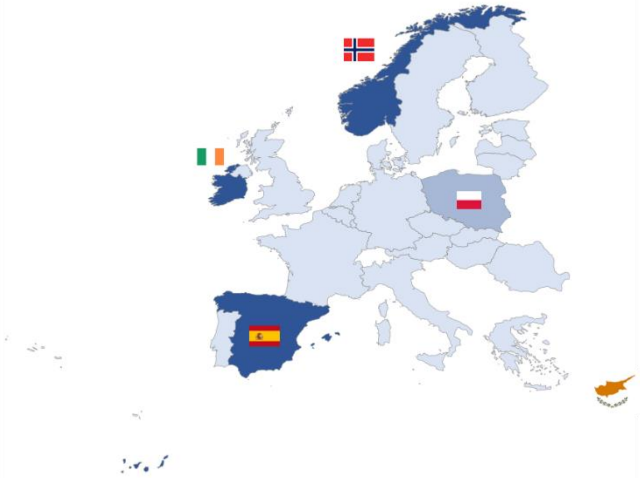
Cypriot harmonisation consultation closed: could covered bonds stage a comeback?

With the last Cypriot covered bond maturing in December 2021 and only one active issuer left, local regulators do not need to give much thought to legacy covered bonds. But they are speeding ahead with harmonisation: their consultation on how to align their framework with the EU Covered Bond Directive closed on 7 August. Short-term liquidity protection will improve but on our current reading, extendible-maturity structures will not be allowed. Scope classifies CPT structures as an extendible-maturity structure; their exclusion would be credit negative. This needs to be clarified.

Cyprus has become the fourth country in which the covered bond harmonisation train has started to gather pace (see Figure 1). Unlike Poland, where regulators recently announced not just to apply a fine polish to align its covered bond framework[1] but to go back to the drawing board, we expect limited changes and discussions in Cyprus.

Figure 1: Harmonisation status



Source: Scope

No activity since 2011; last covered bond matures in 2021

Covered bond harmonisation might help investors regain appetite for Cypriot covered bonds (kalimmena axiografa) and help re-establish the asset class in Cyprus. To date, Cypriot covered bonds have not met the expectations of becoming a stable capital market funding tool for domestic banks, however.

The covered bond framework dates back to December 2010 and met most expectations for a newcomer covered bond framework. It was unfortunate timing, though, as the European sovereign crisis gathered pace and Cyprus and Greece were in the eye of the storm. Once the framework entered into force, Cypriot covered bond issuance soared to more than EUR 5bn in 2011 (see figure 2) but the rapid deterioration of the economy and the domestic banking system – also reflected by sovereign and succeeding bank and covered bond downgrades – closed the market just when it was starting up.

[1] On 16 July 2020 the Polish FSA and the Polish Ministry of Finance published a notice that in line with the transposition of the covered bond directive they also want to revisit the specialist banking system, the way mortgage collateral is pledged and mortgage banking in general.

Analysts

Karlo Fuchs
+49 69 6677389-78
k.fuchs@scoperatings.com

Mathias Pleißner
+49 69 6677389-39
m.pleissner@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

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Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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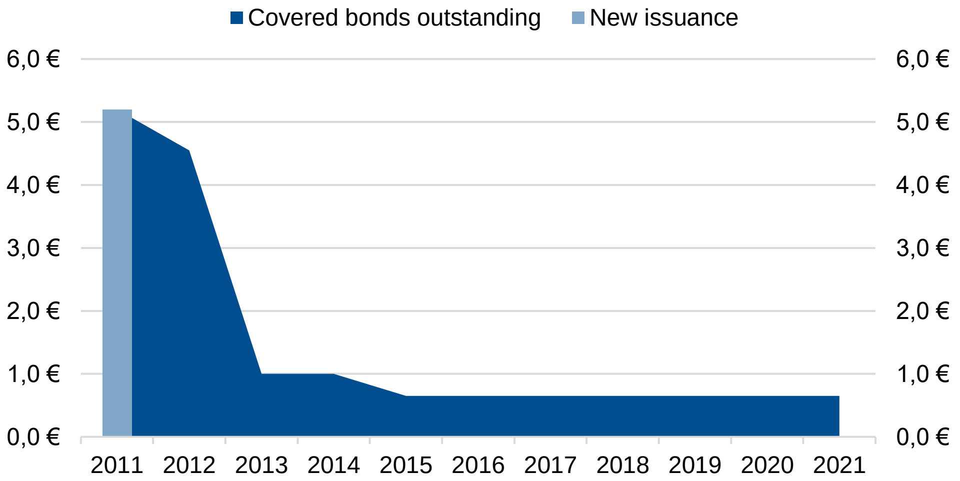
Figure 2: Cypriot covered bonds



Source: ECBC, Scope

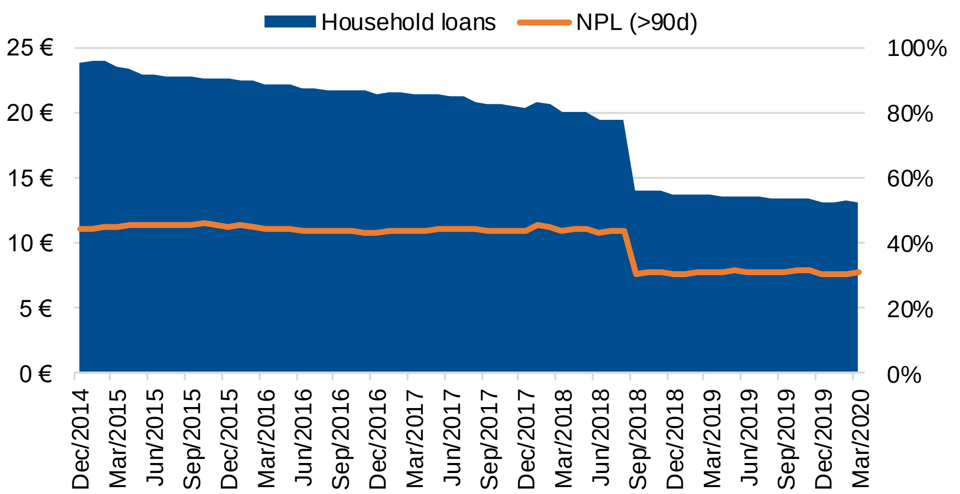
Covered bonds were only able to be issued in retained format for ECB repo purposes. But the deterioration of the banks and the credit quality of covered bonds even closed this door. Initially Single A covered bond ratings swiftly migrated to non-investment grade. Even though they didn't default, their credit quality migrated as far down as to the C rating category by one CRA at the beginning of 2013.

Improved balance sheets challenged by Covid-19

Level of NPLs remain highest in a European context..

The impact of the European sovereign crisis was significant in Cyprus. Banks had to be bailed out, restructured and the central bank reported up to 46% of non-performing household loans in 2015 (see figure 3). Thanks to the ESTIA scheme, where the State covers up to one third of borrowers' restructured loan obligations as well as the government take up of NPLs, banks were able to restructure their balance sheets.

Figure 3: Cypriot household loans (lhs)/ NPLs (rhs)



Source: Scope, Central bank of Cyprus

Still, with NPL levels of 30% for exposures to households at the end of Q1 2020, Cypriot NPL quotas rank among highest in Europe. With fewer clouds in the sky, the onset of Covid-19 is still likely to become a test for banks. For now, the Cypriot debt-repayment suspension scheme – valid until December 2020 – means that NPLs might not become visible in 2020 accounts: 2021 might be the litmus test.

Evergreen cover pools might foster confidence with investors

…but protection against NPLs might favour new CB issuance?

The fact that even at the height of the crisis Cypriot covered bonds did not default and that even at times of rising NPLs on banks' balance sheets cover pool replenishment criteria meant that investors always had recourse to performing borrowers might help to reintroduce covered bonds as a supplementary capital market funding product.

If the updated covered bond framework meets the "Premium label" it could provide a fertile ground for a re-start for Cypriot covered bonds.

Covered bond harmonisation – the Cypriot way

The proposal for an updated covered bond framework has been prepared by the Ministry of Finance and the Central Bank of Cyprus. To-date, it is only available in Greek[2]. It makes references to secondary legislation, which is not yet available but will be needed to form a rounded assessment of the strength of the updated Covered Bond Framework.

Definition of eligible assets remains open to new covered bond types

Additional CB types only to remain a theoretical option

The updated framework maintains the ability to issue covered bonds backed by five primary asset types: i) public sector loans; and loans backed by ii) residential property, iii) commercial property iv) shipping and v) other collateral specified by the central bank.

As in the past, we only expect residential mortgage-backed covered bonds to become relevant. Volatility of collateral values and the size of the domestic market will likely be a hindrance i.e. CRE and public sector-backed covered bonds becoming an economically feasible option for the issuer – and to create sufficient investor interest.

Cross border and multi originator cover pools ?

Cross border and multi originator cover pools possible

Not surprisingly, the new law will maintain the option of cross-country cover pools reflecting the proximity and close business ties of the domestic banks with Greece.

From a credit perspective, this option could foster diversification of cover pools. At the same time, operational differences as well as different dynamics in the underlying mortgage markets could add to complexity premiums demanded by investors. Unless cross-country shares are only a fraction of the primary pools and aid diversification, cross-country cover pools geared towards volatile markets could see higher volatility in stressed credit risk assessments.

The proposal also allows for pooling, both using the Danish concept (i.e. including a covered bond issued by a group company that then becomes part of the cover pool); and also using cover assets sourced by external companies where the assets are registered in the cover pool.

Such provisions typically allow smaller entities to gain access to the wholesale funding market. However, conflicts of interest and ongoing support to maintain the quality and sufficiency of over-collateralisation often renders this a rather theoretical option; in particular if the ultimate originators are of weaker credit quality.

[2] https://www.cysec.gov.cy/CMSPages/GetFile.aspx?guid=fb056bf7-87f4-457f-aff0-28500a88b203

Streamlining short-term liquidity coverage strengthens protection…

Harmonised short term liquidity coverage credit positive…

The Act will improve short-term liquidity protection for Cypriot covered bonds. Already present in the previous framework, short-term liquidity provisions prescribed different treatment for interest and principal coverage. Introducing combined interest and principle coverage increases investor protection as the full repayment obligations are covered.

We also understand that the regulators currently will not allow for the LCR carve-out, which means that substitute assets will need to cover the full 180 days and not the bank covering the first 30 days via the LCR and the cover pool only comprising sufficient liquidity for the following 150 days.

… and focus on scheduled maturities in particular important for CPT CBs

…as focus on scheduled maturities provides more buffer

With current CPT structures, a strength of the proposal is that regulators will stipulate the scheduled maturity and not the final extended maturity as relevant for the short-term liquidity coverage. As an illustration, the only remaining Cypriot covered bond has a CPT structure with a scheduled maturity of December 2021 and a pass-through maturity in December 2075. Assuming an issuer could use the final legal extended maturity would put the full (scheduled) repayment responsibility on the shoulders of the issuer. Conversely, requiring the currently proposed scheduled maturity means that the full outstanding repayment obligation will have to be buffered by highly liquid and at least investment-grade assets within the cover pool.

Will CPT structures no longer be allowed?

Clarification of CPT structures needed

Our current reading of the proposal suggests regulators will not allow for the extension of covered bonds as they will not provide clear definitions on when the extension would be triggered[3]. This could mean that use of CPT structures – which analytically are extendible maturities – would no longer be possible.

If this reading prevails, this would be credit negative. Cypriot covered bonds would have to become hard-bullet bonds so exposed to refinancing risk. Given the illiquidity of Cypriot mortgages and the small size of the domestic banking market, this could significantly increase the level of protection needed to support ratings that are significantly higher than the issuer rating.

We understand that transposing current frameworks into harmonised versions will prompt most countries to introduce or clarify soft-bullet structures. As such, we hope that the disapplication of extendible-maturity structures are simply a result of our translation of the current proposal.

Combination of nominal and NPV-based OC requirements unchanged

Based on the current draft, the combined one-to-one nominal coverage of assets and liabilities and an NPV-based coverage test (with the latter stipulating 5% minimum OC) remains unchanged. Coverage requirements also stipulate coverage of set-off risks, which are often not addressed in legislation. However, details of the how those elements will be calculated have not been provided and will subject to the secondary legislation.

[3] The proposal mentions that options provided in Article 17 of the CB Directive ((EU) 2019/2162) will not be used. Our reading of this means that ultimately extendible maturity structures would not be allowed.

Use of 'other' transposition options improve clarity and security

Most of the remaining options chosen by Cypriot regulators are credit neutral but increase the clarity of the framework. Among other things, they clarify the required cover register, public supervision and the role of the central bank, the duties and responsibilities of external trustees as well as those of the special administrator.

We also note that compared to other legislation, more details are provided on the winding-up or transfer of covered bond programmes – which the Cypriot covered bond programmes have already had to experience in real life.

Secondary legislation not yet provided but key for final assessment

Secondary legislation will be key for a well-rounded assessment

As highlighted, regulators to-date have only shared the updated Covered Bond Act. The Act makes repeated reference to secondary legislation. As highlighted in our commentary on the Irish covered bond harmonisation, such secondary legislation matters. For an NPV-based over-collateralisation requirement, details of the accompanying stress tests and the actual calculation of the NPV are very relevant. Similarly, if a country opts for a pre-provisioning of the servicing costs in a lump sum, details such as the extent to which a conditional pass-through maturity needs to be reflected are needed.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

London

3rd Floor
111 Buckingham Palace Road
London SW1W 0SR

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director: Guillaume Jolivet.