



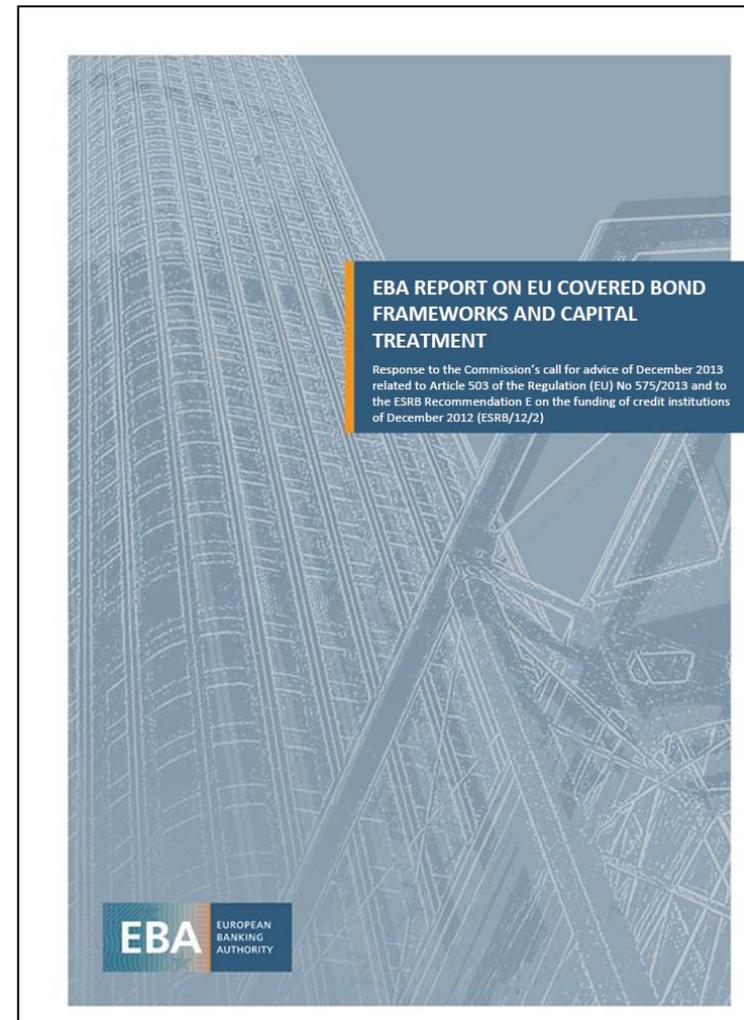
# Technical-Legal Panel: Elements for an Integrated Covered Bond Framework Part III of the CP

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# EBA's Work on Covered Bonds in the EU

- EBA published its Report on EU Covered Bond Frameworks and Capital Treatment, July 2014
- Comparative analysis of legal / regulatory / supervisory national covered bond frameworks
  - Identifies **most important areas of regulatory intervention** on covered bonds
  - Highlights **current high heterogeneity of national practices**
  - Identifies **principles of best practice**
- **Transparency towards investors** when issuing covered bonds: market practice and regulation
- Asset class-specific chapters: i) aircraft liens; ii) guaranteed residential loans; iii) RMBS/CMBS derogation
- Covered Bonds issuance and structural subordination of creditors (asset encumbrance)



# EBA Recommendations – Public Supervision

## Supervision of the covered bond Issuer

- The competent authority **approves the establishment** of a new covered bond programme
- The authority should be satisfied, at least on the basis of information received from the issuer, that:
  - **adequate operational policies, procedures and controls are put in place** by the issuer for the management of the covered bond programme, **including in issuer insolvency or resolution scenario**;
  - where provided by the national framework, the restrictions applicable to the issuer are met;
  - the features of the cover pool meet the applicable requirements.
- The legal/regulatory covered bond framework should provide a clear and sufficiently detailed illustration of the **duties and powers of the competent authority regarding the on-going supervision** of covered bond transactions

## Duties and powers of the national authority in a scenario of issuer's insolvency

- The legal/regulatory covered bond framework should provide sufficiently detailed description of what the duties and powers of the competent authority are on the covered bond programme, and its independent administrator, in a scenario of issuer's default

# EBA Recommendations – Dual Recourse and Insolvency/Resolution

## Dual recourse

- The (covered) bond must grant the investor:
  - a claim on the covered bond issuer limited to the complete fulfilment of the payment obligations attached to the cover bond, and
  - in case of issuer's default, a priority claim on the assets included in the cover pool limited to the complete fulfilment of the payment obligations attached to the cover bond.
- Should the cover assets included in the cover pool prove insufficient to fully meet the payment obligations towards the covered bond investor:
  - the covered bond investor should be granted a claim on the covered bond issuer's insolvency estate which **ranks pari passu** with the claim of the issuer's unsecured creditors

## Segregation of cover assets

- Effective segregation should result in **legally binding and enforceable arrangements**, including in the event of default or resolution of the issuer can be ensured by:
  - registration of the cover assets into a cover register; and / or
  - transfer of the cover assets to a special entity (SPV or specialised entity).
- Segregation arrangements should include:
  - all primary assets collateralising the covered bonds;
  - substitution assets;
  - derivatives entered into for the purposes of hedging the risks arising in the covered bond programme.

# EBA Recommendations – Dual Recourse and Insolvency/Resolution

## Bankruptcy remoteness of the covered bond

- The legal/regulatory covered bond framework:
  - **should not require that the payment obligations attached to the covered bond automatically accelerate** upon issuer's default or resolution, in order to ensure that the options available to the covered bond administration to achieve the full and timely repayment of the bonds are not constrained;
  - **should not permit a claim by the issuer's insolvency estate on the cover pool assets, other than on a subordinate basis** with respect to the claim of covered bond investors and other entities involved in the programme whose claim ranks pari passu or senior to the investors' claim;
  - should ensure that the issuer has at all times a plan in place specifying the operational procedures aimed at ensuring an orderly functioning of the covered bond programme upon default or resolution of the issuer.

## Administration of the covered bond programme post issuer's default or resolution

- The legal/regulatory covered bond framework:
  - should provide that upon issuer's default or resolution the covered bond programme is **managed in an independent way and in the preferential interest of the covered bond investor**;
  - should provide for **clear and sufficiently detailed provisions over the duties and powers of the administrative function**.

# EBA Recommendations – the Cover Pool

## Coverage requirements

- The coverage requirement should **include all the liabilities** of the covered bond programme, including liabilities towards counterparties in derivative contracts and service providers
- A **legal/regulatory minimum overcollateralisation** should be considered as a qualifying criterion for preferential treatment
  - The formulation of a quantitative legal/regulatory minimum over-collateralisation requirement would require further analysis as it depends on several factors, including but not limited to:
    - ▶ the class of cover assets;
    - ▶ the chosen coverage principle among the several different coverage principles currently adopted across jurisdictions (nominal, NPV, NPV under stress, etc.).

# EBA Recommendations – the Cover Pool

## Eligibility Criteria

- Asset type
  - Cover pools which comprise of primary asset classes other than residential or commercial mortgages (not taking into account asset classes included in the pool as substitution assets) **should comprise exclusively of one primary asset class**, reflecting the specificities of each class of cover assets
  - For mixed real estate pools **regulatory limits on the composition of such mortgage pools** could represent a best practice to ensure that a certain degree of consistency is maintained in the risk profile of the cover pool throughout the life of the covered bond, given the different risk profile of residential and commercial real estate loans
- Geographic location
  - Cover pools should be limited to comprise of assets located in the EEA.
  - Assets located outside the EEA should be considered for inclusion in cover pools provided that the non-EEA jurisdiction under consideration is assessed to **apply prudential supervisory and regulatory requirements at least equivalent** to those applied in the EU.
- LTV criteria – the legal/regulatory covered bond framework should encompass:
  - maximum LTV parameters to determine the percentage portion of the loan that contributes to the requirement of coverage of the liabilities of the covered bond programme (so called **'soft LTV limits'**);
  - LTV eligibility limits (i.e. limits whose breach determines the full non-eligibility of the loan for inclusion in the cover pool or **'hard LTV limits'**) when a given loan is first included in the cover pool.
- Valuation – the legal/regulatory covered bond framework should establish:
  - the **value of the property** securing each loan, and the corresponding regulatory LTV limit be updated or re-valued (e.g. at least via an indexation) and **monitored at least on a yearly basis** for both residential and commercial properties.
  - the revaluation of the properties securing the loans should be based on **transparent valuation rules** and be carried out by an agent who is **independent** from the credit granting process.

# EBA Recommendations – the Cover Pool

## Cover pool management

- The legal/regulatory covered bond framework should provide that:
  - derivative contracts are only allowed in covered bond programmes **exclusively for risk hedging purposes**;
  - derivative contracts entered into by the covered bond issuer with a derivative counterparty, and registered in the cover pool, **cannot be terminated upon issuer default**.
- Liquid assets buffer
  - The EBA considers that a requirement to mitigate liquidity risk in the covered bond programme, by means of **liquid assets available at all times to cover the cumulative net out-flows of the covered bond programme over a certain time horizon**, constitutes a regulatory best practice
- Stress testing
  - **Issuers should carry out stress-test exercises** on the calculation of the coverage requirement taking into account a specific set of factors including interest rate shifts, deterioration of credit quality of cover pool, etc. in order to ensure that coverage requirements are always met

# EBA Recommendations – Transparency

## Scope of disclosure

- Issuers should be required to disclose aggregate data on:
  - credit risk;
  - market risk;
  - liquidity risk;
  - the levels of contractual and voluntary overcollateralisation;
  - other relevant information, including information concerning the counterparties involved in the programme.
  
- The information should be disclosed to a level of detail which enables investors to **carry out a comprehensive risk analysis**.

## Frequency of disclosure

- Disclosure of the information should occur at least on a **quarterly** basis.

## Concluding Remarks

- Due to the good historical default/loss performance of covered bonds in the EU, the dual recourse principle embedded in covered bond frameworks whereby the covered bond holder has a claim on the issuing institution and a priority claim on the cover assets, the special public supervision for the protection of the bondholders mandated by the UCITS Directive and the existence of qualifying criteria in Article 129 of the CRR, **the EBA considers the preferential risk weight treatment laid down in Article 129 of the CRR to be, in principle, an appropriate prudential treatment**
- **Further convergence of national legal/regulatory and supervisory covered bond frameworks should be achieved**, so as to further support the existence of a preferential regulatory treatment to covered bonds in the EU
- The creation of a common European covered bond market should ensure:
  - the national covered bond product to be legally defined thereby safeguarding the product's preferential risk weight and liquidity treatment from covered bonds-like products or less suitable cover pool asset classes;
  - the creation of a prudentially sound covered bond framework and ensure that uncertainties about the differences in legal frameworks are removed;
  - the creation of transparency and comparability across issuers;
  - increased cross-border investor demand for covered bonds;
  - that that defaults of covered bond issuers, when finally put to the test, leads to none or very limited losses.



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