Jon Nicolaisen: Covered bonds and their impact on investors, banks and the real economy

Remarks by Mr Jon Nicolaisen, Deputy Governor of Norges Bank (Central Bank of Norway), at the European Covered Bond Council (ECBC) Plenary Meeting, Oslo, 6 April 2017.

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Accompanying slides

Good morning and thank you for inviting me. Today, I will briefly discuss three issues that I believe will be central to further market development. First, the role of covered bonds in asset markets in general; second, the impact of covered bonds on the balance sheet of banks; and, third, the potential impact on the allocation of capital between households and enterprises. The market for covered bonds is perhaps especially interesting for us, given the strong growth of covered bonds in Norway over the last 10 years.

Chart 1 Covered bonds outstanding

Covered bonds remain a key funding tool for residential mortgage loans in many European countries. They have confirmed their position as a resilient source of funding also under stressed market conditions. This has been particularly evident in the Nordic region.

Role in asset markets

Covered bonds provide investors with a liquid and safe asset. The small premium above government bonds indicates that these securities are considered almost as safe as triple-A sovereign debt. Relative to senior bonds, covered bonds now appear more attractive than before the financial crisis.

Chart 2 Covered bond spreads

The fundamental characteristics of covered bonds support this pricing. Covered bonds are secured primarily by a preferential claim on a pool of residential or commercial mortgage loans. They are protected from potential bail-in under the new crisis resolution regime and are subject to special supervisory monitoring.

The European Commission has determined that covered bonds may be included as level 1 qualifying assets in fulfilling banks' liquidity coverage ratio requirements. Covered bonds also receive favourable treatment both under Solvency 2 and in the regulation of large exposures. In addition, the European Central Bank's Asset purchase programmes have supported market liquidity.

Covered bonds have a long history of strong performance in general and they have survived and developed during shifting market conditions. The safety of covered bonds supports high and stable ratings. It also drives demand and market depth, confirming their position as liquid assets.

Large falls in house prices may present a key risk for the covered bonds market, given the dominance of residential mortgages as collateral. At Norges Bank, we have looked at this risk and we have so far concluded that Norwegian covered bonds are quite robust against a potential decline in house prices. In the 2015 Financial Stability Report, Norges Bank estimated that a 40% fall in house prices would reduce the eligible cover pool by around 20%. In such an extreme scenario, refinancing costs may rise for covered bonds. However, the rise in costs would probably be somewhat limited compared with the rise in refinancing costs for unsecured funding. Thus, even under extreme market conditions, covered bonds would remain attractive, at least in relative terms.

Role in balance sheet of banks

While covered bonds provide investors with a broad range of options to the investment opportunity set and contribute to deep and liquid markets, they also impact banks' balance sheets.

When banks use covered bonds as a source of funding, a proportion of the banks' assets become pledged to covered bond creditors. One issue that arises is what effect this may have on the quality of the balance sheet of banks.

At the outset, a banking group's liquidity and credit risk will rise since covered bonds reduce the volume of encumber-able assets available to the bank. In addition, banks are often both significant issuers and holders of covered bonds. Such interconnection may increase systemic risk. However, market participants may assume that resolution rules and liquidity and capital requirements nonetheless limit the risk.

For example, all banks are subject to regulation of their core equity – notably through the Basel III standard of the Basel Committee, implemented in Europe through the CRD4/CRR regulation. This is the primary insurance for tax payers and investors against the potential failure of large banks. Sufficient equity and a resilient banking system will always be the main instruments to ensure stability in the financial system as a whole. This is why senior bonds are also considered a relatively safe asset.

Impact on the supply of credit and capital allocation

How do covered bonds impact the supply of credit and capital allocation?

Capital requirements under Basel II and III incentivise banks to supply residential mortgage lending. The introduction of IRB models for calculation of capital requirements have resulted in low risk weights for residential mortgages. This may encourage leveraging. Some countries where large shares of covered bonds are backed by residential mortgages, have experienced relatively strong growth in residential mortgage lending and brisk house price growth. The availability of a large and liquid covered bond market may have facilitated this development.

One would expect that the emergence of a vibrant residential covered bond market would generally deepen fixed income markets through larger volumes and better liquidity. The cheaper financing of residential mortgages through covered bonds has been reflected in household lending rates. In combination with very low risk weights and corresponding low capital requirements on residential mortgages, banks may have favoured such lending.

As a result, corporations seeking financing may be *pushed* into bond markets through a crowding out effect. In addition, a vibrant market could make bond financing more attractive and *pull* corporate borrowers to the market. Higher interest rates on banks' corporate loans may contribute to this effect. In some of the markets in Europe that have seen substantial deleveraging, loans to SMEs have been provided at steep interest rates. However, the economic situation and investment demand in general are probably much more important in determining overall growth in investment financing by banks. In general, banks still provide loans to profitable enterprises.

To sum up: The covered bond market provides investors with a broad set of investment opportunities, banks with cheap funding and house buyers with ample credit. At the same time, extensive regulatory measures safeguard the solvency and liquidity of the banking system as a whole. A well-capitalized banking system with stable and liquid funding options is a prerequisite for markets to develop and thrive. That includes the covered bond market.

Thank you for your attention.