

Joachim Nagel: The Bundesbank perspective on the Pfandbrief market

Speech by Dr Joachim Nagel, Member of the Executive Board of the Deutsche Bundesbank, at the Tokyo Pfandbrief Investor Seminar 2011, Tokyo, 26 January 2011.

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1. Welcome

Ladies and gentlemen

First of all, I would like to thank the Association of German Pfandbrief Banks for giving me the opportunity to present the Bundesbank perspective on the Pfandbrief market to you. The motto of this event, “The Pfandbrief 2011 – return on investment in volatile times”, suggests what is going on in financial markets. From my point of view as a central banker it is too early to give the all-clear, but nevertheless measures were set in motion to overcome the financial crisis.

When the US subprime crisis disrupted the global capital markets in 2007, the European securitisation markets were also affected. That is why the Pfandbrief and other covered bonds played a central role in European monetary policy, not only as collateral but also during the covered bond purchasing programme. But first of all, I will comment briefly on the special role of the Pfandbrief on the European covered bond market.

2. Pfandbrief in comparison with European covered bond products

European covered bonds are very heterogeneous. The reasons for this are different legal systems and different market standards or traditions in certain financing segments.

Though there is a trend towards separate covered bond laws in most European countries, there are significant differences in terms of scope. The German Pfandbrief Act has the broadest scope and it is the strictest in many areas. For example, there are no derivatives in the underlying and the loan-to-value rules are the most conservative. Its simplicity and transparency make the Pfandbrief the benchmark for European covered bonds.

The cover pool of a Pfandbrief is of extraordinary quality, since structured products are excluded and cover assets are separated in the so-called “cover pool register”. The cover assets contained in this pool serve first to satisfy the Pfandbrief creditors, and in the event of a Pfandbrief bank’s insolvency do not participate in the insolvency proceedings. In order to engage in Pfandbrief business, a specific licence is required demanding that issuers provide evidence of their intention to conduct Pfandbrief business on a regular and sustained basis. The benchmark role also results from the high liquidity of the Pfandbrief asset class.

There has been no case of default so far. To continue this success, lawmakers are permanently working to improve the Pfandbrief Act. The latest improvements were adopted in 2009 and 2010.

At this point, I would like to make a brief comment on Basel III. The negotiations were finalized some months ago and the general outcome is an increase in equity requirements and new buffers to withstand future periods of stress. Therefore, Pfandbrief issuers fear massive threat to their business activities. The Commission plans to present draft legislation on the implementation of Basel III before the summer.

3. Covered bonds as collateral for Eurosystem refinancing operations

I would now like to elaborate on the role of the Pfandbrief in European monetary policy. All Eurosystem credit operations have to be based on adequate collateral. The Pfandbrief and

UCITS¹-compliant covered bonds enjoy a privileged status within the Eurosystem collateral framework. In contrast to uncovered bank bonds or ABS, for example, the issuer of a Pfandbrief can use self-issued assets as collateral. This is of great importance, especially for Bundesbank counterparties.

On 1 January 2011, a new haircut schedule entered into force. It contains the valuation haircuts applied to eligible marketable assets. Covered bonds keep their privileged status within the Eurosystem Collateral Framework. Jumbo covered bonds are part of Category II and a non-Jumbo Pfandbrief is part of Category III. One innovation is that structured covered bonds and Spanish multi-Cédulas were switched from Category IV to Category III. Furthermore, there is a new 5% add-on valuation haircut in the case of theoretical valuation applicable to all bank bonds, which is to say to the Pfandbrief as well. The haircut ranges from 1% to 38% depending on the credit quality.

As regards the composition of collateral put forward in the whole Eurosystem, the average share accounted for by covered bonds rose to 13% at the end of 2009. Thus, it was possible to halt the downward trend of recent years. One explanation could be that covered bonds became more important during the financial crisis due to their “own-use-ability”. Data for 2010 will not be available until after the 2010 annual report is published.

Breaking down the collateral pool of German institutions for 2009, the Pfandbrief and other covered bonds take a larger share than within the whole Eurosystem. More recent data have not been published yet.

4. Eurosystem’s covered bond purchase programme

Besides the collateral framework, covered bonds were also part of the first “non-standard” measure of the Eurosystem during the financial crisis. The covered bond purchase programme (CBPP) was announced on 7 May 2009 in order to stimulate activity in the euro-area covered bond market. Last year, on 30 June precisely, the CBPP was completed, and it proved to be an effective policy instrument: it contributed to a decline in money market rates, encouraged banks to maintain and expand their lending to clients, helped to improve market liquidity in one of the most important segments of the private debt security market and eased funding conditions for banks and enterprises.

In total, 422 different bonds were purchased: 27% in the primary market and the remaining 73% in the secondary market. The Eurosystem mainly purchased covered bonds with maturities of three to seven years, and it intends to hold the purchased covered bonds until maturity.

In terms of developments in the secondary market, the reaction of most European covered bond markets to the announcement of the CBPP was noticeable, and appears to have initiated a declining trend in covered bond yield spreads. This trend increased when the programme was launched, and ultimately, pre-Lehman levels were reached.

In the wake of the European debt crisis, market participants began to differentiate strongly between the issuers’ countries of origin. In those countries where government bonds suffered the most, covered bonds also came under pressure. While bonds from core countries – such as the German Pfandbrief or French Obligations Foncières – remained relatively expensive, risk premia for peripheral bonds rose steeply. Overall, the results of a current analysis suggest that the CBPP had a noticeable impact on euro-area covered bond secondary markets. While the German Pfandbrief market had already started recovering by early 2009,

¹ UCITS = Undertakings for Collective Investments in Transferable Securities. The UCITS Directive in general is an investment guideline for insurance, investment funds etc limiting the share of assets one investor can invest in with one issuer.

the announcement of the CBPP seems to have provided an important stimulus to the recovery of other covered bond markets.

Since the primary market of European covered bonds had almost come to a halt, the aim of the CBPP has also been to support a revitalisation of the covered bond market. And indeed, issuance volumes and total outstanding amounts of covered bonds increased significantly shortly after the CBPP was announced. Even so, this development is not necessarily the result of the programme, as other factors could have played a significant role. In particular, it is important to recall in this context that market conditions generally improved in 2009. On the other hand, it is also possible that, while the CBPP may have had a positive effect on the outstanding amounts of covered bonds, the programme had no effect on the outstanding amounts of bank bonds – both covered and uncovered. In this case, uncovered bank bonds would have been substituted by covered bank bonds. To sum up, the primary covered bond market has recovered well, as is also indicated by the very good performance of emissions during the first weeks of this year.

There is another trend I would like to mention. During the last couple of months, a trend towards so-called sub-Jumbo issues – 500 million to 1 billion euro – has emerged. According to market participants, this trend will probably continue and has the potential to change the nature of the covered bond market.

Since the beginning of 2009 the French, Spanish and German covered bond markets have experienced most issues. In several European countries, German-style covered bond markets have been created. Since the announcement of the CBPP, new issuers have entered the European covered bond market in various euro-area countries. Some national markets – the Italian for example – have seen a significant increase in the number of issuers and outstanding amounts. The broader distribution across various new countries and issuers will probably boost and further reinvigorate the covered bond once the financial crisis is over.

5. Covered bonds securities lending

Since March 2010, the Eurosystem has lent covered bonds held in its CBPP portfolio, responding to demand from Eurosystem counterparties who wished to borrow such covered bonds against eligible collateral. Beyond that, the Bundesbank Executive Board decided to make not only its CBPP but also other own portfolio holdings of covered bonds available for the so-called Automated Securities Lending Programme by Clearstream. The securities lending activity should help to support market liquidity, particularly in situations in which market making has been discontinued or dealers' limits for covered bond holdings have become tighter. This lending activity will continue.

6. Outlook

The Pfandbrief is undoubtedly a winner of the financial crisis. The voluntary transparency initiative of the Association of German Pfandbrief Banks has also contributed to this. This initiative could be a model for other asset classes – for example ABS – to increase transparency and to regain investors' confidence. Though issuers have to cope with higher competition for the favour of investors, from the perspective of the Bundesbank the Pfandbrief is well positioned for the future.

Thank you very much.