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Developed Markets
Global

Covered Bond Strategy

Redemptions 2015: €139bn – Sufficient to Let the Market Shrink

- **Covered bond redemptions 2015:** Covered bond investors will again face a relatively large amount of maturing bonds in 2015, albeit a lower number than this year. Again, redemptions are skewed mainly to the most mature covered bond segments.
- **Spain leading the pack:** Similar to 2014, the cédula market will record the highest redemptions and accounts for 25% of the total volume of maturing bonds. The youngest segments from Australia and Canada will continue to grow and record no redemptions in the euro benchmark market in 2015.
- **Supportive for spreads, increasingly challenging for investors:** 2015 will most probably be another year of a shrinking euro benchmark covered bond market. Although this might sound supportive for spreads, re-investing principal repayments into covered bonds becomes increasingly challenging at these rich valuations.
- **Redemptions in other currencies:** The GBP and AUD covered bond markets face only low amounts of maturing bonds in 2015. In the USD covered bond market redemptions of syndicated deals will total $27.6bn next year.

Michael Spies
+49-69-1366-8403
michael.spies@citi.com

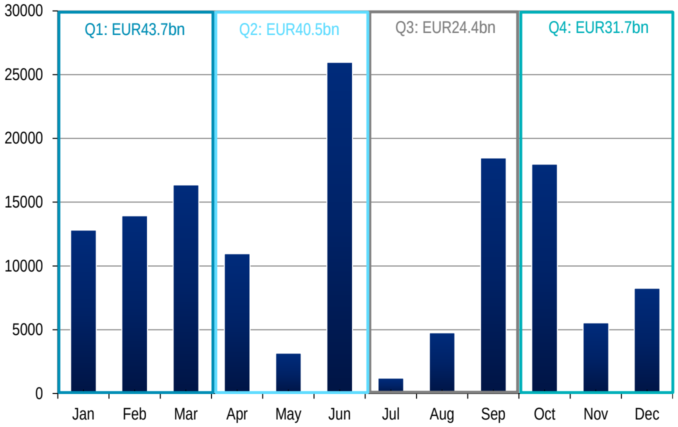
See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Covered Bond Strategy – Redemptions 2015

€139bn – sufficient to let the market shrink

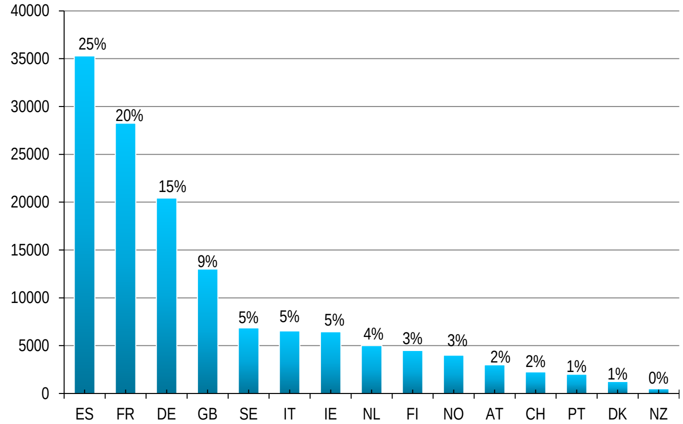
2015 redemptions lower than this year: After a record-high volume of redemptions in 2014, covered bond investors will again face a relatively large amount of maturing bonds in 2015, albeit a lower number than this year. Yet, for spreads this should be an additional supportive factor as gross supply should not be expected to outweigh redemptions next year.

Figure 1. 2015 Euro benchmark covered bond redemptions by month, EURmn



Source: Bloomberg, Citi Research

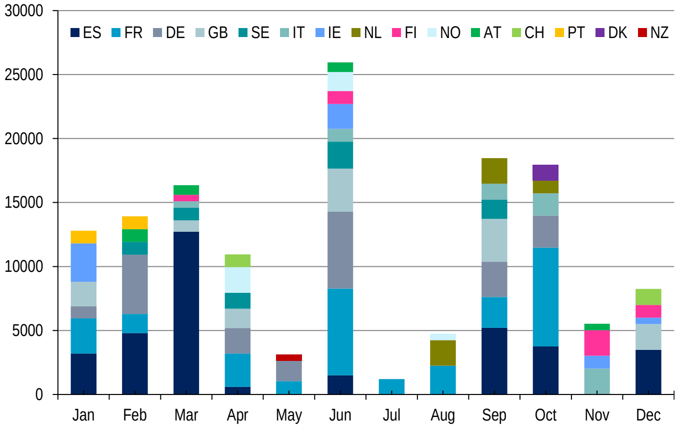
Figure 2. 2015 Euro benchmark covered bond redemptions by segment, EURmn



Source: Bloomberg, Citi Research

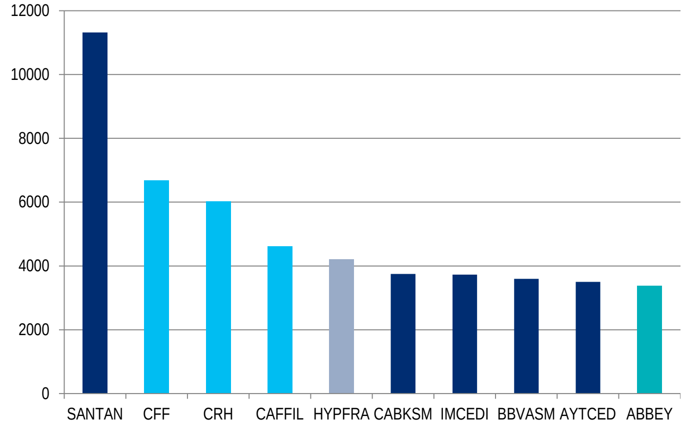
Highest redemptions in biggest market segments: 2015 euro benchmark redemptions will total €139bn. This is again skewed to the first quarter and generally to the first half of the year with around 60% (€83bn), although the skew is less pronounced than in the last few years (Figure 1). On a country perspective, the highest redemptions will again be recorded for the cédula segment, which will account for 25% of total benchmark redemptions (€35bn). As in 2014, this is followed by France (20%, €28bn) and Germany (15%, €20bn). The younger markets which have been growing strongly during the last two years – Australia and Canada – won't face any redemptions in 2015 (Figure 2).

Figure 3. 2015 Euro benchmark covered bond redemptions by month and segment, EURmn



Source: Bloomberg, Citi Research

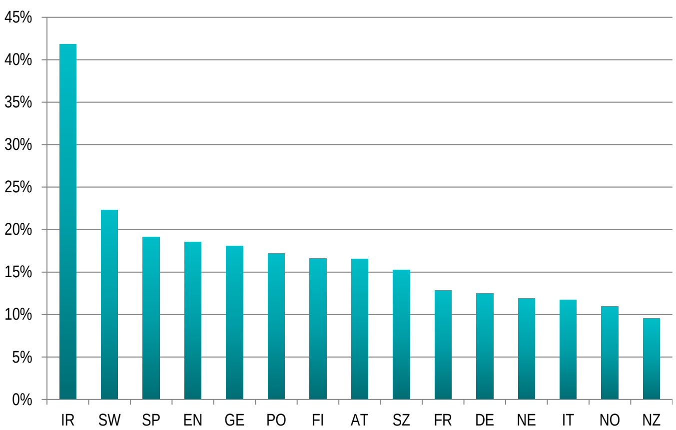
Figure 4. Top 10 euro benchmark covered bond redemptions by issuer, EURmn



Source: Bloomberg, Citi Research

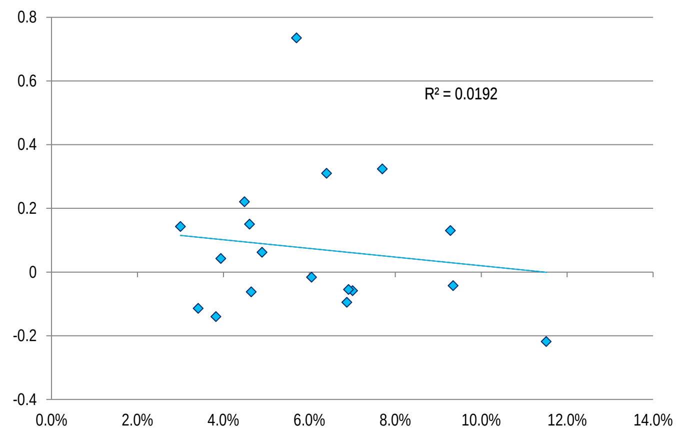
Strong redemptions in Spain during Q1: Drilling deeper into the numbers, one can observe a strong aggregation of redemptions in the first quarter within the Spanish segment: 59% of FY redemptions will mature during the first three months (Figure 3). Such strong patterns cannot be observed in other segments except in the very small markets. Not surprisingly, on a single name basis five of the top ten issuers facing highest redemptions are Spanish banks. Banco Santander stands out with total redemptions of €11.3bn, followed by the three biggest French covered bond entities (Figure 4). With Abbey also facing a volume of €3.4bn of maturing bonds, Santander Group total euro benchmark redemptions account for nearly €15bn. Interestingly, four of the top ten entities scaled back issuance activity as they are in a wind-down scenario (HYPFRA), are not used as issuance vehicles any more (IMCEDI, AYTCED) or have been absent from the benchmark primary market for more than one year due to regulatory reasons and strong own market access of the entity's shareholders (CRH).

Figure 5. Relative share of 2015 redemptions versus euro benchmark covered bonds outstanding, %



Source: Citi Research

Figure 6. YTD Total Return by euro covered bond segment versus the share of ytd net supply to outstanding covered bonds, %



Source: Citi Research

Figure 7. Total Return Analysis by selected covered bond segments, %

Segment	Total Return ytd
Spanish Multi-cédulas	19%
Portuguese CB	10%
Italian CB	10%
Spanish Single-cédulas	9%
Australian CB	8%
EUR Covered	7%
French CB	7%
Belgian CB	7%
Irish CB	6%
Canadian CB	6%
Pfandbriefe	4%
Swedish CB	4%

Source: Markit, Citi Research

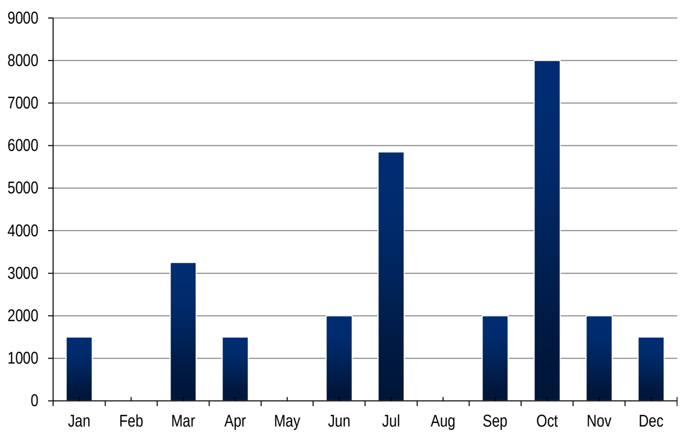
Substantial market shrinkage expected in Ireland: During recent years, redemption volumes have been skewed mainly to the most mature markets, i.e. Germany, France, Spain, the UK but also Ireland. High redemptions do not necessarily mean strong shrinkage of the segment, *ceteris paribus*, as new supply can obviously outweigh this development to a certain extent. However, in 2015, strong shrinkage will probably be the case for the Irish ACS segment as we don't expect a strong return of the remaining active two Irish covered bond issuers to the primary market to offset total redemptions of more than €6bn. Given the size of the segment, this could eventually translate into shrinkage of around 40% (Euro benchmark covered bonds only). In the case of Spain, the UK and Germany, 2015 benchmark redemptions are between 15% and 20% of total euro benchmark outstanding covered bonds (Figure 5).

Total return versus market shrinkage: Although net negative supply is often cited as a main supportive factor for secondary market development, this is not entirely supported by the data. The coherence between net supply and total return in 2014 is relatively low (R^2 of 0.14). Taking into account the outstanding volume of a segment to net supply in 2014 and comparing these numbers with year-to-date total return results (Figure 7), the correlation diminishes entirely (Figure 6). The most prominent examples for strong performance despite positive net supply so far this year have been Italy (€7.25bn) and Australia (€5.5bn) while French and German markets performed relatively poorly despite net negative supply (-€12.9bn and

-€15.9bn). Obviously, the Spanish segment recorded negative net supply and performed best among peers. However, we attribute this more to rating upgrades, Spain's stronger-than-expected economic recovery, relatively strong bank capitalization, the supportive backstop of the ECB and the better-than-expected regulatory treatment of lower-rated covered bonds. In general, clearly, net negative supply should lead to higher demand for the outstanding covered bonds. However, at current very rich valuations, we are skeptical if principal repayments are being re-invested in covered bonds rather than finding their way into other markets.

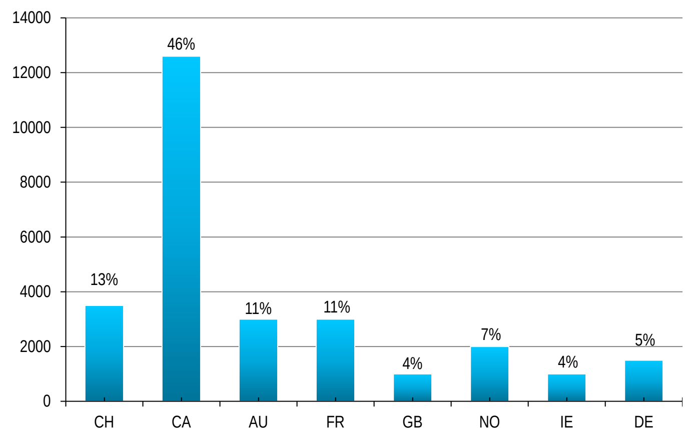
High redemptions of Canadian covered bonds in USD: In other covered bond markets, redemptions are much smaller than in the euro benchmark segment. In the USD covered bond market, redemptions of syndicated deals will total $27.6bn. Nearly half of that will be recorded for Canadian issuers (Figure 9). All these bonds that will mature were issued before the introduction of the Canadian covered bond law. This eventually means that those covered bond programs that are in wind-down mode will continue to gradually ablate, freeing up collateral for new supply issued under the legal framework. Apart from that, Swiss, Australian and French banks record highest redemptions in the USD covered bond segment. Redemptions are skewed mainly to the fourth quarter of 2015 (Figure 8)

Figure 8. 2015 USD benchmark covered bond redemptions by month, $mn



Source: Bloomberg, Citi Research; only syndicated deals

Figure 9. 2015 USD benchmark covered bond redemptions by segment, $mn



Source: Bloomberg, Citi Research; only syndicated deals

Low volumes in GBP and AUD: In the sterling covered bond market, where the 'benchmark' is defined differently (i.e. all sterling-denominated covered bonds with a minimum size of £250mn, including FRNs), total 2015 redemptions sum to £4.5bn. This is skewed mainly to the first three months of the year (£4.1bn, 91%). The most active issuers are UK banks. Hence, it should not surprise that 89% of the outstanding bonds maturing next year have been issued by domestic financial institutions. The remaining 11% can be traced back to Australian NAB. In the AUD covered bond market, 2015 redemptions will total AUD1.85bn. This low number shouldn't surprise as primary market activity started strongly only in 2011 with domestic banks starting to be active in their domestic market in 2012. Hence, redemptions will increase in the years ahead.

Conclusion: 2015 redemptions will be lower than the record-high volume seen in 2014. We will soon present our 2015 supply forecast. Yet, we can already say at this point that we expect the covered bond market to shrink for another year, albeit on lower volumes than recorded in 2014. For covered bond investors, this means that investments become increasingly challenging as lower supply meets very rich valuations, which will probably be driven even more by the ECB in 2015.

Appendix A-1

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