

Talking point

SME-backed covered bonds: A rising star – just not yet?

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SMEs' access to finance problem constitutes a considerable impediment to the recovery in many European countries, therefore prompting calls for policy action. Among the options to spur bank lending to SMEs, covered bonds backed by SME loans are currently discussed as a potential remedy. Despite SME-covered bonds offering lucrative features for investors and issuers alike, there are significant constraints that may limit their potential to revitalise bank lending to SMEs for the time being.

To revitalise bank lending to small and medium-sized enterprises, policymakers currently consider covered bonds backed by SME loans to be a potential remedy. SMEs are the backbone of the euro-area economy, accounting for 58% of gross value added and 67% of employment, and are thus crucial for the recovery. Hence, any step taken to unlock bank lending to SMEs is of great importance.

In general, covered bonds – like other asset-backed securities – offer banks access to market liquidity and open up additional sources of funding. In addition, due to the dynamic nature of the pool of underlying assets, covered bonds allow for a “reverse maturity transformation”, i.e. enable banks to issue debt with even longer tenors than its loans. Furthermore, and unlike true-sale securitisations, covered bonds reduce banks' funding costs thanks to the double backing from the asset pool and the issuer itself. For all these reasons, covered bonds in principle may facilitate bank lending, including lending to SMEs. However, the extent to which SME-backed covered bonds can revive credit supply to SMEs in the current circumstances mainly depends on i) the legal framework, ii) investors' appetite and iii) banks' ability to supply these products.

Prima facie, SME-backed covered bonds are “simple” fixed-income securities backed by high-quality SME loan pools serving as collateral. They have dynamic cover pools, and non-performing SME loans (depending on contract and legislation) are replaced to ensure continuous payments. To achieve the highest possible rating and in some cases to satisfy regulatory requirements, they are overcollateralised. In other words the SME loan pool is larger than the face value of the bonds issued. In contrast to other asset-backed securities, covered bonds remain on the balance sheet of the issuer (usually banks) and are backed not only by the cover pool, but also by the issuer's balance sheet – the “dual recourse”. There are advantages for issuing institutions as well: in addition to the general features mentioned above, SME-covered bonds provide banks with greater flexibility with respect to the collateral spectrum, i.e. they allow using an asset class other than the typical mortgage or public-sector loan to back these securities. Taken together, SME-backed covered bonds offer favourable features for investors and issuers alike. Yet in practice, legal issues and market dynamics have so far limited their impact as a potential quick fix to revitalise bank credit for SMEs.

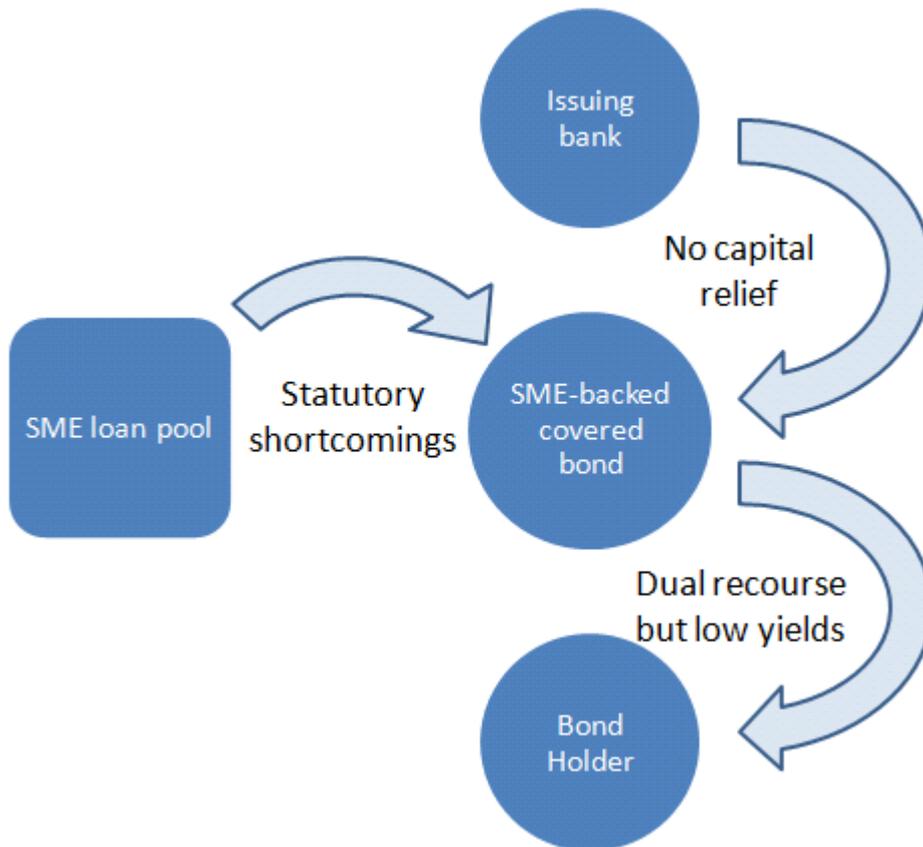
First and foremost, statutory shortcomings are a major impediment to SME-covered bond issuance. Unlike traditional covered bonds that are built on strong legal frameworks and enjoy regulatory advantages such as preferential risk weighting under the Capital Requirements Regulation, SME loans in principle are not yet eligible as covered bond collateral in the EU. Only at the national level has some progress been achieved in terms of the legal framework. For example, a recently proposed change to the Spanish securitisation law aims to remove limitations on collateral, thereby making SME loans automatically eligible for covered bonds. In Italy meanwhile, with *Obbligazioni Bancarie Collateralizzate*, SME claims can now be used as collateral. In addition, in the absence of a respective legal framework, some lenders and lending platforms in Germany and France have issued dual-recourse bonds backed by SME loans based on contractual law alone.

For investors, being able to conduct a reliable credit risk analysis is a precondition for holding SME-covered bonds. However, unlike for widely used collaterals such as mortgages or public-sector loans, standardised and transparent information on SME loans usually does not exist. This makes it difficult to assign a robust credit rating to SME-backed covered bonds. In addition, investors also look at the yields of these products which – due to the dual-recourse structure – are already relatively low in “normal” times. Even more so now, as ample central bank

liquidity has led to significant spread compression for all debt securities, including covered bonds. For example, while SME-covered bonds issued in 2013 still carried a coupon of 1% to 2%, the yields came down to roughly 0.5% recently, reducing the attractiveness for investors.

For banks, unlike other asset-backed securities, covered bonds remain on the balance sheet and therefore count as a liability – while the corresponding SME loans stay an asset. Since there is no risk transfer to the capital market, banks cannot free up regulatory capital by issuing SME-covered bonds. Both the ongoing balance sheet restructuring (including the build-up of capital) and central banks' provision of extremely cheap liquidity therefore currently dampen banks' incentives to issue covered bonds.

All in all, even though SME-covered bonds offer lucrative features for investors and issuers alike, the statutory shortcomings on the one hand and adverse market dynamics on the other will limit their potential to revitalise bank lending to SMEs for the time being.



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For more information see:

SME financing in the euro area: New solutions to an old problem



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