A battle over collateral

If regulators are worried about over-encumbered bank assets, they must look beyond just covered bonds

Covered bonds' dual recourse nature makes them a favoured instrument for investors seeking both safety and yield. If the issuing financial institution fails, investors have preferred access – over all other creditors – to the cash flow and proceeds of the cover pool.

This often means that when market conditions are volatile or difficult, investors are more likely to buy covered bonds than a bank's unsecured senior debt. Not surprisingly, it follows that issuers tend to rely more heavily on covered bonds over senior debt funding in difficult times. The result is that significantly more of an issuer's assets become dedicated to covered bond investors.

This has led to a growing concern among regulators about the level of encumbered assets held by banks issuing covered bonds. Some of the concern appears misplaced as it relates to apparently very high overcollateralisation levels in some European covered bond programmes.

This, however, is not the result of programme requirements, but rather the issuer's structure as a special purpose covered bond issuer, all of whose assets are available to support its covered bonds.

In other cases, some banks' heavy reliance on covered bonds, particularly at a time of difficulty for senior debt markets, has worried regulators. They are concerned that the encumbrance represented by cover pools can significantly reduce the availability of quality assets to support depositors, and that the preference for covered bondholders in effect subordinates depositors.

> The appropriate balance of secured and unsecured funding is likely to vary from bank to bank

At the same time, changing rating agency requirements have led to downgrades and higher overcollateralisation levels for some issuers. In addition, the euro crisis and the difficulties often faced by banks issuing senior debt have made them more reliant on covered bonds.

In some countries, there are limits on the percentage of bank assets that can be encumbered by covered bonds. Canada for example has a four percent limit. The UK started with a four percent limit that could be increased up to 20% upon notification to the Financial Services Authority (FSA) – that has evolved into a determination on a case-by-case basis. Australia and New Zealand have eight percent caps and Sweden is now talking about implementing limits.

Similar concerns have been raised by the Federal Deposit Insurance Corporation (FDIC) about the proposed US covered bond legislation and a four percent limit was included in the FDIC Policy Statement on covered bonds.

Not an isolated problem

What seems to be missing in these discussions, however, is any recognition of other bank financing alternatives that would be expected to raise similar concerns. Covered bonds are not the only form of bank financing that isolates assets and makes them unavailable to meet deposit obligations.

Repurchase agreements also have collateral requirements, which tend to increase sharply as a bank approaches insolvency. At the same time, the maturities available to a bank refinancing a repo tend to shorten dramatically as the institution's credit condition deteriorates. Any other secured borrowing, such as from a central bank, also involves the dedication of assets to repayment of the borrowing. Swap agreements also provide for collateralisation of the swap obligation by high grade assets, often local treasuries. Further, these requirements often increase sharply as a bank's credit rating deteriorates.

Securitisation can create similar situations to the covered bond encumbrance issues concerning regulators. If a bank securitises its assets, the market often demands that it retain a significant – and usually subordinated – interest in the instrument. This is to provide comfort to the market on the quality of the underlying assets. In fact, recent legislation in both the US and Europe now require banks to hold a significant retained interest in securitised assets. In both cases, the bank will need to finance the retained portion with deposits, senior debt or other sources. Securitisations dedicate a pool of assets to the repayment of the asset-backed securities in preference to depositors, reducing the assets available to support banks' deposit obligations.

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Learning from mistakes

However, the appropriate balance of secured and unsecured funding is likely to vary from bank to bank. The asset mix of a bank must be taken into consideration in this regard.

Funding long-term assets with short-term liabilities presents risks. As the liabilities are renewed at rollover, the interest rates can increase in adverse markets and in extreme cases the funding simply may not be available.

We saw this happen during the financial crisis with the failure of structured investment vehicles (SIVs) that funded long-term assets with commercial paper. The US savings and loan crisis of a

generation ago arose from funding mortgage loans with deposits that fled to higher yielding opportunities during periods of high interest rates. The inability to meet growing demands for collateral on its repo financings was the immediate cause of the Lehman bankruptcy. Similar problems can arise under swaps and central bank lending facilities.

This concern about asset-liability mismatches is reflected in Basel III by the adoption of the net stable funding ratio (NSFR), which requires banks to reduce the mismatch in maturities between long-term assets and their funding.

Also, in many jurisdictions the deposit base of a bank is simply inadequate to fund some or much of a bank's lending, so banks turn to other means of financing. When funding long-term assets, the more attractive interest rates available from secured financings suggest that relying entirely on senior debt financing is not sensible. Accordingly, some form of securitisation or covered bonds is used to obtain a better balance of funding costs.

It is likely that every institution is different when determining the appropriate balance of funding. The mix of long-term and short-term assets is different, and the balance between deposit base and other available financings is different.

The capital markets' view of banks will make different types of financing available to banks based on their different circumstances. The balance of types of financings used by a bank will be very dependent on the institution's particular circumstances.

With this understanding, it is unlikely that a single limit on the percentage of assets that can be used for covered bond financing is appropriate. The limit instead should depend on each bank's circumstances and address all forms of secured bank financing.

The focus on covered bonds to the exclusion of securitisation, repo financing and other transactions that encumber asset will tend to encourage the use of securitisation and repo financing over covered bonds. The wisdom of this policy choice is questionable.

By Jerry Marlatt, partner at Morrison & Foerster in New York

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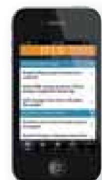

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