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Do European banks with a covered bond program issue asset-backed securities for funding? ☆

Nils Boesel [a], Clemens Kool [b], Stefano Lugo [c,*]

[a] Deutsche Bundesbank, Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany
[b] Centraal PlanBureau (CPB) and Utrecht University School of Economics (U.S.E.), Kriekenpitplein 21-22, 3584 EC Utrecht, Netherlands
[c] Utrecht University School of Economics (U.S.E.), Kriekenpitplein 21-22, 3584 EC Utrecht, Netherlands

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ABSTRACT

The decline in the issuance of asset-backed securities (ABSs) since the financial crisis and the comparative advantage of covered bonds (CBs) as a funding alternative to ABSs raise the question of whether banks still issue ABSs as a way to receive funding. By applying double-hurdle regression models to a dataset of 134 European banks observed during the period from 2007 to 2013, this study reveals that banks with a covered bond program (CBP) securitize, ceteris paribus, less of their assets. The estimated difference in ABS issuance is driven mainly by banks being more likely to issue ABSs as a funding tool rather than trying to manage their credit risk exposure or to meet regulatory capital requirements. Consistently, a worse liquidity/funding position results in higher levels of securitization only for banks without a CBP.

1. Introduction

The issuance of asset-backed securities (ABSs)[1] in Europe has decreased dramatically in size since the start of the 2007 financial crisis. According to SIFMA/AFME data,[2] the amount of euro-denominated structured finance products (excluding retained securities) issued in 2007 was 418 billion euro; by 2012, the figure had shrunk to 253 billion euro. Clearly, one of the main drivers of this trend was the central role that structured finance products have played in the unfolding of the crisis in the United States (e.g., Coval et al., 2009; Longstaff, 2010; Gorton and Metrick, 2012). European financial institutions were among the main investors in US ABSs before the start of the crisis (Bertaut et al., 2012), creating a direct link for contagion. This has raised investors' skepticism toward this class of complex financial products (e.g., Célérier and Vallée, 2014). Despite the potential conflicts of interest and misaligned incentives that characterize the originate-to-distribute banking scheme, European

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* Corresponding author.
E-mail addresses: nils.boesel@bundesbank.de (N. Boesel), c.j.m.kool@uu.nl (C. Kool), s.lugo@uu.nl (S. Lugo).

[1] Throughout this paper, we use the term ABS to generally identify structured finance products resulting from the securitization of extant financial assets via a special-purpose vehicle (SPV). The term thus encompasses mortgage-backed securities (MBSs), collateralized debt obligations (CDOs), and collateralized loan obligations (CLOs).

[2] Data accessed at www.sifma.org on November 11, 2015.

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official institutions still consider ABSs to be key instruments that allow banks to raise the necessary capital to provide consumers and small- and medium-sized enterprises (SMEs) with credit (European Commission, 2015). Thus, it is important to understand what currently drives European banks' decisions to securitize their assets.

Whereas ABS issuance has shrunk by approximately half between 2007 and 2012, during the same period, the issuance of euro-denominated covered bonds (CBs) has actually increased, from 332 billion euro to 405 billion euro, according to European Covered Bond Council (ECBC) data.[3] Van Rixtel and Gasperini (2013) report that the share of CBs of total gross bonds issued by European banks has increased from 26% in 2007 to 42% in 2012. Some commentators (e.g., European Central Bank, 2011) have argued that banks have replaced ABSs with CBs since the start of the crisis. To a certain extent, ABSs and CBs can, in fact, be considered substitutes. Both are fixed-income securities backed by a ring-fenced pool of collateral assets. However, ABSs and CBs also exhibit some key differences, as discussed at length in Section 2. Most notably, the transfer of credit risk from originators to investors is less complete with CBs than with ABSs. This has two direct consequences. On the one hand, the lower level of risk for investors entailed by CBs results in lower yields and thus lower costs of funding. On the other hand, CBs are not an effective way for the originator to reduce its credit risk exposure (Packer et al., 2007). This and other material differences between ABSs and CBs can provide the latter with a comparative advantage as a funding tool but not as a method to reduce credit risk exposure and/or risk-weighted assets (RWAs).

However, not every bank can issue CBs because covered bond programs (CBPs) are strictly regulated in most European countries. On the contrary, contract-based ABSs allow greater flexibility and can be issued as one-off transactions. Thus, securitization can still be a viable source of liquidity for banks with no access to the CB market.

In this study, we address how the ability to issue CBs as an alternative to ABSs affects the issuance of structured finance products by European banks. We use a sample of 775 observations of 134 European banks between 2007 and 2013 to investigate how CBPs affect if, how much, and why banks issue ABSs. We do so by employing double-hurdle models, which enable accounting for potential differences in the effect of a bank's characteristics on if and how much it engages in securitization.

Our main findings are readily summarized. We show that all else being equal, banks with a CBP are expected to securitize a lower share of their assets. The difference is approximately 0.11–0.13 percentage points, depending on the model. As a term of comparison, banks in our sample securitize on average 0.18% of their assets. Consistent with the comparative advantage of CBs as a funding tool, the difference between the level of ABS issuance for banks with and without a CBP is mainly driven by banks with a low level of asset liquidity. Proxies for the level of a bank's credit risk exposure or need to meet regulatory capital requirements do not appear to play an equally relevant role. Coherently, we find a negative marginal effect of asset liquidity on securitization levels for banks without a CBP but not for banks able to issue CBs. The difference between the two marginal effects is statistically significant and increases with the level of asset illiquidity. These results are robust to the use of alternative proxies for a bank's liquidity/funding needs. No significant difference in the marginal effect of proxies for a bank's assets' credit risk and regulatory capital position is found for both banks with and without a CBP.

This paper contributes to a growing literature addressing banks' securitization activities (Maddaloni and Peydró, 2011; Pagano and Volpin, 2012; Jiang et al., 2013; Wang and Xia, 2014, among others) and in particular to the literature focusing on how individual characteristics of European banks can explain their ABS issuance levels (Affinito and Tagliaferri, 2010; Cardone-Riportella et al., 2010; Farruggio and Uhde, 2015). These studies have generally identified a bank's need for liquidity as one of the main determinants of securitization. However, they typically do not consider the role played by the availability of alternative sources of funding/liquidity. To the best of our knowledge, this is the first study to demonstrate how the ability to issue CBs influences a bank's securitization activity–and particularly so during the recent crisis period. In a related study, Carbó-Valverde et al. (2011) examine the determinants of both CB and mortgage-backed security (MBS) issuance as independent from each other. They find that banks issue CBs, but not MBSs, to meet their liquidity needs. By considering a bank's *ability* to issue CBs, we complement their results by demonstrating that European banks still issue structured finance products for funding/liquidity reasons, but only when they cannot resort to CBs. This result is consistent with the idea that–when available–CBs currently constitute a preferred funding tool compared with ABSs.

The rest of this paper is organized as follows. Section 2 reviews the rationales for securitization in light of the existing literature and discusses the material differences between ABSs and CBs. Section 3 presents the data and methodology used in this study. The empirical results are presented and discussed in Section 4. Section 5 concludes with some final remarks.

2. Background and empirical predictions

In this section, we review the extant literature regarding banks' rationales for securitization (Section 2.1) and discuss the main differences between ABSs and CBs, culminating in our empirical predictions (Section 2.2).

2.1. Rationales for securitization

The extant literature identifies three main rationales for securitization linked to the individual characteristics of the issuer.

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[3] Data accessed at http://ecbc.hypo.org on November 24, 2015.