



RECOMMENDATIONS ON THE HARMONISATION OF THE COVERED BOND FRAMEWORKS IN THE EU

Public Hearing

EBA, 18 November 2016

MANDATE AND CONTENT OF THE ANALYSIS

Mandate and previous work

Mandate

- **ESRB Recommendation on funding of credit institutions (Recommendation E, ESRB/2012/2):**
- ... *'by 30 June 2016, the EBA is requested to deliver a final report to the ESRB and to the Council containing an assessment of the functioning of the framework for covered bonds under the best practice principles and its view on recommended further action if deemed desirable.'*

• https://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2012_2.en.pdf?8de3922e86b0f4863bc6e748f1f1a4c0

Previous work

- Follow up to the **EBA report on covered bonds (July 2014)**
 - Identified best practices in 8 areas to enhance robustness of the covered bond regulation across the EU

• <https://www.eba.europa.eu/-/eba-supports-capital-treatment-of-covered-bonds-but-calls-for-additional-eligibility-criteria>

Content of the draft report

Chapter 1

- Assessment of **developments in national covered bond frameworks and their alignment with the EBA 2014 best practices**

Chapter 2

- Analysis of the **latest market and regulatory developments** in relation to covered bonds since 2014

Chapter 3

- **Detailed recommendations on harmonisation of the covered bond frameworks in the EU – ‘three step approach’**

Timeline

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Subject to approval by EBA
decision making body

Publication in December
2016 and submission to
the ESRB, the Council and
the European Commission

ANALYSIS OF DEVELOPMENTS IN NATIONAL COVERED BOND FRAMEWORKS

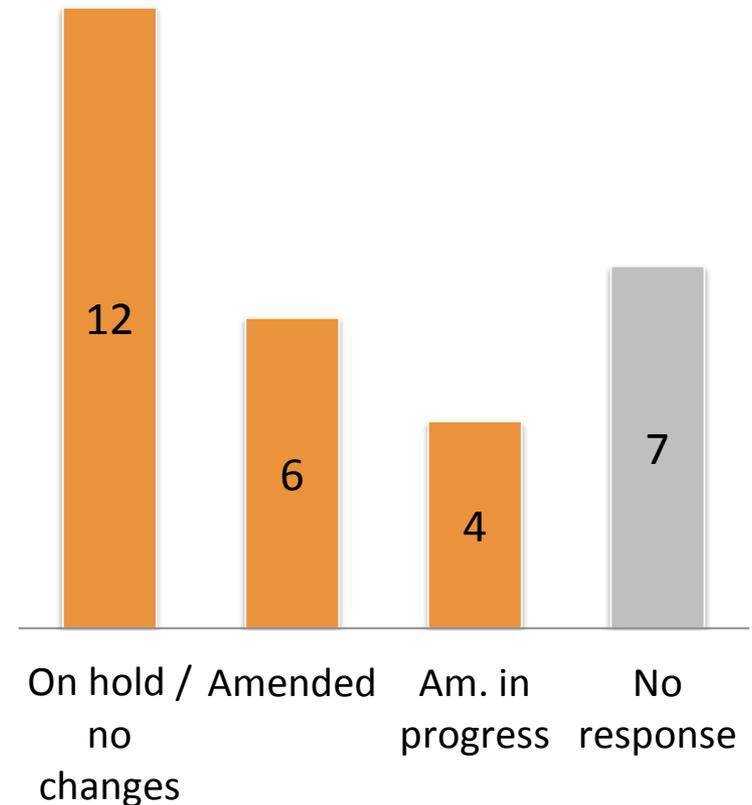
Coverage and principles of analysis

- Assessment of alignment of national covered bond frameworks with each of the EBA best practices
 - Assessment as **fully aligned, partially aligned or non-aligned**
- Reliance on the **self-assessments** by the competent authorities; not subject to peer review
- Coverage of **22 jurisdictions**, including the ones with the most active covered bond markets (21 EU Member States and Norway)
- Consideration of **legal and regulatory covered bond frameworks**
 - Supervisory frameworks and contractual arrangements not taken into account

Changes in national covered bond frameworks since 2014

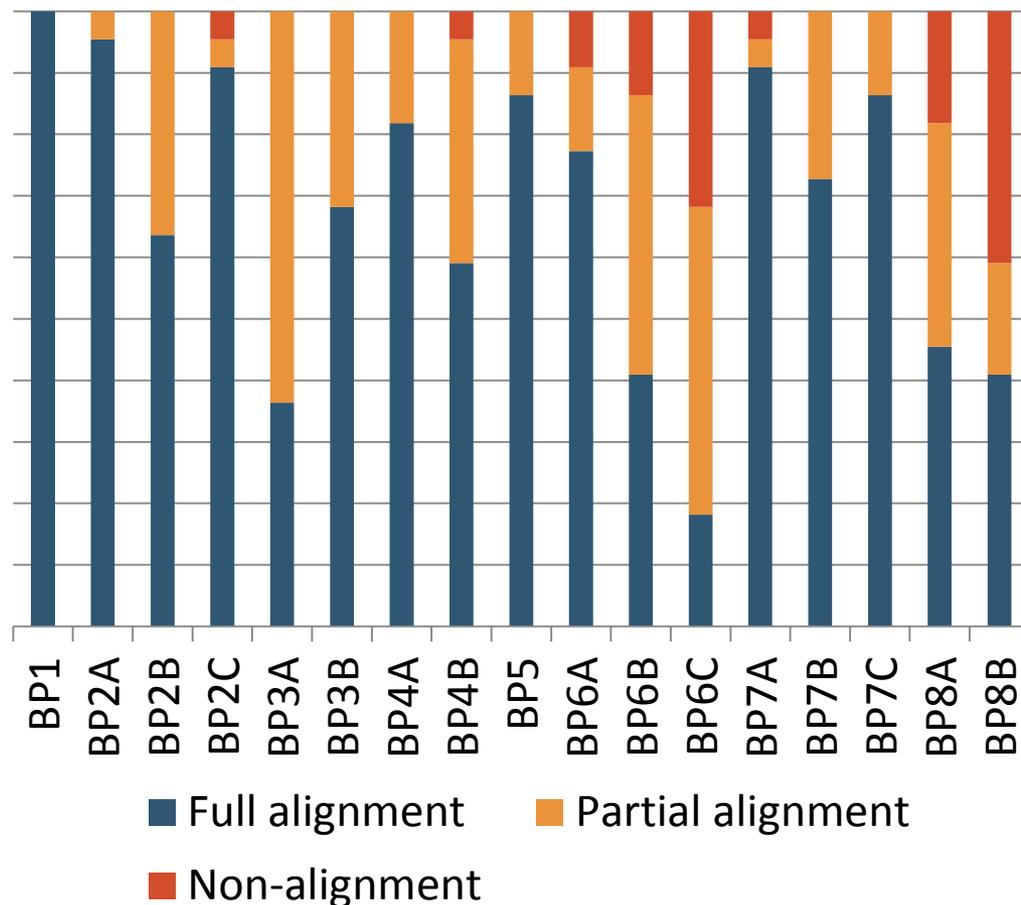
- **In majority of jurisdictions:**
 - **no changes/changes on hold** pending the European Commission’s review on covered bonds

- **In minority of jurisdictions:**
 - **frameworks amended/in the process of amendment**



Overall alignment with the EBA best practices

(to note different level of importance and weight of best practices for overall quality and strength of the CB business)



- BP1: Dual recourse
- BP2 – A: Segregation of the cover assets
- BP 2 – B: Bankruptcy remoteness of the covered bond
- BP2 – C: Administration of the covered bond programme post issuer’s insolvency or resolution
- BP3 – A: Composition of the cover pools
- BP3 – B: Cover pools with underlying assets located in different jurisdictions
- BP4 – A: LTV limits
- BP4 – B: LTV measurement and frequency of re-valuation
- BP5: Coverage principles and legal/regulatory overcollateralisation
- BP6 – A: Use of derivatives
- BP6– B: Liquidity buffer
- BP6 – C: Stress testing
- BP7 – A: Appointment of the cover pool monitor
- BP7 – B: Supervision of the covered bond issuer
- BP7 – C: Duties and powers of the national authority in a scenario of issuer’s insolvency
- BP8 – A: Scope of disclosure
- BP8– B: Frequency of disclosure

Main conclusions of the analysis

- **Diversity of the national covered bond frameworks**
 - From legal, regulatory as well as supervisory perspective
- **High divergence in the level of alignment with the EBA best practices** across individual jurisdictions
- Best practices related to the **core features of the covered bonds** very well adhered to:
 - Dual recourse principle
 - Segregation of cover assets
 - Structural features of the bankruptcy remoteness
 - Coverage principle

Main conclusions of the analysis - cont.

- **A number of specific areas of the covered bond regulation with low level of adherence:**
 - Disclosure of data by issuers on the cover assets and covered bonds
 - Existence of liquidity buffers addressing liquidity risks in the covered bond programmes
 - Composition of the cover pool
 - Stress testing on calculation of the coverage requirement

- In addition, significant differences in the rules on **special public supervision of covered bonds** across jurisdictions:
 - Content and level of details of rules on special public supervision of covered bonds
 - Scope of duties and powers of supervisory authorities
 - Supervisory practices

ANALYSIS OF LATEST MARKET AND REGULATORY DEVELOPMENTS

Key trends observed in the past two years

- **Special/favourable treatment of covered bonds in EU financial regulation and ECB's monetary policy:**
 - Eurosystem's CBPP3
 - LCR Delegated Act: covered bonds as part of the LCR buffer
 - BRRD: exemption from bail-in
 - RTS on OTC derivatives not cleared by CCP: exemption from clearing obligations/posting margins

- **Developments in relation to rating agencies:**
 - Changes in methodologies for evaluation of covered bonds
 - Upgrades of ratings
 - New rating agencies in the market for ratings of covered bonds

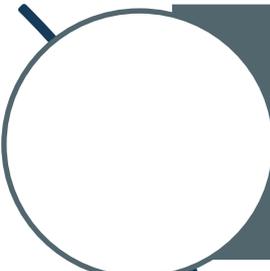
- **Innovations in the covered bond structures:**
 - Move from traditional (hard bullet) amortisation structures to 'soft bullet' and 'conditional pass through (CPT)' structures

Key trends observed in the past two years – cont.

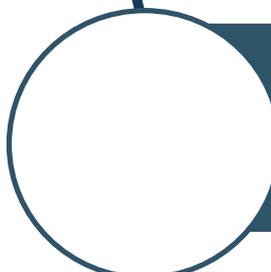
- **Dynamics in issuance and outstanding volume of covered bonds** (ref. date end 2015):
 - Trend of contraction of the market following the crisis slowing down, increasing issuance since 2013
- **Expansion of covered bond markets outside EU:**
 - Global product, first issuances in Asia in 2015
- **Changes in the composition of the investor base:**
 - Substantial expansion of the share of central banks
- **Continuing trend in the last decade as regards the composition of the cover pool:**
 - Increasing use of mortgages as cover pool collateral
 - Decreasing use of public sector loans and other asset classes
- **Enhanced transparency:**
 - Market initiatives (e.g. ECBC's HTT)

THREE-STEP APPROACH TO HARMONISATION OF COVERED BOND FRAMEWORKS IN THE EU

Principles behind the EBA recommendations on the harmonisation



Taking into account conclusions of the EBA analysis, confirming in particular existing diversity in the legal, regulatory and supervisory covered bonds frameworks across EU jurisdictions



Allowing to better protect the ‘covered bond brand’ by ensuring more consistency across definition and regulatory treatment of the covered bond products in the EU



Proposing a balanced solution towards harmonisation:

- Allowing to meet prudential objectives**
- Building on the strengths of existing national frameworks, keeping their specificities and leaving room for varying national implementation, where appropriate**

Three-step approach to harmonisation

STEP I:

- **Development of a covered bond framework:**
- Establishment of the base-line definition of the covered bond for EU financial regulation
- Replacement of covered bond-related provisions in UCITS Directive
- Focus on structural features, including soft bullet and CPT features
- Point of reference for prudential regulatory purposes (e.g. BRRD, LCR)
- Applicable across sectors
- Requirements in Step I obligatory for all covered bonds seeking regulatory recognition

STEP II:

- **Amendments to CRR, related to preferential risk weight treatment:**
- Enhanced conditions for preferential capital treatment
- Focus on credit risk related features
- Requirements in Step I as well as Step II obligatory for all covered bonds seeking preferential capital treatment

STEP III:

- **Voluntary convergence at national level:**
- Voluntary convergence at national level through non-binding instruments
- Specific areas with less material impact on the overall robustness of the covered bond frameworks

Overview of areas covered by the three-step approach



Covered bond framework:

Standard structural requirements:

STEP I:

1. Dual recourse, segregation of cover assets and bankruptcy remoteness of the covered bonds
2. Requirements on coverage, liquidity risk mitigation and cover pool derivatives
3. Requirements on system of special public supervision and administration
4. Transparency requirements
5. Specific conditions for soft bullet and CPTs



Amendments to CRR:

Conditions for preferential risk weight treatment:

STEP II:

- All requirements in STEP 1
- +
1. Requirements on eligibility of cover assets
 2. Requirements on substitution assets
 3. LTV limits
 4. Minimum overcollateralisation



Voluntary convergence:

Areas subject to voluntary convergence:

STEP III:

1. Composition of the cover pools
2. Cover pools with underlying assets located outside the EEA
3. LTV measurement and frequency of re-valuation
4. Stress testing by the covered bond issuer

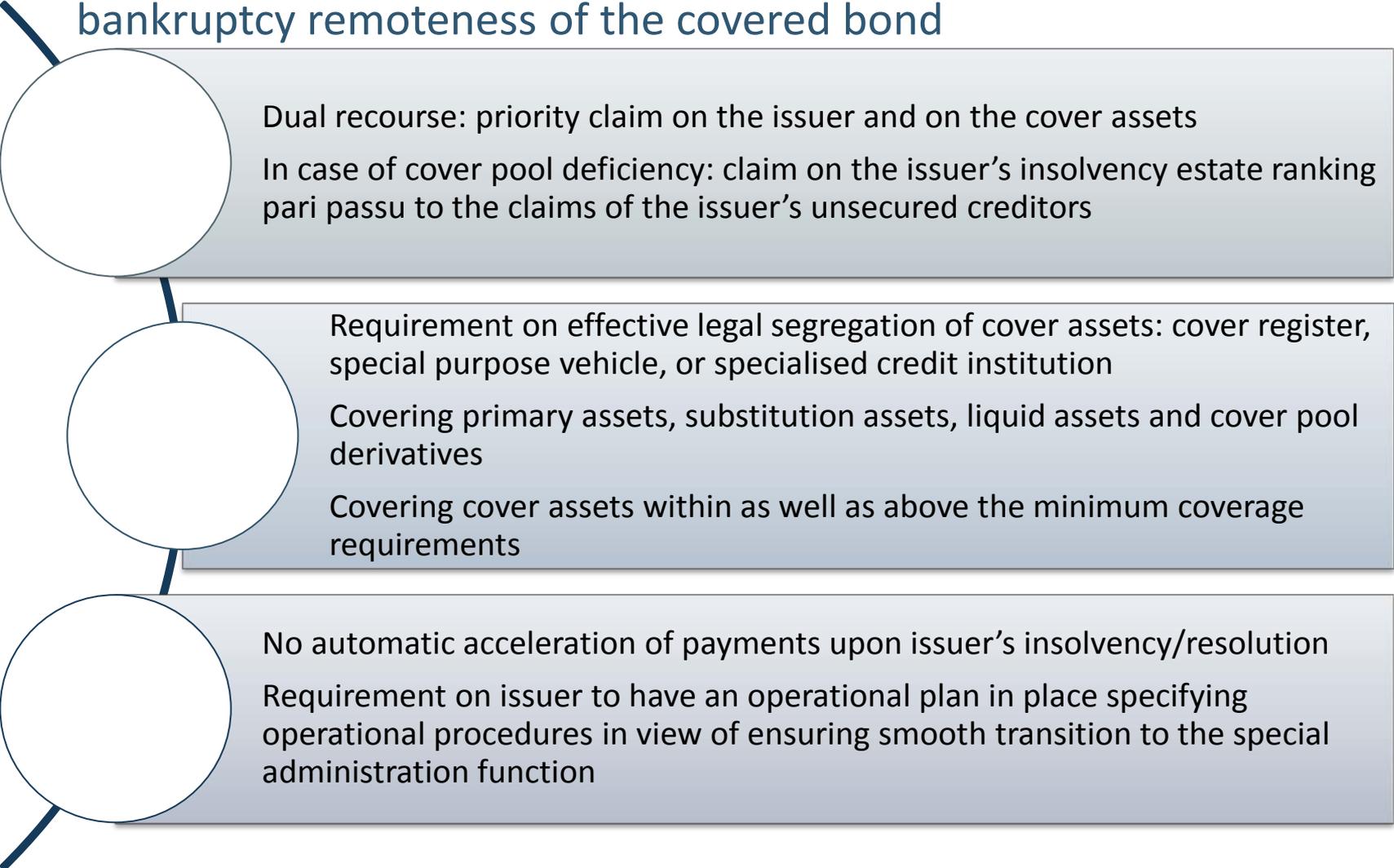
STEP I:

COVERED BOND FRAMEWORK

Overview of areas covered

Areas covered in the step I: Covered bond framework	Relation to the current regulatory treatment
<i>Dual recourse, segregation of cover assets and bankruptcy remoteness of the covered bonds</i>	
Dual recourse	Extension/amendment of the existing rule
Segregation of cover assets	New rule
Bankruptcy remoteness of the covered bond	New rule
<i>Requirements on coverage, liquidity risk mitigation and cover pool derivatives</i>	
Coverage requirements	Extension/amendment of the existing rule
Liquidity risk mitigation requirements	New rule
Requirements on cover pool derivatives	New rule
<i>System of special public supervision and administration</i>	
Cover pool monitor	New rule
Supervision of the covered bond issuer	New rule
Supervision in the event of issuer's insolvency/resolution	New rule
Administration of the covered bond programme post issuer's insolvency/resolution	New rule
<i>Transparency requirements</i>	
Scope, format and frequency of disclosure	Extension/amendment of the existing rule
<i>Requirements for soft bullet and CPT covered bonds</i>	New rule

Dual recourse, segregation of cover assets and bankruptcy remoteness of the covered bond



Dual recourse: priority claim on the issuer and on the cover assets

In case of cover pool deficiency: claim on the issuer's insolvency estate ranking pari passu to the claims of the issuer's unsecured creditors

Requirement on effective legal segregation of cover assets: cover register, special purpose vehicle, or specialised credit institution

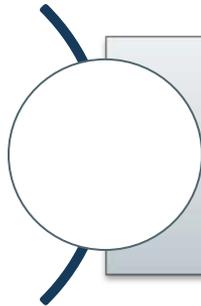
Covering primary assets, substitution assets, liquid assets and cover pool derivatives

Covering cover assets within as well as above the minimum coverage requirements

No automatic acceleration of payments upon issuer's insolvency/resolution

Requirement on issuer to have an operational plan in place specifying operational procedures in view of ensuring smooth transition to the special administration function

Requirement on coverage



Sum of all payment claims attached to the cover assets has at all times to be at least equal to the sum of all payment obligations attached to the covered bond (including operational costs)



Scope of cover assets contributing towards the coverage

- Claims for payments of principal and interest of primary assets, substitution assets and liquid assets in the liquidity buffer
- Net amounts from cover pool derivatives used for hedging purposes (net cash flow value or closing-out amount, whichever is lower; may be a 'negative' asset)



Scope of covered liabilities

- Obligations for the payment of principal and (undiscounted) interest of outstanding covered bonds
- Variable future payment obligations taken at current spot rates (the same rates as used for the cover assets)
- Operational costs, at least to the extent they are current

Liquidity risk mitigation requirement

Requirement

- Liquidity buffer to cover liquidity risks and needs of the covered bond programme over the next 180 days

Size

- Value of liquid assets (market value minus haircut) covering all principal and interest payments of the covered bond programme, and cash flow profile of cover pool derivatives, over the next 180 days, on a net basis (i.e. taking into account contractual cash inflows on cover assets)

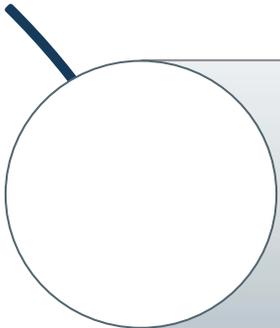
Interactions with the LCR requirement

- Interaction with the current prudential liquidity requirement (LCR) with respect to the covered bond related outflows in the LCR, while avoiding weakening of the LCR
- Proposal to clarify requirement in the LCR Delegated Act on non-encumbrance of the liquid assets, with respect to the covered bond liquidity buffer assets

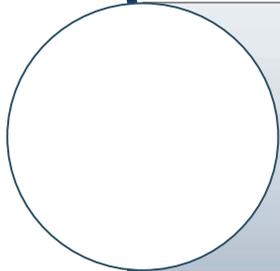
Soft bullet and CPT covered bonds

- Calculation of the size of the liquidity buffer may take into account the final maturity date (i.e. not the scheduled maturity date)

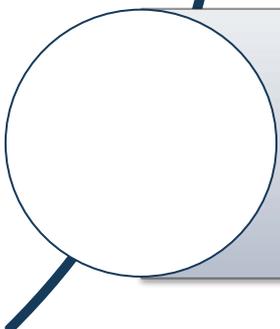
Requirement on cover pool derivatives



Derivative contracts allowed as part of covered bond programmes exclusively for risk hedging purposes

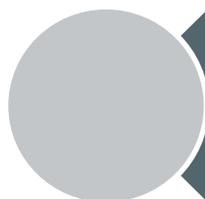
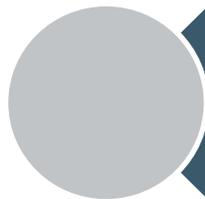
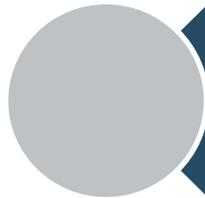


Derivative contracts registered in the cover pool not to be terminated upon issuer's insolvency

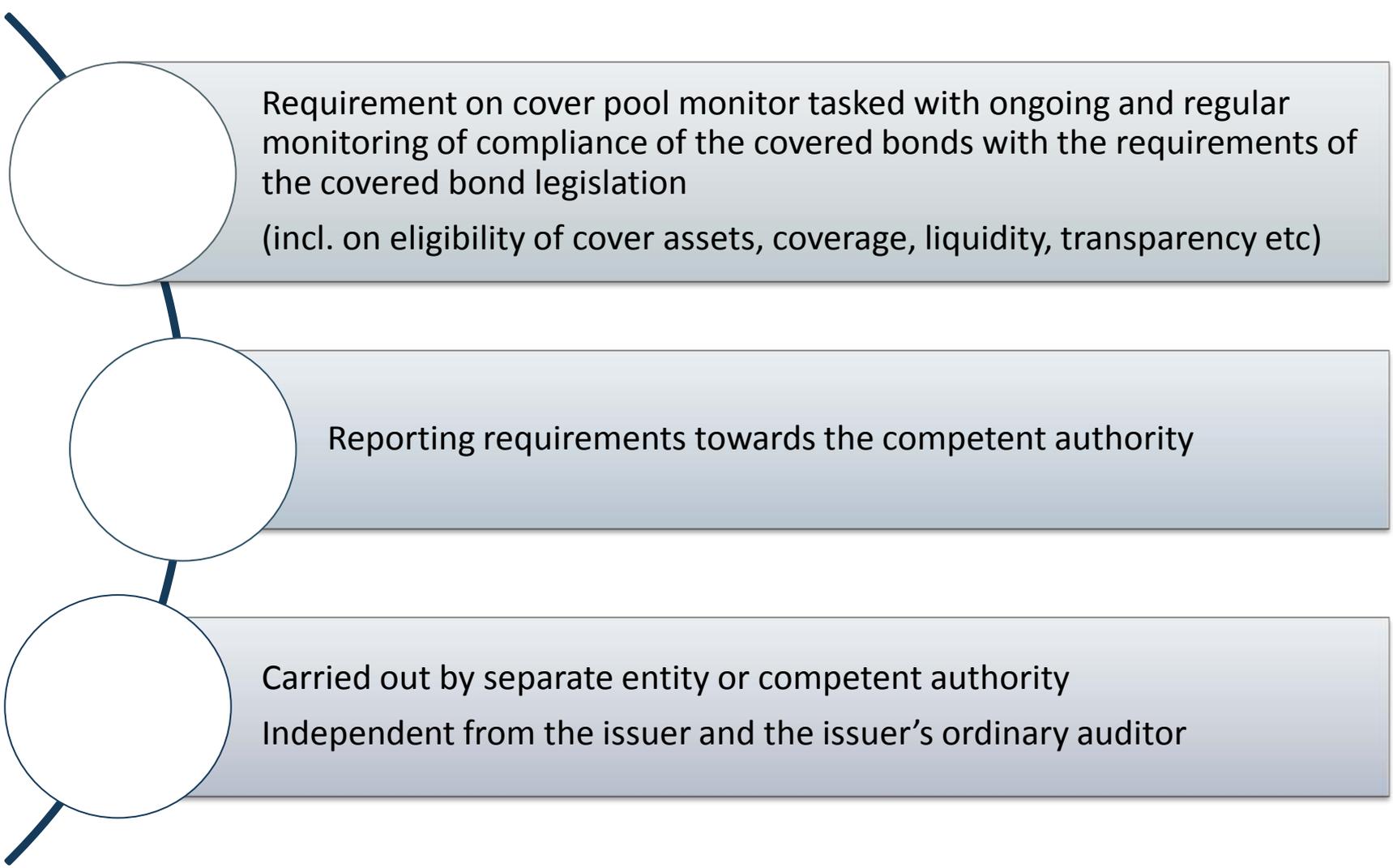


In the event of the loss of sufficient creditworthiness of the counterparty, the counterparty to be subject to collateralisation requirement and/or forced to arrange for its replacement by another counterparty

System of special public supervision and administration

-  (i) Cover pool monitor
-  (ii) Supervision of the covered bond issuer in going concern
-  (iii) Supervision in the event of issuer's insolvency/resolution
-  (iv) Administration of the covered bond programme post issuer's insolvency/resolution

Cover pool monitor

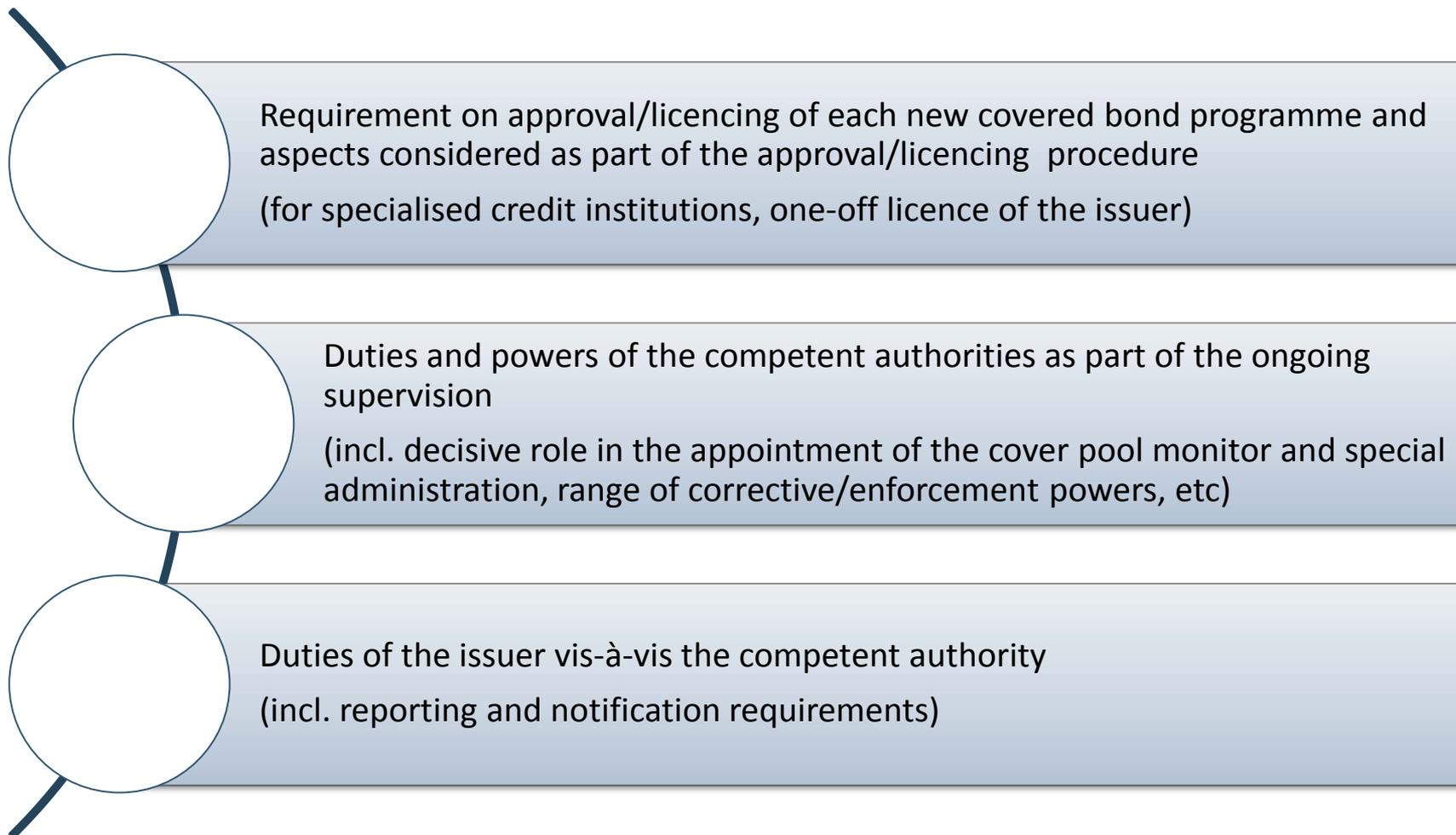


Requirement on cover pool monitor tasked with ongoing and regular monitoring of compliance of the covered bonds with the requirements of the covered bond legislation
(incl. on eligibility of cover assets, coverage, liquidity, transparency etc)

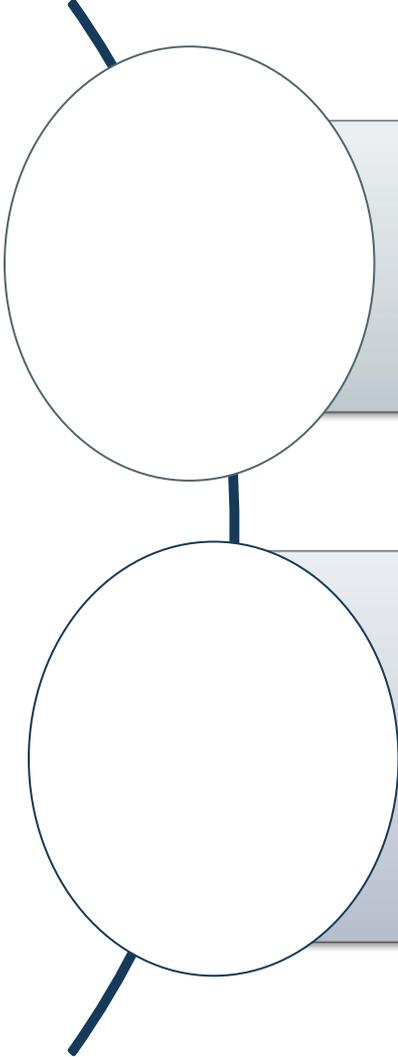
Reporting requirements towards the competent authority

Carried out by separate entity or competent authority
Independent from the issuer and the issuer's ordinary auditor

Supervision of the covered bond issuer



Supervision in the event of the issuer's insolvency/resolution



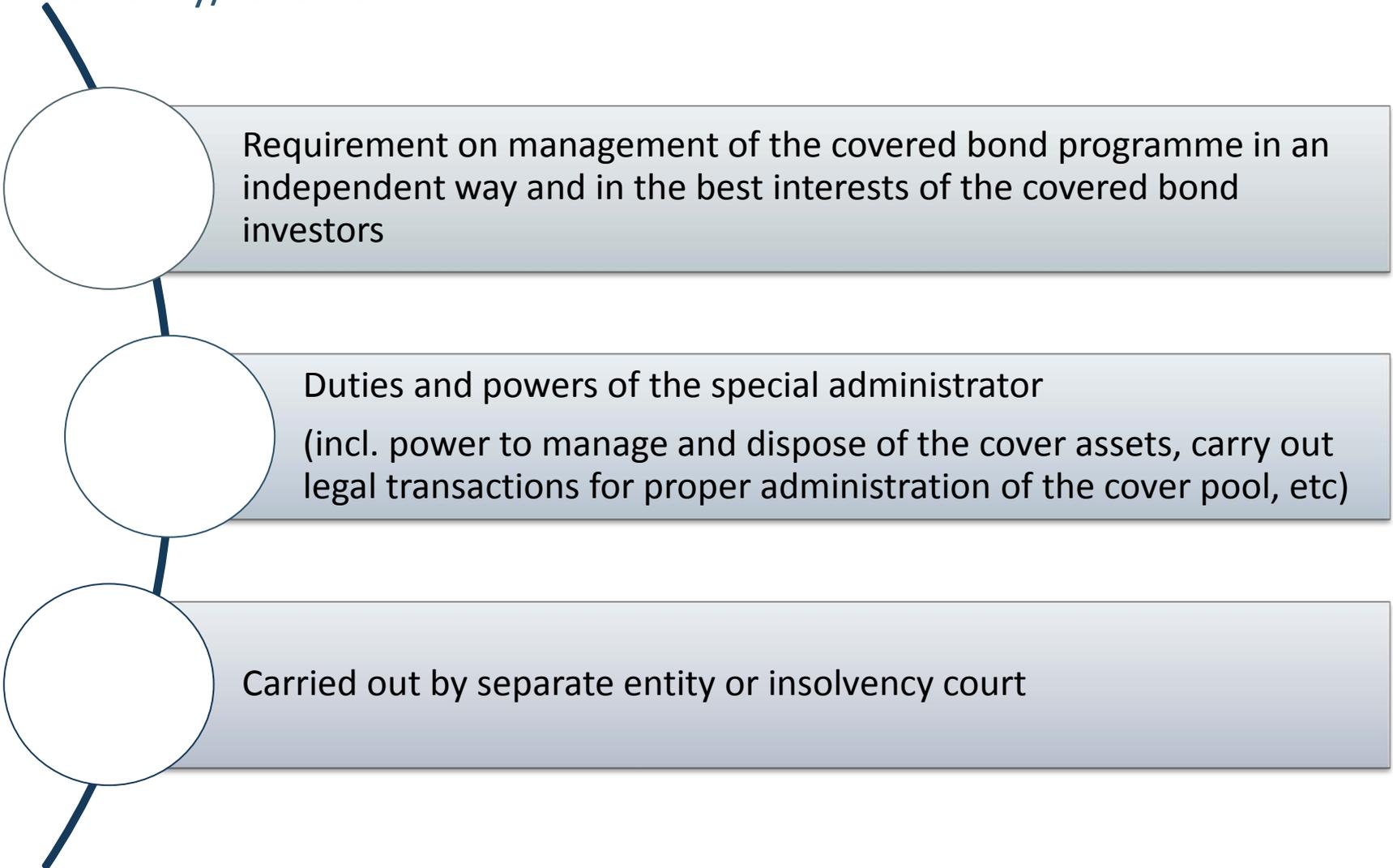
Duties and powers of the competent authority

(incl. decisive role in the appointment of the covered bond administrator, approval of the transfer of the cover assets to other covered bond issuers, etc)

Coordination and exchange of information between the competent authority, the special administrator and the resolution authority

Resolution authority to ex ante notify the competent authority and the special administrator of any decision impacting the covered bonds

Administration of the covered bond programme post issuer's insolvency/resolution

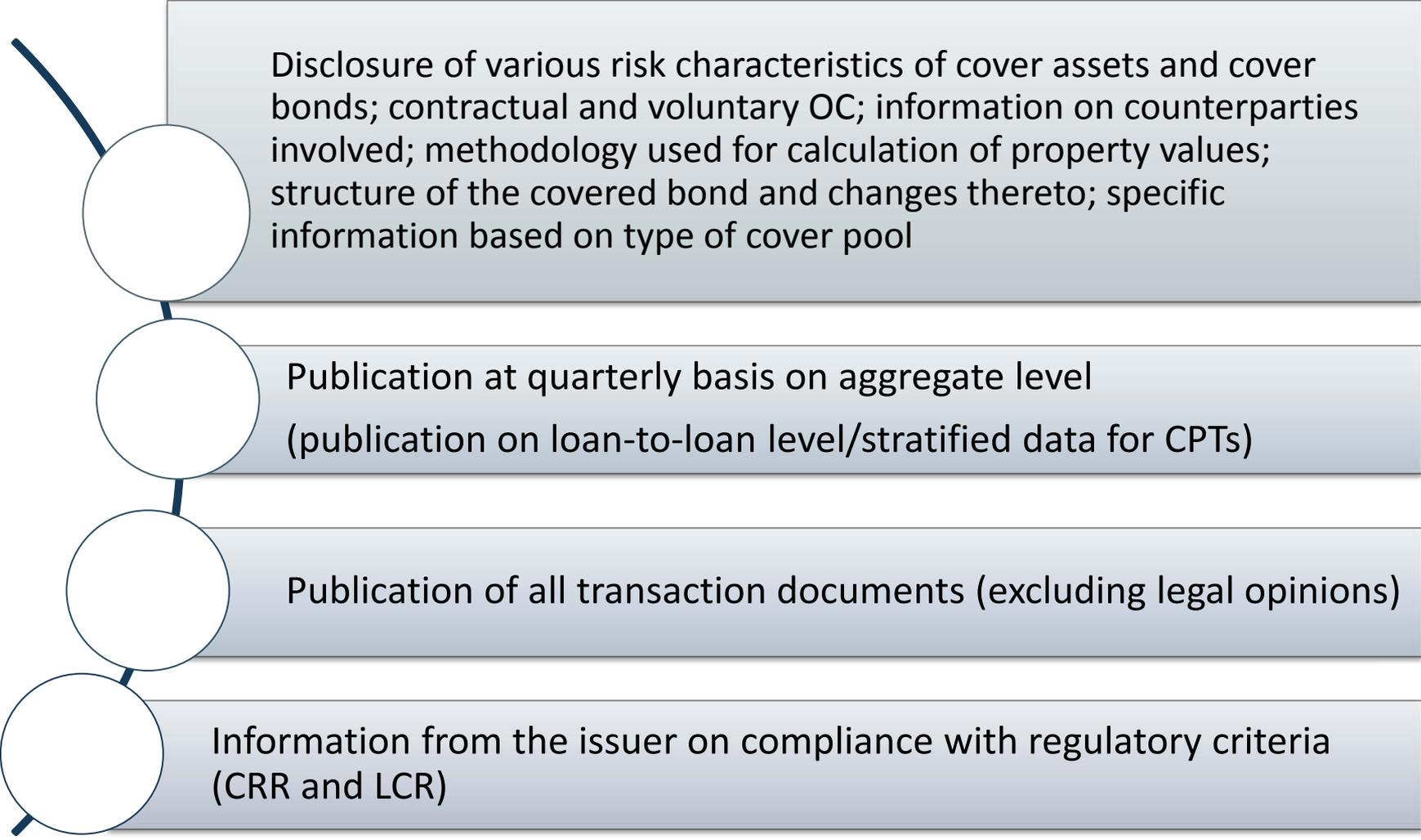


Requirement on management of the covered bond programme in an independent way and in the best interests of the covered bond investors

Duties and powers of the special administrator
(incl. power to manage and dispose of the cover assets, carry out legal transactions for proper administration of the cover pool, etc)

Carried out by separate entity or insolvency court

Transparency requirement for the issuer



Disclosure of various risk characteristics of cover assets and cover bonds; contractual and voluntary OC; information on counterparties involved; methodology used for calculation of property values; structure of the covered bond and changes thereto; specific information based on type of cover pool

Publication at quarterly basis on aggregate level
(publication on loan-to-loan level/stratified data for CPTs)

Publication of all transaction documents (excluding legal opinions)

Information from the issuer on compliance with regulatory criteria
(CRR and LCR)

Conditions for soft bullet/CPT covered bonds

Rationale

- Soft bullet and CPT allowed the access to step I and step II, i.e. be considered compatible with the covered bond definition and eligible for the regulatory and preferential risk weight treatment, subject to specific conditions

Conditions

- The change of the payment mode may not be effected by the issuer
- The change of the payment mode may only be effected:
 - At the discretion of the special administration
 - Upon the following two triggers (both triggers must occur): (i) the covered bond issuer has defaulted; and (ii) the covered bond reached its scheduled maturity date and failed to be repaid.
- Tools available to the special administration (e.g. the partial sale of the cover pool) would not be sufficient to redeem the relevant covered bond

STEP II:

AMENDMENTS TO CRR

Overview of areas covered

Areas covered in the step II: Amendments to CRR	Relation to the current regulatory treatment
<i>Conditions for preferential risk weight treatment</i>	
Requirements on the eligibility of cover assets	Extension/amendment of the existing rule
Requirements on the substitution assets	New rule
LTV limits	Extension/amendment of the existing rule
Minimum overcollateralisation	New rule

Eligibility of cover assets and substitution assets

Requirements on cover assets

Reiteration of the conclusions of the 2014 analysis

Eligible cover assets not to be widened

Loans to SMEs, to additional non-public sector debtors and infrastructure loans: not to be considered as eligible cover assets

Further impact analysis proposed on the eligibility of ship loans

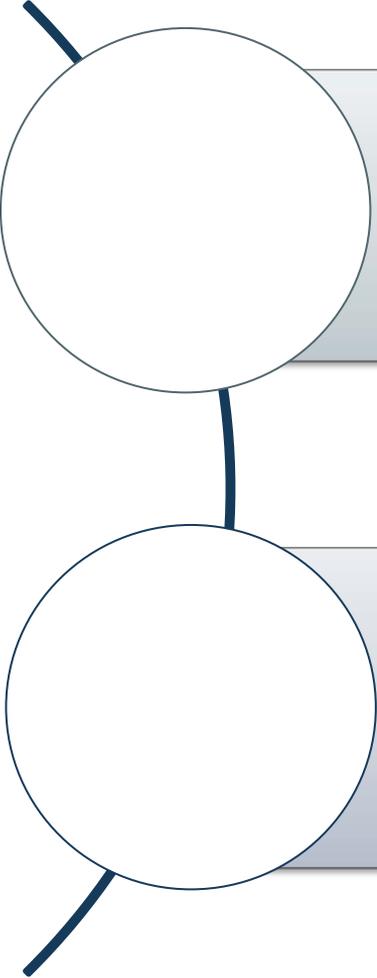
Requirements on substitution assets

Composition: all the cover assets as specified in the Art. 129(1)(a)(b) and (c) of the CRR to be eligible

Quantitative limits: Nominal value of the substitution assets max 15% of the nominal value of the outstanding covered bonds

Requirements to apply to the portion of the substitution assets necessary to comply with the minimum coverage requirement

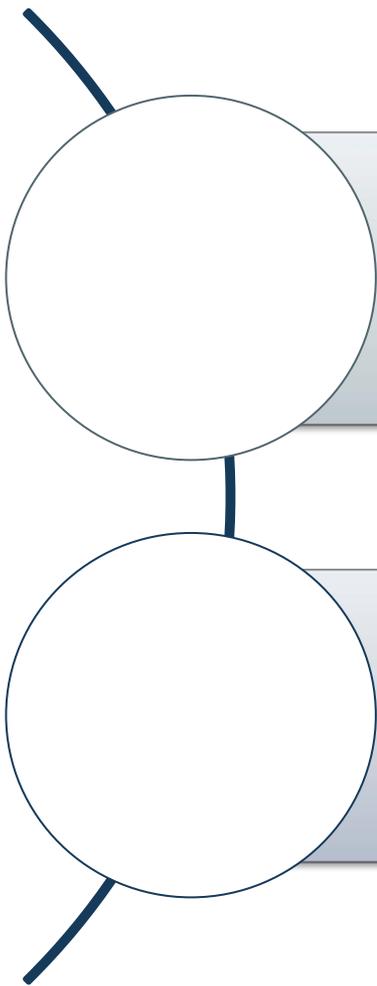
LTV limits for mortgage cover pools



Current LTV limits as set out in the CRR appropriate
(80 % for residential property, 60 % for commercial property)

Clarification in the CRR that the LTV limits are 'soft' LTV limits,
and applied on an ongoing basis
('hard' LTV limits only allowed at the inclusion of the loan in
the cover pool and not throughout the life of the programme)

Minimum overcollateralisation



Minimum effective overcollateralisation of 5%
(recommendation on the amount to be carefully calibrated based on impact assessment)

Uniform level of OC, no differentiation for
different asset classes

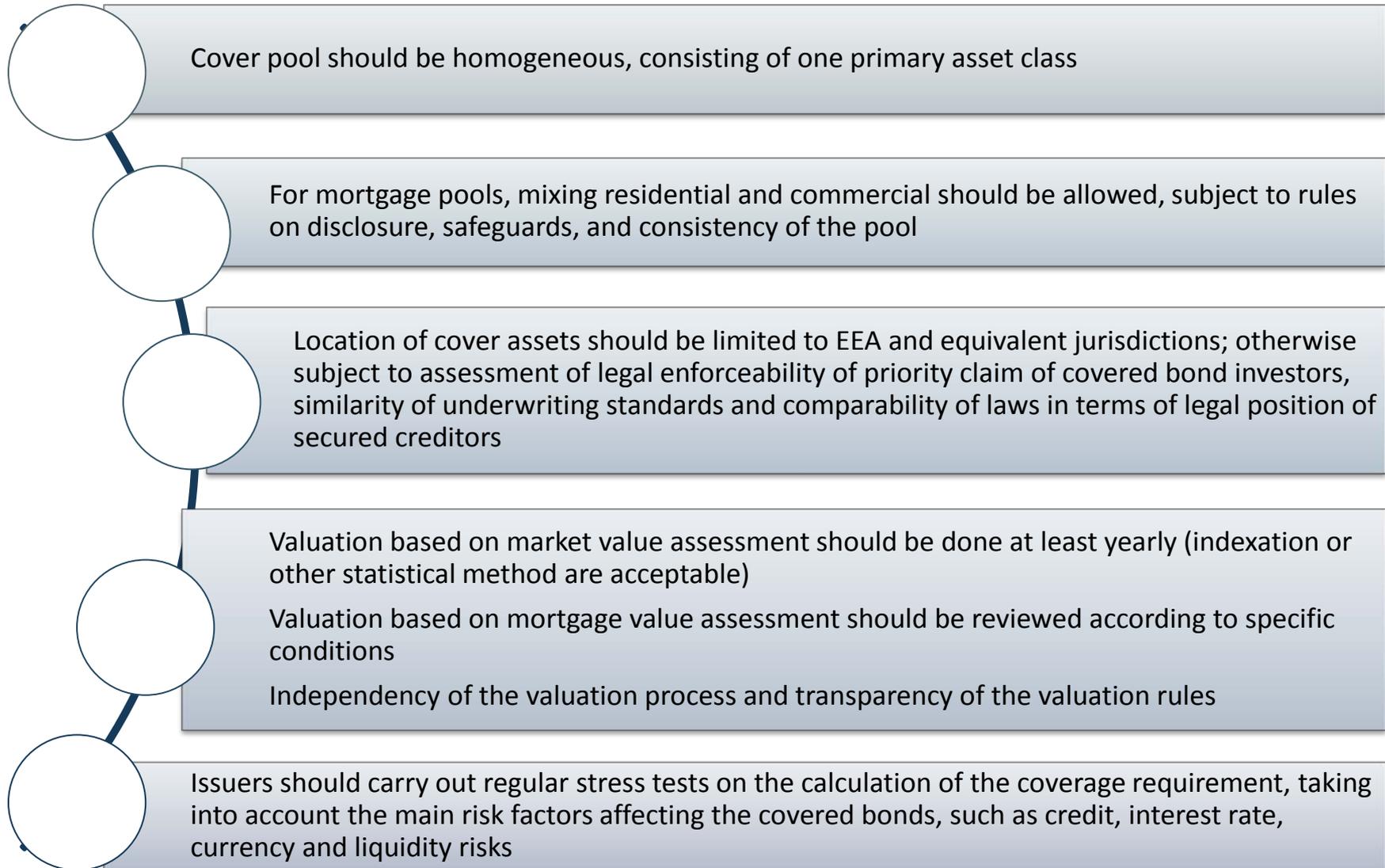
STEP III:

VOLUNTARY CONVERGENCE

Overview of areas covered

Areas covered in the step III: Voluntary convergence at national level	Relation to the current regulatory treatment
Composition of the cover pools	New rule
Cover pool with underlying assets located in jurisdictions outside the EEA	New rule
LTV measurement and frequency of re-valuation	Extension/amendment of the existing rule
Stress testing by the covered bond issuer	New rule

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