In association with CRÉDIT AGRICOLE CORPORATE & INVESTMENT BANK

NORDIC FIs & COVERED

INSIDE:

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Covered bonds in 2015: Victims of their own success?

Throughout the sovereign crisis, covered bonds were a remarkably stable asset class that at the same time offered a wide range of investors an attractive investment case, write Crédit Agricole CIB covered bond analysts in their outlook for 2015.

Covered bonds were yieldy enough for asset managers as well as insurance companies, while at the same time often offering higher ratings and less volatility than sovereign or bank senior debt, and bank treasuries could profit from preferential regulatory treatment.

Looking at today's market, the stability and quality elements are clearly still there, but apart from this one can say covered bonds have become a victim of their own success. With the start of the third covered bond purchase programme (CBPP3), the European Central Bank added buying covered bonds to its policy kit and in doing so has pushed covered bond spreads to levels where the investment abovementioned case simply isn't there anymore for many investors. The spread rally of the past years seems to have found its bottom for now.

One might think that in times of record low interest rates and spreads issuers will rush to enter the covered bond market and profit from the prevailing conditions. We do not follow this line of argument in our issuance forecast for euro benchmark covered bonds. With forecast euro benchmark covered bond issuance of Eu120bn after Eu114bn this year, we expect only a slight increase.

For covered bond funding volumes to grow substantially, we need loan book growth or very volatile markets. In the absence of this, peripheral issuers will grow slightly as they optimise their funding and replace ECB with market funding, and we will have a handful of new markets such as Poland and Singapore. Many issuers in core European countries may well put their focus on other products that count as loss-absorbing capital, though.

Looking at the Nordics, we expect a slightly higher focus on euro covered

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Season's greetings from Nordic FIs & Covered, and best wishes for 2015!

This will be the last issue of Nordic Financial Institutions & Covered Bonds of the year, so we, at The Covered Bond Report and Crédit Agricole CIB, would like to take this opportunity to wish you all season's greetings.

Appropriately, we leave you with a look forward into how the covered bond market might turn out in 2015 courtesy of Crédit Agricole CIB's analysts, as well as bullish rating agency expectations for Nordic banks in general and Additional Tier 1 in particular.

We will be returning in the new year and in the meantime would like to thank you for your interest in our publication throughout 2014.

Best wishes to you all for 2015!

Latest Nordic FI benchmarks

Senior unsecured (z spreads mid)			
JYBC	FRN	06/17	34bp
POHBK	1.125%	06/19	18bp
DANBNK	FRN	11/18	39bp
Covered bonds (asw spreads mid)			
POHBK	1.000%	11/24	5bp
NDASS	1.000%	11/24	-1bp
SHBASS	0.625%	11/21	1bp

Source: CACIB trading 18/12/14

Raters expect AT1 supply from strong Nordics

Moody's expects Swedish banks to make early, sizeable issuances of Additional Tier 1 (AT1) instruments, while Standard & Poor's expects a similar trend across Nordic banks, which it said are pulling away from their European peers in terms of capital strength.

Moody's said in a report on Friday (12 December) that the Swedish issuance of contingent capital securities (CoCos) is credit positive for banks and their creditors, due to an early phasing-in of increased capital requirements in the country. The rating agency forecast $2bn-$2.9bn (Skr15bn-Skr22bn, Eu1.6bn-Eu2.3bn) of Swedish AT1 issuance by 2016 (excluding issuance to date), rising to $4.9bn by 2019.

"We believe AT1 securities will be attractive for Swedish banks because Sweden adopted close to fully-loaded Basel III rules from 2014, ahead of most other European nations and well ahead of the mandated introduction schedule that allows a gradual move to Basel III by 2019," said Daniel Forssen, associate analyst at Moody's.

Meanwhile the rating agency said that there is likely to be market appetite for such a volume of issuance because Swedish banks have stronger performance metrics than their European peers and AT1 CoCos provide a higher yield than Tier 2 debt and senior unsecured debt. In addition, as legacy Tier 1 instruments come up for call, Moody's expects banks to redeem such securities and replace them with AT1 CoCos.

Nordea kicked off Swedish AT1 in September with Skandinaviska Enskilda Banken (SEB) following in November, and Moody's said Svenska Handelsbanken and Swedbank are likely to issue AT1 securities over the next few years.

"The issuance of AT1 securities is credit positive for Swedish banks and their creditors, because they will boost the banks' loss-absorbing capital, replace legacy instruments that have less clearly defined loss-absorption features, and increase the possibility that banks can continue to operate as a going concern," said Oscar Heemskerk, associate managing director at Moody's.

S&P said in a biannual report on the risk-adjusted capital (RAC) ratios of Nordic banks published today (Thursday) that as at mid-year 2014 the financial institutions have strengthened an already strong position relative to their European peers. It said that this has happened on the back of a more stable operating environment and in the context of more stringent capital requirements that have been imposed by Nordic regulators.

Of 25 Nordic banks S&P rates, five have this year enjoyed positive rating actions — ranging from improvements to elements of their standalone credit profiles (SACPs) to upgrades — associated with improvements in capital levels

"After seeing the market demand for TAC-eligible hybrid issues by Danske Bank, Nykredit Realkredit, Nordea Bank, and SEB in 2014, we expect a number of new and potentially repeat issuers in 2015," said the rating agency. "These instruments could account for a large share of the capital build over the next two years.

"While increased issuance of loss-absorbing Basel III-compliant hybrid instruments would reduce the proportion of core equity, we note that Nordic banks have a strong quality of capital, represented by common equity to TAC exceeding 90%," it added. "Consequently, we believe that hybrid issuance could bring improvements in the banks' RAC ratios and, in some instances, could support SACP improvements." ■

Nordic FIs & Covered Bonds

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CRÉDIT AGRICOLE CORPORATE & INVESTMENT BANK

Neil Day
Managing Editor
nday@coveredbondreport.com
+44 20 7428 9575

Tom Revell
Reporter
trevell@coveredbondreport.com
+44 20 7267 5354

news.coveredbondreport.com

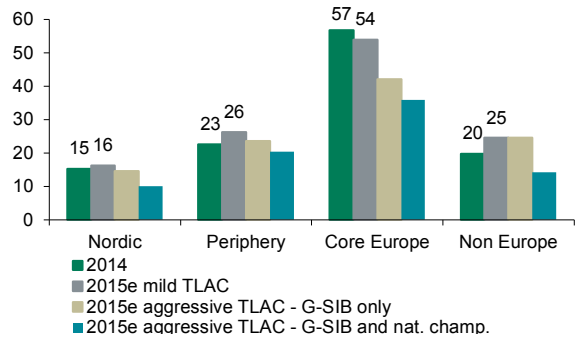
Vincent Hoarau
Head of FIG Syndicate
vincent.hoarau@ca-cib.com
+44 20 7214 6162

Julian Burkhard
Global Head of Capital Solutions,
Head of FI DCM Nordics & UK
julian.burkhard@ca-cib.com
+44 20 7214 5472

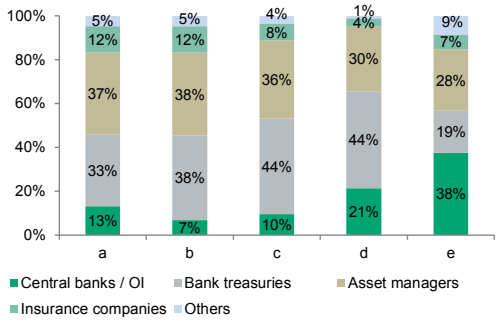
Florian Eichert
Senior Covered Bond Analyst
florian.eichert@ca-cib.com
+44 20 7214 6402

Covered bond outlook 2015: Comfortably numb

Euro benchmark covered bond issuance forecast for 2015



Investor distribution by investor type for Eurozone euro benchmark covered-bond issues (%)



Source: Crédit Agricole CIB

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bond markets and less US dollar issuance, while at the same time the Finnish weight could grow as Swedish and Danish issuers make use of their Eurozone subsidiaries to access CBPP3 demand.

We also expect more issuers to make use of soft bullet structures. Issuers from the Netherlands, France and Switzerland are these days joining the soft bullet camp. In Nordic countries soft bullets are already widespread, with Norway and Denmark only issuing soft bullets and Finland predominantly making use of this. Even the first Swedish issuers have started to do this and we would expect others to follow.

CBPP3 activity and impact

We've mentioned the ECB already at the beginning of this article and the impact it has had on spreads. The biggest problem the CBPP3 has is its danger of crowding out private sector investors and reducing the depth of our market. The ECB mentioned on a number of occasions that it wants to maintain a functioning investor base in covered bonds.

Well, as can be the case with good intentions, it is hard to keep promises in real life. The share of central banks in euro benchmark covered bond new issues from the Eurozone went up in recent weeks at the expense of asset managers and bank treasuries. The latter have predominantly moved to SSA and sovereign debt, while the former have moved on to sovereign debt, corporate bonds and bank senior and sub debt.

In general there are two main themes among investors in the last few days and weeks:

- At these spread levels covered bonds are not an attractive proposition to end-clients, and investors overweight either sovereign debt or go the other way, buying corporates or senior/sub bank debt.
- Given the difficult liquidity situation in the market, net negative issuance and the CBPP3 constantly buying in the secondary market, big accounts in particular are starting to question whether they can in practice maintain the same focus on the asset class as in the past.

The first theme is something that can probably be sorted out by core covered bonds widening 10bp-15bp to get back to around swap flat and Bunds plus 25bp-30bp, which would bring back bank treasuries and asset managers with LCR mandates. In the periphery, moving 20bp-30bp wider to get a little closer to their domestic sovereign debt would probably bring back some of the yield-hungry asset managers and insurance companies.

The second theme, however, is more structural in nature and more worrying, especially when thinking about a potential time after CBPP3.

From our meetings in the last days we can say that much of the covered bond underweight so far has been tactical in nature. With all of the talk about investors moving out of the asset class, at the end of the day it is probably fair to assume that a low double-digit billion amount has changed hands so far. After all, our secondary purchase estimate for the CBPP3 is around Eu16bn so far and the big account on the buying end of this rotation has after all been CBPP3.

However, we are at the year-end and in the coming days and weeks many investors will have their year-end meetings with their end-clients. And one thing that will certainly be discussed is the asset allocation and benchmarks to be used for 2015.

The feedback to our second CBPP3 survey is all pointing in the same direction. Many accounts are frustrated and

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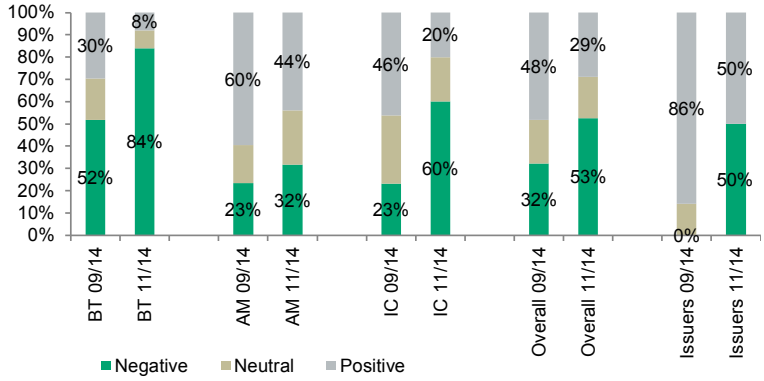
What impact do you think the CBPP3 will have on covered bond investors? Answers by investor type (%)



Source: Crédit Agricole CIB

IMF recognises Danish moves, but calls for more

A drop in confidence in Danish covered bonds was one of four downside risks highlighted by the International Monetary Fund (IMF) upon the conclusion of its latest report on the Danish economy last week, although the supranational body acknowledged progress being made by the authorities in tackling the area.

Although the likelihood of Denmark experiencing such an event occurring was considered low and the lowest among the risks highlighted in the report, its impact if it materialised was seen as the highest.

The IMF *(pictured)* acknowledged that financial stability risks in Denmark are "contained", noting several steps the authorities have taken since the onset of the financial crisis, including, among other measures, recent legislation requiring the maturity extension of covered bonds in stress situations with the aim of reducing refinancing risk in the mortgage finance system. The new Danish supervisory diamond for mortgage credit institutions was also noted.

However, the IMF said that while such policy actions have helped safeguard financial stability, the large size and high domestic interconnectedness of the financial system require even greater resilience, and made several recommendations.

"To mitigate risks introduced by recent product innovation, use regulatory policies to encourage longer bond maturities, ensure that interest-rate risk is better reflected in loan pricing and approvals, and increase buffers in loans with interest-only periods, for example, by reducing the loan-to-value ceiling," it said. "The proposal for a supervisory diamond for mortgage credit institutions goes in the right direction."

Moody's said on Monday that implementation of the IMF's recommendations would be credit positive for Danish mortgage credit institutions and covered bonds because they address vulnerabilities in the mortgage market. ■

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despite the expectation of further spread tightening eventually, their predominant fear is to be further crowded out while no new investors are expected.

CBPP3 determining our bottom line recommendation

Consequently we have chosen a rather conservative stance in our covered bond outlook. We feel that at the current spread levels there is not sufficient demand to stabilise the market without CBPP3. And given the stable CBPP3 buying, the central banks' activity is likely sufficient to support covered bonds in the long run and keep volatility levels fairly low, especially when putting covered bonds into the bigger context. The programme is, however, not reactive enough to respond to weaker days with more selling. It thus cannot prevent markets from widening in the shorter term. Accessing today's market does carry noticeable execution risk for issuers at these spreads, even when factoring in CBPP3 buying. It is tougher for syndicate banks to find 30% private sector demand these days after CBPP3 buys the maximum 70% than it was to find 100% private sector demand three months ago.

The most likely way the market will move in the coming weeks is range-bound trading. Individual accounts that decide to sell in bigger size will trigger widening while the ongoing buying of CBPP3 will push the market back tighter in the following days.

We thus continue to favour a buy-on-dips strategy for investors' tactical asset allocation, while maintaining a structural underweight of covered bonds versus sovereign debt and the SSA space.

For a healthier market and a more structural shift back to more covered bonds, we would need the ECB to focus on other markets with its buying, which would make covered bonds look more attractive in relative terms. Should the ECB decide to go for this we expect covered-sovereign spreads to widen from both ends of this product pair as investors would certainly question CBPP3's ongoing commitment. In our view, CBPP3 would, however, continue to buy at an unchanged pace, and at Bund spreads of 30bp covered bonds are LCR-efficient instruments again, adding private sector demand to the ECB's buying. To us, the sooner QE and this widening comes the better for the covered bond investor base. Staying in this zombie-like range-bound trading mode means we will be bleeding investors week after week.

The positive aspect of these squeezed markets is that for the first time in a long time, fundamental analysis does make sense again. As sectors have compressed substantially, investors don't have to pay up to move into the better quality. At the beginning of last year one would have still given up carry to move out of French, Belgian or Austrian covered bonds into some strong Nordic programmes. These days, with the CBPP having distorted Eurozone covered bond levels, this move cannot only be done for free but it actually adds carry to portfolios.

Florian Eichert
Senior Covered Bond Analyst
Stephan Dorner
Covered Bond Analyst
Crédit Agricole CIB

Euro Nordic covered bond & senior unsecured secondary spreads

Nordic benchmarks: covered versus ASW, senior unsecured (shaded) versus Z spreads, 18/12/14.

ISIN	Coupon	Maturity	Mid Spd
AKTIA (*AKTIA REMB)			
XS0640889803*	3.125	22/06/2016	-4
XS0946639381	1.125	25/06/2018	-5
XS1056447797	1.000	15/04/2019	-4
BRF			
XS0882166282	2.500	31/01/2018	49
DANBNK			
XS1113212721	0.375	26/08/2019	-2
XS0469000144	4.125	26/11/2019	-3
XS1071388117	1.250	11/06/2021	4
XS0519458755	3.750	23/06/2022	5
XS0802067636	2.500	09/07/2015	-1
XS0627692204	3.875	18/05/2016	2
XS0751166835	3.875	28/02/2017	10
XS1139303736	3mE+35	19/11/2018	39
DNBNO			
XS0728790402	2.375	11/04/2017	-8
XS0877571884	1.000	22/01/2018	-6
XS0992304369	1.125	12/11/2018	-5
XS0794233865	1.875	18/06/2019	-3
XS1117515871	0.375	07/10/2019	-1
XS0637846725	3.875	16/06/2021	2
XS1137512742	3mE+10bp	17/11/2021	11
XS0759310930	2.750	21/03/2022	4
XS0856976682	1.875	21/11/2022	5
XS0522030310	3.875	29/06/2020	14
XS0595092098	4.375	24/02/2021	24
XS0732513972	4.25	18/01/2022	29
EIKBOL			
XS0736417642	2.250	25/01/2017	-4
XS0851683473	1.250	06/11/2017	-5
XS0794570944	2.000	19/06/2019	2
XS1044766191	1.500	12/03/2021	5
JYBC			
XS0856532618	3mE+110bp	20/05/2015	15
XS1078186001	3mE+50bp	19/06/2017	34
LANSBK			
XS0926822189	1.125	07/05/2020	1
MINGNO			
XS0893363258	2.125	21/02/2018	29
XS1069518451	1.500	20/05/2019	37
NDASS			
XS0478492415	3.500	18/01/2017	-12
XS0731649660	2.375	17/07/2017	-13
XS0965104978	1.375	20/08/2018	-12
XS1014673849	1.250	14/01/2019	-9
XS0778465228	2.250	03/05/2019	-7
XS0874351728	1.375	15/01/2020	-4
XS0591428445	4.000	10/02/2021	-2
XS1132790442	1.000	05/11/2024	-1
XS0801636571	2.250	05/10/2017	13
XS0916242497	1.375	12/04/2018	17
XS0728763938	4.000	11/07/2019	16
XS0520755488	4.000	29/06/2020	16
XS1032997568	2.000	17/02/2021	23
XS0801636902	3.250	05/07/2022	12
NYKRE (*senior secured)			
LU0787776052*	3.250	01/06/2017	30
LU0921853205*	1.750	02/05/2018	30
LU0996352158*	1.750	28/01/2019	36

ISIN	Coupon	Maturity	Mid Spd
POHBK			
XS0785351213	1.625	23/05/2017	-11
XS0646202407	3.500	11/07/2018	-9
XS1076088001	0.750	11/06/2019	-7
XS1045726699	1.500	17/03/2021	-3
XS1144844583	1.000	28/11/2024	5
XS0758309396	2.625	20/03/2017	6
XS0540216669	3.000	08/09/2017	5
XS0931144009	1.250	14/05/2018	15
XS1077588017	1.125	17/06/2019	18
XS1040272533	2.000	03/03/2021	24
SAMBNK			
XS0693226978	2.750	19/10/2016	-9
XS0834714254	1.625	27/09/2019	-5
XS0640463062	3.875	21/06/2021	3
SBAB			
XS1117542412	0.625	07/10/2021	2
XS0968885623	2.375	04/09/2020	41
SEB			
XS0548881555	2.625	16/10/2017	-10
XS0894500981	1.500	25/02/2020	-4
XS0988357090	1.625	04/11/2020	-3
XS0614401197	4.125	07/04/2021	0
XS0628653007	3.750	19/05/2016	4
XS0730498143	3.875	12/04/2017	8
XS0592695000	4.250	21/02/2018	14
XS0972089568	2.000	18/03/2019	13
XS0854425625	1.875	14/11/2019	14
XS1033940740	2.000	19/02/2021	26
SHBASS			
XS0760243328	1.875	21/03/2017	-12
XS0906516256	1.000	19/06/2018	-7
XS1050552006	1.000	04/01/2019	-5
XS1135318431	0.625	10/11/2021	1
XS0490111563	3.750	24/02/2017	4
XS0732016596	3.375	17/07/2017	4
XS0794225176	2.250	14/06/2018	5
XS0965050197	2.250	27/08/2020	11
XS0693812355	4.375	20/10/2021	17
XS0819759571	2.625	23/08/2022	21
SPABOL			
XS0495145657	3.250	17/03/2017	-7
XS0820929437	1.250	28/02/2018	-5
XS0738895373	2.750	01/02/2019	-5
XS0995022661	1.500	20/01/2020	-1
XS0942804351	1.500	12/06/2020	1
XS0587952085	4.000	03/02/2021	2
XS0674396782	3.375	07/09/2021	3
SPAROG			
XS0853250271	2.000	14/05/2018	36
XS0965489239	2.125	27/02/2019	41
XS0876758664	2.125	03/02/2020	44
XS1055536251	2.125	14/04/2021	63
SWEDA			
XS0496542787	3.375	22/03/2017	-11
XS0925525510	1.125	07/05/2020	-1
XS1069674825	1.125	21/05/2021	-1
XS0768453101	2.375	04/04/2016	-2
XS0740788699	3.375	09/02/2017	12
XS1045283766	1.500	18/03/2019	11

Source: Crédit Agricole CIB Trading, Bloomberg — See disclaimer on page 6

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