ECB liquidity stress test: bank survival at the expense of covered bond investors?

The 2019 liquidity stress test indicates that the ECB could guide issuers to deprive covered bond investors of protection when they need it most. The test requires banks to report the maximum amount of additional covered bonds that can be issued against existing cover pools. As such, it sends the wrong signals and highlights the importance of independent covered bond supervision. If the one-off stress test becomes standard in its current form, risk premia and ratings for covered bonds might have to be adjusted.

The 2019 ECB stress test will assess a bank's sensitivity to liquidity risk. Scope Ratings generally welcomes the shift towards a dynamic assessment of a bank's main vulnerability – liquidity risk (see ECB liquidity risk stress tests: a step forward but with two caveats, Feb. 2019). Assessing a bank's idiosyncratic "liquidity survival period" is a step forward, even though supervisory assumptions are likely to be biased and based on past experience. Idiosyncratic testing will also not incorporate likely system-wide contagion.

Digging deeper into the ECB's methodological notes shows that the ECB is focusing only on the survivability of banks. As such, they are willing to jeopardise the credit strength of the dual-recourse nature of covered bonds: the strength of the cover pool. The ECB is asking banks to report the amount of additional liquidity that could be generated by issuing new covered bonds against existing over-collateralisation (already registered assets).

Stress test highlights management discretion in managing over-collateralisation

Levels of over-collateralisation (OC) provided by covered bond issuers in good times cannot be taken as guidance for the protection investors might see when the bank is in distress. At the same time, issuers have a strong incentive to maintain OC at stable levels to maintain access to capital market funding.

Scope balances this conundrum in its methodology via the level of OC taken into account for cover pool analysis: the level above regulatory and legal minimums has to become more affirmative and protected, even legally binding, the lower the rating of the issuing bank. Funding excess OC above the legal minimum becomes costlier the lower the issuer rating. From the issuer's perspective, therefore, alternative use of excess OC might become more economic.

Emergency funding plans often incorporate the use of such excess collateral. The cover pool, in particular generally highly-liquid substitute collateral, is often eyed with interest by treasuries of banks in distress for alternative use. In most countries and covered bond regimes, de-registration of assets from the cover pool is an option issuers can exercise. In the absence of strong and independent trustees, issuers can very easily exert management discretion – provided the legal minimum is maintained.

The ECB stress test highlights the swiftest and easiest option to deprive covered bond investors from their collateral: issuing new covered bonds and repo-ing them with the ECB or national central banks. Such behaviour was already observed at the height of the sovereign crisis. Southern European issuers that were cut off from the capital markets used this route and accessed central bank liquidity with covered bonds.

Analysts

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

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

Related Research

ECB liquidity risk stress tests: a step forward but with two caveats, February 2019

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Emergency covered bond funding can increase risk profile

Issuer that took recourse to such central bank-focused covered bond funding often also increased the risk profile of their covered bond programmes, as banks intended to optimise the maximum amount of liquidity that could be generated at the lowest haircuts applicable.

Haircuts in the eurosystem's repo framework are a function of a bond's residual maturity, coupon structure, credit-quality steps and haircut category. In good times, the maturity and the coupon structure of choice reflects a bank's ALM profile and risk management philosophy. The maturity of choice is also a function of the current shape of the interest-rate curve and thus dependent on market appetite.

For standard new issuance, the risk profile of a covered bond programme is typically not materially altered by incremental new issuance. A bank in distress only focuses on central bank liquidity. As such single-issue sizes can be significant and swiftly and significantly alter the asset and liability mismatch of a covered bond programme.

Maxing out issuance potential increases market risk at the expense of OC. Ratings have to reflect this lower cover-pool support and will likely migrate downwards. Investors will be deprived of the umbrella of strong cover support and high OC when it starts raining.

ECB should incentivise discipline in OC management

The ECB, acting as investor and lender of last resort as well as supervisor, should send clear messages to covered bond issuers that they should not push covered-bond issuance to the maximum, i.e. reducing OC to the legal minimum if they are in distress.

The strong credit quality of covered bonds rests on their untarnished track record and on the fact that most issuers have in the past done their utmost to maintain high credit quality and thus could access the covered bond funding channel even in times of distress. High credit quality and high ratings reflect a level of OC that is sufficient to mitigate prevailing risks. This high level of security from a strong cover pool supports a very strong rating differential between the issuer and the covered bond. Suggesting that the bank supervisory side of the ECB is asking banks to deprive investors of their main protection – OC – sends the wrong signals.

The reduction of OC to the legal minimum will no longer allow high credit differentiation and could even prompt investors to demand higher risk premia if they know that supervisors are fine with issuers diluting existing security packages. Even more, the ECB as the single largest investor in this asset class should have a clear incentive to preserve their quality. Knowing that the supervisory side of the ECB could deprive them of credit enhancement could prompt a revision of haircuts used for repo. As OC is the ultimate credit enhancement that lifts this bank funding product to credit qualities similar to those of a sovereign, it ultimately could endanger the status of covered bonds as the only "self-issued" debt instrument a bank can issue and use with the ECB.

If stress testing becomes institutionalised, should investors demand ringfenced excess OC?

The ECB's focus on liquidity is currently no more than a fact-finding exercise. If and when it finds its way into the standard regulatory toolkit and when used alongside the LCR and NSFR, regulators should clarify that "excess issuance potential" can only be taken into account if levels of OC are at least at the same levels as those currently provided to support high credit quality. Investors should demand a legally ringfenced "excess oc" to ensure that protection that was available when they invested remains available.

Covered bond harmonisation should provide covered bond supervisors with a backstop against excessive OC depletion

The upcoming European covered bond harmonisation provides a unique opportunity to avoid any weakening in the product's credit quality. The harmonisation will formalise the role of dedicated covered bond supervisors. They will be charged with more detailed (currently not too clearly defined) special covered bonds oversight. To avoid negative consequences from an idiosyncratic problem of one covered bond-issuing bank turning into a systemic one, supervisors should have the ability to avoid excessive changes of OC in times of stress.

Bank and covered bond supervisors will be separate but will generally focus on similar topics and might have a joint agenda for banks as going concerns. When a bank faces liquidity problems and ultimately the bank supervisors start thinking about a regulatory intervention, there should be a strong delineation between the two, however.

The ECB as the bank supervisor has a clear mandate to maintain the bank as a going concern where feasible, eventually intervene and if push comes to shove facilitate a bail-in of the bank's capital and liability structure.

To maintain covered bonds as a high credit-quality funding product that merits preferential status, a clear empowerment of the covered bond supervisor (currently often the national supervisor) and a delineation vis-à-vis the tasks of the bank supervisor is needed. Such delineation has to be made upfront and transparent; otherwise a "weekend (re)solution" is not feasible.

If the ECB's current guidance becomes the "new-normal" and the dedicated covered bond supervision cannot avoid a bank supervisory-driven deterioration of a covered bond's sound credit quality, the arguments that support preferential treatment for covered bonds would fade and ultimate make them a fair-weather funding product.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 82 88 55 57

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com