CIBC first Canadian bank to tap Europe's negative yields

By Tim Kiladze
July 19, 2016 – *The Globe and Mail*

Canadian Imperial Bank of Commerce has become Canada's first bank to benefit from Europe's rush to debt with subzero yields.

CIBC sold €1.25-billion ($1.79-billion) worth of six-year covered bonds – with a yield of negative-0.009 per cent – on Monday. According to a person familiar with the transaction, investor demand was so strong that the value of orders roughly doubled the deal size.

Not only is CIBC the first Canadian bank to issue such debt at a negative rate, it is also the first non-European bank to do so. In March, Germany's Berlin Hype was the first lender to borrow at negative rates, cashing in on a hunger for quality debt, coupled with Europe's unique fixed-income markets.

At the start of this month, nearly $12-trillion (U.S.) worth of government debt carried negative yields. As CIBC's latest foray into the market highlights, the phenomenon is now spreading to other types of bonds, as investors search for securities that pay at least a tiny yield – or cost less to own than sovereign bonds.

Since the global financial crisis of 2008-09, some of the world's biggest central banks have unleashed multiple rounds of quantitative easing, or bond buying, designed to keep bond yields low.

Their heavy demand for debt, combined with stubbornly low global growth that continues to sink inflation expectations, has helped dramatically lower the cost of borrowing for many governments and companies around the world.

As a result, bond yields – particularly in Europe – have plunged to levels few thought possible. Germany's 10-year debt, for example, now carries a negative-0.016 yield.

Covered bonds, such as those issued by CIBC, are secured by mortgages on a bank's balance sheet and have existed in Europe for years, but they only grew popular among Canadian banks in the past decade. Investors like them because their buyers have a claim on the assets, or mortgages, should the issuing bank ever default, offering two layers of security.

Because there is such strong protection, most issues are rated Triple-A, a category of debt that is hard to find from corporate issuers.

As for the banks themselves, covered bonds are popular because they provide the financial institutions with a cheap source of funding, relative to selling traditional senior unsecured debt. Because investors are given extra security, they accept lower yields – or now even pay – to own these bonds.

"Covered bonds are obviously ultrasafe or tend to be at or near a Triple-A rating," explained Terry Carr, head of Canadian fixed income at Manulife Asset Management, adding that "if anything is going to be pushed toward zero or pushed through to negative, it's going to be something like this."

Whether that continues on to corporate debt is a little less certain. "It's a little hard to get your head around," he said of corporate debt with negative yields, because "there would be tremendous resistance from the investor base."

Normally, corporate bond yields lag sagging sovereign debt yields, he said. If government debt quickly pays less, corporate debt often doesn't fall as fast because investors like to keep a decent return on riskier bonds.

In 2007, Royal Bank of Canada was the first Canadian lender to issue covered bonds, and the remaining Big Six lenders rushed to join the market shortly after. Originally, there were few

guidelines as to which types of mortgages could be included in these programs, meaning government-insured loans could get wrapped in. That created a conflict of interest, and Ottawa eventually cracked down.

The problem, in the Finance Department's eyes, was that mortgages insured by Canada Mortgage and Housing Corp. are implicitly guaranteed by the government, yet the insurance is paid for by the homeowner. That means the individual paid for it, the federal government guaranteed it and the financial institution benefited by being able to borrow money at a lower cost.

Since the rule change in 2012, the banks' covered bond programs no longer include home loans insured by CMHC – a move many people expected would eventually be made.

While the benefits of negative yields are clear for bond issuers because they get paid to sell debt, it can be difficult to appreciate what motivates investors to buy such bonds. Jim Keohane, who runs the Healthcare of Ontario Pension Plan, which manages $64-billion (Canadian), called it an "irrational thought process" in a recent interview.

Yet, some of Canada's largest asset managers justify such purchases by arguing there has been a paradigm shift within bond markets – from searching for returns to simply preserving capital. As frustrating as it can be to have to pay to do that, the broad asset allocation strategies set out by their boards often prevent them from switching gears and investing more in the likes of equities.