

Box 3

COVERED BOND MARKET DEVELOPMENTS AND THE COVERED BOND PURCHASE PROGRAMME¹

On 7 May 2009 the Governing Council decided to initiate the covered bond purchase programme (CBPP), under which the Eurosystem purchased eligible covered bonds. The operational specifications of the CBPP were announced on 4 June 2009. The purchases started on 6 July 2009 and ended on 30 June 2010.

The CBPP was aimed at improving the funding conditions for financial institutions that issue covered bonds, as well as the secondary market liquidity of covered bonds, and at encouraging an easing of credit conditions, given that the process of deleveraging in the banking sector was predicted to continue for some time. These measures were also meant to improve the risk profile of institutions holding covered bonds and, thereby, to spur credit growth.

The announcement of the CBPP was followed by a rather swift tightening of the spreads between covered bond yields and swap rates, which accelerated with the start of the purchases themselves in the case of some markets (Chart A a)). As from 7 May 2009 activity on the secondary market shifted very quickly from the previously strongly one-sided selling interest to a one-sided buying interest. The primary market, which had remained more or less closed since mid-2008, also recovered quickly and saw strong issuance activity in the period between May and October 2009, with the exception of August, when new issuance activity is traditionally low because of the holidays.

In the fourth quarter of 2009 the earlier trend of rapidly tightening spreads came to an end. This induced many investors to engage in profit-taking. Moreover, since the spreads between the yields on many covered bonds and those on their respective sovereign benchmarks had also become relatively narrow (Chart A b)), some investors started undertaking so-called switching transactions, i.e. to move out of covered bonds into government bonds. As a result, the situation

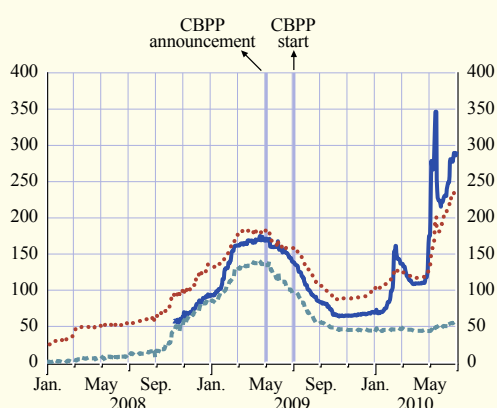
¹ Further information is available in the ECB's press releases of 4 June 2009 and 30 June 2010, in the ECB's Decision of 2 July 2009 on the implementation of the covered bond purchase programme (ECB/2009/16) and in the monthly reports on the Eurosystem's covered bond purchase programme, published on the ECB's website from July 2009 to June 2010. See also the special feature on European covered bonds in the ECB's Financial Integration Report of April 2010.

Chart A Developments in selected covered bond market segments

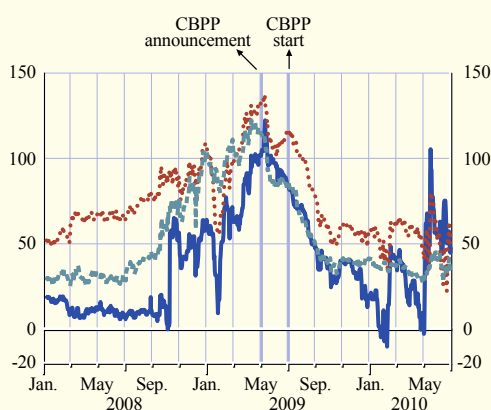
(basis points)

— Portugal
- - - Spain
- - - France

a) Spreads between covered bond yields and swap rates



b) Spreads between covered bond and government bond yields



Source: ECB calculations based on iBoxx data.

review, a significantly broader spectrum of euro area credit institutions turned to the use of covered bonds as a funding instrument. This helped some jurisdictions to significantly increase the number of issuers and outstanding amounts, and thereby to deepen and broaden their covered bond markets. These developments contributed to improving the overall funding situation of both euro area and non-euro area financial institutions, in the case of the latter via positive spillover effects. Between the announcement of the CBPP on 7 May 2009 and its termination on 30 June 2010, 175 CBPP-eligible new covered bonds and 55 taps of already existing CBPP-eligible covered bonds were issued for an overall amount of around €184 billion. Over this period a new covered bond jurisdiction saw its first publicly placed covered bond, and 25 banks issued covered bonds for the first time.

with respect to buying and selling interests on the secondary market became more balanced, with more two-way flows. After the very high new issuance activity seen in September 2009, the primary market also calmed down somewhat in the fourth quarter, and issuance volumes returned to more normal levels.

In the first few months of 2010, developments in the covered bond market were dominated by spillover effects induced by tensions in euro area sovereign debt markets. Sharp moves in government bond yields also led to sharp changes in covered bond yields, which did not, as a rule, fall below their respective sovereign benchmarks. After a record high in January, activity on the primary market for covered bonds came to a standstill in several jurisdictions, except for a brief respite on account of sovereign risk concerns in March 2010.

After the start of the Securities Markets Programme on 10 May 2010, the covered bond market recovered somewhat. The spreads between covered bond yields and swap rates tightened in almost all jurisdictions, although this move towards tightening was later reversed in some cases. In several jurisdictions, primary market activity resumed.

As the above retrospective overview of market developments since the launch of the CBPP highlights, one of the important signs of the success of the CBPP is to be found in the noticeable re-activation of primary market activity for covered bonds. In the period under

The Eurosystem supported new issuance of covered bonds in two ways, namely by, first, directly participating in primary market transactions, albeit mainly for a small portion of the total amount issued, and, second, by buying covered bonds held by other investors in the secondary market who then had the opportunity to participate in primary market transactions. Both supporting mechanisms helped to stabilise covered bond spreads. The amounts purchased by the Eurosystem in the primary market generally corresponded to the primary market supply (Chart B). This response, however, was not mechanistic. For example, in September 2009 there was a very favourable market environment for primary market issuance of covered bonds, so Eurosystem support was not really needed. In that month, purchases by the Eurosystem in the primary market were therefore more limited than in other months that saw similar amounts issued. Overall, of the total nominal amount of €60 billion purchased by the Eurosystem, 27% was purchased in the primary market.

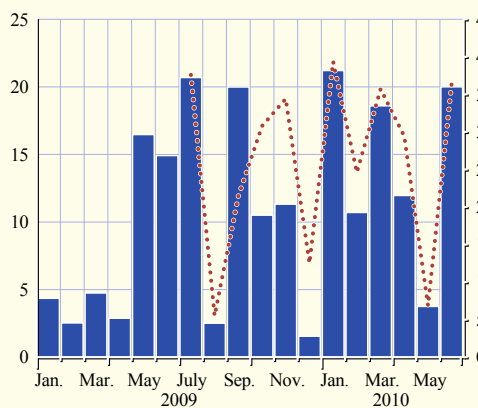
In the secondary market, the Eurosystem allocated the CBPP purchases widely to the various segments of the covered bond markets, taking into account the outstanding amounts of covered bonds and the selling offers submitted by eligible counterparties to the Eurosystem's CBPP portfolio managers. The launch of the CBPP led to a narrowing of quoted bid-offer spreads in the covered bond market. However, the market depth and liquidity only improved significantly when, in late 2009, more balanced two-way flows emerged. Some of this improvement was reversed between February and May 2010, given spillover effects of tensions in euro area sovereign debt markets. Overall, the depth and liquidity of the secondary market for covered bonds have improved since May 2009. Of the total nominal amount of €60 billion, 73% was accounted for by purchases in the secondary market.

The securities held by the Eurosystem in its CBPP portfolio have been made available for lending to eligible counterparties against eligible collateral since March 2010. The amount of securities lent is not large, but it is not negligible either. Thus, the availability of CBPP securities for lending meets

Chart B Jumbo covered bond issuance in the euro area and CBPP participation in primary market transactions

(EUR billions; percentages)

■ covered bond issuance, EUR billions (left-hand scale)
 percentage of CBPP purchases in the primary market (right-hand scale)

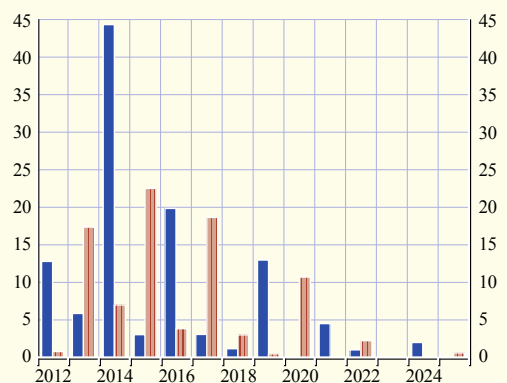


Source: ECB calculations based on Dealogic data.
 Note: Issuance amounts refer to CBPP-eligible securities with issue volumes of €500 million or more.

Chart C Jumbo covered bond issuance in the euro area, broken down by maturity

(EUR billions)

■ 7 May to 31 December 2009
 ■ 1 January to 30 June 2010



Source: ECB calculations based on Bloomberg data.
 Note: CBPP-eligible securities with issue volumes of €500 million or more.

some demand and contributes positively, albeit to a rather small extent, to a proper functioning of the covered bond market. In particular, the awareness of market participants that CBPP securities are available for lending against eligible collateral on demand probably contributes to expectations that the market will continue to function properly at the aggregate level.

The CBPP portfolio contains covered bonds with maturities of mainly between three and seven years. With regard to the maturity of the securities purchased, the Eurosystem likewise responded to the supply in markets: most new issuance and secondary market offers were in this maturity bucket (Chart C). As a result, the average modified duration of the portfolio was 4.12 as of June 2010, meaning that the average remaining maturity of the portfolio is around four years.

Overall, it can be concluded that the functioning of the covered bond market has improved significantly since the announcement of the CBPP in May 2009, although it suffered from the effects of tensions in the sovereign debt markets in the first few months of 2010.