

# The Role of Dual Recourse Instruments for Long-Term Finance in Europe<sup>1</sup>

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## PREAMBLE

In light of the latest debate on the free movement of capital in the European Union, Commission President Jean-Claude Juncker set out, in his political guidelines for the new Commission, the creation of a Capital Markets Union (CMU). The greater integration of capital markets would ensure further diversification in the funding of the economy and reduce the cost of raising capital. In particular, the CMU would:

- enhance the flow of capital from investors to key areas of the European economy, namely: start-ups, SMEs and long-term projects;
- ensure that market infrastructures and intermediaries can channel funds across borders to companies that want to finance their growth efficiently, at reasonable costs and on the same terms as nationally;
- improve risk transfer and allocation of capital across the EU to those better able to bear it; and
- diversify sources of funding, by expanding risk finance and making Europe less reliant on bank lending and more resilient to shocks.

**The Commission has therefore committed to put in place the building blocks of a Capital Markets Union (CMU), encompassing all Member States, by 2019, with a view to broaden the access to long-term finance.** It is therefore pivotal that the industry responds to this initiative by, among other things, providing the appropriate market-based instruments that can ensure that the CMU will have the desired impact on the EU economy by promoting long-term, stable and safe financing. The European Covered Bond Council (ECBC)<sup>2</sup> has established two task forces comprising a qualified group of market participants to explore the harmonisation of market practices in the traditional covered bond space and the potential contribution of dual recourse instruments in the development of the CMU.

**The aim of this paper is to analyse the market views and provide options and recommendations for the potential development of a new dual recourse instrument that, whilst using structural techniques similar to covered bonds, would not be considered a traditional covered bond.** Traditional covered bonds have demonstrated their resilience to stress during the financial crisis due to their particular security and macro-prudential characteristics. While

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<sup>2</sup> The European Covered Bond Council (ECBC) represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was launched by the European Mortgage Federation (EMF) to promote the interests of covered bond market participants at international level. As of February 2015, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of the EUR 2.6 trillion outstanding covered bonds.

preserving the integrity of the traditional covered bond as a unique long-term funding instrument, particular features of covered bonds could serve as a basis for the creation of more generally defined (covered bonds-like) 'dual recourse instruments'. This would, on the one hand, ensure a clear separation between traditional covered bonds and all other instruments, and on the other hand enhance, with solid qualitative characteristics, the funding sources available to market participants.

## A. Background

**Dual recourse instruments could help overcome the adverse effects of financial fragmentation in Europe by diversifying funding sources.** In its *Communication on Long-term Financing of European Economy*, the European Commission (2014a) emphasised the importance of small and medium-sized enterprises (SMEs) finance for growth, and endorsed both securitisation and covered bonds as effective market-based funding sources that complement more traditional forms of financial intermediation by providing a closer alignment between the sources and uses of funds. Expanding the scope of dual recourse instruments in tandem with restarting securitisation could help mitigate structural constraints on credit supply for attractive prices by lowering the economic cost of capital in the short term and encouraging the use of standardised and more efficient origination and loan pricing processes in the medium term, leading to lower transaction costs. However, unfavorable economic terms in an environment of monetary easing and adverse cyclical factors reduce the incentives for issuing secured funding instruments.<sup>3</sup>

**Further developing dual recourse instruments in the euro area, especially for funding purposes that support lending to SME,** could help remove impediments to credit supply by improving the allocation and pricing of liquidity, and supporting cross-border investment within the euro area. More official sector involvement is required to ensure progress towards a more integrated capital market (Jobst, 2015) in order to overcome the adverse effects of financial fragmentation on long-term funding of viable firms. This would require:

- Greater regulatory differentiation in solvency regimes, liquidity standards, and central bank collateral frameworks between securities of different quality across the spectrum of long-term funding sources, which better acknowledges the complementarities of covered bonds and securitisation transactions while encouraging demand by non-bank institutional investors;<sup>4</sup>

<sup>3</sup> SME-based transactions face particular challenges related to the heterogeneity of SME loan portfolios both within and across countries and the absence of standardised credit quality information on SMEs.

<sup>4</sup> This could be facilitated by expanding the scope of data collection and publication via the Covered Bond Label for covered bonds and by the European Datawarehouse (EDW) for ABS and RMBS to facilitate comparative pricing and benchmarking between securitisation transactions and covered bonds.

- Structural reforms, such as the harmonisation of insolvency frameworks (European Commission, 2014b)<sup>5</sup> and the standardisation of loan reporting requirements across countries, which could facilitate the development of cross-border solutions; and
- A wider range of eligible asset classes for dual recourse instruments using covered bonds techniques to fund new collateral types, such as SME loans, facilitate cross-country harmonisation of asset structures.<sup>6</sup> Given the pervasive use of covered bonds by banks in some countries, this would enhance the possible economic impact of improved credit quality information about SMEs (Jobst and others, 2011);
- The introduction of a pan-European regulatory framework for the issuance of dual recourse securities as a necessary condition for comparability and transparency across jurisdictions to allow for competitive pricing and simple dual recourse structures across Europe.

**The technical analysis aims at the identification of further enhancing the convergence of market best practices from both market and regulatory perspectives.** This exercise would ideally generate a working solution for the creation of pan-European dual recourse instruments (with greater flexibility regarding the eligibility of cover assets) but underpinned by a clear and net qualitative demarcation relative to traditional covered bonds. This proposal would also draw a demarcation line between dual recourse instruments and traditional covered bonds, facilitating the identification of market best practices for pan-European high-quality covered bonds comprising simple, transparent and efficient asset structures, which would facilitate a continued preferential regulatory treatment, in addition to preventing possible contagion risks in terms of the reputation of traditional covered bonds.

## B. Topics

### Topic 1—Draft guidelines for key elements of a pan-European framework for dual recourse instruments

The current focus on the development of a principles-based definition of high-quality securitisation (HQS) (EIOPA, 2013; BCBS/IOSCO, 2014; EBA, 2014) has diverted attention from similar efforts in covered bond market such as the *Covered Bond Label Convention*<sup>7</sup> (2014), which was launched in

<sup>5</sup> For instance, the average length of foreclosure proceedings in Italy is almost five years compared to less than one year in Germany.

<sup>6</sup> The lack of comparable and harmonised information about the credit risk of SMEs and the differences between SMEs in terms of size, business activity and geographic location render securitisation of SME-related claims more costly than others. Moreover, the complexity of information and different reporting requirements makes it difficult for investors to assess credit risk across jurisdictions and creates a home bias. Efforts have been made, however, by the European Central Bank (ECB), which has produced an SME reporting Template intended to improve transparency and designed to ensure compliance with the data protection, banking secrecy and confidentiality regulations (<https://www.ecb.europa.eu/paym/coll/loanlevel/transmission/html/index.en.html>).

<sup>7</sup> The Covered Bond Label Convention defines the core characteristics required for a covered bond programme to qualify for the Covered Bond quality Label ([www.coveredbondlabel.com](http://www.coveredbondlabel.com)).

2012. This market initiative was instrumental in boosting convergence of best practices based on issuer self-certification with a view towards establishing progressively a quantitative and qualitative perimeter of enhanced due diligence and transparency.<sup>8</sup> However, this development is currently not reflected in the regulatory treatment of covered bonds beyond the requirements of Article 129(4) and (5) of the Capital Requirements Regulation (CRR) and Article 52(4) of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive. In addition, information disclosure requirements associated with structured finance instruments (SFI) continue to evolve with the adoption of the Regulatory Technical Standards (RTS) under the Credit Rating Agencies (CRA3) Regulation regarding the transparency of structured finance instruments (ESMA, 2014). This following section will develop technical guidance on common criteria for high-quality dual recourse (HQDR) instruments by revisiting the current Covered Bond Label Convention, which defines the core characteristics required for a covered bond programme to qualify for the Label, with criteria contained in the current definition of HQS. Note: Given the European Commission's work on the Capital Markets Union, this would be very timely and would provide a proactive response to current policy considerations. Moreover, this work could be combined with a Primer on the complementarities of covered bonds and ABS in the spirit of Annex I.

A pan-European standard or framework, with transparent and simple features, for dual recourse instruments could:

- Define safeguard simplicity and comparability principles, triggering convergence of legislative and market best practices in a landscape of diverse national frameworks or issuer structures;<sup>9</sup>
- Enhance transparency via a common reporting and common supervision practices coordinated from, for example, the European Central Bank (ECB);<sup>10</sup>
- Focus on standardising the eligibility criteria, the reporting and the structures whilst taking into account the national differences;
- Allow for an alternative funding source at competitive rates if combined with preferential regulatory treatment of new instruments for investors;

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<sup>8</sup> The European Mortgage Federation (EMF) and the European Covered Bond Council (ECBC) established the Covered Bond Label Foundation in 2012, which certifies the compliance of covered bonds with a set of defined disclosure requirements, which respond to a market-wide request for improved standards and increased transparency in the European covered bond market.

<sup>9</sup> Development of criteria promoting simplicity referring to the homogeneity of underlying assets with simple characteristics, and a transaction structure that is not overly complex. Development of criteria promoting comparability could assist investors in their understanding of such investments and enable more straightforward comparison between long-term financing/securitisation products within an asset class.

<sup>10</sup> Development of criteria for minimum transparency requirements providing investors with sufficient information on the underlying assets, the structure of the transaction and the parties involved in the transaction, thereby promoting a more thorough understanding of the risks involved.

- Even be more efficient if funding solutions can be combined with structures that allow for capital relief.

This work could be augmented (by way of background) by the results of the transparency criteria for dual recourse instruments based on the results of a questionnaire which the ECBC Long-Term Financing Task Force has prepared for investors precisely on this topic (due in 2015 Q1). Analysis of investors needs per collateral type and appetite on dual recourse instruments vs. securitisation products should also be undertaken,<sup>11</sup> as well as of the feasibility of assessing this dual recourse instrument's pool within a benchmark.

### **Topic 2—Analytical paper on the macro-financial transmission of dual recourse instruments**

Efficient mechanisms for long-term funding of a broad range of high-quality collateral assets should enhance the convergence of borrowing costs and funding conditions, which helps reduce financial fragmentation and enhances the transmission of monetary policy. Especially dual recourse instruments boost the capacity of developing common risk assessment areas and pave the route for a cross border funding market in the European Union.

The following element can be analysed:

- Can we identify the contribution of dual recourse instruments and securitisation issuance to credit conditions? (Annex II provides a sketch of a possible model specification)

### **Topic 3—Prudential/risk management requirements for small and medium-sized enterprise (SME) loans as collateral in dual recourse structures**

The lack of comparable and harmonised information about the default frequency of SMEs and the differences between SME loan portfolios in terms of size, business activity and geographic location render structured finance backed by SME-related claims more costly than others. Moreover, the complexity of information, transferability of legal title/security and different reporting requirements make it difficult for investors to assess credit risk across jurisdictions and creates a home bias<sup>12</sup>. The harmonisation of reporting requirements would not only enhance cross-border investor demand but also facilitate the comparability of SME loan performance within the euro area, thus providing the empirical basis for differentiating between transactions of different quality.

The following elements should be analysed from a macro-/micro-prudential perspective:

- The contribution of the banking sector, especially small medium banks, in terms of lending capacity to SME, and the development standardised risk assessment parameters for SME.

<sup>11</sup> In addition, it would be important to clearly identify the potential investor base in order to understand their needs and ensure that they are aware of the differences with traditional covered bonds.

<sup>12</sup> As mentioned in footnote 5, efforts have been made by the ECB in order to improve transparency in this field.

- From an issuer's and investor's perspective what are the current impediments and how can they be overcome? What are the lessons from the crisis? The importance of capital, and to a lesser extent funding, for SME lending by banks. In the light of the prudential and risk management requirements analysed and developed, what regulatory support and macro-prudential recognition should be considered appropriate?
- An example of options, where the European Central Bank (ECB), European Investment Bank (EIB) and European Commission (EC) cooperate and propose joint solutions, should be explored. *Inter alia*, the following options could be analysed:
  - The ECB could allow SME loan pools as collateral directly (unrated but with significant haircuts).
  - Banks could hold 5% junior tranches or at least 5% of vertical slices if they were to obtain credit protection and/or capital relief on junior tranches via synthetic credit default swaps (CDS).
  - A "Collateral Directive" could be implemented throughout Europe to allow its use for SME loans. This would allow creating standard, simple, comparable and cost-efficient structures.
  - In order to grant also smaller originators of SME assets access to the new funding tool, an inter-bank pooling options could be included in such a collateral framework. This needs to be reconciled with general local commercial legislation.
- Careful attention should be given to the correlation of risks between the issuer, the country and strength of its economy and the underlying collateral.
- The ability to assess the cover pool within a benchmark would be critical for the well function of this instrument, as it is currently done for mortgages versus the state of property markets, and should therefore also be analysed.

#### **Topic 4—Developing a pan-European issuance platform for dual recourse instruments**

- What are the market best practices and legislative requirements that would need to be implemented for the creation of common funding models in the various Member States?
- What are the pros and cons of using pooling models? The analysis could look at examples such as the French Caisse de Refinancement de l'Habitat (CRH), Euro Secured Notes Issuer (ESNI), Italian mini-bonds or the Spanish Multi Cédulas. What are the common elements?
- Develop a draft proposal for a issuance platform for dual recourse instruments and critical success indicators like capital charges for investors, LCR eligibility, etc.

## C. Summary

A successful implementation of a dual-recourse instrument for the long-term refinancing, in particular of SME lending, will trigger the following beneficial effects:

Direct benefits include:

- attracting significant additional funds into the asset class potentially combined with lower funding costs (for SMEs); and
- inducing increased lending to the sector by increased Net Interest Margins due to lower funding costs;

thereby, increasing the availability of long-term finance for critical parts of the European economy.

Further benefits potentially include:

- the introduction of another liquidity management tool for banks (LCR & NSFR);
- the introduction of a more efficient monetary policy transmission vehicle; and
- making bank balance sheets more manageable to regulators (and investors) by employing common standards for (SME) loan reporting and transparency, thereby reducing uncertainty around bank balance sheets significantly.

With the successful implementation of a (SME) dual recourse instrument in this way, the process can serve as a template to induce lending into other sectors of the economy that are currently underfinanced from a macro-prudential perspective, i.e. the transmission of the world economy to greener energy management.

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## Annex I—The Complementarities of Covered Bonds and Asset-Backed Securities (ABS)

- On an even playing field, covered bonds and securitisation transactions should be viewed as complementary rather than competing sources of long-term funding. During normal times, they both increase the range of available financial instruments and enhance the allocation of capital from savers to borrowers. During periods of market stress, covered bonds provide the time tested funding backstop, albeit mainly for investment grade-rated banks without regulatory capital constraints and low levels of asset encumbrance. However, for lower-rated banks, securitisation may be the best funding option, because it isolates the credit quality of the collateral from that of the issuer (Jobst and others, 2011).
- However, ABS and covered bonds are different due to several distinguishing characteristics (see Table 1 below): (i) covered bond investors have recourse to both the issuer and the cover pool, where the issuer is a credit institution (with the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of bondholders at all times), securitisation transactions grant investors only recourse to the underlying assets; (ii) whereas securitisation transactions are mostly based on contractual mechanisms, covered bonds are issued under special/general law and are subject to special public supervision for the protection of investors; (iii) covered bonds serve primarily as funding and market risk management instruments while securitisation transactions can be used for both funding and risk-transfer (i.e., capital relief) purposes; and (iv) securitisation transactions are characterised by the process of credit risk tranching, whereas covered bonds typically are not (EBA, 2014).

**Table 1.** Comparison of Covered Bonds, Mortgage-Backed Securities and Senior Unsecured Debt

	Senior Unsecured Debt	Covered Bonds		Mortgage-backed Securities (MBS)
		Special Law	General Law	
<b>Issuer</b>	Lender			Special Purpose Vehicle (SPV)
<b>Payments</b>	Lender	Lender (until insolvency)		
<b>Preferential claim on collateral?</b>	No	Yes		
<b>Residual recourse to issuer?</b>	After all secured/other claims (e.g. tax)	Yes (1)		No
<b>Payment acceleration?</b>	On issuer default	On issuer or cover pool default		On specific event(s) ("triggers")
<b>Collateral pool dynamics</b>	No dedicated pool of collateral	Typically <i>dynamic</i> : issuer must maintain quality and size of cover pool		Typically <i>static</i> , but issuer can sometimes add new assets
<b>Collateral defined by:</b>	n/a	Regulation	Contract	
<b>Repayment from:</b>	Operating cash flows	Bondholders rank <i>pari passu</i> among each other and have a preferential claim on the cover pool		Securitized assets
<b>Asset-liability management</b>	n/a	Regulation	Contract	Typically pass-through
<b>Repayment structure</b>	Typically bullet	Typically bullet, but potentially soft-bullet (2)		Amortising
<b>Issuer capital relief</b>	No			Yes
<b>Disclosure requirements</b>	Comprehensive			Heavy

Source: IMF (2011). Notes: 1/ Covered bonds usually enjoy full recourse to the issuer's assets. 2/ A soft bullet structure allows for a (typically 12-month) due payment reprieve after a "failure-to-pay" event to allow the administrator to achieve sufficient liquidity.

## Annex II—Assessing the impact of dual recourse instruments and securitisation on credit conditions

- The analysis seeks to explain loan growth at the bank level with bank-specific financial indicators and key macroeconomic variables that affect the entire banking industry of a country in a multivariate panel setup, focusing on transmission channels and feedback loops (and building on existing studies). Previous work in this area includes European Banking Coordination “Vienna” Initiative (2012) and EIB (2014).
- Overview of input variables (varying lag structure/first differences) in multivariate/dynamic panel estimation: *individual variables* (loan growth (corporate, commercial), flow of covered bonds/ABS/other structured finance issuance); *vector of bank-specific variables* (capital ratios, profitability (EBITA and RoE), growth rate of deposits, risk-adjusted return of lending on capital (net return times regulatory capital requirements), NPL ratio and loan loss provisioning); *vector of country-specific/area-wide state variables* (real growth, inflation, accumulation of total private debt, incl. debt-to-GDP gap, debt affordability in household and corporate sector, interest rates (EONIA, long-term government bond yield (10Y), term premium), corporate/commercial sector leverage times avg. cost of capital); also distinguish supply and demand side effects of model specification above.