Bank+Insurance Hybrid Capital

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OBGs BACK IN BUSINESS

MAY 2023

OBGs
Back in business

The Italian covered bond market is set to reopen in June after almost a year's hiatus, with the first new OBGs eagerly awaited since the Bank of Italy finalised its framework in March. On 17 May, Crédit Agricole CIB gathered issuer, investor and rating agency reps to discuss the prospects for Italian issuance, exploring pricing, duration and credit questions against the backdrop of a booming covered bond market but also challenging macro backdrop.

Capital, solvency, liquidity, funding, profitability — in different phases since the financial crisis, investors and regulators have scrutinised and rethought different aspects of bank's business models. The most recent banking panic of March took in almost all aspects, but alongside the surprise zeroing of Additional Tier 1 instruments, a focus on liquidity came to the fore.

At the same time, the withdrawal of TLTROs is forcing banks to reappraise their wholesale funding strategies amid LCR and NSFR considerations. For their part, investors have reappraised the different parts of the FIG market in light of resurgent yields and evolving relative value across the fixed income markets.

Against this backdrop, one piece has been missing from the puzzle in Italy: covered bonds. As their peers across Europe and globally have issued record volumes, Italian banks have had to wait for their framework to be updated to comply with the EU Covered Bond Directive — not since June 2022 have any new euro benchmark obbligazioni bancarie garantite (OBGs) hit the market.

But after the Bank of Italy completed its implementation work in March, the stage is set for Italian issuers to reopen the OBG market.

With the reopening come renewed questions. How will the instrument fit in Italian banks' funding strategies? What credit issues could the OBG framework, banking landscape and housing market pose? And how easily and at what price will new supply be absorbed?

For this special *Bank+Insurance Hybrid Capital* report, Crédit Agricole CIB convened a roundtable where issuer, investor and rating agency representatives discussed the prospects for the Italian market, offering insights into the dynamics that will shape the first wave of OBGs. Read on to find out what to expect as the OBG market reopens. ●

Roundtable participants:

- Peter Benschop, Portfolio Manager Euro Aggregate and SRI, BNPP AM
- Florian Eichert, Head of Covered Bond & SSA Research, Crédit Agricole CIB
- Vincent Hoarau, Head of FI Syndicate, Crédit Agricole CIB
- Tom Lucassen, Investor Relations – Head of Shareholder Strategy, Investor Coverage and Rating Agen-cies, Banco BPM
- Stefano Marlat, Head of Finance, Crédit Agricole Italia
- Alberto Pisana, Fixed Income Senior Portfolio Manager, Insurance & Regulatory Strategies, Allianz Global Investors
- Nicola Selvaggi, Analyst, Moody's
- Stefano Sibari, DCM & Secured Funding, Credem
- Stephane Taillepied, Financial Analyst, Amundi
- Francesco Villa, Funding and Capital Management – Head of Covered Bonds, Banco BPM

Vincent Hoarau, Crédit Agricole CIB: Could you summarise the main themes in the asset class in terms of issuance dynamics and spread drivers since the beginning of the year?

Florian Eichert, Crédit Agricole CIB: We basically moved from not having a market, to having a market again on both sides, secondary liquidity as well as primary supply. We've come from years where the ECB was distorting supply — with TLTROs limiting funding needs — and on top of that squeezing the residual liquidity out of the market through large-scale asset purchases. So the market was shrinking in terms of free float and losing traction with investors, who perhaps only put in a few new issue orders and then forgot about the secondary market. We have now moved to a situation where banks are no longer underfunding, but overcompensating, as they now need to repay the TLTROs. Hence, supply is up and we are experiencing record volumes. That has improved liquidity and brought investors back. Higher yields have played their part, of course, but the sheer level of activity in this market is drawing old, established players back in, and also drawing in newcomers who hadn't been looking at the covered bond space before QE. Supply is high, it's broad, and fortunately it's also broader on the investor side.

Across the entire year investors have had a very positive stance vis-à-vis covered bonds. Asset managers have been de-risking and moving money into this market, and bank treasuries have been investing the excess liquidity they didn't invest last year. So overall it has been a very strong market.

But more recently, in the past one to three weeks, it's been heavier going in terms of supply but also how these bonds have been absorbed. Some trades barely managed to get across the finish line and, unfortunately, the negative sentiment from these trades hasn't kept further issuers from approaching the market. We had a large EIB seven year yesterday with a €35bn order book and at the same time some of the covered bonds really struggled.

However, I believe this is more of a shorter term theme and a few weeks with more limited supply will go a long way towards alleviating some of this short term pressure.

Hoarau, Crédit Agricole CIB: You say the dynamic has changed in the past couple of weeks. At the beginning of May, Christine Lagarde announced the end of the reinvestment of APP redemptions. We all know CBPP3 has long played a tremendous role in supporting the asset class. Hence, it's the end of an era from July 2023. Is it going to have a major impact on covered bonds overall? And what could be the impact on the OBG segment in particular?

Eichert, Crédit Agricole CIB: There has already been a big impact, because Eurosystem primary orders have come down from 50% at the peak to zero. On the back of this, we've had a massive widening and spread decompression, across jurisdictions and also within jurisdictions. Hence, to a large extent I would say that the QT effect is already priced in.

There's just one thing that I'm nervous about when it comes to secondary flows stopping in July: if we were also to have more issuance than expected in the second half of the year, the absence of CBPP3 flows could lead to the market gapping one leg wider. At some point, PEPP will be able to mitigate some of this, but I think they will not start firing straight away; they will want to wait and see some pain in the market before that gets deployed. However, if the market consensus turns out to be correct and we are in for a quieter H2, then we should be able to deal with no more secondary purchases fairly easily.

> **'In the second half of June you may have a bit of a mini-revival of CBPP3'**
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> **Florian Eichert, Crédit Agricole CIB**

Hoarau, Crédit Agricole CIB: Because if we crunch the numbers, in March alone around €5bn of covered bonds on the ECB balance sheet redeemed, if I'm not mistaken.

Eichert, Crédit Agricole CIB: Yes. And — in what, to me, is a good sign for Italy — the ECB underinvested these March redemptions. Hence, if Italian issuers start issuing in the second half of June, there's effectively still two weeks left for the ECB to support the reopening of the OBG market early on. Beyond that, PEPP is not going to be a big player in the covered bond space, but I do get the sense that the ECB almost feels sorry for Italian issuers, as the Bank of Italy kept them out of the market almost up until the point that APP is no longer buying covered bonds. I don't want to say there's a mini-pocket in the PEPP that is sort of reserved for OBG purchases, but in any case, in the second half of June you may have a bit of a mini-revival of CBPP3 purchases before it then comes to an end at the beginning of July.

Hoarau, Crédit Agricole CIB: But my point was just to say that this type of support is now disappearing completely.

Eichert, Crédit Agricole CIB: Yes. But again, it all depends on supply and whether banks are two-thirds done with

> **'We use the market to reach long and extra-long durations'**
> **Stefano Marlat, Crédit Agricole Italia**

their funding or not. After all, the backdrop for covered bonds is still supportive: spreads are still wide versus govvies and versus SSAs, yields are high. However, if supply stays high and the ECB is gone, trading books are going to be less aggressive in bidding for paper and you will clearly feel an impact on the market.

Hoarau, Crédit Agricole CIB: Turning to the issuers, have 2022 and 2023 funding plans been significantly impacted by the fact that you were unable to issue OBGs? How did you navigate through funding needs since the beginning of last year, in the context of TLTROs coming to an end?

Francesco Villa, Banco BPM: In our case, we were very active in the primary market. We have been more focused on the senior unsecured space and subordinated debt in order to fulfil our regulatory requirements. We did a green covered bond in March 2022, which was a very good transaction, but we have not been impacted by the Bank of Italy delay because we have a lot of liquidity. Our funding is still supported by TLTROs. We have a lot of long term repo trades using retained covered bonds — this is a very important tool to support our indicators. So we have only really been impacted in terms of time to market, because it's true that last year we had envisaged issuing another covered bond but we were not able to. So this year, for sure, we have been forced to change our plan a little bit, but we want to tap the market with a covered bond before the summer break, also because we have another transaction to do by year-end. At the end of the day, we have not been negatively impacted by this delay.

Stefano Sibari, Credem: We have also been very active in the market in 2022. We issued a senior preferred, a subordinated Tier 2 and a covered bond. Historically, we have always been present on the market with at least one issuance of benchmark covered bonds per year. Hence, when we saw that there was some delay with the Italian regulation last year, we decided to anticipate our issuances and we issued a €500m covered bond in May. After the hard deadline of 8 July, we closely monitored the Bank of Italy's progress. In developing the 2023 funding plan, our strong liquidity position and indicators allow us to wait and see how the market and the Italian regulation would evolve. Covered bonds remain a strategic instrument for us, and we will closely monitor the market to find an attractive window in the near future.

Stefano Marlat, Crédit Agricole Italia: On the market, we only issue covered bonds — nothing else. This means that in 2022 we did what we had in mind at the beginning of the year. Also, we use the market not so much for funding in itself, but to manage the funding mix, to differentiate the investor base and to reach long and extra-long durations — which is evident from our past issuance.

At the beginning of this year, we could not do what was planned for 2023. However, at that time, the market was very crowded and focused on really short tenors. So although we had to wait, I don't even know if we would have approached the market had we been able to, given the prevalence of these short tenors which were favoured by investors.

Hoarau, Crédit Agricole CIB: Coming back to the change in the OBG framework so that everyone understands why we are where we are today and why Italian issuers are still not technically able to issue OBGs — perhaps can you guide us through what the main obstacles were and why we had this delay?

Villa, Banco BPM: It was more of a fine-tuning process overall, because the Italian OBG framework was pretty much in line with the new requirements set by the covered bond directive. Rules around internal controls, but also in terms of the general structure, new requirements in terms of liquidity buffers and in terms of overcollateralisation were all more or less in place in our covered bond programme already. So, it has just been a matter of updating the programme and being aligned with the new regulation.

The biggest concern was regarding the transitional regime Bank of Italy put in place within the new regulation. During the consultation period, we had a very constructive discussion with Bank of Italy, though, and the notice period between communicating to Bank of Italy our intention to issue a new covered bond under an already-established programme and the actual first issuance was reduced from 60 days to 30 days. This 30 day period is manageable. It's a period where banks have to complete all the internal approvals, change the internal procedures in order to be ready to issue in line with the new framework. So, implementation was a real challenge for banks, but everything has been resolved through very constructive discussions with the regulator.

Hoarau, Crédit Agricole CIB: Moving to the critical topic of higher interest rates, what has been the greatest challenge for each Italian issuer in this respect since the beginning of last year?

Tom Lucassen, Banco BPM: At current levels, for a commercial bank with a strong retail footprint like us, it's less a challenge and more a great opportunity. It is in light of the interest rate hikes that we have continued to raise upward our guidance in terms of profitability. Profitability guidance has also been raised on the back of other factors, including the path towards normalisation of the cost of credit risks and operating costs being under control. However, net interest income (NII) is the key driver. In November 2022, we had guided towards a total NII of more than €2.5bn to be reached in 2023 with an underlying interest rate level of about 2%. In February 2023, we moved our expectation up to more than €2.7bn, with an underlying interest rate level of about 2.5%, and just recently, in conjunction with the presentation of our Q1 2023 results, we revised our guidance up further to more than €3bn, with an underlying interest rate level of 3.3% in terms of average Euribor. This has been the key driver behind our upward revision of bottom-line profitability, with our net income expectation for 2023 up from €740m originally embedded in the Strategic Plan that we approved in November 2021 to about €1.1bn. At the same time, for 2024, our net income target of €1.05bn in our original Strategic Plan has been revised upward to a new guidance just below €1.4bn. As a bank with a strong retail focus, some 82% of our funding is represented by customer deposits with a relatively low cost of funding. In fact, we have seen a significant degree of stickiness in the cost of these deposits, which has moved up from 5bp in Q3 to 24bp in Q4, and up to 46bp in Q1 of this year. With an observed deposit beta of about 33%, we expect to further shore up our underlying profitability, and the NII guidance of more than €3bn that we have recently provided may turn out to be prudent, in particular in case of a scenario of higher interest rates, from which we stand to benefit given our positive NII sensitivity. We will update and approve our Strategic Plan in the second half of this year, also considering that the general economic assumptions have changed so radically.

There is, of course, the question whether the rise in interest rates has negative repercussions on our asset quality. However, if we look at the default rate, we stood at an annualised level of 88bp in Q1 2023, which compares with 94bp seen in the full year 2022, so that, at this stage, we are not seeing a deterioration. Let me add that our group comes from a very high level of NPEs and over the past years we have been focusing sharply and successfully on the reduction of our NPE exposures and on the de-risking and improvement of our asset quality profile. Actually, we are two years ahead in terms of achieving our gross NPE ratio target: for year-end 2024, we had pencilled in a 4.8% gross and 2.5% net NPE ratio target, while today we are already down at 4.2% and 2.1%, respectively.

We are not seeing a deterioration in asset quality

Sibari, Credem: The current dynamics of interest rates are leading to higher profitability, mainly driven by the increase in NII started in the second half of 2022. There are more opportunities than challenges in the current scenario. Our business model is highly diversified, therefore, on top of a resilient fee component, we found a renewable profitability coming from new NII levels while maintaining outstanding levels of asset quality. Furthermore, we have a more than comfortable liquidity position, which translates into less competition on the deposit side, avoiding, for the time being, rapid increases of average interest rates on our clientele's deposits. Indeed, the cost of funding from our customers increased at a lower pace with respect to that on the loan side, favouring the widening of customer spread and, therefore, supporting revenue growth. Interest rate rises might lead to potential contraction in loan demand and to deterioration in asset quality. However, we are not seeing any material signs of contraction in loan demand nor any signs of deterioration in asset quality so far, with a year-on-year growth in loans to customers that stood at +3.2% as of 1Q23, while registering 5bp of annualised cost of risk as of 1Q23. On the securities portfolio side, interest rate risk is hedged, so there's limited/negligible impact from interest rate rises.

'It's less a challenge and more a great opportunity'

Francesco Villa & Tom Lucassen, Banco BPM

Marlat, Crédit Agricole Italia: In terms of the impact of rising interest rates on our bond portfolio, there is really no impact, as we manage our portfolio in terms of spreads, not in terms of rates. And in terms of lending and what the others have said, you can imagine that we are also taking advantage of that. Things are much more interesting on the funding side. As I said, we have limited market funding needs as we are cash-rich. In terms of our client base, with extremely low or even negative rates, a lot of liquidity went into current accounts. However, the recent rates moves have led to clients asking for higher interest rates again. So what we try to do is to offer time deposits or within our retail network to start issuing senior bonds for only our clients. However, for the time being it's still very limited and used much more to attract new clients. In any case, it's difficult to find tenors longer than three to five years with private customers via term deposits or senior notes.

Hoarau, Crédit Agricole CIB: Nicola, what are the main rating drivers for Italian covered bonds at Moody's? How is country risk factored in? And has covered bond directive

implementation and the changes to the Italian OBG framework led to an improvement in TPIs, and hence the rating uplift above the issuer?

Nicola Selvaggi, Moody's: Italian mortgage covered bonds are rated Aa3, the country ceiling for Italy. Country ceilings indicate the highest rating level that would generally be assigned to the financially strongest debt from issuers domiciled in a country. This ceiling effectively constrains the highest achievable rating for Italian covered bonds at their current level. The main driver remains the issuer credit quality, which is the starting point for our analysis. The quality of the cover pool underlying the covered bonds is high and therefore less of a driver in our rating analysis. These aspects remained unchanged with the new law.

Perhaps it is worth taking a step back to look at our methodology. This is based on a two-step approach. The first is numerical, so the calculation of the expected loss, which drives the OC requirement for a given rating. And then, a more qualitative step, the timely payment indicator (TPI) framework, which assesses the likelihood that the issuer will make payments in the aftermath of an issuer insolvency and limits the maximum achievable rating of a covered bond. Now, considering that the country ceiling is a further cap to this, it means that covered bond ratings have a certain leeway or buffer against issuer rating downgrades. In general, the leeway is between one and two notches in Italy. For the sake of completeness, movements in the sovereign rating will likely have a direct impact on Italian covered bond ratings.

With regards to the new legislation, its impact is positive. However, even before the recent changes, Italian covered bonds benefited from strong credit standards as the contractual provisions present in OBG programmes were stricter than the provisions in the law. For example, while no minimum OC level is prescribed by the law, the typical minimum committed OC in programmes is 7.5%. Also, regarding liquidity risk, the law now explicitly mandates a 180 day liquidity buffer, but existing

programmes already had contractual liquidity protections, albeit for smaller amounts than what is required now.

So, to reiterate: the new law has not had a material impact on the drivers of our rating analysis for OBGs.

Hoarau, Crédit Agricole CIB: Just to clarify one point: interest rates have been rising and the OBG market has been shut for almost a year, so covered bond outstandings have been getting shorter, leading to bigger ALM mismatches. How have those two factors affected OC requirements?

Selvaggi, Moody's: The shortening of the duration of outstanding covered bonds is a phenomenon that we have seen in various markets, not just Italy. Maybe in Italy this was exacerbated by the lack of issuance.

To your question whether a bigger gap between the duration of the cover pool and the covered bonds increases refinancing risk, the answer is yes. Has this been reflected in changes to OC requirements on our side? No, because our methodology measures and accounts for the risk of deterioration of asset and liability profile, including what we are currently observing, shortening of covered bond durations. For example, the exposure subject to refinancing needs that the methodology takes into account is not only that which is depicted within a given cut-off on a given asset-liability profile; our methodology works with stressed scenarios, in particular, the portion of the cover pool subject to refinancing risk

> **'With regards to the new legislation, its impact is positive'**
> **Nicola Selvaggi, Moody's**

we model is typically higher than 50%. Our refinancing assumptions are set on a through-the-cycle basis, so we generally do not change them in response to temporary market fluctuations.

Another aspect related to the shortening of the duration of outstanding bonds is that we would have taken this into account when determining the programme's TPI. Hence, if the issuer has discretion to issue shorter covered bonds or do something else that will change the refinancing risk in the structure, this will also be reflected on that end.

So to answer the question, there have not been any material changes to the minimum OC that is consistent with current OBG ratings.

Hoarau, Crédit Agricole CIB: Higher rates have impacted mortgage demand across Europe and led to house price falls in many countries. Have you seen a similar impact in Italy, or has the slower momentum in house prices in recent years meant there was no excessive growth that could now be pared back? Also, are there any signs in your loan book that NPLs are growing?

Villa, Banco BPM: In terms of house prices and the real estate market, we are mainly based in Milan and in Lombardy where the real estate market has been resilient, supporting house prices. As of today, it seems that the real estate market has not been impacted by the interest rate environment. I think there is even upside for prices, especially in residential real estate.

Lucassen, Banco BPM: We are rather cautious in this period because the macroeconomic environment is what it is. We are certainly not seeking to push on growth; rather, we focus on preserving the quality of our loan portfolio in the best possible way. A reflection of this is also that we have seen a significant further increase in the share of loans that are either collateralised or enjoy state guarantees. This is true both for Households and for Non-financial corporate clients, but is even more so as far as small and medium-sized enterprises are concerned.

Hoarau, Crédit Agricole CIB: What about the breakdown of the structure of fixed versus variable rates?

Villa, Banco BPM: In our cover pool, more or less 80% of mortgages are fixed rate. This is a good thing in terms of, for example, being a natural hedge on the liability side. For the Moody's methodology, it can be a little tricky, though, because this part of the cover pool is now out of the money in terms of pricing because of the higher market rates. But in any case, this is a reflection more or less of the trend that we have seen in our client base for new mortgage business recently, which has been more focused on fixed than on floating rates.

Lucassen, Banco BPM: Putting the situation into perspective, and looking at our performing loan book from a wider angle, of the €105.9bn total of gross performing loans as at 31 March 2023, 59.2% relates to Non-financial companies and 26.9% relates to Households, which are essentially residential retail mortgage loans. These segments together account for more than 85% of the total, with the remainder spread across financials, public sector, non-profit organisations and other.

Sibari, Credem: The Italian case is very peculiar. From our perspective, we haven't seen a deterioration in house prices yet. What we are seeing is that the Italian government has incentivised the renovation and retrofitting of existing properties via tax incentives, and these

energy efficient interventions actually added value to properties. Hence, it's still too early to see a deterioration in house prices. We'll probably see that effect when these types of government bonuses end and we return to a more normalised market.

At the same time, we have noticed — and that's reflected in our cover pool, as well as in our wider loan book — that loan-to-values have decreased slightly overall to an average of around 50%-60%. All of this means that we see very low default rates in the near future. Our cover

The Italian case is very peculiar

pool has close to zero defaulted assets, as families have been able to pay their loans and they have not been affected by Covid-19 and the events of the last three years (rise in inflation, Russia-Ukraine conflict, etc).

So right now we are very positive in terms of the residential mortgage market, and we think that this effect may last a bit longer than 2023.

Marlat, Crédit Agricole Italia: Just to add some colour in terms of fixed or floating rates, I would say that historically, the Italian market was characterised by floating rates. However, with low rates, a large part of the market moved and switched to fixed rates up to around 2022. At that point, pricing turned again, and fixed rates began to be more expensive than floating rates. Hence, customers looked to move back to floating rates again. What we did was revive a product that we have used a lot in the past, floating rate loans with a cap. We did it in order to avoid rising credit risk further down the line as customers are faced with higher monthly instalments. After all, right now, the default rate is really low, around 0.5% at market level. Floating rate mortgages with a cap are something that are natural for our clients but are not a game-changer for the bank because we hedge ourselves in the market. At the end of the day, it means that something like 59% of our new mortgage production in H2 2022 has been done via floating rates with a cap.

'We are very positive in terms of the residential mortgage market'

Stefano Sibari, Credem

Hoarau, Crédit Agricole CIB: What is Moody's view on the real estate market and to what extent it can affect ratings? Are you focusing more on the market and refinancing risk, or the situation in the real estate market and impact on loan quality?

Selvaggi, Moody's: Let me start by saying that the cover pools represent a positive selection vis-à-vis the overall mortgage market. This is not only driven by the programmes' eligibility criteria, but also by issuers' practice (for example, non-performing loans are usually repurchased by originators). The drivers of credit loss of the individual mortgages that we find in the cover pool can be summarised under two aspects. One is low LTVs, on average around 50%, and the other is long seasoning. The combination of the two makes the credit quality of Italian cover pools reasonably high.

> **'We are becoming a little more selective on issuers and jurisdictions'**
> **Alberto Pisana, AllianzGI**

Regarding the evolution of collateral pools in terms of the split of fixed to floating, we've seen an increase in long term fixed rate loans — I think the spectrum varies between 30% and 80%. The main driver of OC is indeed the market risk associated with the cover pool rather than the expected credit loss, as mentioned earlier. In a scenario in which you have to potentially sell the cover pool to repay the obligation (for example a "fire-sale" scenario), a fixed rate loan is less valuable than a floating rate loan in a rising rates scenario. On the other hand, the performance of mortgages is of course better when fixed because these are immune to higher interest rates.

The only thing which I would add on the housing market is that even in case of a slowdown of prices, we do not expect this to be disruptive in Italy, largely because house price growth in Italy in the past years has been quite slow compared to other markets.

Hoarau, Crédit Agricole CIB: Turning to the investor side, the last 12 months have been quite eventful. How has the new yield as well as risk environment affected your asset allocation towards covered bonds?

Alberto Pisana, Allianz Global Investors: The main trigger for a change in our allocation to covered bonds has clearly been the higher absolute yields of the asset class, but the low beta has also helped. We come from a period where the allocation to covered bonds was decreasing. This trend has clearly stopped and it is now starting to increase for certain accounts. The decisions by the ECB are also playing a role, of course, because we are seeing a decompression trend which started last year and is continuing. In turn, this means we are also becoming a little more selective on issuers and jurisdictions. We are happy to have done our homework in the past where there was almost no discrimination across issuers. We have analysed the fundamentals, or the differences in fundamentals across issuers and jurisdictions, as well as their respective legal frameworks. We are happy to finally be able to apply this know-how now and get paid for it with wider spreads.

The short term is really our preferred spot

Peter Benschop, BNPP AM: Our view of the asset class has turned much more positive and this obviously has to do with the regime change. We had the ECB for years and years, they crowded out real money investors when there was little supply to begin with, yields were negative in many cases, spreads very tight. The result was that there was little interest among investors and the asset class fell out of favour. Now, with the ECB retreating, rates are higher and asset swap spreads wider, making absolute yields of covered bonds overall much more interesting. So what we did during the second half of last year was to start building up a position in covered bonds again, coming from an underweight position. We mostly used the primary market and have continued to do so this year. So we are more positive on covered bonds.

Having said that, the short term is really our preferred spot. Up to five years, we are very interested if there are new issues. We also look at longer tenors, but it all depends on the shape of the swap curve and the curve inversion makes longer dated bonds relatively less attractive, so the curve shape is a bit of a hurdle. We're still looking at covered bonds up to 10 years, but regarding tenors beyond 10 years, we clearly prefer European Union bonds.

Stéphane Taillepied, Amundi: For us, the main point is the appetite for short term duration, frankly, particularly for covered bonds. We expect around €200bn of overall covered bond new issuance this year. But the duration is currently below the historical average, and for Amundi in particular, we are quite reluctant to look at issuance above five years because of the very low visibility both for macro but also micro issues.

We have been quite surprised to have no issuance from Italy because there is a strong improvement in the sector's profitability, banks have low levels of non-performing loans, average LTVs in cover pools are very low. I don't know what could happen in the second half, because investors are expecting around €30bn of issuance. Maybe that's realistic, but it's a lot.

Hoarau, Crédit Agricole CIB: Let's indeed focus specifically on the OBG market now and how our investors position the segment versus its European peers. Alberto, you highlighted spread differentiation and that you can now focus on relative value again. How would you position, or reposition OBGs in this investment universe?

Pisana, AllianzGI: There are different metrics one can look at. The first, in my mind, is the comparison with BTPs. It's true that in a market that has been driven by the ECB, we've seen BTPs trading very cheap relative to OBGs, which was not really normal. The spread between the two

has by now tightened a lot. Still, it would be difficult to justify an investment in OBGs when they are maybe 20bp more expensive than BTPs, taking the five year point or a bit longer. We are coming from an era where many real money investors had to reduce their exposure to BTPs. They may now have a little bit more space to add BTPs and less forced to buy OBGs as a replacement. At the very short end, we like the current situation where covered bonds sometimes pay higher spreads than senior unsecured bonds. At the end of the day, when you're managing an aggregate fund and you can enjoy an overweight in OBGs against senior debt at the short end, you can also accept being underweight them against BTPs in longer tenors.

Within the covered bond asset class, historically we would have likely looked at cédulas from Spain or Portugal. If we have to do this exercise now, when there will be new issues coming from Italy, we need to acknowledge the fact that the Italian market has been dormant for some time. Hence, we have less visibility on the Italian market than we have on Spanish or Portuguese names. So if Italian issuers are targeting the belly of the curve, that's really the starting point. However, we would need a higher premium, at least for the first issuances. You're seeing other jurisdictions coming to the market with levels in the 40bp area, or a Nordic name in the seven year space pricing at 30bp today, for example. So these numbers are more or less the expectations for the lower bound of a possible price discovery for OBGs.

Taillepied, Amundi: There are many positive points for Italy. OC is quite strong, around 35%-40%, NPLs in the covered pool are below 1%, and we have more visibility on the mortgage market in case of a recession in Italy than for the rest of Europe. So we have many positive points. I think there will be great interest from investors in the event of new issuance. I agree there will be a premium for the first issuance, because there was no issuance for almost a year. However, I do think that versus Nordics, even versus Spain, there is room for issuance for the near and medium term.

Benschop, BNPP AM: We look at Italian curves and obviously it's a unique situation compared to other jurisdictions. The OBG curve is far flatter than the BTP curve, and OBGs are more expensive, from around the four to five year point, so we're making this trade-off for portfolios that can do either sovereigns or covered bonds. In terms of valuation, I agree there definitely has to be a premium. If you look at outstanding Italian covered bonds, many of them are quite old and illiquid now, so I'm not sure they are very good reference points for valuing new issues. You would therefore look at Spain and it definitely needs a decent pick-up against those.

There are many positive points for Italy

Hoarau, Crédit Agricole CIB: I believe there is no doubt around the table that when we open the market issuers will have to put the right price on the table and cannot afford failure early-on, but a lot of price discovery will be involved. Florian, how would you position OBGs in a relative value scheme?

Eichert, Crédit Agricole CIB: As has already been mentioned, secondary levels are inconsistent and irrelevant when it comes to pricing new issues. Take a historically large OBG issuer such as UniCredit: they have not been active for years and the longest benchmark OBG they have outstanding is a 2026. To be fair, the difficulty of taking secondary

> **'In terms of valuation, I agree there definitely has to be a premium'**
> **Peter Benschop, BNPP AM**

references for pricing new issues was also there when many other markets reopened issuance in 2022 and 2023, including Spain and Portugal.

Hoarau, Crédit Agricole CIB: Also because the Eurosystem is distorting things.

Eichert, Crédit Agricole CIB: Yes, CBPP3's ISIN limit is at 70% and I'm pretty sure they are very close to this for many Italian issuers, as they are for the older vintage Portuguese and Spanish covered bonds. Hence, free float is negligible. So you reference other jurisdictions that have priced new issues more recently, and the ones that come to mind are Spain and Portugal, where we've seen supply fairly recently. From Spain, Santander re-entered the cédulas market via dual tranches and the issuer has by now created live points in the three, five, seven and 10 year tenors. These levels alongside a Santander Totta five year would clearly be good starting points for any OBG issuance. In the past, you would have had OBGs pricing around the same levels as strong Spanish issuers. However, if we factor in supply, with Spanish banks having issued a lot already, while out of Italy we are only getting started, your starting point is clearly wider. If we are talking about, say, five years, Santander Totta plus 5bp could be something to focus on for the first issue out of Italy, and if it goes well, we could quickly move inside Portugal and start moving towards cédulas levels. Of course, just which issuer we are talking about is extremely relevant. UniCredit or Intesa? Or rather smaller issuers? Italy is a much more diverse

country than many other jurisdictions when it comes to the issuer universe. Hence, the most interesting bit to me is rather going to be where you price second tier names. In the secondary market, we currently see a good 15bp differential between Intesa in five years at plus 20bp and some of the second tier names in the mid-30s. Whether this gap is similar in the primary market, whether it needs to be 20bp or 25bp, that's what's interesting, and this is where syndicates will really prove their worth.

'I believe there is a structural need for duration in this market'
Vincent Hoarau, Crédit Agricole CIB

Hoarau, Crédit Agricole CIB: At the beginning of the conversation we mentioned the keyword, namely differentiation. We had a phase where for a decade spreads were compressed to the extreme but we are now evolving into a very strong decompression phase and the difficulty is to price the credit differential. Bookbuilding will play its part, but there is still a very strong price discovery element involved, while the supply element across the board, across jurisdictions is certainly also going to further impact pricing for the entire segment.

Eichert, Crédit Agricole CIB: As we've seen this week and last, if you have too much issuance in a short period of time, demand may not always be there, even though absorption capacity structurally is there. So if Italian issuers manage to coordinate between pre-summer and post-summer, with the large issuers setting pricing references that can then be used for the second tier issuers, then I'm fairly confident on the outlook. But if you have too many issuers jumping into the pre-summer period, maybe also second tier names with tenors that are too long for investors, then you could indeed have accidents. And if you have an accident in this market-reopening period, that will set the scene for whatever comes after the summer. Therefore, it is super-important that to the extent that issuers can, there is coordination amongst them to not overwhelm the market.

Because, size-wise, around €10bn of OBG benchmark issuance between now and year end is well absorbable. It's more about coordination, avoiding short term indigestion symptoms, and getting the tenor choices right. After all, we have heard from Peter, Stéphane and Alberto that it's not necessarily the 12 to 15 year part of the curve where issuers will find the bulk of demand, yet we have in the past had issuers from Italy that have typically tried to term out funding as much as they can via OBGs. For me, those are the pressure points that will also determine the differentiation across issuers, and they can quite easily move this from 15bp to 20bp or even to 30bp.

Hoarau, Crédit Agricole CIB: Stefano, Crédit Agricole Italia has been a specialist in issuing 15, 20 or even 25 year tenors. What can you accommodate when you hear investors saying that they're happy up to five years, more careful with seven years, and unsure whether there is a market for longer tenors than that? Personally, I'm a bit more optimistic in this respect. For insurance companies, for example, I believe there is a structural need for duration in this market.

Pisana, AllianzGI: Yes, there is, but you do have alternatives to covered bonds in other asset classes.

Hoarau, Crédit Agricole CIB: True, there are certainly alternatives, and in that case we are back to pricing. But we have seen Deutsche Bank successfully issuing a 10 year benchmark Pfandbrief while some others were struggling to close their books on shorter tenors. I believe that if the right name were to come with a 12 year benchmark, it would go nicely. I'm not talking about 15 or 20 years. Obviously the issuer will also pay a little bit of the credit curve, maybe something in the mid-single digit context for the 10s-12s curve. After having seen €110bn of supply in the three to five year part of the curve, I'm sure that if a very prime name out of the Nordic region or Netherlands came to market with a 12 year deal, it would work.

But going back to my question to Stefano, how will you manage things? Because indeed at the end of the day, it's more five years, potentially seven years, that people would like to see, while you are clearly not keen to do a three to five year.

Marlat, Crédit Agricole Italia: At the beginning of our discussion, I mentioned the crowded market early in the year, with the heavy concentration in short maturities. I also noted that I'm not sure we would have been there even had the regulation already been in place. And the rationale is the same now. We are not looking for cash, we are looking to manage our liability structure, and at the same time, we have to pay back TLTRO III liquidity in June like everybody else. In June we also have a maturity of an outstanding covered bond benchmark. From my point of view, we currently have enough excess liquidity to pay both back without having to access the market. Our idea has always been to be a frequent issuer, as we promised to the market from 2014. However, at the same time, it is crucial to be free to choose and not to be obliged to fund our needs on the market. Like you say, to cut a long story short, if you take a

look to our yield curve, I think that anything shorter than seven years doesn't make sense for us.

Hoarau, Crédit Agricole CIB: Stefano and Francesco, what can you tell us about what could make sense for you in this respect?

Sibari, Credem: Well, I think we have a lot of elements on the table right now. We are definitely evaluating how to access the market relative to what our needs might be and what investors' expectations will be. The price discovery phase will be fundamental, among all factors. As Stefano was saying, a lot of banks have an excess of liquidity, so they can take their time in approaching a potential window to access the market. At the same time, Italian banks have been looking at the stability of liquidity indicators such as LCR and NSFR. It will be crucial to see where these ratios land after banks have repaid all the TLTROs. If ratios might be too low, in that case banks might privilege longer tenors, around five or seven years, to maintain stability and flexibility over time in their liquidity position. At the end of the day, many factors will need to be evaluated and taken into account to determine the duration of new issuances of covered bonds, which will also depend on market conditions.

Villa, Banco BPM: We would replicate a little of what we had in mind last year, when we placed a five year covered bond in the market and then planned to do another transaction with a longer maturity. Assuming that we have two transactions in our plans for 2023, the best approach would be to go for a first trade with a tenor no longer than five years, and we would then plan to go longer in the second part of the year with the second transaction that we have in our funding plan. So, this is mainly our strategy in terms of maturity.

Hoarau, Crédit Agricole CIB: Back to the buy-side, to what extent could the ESG angle change or influence your view or perception towards investing in OBGs in the coming weeks or months?

Pisana, AllianzGI: Well, ESG has by now been a crucial topic for years. All our ESG analyses and considerations are already embedded in our investment process. Hence, from my point of view, there is not much difference between a conventional and an ESG covered bond. We focus on the issuers and, as such, we are pretty much aligned with the ECB guidelines when it comes to greening their balance sheet. What I have also been saying to issuers in the past is that a green label may be necessary but not sufficient to show the ESG quality of a cover pool. So for me, it's a more holistic assessment that I apply to the issuer and not only to the bond.

> **The quality of the issuer is the priority**

Taillepied, Amundi: In 2021, ESG covered bond issuance represented around about 15% of all issuance, and year-to-date it is below 10%. However, irrespective of these volumes, I completely agree with Alberto, the quality of the issuer is the priority for investors.

Benschop, BNPP AM: ESG is fully integrated into our investment process, too. Issues in green or social formats are very interesting to us. We have large green bond funds, also a social bond fund, that are growing nicely, and they cannot buy anything that's not green or social. So we're looking for paper, and covered bonds in one of those formats would broaden the range of portfolios that participate in the deal.

Aside from that, all portfolio managers are incentivised to buy green bonds. Every issuer has an ESG score, and our portfolios have to beat their respective benchmark's average ESG score or, if that's not possible, the average score of the relevant investment universe. Green bonds, but also social bonds get an ESG score uplift, and thereby help portfolio managers to improve the ESG score of their portfolio. So yes, green bonds and/or social bonds are indeed interesting to us.

Hoarau, Crédit Agricole CIB: Francesco, Banco BPM has issued green covered bonds. How are you going to, let's say, orchestrate your ESG issuance strategy in the context of the re-opening of the OBG market? Is it something you are considering?

Villa, Banco BPM: Yes. Last year we issued around €2bn of green bonds, including €750m of covered bonds. When we issued these covered bonds in March 2022, the green label helped us greatly reduce execution risk in a very tough market, with the war in Ukraine having broken out shortly beforehand. Without this label, it would have been very difficult to reach €750m, so the project was a great success in terms of size.

But while using the green label for covered bonds is an option, it typically suits the senior space better, and we also have senior bonds planned for this year. We are also updating our green bond framework, in order to align it with the EU Taxonomy, and these updates have an impact on the

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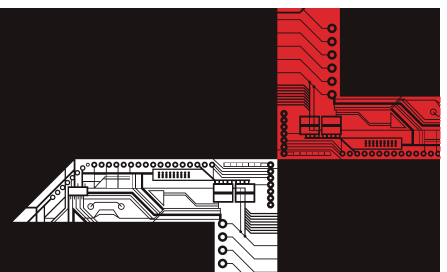

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categories within our framework, in some cases further limiting the potential capacity. So green OBGs are an option, but we have to carefully manage our green bond issuance capacity.

Sibari, Credem: We established our ESG bond framework in 2021 and last year we were very active in the bond market: we issued our first green senior preferred, and we then became the first Italian bank to issue a subordinated social bond. As part of our funding strategy, ESG formats are fully integrated into our funding plan, and when the domestic covered bond market will reopen it will be possible to consider an ESG transaction also for this asset class in either the green or social format.

In 2022, ICMA released a significant update to the section relating to Secured Green and Social Bonds broadly in line with EBA's recommendations. According to this update, new categories of ESG transactions could be implemented: a Secured Collateral Bond, which is where the use of proceeds are applied exclusively to the related collateral pool; and a Secured Standard Bond, which is where the use of proceeds are applied to other assets of the issuer. This amendment has removed an obstacle for the covered bond market which limited the issuance of new covered bonds to the amount of ESG assets within the cover pool and to financing and/or refinancing only specific ESG categories such as green buildings or social housing. Thanks to ICMA, issuers now have greater flexibility for future issuances and a broader range of assets and ESG categories to pick from and apply their use of proceeds. It is possible that in the future we might see an increase in green and social covered bonds in these two different formats.

But I agree with Francesco that it's more efficient to use the green format for senior unsecured debt. It usually adds traction to investors' demand and, in the end, creates more value for the issuer. Nonetheless, the reopening of the domestic covered bond market will influence ESG funding strategies and the sustainability of ESG portfolios will become a key factor in the choice of the type of bonds to issue.

Thanks to ICMA, issuers now have greater flexibility

Marlat, Crédit Agricole Italia: We have been the first to issue a green OBG, and it's interesting that we also have Banco BPM around the table today, as we are the only two to have done so.

We issued because we wanted to, not because it was convenient — it was a lot of work, after all. We have often thought about a second issue, but in Italy the buildings are on average very old. Hence, to achieve eligibility for the taxonomy, we did an update — again, a lot of work. The bottom line is that you need new houses, and if you need new houses when you already have a lot of old houses, you need to use new land, and it's an idea that we do not like so much as it doesn't feel so green. Hence, what we are trying to do is to focus on the restructuring of existing properties where we can achieve an upgrade in the energy class. However, when doing this, you encounter challenges: usually, we have the new updated energy performance class after the upgrade, but very often we do not have the old class in the system, and this makes it difficult to calculate the extent of the upgrade. This is really a challenge. I don't know if we can solve it, but the concept of retrofitting and upgrading for us is much better than using new land.

Hoarau, Crédit Agricole CIB: Does anyone have any final comments or questions?

Pisana, AllianzGI: As we are all expecting these new OBG issues and we know there is this 30 day Bank of Italy notification period, can the issuers say anything on whether this has been done and hence on what date you will actually be ready to start?

Villa, Banco BPM: We have done our homework, we have gotten our internal approvals, and we have made the application to Bank of Italy. So, we think that by the middle of June we can see the market reopen and we will be ready.

Sibari, Credem: We are still doing our homework. We have been working on the internal approvals and the update of the documentation, so we are more looking at a window starting from September — not the first window, because we also want to see how the market will open.

Marlat, Crédit Agricole Italia: We did the same. We had our board of directors meeting and we sent all the documentation to Bank of Italy that they had asked for. Hence, if they do not ask us for anything else, we will be past the 30 day period during the first part of June. We still need to supplement the prospectus, though, which will take another five to 10 days or so. I hope to be able in June, maybe from mid-June, to see how the market is. At that point we will then choose our best strategy. ●

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