ECBC RESPONSE TO THE EUROPEAN COMMISSION'S CONSULTATION DOCUMENT ON COVERED BONDS IN THE EUROPEAN UNION

Brussels, 5th of January 2016

General Comments

The European Covered Bond Council (ECBC)[1] 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 established by the European Mortgage Federation (EMF) to promote the interests of covered bond market participants at international level. As of January 2016, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of the EUR 2.5 trillion outstanding covered bonds.

The ECBC welcomes the European Commission's proposal for further convergence in European covered bond markets and thanks the Commission for the invitation to submit comments on the Consultation Document on Covered Bonds, which, in our view, constitutes one of the most important legislative consultations on covered bonds in decades. To ensure a comprehensive, wide ranging and detailed response to the Consultation Document, the ECBC has collected feedback from more than 750 national covered bond experts.

As an initial comment, the ECBC welcomes the European Commission's cautious approach towards harmonising covered bond frameworks in the European Union (EU). The subjects addressed in the Consultation Document are of crucial importance to the very different legislative frameworks that exist in Europe, which are a consequence of historical national differences in terms of mortgage markets, housing policies, consumer behaviour, insolvency law, credit and valuation regulation etc. Consequently, the ECBC believes that the concept of full EU covered bond harmonisation is a utopia.

However, the ECBC does see room for improvement and further convergence in specific areas in order to safeguard the recognised quality of EU covered bonds, which justifies their preferential regulatory treatment. Further convergence in covered bond frameworks would also enhance transparency, support the rationale of preferential risk weighting and make it easier for investors to take more informed investment decisions.

In the view of the ECBC, a balance must be struck between maintaining national covered bond legislative frameworks and establishing a common European framework, by means of (i) a recommendation to encourage Member States to increase convergence and (ii) a high quality principle-based directive ensuring harmonisation of certain minimum standards.

A combination of a recommendation and a principle-based directive will ensure that national markets continue to function whilst safeguarding the prominent role of covered bonds as a crisis management tool able to promote: (i) investors' confidence; (ii) financial stability; and (iii) long-term financing. In addition, this will maintain competition amongst Member States' covered bond markets, thereby ensuring that EU covered bond markets remain attractive to investors, whose investment decisions are currently mainly driven by risk appetite and search for yield.

[1]The European Mortgage Federation-European Covered Bond Council (EMF-ECBC) is registered in the European Institutions' Transparency Register under ID Number 24967486965-09.

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Country-Specific Issues

The ECBC agrees that certain country-specific issues must be taken into account by the European Commission when evaluating the responses to the Consultation Document. Given the structural differences that exist between national covered bond market structures (see section on “General Comments” above), the many subjects addressed in the Consultation Document are of vital importance to the very different covered bond legislative frameworks within the EU and, consequently, Member States will react individually and according to their national interest.

The ECBC encourages the European Commission to review these national country-specific issues in order to ensure that currently well-functioning national covered bond markets continue to do so in the coming years, and, thereby, avoid disrupting EU covered bond markets more than the Commission deems absolutely necessary.

Finally, the ECBC would like to emphasise the importance of drafting a legislative proposal which incorporates these country-specific points and is sufficiently principles-based so as to provide flexibility for the different national covered bond structures across the EU.

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PART I: COVERED BOND MARKETS: ECONOMIC ANALYSIS

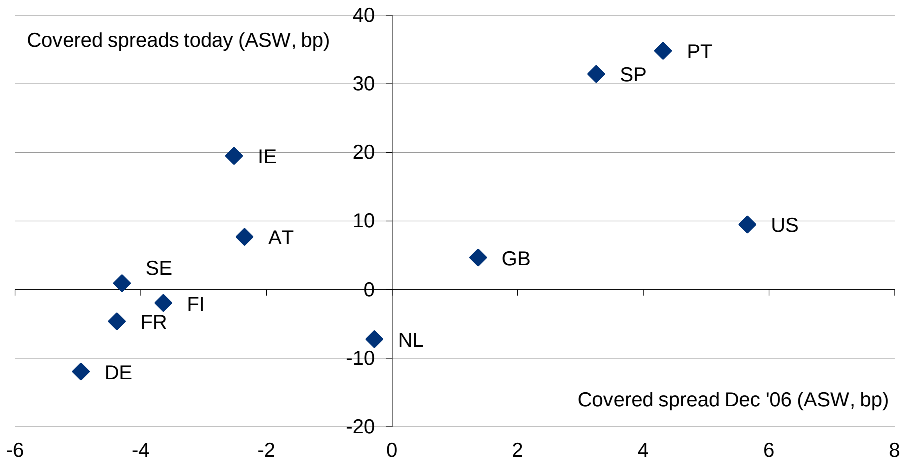
QUESTIONS - COVERED BOND MARKETS: ECONOMIC ANALYSIS[2]

1. In your opinion, did pricing conditions in European covered bond markets converge and diverge before and after 2007, respectively? If so, what where the key drivers of this convergence/divergence? Please, provide evidence to support your view.

Yes, as clearly evidenced by secondary market spreads for peripheral bonds before and after the crisis.

Pricing conditions converged before 2007 as covered bonds were seen as "rates products" and investors did not differentiate between different products within this category. As the Commission correctly points out, this was assisted by the strength of European sovereigns, most of which were very highly rated at this time. However, even before the credit crisis, average covered bond spreads differed, ranging from -5bp through swaps for German Pfandbriefe to almost 6bp over swaps for structured US covered bonds (Figure 1). Spread dissimilarities reflected differences in the perceived protection offered by the different regulatory regimes.

Figure 1: Covered bond spreads differ - ahead of the crisis and today



Source: ING

With the start of the subprime crisis and, later, with the financial crisis, investors became more risk-sensitive leading to price divergence between covered bonds and other asset classes, as well as among covered bond sectors and within sectors by issuers, with those impacted more by the crisis widening more than those less impacted. The first European Central Bank (ECB) covered bond purchase programme led to price convergence again before the sovereign crisis brought about doubts on the financial strength of some European countries, resulting yet again in a widening of spreads and the differentiation of covered bonds across countries and issuers.

Drivers have not changed pre- and post-crisis, but their weighting has. Pre-crisis, the emphasis was on: (1) legal frameworks, which emerged mainly between the end-1990s and mid-2000s; and (2) market technical factors, including the size of the issues given the market-making agreement for Jumbos (i.e., Covered Bonds (CB) ≥ €1bn). The preferential regulatory treatment was also favourable

[2] Please note that the figures included in the responses within Part I provide data on selected jurisdictions.

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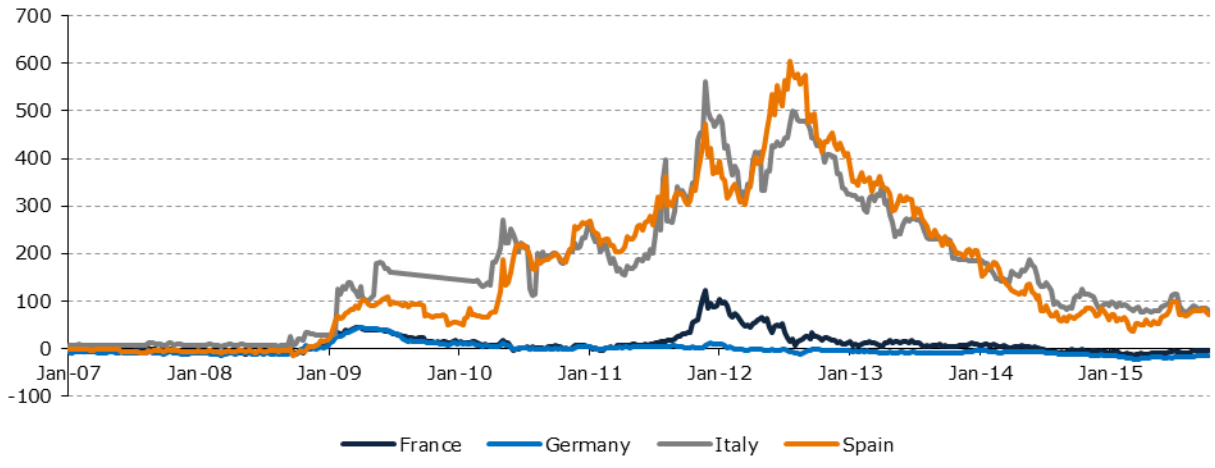
to the asset class, although it was not as extensive and critical as it is today. All new legislation more or less replicated what already existed, leading to limited pricing differentiation in an AAA-rated world, when the creditworthiness of sovereigns and issuers was not a market concern.

During and after the crisis, the drivers were the same but their weight shifted entirely. In a world gripped by fears over banks' creditworthiness and eventually sovereign risks, rating downgrades, market, liquidity and systemic support became the most relevant factors. Systemic support risk was considered mainly at the issuer level as banks were "too big" or "too important" to fail (on a standalone basis or as a group). Indirectly this benefited covered bonds.

If anything, covered bond legislation has improved since 2007, reflecting market developments and/or the recent European Banking Authority (EBA) recommendations, and so has transparency (e.g. via the Covered Bond Label). However, neither factor has regained its pre-crisis prominence, and both remain subdued for pricing. Instead, current covered bond price key drivers are:

- **Country and issuer risks**: Despite the ECB Covered Bond Purchase Programme 3 (CBPP3), we still see spread differentiation between core and peripheral markets, reflecting higher risk appetite, lower ratings, weaker regulatory treatment, lower liquidity, etc. (see Figure 2). The creditworthiness of the underlying issuer is another critical driver, although it needs to be significantly weaker today to result in wider ASW spreads, as illustrated in Figure 3 and Figure 4.

Figure 2: EUR ASW spreads show no pricing differentiation until the banking & sovereign crisis



Source: BofA Merrill Lynch Global Research; 3-5yr EUR ASW (bp)

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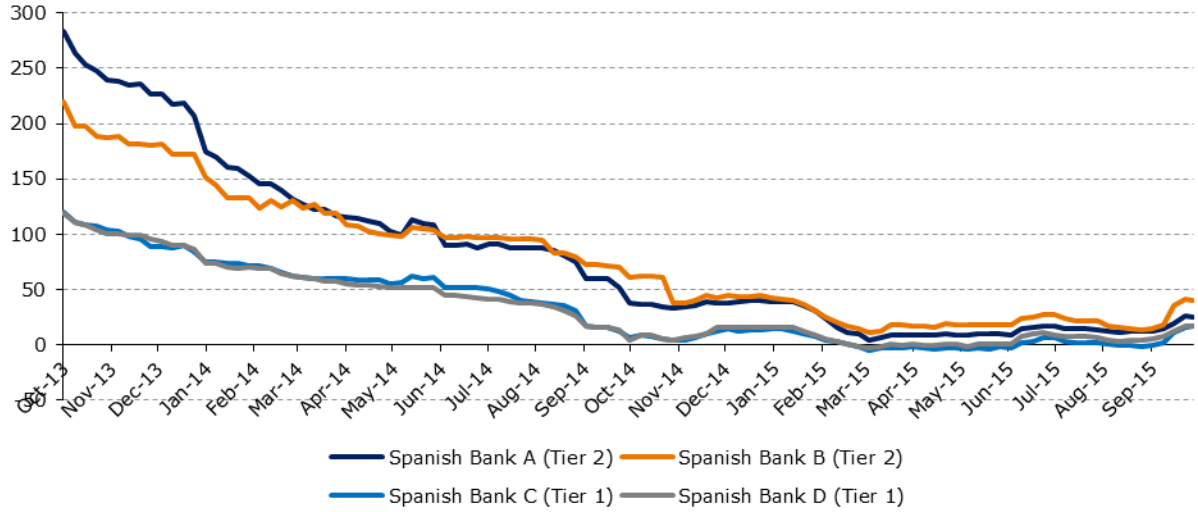
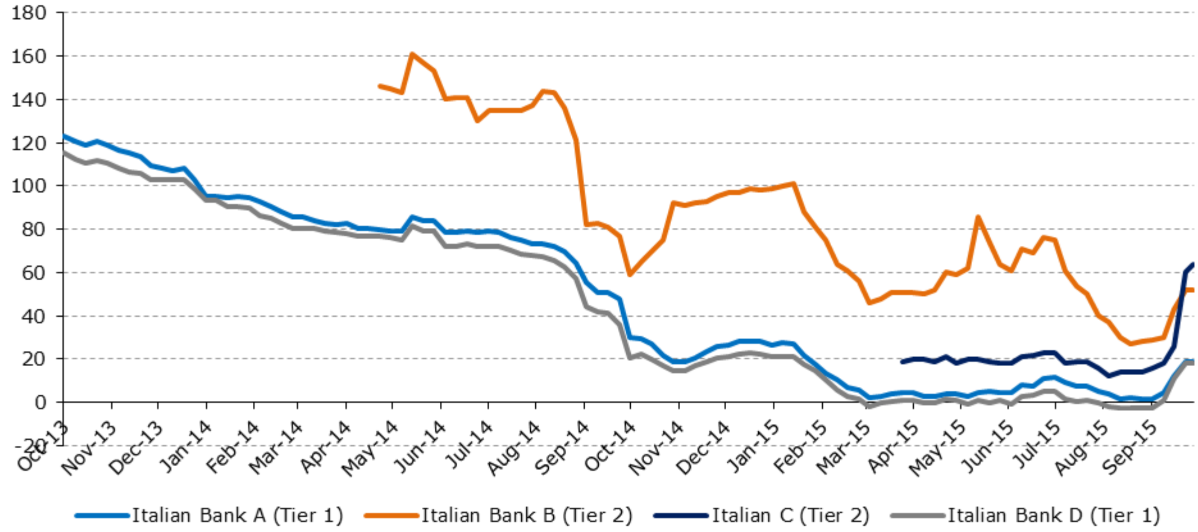
Figure 3: CBPP3 has compressed EUR ASW spreads to similar levels



Source: BofA Merrill Lynch Global Research; 3-5yr EUR ASW (bp)

Figure 4: Except for weaker CB issuers



Source: BofA Merrill Lynch Global Research; 3-5yr EUR ASW (bp)

- **Regulatory treatment:** Regulation is another major driver of CB demand. Pre-crisis, the product benefited from preferential repo haircuts and risk-weighting. Post-crisis, this is still the case, while CBs have become an important asset class for the EU Liquidity Coverage Ratio (LCR) and ECB Quantitative Easing. Solvency II is also favourable to the product, even though CB yields have been less attractive to insurers after CBPP3. As shown in Figure 5, ASW spreads for EZ EUR-denominated CBs are trading tight on a relative basis, supported by EU regulation (CRR/CRD IV, LCR, Solvency 2, ECB repo, CBPP3). In contrast, Swiss CBs have been among the widest, being only ECB repo eligible if EUR-denominated. UK CBs are in-between, being CRR and LCR compliant, but not CBPP3 eligible as a non EZ.

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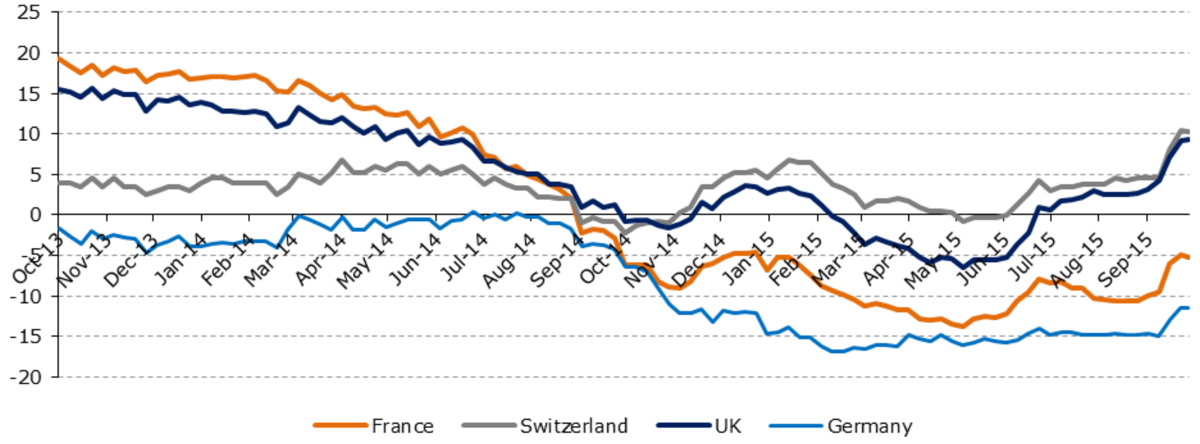
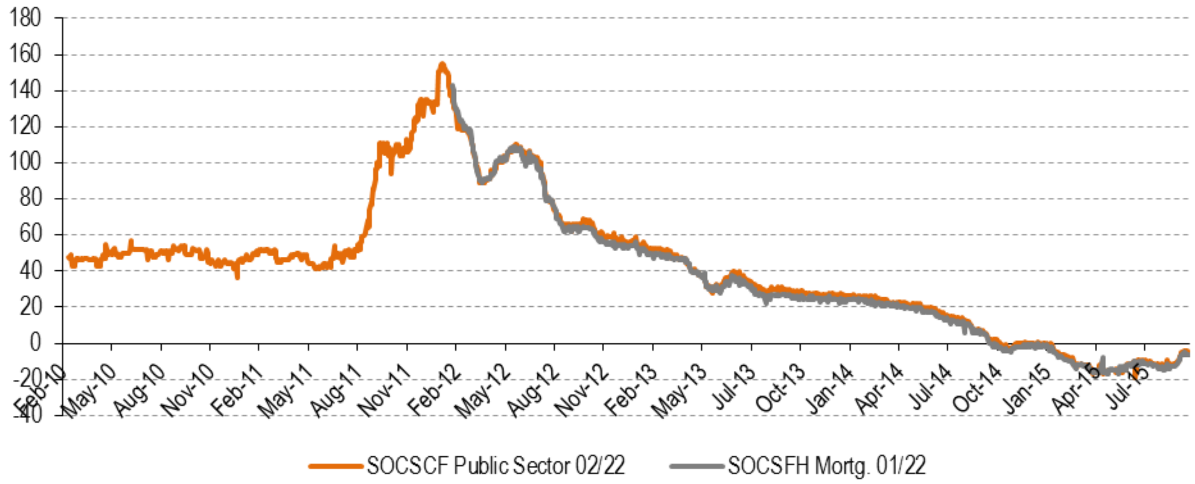
Figure 5: Swiss CBs EUR ASW spreads trade wider as they do not comply with the LCR and CBPP3



Source: BofA Merrill Lynch Global Research; 3-5yr EUR ASW (bp)

- **Collateral type:** Traditional CBs backed by mortgages and the public sector have been trading similarly, including during the crisis for peripheral CBs (see Figure 6). Only when the issuer was considered to be a concern would the collateral type impact pricing. This is unlike non-traditional asset types such as aircraft or SME loans, which have traditionally priced wider given their higher risk profile and less favourable regulatory treatment (see Figure 7 and Figure 8).

Figure 6: Mortgage and public sector CBs price similarly



Source: BofA Merrill Lynch Global Research; ASW spreads (bp)

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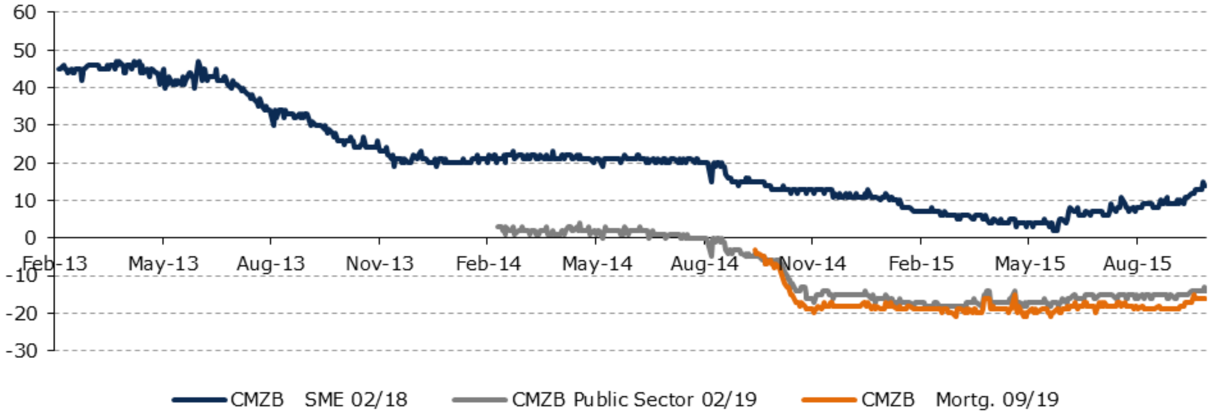
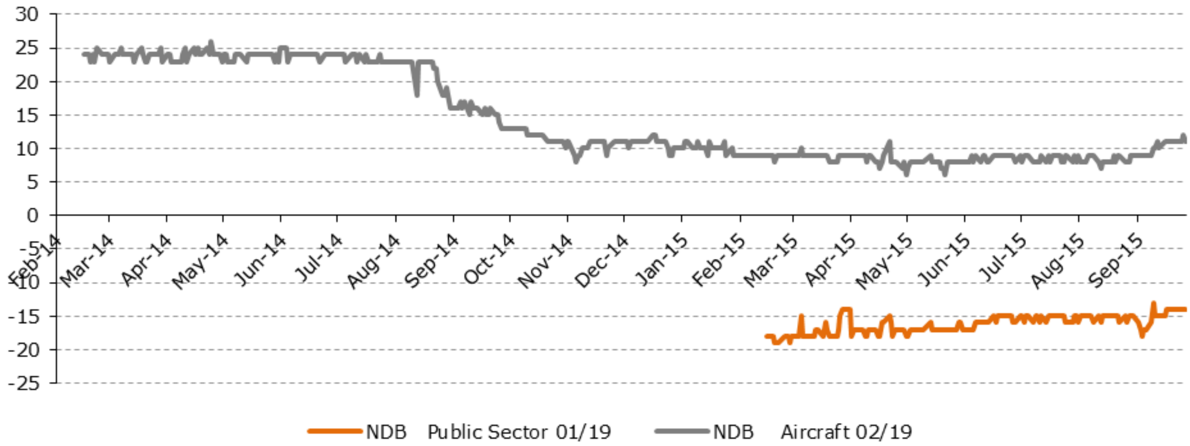
Figure 7: Unlike SME CBs



Source: *BofA Merrill Lynch Global Research; ASW spreads (bp)*

Figure 8:... and unlike aircraft CBs



Source: BofA Merrill Lynch Global Research; ASW spreads (bp)

2. Was pricing divergence an evidence of fragmentation between covered bonds from different Member States? Do you agree with the reasons for market fragmentation described in section 2.1 of Part I? Were there any other reasons?

Was pricing divergence an evidence of fragmentation between covered bonds from different Member States?

No, it was not. Spread widening across covered bond sectors did happen during the sovereign crisis. However, this was more a sign of covered bonds not being able to fully de-link from their underlying sovereign and fragmentation in sovereign markets, rather than fragmentation that would have come from within the covered bond market.

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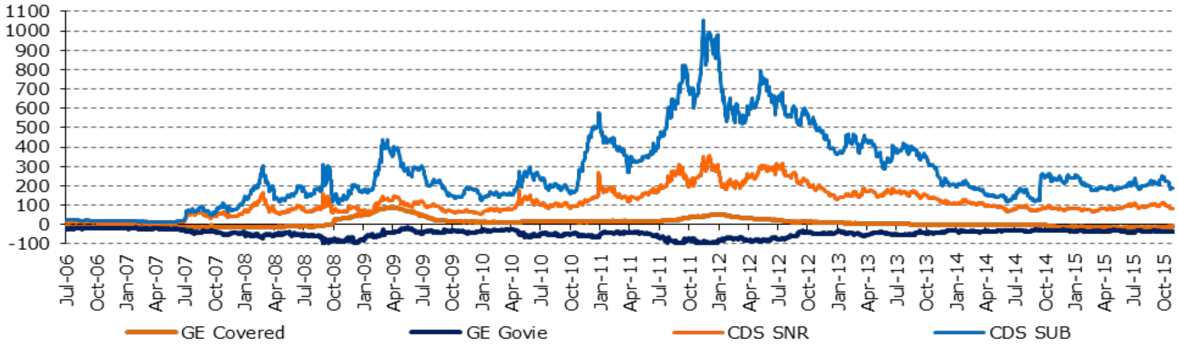
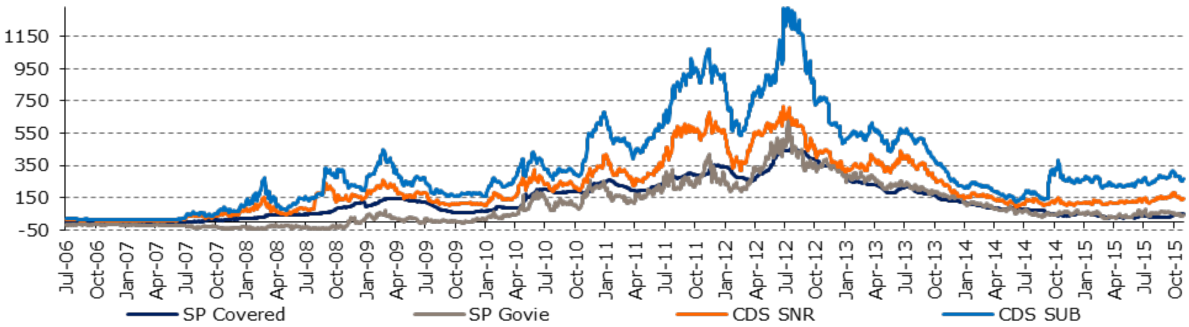
In order to substantiate this claim and show that fragmentation was imported into covered bond markets from the sovereign space, rather than resulting from factors from within the covered bond market, we have put together long time series of covered spreads from countries vs. sovereign, senior and sub-bank paper.

When looking at these time series it becomes clear that covered bonds come out as the least volatile asset class by far (see figures below). 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. Despite the differences in the legal frameworks, fragmentation appeared lower in covered bonds than in government bonds. As such, 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.

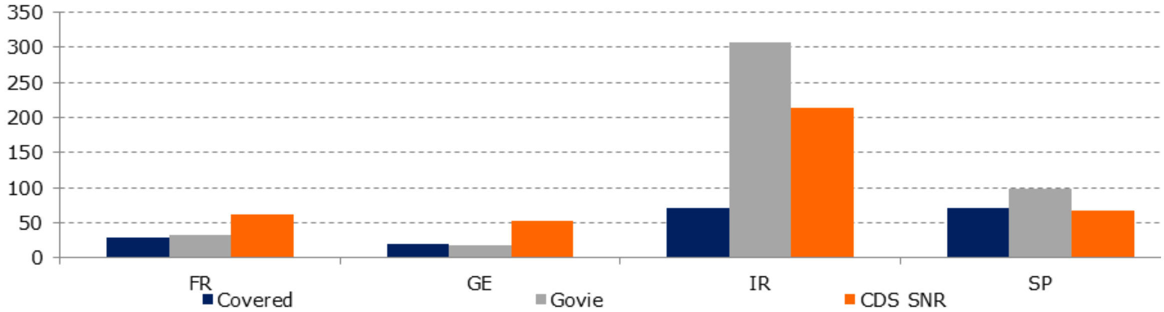
Figures 1 and 2: Spread histories by country (Germany, Spain)





Source: Crédit Agricole CIB

Figure 3: Max of rolling standard deviation (90d) by asset class (5Y) since 2006



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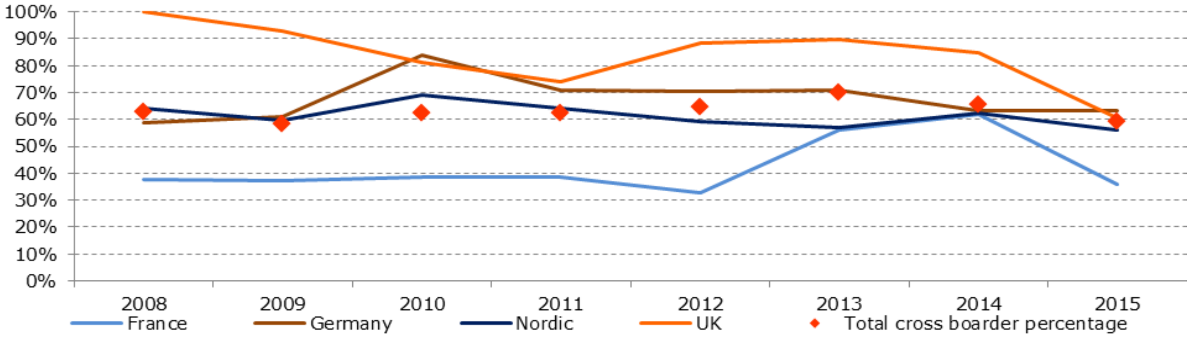
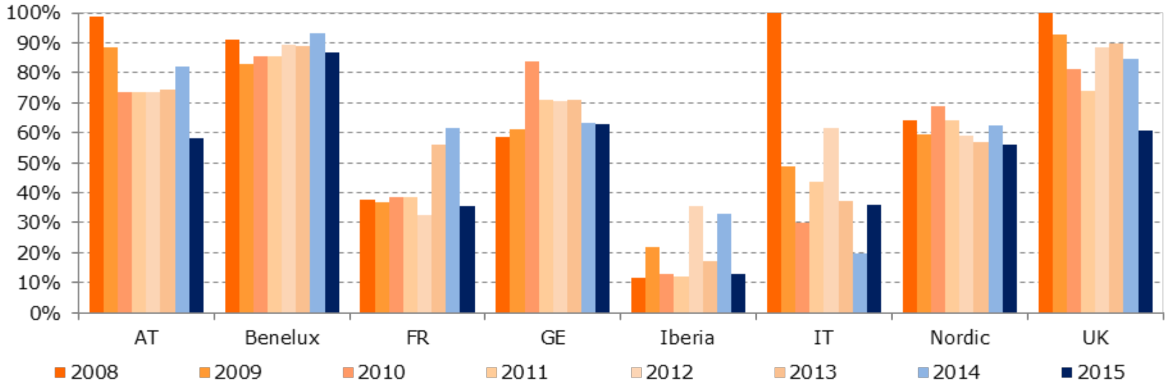
Source: Crédit Agricole CIB

In addition to spread data, we have also looked at investor distribution statistics of EUR benchmark covered bond new issues over time. As can be seen from the figures below, we have 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.

In our view, this underlines the statement made above about the sources of fragmentation and investors' concerns about them. 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.

Figures 4 and 5: Share of cross border investments of total covered bond primary benchmar investments





Source: Crédit Agricole CIB

In a nutshell, fragmentation came from sovereign debt markets. Covered bonds could withstand the sovereign pressure despite the different legal frameworks but not fully de-couple from it. Throughout this time, there has been a high level of cross-border investments, thus investors clearly have not been affected by multiple laws even during times of crisis.

Do you agree with the reasons for market fragmentation described in section 2.1 of Part I? Were there any other reasons?

The primary reasons for the divergence relates to the first two points in section 2.1, Part I - i.e. the risk assessment of the cover pool/credit rating of the issuer and the sovereign.

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In our opinion, the potential fragmentation of covered bond markets in the EU observed during this period does not reflect a loss of confidence by investors in covered bond products or the absence of a common European regulatory framework. Rather, it only reflects the minimum pricing requested by investors to cover the intrinsic country-related risks in covered bond products, as well as the impact the sovereign has on the quality of the different underlying cover assets. Together with the link to government bonds, national supervisory architecture and a lack of common vision has also played a role.

Generally, investors use a top-down approach, meaning they do not invest in any asset if they are sceptical about the asset's country as a whole. Their investment processes starts with credit lines for a given country and if those lines are cut, the second level analysis into different products doesn't even start.

Even the existence of a single European covered bond framework or the setting of minimum standards for covered bond laws would not have eliminated the pricing divergence and fragmentation.

After all, covered bonds will always be linked to macroeconomic fundamentals. This is especially true for covered bonds backed by public sector assets. However, mortgage cover assets can also be impacted by an economic slowdown in a specific country as higher unemployment rates put pressure on default rates and falling house prices put pressure on recoveries for residential mortgages. Levels of economic activity are also relevant in the case of commercial cover assets from different countries, including (extra-EU countries) as the cycles of different national mortgage markets are hardly correlated. This is a further reason not to add limits to country or product diversification in cover pools and prevent issuers from setting up multi-jurisdictional cover pools, provided that a fair level of transparency is maintained.

In this context, markets have compensated for this fragmentation and added transparency through market-based initiatives, such as the Covered Bond Label. With such instruments, the market has managed to curb fragmentation and, in a process of regulatory osmosis, it has shared best practices across Europe and beyond.

3. In your view, is there any evidence of pricing differentiation/fragmentation between covered bond issuers on the basis of size and systemic importance, as well as their geographical location?

Issuer Size

The issuer size may have a minor impact on covered bond pricing. Rather than size, it is the credit quality of an issuer that is mainly relevant. ECBC members have experience of issuers from various countries that were small but of high quality that managed to price covered bonds inside bigger but weaker entities. The weakness of the bank may magnify the "size effect" of course, but short of any major creditworthiness concerns, size does not really matter. The exclusion of covered bonds from bail-in in the BRRD naturally disconnects bank size and covered bond price even more.

Moreover, according to the ECBC's data, between 20% and 34% of the yearly issuance volume in the last three years was made through private placements, which tend to best suit the issuing need of smaller lenders. In Germany, private placements represent more than 50% of the outstanding Pfandbriefe. Given the small issuance sizes and the high flexibility, all the way to tailor-made covered bonds for specific investors, smaller issuers have good access to the market.

Recently, we have seen that new regulations could have different effects depending on the size of the issuer. The issue size requirement of level 1 covered bonds in the LCR (>500 million euro) creates a pricing difference related specifically to issue size, which is a consequence of issuer size. That is,

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regulation (LCR) in itself creates size related price differences. In Denmark the spread between level 1B covered bonds and "non-level" covered bonds (<250 million euro) is 10-15 bps. Such regulatory consequences must be in avoided.

Geographical Location

The situation is clearly different with regard to the geographical location of the issuer. Indeed, there were times when issuers from some countries were not able to access the covered bond market. However, as we have stressed above, the main reason was investor scepticism about these countries in general. As the Commission correctly pointed out and as detailed in our response to Question 2, European covered bonds became a proxy for sovereign risk, and even today sovereign spreads and underlying bank credit risks explain the persistently wider trading levels of covered bonds from peripheral Eurozone jurisdictions.

However, even after spreads have come in a long way from the highest levels observed during the crisis and investor concerns about certain countries have receded, the geographic location of an issuer is still a relevant factor. However, again this is a type of fragmentation that does not come from within the covered bond market but from the outside. While it was sovereign spread volatility during the crisis, today we can observe fragmentation brought into the market by the Eurosystem's actions. The fact that the CBPP3 itself uses a certain geographic scope to determine the CBPP3 eligible universe is the main reason why some Member States' covered bonds trade wider than others. CBPP3 eligibility explains why German, Dutch, French, Belgian and Finnish covered bonds trade at much tighter levels compared to Swedish, Norwegian or Danish EUR covered bonds for example. Neither different legal frameworks, nor different underlying sovereign risk is the main driver here.

4. Is there an appropriate alignment in the regulatory treatment between covered bonds and other collateralised instruments? If there is a misalignment, could you illustrate what differences in regulatory treatment you deem as inappropriate and why?

Yes, there is an appropriate alignment. Covered bonds enjoy preferential treatment because of a number of characteristics that are unique to this asset class. They are a very efficient instrument for both issuers and investors, offering the former cheap funding and the ability to guarantee long-term loans at favourable conditions. Based on strong legal frameworks, which cover all important features from an investor and regulatory perspective, covered bonds can be issued in different sizes and currencies very quickly and even when times become challenging. The EBA has acknowledged this and in it has reiterated the appropriateness of the preferential risk weight treatment of covered bonds based on historical performance and the structure of the product.

Nevertheless, the high flexibility and low funding spreads are not free of charge. Strong legal quality requirements produce enormous ongoing costs. Only high quality assets (i.e. real estate mortgages, public sector loans, ship as well as aircraft loans) fulfilling strict requirements qualify as eligible assets. Already, this limits the use of covered bonds and, thereby, also limits the potential asset encumbrance. Furthermore, special valuation requirements are costly and time-consuming, a cover pool monitor has to be paid, specific risk management systems for the covered bond business have to be put in place and transparency reports have to be provided. All these specific requirements have to be fulfilled on top of the general regulatory banking requirements as assets and liabilities remain on the balance sheet of the bank. Thus, the ongoing costs for fulfilling the necessary quality requirements are significant.

The ranking of preferential regulatory treatment between covered bonds and other collateralised products should also not be changed. We do believe that the current regulatory treatment of ABS needs to be improved. After all, the risk transfer through securitisations allows banks to free capital and grant new loans, which is in line with the spirit of the Capital Markets Union (CMU). With this different purpose securitisations are an important instrument among the funding tools of a bank.

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However, the preferential regulatory treatment of covered bonds in comparison to ABS is justified, given the aforementioned strict legal provisions and the special public supervision on covered bonds.

In conclusion, and also taking into account the special public supervision aspect, the current preferential regulatory treatment of covered bonds is justified and it should be maintained and not be reduced in future regulation, such as the NSFR.

5. Are operational costs for covered bond issuance lower than for other collateralised instruments? Can you quantify the respective costs, even if only approximately?

As indicated in the previous answer, there are significant upfront and ongoing costs to the establishment and running of a covered bond programme. Whether the issuance of a covered bond is more efficient than other collateralised instruments will depend on (i) the structure of the covered bond issuer and (ii) the volume of issuance. While for covered bonds the ongoing costs for fulfilling the necessary quality requirements are significant (see the response to Question 4), securitisations tend to have high "per transaction" operating costs.

However, the advantage of a covered bond programme, once established and registered, is that multiple transactions can be issued under the programme. Moreover, on an ongoing basis, the annual running costs of the programme are much lower compared to RMBS issuance as for each new RMBS issue set-up costs have to be incurred. Therefore, the costs per covered bond transaction are substantially lower than for RMBS issuance. The difference is even broader for issuers that use a master trust structure for their RMBS issuance. Both establishment and maintenance costs are higher than that of stand-alone RMBS programmes.

Furthermore, a single swap covering a covered bond programme is naturally less costly than multiple swaps for heterogeneous securitisation transactions.

6. Are there significant legal or practical obstacles to:

a) Cross-border investment in covered bond markets within the Union and in third countries?; and

b) Issuance of covered bonds on the back of multi-jurisdictional cover pools?

Please provide evidence to support your views.

a) Cross-border investment in covered bond markets within the Union and in third countries?

There are no legal obstacles that impair or limit the possibility for cross-border investments or issuance of covered bonds on the back of multi-jurisdictional cover pools.

As we have shown above, cross-border investment in covered bond markets did take place throughout the crisis. There were investors that did not have country credit lines for some countries and were thus prevented from buying covered bonds from these countries even if they felt comfortable with the risk they would be taking. But many others did invest.

Other investment restrictions involve minimum covered bond or issuer rating requirements, which prevented some investors from buying certain peripheral euro area covered bonds as they were subject to sovereign ceilings by rating agencies. Also, some withholding tax problems in a few Member States have been reported.

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If there are bigger legal obstacles to cross-border investments in covered bond markets, they mostly relate to bonds issued from non-EEA jurisdictions. These covered bonds are subject to different regulatory rules, e.g. LCR, ECB repo eligibility, which investors will take into account when considering investment opportunities. In fact, some investors are only allowed to invest in LCR eligible paper, while for others the repo eligibility of the covered bonds is key instead. Hence, cross-border investments in third country covered bond markets are not always straightforward.

Overall, as the Commission correctly points out, the investor base is well diversified with sizable cross-border flows.

b) Issuance of covered bonds on the back of multi-jurisdictional cover pools?

There are numerous examples of the issuance of covered bonds versus pools of assets in multiple jurisdictions. Covered bond issuers from a number of Member States are able to place covered bonds backed by multi-jurisdictional cover pools and it is up to the national covered bond legislation to allow for multi-jurisdictional cover pools.

At the same time, there are a number of difficulties when issuing multi-jurisdictional covered bonds: legal peculiarities in each jurisdiction – e.g. in terms of asset segregation, constitution of guarantees or potential problems related to fiscal or operational issues for assets, such as different IT systems.

In addition, the transfer of the cover assets to the cover pool must be legally sound. In cases of multi-jurisdictional assets the legal soundness needs to be assessed for all jurisdictions. This legal soundness amounts to transferability of the loans, perfection of the transfer, recognition of an effective transfer, perfection of any security, recognition of effective security, availability of all security rights on the mortgaged/secured assets for the pool as transferee etc. The complexity involved might prevent issuers from including multi-jurisdictional assets and investors from investing in such covered bonds.

The market-led Covered Bond Label Initiative enhanced significantly the level of transparency by implementing the Harmonised Transparency Template. The latter provides detailed information, amongst other, on geographical exposure of the cover pool facilitating the investor's due diligence when it comes to multi-jurisdictional cover pools.

PART II: EXPLORING THE CASE FOR A MORE INTEGRATED FRAMEWORK

QUESTIONS – LEGAL FRAMEWORK AND INTEGRATION

1. Would a more integrated "EU covered bond framework" based on sound principles and best market practices be able to deliver the benefits suggested in section 2 of Part II? Are there any advantages or disadvantages to this initiative other than those described in section 2 of Part II?

The ECBC is supportive of the European Commission's initiative for further convergence as it provides a unique opportunity to make the covered bond market more comprehensive for investors and, consequently, more efficient while serving the real economy and financing in Europe.

In our view, a more integrated EU covered bond framework based on sound principles and best market practices may be able to deliver some of the benefits suggested in section 2 of Part II of the Consultation Document. However, the level of achievement depends to large extent on the choice of approach towards the establishment of such an EU framework.

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The ECBC considers it essential that any adopted framework maintains appropriate flexibility to avoid disrupting or jeopardising existing covered bond structures and markets, which have already proven their viability and well-functioning. Moreover, any principle on which harmonisation targets are set should be adjustable and sufficiently flexible in order to ensure that there is no emphasis on one covered bond model over the others, as one model which operates well in one country will not necessarily perform that well if applied to another country. In this context it is important to keep in mind that these differences in applied models arise in particular from dissimilar legislations (especially insolvency laws), various markets (different levels of significance of buy-to-let sector, state subsidies on loans for low income families etc.) and diverse banking sectors (centralised banking groups, cooperative groups with regional banks). For example, the model "assets on the balance-sheet" is acceptable for centralised banks, but not for cooperative groups with regional independent banks. Thus, to favour one model over another would undermine the global efficiency of this refinancing instrument and imply extra costs that would jeopardise the financing of real-estate and public sector in general.

The ECBC agrees that a common EU framework should further converge via a high quality principle-based approach taking into account national specificities. ECBC members are not in favour of any formal CB regulation and would caution the EU authorities against pursuing such a mandatory harmonisation approach given the corresponding costs and market disruption (including to existing covered bond investors and programmes) such an approach would entail. As a general comment, a high-scale harmonisation could damage well-functioning CB instruments, and hence neutralise any potential benefits of the initiative as a whole.

To improve and facilitate further convergence, ECBC members have emphasised that voluntary market-led initiatives - such as the Covered Bond Label (CBL) and the Harmonised Transparency Template (HTT), which brings together market participants - are an effective and collaborative mechanism through which greater harmonisation and its expected benefits can be achieved. In relation to this, in terms of policy options, the first proposal of the European Commission with *subsidiarity and indirect harmonisation* englobing the guidelines that ought to be adopted by different countries is widely supported by ECBC members as a solution aiming at ensuring market efficiency while taking into account national legislative specificities on key issues. However, the ECBC and its members are also supportive of combining option I with option II *EU protect regulation – elements and shape of an integrated framework* in order to ensure the protection of the covered bond and also as a means to create further convergence in the covered bond space via a principle-based approach.

2. In your view, are market-led initiatives such as the "Covered Bond Label" sufficient to better integrate covered bond markets? Should they be complemented with legislative measures at Union or Member State level?

The ECBC firmly believes that market-led initiatives such as the Covered Bond Label are an effective mechanism to achieve the goal of harmonisation by assisting further convergence, thus improving the integration of covered bond markets. Furthermore, market-led initiatives raise awareness amongst market participants, policy makers and competent authorities at national level that such a convergence should be achieved.

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. 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 role played by the Covered Bond Label in order to achieve better integration and improve the transparency of covered bond markets in Europe has been of paramount importance – raising the

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standard of transparency in the covered bond market in a harmonised way by facilitating and improving the access to information on i) liability, ii) regulation and iii) assets and regulatory compliance. The Covered Bond Label has provided a user-friendly harmonised transparency tool, presently used by 76 covered bond issuers, which has increased transparency convergence in the EU covered bond market for the first time since transparency principles were identified in article 52(4) of the UCITS Directive in 1985. Acknowledging the adequacy of the Covered Bond Label to the market and to covered bond issuers across Europe with a degree of regulatory recognition would furthermore help to: (i) avoid the requirement to legislate for grandfathering, which is important considering the IT costs it would impose on issuers to implemented transparency standards via law; (ii) 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 (iii) increase incentives for more issuers to join the Label initiative and thus ensure further convergence in the European covered bond market.

Furthermore, the ECBC agrees that 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. The European Commission's CMU Action Plan expressly notes that these national regimes are functioning well in general and also points to the use of market-led initiatives to increase convergence whilst maintaining the different national frameworks already in place.

3. Should the Commission pursue a policy of further legal/regulatory convergence in relation to covered bonds as a means to enhance standards and promote market integration? If so, which of the options suggested in section 3 of Part II should the Commission follow to that end and why?

The ECBC is supportive of the European Commission's proposal for further convergence in European covered bond markets, as it is a prerequisite for a continued regulatory recognition of the instrument's inherent quality features. Another important criterion for such convergence is the creating of a level playing field aspect in the use of a private sector funding instrument.

Amongst ECBC members there is a preference for further convergence to preferably be achieved through option 1, i.e. indirect harmonisation through a recommendation addressed to Member States in combination with an improved/complemented Article 129 CRR. Such convergence should, according to ECBC members, be based on the principle of competition of covered bond regimes, which have proven to be an efficient approach towards further convergence in the past, as diversity of national systems drives best practice principles and competition. Employing indirect harmonisation to the covered bond space will beneficially allow for the preservation of domestic frameworks insofar as permitted by the aims of harmonisation. Option 1 also has the additional benefit of being capable of introduction without undertaking additional legislative measures (e.g. via the Covered Bond Label), which facilitates harmonisation in the timeliest fashion of the options proposed.

The ECBC and its members are also supportive of an alternative option, which would combine the proposed option 1 and option 2, thus allowing some flexibility and diversity, which is critical, and also introduce certain legislative measures to set minimum standards in order to better protect the covered bond market. The ECBC suggests the following split:

- New secondary legislation in selected fields currently covered by UCITS 52(4) and Article 129 CRR – namely, public supervision, over-collateralisation, liquidity-risk management, asset segregation and minimum transparency.

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- Voluntary convergence via EU non-legislative recommendations/best practice guidelines/market initiatives in other areas such as the cover pool administration post issuer default, dual recourse, eligibility criteria, mixed cover pools, LTVs and valuations, stress testing, transparency (Covered Bond Label, Harmonised Transparency Template) and soft bullet/conditional pass-through structures.

The ECBC is of the opinion that further convergence of covered bond markets should be based on a high quality principle-based approach and best markets practices. Here, it is worth mentioning that some markets have already modernised their legal frameworks to reflect recent developments or the EBA's recommendations, for example. New additions (e.g. Belgium, Canada) have also managed to combine the best of the existing legislation. Similarly, market-led initiatives such as the Covered Bond Label have already achieved key milestones regarding transparency (regulatory, data). The Harmonised Transparency Template (HTT), agreed upon by all key parties (issuers, investors, regulators), should help further address current issues.

The additional benefit of combining the European Commission's option 1 and option 2 proposals, as shown above, would consist of combining a recommendation with harmonisation of certain minimum standards, thus allowing a voluntary integration process on existing legal structures and a consolidation of key characteristics and legal requirements of covered bonds in one legal framework. While such an approach would obviously trigger an amendment process of national covered bond frameworks, it would be a soft and flexible process leaving enough space for national legislators to safeguard national specificities and traditions.

In regards to option 3, ECBC members are doubtful as to whether or not the establishment of a 29th Regime would be workable in practice due to several reasons. Firstly, ECBC members do not expect countries with strong covered bond frameworks and well-established markets to apply such a regime: why should they abandon their (benchmark) position and issue covered bonds under an untested new framework?

Secondly, concerns have been raised as to whether or not a 29th Regime could be drafted in such a way that it accommodates the full range of national traditions and/or specificities of all EU covered bond countries as regards the level of detail, consistency, legal certainty and confidence for investors. Obviously, such requirements must be met by a 29th Regime in order to be competitive against the covered bond frameworks of these countries or even replace them. Many national covered bond laws have already been going through an evolutional "improvement process" for decades in order to reinforce their reliability, rating agencies' requirements and investors' confidence.

Thirdly, investors have developed a knowledge bank about existing covered bond frameworks by a long course of dealing with them. Any harmonisation scheme must factor-in the significant project of investor re-education in order to maintain the existing levels of investor knowledge and comfort as gaps in investor knowledge or uncertainty surrounding a new framework, in particular with regards to insolvency laws, would likely adversely affect covered bond investment.

Finally, doubt has been expressed that the interface between a 29th Regime and national provisions will succeed without any shortcomings. As a 29th Regime cannot cover all technical aspects of the covered bond business at European level (e.g. a general European insolvency framework does not exist), it has to refer to national rules in many respects such as n terms of insolvency rules, asset segregation, appointment and competences of cover pool administrators, access to liquidity, enforcement, etc.). The ECBC does not believe that these aspects could appropriately be addressed through the setting-up of technical standards. Gaps or legal uncertainties have an immediate impact on investor confidence and the risk profile of the instrument.

One should also consider that a major threat to the European covered bond market would be

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provoked by restricting the preferential regulatory treatment of covered bonds to only those instruments issued under a 29^{th} Regime.

4. Specifically, if the Commission were to issue a recommendation to Member States as suggested in section 3 of Part II would you consider that sufficient or should it be complemented by other measures (both legislative and non-legislative)? (see question 8 below)

While ECBC members have expressed a preference for option 1, there is also considerable support among ECBC members for an alternative option combining the recommendation with a high quality principle-based directive to help ensure a level playing field between market participants across countries. According to ECBC members, such a directive should provide an improvement or complement to Article 129 CRR along the lines of the EBA recommendations in order to trigger further convergence and to ring-fence the asset class. This is derived from the fact that the level playing field principle suggests that there must be a common understanding of what can be considered as eligible assets with regard to the preferential treatment of the instrument. ECBC members have also expressed the view that the Resolution Directive should be amended to specifically contemplate covered bonds (beyond the bail-in tool) in order to give a "good" treatment only to covered bonds following the Recommendation.

The ECBC agrees that if any recommendations of best practices are linked to preferential treatment under article 129 CRR, then appropriate transitional provisions will be necessary to accommodate existing arrangements. In particular, it will be necessary to ensure that existing covered bond holders are not prejudiced and that existing covered bond issuers maintain access to covered bond markets. Sufficient transition time will also be required to the extent that any adjustments may be required for existing programmes.

5. On the suggested list of high level elements for an EU covered bond framework:

a) Is the list sufficiently comprehensive or should it include any other items?

b) Should the Commission seek to develop all the elements or a subset of them?

c) If only a subset, should the Commission give priority to the target areas identified by the EBA Report: (i) special public supervision of cover pools and issuers; (ii) characteristics of the cover pool; and (iii) transparency?

a) Is the list sufficiently comprehensive or should it include any other items?

ECBC members have highlighted two elements which should be added to the list:

- The position of the European Commission with respect to "timely payment" as an inherent characteristic of covered bonds.
- An indication of the requirements to be fulfilled by the institutions allowed to issue covered bonds.

b) Should the Commission seek to develop all the elements or a subset of them?

The ECBC is supportive of the European Commission's proposal for further convergence within covered bond markets and considers all elements appropriate at this stage. However, certain elements require a greater degree of focus than others:

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- Convergence on asset-liability management (ALM).
- Focus on a subset mainly focused on covered bond definition and protection of term (sub-section I), special public supervision (sub-section II), the cover pool (sub-section IV) and transparency requirements (sub-section V).

c) If only a subset, should the Commission give priority to the target areas identified by the EBA Report: (i) special public supervision of cover pools and issuers; (ii) characteristics of the cover pool; and (iii) transparency?

The ECBC is in favour of the European Commission concentrating its work on the following elements:

- New secondary legislation in selected fields currently covered by UCITS 52(4) and Article 129 CRR – namely, public supervision, over-collateralisation, liquidity-risk management, asset segregation and minimum transparency.
- Voluntary convergence via EU non-legislative recommendations/best practice guidelines/market initiatives in other areas such as the cover pool administration post issuer default, dual recourse, eligibility criteria, mixed cover pools, LTVs and valuations, stress testing, transparency (Covered Bond Label, Harmonised Transparency Template), and soft bullet/conditional pass-through structures.

6. What are your views on the merits described under section 3 of Part II of using different legal instruments to develop an EU covered bond framework? In particular, would it be desirable to harmonise through a directive some of the legal features of covered bonds and requirements applicable to them under Member States' laws? If it were proposed, how could a 29th Regime on covered bonds be designed to provide an attractive alternative to existing national laws?

With regards to the choice of legal instrument, we refer to our answer to Question 3 in part II, which advocates for a combination of a recommendation and a high quality principle-based directive.

With regards to the establishment of a 29th Regime, it is essential to clearly define what a 29th Regime means in practice in order to assess the benefits and disadvantages of such a concept. We understand a 29th Regime as being an addition to the existing national regimes offering issuers the choice of either using their national or the European regime. Further harmonisation of national regimes or their replacement would not be the purpose of such a regime. Nor would it necessarily and automatically receive a regulatory treatment which would be more favourable compared to the national regimes currently in place.

There are numerous potential designs for such a regime incorporating completely different levels of harmonisation starting from the harmonisation of certain characteristics of covered bonds, such as transparency, special supervision or eligible assets, up to a fully-fledged European framework which sits alongside the national regimes, aiming at fostering further harmonisation by replacing – in the mid-term – national regimes.

Advantages of such a regime:

- Additional funding option.
- Additional investment option.
- Common understanding of key elements of a covered bond regime and their design providing guidance for preferential regulatory treatment – and thereby ring-fencing what

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is understood as being a high quality covered bond.

Disadvantages of such a regime:

- Additional complexity as the number of existing regimes is not reduced but increased by a 29th Regime.
- Important open questions at this stage, for example regarding the interface between the European and national rules (e.g. insolvency proceedings etc., see response to Question 3).
- Difficulty to assess the impact of a 29th Regime on existing covered bond markets, investor perceptions, spreads, demand and supply, liquidity, volatilities, etc. In a best case scenario, a 29th Regime would work and successfully compete with national markets/covered bonds, but then probably squeeze out covered bonds issued on the basis of national frameworks. In a worst case scenario, a 29th Regime would not work and it would trigger confusion and uncertainties amongst market participants (issuers, investors, supervisors etc.) and, hence, provoke market disruption or introduce inconsistencies in covered bond markets. In both scenarios, existing covered bonds would be damaged.

In order to provide feedback on the 29th Regime proposal, the suitability of the initiative to deliver a fully integrated regime against a recognisable "European covered bond instrument" have been measured below:

- **Improve market discipline and efficiency:** One of the key characteristics of European covered bonds throughout the crisis consisted of a high level of confidence. Enhanced transparency and comparability are indeed instrumental to building up a high level of investor confidence. But transparency and sufficiently high granular information are not intrinsic to a 29th Regime. Rather, this shall be part of any regulatory tool. Nonetheless, the impact of the solvency of issuing banks and of their countries of origin, as well as expected support from the sovereign, can probably not be eliminated from the credit quality assessment. It is not by introducing a 29th Regime that these criteria would be ignored by investors.

- **Facilitate simplification and standardisation in market practices:** A 29th Regime would, at first glance, increase market fragmentation as it would add an additional framework to the already existing universe of covered bonds. However, it could serve as an indication of what the European regulator considers as being the key elements of a safe and high quality covered bond framework, thereby ring-fencing the asset class, which would be eligible for a preferential treatment from a regulatory point of view. But such a "benefit" would trigger significant downside effects in other areas, which are described below.

- **Home bias in the investor base:** Home bias of investors is essentially crisis driven and appears independent from financial products. As this also applies to sovereign risk, we do not believe that a 29th Regime instrument would be exempt from such investor behaviour.

- **Reducing cost and time for investors:** If a 29th Regime is expected to initiate further convergence of national regimes, it could, to a certain extent, reduce the complexity, cost and time needed to analyse legal frameworks; however, it would at the same time significantly 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.

- **Facilitating the application of prudential requirements:** A common framework provided by a 29th Regime would facilitate the application of prudential requirements as it would define the key characteristics of covered bonds eligible for a preferential treatment. But it would not

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provide a solution for all other still existing national covered bond regimes. Therefore, equivalent criteria should be available to assess the eligibility of each national covered bond system for the preferential treatment. In this respect, we consider a regulatory level playing field between a potential 29th Regime and national covered bond instruments as a crucial requirement.

The ECBC does not see how more comparable and consistent levels of credit quality and liquidity would facilitate the application of prudential requirements, as regardless of such convergence, supervisors and bank investors would not be released from assessing the eligibility of each piece of national legislation for preferential treatment.

The ECBC would also strongly oppose a development where the preferential regulatory treatment of covered bonds would be reduced to only those issued under a 29th Regime, with the consequence that national covered bond systems would be excluded from the preferential treatment in the future. Such an approach would inevitably crowd-out existing national covered bonds from markets and ultimately stall these instruments.

- **Enhance the effectiveness of the ECB's monetary policies**: The ECBC does not envision that 29th Regime would enhance the effectiveness of the ECB's monetary policies. The market volume would not increase, national central banks (NCBs) also significantly buying the covered bonds of their home country. In our view, a common covered bond framework would not change the monetary transmission mechanism in the Eurozone.

- **Asset encumbrance:** There is evidence that covered bonds are not the main driver of asset encumbrance and that average encumbrance levels produced by covered bonds are low, ranging between 10% and 15% (see EBA Report on Asset Encumbrance, September 2015). The described effect of an adequately narrow definition of eligible cover assets is *de facto* already in place, driven by the definition and requirements of Article 129 CRR. We agree that asset encumbrance should be tackled by other policy measures.

- **Over-collateralisation (OC):** High levels of OC are not required because of a lack of investor confidence, but because of rating agency methodologies which demand certain minimum levels of OC to achieve high grade ratings. If the current reliance on external ratings were mitigated, OC levels could be reduced.

To conclude, the ECBC believes that a 29th Regime cannot be designed as an attractive alternative to existing national laws.

7. How should an EU covered bond framework deal with legacy transactions?

ECBC members generally consider legacy transactions as very problematic because they might provoke disruptions in the market through the setting-up of new cover pools and new issuers. Ideally, an EU covered bond framework should avoid any legacy issues. Establishment of new cover pools with grandfathering schemes for earlier issues would be both cost-intensive and detrimental to bond series' liquidity.

To the extent that voluntary convergence and/or a more formal framework for covered bonds is pursued and satisfaction of the new regime is required for preferential treatment, full grandfathering should be considered with respect to legacy transactions. This is in order to ensure that such transactions do not become subject to a different product standard and no longer benefit from preferential treatment as a result. The ECBC considers this particularly important to ensure that existing covered bond holders continue to have liquidity in the secondary markets in respect of any covered bonds they hold.

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ECBC members consider that relief for existing transactions should extend to established programmes as well as issues under such arrangements. However, if programmes are not grandfathered, then sufficient transition time in advance of the new regime taking effect will be required to identify and make any necessary adjustments to existing programmes. The amount of time which may be needed in this regard should not be underestimated, particularly where transaction party consents may be required and/or liability management exercises may form part of the process.

8. Would you view a combination of recommendations to Member States (Option 1) and targeted harmonisation of certain minimum standards (Option 2) as desirable and sufficiently flexible? If so, what should be the subject of each option?

As mentioned in response to Question 3, Part II, ECBC members are generally in favour of further convergence through option 1, i.e. an indirect harmonisation through a recommendation addressed to Member States.

However, the ECBC and its members are supportive of combining the proposed option 1 and option 2, thus allowing some flexibility and diversity, which is critical, and also introducing certain legislative measures to set minimum standards in order to better protect the covered bond market. The ECBC suggests the following split:

- New secondary legislation in selected fields currently covered by UCITS 52(4) and Article 129 CRR – namely, public supervision, over-collateralisation, liquidity-risk management, asset segregation and minimum transparency.
- Voluntary convergence via EU non-legislative recommendations/best practice guidelines/market initiatives in other areas such as the cover pool administration post issuer default, dual recourse, eligibility criteria, mixed cover pools, LTVs and valuations, stress testing, transparency (Covered Bond Label, Harmonised Transparency Template), and soft bullet/conditional pass-through structures.

The advantages of combining the European Commission's option 1 and option 2 proposals, as shown above, would consist of combining a recommendation with the harmonisation of certain minimum standards, thus allowing a voluntarily integration process based on existing legal structures and a consolidation of key characteristics and legal requirements for covered bonds under one legal framework.

The ECBC and its members are also supportive of market-led initiatives and the benefits they bring in terms of increased convergence across very diverse national covered bond frameworks – see answer to Question 2, Part II.

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PART III: ELEMENTS FOR AN INTEGRATED COVERED BOND FRAMEWORK

QUESTION – COVERED BOND DEFINITION

What are your views on the proposals set out in section 1 of Part III for a "new legal definition" of covered bonds to replace Article 52(4) of the UCITS Directive?

The ECBC supports the European Commission's proposal for strengthening the definition of a covered bond, thereby replacing the current definition set out in the UCITS Directive. ECBC members have also expressed their support for the proposed "new legal definition" of a covered bond, as it would provide more certainty to the covered bond framework and also help to protect the term in light of current innovations.

However, the ECBC does not support a simple abandon of the only-UCITS-compliant covered bond framework only leaving current CRR-compliant covered bonds as the protected framework going forward. This could be disruptive for some covered bonds systems – for instance for some specialised credit institutions systems.

Furthermore, the ECBC agrees with the extension of the definition to "equivalent third countries" providing that there is sufficient certainty with respect to those third countries considered being equivalent. Extending the definition will also help to level the playing field and set a clear precedent for other markets which may follow suit, thereby potentially strengthening the global covered bond marketplace and sources of funding for banks. For example, some non-EU countries (such as Canada, Australia and Singapore) have developed high-quality covered bond legal frameworks which have replicated or improved upon existing EU features. By becoming UCITS equivalent, non-EU covered bonds should enjoy a preferential risk weighting if they are also in line with CRR; this would benefit investors. Given the importance of working together across nations and continents to continue the development of the covered bond space, the ECBC has recently established a new ECBC Global Issues Working Group, which will focus on global issues and developments in relation to covered bonds.

Regarding a system of certification as proposed by the European Commission, ECBC members have expressed concern given that such a system can be argued to be counterproductive, most notably when it comes to ESMA or EBA certifying every single issue as a qualifying instrument. Rather, the ECBC believes that the focus should be on the national legal framework under which the instruments are issued. Therefore, an official process should be implemented confirming that a national covered bond framework complies with the framework or requirements defined at European level.

Moreover, it is important to keep in mind that the granting of the attribute "regulated" must avoid "reverse discrimination" of national covered bonds against a potential European instrument on the one hand, and of EU/EEA covered bonds against non-EU/EEA instruments on the other hand. For example, it is difficult to conceive that a non-EU/EEA covered bond would benefit from a designation as "recognised", "equivalent" or "complying", whereas instruments issued under national covered bond frameworks in the EU would not.

The ECBC further agrees that any amendment on the basis of the European Commission's Consultation Document which could negatively impact on the current regulatory treatment of outstanding covered bonds should be subject to grandfathering to avoid any market disruption.

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1. Should the current licensing system be simplified to require a "one-off" authorisation only for all covered bond issuers based on common high level standards? What specific prudential requirements (that is, in addition to those in CRR and CRD) could be applied as a condition for granting a covered bond issuer license?

The ECBC firmly believes that the current licensing systems should not be streamlined as each system represents and is developed based on the different issuer structures and local legal frameworks and insolvency regimes that exist across Member States. Due to such structural differences, a "one-size-fits-all" solution is not a feasible proposal as long as different covered bond models within which the relationship between the issuer and the holder of cover assets are different exist.

However, if a cut-off authorisation is decided upon, the ECBC recommends that the framework should be as flexible as suggested in the Consultation Document, with any requirements adopted being sufficiently flexible to accommodate the full range of issuer models in place across the market, including those using a credit institution issuer, which is separate from the cover pool-owning SPV. Moreover, it should utilise common best practice principles.

With regards to the prudential requirements there are two answers due to the different regulatory approaches/frameworks which exist within the EU:

I. It should be ensured that all covered bond issuers dispose of the human resources, systems, devices and dedication required for the maintenance of the cover pools and covered bond issuance. Therefore, it would be a remarkable lowering of standards in many jurisdictions if covered bond issuance would be opened up to any credit institution in accordance with the CRR without further specific covered bond license requirements.

II. If a bank satisfies the prudential requirements set forth under the CRR/CRD rules (and complies with the MREL limit), it should be allowed to issue covered bonds without the need for any additional capital requirement conditions.

2. If the covered bond issuer is subject to a one-off covered bond-specific licence, what would be the additional benefits of requiring that each covered bond programme be subject to prior authorisation as well? Alternatively, would pre- or post-notification to the competent authority of the programme and of each issue within or amendment to the programme suffice? How should "covered bond programme" be defined for these purposes?

In our view, adding a one-off covered bond specific licence for covered bonds programmes would mean creating a system involving two layers of supervision, i.e. one at a Member State level and one at EU level, creating a duplication of authorisation processes. At present, issuers are already regulated entities and supervised either by the SSM or by national central banks or national FSAs. Hence, there is no guarantee that an EU authorisation process would add value to the instrument. In relation to this, the issuance of covered bonds is an ordinary funding tool and, as such, should be within the full control of the prudent management of the bank. It would only make sense to replace the national supervision/licensing system by a European level license if the SSM would supervise all covered bond programmes in Europe.

As to notification of issues and programme amendments, there are slightly different views and approaches applied in individual Member States, but the main common principle that could be applied is the following:

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- Each issuer will request a covered bond license prior to issuance and when the license is obtained, the issuer can issue covered bonds as long as:

  - The issuer updates its covered bond programme documentation at least annually in line with the prospectus regime and as approved by the listing authority.
  - The issuance amount remains within the pre-agreed issuance limits (where applicable/relevant).
  - The issuer provides regular reporting to the asset monitor and/or regulator on the cover pool and the covered bonds issued.

The ECBC agrees that the term "covered bond programme" should be equal to that of a cover pool, meaning that the covered bond programme should be defined for the issue of instruments that qualify as covered bonds, under a set of homogenous key features, such as the total amount of the programme, the type and characteristics of the covered bond to be issued and backed by a specific cover pool, and which are subjected to a specific legal framework. For example, when a bank wants to set up a new cover pool, it would have to show in advance that it can meet the requirements for the asset class the cover pool is dedicated to. In those countries where only one asset type per cover pool is permitted, an additional license would apply in cases where the bank wants to set up a new covered bond programme backed by a different asset class. However, in countries where several cover pools can be set up for the same asset class, additional licenses for the same asset class do not appear necessary.

3. Should the Framework explicitly allow the use of SPVs to ring-fence cover pools of assets backing issues of covered bonds? What specific requirements should apply to these SPVs?

The ECBC considers it very important that the European Commission recognises that the three most common covered bond models used in Europe (specialist issuer, direct on-balance sheet and direct with SPV guarantee) each have their own *raison d'être*. Therefore, the use of SPVs holding cover pools should be allowed where the legislator finds them appropriate to guarantee the ring-fencing of the cover pool which is valid, also post-insolvency, of the issuing bank.

Furthermore, where the holder of the cover pool assets is a legal entity, which differs from the originator and/or covered bond issuer, it must be safeguarded that the transfer of these assets to the holder of the cover pool is legally valid, binding and enforceable.

The ECBC further agrees that an explicit permission and the corresponding regime applicable could in fact contribute to the use of SPVs. However, in cases where SPVs are not expressly provided for by the European Commission, it is essential that any adopted framework does not restrict the use of such SPVs as they are an important tool in many countries to ensure double recourse and asset segregation.

4. Regarding the use of pooled covered bond structures and SPVs:

a) Would it be desirable for an EU Covered Bond Framework to allow the use of these structures and why? What legal structures are used in your jurisdiction to pool assets from different lenders or issuers?

b) Which approach would be the most suitable for pooling assets across borders?

c) Where the issuer of pooled covered bonds is an SPV, should this issuer be regulated as a credit institution or as some other form of legal entity?

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a) Would it be desirable for an EU Covered Bond Framework to allow the use of these structures and why? What legal structures are used in your jurisdiction to pool assets from different lenders or issuers?

The ECBC believes that it is desirable for an EU covered bond framework to allow the use of such pooled covered bond structures and SPVs in order to allow smaller banks to access the covered bond market by permitting covered bond issuances.

If mortgages are pooled in order to collect them from different originators and thus create a larger cover pool, an SPV is often necessary to ensure that the assets can be legally segregated from the originators and pooled together.

In general, the use of an SPV to pool assets from different lenders could be an efficient tool for the transfer of those assets to the SPV, which subsequently could be the covered bond issuer if it is licensed as a credit institution/bank. Without such a license, one of the banks would need to be the issuer and the SPV could guarantee the covered bonds issued to provide the double recourse to the cover pool of pooled assets.

If an EU framework recognises such structures, it should positively encourage the pool structures by removing regulatory obstacles to the implementation of such structures.

National Jurisdictions:
Today, in Germany, a fiduciary relationship between the different lenders and the covered bond issuing bank is the typical structure to pool assets from different lenders. While the loan is often just assigned to the covered bond bank, the originating bank would hold the security right over immovable property for the covered bond issuer in a fiduciary relationship (rather similar to a common law trust). This relationship is based on a right for transfer, which the originator has to enter into a “funding register” (“*Refinanzierungsregister*”). This registration makes the fiduciary relation (trust) insolvency tight and gives the covered bond bank a right on all proceeds from the trust assets. Because of these parliamentary law provisions, the use of a SPV is not necessary in Germany.

The Irish framework utilises the specialist banking model. Harmonisation as to issuer model such that an issuer could adopt the specialist banking model, the universal banking model or the SPV model in line with many other EU Member States would be welcomed. Pooling is not facilitated by the Irish legislative framework and there is no appetite for its inclusion in the Irish framework.

Spanish covered bonds (*Cédulas Hipotecarias*) are issued directly by the originator bank with no use of SPVs. In the past, some issuers occasionally issued single covered bonds which where simultaneously acquired by the same SPV created ad hoc (“*cédulas multicendentes*”).

Danish mortgage banks are specialised credit institutions, which originate the mortgage loan and issue the corresponding amount of covered bonds that finance the loans granted by the mortgage bank. Danish specialised mortgage banks can also fund mortgage lending granted by other mortgage banks, conditional upon special “joint funding” approval by the Danish FSA. Danish mortgage banks can also purchase loans granted by other banks and finance these by issuing covered bonds, again conditional upon special approval by the Danish FSA. In order to obtain such approval, the process has to ensure that the loan transfer meets the same requirements as if the mortgage had been originated by the mortgage bank itself.

b) Which approach would be the most suitable for pooling assets across borders?

With regards to Question 4b, there are different schools of thought amongst ECBC members.

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Some ECBC members agree that the most suitable approach depends on the laws regarding the assignment of assets of the countries where the different lender and/or the assets are located. Therefore, a trust approach would be most suitable in this regard, but it is important to stress that the laws are so different in this field that any harmonisation would require an enormous effort affecting large parts of national law. Another suggestion would be for pooling assets through an SPV, which would purchase such assets from the different originators.

On the other hand, some ECBC members have also suggested the removal of any barriers hindering cross-border transfer of assets (including tax or notarial-registry barriers) and deepening the Capital Market Union initiative.

This shows that at present, no simple solution exists that would allow the pooling of assets in all Member States.

c) Where the issuer of pooled covered bonds is an SPV, should this issuer be regulated as a credit institution or as some other form of legal entity?

Amongst ECBC members, there are two points of view. The majority of ECBC members agree that not regulating the SPV as a credit institution would leave the cover assets and a lot of covered bond matters out of the reach of the CRR and other European bank supervisory regulation.

However, if the SPV is consolidated with the issuer regarding banking supervision law, this deficit might be compensated, especially in those covered bond structures where the issuing bank is the full owner of the SPV holding the cover assets. However, it should be carefully analysed whether or not the banking law consolidation might trigger a consolidated insolvency procedure and thus destroy or at least endanger the insolvency segregation of cover assets.

With regards to resolution, it may be important for the SPV to have access to all the options that a credit institution has. However, there should be no “cherry picking”, meaning that the SPV either is a credit institution with all advantages of a credit institution (including ECB counterparty eligibility) and the burden that such a qualification brings to a credit institution.

In relation to this, having a covered bond structure where the cover assets-holding SPV is out of the reach of banking supervision and resolution authorities, what does this mean for the resolution procedure? Will the covered bonds then be qualified as senior unsecured bonds and subject to bail-in?

On the other hand, a few ECBC members believe that with respect to authorisation, in principle, if all of the entities selling assets to the SPV issuer are authorised, then it should not be necessary for the SPV issuer itself to also be an authorised entity.

QUESTIONS – ON-GOING SUPERVISION AND MONITORING OF COVER POOLS (PRE-INSOLVENCY)

1. In your view, would it be desirable for an EU Covered Bond Framework to set common duties and powers on competent authorities for the supervision of covered bond programmes and issuers? What specific duties and powers should be included in the Framework and/or EBA or ESMA Guidelines?

The ECBC is supportive of the European Commission’s proposals to further converge within Member States their national covered bond frameworks. The ECBC agrees that a set of common supervisor duties and powers for national supervisory authorities would be desirable in order to promote consistent practice and supervision by competent authorities within national frameworks. Thus, supporting the public supervision requirement of the UCITS Directive with more detailed supervisory standards.

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However, ECBC members have stressed that such a common supervisory framework must be referred to as general principles and describe these only in high-level terms, rather than as more specific functions, which may not fit appropriately with aspects of local regimes.

What specific duties and powers should be included in the Framework and/or EBA or ESMA Guidelines?

Below is a non-exhaustive list of specific duties and powers that ECBC members have highlighted as areas which could be included within a supervisory framework:

- Regular random checks of cover pools that are conducted or supervised by national competent authorities.
- That national covered bond laws enact a separation of the competences of the cover pool monitor from those of national supervisory authorities in order to clarify competences and responsibilities.
- The supervisor should make sure that an independent party (cover pool monitor) should - at the very least - on an annual basis perform the following duties:
  - Check calculations related to the liquidity buffer.
  - Check calculations related to the over-collateralisation ratios.
  - Check files of cover pool assets on a random basis.
- Adequate segregation of assets.
- Prompt corrective-action practices.
- Powers of the manager/administrator in the event of issuer insolvency.
- Mechanisms to oversee valuation criteria.
- Mechanisms to oversee withdrawal from cover pools.
- Assessments of coverage calculations.
- Assessments of asset eligibility.
- Approval of issuers' plans for adequate management of the cover pool post-issuer default;
- Covered bond investors hold a priority claim.
- A centralisation of covered bond supervision within a special department or at least by a precise specialist within the supervisory authority in order to achieve level playing field on a national level.
- General consistency in the interpretation of EU level covered bond related requirements and guidance between national competent authorities.

The European Commission also indicates the implementation of supervisory guidelines specific to the covered bond issuance business but without giving any specific details, which the ECBC agrees could be useful for ensuring, for example, adequate governance and risk management strategies at all times.

2. What are your views on the proposals set out in subsection 2.2 of Part III on the appointment of and legal regime for cover pool monitors?

The ECBC is supportive of the European Commission's proposals for a regime for cover pool monitors. ECBC members have expressed a positive interest for such a regime, but stressed that given the particularities of each national covered bond model, more precise recommendations than those introduced in the Consultation Document would be difficult to agree upon as requirements of duties and powers depend on the national covered bond model.

With regards to the appointment of an independent third-party with the right professional skills, there are two different schools of thought amongst ECBC members.

Some ECBC members have argued that cover pool monitors should be allowed to be appointed by the

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issuer, but compliant with requirements on their independence. Given the legal obligation to rotate between auditors and the fact that accountants are members of professional organisations which are also confronted with strict oversight of their activities, some ECBC members have argued that accountants should therefore be trusted with both the task of auditing the issuer as well all activities related to the cover pool. Thus, there is no need to limit the landscape of eligible auditors.

On the other hand, some ECBC members have stressed their agreement with the proposed cover pool monitor framework, believing that cover pool monitors should be approved by supervisory authorities and that it is important that cover pool monitors are in no contractual relationship with the particular banks, but holds a public office for which they are nominated by the national supervision authority.

Other areas which have been highlighted as important with regards to supervisory practices are:

- The cover pool monitor should conduct direct and regular reporting (minimum quarterly).
- The cover pool monitor should have full access to any required information.
- The cover pool monitor should carry out random checks (including onsite) of cover assets to ensure their appropriateness.
- The cover pool monitor should validate any asset entry and withdrawal.
- Any resignation of the cover pool monitor should be approved by supervisory authorities.

To avoid possible confusion in terms of compliance, ECBC members have stressed that it is essential that any recommendations adopted in this regard make the specific duties of monitors sufficiently clear and provide flexibility for such duties to be performed in accordance with agreed upon procedures. With respect to the reports to be provided by monitors, ECBC members have stressed that these should be transparent and sufficiently detailed. In addition, some ECBC members have stressed that the different ways in which supervision tasks are distributed between the national authority, special accountants and the cover pool monitor must be taken into account.

Furthermore, the ECBC shares EBA's recommendation that the appointment of a cover pool monitor is not necessary if the similar tasks of such monitor are carried out by the competent authority.

With regards to a "passporting" mechanism to allow for cross-border monitoring in the EU, in general there is no objection to the proposals amongst ECBC members.

QUESTION – COVERED BONDS AND THE SSM

Should the ECB have specific supervisory powers, and if so which ones, in relation to covered bond issuance of credit institutions falling within the scope of the SSM?

At present the ECBC is not in favour of extending the supervisory powers of the ECB/SSM. ECBC members firmly believe that national covered bond supervision should continue to have a specific role in the supervision of covered bond programmes.

In our view, supervision should be granted to the authorities monitoring the issuer or its parent, as covered bonds are on-balance sheet bank debt and cannot be isolated from the underlying institution. The issuer's business model, underwriting criteria, funding strategy and creditworthiness, for example, matter for the covered bond programme and its holders. This is even truer under the EU BRRD, which will require better supervisory coordination and clarity regarding the implications for the covered bond programmes and their investors. As such, at a later stage a potential evolution of the current supervisory environment could see that the ECB/SSM would supervise covered bonds for the largest banking groups and national supervisors for the remaining ones. Supervisory colleges should also ensure the sharing of best practices between the ECB/SSM and national authorities.

In accordance with the large differences between European mortgage markets, housing policies,

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insolvency laws etc., supervising covered bonds and assessing them correctly in accordance with the specific country particulars makes it difficult for the ECB to supervise covered bonds across the EU. Rather, the ECB should continue to monitor covered bond related matters indirectly through its supervision of certain credit institutions.

From a fragmentation perspective, specific supervisory powers in respect of issuers in SSM jurisdictions would likely lead to a division in the EU covered bond market between issuers in SSM jurisdictions and issuers in non-SSM jurisdictions, which would appear to be at odds with the goal of market convergence.

QUESTION – DUAL RECOURSE PRINCIPLE

Do you agree with the proposed formulation for "dual recourse"?

The ECBC agrees that the dual recourse principle should be anchored in a common European covered bond framework.

We believe that the European Commission should be more specific in its definition of dual recourse; specifically, that it should restrict it to insolvency followed by liquidation.

Clarity is also needed more generally on the concept of resolution so that covered bond investors have a clear understanding of their effective protection via the dual recourse principle: the investor has a claim against: i) the issuing institution; and ii) the cover pool.

However, the definition does not take into account that derivative counterparties (hedging imbalances between the covered bonds and the loans), which, typically, have the same legal position as the covered bond holders.

Furthermore, in some jurisdictions the bond holders still have a privileged claim (and not only a senior unsecured claim) against the insolvency estate in case the cover pool does not suffice. A new definition should not restrict this, especially for specialised credit institutions.

We go into further detail regarding the absolute priority issue in the section on "*RANKING OF COVER POOL LIABILITIES* ".

It should also be noted that the description of the full recourse claim against the issuer seems to assume that the cover pool assets will be realised first and that the claim against the issuer will be residual in nature, such that it may only be made for any deficit that may result after applying the proceeds of such assets to meet the liabilities. In the context of various jurisdictions, dual recourse instead means that the covered bond holder effectively has a separate claim against each of the issuer and the SPV asset pool owner, and the latter is only triggered in certain scenarios.

Furthermore, it is crucial to require that the issuing entity be a credit institution.

QUESTIONS – SEGREGATION OF THE COVER ASSETS

1. Are there any advantages to using an SPV as an additional segregation mechanism at issuance? Are cover assets typically transferred to the SPV at issuance via legal or equitable assignment?

The ECBC would encourage the EU authorities to regard each existing model/method (i.e. use of an SPV or reliance on statutory provisions) as a robust option for approaching asset segregation rather

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than pitching the options against one another.

Operational procedures should be clarified under each model so that the priority claims over the cover pool are as clear as for SPV structures, while ensuring the protection of all assets (primary, substitution, hedging derivatives) as suggested by the European Commission. We believe that a "best practice" approach would be better here in order to take into account all the legal specificities of the different countries and issuers. Guidelines to mitigate set-off and/or commingling risks could be useful as well.

The use of SPVs, within the covered bond framework, has proven to be a successful means of asset segregation, as well as other types of asset segregation used in other jurisdictions. Using an SPV as an additional segregation mechanism has advantages as well as disadvantages (more complexity, assignment risk, transfer pricing) and the future legal framework should give a fair treatment to both alternatives.

All identified means of transfer are good. The advantage of transfer to an SPV is that the SPV is established as a limited purpose vehicle to act solely in the interests of the covered bond holders for the relevant programme. This limited purpose principle is further safeguarded in the legal documentation. The deeds of assignment relating to the pool need to be signed by both the issuer and the SPV. The check to be performed by the SPV on both the legal validity of the deed and the amount of collateral provides for an additional safeguard that the assets are actually transferred and that sufficient collateral is transferred prior to issuance. We reiterate that these transfers will have been made and legally perfected prior to issuance (i.e. segregation takes place prior to issuance).

Whenever a significant amount of mortgages should be transferred from one legal entity (originator) to another (SPV), market participants are looking for less costly ways of transfer, which might trigger less security. If the water tightness of these transfers is not ensured by specific parliamentary law, respective legal opinions should be published to increase legal transparency.

2. In your jurisdiction, what legal and practical steps are required in order to segregate effectively the cover assets from the issuer's insolvent estate or in resolution? Would it be necessary to serve a notification to each borrower of the issuer? Until notification is served, what is the legal status of any proceeds of the cover assets which may be paid directly into the insolvent estate or to the issuer in resolution?

Eleven countries replied to this question (DE, DK, FR, IE, IT, LU, NL, NO, PT, ES & UK)

Denmark:
In the specialised Danish mortgage banks, all assets are assigned to specific cover pools in Danish regulation referred to as Capital Centres. Each Capital Centre must comply with minimum capital requirements implied by the CRR. Assets may be transferred from one Capital Centre to another insofar as the Capital Centre is solvent. If the transfer would lead to insolvency, the transfer is prohibited by law. Furthermore, if insolvency procedures have been initiated, the transfer of assets between Capital Centres is prohibited in general.

France:
In France, no legal or practical steps are required to effectively segregate the cover pool from originator and/or servicer estate after its transfer to the specialised credit institution occurring before or at covered bond issuance. Indeed, under the specialised credit institution model prevailing in France, cover pool segregation is effective and enforceable against third-parties by law as it is transferred to the specialised credit institution (legal assignment at the transfer data).

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A notification to the borrowers is necessary only when the originator and/or servicer becomes insolvent in order to effectively segregate the cash flows under the cover assets from the originator/servicer's insolvent estate (unless such notification has already been served before insolvency). Practically, a notification to the borrowers will be served at that time, if not served before, to ensure that the cash flows under the cover pool are directly collected by the specialised credit institution into its own accounts. The notification notice shall inform the borrower of the transfer of his/her loans to the specialised credit institution and of new payment instructions.

No notification is needed when the originator and/or servicer enters into resolution; indeed, at that stage, the covered bond is not in default and there is no need for legal segregation of the cash flow under the cover assets.

The insolvency of the originating credit institution is not necessarily concomitant with the resolution or insolvency of the issuer. Indeed, it should be noted that the issuer is an independent credit institution with a specific bankruptcy procedure. The bankruptcy of the originating credit institution cannot be extended to the issuer as stipulated by the law (article L.513-20 of the French Monetary and Financial Code).

In the case where the originator and/or servicer has become insolvent, any cash flow collected in the servicer's accounts from the cover pool before the debtor has been notified is due to the issuer by the originator/servicer, acting as servicer for the account of the issuer on an unsecured basis.

Germany:
We share the view that a common covered bond framework shall address the segregation of cover assets in the case of default of the issuing institution. As asset segregation rules are embedded in national law, provisions at European level will probably be principle-based.

The main challenge underlying the asset segregation process consists of an efficient and bankruptcy-remote full transfer of the mortgage collateral. For covered bond models where the cover assets remain on the balance sheet of the issuing institution, their identification is ensured through a registration in a cover register, as is done in Germany and many other countries.

In Germany, the segregation of the cover pools happens *ipso jure* with the appointment of a cover pool administrator. All assets registered at that moment in the cover register would form the "Pfandbrief bank with limited business activity". No notification to the debtor of the cover asset loan is required. The Pfandbrief bank with limited business activity is not a new legal unit but an estate within the existing bank which now would comprise of two estates: the insolvency estate and the Pfandbrief bank with limited business activity. All proceeds from the cover assets received by the bank since the appointment of the cover pool administrator would be part of the Pfandbrief bank with limited business activity. This legal segregation then would be followed by a practical separation of bank accounts, staff, resources etc., which the insolvency administrator and the cover pool monitor would undertake over time. Until then, all proceeds would have to be separated in the accounts on a permanent base.

As a matter of principle, effective asset segregation could be achieved in two ways: either by legal provisions or by contractual tools.

Regarding the first option and in line with the EBA recommendation, a common covered bond framework should require that effective asset segregation shall result in legally binding and enforceable arrangements. In this context, an effective assignment of mortgage collateral can also be processed without a transfer in a stricter sense but through legal trust structures.

Should the transfer of mortgages rely on contractual agreements, it is of paramount importance that

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the legal opinions underlying such arrangements be disclosed to investors/the public and assessed by the competent authorities.

Ireland:

Under the Irish framework, all cover assets are held within a specialist legal entity – a designated credit institution, the activities of which are restricted within the context of being a covered bond issuer.

Preferred creditors (bond holders, hedge counterparties, cover asset monitor or manager) have preferred claims over cover assets and their proceeds. The claims and rights of preferred creditors are not affected by the insolvency of a designated credit institution or its parent.

Italy:

Generally speaking, in order to fully segregate the assets from the issuer's capital, under the Italian framework, the issuer is required to register the sale of receivables identified by means of common criteria with the Companies' Register and to publish a notice of the assignment in the Official Gazette.

The registration of the sale of the receivables in the Companies' Register and the publication of the notice of the assignment in the Official Gazette are necessary in order to render the assignment enforceable against the debtor. Even if this is not necessary to make the assignment effective against the debtor, the seller is also obliged to give notice to the debtor of the assignment as soon as is possible.

Luxembourg:

In the case of the bankruptcy of a covered bond bank, the assets and derivatives products registered in the cover pools are separated from the other assets and liabilities of the bank, whereby each category of cover pool forms a special estate (*compartiments patrimoniaux*). The special estates will be run and managed as a covered bond bank with limited business activity by a qualified trustee, appointed by the responsible insolvency court. As the covered bond bank with limited business activity remains solvent and continues the covered bond business in respect to the outstanding *Lettres de Gages*, it is bound to the legal regulations and reporting requirements for covered bond banks and subject to banking supervision by CSSF. The management of the special estates by the trustee is furthermore carried out independently and solely in the interest of the covered bond holders. The trustee is empowered to issue new covered bonds for the account of the covered bond bank with limited business activity, dedicated to the relevant cover pool category, and to engage in open market operations carried out by the European Central Bank.

Netherlands:

In the Netherlands, the assets have been segregated prior to issuance. Therefore, the bankruptcy of the issuer will not affect a prior transfer of cover assets. In Dutch covered bond programmes, loan receivables are legally transferred to the SPV by way of silent assignment. To perfect such silent assignment, a deed of assignment must be executed between the SPV and issuer, and such a deed must be registered with the Dutch tax authority for evidence purposes. As a result, the legal ownership of the loan receivables the subject of such assignment will have been transferred to the SPV without further action being required.

The assignment will only be notified to the debtors under the loan receivables if certain trigger events occur (e.g. bankruptcy, default of issuer/originator, etc.). Notification is only necessary to ensure that the debtors under the loan receivables can no longer discharge their obligations by paying to the issuer/originator. Such notification can also be given after default or insolvency.

As long as no notification has taken place, any payments made by the debtors under the loan receivables must continue to be made to the issuer. In respect of payments so made prior to a Dutch

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insolvency proceeding of the issuer, the SPV will be an ordinary, non-preferred creditor, having an insolvency claim against the issuer. In respect of post-insolvency payments, the issuer will be a creditor of the insolvent estate and will receive payment prior to creditors with insolvency claims, but after preferred creditors of the estate.

To mitigate any commingling risk in relation to payments made by debtors to the issuer, the Dutch covered bond programmes contain mandatory and contractual liquidity/cash reserves.

Norway:
The issuers of covered bonds are licensed credit institutions, supervised by the Financial Supervisory Authority (FSA) of Norway (*Finanstilsynet*), and subject to the paramount regulation of credit institutions. The Norwegian covered bond legislation ensures that the cover pool is ring-fenced, designed to survive the insolvency of the issuer (and the owner bank) and continue the payments to the bond holders according to the original maturity schedule. In order to comply with the legislation, the value of the cover pool must at all times exceed the value of the outstanding covered bonds and other preferential claims (e.g. claims from derivative counterparties) against the cover pool. The preferential right to the cover pool distinguishes covered bonds from unsecured debt. Only specialised, licensed mortgage credit institutions (*kredittforetak*) are allowed to issue covered bonds in Norway. However, these may be established as subsidiaries of commercial banks or savings banks. The covered bond issuers have a narrow mandate limited to the granting or acquisition of specified types of mortgages and public sector loans, and financing of this business by primarily issuing covered bonds.

Portugal:
The current process is foreseen in the law and regulation from the competent authority. We believe it would be useful to have some more detail. The law is clear in the sense that no cover pool proceeds can be allocated to the issuer's insolvency estate but shall be segregated to pay holders of covered bonds.

Spain:
In Spain, cover assets are recorded in a special and well-regulated internal register.

Inclusion of assets in this register does not prejudice the borrowers at all, so borrowers do not have to be notified. This solution is coherent with Spanish Civil Law where the assignment of loans/credits does not need to be notified to debtors.

UK:
UK covered bond programmes use a structure involving a separate SPV which acquires the cover pool assets from the issuer. Such acquisition is typically documented as an equitable assignment and notice is not provided at the time of transfer, but provision will be made for such notice to be provided upon the occurrence of certain trigger events (including the insolvency of the issuer/seller).

Once notice is provided, payment to the issuer/seller does not discharge the obligation of the underlying obligor, who remains liable to the SPV asset pool owner. Prior to notice being given, an underlying obligor may discharge its obligations by payment to the issuer/seller without any liability to the SPV asset pool owner. However, in this scenario, the SPV will have a claim (subject to set-off rights and certain other equities) for, and will not be precluded from recovering from the issuer/seller, identifiable proceeds of the assigned cover pool assets, although until notice is given, the SPV must, as a procedural matter, join the issuer/seller as a party to its action against the obligor. In general, such proceeds will not be available to the liquidator of the issuer/seller for distribution to general creditors because the assets (and proceeds) will have been assigned. As a result, the claim of the SPV is effectively protected.

In general, the exercise of resolution tools and powers in respect of the issuer/seller under the UK Banking Act should not affect this analysis.

QUESTIONS – LEGAL FORM AND SUPERVISION OF THE COVER POOL

1. Should the cover pool be incorporated as a regulated entity? In that case, what type?

This question affects the fundamental legal structures of a covered bond model. We can differentiate five covered bond models, all of them having advantages and disadvantages: fully specialised issuer, largely specialised issuer, non-specialised issuer, issuer with separate cover pool SPV and pooling of cover assets. It would be useful to establish at EU level a high level set of regulatory requirements for the cover pool/SPV which Member States could implement in national legislation as part of the other national legislative covered bond requirements. The SPV/cover pool should obtain a specific licence on the basis of such covered bond legislation as part of the approval process applicable to the covered bond programme and issuer under such covered bond programme.

In cases of insolvency/resolution of the issuer, the cover pool should be administered as a separate entity but this entity does not have to be a "new" legal person.

If an SPV is to qualify as a regulated entity to enable supervision by the ECB/NCA post-issuer default, we would strongly advise to limit licensing requirements and ongoing compliance requirements to an absolute minimum (i.e. to avoid overlap with the other EBA recommendations).

If similar licensing/ongoing requirements would be applied which are applicable to banks, this would make the structure inefficient (e.g. from a cost/benefit and transparency perspective) and complicated. If the SPV were to qualify as a regulated entity, appropriate safeguards should be included in EU legislation to avoid unintended requalification risks or adverse consequences for the SPV (or the investors) as a result of such status (e.g. under EMIR, CRR and other financial regulations).

2. Who should be the supervisory authority for these purposes, the competent authority or the resolution authority?

Provisions at European level addressing duties and powers of the national authorities should remain principles-based. A European covered bond framework could identify these principles and define the following two pillars:

- Principle of implication of the national authority: the national supervisory authority must constantly be involved in the post-default proceedings. All technical details shall be provided by the national covered bond framework.
- Principle of competence of the national authorities: national authorities must remain competent for all insolvency and/or resolution proceedings even for significant credit institutions under ECB supervision when covered bond specific issues are at stake.

The incorporation or not of the cover pool could be determined by the issuer model(s) adopted within the relevant national framework – specialist entity model (institution or SPV) or universal model. An option of either approach is available in some EU jurisdictions.

Once the assets have been segregated from the issuer, the resolution authority has no jurisdiction over the assets. Therefore, the competent authority should be the supervisory authority, but coordination between the competent and the resolution authorities should take place.

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QUESTIONS – SPECIAL ADMINISTRATOR OF THE COVER POOL

1. What are your views on the proposals set out in subsection 3.3 of Part III on the appointment and legal regime for a cover pool special administrator?

The ability to act is an important issue for a cover pool administrator, especially because he must be able to act very quickly after being nominated by the competent authority in crisis situations.

Running a cover pool – unlike administering an insolvency estate – means controlling a going-concern business. The cover pool administrator would need wide powers in order to successfully run the cover pool, which may require many different kinds of permanent business. Insolvency administrators may be a good choice, but the necessary qualifications for them are diverse in European legislations. Room should be given to reflect these differences and also to choose other persons or institutions that may be appropriate in a particular country. An asset management company or a credit institution might be suitable, especially regarding contributing liquidity at the same time, as well as national deposit insurance and bank guarantee systems.

It is also important to bear in mind not to create a regime where the liquidator of the issuer can, at the same time, act as the administrator of the cover pool; the interests of the creditors of the estate of the issuer and the interests of covered bond investors are not necessarily always aligned.

2. Should the special administrator be obliged to report regularly to the relevant supervisory authority? Should the content and regulatory of such reporting be the same as for the issuer?

The national supervisory authority must be constantly involved in the post-default proceedings. A mere reporting requirement would not be enough. All technical details shall be provided by the national covered bond framework.

The contents and the regulation of such reporting should be similar to the one legislations foresee for issuers' administrators, but perhaps a little more intense due to the importance of an orderly and adequate management of the cover pool once the issuer enters into bankruptcy/insolvency.

QUESTIONS – RANKING OF COVER POOL LIABILITIES

1. Do you agree with the suggested ranking for cover pool liabilities? Is the wording proposed in subsection 3.3 of Part III sufficient to define clearly the claims that may arise, avoid confusion between claims and prevent claims in an unreasonable amount from arising?

All liabilities of the cover pool/SPV owed to services providers and liabilities relating to the existence and maintenance of the cover pool/SPV ("transaction costs") should rank in priority to or pari passu with the covered bond holders (depending on the covered bond model). In addition, all hedges entered into to mitigate rate/currency exposure should be permitted to rank in priority to, or, as applicable, pari passu with, the covered bond liabilities.

Service providers, for which further detail is needed as to whether or not direct and indirect service providers are included, and interest rated hedging counterparties should be allowed to rank senior to the covered bond holders, since their activity is relevant for the protection of the value and the management of the cover pool. The possibility for certain liabilities to rank senior to the covered bond should be taken into account in asset coverage test calculations.

We would also propose to include cover pool swaps senior to covered bond holders and other

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derivatives in the past issuer default "waterfalls" (these waterfalls are often referred to as Guarantee Priority of Payments.) As this is an operational concern aimed at facilitating payments to borrowers, it should continue to be allowed.

Both for the hedges and the costs it should be noted that the regulation should prescribe that the cover pool needs to be sufficient to pay the covered bonds, taking into account any prior or, as applicable, pari passu ranking payments.

In any case, it has to be taken into account that this is not a dead pool, but for many years a going concern. In these transactions, the administrator has no chance to postpone payments that may rank junior.

2. Is it possible to define hedging activity better and, if so, how?

We do not see the need to provide more precision in the definition of hedging since it is a reality well known by the financial world and any attempt to define it could be partial and exclusive. This should be left to national regulation.

The hedges purport to mitigate rate/currency risks between the cover assets and covered bond liabilities (e.g. currency and interest rate of the covered bonds) and are therefore beneficial to the covered bond holders.

QUESTIONS – INTERACTION BETWEEN COVER POOL AND ISSUER IN INSOLVENCY/RESOLUTION

1. Are current provisions in EU law sufficient to deliver effective protection for bondholders in a resolution scenario involving covered bonds? In particular, is it sufficiently clear:

a) How the cover pool would be segregated under each possible resolution or recovery scenario of the issuer?

b) How the full recourse against the issuer would take effect if the issuer is in resolution and is not placed subsequently into liquidation?

c) What procedural steps should be followed in resolution and by whom in order to make effective the dual recourse mechanism?

a) How the cover pool would be segregated under each possible resolution or recovery scenario of the issuer?

Current EU law does not provide for any effective protection for cover pool and covered bond holders. Only art. 52 IV UCITS requests a kind of segregation, but leaves unregulated what level of segregation should be achieved and in what way. National covered bond regimes do fill that gap via different asset segregation mechanisms (i.e. on-balance sheet, specialist banks or special purpose entities) albeit generally without specific reference to the possible resolution or recovery scenarios of the issuer as distinguished in the BRRD. In turn, the BRRD is, with the exception of the bail-in tool, insufficiently detailed regarding the treatment of covered bonds under the different resolution tools. In our view, within a common EU covered bond framework, the independent management of the covered bond programme would also need further clarification. The cover pool administrator should act in the interest of the covered bond holders,

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which is best warranted if the cover pool monitor is solely responsible for the management of the cover pool and not for the remaining insolvency estate. We would advocate giving a cover pool administrator permission to raise liquidity.

b) How the full recourse against the issuer would take effect if the issuer is in resolution and is not placed subsequently into liquidation?

The current provisions in EU law give no detail whatsoever on how the full recourse against the issuer should take effect if the issuer is in resolution. If insolvency procedures are started against the issuer, covered bonds and cover assets should not be subject to insolvency law and insolvency administration if the cover pool is sufficient and liquid. Acceleration of covered bonds in cases of issuer default should be excluded. As long as a resolution procedure does not trigger an insolvency procedure over the issuer, covered bonds would have to be fully and timely redeemed. Covered bond issuers should have plans in place specifying the operational procedures ensuring the orderly functioning of the covered bond programme. We strongly recommend a common covered bond framework to clarify if this requires operational procedures enshrined in law or if it would be sufficient to have specific rules of conduct in place within the rescue regime of the issuing institution. Either the common framework regulates these "plans" itself, or it requires equivalent rules to be contained in the recovery and resolution plans.

In both cases, these rules or plans should be principles-based only, because precise requirements at European level would not provide added value. More clarity should also be provided on the fact that if liabilities exceed the cover assets, the national implementation of the BRRD/SRM could allow resolution tools (such as bail-in) to be applied to the excess liabilities.

c) What procedural steps should be followed in resolution and by whom in order to make effective the dual recourse mechanism?

Clarification about the relationship between the bank resolution regime and a common covered bond framework is required. We see the need to clearly determine the precedence or priority of the covered bond framework over the resolution provisions. It is important to avoid that covered bond provisions be eroded by the resolution rules. The cover pool administrator should have the duty and power to register all covered bond holders as creditors towards the insolvency estate. Any legal solution should envisage that the different scenarios involving a transfer of assets (i.e. sale of business, bridge institutions or asset separation) should avoid assets included in a specific cover pool being split.

Moreover, although technically difficult to articulate, bondholders should keep having some rights on the remaining assets (i.e. the dual recourse principle to be calibrated but not suppressed). Practical enhancements could include the imposition of a duty on: (i) the liquidator to co-operate with the manager/special administrator and to have regard to claims of covered bond holders; and (ii) the competent authority to have regard to the claims of covered bond holders in applying resolution tools.

Furthermore, the BRRD specifies that senior unsecured creditors should not be worse off in the case a resolution tool is applied compared to a situation when insolvency procedures are started against the issuer. We note that where a bail-in tool is applied to covered bond holders to the extent that the assets are insufficient to fully compensate the claim of the covered bond holders, covered bond holders may in such a case actually be worse off compared to a situation where insolvency procedures are started against the issuer and they have a dual recourse *pari passu* claim with other senior unsecured creditors against the full remaining estate of the issuer for this particular shortfall.

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2. Should the Framework provide for a cut-off mechanism as suggested in subsection 3.4 of Part III? In particular, should such a cut-off mechanism:

a) Preclude the closure of insolvency or resolution before possible residual claims from the covered bondholders against the issuer or the insolvent estate have been identified and quantified?

b) Set out clear and objective requirements on the valuation of the cover pool and the timing for such valuation?

c) Extinguish the residual claim on the estate or the successor credit institutions after sufficient assets have been segregated for the benefit of covered bond holders at the outset of the resolution or insolvency proceedings?

d) Give specific powers and duties to the resolution authority and, if so, what should those consist in?

a) Preclude the closure of insolvency or resolution before possible residual claims from the covered bondholders against the issuer or the insolvent estate have been identified and quantified?

This is closely related to national insolvency laws and, therefore, difficult to have a harmonized approach to. We think this should be up to national regulations. A dual recourse issue between cover pool and insolvency estate can only arise in covered bond models, where covered bond holders have claims against some other estate than the cover pool. Notwithstanding the national peculiarities, it would be best for covered bond holders if the proceeds of the insolvency estate cannot be fully distributed before all cover assets were liquidated, to see, whether and how much still is needed for the covered bonds.

b) Set out clear and objective requirements on the valuation of the cover pool and the timing for such valuation?

For any "valuation" of the cover pool in comparison to the covered bond volume, the national covered bond law regarding coverage principles should be decisive.

c) Extinguish the residual claim on the estate or the successor credit institutions after sufficient assets have been segregated for the benefit of covered bond holders at the outset of the resolution or insolvency proceedings?

No, if cover assets have long maturities, no clear forecast can be made how they will develop. Therefore, the residual claim against the general insolvency estate should always remain as a last resort, in order to ensure that covered bonds are not treated worse than the senior unsecured of the same issuer.

d) Give specific powers and duties to the resolution authority and, if so, what should those consist in?

No, the resolution authority should not interfere in the covered bond, the cover pool and residual claim. If encumbrance is a concern then each national regulator (or the ECB) can monitor the total quantum of encumbered assets (i.e. the cover pool up to the Additional OC Amount) as a percentage of the balance sheet.

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1. Do you agree with the proposed definitions for "residential" and "commercial loans" as cover assets? Should certain riskier residential or commercial loans (i.e. buy-to-let mortgages; second home loans; loans to real estate developers; etc.) be excluded from the cover pool or permitted subject to stricter criteria?

We advocate a principles-based approach that does not override national legislation. In principle, we believe no category of mortgage loan should be excluded as collateral, but that the issuer should give appropriate disclosure to the investors as per the inclusion of any such assets in the cover pool. Rather than excluding a sub-set of assets (e.g. buy-to-let, second home loans, etc.), the accent should be placed on the level of transparency in the market. Restricting the scope of eligible assets should be left at the discretion of national legislators.

Riskier loans should be allowed in cover pools for the following reasons:

I. Not allowing certain assets that are currently eligible in cover pools will have a detrimental impact on the ability of banks to provide finance to the real economy.
II. Rating agency analysis will capture the impact of “riskier” loans by requiring higher OC and/or lower ratings.
III. Given the differing mortgage markets, defining riskier loans will be very difficult to achieve and the definition will evolve over time.
IV. Excluding certain loans could lead to unintended consequences i.e. excluding certain types of loans that are currently deemed risky could create a concentration of lending in another category of loans that are deemed not risky – this could lead to a bubble in the previously perceived non-risky category.

We agree with the provided definition in subcategory a) of mortgage loans for residential or commercial purposes. Definitions of eligible residential or commercial loans used in the context of covered bonds should be consistent with the definitions of residential and commercial property provided by Art. 124, 125 and 126 CRR. Hence, for the classification by category of asset, the focus must be on the purpose of the asset (housing or commercial purpose) in order to be in line with the approach underlying Art. 124 to 126 CRR.

We do not agree with the EBA recommendation for French guaranteed residential loans as provided in subcategory b) and would recommend its removal.

This recommendation is to ensure the continuous eligibility of the cover pool, even in a scenario of simultaneous defaults of the lending bank, the guarantor and the borrower(s). French issuers are in a position to demonstrate that this recommendation aims to cover a risk which is statistically extremely remote. Furthermore, in general, all the assets of a defaulting borrower constitute the common pledge of its creditors (known as “*droit de gage général*”), except for assets pledged in favour of secured creditors or when provided otherwise by law. Therefore, the mortgage registration procedure gives leeway to the unsecured mortgagor, including the French issuers (in cases, where it is subrogated in the lender’s rights), to obtain by court order preferential access, before any enforceable measures are taken.

Moreover, since in accordance with CRR 129 (1)(e), the loans are free of any mortgage in case of borrowers’ default, the referee in bankruptcy should not have to face any impediment to raise a forced judicial mortgage. Clearly, in such a case, the borrower could face legal sanctions if he/she contracts a loan on the condition that he/she will not take out a mortgage in favour of third parties (without the lender). Indeed, under French law, contracts are presumed to be concluded under the

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implied covenant of good faith.

Consequently, the severe and dissuasive nature of the sanctions incurred, enables the lender to require the forfeiture of term, interest on the account of late payment, severance pay and further damages. The fact that very few borrowers are currently not complying with this contractual commitment, has been proved in a study undertaken by Crédit Logement (a professional guarantor, market leader in France).

2. In relation to mortgage loans:

a) What are your views on the proposed requirements on "perfection of security" and "first ranking mortgage"? Is registration of the security a requirement for perfection in your jurisdiction?

b) Is the enforceability of mortgages in the different Member States equivalent or should there be additional requirements to ensure their equivalence?

c) Are minimum standards for mortgage rights in third countries necessary?

"Perfection of security" is not a category of continental European law. The definition given in Art. 208 no. 2 lit (a) CRR is more appropriate: "*enforceable in all jurisdictions which are relevant … and shall be properly filed on a timely basis*". It is not enough that the mortgage is enforceable against the borrower; it must also give protection against third-parties. At the same time, often the borrower is not the owner of the property encumbered. It must be secured that the mortgage gives a right of enforcement, has a secured ranking against third-parties also in the insolvency of the owner. These requirements may be achieved with registration, but sometimes also earlier via a security right over real property with a clear title from a reliable land register or, as far as the land register does not give evidence and liability for the title, with a clear legal analysis. Among others these criteria contribute to the reliability, enforceability and long-term trust in security rights over real property: no rights with priority in enforcement or insolvency which are not evident from the land register or legal analysis and which cannot be calculated or have a significant amount.

Enforceability of mortgages is different across the EU Member States. Any attempt to harmonise a minimum level in mortgage enforcement procedures would mean a very long and burdensome endeavour. For this would affect fundamental principles of civil law and civil law procedures, land registration, tax, enforcement and insolvency law. The framework should include minimum requirements on the enforceability of mortgages.

"First ranking mortgages" should not become a requirement. The important requirement is the LTV-level and not the ranking. Loans within a defined LTV-limit should be allowed as assets in the cover pool. The purpose of the loan and the ranking of the loan are less important as long as there are sufficient assets in the cover pool, inter alia based on LTV limits.

Regarding national mortgage laws, it is crucial that real estate and enforcement rules are consistent and of high quality. This approach is in line with Art. 208 CRR emphasising the importance of the legal requirements to be applied to the mortgage collateral and of its enforceability.

3. In relation to LTVs:

a) What are your views on the proposals set out in subsection 4.1 of Part III on minimum LTVs?

b) In the case of insured properties, should higher LTV limits be allowed if the insurance cover meets certain requirements and, if so, what should such requirements be? In what

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other cases should higher LTV limits be allowed?

Could loan-to-income requirements be used to replace or complement LTV limits?

c) Should there be an additional average LTV eligibility limit at portfolio level?

d) With the advent of a Binding Technical Standard defining Mortgage Lending Value, is it appropriate to apply this for eligibility in all cover pools across the Union as a prudent measurement?

e) Should LTV limits be used to determine: eligibility (loan in/out) of loans at inception? Eligibility (loan in/out) of loans on an ongoing basis? Should they instead be used to simply determine contribution to coverage? A combination of the above?

a) What are your views on the proposals set out in subsection 4.1 of Part III on minimum LTVs?

We agree that any framework should regulate LTVs. As a general comment, we recommend the introduction of a clear definition of the main component of the LTV which is the value basis of the property value. The denominator of the equation, i.e. market value or mortgage lending value, must be clearly defined. Only with such a definition are LTVs comparable and can LTV limits serve as a risk-related parameter for covered bonds.

Furthermore, we agree that a distinction in LTV limits can be made between residential and commercial loans, as long as the two categories are clearly defined and the handling of loans for mixed-use properties is addressed.

However, we do not support the introduction of LTV limits for the eligibility of individual loans. Applying such "hard" limits, at inception or on an on-going basis would significantly reduce the availability of long-term funding to credit institutions (with knock-on impacts to the supply of credit to the real economy). It would also expose covered bond issuers to very significant liquidity risks (i.e. loans becoming fully ineligible), thereby further exacerbating the impact of an economic downturn. Incidentally, loans with a high LTV cannot be systematically considered as being riskier loans. "Soft" LTV limits (where a loan above a certain LTV will still be eligible for inclusion in the pool and the capital requirement for the loan is included in the cover pool as mandatory OC or the loan will have a discounted value when calculating OC), provided pool collateral is subject to regular revaluation, strike the balance between protecting investors against declining asset prices and not creating liquidity risk for covered pools that result from "hard" limits.

Privilege for any excess over the LTV cap, in the understanding that this refers to LTVs at cover pool level, should be recognised, so that covered bond holders are entitled to that excess on a priority basis in the event of liquidation of the cover pool. There is no need for varying limits in the coverage ratio calculation, other than a global cap on the loan's current balance in the cover pool.

b) In the case of insured properties, should higher LTV limits be allowed if the insurance cover meets certain requirements and, if so, what should such requirements be? In what other cases should higher LTV limits be allowed?

In our view, it is unnecessary to complicate the approach outlined in a) with such measures. The recognition of other instruments would not be compatible with the real estate-based approach of the mortgage covered bond security regime and would result in a dilution of the explanatory power of the LTV limit, thereby reducing the transparency of the covered bond instrument itself. A thorough risk analysis based on the real estate collateral, its loan-to-value ratio, type and location of the property etc. would not be possible anymore because additional "external" risk aspects would have to be

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considered such as corporate risk (insurance company) or the customers' creditworthiness. This would increase the complexity of the cover pool.

Could loan-to-income requirements be used to replace or complement LTV limits?

c) Should there be an additional average LTV eligibility limit at portfolio level?

In line with our responses to a) and e), an additional LTV limit at portfolio level would not be helpful. As the LTV should cover the risk based on the loan amount in relation to the value of the collateral, the fact that a property is financed as part of a portfolio or as a single loan has no influence on the property risk itself. An additional average LTV limit at portfolio level would only make sense if it were set below the LTV limit of each single eligible loan. This would significantly reduce the use of the instrument in practice and its contribution to the European growth agenda.

However, if it were to be applied, it should not be a crude, "hard-wired" number. Flexibility for the competent authority to flex such a portfolio limit would be an important safeguard. Unanticipated consequences in a severe market downturn affecting property prices may not be in the interests of bond holders.

A further alternative could be an obligation for the issuer to regularly publish LTV data through ECBC National Transparency Templates report (cf. stratification tables).

d) With the advent of a Binding Technical Standard defining Mortgage Lending Value, is it appropriate to apply this for eligibility in all cover pools across the Union as a prudent measurement?

The EMF-ECBC is supportive of an EBA Guideline providing principle-based rules for Mortgage Lending Value valuation in order to ensure a consistent understanding and transparency in property valuation for lending purposes. However, it is important to recognise that valuation methodologies rightly differ across the EU as a functionality of property markets and that data availability also varies from one Member State to another. Therefore, according to the market, market value, mortgage lending value or sometimes both are used and the possibility of choosing which value is most appropriate should be maintained.

e) Should LTV limits be used to determine: eligibility (loan in/out) of loans at inception? Eligibility (loan in/out) of loans on an ongoing basis? Should they instead be used to simply determine contribution to coverage? A combination of the above?

The EMF-ECBC supports the measuring of the eligibility of loans on an ongoing basis. The application of maximum LTV parameters to determine the amount of collateral which can contribute to the coverage requirements for programme liabilities is both sensible and well established in most European covered bond frameworks The on-going monitoring of these parameters with revised collateral valuations, together with legislative minimum OC levels, provides the conservative coverage required for bond investors. It is furthermore important that related requirements are in line with the monitoring requirements for capital allocation purposes. Credit institutions must be allowed to use their monitoring tools of property values for both purposes.

One method of implementing LTV limits is on the basis of eligibility of loans at inception which, in combination with mandatory OC in the cover pool in the form of capital requirements for the loans, accounts for the coverage for the investors throughout the lifetime of the loan. In such a model, the ongoing monitoring of LTV determines changes to the mandatory OC, e.g. an increase in LTVs triggers an increase in mandatory OC. Another method of implementing 'Soft' LTV-limits is by only calculating a discounted value as a contribution to coverage, i.e. where a loan above a certain LTV will still be eligible for inclusion in the pool but will have a discounted value when calculating OC.

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The EMF-ECBC is not supportive of LTV determining eligibility of individual loans, otherwise known as 'Hard' LTV limits for the reasons outlined above under a). As also indicated above, 'Soft' LTV, provided pool collateral is subject to regular revaluation, strikes the balance between protecting investors against declining asset prices and not creating liquidity risk for covered pools that result from 'Hard' LTV. LTV limits should not be used to determine in/out eligibility ('Hard' limits) as this is unnecessary and does not reflect individual market characteristics. 'Soft' limits can be applied that ensure only a prudent contribution to coverage is taken into consideration.

4. In relation to the valuation of cover assets:

a) How frequently should the value be updated and in which way (revaluation, update of the initial valuation, and in which way)?

b) What criteria should be applied to (i) the valuer and (ii) the valuation process to ensure that they meet the transparency and independence principles set out in the first and second subparagraphs of Article 229(1) CRR?

a) How frequently should the value be updated and in which way (revaluation, update of the initial valuation, and in which way)?

The monitoring of property values and subsequent revaluation where necessary for the purposes of covered bond funding should be aligned with the requirements of Art. 208(3) of the Capital Requirements Regulation for the purposes of assessing credit risk. Any misalignment of requirements for these two purposes would be extremely burdensome for credit institutions to manage in practice.

Concretely, this means the following:

- Monitoring of the value of the property is necessary on a frequent basis and at least once a year for commercial immovable property, and once every three years for residential real estate. Institutions should carry out more frequent monitoring where the market is subject to significant changes in conditions.
- Institutions may use statistical methods to monitor the value of the property and to identify a property that needs to be revalued.
- The property valuation shall be reviewed when information available to institutions indicates that the value of the property may have declined materially relative to general market prices and that review is carried out by a valuer who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process.
- For loans exceeding EUR 3 million or 5% of the own funds of an institution, the property valuation shall be reviewed by such a valuer at least every three years, even when monitoring does not indicate market changes.

b) What criteria should be applied to (i) the valuer and (ii) the valuation process to ensure that they meet the transparency and independence principles set out in the first and second subparagraphs of Article 229(1) CRR?

As a general remark, the EMF-ECBC believes that any requirements adopted in this respect should be principles-based and respect existing legislation and practices.

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- ***Criteria to be applied to the valuer***

The internal or external valuer, or valuation company, should possess the necessary qualifications, ability and experience to execute a valuation. This is in line with the requirements provided by the CRR and the Mortgage Credit Directive (MCD).

Recital 26 of the MCD points to recognised valuation standards, in particular those developed by the International Valuation Standards Committee (IVSC), the European Group of Valuers' Associations (TEGoVA) or the Royal Institution of Chartered Surveyors (RICS), which ensure that all valuation reports are prepared with appropriate skill and diligence, and that valuers meet certain qualification requirements.

It would be appropriate and sufficient to make a similar reference in any requirements in this respect.

- ***Criteria to be applied to the valuation process***

As a general comment, as specified in the MCD, in relation to the valuation, recognised valuation standards shall be used, taking into account internationally recognised valuation standards.

As far as the valuation process is concerned, it is also vital that the internal or external valuer, or valuation company, is independent from the credit decision process, the cover pool management process and covered bond reporting process. This is a logical extension to the requirement both in the CRR and MCD, both of which are, in our view, sufficiently clear in their current form.

The CRR requirements in this respect were substantiated in an EBA response to a question received in the context of its online Single Rule Book Q&A tool regarding the CRR definition of independence and whether this applies to internal valuers:

"In accordance with Article 208(3)(b) of Regulation (EU) No 575/2013 (1cCRR 1d), the review of an immovable property collateral has to be carried out by a valuer who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process. As long as an employee of the bank meets all the aforementioned conditions, he/she can be considered as an independent valuer for the purposes of Article 229(1)".

5. Should the Framework adopt the definition of "non-performing exposures" as set out in the EBA's draft Implementing Technical Standards on Supervisory Reporting on Forbearance and Non-performing Exposures?

The Consultation Document proposes that all non-performing loans should be completely excluded from the cover pool. This would exclude both loans that are non-performing at the time of issuance and loans that become non-performing afterwards. In theory, this measure can be easily adopted for covered bond models with the underlying assets on the balance sheet of the bank. In this model, they are simply selected for the benefit of bond holders and hence they may be easily replaced by other "healthy" loans.

However, this measure does not seem suitable for both covered bond models ("on-balance sheet", both universal banking systems or specialised banking systems, and "off-balance sheet") as it presents a certain risk in cases of a cessation of loan production or a default of the originating credit institution. In this situation, given the increasing number of non-performing loans, the issuer will not be able to replace them due to the shortage of substitution collateral which, in turn, will provoke a possibility of systemic risk. In specialised banking systems, no loans exist outside of the cover pool per definition and non-performing loans cannot be refinanced by other instruments.

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Furthermore, the obligation of replacement of non-performing assets does not seem to be relevant as the loans are granted on the basis of a risk criterion: the LTV ratio that measures a guarantee amount against a loan amount. Hence, any possible loss is already covered by the guarantee and the obligation of replacement of non-performing loans not only makes the LTV practices inoperable but above all it makes redundant the guarantee system in general as the guarantee will never be used in the benefit of covered bond holders. What is more, the definition of a non-performing loan does not imply a certain loss on it; therefore, there is no reason to launch a replacement procedure as soon as an unpaid amount was stated.

In addition, the exclusion of non-performing loans raises additional specific issues regarding the models with eligible assets being segregated on the issuer's balance sheet from the beginning through a true sale. Indeed, in such a model the issuing credit institution, as a legal credit institution and given its risk management policy, is obliged to make provisions for every loan becoming non-performing. For the purposes of the overcollateralisation ratio, the loans are recorded net of provisions. Naturally, the provisions on non-performing loans are thus reducing the overcollateralization. Consequently, there is no reason to replace the loans concerned.

6. In light of the EBA's prudential concerns in relation to the use of RMBSs and/or CMBSs in cover pools, should the Framework exclude these assets completely from qualifying as cover assets (including, for these purposes, as substitution assets) or should they be allowed only subject to strict criteria and within the 10% limit currently permitted under Article 129 of the CRR? What is the added value and practical uses of RMBS/CMBS as collateral in your jurisdiction/issuer?

Feedback received from market participants provides support for the EBA's prudential concerns on the use of securitisation instruments as cover assets, as it adds legal and operational complexity resulting from the double layer structure provided by covered bonds and the securitisation instrument backing those. Should a default occur, the direct access of the covered bond holder to the underlying collateral would not be possible in cases of RMBS/CMBS in the cover pool, the claim of the creditor being directed against an SPV structure instead of real estate. Strict eligibility criteria would not reduce the complexity issues linked to double layer structures.

The ECBC also supports the EBA's conclusions concerning specific intra-group transfers of CRR-compliant covered bonds as eligible collateral, cf. footnote 106 of the EBA's Report.

At European level, a compromise could consist of recognising High Quality Securitisation Instruments as "substitution" cover within a 10% limit so as to provide issuing institutions with an appropriate instrument for the liquidity management of their cover pools. However, the risk profile of such structures would be different as the underlying assets of an eligible MBS structure would probably not meet the strict eligibility criteria of mortgages for covered bonds, e.g. in terms of LTV limits (60%/80%) etc.

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QUESTIONS – PUBLIC SECTOR LOANS

1. What are your views on the proposals for public sector loans as cover assets set out in subsection 4.1 of Part III?

Any EU-wide harmonisation in these areas could cause severe damages on a national level. The decisive question is what Member States - according to their national law - interpret as being part of the "public sector"?[3] Given the (traditionally developed) national particularities, before discussing the harmonisation of quality requirements, a fundamental analysis should be made on how the national covered bond eligibility criteria for public debt are defined in detail.

The definition proposed by the Consultation Document is much more restrictive than the Article 129 (1)(a) CRR provisions, thus excluding all local government exposures which have been assigned a risk weight of 20%.

Moreover, the proposed title of the section, "public sector loans", seems to indicate that only assets under a loan legal framework could be eligible, while bonds are also answering the proposed requirements. The term "public sector exposures" as defined in the CRR article 129 should be improved upon.

In addition, the proposals appear to change to the definition of a "Third country" and may exclude some of the existing assets that are eligible. We do not consider it is convincing to link the quality of cover assets to the supervisory regime of non-EEA countries, as in linking the quality of the supervisory regime to the eligibility of the asset, it appears the eligibility/quality of an asset could become more subjective. Under the requirements as they stand, it is much more definitive on what is/is not eligible.

We believe that Articles 129 (1)(a) and (b) of CRR give the best harmonised definition of Public sector exposures, bearing in mind that according to the CRR risk weighting rules, there are several steps of qualification with a range of possible outcomes (e.g. risk weight of 0%, 20% or 100%). In terms of covered bond eligibility, there are only black and white solutions: either the claim is fully eligible for the cover pool or it is not eligible. This has to be taken into account when setting quality requirements for covered bond assets on the basis of CRR risk weighting rules.

[3] The Luxembourg Bankers' Association (ABBL) is convinced that the Luxembourg legislation is strong in all key areas considered in the Consultation on Covered Bonds and the Luxembourg Law should therefore be examined closely in the frame of the Consultation. This is not least because a definition of Covered Bonds in accordance with Article 129 CRR (as foreseen in the Commission´s Consultation Paper) would prevent Luxembourg Public Covered Bonds from qualifying as regulated Public Covered Bonds, though they fully meet the requirements of Article 52 (4) of the UCITS Directive.

The ABBL is firmly concerned as regards a definition of Public Sector Loans that is based on Article 129 CRR as this definition is too narrow and leads to an unification of cover pools that is neither required nor appropriate nor in the interest of investors; Even obligations from public sector institutions including public private partnerships (providing a controlling public sector stake) should be cover pool eligible not least because this allows Covered Bond Banks to make a valuable contribution as regards infrastructure finance and the (re-) financing in favour public enterprises. This possibility would be eliminated in case of the introduction of a "CRR based- definition.

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2. What eligibility requirements in terms of validity and enforceability should apply to the guarantee granted by the relevant public sector entity?

A guarantee should grant a clear and enforceable claim of the creditor/beneficiary against the guarantor – to pay directly to him or to pay to the debtor so that he will be able to pay to the creditor.
In general, the guarantee should be legally valid, binding and enforceable against the guarantor. However, difficulties can arise in the context of public sector entities where legal confirmation of the guarantee is sought. We note that, for eligible collateral purposes, the European Central Bank does not require legal confirmation of guarantees where the guarantee is provided by a public sector entity with the right to levy taxes, whereas such confirmation is sought in the context of all other guarantors.

QUESTIONS – OTHER ASSET CLASSES: AIRCRAFT, SHIP AND SME LOANS

1. Should the Framework exclude aircraft, ship and SME loans from cover pools or should they be allowed only subject to strict criteria and limits? If so, what criteria and limits should be applied?

When deciding about the range of collateral types covered by the framework, the ECBC believes that the following criteria should be taken into consideration:

- Investor/market perception
- Technical collateral features facilitating covered bond holder protection
- Existing regulatory treatment of different collateral types

(I) Investor/market perception is essentially focused on covered bonds backed by residential, commercial and public sector assets, accounting for approx. 99% of the outstanding market. From that angle, other collateral types should only be added to the framework if this does not jeopardise the investor perception of covered bonds backed by residential, commercial and public sector assets.

(II) From a covered bond holder protection point of view, cover assets must be enforceable as a security over longer maturities. Moreover, an eligible asset must be suitable to serve as a long-term credit security and be appraisable. In order to be appraisable, the foreseeability of values as well as the definition of LTV limits are crucial characteristics to be complied with by cover assets.

(III) With regards to existing regulatory treatment, we note that CRR Art 129 (g) allows as eligible collateral for covered bonds with preferential risk-weighting loans secured by maritime liens on ships up to the difference between 60% of the value of the pledged ship and the value of any prior maritime liens. A removal of the preferential risk-weighting could have negative consequences for this asset class.

For collateral types currently not benefiting from regulatory privileges, namely SME loans, the ECBC has proposed another funding instrument, the European Secured Note (ESN), which we believe is more suitable for the variety of SME loans across the European Union. For more details on the European Secured Note proposal, please see the ECBC Response to the Green Paper on Building a Capital Markets Union - Analysing the Potential of a Dual Recourse Funding Instrument, European Secured Note (ESN), as a Source of Long-Term Financing for the Real Economy in the EU dated the 12th of May 2015. Link: http://ecbc.hypo.org/Content/Default.asp.

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2. In relation to SME loans, is it possible to identify a category of "prime" SME loans as a potential eligible asset class for cover pools?

Following on from feedback provided by our members and the response provided to Question 1 above, we would be sceptical to propose the widening of the eligibility requirements for this asset class, going beyond mortgages and public sector assets. Additionally, it would be difficult to identify sub-categories of SME loans given the inherent diversity in SMEs in terms of size (ranging from micro-sized enterprises with nine employees or fewer, to medium-sized enterprises with 50 to 249 employees), duration of credit history and leverage levels. That said, SME lending is not considered "sub-prime" lending in general and should not be regarded as such.

QUESTIONS – MIXED POOLS AND LIMITS ON EXPOSURES

1. Do you agree that mixed-asset cover pools should be allowed?

The ECBC is of the view that the use of high quality mixed cover pools should be allowed as a discretionary funding option for lenders and a diversification element for investors. At the same time, the ECBC strongly believes that it is crucial to ensure the highest possible level of transparency combining the compliance with the minimum disclosure requirements provided by European legislation and national law (where applicable) as well as the additional standards set up by the Covered Bond Label at European and global level (such as the Harmonised Transparency Template) to provide investors with high quality, detailed and comparable information on the cover pool, and thus guarantee optimal transparency and clarity on the composition of the mixed pool structure.

2. What are your views on the proposed limits on specific assets and concentration of exposures? Should any other limits or requirements apply?

First of all, guaranteed loans and mortgage loans should not be qualified as "mixed pool". They are part of the same homogenous pool of assets since the loans are financing mainly residential and commercial properties, and only the type of guarantee differs.

In addition, article CRR 129(1)(e) clearly indicates that residential home loans fully guaranteed by an eligible protection provider are currently eligible assets for covered bonds, subject to preferential risk weight treatment, and provided that the conditions of CRR Article 129(1)(e) are met. Consequently, the existing 35% limit on guaranteed loans applicable in France to *société de credit foncier* should be abandoned.

Exposures to credit institutions are an indispensable part of the cover pool's liquidity management. Where there are many smaller cash flows on the asset side and individual large maturities on the liability side, it makes sense to collect the incoming payments in order to have sufficient liquidity to service a covered bond. Particularly in the event of a covered bond issuer's insolvency, a high level of liquidity is crucial. If a covered bond matured immediately after a cover pool administrator was appointed, the administrator would have to be able to generate liquidity at very short notice. The substitute assets are useful in this situation, as mortgage loans cannot be made liquid as readily. Against this background and based on feedback received from our members, covered bond issuers consider the 15% limit should not apply to voluntary overcollateralisation exceeding that required by law. Therefore, article 129(1)(c) should not be interpreted as a prohibition to hold exposures to credit institutions exceeding 15% of the issued covered bonds, but as a requirement to guarantee these covered bonds by at least 85% of eligible assets that are not exposures to credit institutions.

Furthermore, derivatives play an important role for hedging purposes. As derivatives do not represent typical cover assets, no limits should apply to derivatives for hedging purposes (please refer to the

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answers to the question "*Should derivatives entered into in relation to the cover pool be taken into account for the purpose of determining the coverage requirement? If so, what valuation metric should be used for these purposes?*" and the question "*Should the Framework lay down specific requirements on the use of derivatives as suggested in subsection 4.3 of Part III? How should "eligible counterparties" be defined for the purposes of entering into permitted derivatives?*").

Overall, limits regarding different types of land mortgages should not be introduced. A European-wide limit system would not be able to recognise sufficiently the different features of national mortgage and real estate markets. Retail, owner-occupied and rental housing mortgages are often mixed in cover pools with real estate for commercial purposes. Furthermore, the mixed use of real estate is widespread. How a piece of real estate is used is often less important from the view of a covered bond holder than the reliability of mortgage enforcement and the issuer's access to the real estate cash flows; often both are more likely in commercial mortgages than in consumer mortgages.

Limits to assets in third countries should only be introduced for those assets for which insolvency treatment in favour of the covered bonds is not secured.

QUESTIONS – COVERAGE REQUIREMENT

1. Which option should be preferred for the Framework to formulate the coverage requirement and why?

a) A general requirement along the lines of Article 52(4) of the UCITS Directive, amended to include the wording suggested by the EBA;

b) A nominal coverage;

c) A net-present value coverage;

d) A net-present value coverage under stress; or

e) any other or a combination of the some or all of the above.

We would opt to keep a general requirement along the lines of article 52(4) of the UCITS Directive as envisaged by option a).[4] Such an option preserves the current principles-based approach and provides sufficient flexibility for coverage calculations to be assessed in the round, rather than seeking to apply a relatively rigid prescriptive and "one size fits all" approach.

2. If the coverage requirement were formulated as net-present value coverage under stress, should the stress tests be specified in any form in the Framework or ESMA/EBA regulatory guidelines? If so, what specific stress tests should be required and why?

While it could be conceivable to define the areas subject to a stress-test, any technical requirements should be left in the remit of national authorities. Any adopted provisions should be principles-based and not highly prescriptive in terms of the specific tests required.

3. Should derivatives entered into in relation to the cover pool be taken into account for the

[4] ACS Ireland would not support option a) which envisages reformulating "the coverage requirement to include explicit coverage over all liabilities of the covered bond programme as recommended by the EBA, thus including both the liabilities towards bondholders and other parties involved in the process of covered bond issuance and management such as counterparties in derivative contracts, managers, administrators, servicers, trustees, the cover pool monitor and any other relevant parties".

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purpose of determining the coverage requirement? If so, what valuation metric should be used for these purposes?

The only purpose of derivatives in the cover pool is protection against interest rate and/or currency risk, rather than collateralising covered bonds. Therefore, derivatives represent neither "orderly" cover assets nor "substitution" assets. However, depending on market fluctuations of interest and forex rates, the net derivative exposure varies over time. The focus on derivatives should be to ensure all collateral posted is effectively segregated, but clearly identified as collateral posted for the benefit of cover pool derivatives. In addition, the frequency and methodology used to mark-to-market should be given careful consideration – the more frequent the process then the less risk in the cover pool and similarly the mark-to-market methodology should follow market standards for derivatives.

4. What exposures to credit institutions within the pool should be taken into account to determine the coverage requirement and why?

Exposures to credit institutions are an indispensable part of the cover pool's liquidity management. This is especially true in the case of mortgage covered bonds, the original cover assets of which are usually less liquid and frequently highly granular. Where there are many smaller cash flows on the asset side and individual large maturities on the liability side, it makes sense to collect the incoming payments in order to have sufficient liquidity to service a covered bond. For this, besides deposits with or money claims against banks, a covered bond issuer can use government or bank bonds. The vital point is that these substitute assets help to make many, somewhat illiquid assets, liquid. The importance of sufficient liquidity has been demonstrated by problems experienced by a number of open-end real estate funds.

Particularly in the event of a covered bond issuer's insolvency, a high level of liquidity is crucial. If a covered bond matured immediately after a cover pool administrator was appointed, the administrator would have to be able to generate liquidity at very short notice. The substitute assets are useful in this situation, as mortgage loans cannot be made liquid as readily. Therefore, we highly appreciate, that Article 129 CRR allows for exposure to credit institutions as cover assets for covered bonds. However, as exposure to credit institutions does not offer additional security, for instance in the form of property charges, the credit institutions must be of high credit quality. We deem the credit quality requirements of Article 129 CRR as appropriate, if the waiver according to Article 129 CRR is taken into account.

QUESTIONS – OVERCOLLATERALISATION

1. Should a quantitative mandatory minimum OC level be set in the Framework? If so, what should that level be and should it be the same for all types of covered bonds?

We recommend a realistic amount of a minimum legal OC in the single digits, calculated either on the basis of the nominal or net-present values. An example could be the minimum OC as prescribed by the LCR, albeit that this will introduce volatility around key rating triggers, e.g. loss of AA- rating would result in minimum OC rising from 2% to 7%. Another example could be a minimum OC which is calculated based on capital requirements and which represents what is needed to cover for losses in stress scenarios. However, in any case, the level should obviously be dependent on the type of covered bond as well as on how each national legislation implements the different building blocks the Framework is supposed to cover.

2. If a mandatory minimum OC level were set in the Framework, should there be exceptions to the requirement? (for example where the issuer applies a precise "match funding model"

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or where certain targeted liquidity and market risk mitigation measures are used – see subsection 4.3 of Part III)

A full exemption does not seem appropriate and the minimum should apply to all covered bonds. In addition, these innovative structures have never been tested in a stressed environment so it would be inappropriate to give derogation to any minimum OC requirements in the absence of empirical evidence that these bonds will outperform more traditional structures in severe circumstances such as insolvency. Besides that, in match funded models the refinancing/liquidity risk may be lower but credit risk and interest rate risk, for example, may still exist to some extent.

3. Should the Framework set a maximum level of permitted OC? If so, when and at what level?

We do not see any beneficial effects for either covered bond holders or issuers. Setting a maximum level of permitted OC wouldn't be in line with the proposal to allow regulators to set additional individual OC requirements. Moreover, there might be times where appropriate instruments to address risks like interest rate or currency risk are not available anymore, which would automatically lead to higher OC needs. Setting a maximum OC could also increase rating volatility as rating agencies put a high emphasis on OC, especially in periods of stress where banks may be downgraded and, hence, would have to rely more on stable secured funding coming from covered bonds.

There are other, more appropriate, means of mitigating any risks with respect to OC levels. Various general considerations may determine the level of OC within programmes and a rigid approach to introducing a maximum level may interfere with the usual management of these considerations. Asset encumbrance levels are monitored through regular and special supervision, which occurs amongst others in the UK through the supervision of the issuer as a credit institution taking into account its full balance sheet and the supervision of the covered bond programme as a regulated arrangement.

4. Should the Framework provide for the treatment of voluntary OC in the event of insolvency/resolution of the issuer?

With regards to resolution, "voluntary" OC has to be protected. According to Article 34 (g) BRRD, "*no creditor shall incur greater losses than would have been incurred if the institution…had been wound up under normal insolvency proceedings…*". As "voluntary" OC is protected under insolvency procedures and might be needed to redeem covered bonds, "voluntary" OC must be protected in the event of resolution of the issuer, too. Otherwise, the Framework would violate the BRRD.

The Framework should clearly stipulate that all assets which are part of the cover pool (or transferred to an SPV) at the time of the issuer's insolvency or at the time of the appointment of a cover pool administrator can be used to redeem the outstanding covered bonds in full and on time. In addition, one has to keep in mind that assets remaining after covered bond creditors are satisfied and management costs are paid have to be surrendered to the insolvent estate.

QUESTIONS – MARKET AND LIQUIDITY RISKS

1. In your view, are OC levels adequate to mitigate market and liquidity risks in the absence of targeted measures such as those described in subsection 4.3 of Part III?

The main purpose of OC is to cover administration costs and credit risk/unexpected losses. The liquidity risk should mainly be addressed via other instruments such as a liquidity buffer or soft bullet structures. Interest rate risk could be addressed through different tools, for instance derivatives or required stress tests, which have to be passed in order to fulfil the legal coverage requirement. The

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currency risk is of different relevance for the national covered bond systems and therefore the means of its mitigation should also be left at the national level. Other covered bond systems have a pass-through model virtually eliminating asset-liability mismatches and thus eliminating market and liquidity risks.

However, the resulting OC should be adequate to mitigate any remaining market and liquidity risk at least based on the regulator's assumptions.

2. Should the Framework lay down specific requirements on the use of derivatives as suggested in subsection 4.3 of Part III? How should "eligible counterparties" be defined for the purposes of entering into permitted derivatives?

Derivatives are part of the covered bond model destined to manage ALM risks. In fact, it is not possible that assets and liabilities are perfectly matched in terms of interest rates and maturity, and at the same time in terms of currency. Accordingly, the derivatives in the covered bond models are only allowed to be used for hedging/reduction of the interest and currency risks. In this regard, derivatives represent neither "orderly" nor "substitution" assets and shouldn't be limited at all.

Having proposed the prohibition of the intra-group hedging, the Consultation Document does not specify what exactly it is referring to. This could be interpreted either as derivatives between two desks within a single company or derivatives between two companies belonging to the same banking group. Based on market participants' feedback, we can conclude that there is no reason why the intra-group derivatives between distinct legal entities should be prohibited as long as the framework in place provides at least the same management and mitigants of the counterparty risk as for extra-group derivatives.

Therefore, the focus should be on the quality of the management of the counterparty risk, rather than on whether this counterparty belongs to the sponsor group. Supposing that intra-group counterparties are forbidden, the only recourse that will be left for covered bonds is the use of external hedging, which, in turn, implies a serious problem because in this case the market should obviously be able to provide this type of service, which is not necessarily a certainty nowadays. Given the rating constraints applied to derivative counterparties, the number of eligible counterparties is rather small. As a consequence, it provokes a concentration risk on a few counterparties being eligible and willing at the same time.

Nevertheless, requirements for eligible derivatives and eligible counterparts are needed. The most important requirement is that the derivative contract needs to survive the covered bond issuer's insolvency. An eligible counterpart needs to fulfil quality requirements and may be based on external ratings. Only credit institutions and central counterparts should qualify as eligible counterparts. However, a hard rating threshold like credit quality step 1 according to CRR is not suitable as it could force the covered bond issuer to terminate the swap contract and expose the cover pool to interest and/or currency risk. Instead, an adequate collateralisation of claims against counterparts stemming from cover pool derivatives should be required. The cover pool itself is not designed to deliver collateral on a physical basis.

With regards to explicit obligations on issuers to hedge interest rate risk and currency risk in the cover pool, there is confusion amongst market participants as to how to interpret the reference to an "explicit obligation on issuers to hedge". Currently, in some European jurisdictions, interest rate swaps on both asset and liability sides do not exist as such and have been replaced by so-called "natural hedging strategies" reflecting the natural hedge between fixed and floating assets, and liabilities. Only non-euro denominated covered bonds are hedged by cross-currency swaps. The residual interest rate mismatches between the collateral pool and the covered bonds are mitigated by an appropriate collateral management, aiming at covering covered bonds' interest payments in a

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prudent interest rate scenario through a substantial excess spread, and by the programme's overcollateralisation. Additionally, some issuers have implemented interest reserves contingent on rating agencies' downgrades, which would cover any shortfall between interest to be received on cover assets and interest due on covered bonds. Therefore, we advise to refrain from a hedging requirement for all risks as other tools could address these risks as well. In addition, and especially for small covered bond issuers and cover pools, we deem it very difficult to find swap counterparties.

3. What are your views on the potential provisions on the management of cash flow mismatches suggested in subsection 4.3 of Part III? In particular:

a) For issuers, do cash flow mismatches between cover assets and covered bonds arise in your jurisdiction and/or transactions, and, if so, in which way? Are you able to describe a scenario for the timely repayment of the covered bonds? Do you plan for contingencies? Are such scenarios and contingencies disclosed to investors?

b) For investors, do you understand how such cash flow mismatches would be dealt with in practice? Would it be beneficial from your perspective to get systematic information about cash flow mismatches and how these would be managed?

In most covered bond systems, cash flow mismatches are intrinsic. A purpose of covered bonds is to collect smaller assets like residential or commercial loans and refinance them via bonds that usually can be traded in the capital market. In other words, covered bonds make illiquid assets liquid. As a result, cash flows on the asset side are usually much more granular than on the liability side.

Therefore, it is of the utmost importance to be able to manage the risks stemming from this mismatch. A suitable risk management system for the covered bond business must be in place covering *inter alia* liquidity, concentration and operational risk. Provisions for stress tests should be in place, for instance for interest rate and currency volatility.

Stresses on property values could be addressed by strict valuation requirements and a conservative 80% LTV-limit combined with ongoing monitoring and revaluation provisions.

However, while it could be conceivable to define the areas subject to a stress-test, any technical requirements should be left within the remit of national authorities. Real estate and covered bond markets are too diverse as to apply a "one-size-fits-all" technical standard for stress-testing at European level.

Furthermore, detailed rules are needed for the timely appointment of a cover pool administrator being solely responsible for the management of the cover pool in order to avoid friction right after the covered bond issuer's insolvency (please also refer to the answers on segregation of the cover assets and on interaction between cover pool and issuer insolvency/resolution).

The covered bond administrator must possess a variety of instruments and powers in order to manage the cover pool. He should be entitled to make use of staff and material of the covered bond issuer needed for the performance of his task. With regard to liquidity risk he should be equipped with tools to bridge short-term liquidity gaps, like disposing assets, procuring liquid funds or postponing the redemption of covered bonds for some time (soft bullets). The access to central bank liquidity could be a refinancing tool as well, while an institutionalised access to central bank funding needs to be discussed. For all these measures the status as a credit institution is essential.

The active management of the cover pool after the issuer's insolvency is crucial. It is very unlikely that the cover pool administrator will just "wait and see". Rather, he and the staff will proactively use its discretion to react to the individual situation.

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Nevertheless, as long as the covered bond issuer is solvent it needs to address the relevant risks mentioned above and to mitigate the liquidity risk through adequate risk management and features like liquidity buffer and/or soft bullet structures.

4. On the EBA's liquidity buffer recommendation:

a) Should covered bond issuers hold a "liquidity buffer" to mitigate liquidity risk in the cover pool and, if so, in what circumstances?

b) Should the buffer be calibrated to cover the cumulative net out-flows of the covered bond programme over a certain time frame? What length of time should be used as a time frame for calibration purposes?

c) What eligibility criteria should liquid/substitution assets meet to qualify for the purposes of this buffer?

First of all, it is worth noting that in almost all covered bond systems cash flow mismatches are inherent and thus liquidity risk arises. Therefore, there is the need for provisions addressing the liquidity risk of cover pools. The existence of a liquidity buffer is certainly one appropriate tool. However, as other options are available (e.g. soft bullet or pass through structures), the decision on how to address liquidity risk should be left to national covered bond laws.

In addition, it is important to ensure that covered bond issuers do not have to hold a liquidity buffer twice: one required through the LCR provisions and the other one based on covered bond legislation. If covered bond issuers have to hold a liquidity buffer for covered bonds, it should be deducted from the LCR liquidity buffer.

QUESTIONS – TRANSPARENCY REQUIREMENTS

1. What are your views on the current disclosure requirements set out in Article 129(7) of the CRR? If more detailed requirements were preferred, do you agree that issuers should disclose data on the credit, market and liquidity risk characteristics to a more granular level? If so, what data and to what level of granularity?

The CRR 129(7) and the Industry reports more typically via issuers own reporting, the National Transparency Templates (NTTs) and rating agencies. 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.

The implementation of the HTT will improve transparency through harmonisation, making it easier to process and analyse covered bond data across different issuers/regions. We also welcome the fact that reporting requirements are quarterly, which are in line with minimum market requirements.

The ECBC believes that current disclosure requirements are sufficiently comprehensive and with the proposed HTT, market participants report that there is no need for further requirements in relation to additional data disclosures. The fact that these initiatives related to transparency have been industry-led demonstrates the commitment of the covered bond issuer community to ensure that investors continue to have access to relevant and up-to-date information.

As a matter of background information, the Harmonised Transparency Template is built upon

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"Three Pillars of Transparency" which provide for a high level of transparency and comparability of data, and definitions:

- Liability Transparency - Statistics ISIN-by-ISIN, and issuer-by-issuer for every covered bond with a direct link to its cover assets. Investors have at their disposal a comparable set of data around the globe.
- Regulatory Transparency - A unique centralised database of the major covered bond markets globally, with summaries of legal frameworks and legislative texts (in English).
- Asset Transparency - Asset disclosure comparable at a national level and, from 2016, global level via the National/Harmonised Transparency Templates.

2. Should issuers disclose information on the counterparties involved in a covered bond programme and, if so, what type of information?

With respect to the counterparties, an approach disclosing the minimum required information is preferred. In the disclosures to investors, issuers should be invited, on a voluntary basis, to include the relevant counterparties involved in the covered bond programme as well as the applicable minimum credit ratings required for the relevant counterparties. However, this information should only be disclosed if the counterparties are of very high importance for the programme. If, for instance, a single cross-currency swap mitigates the entire currency risk, information on the swap counterparty is meaningful. If there are a few swaps with several derivative counterparties addressing minor interest rate and/or currency risk, information on the counterparties involved in the covered bond programme is not necessary. The same applies to other counterparties involved in covered bond structures (bank accounts, etc.). In any case, issuers should not be forced to breach laws regarding the protection of confidentiality.

3. How frequently should covered bond issuers be required to make disclosures to investors?

While a cover pool is dynamic, its composition does not change often and quickly. Thus, a quarterly disclosure is desirable and meets market/investor needs.

4. What are your views on the existing and prospective investor reporting templates prepared by industry bodies and referred to in section 5 of Part III? Would these templates:

a) Be granular enough to enable investors to carry out a comprehensive risk analysis as recommended by the EBA? and

b) Be sufficient without further legislative backing to deliver enhanced and consistent disclosure in European covered bond markets?

The prospective investor reporting templates prepared by industry bodies and referred to in section 5 of Part III could be considered sufficient to carry out comprehensive risk analysis without further legislative backing.

For example, the ECBC has developed the common Harmonised Transparency Template (HTT) which aims to provide more transparency and ease comparability by providing the same qualitative and quantitative data across the various countries. Market participants have informed the ECBC that the HTT is sufficiently detailed to enable investors to carry out comprehensive risk analysis, in accordance with the EBA recommendations, due to the fact that the HTT provides cross-

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jurisdictional information. Due to the overwhelmingly positive feedback, the HTT initiative is seen as an important step in delivering enhanced and consistent disclosure in relation to European covered bond markets.

5. Should detailed disclosure requirements apply to all European covered bonds or only to those that would fall within the scope of the Prospectus regime?

A considerable part of the investor base prefers to invest in covered bonds issued in the form of private placements, which are not listed. As these bonds of a covered bond issuer are backed by the same cover pool as benchmark covered bonds from the issuer, disclosure requirements should apply to all European covered bonds. Only then will a comprehensive overview of the European covered bond market be possible. Nevertheless, the scope of disclosure must be balanced between precise requirements at European level and sufficient flexibility for national covered bond regimes.

6. Should the same level of disclosure standards apply pre- and post-insolvency/resolution of the issuer (except for those reporting items referring to the issuer itself)?

As investors may still hold the covered bonds after the issuer's insolvency, they need to receive information on the quality of the cover assets. However, more information is not needed. If a covered bond issuer became insolvent, the investor would have to decide either to stick to its investment or to sell the covered bonds. This decision would be driven by factors other than loan-level information on the cover pool, for instance by rating constraints.

An obligation to switch to a disclosure of loan-level-data after the issuer's insolvency could damage the cover pool because of the costs which may be provoked by huge expenditures in technical equipment and human resources to fulfil this duty. 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.

Therefore, the same level of disclosure standards should apply pre- and post-insolvency/resolution of the issuer.

7. In relation to covered bonds issued in third countries, what minimum level of disclosure should apply for European credit institutions investing in those instruments to benefit from preferential risk weights?

If covered bonds issued in third countries should qualify for preferential risk weights, they should fulfil the same transparency requirements as European covered bonds. In particular, countries outside of the EU are eligible to apply for the Covered Bond Label and, therefore, they are obliged to comply with the same requirements applicable to EU issuers, including the minimum disclosure requirements as outlined in Article 129(7) of the Capital Requirements Regulation (CRR).

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