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SME COVERED BONDS: AN INTERESTING NEW FORMAT

Covered bonds backed by unsecured loans to small and medium-sized enterprises (SMEs) could be a new funding tool for European banks. However, with the European Central Bank (ECB) providing unconditional cheap funding under its targeted longer-term refinancing operations (TLTROs), at least for the first two years, interest by eurozone banks to actively use SME covered bonds will likely be limited for the time being.

Nevertheless, banks, regulators and market participants are showing a general interest in SME covered bonds owing to the need of European SMEs to find alternative funding sources, especially given the relatively low level of investor demand for SME asset-backed securities (ABS) and the generally favourable regulatory treatment of covered bonds in the European Union (EU).

The greater structural complexity of SME covered bonds typically distinguishes them from traditional mortgage and public sector covered bonds, and makes them less attractive for traditional investors interested mainly in "plain vanilla" legal-framework-based covered bonds. Still, investor interest in SME covered bonds could increase due to the ultra-low yield environment, forcing real money investors in particular to watch out for any yield pickup.

SME COVERED BONDS ARE NOT CRR AND ECBC COMPLIANT

Article 129 of the EU Capital Requirements Regulation (CRR) defines assets that are eligible collateral for covered bonds and which receive preferential treatment under EU regulations (for example, preferential risk weighting). As unsecured SME loans are not mentioned in the CRR, SME covered bonds do not benefit from risk weight preferential treatment in the EU. According to the

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European Covered Bond Council (ECBC), the use of covered bond structuring techniques to finance the portfolios of unsecured loans to SMEs increased significantly during the global financial crisis, and covered bonds have generally proven to be a highly effective financing tool. However, over the past few years the covered bond community has identified and agreed upon the key macro-prudential features required for an asset to qualify for the ECBC Covered Bond Label (CBL). The CBL, which establishes a qualitative parameter for covered bonds and defines minimum quality standards, does not envisage unsecured SME loans as qualifying assets.

LEGAL-FRAMEWORK-BASED SME COVERED BONDS COULD QUALIFY FOR CBPP3

On 4 September 2014, the ECB announced its third covered bond purchase programme, CBPP3, which requires covered bonds to "fulfil the conditions for their acceptance as own-use collateral" but also mentions "underlying assets that include exposure to private and/or public entities". While unsecured SME loans are not CRR compliant, in our understanding, legal-framework-based and UCITS-compliant[1] SME covered bonds offering comparable protection to the criteria set out by the ECB[2] do qualify for CBPP3. At this stage, the practical relevance is negligible.

Unsecured SME loans are eligible collateral for legal-framework-based covered bonds in Italy and Spain. However, so far, there are no outstanding SME covered bonds in those countries. Moreover, numerous Italian banks have publicly said that they are not interested in using the opportunity provided by the new legal framework to issue SME covered bonds.

LIKE ALL COVERED BONDS, SME COVERED BONDS ARE BANK BONDS

In line with covered bonds in general, SME covered bonds are characterised by a dual recourse nature. That is, they have recourse to the issuing bank and recourse to the pool of assets if the issuer defaults. However, there are major differences between SME covered bonds and traditional mortgage and public sector covered bonds with regard to cover pool credit quality, refinancing risk and interest rate risk.

Banks that issue SME covered bonds retain the SME loans on the balance sheet and have a strict legal obligation to pay the principal and interest on the covered bond regardless of the performance of the SME loans in the cover pool. Generally, covered bond cover pools are dynamic. That is, the issuing bank can, and based on contractual or legal obligations often must, replace non-performing loans with performing loans. Strict eligibility criteria stipulated in specific covered bond framework, and/or the SME covered bond documentation, typically reduce the replacement risk of the dynamic cover pool. The issuing bank has an incentive to make sure that the cover pool quality remains strong, otherwise future public issuance of SME covered bonds could be challenging. Moody's and DBRS highlighted that the new type of covered bond may lack systemic support, arguing that it should be subject to specific regulations and supervision, which is the case for mortgage and public sector covered bonds.

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A specific legal framework for covered bonds could govern the eligibility of SME loan receivables as cover assets and ensure the segregation of the cover pool from the issuer's insolvency estate, among other protection measures in place for covered bond investors. In the case of contractual law-based SME covered bonds, the structure is solely based on contractual bond documentation (that is, unsecured SME loans are not specifically mentioned as eligible collateral by a covered bond law). In both cases – SME covered bonds based on a specific legal framework for covered bonds and structured SME covered bonds based on contractual law only – asset encumbrance increases. Hence, banks that heavily use traditional covered bonds or other sources of secured funding (for example, repurchase transactions) need to keep an eye on asset encumbrance, a topic of increasing focus for regulators (even though a strict regulatory asset encumbrance limit regarding covered bonds is unlikely to be imposed in the EU in the near future).

INITIATIVES TO KICK-START SME COVERED BOND ISSUANCE IN VARIOUS COUNTRIES

There have already been various efforts to kick-start SME covered bond issuance. Among others, HSH Nordbank in Germany has included unsecured SME loans guaranteed by KfW in its existing covered bond pools. Due to the KfW guarantee, the loans meet the eligibility criteria of the German Pfandbrief Act regarding public sector collateral. Consequently, the respective covered bonds are not SME covered bonds but public sector covered bonds based on a specific legal framework, the Pfandbrief Act.

Meanwhile, with the Decree Law 145 (Destinazione Italia) passed on 19 February 2014, Italy created a new type of covered bond backed by assets other than mortgage and public sector loans. According to Fitch Ratings, the new "collateralised bank bonds" will be dual recourse bonds similar to Italian mortgage and public sector covered bonds, but secured by assets (for example, SME loans) that were not, up until now, eligible collateral for Italian covered bonds.

SME COVERED BONDS TYPICALLY USE A PASS-THROUGH STRUCTURE

According to Fitch Ratings, in the case of Italian SME covered bonds, the liquidity gaps and creditworthiness of the underlying cover pools could limit the potential uplift of the bonds above the issuer rating. Should the issuer default, any maturity mismatches between the cover assets and bonds would be difficult to bridge given that SME loans are typically less tradeable than assets eligible for mortgage and public sector covered bonds. However, this is not specific to Italian SME covered bonds. Due to lower liquidity and higher discounts in the case of fire sales of SME loan portfolios, compared with mortgage or public sector loan portfolios, the argument applies to SME covered bonds in general.

Consequently, the typical hard or soft bullet structure of traditional covered bonds does not result in the same notching differential between the bank's unsecured rating and the rating of the covered bonds. In the case of SME covered bonds, using a hard or soft bullet structure (with maturity extensions up to 24 months) would typically either lead to very high over-collateralisation requirements by rating agencies to achieve a certain rating, or even generally limit the potential rating uplift of SME covered bonds above the bank's unsecured rating.

In line with this, according to DBRS, banks are more likely to contractually include more flexible asset-liability matching terms – such as a conditional pass-through structure – in SME covered bond contracts. Pass-through covered bonds reduce the risk of asset fire sales if the issuer defaults. As a result of the long maturity extensions associated with pass-through covered bonds, post-bank-insolvency cover pool administrators are able to collect sufficient cash flow from the assets before repaying the bonds.

In contrast to public sector and mortgage covered bonds, Italian banks issuing SME covered bonds are not subject to the minimum capital ratio requirement. As a result, smaller Italian banks, which cannot issue Italian mortgage and public sector covered bonds because they do not meet respective capital requirements for issuing banks, could issue SME covered bonds.

SME LOANS ARE ELIGIBLE AS COVERED BOND COLLATERAL IN TURKEY

Turkish banks started to issue SME covered bonds in 2011 following the Turkish asset-backed covered bond legislation, under which unsecured SME loans became eligible as cover pool collateral, as is the case for asset-covered bonds. Asset-covered bond is the term for Turkish covered bonds backed by eligible assets other than mortgage loans. Prior to this, Turkish SME covered bonds were typically privately placed (for example, with the European Investment Bank).

Besides the Turkish covered bond regulation, Turkish SME covered bonds also include various contractual enhancements in the bond documentation, further increasing investor protection. The law provides assurance that the asset pool and transaction accounts will not form part of the issuer's insolvency estate, if the issuer becomes insolvent. A security supervisor – an independent audit institution authorised by the Capital Markets Board of Turkey – is responsible for monitoring the assets in the cover pool and ensuring that the issuer operates in accordance with the provisions of the Turkish covered bond legislation.

The Turkish covered bond law stipulates strict asset coverage, as well as matching and over-collateralisation requirements, which the security supervisor must check. The assets in the cover pool cannot be pledged or be subject to an attachment, or be included with the issuer's other assets in the case of insolvency.

COMMERZBANK SME COVERED BONDS: AN EXAMPLE OF CONTRACTUAL-BASED SME COVERED BONDS

In Germany, under the Pfandbriefe Act, unsecured SME loans are not eligible as collateral for legal-framework-based covered bonds. Besides a limited number of substitute assets, German asset-covered bonds (Pfandbriefe) can be backed by several types of loans. Indeed, there are four different categories of German asset-covered bonds: mortgage Pfandbriefe (backed by residential and commercial mortgage loans), public sector Pfandbriefe, ship Pfandbriefe and aircraft Pfandbriefe.

In 2013 Commerzbank (CBK) introduced a covered bond programme for SME loan collateral, which is not governed by the German Pfandbriefe regulations, but is based on contractual law and the use of a refinancing register. Commerzbank SME covered bonds are ECB eligible (as covered bonds) but not CRR compliant. As such, they are not eligible for own-use ECB repo transactions.

Contractual-based SME covered bonds are directly issued by Commerzbank but benefit from dual recourse via an unconditional and irrevocable guarantee by SME Commerz GmbH, a special-purpose vehicle (SPV) holding the unsecured SME loans. The cash flow from a cover pool of SME loan receivables is transferred to the SPV, which backs the guarantee given to covered bond investors. The SPV is consolidated on Commerzbank's balance sheet and buys SME loans from covered bonds funded by a subordinated loan. If Commerzbank issues new bonds, the SPV will buy further loans to fulfil the over-collateralisation requirements stipulated in the covered bond documentation. The SME loans in the SPV are registered in a refinancing register, and once registered, are deemed insolvency remote.

While Commerzbank SME covered bonds are not based on a specific legal framework for covered bonds, the use of the refinancing register, which enables cover pool asset segregation in case of bank insolvency, provides safety measures and ensures insolvency remoteness (that is, Commerzbank SME covered bonds are at least partly based on specific legislation instead of contractual law only). According to Fitch Ratings, the refinancing register provides sufficient comfort that the register effectively allows segregation of the registered loans from the insolvency estate of Commerzbank. Prior to this, the refinancing register had only been used by German banks in structured finance transactions.

COMMERZBANK SME COVERED BONDS USE A PASS-THROUGH STRUCTURE

As long as Commerzbank pays all its dues with regard to the SME covered bonds which it directly issued, and fulfils the over-collateralisation requirements stipulated by the covered bond documentation, cash flows generated by the SME loans are released to the bank. Should Commerzbank stop paying SME covered bond dues, the guarantee provided by the SPV for the covered bonds will be triggered and the cash flows generated by the SME loans in the cover pool (the SPV) will be used to pay interest and principal on the SME covered bonds.

Hence, in a situation where Commerzbank is not making the necessary payments, the guarantee will step in. The guarantee will be irrevocably triggered if the bank defaults on an interest or principal payment on any bond for more than 30 days, or if the bank ceases to make any other payment for 60 days. Following a guarantee event, cash flows from the asset pool will no longer be released to the issuer, but will be accumulated in eligible investments or used for principal payments. All existing bonds

NOTES

1 UCITS stands for Undertakings for Collective Investment in Transferable Securities.

2 See Annex VI, Part 1, point 68 to 70 of Directive 2006/48/EC, available at www.ecb.europa.eu/ecb/legal/pdf/oj-jol_2014_ 335_r_0010-en-txt.pdf (last accessed 10 January 2015).

maintain their original (bullet) maturity date. As soon as a bond reaches its maturity date, principal is paid to the extent available under the new priority of payments. If principal remains outstanding after the maturity date, the remainder is paid as soon as available (that is, the bond switches to pass-through). All available amounts (for example, interest and principal from the asset pool, amounts transferred from reserves, swap payments received, liquidity facility drawings and eligible investments) will be distributed on each monthly payment date, according to a priority ranking stipulated in the Commerzbank SME covered bond documentation.

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SME COVERED BONDS LIKELY TO REMAIN A NICHE PRODUCT

Overall, SME covered bonds are an innovative covered bond format that differs greatly from SME asset-backed securities and traditional covered bonds. Despite significant differences and typically higher complexity compared with traditional mortgage and public sector covered bonds, most strikingly via the use of pass-through structures to achieve a relatively high rating above the issuer, investor protection is strong. Consequently, SME covered bonds could be a valid investment alternative when the risk of bail-in increases, as is the case with unsecured bank bonds, because SME covered bond investors would benefit from additional security provided by the SME loans (a security layer that unsecured bank bond investors do not have). In addition, a potential yield pickup compared with traditional covered bonds could provide a strong incentive for investors in the ongoing ultra-low yield environment. While the European Central Bank's TLTROs reduce the likelihood of public issuance taking off in the near future, SME covered bonds are likely to remain on bank radars as alternative funding tools, or at the very least are likely to remain on the radar of regulators and politicians willing to support the real economy by supporting unsecured SME lending. The fact that numerous countries – for example Italy, Spain and Turkey – already allow unsecured SME loans as eligible collateral for legal-framework-based covered bonds confirms this view.