

Retained Covered Bonds: A Blessing for Issuers but a Challenge for Investors

Disclosure needs to improve



Last week Italian Banca Monte dei Paschi di Siena S.p.A. (MPS) reminded investors that covered bond programmes are actively managed funding instruments. Investors must actively monitor the risk profile of covered bond programmes, in particular when these contain 'retained' covered bonds. The share of retained issuances is not easy to identify and such programmes might ultimately be subject to a higher volatility of changes to repayment or other risk profiles, compared to those that are fully placed with investors.

On 15 May 2017 bondholders of one Italian covered bond (obbligazioni bancarie garantite or OBG), issued from the first covered bond programme maintained by MPS (the series 13 OBG guaranteed by MPS Covered Bond S.r.l.), gave notice to the bondholder representative that they have approved of a change to the scheduled maturity. Effectively, the series 13 OBG, initially due on 30 June 2017, has been extended by more than eight years, until 31 December 2025. We understand that the bond's sole investor is the bank itself.

MPS covered bond programme converted to CPT structure in 2015

This is already the second change to the terms and conditions of this series, as in June 2015 MPS had already asked for investors' consent to amend the then-existing soft bullet structure. This resulted in the covered bond programme being converted to conditional pass-through (CPT) from soft bullet.

The issuer's initial ability to extend the repayment of the bonds by one year from the scheduled maturity to the extended maturity date (soft bullet) has, following the investors' consent, switched them to a CPT structure. In the case of MPS's OBG, this means: i) a significantly longer period between the scheduled maturity and the extended maturity dates, to 38 years from one year; and ii) the bullet repayment obligation's conversion to a pass-through payment structure. As some of the bonds were placed with investors, the issuer then offered a consent fee of 50 basis points for the conversion.

Retained covered bonds – often drawn under CPT covered bond programmes that were solely placed with the ECB – have surged during the European sovereign credit crisis. Their risk profiles markedly differ to fully investor-placed programmes as they are optimised for ECB funding. For example, they were often issued as floating-rate covered bonds to avoid higher haircuts when used for the ECB's open-market operations, and dedicated programmes were set up solely for ECB repo purposes. Only when market sentiment improved did issuers start to restructure the programmes, eventually introducing swaps or other measures to reduce risk, to become acceptable for 'real money' investors as well.

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No requirements to disclose share of retained covered bonds

Share of retained covered bonds not easy to identify

Often, only the share of non-market-standard floating-rate covered bonds can be used to indicate the share of retained covered bonds. We believe investors should be aware of the amount of retained covered bonds within a programme.

Depending on the individual programme's documentation the quotas needed to introduce changes differ between simple majorities and the qualifying majorities of at least two-thirds. The higher the share of retained covered bonds, the stronger the ability of the issuer to avoid compensating investors for the change or even the ability to force changes upon investors.

This is particularly relevant, as some programmes do not have fixed provisions that ensure a change does not negatively impact a covered bond programme's credit profile (i.e. that changes do not negatively impact the ratings).

Neither regulatory-driven transparency requirements (e.g. an obligation in existing legal covered bond frameworks, or being a part of the current EC harmonisation proposal) nor market-standard transparency reports (e.g. the ECBC's harmonised transparency template) require a mandatory disclosure regarding the share of retained covered bonds. Currently the ECB also does not distinguish between retained and publicly placed covered bonds.

ECB to drive more disclosure on retained covered bonds?

ECB to enforce more transparency going forward?

Based on the ECB's November 2016 statement¹ we understand that more information might be available going forward – though only indirectly. The ECB is currently considering the adjustment of its risk control measures for some retained covered bond types. Detailed information on such changes will be provided in the second half of 2017. We believe this is also likely to result in higher transparency for other investors, which in general will be credit-positive and will allow them to identify programmes that are more prone to forced changes.

¹ "ECB reviews its risk control framework for collateral assets", published on 3 November 2016 (https://www.ecb.europa.eu/press/pr/date/2016/html/pr161103_1.en.html)



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