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Briefing

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Covered bonds – ripe for expansion?

SUMMARY

The covered bond is a debt instrument with a long history in Europe. There has never been a default of a covered bond, and they performed relatively well during the latest financial crisis. They are characterised by the double protection offered to their holders, the separation of collateralised assets in a cover pool that is dynamically managed, and strict regulatory and supervisory frameworks.

The main issuers of covered bonds are banks and the debt they use is mainly mortgage or public-sector debt, although in the context of the current economic environment, many suggest extending them to include SME debt too.

Covered bonds bring numerous benefits to all parties involved, although some researchers have pointed out certain drawbacks which can increase systemic risk and therefore need to be investigated more closely by regulators and supervisors.

There is no single, harmonised, legal framework for covered bonds, and the legislation relating to them at EU level is interwoven in the provisions of different regulations and directives. However, some convergence has taken place following the development of the eligibility criteria for preferential capital requirements under the Capital Requirements Directive (CRD IV). The European Commission, after consulting the European Banking Authority, intends to review the treatment of such bonds in this context. Taking into account the findings of this review, it is then expected to launch a study on the merits of introducing an EU framework for covered bonds in 2015.

In this briefing:

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Glossary

Asset encumbrance: a claim on assets provided as collateral in a transaction, which restricts their use.

Collateral: the asset(s) used as security for a loan, which can be seized by the lender(s) if the borrower defaults on repayments.

Cover pool: a clearly identified, 'ring-fenced' (segregated) pool of assets dedicated to securing the covered bonds.

Face value: the amount paid to the bondholders when the bond matures.

Market-maker: a broker-dealer firm that holds a number of shares of a given financial instrument and is ready and able to buy or sell at any time on its own account.

Origination: the process of creating a loan (especially a mortgage).

Principal: the amount borrowed or invested, on which interest is paid or earned.

Primary market: the market on which new securities are issued and sold directly by the issuer.

Secondary market: the market on which a security is traded after its initial sale.

Security: a term for tradable financial investments that give a right to income or ownership.

Special purpose vehicle: an entity formed for a particular project or task.

Unsecured creditors: those that do not have any rights to specific assets of the business.

Yield: the annual income generated by an asset (as a percentage of the asset's purchase or market price).

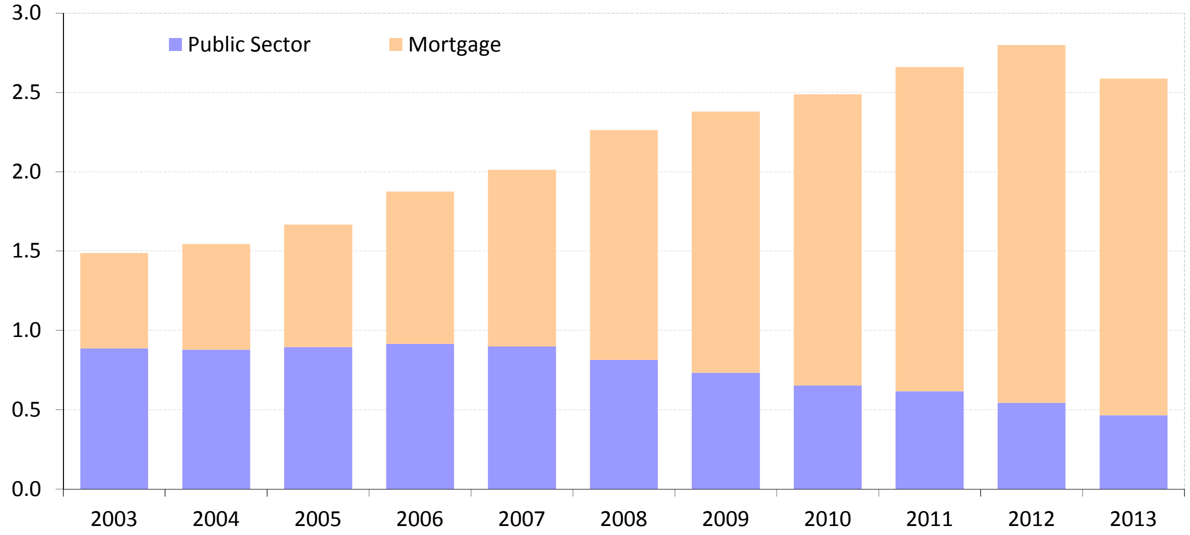
Background

The ability of the financial system – banks and capital markets – to channel funds efficiently to the real economy is considered by many to be essential for economic growth. In Europe, the crisis and its aftermath have created a complex problem: stricter capital requirements introduced by regulators have prompted banks, which finance up to 75-80% of the economy in the EU, to deleverage by selling assets and reducing their lending. But by acting in this way, they reduced the available funds necessary for the recovery of the real economy. In its Communication on the Long-term Financing of the European Economy the European Commission presented a set of concrete actions to remedy this situation. It proposed, among other actions, to focus on developing capital markets in order to provide the real economy with alternative financing methods, and on increasing the capability of banks to refinance themselves at competitive rates with safe, high-quality instruments. In this area, the Commission highlighted the role of securitisation and covered bonds.

Securitisation, a financial practice developed in the US in the 1970s, can be defined as the pooling of assets (such as mortgages) into securities – backed by the income generated by the assets – that are subsequently sliced up according to their risk and sold to different types of investor according to their risk profile.

The **covered bond** is a debt instrument with a long history in Europe, that has recently come to be used in an increasing number of EU countries: according to statistics published by the European Covered Bond Council, the covered bond market has developed into the most important segment of privately issued bonds on Europe's capital markets, with a volume of €2 600 billion at the end of 2013 (see figure 1).

Figure 1 – Total outstanding covered bonds by underlying assets, 2003-13 (trillion euros)



Source: ECBC European Covered Bond Fact Book, 2014.

There is no formal, universally accepted definition of 'covered bonds', just as there is no single name for them (they are called *Pfandbriefe* in Germany, *obligations foncières* in France, and *cedulas* in Spain). However, they do share some characteristics that are seen as defining them. The ECBC emphasises as most important:

- **the dual recourse** – the double protection offered to bondholders: if the credit institution issuing the bond does not pay them, they have the right to turn against the institution's assets, and – in case the institution goes bankrupt – they have a claim against a separate 'cover pool' of financial assets in priority to unsecured creditors;
- **the asset segregation** and **dynamic cover pool** – the obligation of the credit institution that issues the bond to 'ring-fence' the cover pool, and to ensure that the value of the assets making up the cover pool is equal to, or even higher than, the value of the covered bonds, at all times (also called over-collateralisation);
- **the strict legal and supervisory frameworks** – to ensure asset segregation and the quality of the cover pool, public bodies must ensure both the supervision of the credit institution itself ('general' supervision), as well as the supervision of its obligations in respect of the cover pool ('special' supervision).

Who issues and who invests in covered bonds?

Banks (in particular German and Austrian) are the main issuers of covered bonds. Banks are also the most important investors in covered bonds, followed by insurance companies and mutual funds. Central banks play an important role, using covered bonds to boost the economy but also to support the banking system in times of stress with long-term funding.

Up to now, the main elements of the cover pool used to secure a covered bond are mortgage loans or public-sector debt. An ongoing discussion in the current economic context is whether covered bonds could serve for SME financing, through the bundling of their loans in a cover pool, against which covered bonds would be issued. This is not the case to date in most countries in Europe, because most national laws do not allow for the use of SME loans as an asset class and because, at EU level, SME loans are not eligible as covered bond collateral under the Capital Requirements Regulation (which, in turn means that they are not accompanied by preferential risk-weighting). This is due to the fact that the credit quality of a cover pool backed by SME loans and the related refinancing risk are higher than in the case of mortgages or public-sector loans. Additionally, the credit assessment of such a cover pool and therefore the covered bonds issued against it, is more difficult than for the other asset classes, because of the sheer diversity of SME loans and because there is no clear and standardised information on their credit profile in Europe.

Nonetheless, private initiatives have been undertaken to start such a market – for example, even though in Germany SME loans are not eligible as collateral for *Pfandbriefe*, Commerzbank has launched a €500 million covered bond programme with SME loans (nonetheless structured in such a way as to meet the requirements of the law). It remains to be seen whether such initiatives, coupled with more standardisation and greater safety requirements (such as, for example, more over-collateralisation) will bring wider acceptance of SME loans as collateral, and changes in national or EU legislation

Benefits to stakeholders

Covered bonds present attractive features to issuers, investors and market supervisors.

They constitute an additional source of funding and thus give the opportunity to **issuers** to diversify their funding sources. Furthermore, the dual recourse and the supervisory framework enhance the perceived safety of covered bonds and partly de-link their credit quality from that of their issuer: the most important credit rating agencies not only give a higher rating to covered bonds than to their issuers, but in addition hold the view that these bonds could even withstand a modest downgrade in the credit rating of the issuer without being downgraded. This, in turn, allows issuers to access cheaper funding for longer maturities and gives an issuer entering the bond market the possibility to issue covered bonds to establish themselves, before issuing other, more risky types of bonds.

Investors in covered bonds obtain access to low-risk bonds which are highly rated, have a more attractive yield than government debt (even though they are less liquid, that is, less easy to trade) and are perceived to be safer and more liquid than securitised products.

Finally, they are attractive to **market supervisors:** the legislative framework for covered bonds indicates clearly the potential risks, as well as the protection investors benefit from, thus facilitating supervision and action in times of stress.

EU legislation in force

There is no specific legislation which comprehensively governs covered bonds at EU level. Instead, their framework is interwoven in provisions from different directives[1]:

Undertakings for Collective Investment in Transferable Securities (UCITS)

The central legislative element of covered bonds is Article 52(4)[2] of the UCITS Directive which sets limits and provides exceptions for the assets in which a UCITS can invest.

Capital

European legislation in this area is contained in the Capital Requirement Directive (CRD IV) for banks – which, inter alia, modifies the risk-weighting approach for covered bonds – and the Solvency II Directive (2009/138/EC) for insurance companies –

a complex framework which addresses many different sources of risks that interact with each other and allows for the calculation of a solvency capital requirement.

Liquidity
The central element here is the liquidity coverage ratio (LCR), a liquidity coverage requirement that firms must respect, to ensure that they have assets that they are able to convert into cash to meet their liquidity needs for a 30 calendar day period where conditions are strained. On 10 October 2014, the Commission adopted a Delegated Act on the LCR under which covered bonds are classified as one of the relevant liquid assets.

Recovery and resolution
The Bank Recovery and Resolution Directive (BRRD) came into force on 1 January 2015. It sets a common framework for Member States for dealing with troubled banks. Article 44 of the Directive exempts, in principle, covered bonds from being written down following a bail-in intervention of the national authorities, and provides that the assets of the cover pool must remain segregated and well-funded.

The Banking Union
The entry into force of the Single Supervisory Mechanism (SSM) in November 2014 and the Single Resolution Mechanism (SRM) will change the procedures relating to supervision and resolution of banks, which, in turn, according to some stakeholders, could dramatically increase the reporting requirements for covered bonds and create conflicts of competence between European and national supervisors. Therefore, steps will have to be taken at national level to adjust to this new system.

Possible drawbacks

Different researchers have expressed the fear that covered bonds may increase market instability in times of stress due to:

- the role of banks as market-makers, which concentrates risk in a downturn − if many investors decide to sell their covered bonds at the same time, the banks (in their role as market-makers) *must* be able and prepared to buy them on their own account. This raises the risks on their balance sheet, possibly above the levels accepted internally or by the regulators, prompting them to sell on. If other banks experience the same problem and market conditions are strained, this situation is not sustainable;
- covered bonds being used as liquidity buffers − given that the market in covered bonds is less liquid than others, in the event that markets are strained, covered bonds, which may constitute a significant part of the liquidity buffers of the banks, render a large part of a bank's liquidity buffer unusable.
- the problem of asset encumbrance (at least during economic downturns) − falling collateral values require more assets to be pledged to raise a given level of funding. In a crisis situation, where a bank needs to deleverage, this may limit significantly the bank's activities and increase investors' concerns about its financial health.

Covered bonds' performance during the financial crisis and since

Although no covered bond has ever defaulted and no covered bond-holder has been asked to take a loss (not in Germany during the crisis in 2008-09, not during the Greek crisis, not even in Cyprus, where there were talks even of a deposit levy), certain covered bond issuers did have to be bailed out during the financial crisis.[3] That raised concerns among investors about the stability of the market, and added to the strains in funding conditions experienced up to that moment by issuers, prompting the European

Central Bank to intervene in order to support the market through the purchase of covered bonds under the Covered Bond Purchase Programme (CBPP). The purchases under the programme amounted to €60 billion and the goal was to restore liquidity to the market, re-launch issuance and reduce spreads. An analysis conducted after the end of the programme shows that these goals were achieved, since the programme has stimulated issuance of covered bonds in the primary market, thereby easing funding conditions for banks and improving market liquidity.

With the introduction of the Single Resolution Mechanism for the Banking Union, governments will not be able to support bond issuers in the way they did during the crisis. However, reduced support to issuers does not necessarily mean less support to their covered bonds: the CBPPs initiated by the European Central Bank showed that there is support to the whole covered-bond segment at European level.

Latest developments

In its communication on the Long-term financing of the European Economy the Commission notes that, although there are references to covered bonds in various legal systems, there is no single, harmonised, legal framework for covered bonds. Industry participants note that this can partly be explained by the fact that the cultural, legal and economic fundamentals vary from country to country and as a result, real-estate finance systems and the role of covered bonds as funding instruments for housing mortgages vary accordingly. While this holds true, some convergence has taken place following the development of the eligibility criteria for preferential capital requirements under the CRD IV.

According to Article 503 of the Capital Requirements Regulation, the Commission – after consulting the European Banking Authority (EBA) – should report (and submit appropriate proposals) to the European Parliament and Council by 31 December 2014 on whether the risk weights and the own-funds requirements for specific risk for covered bonds are adequate. Although the Commission has postponed this to 2015, in July 2014 the EBA issued an opinion on their preferential capital treatment. It believes that they are 'in principle appropriate' due to their good historical performance and dual recourse principle, but it advised the strengthening of covered bond frameworks by introducing further criteria for their preferential treatment.

After the Commission reports, it will consider whether or not to launch a study on the merits of introducing an EU framework for covered bonds. If it decides to go forward with this, it may take into account a July 2014 report from the EBA. This report, which identifies the most important areas for the establishment of a framework for covered bonds and indicates the principles of best practice in each area based on the existing frameworks in the EU, could be a step towards a Common European Framework.

Main references

Communication on Long-term Financing of the European Economy, European Commission COM(2014) 168, 27 March 2014.

EBA report on EU covered bond frameworks and capital treatment, July 20014.

Endnotes

[1] The UCITS Directive, the Capital Requirements Directive (CRD IV) the Solvency II Directive, the MiFIR/MiFID, the Market Abuse Directive, the Prospectus Directive, the Transparency Directive, and the Directive establishing a framework for the recovery and resolution of credit institutions and investment firms.

[2] 'They must be issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders. ..., sums deriving from the issue of those bonds shall be invested in accordance with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.'

[3] In Germany only, Düsseldorfer Hypothekenbank was bailed out in April 2008, Hypo Real Estate AG in October 2008, Eurohypo AG in May 2009 and Valovis Bank at the end of 2011.

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