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Securitisation and Covered Bonds:

Essential complementarity of two European financing pillars

Introduction

- This note aims to clarify and highlight the **crucial complementarity** between securitisations and covered bonds, two financial instruments indispensable to the financing of the European economy.
- It is imperative to examine this complementarity from various angles: the issuer, the investor, and the perspective of overall financial stability, highlighting the specific strengths of each instrument.
- The main objective is to go beyond any reductive vision that would oppose these instruments. It is about promoting an integrated approach where they are valued as complementary tools within a European financial "toolbox", thus ensuring a robust and diversified financial ecosystem.
- Both covered bonds and securitisation can foster the expansion of capital markets and contribute to the Savings and Investment Union. In the ongoing policy discussions, these financial tools have distinct yet complementary added value within the financial system

I. The Issuer's perspective:

a. Strengths of Covered Bonds

- **Market access:** The Covered Bonds market is a well-established market, with a long-standing history (Prussia (1770), Denmark (1797), Poland (1825) and France (1852)) and has become one of the main funding sources for EU banks, with ~200bn€ of new issuance per year, and an outstanding volume of over 3trn€.
- **Eligible assets:** Covered bonds are a cost-efficient long-term funding instrument to refinance mortgages and public sector loans, as well as shipping financing.
- **High quality Loan-to value** criteria (80% for RRE, 60% for CRE and shipping).
- **Double-recourse**: Covered bonds are debt obligations issued by credit institutions which offer a so-called double-recourse protection to bondholders: if the issuer fails, the bondholder has a direct and preferential claim against certain earmarked assets and an ordinary claim against the issuer's remaining assets.

- **Enhancing maturity profiles**: Covered bonds allow banks to extend maturities, compared to senior unsecured debt, thus better matching their long-term lending portfolios.
- **Diversification of investor base**: Covered Bonds are typically attractive to the more conservative investors (including public institutions), who may not be investing in senior unsecured bonds.

Overall, the Covered Bond market is a cost-effective funding instrument, with lower costs for the issuer, compared to senior unsecured debt (given collateralization) and to securitisation (given the recourse to the issuing bank).

b. Strengths of Securitisation

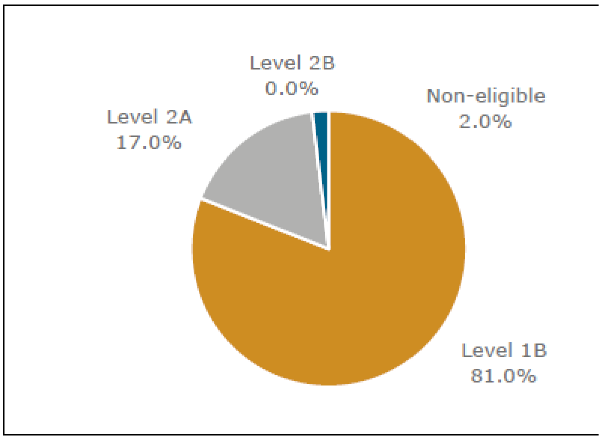
- **Market access:** Securitisation opens financing doors to a range of issuers who do not have access to the covered bond market, including lower rated banks or banks in lower rated countries, corporates (refinancing of auto loans, trade finance claims, etc.) and non-bank entities, thereby enabling **greater financial inclusion**.
- **Financing a broader range of assets:** Securitisation enables the financing of a wider range of assets, including non-mortgage assets such as SME loans, trade receivables, and leasing, thereby supporting various sectors of the economy. No limit on the underlying asset quality is set by regulation, and there is even a market segment for NPL securitisation that allowed banks to significantly clean up their balance-sheet after the Eurozone crisis.
- **No dual recourse:** While for well rated banks, the dual recourse is a factor of cost reduction, for weaker banks, or in times of stress (as was the case during the Euro crisis), access to securitisation may be more resilient, as investors may want to reduce their bank exposure, while continuing to have exposure to resilient assets in the real economy.
- **Strategic diversification of funding sources:** Even for bank issuers with the option to issue covered bonds, securitisation offers useful diversification, reducing dependence on a single instrument and thus improving financial resilience, especially as funding options may narrow during crisis periods. Securitisation can serve as an alternative when funding through covered bonds becomes difficult, particularly in times of banking or sovereign crisis (cf. 2011). Having an established securitisation program with an established investor base is therefore an important aspect of prudent liquidity management, even if the cost may be higher.
- **Capital optimization and risk management:** Securitisation offers banks the opportunity to transfer risks off their balance sheets, thereby improving their capital efficiency and their ability to grant new loans, subject to complying with a rigorous "Significant Risk Transfer" assessment by the competent authority.
- **Liquidity:** Traditional (cash) Securitisation can also, like Covered Bonds, serve as a funding tool in Self-retained programs, allowing banks to transform illiquid assets into eligible collateral for central banks facilities.

II. The Investor's perspective:

a. Added value of Covered Bonds

- Simplicity
    - No tranching
    - No due diligence requirement
- Dual recourse to the assets and the issuing bank (which means that investments in Covered bonds are part of the credit exposure limit on the bank)
- Higher rating and lower rating volatility than senior unsecured bank debt
- Favorable capital treatment for banks as investors
- Favourable liquidity treatment for banks as investors
    - Covered Bonds are eligible to High Quality Liquid Assets in the LCR ratio, based on the following rules:
        - Extremely High-Quality Liquid Assets are eligible in Level 1 with a 7% haircut, subject to being issued by an EEA issuer with a credit rating of at least AA-
        - Non-EEA issuers and EEA covered bonds with a rating of at least A- are eligible in Level 2A, with a haircut of 15%
        - Other covered bonds are eligible in the Level 2B category, with haircuts varying from 25% to 50%
    - In practice, as shown in the graph below, most Covered Bonds are eligible as Level 1 or level 2A. This suggests that banks that do not reach the A- rating (including due to sovereign ceiling) de facto do not have access to the Covered bond market.

> FIGURE 3: CLASSIFICATION OF COVERED BONDS



Source: HSBC, Bloomberg (only EUR benchmark covered bonds)

- Exemption from Bail-in under BRRD (CBs are bankruptcy remote, cover assets are segregated in the balance sheet of the issuer)
- Favorable treatment under Solvency II
- Favorable Treatment for repos at the ECB and other Central Banks

b. Added value of Securitisation

- **Portfolio diversification:** Asset-backed securities (ABS) offer investors an opportunity to diversify their portfolios beyond traditional bonds, with varied risk and return profiles. Different investor profiles are interested in ABS and covered bonds. Large funds have fewer restrictions on covered bonds and ABS. Banks treasurers' LCR buffer would benefit from such diversification.

- **Access to specific asset classes:** Securitisation allows investors to access specific asset classes, such as SME loans or auto receivables, which are not eligible for Covered Bonds, nor easily accessible by other means. It will also allow specific access to investments, as green assets.
- **Tranching** allows a broad range of investors to target specific parts of the credit spectrum, as a function of their risk/return appetite.
- **Securitisation offers direct Exposure on the underlying assets, without exposure to the originating bank. This implies that those exposures are not included in the investor credit limit on the issuing bank. Therefore, the development of securitisation should not be at the detriment of covered bonds.**

III. <u>The Market angle: additionality or cannibalization?</u>

A key concern in the securitisation vs Covered Bonds debate is the perceived risk that the development of securitisation may be at the detriment of the Covered Bonds market.

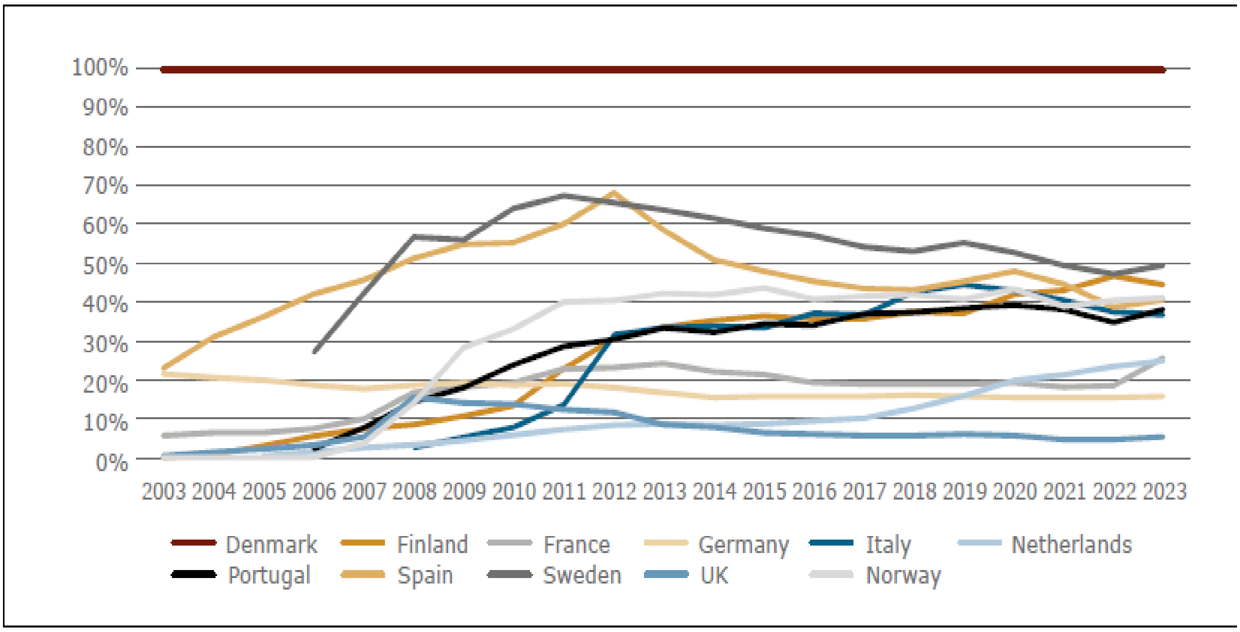
The arguments above have shown that, whether for issuers or for investors, the two instruments are complementary, may be used for different purposes, and at different points in the cycle, and depending to each institutions business model, geographic footprint, risk appetite, asset mix etc…

While the Covered Bonds market is a highly mature market, the securitisation market is subdued, and has ample room to grow, without negative impact on the Covered Bonds market.

The main asset classes targeted for securitisation are not eligible for covered bonds (corporates, SMEs, trade receivables,…).

Even on the mortgage market where there could be an overlap, numbers show that, with the exception of Denmark where 100% of the mortgages are financed by Covered Bonds, in other member states, this percentage ranges between 5 and 50%. There is clearly room for a development of both markets, to increase the velocity of the EU economy and the bank financing capacity.

> Figure 2: Mortgage backed covered bonds as % of residential mortgage loans



Source: EMF-ECBC

Figure 8: Covered bond issuance volumes, 2011-2023

Source: Dealogic and EBA calculations.

In short, the covered bond and securitisation markets are driven by different economic, financial and monetary drivers. The development of securitisation is unlikely to be at the detriment of covered bonds, and vice versa. A deep and active market in both covered bonds and securitisation would enhance the diversity of sources of funding and make the banking sector more resilient.

In any case, regulation should be agnostic as to which instrument should be prioritized, as the answer will depend on the issuer and on the point in time in the cycle. Regulation of both covered bonds and securitisation should be unbiased, risk sensitive and proportionate.

IV. Macroprudential and systemic perspective: the stabilizing role of securitisation

- Securitisation helps the financing of the real economy and promotes risk sharing among market participants. Careful consideration is currently being given to making it more risk sensitive and balanced in many respects, in order to reach its full potential, which is very important for the overall EU economy, as outlined in many recent high-level reports. The securitisation revival should also leverage on and be supported by the significance and good performance of both covered bonds and securitisation.
- **Reduction of systemic risk:** By diversifying funding sources and transferring risks outside the traditional banking system, securitisation helps reduce systemic risk and strengthen financial stability.
- Leverage banks' highly regulated origination and monitoring process, while allowing balance sheet velocity, will boost growth, ensure highest degree of consumer protection, and avoid building excessive reliance on unregulated private credit and NBFI.
- **Financing the real economy:** Securitisation supports the financing of the real economy by enabling banks and businesses to access funding for productive projects and investments.
- **Liquidity:** A study by the ECB showed that the liquidity of covered bonds and senior securitisation tranches was similar.

IV. Securitisation and SME Financing: an essential layer

- **Facilitating access to finance:** Securitisation is a crucial way to facilitate access to finance for SMEs, by transforming their receivables into negotiable securities that can be sold to investors. Regulators seek to develop access to finance for SMEs.
- **Refinancing SMEs:** ABCP Conduits can refinance SMEs, providing an alternative source of funding to traditional bank loans.

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Conclusion

- Securitisations and covered bonds are not only complementary but also indispensable to ensure the growth and diversification of funding sources for the European economy.
- In order to finance the massive EU investment needs, it is imperative to actively promote both markets, recognizing and valuing their respective specific advantages, rather than opposing them. A balanced approach, which takes into account the nature of each instrument, and applies a risk-sensitive capital and liquidity framework to both, is essential to ensure stable, diversified, and resilient financing of the European economy.
- By allowing banks to maintain their central role in financing the economy, securitisation prevents less regulated players from taking over, ensuring greater stability and transparency of the financial system.