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EUROPEAN MORTGAGE FEDERATION
EUROPEAN COVERED BOND COUNCIL

ECBC GLOBAL ISSUES WORKING GROUP

EMF-ECBC
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SECTION I. INTRODUCTION

By the **EMF-ECBC Secretariat**, **Colin YS Chen**, DBS Bank & Chairman of the ECBC Global Issues Working Group and **Christopher Walsh**, Clifford Chance

A QUICK GLANCE AT THE GLOBAL PICTURE

For over 200 years, covered bonds have proven to be an efficient debt instrument enabling banks to mobilise private sector means and capital towards long-term investment with a wide public benefit and, in particular, real estate loans and public sector debt. During the years of market turmoil, covered bonds demonstrated a strong degree of resilience. Throughout the crisis, they played a pivotal role in bank wholesale funding, providing lenders with a cost-effective and reliable long-term funding instrument for mortgage and public-sector loans. The Industry continues to build on the lessons learnt from the financial crisis while maintaining a focus on the essential features and qualities that have made the asset class such a success story.

The ongoing EU Capital Markets Union (CMU) and Basel IV discussions are now, more than ever, opening new frontiers for covered bonds at both EU and international levels. The covered bond financing instrument is being exposed to critical evolutions which can bring about both new opportunities but also new risks. The covered bond market is faced with new regulatory, policy and supervisory developments, while market innovation, the continuous process of globalisation and national implementation of the covered bond concept will also leave their mark on the asset class.

In view of these considerations, the covered bond industry firmly believes that, in any evolution, there is a clear need to preserve the key nature of the product as a crisis management tool rooted in robust qualitative and macroprudential characteristics which are the basis for ensuring a regulatory recognition at global level.

ROLE OF THE ECBC GLOBAL ISSUES WORKING GROUP

In order to develop synergies between traditional covered bond markets and new and emerging covered bond markets, as the joining of forces should allow the development of a more level-playing field for all at a global level, the European Covered Bond Council (ECBC) established its ECBC Global Issues Working Group (GIWG) in 2015. So far, the work undertaken by the GIWG has been instrumental in ensuring the proper recognition of the macro-prudential value of the covered bond asset class while securing an appropriate, homogenous and cross-border regulatory treatment by different jurisdictions at a global level.

To this end, ECBC members have identified an import role to be played by the Working Group as a discussion forum for exchanging market best practices and as an educational platform for issuers and global investor communities. The overarching aim of the Working Group is to enhance transparency and convergence, and to ensure that there is a progressive common understanding of the covered bonds concept, with similar market solutions and infrastructures, and more important comparable regulatory treatments. For this reason, the Working Group has been closely looking into the following topics which were initially allocated to the following topical Work Streams within the Group:

- **Work Stream 1 –** "Identification of the guiding fundamental principles of covered bonds at global level" with Coordinator Maureen Schuller, ING Bank
- **Work Stream 2 –** "Ensuring a principle-based convergence and common regulatory treatment and developing a matrix of regulations that are at issue" with Coordinator Sascha Kullig, vdp
- **Work Stream 3 –** "Mapping of covered bond market best practices as well as critical elements and challenges" with Coordinator Christopher Walsh, Clifford Chance
- **Work Stream 4 –** "Mapping of investors' appetite for covered bonds" with Coordinator Franz Rudolf, UniCredit Bank
- **Work Stream 5 –** "Coordination of activities at Basel Committee level" with Coordinator Peter Jayaswal, Finance Denmark
- **Work Stream 6 –** "Coordination of activities at EU level to extend the UCITS definition to include non-EEA countries" with Coordinator Lily Schum, Canada Mortgage and Housing Corporation (CMHC)

POLICY DEVELOPMENTS

Looking back over the past months, it is clear that the covered bond space has been fundamentally impacted by major waves of monetary policy, supervisory review and regulatory change which is having a significant impact on the long-term financing and housing finance sectors.

At EU level, for example, an ambitious initiative called the Capital Markets Union (CMU) that will ensure the capability of the Industry to support the growth agenda and provide long-term financing to the real economy has identified the following areas of reflection:

- Striking the right balance, in terms of a level playing field, between international banks operating in the European Union and European actors operating both internationally and domestically.
- Carefully examining the market impact of several key regulatory developments and trying to secure the European banking pillars in the Basel Committee debates: i.e. Net Stable Funding Ratio (NSFR), risk weighting, capital floors framework, leverage ratio.
- The role of European lenders in the framework of housing and small and medium sized enterprise (SME) financing, and lending to the real economy is becoming increasingly multi-faceted with the introduction of the Capital Markets Union.
- The role of covered bonds and the Industry's firm commitment to achieve a higher level of harmonisation, in line with EU objectives and market preferences.
- Developing energy efficient mortgages and green covered bonds for the benefit of EU citizens and the environment.

Further to this, in June 2017, the European Commission published its Mid-term CMU Review, and announced, amongst other planned actions, the adoption in Q1 2018 of a legislative proposal for an EU-framework for covered bonds. This follows on from the closing of a Commission's public consultation on covered bonds in January 2016, to which the ECBC has replied in detail. Supervisors' views also converged in advocating legislative action at EU level, as evidenced by the European Banking Authority's Report on Covered Bonds from December 2016. The European Central Bank (ECB) also supported the harmonisation of covered bonds and the European Parliament presented an Own-Initiative Report on the covered bonds file in June 2017. The ECBC remains committed in liaising with the EU institutions on a regular basis regarding this key policy file with the invaluable support of the ECBC Task Force on the EU Framework for Covered Bonds.

MARKET DEVELOPMENTS

Covered bonds are at the heart of the European financial tradition, having played a central role in funding strategies for the last two centuries. The strategic importance of covered bonds as a long-term funding tool is now recognised at a global level. Outside Europe, Australia, Canada, New Zealand, Singapore and South Korea have already implemented covered bond legislation in recent years. Major jurisdictions including Brazil, Chile, India, Japan, Mexico, Morocco, Panama, Peru, South Africa and the United States, are either in the process of adopting covered bond legislation or are investigating the introduction of covered bonds.

In 2016, the outstanding covered bond market remained virtually stable at around EUR 2.5 tn with respect to the previous year, while issuance figures contracted by 10% with respect to 2015 reaching around EUR 485 bn. The most common collateral used for covered bonds is a mortgage which accounts for EUR 2.1 tn or nearly 85% of the outstanding market and this share has been constantly increasing since in 2003, when the figure was at 40%. The major players remain Denmark, France, Germany and Spain, which account for 53% of the outstanding in the market. One interesting development in 2016 was that Denmark surpassed Germany for the first time as the largest covered bond market in Europe. On the other side, outstanding covered bonds from non-EU countries accounted for more than 17% of the total in 2016, a 1.7 pps increase with respect to previous year.

The firm commitment to contribute to European efforts to enhance financial stability and transparency led the covered bond industry to launch a quality Covered Bond Label in 2012. The Covered Bond Label was developed by the European issuer community under the leadership of the ECBC and in close cooperation with investors and regulators, and in consultation with all major stakeholders such as the European Commission and the European Central Bank. The Covered Bond Label and its transparency platform (www.coveredbondlabel.com) have been operational since January 2013, providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. As of the end of Q1 2018, 116 labels have been granted to 100 issuers from 18 countries, covering over EUR 1.5 trillion of covered bonds outstanding, where 4.800 covered bonds include information on the Liquidity Coverage Requirement (LCR) maturity structures, regulatory treatment, etc.

In this context, covered bond issuers from these 18 different jurisdictions have come together to develop a Harmonised Transparency Template (HTT). Since 2016, this has been providing cover pool information in a harmonised format, which allows for both the recognition of national specificities, with the National Transparency Tabs, and the comparability of information required to facilitate investors' due diligence.

The critical mass achieved by this initiative (c. 60% of covered bonds outstanding globally hold the Label) is a clear sign that the Industry recognises the need to respond to the requirements of new classes of investors by providing higher levels of transparency to aid investment decisions. Equally, it is important to highlight the progress that has been made in recent years in terms of collating and distributing relevant macro-level information on the covered bond sector.

LOOKING AHEAD

The Industry has demonstrated that through market initiatives such as the Covered Bond Label and the European Secured Note (ESN) instrument, developed by the market experts of the ECBC Long-Term Financing Task Force (now renamed the ECBC ESN Task Force), it is possible to build, from the bottom-up, proposals based on market consensus in order to initiate pan-European solutions which enhance transparency, comparability, convergence of markets and best practices. Taking stock of where we have come from, where we are now and where we are heading, it is clear that the market and the environment in which it operates is constantly evolving and as such the work of the ECBC and its Global Issues Working Group is always in progress. This provides us with an ongoing challenge and we believe that the ECBC initiatives underway will strengthen the asset class and facilitate the convergence of market and supervisory best practices. We are ready to support the creation of a common regulatory framework for covered bonds which is fit for purpose and enables the market to flourish further to the benefit of all, to help build the CMU at EU level and do everything we can to support the covered bonds asset class at international level.

SECTION II. MAPPING

The Current State of Play and Outlook for Covered Bonds outside the European Economic Area

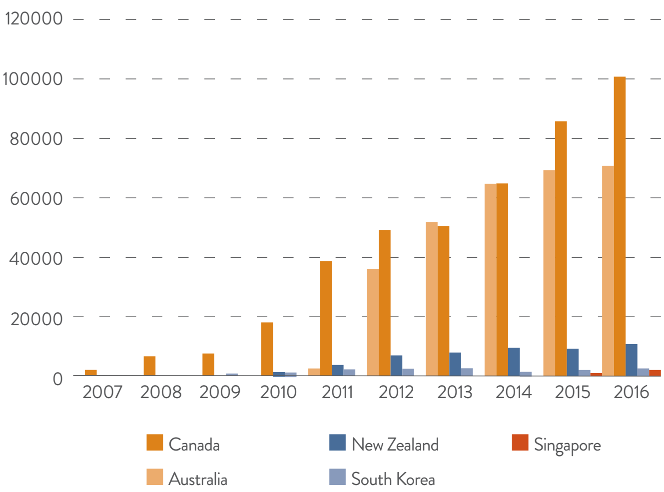
By **Antonio Farina**, S&P Global Ratings, **Filipe Pontual**, ABECIP, **Lily Shum**, Canada Mortgage and Housing Corporation (CMHC) and **Colin YS Chen**, DBS Bank & Chairman of the ECBC Global Issues Working Group

Covered bonds represent a €2.5 trillion global asset class. Initially dominated by European issuers, the product is becoming increasingly relevant in many other markets, such as Australia, Canada, Singapore, and South Korea.

The global financial crisis proved that covered bonds can be a resilient source of funding in times of wider market turmoil. Even in the European countries most affected by the crisis, such as Italy and Spain, banks were able to tap the covered bond market despite other sources of wholesale funding evaporating.

Issuers and regulators outside the traditional European markets duly noted banks' ability to issue covered bonds in time of stress, and expedited the approval or the amendment of legislation governing the issuance of covered bonds. Covered bond issuance picked up quickly in most of these countries once the dedicated legislation was approved.

FIGURE 1 | OUTSTANDING COVERED BONDS OUTSIDE EUROPE, EUR M



Source: EMF-ECBC

It is believed that market conditions will remain supportive for covered bonds in new jurisdictions in the next few years, despite the diminishing monetary support from central banks. Moreover, an expected increase in mortgage lending will drive bond supply by increasing lenders' need for wholesale funding and the availability of eligible collateral. Finally, the legislative and regulatory environment remains favorable to covered bonds.

Hereby is presented an overview of the major non-EEA covered bond markets.

BOX 1 | TURKISH MARKET

TURKEY

The Capital Markets Board of Turkey issued a covered bonds communiqué in January 2014. This repealed two earlier communiqués on assets and mortgage covered bonds, and aimed to boost interest in structured capital markets products. In September 2014, the Capital Markets Board amended the January Communiqué to clarify certain aspects, such as the treatment of derivative instruments and required overcollateralisation ratios, and enable the issuance of Turkish covered bonds.

The Turkish framework contemplates on-balance-sheet issuances by eligible issuers, such as banks, of covered bonds that may be backed by a variety of assets including mortgage loans, consumer loans, financial leases, or factoring receivables. The basic issuance structure under the Communiqué calls for the issuer to segregate a pool of assets, registered in a cover registry, and set aside to service and repay the covered bond creditors, who also have recourse on the other assets of the issuer on an unsecured basis in case of default (the dual recourse principle). Among other things, the Communiqué allows derivative instruments to be included in the asset pool to mitigate the risk exposures on issuances. It also enhances the underlying asset ratio (to 15% for consumer or mortgage loans, for example). The Communiqué also regulates the use of cash flows collected from the pool assets and provides for a third party – the cover monitor – to control the cover pool and the issuer's compliance with its obligations.

Turkey has generally low household and residential mortgage debt, and it is expected to have sustained loan growth. This will increase the pool of assets that issuers could use as collateral for covered bonds. However, market volatility and political uncertainty has slowed down the development of a covered bond market. Despite several Turkish banks establishing covered bond programs after the revision of the legal framework, so far only Turkiye Vakiflar Bankasi TAO (Vakifbank) has issued euro-denominated mortgage-backed covered bond benchmarks, in April 2016. Additionally, in 2017, Vakifbank also placed the first Turkish lira-denominated covered bond away from development banks, which has opened the market for privately placed covered bonds in local currency. Other issuers have placed their issuances with supranationals and development agencies that can invest in bonds denominated in Turkish lira.

NORTH AMERICA

Canada represents one of the most successful covered bond markets outside Europe, with nearly 10% of the entire mortgage market funded by covered bonds. While Canadian banks issue opportunistically in a number of currencies to build a globally diversified funding platform, issuances denominated in Euros represented just over half of total bonds outstanding (please see Box 2 below).

Covered bonds proved less successful in the US. No covered bond legislation has been passed yet despite several attempts in the post-crisis period. Moreover, the previously issued structured covered bonds have now matured and there are currently no outstanding US covered bonds. As long as government-sponsored enterprises such as Fannie Mae and Freddie Mac guarantee the majority of all the new mortgages, there will be little appetite for market based alternatives such as covered bonds.

BOX 2 | CANADIAN MARKET BY LILY SHUM, CANADA MORTGAGE AND HOUSING CORPORATION (CMHC)

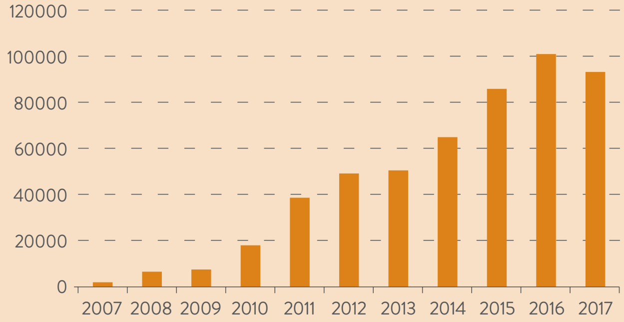
CANADA

From 2007 until 2012, Canadian covered bonds were issued pursuant to a contractual framework. In 2012 Canada implemented legislation that gives covered bond investors statutory protection. Canada Mortgage and Housing Corporation ("CMHC") is responsible for the administration of the legal framework in Canada and registers issuers and programmes, maintains the issuer registry, and develops and updates the Canadian Registered Covered Bond Programs Guide ("CMHC Guide") which specifies the framework requirements. Currently there are 7 registered covered bond issuers. Through the CMHC Guide and continuous enhancements based on international best practices, CMHC plays an important role in ensuring that a robust, globally recognised legal framework is in place.

Growth of Covered Bond Issuances

Since the first covered bond issued by Royal Bank of Canada in 2007, outstanding issuances have grown steadily – please see Figure 2 below. Further growth in issuances followed after the passage of a dedicated covered bond legislation that established a statutory covered bond regime in Canada. As a result, record issuances occurred in 2015 and 2016. This rapid growth over the last few years has fundamentally shifted the Canadian banks' wholesale term funding profile. In 2013, 10% of the banks' wholesale term funding was done through covered bonds. In 2016, covered bonds have accounted for 35% of total term funding[1]. Covered bond issuances, however, must not make up more than 4% of the issuer's total assets.

FIGURE 2 | COVERED BONDS OUTSTANDING FROM CANADIAN ISSUERS, 2007 - 2017, EUR M



Source: EMF-ECBC

[1] RBC Capital Markets.

With a large overseas market, covered bond issuances are largely targeted outside of Canada to broaden the sources of funding geographically. As a nascent domestic market, the Canadian dollar-denominated covered bond market has also emerged, with issuances to date from Royal bank of Canada, Toronto Dominion bank and Bank of Montreal. While 2017 was a much more muted year in issuances, looking forward, covered bonds remain a strategic source of funding for Canadian issuers, while the Canadian bail-in regime enters into the regulatory landscape[2].

Globalisation, Cross-boarder Issuances and Beyond

Canadian issuers remain key participants in international covered bond markets, issuing opportunistically in CAD$, EUR€, USD$, GPB£, CHF and AUD$ markets to build a globally diversified funding platform. As of the end of 2017, issuances denominated in Euros represented 54% of outstanding issuances. The US investor base continues to provide important diversification.

CENTRAL AND SOUTH AMERICA

Covered bonds in this region have a short and limited track record. Panama was the first country to see a covered bond issuance in October 2012. Panama does not have a specific legal framework for covered bonds, which are based on contractual agreements. Chile is the other only covered bond market in the region, with a limited, locally distributed covered bond issuance.

The lack of a dedicated legal framework is probably one of the main reasons for the lack of covered bond issuance in the Latin America. Things may change thanks to legislative developments in Brazil). If covered bonds prove successful in Brazil, we may see other countries in the region follow its lead, such as Argentina, Peru, Mexico, or Colombia.

BOX 3 | BRAZILIAN MARKET BY FILIPE PONTUAL, ABECIP

In January 2015 Brazil enacted Law No. 13,097 which outlined the main framework for Brazilian covered bonds (*Letra Imobiliária Garantida- LIGs*). In August 2017, the Brazilian National Monetary Council approved the secondary legislation that complemented the primary legislation and define the operational details for the product.

Main Characteristics of the Brazilian Covered Bonds (or LIG – the local acronym for Real Estate Guaranteed Notes):

- Debt instrument issued by financial institutions.
- Asset Pool segregation within the issuers balance sheet in favor of the covered bond holders guaranteed in the law, including precedence over fiscal and labor demands.
- Demands a fiduciary agent that will follow-up on the asset pool quality and represent the notes holders' interests in case of issuer´s default.
- Minimum overcollateralisation of 5%.
- The Notes and the assets within the asset pool must be deposited/registered with and Central Depositary agent authorised by the Brazilian Central Bank.
- Brazilian Central Bank will authorise the LIG programmes.
- Delegates to the National Monetary Council ("CMN") and the Brazilian Central Bank the issuance of secondary regulation.
- CMN Resolution establishes Asset Pool stress test and minimum liquidity rules.
- Issuers can choose if their programme will be hard bullet, soft bullet or CPT.

The national market is awaiting some further regulation to be issued by the Brazilian Central Bank in the next months.

[2] In conjunction with OSFI's release of the draft guideline on TLAC, the Department of Finance introduced draft regulations under the Canada Deposit Insurance Corporation (CDIC) Act and the Bank Act, which sets out the details of the bail-in framework for Canada's 6 D-SIBs.

AUSTRALIA AND NEW ZEALAND

Australia is the second biggest covered bond market outside Europe, and New Zealand is the third. Australia amended its Banking Act in 2011 to permit the issuance of covered bonds, while New Zealand approved its dedicated covered bond legislation in 2013. Covered bond issuance is constrained by asset encumbrance limits at 8% in Australia and 10% in New Zealand. Banks issue in a number of currency, with euro-denominated issuance constituting 40% of the total in Australia and 84% of the total in New Zealand.

ASIA

South Korea and Singapore have made great advances in establishing legislative frameworks and launching covered bond programmes. As these countries have ample liquidity, their primary motivation in establishing covered bond capabilities was to access to a strategic risk management tool rather than funding.

Covered bonds in South Korea have been issued through one of the following legislations: the ABS Act, the Covered Bond Act, which came into effect on April 15, 2014, and the Korea Housing Finance Corp. (KHFC) Act. There are currently two active covered bond issuers: Kookmin Bank and the Korea Housing Finance Corporation. For South Korean banks, customer deposits remain the main funding source. Nonetheless, we expect covered bond issuance from South Korean banks to be limited and opportunistic, based on market conditions and encumbrance limits but also the structural makeup of the South Korean market.

The regulatory framework for the issuance of covered bonds by banks incorporated in Singapore was established on Dec. 31, 2013, and refined on June 4, 2015, through the Monetary Authority of Singapore (MAS)'s Notice 648 (see Box 4).

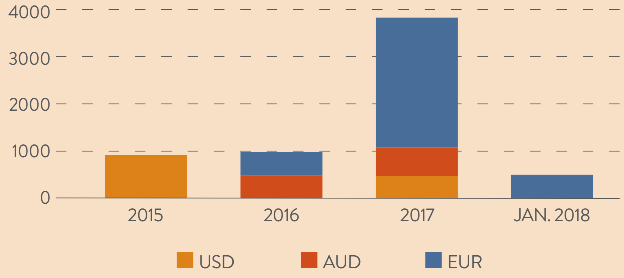
Since the legislative framework was set in place, we have observed a stable flow of covered bonds as issuers seek to maintain and manage their programs. The three domestic major banks have already set up their programs, and a few larger foreign banks also have well-entrenched and stable market share, so more covered bond programs may be set up in the near future. However, the overall supply of covered bonds from Singapore will likely be limited because banks in Singapore are mostly funded by depositors. Moreover, the regulatory limit for cover pool assets--they may amount to no more than 4% of the issuer's total assets--could also subdue the issuance of covered bonds.

BOX 4 | SINGAPOREAN MARKET BY COLIN YS CHEN, DBS BANK & CHAIRMAN OF THE ECBC GLOBAL ISSUES WORKING GROUP

SINGAPORE

Covered bonds as a funding tool for banks, came into existence in Singapore after revisions to the final covered bond legislation, MAS Notice 648, which was introduced in 2014. DBS Bank Ltd performed the country's inaugural covered bond issuance. Since then, the nascent market has grown to include OCBC and UOB as issuers, and the local market cumulatively issued the equivalent of EUR 6,229m as at 31 Jan 2018 (please see Figure 3 below). As the market continues to grow, foreign banks incorporated in Singapore are also considering setting up covered bond programs here to tap on demand.

FIGURE 3 | COVERED BONDS OUTSTANDING FROM SINGAPOREAN ISSUERS 2015 – JAN 2018, EUR M



Singaporean covered bonds rely on structural arrangements to provide security over the cover pool. The covered bond market is regulated by MAS Notice 648, which stipulates requirements on issuers (financial institutions incorporated in Singapore), cover pool assets (residential mortgages), asset encumbrance limit (4%) and over-collateralisation (103%), among other things.

So far, Singaporean banks have issued across a mix of currencies (predominantly EUR and USD) according to each institution's funding requirements. This is expected to continue in response to banks' continued local and regional expansion. Singapore is fully supportive of the global harmonisation efforts, with all Singapore issuers being ECBC Label holders and adhering to global best practices.

To the Future, and Beyond

The covered bond market in Singapore has been on an upward trend since the first issuance in 2015. Future issuance pipeline is strong, with banks indicating commitment to a regular presence in the market for benefits including market access maintenance, investor-base diversification and funding diversification.

Further, market participants engage with each other and the regulator through the Association of Banks Singapore (ABS) Standing Committee on Covered Bonds. This committee represents the commitment from industry and highlights the support from / collaboration with the local authorities that will mark the next phase of growth for the Singapore covered bond market.

Customer deposits predominantly fund banks in India currently, but issuers and regulators are considering alternative sources of wholesale funding. While the structured finance market is growing rapidly, it has also so far been domestic and rupee-denominated. Covered bonds may have the potential to further facilitate the development of the Indian capital market and provide an additional tool to attract external funding for financial institutions. Similar to other Commonwealth countries such as Australia and the U.K., India does not have specific legislation governing securitisation. Rather, the legal framework for India's securitisation market is based on existing trust, contract, and property law, and a series of guidelines issued by the Reserve Bank of India (RBI.) We believe that structured covered bonds may be issued without European-style special covered bond legislation, but regulators' guidance is likely to be required. Key clarifications required will include whether the issuance of covered bonds is permitted under Indian legislation generally, whether existing securitisation guidelines can be applied to covered bonds, how asset segregation can be achieved, the treatment of assets in an issuer insolvency scenario, and whether there are any challenges from a tax perspective, including stamp duty and withholding tax.

AFRICA

Morocco was the first country in the region to release draft covered bond legislation. However, it has not yet approved the final law, which is a testament to the difficulties that can be encountered in the legislative process.

South Africa has historically ruled out covered bonds because of concerns about their seniority over depositors. In 2014-2015, these regulatory concerns seemed to diminish, thanks to a discussion regarding resolution regimes, and specifically, the anticipated introduction of retail depositor guarantees.

However, domestic investors – who provide a considerable amount of domestic bank funding – remain resistant to the idea of a covered bonds framework. This is due to investors' concerns about the potential pressure on the pricing of their senior unsecured debt, the losses if an issuer becomes insolvent, and what could happen to the ratings on this debt. As a result, we don't expect any covered bond market development in South Africa in the near future.

SECTION III. HARMONISATION AND GLOBAL BEST PRACTICES
Identifying Fundamental Principles of Covered Bonds

By **Sascha Kullig**, vdp and **Maureen Schuller**, ING Bank

Covered bonds are meanwhile widely used around the globe, but their regulatory treatment varies. In order to achieve their global convergence, the Global Issues Working Group (GIWG) of the ECBC aims to develop fundamental principles of covered bonds on a global scale. A common understanding of such fundamental principles could also support countries that consider introducing a covered bond framework.

THE REGULATORY TREATMENT OF COVERED BONDS ON A GLOBAL SCALE – ON DIFFERENT TRACKS

With this purpose, the GIWG conducted an analysis of the current requirements covered bonds have to meet globally in order to receive preferential regulatory treatment. The focus was on preferential risk weightings for banks and insurance companies, the qualification as liquid assets according to the LCR, the treatment within the NSFR framework, the exemption from Bail-In, exposure limits, investment limits and the eligibility for central bank liquidity.

The feedback received from the Eurozone and on Canada, Denmark, South Korea, Sweden and Turkey revealed that covered bonds are recognised as liquid assets according to the LCR in all countries, albeit to a different extent. However, such consistent preferential treatment is rather the exception than the rule.

Differences exist, for instance, with regard to risk weighting, where outside Europe hardly any preferential treatment of covered bonds exists in the countries we were looking at, neither for banks nor for insurance companies. The preferential treatment in central bank funding seems to be a European speciality, too.

Apart from that, the survey shows that the requirements for a preferential treatment of covered bonds are not always very detailed. Instead, it is often referred to Article 52 (4) of the UCITS-Directive, which does not require much detail. In non-European countries the relevant laws or regulations often require a 'dedicated' covered bond law without outlining more details or definitions.

Based on these results the GIWG concluded that the current requirements for a preferential treatment of covered bonds on a global level do not qualify as an appropriate starting point for fundamental principles of covered bonds.

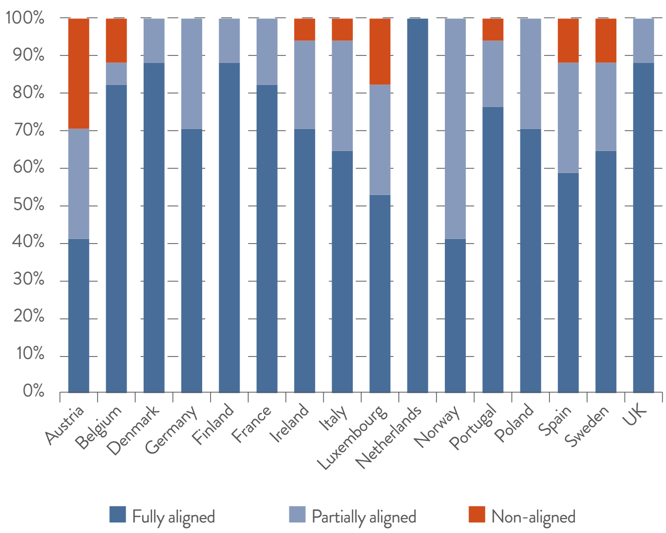
GLOBAL BEST PRACTICES – MEASURED ON THE BASIS OF THE EBA'S HARMONISATION PROPOSALS

As a next step, the GIWG analysed if and how different global covered bond regimes meet the *proposals for covered bond harmonisation* in the EU, disclosed by the European Banking Authority (EBA) in December 2016. EBA suggests a three step approach covering important features of covered bonds.

- According to the proposal, in *step 1* the following aspects should be addressed by a *European covered bond framework*: Dual recourse, asset segregation, bankruptcy remoteness; coverage, liquidity, derivatives; asset monitor, issuer supervision, post insolvency supervision, administration; transparency and rules regarding soft bullet and conditional pass-through structures.
- In *step 2* the *conditions for preferential risk weighting*, specified in Article 129 of the CRR, should be enhanced. In order to receive a preferential risk weight, covered bonds need to comply with the requirements of the European covered bond framework and on top of that with enhanced requirements of Article 129 CRR, which should cover conditions on eligible and substitution assets, LTV-limits and minimum overcollateralisation.
- *Step 3* proposals comprise the cover pool composition, assets in non-EEA jurisdictions, LTV measurements and stress tests, all of which should be subject to *voluntary convergence.*

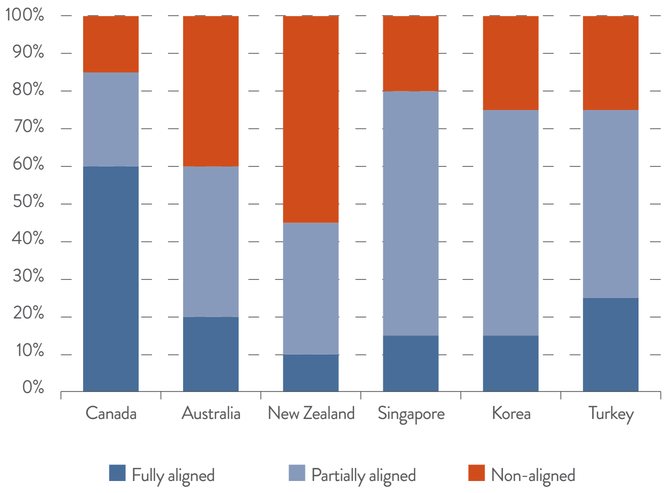
The GIWG concentrated its analysis on non-EEA countries, as the EBA had already disclosed the alignment of EU countries with the EBA's 2014 best practices proposals (please see Figure 4 below). The results are very interesting. Despite an, at first sight, more moderate full alignment with the harmonisation proposals in non-EEA countries (please see Figure 5 below), the level of compliance with a large number of the EBA's covered bond proposals is not that different for non-EEA countries from the EU.

FIGURE 4 | EBA - BEST PRACTICES ALIGNMENT (EEA)



Source: EBA

FIGURE 5 | ECBC GIWG – HARMONISATION ALIGNMENT (NON-EU)



Source: ECBC Global Issues Working Group

In more detail, the EBA proposals regarding dual recourse and asset segregation are more or less already fulfilled on a global level and to a large extent, there is compliance with LTV-limits. While the requirements concerning bankruptcy remoteness are generally fulfilled, operational plans are hardly to be found.

Rules regarding the appointment of a cover pool monitor are generally in place, but the description of its reporting duties vis-à-vis the competent authorities is not always as detailed as in the EBA's proposals. The requirements for the going-concern supervision of the issuer are in most cases not fully met. The national rules regarding post insolvency supervision and administration are also often not in line with EBA's proposals.

Almost all non-EEA covered bond regimes require a minimum overcollateralisation, even though sometimes lower than 5%. However, the national coverage requirements usually do not address administrative costs post issuer insolvency and liquidity buffers are not common in non-EEA covered bond frameworks either. Finally, some jurisdictions do not provide for transparency requirements at all, while others do partially or even fully meet them.

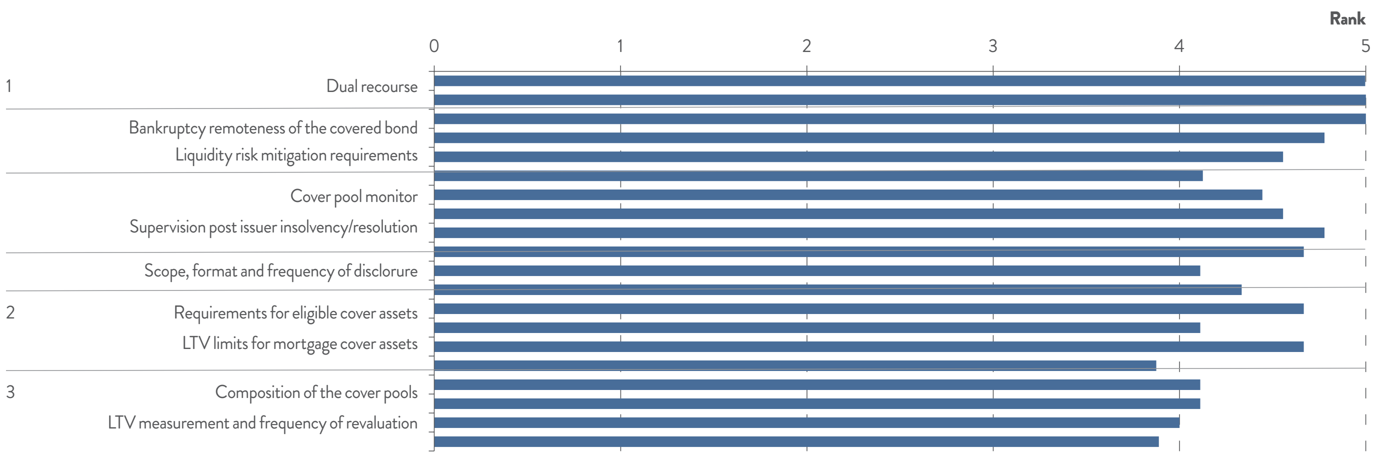
Mapping the relevance of the harmonisation proposals

The EBA's harmonisation proposals mark a detailed and valuable set of guidelines for regulators across the globe establishing or rethinking the regulatory requirements for covered bonds or the preferential regulatory treatment thereof. However, to offer some indication to the level of importance of all these proposals for the purpose of (drafting) covered bond regimes, the GIWG has sought to identify the most important aspects that should be regulated as a minimum. To this purpose nine global covered bond experts within the GIWG independently assigned scores to all the EBA's harmonisation proposals, including the specified details underlying each generic requirement.

The results show that on a scale of 1 (irrelevant) to 5 (highly relevant), all the generic harmonisation requirements are either relevant (4) or highly relevant (5), with an average score ranging from 4 to 5 (please see Figure 6 below). With the highest possible average score of 5, all respondents were unanimous in their judgment that the requirements assuring dual recourse, the asset segregation and bankruptcy remoteness of the covered bonds should be regulated in detail. Almost equally important are the specification of minimum coverage requirements, the cover asset eligibility criteria, including LTV restrictions for mortgage cover assets, and the establishment of requirements for supervision post issuer insolvency/resolution and the post insolvency administration of the covered bond programme.

The conditions for voluntary convergence, including criteria for the composition of cover pools, cover pools with assets located in non-EEA jurisdictions, LTV measurement and the frequency of revaluation and stress testing are also relevant, but not as highly relevant as the aforementioned conditions. The same holds for certain step 1 and 2 requirements related to cover pool derivatives, disclosure criteria, limitations on substitution assets and a minimum overcollateralisation level.

FIGURE 6 | RANKING THE REGULATORY RELEVANCE OF THE EBA'S HARMONISATION PROPOSALS



Source: EBA, ECBC Global Issues Working Group

It is interesting that the harmonisation requirements highlighted in figure 6 as the most relevant, such as dual recourse, asset eligibility criteria, coverage requirements and supervision of the covered bond issuer, show a strong overlap with the qualitative standards for covered bonds indicated in the Covered Bond Label Convention (please see Figure 7 below). This confirms the high-added value of the Covered Bond Label as a quality mark for covered bonds.

FIGURE 7 | THE COVERED BOND LABEL CONVENTION CRITERIA

I. LEGISLATION SAFEGUARDS

a) The CB programme is embedded in a dedicated national CB legislation;

b) The bond is issued by – or bondholders otherwise have full recourse, direct or indirect, to – a credit institution which is subject to public regulation and supervision;

c) The obligations of the credit institution in respect of the cover pool are supervised by public supervisory authorities.

II. SECURITY FEATURES INTRINSIC TO THE CB PRODUCT

a) Bondholders have a dual claim against:
   i. The issuing credit institution as referred to in point I b);
   ii. A cover pool of financial assets (mortgage, public sector or ship assets), ranking senior to the unsecured creditors.

b) The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times.

c) Issuers are committed to providing regular information enabling investors to analyse the cover pool, following the Harmonised Transparency Template and in compliance with the transparency requirements of Article 129(7) of the CRR.

Source: ECBC, Covered Bond Label

Not all specified details are equally relevant

Despite the (high) relevance of the generic requirements, not all the EBA's suggestions detailing them are considered equally important. To assure bankruptcy remoteness for instance, it is highly relevant that a covered bond framework assures that there is no automatic acceleration of payments upon issuer insolvency and grants covered bondholders a priority claim to the cover assets. However, the importance of the establishment of an operational plan to assure continuity of the administration function post issuer insolvency is disputed, with some respondents considering this even irrelevant.

Liquidity risk mitigation requirements are also considered very relevant, but it is for instance not that important that the liquidity buffer is segregated and held separately from the other cover assets within the cover pool, or remains segregated from other liquid assets held for the purpose of the LCR.

Figure 6 provides an indicative overview of the most relevant regulatory requirements to cover in a covered bond framework. All the suggested requirements that are scored at least 4.5 by the GIWG are included in the "very relevant" column, while all proposals that obtained a score of at least 4 or higher (albeit below 4.5) are in the "relevant" column. The table indicates for instance, that in order to assure dual recourse, it is of utmost importance that covered bondholders have a) a claim on the covered bond issuer, b) a priority claim on the cover assets, and c) a claim on the issuer's insolvency estate that is pari passu to the claim of unsecured credits (but not senior to this claim, unless the issuer is a specialised covered bond issuer).

The current state of play on the introduction of preferential risk weights for covered bonds at global level

BASEL III REFORMS PAVE THE WAY FOR PREFERENTIAL RISK WEIGHT TREATMENT ON A GLOBAL LEVEL

In December 2017 the Basel Committee on Banking Supervision finalised its post-crisis regulatory reforms. This includes preferential risk-weights for covered bonds on global level for the first time. The requirements set by the Basel Committee are built on the more general conditions according to Article 52 (4) of the UCITS-Directive and similar to the additional requirements according to Article 129 of the CRR. The eligible cover assets are restricted to public sector assets and to claims secured by residential and commercial real estate. Claims on banks are eligible up to 15% of outstanding covered bonds. In contrast to Article 129 of the CRR, Ship mortgages do not qualify as eligible assets.

While the transparency requirements are more or less in line with Article 129 of the CRR, Basel requires a nominal overcollateralisation of 10%, which goes beyond the requirements at European level. However, national legislations do include overcollateralisation requirements, which vary strongly. In its proposal for a harmonisation of European covered bond frameworks the European Commission asks for an overcollateralisation of 5%.

FIGURE 8 | RISK WEIGHT TABLE FOR RATED COVERED BOND EXPOSURES ACCORDING TO BASEL COMMITTEE

Issue-specific rating of the covered bond	AAA to AA–	A+ to A–	BBB+ to BBB–	BB+ to B–	Below B–
"Base" risk weight	10%	20%	20%	50%	100%

Source: Basel Committee on Banking Supervsion; Basel III: Finalising post-crisis reforms

EUROPEAN COMMISSION PROPOSES HARMONISATION OF COVERED BONDS AT EUROPEAN LEVEL; NO GLOBAL EQUIVALENT TREATMENT YET

In mid-March the European Commission published its proposal for a harmonisation of covered bond frameworks in Europe, consisting of a principles-based Directive and an amendment of Article 129 of the CRR. The draft Directive is based on the EBA proposals and addresses all elements identified as crucial for covered bonds, e.g. eligible assets, dual recourse, bankruptcy remoteness and asset segregation. Moreover, it also sets conditions regarding coverage requirements, liquidity risk mitigation, cover pool derivatives, maturity extension structures, special supervision pre- and post-issuer insolvency and transparency. The requirements are principles-based and leave enough room for important national adaptation in order to avoid disruptions of existing markets.

With regard to preferential risk-weights for covered bonds the European Commission suggests the introduction of a mandatory overcollateralisation of 5% in Article 129 of the CRR. The transparency requirements will move from the CRR to the Covered Bond Directive. It is expected that the political process will proceed smoothly.

The European Commission decided to leave the potential equivalent treatment of covered bonds issued by credit institutions outside the EEA outside the scope of its proposals for a covered bond Directive and Regulation. Instead, the European Commission intends to submit a report to the European Parliament and Council within three years after the date that the Member States have to apply the provisions of the Directive. The European Commission will first, together with the EBA, assess the need and relevance of an equivalence regime for third-country issuers of and investors in covered bonds. If appropriate, a legislative proposal will be submitted to the European Parliament and Council alongside the aforementioned report on this matter. Therefore, alignment of the regulatory treatment of EEA covered bonds and their comparables outside the block remains important work in progress.

In Summary

The overall conclusion is that the EBA proposals and the upcoming European Covered Bond Directive, which is based on the EBA proposals, can be considered a good starting point for fundamental principles of covered bonds at global level. These principles should cover the following aspects: dual recourse, bankruptcy remoteness, asset segregation, asset eligibility criteria (incl. LTV), minimum coverage requirements and special supervision (incl. asset monitor). These are criteria that are also broadly covered by the qualitative standards for covered bonds under the Covered Bond Label Convention. The introduction of preferential risk-weights for covered bonds in the Basel framework is a great success and could potentially boost the use and investment in covered bonds worldwide. However, it should not prevent the covered bond industry from defining fundamental principles for covered bonds going beyond the Basel requirements. The European Commission decided to leave the potential equivalent treatment of non-EEA covered bonds outside the scope of its harmonisation rules, but not without commitment to assess the relevance hereof within three years. This all underscores the strengthening of the covered bond footprint on a global level as a secure and important funding tool for banks, serving global economic purposes.

FIGURE 9 | LISTING MINIMUM REGULATORY REQUIREMENTS – THE MOST RELEVANT HARMONISATION PROPOSALS

REQUIREMENT	VERY RELEVANT (≥4.5)	RELEVANT (≥4.0)
1) STANDARD STRUCTURAL REQUIREMENTS		
Dual recourse	Claim on the covered bond issuer	
	Priority claim on the cover assets	
	Pari passu claim unsecured creditors	
	Specialist issuers: senior to unsecured	
Asset segregation	Effective legal segregation of assets	
	Legally binding and enforceable	
	Segregation agreement incl. primary and substitution assets	Segregation agreement includes assets liquidity buffer, cover pool derivatives, voluntary OC
Bankruptcy remoteness	Covered bondholders have priority claim	Issuer should have an operational plan
	No automatic acceleration payments	(updated at least annually, availability cover pool data, IT system readily available to administrator)
Coverage requirements	Payments on assets equal to obligations on covered bonds	
	Scope assets: Principal, interest,	
	Scope liabilities: Principal CB,	Cover pool derivatives
	Coverage: Nominal,	Interest CB, Operational costs
		Soft LTV restrictions
Liquidity risk mitigants		Establishment liquidity buffer
		LCR Level 1 and 2a assets, exposures to institutions
		Should be part of coverage requirements
Derivative requirements		Derivative contracts allowed exclusively for hedging
		Standard industry master agreement
		Part of the cover, no termination upon issuer insolvency
		Counterparty eligibility requirements
Cover pool monitor	Duties of reporting to supervisor	Rules on appointment and dismissal
		Eligibility criteria and specification main duties
		Should be separate from issuer's ordinary auditor

Going concern supervision	Special supervisory role supervisor	Issuer should have adequate operational procedures
	Monitoring compliance with requirements	Legal restrictions should be met by the issuer
	Approve establishment programme	Cover pool should meet the minimum requirements
	Regular reporting by the issuer	Distribution tasks between competent authority, resolution authority, asset monitor and administrator
	Notification in case of ownership transfer	
Supervision post insolvency	Description powers competent authority and administration of programme	Approval of transfer of assets and obl. to other issuer
		Coordination of information between competent authority, special administrator and resolution authority
Post insolvency Administration	Independent management CB programme	Detailed provisions duties/powers administrator
		Rules on appointment of the special administrator
		Rules on objectives and duties of the administrator
Transparency	Information on required coverage, contractual and voluntary OC	Scope: credit risk, market risk and liquidity risk features
	Information on structure covered bond	Information on counterparties, methodology for property valuation and LTV calculation
		Transaction documents should be published
		Information should be disclosed at least quarterly and standardised format from a common point of access
Requirements SB and CPT		Maturity extension may not be affected by the issuer
		Maturity extension may only be affected at the discretion of the special administration
		Covered bond investors and pari-passu creditors must be treated equally after maturity extension

2) STANDARD STRUCTURAL REQUIREMENTS		
Requirements eligible assets	Exposures to EU and 3rd country entities	Residential guaranteed loans
	Exposures to institutions (up to 15%)	Ship loans
	Residential and commercial mortgages	Scope of assets should not be widened
Limits substitution assets		Cover assets identified under CRR Art 129(1)(a-c) should be eligible, subject to limits Art 129(1)
LTV limits mortgage assets	80% residential mortgage loans	
	60% commercial mortgage loans	
Minimum OC	Treatment of voluntary OC in a resolution should be specified by statutory law	Minimum effective OC should be 5%
		In case of partial transfer voluntary OC should be subject to the segregation requirements (not separate)
		Partial transfer may never result in undercoverage

3) STANDARD STRUCTURAL REQUIREMENTS		
Composition cover pool	Mixed pools for mortgage loans	Mixed mortgage pools should be subject to disclosure and safeguards
Non-EEA assets	For mortgage assets outside the EEA, CRR Art 208(2) should be met and underwriting standards should be similar to the EU	
LTV measurement		Mortgage enforceability requirements CRR Art 208 and valuation principles CRR Art 229 should be met
		Expansion property valuation rules Art 208 & 229 CRR
		Annual valuation to determine LTMV
Stress testing	Stress test on coverage requirements:	
	-Shift of interest rate curves	-Shift in currency pairs
		-Stress on market prices of physical underlying assets
		Summary of stress test results should be published

Highly relevant are the criteria with an average score of 4.5 and higher. Relevant are the criteria with an average score between 4 and 4.5.

Source: EBA, ECBC Global Issues Working Group

SECTION IV. INVESTOR SURVEY

By **Franz Rudolf**, UniCredit Bank and **Lily Shum**, Canada Mortgage and Housing Corporation

The first part of the GIWG investor survey aims to capture the investors' perspectives on key features of covered bonds. The second part of the survey examines the investors' views on EEA covered bonds vs non-EEA covered bonds. The purpose of the survey is to capture the investors' view on EBA proposals and on preferential regulatory treatment of covered bonds from non-European third countries.

Survey results were gathered from 24 respondents, of which 19 were investors from banks, insurance companies and asset managers and 5 respondents were issuers, rating agency analysts and credit analysts. For global representation, respondents were based in Germany, Denmark, France, UK, Canada, USA, Switzerland, Luxembourg, Italy, Poland and Greece.

KEY FEATURES OF COVERED BONDS IN INVESTMENT DECISIONS – NOT ALL FEATURES A "MUST HAVE"

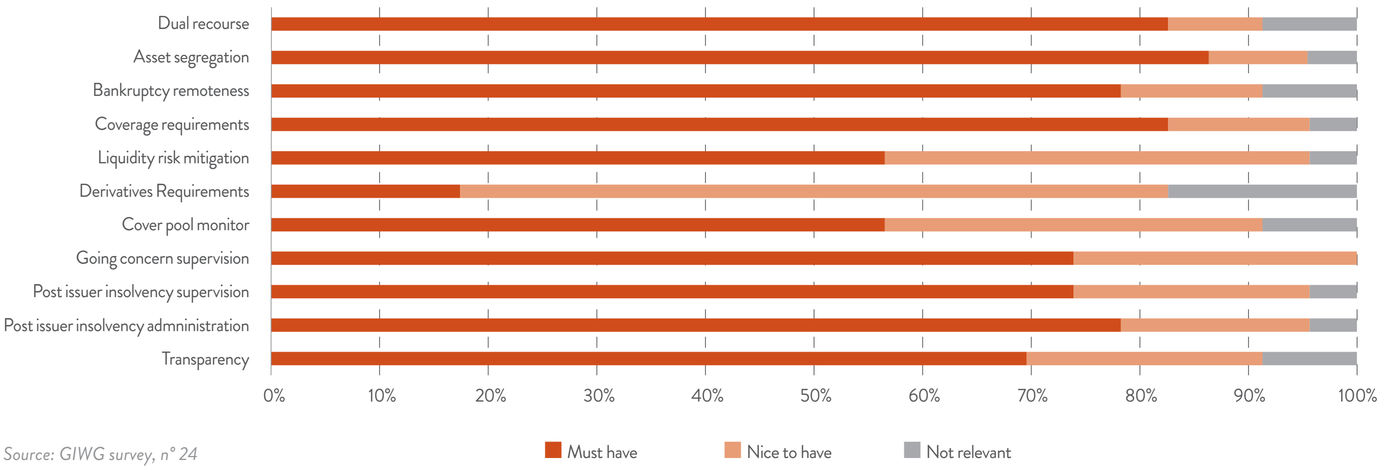
Respondents were asked to evaluate the key features of covered bonds. Over 75% of respondents identified the features of dual recourse, asset segregation, bankruptcy remoteness and coverage requirements as necessary features consistent with the observations outlined in Section III. Derivatives requirements was a "nice to have" by 65% of respondents.

COVERED BONDS FROM NON-EEA COUNTRIES

Respondents were then asked whether they see a price advantage for covered bonds enjoying preferential regulatory treatment (e.g. regarding risk weight, LCR etc) assuming all else equal. Almost all the respondents (91% of respondents) stated there was a clear price advantage associated with covered bonds enjoying preferential regulatory treatment, with most estimating the price advantage to fall between 3-10 bps.

Respondents were also asked how their investment decisions are impacted by the extension of preferential regulatory treatment to non-EEA covered bonds, in which half of the respondents indicated there would be greater interest in non-EEA covered bonds, and 39% indicating relative pricing of non-EEA covered

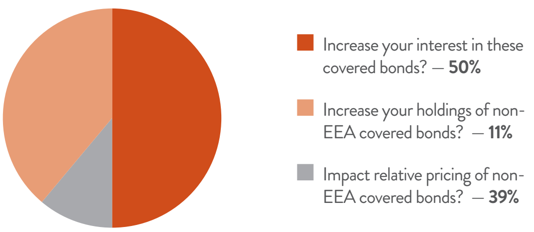
FIGURE 10 | KEY FEATURES OF COVERED BONDS IN INVESTMENT DECISIONS



Source: GIWG survey, n° 24

FIGURE 11A | EXTENSION OF PREFERENTIAL REGULATORY TREATMENT

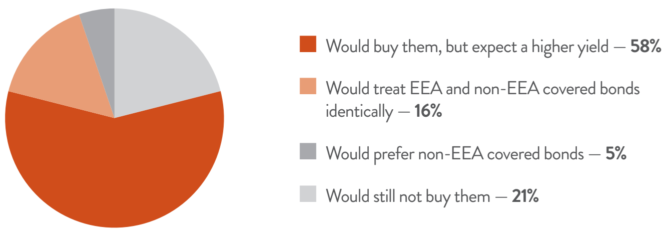
Does the extension of preferential regulatory treatment to non-EEA covered bonds?



Source: GIWG survey, n° 24

FIGURE 11B | EXTENSION OF PREFERENTIAL REGULATORY TREATMENT

If preferential regulatory treatment was extended to non-EEA covered bonds



bonds would change (Figure 11a). Of special interest, if preferential regulatory treatment were extended to non-EEA covered bonds, over half of the respondents (58%) would then buy non-EEA covered bonds, but only with a higher yield (Figure 11b). So, while extension of preferential regulatory treatment to non-EEA covered bonds could narrow the pricing differential between EEA and non-EEA covered bonds, there may still be a higher yield compared to EEA covered bonds, based on investor expectations.

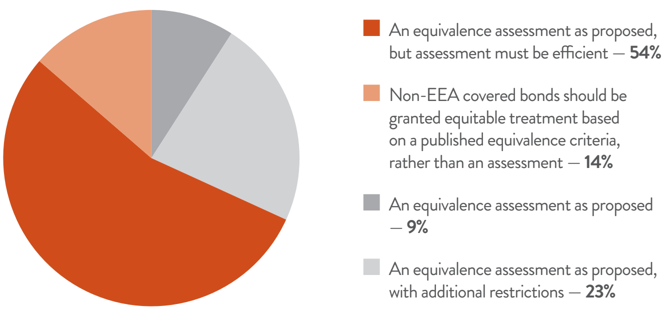
Finally, views were sought on an equivalence assessment as a means to qualify covered bonds from non-EEA countries for equitable treatment. Responses were mixed with over half of respondents indicating that an equivalence assessment must be efficient, while 23% recommended an equivalence assessment with additional restrictions (in addition to examining legal, institutional and supervisory environment) and 14% preferred published equivalence criteria over an equivalence assessment conducted. Based on the mixed views, the criteria for the recognition of equivalence need to be further assessed in light of the recent Basel recommendation of preferential risk weights for covered bonds.

IN SUMMARY

Not all features specified in EBA proposals are identified as necessary by investors, however, features such as asset segregation, dual recourse, bankruptcy remoteness and coverage requirements still emerge as key critical features for investors. Providing equitable treatment to non-EEA covered bonds would raise greater awareness and interest in non-EEA covered bonds, with some even indicating relative pricing of non-EEA vs EEA covered bonds would be impacted. Greater investor interest can help facilitate further cross-border capital market activities and provide greater geographic diversification in investment portfolios, in particular for bank treasury portfolios, which is an important contribution to stability. Assuming all else equal, investors view a price advantage to be associated with covered bonds enjoying preferential regulatory treatment, however, investors may still expect a higher yield even if equitable treatment was extended to non-EEA covered bonds. The criteria by which the covered bond definition is extended warrants more discussion, in light of the recent Basel recommendation.

FIGURE 12 | PROPOSAL THAT MARKET ACCESS BARRIERS BE REMOVED BY PROVIDING EQUITABLE TREATMENT TO COVERED BONDS FROM ISSUERS IN NON-EEA COUNTRIES, PROVIDED THEIR LEGAL, INSTITUTIONAL, AND SUPERVISORY ENVIRONMENT PASSES AN EQUIVALENCE ASSESSMENT

Covered bonds in non-EEA countries and equivalence assessment



Source: GIWG survey, n° 24

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