Market fragmentation: evidence and reasons

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“Covered bond….pricing should normally by driven by….

(i) the credit quality of the cover assets;

(ii) the repayment capacity of the issuer; and

(iii) relevant country factors..

..relative strength of the sovereign

..robustness of the underpinning legal and supervisory framework”

Welcome to country A. Where do the covered bonds price?

COUNTRY A

CB Policy
……
Bank policy

Quality of covered bond law?
Scope for contractual add-ons
Quality of CB supervision
Probability of gov’t support for banks
Probability of gov’t support for CB
Probability of gov’t negative actions

Sovereign credit

Inability to support cb/bank
Risk of catastrophic failure
Relative value: cb:govvies

Economy

Technicals: investor parochialism
Asset pool
Banking system credit

Covered bond pricing

Problems!

Beta pricing

- Covered bonds pricing on a good-bad continuum
- What changed was the price of risk, not the relative price of different covered bonds
- Investors assume credit variables are more correlated than they are

Changing perceptions

- EG, investors used to say: UK is periphery / covered bonds price over govvies / asset pools reflect state of housing market
- Most of these happened DURING the crisis, not before or since

Evolution of market

- EBA - convergence of supervisory practices
- BRRD – convergence of support probability?
- ECBC – convergence of transparency

Investors want to price risk

- But they must do so rationally
- The risks must be legitimate (different commercial models) not due to fragmentation

Which pricing differences are legitimate? / Which are evidence of market failure?