EU Covered Bond Directive

Policymakers solicit views on outstanding items. Are ESNs the next frontier?

Analyst

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

Team leader

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

Media

Keith Mullin
k.mullin@scopegroup.com

Efforts to address remaining items in the Covered Bond Directive (CBD) continue, with a European Banking Authority (EBA) questionnaire in response to a Call for Advice from the Commission. While the CBD has brought many benefits, there is room for improvement, particularly for European Secured Notes, which could offer both banks and SMEs funding benefits. This report summarises aspects of Scope's response to the EBA.

The CBD has brought a number of benefits to national covered bond markets. In harmonising legal frameworks at EU level, the CBD has been particularly credit-positive for smaller and less developed markets such as in Central and Eastern Europe, as there are fewer uncertainties about their legal strengths and better clarity on regulatory oversight.

Generally speaking, the alignment of frameworks brought about by the CBD has enhanced levels of sophistication, improved clarity and introduced improvements to liquidity and market depth. The CBD has also eased the path to more cross-border funding and investment activity by removing some investment barriers, again because there are fewer legal uncertainties.

The CBD has improved the way liquidity risk is mitigated. The introduction of 180-day liquidity provisions and maturity extensions is credit positive. It has reduced complexity with regards to triggers, having changed the market from its previous hard-bullet maturity structure into a market dominated by soft bullets.

The CBD clarified and strengthened the legal isolation of cover pools upon issuer resolution or insolvency. And it enhanced and harmonised the clarity of eligibility criteria and the ability of covered bonds to remain unaffected by a moratorium on the issuer.

The governance support assessments that are embedded into our rating approach capture the strength and sophistication of legal frameworks as well as their cohesiveness and levels of stakeholder support. Since the CBD was introduced, most EU covered bond markets are in principle eligible for the highest governance support uplift under our covered bond rating methodology. Differentiation is no longer constrained by considerations of legal framework but by considerations of systemic relevance and resolvability.

Room for improvement remains

The Directive has some natural limitations, however. As a principles-based framework, it only addresses covered bond issuance-related activities. It has not aligned – nor did it seek to align – issuers' business profiles, the specifics of individual mortgage market or insolvency regimes. Assessing the credit quality and risk attributes of covered bonds in the EU therefore still requires investors and rating agencies to factor in issuer, market and country specifics.

From a ratings perspective, the strongest risk contributors that need to be mitigated by over-collateralisation (OC) are asset-liability and market-risk mismatches. Those risks had been addressed in an earlier EBA assessment that laid the groundwork for the CBD but the focus was diluted in the final version of the CBD.

In our view, covered bonds and corresponding European legal frameworks would benefit from:

- Stronger and better aligned market-risk-management guidelines;
- Clarity on liquidity access for covered bonds that are in an orderly and stand-alone wind down; and
- More dynamic OC rules. Since cover-pool composition and mismatches are dynamic, OC levels should also be dependent on a covered bond's risk profile.

Aligning covered bond funding with prudential frameworks

We would consider it credit-positive for banks if covered bond funding were more closely entrenched with prudential frameworks to reduce banks refinancing imbalances. Countries such as Poland and Hungary have introduced minimum covered bond refinancing ratios for long-term mortgages as part of macroprudential toolkits. Such measures can help reduce financial stability risks by reducing a bank's susceptibility to deposit runs, and increase covered bond issuance.

This also benefits market liquidity and provides domestic investors with high-credit-quality and long-term investment opportunities. In smaller and nascent covered bond markets in particular, it can also foster the development of domestic debt markets and reduce reliance on more volatile international capital markets.

Limited cross-border activity reflects issuer and investor preferences

Cover pools focus on domestic residential mortgages

Increased investor access and better liquidity are key drivers of cross-border covered-bond issuance. In principle, cross-border diversification can mitigate risks owing to exposure to different credit cycles. That said, cover pools mirror the business profiles of issuing banks, which for most covered bond programmes we rate are domestic and focused on granular residential mortgages. Banks active in EU jurisdictions generally use country-specific covered bond issuing vehicles rather than add legal and operational complexity or create analytical challenges for investors by transferring cover assets to parent entities.

Banks such as Nordea, Danske, UniCredit and Santander, for instance, do not consolidate covered bond issuance at the parent level but issue covered bonds out of countries in which they are active. Through this approach, banks can benefit from different funding levels since covered bonds in, for example, Italy or Spain trade more expensively than covered bonds in Germany or Austria. They also can avoid costly FX hedging.

Investors prefer 'pure-play' approach

On the topic of cross-border investment, covered bond investors typically favour a 'pure play' approach. They have shown limited demand for exposure to multiple markets. The exceptions are in relation to banks that focus on financing commercial real estate and/or are engaged in international public finance. Given investor preferences for pure-play exposure, we expect the share of single country residential mortgage-backed covered bonds to increase and covered-bond programmes with bespoke cover assets (CRE/aircraft/ships) to shrink and become even more of a niche product.

Strong oversight will be needed for niche products to avoid idiosyncratic problems in underlying markets spilling over into the traditional covered bond market. This was recently in evidence when CRE-backed covered bonds exhibited higher credit and spread volatility, which some investors did not deem to be commensurate with the highest ratings.

ESNs could create more competitive SME funding – but challenges abound

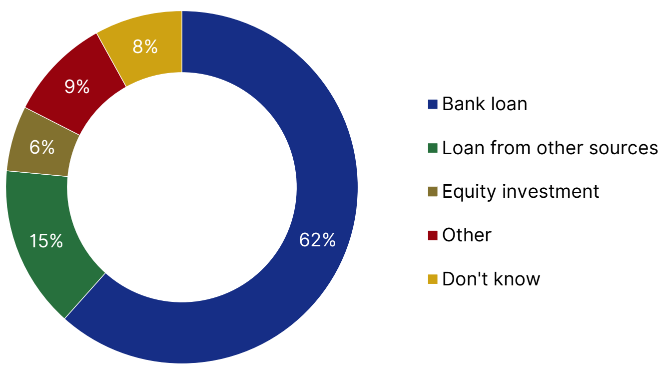
The market's resistance to European Secured Notes to fund European SMEs does not appear to be easily resolvable. ESNs were brought to the table as part of the capital markets union project. From a macro perspective, ESNs could offer funding benefits to banks and ultimately to SMEs, which are the backbone of the European economy. We are supportive and believe banks issuing ESNs could provide the desired benefits.

Banks will not increase their SME financing with ESNs

There is a catch, though: ESNs will not allow banks to increase their SME financing. Plus, Basle III risk floors will increase risk weights for SME portfolios. And unlike securitisations, which can be used to free up capital and increase banks' SMEs lending capacity, ESNs will tie up capital.

Banks will need to carefully consider the extent of which they want to use ESNs. The higher velocity and shorter tenors of SME loans will also require more management attention than longer-term mortgage refinancing. In the absence of common standards too, costly structuring efforts will initially challenge their economic viability.

Figure 1: SME preferred funding options



Source: European Commission Survey on Access to Finance of Enterprises (SAFE), December 2023

Pan-European regulatory framework to support market growth

The key to success will be a pan-European regulatory framework similar to the CBD aided by supervision and lower risk weights to support the growth of the product and foster investor confidence. Harmonised and comparable risk measures for SME exposures across Europe are also needed for transparency, comparability as well as regulated eligibility criteria.

Given the absence of commonly accepted risk measures (compared to LTVs for mortgages) a concerted effort by stakeholders is needed to establish an easy-to-understand credit-risk measure for SME cover pools. Transparency by industry sector or granularity will not be enough to allow investors to assess credit risk.

Only when all of the above items are addressed will ESNs be able to provide investors with high-credit-quality, short-to-medium term-investment opportunities. ESNs can also complement banks' funding toolkits and foster confidence in the SME asset class. At the same time, ESNs can help European securitisation markets to grow, a core aim of EU policymakers. In this regard, ESNs should be seen as a complement to securitisation not as competition.

Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin
scoperatings.com

Phone: +49 30 27891-0
Fax: +49 30 27891-100
info@scoperatings.com

in
Bloomberg: RESP SCOP
Scope contacts

Disclaimer