

# Euro SSA and Covered Bond Monthly

## The Iberian markets and the spread outlook

- **Spanish SSA and covered bonds:** Spanish agency debt can be seen as an interesting alternative to Spanish government debt given the various guarantees that exist. Strong performance over 2013 has driven many spreads to historically tight levels. Spanish covered bonds have also been well sought after this year. We detail spread performance, market structure, the investor base and analyse relative value opportunities such as spreads between covereds and unsecured debt.
- **Portuguese SSA and covered bonds:** The Portuguese SSA and covered bonds markets are smaller than other geographical segments. Portuguese covered bonds continue to offer relatively high yields compared with other sectors while having a sound covered bond law and a quality of cover pools above average. For both SSA and covered bonds, we believe performance will continue to be closely linked to that of the underlying sovereign.
- **Euro SSA strategy:** Although a pick-up in supply has already begun and is likely to weigh on the market in the near term, we do not believe September issuance will lead to significant underperformance.
- **The prospect of ESM supply:** The ESM has provisionally indicated a supply pipeline of €9bn for H2 2013. The ESM is now the permanent euro area stability mechanism for new programmes and has commitments to Spain and Cyprus. We believe its enhanced credit features is likely to make it a core market issuer within the SSA universe.
- **Covereds and Carney:** UK covered bonds are likely to play a more prominent role in UK bank treasuries following Carney's speech. The simultaneous goal to reduce excess liquidity trapped in UK gilts should support sterling covereds in particular.
- **Covered bonds - The end of the summer lull:** The last two weeks of August saw gross covered bond issuance of €6.45bn. This marks the second month in 2013 where the benchmark covered bond market actually increased. However, for September, we are again less optimistic.
- **SSA and covered bond supply:** Euro denominated agency and supranational issuance totaled ~€10bn in August and stands at nearly €115bn YTD. Covered issuance in August was €6.7bn, and stands at €67.4bn YTD.

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

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# The Spanish and Portuguese markets

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Following our recent publications on the German market ([Overview and opportunities: German agency and covered bonds](#)) and the French market ([French agencies and covered bonds in focus](#)), we continue with our core market primers and detail the Spanish and Portuguese sectors. We have generally seen strong performance in these markets and many spreads to their reference government bonds and to swaps are at historically tight levels.

## (1) Spanish agencies and covered bonds

The Spanish agency market represents around €97bn in bond debt outstanding. We detail the market structure and assess relative value in the key issuers against the underlying sovereign and other core agency markets. In general, we have seen very good performance of Spanish agencies, with many spreads to underlying Bonos at historic tightness and now in single digits. For the Spanish covered bond market, we present primary and secondary market developments, have a closer look at switch opportunities – especially in the multi-cédula market where still more than €75bn of bonds are outstanding making a 33% share of the whole Spanish benchmark covered bond market. Going forward, we believe yields and spreads should remain low (especially given the lack of supply in the covered bond market) versus government bonds.

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### Spanish agency sector: ~ €99bn debt outstanding

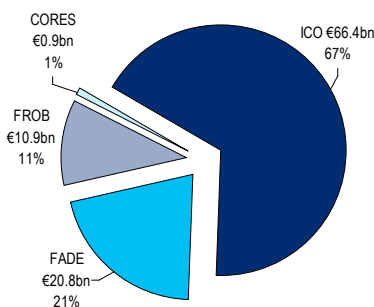
Compared with the German and French agency markets, where there are many issuers operating under a variety of structures and mandates, the Spanish agency market is smaller. Although there are four agencies which have issued bonds over recent years, the market is dominated by the leading development agency, ICO. Following that, the other in terms of bond debt outstanding, total assets and typical issuance patterns, FADE and FROB make up the bulk of the rest of the market. These are the issuers we focus on, detailing fundamentals and secondary market behaviour. An outline of key characteristics of Spanish agencies can be found in the peer comparison table in Figure 1.

Figure 1. The Spanish Agency Market

| Ticker | Issuer  | Agency Type and Mission   | Established | Ownership Structure   | Moody's Rating | S&P Rating | Total Assets 2012 (€bn) | Bond Issuance 2012 (€bn) | Bond Debt Outstanding (€bn) |
|--------|---|---|-------------|---|----------------|------------|-------------------------|--------------------------|-----------------------------|
| ICO    | Instituto de Credito Oficial                                      | State finance agency and state owned bank. Functions include promoting economic activities contributing to growth. "Particularly, those of a social, cultural, environmental or innovative significance are awarded special attention". | 1971        | State owned with its own legal status as a credit institution with Articles of Incorporation approved by Royal Decree 706/1999. Explicit, irrevocable, unconditional and direct government guarantee. Self governing, attached to the Ministry of Economic Affairs and Competitiveness. | Baa3           | BBB-       | 115.2                   | 17.4                     | 66.4                        |
| FADE   | Electricity Deficit Amortization Fund                             | Fund established to regulate the process of amortising the tariff deficit within the Spanish electricity sector   | 2010        | Explicit government guarantee. FADE was created within the Royal Decree 437/2010 and is guaranteed by Spain. Its main governing body is the Interministerial Commission; its day-to-day operations are monitored by TdA, a private fund manager.  | Baa3           | BBB-       | 15.8                    | 5.7                      | 20.8                        |
| FROB   | Fondo de Reestructuración Ordenada Bancaria                       | Fund established to manage the restructuring and resolution of credit institutions  | 2009        | Public law institution acting under legal regime within Law 9/2012 of November 2012. 100% owned by the government with explicit, unconditional and irrevocable government guarantee.  | Baa3           | BBB-       | 9.5 (2011)              | 0.0                      | 10.9                        |
| CORES  | Corporación de Reservas Estratégicas de Productos Petrolíferos SA | Corporation that is responsible for managing Spain's strategic oil and gas reserves   | 2004        | Corporation governed by public law (A23 of Royal Decree 1716/2004). Chairman is appointed by the Ministry of Industry. Although there is no explicit guarantee, CORES strategic importance means there is a strong link between it and the government.                                  | Ba1            | BBB-       | 2.1                     | 0.0                      | 0.9                         |

Source: Investor Presentations, S&P, Moody's, Bloomberg, Dealogic DCM Analytics, Citi Research

\* Note Moody's and S&P's rating for FADE is at the individual bond level, not the issuer level.

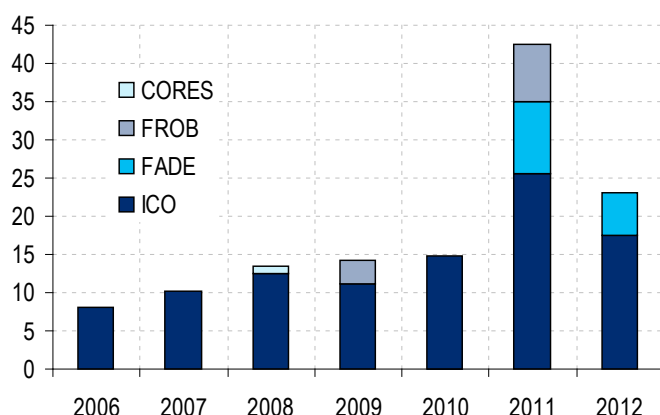
**Figure 2. Spanish Agency Market Bond Debt Outstanding (€bn)**

Source: Citi Research, Bloomberg

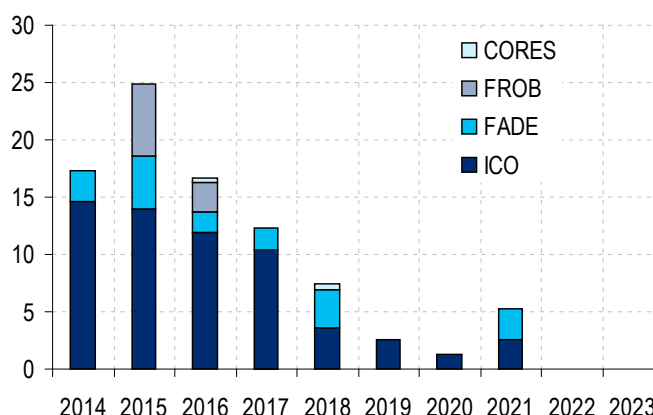
Total debt outstanding is around €99bn, making the Spanish market smaller than other European agency sectors such as the German agency market (~€700bn) and the French agency market (~€250bn). The market structure is clearly dominated by ICO which accounts for about two thirds of all Spanish agency bond debt outstanding. Following ICO, FADE (21%) and FROB (11%) make up the bulk of the rest of the market. This can be seen in Figure 2. Having just three main agencies (whose bonds benefit from an explicit) means the market is less fragmented than some other SSA markets, albeit their individual mandates are rather specialized.

Total bond supply was around €23bn last year: €17.4bn of which (75%) was issued by ICO (Figure 3). For 2013, ICO recently revised down its funding programme from €14bn-€15bn to €11bn-€12bn and has so far issued €9.2bn. In recent years FADE has issued €9.3bn in 2011 and €5.7bn in 2012. The FROB has not issued in 2012/2013 as various responsibilities for recapitalizing Spanish banks have been assumed by the ESM ([Euro SSA Strategy - ESM Bond Supply Is Nearly Here](#)).

The debt distribution in terms of maturity profile is shown in Figure 4. Total redemptions next year are around €17n and then peak at €25bn in 2015. The weighted average maturity of the key issuers is around 3yr-4yrs.

**Figure 3. Gross Issuance of Spanish Agencies (€bn)**

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

**Figure 4. Debt Maturity Profile for Spanish Agencies (€bn)**

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

### ICO – issuer characteristics

**ICO is the state owned bank of Spain and is also the state finance agency**

ICO was founded in 1971 as the entity to co-ordinate and control State-owned banks. Since the 1991 State banking reforms, ICO took on its current role as the State-owned bank providing loans (both directly to companies and second-floor facilities whereby funds are “on-leant” to banks and saving banks) and the role of State finance agency. It is supervised as a credit institution by the Central Bank of Spain. Its purpose is to “*maintain and promote economic activities conducive to the growth and improved distribution of the national wealth*” (“ICO At A Glance” 26<sup>th</sup> July 2013). A large part of ICO’s economic activities is promoting SME finance.

**ICO’s ratings are normalised to Spain**

With total assets around €107bn (as at July 2013), ICO is smaller than KfW, but has grown to be the sixth largest bank in Spain illustrating its growing strategic importance. Issuance in 2013 is set to be €11bn-€12bn (down from €19bn in 2012 and €27bn in 2011) with the majority of funding carried out on the debt capital markets (benchmark bonds and private placements). ICO benefits from an explicit, direct, irrevocable and unconditional government guarantee. Its ratings are therefore normalized by Moody’s and S&P to that of Spain’s Baa3/BBB- rating.

### Vehicle established to amortise the deficit within Spain's electricity sector

### FADE – issuer characteristics

FADE (Fondo de Titulización del Deficit Eléctrico) is a vehicle established to securitise the tariff deficit accumulated by Spain's electricity companies. The deficit exists because of the difference in price electricity companies charged, as set by the regulator, and the price that fully covered the cost of production between 2001 and 2010. FADE effectively buys these claims by the issuance of bonds on the capital markets. Issuance last year was €5.7bn. Its debt programme is backed and explicitly guaranteed by Spain up to a limit of €22bn. Where Moody's assigns ratings to bonds, it does so on the basis that the rating depends on the rating of the Spanish government through the guarantee (Royal Decree 6/2010). This guarantee is reviewed annual within the state budget laws.

### Fund established to oversee Spanish bank restructuring founded in 2009

### FROB – issuer characteristics

The FROB (Fondo de Reestructuración Ordenada Bancaria) is the Fund for Orderly Bank Structuring in Spain, established in 2009 (Royal Decree 9/2009) as a public law entity. By law, FROB's goal is to manage the restructuring and resolution processes of credit institutions, aimed at ensuring the stability of the financial system, depositor protection and an efficient use of public resources (FROB Investor Presentation, April 2013). It is supervised by Central Bank of Spain.

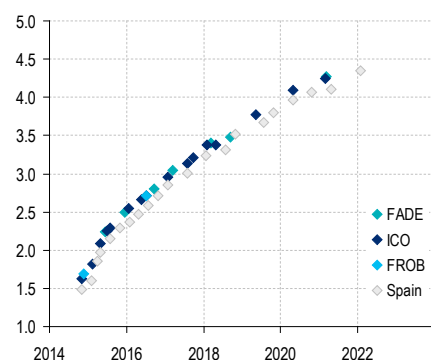
FROB is 100% owned by Spain and benefits from an explicit government guarantee (within a debt programme of €13bn) and bonds are eligible assets in ECB monetary operations. There is to be no issuance in 2012 and 2013 due to the involvement of the ESM in the Spanish bank recapitalization package (up to €100bn of which €41bn has been provided). Due to the explicit guarantee, FROB also has its rating normalized to Spain at Baa3 (Moody's) and BBB- (S&P).

### Spreads to Bonos at historic tight indicating strong performance; scope for further outperformance is now very limited

### Secondary market performance

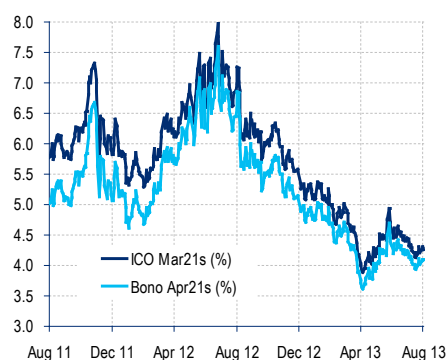
**Relative value vs Bonos:** As with many agency sectors, issuers tend to trade with a spread to the underlying sovereign (Figure 5), largely a function of the wider risk environment and the perceived strength of the government guarantee. While the belly of ICO's curve once traded around 70bp over Spain, spreads have now rallied to approach single digits (Figure 6, Figure 7). Scope for further outperformance is therefore limited and better opportunities are probably sought elsewhere (such as in extension trades) following such strong performance. Given that the FROB and FADE also benefit from an explicit government guarantee, variation in secondary market performance can be limited, but we would still monitor differentials for relative value purposes should spreads get out of line.

Figure 5. Spanish Agency Yields (%)



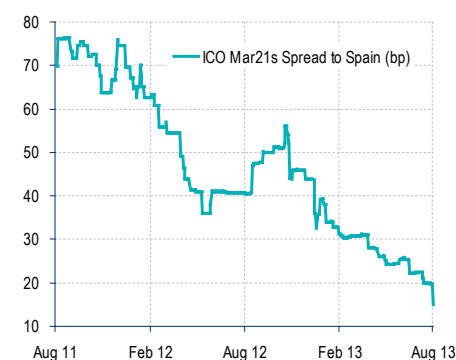
Source: Citi Research

Figure 6. ICO Mar21s and Spain Apr21s Yields



Source: Citi Research

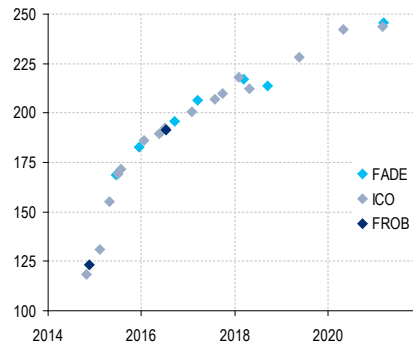
Figure 7. ICO Mar21s Spread to Spain (bp)



Source: Citi Research

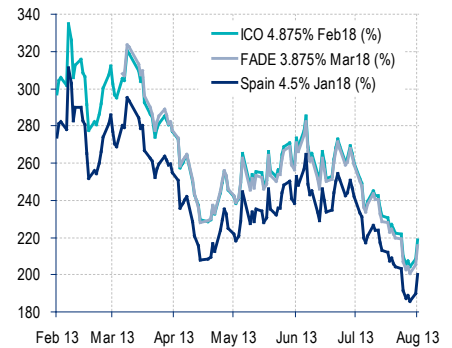
**Performance vs swaps:** ASW curves for the main Spanish agencies can be seen in Figure 8, where variation at the single name level is again small (Figure 8, Figure 9). Performance has been strong, with 5yr Spanish agency debt now trading around 220bp-225bp, rallying in some cases by over 100bp since early 2013.

Figure 8. Spanish Agency ASW Curves (bp)



Source: Citi Research

Figure 9. 5yr ASW Spread History (bp)



Source: Citi Research

### Conclusion - Spanish agency market

The Spanish agency sector can represent an interesting alternative to Spanish government debt, given that the main issuers ICO, FROB and FADE all benefit from an explicit government guarantee. Performance vs Bonos has been strong and many spreads to Spain are around 10bp-30bp, meaning that the scope for further tightening is therefore limited. In this sense, the agency sector will likely contend with the similar drivers affecting the Spanish government bond market for the foreseeable future.

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The Spanish market is thinning out

### Spanish covered bonds: net negative issuance in 2014

#### Primary Market – redemptions will outweigh gross supply in 2014

**Core characteristics:** Cédula redemptions total to €39bn for 2013. During the first eight months, Spanish banks issued €10.25bn publicly. This fits in with the long-term trend. Over the last three years, public cédula issuance has not reached pre-crisis levels. Rather, covered bonds were retained and used for ECB repo operations. This procedure has lost importance for Spanish covered bond issuers this year as the market has offered several funding opportunities – even for second row issuers. Since July it has become clear that the importance of retained covered bonds might decrease even further given the changes in the collateral framework of the ECB recently (for more information please see the [European Rates Weekly](#) 17<sup>th</sup> July 2013). While public issuance has mostly come from the bigger Spanish banks until 2012, smaller institutions also found their way to the market in 2013, even with an inaugural issuance of Caja de Navarra. Multi-cédula issuance stopped in 2009 during the financial crisis and has not come back so far. We don't expect this market to have a comeback on the primary market. However, secondary market opportunities are opened up as the Spanish consolidation process in the banking industry has positive spill-over effects for the multi-structures.

Figure 10. Covered bond programs in comparison

|        | Assets  | Liabilities | Total OC | Eligible OC | Share (residential) | Original LTV | WA Seasoning | Covered Bond Rating | Issuer Rating | Collateral Score |
|--------|---------|-------------|----------|-------------|---------------------|--------------|--------------|---------------------|---------------|------------------|
| BBVASM | 82.96   | 47.763      | 74.0%    | 32.0%       | 78.0%               | 58.0%        | 66.6         | A3/A-               | Baa3/BBB-     | 15.8%            |
| BKIASM | 84.389  | 48.454      | 74.0%    | 30.0%       | 72.0%               | 54.0%        | 59.0         | Baa1-/BBB+*         | Ba2*/BB-      | 21.6%            |
| BKTSM  | 23.641  | 13.096      | 81.0%    | 41.0%       | 69.0%               | 54.6%        | 67.3         | A3/A                | Ba1/BB        | 17.9%            |
| CABKSM | 140.782 | 76.508      | 83.0%    | 28.0%       | 70.0%               | 57.7%        | 74.0         | A3/AA-              | Baa3/BBB-     | 18.7%            |
| CAIXAC | 18.987  | 9.915       | 91.0%    | 32.0%       | 83.0%               | 58.5%        | 66.0         | Ba2/BBB             | B3/--         | 20.0%            |
| CAJARU | 18.312  | 6.1         | 200.0%   | 79.0%       | 57.0%               | n/a          | 57.9         | Ba2/--              | --/--         | n/a              |
| CRUNAV | 3.614   | 0.5         | 622.9%   | 325.4%      | 70.0%               | 62.2         | 46.7         | A3/--               | Baa3/BBB      | 19.9%            |
| KUTXAB | 28.357  | 9.255       | 206.0%   | 111.0%      | 79.0%               | 60.9%        | 67.1         | Ba1/BBB-            | A3/AA-        | 18.4%            |
| NOVAGA | 18.569  | 9.255       | 101.0%   | 40.0%       | 78.0%               | 59.3%        | 61.8         | Ba2/BBB+            | B3/BB-        | 20.4%            |
| POPSM  | 59.366  | 27.038      | 120.0%   | 25.0%       | 41.0%               | 56.0%        | 46.7         | A3*/--              | Ba1*/BB       | 25.2%            |
| SABSM  | 58.173  | 25.727      | 126.0%   | 41.0%       | 45.0%               | 59.9%        | 58.0         | A3*/--              | Ba1*/BB       | 37.2%            |
| SANTAN | 50.14   | 26.21       | 91.0%    | 29.0%       | 59.0%               | 58.0%        | 70.0         | A3/--               | Baa2/BBB      | 21.5%            |
| UCALJN | 16.053  | 9.177       | 75.0%    | 34.0%       | 74.0%               | 61.1%        | 68.5         | A3*/--              | Ba1*/--       | 20.5%            |

Source: Moody's, Citi Research; as of 31/03/13

**15% share of primary market deals year to date**

**2013/2014 Issuance:** To date, Spanish benchmark covered bond issuance stands at €10.25bn. This is 15% of overall new EUR benchmark issuance year to date which stands at €67.4bn. More than half of the bonds (59%) were issued with a maturity of five years. Only one bond was placed in the longer end of the curve. BBVA has issued in the 10yr sector which was the first Spanish issuance in this maturity bucket for three years. At the beginning of the year, we forecasted total benchmark issuance for €12.5bn. We stick to this forecast as we think that primary market activity will return in the last quarter of the year. If funding levels remain attractive for the time being, certain issuers might also use the opportunity to pre-fund themselves for 2014. For 2013, this would still imply that the Spanish covered bond segment shrinks at around €26bn given the high amount of redemptions.

Figure 11. ECB Repayment analysis, EURbn

**ECB Repayment Analysis (EUR bn)**

| Country     | Dec-12 |      |     | Jul-13 |      |     | LTRO Change |
|-------------|--------|------|-----|--------|------|-----|-------------|
|             | MRO    | LTRO | DF  | MRO    | LTRO | DF  |             |
| Belgium     | 0      | 40   | 11  | 50     | 14   | 2   | 25          |
| France      | 5      | 174  | 74  | 2      | 94   | 50  | 81          |
| Germany     | 3      | 70   | 40  | 1      | 12   | 23  | 58          |
| Greece      | 17     | 2    |     | 60     | 2    |     | 0           |
| Ireland     | 8      | 63   | 2   | 8      | 36   | 1   | 27          |
| Italy       | 3      | 268  | 3   | 6      | 242  | 1   | 27          |
| Netherlands |        | 148  | 158 |        | 89   | 108 | 58          |
| Portugal    | 4      | 49   | 4   | 5      | 45   | 1   | 4           |
| Spain       | 41     | 316  | 44  | 23     | 229  | 8   | 87          |
| Eurosystem  | 90     | 1036 | 262 | 102    | 698  | 79  | 338         |
| Core        |        |      |     |        |      |     | 222         |
| Non-core    |        |      |     |        |      |     | 145         |

**Total LTRO repayment (End July 2013)****306**

Source: ECB, Citi Research;

**We are slightly more optimistic for issuance in 2014**

For 2014, issuance prospects should not be substantially different. After €10.3bn in 2012 and expected issuance volume of €12.5bn for 2013, issuance volume of €14bn is reliable – in case of no new substantial external monetary measures – given the even higher redemptions in 2014. We think that one main factor which



might have a positive impact on issuance activity is the still unpaid amount of LTRO money. Spanish banks have already repaid a decent amount of LTRO at the beginning of the repayment period. However, as of July 2013, the amount of LTRO liquidity held by Spanish banks has still been above €229bn in July given the slow repayment speed in general, but in southern European markets in particular. The two 3y LTROs will expire in 2015. As current average repayment speed of €1.5bn/week is too slow to see a smooth path to the final cancellation date, there's a probability that excess liquidity is still substantial in 2014. The sudden repayment of excess liquidity (if not shifted to MRO or DF) would lead to distortions. This could be mitigated by covered bond issuance ahead during 2014. Another option would be a further LTRO which is our base case. The latter would again have negative effects on primary market activity, especially in peripheral countries.

Figure 12. Issuance capacity, EURbn

|                      | Mortgage portfolio | Eligible portfolio | Outstanding cedulas | Issuance cap | Issuance capacity |
|----------------------|--------------------|--------------------|---------------------|--------------|-------------------|
| Bankia               | 81.710             | 60.862             | 45.160              | 48.689       | 3.529             |
| Sabadell-CAM         | 57.839             | 36.173             | 25.147              | 28.938       | 3.791             |
| Catalunya Banc       | 18.680             | 12.919             | 9.415               | 10.335       | 0.920             |
| Ibercaja             | 20.828             | 15.942             | 8.130               | 12.753       | 4.623             |
| Novacaixa Galicia    | 18.666             | 12.855             | 8.455               | 10.284       | 1.829             |
| Unicaja              | 15.602             | 11.844             | 8.827               | 9.476        | 0.649             |
| BMN                  | 37.515             | 26.221             | 16.096              | 20.976       | 4.880             |
| Banco CEISS          | 13.648             | 11.228             | 7.028               | 8.982        | 1.954             |
| Cajasur              | 10.180             | 7.124              | 4.053               | 5.699        | 1.646             |
| Kutxabank            | 28.357             | 19.610             | 9.255               | 15.688       | 6.433             |
| Unnim                | 13.513             | 9.494              | 7.041               | 7.595        | 0.554             |
| Liberbank            | 12.099             | 10.463             | 5.183               | 8.371        | 3.188             |
| BCCM                 | 8.924              | 5.872              | 4.048               | 4.698        | 0.650             |
| Caja3                | 6.381              | 5.304              | 2.047               | 4.243        | 2.196             |
| Banco Popular        | 60.752             | 31.858             | 24.937              | 25.486       | 0.549             |
| Banco de Valencia    | 5.478              | 3.79               | 2.55                | 3.032        | 0.482             |
| Caixabank            | 138.681            | 95.8               | 74.499              | 76.640       | 2.141             |
| Unnim Bank           | 13.513             | 9.493              | 7.041               | 7.594        | 0.553             |
| Caja Laboral Popular | 12.519             | 8.474              | 5.075               | 6.779        | 1.704             |
| Cajas Rurales Unidas | 18.295             | 10.731             | 6.35                | 8.585        | 2.235             |
| Banca March          | 3.865              | 2.674              | 1.95                | 2.139        | 0.189             |
| Banco de Sabadell    | 57.838             | 36.172             | 25.147              | 28.938       | 3.791             |
| Banco Espirito Santo | 1.138              | 0.402              | 0.305               | 0.322        | 0.017             |
| Banco Gallego        | 1.26               | 0.70               | 0.92                | 0.556        | -0.360            |
| Banco Santander      | 50.14              | 33.82              | 26.21               | 27.057       | 0.847             |
| BBVA                 | 82.96              | 62.85              | 47.76               | 50.282       | 2.520             |
| Bankinter            | 23.64              | 18.45              | 13.10               | 14.762       | 1.666             |

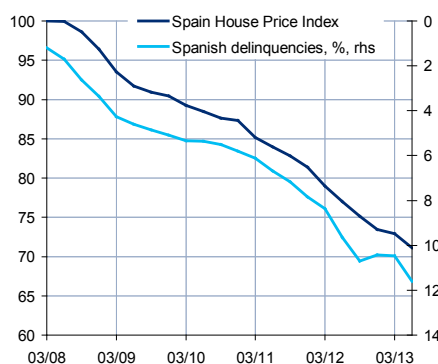
Source: Citi Research

**But the lack of loan origination is substantial**

A negative factor for issuance expectations is the lack of issuance capacity for many Spanish covered bond issuers. However, the figures below also include such bonds which have been used for repo operations at the ECB. These operations can be cancelled which would free up collateral against which public issuance would be possible. Only a few issuers provide data of the share of retained covered bonds. Nevertheless, the numbers give an indication that issuance capacity comes closer to the limits, especially against the background of the very low volume of new loan origination. Moreover, a further round of asset transfers to SAREB cannot be ruled out given the record volume of non-performing loans in 2Q13. In June, Non-

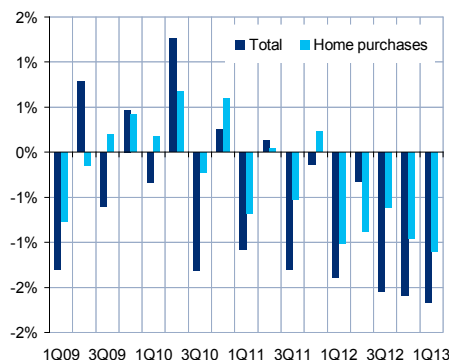
performing loans were trending higher, reaching an outstanding value of €176.4bn (around 17% of GDP) in June. The NPL ratio rose to 11.6%, from 11.2% in May, hitting a new record high since records began in 1963 (previous peak was in 1994 at 8.9%). Total loans were roughly unchanged in June, after falling by an average of 1.1% MM in the first five months of 2013. Given the fact that Bank of Spain introduced stricter rules for the recognition of loan losses recently, a push of NPLs further up should not surprise.

Figure 13. Spanish housing market



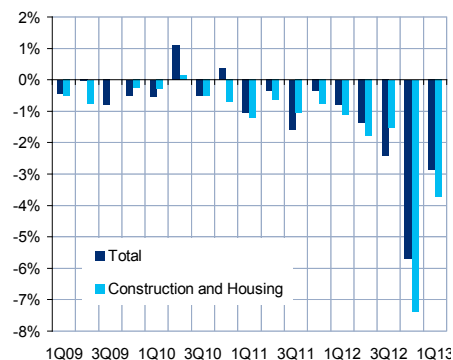
Source: Bank of Spain, Citi Research

Figure 14. Lending activity: Financing of individuals, yoy, %



Source: Bank of Spain, Citi Research

Figure 15. Lending activity: Financing of productive activities, yoy, %

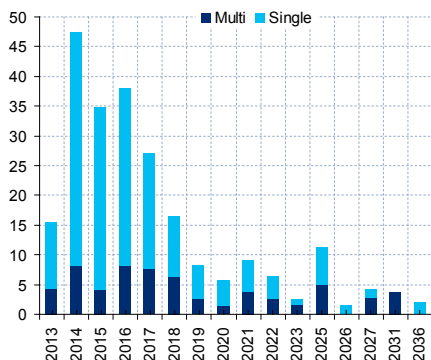


Source: Bank of Spain, Citi Research

...while deleveraging continues to be a main topic

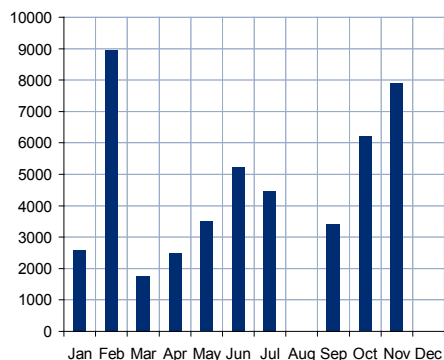
The end of the 3y-LTRO on the one hand and the lack of growth of the underlying market might outweigh as determinants for primary market issuance prospects. Other aspects are the general trend of deleveraging and the regulatory importance of capital on the one hand but the clear preference of secured funding compared to unsecured funding but also with respect to term funding on the other hand.

Figure 16. Long-term redemptions by issuance structure, EURbn



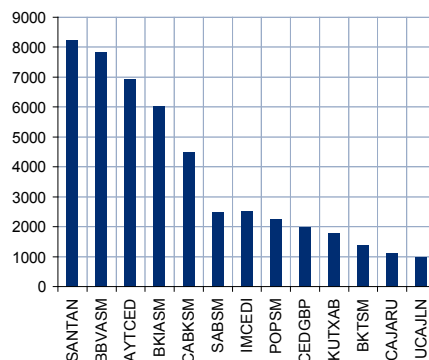
Source: Citi Research

Figure 17. Redemptions 2014 by month, EURmn



Source: Citi Research

Figure 18. Redemptions 2014 by issuer, EURmn



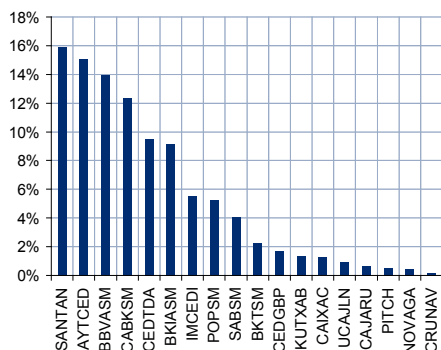
Source: Citi Research

### Redemptions in 2014: €48bn

In 2014, redemptions will outweigh covered bond issuance again. In total, redemptions amount to €48bn. The repayments are heavily skewed to February and a surprisingly big amount can be expected in the fourth quarter of 2014. The two most active covered bond issuers over the last three years, BBVA and Banco Santander, record total redemptions 2014 of €8.25bn and €7.85bn, respectively. Most issuers of CH still manage a public sector covered bond program. However, it's only a few issuers that have public sector backed cédulas outstanding. BBVASM

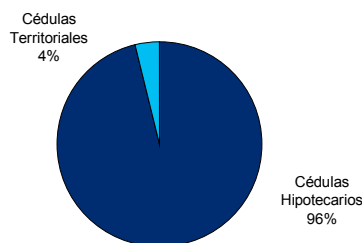
and SANTAN have the biggest amount of CT outstanding. But, as it can be seen below, the share of CT on the whole cédula market is rather small. Although the Spanish covered bond primary market has been showing a sign of thawing in 2013, in the longer term it is unlikely to see public sector backed covered bonds coming back to the Spanish market. One reason for that is as well the decreasing attractiveness of public sector financing.

**Figure 19. Outstanding benchmark covered bonds: market share**



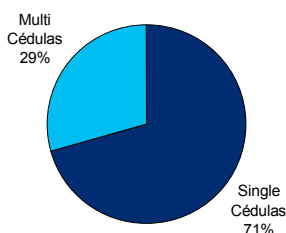
Source: Citi Research

**Figure 20. Outstanding benchmark covered bonds by collateral**



Source: Citi Research

**Figure 21. Outstanding benchmark covered bonds by issuance structure**

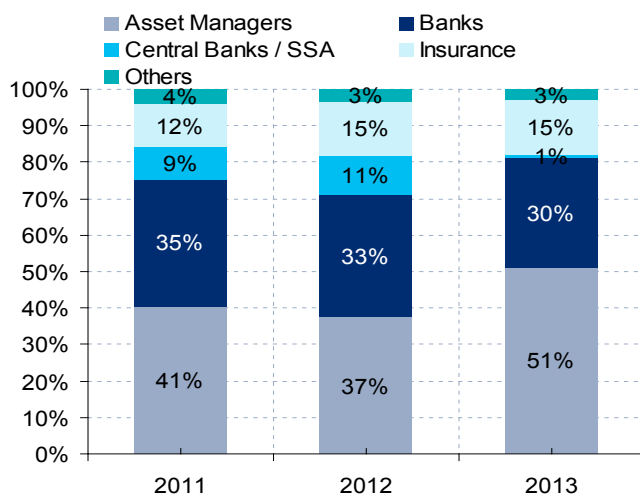


Source: Citi Research

#### Consolidation efforts should continue to support the multi-cédula segment

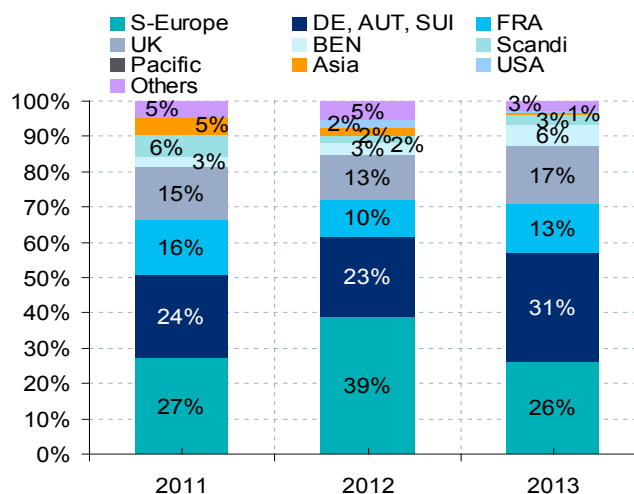
The other niche market in the Spanish covered bond market, the multi-cédula segment, will be shrinking constantly. Issuance in this segment is further constrained by the losing attractiveness of the funding vehicle against the background of the several mergers, acquisitions or restructurings within the banking sector.

**Figure 22. Type of investors in Spanish cédulas**



Source: CBR, Bloomberg, Citi Research

**Figure 23. Geographical distribution of cédula order books**



Source: CBR, Bloomberg, Citi Research

#### Asset managers are the most active investors in Spanish deals

The main investor type in Spanish covered bonds has been asset managers. Year to date, their share increased substantially and makes on average more than 50% of Spanish order books. Central banks meanwhile backed down substantially. Given the ratings of Spanish covered bonds, these movements should not surprise. Investors from Germany, Austria and Switzerland – the dominant investors in order

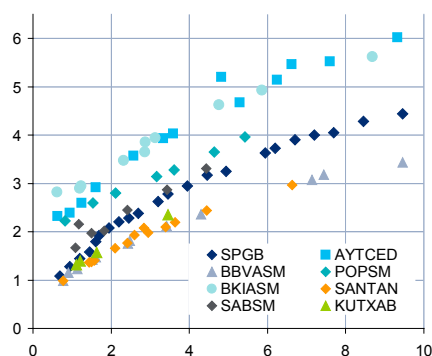
books from nearly all segments – came back strongly and are the biggest share in 2013. The uncertainties in 1H12 around the debt sustainability of Southern European countries led to a shift back to the core covered bond segments. Given Draghi's backstop which is in place since 2H12, this investor group felt again more comfortable to increase exposure in Spain and other peripheral covered bond segments.

### Secondary Market – opportunities in volatile markets

#### ASW Spreads near 3y lows

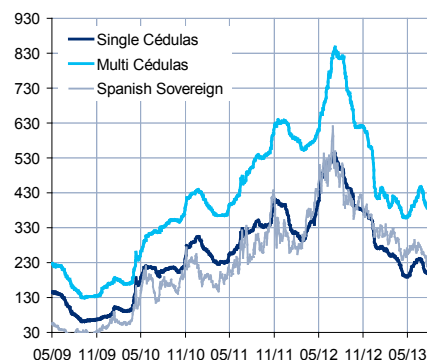
In the secondary market, Spanish covered bonds have in general been rallying over the last year. However, back in June, when spreads were at 3y lows and tapering started to be priced in for the first time, the market cheapened providing investors with short-term entry levels. Currently, ASW-spreads are again near 3y lows. However, there is still a spread differentiation within the segment. In general, multi-cédulas trade cheaper to single-cédulas providing opportunities given the ongoing banking consolidation (see next page). Moreover, there are some small Spanish banks which can clearly distinguish themselves and are trading at similar levels as BBVA and SANTAN which are still perceived to be the national benchmark.

Figure 24. Cédulas und Bonos, yield, %



Source: Citi Research

Figure 25. Index performance, ASW-Spread, bp



Source: Citi Research

Figure 26. Spread evolution, ASW-Spread, bp



Source: Citi Research

#### Short-term switch opportunities in Spain

Moreover, the Spanish market is one of the most volatile covered bond markets, with higher beta names in the multi-structure segment. Generally, given the high correlation to the underlying sovereign market, the covered bond segment follows the government bond curve in the medium term. In the short-term, however, strong movements in the sovereign bond market are followed with a time-lag of two to three days. This provides switch opportunities between the two asset classes. In the long-term, on the other side, covered bonds can decouple from the sovereign market. During the last year, the general pattern of some covered bonds trading richer in times of financial distress and softer in bullish markets versus government bonds has disappeared. For more than one year, Tier-1 cédulas trade richer and seem to have found a trading range. Given the ongoing shrinkage of the secured market on the one hand and the ongoing deteriorating debt sustainability on the sovereign side we currently don't see the short- and medium-term catalyst for a reversal of the newly established pattern. That said, the few rather positive economic figures from Spain the market is currently focusing on might support a slight outperformance of the government bonds in the short-term. We currently don't see covered bonds trading on tighter spreads than in March when the spread reached all time highs.

Figure 27. Consolidation process in the Spanish banking industry

| 2009                              | 2010                     | 2011                        | 2012                        | July 2013  |
|-----------------------------------|--------------------------|-----------------------------|-----------------------------|--|
| Banco Santander                   | Banco Santander          | Banco Santander             | Banco Santander             | Banco Santander                                      |
| Banesto                           | Banesto                  | Banesto                     | Banesto                     |  |
| BBVA                              | BBVA                     | BBVA                        | BBVA                        | BBVA   |
| Caixa Sabadell                    |                          |                             |                             |  |
| Caixa Terrassa                    | Unnim Banc               | Unnim Banc                  | Unnim Banc                  |  |
| Caixa Manlleu                     |                          |                             |                             |  |
| La Caixa                          | La Caixa                 | Caixabank                   | Caixabank                   |  |
| Cajasol                           | Cajasol- Guadalajara     |                             |                             |  |
| Guadalajara                       |                          |                             |                             |  |
| Caja Navarra                      |                          | Banca Civica                | Banca Civica                |  |
| Caja Burgos                       | Banca Civica             |                             |                             |  |
| Caja Canarias                     |                          |                             |                             |  |
| Banco de Valencia                 | Banco de Valencia        | Banco de Valencia (FROB)    | Banco de Valencia (FROB)    |  |
| Banco Pastor                      | Banco Pastor             | Banco Pastor                |                             |  |
| Banco Popular                     | Banco Popular            | Banco Popular               | Banco Popular               | Banco Popular  |
| BBK                               | BBK Bank Cajasur         | BBK Bank Cajasur            |                             |  |
| Cajasur                           |                          |                             | Kutxabank                   | Kutxabank  |
| Caja Vital                        | Caja Vital               | Caja Vital                  |                             |  |
| Kutxa                             | Kutxa                    | Kutxa                       |                             |  |
| Unicaja                           | Unicaja                  | Unicaja Banco               | Unicaja Banco               | Unicaja Banco  |
| Caja Jaén                         |                          |                             |                             |  |
| Caja Duero                        | CEISS                    | CEISS                       | CEISS                       | CEISS  |
| Caja Espana                       |                          |                             |                             |  |
| Caixa Catalunya                   |                          |                             |                             |  |
| Caixa Tarragona                   | Catalunya Banc           | Catalunya Banc              |                             |  |
| Caixa Manresa                     |                          |                             | FROB/Spanish State          | FROB/Spanish State                                   |
| Caixa Galicia                     | Nova Caixa Galicia       | NGC Banco                   |                             |  |
| Caixanova                         |                          |                             |                             |  |
| Caja Murcia                       | Caja Murcia              |                             |                             |  |
| Caja Granada                      | Caja Granada             | Banco Mare Nostrum          | Banco Mare Nostrum          | Banco Mare Nostrum                                   |
| Sa Nostra                         | Sa Nostra                |                             |                             |  |
| Caja Madrid, Bancaja              |                          |                             |                             |  |
| Caja Insular Canarias, Caja Avila | Bankia                   | Bankia                      | Bankia (FROB/Spanish State) | Bankia (FROB/Spanish State)                          |
| Caixa Laietana, Caja Rioja        |                          |                             |                             |  |
| Ibercaja                          | Ibercaja                 | Ibercaja                    | Ibercaja                    |  |
| CAI                               | CAI                      |                             |                             |  |
| Caja Circulo                      | Caja Circulo             | Banco Grupo Cajates (Caja3) | Banco Grupo Cajates (Caja3) | Ibercaja / Banco Grupo Cajates                       |
| Caja Badajoz                      | Caja Badajoz             |                             |                             |  |
| Cajastur                          | Cajastur                 |                             |                             |  |
| CCM                               |                          | Liberbank                   | Liberbank                   | Liberbank  |
| Caja Extremadura                  | Caja Extremadura         |                             |                             |  |
| Caja Cantabria                    | Caja Cantabria           |                             |                             |  |
| Caja Castilla-La Mancha           | Caja Castilla-La Mancha  | Banco Castilla-La Mancha    | Banco Castilla-La Mancha    | Banco Castilla-La Mancha (Liberbank 75% shareholder) |
| Banco de Sabadell                 | Banco de Sabadell        | Banco de Sabadell           |                             |  |
| CAM                               | CAM                      | CAM                         | Banco de Sabadell           | Banco de Sabadell                                    |
| Banco Guipuzcoano                 | Banco Guipuzcoano        | Banco Guipuzcoano           |                             |  |
| Caja Penédes                      | Caja Penédes             | Caja Penédes                |                             |  |
| Banco Gallego                     | Banco Gallego            | Banco Gallego               | Banco Gallego               |  |
| Other Building Societies          | Other Building Societies | Other Building Societies    |                             |  |
| Cajamar                           | Cajamar                  | Grupo Cooperativo Cajamar   | Caja Rurales Unidas         | Caja Rurales Unidas                                  |
| Other Building Societies          | Other Building Societies |                             |                             |  |
| Caja Laboral Popular              | Caja Laboral Popular     | Caja Laboral Popular        | Caja Laboral Popular        | Caja Laboral Popular                                 |
| Ipar Kutxa                        | Ipar Kutxa               | Ipar Kutxa                  |                             |  |
| Bankinter                         | Bankinter                | Bankinter                   | Bankinter                   | Bankinter  |
| Banca March                       | Banca March              | Banca March                 | Banca March                 | Banca March  |
| Caixa Ontinyent                   | Caixa Ontinyent          | Caixa Ontinyent             | Caixa Ontinyent             | Caixa Ontinyent                                      |
| Banco Caminos                     | Banco Caminos            | Banco Caminos               | Banco Caminos               | Banco Caminos  |

Source: IM Titulización, Citi Research

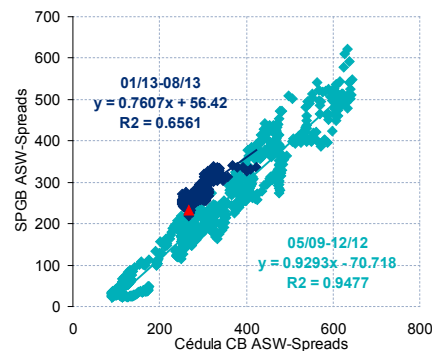
### Spanish senior bonds still trade too rich versus covered bonds

The spread between senior bonds and covered bonds varies substantially between the issuers. The newly introduced resolution regime that was presented in April 2013 did not have explicit consequences for the relationship between unsecured and secured bonds. In case of BKIASM, the senior ASW-spread is currently at same levels like it has been three years before.

It seems as if the market still hasn't priced in potential losses for senior bondholders they would have to carry in case of a restructuring of the company's debt. We think that the same applies to CABKSM. Although full implementation of the resolution regime is planned to be finished in 2018, the introduction starts in 2015. Hence, first effects might be seen for the years in between.

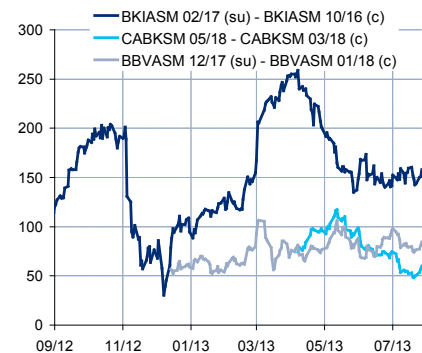
Therefore, especially against the background of the preferential claim of covered bondholders on the company's mortgage book, we think that the senior-covered spread is too tight, especially in Spain. Moreover, there are only few benchmark senior bonds outstanding. Apart from BBVASM, SANTAN and CABKSM, it's only POPSM (2 bonds, both maturing in 2015) and BKIASM (one bond maturing in 2017) with outstanding bank senior bonds.

Figure 28. Correlation Cedulas vs SPGB, bp



Source: Citi Research; red: current spread

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



Source: Bloomberg, Citi Research

For more information on all Spanish cover pools, please see our [Covered Bond Strategy - The Multi-Cédula Road Map](#) 15<sup>th</sup> of August 2013 which contains information on all cover pools.

### Relative value opportunities

#### Most opportunities in the multi-cédula market

In our recent [European Rates Weekly](#) publication we provided some switch opportunities given our expectations on multi-cédula rating actions. While one of these recommendations has been running in favor of us but still seems attractive (prefer AYTCED 12/16 versus CEDGBP 04/17) the other recommendation offers a more attractive entry level now (prefer CEDGBP 04/17 to POPSM 03/17).

Figure 30. Switch opportunity, ASW-Spread, bp



Source: Citi Research

Figure 31. Switch opportunity, ASW-Spread, bp



Source: Citi Research

Figure 32. Spread evolution, ASW-Spread, bp



Source: Citi Research

Given the fact that both bonds are backed by the same issuer and the same cover pool, we don't see the 40bp difference as justified. Moreover, we recommend switching from BKIASM 04/22 to IMCEDI 02/22 given the rating difference, the banks involved in the multi-cédula structure and the higher weighted average OC levels in this structure. More information on IMCEDI can be found on p.30 of the [Covered Bond Strategy - The Multi-Cédula Road Map](#).

## (2) Portuguese agencies and covered bonds

The Portuguese agency and covered bond markets are, perhaps as expected, smaller than that of Spain. We outline the salient features of both sectors below.

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### Portuguese agency sector

For the agency market, the main issuer is REFER which is the entity responsible for Portugal's railway network. We detail fundamentals below in Figure 33.

Figure 33. The Portuguese Agency Market

| Ticker | Issuer                        | Agency Type and Mission   | Established | Ownership Structure   | Moody's Rating | S&P Rating | Total Assets 2012 (€bn) | Bond Issuance 2012 (€bn) | Bond Debt Outstanding (€bn) |
|--------|-------------------------------|---|-------------|---|----------------|------------|-------------------------|--------------------------|-----------------------------|
| REFER  | Rede Ferroviária Nacional EPE | Portuguese agency responsible for managing Portugal's national railway network infrastructure | 1997        | 100% State owned and benefits from explicit legal status as an "Entidade Publica Empresarial" (EPE) with articles defined in law. REFER's budget is included in the State Budget and the entity enjoys a high degree of integration with the State. | B2             | NR         | 5.3                     | 0.0                      | 2.7                         |

Source: Investor Presentations, S&P, Moody's, Bloomberg, Dealogic DCM Analytics, Citi Research.

### REFER – issuer characteristics

**Rating:** Unlike other agencies covered in our *Euro SSA and Covered Bond Monthlies*, REFER differs in not having its rating normalized to that of the underlying sovereign. Specifically, where Moody's rates Portugal Ba3, the rating of REFER is two notches lower at B2. This rating reflects REFER integral role as manager of Portugal's railway network and special legal status, but also takes into account the fact that "REFER's financial profile is weak and would make REFER unviable if it were to be considered a stand-alone entity" (Moody's Credit Opinion, Feb 2013).

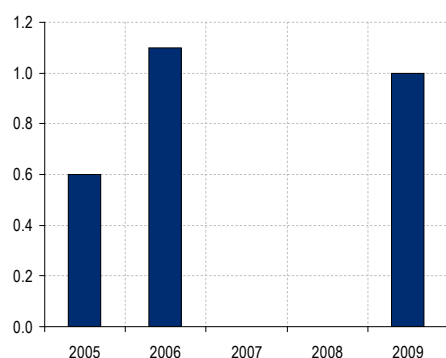
**Fundamentals:** Moody's takes various drivers into account. Firstly, REFER has relatively weak financials, with negative operating cash flow, negative equity, a loss making position and a high debt burden (€6.9bn in Dec 2012). As another factor, due to the strong and supportive link to Portugal, REFER's fundamental outlook is



connected to that of the underlying sovereign. Portugal remains under a €78bn Troika programme and there are “residual risks” that Moody’s identifies: “*residual risks reflect the financial strains to which RoP is subject, the measures it must introduce to comply with the Memorandum of Understanding it has agreed with the IMF and EU, and the competing claims that it has on its financial resources*”. REFER has recently made use of various state loans for refi purposes given the lack of market access. Citi’s views on Portugal can be found in our latest [Global Economic Outlook and Strategy - August 2013](#).

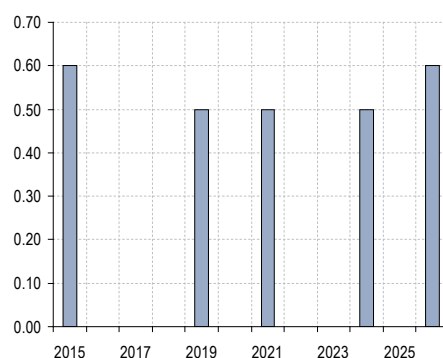
**Bond supply:** REFER’s last issuance was in 2009 at €1bn and secondary market liquidity reflects such bond scarcity (Figure 34, Figure 35).

Figure 34. REFER Bond Supply (€bn)



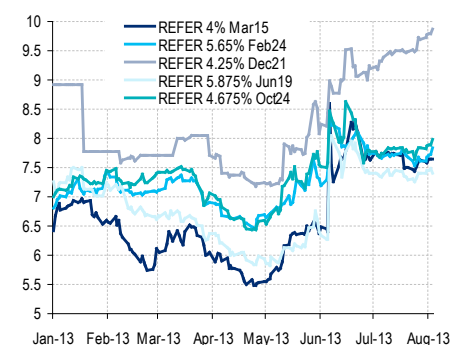
Source: Citi Research, DCM Dealogic

Figure 35. REFER Bond Maturity Profile (€bn)



Source: Citi Research, Bloomberg

Figure 36. REFER Yields



Source: Citi Research

**Secondary market curves:** Spreads have been largely range bound recent for REFER bonds, those guaranteed by Portugal trading about 100bp to the sovereign. The existence of a government guarantee on some bonds is a defining characteristic in REFER’s curve, explaining secondary market variation in our view.

### Conclusion – Portuguese agency sector

The Portuguese agency sector is relatively small, and hence it is one of the less liquid segments of the broader European SSA universe. Given that Portugal remains in a Troika programme, with financial commitments to the IMF and EFSF, the evolution of Portuguese agency debt is very much linked to Portugal’s economic trajectory and its prospect to regain market access next year.

### Portuguese covered bond market

#### Portuguese Covered Bond primary market

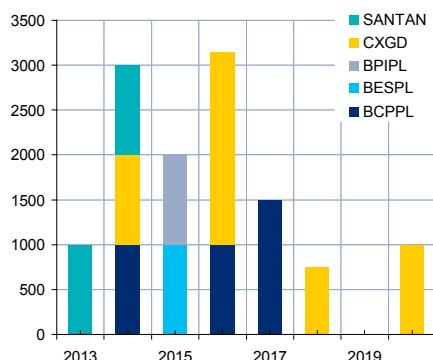
The Portuguese covered bond (PCB) market has been in stand-by mode for a long time. There has only been one bond issued over the last three and a half years when CXGD issued a 5y mortgage covered bond in January 2013. That means that the market has shrunk so far this year by €0.25bn as €1bn PCB matured in April 2013. The five banks which have covered bonds outstanding preferred to use retained covered bonds for ECB repo operations over the last four years. In 2014, total redemptions will amount to €3bn. With these redemptions, the only bond issued by Banco Santander Totta will mature. Therefore, the number of market participants might fall next year as well. Currently, overall outstanding volume of EUR benchmark bonds totals €11.4bn. The main issuer in the Portuguese covered bond market is CXGD with a market share of more than 40%, followed by BCPPL with more than 30%.

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The Portuguese market has been very silent over the last three years

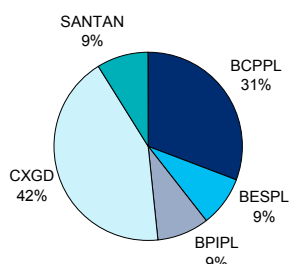


Figure 11. Redemption profile for PCB (€mn)



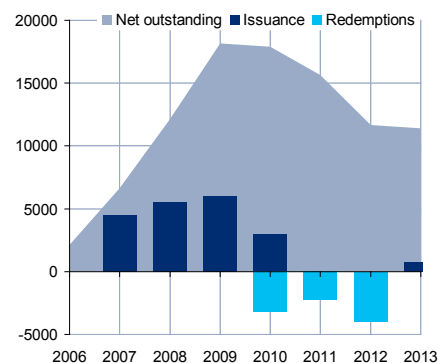
Source: Citi Research

Figure 12. Market share of PCB issuers (%)



Source: Bloomberg, Citi Research

Figure 13. Market volume (€mn)



Source: Bloomberg, Citi Research

### Issuance in 2014 should also remain low

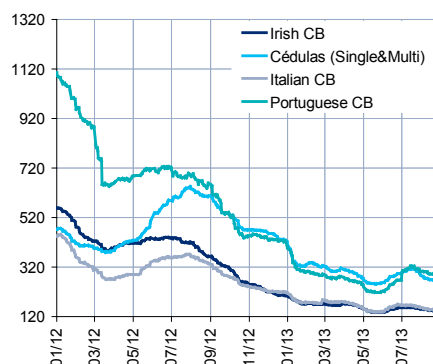
While there has also been a market for public sector backed covered bonds in the past, this market has mostly disappeared. It's only CXGD and Banco BPI with outstanding liabilities of €800mn and €400mn, respectively. In case of CXGD, the only bond outstanding is going to mature in 2014 while we understand that Banco BPI currently uses the public sector covered bond program with the sole purpose of repo operations with the ECB. For next year, our issuance projections remain cautious. Our economists believe that Portugal will need a second fully funded ESM programme. In order to offer some hope of the country eventually achieving debt sustainability, a second programme may include — at the outset — some restructuring of liabilities for the general government, public corporations and/or banks. This might not be the hotbed for a return of the banks to the covered bond market. Therefore, we think that issuance will not be higher than €2bn in 2014.

### Over the last two months OCB underperformed the covered bond markets

### PCB Secondary Market

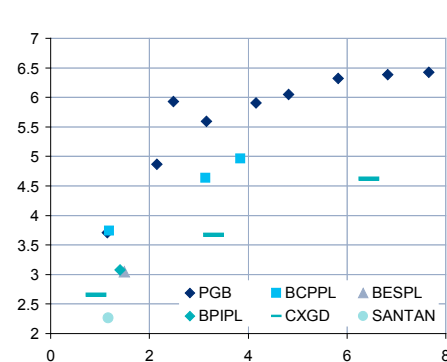
After a substantial rally (900bp) between January 2012 and June 2013 the Portuguese covered bond market reached ASW levels it has last seen in April 2010. After the first announcement of tapering, Portuguese bonds started again to cheapen and underperformed the covered bond universe. Over the last six weeks, Portuguese secured paper also decoupled from Spanish cédulas which has seen some buyers coming back into this segment while PCB couldn't benefit from the recent cheapening.

Figure 11. Index performance, ASW-spread, bp



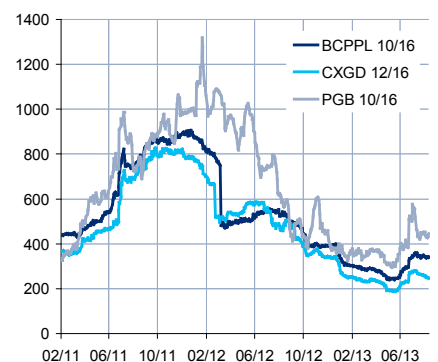
Source: Markit, Citi Research

Figure 12. BCP vs PGB, yield, %



Source: Citi Research

Figure 13. Market volume (€mn)



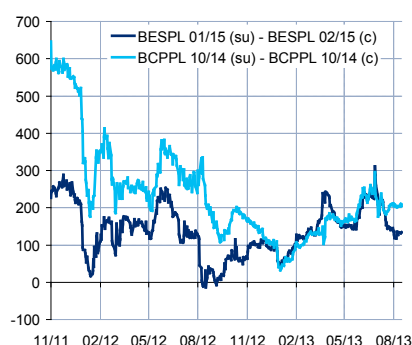
Source: Bloomberg, Citi Research

### PCB are highly correlated to sovereign debt

The Portuguese covered bond market is the only market where all covered bonds trade richer than the underlying sovereign bond market. We think that this is justified, especially against the background of our economists' projections for 2014. Moreover, as it is a pattern for most mature covered bond markets, the Portuguese market will shrink in 2014 as well. This should be a further supportive factor for secondary markets.

Nevertheless, the main spread driver for spread movements in this sector is still the underlying government bond market. Given the fact that we expect some kind of debt restructuring in 2014 for Portuguese government debt and/or bank debt, we continue to stay defensive with respect to PCB in the long term. In the medium term we also see little opportunities given the general spread widening in European fixed income markets following the fast sell-off in UST. However, we think that given the low market volume and the lack of primary market issuance, spread movements are mostly driven on price adjustments and to a much lesser extent on real buying and selling orders of clients.

**Figure 37. Covered vs Senior, ASW-spread, bp**



Source: Bloomberg, Citi Research

During 2012, senior bonds outperformed covered bonds. This came to a stop in January 2013. Since then, this spread widened again in a volatile range and is now around 150bp. Although these higher spreads could be seen as an entry point we remain cautious and would recommend staying in the secured paper. This should again be seen against our assumptions of Portugal probably needing a second fully funded ESM program. This should have severe spillover-effects and higher beta names like senior bank bonds should be more affected than PCB. Also, in the medium-term we don't expect a reversal of the eight-month trend. We rather prefer to stay with / switch to covered bonds in the Portuguese market.

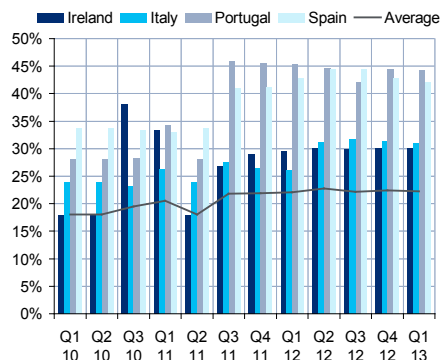
### PCB Programs in comparison

Portuguese covered bond spreads are still mainly driven by the development on the underlying PGB market. Cover pool performance and covered bond law quality only play a minor rule. Although Portugal didn't see any inflationary trends on the domestic property market, the deep recession over the last years also led to a house price decrease. This tendency was broken in March. Since then, property prices increased slightly again.

The apparent decrease in cover pool quality which can be interpreted from Moody's Collateral Score between 2Q11 and 4Q12 is misleading. Although property prices decreased between 2Q10 and 4Q12 on the one hand and lower employment rates on the other hand also led to a lower cover pool quality, the higher collateral scores for mortgage covered bond programs remained constant. That said, it was specifically the public sector covered bond programs rated by Moody's whose cover pool quality worsened.

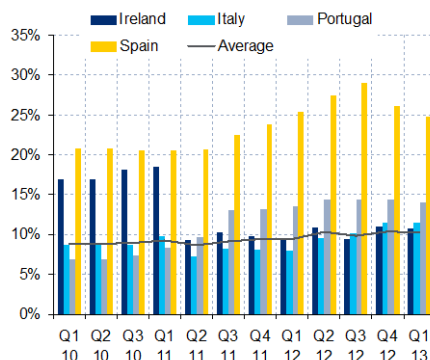
Currently, the average collateral score of mortgage covered bond programs credit quality would be better than the general average of Moody's rated covered bond market (10% vs. 10.3%). Currently, each issuer displays a collateral score of 10% which includes systematic risk. Banco BPI also shows a collateral score excluding systemic risk with 4.3%. This value is at same levels like the best German mortgage covered bond programs.

Figure 38. Moody's cover pool losses, %



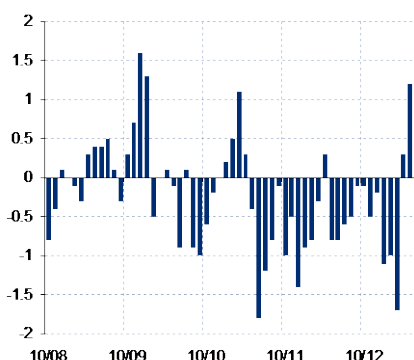
Source: Moody's, Citi Research

Figure 39. Moody's Collateral Score, %



Source: Moody's, Citi Research

Figure 40. Portugal House Prices, mom, %



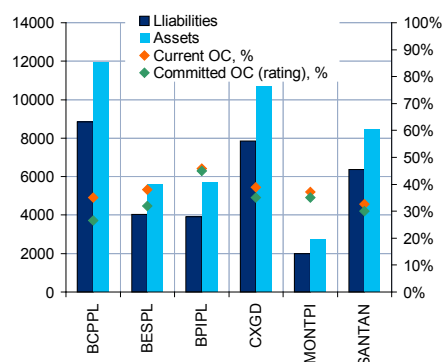
Source: Instituto Nacional des Estatistica Portugal

## Cover pool quality is still high

As the Portuguese covered bond law does not allow to have mixed cover pools it is unsurprising that the mortgage covered bonds are secured by mortgage loans (Figure 38). As a credit support, we see that all issuers concentrate residential loans in their cover pool. Historically, these exhibit lower default rates than commercial loans. Moreover, all pools are composed by Portuguese assets only. As of 2Q13, BPIPL displays highest OC levels within the Portuguese covered bond market. This is in line with the highest OC committed to rating agencies to obtain current ratings. While mandatory OC is 5.3%, most issuers have to hold higher OC in order to maintain current covered bond ratings (Figure 39). All Portuguese cover pools are very seasoned (Figure 40). More than half of the collateral has been originated more than five years ago.

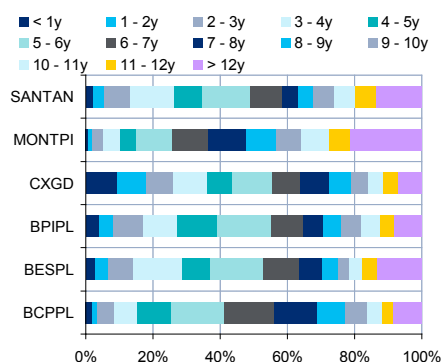
The bulk of Portuguese cover pool loans are characterized by remaining terms of 30-40 years. As original LTV-distribution shows, CXGD included the biggest part of loans with lowest LTVs. One backdrop by analyzing Portuguese cover pools is that issuers don't provide indexed LTV brackets but only partly WA indexed LTVs (table below). However, the month-on-month house price developments (Figure 40) as well as the relatively low number of loans in arrears reflect that credit deterioration was much less significant in Portugal than in Spain or Ireland. While Ireland removes loans which are in arrears more than a specific number of days, this doesn't happen in Spain as long as the loan is not overdue. In Portugal, the covered bond law ensures issuers to exclude all loans that are overdue more than 90 days.

Figure 41. OC-Levels in Comparison, €mn, %



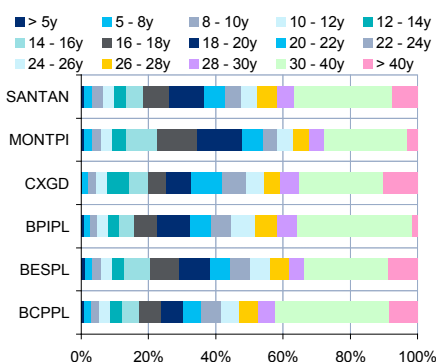
Source: Citi Research, Issuers

Figure 42. Cover pool distribution by seasoning, years



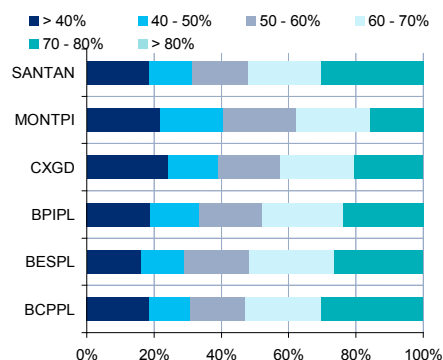
Source: Citi Research, Issuers

Figure 43. Cover pool distribution by remaining terms, years



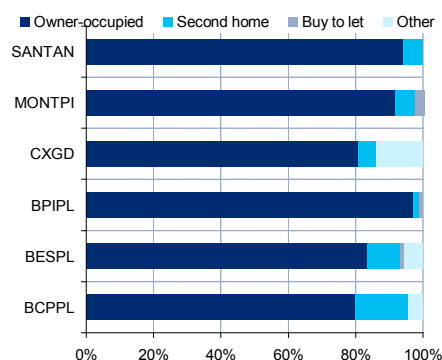
Source: Citi Research, Issuers

Figure 44. Cover pool distribution by current unindexed LTV, %



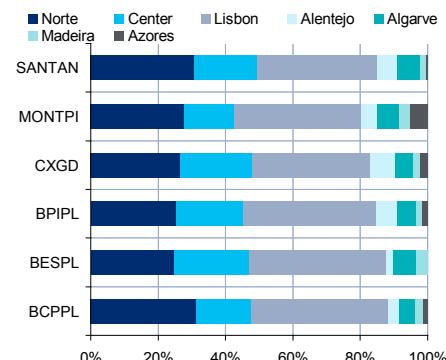
Source: Citi Research, Issuers

Figure 45. Cover pool distribution by loan usage, %



Source: Citi Research, Issuers

Figure 46. Cover pool distribution by geography, %



Source: Citi Research, Issuers

The major part of the cover pools are composed of loans which are used for owner occupation and for second homes. The geographical distribution of the cover pool are very similar with major exposure to Lisbon region and the country's North. Loans to borrowers in Madeira and Azores play a minor role in all pools.

Figure 47. Comparison of Portuguese covered bond programs

|   | BCPPL         | BESPL        | BPIPL        | CXGD             | MONTPI          | SANTAN           |
|---|---------------|--------------|--------------|------------------|-----------------|------------------|
| Issuer rating (Moody's/S&P/Fitch/DBRS)        | B1/B/BB+/BBBL | Ba3/BB-/BBBL | Ba3/BB-/BB+  | Ba3/BB-/BB+/BBBL | Ba3/BB-/BB/BBBL | Ba1/BB/BBB-/AL   |
| Covered bond rating (Moody's/S&P/Fitch/DBRS)  | Ba1/BBB-/AL   | Baa3/BBB-/AL | Baa3/A-/BBB/ | Baa3/BBB-/A      | Baa3/BBB-/BBB/  | Baa3/BBB-/BBB/AL |
| Outstanding liabilities (EURmn)               | 8850          | 4040         | 3925         | 7851.45          | 2000            | 6380             |
| Outstanding assets (EURmn)                    | 11911.6       | 5562.216     | 5721.508     | 10684.12         | 2729.647        | 8457.59          |
| % of ECB eligible assets                      | 100.0%        | 0.0%         | 99.8%        | 100.0%           | 100.0%          | 0.0%             |
| Current OC, %                                 | 35.0%         | 38.0%        | 45.8%        | 38.9%            | 37.2%           | 32.6%            |
| Committed/required OC (rating), %             | 26.5%         | 32.0%        | 45.0%        | 35.0%            | 35.0%           | 30.0%            |
| Legal OC, %                                   | 5.3%          | 5.3%         | 5.3%         | 5.3%             | 5.3%            | 5.3%             |
| Avg. original principal balance per loan, EUR | 66631         | 68032        | 68021        | 62946            | 70011           | 65775            |
| Avg. current principal balance per loan, EUR  | 51880         | 51915        | 52292        | 42993            | 51339           | 49682            |
| Share of residential assets, %                | 100.0%        | 100.0%       | 100.0%       | 100.0%           | 100.0%          | 100.0%           |
| Share of insured property, %                  | 100.0%        | 100.0%       | 100.0%       | 100.0%           | 100.0%          | 100.0%           |
| Share of interest-only loans, %               | 0.0%          | 100.0%       | 0.5%         | 0.0%             | 0.0%            | 5.6%             |
| Share of 5 largest borrowers, %               | 0.1%          | 0.2%         | 0.1%         | 0.0%             | 0.1%            | 0.1%             |
| Share of 10 largest borrowers, %              | 0.1%          | 0.3%         | 0.2%         | 0.1%             | 0.2%            | 0.2%             |
| WA seasoning (months)                         | 57.1          | 80.43        | 76.4         | 97.4             | 104.8           | 86.6             |
| WA remaining terms (months)                   | 317.4         | 301.9        | 162.1        | 280.6            | 276.7           | 308.5            |
| WA unindexed LTV, %                           | 57.1%         | 57.4%        | 55.8%        | 53.0%            | 57.9%           | 56.8%            |
| WA indexed LTV, %                             | n/a           | 61.6%        | n/a          | 54.9%            | 52.6%           | 57.2%            |
| Share of fixed rate loans, %                  | 6.6%          | 2.0%         | 4.8%         | 0.0%             | 4.6%            | 2.1%             |
| Loans in arrears (>30d), %                    | 0.7%          | 0.0%         | 0.3%         | 0.2%             | 0.2%            | 0.6%             |

Source: Issuers, Citi Research

### Immediate rating pressure is relatively low

There have been several PCB downgrades during the last three years. This was mainly due to sovereign and issuer rating downgrades (for a rating overview, please see the table above) and changes in rating methodologies. Currently, most covered bond ratings are confirmed. Therefore, immediate rating pressure is relatively low. However, as Portuguese covered bonds don't show further unused uplift, i.e. a sovereign or issuer downgrade would have a direct impact, a PCB downgrade would be very likely if the rating spiral starts again in our view.

In case of Moody's, this would also mean that the covered bonds would move to sub-investment territory. Some of the Portuguese issuers chose to be rated by DBRS where they are rated clearly better where the issuers are still in A territory. This should also make sure that the Portuguese covered bonds continue to be treated preferentially at the ECB collateral framework.

### Relative value opportunities

#### Santander Totta is back to cheap levels vs Santander Spain

At current stages we think it's hard to implement relative value opportunities with Portuguese covered bonds involved. Secondary market liquidity is very small and should not be expected to improve as long as the sovereign debt crisis is ubiquitous and primary market issuance continues to be very low. Nevertheless, we want to show an opportunity within the Iberian covered bond market. Banco Santander Totta still has one bond outstanding (expiring in 10/2014).

After a six-month lasting outperformance of the secured paper issued by its parent company in Spain, the Portuguese bond cheapened again in light of the general decoupling between Spain and Portugal on the one hand and a downgrade of the covered bond after not complying with committed OC levels to obtain a specific rating (S&P and Fitch).

**Figure 48. SANTAN in Portugal and Spain, ASW-Spread, bp**



Source: Citi Research

**Figure 49. Reducing duration in CXGD, ASW-Spread, bp**



Source: Citi Research

Moreover, we think that the current spread between CXGD 01/20 and CXGD 01/18 is near historic lows. CXGD 01/20 seems to trade too expensive to its own curve. Hence, there is an opportunity to reduce duration while sticking to the same issuer.

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# Euro SSA Strategy

## (1) Strategy views

### Will the return of supply widen spreads materially?

Supply has returned in force this week. Across agencies, both KfW and RENTEN issued benchmark bonds (KfW €3bn Aug23s, RENTEN €1bn Sep16s) and across supnationals, the EFSF issued €3bn in a new 21yr benchmark. The EIB has also been a frequent issuer earlier in August, tapping the 7yr-8yr sector in particular. This follows the usual lull in issuance seen in the SSA sector, and more broadly in corporate credit, over July and early August.

Barring negative catalysts such as a significant deterioration in the credit quality of the underlying sovereigns, we expect spreads to remain low and range bound. The pick-up in supply, typical in September and seen over recent days, is likely to weigh on spreads but not to the extent that they break existing ranges in our view. Many SSAs have made good progress in their respective supply pipeline. Furthermore, the historically large issuance last year and the dramatic spread tightening that occurred also provide further context. We do not believe a material spread widening trajectory lies ahead, and we continue to believe that once spreads reach the high end of ranges, buying interest is once again likely to emerge. Further details on this topic can be found in our recent [European Rates Weekly](#).

### Credit quality of supras and Moody's "scorecard"

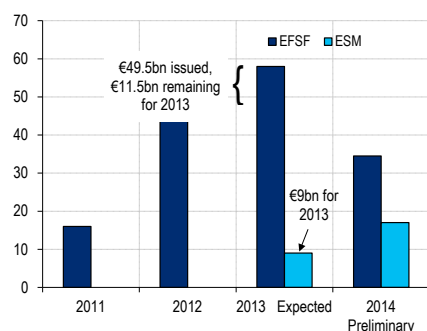
As well as affirming the Aaa ratings of the EU and the EIB in recent Credit Opinions, Moody's has published a draft proposal to revise its Credit Rating for supranational institutions. In short, the proposal is to introduce a reference "scorecard" that quantifies several factors to act as a stylized representation of their credit assessment. We welcome this enhancement and provide an overview of the core features in our piece [Euro SSA Strategy](#).

### ESM supply – a new species of bond

**European Stability Mechanism:** The ESM is now the permanent stability mechanism for the euro area. The EFSF is no longer active in new programmes but will continue to fund its existing commitments to Greece, Portugal and Ireland and to refi and manage existing debt until all loans have been repaid ([EFSF in June 2013: Au revoir, not adieu](#)). The ESM has commitments to Spain (up to €100bn) and Cyprus (€9bn) as detailed below.

**Supply outlook:** The ESM has indicated (August Investor Presentation) a preliminary supply pipeline for its long-term funding programme of €9bn for 2013 (and €17bn for 2014, Figure 19). Bonds may range in 1yr-30yr maturities, are likely to come in benchmark size and will be traded on the secondary market. However, note that ESM "issuance" has already occurred. The ESM has issued and provided €41.3bn of its capacity to the FROB in cashless securities to be used for the Spanish bank recapitalization package. It has also been issuing bills for much of the year (having taken over this responsibility from the EFSF) and such funds have already been used to provide Cyprus with €3bn in bailout resources. Further details can be found in our note, [Euro SSA Strategy - ESM Bond Supply Is Nearly Here](#).

Figure 50. EFSF and ESM Supply (€bn)



Source: Citi Research, EFSF, ESM

## (2) Primary market activity

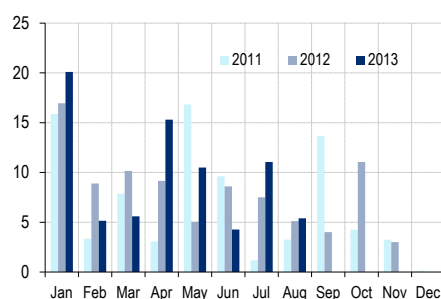
We detail European SSA supply data, including the key transactions of August, and provide completion rates for core issuers as well as upcoming cash flows.

Supply has picked up in late August and may rise further in September

**Supranationals:** Euro-denominated supranational supply in August was over €5bn (Figure 51). EFSF issued €3bn in a new benchmark bond, EFSF 3% Sep34s and EIB engaged in various taps across its curve.

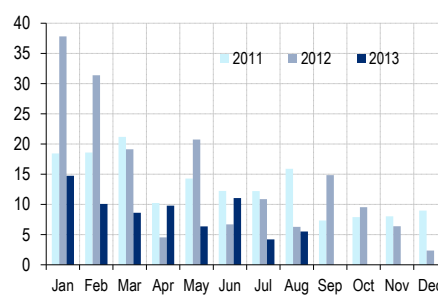
**Agencies:** Euro agency supply also totaled over €5bn in August (Figure 52) with benchmark issuance coming from KfW (€3bn in a new 10yr) and RENTEN (€1bn in a new 3yr).

Figure 51. EUR Supranational Issuance (€bn)



Source: Citi Research, Dealogic DCM Analytics

Figure 52. Non-US Agency EUR Supply (€bn)



Source: Citi Research, Dealogic DCM Analytics

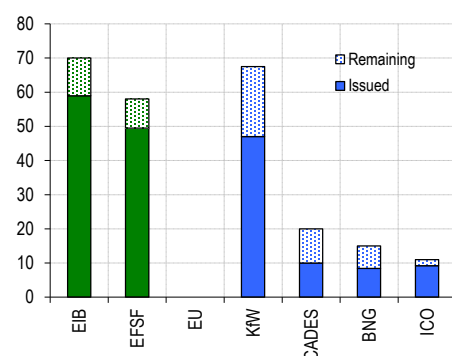
Many supras have now completed around 80% of their 2013 supply pipelines

**Completion rates:** Aggregating across currencies (Figure 53), many supranationals have issued around 80% of their 2013 supply targets (EIB 84%, EFSF 85%). Figure 54 and Figure 55 show monthly € supply for EIB and KfW which suggest issuance tends to pick up in September. Note KfW recently reduced its funding requirement and now expects total issuance in 2013 of €65bn-€70bn.

### Upcoming € cash flows in September:

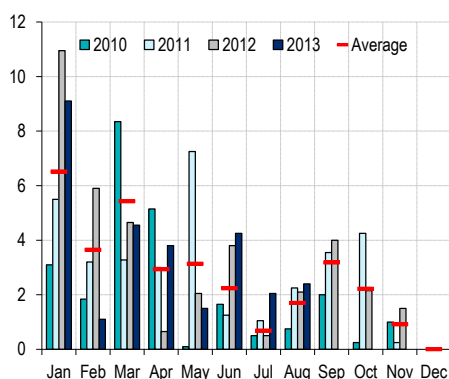
- €3bn redemption from CADES on 4<sup>th</sup> September (CADES 4.5% Sep13s)
- €1.5bn redemption from ICO on 10<sup>th</sup> September (ICO 4.5% Sep13s)
- €2.1bn redemption from FADE on 17<sup>th</sup> September (FADE 4.4% Sep13s)

Figure 53. European SSA Issuance Completion Rates, All Currencies, (€bn)



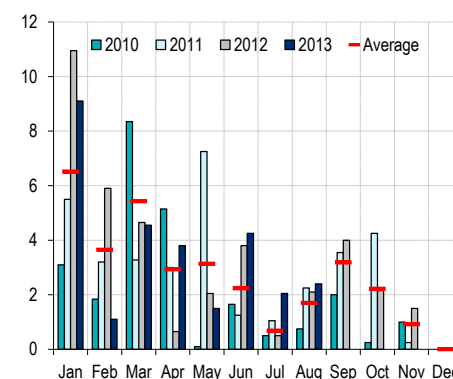
Source: Citi Research, Dealogic DCM Analytics, Issuers

Figure 54. EIB EUR Supply by month with average levels over recent years (€bn)



Source: Citi Research, EIB, Dealogic DCM Analytics

Figure 55. 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.

#### August total returns

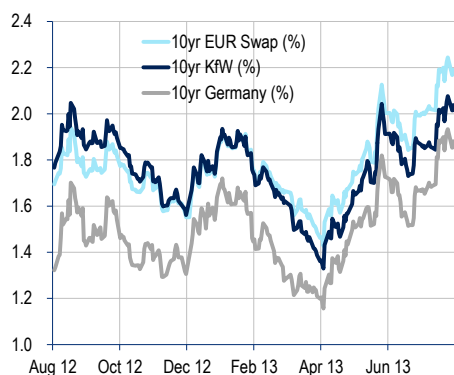
€ iBoxx Supranationals -0.64%

€ iBoxx Agencies -0.48%

**Returns in August:** Returns for € iBoxx Supranationals and € iBoxx Agencies over August were -0.64% and -0.48% respectively.

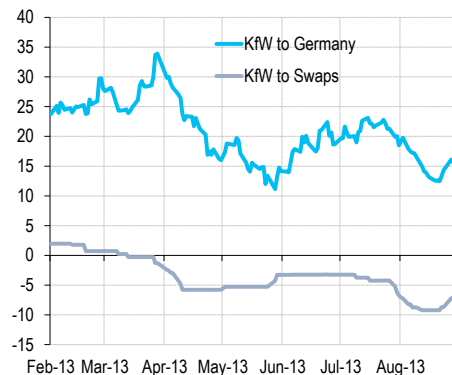
**Spread performance:** SSA yields generally moved higher in August, prompted by moves in global core yields on the back of improvements in economic data (Figure 56). However, in spread terms over the month of August, SSAs generally tightened. The tone has been a little softer recently, but 10yr KfW continues to trade well in ASW and spreads to Germany are near the low-end of existing ranges (Figure 57). The picture is similar regarding EIB (Figure 58).

Figure 56. 10yr KfW, Germany and € Swap



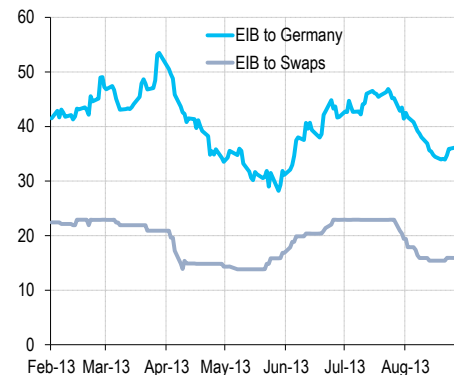
Source: Citi Research

Figure 57. 10yr KfW Spreads (bp)



Source: Citi Research

Figure 58. 10yr EIB Spreads (bp)



Source: Citi Research

**August moves:** Over August, core SSA yields sold off around 10bp-15bp (Figure 59) in a bear steepening trend (see overleaf). ASW spreads generally tightened by around 5bp and spreads to Germany also tightened. Single name moves for both core supranationals and agencies can be found overleaf.

Figure 59. Select 10yr Core SSA Bonds, Details and Performance in August

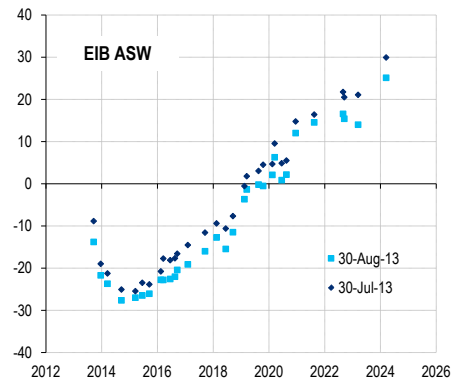
| Issuer      | Issue Date | Select Bond            | Maturity  | Amt Outstanding (€bn) | Yield Level (%) | Yield MoM Change (bp) | Spreads to Swaps |                 | Spreads to Germany |                 |
|-------------|------------|------------------------|-----------|-----------------------|-----------------|-----------------------|------------------|-----------------|--------------------|-----------------|
|             |            |                        |           |                       |                 |                       | Level (bp)       | MoM Change (bp) | Level (bp)         | MoM Change (bp) |
| EIB         | 04-Jun-13  | EIB 2% Apr23           | 14-Jul-13 | 4.00                  | 2.28            | 10                    | 15               | -6              | 42                 | -9              |
| EU          | 25-Apr-12  | EU 2.75% Apr22         | 04-Apr-22 | 2.70                  | 2.03            | 12                    | 4                | -4              | 17                 | -7              |
| EFSF        | 28-Aug-12  | EFSF 2.25% Sep22       | 05-Sep-22 | 3.97                  | 2.24            | 12                    | 19               | -5              | 38                 | -7              |
| KfW         | 09-Oct-07  | KfW 4.625 Jan23        | 04-Jan-23 | 3.00                  | 2.02            | 16                    | -7               | 0               | 16                 | -3              |
| CADES       | 11-Apr-11  | CADES 4.125% Apr23     | 25-Apr-23 | 5.02                  | 2.49            | 22                    | 36               | 5               | 63                 | 2               |
| BNG         | 19-May-11  | BNG 3.875% May23       | 26-May-23 | 1.50                  | 2.36            | 15                    | 22               | -1              | 50                 | -4              |
| iBoxx Index |            | € iBoxx Agencies       |           |                       | 1.80            | 14                    | 40               | 1               |                    |                 |
| iBoxx Index |            | € iBoxx Supranationals |           |                       | 2.05            | 12                    | 24               | -2              |                    |                 |

Source: Citi Research, Bloomberg



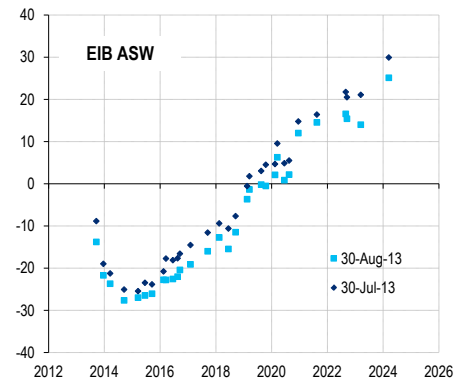
## € Supranational Yield and ASW MoM Changes

Figure 60. EIB Yield Curve, Now and 1m Ago



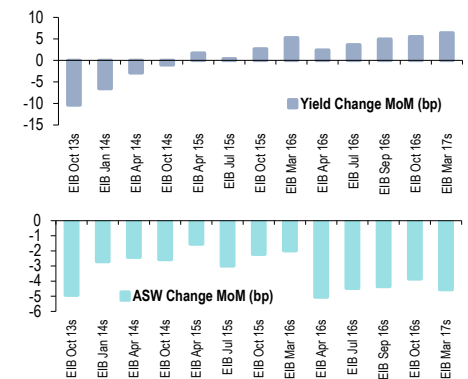
Source: Citi Research

Figure 61. EIB ASW Curve, Now and 1m Ago



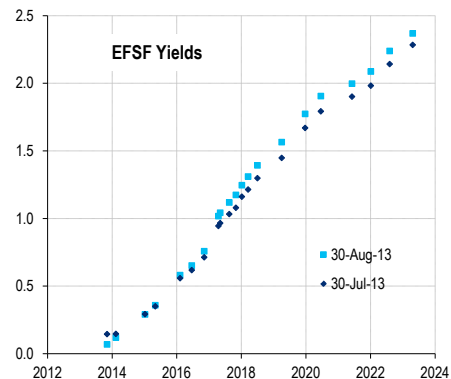
Source: Citi Research

Figure 62. MoM Yield and ASW Changes (bp)



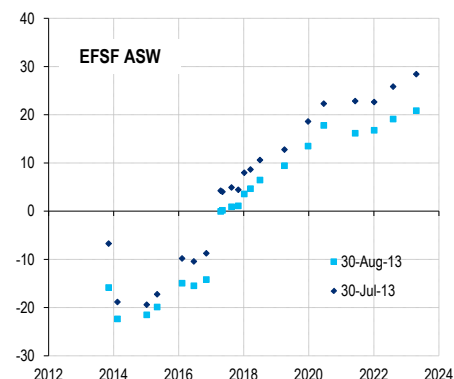
Source: Citi Research

Figure 63. EFSF Yield Curve, Now and 1m Ago



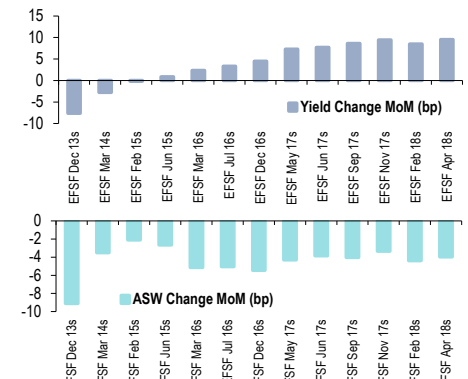
Source: Citi Research

Figure 64. EFSF ASW Curve, Now and 1m Ago



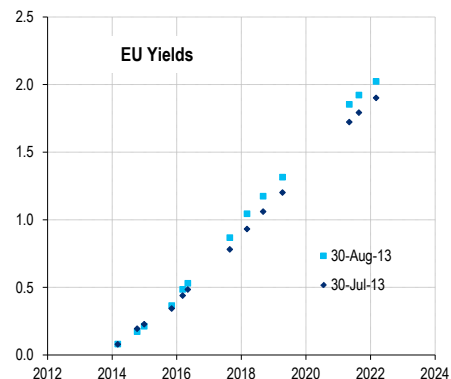
Source: Citi Research

Figure 65. MoM Yield and ASW Changes (bp)



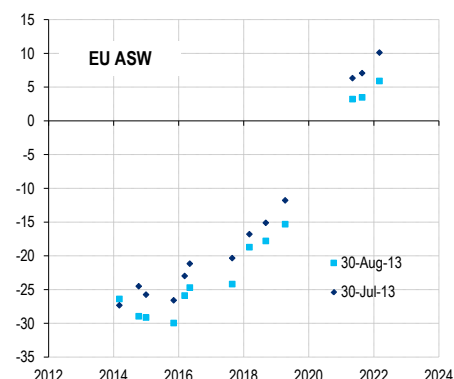
Source: Citi Research

Figure 66. EU Yield Curve, Now and 1m Ago



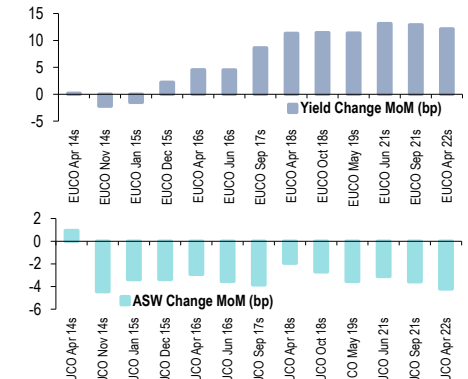
Source: Citi Research

Figure 67. EU ASW Curve, Now and 1m Ago



Source: Citi Research

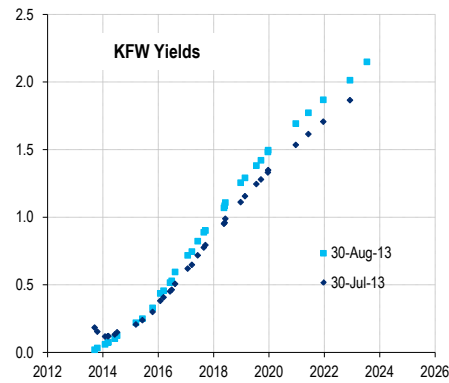
Figure 68. MoM Yield and ASW Changes (bp)



Source: Citi Research

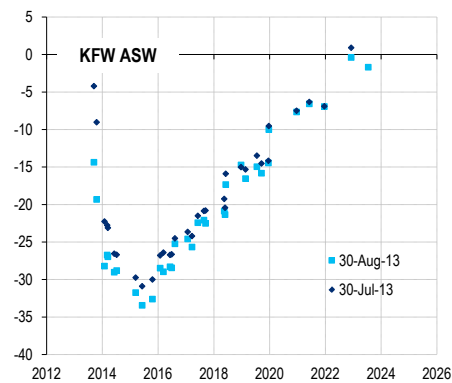
## € Agency Yield and ASW MoM Changes

Figure 69. KfW Yield Curve, Now and 1m Ago



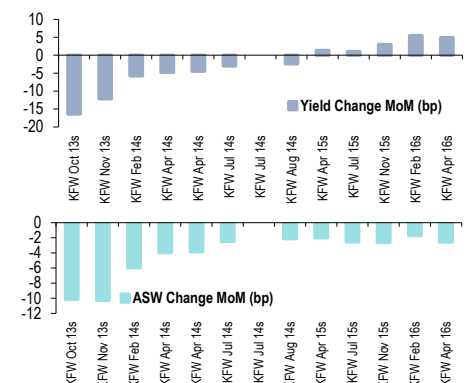
Source: Citi Research

Figure 70. KfW ASW Curve, Now and 1m Ago



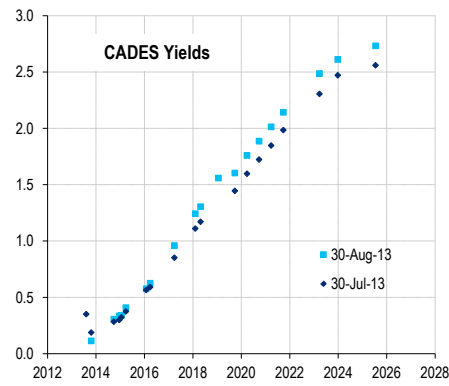
Source: Citi Research

Figure 71. MoM Yield and ASW Changes (bp)



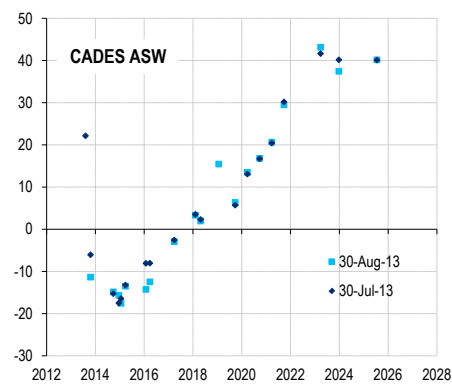
Source: Citi Research

Figure 72. CADES Yield Curve, Now &amp; 1m Ago



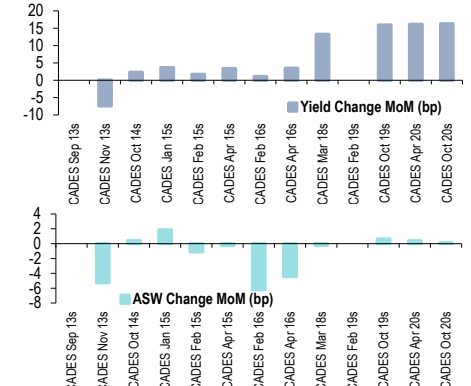
Source: Citi Research

Figure 73. CADES ASW Curve, Now &amp; 1m Ago



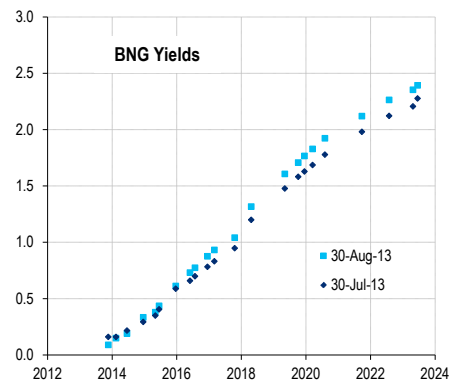
Source: Citi Research

Figure 74. MoM Yield and ASW Changes (bp)



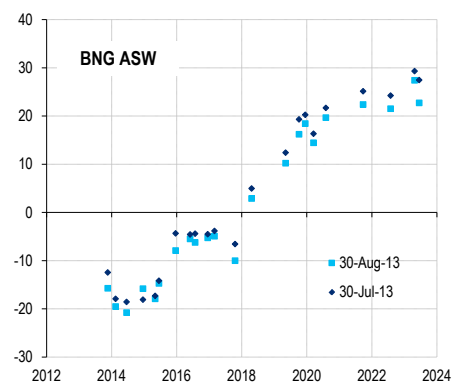
Source: Citi Research

Figure 75. BNG Yield Curve, Now and 1m Ago



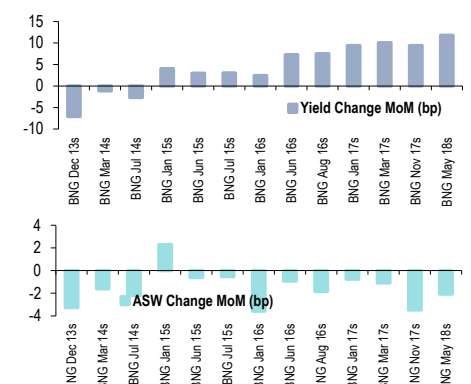
Source: Citi Research

Figure 76. BNG ASW Curve, Now and 1m Ago



Source: Citi Research

Figure 77. BNG Yield and ASW Changes (bp)



Source: Citi Research

# Covered Bond Strategy

## (1) Strategy views

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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. Moreover, we added country-specific recommendations

Figure 78. Recommendation sheet

| Covered Bond Segment | Portfolio recommendation | Changes | Environment   | Country-specific recommendation  |
|----------------------|--------------------------|---------|---|--|
| Australia            | Overweight               | ↗       | Non-Euro diversification, strong banking system, high contagion risk wrt. China             | Covered bonds of NZL affiliates caught up and look expensive against Australian covered bonds now                |
| Austria              | Overweight               | ⇒       | Fiscal and economic situation, positive net supply in covered bonds                         | Prefer covered bonds to RAGB and SSA; Prefer BACA to ERSTBK  |
| Belgium              | Neutral                  | ⇒       | Diversification, but rich versus other covered bond segments                                | Prefer covered bonds at the short-end and sovereign bonds at the longer end                                      |
| Canada               | Neutral                  | ↘       | Highly rated, healthy sovereign, expensive at current stage                                 | Inaugural issuances should be more attractive than current outstanding bonds                                     |
| Denmark              | Neutral                  | ⇒       | Weak property sector, strong sovereign  | Prefer covered bonds to senior secured bonds   |
| Finland              | Overweight               | ⇒       | Strong sovereign, high quality cover pools, latest cheapening vs peers                      | Prefer highest yielding name AKTIA   |
| France               | Overweight               | ⇒       | Attractive demand-supply pattern, relatively high secondary market liquidity                | In the short-term covered bonds lost attractiveness vs OAT; prefer BPCECB to all other BCPE issued covered bonds |
| Germany              | Neutral                  | ⇒       | Safe haven bid, very attractive demand-supply pattern, trading very expensive               | Prefer PBBGR to most expensive names; pfandbriefe look again expensive vs Bund                                   |
| Ireland              | Neutral                  | ⇒       | Easing situation on property market and the economy, backdrops to be expected               | Prefer MACS vs PSACS; Prefer covered bonds to government bonds   |
| Italy                | Underweight              | ⇒       | Generally weak capitalised banks, Headline risk   | OBG look expensive to BTP at current stages  |
| Netherlands          | Neutral                  | ⇒       | Deteriorating housing market, deteriorating macro outlook, attractive demand-supply pattern | Prefer SNS to other Dutch covered bond issuers   |
| New Zealand          | Neutral                  | ↘       | Non-Euro diversification  | Covered bonds of NZL affiliates caught up and look expensive against Australian covered bonds                    |
| Norway               | Overweight               | ⇒       | Strong sovereign, decreasing new issuance pressure  | Prefer highest yielding name EIKBOL  |
| Portugal             | Underweight              | ⇒       | Headline risk, contagion risk, relatively high quality cover pools                          | Reduce duration in CXGD without give-up  |
| Spain                | Underweight              | ⇒       | Weak housing market, attractive demand-supply pattern                                       | Prefer selected CEDGBP vs POPSM, IMCEDI vs BKIASM; Prefer BKTSM to SABSM and POPSM                               |
| Sweden               | Neutral                  | ⇒       | Trading rich to historical levels, favourable demand-supply pattern                         | Prefer highest yielding name LANSBK  |
| Switzerland          | Neutral                  | ⇒       | Overheating property market, strong sovereign   | --   |
| UK                   | Neutral                  | ⇒       | Non-Euro diversification, demand-supply pattern, slower than expected economic recovery     | Prefer covered bonds to senior bonds: spread is still at all-time lows   |

Source: Citi Research

## (2) Primary market activity

### Scandi supply on the brink

At the end of August, Sparebanken Vest Boligkreditt (SVEGNO) announced to return to the covered bond market with a EUR benchmark covered bond soon. In the following, we present key characteristics of the issuer.

#### SVEGNO is on the road

The issuer which has been established in May 2008 is a wholly owned special bank subsidiary of Sparebanken Vest. The parent company is the third largest savings bank in Norway with its main focus on Western Norway. Although the geographic concentration might be seen as a negative, one should note that this area is the economically most diversified and wealthiest region in Norway with unemployment rates below 1.9%. With this, the issuer is one of the few Norwegian saving banks which are not part of the Sparebank 1 Alliance, the second biggest covered bond issuer from Norway. According to Moody's, the bank's rating is driven by the following factors:

- The bank benefits from a sound market position in western Norway.
- The bank's reliance on market funding renders it vulnerable to fluctuations in investor sentiment.
- The earnings profile is supported by resilient core banking operations.
- The bank's asset quality is currently sound but its sizeable exposure to more volatile sectors pose downside risks.
- Capital adequacy is seen as adequate given the bank's risk profile.<sup>1</sup>

#### Business concentration to Norway

The bank's geographical concentration on Western Norway is also reflected in the cover pool composition. 95% of the loans are located in this region (Hordaland, Rogaland and Sogn & Fjordane with 79%, 10% and 6%, respectively). To reduce collateral risk, the issuer applies several eligibility criteria which are supportive for cover pool quality:

Figure 79. Cover pool eligibility criteria

| Eligibility criteria for cover pool |  |
|-------------------------------------|--|
| Customer criteria                   | Norwegian citizen, residency in Norway, Retail clients and independent self employed individuals |
| Credit criteria                     | Probability of default max 1.25%, not in arrears, not delinquent - 31 days or loss write-down    |
| Collateral                          | Max LTV 75%, recent valuations, quarterly valuation from independent 3rd party                   |
| Type of properties                  | Primary residences, cooperative housing loans, no holiday homes                                  |
| Type of products                    | Principal repayment loans, flexi-loans, fixed and floating rate loans                            |

Source: Sparebanken Vest Boligkreditt, Citi Research

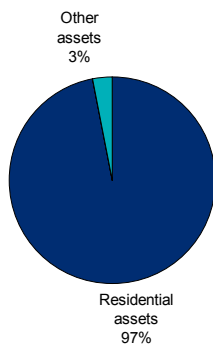
#### Current OC at 16.8%

As of 2Q13, the cover pool consisted of 35,682 loans totalling outstanding assets of NOK41.5bn and outstanding liabilities of NOK35.6bn resulting in an OC ratio of 16.8%. The issuer did not commit any OC to the rating agency. Moreover, the Norwegian covered bond law does not foresee any legal surplus OC requirements. The average loan balance therefore is NOK1.128mn. The pool consists exclusively

<sup>1</sup> Moody's: Credit Opinion: Sparebanken Vest, 05.04.2013

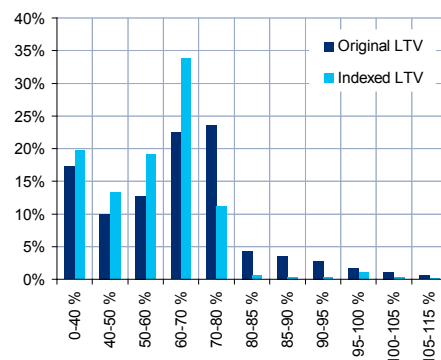
of 100% prime Norwegian residential mortgages with WA seasoning of 42 months and WA remaining terms of 278 months. The WA indexed LTV is at 54.6% at current levels. 0.04% of all loans are non-performing while all loans are variable rate loans.

Figure 80. Cover pool composition, %



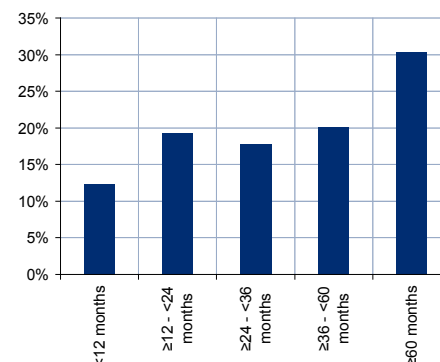
Source: Moody's, Citi Research

Figure 81. LTV distribution, %



Source: Moody's, Citi Research

Figure 82. Seasoning, months

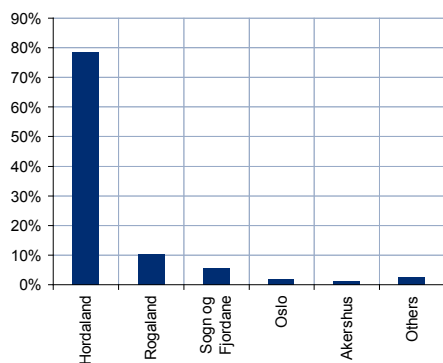


Source: Moody's, Citi Research

### The covered bonds are currently rated Aaa by Moody's

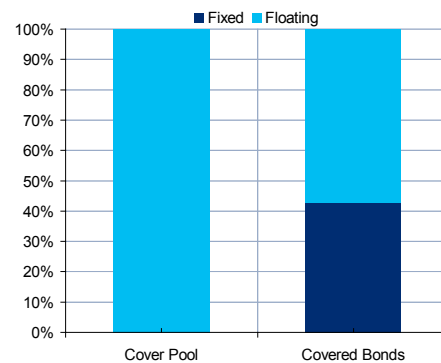
Moody's currently rates SVEGNO covered bonds with Aaa. As the rating agency sees the probability of timely payments as "high" (TPI of "high") Moody's grants the covered bonds a further rating buffer of two notches. This means that the covered bonds can withstand a two notch downgrade of the parent company and continue to be Aaa rated. Currently, the collateral score is 5.5% which is slightly higher than the Norwegian average but substantially better than the European average.

Figure 83. Geographical distribution, %



Source: Moody's, Citi Research

Figure 84. Interest rate matching, %



Source: Moody's, Citi Research

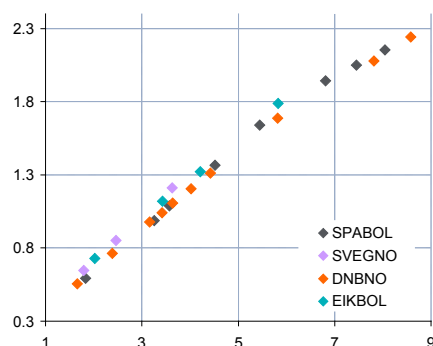
Figure 85. Key figures

|                                |            |
|--------------------------------|------------|
| Total Cover Pool               | NOK 41.3bn |
| Total Loan Balance (mortgages) | NOK 40.3bn |
| Average Loan Balance           | NOK1.128bn |
| Number of loans                | 35682      |
| OC level (eligible)            | 16.90%     |
| Number of properties           | 33303      |
| WA Seasoning (in months)       | 42         |
| WA remaining term (in months)  | 278        |
| WA indexed LTV                 | 54.60%     |
| Variable rates                 | 100%       |
| Defaults (Basel)               | NOK16m     |

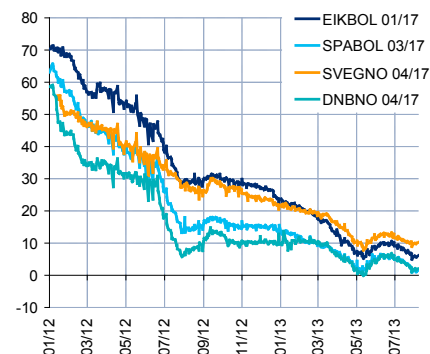
Source: Issuer, Citi Research

### Outstanding bonds trade higher than SPABOL and DNBO

SVEGNO is currently the smallest EUR benchmark covered bond issuer with only three bonds outstanding. Its secondary market levels are similar to those of EIKBOL. Both issuers are trading slightly cheaper than the bigger issuers DNBO and SPABOL. In general, we remain supportive with Norwegian covered bonds. We do not see justification for the spread differential between Norwegian covered bond issuers and its neighbours from Sweden and Finland. Within the Norwegian segment we would prefer to stick to the highest yielding entities, i.e. EIKBOL and SVEGNO. Moreover, we do not expect price affecting issuance pressure for the upcoming months. Several domestically introduced regulatory measures should continue to reduce the volume of secured funding for the rest of the year.

**Figure 86. Norwegian covered bond yield universe, %**

Source: Citi Research

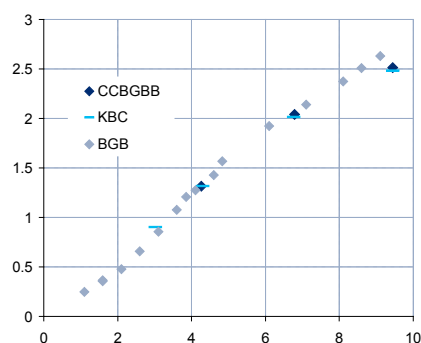
**Figure 87. Spread development, ASW-Spread, bp**

Source: Citi Research

### Primary market comes out of aestivation

#### Market activity came back

While SVEGNO should be expected to come to the market in the first two weeks of September, the first issuers wanted to make sure to be on stage ahead of the bulk of all issuers. Hence primary market activity gathered pace in the third week of August with four issuances and one tap amounting to €3.95bn. This was the biggest weekly amount since the end of May in 2013. Among those deals, there was one which brought back history. It's the new normality but only one year lasting that covered bonds are priced more expensive than government bonds in the primary market. Unicredit did a historical deal when it issued its OBG 100bp through the BTP curve in September 2012. The annual jubilee was underscored by a follow-up deal this August which was again 100bp inside the government curve. Given the absolute yield level development during the one year ongoing compression the latest deal shows that the "reverse" relation between government bonds and covered bonds is probably here to stay in several European countries.

**Figure 88. Belgian yield universe, %**

Source: Citi Research

In Belgium, which is the only non-peripheral country so far where covered bonds have been priced more expensive than OLOs in the primary market, the 3y covered bond issued by KBC offered a 10bp premium to the underlying sovereign markets. This can be traced back to the fact that covered bond curves in general are less steep than government bond curves leading to relative cheapness of the respective covered bonds versus the underlying government debt in the short end of the curve.

August gross issuance has again been a rather low amount (€6.7bn) compared to the last four years. Nevertheless, given the small amount of redemptions (€2.5bn), August has only been the second month in 2013 where net issuance developed positively. Given the high amount of redemptions in the next four weeks, we don't expect that September net issuance will follow this positive trend in net issuance.

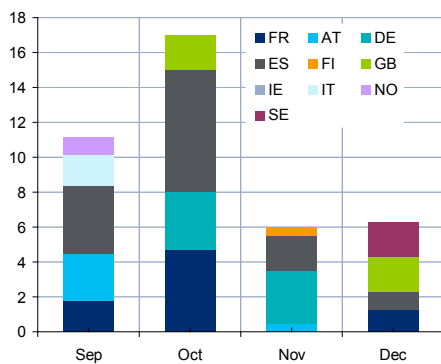
Nevertheless, for the upcoming days, we expect some further action on the primary market. While we mentioned above the return of SVEGNO, the inaugural issuance of the French La Banque Postale should be expected for the first two weeks of September (for more information, please see here: [European Rates Weekly - EMU spread outlook and downgrade concerns](#) as of 15.08.2013). Moreover, a structural novelty is about to be introduced to the market. NIBC's partial pass-through covered bond should be a topic in the next four weeks as well (more information on the structure, please see [European SSA and Covered Bond Monthly](#) of last month). Moreover, BACA might be returning to the Austrian pfandbrief market. Note that the issuer was active in July with a mortgage pfandbrief already while the issuer

announced to return with a public sector pfandbrief over the next months. Given the redemption of a public sector benchmark pfandbrief in September, the issuer would probably be able to react quickly after the maturing bond's redemption.

**But redemptions will probably again outweigh issuance activity in September**

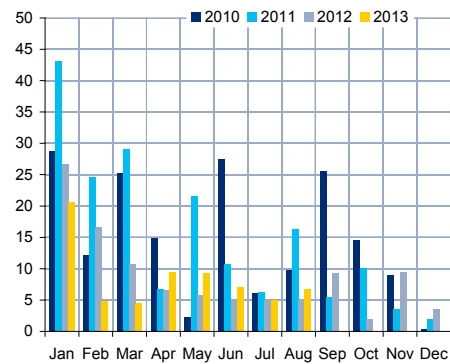
In general, redemptions in September are relatively high although this will be topped in October. For September, we expect €11.2bn covered bonds maturing. This is mainly concentrated on Spain and Austria, with €3.9bn and €2.75bn, respectively (see table in the appendix). Year to date, average net negative issuance per month was EUR7.4bn with now two months 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 89. Redemptions 2013, EURbn



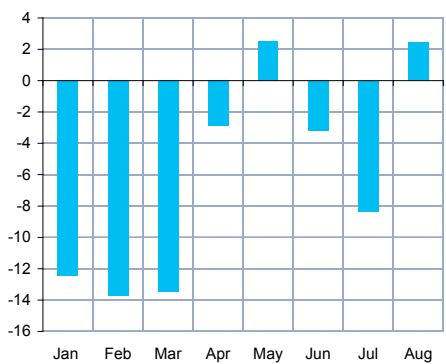
Source: Citi Research

Figure 90. Primary market activity, EURbn



Source: Citi Research

Figure 91. Net supply per month, ytd, EURbn



Source: Citi Research

### (3) Secondary market activity

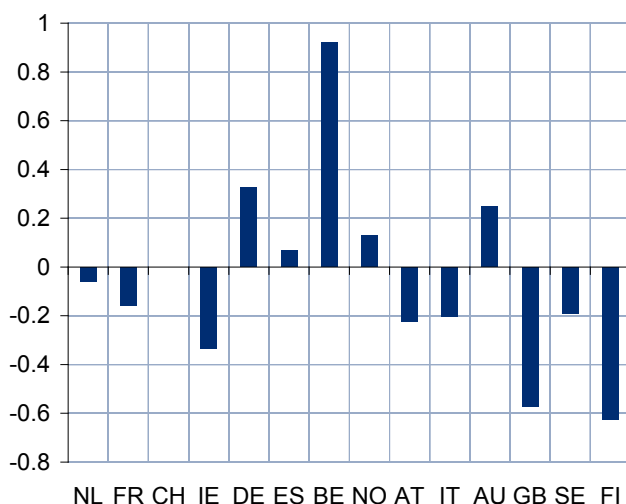
#### All segments developed positively in August

Secondary market development in August was positive in general. In summary, Spanish covered bonds performed best, followed by Italian OBG, Irish ACS and Portuguese covered bonds. ASW-spreads of all covered bond segments developed positively during this period. While the market rallied in the first two weeks following increasing interest since mid of July, spreads remained very stable over the last two weeks of August. With this, the “no news is good news” rally seems to have found an end. Selling interest increased this week with first effects on spreads. Moreover, the increase in primary market activities recently and the expected deals to come in September already led to respective pricing in the covered bond market recently.

#### Finland saw more sellers in August

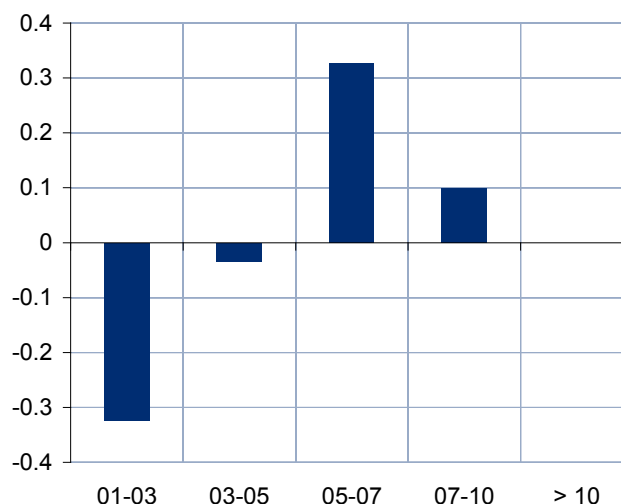
The graphs below describe in which segments net flow was positive or negative over the last month, based on electronically executed flows recorded by Bloomberg.<sup>2</sup> On the one hand this shows that the largest spread movements (Spain and Italy) do not implicitly go in hand with excess demand for these bonds. This finding should not surprise as it is especially such segments where spread changes are very often fuelled by non-trading price adjustments. Interestingly, the recent cheapening in the Finnish covered bond segment – mainly led by the expectation of relatively large supply by Nordea Bank Finland – can be found in the actual trading data as well. However, we also want to note that interpretation needs to be done with caution. UK covered bonds haven't seen any kind of sell-off. However, in light of very low trading volume, more sell tickets than buy tickets - measured by volume – have been recorded. In terms of buckets, buy interest has been dominating for maturities longer than five years.

Figure 92. Net flow in covered bonds during August per Segment, log



Source: Bloomberg, Citi Research

Figure 93. Net flow in covered bonds during August per bucket, log



Source: Bloomberg, Citi Research

<sup>2</sup> We are aware that phone trades and trades via other electronic platforms like Tradeweb are not recorded. However, we think that the picture that can be drawn with Bloomberg data is reliable. For this we filter data of the 100 most actively traded bonds via Bloomberg and sum the traded volume by country/bucket. Numbers below zero show that the number of buy tickets ordered by overall volume has been lower than the number of sell tickets. Numbers above zero show that the number of buy tickets ordered by overall volume has been bigger than the number of sell tickets. The level of the figure tells you something on the relative difference between sell and buy tickets but nothing on the absolute volume traded. Example in the graph above: Trading volume in Germany was biggest, but the number of sell tickets in comparison to buy tickets has been higher in UK and Finland.



### Covered bonds were profiting of July cheapening vs govies

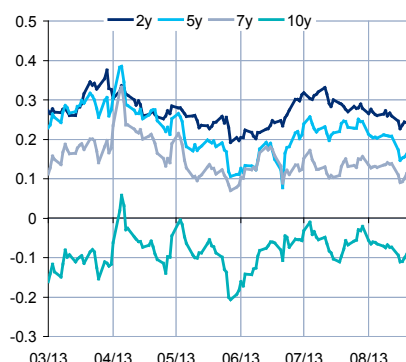
The cheapening of covered bonds versus government bonds that happened post-FOMC speech ended in July. Since then, our short-term recommendation to use the latest cheapening in French and Spanish covered bonds developed well so far. Since then, covered bonds were able to outperform its underlying sovereign debt in these countries.

Figure 94. Spreads cédules vs SPGB by tenor, ASW, %



Source: Citi Research

Figure 95. Spreads French covered bonds vs OAT by tenor, ASW, %



Source: Citi Research

Figure 96. Spreads pfandbriefe vs BUND by tenor, ASW, %



Source: Citi Research

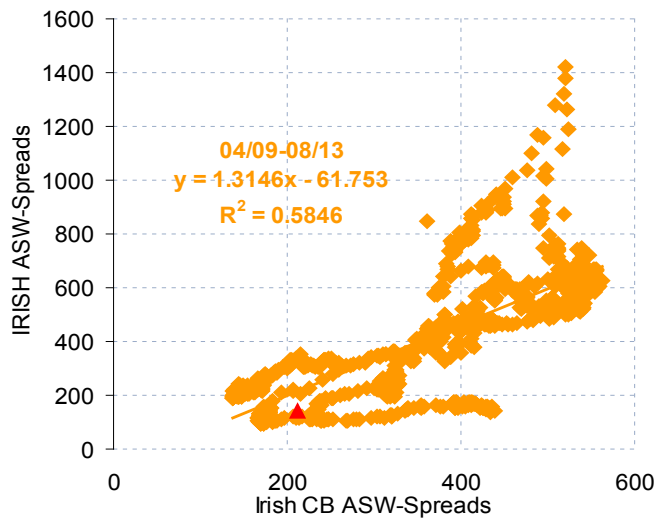
### Further potential is limited

In the short-term we don't think that the outperformance will continue. This is mainly due to the upcoming primary market activity that can be expected for the covered bond space in general. In the longer term, we still see added value in French covered bonds than in the underlying government debt. 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 – not only on the longer end of the curve. Obviously, this pattern is the case in Spain. However, it seems as if spreads to SPGB found their lows in March followed by range trading since then. We expect this to continue without any new lows in the near future. However, this also implies that we are convinced and expect covered bonds in Spain to continue trading more expensive than SPGB.

### OBG decoupled and seem to be too expensive versus BTO and cédules

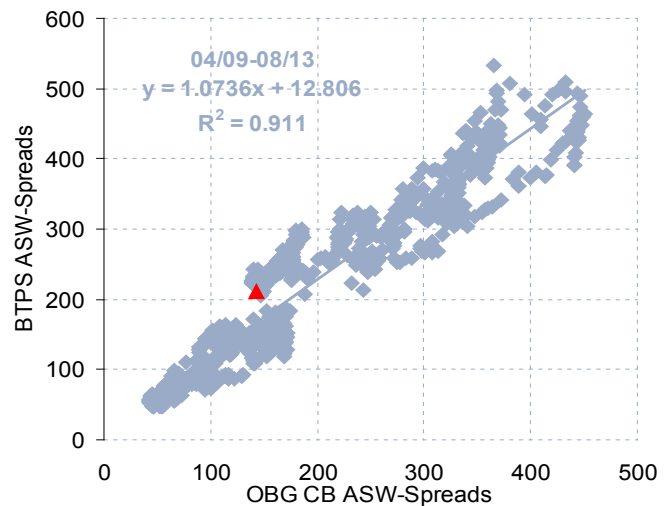
In the peripheral covered bond space, the decoupling we mentioned last month is still taking place. While the general re-pricing of risk in the aftermath of the tapering debate has been most pronounced in the peripheral covered bond segments in general, the volatility in Irish and Italian covered bond segments has been much lower than in Portuguese and Spanish covered bonds (see appendix for the respective graphs). However, it should be stated that the Portuguese covered bond segment underperformed cédules recently as it could not follow the tightening move like recorded for the Spanish covered bond segment. While we see the decoupling justified for Irish ACS issuers, we think that high short-term political risk is given especially for Italy. 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. 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 our latest [Global Economic Outlook and Strategy](#)). That said, it should be noted that we clearly see higher political risk for the Italian market. This implies that SPGB have the potential to outperform BTP. Hence, a continuation of the compression movement between cédules and OBG should be expected. This is why we also prefer Spanish over Italian covered bonds at current stage.

Figure 97. Relative cheapness of Irish ACS vs. IRISH, bp



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

Figure 98. Relative richness of Italian covered bonds vs. BTP, bp



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

#### We expect MACS to outperform IRISH in the longer term

In case of Irish ACS we continue to see this segment constructively. However, the potential of outperformance is more skewed to MACS issued by Bank of Ireland and AIB Mortgage Bank than to public sector ACS. Hence, the actively managed MACS not only seem attractive compared to other covered bond segments, they should also be preferred to Irish government bonds.

Since beginning of July, Irish government debt outperformed the secured paper. Hence, we think it is an interesting opportunity to switch to the MACS market. Ireland's 2Q13 market was a positive surprise as well as the pricing developments on the Irish property market. Here, the first annual house price increase since 2008 was recorded proving ongoing stabilization in the property market.

#### Australian covered bonds currently look cheap vs NZL covered bonds

In the APAC markets the last months also showed ongoing spread compression between Australian and New Zealand covered bonds. Given the fact that the NZL issuers are affiliates of the Australian covered bond entities, we argued that the historical spread difference of up to 30bp is unjustifiable.

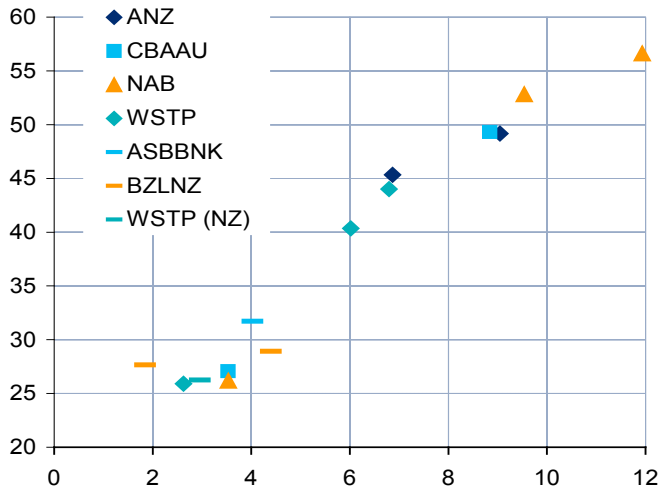
Over the last months, spreads were narrowing on a bond level (not on an index level given the different durations). We think that at current levels, the Australian covered bonds look cheap versus the secured paper of their New Zealand peers. This is especially the case for WSTP and NAB with their affiliates WSTP and BZLNZ.

There are several reasons for our stance that the current spread is seen as too narrow. On the one hand, NZL covered bonds are still structural covered bonds waiting for more than one year for the introduction of the covered bond law while AUS covered bonds are law based. Moreover, we expect liquidity in the Australian segment being higher given the higher amount of outstanding covered bonds. Comparing rating key figures, it is noticeable that Moody's Collateral Score – the lower the value, the better the cover pool quality – doesn't draw a clear picture.

While WSTP Australian cover pool is ascribed a higher cover pool quality than the pool of the New Zealand (8.2% and 10%, respectively), the picture is vice versa in case of CAB (8.8% vs 6.7%). At NAB and BNZNZ the key figures are very similar

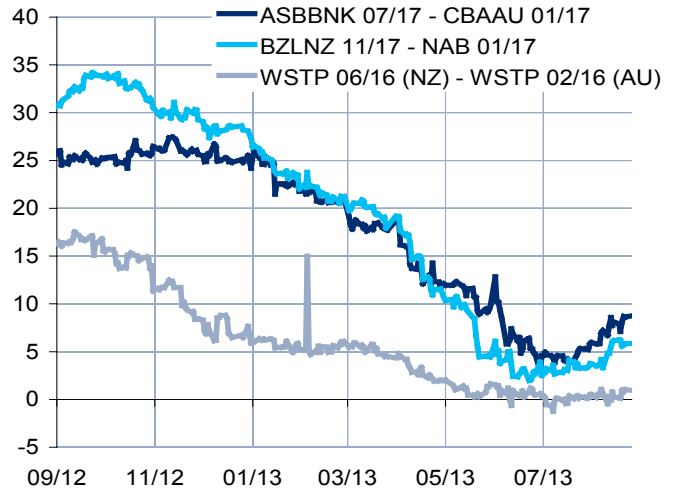
(9.4% and 9.1%, respectively). A key determinant should also be the robustness of the Aaa ratings all covered bonds currently display. And here is the main difference. All Australian covered bonds could withstand a four notch downgrade of the issuer while the leeway for New Zealand covered bonds is smaller (1 notch in all cases mentioned). Hence, we think at current levels a switch from covered bonds issued by NZL affiliates to the secured paper of its Australian parent companies looks attractive.

Figure 99. APAC EUR covered bonds, ASW-Spread, bp



Source: Citi Research

Figure 100. Australian covered bonds vs NZL affiliates, ASW-Spread, bp



Source: Citi Research

Figure 101. Spread performance table

|        | Current | EUR  | PB   | MPB  | PSPB | 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    | 87      | -1   | 74   | 74   | 74   | 48   | 53   | 50     | 54     | 50    | -61    | -59    | 76     | 61     | -206   | -182  | -112   | -303   | 72     | 56    | 50     | 68     | 53     | 61     | 68     | 64     | -19    |
| PB     | 14      | 73   | -1   | 0    | 0    | -26  | -21  | -24    | -20    | -24   | -134   | -133   | 2      | -13    | -280   | -256  | -186   | -377   | -2     | -18   | -24    | -6     | -20    | -13    | -6     | -10    | -93    |
| MPB    | 14      | 73   | 0    | -1   | 0    | -26  | -21  | -24    | -20    | -23   | -134   | -133   | 2      | -13    | -280   | -256  | -186   | -376   | -2     | -18   | -24    | -6     | -20    | -13    | -6     | -10    | -93    |
| PSPB   | 13      | 74   | 0    | 0    | -1   | -26  | -21  | -24    | -21    | -24   | -135   | -133   | 1      | -13    | -280   | -257  | -186   | -377   | -2     | -19   | -24    | -6     | -21    | -14    | -6     | -10    | -93    |
| OF     | 39      | 47   | -26  | -26  | -26  | -1   | 5    | 2      | 5      | 2     | -109   | -107   | 28     | 13     | -254   | -231  | -160   | -351   | 24     | 8     | 2      | 20     | 5      | 13     | 20     | 16     | -67    |
| OH     | 34      | 52   | -21  | -21  | -21  | 5    | 0    | -3     | 0      | -3    | -114   | -112   | 22     | 8      | -259   | -236  | -165   | -356   | 19     | 2     | -3     | 15     | 0      | 8      | 15     | 11     | -72    |
| FRA CB | 38      | 49   | -24  | -24  | -24  | 2    | -3   | -1     | 4      | 0     | -111   | -109   | 26     | 11     | -256   | -232  | -162   | -353   | 22     | 6     | 0      | 18     | 3      | 11     | 18     | 14     | -69    |
| AUT CB | 34      | 53   | -20  | -20  | -21  | 6    | 1    | 4      | -1     | -3    | -114   | -113   | 22     | 8      | -260   | -236  | -166   | -356   | 18     | 2     | -4     | 14     | 0      | 7      | 14     | 10     | -73    |
| NL CB  | 37      | 50   | -24  | -23  | -24  | 2    | -3   | 1      | -3     | -1    | -111   | -109   | 25     | 11     | -256   | -233  | -162   | -353   | 22     | 5     | 0      | 18     | 3      | 10     | 18     | 13     | -69    |
| ITL CB | 147     | -60  | -133 | -133 | -134 | -107 | -112 | -109   | -113   | -110  | -2     | 2      | 136    | 122    | -145   | -122  | -51    | -242   | 133    | 116   | 111    | 128    | 114    | 121    | 129    | 124    | 42     |
| IRL CB | 143     | -56  | -129 | -129 | -130 | -103 | -108 | -105   | -109   | -106  | 4      | -4     | 135    | 120    | -147   | -123  | -53    | -244   | 131    | 115   | 109    | 127    | 112    | 120    | 127    | 123    | 40     |
| CAN CB | 13      | 74   | 1    | 1    | 0    | 27   | 22   | 25     | 21     | 24    | 134    | 130    | 0      | -15    | -282   | -258  | -188   | -378   | -4     | -20   | -26    | -8     | -22    | -15    | -8     | -12    | -95    |
| NOR CB | 26      | 61   | -12  | -12  | -13  | 14   | 9    | 12     | 8      | 11    | 121    | 117    | -13    | -1     | -267   | -244  | -173   | -364   | 11     | -5    | -11    | 7      | -8     | 0      | 7      | 3      | -80    |
| POR CB | 289     | -202 | -276 | -276 | -276 | -250 | -255 | -252   | -256   | -252  | -142   | -146   | -276   | -263   | -5     | 24    | 94     | -97    | 278    | 262   | 256    | 274    | 259    | 267    | 274    | 270    | 187    |
| ES CB  | 267     | -180 | -253 | -253 | -254 | -228 | -233 | -229   | -233   | -230  | -120   | -124   | -254   | -241   | 22     | -3    | 70     | -120   | 254    | 238   | 232    | 250    | 236    | 243    | 250    | 246    | 163    |
| ESS CB | 198     | -111 | -184 | -184 | -185 | -158 | -163 | -160   | -164   | -161  | -51    | -55    | -185   | -172   | 91     | 69    | -2     | -191   | 184    | 168   | 162    | 180    | 165    | 173    | 180    | 176    | 93     |
| ESM CB | 385     | -298 | -371 | -371 | -371 | -345 | -350 | -347   | -351   | -347  | -238   | -242   | -372   | -359   | -95    | -118  | -187   | -6     | 375    | 358   | 353    | 371    | 356    | 363    | 371    | 367    | 284    |
| SWE CB | 16      | 71   | -2   | -2   | -3   | 24   | 19   | 22     | 18     | 21    | 131    | 127    | -3     | 10     | 274    | 251   | 182    | 369    | 0      | -16   | -22    | -4     | -19    | -11    | -4     | -8     | -91    |
| UK CB  | 31      | 56   | -17  | -17  | -18  | 9    | 4    | 7      | 3      | 6     | 116    | 112    | -18    | -5     | 259    | 236   | 167    | 354    | -15    | -2    | -6     | 12     | -2     | 5      | 12     | 8      | -75    |
| AUS CB | 36      | 51   | -23  | -23  | -23  | 3    | -2   | 1      | -3     | 1     | 111    | 107    | -23    | -10    | 253    | 231   | 162    | 348    | -21    | -6    | -2     | 18     | 3      | 11     | 18     | 14     | -69    |
| FIN CB | 20      | 67   | -6   | -6   | -7   | 20   | 15   | 18     | 14     | 17    | 127    | 123    | -7     | 6      | 270    | 247   | 178    | 365    | -4     | 11    | 16     | 0      | -15    | -7     | 0      | -4     | -87    |
| BEL CB | 34      | 53   | -20  | -20  | -20  | 6    | 1    | 4      | 0      | 4     | 113    | 109    | -21    | -8     | 256    | 233   | 164    | 351    | -18    | -3    | 3      | -14    | -1     | 7      | 15     | 10     | -72    |
| DEN CB | 27      | 60   | -13  | -13  | -13  | 13   | 8    | 11     | 7      | 11    | 120    | 116    | -14    | -1     | 263    | 240   | 171    | 358    | -11    | 4     | 10     | -7     | 7      | -1     | 7      | 3      | -80    |
| SUI CB | 19      | 68   | -5   | -5   | -6   | 20   | 15   | 19     | 15     | 18    | 128    | 124    | -6     | 7      | 270    | 248   | 179    | 366    | -3     | 12    | 17     | 1      | 15     | 8      | -1     | -4     | -87    |
| NZL CB | 23      | 64   | -10  | -10  | -10  | 16   | 11   | 14     | 10     | 14    | 124    | 120    | -10    | 3      | 266    | 244   | 175    | 361    | -8     | 7     | 13     | -3     | 10     | 3      | -4     | -1     | -83    |
| LUX CB | 106     | -19  | -92  | -92  | -92  | -66  | -71  | -68    | -72    | -68   | 41     | 37     | -93    | -80    | 184    | 161   | 92     | 279    | -90    | -75   | -69    | -86    | -72    | -79    | -87    | -82    | -1     |

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

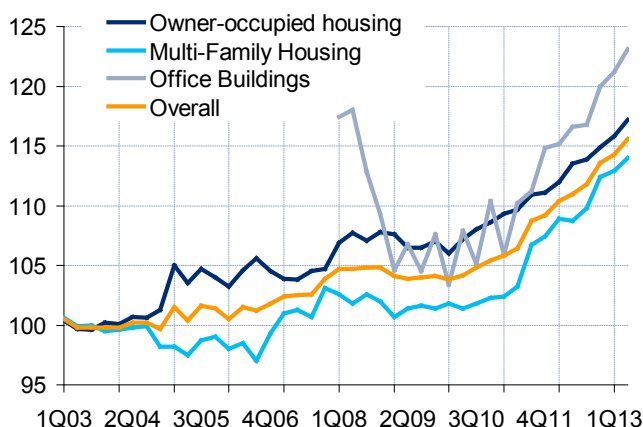
### Groundhog Day in Germany

The association of German pfandbrief banks recently published a note proving that property prices continued to increase. At the same time, they also provided fundamental justifications for this. We agree with this assessment and compare the results with developments seen in other European countries.

Prices have developed one-way for three years now

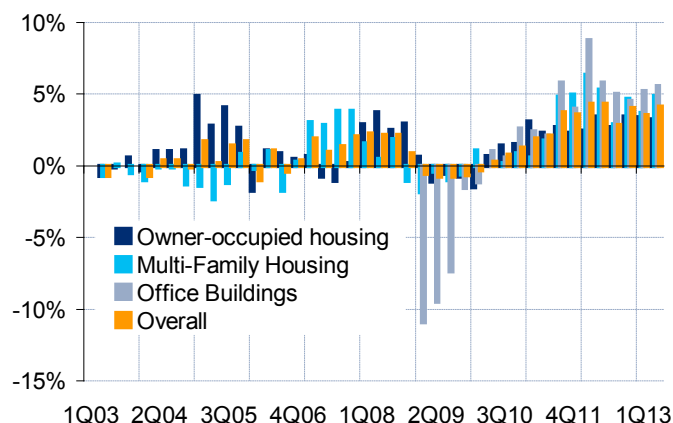
“Prices for owner occupied housing in Germany rise further” – the message of the quarterly published study of the German Association of pfandbrief banks (vdp) on the state of Germany’s property market hasn’t changed – since 2Q10. Moreover, according to the vdp, the surge in house prices can be derived from fundamental factors. This has also been repeated for the 12<sup>th</sup> time in a row. But is this still valid?

Figure 102. House price developments, 2003=100



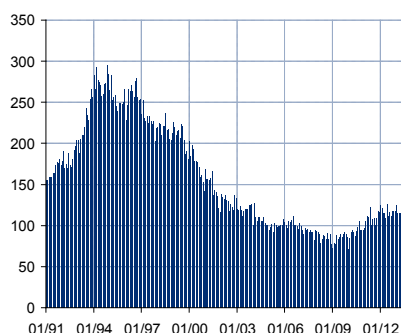
Source: vdp, Citi Research

Figure 103. Change in house price developments, yoy



Source: vdp, Citi Research

Figure 104. Housing construction in Germany, 2005=100



Source: Destatis, Citi Research

We opine that although the trend within the German property market has been positive over the last three years, we think that these price developments can be explained fundamentally. Compared to other European countries it still seems as if the German property market does not show severe price exaggerations but has potential to catch up. Given the economic outlook for Germany, further price increases can be expected. But against the background of our interest rate outlook (see [Global Economic Outlook and Strategy](#)) we also think that affordability continues to be given. Therefore, we expect the quality of the German mortgage cover pools to remain constant.

In 2Q13, the overall index for housing rose by 4.1%. This index is a composition of the indices for rented and owner occupied residential properties. All other markets developed similar. The index for multi-family houses rose by 4.9% yoy. This was mainly driven by a surge in demand for rental contracts (+4.6% yoy). The index for owner-occupied housing rose by 3.3% which was mainly driven by the market for condominiums recording an increase by 6% yoy. For single-family and semi-detached houses the surge in prices was less severe, with a 2.3% increase. Prices for office property increased by 5.6% yoy. Although news of the rising German property market has become repetitious over the last twelve quarters it still doesn’t make a bubble. The development of the German property market over the last three years is a break of the long-term trend. Before that, property prices have developed

extremely stable (or even negative) since 1970. Therefore, we don't think that the current price development already points to an overall price distortion.

**House price inflation was much more severe in other European countries**

That said, the severe price surges that are mainly concentrated to certain districts of specific (university) cities are probably first exaggerations that can be recorded. One main reason why the general trend is ticking upwards is that the demand is concentrating on cities while building permits have been very low area-wide over the last decade. This changed over the last two years and first investments have been made. Housing construction has been developing positively since 2010 after a 15 year lasting decline. This is a main difference to other European cities whose property markets were characterized by severe price exaggerations. While Netherlands might be a special case given their tax system (for more information, please see [Netherlands \(Aaa/AAA/AAA, neg. outlook\) - Risks vs Rewards](#)), Ireland and Spain still suffer the repercussions of such exaggerations. In France and UK, the positive trend on house prices has also been more significant than at current stage in Germany. The comparison of the price surges during the respective housing booms show that the upward trend in Germany is much less severe than in other countries during the last decade.

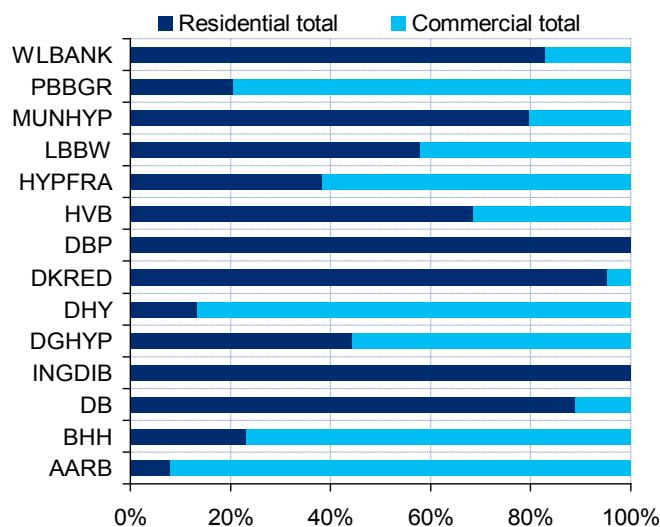
Figure 105. Nominal house price changes, yoy, %

|         | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---------|------|------|------|------|------|------|------|------|------|------|
| Ireland | 20.4 | 21.2 | 4.5  | 13.3 | 13.6 | 8.8  | 9.3  | 11.8 | -6.9 | -8.8 |
| Spain   | 9.6  | 7.7  | 11.1 | 17.3 | 18.5 | 17.2 | 12.8 | 9.1  | 4.8  | -3.2 |
| UK      | 11.5 | 14.3 | 8.4  | 17.0 | 15.7 | 11.8 | 5.5  | 6.3  | 10.9 | -0.9 |
| France  | 7.5  | 7.9  | 8.1  | 9.0  | 11.5 | 17.6 | 14.7 | 9.9  | 5.7  | -2.9 |
|         | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
| Germany | -1.0 | 0.6  | 3.6  | 0.3  | -0.3 | 4.3  | -1.3 | 0.7  | 2.0  | 2.7  |

Source: EMF, vdp, Citi Research

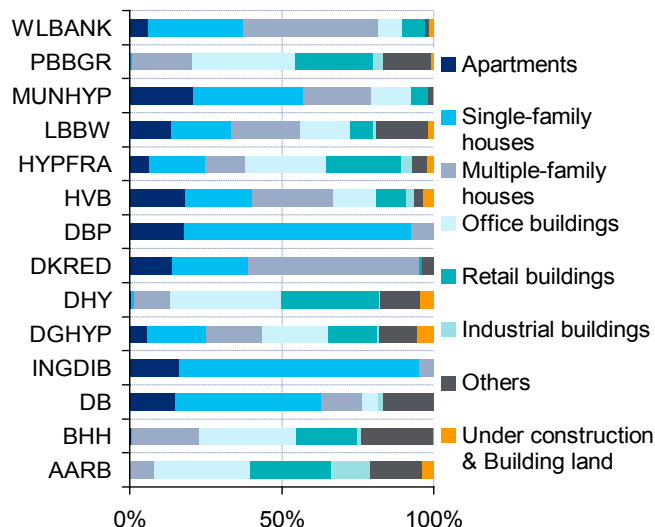
Below we added the cover pools of German mortgage pfandbriefe, splitting the pools by assets.

Figure 106. Mortgage pfandbriefe: cover pool composition I, %



Source: vdp, Citi Research

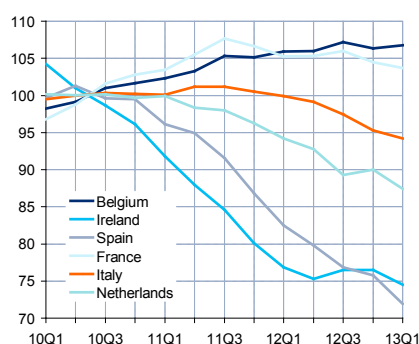
Figure 107. Mortgage pfandbriefe: cover pool composition II, %



Source: vdp, Citi Research

## €5bn for support of the Italian mortgage market

**Figure 108. European house price indices, 2000=100**



Source: Eurostat, Citi Research

## Market effects should not be overestimated

## Does a state guarantee help?

## CdP re-entering the covered bond stage?

Two weeks ago, Italian newspaper “Il Corriere” reported that the Italian government is working on a plan to re-boost the mortgage lending market<sup>3</sup> (for more information, please also see [Euro Area: Sovereign Debt Crisis Update](#) as of 12.08.2013).

According to the press report, the Italian government plans to set up a general plan to stop the substantial decline in mortgage lending and housing prices (see graph left). With this comes the plan to provide €5bn to CdP which should help to increase liquidity for smaller Italian banks and as a consequence restore lending to potential home-owners. The plan might be implemented soon and start in fall.

We understand that under this plan covered bonds will be issued by Italian banks. The €5bn of the government support transferred to CdP would then be used to guarantee these bonds. Moreover, the plan states that the liquidity which is collected by the issuance of these bonds would exclusively be used to finance mortgage loans. Apart from the preparation of the covered bond guarantee, it is additionally considered for CdP to buy securitized mortgages from Italian banks. At the beginning of the month, CdP presented its approved medium term business plan where the amount of total resources has been increased from €80bn to €95bn. The surplus 15% should be channeled to the economy through specific programs. This might also include the possibility to buy securitized mortgages to free up resources of the banks which eventually could be used for new mortgages, according to the newspaper.

This would clarify which path has finally been chosen with respect to CdP and its potential role in a revitalization of the mortgage lending market on the one hand and an improvement of the liquidity position for some Italian banks on the other hand. In the past, it was discussed if it made sense to use CdP as anchor investor for the issuance of multi-structures or single OBG (Obbligazioni Bancarie Garantite, covered bonds) in the hope of lower refinancing levels. However, this plan now seems to not have been set through. However, it would have been charming as the issuance of multi-OBG would have channeled through the proceeds to smaller and/or regional banks. Moreover, it was discussed if CdP was able act as the issuer for covered bonds. The small banks would have received proportionate proceeds depending on the amount of collateral transferred to CdP. Now, these possibilities do not seem to be under consideration.

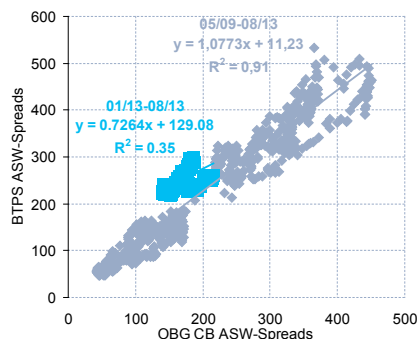
We think that the current arrangement will not have a substantial positive impact on the Italian mortgage lending and housing market - if introduced like described. Given the sheer size of the mortgage market (nearly €365bn, according to EMF), the €5bn guarantee should be too small to have significant positive impact on the lending market. Obviously, it is a positive that the proceeds should be exclusively used to finance mortgage loans. However, it still seems to be a drop in the bucket.

Apart from that, one should also question if a state guarantee will be as useful as it might have been some years ago. Italy was the first covered bond segment where covered bonds have been priced more expensively than government bonds. Currently, more than 67% of all outstanding Italian secured debt is trading below sovereign debt. Obviously, this is also traced back that the by far biggest covered bond programs are managed by pan-European banks which have been seen less risky than their smaller, domestically active peers and the sovereign for a while. Therefore, would it make sense for the small institutions to use the new structure –

<sup>3</sup> [http://www.corriere.it/economia/13\\_agosto\\_11/piano-casa-per-famiglie-imprese-prestiti-piu-facili\\_9e4556ce-024c-11e3-8e0b-f7765a3f55a3.shtml](http://www.corriere.it/economia/13_agosto_11/piano-casa-per-famiglie-imprese-prestiti-piu-facili_9e4556ce-024c-11e3-8e0b-f7765a3f55a3.shtml)



**Figure 109. Long-term correlation is extremely high, but much lower in the short-term**



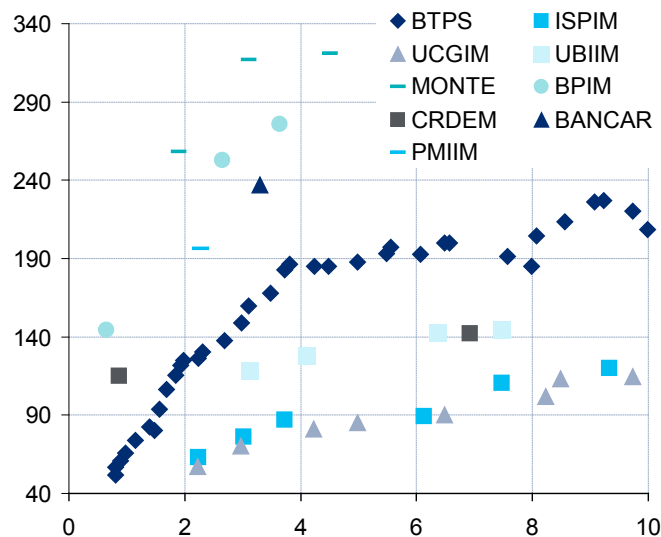
Source: Markit, Citi Research; 2013 = light blue, 05/09-08/13 = light grey

if implemented – with the involvement of CDP? And moreover, what's the long-term prospect of this plan given the extremely high correlation between BTP and OBG?

Currently, the Italian secondary market is divided upon the biggest banks which exclusively trade richer than sovereign bonds on the one hand. On the other hand the smaller banks trade softer than domestic government debt. The exception is CREDEM which is trading through the government curve in the 7yr spectrum. But given the different steepness in the government and the covered bond curve the issuer is trading cheaper on the front end of the curve.

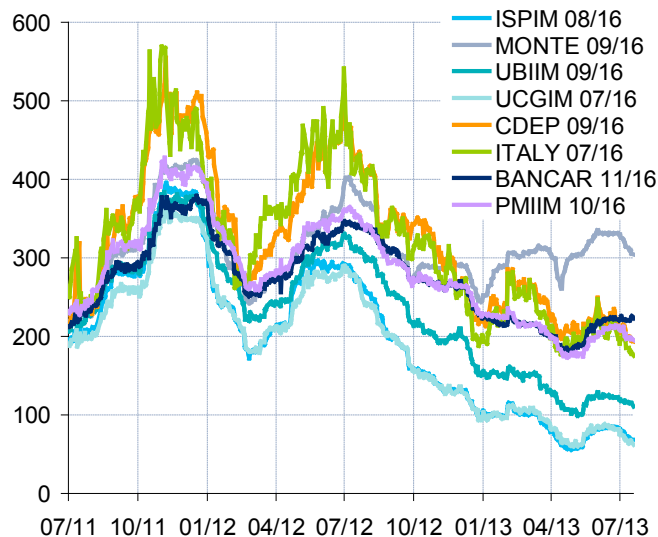
The right graph below shows secondary market levels for Italian covered bonds, CdP and the Italian government debt in the 3y sector. Note that CDEP 09/16 is not a covered bond (they used to have a covered bond program until some months ago). As mentioned above, the bigger banks ISPIM, UCGIM and UBIIM trade substantially more expensive than the rest of the Italian BTP and OBG universe. MONTE, whose bailout still needs to be approved by European regulators, is trading cheapest compared to its peers. The relational movement of OBG and BTP in the recent past was the outperformance of covered bonds until March 2013, followed by an underperformance until now. And this pattern can also be recorded for PMIIM, BANCAR and BPIM which are now trading cheaper than CDEP. Over the last two years, however, the potential future guarantor has been trading cheaper than most of the Italian covered bonds. Therefore, the surplus value of a guarantee provided by CdP might be limited, at least for the banks which are still active in the covered bond spectrum.

**Figure 110. Spread universe Italy, ASW-Spread, bp**



Source: Citi Research

**Figure 111. CDEP versus OBG, ASW-Spread, bp**



Source: Bloomberg, Citi Research

### Collateral + state guarantee is often not enough

One might argue that the pool of collateral provides surplus recovery in case of a default of the issuing bank and the guarantor. Hence, the bonds backed by a guarantee and a cover pool could trade more expensive than the guarantor's bonds and refinancing levels would therefore be more appealing for issuers. That said, reality is different in most cases in the covered bond space. There are many examples in the peripheral and core markets which show that the combination of physical collateral (i.e. not public sector backed bonds) and a guarantee is not price determinant and therefore not leading to lower refinancing costs. Therefore, we do

not expect to get substantially lower refinancing costs because of the role played by CDEP.

**An Italian CRH might make more sense**

In our eyes, one way to decrease refinancing costs for smaller Italian banks would be the introduction of an issuance vehicle/institution with several features to build up something similar to CRH in France. This issuer is characterized by the fact that several French banks are the institution's equity shareholders, among others the country's largest banks (Crédit Agricole 36.9%, Société Générale 13.8% and BNP Paribas 10.0% among others). At the same time, CRH refinances residential home loans which are granted by those aforementioned banks. A further clear advantage which CRH bondholders have compared to other French covered bonds is the fact that CRH has to obtain a legal overcollateralization ratio of 25% compared to 2%. We therefore think that one main assumption for a successful implementation of such entity would be the participation of Unicredit and Intesa Sanpaolo as equity shareholder while at the same time introducing legal features like a substantially high legal OC requirement or liquidity backup lines giving this special law a superior role to the current Italian covered bond law.

**But might be hard to introduce in the short- and medium-term**

However, we are also aware that this is not a plan which can be implemented in the short and medium term. Italy's government is still in a very fragile position. Tensions within the unusual (by Italian standards) PD-PdL grand coalition backing the government have recently intensified, after centre-right leader Silvio Berlusconi was sentenced to four years in jail for tax fraud. If the crucial Senate vote on 9 September forces Mr. Berlusconi out of Parliament — as seems likely at this point — the 4-month old government led by PD Enrico Letta may topple. The ballot boxes could be avoided in the immediate aftermath by finding a different coalition supporting a new temporary government, but our economists reckon new elections are most likely in 2014. High political uncertainty, fading political commitment to fiscal consolidation and structural reforms, rising public debt and economic stagnation look set to keep Italy highly vulnerable to any gyration in market sentiment. And in such environment, it seems likely that the €5bn program for CDEP is the highest achievable outcome for the revitalization of the Italian mortgage and property market.

## Carney – and why he may matter for UK covered bonds

Carney's first speech had some implications for the covered bond market. The broadening of asset eligibility for liquidity buffers should support demand for covered bonds. A revival of primary market activity, however, still seems unlikely in our view.

### UK banks hold too much liquidity

Yesterday, Mark Carney held his first speech as new governor of the Bank of England. For a summary of his speech, please see [UK - Carney Speech](#). Implications for the gilts market can be found here in detail: [UK Rates Strategy - Carney's speech: what does it mean for the front-end](#). While sticking broadly to macroeconomic themes, Carney also announced changes to the regulatory scheme for UK banks which should put banks "in a position to support the real economy." This might also affect the UK covered bond market (for more information on the UK covered bond market, please see [European SSA and Covered Bond Monthly - Sterling SSA and UK Covered bond markets in focus](#).)

### £90bn of holdings in government bonds should be reduced

The new macro-prudential measure which is planned to be introduced looks the following: for major banks which are meeting a 7% capital threshold, the BoE will reduce the level of required liquid assets holding. The consequence should be that the overall amount of total holdings required will be reduced by £90bn "once all eight major banks and building societies meet the capital threshold. That will help to underpin the supply of credit, since every pound currently held in liquid assets is a pound that could be lent to the real economy."<sup>4</sup> The eight banks which are referenced to are the most important issuers of UK covered bonds. The fact that UK regulators ask their banks to reduce liquidity buffers, i.e. an adjusted Liquidity Coverage Ratio - called the Individual Liquidity Guidance (ILG, see below) -, stems back to an earlier investigation by the Financial Policy Committee (FPC). The main results were that due to the expected capital situation of UK banks on the one hand and the access to central bank liquidity facilities on the other hand, a relaxation of liquidity requirements would be acceptable in order to grant credit to the economy.

### ...while the adjusted LCR can still be fulfilled

Hence, the Prudential Regulation Authority (PRA) agreed that those banks fulfilling the 7% capital threshold will need to fulfill the ILG which is broadly equivalent to an 80% of LCR. IF LCR comes into force in 2015 and is accurately defined by the European regulators until then, PRA will switch from the national ILG to the LCR. The asset composition of Basel's LCR and ILG is largely equivalent.

### Major change to the LCR composition was announced

The Level 2 bucket (40% limit incl. haircut) which the PRA will accept are assets pre-positioned at BoE's Discount Window Facility<sup>5</sup> or assets which the regulator will define in due course. As it is mentioned that the outcome should be similar to that of the nature of Basel's LCR, we expect an equivalent definition of level 2 assets. That is a major change. So far, high quality debt securities issued by a government, central bank and designated multilateral development bank as well as cash were the only assets eligible for the liquidity buffer in the UK.

## Implications

### This should support £ UK covered vs Gilts in theory

Carney's speech hasn't led to many implications in general. However, the main implications of the change in the liquidity framework for UK covered bonds will be twofold but not substantial in our eyes. In theory, the broader catalogue of eligible assets which also includes covered bonds, should lead to an increase of demand for such securities. The bigger effects would however be expected to be seen in the

<sup>4</sup> <http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech675.pdf>

<sup>5</sup> for eligibility under DWF, please refer to <http://www.bankofengland.co.uk/markets/Pages/money/eligiblecollateral.aspx>

GBP UK covered bond market and to a lesser degree in the EUR UK covered bond segment. In general the new amendments should be positive for outstanding UK covered bonds given the increasing demand for UK covered bonds. The simultaneous attempt to reduce holdings of £90bn of government debt should drive yields higher in this segment. Hence, there is an attractive opportunity to switch from UK Gilts to GBP UK covered bonds. That said, we think that the overall effects on secondary market liquidity for UK covered bonds should be negative.

Figure 112. UKT vs £ covered bonds, ASW-Spread, bp



Source: Bloomberg, Citi Research

Figure 113. The revised BIS Liquidity Coverage Ratio

| BIS Revised Liquidity Coverage Ratio (January 2013) |   |   |
|---|---|---|
| HQLA  | Level 1 (no limit - no haircut)           | Coins and bank notes  |
|   |   | Qualifying marketable securities from sovereigns, central banks, PSEs, multilateral development banks |
|   |   | Qualifying central bank reserves  |
|   | Level 2A (40% limit - 15% haircut)        | Domestic sovereign or central bank debt for non-0% risk weighted sovereigns                           |
|   |   | Sovereign, central bank, multilateral development banks, PSE assets qualifying for 20% risk weighting |
|   |   | Qualifying corporate debt rated AA- or higher   |
|   | Level 2B (15% limit - 25% or 50% haircut) | Qualifying Covered Bonds rated AA- or higher  |
|   |   | Qualifying RMBS   |
|   |   | Qualifying Corporate debt rated between A+ and BBB-   |
|   |   | Common equity shares  |

Source: BIS, Citi Research

#### The practice might look different

In practice, however, we doubt that the UK banks will start to reduce their liquidity buffers substantially. The new recommendation of PRA is what it is – a recommendation. Hence, UK banks are not forced to scale back their liquidity buffers. And given the longer-term prospect that a switch to LCR will take place in 2015 at the latest, there is less of an incentive to reduce liquidity buffers substantially – although UK guidelines are still stricter than the planned 60% LCR fulfillment for European banks as of 2015. But the main reason why we don't believe to see substantial changes to the liquidity buffers is that a high liquidity buffer is seen as a healthy sign by market participants.

#### We don't expect a boost for primary market activity

Carney's goal to transfer the liquidity which is currently stuck in the liquidity buffers to the "real" economy is honorable but we doubt that a substantial credit boost can be recorded following the new amendments. In theory, the implementation of the plan to boost lending for mortgages or to small businesses by decreasing "trapped" liquidity should support the overall recovery of the economy. As a consequence, the refinancing needs for such banks would increase as well, supporting new issuance of covered bonds and hence increase liquidity in this segment. Reality, however, might again be different. UK banks have relied on the FLS scheme for more than a year and can do until 2015. Lending, however, decreased at the same time.

## Covered Bond Rating Overview

Figure 114. Ratings of selected covered bond issuers

|                     |                              |                     |                              |                       |                              |
|---------------------|------------------------------|---------------------|------------------------------|-----------------------|------------------------------|
| <b>Australia</b>    | <b>S&amp;P/Moody's/Fitch</b> | DGHYP               | AAA/-/-                      | <b>New Zealand</b>    | <b>S&amp;P/Moody's/Fitch</b> |
| 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                   |
| <b>Austria</b>      | <b>S&amp;P/Moody's/Fitch</b> | HSHN                | --/Aa3/-                     | <b>Norway</b>         | <b>S&amp;P/Moody's/Fitch</b> |
| BACA                | --/Aaa /*-/-                 | HYPFRA              | --/Aa3/-                     | DNBNO                 | AAA/Aaa/AAA                  |
| BAWAG               | --/Aa1/-                     | INGDIB              | --/Aaa/-                     | EIKBOL                | --/Aa2/-                     |
| ERSTBK              | --/Aaa/-                     | LBBW                | --/Aaa/-                     | SPABOL                | --/Aaa/AAA                   |
| HYNOE               | --/Aaa/-                     |                     |                              | SVEGNO                | --/Aaa/-                     |
| KA                  | --/Aa2/-                     | MUNHYP              | --/Aaa/-                     | <b>Portugal</b>       | <b>S&amp;P/Moody's/Fitch</b> |
| RFLBNI              | --/Aaa/-                     | SPKKB               | --/Aaa/-                     | BCPPL                 | --/Ba1/BBB-                  |
| RFLBST              | --/Aaa/-                     | HVB                 | --/Aa1/AAA                   | BESPL                 | --/Baa3/-                    |
| VORHYP              | --/Aaa/-                     | WLBANK              | AAA/-/-                      | BPIPL                 | A-/Baa3/BBB                  |
| <b>Belgium</b>      | <b>S&amp;P/Moody's/Fitch</b> | <b>Germany (ps)</b> | <b>S&amp;P/Moody's/Fitch</b> | CXGD                  | --/Baa3/BBB-                 |
| KBC                 | --/Aaa/AAA                   | HVB                 | AAA/Aaa/-                    | SANTAN (PT)           | BB+/Baa3/BBB                 |
| CCBGBB              | AAA/-/AAA                    |                     |                              | <b>Spain</b>          | <b>S&amp;P/Moody's/Fitch</b> |
| <b>Denmark</b>      | <b>S&amp;P/Moody's/Fitch</b> | BHH                 | --/Aa1/AA-                   | BBVASM                | A-/A3/-                      |
| DANBNK              | AAA/-/AAA                    | DGHYP               | AAA/-/-                      | BKIASM                | BBB/Ba1/-                    |
| <b>Finland</b>      | <b>S&amp;P/Moody's/Fitch</b> | DKRED               | --/Aa1/-                     | BKTSM                 | A/A3/-                       |
| AKTIA               | --/Aa3/-                     | PBBGR               | AA+/Aa1/-                    | CABKSM                | AA-/A3/-                     |
| AKTIA               | --/Aaa/-                     | DPB                 | --/Aaa/AA                    | CAIXAC                | BBB/Ba2/-                    |
| NDASS               | --/Aaa/-                     | DEXGRP              | A+/-/-                       | CAZAR                 | A/Baa1 /*-/-                 |
| POHBK               | AAA/Aaa/-                    | HSHN                | --/Aa2/-                     | CRUNAV                | --/A3/-                      |
| SAMBNK              | --/Aaa/-                     | PBBGR               | AA+/Aa1/-                    | KUTXAB                | AA-/A3/-                     |
| <b>France</b>       | <b>S&amp;P/Moody's/Fitch</b> | HYPFRA              | --/Aa3/-                     | NOVAGA                | BBB+/Ba2u/BBB+ /*-           |
| ACACB               | AAA/Aaa/AAA                  | LBBW                | --/Aaa/AAA                   | POPSM                 | --/Baa2/-                    |
| ACASCF              | AAA/Aaa/-                    |                     |                              | SABSM                 | --/A3 /*-/-                  |
| AXASA               | --/Aaa/AAA                   | MUNHYP              | --/Aaa/-                     | SANTAN                | --/A3/A                      |
| BNPPCB              | AAA/-/AAA                    | NDB                 | --/Aaa/AAA                   | <b>Sweden</b>         | <b>S&amp;P/Moody's/Fitch</b> |
| BNPSCF              | AAA/-/AA+                    | WLBANK              | AAA/-/-                      | LANSBK                | AAA/Aaa/-                    |
| BPCECB              | AAA/Aaa/-                    | <b>Ireland</b>      | <b>S&amp;P/Moody's/Fitch</b> | NDASS                 | --/Aaa/-                     |
| BPCOV               | AAA/-/-                      | AIB                 | A/Baa3/A                     | SBAB                  | AAA/Aaa/-                    |
| CAFFIL              | AAA/Aaa/AA+                  | BKIR                | --/Baa3/-                    | SEB                   | --/Aaa/-                     |
| CDEE                | AAA/Aaa/-                    | DEPFA               | BBB/A3/A                     | SHBASS                | --/Aaa/-                     |
|                     |                              | ERSTAA              | --/A3/-                      | SPNTAB                | AAA/Aaa/-                    |
| CIFEUR              | --/Aa2/AA+                   | <b>Italy</b>        | <b>S&amp;P/Moody's/Fitch</b> | <b>Switzerland</b>    | <b>S&amp;P/Moody's/Fitch</b> |
| CMARK               | AAA/Aaa/-                    | BANCAR              | --/Baa1/BBB+                 | UBS                   | --/Aaa/AAA                   |
| CMCICB              | AAA/Aaa/AAA                  | BPIM                | --/Baa2/BBB+                 | CS                    | --/Aaa/AAA                   |
| CRH                 | --/Aaa/AAA                   | CRDEM               | --/A2/A+                     | <b>United Kingdom</b> | <b>S&amp;P/Moody's/Fitch</b> |
| GE                  | AAA/Aaa/-                    | ISPIM               | --/A2/-                      | ABBEY                 | AAA/Aaa/AAA                  |
| HSBC                | AAA/Aaa/-                    | MONTE               | --/Ba1/A                     | BACR                  | AAA/Aaa/AAA                  |
| SOCSCF              | AAA/Aaa/-                    | PMIIM               | --/Baa2 /*-/A- /*-           | COVBS                 | --/Aaa/AAA                   |
| SOCSEFH             | --/Aaa/AAA                   | UBIIM               | --/A2/A+                     | LLOYDS                | AAA/Aaa/AAA                  |
| <b>Germany (m.)</b> | <b>S&amp;P/Moody's/Fitch</b> | UCGIM               | AA/A2/A                      | NRKLN                 | AAA/Aaa/AAA                  |
| AARB                | --/-/AAA                     | <b>Netherlands</b>  | <b>S&amp;P/Moody's/Fitch</b> | NWIDE                 | AAA/Aaa/AAA                  |
| HVB                 | --/Aa1/AAA                   | ABNANV              | AAA/Aaa/AAA                  | RBS                   | --/Aaa /*-/AAA               |
| BHH                 | --/Aa1/AA+                   | ACHMEA              | --/Aa2/AAA                   | <b>USA</b>            | <b>S&amp;P/Moody's/Fitch</b> |
| DB                  | AAA/Aaa/-                    | INTNED              | AAA/Aaa/AAA                  | BAC                   | A+/A1/AA-                    |
|                     |                              | SNSSNS              | --/A1 /*-/AA+                | JPM                   | A+/-/AA-                     |

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

## Covered Bond Rating Overview – Multi Cédulas

Figure 115. Ratings of selected Multi-Cédulas

| AYTCED                 | ISIN         | S&P/Moody's/Fitch | CEDTDA                  | ISIN         | S&P/Moody's/Fitch |
|------------------------|--------------|-------------------|-------------------------|--------------|-------------------|
| AYTCED 4.75 04.12.2018 | ES0370148019 | A+/A3 /*-/BBB     | CEDTDA 4.5 26.11.2013   | ES0317019000 | A/Baa1 /*-/BBB    |
| AYTCED 4.5 04.12.2013  | ES0370148001 | AA-/A3 /*-/BBB    | CEDTDA 4.375 03.03.2016 | ES0317043000 | A-/A3 /*-/BBB     |
| AYTCED 4 07.04.2014    | ES0312360003 | A+/Baa1 /*/BBB    | CEDTDA 4.125 29.11.2019 | ES0317045005 | BBB/Baa1 /*-/BBB  |
| AYTCED 4 07.04.2014    | ES0312360011 | A+/Baa1 /*/BBB    | CEDTDA 3.875 23.05.2025 | ES0317046003 | BBB-/Baa1 /*-/BBB |
| AYTCED 4 18.11.2014    | ES0312362009 | A+/A3 /*-/BBB     | CEDTDA 3.5 20.06.2017   | ES0317047001 | BB+/Baa1 /*-/BB+  |
| AYTCED 4.25 18.11.2019 | ES0312362017 | A-/A3 /*-/BBB     | CEDTDA 4.25 10.04.2031  | ES0371622020 | BBB-/Baa1 /*-/BBB |
| AYTCED 3.75 31.03.2015 | ES0312358007 | BBB/Baa1 /*-/BBB  | CEDTDA 4.125 10.04.2021 | ES0371622012 | BBB-/Baa1 /*-/BBB |
| AYTCED 4 31.03.2020    | ES0312358015 | BBB/Baa1 /*-/BBB  | CEDTDA 4 23.10.2018     | ES0371622038 | A-/A3 /*-/BBB     |
| AYTCED 3.75 30.06.2025 | ES0312342019 | BBB/Baa1 /*-/BB+  | CEDTDA 4.25 28.03.2027  | ES0371622046 | BBB-/A3 /*-/BBB   |
| AYTCED 3.5 14.03.2016  | ES0312298013 | BBB/A3 /*-/BBB    | IM CEDULAS              |              |                   |
| AYTCED 3.75 14.12.2022 | ES0312298021 | BBB-/Baa1 /*-/BBB | IMCEDI 4.5 11.06.2014   | ES0347859003 | --/Baa1 /*/BBB    |
| AYTCED 4 24.03.2021    | ES0312298054 | BBB/Baa1 /*/BBB   | IMCEDI 4 19.11.2014     | ES0347852008 | A-/WR/--          |
| AYTCED 4.25 14.06.2018 | ES0312298070 | BB+/Baa1 /*-/BB+  | IMCEDI 3.75 11.03.2015  | ES0347848006 | BBB/Baa3 /*/--    |
| AYTCED 4.25 25.10.2023 | ES0312298096 | BBB-/A3 /*-/BBB   | IMCEDI 3.5 15.06.2020   | ES0347849004 | BB+/-/--          |
| AYTCED 3.75 25.10.2013 | ES0312298088 | A+/Baa1 /*-/BBB   | IMCEDI 3.5 02.12.2015   | ES0362859003 | BBB-/Baa1 /*/--   |
| AYTCED 4 20.12.2016    | ES0312298104 | A-/A3 /*-/BBB     | IMCEDI 4 31.03.2021     | ES0347784003 | --/A3 /*-/BBB     |
| AYTCED 4 21.03.2017    | ES0312298112 | BBB-/A3 /*-/BBB   | IMCEDI 4.25 09.06.2016  | ES0347785000 | --/Baa1 /*-/BB+   |
| AYTCED 4.75 25.05.2027 | ES0312298120 | BB+/Baa1 /*-/BBB  | IMCEDI 4.5 21.02.2022   | ES0349045007 | --/Baa1 /*-/BBB   |
| AYTCED 4.75 15.06.2016 | ES0312298229 | AA-/--/--         | PITCH                   |              |                   |
| AYTCED 4.25 29.07.2014 | ES0312298237 | A+/Baa1 /*/--     | PITCH 5.125 20.07.2022  | ES0334699008 | A-/A3 /*/--       |
| AYTCED 4.5 02.12.2019  | ES0312298245 | A/Baa2 /*/--      |                         |              |                   |
| AYTCED 3.75 25.05.2015 | ES0312298252 | AA-/Baa2 /*/--    |                         |              |                   |

Source: Bloomberg, Citi Research

## Covered Bond Rating Actions August 2013

Figure 116. Rating actions in the covered bond universe

| Issuer             | Program       | Country | Agency  | From  | To        | Reason   |
|--------------------|---------------|---------|---------|-------|-----------|--|
| HSH Nordbank       | Mortgage      | Germany | Moody's | Aa2   | Aa3       | Downgrade has been prompted by the issuer's decision not to put in place over-collateralisation (OC) in a committed form that would have been sufficient to maintain an Aa2 rating on the covered bonds. |
| Dexia Kommunalbank | Public Sector | Germany | S&P     | A     | A+        | Available overcollateralisation has increased making a A+ rating possible  |
| Mediobanca         | Mortgage      | Italy   | S&P     | BBB*- | BBB (neg) | Negative outlook reflects that on the issuer   |
| Banco Popular      | Mortgage      | Spain   | S&P     | BBB   | BBB+      | The issuer decreased Asset-Liability mismatch risk of the covered bond program   |

Source: Bloomberg, Citi Research



## Redemptions September 2013

Figure 117. Redemption payments: September 2013

| Issuer Name   | Ticker | Coupon | Maturity   | Announce   | Amount (EURmn) | Country |
|---|--------|--------|------------|------------|----------------|---------|
| Erste Group Bank AG   | ERSTBK | 1.625  | 02.09.2013 | 24.08.2010 | 750            | AT      |
| BAWAG PSK Bank fuer Arbeit und<br>Wirtschaft und Oesterreichische<br>Postsparkasse AG | BAWAG  | 1.75   | 02.09.2013 | 26.08.2010 | 500            | AT      |
| SpareBank 1 Boligkreditt AS   | SPABOL | 5      | 10.09.2013 | 03.09.2008 | 1000           | NO      |
| Kommunalkredit Austria AG   | KA     | 4.5    | 10.09.2013 | 02.09.2003 | 1000           | AT      |
| Banco Popular Espanol SA  | POPSM  | 3.5    | 13.09.2013 | 31.08.2010 | 800            | ES      |
| CaixaBank   | CABKSM | 3.125  | 16.09.2013 | 02.09.2010 | 1000           | ES      |
| Banco Pastor SA   | POPSM  | 3.875  | 20.09.2013 | 13.09.2006 | 1300           | ES      |
| Bankinter SA  | BKTSM  | 3.75   | 23.09.2013 | 09.09.2010 | 750            | ES      |
| Banca Monte dei Paschi di Siena SpA   | MONTE  | 2.5    | 23.09.2013 | 14.09.2010 | 1250           | IT      |
| Banca Carige SpA  | BANCAR | 2.375  | 25.09.2013 | 01.09.2010 | 550            | IT      |
| UniCredit Bank Austria AG   | BACA   | 1.875  | 27.09.2013 | 16.09.2010 | 500            | AT      |
| GCE Covered Bonds SA  | CDEE   | 2      | 30.09.2013 | 16.09.2010 | 1750           | FR      |

Source: Citi Research

## Covered Bond Performance

Figure 118. iBoxx Covered Bond Indices: Total Return in August 2013, %

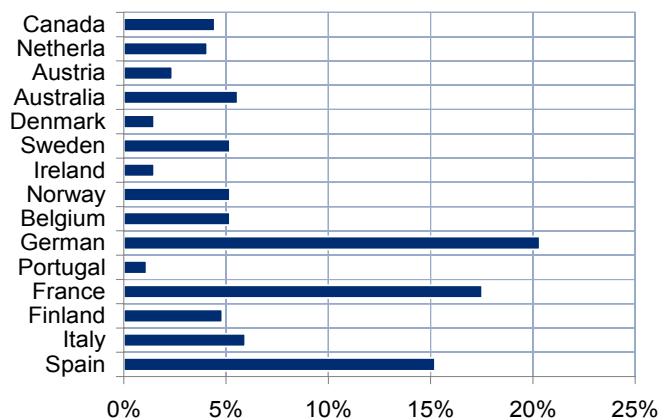
| Segment                      | Absolute | Δ 1m  | Δ ytd | Δ 1y  |
|------------------------------|----------|-------|-------|-------|
| Australian Covered Bonds     | 96.99    | -0.6% | --    | --    |
| Austrian Covered Bonds       | 134.38   | -0.5% | -0.2% | 1.0%  |
| Belgian Covered Bonds        | 96.95    | -0.6% | --    | --    |
| Canadian Covered Bonds       | 124.59   | -0.5% | 0.0%  | 1.3%  |
| Danish Covered Bonds         | 98.23    | -0.5% | --    | --    |
| Dutch Covered Bonds          | 142.69   | -0.5% | -0.3% | 1.0%  |
| EUR Covered                  | 193.39   | -0.1% | 1.7%  | 5.3%  |
| Finnish Covered Bonds        | 98.70    | -0.4% | --    | --    |
| French Covered Bonds         | 208.21   | -0.5% | 0.4%  | 2.1%  |
| Irish Covered Bonds          | 142.66   | 0.1%  | 2.5%  | 8.8%  |
| Italian Covered Bonds        | 126.43   | 0.1%  | 2.8%  | 9.2%  |
| Luxembourg Covered Bonds     | 99.03    | -0.5% | --    | --    |
| Mortgage Pfandbriefe         | 190.60   | -0.4% | -0.4% | 0.4%  |
| New Zealand Covered Bonds    | 98.90    | -0.3% | --    | --    |
| Norwegian Covered Bonds      | 134.33   | -0.4% | -0.2% | 0.5%  |
| Obligations à l'Habitat      | 129.37   | -0.1% | 0.5%  | 1.0%  |
| Obligations Foncières        | 141.56   | -0.5% | 0.6%  | 2.6%  |
| Pfandbriefe                  | 185.03   | -0.3% | -0.2% | 0.5%  |
| Portuguese Covered Bonds     | 141.14   | 0.3%  | 4.7%  | 14.9% |
| Public Sector Pfandbriefe    | 183.47   | -0.3% | 0.0%  | 0.6%  |
| Spanish Covered Bonds        | 191.90   | 0.8%  | 6.6%  | 17.0% |
| Spanish Multi Covered Bonds  | 131.51   | 1.7%  | 9.0%  | 26.2% |
| Spanish Single Covered Bonds | 127.33   | 0.5%  | 5.5%  | 13.3% |
| Swedish Covered Bonds        | 131.44   | -0.2% | -0.1% | 0.4%  |
| Swiss Covered Bonds          | 98.58    | -0.4% | --    | --    |
| UK Covered Bonds             | 142.69   | -0.3% | 0.2%  | 1.9%  |

Source: Markit, Citi Research



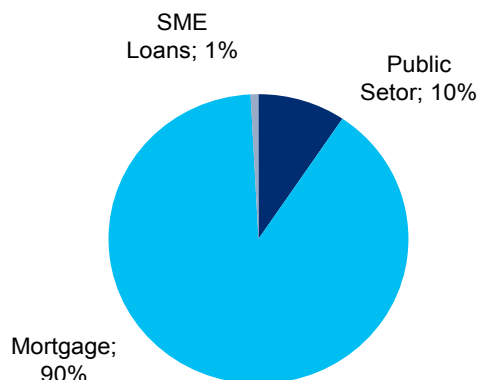
## Primary Market 2013: EUR benchmark covered bonds

Figure 119. Geographical distribution, %



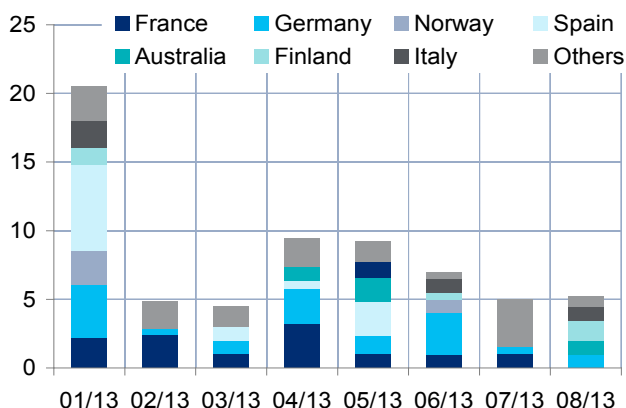
Source: Citi Research

Figure 120. Distribution by Collateral, %



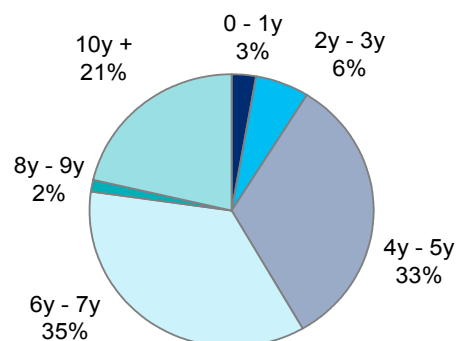
Source: Citi Research

Figure 121. Issuance by month



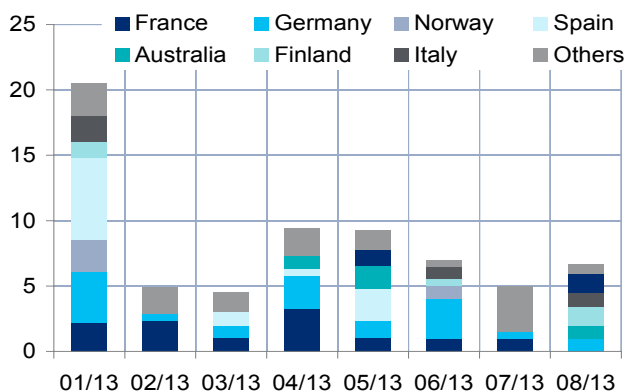
Source: Citi Research

Figure 122. Issuance by maturity, %



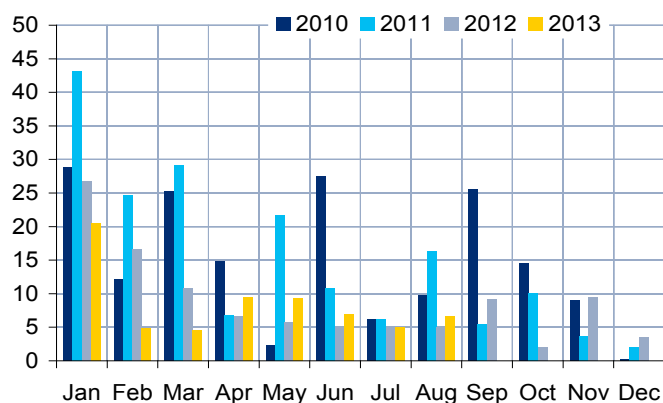
Source: Citi Research

Figure 123. Selection of primary deals' performance after 5 trading days



Source: Citi Research

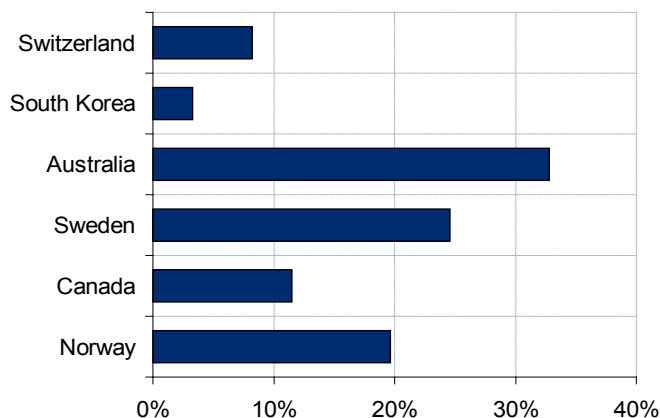
Figure 124. Historical new issuance, EURbn



Source: Citi Research

## Primary market 2013: USD Benchmark covered bonds

Figure 125. Geographical distribution, %



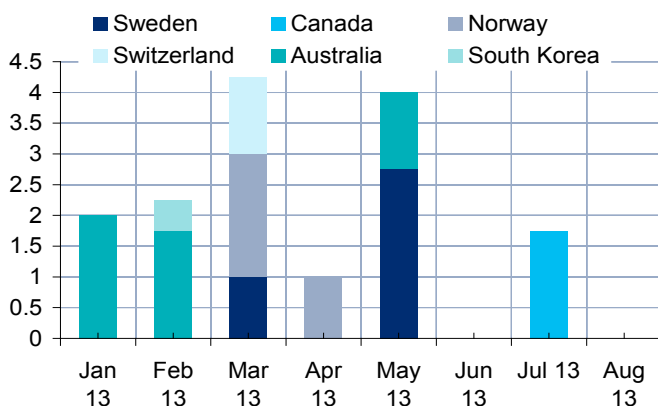
Source: Citi Research

Figure 126. Distribution by Collateral, %



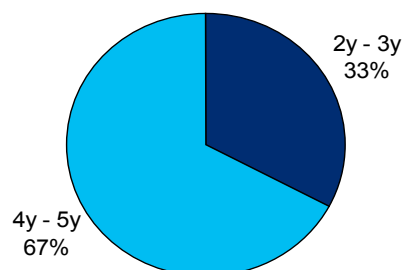
Source: Citi Research

Figure 127. Issuance by month



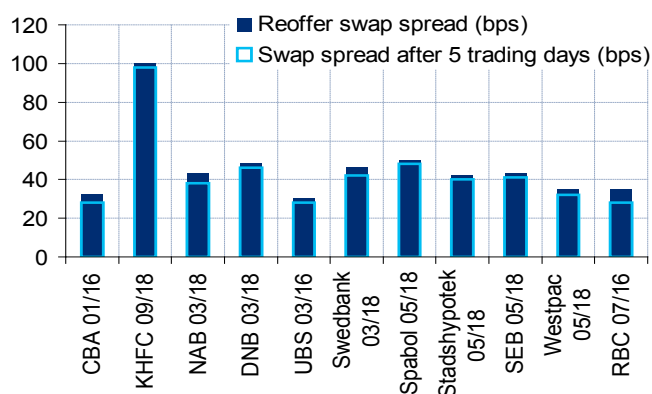
Source: Citi Research

Figure 128. Issuance by maturity, %



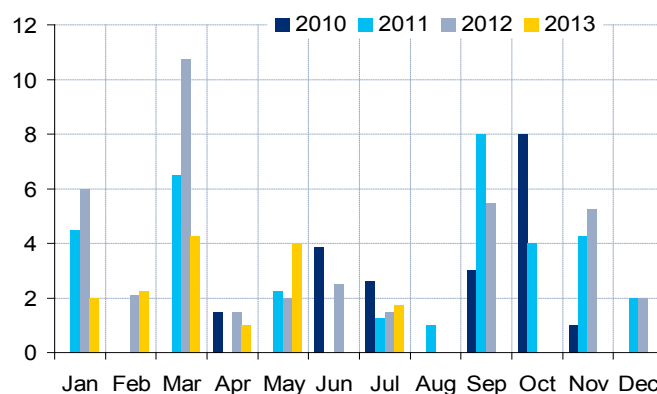
Source: Citi Research

Figure 129. Selection of primary deals' performance after 5 trading days



Source: Citi Research

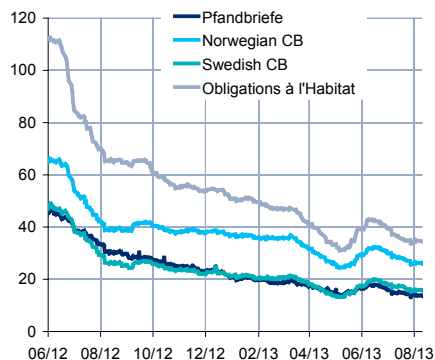
Figure 130. Historical new issuance, USDbn



Source: Citi Research

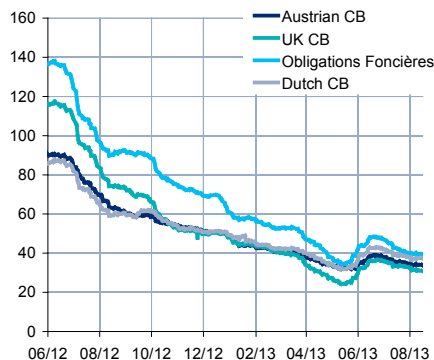
## Secondary Market 2013: EUR Benchmark covered bonds

Figure 131. Secondary Market Performance, ASW-Spreads, bp



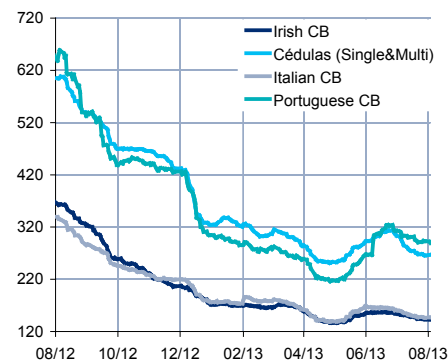
Source: Citi Research, Markit

Figure 132. Secondary Market Performance, ASW-Spreads, bp



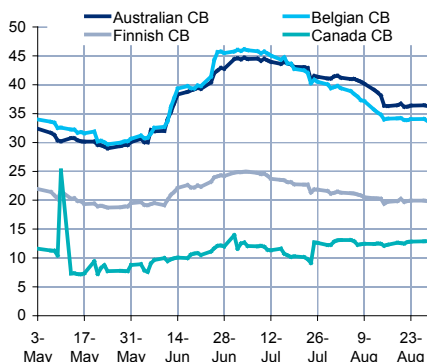
Source: Citi Research, Markit

Figure 133. Secondary Market Performance, ASW-Spreads, bp



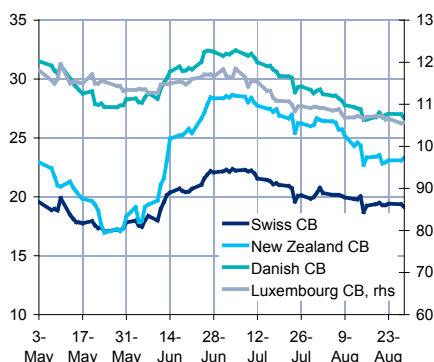
Source: Citi Research, Markit

Figure 134. Secondary Market Performance, ASW-Spreads, bp



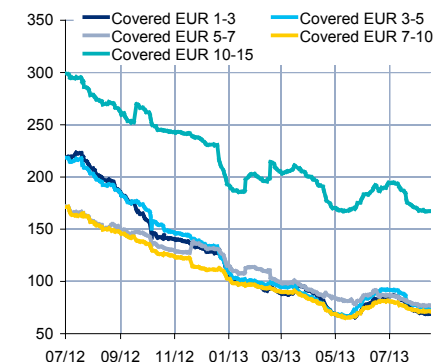
Source: Citi Research, Markit

Figure 135. Secondary Market Performance, ASW-Spreads, bp



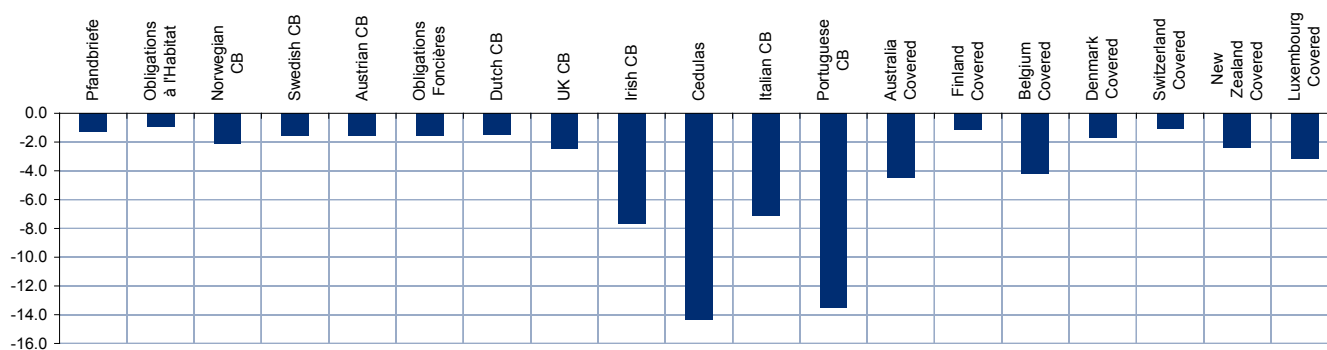
Source: Citi Research, Markit

Figure 136. Secondary Market Performance, ASW-Spreads, bp



Source: Citi Research, Markit

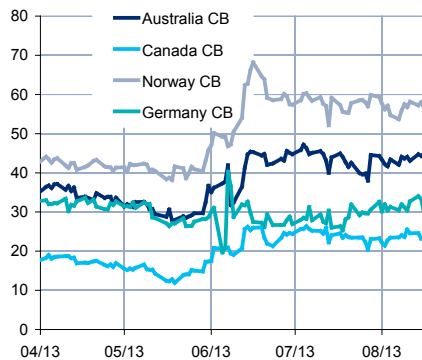
Figure 137. Spread performance over the last month



Source: Markit, Citi Research

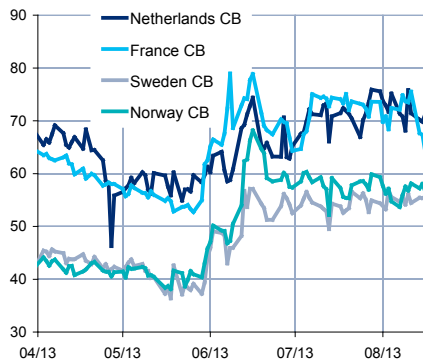
## Secondary Market 2013: USD Benchmark covered bonds

Figure 138. Secondary Market Performance, ASW-Spreads, bp



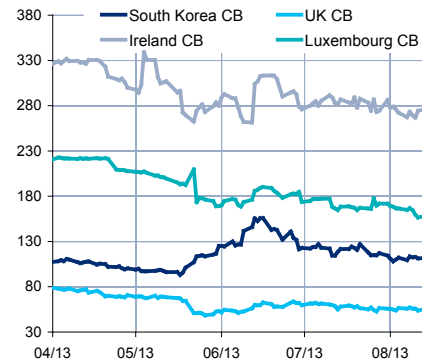
Source: Citi Research, Markit

Figure 139. Secondary Market Performance, ASW-Spreads, bp



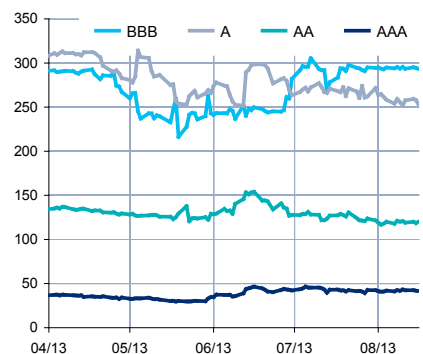
Source: Citi Research, Markit

Figure 140. Secondary Market Performance, ASW-Spreads, bp



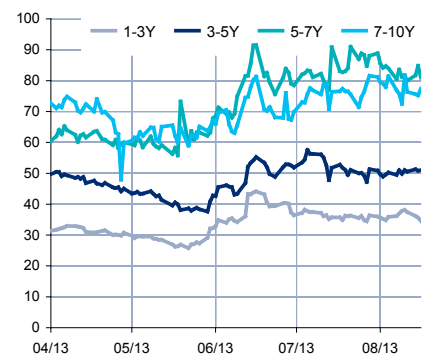
Source: Citi Research, Markit

Figure 141. Secondary Market Performance, ASW-Spreads, bp



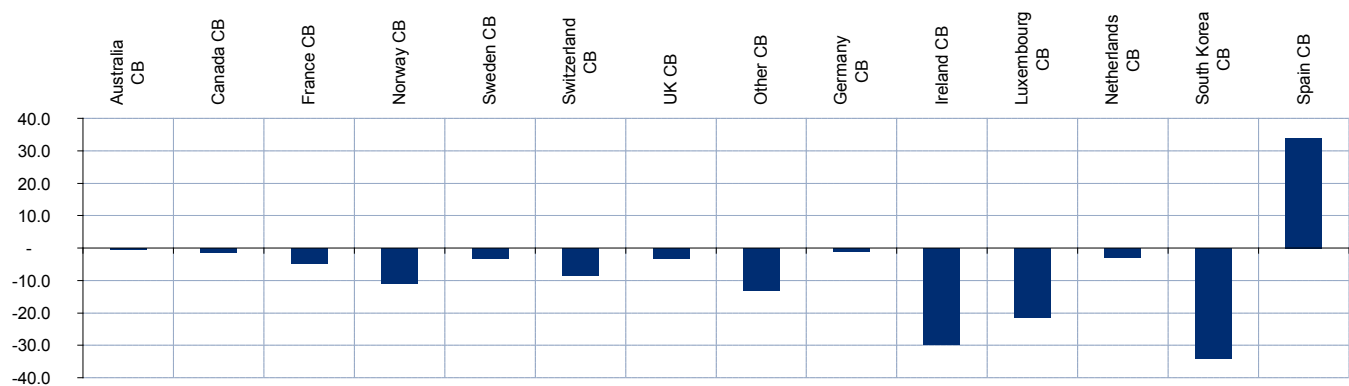
Source: Citi Research

Figure 142. Secondary Market Performance, ASW-Spreads, bp



Source: Citi Research

Figure 143. Spread performance over the last month



Source: Markit, Citi Research

**Notes**

**Notes**

## Appendix A-1

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