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GLOBAL MARKETS RESEARCH

A more integrated Covered Bond Framework? The investor's perspective

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Section I

The first push towards EU covered bond framework harmonisation: the EBA recommendations on best practice

- **In July 2014, the EBA released a 'best practices' guide for covered bond legal frameworks.** This was produced in order to inform the EC on the adequacy of the current CRR rules for assigning beneficial risk weights to qualifying covered bonds.
- No jurisdiction at the time adhered completely to the best practices, and the EBA's views have undoubtedly been the major driver of the changes in the frameworks in 2014 and 2015.

The EBA's 'best practice' framework recommendations

The principal areas of focus relate to transparency and asset liability mismatch risk. The report is more along the lines of a harmonisation of frameworks as opposed to standardisation.

Monitoring and the role of the competent authority

- Covered bond monitor exists and the role of the competent authority in policing the legal framework is clearly defined

Coverage principles

- Stress-testing to be taken in calculation of coverage requirement based on:
- Interest rate movements, FX volatility, credit quality evolution, repayment behaviour and liquidation price of underlying assets.

Stress testing and liquidity

- Legal minimum OC
- Minimum six-month liquid asset buffer

Disclosure

- Enhanced quarterly disclosure of cover pool composition
- Information provided on credit, market and liquidity risks alongside contractual and voluntary OC

Valuation and LTV limits of cover assets

- LTVs. should be updated annually
- Hard LTV limits for eligibility, soft LTV limits to determine percentage of loan that contributes to coverage levels

Features of the cover pool

- Only one primary asset class
- Composition limits, i.e.. limitations on commercial mortgages
- Residential/commercial mortgages, public sector and ship loan collateral only

Section I

The EBA recommendations have being taken very seriously, catalysing further convergence

- **Many frameworks have already proposed or legislated changes to reflect many of the areas which the EBA 'best practice' report discusses**, including the imposition of liquidity mitigants, legally defined minimum OCs and, interestingly, the imposition of liability driven liquidity mitigants such as conditional pass-through structures.
- The Polish framework is the first one to include in a statutory covered bond framework conditional pass-through features upon breach of liquidity or asset coverage tests, thus transferring liquidity risks to covered bondholders.
- It is important to note that the EBA seeks to establish a 'best practice' with respect to the covered bond legal framework as opposed to being contractually/market standard based, hence legal framework changes are required. Some of these framework changes are listed below:

Selected covered bond framework changes

Source: BBVA GMR

Selected frameworks	Outline changes
German – Pfandbriefe	Regulated issuer specific minimum OCs based upon Bafin stress tests, limitation on credit quality of derivative counterparties
French – OF's and OH's	Increase mandatory OC (to 5%), introduction of two maturity tests to mitigate ALM risks, limit of swap exposures to intra-group entities, introduction of servicing contingency plan and strengthening of 180-day liquidity requirement
Dutch	Imposition of minimum nominal OC (5%), removal of issuer rating threshold, 180-day liquidity requirement to cover interest and hard bullet covered bond redemption payments, performance information, only mixed pools of residential/commercial mortgages allowed but in a predetermined fixed ratio
Italian – OBG's	Restriction on securitised notes, changes in capitalisation requirements to better reflect regulated capitalisation levels and collateral valuations to be regularly updated
Polish	Minimum OC increased (10%) and liquidity provision set at a minimum of 12 months of interest payments. LTV limits changed to reflect maximum CRR allowed eligibility, and conditional pass-throughs are legally introduced in case of asset or liquidity coverage becomes insufficient. In case a two-thirds majority of the bondholders votes against the application of the pass-through approach, the cover pool can be liquidated and the proceeds will be distributed among bondholders (at the latest three months after the announcement of the test results)

Section I

The EC consultation on covered bonds: regulatory and industry initiatives for covered bonds

	2012	July – Oct 2014	Feb 2015	Sep-Oct 2015
Europe 	**ESRB Recommendation** of 20 December 2012 on funding of credit institutions. Advises NSAs to identify **best practices** and encourages **harmonisation of national frameworks**. EBA coordinating role.	**EBA Opinion to the EC** following mandate of CRD IV: i) to maintain in the short term the **preferential capital treatment** but consider strengthening eligibility criteria (min OC, liquidity buffers,..) ii) in the longer term **further convergence to support a single preferential treatment**		**EC report to EP/Council on capital requirements for CBs (20th of Oct)** **EBA opinion on the RTS on MLV and CBs and request to the EC** **ECBC** agrees on a **Common Harmonised Transparency Template** to be implemented from Jan 16, with a phase-in period of 1y
	EMF/ECBC creates the **Covered Bond Label.** Self-certification of compliance with the CBL Convention	**EBA Report** on **EU Covered Bond Frameworks** and capital treatment. Following ESRB recommendation **Best practices** identified in relation to the core elements	**EC consults on the CMU project,** including the development of a **more integrated European** covered bond market	**EC consultation** on an **EU covered bond framework.** Until 6 January 2016
Spain 		**Oct. Consultation** on the improvement of the **regulatory framework for covered bonds**.		

On 30 September, the EU published the Consultation on Covered Bonds alongside the Capital Market Union (CMU) Action Plan (feedback deadline is 6 January 2016).The regulatory pressure to harmonize EU covered bonds regimes has been linked to concerns about asset encumbrance (and related systemic risks) and requirements arising from the solvency regulations. The emergence of the CMU project adds an extra push.

Section I

The EC consultation on covered bonds: EU fragmentation as the driving concern

Fragmentation observed in EU CB markets

Causes of the spread widening between core MS and peripheral (after 2007, until 2012)

Drivers of pricing

Drivers of pricing	Causes
• Credit quality of the **issuer** • Credit quality of the **cover assets**	• Raising concerns in the credit quality cover assets in MS undergoing mortgage markets downturns
• **Country** factors: 1. Strength of the **sovereign**	• CB proxy of sovereign given the implicit/explicit public support • Currency redenomination fears (euro crisis mid-12)
2. Robustness of the legal and supervisory framework to protect bondholders	• Robustness questioned, with heterogeneity across MS. The lack of high quality standards for all covered bonds favoured stigmatisation of CBs issued in heavily crisis-hit countries.

A more integrated EU framework could help smoothing episodes of excessive differentiation between CBs from core and peripheral countries.

Section I

The EC consultation on covered bonds: asset encumbrance and market fragmentation

- During the crisis **asset encumbrance has increased** in the EU (Spain from 15% to 22%, Germany exception)
- Other sources: Central bank funding, repo markets, ABS
- **CB issuance exceeded senior unsecured for the first time**

Supervisors/ policy makers concerns

1	Unavailability to **support resolution**	→	Increased losses for unsecured loans and taxpayers
2	Unavailability to **obtain liquidity**	→	Fragility in the event of unforeseen stresses

- But other policy initiatives could be more appropriate tools to **limit asset encumbrance**

→ **Indirect limit**: MREL requirement

→ **Direct limits**: Macroprudential tools

EC considers that a more integrated European CB framework could contribute to "some extent" to mitigating asset encumbrance: reduce the high levels of OC, narrow definition of eligible cover assets.

Section I

The EC consultation on covered bonds. Why?

A — Why?

- **Covered bonds were not immune to the challenges presented by the financial crisis:** i) investor retrenchment to their domestic jurisdictions ii) spread widening following sovereign spreads.
- **CMU project's objectives of promoting market integration and efficiency** are relevant for European covered bond markets.

B — Objectives

- **Assess the convenience of a possible future integrated European covered bond framework.**
- **Potential benefits**: facilitate cross-border investment and issuance, improving funding conditions throughout the EU.

C — Main issues to discuss

1. **Convenience of a more integrated EU framework for covered bonds** based on high quality standards and best market practices.
2. **Mitigation of asset encumbrance.**
3. **High level design for a hypothetical EU covered bond framework.**

In its consultation paper on covered bonds, the European Commission is asking for feedback on "the merits and potential shape of an EU covered bond framework and present policy options to achieve greater integration in covered bond markets, based on experience gained from well-functioning national frameworks".

Section I

The EC consultation on covered bonds: three alternatives for further integration of frameworks

The EC Consultation: the three options for harmonisation

Source: European Commission

	Current	Option 1: voluntary convergence of MS	Option 2: EU CBs legislative framework			
Legislation on the instrument	National laws	Voluntary revisions of national laws based on **EC recommendation** **More effective if aligned** **With preferential treatment for CBs** **Pros** Max flexibility to adapt to national specificities **Cons** Maintenance of hurdles for cross-border investment? Legacy (national issue)	**Alternatives**		**Pros**	**Cons**
			Directive	1	Flexibility Supports rationale to maintain preferred regulatory status of CBs in CRR Compromise point between issuers, investors and regulators	Legacy issues
			Regulation	2	Greater harmonisation	More challenging at this stage (CB laws rooted in legal tradition of many MS) Legacy issues
			29th Regime	3	A "second regime" available for issuers. Not requires amendment to national laws	Increases fragmentation in the short-run
Prudential treatment	CRR preferential treatment	**Revise CRR preferential treatment**: strengthen eligibility criteria				

Three options for a more integrated EU framework for covered bonds are discussed: i) voluntary convergence of national covered bond laws, in accordance with non-legislative coordination measures by the Commission, ii) direct EU legislation on covered bonds, to harmonise existing national laws or provide an alternative framework and iii) the 29th Regime could be conceived as a "2nd Regime" in each Member State, thus providing parties with an option to choose between the current and the new regime.

Section I

The design of a hypothetical EU covered bond framework

1	Covered bond definition
2	Covered bond issuers and system of public supervision
3	Dual recourse and insolvency/resolution regime
4	The cover pool
5	Transparency requirements

The design is largely based on the best practices recommended by EBA although some elements have been added. According to rating agencies, main positives of the proposed EU framework would be: a) streamlined derivatives requirements and characteristics, such as a general obligation to hedge cover pool vs. covered bond interest rate and currency risk and no termination of derivatives on issuer insolvency, b) mandatory liquidity risk reserve/liquidity tests for interest payments after issuer default, c) treatment of non-performing assets, d) responsibility for cover pool administration after issued default, where each issuer would be required to have a detailed plan setting out operational procedures that ensure the orderly segregation and on-going operation of the cover pool after issuer default and where special administrator would administer the cover pool after issuer default and e) specific provisions in the law for liquidity to address refinancing risk.

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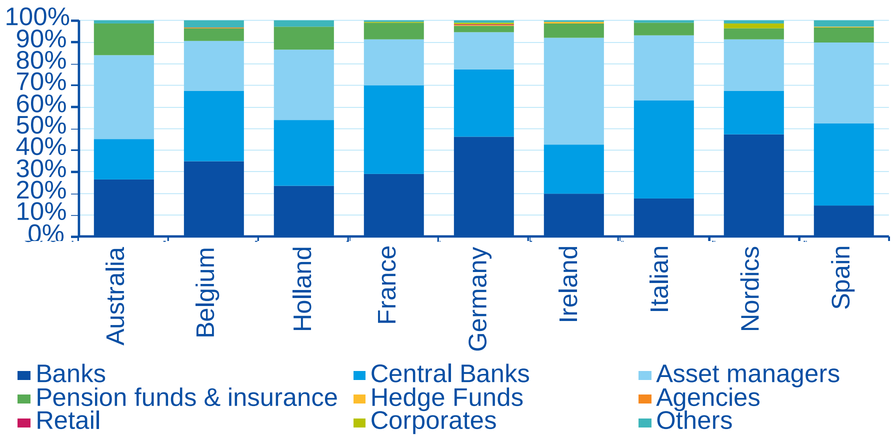
Section II

Investor distribution in 2015 by country and investor type

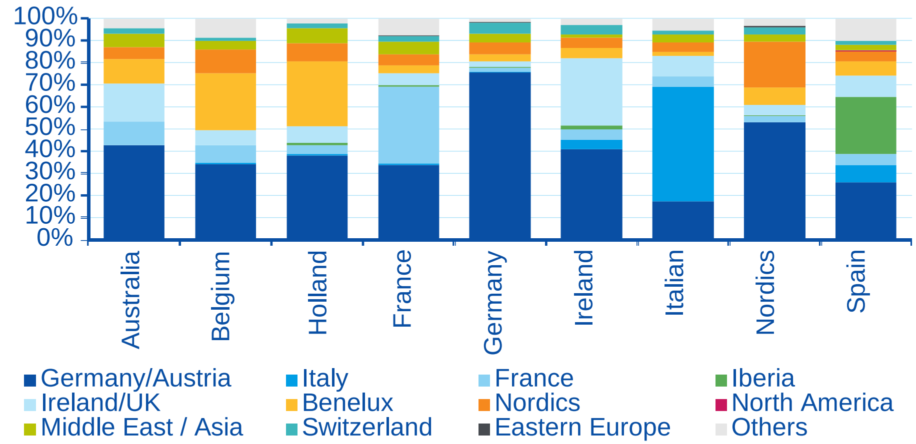
Allocation by type for each market – EUR CB FY2015

Source: Bond Radar, The Cover, Covered Bond Report



Allocation by country for each market - EUR CB FY2015

Source: Bond Radar, The Cover, Covered Bond Report



- **Investors that we speak with are broadly neutral to the asset class selectively adding exposure in the primary market, and using the ECB to manage their exits from certain positions**; many investors which remain invested in covered bonds are using their positions as a hedge against market volatility; a 'flight to quality' effect. The share of asset managers and pension funds/insurance has been cut by half since the start of CBPP3.

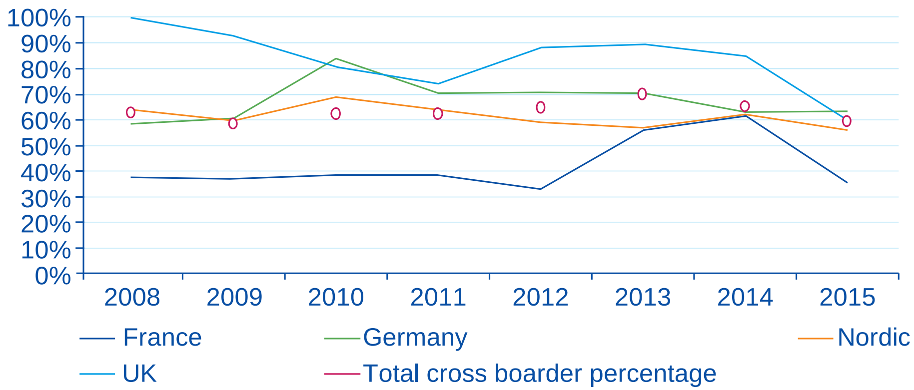
Section II

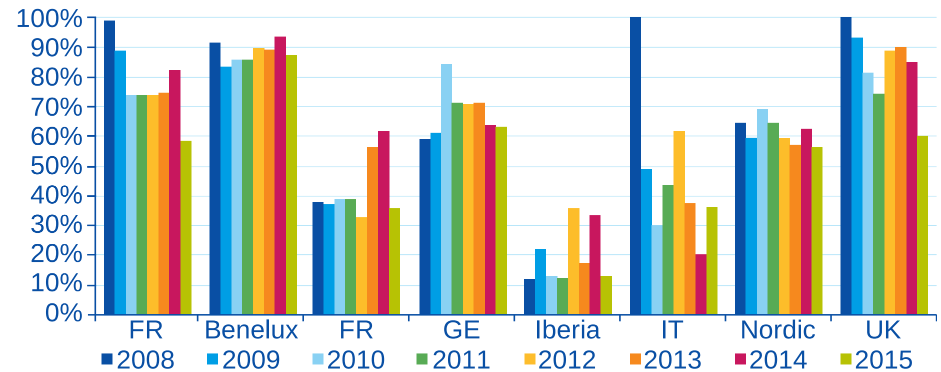
Cross-border investment is a positive feature of covered bonds

- **Looking at investor distribution statistics of EUR benchmark covered bond new issues over time, there is clear evidence that there was cross-border investment in covered bond markets throughout the crisis**. The different frameworks have not prevented this from happening. Furthermore, the recent drop in the foreign investment share is in fact due exclusively to the CBPP3, which has increased the domestic share as the home central bank channels the Eurosystem buying.
- **The strength of the different frameworks and investors' understanding and appreciation of them actually led to less fragmentation in covered bonds than in sovereign bond markets**. Spreads did move out on the back of sovereign spread widening but this did not lead to investors losing faith in covered bond markets from other countries despite the different legal frameworks.

Share of cross border investments of total covered bond primary benchmark investments

Source: ECBC





- **Cross-border investment in covered bond markets did take place throughout the crisis**. The crisis has inevitably prompted some home bias, particularly on the demand for medium or small less well-known financial entities, but cross-border flows have still been a supporting anchor of covered bonds spreads even during the darkest episodes of the sovereign crisis.

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Section III

An EU integrated covered bond framework: the pros

Depending on how they were to develop, pan-European standards could strengthen the average creditworthiness of European covered bonds and investors could benefit from a reduction in costs.

1. Simplification/standardisation helps to **develop deeper and more liquid markets for all Member States, which could become, as a result, a more consistently safe and predictable source of funding.**

2. Enhances transparency/comparability, improving **market discipline and efficiency.**

3. Prevents undue distinction between MS, **promoting cross-border activity as common standards would prevent an undue or unjustified distinction between stronger and weaker sovereigns.**

4. Facilitates investors' analysis, **widening the investor base** (small investors/markets) . It could ultimately lead to an aggregate increase in creditworthiness, liquidity, and transparency in the market, as well as a reduction in investors' costs.

5. It could reduce the high levels of OC and **mitigate asset encumbrance risks.**

6. **Facilitates the application of the prudential requirements**. It could mitigate mechanistic reliance on external credit ratings in the prudential regulatory treatment of covered bonds by providing a more risk sensitive and comprehensive basis for the prudential treatment of covered bonds.

7. **It would benefit public authorities** as an integrated framework would limit the existing wedge present between the benefits expected from covered bonds (close to being a risk free asset) and the (implicit) need by public authorities to support them.

Section III

An EU integrated covered bond framework: cons outweigh pros (I)

An harmonised covered bond framework is unlikely to have a material impact on pricing convergence/divergence given that the market is currently functioning efficiently' an, a divergence in collateral, issuer and country risks could still happen in the future.

1. **It would miss key points:** in our view a unique fully-harmonised covered bond framework in Europe would miss key points about how this market works, such as pricing drivers, domestic insolvency laws, domestic mortgage market laws, consumer behaviour, constitutions, amongst others.

2. **Several factors lead to market fragmentation**: In our view, peripheral covered bonds did not suffered stigmatisation due to weaknesses in legal frameworks but rather due to the other reasons put forward in the consultation such as the scale of local mortgage market downturns, covered bonds perceived as a proxy for sovereign risk, rating agency actions, among others. Fragmentation in sovereign markets was much higher than in covered bond markets and, consequently, it cannot be said that different covered bond frameworks have led to spread differentiation.

3. **Legal frameworks a secondary driver of investor demand:** Investor demand across markets has been driven mainly by risk appetite, search for yield, investment strategies, regulatory treatment, market liquidity, etc., rather than the difference in legal frameworks. Covered bonds are subject to different regulatory rules, e.g. LCR, ECB repo eligibility, which investors will take into account when considering investment opportunities.

4. **Impact of frameworks limited to stressed scenarios:** The impact of a fragmented covered bonds market is only likely to result in material pricing divergence in a much stressed environment when bondholder protection (indexation of cover pool, supervision, minimum over-collateralisation etc..) becomes an increasing focus for investors – typically distressed fund/high yield investors in legal frameworks – which are secondary for pricing in our view.

5. **Frameworks have already strengthened in recent times:** If anything, CB legislation has improved since 2007, reflecting market developments and/or the recent EBA recommendations, for example – and so has transparency. But neither factor has regained its pre-crisis prominence, and both remain secondary for pricing.

6. **CBPP3 has not achieved spread harmonization:** Despite the ECB Covered Bond Purchase Programme 3, we still see spread differentiation between core and peripheral markets, reflecting higher risk appetite, lower ratings, weaker regulatory treatment, lower liquidity, etc., in the latter.

Section III

An EU integrated covered bond framework: cons outweigh pros (II)

An harmonised covered bond framework is unlikely to have a material impact on pricing convergence/divergence given that the market is currently functioning efficiently' an, a divergence in collateral, issuer and country risks could still happen in the future.

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- **Cover pool collateral performance to be driven by domestic shocks, irrespective of the framework:**
  - In a public-sector backed programme the underlying loans are as closely correlated to the sovereign risk as they can be and as a consequence, during the sovereign crisis, these bonds, which had previously been considered of a higher credit quality than mortgage-backed deals, were demoted to a lower standing.
  - Mortgage-backed deals should also be affected by the weaker economic growth that is associated with sovereign stress because it usually leads to higher unemployment. With homeowners less able to afford mortgage repayments, delinquency and default rates would be expected to rise.
  - The performance of commercial mortgage loans that are also eligible for these deals, would also suffer as the ability of companies to earn income and repay the loans would be correlated to the strength of the national economy as well as the valuations of commercial property are heavily correlated with general economic health.

8

- **Heterogeneous rating impact as EC Proposals could already weaken certain frameworks:** The proposed EU framework in its current form contains some proposals that could have a negative credit impact in countries where the current framework is stronger than the Proposed Framework in areas such as assets eligibility, valuation requirements, derivatives in the cover pool, legal minimum OC, cover tests, role of the regulator, trigger(s) for default of issuer (as according to the Commission the issuer's default may be triggered upon its resolution or declaration of insolvency), the unsecured claim after issuer default, management of the cover pool, covered bonds refinancing and time subordination.

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- **Investor re-education:** The EU covered bond market is comprised of established, well-regarded domestic legislative frameworks. Investors have developed a knowledge bank in these frameworks by a long course of dealing. Any harmonisation scheme must factor in significant project of investor re-education. The cost of disruption to existing norms and market practices. Given the long history of some covered bond markets, these may be deeply entrenched, making change more difficult.

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- **Legacy issues:** If an EU Directive on covered bonds is finally enacted, it would also need to include some provisions regarding the grandfathering of all the outstanding issues. Establishment of new cover pools with grandfathering schemes for earlier issues would be both cost-intensive and detrimental to bond series' liquidity.

Section III

An EU integrated covered bond framework: cons outweigh pros (III)

An harmonised covered bond framework is unlikely to have a material impact on pricing convergence/divergence given that the market is currently functioning efficiently' an, a divergence in collateral, issuer and country risks could still happen in the future.

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- **An integrated EU framework would reduce investment options for investors:** There is a trade-off between cost and investment options. In general, institutional investors appreciate the diversity of the covered bond market, currencies and related leverage options.

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- **Potential underestimation of risk by investors:** An integrated EU framework could trigger the risk that investors could underestimate the degree of product diversity that would inevitably remain despite the introduction of a standardized framework. greater homogeneity in the market could foster complacency in market participants' credit risk assessment and support the perception that all covered bonds are low-risk instruments.

Section III

An EU integrated covered bond framework: the ratings implications

A single framework would not lead to homogeneous ratings…:

1

- Differentiation in covered bonds ratings will continue to be driven by **the issuer credit strength, the credit quality of individual cover pools, the programme's actual asset and liability mismatches and macro-economic conditions prevailing in the country**.
  - In addition, the agencies' Country Ceilings would still apply even under a harmonised regime or common guidelines in the EU.
  - Issuers still pursue different business strategies, mortgage and public sector markets remain diverse and there are significant variations in economic performance among countries in the EU, which are unlikely to vanish
  - The new financial regulatory requirements aiming to make the banking system as a whole safer are still leaving extensive room for differences between banks within as well as across countries.
  - They can also be affected by an issuer's decisions regarding cover pool composition, funding strategy and maintenance of OC due to the dynamic nature of the cover pool.
  - Protection against liquidity risk and maturity mismatches is the main determinant of lower default risk for covered bonds compared with senior debt.
  - **Certain aspects of the EC document could have negative rating implications if not defined properly**, such as the introduction of maximum OC limits, a "cut-off mechanism" to limit in time the unsecured claim or making it conditional upon recourse to the cover pool and the triggers of default of the issuer (resolution/insolvency).

Section III

An EU integrated covered bond framework: the ratings implications (I)

… although it would include some positive rating factors, such as:

1. **Mandatory liquidity provisions upon the switch from the issuer to the cover pool as the source of payments**, the key rating component of covered bonds. Therefore, the potential for rating upgrades would be highest for countries with no mandatory liquidity protection embedded in the covered bond law such as Austria, Spain and Sweden.

2. Clarity on the availability of voluntary overcollateralisation (OC) held above a legal minimum, if implemented.

3. Dedicated insolvency administrator for the benefit of covered bondholders, independent of the general insolvency administrator, would help prevent conflicts of interest between bondholders and other creditors after issuer insolvency

4. A general obligation to hedge cover pool vs covered bond interest rate and currency risk, in addition to limits on purposes of hedging and derivatives' counterparty eligibility criteria and no termination of derivatives on issuer insolvency

5. **Responsibility for Cover Pool Administration After Issuer Default**: Each issuer would be required to have a detailed plan setting out operational procedures that ensure the orderly segregation and on-going operation of the cover pool after issuer default. A special administrator would administer the cover pool after issuer default.

Section III

An EU integrated covered bond framework: information disclosure and investors

- **Harmonised periodic reporting under the ECBC's "Covered Bond Label" has improved the degree of transparency in the covered bond market.** The Covered Bond Label has been recognised as the hallmark of covered bonds issued in accordance with high standards and in line with a strict definition, through the Label Convention, of the essential features of the asset class, by facilitating and improving the access to information on i) liability, ii) regulation and iii) assets and regulatory compliance. In addition, the Covered Bond Label has been instrumental in the harmonisation of cover pool disclosures across its member jurisdictions and an effective means of achieving the goal of harmonisation.
- **The ECBC's "Harmonised Transparency Template", which will be phased in during 2016**, will provide further and more detailed information by Covered Bond Label. The implementation of the HTT will improve transparency through harmonisation, making it easier to process and analyse covered bond data across different issuers/regions.
- The CRR 129(7) and the Industry reports more typically via issuers own reporting, the National Transparency Templates (NTTs) and rating agencies. In our view, **the ECBC's common Harmonised Transparency Template (HTT) addresses the relevant risk factors**, i.e. information on credit, market and liquidity risk, provides a good level of granularity and allows for a comprehensive risk analysis.
- **We do favour a market-led initiative to ensure that the Covered Bond Label will continue to be able to adapt and react rapidly to address market developments** without the requirement for lengthy legislative processes, which is essential given the dynamic nature of transparency within a changing financial landscape and to increase incentives for more issuers to join the Label initiative and thus ensure further convergence in the European covered bond market.
  - Acknowledging the adequacy of the Covered Bond Label to the market and to covered bond issuers across Europe with a degree of regulatory recognition.
  - In our view, market-led initiatives such as the Covered Bond Label are both a sufficient and effective method to achieve the goal of convergence as Member States have a very different national legislative framework for covered bonds with respect to insolvency and asset segregation etc., which are extremely difficult - if not impossible - to harmonise via law.
- **We do not consider loan-by-loan data to be as valuable for covered bond investors as for investors in securitisations**. This is because loan-level data does not give a complete picture of the risks inherent in a covered bond programme. These can also stem from mismatches between the assets and liabilities. The repayment of covered bonds only becomes dependent on the actual cover assets after issuer insolvency. Moreover, non-performing loans are taken out of the cover pool in most programmes.
  - Moreover, the special public supervision of the covered bond business, which covers the oversight of cover assets, would still be in place and investors still have a claim against the insolvent estate.

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