread is currently at -82bp in case of Italy, it is at 41bp in case of Spain. Historical tight levels were reached in March where OBG were trading 118bp tighter on an index level than BTPs and Spanish cédulas 15bp tighter than their government paper. We therefore think that Spanish covered bonds are currently attractive compared to Bonos while the potential of further outperformance of the secured paper versus government debt is lower in case of Italy. We should however note that in the context of the whole covered bond universe we remain cautious on both covered bond segments. The current performance mainly seems to be driven by the lack of news on generally low trading volume.

Canadian covered bonds are an interesting safe haven alternative

Within the spectrum of covered bond safe havens, the newly re-born Canadian covered bond space is a good diversification possibility. Investors would be wrong to expect any kind of similar performance which Australian covered bonds recorded after their implementation. The main reason is that the new Canadian covered bond has already been priced on levels of Norwegian covered bonds. The USD covered bond market where Canadian bonds are the lowest yielding segment gave a hint that the first Euro denominated Canadian covered bond has been priced relatively cheap. Currently, we would see Canadian covered bonds still as an attractive alternative to German pfandbriefe and Swedish covered bonds. Although issuance expectations are given for the North-American banks, future issuance volume should not have negative effects given the general drought in the covered bond space while the increasing ability of investors to buy such paper the more the segment establishes should be a supportive factor.

Figure 83. 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	97	-4	84	84	85	54	60	56	63	59	-64	-56	89	70	-218	-210	-139	-338	82	65	57	78	57	70	80	74	-12
PB	15	82	-2	0	0	-30	-24	-28	-21	-25	-149	-140	5	-14	-302	-294	-223	-423	-2	-19	-27	-7	-28	-14	-5	-11	-97
M PB	15	82	0	-2	0	-30	-24	-28	-21	-25	-149	-140	5	-14	-302	-294	-223	-422	-2	-19	-27	-7	-28	-14	-5	-11	-96
PS PB	14	82	0	0	-2	-30	-24	-28	-22	-25	-149	-141	5	-15	-302	-294	-224	-423	-2	-19	-27	-7	-28	-15	-5	-11	-97
OF	42	54	-28	-28	-28	-4	6	2	9	5	-119	-110	35	16	-272	-264	-193	-393	28	11	3	23	2	16	25	19	-67
OH	37	60	-22	-22	-22	6	-4	-4	3	-1	-125	-116	29	10	-278	-270	-199	-399	22	5	-3	17	-4	10	19	13	-73
FRA CB	40	56	-26	-26	-26	2	-4	-4	7	3	-121	-112	33	14	-274	-266	-195	-395	26	9	1	21	0	13	23	17	-69
AUT CB	35	61	-21	-21	-21	7	1	5	-2	-4	-128	-119	26	7	-281	-273	-202	-401	19	2	-6	14	-6	7	16	10	-75
NL CB	39	58	-24	-24	-24	4	-2	2	-3	-3	-124	-115	30	11	-277	-269	-198	-397	23	6	-2	18	-3	11	20	14	-71
ITL CB	160	-63	-145	-145	-145	-117	-123	-119	-124	-121	-6	9	154	134	-153	-145	-75	-274	147	130	122	142	121	134	144	138	52
IRL CB	153	-56	-138	-138	-138	-110	-116	-112	-117	-114	7	-4	145	126	-162	-154	-83	-282	138	121	113	133	113	126	136	129	44
CAN CB	12	85	3	2	2	30	24	28	23	27	147	140	1	-19	-307	-299	-228	-428	-7	-24	-32	-12	-33	-19	-10	-16	-102
NOR CB	28	68	-14	-14	-14	14	8	12	7	10	131	124	-16	-3	-288	-280	-209	-408	12	-5	-13	7	-13	0	10	3	-82
POR CB	312	-215	-297	-297	-297	-269	-275	-271	-276	-273	-152	-159	-300	-283	-7	8	79	-121	300	283	275	295	274	287	297	291	205
ES CB	302	-205	-287	-287	-287	-260	-265	-261	-267	-263	-142	-149	-290	-273	10	-9	71	-128	292	275	267	287	266	280	289	283	198
ESS CB	229	-132	-214	-214	-214	-186	-192	-188	-193	-190	-69	-76	-216	-200	83	73	-11	-199	221	204	196	216	196	209	219	212	127
ESM CB	434	-337	-419	-419	-419	-392	-397	-394	-399	-395	-274	-281	-422	-405	-122	-132	-205	-5	421	404	396	416	395	408	418	412	326
SWE CB	17	80	-2	-2	-3	25	20	23	18	22	143	135	-5	11	295	285	212	417	-1	-17	-25	-5	-26	-12	-3	-9	-95
UK CB	33	63	-19	-19	-19	9	3	7	2	5	126	119	-21	-5	278	269	195	401	-16	-2	-8	12	-9	5	14	8	-78
AUS CB	41	56	-26	-26	-27	1	-4	-1	-6	-2	119	111	-29	-13	271	261	188	393	-24	-8	-3	20	-1	13	22	16	-70
FIN CB	22	75	-7	-7	-7	21	15	19	14	17	138	131	-9	7	290	280	207	412	-4	12	20	-2	-21	-8	2	-4	-90
BEL CB	40	57	-25	-25	-26	2	-3	0	-5	-1	120	113	-28	-12	272	262	189	394	-23	-7	1	-18	-4	13	23	17	-69
DEN CB	29	68	-14	-14	-15	13	8	11	6	10	131	123	-17	-1	283	273	200	405	-12	4	12	-8	11	-2	10	4	-82
SUI CB	20	77	-5	-5	-5	23	17	21	16	19	140	133	-8	9	292	282	209	414	-3	13	21	2	20	9	-2	-6	-92
NZL CB	26	71	-11	-11	-12	16	11	14	9	13	134	127	-14	2	286	276	203	408	-9	7	15	-4	14	3	-6	-1	-86
LUX CB	109	-12	-94	-94	-95	-67	-72	-69	-74	-70	51	43	-97	-81	203	193	120	325	-92	-76	-68	-88	-69	-80	-89	-83	-4

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) Covered bond market developments

NIBC – The conditional pass-through covered bond is on its way

Dutch covered bond issuance has been extremely low so far

The Dutch covered bond market didn't distinguish itself as a highly active covered bond primary market. Year to date, only one Dutch covered bond was placed by INTNED in May. However, it was known that NIBC was not only working on a new covered bond structure but originally planned to issue a covered bond program in 2H13 under the old structure. However, things have changed and a new payment structure will be introduced to the covered bond space earlier than expected. The main reason why NIBC changed its plans and precipitates the introduction of pass-through structures in the covered bond space is a peculiarity in the Dutch covered bond law and latest rating actions on NIBC. Amendments to the covered bond law in 2008 introduced the necessity for a covered bond issuance to obtain at least one credit step 1 rating (i.e. Aa3/AA-/AA-) while still giving the central bank the ultimate right to question credit ratings and hence still allow the covered bond issuance.

NIBC will come back issuing through a newly built transaction structure…

At the mid of the month, the covered bond program of NIBC lost its last AA- after the downgrade of the long-term issuer default rating by Fitch. The reason for the downgrade was "the prolonged profitability challenges faced by the bank's niche business model in the current operating environment", according to the rating agency. The covered bonds are rated by Moody's and Fitch and currently display an A1/--/A+ rating. After this, covered bond issuance would only have been possible if the Dutch central bank doubted the judgment of the credit rating agencies. However, the issuer decided to prioritize the implementation of the new covered bond structure. This new structure would heave the covered bonds back to Aaa/AAA and issuance would become possible again. Apart from the fact that the issuer expects these covered bonds to be AAA rated by both agencies, the covered bonds will be law based and compliant with UCITS and CRD.

…where potential fire sales should be prevented

The main difference between conditional pass-through covered bonds and traditional bullet covered bonds is that fire sales can be avoided in the former case and this is seen very advantageously by credit rating agencies. The conditional pass-through structure is not completely new to the covered bond community. Commerzbank's SME structured "covered" bond of February 2013 was the first collateralized bond which made use of this structure helping the issuer to achieve ratings in the AA area.

We expect the structure to be similar to CMZB's SME structure

As far as we understand NIBC goes a similar way like Commerzbank. This would mean that while going concern, the payments to the investor are equal to bullet payments of traditional covered bonds. In the event of insolvency of NIBC or a breach of the Asset Coverage Test, the guarantee of the SPV would be activated. Hence, the guarantor (i.e. the SPV) will be responsible to make all payments to the covered bondholders. The activation of the guarantee also leads to the removal of the Asset Coverage Test by the Amortization Test. As long as the latter is not breached, bonds maintain their original maturity. However, relevant principal amounts due on the bonds would be paid on a pass-through basis. Later maturing bonds would still be due on the scheduled maturity date. If the latter is breached, this would mean that a Guarantor event of default is given. Hence, principal (and interest) is paid monthly (on a floating and) on a pro rata basis. This also means that the outstanding bonds' maturities might be lengthened and the sale of the cover assets would directly be channeled to the coupon payments to investors while the bonds would amortize in line with the cover pool assets. In case of NIBC, according to The Cover, some further measures would be introduced to realize higher recoveries for the investors (e.g. semi-annual sale attempts if prices recovered).

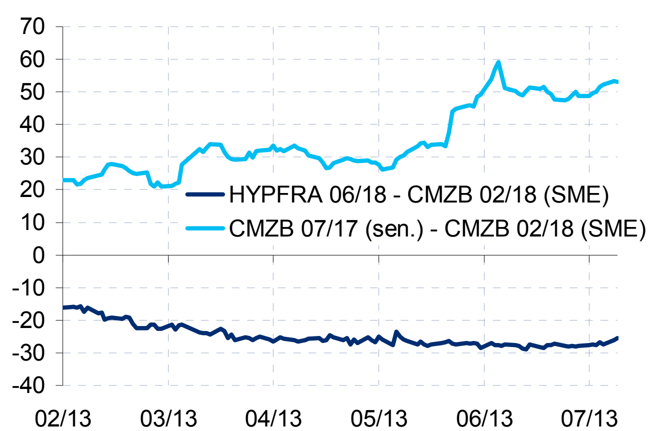
Higher ratings for covered bonds can be achieved

So, where is the advantage? For issuers, the main benefit is a higher rating that can be achieved for the covered bonds as recovery is assumed to be higher than in cases where a fire sale of assets would have to take place. The issuer stated that it expects the top grade of both rating agencies. This implies that the conditional pass-through would get an uplift of four notches compared to the traditional covered bond. Hence, this also means that funding levels will be lower for such issuance. Moreover, it should be expected that ALM mismatches become lower. In bullet covered bond programs such risks are usually compensated by higher overcollateralization which is costly for the issuer. Moreover, the need for liquidity buffers would be lower as well.

Investors might have to accept higher extension risk

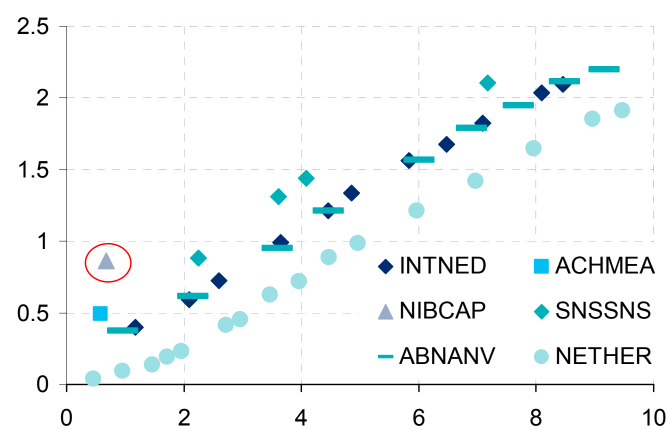
For investors, the story is more complex. On the one hand, extension risk is substantially higher as it can take time until the amortization of assets and liabilities is finished. That said, waiting longer and not forcing issuers to run through a fire sale also implies eventually higher recovery rates. The less experienced investors will however struggle even more to run through an investment approval process smoothly. As it is the case that some investors are not allowed to invest in soft bullet covered bonds (extending maturity by one year in general) it seems hard to argue for investing in conditional pass-through covered bonds. Moreover, as mentioned, the above described structure is the one that Commerzbank used for its SME structured covered bond. This still doesn't mean that other partial pass-through programs look exactly the same. And given the attractiveness of obtaining relatively robust AAA rated covered bonds we would not be surprised to see more issuers implementing such programs. This could go in hand with more diversified covered bond structures, also on a contractual basis where legal frameworks do not allow such structures (which would exacerbate the investment approval again…). Apart from the higher recovery rates mentioned above, we think there are two further benefits. On the on hand, the covered bond market is characterized by a constantly shrinking share of top rated covered bonds. The share of AAA rated covered bonds is only slightly above 50% with the first bonds being in junk territory. Structures like these would imply higher rating security and rating sensitive investors would probably have a bigger pool of investable bonds. On the other hand, we would imagine that such AAA covered bonds are not treated equally to traditional bullet covered bonds obtaining the top grade. Therefore, the partial pass-through covered bonds might yield higher than the traditional ones. If investors are willing to take the risk repayment extension, the new bonds might be an attractive highly rated alternative.

Figure 84. SME decoupling from senior and covered, ASW, bp



Source: Bloomberg, Citi Research

Figure 85. NIBC is yielding highest, yield, %



Source: Citi Research

Covered bond ratings in light of resolution regimes – an update

The link between senior rating and covered bond rating is questionable in light of the EU resolution regime

The discussion on the new resolution regime and its implications are mostly positive for covered bonds. Although there is still some blurredness when it comes to the treatment of excess overcollateralization and the treatment of (un)secured bondholders until the introduction of the regime in 2015 and during the implementation period lasting until 2018, the fact that secured liabilities – including covered bonds – are exempt as a bail-in tool is a positive factor. Moreover, the regime clarified that the probability of using senior bonds as bail-inable tools will increase. Mostly it is assumed that given the disadvantageous treatment of unsecured bonds within the resolution regime the pressure for the ratings of these bonds will increase. What then comes into mind is the rating for covered bonds that are ultimately anchored to a further rating for the bank (senior unsecured debt rating, issuer credit rating or issuer default rating) and the question if changes within the methodology will be necessary. We want to summarize the views of the rating agencies and draw some implications for that.

Fitch doesn't see urgent need for action…

One week ago, Fitch reported that in the near-term the agency does not see the necessity to change its covered bond rating methodology. This is reasoned by its conviction that the current regime is still at an early stage, further negotiations will take place and there's a high probability that the implementation will differ on a national level as some elements of discretion are expected.[2] Fitch thinks that in theory the rating differential between senior unsecured and covered bond rating should increase. This, however, does not affect Fitch's rating methodology. The reason for this is that Fitch links the covered bond rating to the Issuer Default Rating (IDR) which is not the same like the issuer's senior unsecured debt rating. "Contrary to the senior unsecured debt rating, which also incorporates expectation of recoveries given default, the IDR indicates an entity's vulnerability to default, and is therefore independent from the level of recovery given default achieved on a specific debt class", according to Fitch. However, Fitch also concedes that the anchor point might be changed if it becomes clearer which type of default a bank will run through. Therefore, Fitch also thinks that given the potential different configurations on a national level, resolution regimes might lead to less strict criteria on the one hand and potential changes in the future. The implication is that predictability might become more difficult. We think that therefore unsecured ratings can become much more under pressure in times of distress while the rating differential could open up. For the time being, however, no deep structural changes should be expected.

… whereas Moody's might have to undertake some changes

At the beginning of July, Moody's published an article implying that the resolution regime is credit negative for senior bondholders and positive for covered bondholders. However, the article didn't mention if the new regime would have effects on their rating methodology. We however think that it should have. Moody's anchors the covered bond ratings to the issuer's unsecured rating. This however should be the rating which will come under pressure under the new regime – as the agency mentions. Therefore, we assume that Moody's will need to come up with changes to the methodology. Discussions with the agency implied for us that the topic is currently under discussion as the agency sees this potential weakness to their methodology. At the current stage, the most decisive factors running into a covered bond rating is the senior unsecured rating, the value of the cover pool and the TPI (Timely payment indicator). The more probable timely payment is after an

[2] The fact that the French government decided not to bail in senior bonds under their national resolution regime last week until a European regime will be implemented shows that potential leeway might be used differently in certain countries. In other countries like Germany or Denmark, the treatment of senior bondholders is more severe.

issuer event of default, the higher the TPI (six steps ranging from "very high" to "very improbable") and the bigger the buffer between unsecured rating and covered bond rating. Negatively spoken, the TPI is like a ceiling derived from the senior rating in combination with the cover pool. Therefore, one proposal would be to include more steps within the TPI which would increase the ceiling put on the pre-determined covered bond rating. This would eventually imply that senior unsecured ratings lose weight in the rating giving process. Otherwise, the agency would probably have to come up with a new anchor rating and/or methodology. We think that in the long-term one of the mentioned possibilities will be a way, Moody's might choose to go. However, this might also take some time – probably until 2015 – until more clarity on the resolution regime is given.

S&P has a different view on the resolution regime and hence doesn't see need for action

S&P so far did not explicitly mention any impact on covered bond ratings and/or its methodology. However, implicitly, the agency stated that changes to the covered bond methodology are unnecessary. The reason for this is that S&P interprets the EU resolution proposal differently than the other agencies. According to S&P, "the agreement on bank resolution that the EU member states reached on June 27, 2013, has no immediate implications for [S&P's] counterparty credit ratings or senior unsecured issue ratings on banks in the region. Standard & Poor's […] considers that the agreement allows national governments substantial flexibility to decide how to resolve failing banks. In particular, although the agreement presents "bail-ins" as the rule rather than the exception, it appears that governments retain the legal ability to recapitalize banks from taxpayer funds without imposing losses on senior creditors. We also note that the bail-in tool isn't likely to come into force until 2018, despite calls from some members to proceed more quickly. Some EU countries already have bail-in powers under existing national legislation, however."[3] S&P links the covered bond rating to the issuer credit rating (ICR) which is S&P's forward looking opinion about an obligor's overall creditworthiness in order to pay its financial obligations. Hence, the potential effect of senior bonds being bailed in should have severe negative effects on the ICR and therefore lower covered bond ratings as well. Within S&P's methodology, apart from the ICR, the classification of a covered bond program regarding ALMM (Asset-Liability-Mismatch) risk and the categorization of the covered bond program are important inputs apart from the cash-flow and market value risk analysis. If S&P was to change its mind on the impact of the resolution regime on ICRs, we think that a change to the covered bond methodology would probably be necessary as well. A starting point could be amendments to the program categorization (more categories – so far only three – and/or higher rating uplifts).

Policy uncertainties make decisions hard – at current stage

In general, we think that changes to covered bond ratings will be undertaken in the longer term due to the EU resolution regime. This should imply a positive outcome for covered bond ratings. However, we understand the current deadlock in the decision making process of rating agencies. Firstly, the final outcome of the EU resolution regime is too blurred at current stages. Secondly, the treatment of unsecured bondholders in bank restructurings until 2015 will probably continue to be a case-by-case basis. Thirdly, the implementation process will take three years starting from 2015 where uncertainties continue to be given. For the time after 2015, however, we assume that rating agencies will have implemented some amendments to their current covered bond methodologies.

[3] "Under The New EU Resolution Accord, Governments Still Have Leeway To Bail Out Banks", S&P, 02.07.2013

Covered Bond Rating Overview

Figure 86. 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	--/Aa2 /*-/--	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/Ba1/--
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/AA	CAIXAC	BBB/Ba2/--
NDASS	--/Aaa/--	DEXGRP	A/--/--	CAZAR	A/Baa1 /*-/--
POHBK	AAA/Aaa/--	HSHN	--/Aa2/--	KUTXAB	AA-/A3/--
SAMBNK	--/Aaa/--	PBBGR	AA+/Aa1/AA+e	NOVAGA	BBB+/Ba2/BBB+ /*-
France	S&P/Moody's/Fitch	HYPFRA	--/Aa3/--	POPSM	--/Baa2/--
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	NDB	--/Aaa/AAA	LANSBK	AAA/Aaa/--
BNPSCF	AAA/--/AA+	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/AA+	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/AA+	Italy	S&P/Moody's/Fitch	UBS	--/Aaa/AAA
CMARK	AAA/Aaa/--	BANCAR	--/Baa1/BBB+	CS	--/Aaa/AAA
CMCICB	AAA/Aaa/AAA	BPIM	--/Baa2/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 87. 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: Bloomberg, Citi Research

Covered Bond Rating Actions July 2013

Figure 88. Rating actions in the covered bond universe

Issuer	Program	Country	Agency	From	To	Reason
Banca Popolare dell'Emilia Romagna	Mortgage	Italy	Moody's	A2	Baa2	Downgrade has been prompted of the issuer's credit strength
Unicredit Bank Austria	Mortgage	Austria	Moody's	Aaa	Aa1	Downgrade of the issuer's senior unsecured rating to Baa1
Unicredit Bank Austria	Public Sector	Austria	Moody's	Aaa	Aaa*-	
Banco Sabadell	Mortgage	Spain	Moody's	A3	A3*-	Issuer's senior unsecured rating of Ba1 has been put on review for downgrade
Banco Sabadell	Public Sector	Spain	Moody's	A3	A3*-	
Banco Popular	Mortgage	Spain	Moody's	A3	Baa2	Downgrade of the issuer's senior unsecured rating to Ba3 from Ba1
Banco Popular	Public Sector	Spain	Moody's	A3	Baa2	
Hypothekenbank Frankfurt	Public Sector	Germany	Moody's	Aa2	Aa3	Lack of sufficient OC in the transaction
Royal Bank of Scotland	Mortgage	UK	Moody's	Aaa	Aaa*-	Issuer's senior unsecured rating of A3 has been put on review for downgrade
Banco Popolare	Mortgage	Italy	Moody's	A2	Baa2	Issuer has been downgraded to Ba3 from Baa3
Caja Rurales Unidas	Mortgage	Spain	Moody's	Baa2	Ba2	Issuer has been downgraded (rating undisclosed)
Liberbank	Mortgage	Spain	Moody's	Baa2	Ba1	Downgrade of the issuer's senior unsecured rating to B1 from Ba3
Unicaja Banco	Mortgage	Spain	Moody's	A3	Baa2	Downgrade of the issuer's senior unsecured rating to Ba3*- from Ba1*-
HSH Nordbank	Mortgage	Germany	Moody's	Aa1	Aa2*-	Downgrade of the issuer's senior unsecured rating to Baa3 from Baa2
HSH Nordbank	Public Sector	Germany	Moody's	Aa1*-	Aa2	
HSH Nordbank	Ship	Germany	Moody's	Baa1*-	Baa2	
Bankinter	Mortgage	Spain	S&P	A (neg)	A	Outlook on Bankinter has been revised from negative to neutral (BB)
Unicredit SpA	Mortgage	Italy	S&P	AA+ (neg)	AA (neg)	Downgrade follows rating actions on the sovereign and the issuer
Mediobanca	Mortgage	Spain	S&P	BBB+	BBB	Downgrade of the issuer rating to BBB from BBB+
Banco Santander Totta	Mortgage	Portugal	S&P	BBB	BBB*-	Lack of sufficient OC in the transaction
Banca Popolare di Milano	Mortgage	Italy	Fitch	A-*-	A-	Bank's Issuer Default Rating has been put on watch negative
Banco Santander Totta	Mortgage	Portugal	Fitch	BBB+	BBB (neg)	Lack of sufficient OC in the transaction
CIF Euromortgage	Mixed	France	Fitch	AAA	AA+	Downgrade of France's Issuer Default Rating to AA+ from AAA
BNP SCF	Public Sector	France	Fitch	AAA	AA+	Downgrade of France's Issuer Default Rating to AA+ from AAA
CFIL SCF	Public Sector	France	Fitch	AAA	AA+	Downgrade of France's Issuer Default Rating to AA+ from AAA
NIBC	Mortgage	France	Fitch	AA- (neg)	A+	Downgrade of the Issuer Default Rating to BBB- from BBB
Postbank	Public Sector	Germany	Fitch	AAA	AA	The agency assumes the program to be dormant and therefore assumes minimum legal OC

Source: Bloomberg. Citi Research

Redemptions July 2013

Figure 89. Redemption payments: July 2013

Issuer Name	Ticker	Coupon	Maturity	Announce	Amount (EURmn)	Country
Landesbank Baden-Wuerttemberg	LBBW	4	26.08.2013	19.02.2008	1500	DE
Hypothekenbank Frankfurt AG	HYPFRA	4.5	28.08.2013	21.08.2008	1000	DE

Source: Citi Research

Covered Bond Performance

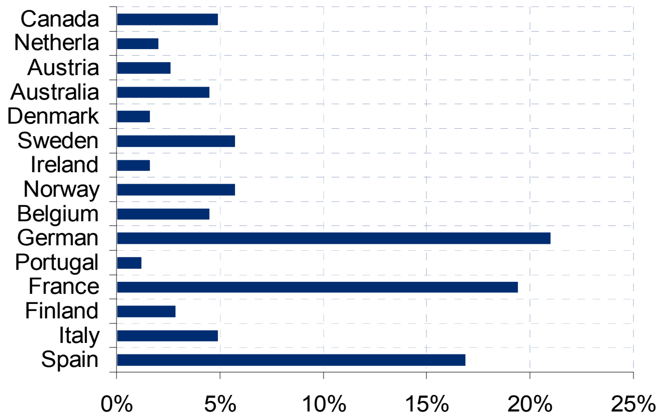
Figure 90. iBoxx Covered Bond Indices: Total Return in June 2013, %

Segment	Absolute	Δ 1m	Δ ytd	Δ 1y
Australian Covered Bonds	97.47	-0.1%	--	--
Austrian Covered Bonds	135.08	0.4%	0.3%	2.4%
Belgian Covered Bonds	97.37	0.1%	--	--
Canadadian Covered Bonds	125.25	0.4%	0.5%	2.7%
Danish Covered Bonds	98.65	-0.1%	--	--
Dutch Covered Bonds	143.43	0.4%	0.2%	2.6%
EUR Covered	193.45	0.3%	1.8%	6.8%
Finnish Covered Bonds	99.05	-0.1%	--	--
French Covered Bonds	209.26	0.5%	0.9%	4.1%
Irish Covered Bonds	142.44	0.4%	2.3%	11.3%
Italian Covered Bonds	126.22	0.6%	2.6%	11.1%
Luxembourg Covered Bonds	99.36	0.1%	--	--
Mortgage Pfandbriefe	191.31	0.3%	0.0%	1.4%
New Zealand Covered Bonds	99.12	-0.1%	--	--
Norwegian Covered Bonds	134.90	0.4%	0.2%	2.0%
Obligations à l'Habitat	129.46	0.2%	0.5%	1.6%
Obligations Foncières	142.24	0.5%	1.1%	4.5%
Pfandbriefe	185.65	0.3%	0.1%	1.4%
Portuguese Covered Bonds	140.27	-0.7%	4.0%	16.4%
Public Sector Pfandbriefe	184.00	0.3%	0.3%	1.4%
Spanish Covered Bonds	189.67	0.0%	5.3%	18.1%
Spanish Multi Covered Bonds	128.80	-0.8%	6.7%	26.2%
Spanish Single Covered Bonds	126.36	0.3%	4.7%	14.9%
Swedish Covered Bonds	131.76	0.3%	0.1%	1.2%
Swiss Covered Bonds	98.92	-0.1%	--	--
UK Covered Bonds	143.15	0.3%	0.6%	3.6%

Source: Markit, Citi Research

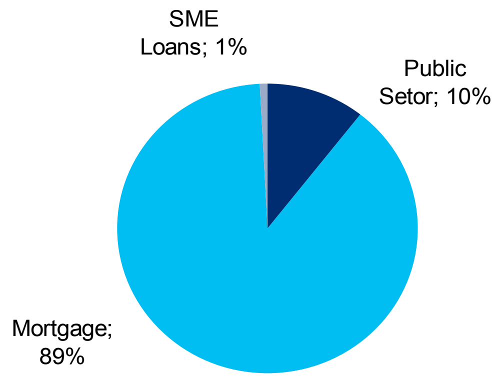
Primary Market 2013: EUR benchmark covered bonds

Figure 91. Geographical distribution, %



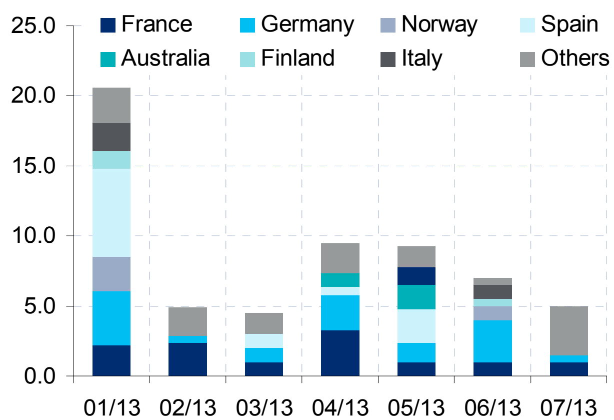
Source: Citi Research

Figure 92. Distribution by Collateral, %



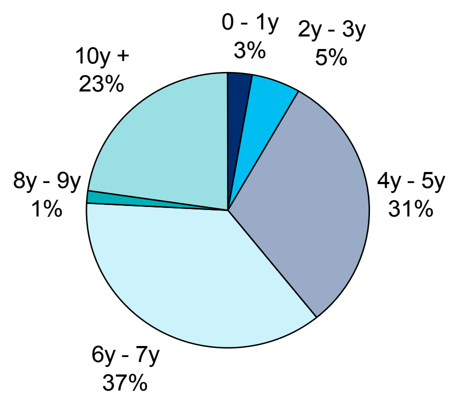
Source: Citi Research

Figure 93. Issuance by month



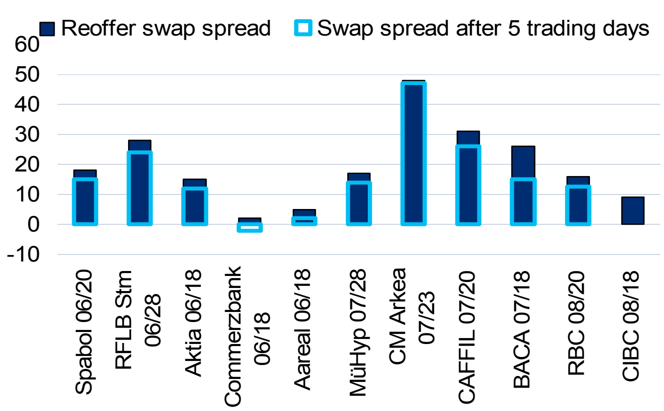
Source: Citi Research

Figure 94. Issuance by maturity, %



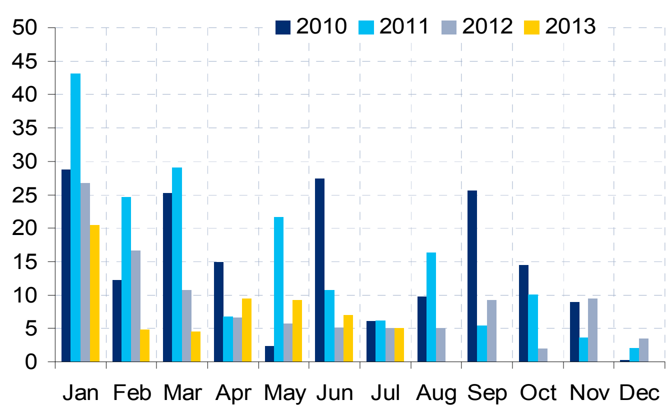
Source: Citi Research

Figure 95. Selection of primary deals' performance after 5 trading days



Source: Citi Research

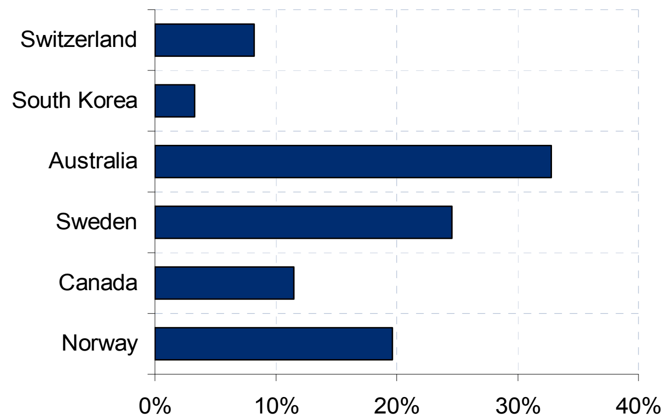
Figure 96. Historical new issuance, EURbn



Source: Citi Research

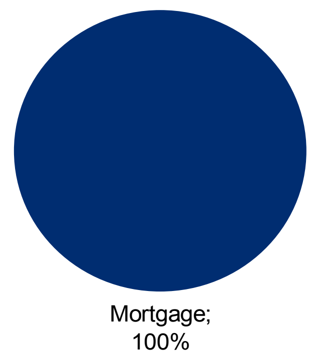
Primary market 2013: USD Benchmark covered bonds

Figure 97. Geographical distribution, %



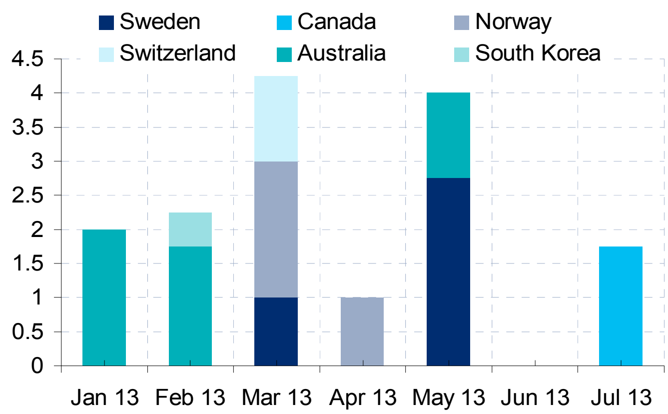
Source: Citi Research

Figure 98. Distribution by Collateral, %



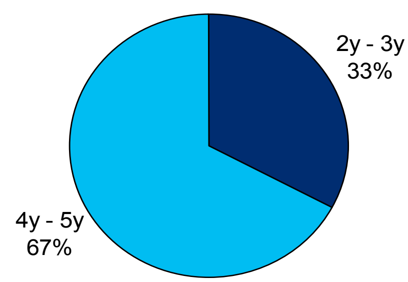
Source: Citi Research

Figure 99. Issuance by month



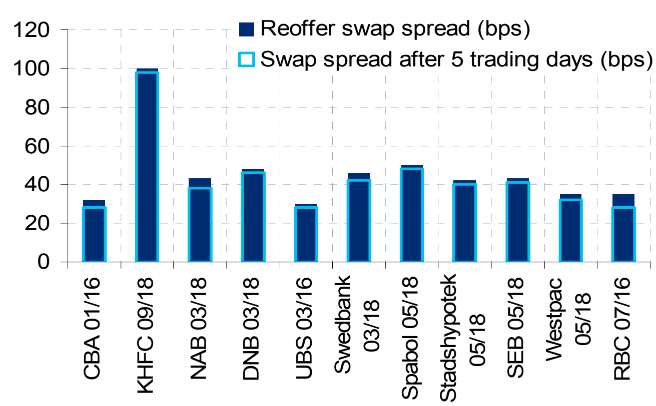
Source: Citi Research

Figure 100. Issuance by maturity, %



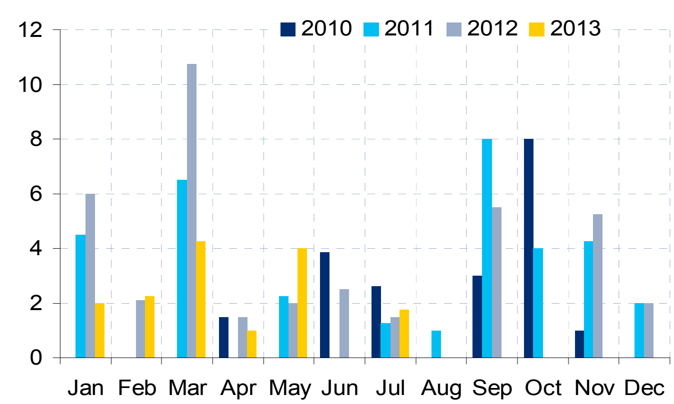
Source: Citi Research

Figure 101. Selection of primary deals' performance after 5 trading days



Source: Citi Research

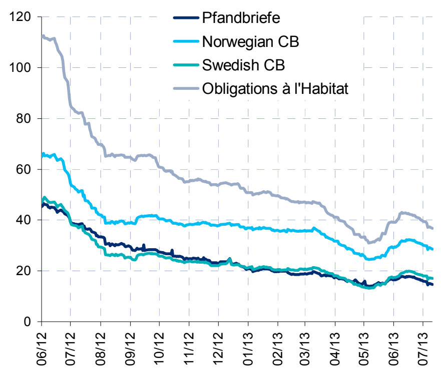
Figure 102. Historical new issuance, USDbn



Source: Citi Research

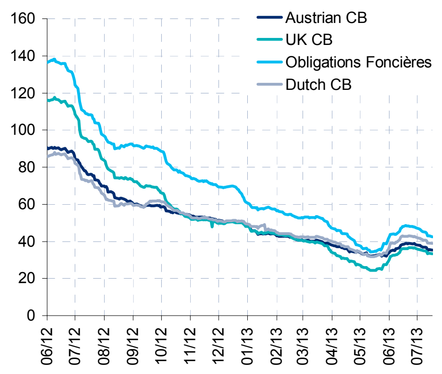
Secondary Market 2013: EUR Benchmark covered bonds

Figure 103. Secondary Market Performance, ASW-Spreads, bp



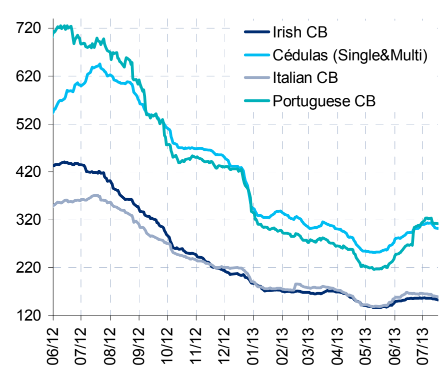
Source: Citi Research, Markit

Figure 104. Secondary Market Performance, ASW-Spreads, bp



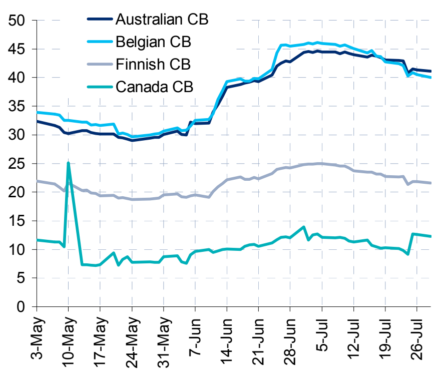
Source: Citi Research, Markit

Figure 105. Secondary Market Performance, ASW-Spreads, bp



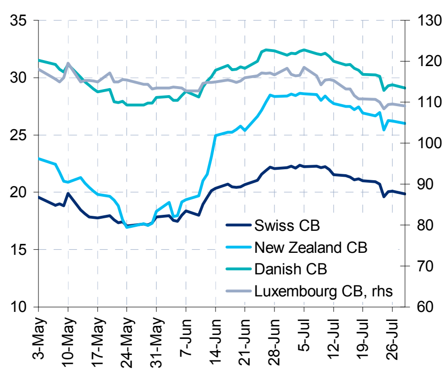
Source: Citi Research, Markit

Figure 106. Secondary Market Performance, ASW-Spreads, bp



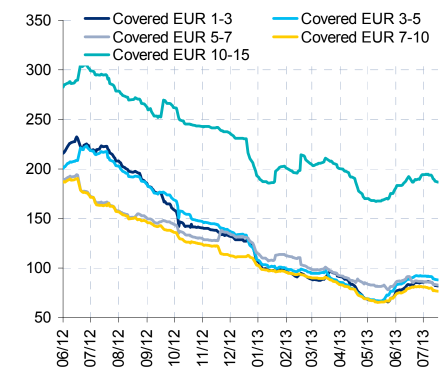
Source: Citi Research, Markit

Figure 107. Secondary Market Performance, ASW-Spreads, bp



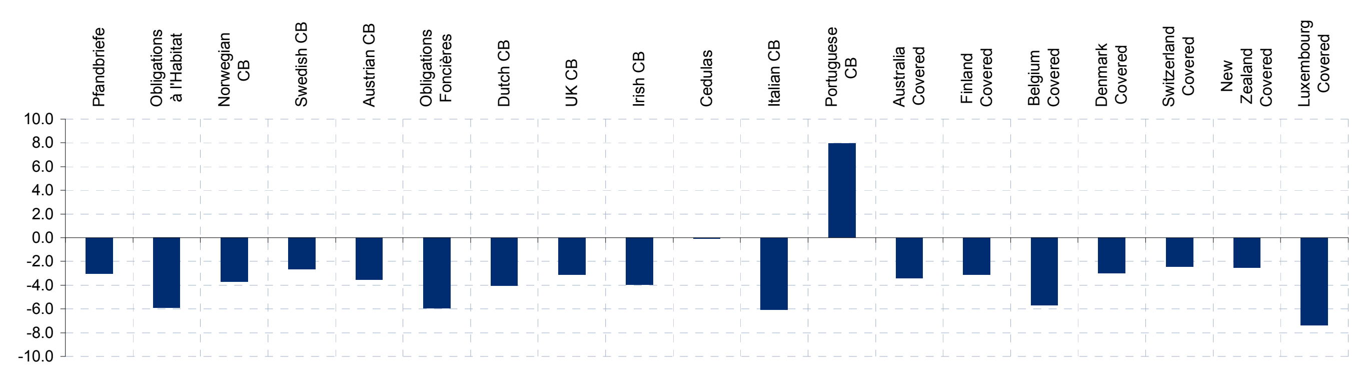
Source: Citi Research, Markit

Figure 108. Secondary Market Performance, ASW-Spreads, bp



Source: Citi Research, Markit

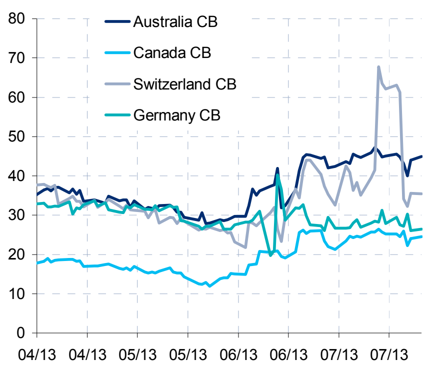
Figure 109. Spread performance over the last month



Source: Markit, Citi Research

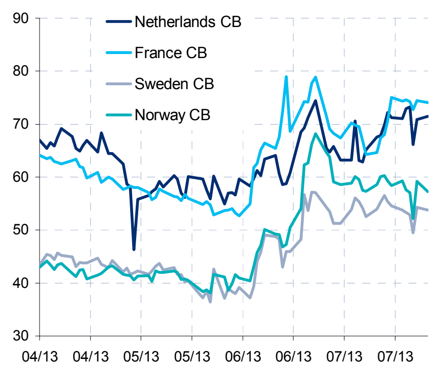
Secondary Market 2013: USD Benchmark covered bonds

Figure 110. Secondary Market Performance, ASW-Spreads, bp



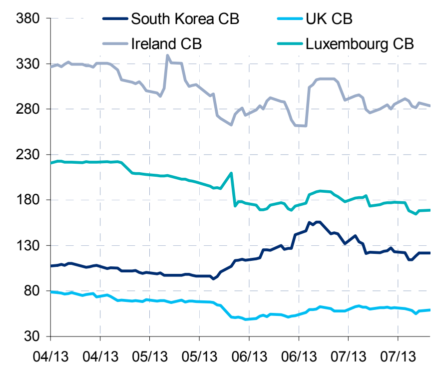
Source: Citi Research, Markit

Figure 111. Secondary Market Performance, ASW-Spreads, bp



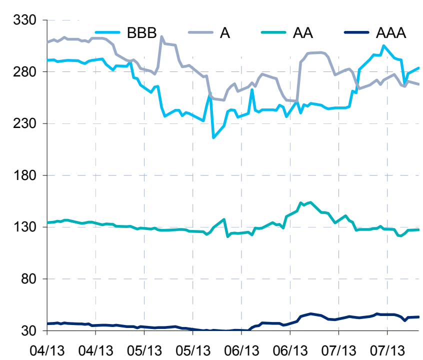
Source: Citi Research, Markit

Figure 112. Secondary Market Performance, ASW-Spreads, bp



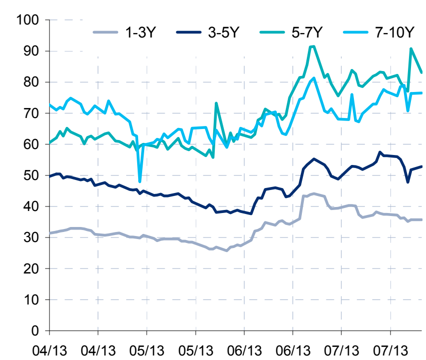
Source: Citi Research, Markit

Figure 113. Secondary Market Performance, ASW-Spreads, bp



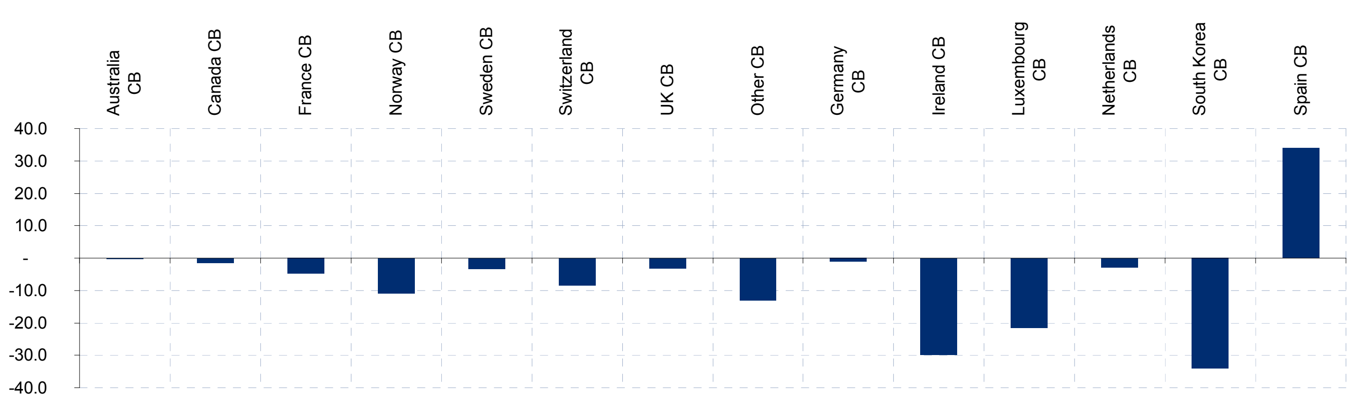
Source: Citi Research

Figure 114. Secondary Market Performance, ASW-Spreads, bp



Source: Citi Research

Figure 115. Spread performance over the last month



Source: Markit, Citi Research

Notes

Appendix A-1

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