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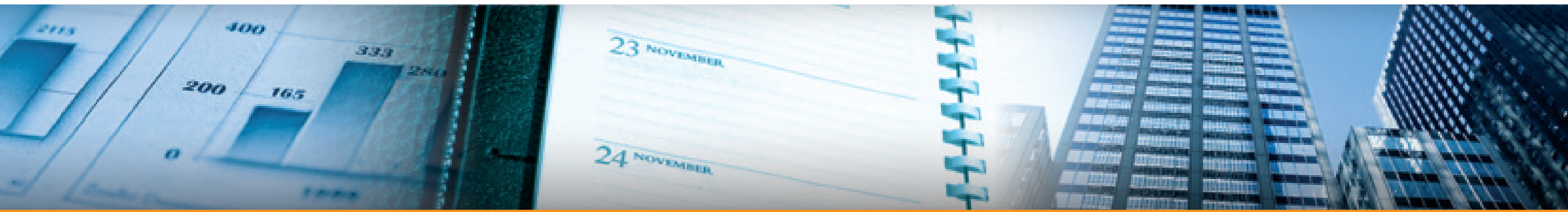

Summary

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European Mortgage Federation

ECBC European Covered Bond Council

EU Regulation – Different Games on a Level Playing Field

By Trineke Borch Jacobsen, Office Manager, Danish Mortgage Banks' Federation

In recent years the European financial sector has been the subject of cascades of EU regulation which has directly and indirectly impacted on the sector and its customers. The key issues include capital requirements, consumer protection, the anti-money laundering regime and the supervision of all of these various pieces of legislation.

There is no doubt that the common EU regulation of the provision of goods and services on a cross-border basis is a precondition for establishing and further developing the EU Internal Market – one of the core goals of the Union.

Uniform legislation ties the Union closer together and opens up the Internal Market for goods, services and, most importantly for consumers and enterprises, market efficiency and more competition.

Not all legislation in the Union can or should be uniform, however. But issues decided by the Union for the Union must be dealt with in the same way everywhere – if not by the letter then in substance. Ideally, the issues under discussion should be carefully thought through with regards to need and proportionality, and impact assessed before being proposed by the European Commission, negotiated and balanced in the Council, democratised by the European Parliament and implemented in Member States, without gold-plating or technical "improvement".

This principle also applies when the purpose of the common efforts is to maintain financial stability through intense regulation of the financial sector. Uniform means that the legislation applies everywhere with as few adjustments as possible and is only adjusted in the pursuit of a uniform result in terms of impact of the regulation on the market.

It is, however, vital that close attention is paid to ensuring that EU regulation is proposed with a focus on issues of common interest which Member States cannot handle (better) on their own. If measures are not prioritised and are not proportional to their objective, they may prove counterproductive to the overall aim of cross-border activity and the development of the products available to European consumers.

National issues should be addressed by national legislators and targeted to the national market and national market players respectively. Issues concerning fundamental national legal infrastructure such as social services, health service and land registration and the interaction with related legislation are policy themes that probably should be reserved for national initiatives. Grey zones will emerge and be the subject of discussion, but it is important that political awareness of the distinction between national and EU legislative competence is in place.

This distinction requires self-discipline from both national legislators, with a tendency to escalate national challenges to the European level, as well as the European Institutions focusing on particular problems in one or two Member States and spreading the cure to the entire EU – whether an overall remedy is needed or not.

The level of harmonisation is often central when negotiating EU legislation. In reality any agreed level of harmonisation, whether minimum or maximum, can be bypassed by national legislators, whether intentional or not, if attention is not constantly paid to the need for the Union-game to be played on a level playing field.

This underlines the need for legislators of all kinds to recognise their mandate and its limits and also to recognise what the EU is all about, whether seen from the national perspective or the European one.

Key for the EU is the development of the Internal Market with a common market policy that aims to secure the four freedoms for citizens and businesses of the 28 Member States: to settle, work, travel and invest in other Member States.

This sounds easy but it is not. European legal structures meet national structures in the process of implementation and strange things happen, often in rather peculiar ways which are quite unhelpful to the European principles and to the Commission's vision of better regulation. Sometimes common legislation becomes **too detailed**, and impacts on practices or conditions in Member States in unforeseen ways. In other instances, national legislators consider EU legislation to be **incomplete** and add layers of national legislation. Finally, on occasion, national legislators and authorities are not aware that national initiatives and practices technically convert EU legislation into something **unintended** and counterproductive.

The need for awareness can probably be illustrated by examples from every Member State in the EU, but I have picked some examples from Denmark covering the categories mentioned in the section above.

1. The Mortgage Credit Directive addresses, among other things, risks for borrowers when taking out loans in a foreign currency. Developments in relation to currencies and interest rates have been a serious problem for borrowers in some Member States, but not everywhere in the Union. In some Member States, consumers took out mortgage loans in a foreign currency prior to the financial crisis. The loan was issued in a different currency to the national currency and also to the currency that the consumer's salary was paid in.

   During the crisis, currencies evolved differently, resulting in defaults by borrowers when payments on the loan stopped converging with salary payments, and outstanding debt increased because of the development in currency exchange rates.

   A practice that was correctly assessed as a serious threat in some Member States ended up being addressed in the Mortgage Credit Directive as a general problem. The Directive defines any loan that is not in the same currency as the consumer's income as a foreign currency loan. It introduces special requirements for the lender regarding monitoring and other measures such as an obligation to provide an alternative currency to the consumer. Many of these measures are, practically-speaking unfeasible, and give rise to problems not seen prior to this legislation.

   In border regions where citizens are employed on a cross-border basis and commute between Eurozone and non-Euro-zone countries, employees are paid in a currency which is different from that of their domestic currency and different from the currency of their loan. This means that a Dane taking out a loan in DKK on a property situated in Denmark and taxed in DKK is a foreign currency borrower when his Swedish employer pays his salary in SKR. Danish mortgage banks cannot issue loans in SKR, meaning that a Danish mortgage loan can no longer be offered to this kind of borrower. This is a problem with no upside.

   As a result mortgage banks and other mortgage loan providers in primarily border regions, but also in other instances where the currency of the income and the loan is not the same, now face legal problems and transaction difficulties when offering loans that are otherwise uncontroversial. This is not the way to encourage cross-border activities, but Member States will have to deal with it. This example illustrates what happens when specific issues are dealt with by general measures.

2. In Denmark lenders have a special obligation to mark loans with a risk indication – a "Traffic Light" – in green, yellow or red warning the borrower in degrees about the risky characteristics of any loan on offer.

   This comes on top of the EU information requirements in the Consumer Credit Directive (SECCI) and the Mortgage Credit Directive (ESIS), plus their respective marketing rules. The mortgage industry has never succeeded in obtaining a definition of risk in this context, but all loans are nonetheless marked with a risk warming.

3. In recognition of the huge volume of information that lenders are obliged to provide to borrowers wanting to take out a mortgage loan, an expert committee under the previous government – in the process of assessing the mobility in the Danish mortgage market – made a recommendation that mortgage banks should agree on and comply with "common principles for the compilation of loan documents". Considering that 22 different legal acts – EU and national – impact on the communication between lender and borrower, there is a lot of complex material to deal with. The industry has highlighted this as a concern for years.

   But with this recommendation, the government and FSA have obliged the industry to negotiate another layer of information with the consumer representatives. The objective is to explain to the borrower how to navigate through the information and to require the lender to organise the documents so that they are provided in the same way.

   The measure makes good sense but this area is already heavily regulated by the EU. Nonetheless the FSA chaired the negotiations and will oversee the implementation of and compliance with the agreement, as with any other piece of legislation. It enters into force in February 2017.

4. By January 2017 a new price-portal for mortgage loans will be launched in Denmark. It will enable borrowers to compare loan prices at the time of entering into the contract and by way of a simulated model (based on real data collected by the mortgage banks and reported to the National Bank, which will be responsible for doing the calculations and maintaining the data in the portal) showing how the loan performs over time in terms of costs. Technically, this is challenging and costly too and requires the design of new IT-systems for the post-contractual monitoring of loans.

   It is a legal requirement to report the data in the correct format to the National Bank and to provide the technical infrastructure in order to be able comply with the requirements. This would also be required from a new market player.

All three of these Danish innovations will make it considerably more difficult for a new EU-market player to penetrate the Danish market. They would be considered as technical hindrances and rightfully so.

To conclude – there is still some room for improvement. In the meantime different mortgage games are being played on un-level playing fields.

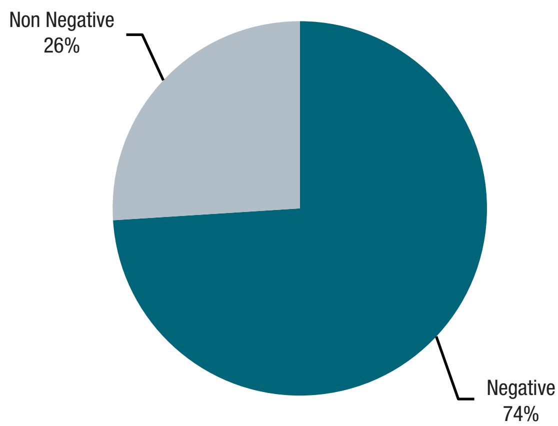
Negative Yields & Negative Net Supply of Euro Benchmark Covered Bonds

By Bernd Volk, Director, Deutsche Bank

Given the current environment, fixed income assets are undoubtedly expensive. As of the 24th of October 2016, the share of negative yielding bonds in the iBoxx EUR Covered index was 74%. This compares to 45% in the case of the iBoxx EUR Sovereign index. Peripheral countries account for 23.7% in the iBoxx EUR Covered (Spain 15.5%, Italy 6.5%, Ireland 1%, Portugal 0.6%) compared to 38.6% in the iBoxx EUR Sovereign (Italy 23.9%, Spain 12.8%, Ireland 2%).

Even though a part of the difference in the share of negative yielding bonds between the iBoxx EUR Covered and the iBoxx EUR Sovereign can be explained by the country distribution (and also by differences in duration), most euro area covered bonds trade tight versus underlying sovereign bonds. Moreover, on top of historically low absolute yields, also versus swaps, covered bonds trade close to historically tight levels. However, with no covered bond investor having suffered a loss in recent history, in contrast to sovereign bonds, relative value remains an open discussion, particularly in the case of covered bond markets that are relatively small and therefore easier to exempt from losses.

Share of bonds in iBoxx EUR Covered with negative yields (as of 24 Oct. 2016)



Source: Markit, Bloomberg Finance LP

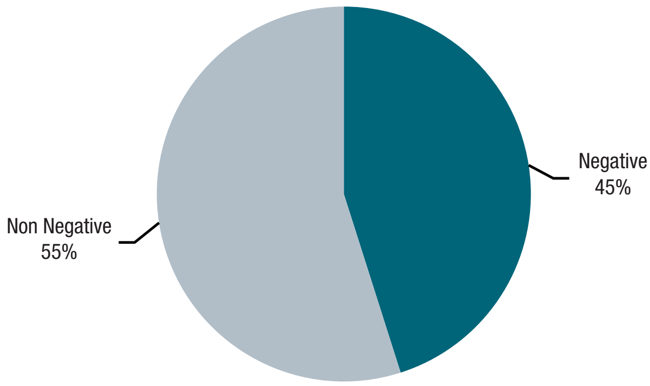
CBPP3 TAPERING HAPPENING ALREADY

Generally, settlements under the European Central Bank's (ECB) covered bond purchase programme (CBPP3) were significantly lower after the summer break compared to settlements before the summer break. In recent weeks, the CBPP3 purchase rate was at the lowest since the programme started. Mainly driven by low issuance of EUR benchmark covered bonds by euro area banks, average weekly purchases under CBPP3 have amounted to EUR 1bn since July compared to EUR 1.7bn in the first half of the year.

Hence, there is some kind of covered bond tapering, which might be due to lack of available bonds or due to relative value considerations by the ECB. The volume of covered bonds purchased by the ECB under CBPP3 as a percentage of volume purchased under PSPP was only 6% in September 2016, the second lowest monthly level since the start of PSPP in March 2015 (after 4.7% in July 2016), comparing to a high of 26.2% in March 2015, 24% in April 2015, and 19.4% in May 2015.

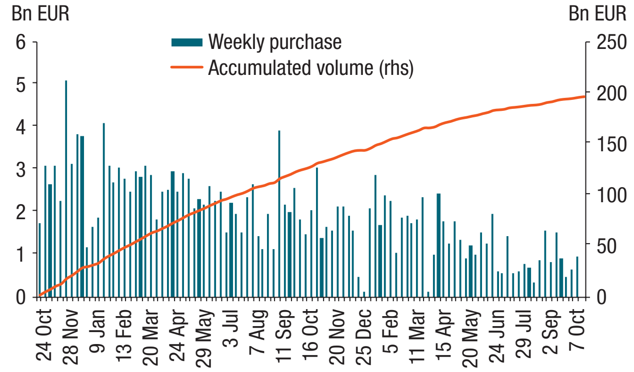
In total, the ECB held EUR 196.5bn of covered bonds under CBPP3 as of the 21st of October 2016. Together with CBPP1/2, the ECB held EUR 218bn of covered bonds. As this compares to EUR 550bn of covered bonds issued by euro area banks in the iBoxx EUR Covered, the ECB holds 40% of the thereby defined public market. However, the total volume of euro denominated covered bonds "issued" by euro area banks registered in the ECB collateral database, including retained covered bonds and private placements, amounts to EUR 1050bn. Consequently, in this respect, the ECB holdings under CBPP1-3 account for only 21%.

Share of bonds in iBoxx EUR Sovereign with negative yields (as of 24 Oct. 2016)

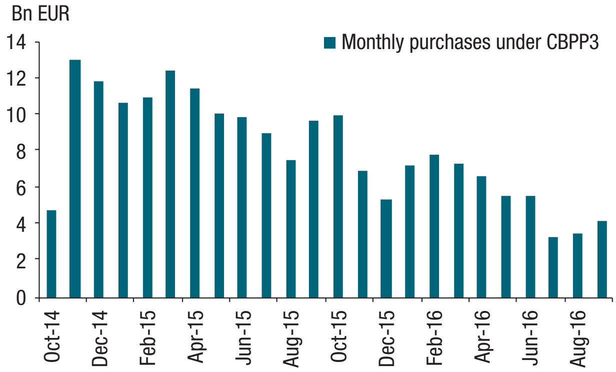


Source: Markit, Bloomberg Finance LP

Weekly and accumulated purchases by ECB under CBPP3



Monthly purchases by ECB under CBPP3



Source: ECB

UNCERTAINTY REGARDING CBPP3 DURATION

The ECB press conference on the 20th of October 2016 did not provide new insights regarding quantitative easing (QE) extension or tapering. Technical changes to enable the ECB to continue sourcing the significant monthly QE volume it targets could be announced at the December 2016 meeting. However, ECB Governing Council member Ewald Nowotny is quoted as saying on the 24th of October (at a speech on wider policy issues at the Vienna University of Economics & Business regarding covered bonds): *"That is an individual area where we have reached limits. In the meantime, we have enough other investment options."*

The question remains if the ECB will formally end CBPP3 before the ending of ECB QE or during tapering of ECB QE. On the one hand, CBPP3 started four months' earlier than PSPP. Moreover, the ECB may want to save itself from what happened with CBPP2, which was closed due to lack of available bonds. On the other hand, as long as ECB QE is running and the ECB does not see CPI inflation moving closer to its target level of "close but below 2%", the ECB may want to keep its flexibility regarding asset purchases. In this respect, exiting CBPP3 earlier than ECB QE would take away a comfortable purchase channel, i.e. purchasing covered bonds in the primary market for euro benchmark covered bonds. Moreover, at the introduction of CBPP3, the ECB highlighted that the programme is "very different" to CBPP 1 and CBPP2. Hence, any comparison between CBPP3 and CBPP1/2 seems challenging.

REINVESTMENTS OF ECB CBPP3 HOLDINGS

In December 2015, the ECB announced the reinvestment of maturing bonds. Given the wording *("reinvest the principal payments on the securities purchased under the APP as they mature, for as long as necessary")*, the announcement seems to refer only to CBPP3 and not to the ECB holdings under CBPP1 and CBPP2 (amounting to EUR 14.281bn and EUR 7.115bn respectively as of the 21st of October). Given that the ECB holds EUR 196.5bn of covered bonds under CBPP3 as of the 21st of October, reinvestments are likely to amount to over EUR 10bn in 2017 and over EUR 15bn from 2018 to 2022.

NEGATIVE NET SUPPLY OF EURO BENCHMARK COVERED BONDS YTD

With only EUR 15bn of new EUR benchmark covered bonds, primary market activity regarding euro benchmark covered bonds in Q3 2016 was at the lowest Q3 level in euro area history, followed by EUR 15.2bn in Q3 2012, EUR 17.2bn in Q3 2002 and EUR 17.5bn Q3 2008.

As of the 24th of October, euro benchmark covered bond issuance amounted to EUR 7.2bn compared to EUR 16.7bn in October 2015. Total year-to-date (ytd) issuance of euro benchmark covered bonds amounted to EUR 115.1bn compared to EUR 122bn in 2015 ytd. Net supply amounted to minus EUR 14.5bn ytd compared to positive net supply of EUR 6bn in 2015 ytd. Overall, the high negative net supply supported tight spreads of covered bonds.

Ytd issuance, net supply and remaining redemption for 2016 versus 2015

	Ytd issuance 2016	Net supply 2016	Remaining redemptions 2016	Ytd issuance 2015	Net supply 2015	Remaining redemptions 2015
Euro Area	70.6	-27.9	15.2	86.9	-4.2	20.5
Non Euro Area	44.5	13.4	2.0	34.8	10.2	3.3
Total	115.1	-14.5	17.2	121.6	6.0	23.8

Source: Deutsche Bank

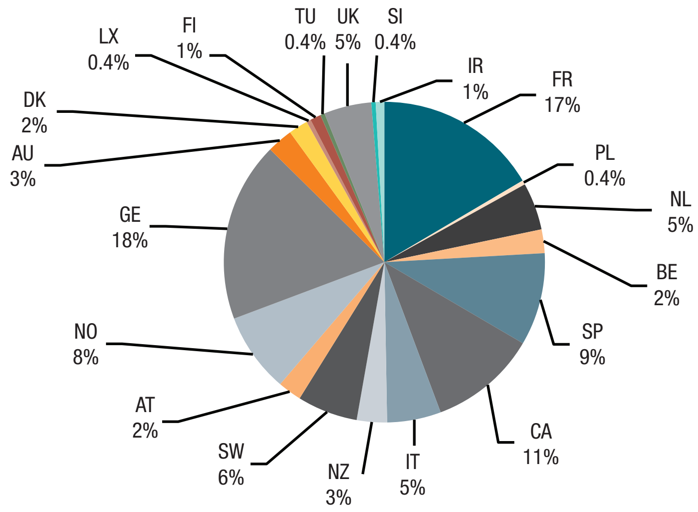
With a share of 18%, German issuers rank highest regarding ytd issuance of euro benchmark covered bonds, followed by French issuers (17%), Canadian (11%) and Spanish issuers (9%). While non-euro area banks provided a remarkable share of 38.2%, with 61.8%, euro area banks still dominated.

Euro benchmark covered bond redemptions until year-end amount to EUR 15.3bn, with EUR 13.3bn being from euro area banks. There seems also no indication for a massive increase of supply until year-end. In 2017, euro benchmark covered bond redemptions will be by EUR 30bn lower than in 2016 (EUR 147bn), amounting to EUR 116.5bn. With EUR 26.1bn, Spanish issuers again face the highest redemptions in 2017, even though declining significantly from the EUR 38.5bn in 2016. French and German issuers follow with EUR 23.5bn and 15.4bn respectively. Overall, given the lower redemptions in 2017 and assuming primary market activity in 2017 would be similar to 2016, 2017 could become a year of positive net supply.

EXTENDIBLE COVERED BONDS – INCREASINGLY IMPORTANT

Besides ECB purchases under CBPP3 and new issuance volumes, also covered bond structures

Country distribution of ytd issuance EUR benchmark covered bonds (EUR 115bn)



Source: Deutsche Bank

remain in focus. Given the increasing issuance and also numerous conversions due to consent solicitations in recent years, the share of extendible covered bonds in the iBoxx EUR Covered Index is at is at 42% already comparable to 27% in 2013.

Soft-bullet structures are already well established in the covered bond market. However, until a few years ago, public issuance of conditional pass-through (CPT) covered bonds was hardly accepted by investors. In the meantime, the issuance of CPT covered bonds has become more and more usual. Supported by the ultra-low yields and structural enhancements in prospectuses, most investors have accepted investing in CPT covered bonds. In contrast to soft-bullet covered bonds, a sale of cover pool assets during extension is an option and not an obligation in case of CPT covered bonds.

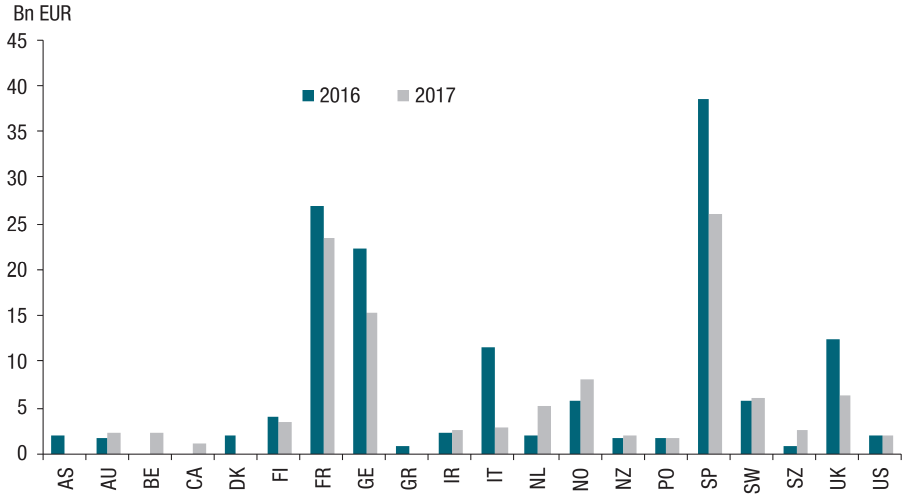
Even though some details of CPT covered bonds are similar to asset backed securities, a main strength is that CPT covered bonds can typically only be extended in case of issuer insolvency. Moreover, issuer insolvency is typically only a necessary but not a sufficient condition for pass-through (PT).

In the case of resolution of the bank issuing CPT covered bonds, the main risk seems to be that the covered bonds end up in the winding-down entity. The switch to PT can apply to one or all series of outstanding CPT covered bonds depending on the trigger breached. CPT covered bonds typically become PT sequentially if the issuers and the cover pool fail to pay principal at the scheduled bond maturity whereas a breach of contractual tests (amortisation/asset coverage test) triggers the switch of all outstanding series. It seems noteworthy that the PT in the case of CPT covered bonds only refers to the principal but not the interest. Covered bonds continue to pay interest during extension.

With an inaugural euro benchmark covered bond out of Poland issued in October 2016, the first legal framework based CPT covered bond had a successful market appearance. In the case of Polish CPT covered bonds, non-payment of the covered bonds at scheduled maturity leads to a mandatory legal framework based on 12 months' maturity extension. A breach of the liquidity test or the coverage balance test during extension would trigger the PT for all outstanding series.

Overall, the share of extendible covered bonds in the euro benchmark covered bond market is likely to increase further. While soft-bullet structures will continue to dominate the extendible covered bonds, also CPT covered bonds are likely to become more important.

Redemption of EUR benchmark covered bonds in 2016 versus 2017



Source: Deutsche Bank

Covered Bond Purchase Programme 3: Implications for primary and secondary markets

By Matthias Melms, NordLB, Franz Rudolf, UniCredit & Maureen Schuller, ING Bank

COVERED BOND PURCHASE PROGRAMME 3 – THE FACTS

On Thursday, 4 September 2014, the European Central Bank (ECB) announced its plan to buy covered bonds. This Covered Bond Purchase Programme (CBPP) came as a surprise to markets and was the third covered bond purchase programme besides the CBPP1 (from July 2009 to June 2010) and the CBPP2 (from November 2011 to October 2012). Purchases of the CBPP3 started at the end of October 2014. The CBPP3 programme was originally scheduled until October 2016. In January 2015, however, it was embedded in a broader asset purchase programme, including sovereign debt as well as international and supranational institutions and agencies with a monthly target volume of EUR 60bn. In December 2015, the ECB asset purchase programme was extended to March 2017 and the monthly volume was increased to EUR 80bn. In March 2016, the asset purchase programme was extended to also include corporate bonds from June 2016 onwards. The ECB's rational is that alongside the public sector programme (PSPP), the asset-backed securities purchase programme (ABSPP), the corporate sector purchase programme (CSPP) and the targeted longer-term refinancing operations (TLTROs), the CBPP3 will further enhance the transmission of monetary policy, facilitate credit provision to the euro area economy, generate positive spill-overs to other markets and, as a result, ease the ECB's monetary policy stance, and contribute to a return of inflation rates to levels closer to 2%.

The purchases are conducted in both primary and secondary markets in a uniform and decentralised manner, meaning that the Eurosystem central banks purchase eligible covered bonds from eligible counterparties.

In order to qualify for purchase under the programme, covered bonds must fulfil the following eligibility criteria:

- Be eligible for monetary policy operations in line with section 6.2.1 of Annex I to Guideline ECB/2011/14 (eligibility criteria for marketable assets) and, in addition, fulfil the conditions for their acceptance as own-used collateral as laid out in section 6.2.3.2. (fifth paragraph) of Annex I to Guideline ECB/2011/14.
- Be issued by euro area credit institutions; or, in the case of multi-cédulas, by special purpose vehicles incorporated in the euro area.
- Be denominated in euro and held and settled in the euro area.
- Have underlying assets that include exposure to private and/or public entities.
- Have a minimum first-best credit assessment of credit quality step 3 (CQS3; BBB- or equivalent) by at least one rating agency.
- For covered bond programmes which currently do not achieve the CQS3 rating in Cyprus and Greece, a minimum asset rating at the level of the maximum achievable covered bond rating defined for the jurisdiction will be required for as long as the Eurosystem's minimum credit quality threshold is not applied in the collateral eligibility requirements for marketable debt instruments issued or guaranteed by the Greek or Cypriot governments, with the following additional risk mitigants: (i) monthly reporting of the pool and asset characteristics; (ii) minimum committed overcollateralisation of 25%; (iii) currency hedges with at least BBB- rated counterparties for non-euro-denominated claims included in the cover pool of the programme or, alternatively, that at least 95% of the assets are denominated in euro; and (iv) claims must be against debtors domiciled in the euro area.
- Covered bonds issued by entities suspended from Eurosystem credit operations are excluded for the duration of the suspension.
- Counterparties eligible to participate in CBPP3 are those counterparties that are eligible for the Eurosystem's monetary policy operations, together with any of the counterparties that are used by the Eurosystem for the investment of its euro-denominated portfolios.
- The Eurosystem will apply an issue share limit of 70% per ISIN (joint holdings under CBPP1, CBPP2 and CBPP3), except in the case of covered bonds issued by issuers in Greece and Cyprus and not fulfilling the CQS3 rating requirement. For such covered bonds, an issue share limit of 30% per ISIN will be applied.
- Covered bonds retained by their issuer shall be eligible for purchases under the CBPP3, provided that they fulfil the eligibility criteria as specified.

Furthermore, the Governing Council has decided to make its CBPP3 portfolio available for lending. Lending will be voluntary and conducted through security lending facilities offered by central securities depositories, or via matched repo transactions with the same set of eligible counterparties as for CBPP3 purchases.

Compared to the CBPP1 and CBPP2, the current purchase programme (CBPP3) did not apply any minimum size or any specific maturity of the covered bonds purchased.

PREVIOUS COVERED BOND PURCHASE PROGRAMMES

In June 2009, the ECB had announced its first Covered Bond Purchase Programme (CBPP1) with a volume of EUR 60 bn – with purchases between July 2009 and June 2010. The programme was fully used with a nominal value of EUR 60 bn, and, in total, 422 different bonds were purchased, 27% in the primary market and 73% in the secondary market. The Eurosystem mainly purchased covered bonds with maturities of three to seven years, which resulted in an average modified duration of 4.12 for the portfolio as of June 2010. In November 2011, the ECB launched its second Covered Bond Purchase Programme (CBPP2) with a programme size of EUR 40 bn and eligible covered bonds to be purchased up until October 2012. However, cumulative purchases reached only a volume of EUR 16.4 bn, of which 36.7% related to the primary market and 63.3% to secondary markets.

As of the 10th of June 2016, the ECB reported covered bond holdings of EUR 179.85 bn under the CBPP3 at amortised cost, deriving from primary market (29.3%) and secondary market sources (70.7%). In addition, the remaining holdings from terminated covered bond purchase programmes were reported as EUR 18.10 bn under the CBPP1 and EUR 7.95 bn under the CBPP2.

PRIMARY AND SECONDARY PURCHASES

After the Eurosystem started to buy public sector securities under the public sector purchase programme (PSPP) in March 2015, the purchases under the CBPP3 have gradually softened. The ECB's decision in March 2016 to expand the monthly purchases under its asset purchase programme (APP) from EUR 60 bn to EUR 80 bn per month,

Figure 1 ▶ Key CBPP criteria in comparison

	CBPP1	CBPP2	CBPP3
Programme size	EUR 60 bn	EUR 40 bn	Not specified
Purchase period	7/2009 to 6/2010	11/2011 to 10/2012	10/2014 to 3/2017
Amount purchased	EUR 60 bn	EUR 16.4 bn	Still ongoing
Bond size	EUR 500mn or above as a rule and in any case not lower than EUR 100mn	EUR 300mn or above	Not specified
Minimum rating	AA as a rule and in any case not lower than BBB-	BBB-	BBB- (special criteria for Cyprus and Greece)
Residual maturity	Not specified but focus on 3Y-7Y	Maximum 10.5Y	Not specified
Underlying assets	Exposure to private and/or public entities	Exposure to private and/or public entities	Exposure to private and/or public entities
Retained issues	Not eligible	Not eligible	Eligible
Limit per ISIN	Not specified	Not specified	70% joint limit of CBPP 1, 2 and 3

Source: ECB, UniCredit Research

to facilitate later inclusion of the corporate sector purchase programme (CSPP), did little to alter this trend. A case in point is the declining share of the CBPP3 in the asset purchase aggregate. This share was 15% on average in 2015 and 12% in the first quarter of this year, but dropped to 7% after the EUR 20 bn increase in monthly purchases per April 2016.

The more moderate buying activity has been most notable in the secondary market. Since September 2015 the gross secondary purchases (unadjusted for redemptions of CBPP3 holdings) have been just above EUR 4 bn on average, half the average secondary purchases recorded during the first eight months of 2015. For most of this period, primary purchases largely compensated for the slower secondary buying pace (please see Figure 2). Primary buying was not only enhanced by the increased covered bond supply activity since September 2015, but also coincided with a higher take-up by the Eurosystem in new covered bond debt in the second half of last year. However, the second quarter of 2016 saw lower fresh covered bond settlements overlap with an abating buying footprint by the CBPP3 in primary. The buying consequences thereof have not been neutralised in full by a stronger presence by the Eurosystem in the secondary market.

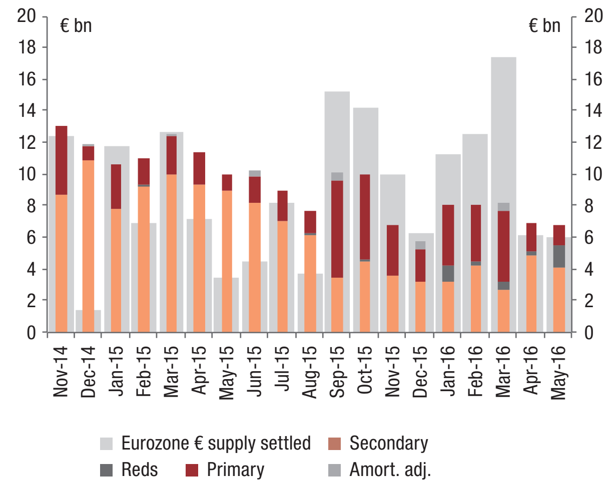
The scaling down of central bank purchases has taken place against the backdrop of ECB covered bond holdings hitting 30% of the eurozone EUR benchmark market, i.e. approaching the average primary take-up of 32% during the term of the purchase programme (please see Figure 3). Even though the Eurosystem is allowed to buy a maximum of 70% per ISIN, this seems to herald a more measured purchase pace. That said, monthly purchases are still well above the EUR 5 bn monthly average recorded during the first covered bond purchase programme. Furthermore the ECB announced in December 2015 that it will reinvest repayments on securities bought under the APP for as long as necessary.

CBPP RELATED SUPPLY DYNAMICS

Figure 4 assesses the impact of the CBPP3 on covered bond supply. We measure the monthly supply during 2014, 2015 and 2016 YTD against the average monthly supply numbers during the period 2006-2015. To make the number of months in which supply exceeded the monthly average reference level more obvious, we darkened the bars with above average supply. The figure illustrates that the strongest increase in covered bond primary activity has been experienced since September 2015, i.e. almost a year after the start of the purchase programme. This contributed to a hoped for modest expansion of the EUR benchmark covered bond market in 2015, after two consecutive years of significant shrinking. The covered bond market may grow further this year if the second series of quarterly targeted longer-term refinancing operations (TLTRO-II) conducted as of June does not throw a spanner in the works.

The supportive demand from the CBBP3 in combination with the expirations of the first two 3yr LTROs in the first quarter of 2015, have been a strong stimulant to the return of peripheral eurozone issuers to the covered bond market last year (please see Figure 5). Peripheral eurozone banks printed EUR 15 bn more benchmark debt compared to the

Figure 2 ▶ CBPP3 primary and secondary purchases



Source: ECB, ING Bank

Figure 3 ▶ Primary take-up trending lower

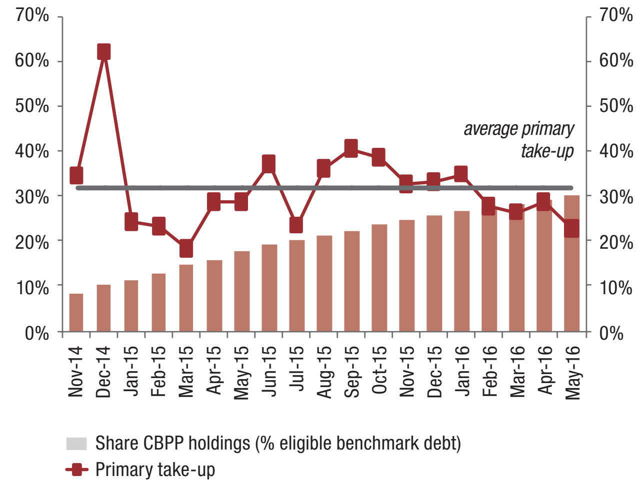
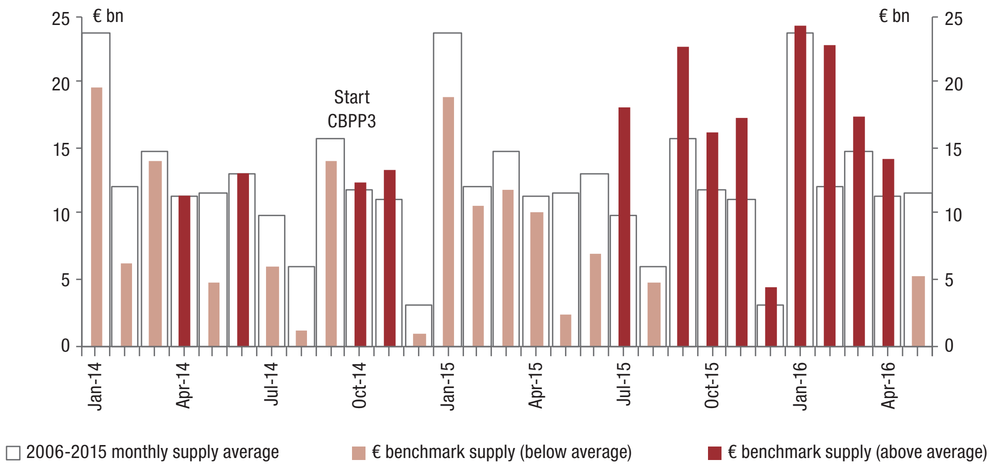


Figure 4 ▶ Assessing the supply effect of the CBPP3



Source: ING Bank

previous year and were responsible for 26% of the total covered bond supply in 2015. However, the option to attract funding under the TLTRO-II seems to curb their share in this year's print.

Additional important supply insights are offered by Figure 6. This graphic illustrates the maturity focus in 2014, 2015 and 2016 YTD versus the average coupon per maturity bucket. The figure shows the decline in the average coupon sizes of the bonds printed across the different maturity buckets as a result of the lower underlying yield levels. Yet the figure does not confirm a shift in supply away from the front end of the curve towards the 10yr area or beyond on the back of demand for yield. The EUR benchmark supply in the 3yr maturity bucket has remained relatively stable, while the share of 10yr issuance in the total supply has declined from 25% in 2014 to 18% in 2015 and 15% YTD.

Demand for longer duration deals has been lukewarm at the prevailing low yield levels. On the other hand, so far only one issuer has printed a shorter duration covered bond at a negative yield to maturity. This demonstrates that issuers strive to offer investors a positive yield, which explains the stronger concentration on the 7yr area that can typically rely on a broader investor base compared to the longer tenors.

CBPP3 AND OTHER INVESTOR BEHAVIOUR IN PRIMARY MARKETS

The combination of low yield and tight spread levels have contributed to a certain reallocation away from covered bonds into better yielding alternatives. This may be one of the explanatory factors for the further rise in distributions to central banks in primary in the second half of 2015 (please see Figure 7). Allocations to banks and financial institutions continued to see the most prominent decline. However, covered bonds have attracted renewed investor interest after the spread re-widening until the beginning of March. This is demonstrated by the modest rise in primary distributions to asset managers and insurers and pension funds in the first half of 2016.

Figure 8 offers an overview of primary allocations to central banks and SSAs per jurisdiction. The figure confirms the higher central bank participation in primary as of the second half of last year. The Southern European jurisdictions have seen the most prominent rise in allocations to central banks in this period. However, Southern European issuers place less fresh covered bond debt with central banks and SSAs this year, confirming the improved interest from other investors for these transactions.

An analysis of primary distribution statistics by maturity buckets (not plotted here) also suggests that the central banks' take-up has been the highest in the 10yr maturity bucket in the final six months of last year at 43% compared to 30% on average for the 3yr, 5yr and 7yr maturity buckets. This supports our findings in the previous paragraph, where we discussed the limited supply in longer

Figure 5 ▶ Primary activity distribution by region

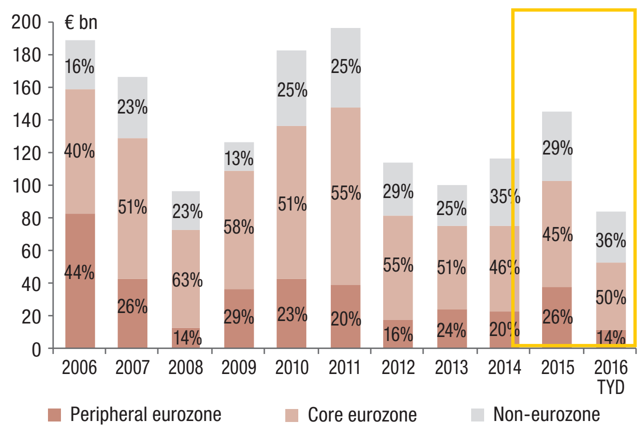
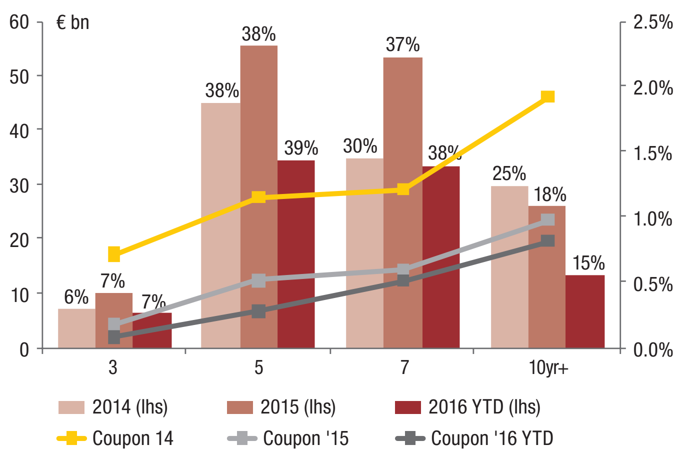


Figure 6 ▶ Coupon and eur benchmark maturity focus



Source: ING Bank

Figure 7 ▶ Primary participation by investor type

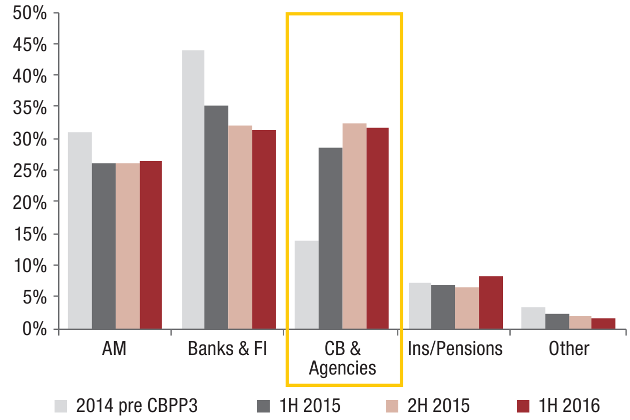
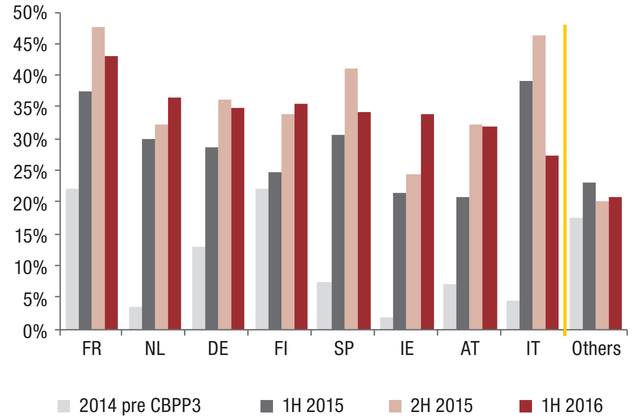


Figure 8 ▶ Central bank participation per jurisdiction



Source: IGM, ING Bank

tenors as a consequence of tepid investor interest. Allocations of 10yr deals to central banks and SSAs have declined to some degree this year, but remain elevated at 40%compared to 29% on average in the 3yr to 7yr maturities.

IMPACT OF THE CBPP3 ON SECONDARY MARKETS

Mario Draghi's announcement at the start of September 2014 that covered bonds would also be included in the quantitative easing programme of the ECB, under the CBPP3, had a significant impact on spread movements in secondary markets. We look at how different covered bond segments have responded to the purchase programme in secondary markets in the period from the 4th of September 2014 (the day of the CBPP3 announcement to the 15th of June 2016). Covered bond markets have not only be directly impacted by the ECB through the CBPP3, but were also affected by the environment created by the overall expanded asset purchase program, i.e. the overall low yield environment, leading to a significant share of covered bonds trading with negative yields.

As of end-May 2016, the iBoxx Euro Covered consisted of 728 bonds with an outstanding volume of EUR 749 bn. The aggregated volume of covered bonds from eurozone countries was EUR 555 bn or 74% and from non-eurozone countries, thus not eligible for the CBPP3, was EUR 194 bn or 26%. As of end-May 2016, the ECB had covered bond holdings under the CBPP3 of EUR 177 bn. In addition, the ECB still held EUR 18 bn under the CBPP1 and EUR 8 bn under the CBPP1. Thus, in total the ECB held EUR 203 bn, reflecting a share of around 36% of the eligible market (assumed that holdings are in benchmark bonds, leaving the also eligible retained issues and private placements aside). The reported breakdown of holdings under the CBPP3 regarding primary and secondary market purchases, was 29% primary and 71% secondary as of end-May 2016.

In order to determine whether the covered bond purchase programme triggered significant spread movements on the covered bond market, it is worthwhile to cluster covered bonds in the iBoxx Euro Covered into four groups:

> Core eurozone, including covered bonds from Austria, Belgium, Finland, France, Germany and the Netherlands;
> Periphery, including Ireland, Italy, Portugal and Spain;
> Core non-eurozone with covered bonds from Denmark, Norway, Sweden, Switzerland and the UK;
> Overseas, consisting of covered bonds from Australia, Canada and New Zealand.

The picture deriving from spread changes (please see Figure 9) is relatively straight forward. Between September 2014 and June 2016, the iBoxx Covered tightened by 11bp on average, with eurozone covered bonds outperforming with a spread tightening of 15bp compared to a slight widening of non-eurozone covered bonds by 5bp. The group of peripheral covered bonds unsurprisingly benefitted the most from the CBPP3 and showed a double digit tightening, with Portuguese covered bonds 50bp tighter, followed by Spanish and Italian covered bonds with spread tightening in the 30s area. Core eurozone covered bonds remained overall relatively stable and stayed within a range of -6 to +2bp. Covered bonds from outside the eurozone, which are not eligible for the CBPP3, widened slightly, but there was no significant differentiation between European and overseas covered bonds.

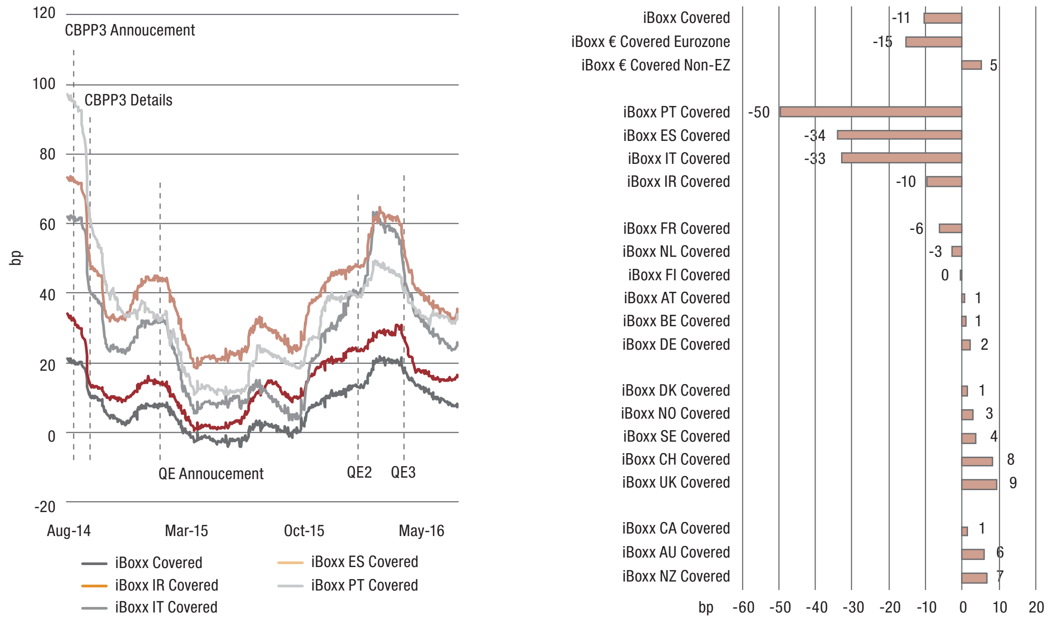
The overall spread development does, however, not reflect the spread volatility which occurred in between the starting and end-point of the period under observation. This can be best demonstrated by looking at the spread changes of peripheral covered bonds, which reacted the most sensibly to changes in market sentiment. Following the CBPP3 announcement on the 3rd of September 2014, spreads tightened massively followed by another tightening pace after the details of the purchase programme were released on the 2nd of October 2014. Following a modest spread correction at the end of 2014, another tightening wave was triggered by the ECB's announcement of the expanded asset purchase programme, including sovereign as well as supranational and agency bonds, on the 22nd of January 2015. In summer 2015, geopolitical risks and uncertainties around Greece led to a spread correction with a widening of around 10-15bp on average for peripheral covered bonds. In September 2015, the combination of a number of effects triggered a more pronounced widening pace, with the iBoxx Covered moving around 20bp wider and peripheral covered bonds widening around 40bp. The key drivers, which are also interrelated, were:

> Strong primary market activities following a supply backlog due to the geopolitical risks and the summer break;
> High new issuance premiums for new bonds due to the large gap between artificially low secondary market levels and real prices in the primary market;
> The change of ECB's covered bond purchasing pattern shifting from mainly secondary market purchases (80% secondary vs. 20% primary market) to a stronger focus on the primary market (50%). This widening pace ended on the 10th of March 2016, when the ECB decided to expand the size of its asset purchase programme to EUR 80 bn monthly purchases and extended the programme with the CSPP (QE3 in the figures below), allowing for the purchases of certain corporate bonds. This led to a continued spread tightening of the iBoxx EUR Covered (-15bp on average) and an even more pronounced tightening of covered bonds from the periphery of up to 30bp.

TIGHTER SPREADS AND NEGATIVE YIELDS

The discussed significant spread impact from the CBPP3 on covered bonds in combination with an overall extremely low yield environment resulted in a large portion of covered bonds being driven to negative yield levels (as shown in Figure 11). The low yield environment so far reached its peak in

Figure 9 and 10 ▶ Spread development of covered bond indices since the CBPP3 announcement on the 3rd of September 2014 to the 14th of June 2016



Source: Markit iBoxx, UniCredit Research

June 2016, with 10Y Bunds yields at a negative level of -0.0355%. Looking at the iBoxx Covered constituents, out of 737 bonds, 373 were showing a negative yield, representing more than 50% of all bonds. Another 118 (16%) had a barely positive yield of below 0.1%, 190 bonds (26%) had a yield in the range of 0.1% to 0.5%, while only 42 (6%) were in the range between 0.5% to 1%. Just 14 bonds (2%) still offered a yield of 1% or above, which is in most cases attributable to ultra-long durations, e.g. maturities in the 2030s or longer (please see Figure 11). This also meant, that even when going for longer maturities, the yield of covered bonds in a number of countries still remained negative, e.g. French and German covered bonds with a maturity of up to around six years had yields largely in negative territory (please see Figure 12).

In addition, the already low liquidity in secondary markets dried up further due to the CBPP3. As a consequence of low covered bond yields and low liquidity, some covered bond investors decided to abandon covered bonds and to switch to other asset classes. This development is also reflected in an investor survey done by Fitch in 2014 and 2015 and published at the beginning of the following year. Fitch's Covered Bond Investor Survey Year-End 2015 is based on the response of 35 institutions (52 in 2014). Investors were asked to choose from four different options, with multiple answers possible. The four options were 1. Switch to other assets than covered bonds; 2. Buy covered bonds that are not eligible for CBPP3; 3. Not change the investment behaviour; and 4. Buy covered bonds with longer maturities. According to the survey in 2015, 66% of the participating investors (up from 58% in 2014) said they expect to switch to other asset classes than covered bonds as at least one of their reactions to factors as the TLTRO, the CBPP3 and quantitative easing (QE). 46% of investors (vs. 37% in 2014) selected the option of buying covered bonds that are not eligible for CBPP3. 20% of the investors (vs. 25% in 2014) did not plan to change their investment behaviour and some 9% (vs. 19% in 2014) stated to buy covered bonds with longer maturities. Survey respondents identified decreasing secondary market liquidity (74%) and European quantitative easing (60%) as the top challenges for the covered bond market. The decreasing liquidity also ranked first in the 2014 survey, highlighting respondents' concern about market behaviour for the period after the end of the APP, including the CBPP3.

Figure 11 ▶ Yields of covered bonds in April 2015

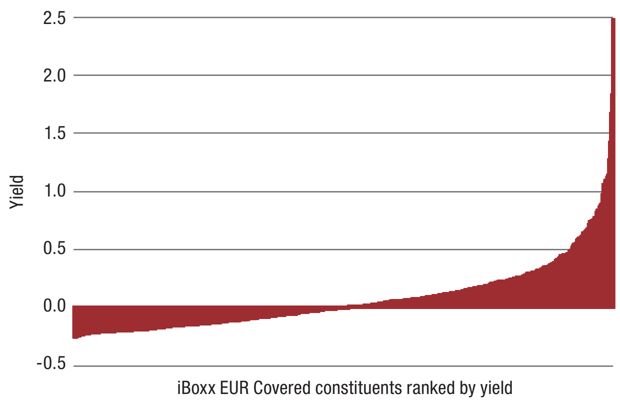
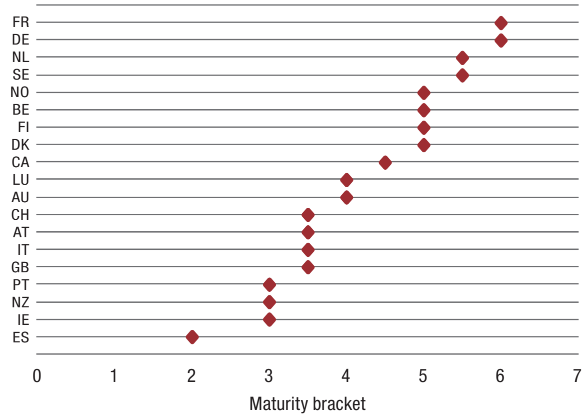
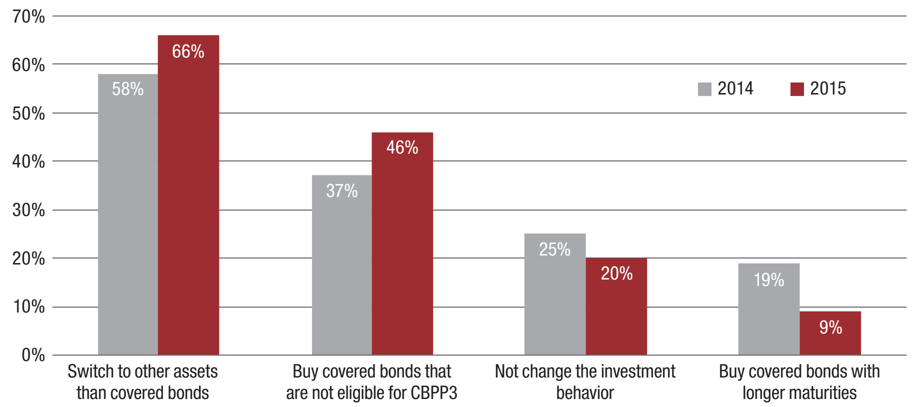


Figure 12 ▶ Time to maturity brackets at which yields are still negative



Source: Markit iBoxx, UniCredit Research

Figure 13 ▶ Investment expectations in the context of TLTRO, CBPP3 and QE



Source: Fitch Ratings, UniCredit Research

CBPP3 MARKET SURVEY[1]
In order to factor in the views of market participants surrounding the issue of purchase programmes, we carried out an anonymous survey in April 2016 on the covered bond purchase programme. Of the 88 participants to our survey, 36% were investors, a further 32% were issuers with a final 32% coming under the "other" heading. This group includes among others employees of banks and rating agencies.

Since the announcement of quantitative easing (QE) by the European Central Bank (ECB), there have been discussions at many levels about whether the implementation of such measures was in fact at all necessary. This range of views is also reflected in the results of our questionnaire: 63% of respondents were of the view that the introduction of QE was necessary, while 37% refuted this (please see Figure 14). There is no clear picture either as to the necessity of including covered bonds in the purchase programme. Although a majority of two thirds (66%) were of the view that including covered bonds in the context of QE was not necessary, a minority of 34% supported the opposite view, stressing that including covered bonds in the purchase programme was definitely justified (please see Figure 15).

The picture is even less clear-cut when it comes to an assessment of the question of whether the purchase programme is having a positive or negative impact on covered bonds. 51% of respondents were of the view that there were positive effects, and 47% saw negative effects. A further 2% could see both positive and negative effects. From a detailed analysis, it is clear that the issuer group in particular sees positive aspects, whereas a majority of investors see the purchase programme in a negative light. A substantial majority of respondents see an impact from the inclusion of corporate bonds in the QE programme. 87% of responses expect an impact on spreads and 74% on liquidity in the market. As many as 59% indicated that the corporate bond purchase programme might also have an impact on the supply of covered bonds.

According to the respondents' expectations, the TLTROs announced should have also an impact on the covered bond market. Tighter spreads on covered bonds are expected by 55% of those questioned, whereas 40% assume there will be no change. Supply activity could decline under the influence of the TLTROs, a position which 61% of respondents support, while 33% do not see any impact on the primary market and hence expect unchanged new issuance activity. Since the TLTROs make it possible for banks to raise short-term funds of four years, it is hardly surprising that market participants expect an impact on the average maturity of the paper to be issued. 76% assume that the newly issued covered bonds will have a longer maturity on average than without the influence of the TLTROs. However, 19% also indicated that the TLTROs would not have any effect on the new issue offer. The TLTROs are also likely to have an impact on liquidity in the covered bond market with 64% of respondents indicating that liquidity is likely to decline, while 36% do not expect this to happen.

Figure 14 ▶ Do you think it was necessary to introduce QE?

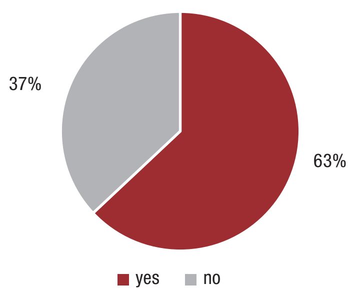
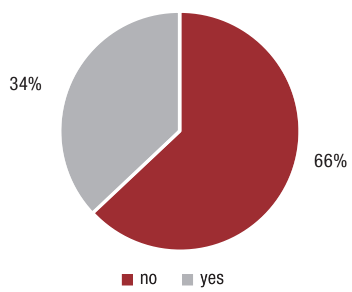


Figure 15 ▶ Do you think it was necessary to include covered bonds and launch CBPP3?



Source: NORD/LB Fixed Income Research

1 This market survey is based on collected feedback from ECBC members and other market participants.

Figure 16 ▶ Is there scope left to further increase the purchases in covered bonds?

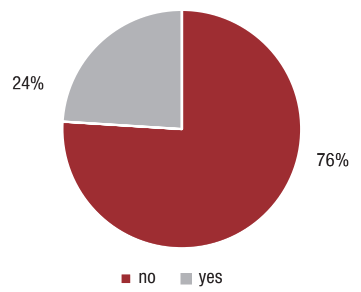
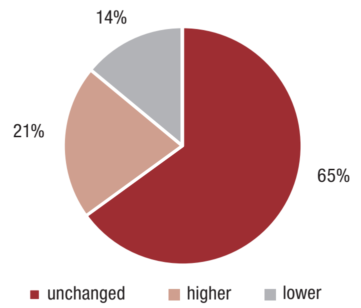


Figure 17 ▶ In light of the expansion of the monthly purchases to eur 80 bn (including corporate bonds), what do you expect for the monthly covered bond purchases



Source: NORD/LB Fixed Income Research

A clear majority of 76% of respondents are of the view that there is no further scope for increasing purchases in the context of CBPP3, although a minority of them (24%) still see scope for an extension in the volume of purchases (please see Figure 16). The ECB's announcement that it plans to increase monthly purchases across all purchase programmes from EUR 60 bn to EUR 80 bn, raises the question of whether covered bond purchases will also be expanded. Only a minority of 21% expect this to happen. The majority expects the purchase volume to remain unchanged at its existing pace (65%). Only 14% expect a reduction in the pace of purchases (please see Figure 17).

Now that the ECB has postponed the potential end of the purchase programme from September 2016 to March 2017 for the time being, with the provision that inflation expectations must be back in line with the area close to 2% indicated by the central bank, the majority of respondents expect the potential end of the purchase programme to be postponed at least one more time (67%). It is worth noting that only a small minority of 3% expects central bank purchases in the covered bond market to be brought to a premature end. As things stand at present, 30% of those surveyed could envisage monetary policy measures in the covered bond market ending in March 2017, which is the latest date indicated by the ECB (please see Figure 18).

As regards the total volume which the Eurosystem will hold by the end of CBPP3, 76% or around three quarters of those surveyed expect a target volume of between EUR 250 bn and EUR 300 bn. If the purchases remain at a monthly level of around EUR 8 bn, the upper end of the range of EUR 300 bn would be reached in March 2017. However, whereas 67% assume that CBPP3 will be extended, only 16% thought that a higher figure than EUR 300 bn would be reached by the end of the purchase programme. Only 8% of participants see a scenario with a figure of between EUR 200 and EUR 250 bn, which would represent a much slower pace of purchases and probably an end to the covered bond purchase programme before March 2017, as being within the realm of possibility (please see Figure 19).

In the context of an exit strategy for the covered bond purchase programme, respondents were more or less unanimous in their views, with 91% expecting purchases to be reduced gradually. Only 9% believe that the purchase programme will be brought to an abrupt end without any reduction in the pace of purchases.

An end to the purchase programme will inevitably have an impact on the market since a major buyer will then no longer be active in the market. However, the Eurosystem has already announced that, in the future, it will reinvest assets maturing in the market, which we estimate could have an effect of around EUR 40 bn p.a. in the medium term. With regard to spreads in the secondary market, a significant majority of 81% expect a widening should the purchase programme be brought to a close. Only 11% expect no impact or tighter spreads (8%). There should not be any implications for primary market supply. At least this is the view of around half of respondents (55%). In contrast, around one in three (33%) of respondents expect a decline in issuer activity in the primary market, whereas as many as 12% could even envisage an increase in issuance activity. The end of the purchase programme should also have an impact on liquidity in the secondary market: 59% of participants surveyed expect an

Figure 18 ▶ When do you expect CBPP3 to end?

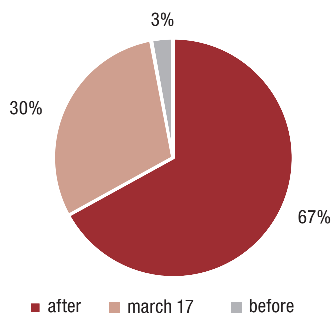
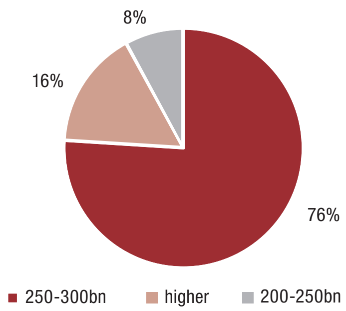


Figure 19 ▶ What will be the total amount in covered bonds held by that time (CBPP1-3; 31/03/2016: EUR 194 bn)?



Source: NORD/LB Fixed Income Research

improved liquidity, whereas 27% do not anticipate any impact. A further 14% are of the view that the liquidity situation will not deteriorate after the end of the purchase programme.

CONCLUDING REMARKS

The ECB's third covered bond purchase initiative has had important ramifications for the covered bond market, both in primary and secondary markets. Despite the fact that purchases under the CBPP3 have gradually softened since March 2015, the strongest increase in covered bond supply activity has been experienced since September last year, i.e. almost a year after the start of the purchase programme. This contributed to a hoped for modest expansion of the EUR benchmark covered bond market in 2015, after two consecutive years of significant shrinking. However, the significant spread impact from the CBPP3 on covered bond spreads in combination with an overall low yield environment drove a large portion of covered bonds into negative yield territory. This has prompted an increasing number of investors to rethink their allocations into covered bonds in favour of other asset classes.

Most of the market participants we surveyed are of the view that it was not necessary to include covered bonds as part of the ECB's QE instruments. Views diverge however about whether CBPP3 has positive or negative implications for the market. There are differences of opinion on this point, especially between issuers and investors. In addition, the majority of market participants do not expect purchases to end in March 2017; in fact, they expect an extension. Buying activity is also not likely to come to an abrupt end; a tapering is expected instead, as has taken place at other central banks in the context of their QE policy. However, an end to the purchases will have an impact on the covered bond market. Survey participants expect rising spreads, unchanged supply and higher liquidity in the market.

This article is taken from the 2016 edition of the ECBC's European Covered Bond Fact Book, the full copy of which can be accessed here.

NEWS IN BRIEF

EBA Updates Risk Dashboard for EU Banks

On the 30th of September 2016 the European Banking Authority (EBA) published the latest periodic update of its Risk Dashboard. This report summarises the main risks and vulnerabilities in the banking sector by the evolution of a set of Risk Indicators (RI) across the EU in Q2 2016. The update shows an increase in EU banks' capital ratios, while the low profitability and the high level of non-performing loans (NPLs) remain a concern.

In Q2 2016, EU banks' ratio of common equity tier 1 (CET1) increased by 10bps to 13.5%, driven by a rise of capital and a slight decline of RWAs (ratios are weighted average). The ratio of non-performing loans was 5.5%, 10bps below Q1 2016. Notwithstanding the improvement, credit quality and the level of legacy assets remain a concern. The coverage ratio for NPLs improved by 10bps to 43.9% (compared to the previous quarter), but with wide dispersion among countries.

The average return on equity (RoE) was 5.7%, unchanged compared to the past quarter and around one percentage point (p.p.) below the second quarter of the last year. The cost-to-income ratio stopped its increasing trend of the four preceding quarters and decreased when compared to year end 2015 (62.8% per year end 2015, 66.0% in Q1 2016 and 62.7% in Q2 2016).

The loan-to-deposit ratio decreased to 120.5%, compared to 121.6% in the former quarter and the asset encumbrance ratio slightly increased to 25.5% (25.4% in the previous quarter).

The full EBA Risk Dashboard report for Q2 2016 can be accessed here.

EBA Publishes Final Guidelines on Implicit Support for Securitisation Transactions

On the 3rd of October 2016 the European Banking Authority (EBA) published its final Guidelines on implicit support for securitisation transactions (available here). The objective of these Guidelines is to clarify what constitutes arm's length conditions and to specify when a transaction is not structured to provide support for securitisations. The Guidelines will contribute towards the successful implementation of the Commission's securitisation package under the Capital Markets Union (CMU) reform, giving clarity on the matter to credit institutions.

The Capital Requirements Regulation (CRR) sets out restrictions on the provision of implicit support to securitisations, as this raises supervisory concerns and undermines the achievement of significant risk transfer. If originator or sponsor institutions fail to comply with the relevant requirements, they shall, at a minimum, hold own funds against all of the securitised exposures as if such exposures had not been securitised.

These Guidelines propose an objective test for the definition of arm's length conditions and for assessing when a transaction is not structured to provide support. Furthermore, guidance is provided on the notification requirements applicable to such transactions and provisions are included to avoid a scenario whereby support is provided on behalf of the originator by another entity.

The final Guidelines take into account the feedback received during the public consultation and should be read in conjunction with the Guidelines on significant risk transfer (available here).

Fitch Ratings Updates Covered Bond Rating Criteria

On the 26th of October 2016, Fitch Ratings published its updated Covered Bond Rating Criteria. The new criteria report replaces the previous one from March 2016 and is broadly in line with the proposals presented in the exposure draft from June 2016, except for adjustments to some aspects of the Issuer Default Rating (IDR) uplift and a less quantitative approach to the recovery uplift limitation.

Overall, Fitch estimates that 93 programmes, out of a total of 123 programmes publicly rated by the agency as at the 25th of October 2016, will not be affected by the criteria change, 23 could be upgraded, six (all rated AAA or in the AA range) could be downgraded unless the over-collateralisation (OC) which Fitch relies upon in its analysis is increased to a level that supports the current rating and one could be placed on Rating Watch Evolving. Fitch intends to apply the new criteria to all covered bonds ratings on a jurisdiction-by-jurisdictions basis over the next six months.

In addition, Fitch reports that the possible upgrades are mainly for programmes issued from low-investment-grade countries (Italy, Spain and Ireland) and from speculative-grade countries (Portugal and Greece). Upgrades are also possible among UK and Norwegian programmes not rated 'AAA'. The main drivers of the upgrades are either due to a higher Issuer Default Rating (IDR) uplift or a higher payment continuity uplift (PCU), than the former Discontinuity Cap (D-Cap), or a combination of both. Of the programmes publicly rated by Fitch, 72 would benefit from a two-notch IDR uplift as opposed to 34 previously.

Moreover, Fitch reports that now it takes a broader view on European programmes eligible for an IDR uplift, in line with the exemption of fully collateralised covered bonds and secured debt from bail-in under the EU Bank Recovery and Resolution Directive (BRRD). Soft-bullet programmes with 12-month protection are generally eligible for a PCU of six notches compared with the current maximum D-Cap of four notches.

For more information, please see the covered bond page of Fitch Ratings' website here.

BCBS Publishes Final Standard on Regulatory Capital Treatment of Banks' Holdings of TLAC Instruments

On the 12th of October 2016 the Basel Committee on Banking Supervision (BCBS) published its final standard on the regulatory capital treatment of banks' holdings of total loss-absorbing capacity (TLAC) instruments (available here).

To recap, in November 2015, the Financial Stability Board published its Principles on loss-absorbing and recapitalisation capacity of G-SIBs in resolution and total loss-absorbing capacity (TLAC) term sheet (available here). These standards introduce minimum TLAC requirements for global systemically important banks (G-SIBs). At that time, the BCBS consulted on a prudential treatment for TLAC instruments held by banks (both G-SIBs and non-G-SIBs).

The final standard reflects changes made following the public consultation, and includes the following elements:

- Holdings of TLAC instruments, and instruments ranking *pari passu* with subordinated forms of TLAC, that are not already included in regulatory capital must be deducted from Tier 2 capital.
- The deduction is subject to the thresholds that apply to existing holdings of regulatory capital and an additional 5% threshold for non-regulatory capital TLAC holdings only.
- To be eligible for the additional 5% threshold, G-SIBs' holdings must meet additional conditions, including being held in the trading book.
- The standard will take effect at the same time as the minimum TLAC requirement for each G-SIB, i.e. the 1st of January 2019 for most G-SIBs.

European Commission Report on Credit Ratings

On the 19th of October 2016 the European Commission published a Report on "Alternative tools to external credit ratings, the state of the credit rating market, competition and governance in the credit rating industry, the state of the structured finance instruments rating market and on the feasibility of a European Credit Rating Agency" (available here).

Overall, the Commission's Report responds to reporting obligations, as set out in Regulation (EC) No 1060/2009 on Credit Rating Agencies (CRA), as amended by Regulation (EU) No 513/2011, (also known as the CRA Regulations), and is divided into the following parts:

- **Section I** analyses references to external credit ratings in EU legislation and in private contracts among parties in financial markets. It also assesses potential alternatives to external credit ratings that are currently being used by market participants across the EU.
- **Section II** assesses the impact and effectiveness of the measures of the CRA Regulation concerning competition in the credit rating industry.
- **Section III** evaluates the impact of the CRA Regulation on governance and internal procedures of CRAs, in particular the prevention of conflict of interests and the use of alternative remuneration morels. The Report also analyses the provisions relating to Structured Finance Instruments (SFIs) and their potential extension to other asset classes.
- **Section IV** considers the feasibility of the establishment of a European CRA for the assessment of sovereign debt and a European credit rating foundation for all other credit ratings.

BNP Paribas Fortis Brings Belgium to the Covered Bond Label Family

On the 6th of October 2016 the Covered Bond Label Foundation (CBLF) announced that BNP Paribas Fortis had become the 79th issuer to join the Covered Bond Label. Moreover, the Belgium-based bank's adhesion to the Label brings the total number of covered bond jurisdictions represented by the Label to 15 and the total number of labelled cover pools to 95.

Commenting on BNP Paribas Fortis' decision to join the Label, Luca Bertalot, Covered Bond Label Foundation Administrator, said:

"We welcome BNP Paribas Fortis as a new labelled issuer. Over recent months we have seen a significant increase in appetite for the Covered Bond Label, from both new countries and from issuers active in jurisdictions already covered. The fact that the Covered Bond Label continues to gain ground in new countries, such as Belgium, shows that issuers and investors around the world see the added value of the improved due diligence and transparency that the Label can provide."

Information on all Covered Bond Label issuers as well as more information regarding the Covered Bond Label itself can be found at www.coveredbondlabel.com.

EBA Publishes Final Guidelines on Corrections to Modified Duration for Debt Instruments

On the 11th of October 2016 the European Banking Authority (EBA) published its final Guidelines on corrections to modified duration for debt instruments (available here). The objective of these Guidelines is to establish what type of adjustments to the modified duration (MD) – as defined according to the formulas in the Capital Requirements Regulation (CRR) – have to be performed in order to appropriately reflect the effect of the prepayment risk. The Guidelines will contribute towards the successful implementation of the Commission's securitisation package under the Capital Markets Union reform, giving clarity on the matter to credit institutions.

The CRR establishes two standardised methods to compute capital requirements for general interest rate risk. One is the so-called maturity-based calculation for general interest risk, while the other one is the duration-based calculation of general risk.

These final Guidelines are relevant for institutions applying the duration-based calculation, and establish two approaches to correct the modified duration calculation. The first approach treats the instrument with embedded optionality as if it were a combination of a plain vanilla bond and an option whilst the second approach proposes to calculate directly the change in value of the whole instrument subject to prepayment risk. The Guidelines also require the calculation of additional adjustments to reflect the negative convexity as well as transaction costs and, where relevant, behavioural factors that may affect the modified duration of the instrument.

EBA Publishes Report on Review of Large Exposures Regime

On the 24th of October 2016 the European Banking Authority (EBA) published its Report on the review of the large exposures regime (available here) in response to the European Commission's call for advice of the 26th of April 2016 (see here) on the review of the large exposures framework laid down in the Capital Requirements Regulation (CRR).

The report is divided in three different sections.

First Section – Impact assessment of aligning the CRR with BCBS standards

In the first section, the EBA analyses the impact of aligning certain aspects of the EU large exposures regime with the standards on large exposures produced by the Basel Committee on Banking Supervision (BCBS). In this respect, the EBA considers it appropriate to strengthen the large exposures capital base by including only Tier 1 capital instead of allowing also a proportion of Tier 2 capital, as it is currently the case.

Second Section – Possible exemptions from the regime

The second section deals with the five exemptions identified in the call for advice, which might be currently used by institutions subject to the discretion of competent authorities or Member States. The EBA recommends removing three of the five exemptions and, more generally, highlights the importance of reducing exemptions and discretions, where appropriate, so as to further enhance the alignment with the BCBS standards and to achieve consistency across jurisdictions.

With regards to real estate finance, the EBA has recommended the removal of the exemption for the guarantees on mortgage loans financed by issuing mortgage bonds as of Article 400(2)(j) or Article 493(3)(j) of the CRR. These guarantees are legally required and used when a mortgage loan financed by issuing mortgage bonds is paid to the mortgage borrower before the final registration of the mortgage in the land register, provided that the guarantee is not used as reducing the risk in calculating the risk-weighted exposure amount.

In order for a mortgage loan to be valid, it has to be registered in the land register. To the extent that a mortgage loan is granted on the basis of mortgage securities (whether mortgage backed securities or covered bonds), the disbursement of the mortgage loan may be made before the final registration of the mortgage in the land register. Such disbursement may be subject to the provision of guarantees. These guarantees may be exempted from the large exposures limit where they are not used for reducing the risk in calculating the risk-weighted exposure amounts.

The recommendation of removing the exemption is largely based on the fact that it has limited use across the EU. Though, this exemption is fully applied in Austria, Germany, Denmark, Lithuania, Luxembourg and Latvia. The exemption is partially applied in Spain (exemption of 50% of the exposure value for credit institutions and full exemption for investment firms) and Poland (exemption only applied to banks). In addition, the removal of this exemption might have a relevant the impact on Denmark. Denmark has highlighted that this exemption is vital for short-term exposures for the strictly regulated Danish mortgage credit institutions, for the Danish capital markets and to allow the Danish banking sector to meet the LCR. Furthermore, it is vital for small- and medium-sized banks' ability to service clients using lending from mortgage credit institutions and the refinancing of such loans in Denmark.

Third Section – Other possible aspects that could be aligned

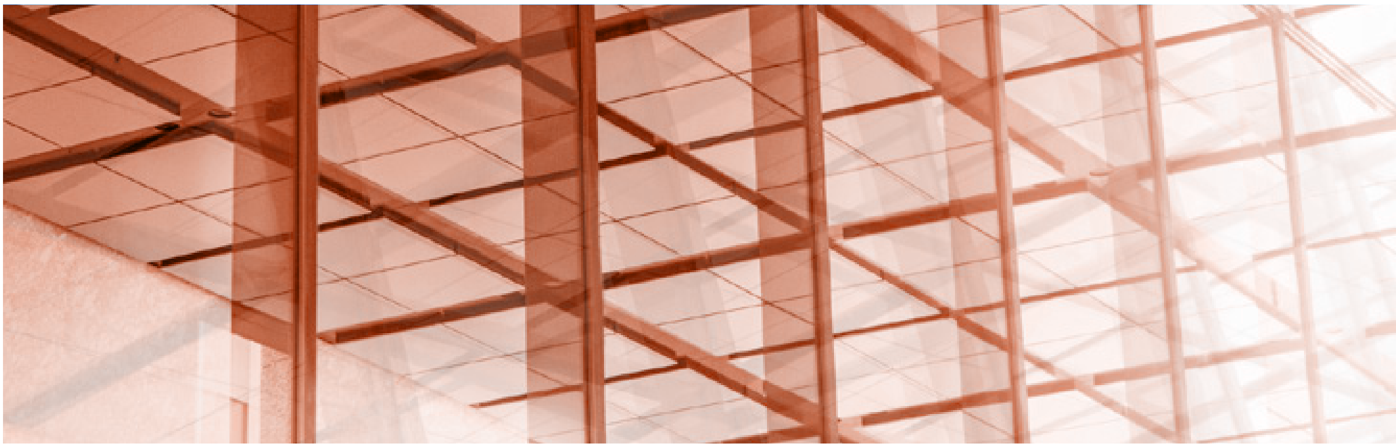
In the third section, the EBA considers other aspects that could be aligned to the BCBS standards or other issues that require further work and quantifies the impact, where possible.

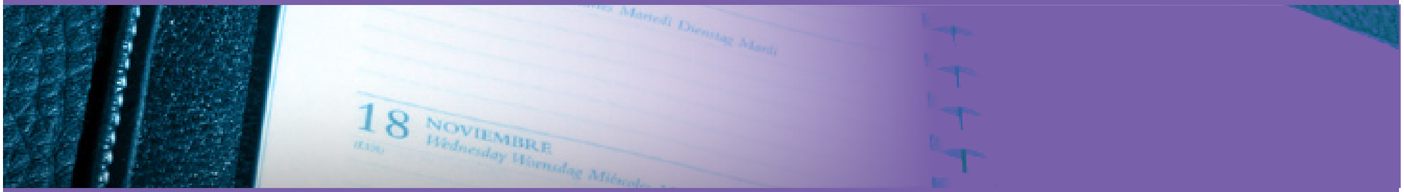
In particular, it quantifies the impact of no longer allowing institutions to reduce the exposure values by the value of immovable property used as collateral, in the framework of the credit risk mitigation (CRM) techniques. The analysis of EBA shows that the non-recognition of 'real estate' as an eligible CRM technique would have a small impact in terms of the compliance with the large exposures limits, at least in its sample. It is noted, however, that this analysis does not consider the impact of the non-recognition of 'real estate' on smaller EU institutions, which could be material. EBA stands ready to further investigate this aspect. Alternatively, a limited recognition of immovable property could be allowed as collateral (i.e. only for specific portfolios, such as retail, or when immovable property is recognised in the standardised approach for credit risk).

This is topical as, under the BCBS framework, institutions are no longer allowed to reduce the amount of exposures by the value of immovable property used as collateral. It should be noted that the BCBS standards also acknowledge that, for banks that fall outside the scope of application of the Basel framework (i.e. non-internationally active banks), there may be a case for recognising physical collateral in the context of the large exposures framework.

Finally, the report draws attention to the Q&As submitted by stakeholders through the EBA Q&A tool (see here), which have identified possible errors, inconsistencies and material issues in the current CRR large exposure text and recommends they are taken into account in the review of the large exposures regime.

This report will support the Commission in its review of the large exposures framework as part of the overall CRR review.





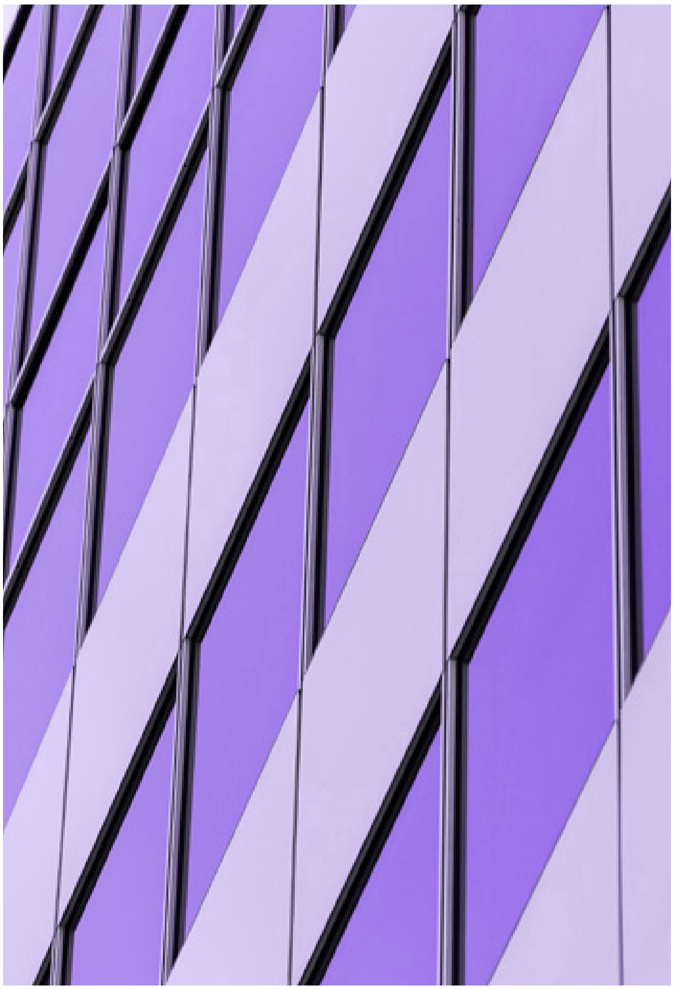
AGENDA

NOVEMBER 2016

07-18/11	Conference of the Parties (COP 22) in session – Marrakech
07/11	European Commission Public Hearing on Review of the EU Macro-Prudential Framework – Brussels
08/11	European Parliament Financial Services Forum (EPFSF) Event on Global Standards for a 'Bail-In' Tool: Implementation Challenge in the Context of an Effective EU Resolution Framework – Brussels
10/11	European Mortgage Federation (EMF) Valuation Committee Meeting – Brussels
11/11	European Commission & Latvian Government Public Conference on Financing Energy Efficiency in the Baltic States – Riga
14/11	UNECE Real Estate Market Advisory Group (REM) & vdp Conference – Berlin
17/11	European Covered Bond Council (ECBC) Steering Committee Meeting – Brussels
18/11	European Mortgage Federation (EMF) Executive Committee Meeting – Brussels
18/11	European Banking Authority (EBA) Public Hearing on Covered Bonds – London
22/11	IMN Conference on Italian & European Non-Performing Loans (NPLs) – Milan
23/11	3rd Meeting of the CEN-CENELEC Working Group on "Energy Efficiency Financing Tools" – Brussels
24/11	Irish Green Building Council Event on Green Mortgages – Dublin
25/11	European Banking Industry Committee (EBIC) Working Group on Banking Supervisory Practices Meeting – Brussels
28/11	4th Single Risk Board (SRB) Banking Industry Dialogue Meeting – Brussels

DECEMBER 2016

07/12	European Parliament Financial Services Forum (EPFSF) Event on Impact of Regulatory Reforms on Market Liquidity – Brussels



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