

## ECBC Paper

# Covered Bonds: Legal and Supervisory Protections for Bank Creditors and Their Relevance to Financial Stability

Brussels, 7 January 2015

The European Covered Bond Council (ECBC)<sup>1</sup> represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was launched by the European Mortgage Federation (EMF) to promote the interests of covered bond market participants at international level. As of December 2014, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of the EUR 2.6 trillion outstanding covered bonds.

### 1. Executive Summary

The issue of asset encumbrance has become a major topic of debate in capital markets over the past years. This debate can have a significant impact on the “capabilities” of the covered bond asset class to ensure financial stability and efficient long-term funding without jeopardising the position of other creditors at the bank. In particular, the gradual increase in asset encumbrance has raised questions about the underlying driving forces and consequences for financial stability. As a result, attention quickly turned to the role of covered bonds when, in 2011, their issuance in the EUR market exceeded the issuance of senior unsecured bonds for the first time.

- In the following bullet points, the ECBC outlines its views on the relationship between covered bonds and asset encumbrance. The ECBC completely agrees on the crucial importance of guaranteeing a proper balance between secured and unsecured debt and of lowering any potential excessive encumbrance. We strongly believe that the asset encumbrance issue needs to be addressed through a holistic and gradual approach taking into consideration all different sources of encumbrance.
- The covered bond asset class plays a key role in guaranteeing financial stability, thanks to macro-prudential characteristics, legal safeguards and risk mitigants embedded in dedicated national legal and supervisory frameworks. In particular, during the recent financial turmoil, covered bonds have been one of the only asset classes able to restore investor confidence and to ensure to European issuers access to debt capital markets. Against that backdrop, it is crucial under financial stability considerations to allow flexibility with regards to asset encumbrance levels and not to set any hard or one-size fits-all limits.
- As acknowledged by the European Commission Green Paper on Long-Term Financing, the intermediation process by which the supply of funding is channelled towards investment has been under pressure over recent years. This is especially the case for commercial banks – the traditional financial intermediaries in Europe (over 75% of total intermediation). For over 200 years, covered bonds have proved to be an efficient debt instrument enabling banks to mobilise

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

private sector means and capital towards long-term investment with a wide public benefit and, in particular, housing loans and public sector debt.

- Covered bond legislation automatically limits asset encumbrance, for example through requiring licenses for covered bond issuance and imposing strict collateral asset eligibility criteria. As a result, covered bond encumbrance tends to remain more stable and less sensitive to market conditions in times of turmoil than other forms of encumbrance arising from Repo haircuts or derivative collateral.
- Recent studies indicate that there is no direct evidence of correlation between the covered bond encumbrance of a bank and its senior unsecured funding conditions.
- From a bank's perspective, covered bonds are cost-efficient funding instruments compared to unsecured bank debt reflecting the low-risk character of the former. This positively impacts the profitability of banks allowing them to strengthen their capital base. This in turn benefits unsecured investors as well.
- The existence of differences in countries' financial systems and different business models requires, in our view, a case-by-case interpretation of the level of asset encumbrance. For specialised issuers for instance, the level of encumbrance – given a broad definition – is close to 100%. For those financial institutions which do not take any deposits, all senior investors are institutional investors who are well aware of their position in the priority ranking in case of insolvency. For such institutions, the high level of encumbrance is only a consequence of their business model and cannot be interpreted differently.
- Other forms of asset encumbrance were more dynamic in the past. The covered bond market has experienced a smooth development over recent years with an average growth of 5.6% since 2005, despite the fact that the market shrank in 2013. This recently observed trend confirms the value of this asset class as a crisis management tool for accessing capital markets during financial turmoil and the reduction of the reliance on this instrument once the funding landscape offers more options for lenders. Compared with the other forms of encumbrance (central bank repo transactions and derivative collateral), and considering the recent introduction of covered bond laws in a number of countries which did not have legislation on covered bonds in place, this remains a sustainable development. This growth has often been misinterpreted because, in parallel, the senior unsecured and securitisation issuance have been shrinking.
- A large part of a bank's total level of asset encumbrance is hard to measure and this may lead to focusing mainly on the most visible and transparent part of encumbrance, such as covered bonds, and hence reaching biased conclusions.
- The transparent nature of covered bonds' rules on asset encumbrance, as well as its stability over time, means that other creditors to the bank, including unsecured investors, will have a clear idea of which assets will be encumbered for covered bond collateral purposes when making their investment decision. This means that issuing covered bonds does not pose a threat to other bank creditors. Even considering the dual recourse nature of CBs, this only places CB holders *pari passu* with respect to other creditors, thus reflecting that the CB holders will not, for what is beyond the encumbered assets, have a preferential treatment especially in deposit-taking banks. As a matter of fact, the very existence of asset encumbrance lowers the element of risk and uncertainty for the unsecured investor, who will be aware of exactly what CB holders are entitled to in case of issuer default.
- The very existence of asset encumbrance on lenders' balance sheets actually reflects a much higher level of financial stability and business model resilience. The simple fact that asset encumbrance is high does not at all signal a concern in terms of financial stability, but merely that the lender is carrying out its borrowing functions (linked to lending) by ensuring it has the means

available to back these operations, which is not the case with unsecured funding. The question of asset encumbrance with respect to the availability of assets for the fulfilment of financial stability requirements is already enshrined in existing regulation, and any further limit on encumbrance levels would only be burdensome for lenders, and redundant in terms of achieving financial stability.

- The covered bond industry has made substantial efforts to increase transparency through the Covered Bond Label initiative. This initiative has provided investors with improved information disclosure, allowing them to better assess asset encumbrance generated through covered bonds.

To summarise, the ECBC believes that establishing hard limits on covered bond issuance would be an inappropriate solution. One-size-fits-all limits would be detrimental for this essential asset class and, therefore, for the European banking industry as a whole. The ECBC, therefore, invites European regulators to further investigate other potential solutions in the dialog with the Industry.

Please refer to Annex I for more details and quantitative evidence on the pattern of performance of covered bonds versus senior unsecured bonds and financial stability.

## 2. Covered Bonds and Financial Stability

Covered bonds are one of the key components of European capital markets with the asset class playing an important role as a robust long-term financing instrument contributing to the efficient allocation of capital and, ultimately, economic development and prosperity.

Under the prevailing adverse market conditions, covered bonds have proved to be the most reliable wholesale funding source, significantly contributing to overall financial stability. It is important to note in that context that the act of encumbering assets itself does not increase the probability of default. On the contrary the encumbrance of assets tends to increase banks' cash holdings and thus decrease banks' immediate probability of default.

In fact, from an issuer's perspective, covered bonds provide a significant contribution to the enhancement of a banks' funding profile and the management of liquidity. Benefits provided by covered bonds include:

- Extending the maturity profile of the liabilities, allowing banks to better match their long-term asset portfolios;
- Providing stability to the funding mix, allowing Asset Liability Management (ALM) teams to increase predictability in the maturity profiles;
- Enabling issuers to increase diversification in the investor base, both in terms of geography and investor type;
- Utilising loan assets which are otherwise illiquid assets (e.g. mortgage loans), and thereby improving the liquidity of bank balance sheets; and
- Serving the industry as one of the most reliable funding tools, even in times of turmoil.

In the context of financial stability, covered asset encumbrance also actively contributes to restore investors' confidence in the European banking system. Therefore, asset encumbrance does not necessarily represent a constraint for senior unsecured creditors and the additional subordination it creates can, to a certain extent, be offset by the benefits that this brings to viability of European banks.

From an investor's perspective, the major strengths and regulatory advantages of covered bonds can be summarised as follows:

- Double recourse to issuer and cover pool;
- Higher rating and higher rating stability than unsecured debt;

- Lower-risk weighting for EEA Covered Bonds bought by EEA banks;
- Favourable treatment under Solvency II;
- Generally better liquidity through larger issue size;
- Favourable repo treatment at the European Central Bank (ECB) and other central banks;
- Eligible as liquid assets under Basel III rules and the Liquidity Coverage Requirement (LCR), and
- No risk of bailing-in.

This explains the success of covered bonds which, for two and a half centuries and through many crises, have played an increasingly important role in the financing of real estate, public sector and ship assets. With over EUR 2.6 trillion outstanding at the end of 2013, covered bonds continue, now more than ever, to play a central role in banks' funding strategies. The EUR 429 billion issuance and arrival of 10 new issuers during 2013 for a total of more than 300 issuers in more than 25 Member States evidence the ability of the asset class to provide essential access to long-term capital market funding, even during volatile market conditions, notably thanks to a stable investor base.

### 3. Covered Bonds as a Long-Term Funding Tool for the European Economy

The covered bond industry shares key objectives and challenges of the current legislative developments undertaken in Europe, which aim at contributing to the long-term growth of the European economy by designing a robust and efficient private financial sector able to ensure financial stability and long-term financing.

Covered bonds are indeed an effective tool to channel long-term financing for high quality assets at reasonable cost. They improve banks' ability to borrow and lend at long-term horizons and, hence, represent a stable source of funding for key banking function such as housing loans and public infrastructure. In this regard, we believe that covered bonds represent a key funding tool for the future European banking industry.

For instance, long-term financing is crucial for housing finance. Building or purchasing a home is the most major investment for the majority of European citizens, representing typically 4 to 5 times their annual income. In absence of pre-existing wealth, they would have to wait for 40 or 50 years if they had to rely solely on their individual savings.

Borrowing resources are therefore necessary to acquire a home and more generally to support the European economy. Given the size of the investment, their repayment must be spread out over a long period to be compatible with annual savings capacity and, hence, requires long-term funding tools for banks to avoid asset and liabilities mismatches. Covered bonds are typically designed for mortgage lending, and it is important to recall that a mortgage-focused bank thus tends to have more asset encumbrance than a bank with a non-mortgage focus. Cutting back lending capacities of those more specialised mortgage-focused banks would limit the credit supply the economically so important area of housing finance.

The efficient availability of mortgage finance is also based on the ready availability of financing at the longest tenors possible and the lowest price feasible. Without this, the mortgage market would be a function of market sentiment and the refinancing rates available to borrowers would be subject to much more price volatility, making planning for private households more challenging.

In this context and in particular in times of low risk appetite from investors, covered bonds with their key safety features such as strict legal and supervisory framework, asset segregation, a cover pool actively managed in order to maintain the quality of the collateral, play an essential role in ensuring the flow of capital in financing long-term growth and the real economy.

During the recent financial turmoil, the existence of a well-functioning covered bond market has allowed governments in Europe to constantly channel private sector funds to housing markets and maintain a relatively efficient lending activity without additional increase of the burden for taxpayers and public debts. This is the case for instance in the US, where 95% of the mortgage markets benefit

from a governmental guarantee after the federal takeover of Fannie Mae and Freddie Mac. However, it is true that over recent years, the relative share of covered bonds in percentage terms has tended to increase in European banks' funding mix (though year-to-date, senior unsecured issuance by European banks has been almost double the size of this year's covered bond supply). The development of the covered bond market has also benefited from the combined effect of four main factors:

- Shrinking of senior unsecured issuance;
- Shrinking of securitisation issuance;
- Investors flight to quality; and,
- Deleveraging of European banks balance sheets.

Recently, covered bonds have been one of the few asset classes able to bridge the gap between issuers and investors. This global trend has therefore reinforced the reliance of financial institutions to this funding channel and has increased the amount of covered bonds on their balance sheets.

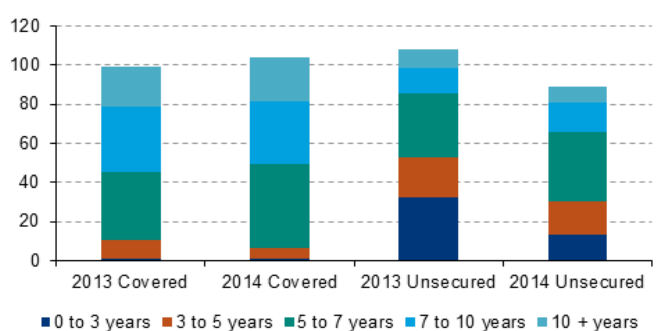
#### 4. Asset Encumbrance and Financial Stability

With regard to asset encumbrance, it is important to note that the level of asset encumbrance varies over time and across banks and countries. For this reason, the ECBC believes that it is crucial to analyse all sources of asset encumbrance: short-term secured funding, such as repos; long-term secured funding, such as covered bonds; but also other sources of encumbrance such as derivatives and insurance claims. Against this background, it is worthwhile stressing that, in some jurisdictions, covered bond issuers are specialised issuers with no deposit funding and, hence, in these cases any asset encumbrance caps or limits adopted would simply not be relevant.

In particular, asset encumbrance levels differ depending on the banks' business models, funding strategies and degree of individual or systemic weakness. These variations of the level of asset encumbrance should be analysed by taking into consideration the funding structure of the issuer, i.e. looking at bank funding sources, market funding and capital; and also by acknowledging the reasons why changes may take place, e.g. increases in asset encumbrance can arise from the need to restore investor confidence and financial stability.

For example, Nordic banks typically show high but safe asset encumbrance given their focus, in most cases, on residential mortgage lending. The importance of covered bonds still prevails as they allow funding of long-term and low margin assets such as mortgage and public sector loans with longer term and competitive debt instruments. The typical maturity of covered bonds year-to-date (YTD) has been 5 years and above, while senior unsecured mainly range between 3 and 5 years. The maturity extension of new covered bond issues has been even more visible during 2H14 driven by the 4yr TLTRO programme by the European Central Bank (ECB) and the covered bond purchase programme as evident from the figure below.

**Figure 1: EUR Benchmark New Issued by Maturity**



Source: Bank of America Merrill Lynch

Asset encumbrance is not restricted to covered bonds with universal banking groups or wholesale/investment banks also being encumbered from repurchase agreements or securities lending. In October 2013, the International Monetary Fund (IMF) published data in its Global Financial Stability report on the evolution of asset encumbrance pre- and post- the financial crisis, showing differences in levels as well as sources. For two thirds of the countries analysed, encumbered assets represented 10% of total or less – with covered bonds not necessarily being the main encumbrance driver. The bulk of asset encumbrance tends to be central bank borrowing (especially in peripheral countries) or private repos.

In contrast with other sources, asset encumbrance from covered bonds is restricted to the amount of eligible assets, e.g. residential mortgages with max. 80% loan to values (LTVs) or commercial real estate loans with max. 60% LTVs. This has limited the ability of some banks in the periphery to repo covered bonds during the crisis as they were running out of eligible assets and thus could no longer issue retained or public covered bonds. Therefore, there is a natural cap to the issuance of covered bonds which is also market-to-market through the LTV indexation. Depending on banks' business models, eligible assets represent a limited amount of total assets.

Furthermore, asset encumbrance from covered bonds is more stable and transparent in comparison with other sources. For example, asset encumbrance from repos could be considered volatile and can change materially in banks' quarterly results. In addition, all covered bonds remain on balance unlike securitisation which can be fully or partially de-recognised depending on the deal structure, who has control, reputation risks, etc.

Covered bonds fall under bank supervision as on-balance debt instruments. In some countries, permission from regulators is specifically required in order to issue covered bonds. These bonds are also scrutinized as part of the review of banks' funding strategies and composition so that any risk arising from covered bond funding or asset encumbrance would be addressed as part of the banks' supervisory monitoring. For instance, the United Kingdom and the Netherlands have been particularly explicit in that respect, although these two countries do not follow a one-size-fits-all approach in order to take into consideration individual banks' characteristics. In May 2014, the German Federal Financial Stability Authority (Bafin) announced its intention to regulate over-collateralisation (OC) and require different levels based on cover pool specificities. Such approach should provide better clarity regarding protected OC and prevent the OC volatility seen, notably due to rating requirements.

Furthermore, secured borrowing can in fact strengthen the franchise value of a bank, e.g. growing residential mortgages via covered bonds, an activity which continued even at the height of the financial crisis and which saved many banks' funding base. The absence of a covered bond market in Europe (supported by credible legal frameworks) would have affected European banks much more than having covered bonds for funding (and with a market for them).

The ECBC also finds it interesting to note that asset encumbrance data can be misleading. For example, asset encumbrance is comparatively lower for larger banks with geographically diversified portfolios, such as large Spanish banks. Therefore, for a bank which is safely booking domestic residential mortgages funded with covered bonds, diversifying away into foreign ventures just to lower asset encumbrance is not helpful as it can in fact augment the levels of risks. Moreover, asset encumbrance as such should be viewed as a dynamic process and not a static situation. Today's unencumbered banks could turn out highly encumbered if their credit characteristics weaken and they lose funding market access and need to rely on secured central bank borrowing to fund their assets.

Asset encumbrance in itself should not lead to credit weakness. It is only if a bank is facing liquidation, which could stem from a variety of reasons that asset encumbrance becomes relevant for unsecured creditors and depositors. The case of straightforward liquidation, which would leave unsecured creditors out, is not plausible for the more significant banks, especially as new resolution regimes are being put into place. The scenario of carving out assets from secured funding never happens to date and is unlikely to occur in the future. It is thus important to focus on resolution scenarios for a bank rather than asset liquidation. In this scenario, the loss waterfall starts with

equity, hybrids, subordinated, and only after those the senior unsecured creditors are affected.

This is confirmed by investors' current focus on banks' loss absorbing capacity, such as the Minimum Requirement for own funds and Eligible Liabilities (MREL) and the total loss absorbing capacity (TLAC) rather than asset encumbrance levels. In fact, asset encumbrance has not prevented banks to access markets for senior unsecured funding as confirmed in 2014. Rating agencies in their updated methodologies also estimate possible losses for senior unsecured and/or non-guaranteed deposit holders depending on the cushion they have below them. Asset encumbrance levels as such have little value as there is no automatic negative correlation with the probability of default of the bank, because as evident from above, high asset encumbrance can actually strengthen the business model of the bank. However, higher transparency of asset encumbrance would be useful in order to better understand the bank's funding flexibility in distressed scenarios for example.

Also, asset encumbrance limits through covered bond issuance caps can prevent some banks to issue covered bonds and as a result, could create an un-level playing field as it is the case in Australia, for example. This 8% limit places Australian regional banks at a competitive disadvantage. Based on the relevant calculations, the Australian regional banks would only be able to establish covered bond programmes of a size ranging between A\$ 0.8bn and A\$ 4.8bn depending on the OC level. Their issuance capacity would be even more constrained if they wish to achieve Aaa/AAA covered bond rating given the lower ratings of the bank. Suncorp-Metway (SUNAU), which has currently a A\$ 5bn covered bond programme, commits 23% OC instead of the 3% minimum by law. Therefore, this limit creates an entry barrier to the covered bond market especially keeping in mind the minimum 500mn benchmark size in each market. It also does not take into account business models and favours the largest banks. This could encourage asset expansion in Australia just to enhance issuance capacity which would not be helpful as it could in fact augment the levels of risks. In addition, asset encumbrance limits put in place so far have no economic rationale and have been set up arbitrarily resulting in negative consequences as it is the case for regional banks in Australia. Moreover, Australian banks want to be regarded as frequent issuers to ensure the widest investor base. However, given the limited pool size, they shy away of issuing very long maturities which would be more attractive from an asset-liability perspective and are almost forced to issue shorter maturities to have more regular roll-overs of their debt. Apart from the aforementioned reasons, there is also the difficulty in setting specific asset encumbrance limits. Recovery analysis related to asset encumbrance under a liquidation scenario may have different outcomes depending on the "market value" assumed for the assets and the level of over-collateralisation tied to covered bonds.

The reliance on covered bonds during the financial crisis has been to a large extent supported by the existence of rating triggers/minimum requirements in regulations which create distortion. If covered bonds have not been immune from downgrades, they have been the least affected in comparison to sovereign and bank ratings, they were more stable and kept at higher levels due to their de-linkage from the underlying issuer. In particular, such de-correlation is even more significant under the updated methodologies taking into account covered bond exclusion from bail-in.

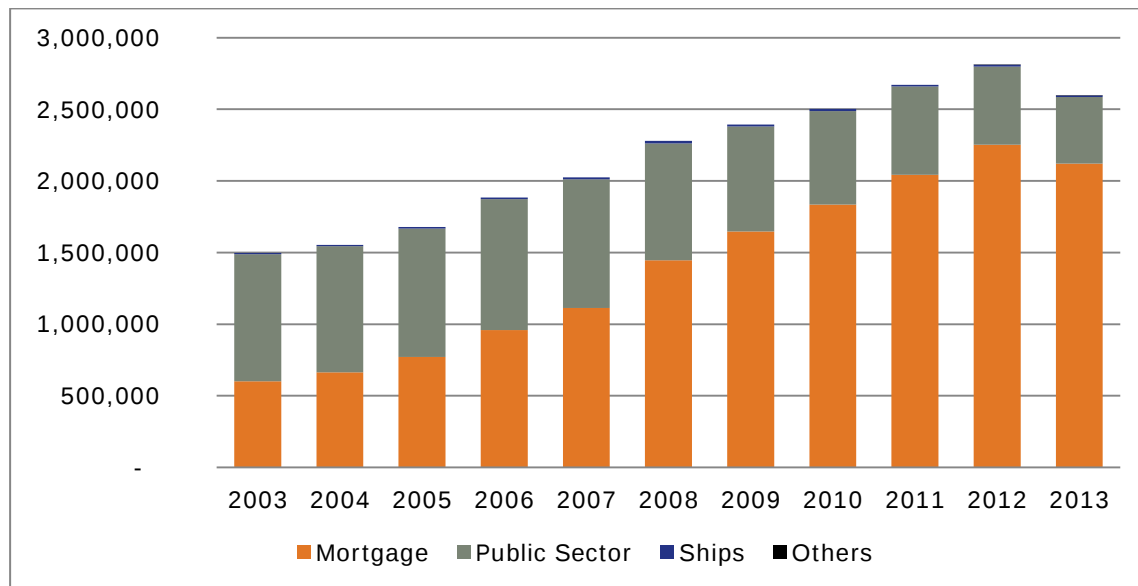
Regulators already have a broad set of instruments available to counterbalance and to identify the optimal level of encumbrance by adopting a case by case approach. In this respect, an important contribution is given by the Covered Bond Label, which provides a framework for more harmonised and transparent disclosure of data on the asset side of the covered bond issuers' balance sheets. We believe that deviating from this targeted approach and setting any hard limits across the board can seriously hamper the capabilities of an issuer to react in times of distress, thereby reducing importantly the set of actions that a bank may choose from in case of market turmoil.

## 5. Covered Bond Transparency and Disclosure of Information

Discussions on asset encumbrance have not really acknowledged the positive impact on financial stability but rather created the myth that the growing issuance of covered bonds would boost asset encumbrance and, therefore, rather destabilise the system. This belief was fostered by the high

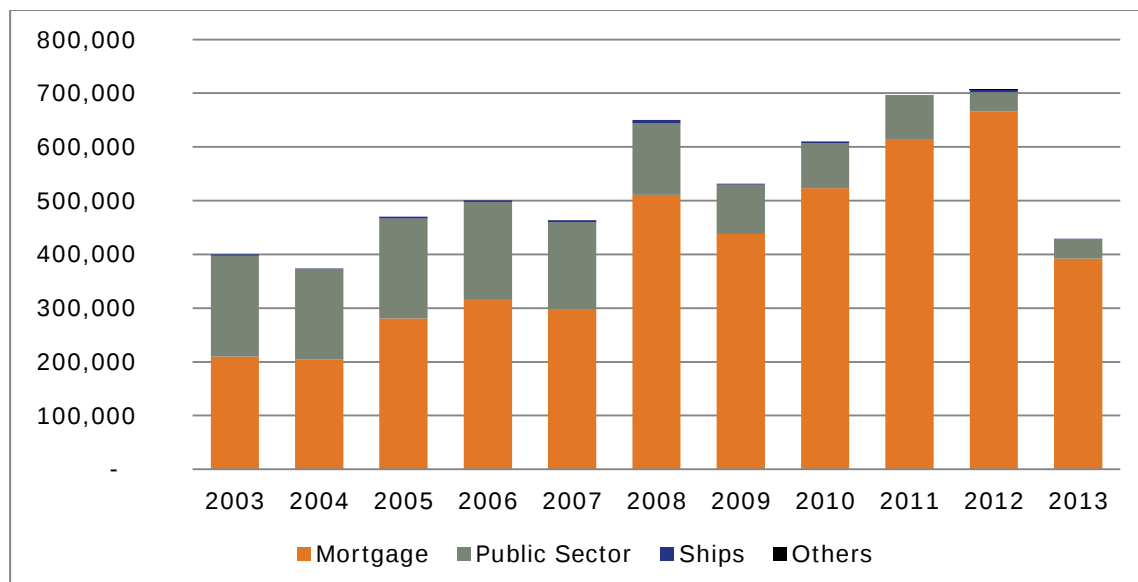
visibility of covered bond issuance and the transparency of underlying cover pools, while other and more important sources of asset encumbrance (e.g. repo, collateral for derivatives) expanded more in secrecy. Looking at the data on covered bonds outstanding and issued (see below charts), we notice that the covered bond market has experienced a smooth development over recent years with an average growth rate of 5.6% p.a. since 2005, despite the fact that the market shrank in 2013. The trend observed confirmed, in our opinion, the value of this asset class as crisis management tool for accessing capital markets during turmoil and the reduction of the reliance on this instrument once the funding landscape offers more financing options for lenders.

**Figure 2: Covered Bonds Outstanding, 2003-2013, EUR million, by collateral type**



Source: ECBC

**Figure 3: Covered Bonds Issuances, 2003-2013, EUR million, by collateral type**



Source: ECBC

Over recent years, the covered bond community has made significant efforts to improve the transparency of their asset class promoting in particular the following initiatives:

- ECBC statistics on worldwide covered bonds outstanding and issuance have been published since 2004 ([here](#));
- ECBC Fact Book ([here](#));
- ECBC Comparative database providing description of the legislative framework of every covered bond model and the official legislative text in English ([here](#));
- Covered Bond Label ([here](#)) providing both covered bond data at issuance level in a comparable format and cover pool data displayed (on each individual issuer's profile from January 2013) on the basis of the respective National Transparency Template.

Whilst the ECBC recognises the concern linked to the increased level of asset encumbrance in recent years due to the need of ensuring investors' confidence in the private sector by using intensively secured funding, when issuing covered bonds this increased level of encumbered assets appears to be manageable as it is strictly supervised and investors have enough information to exercise due diligence. Therefore, we do not consider it appropriate to highlight covered bonds as the main source of asset encumbrance since, in comparison to other sources of encumbrance, they present a high level of transparency and they are under the direct control of the supervisory authorities.

In this relation, the ECBC has made the clear commitment to enhance transparency in the covered bond market through the establishment of the Covered Bond Label ([here](#)) which has become fully operational since January 2013. This initiative, undertaken by the issuer community, was based on an intense and constructive dialogue between the investor community, major national and European authorities, as well as the main law firms active in the covered bond arena who have supported and followed the creation of the Covered Bond Label Foundation and its website. In its essence, the Covered Bond Label aims at providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. This transparency tool presents very detailed asset and liability side information and facilitates the investors' due diligence when comparing different issuer models, products in different markets and national supervision.

In fact, covered bond issuers from 13 different jurisdictions across the European Union have come together to develop a National Transparency Template providing cover pool information in a harmonised format on the basis of common guidelines agreed at European level. This chosen format allows for both the recognition of national and business model specificities and the comparability of information required to facilitate investors' due diligence.

## 6. Covered Bond Over-Collateralisation

Another popular myth in the asset encumbrance debate is the view that the downswing in the credit cycle would force covered bond issuers to boost over-collateralisation (OC) in their covered bond programmes, thereby encumbering more assets without generating new funding.

Eligibility criteria for cover pool assets play an important role in that context. Restricting cover pool eligibility to high-quality collateral, as covered bond frameworks do, has the advantage of effectively limiting the issuance capacity of covered bonds and consequently asset encumbrance. Moreover, restricting cover pool eligibility leads to higher resilience of covered bonds in credit cycle downswings. Consequently, increases in OC requirements due to deteriorating cover pool quality are unlikely, and therefore, covered bond encumbrance would tend to remain more stable and less sensitive to market conditions in times of turmoil than other forms of encumbrance arising from Repo haircuts and derivative collateral. These assets tend to have a higher contingent encumbrance than covered bonds and embed pro-cyclical triggers that require more collateral when a bank's credit and/or market conditions deteriorate. They are both more vastly and more heavily correlated to the bank's health than the mark to market of mortgages. Therefore, the share that covered bonds represent within the total encumbrance of European banks would tend to decrease in a stress scenario.

This is confirmed by recent studies from Moody's and S&P, which indicate that throughout the financial crisis, collateral quality deterioration only played a subordinated role as a reason for requests to increase OC. Asset-liability related (e.g. refinancing conditions) or issuer/sponsor related reasons (e.g. sovereign or systemic risks) are far more important when it comes to defining OC requirements. For example, S&P stated that "on average, about two-thirds of OC levels relate to the coverage of ALMM risk." (S&P, 24<sup>th</sup> of January 2013: Covered Bonds Face Another Tough Year). A comparison of Moody's collateral risk indicators for mortgage covered bond programmes from 2009 and 2012 shows decreases or maximal small increases for most jurisdictions (source: Moody's European Covered Bonds Monitoring Overview).

Of note is the fact that most covered bond downgrades could not have been prevented through boosting OC. As Fitch notes in its December 2012 Covered Bond Surveillance Snapshot, only 13% of the 61 covered bond downgrades in 2012 were caused by lack of OC. Consequently, instead of increasing OC levels, which could not prevent downgrades of their covered bonds, a significant number of issuers kept OC levels unchanged. The *de facto* increases of OC seen in numerous covered bond programmes were rather motivated by precautionary reasons, i.e. to have collateral available to generate liquidity in case the crisis resurges. However, as unsecured funding markets stabilise, most issuers will decrease OC and return to a more credit-quality oriented OC management.

Lastly, it is worth noting that an increasing proportion of covered bonds now use extendible maturity structures which both reduce the amount of over-collateralisation needed (as refinancing risk is lower) and reduce the probability of a fire-sale of assets which both crystallises a loss for unsecured creditors and, presumably, is likely to exacerbate a stress scenario.

To sum up, ensuring that covered bond legal frameworks set high-quality standards for cover assets increases the security of the product and limits the issuance capacity but leaves enough flexibility to allow covered bonds to contribute to financial stability. Evidently, this is a more promising strategy than simply imposing quantity limits for covered bond issuance.

## 7. Which Ratio to Disclose?

Since asset encumbrance has become such a mythical issue, more transparency would clearly help a return to reality and discussions over the past years have identified several indicators or measures for asset encumbrance. Evidently, depending on the issuer's business model, one indicator could present a more appropriate picture than the other. However, from the point of view of the senior unsecured bondholder, it is most important to know which assets cover his claim in case of default, so the most appropriate indicator is the ratio of unencumbered assets to unsecured liabilities. It is not actually the commonly cited share of encumbered assets to total assets that matters to unsecured creditors of banks, but rather the ratio of unencumbered assets to unsecured liabilities (which is more directly relevant to unsecured creditors worried about getting paid back in the event of default).

### *Unencumbered Assets*

Asset Encumbrance = -----

### *Unsecured Liabilities*

In particular for specialised institutions, as is the case for many covered bond issuers, the ratio of unencumbered assets to unsecured liabilities provides a fairer picture than the pure encumbrance ratio (encumbered assets/total assets), which is usually very high for such issuers. Instead, their lower dependence on unsecured funding corresponds to a high ratio of unencumbered assets to unsecured liabilities, indicating a comfortable level of protection for senior unsecured bondholders.

Total capital ratio is another indicator for the level of senior bondholder protection as encumbrance only kicks in when the capital is absorbed. Moreover, the incentives for high underwriting standards, which go along with using covered bonds as main funding instruments, are also beneficial for the

expected recovery ratio of senior unsecured bond holders. Since the 2012 results, issuers have started to publish information on asset encumbrance-

Additionally, and with the aim to provide a framework for harmonised measure of asset encumbrance across the various institutions, the European Banking Authority (EBA) published a final draft Implementing Technical Standards (ITS) regarding asset encumbrance reporting under Article 100 of the Capital Requirements Regulation (CRR) in July 2014. In their essence, the ITS establish the type of information and data variables, together with formats and frequencies of the data, that are most relevant for the harmonised and effective supervision of asset encumbrance and monitoring of any associated risks. More specifically, all transactions that result in an increased level of encumbrance for a given institution have two aspects that need to be reported, i.e. as a source of encumbrance and as an encumbered asset or collateral. As far as covered bonds are concerned, there are two options for reporting, i.e. if the own covered bonds are not pledged and if the own covered bonds are pledged (Annex II of ITS, p. 8). Figure 4 below provides an example template for the reporting of a covered bond issuance of EUR 100 of which 15% is retained and not pledged and 10% is retained and pledged as collateral in a EUR 11 repo transaction with a central bank, where the cover pool comprises unsecured loans and the carrying amount of the loans is EUR 150.

**Figure 4:** Covered Bonds as a Source of Encumbrance

| SOURCES OF ENCUMBRANCE     |                |                              |                      |                                                        |
|----------------------------|----------------|------------------------------|----------------------|--------------------------------------------------------|
| Type                       | Amount         | Cells                        | Loans encumbered     | Cells                                                  |
| Covered bonds              | 75% (100) = 75 | {AE-Sources, r110, c010}     | 75% (150) = 112.5    | {AE-Assets, r100, c10}<br>{AE-Sources, r110, c030}     |
| Central bank funding       | 11             | {AE-Sources, r060, c010}     | 10% (150) = 15       | {AE-Assets, r100, c10}<br>{AE-Sources, r060, c030}     |
| NON ENCUMBRANCE            |                |                              |                      |                                                        |
| Type                       | Amount         | Cells                        | Non-encumbered loans | Cells                                                  |
| Own covered bonds retained | 15% 100 = 15   | {AE-Not pledged, r010, c040} | 15% (150) = 22.5     | {AE-Assets, r100, c60}<br>{AE-Not pledged, r020, c010} |

Source: European Banking Authority

Additionally, it is worth noting that when comparing the different sources of asset encumbrance, one should keep in mind that encumbrance induced by covered bonds is a long-term, non-volatile, good quality form of encumbrance justified by banks' business models. Other sources of asset encumbrance could exhibit much faster, more volatile swings in their volumes as the hurdles to mobilise assets are lower than in covered bond frameworks where usually, a cover pool monitor needs to approve asset transfers. In addition, covered bonds enjoy high disclosure standards for outstanding volumes and cover pool composition. It is desirable that similar high standards are also applied to the more important sources of asset encumbrance, i.e. central bank and third party repo and credit support annexes of derivative transactions.

## 8. Conclusion

Covered bonds represent a very important and stable funding tool for banks. They play a crucial role in the financing of both the European housing market and the public sector, particularly on the sub-sovereign level. The alternative (to ensure the same provision, tenor and cost of mortgages that are currently available within the European Union) would be a far greater level of state support for mortgage finance in line with the support that the United States was obliged to provide to Fannie Mae and Freddie Mac to ensure a working mortgage market.

The ECBC welcomes the plans from European regulators to improve the disclosure of the level of asset encumbrance of European banks as not all forms of asset encumbrance are subject to the same very high standard of disclosure requirements relevant to covered bonds. However, the ECBC strongly argues against the introduction of limits on covered bond issuance. The market already views asset encumbrance as a complex matrix that is not absolute, but a function of the business model, asset quality, capital structure, funding mix, geographical scope and track record of covered bonds. Therefore the asset encumbrance calculations also need to be seen in this light, as part of a mix of evaluations and monitoring measures of bank solvency and liquidity, but not in isolation. The available data also suggests that covered bond encumbrance is not the majority of the balance sheet encumbrance for a great many banks and that, indeed, derivative and repo financing may be a far greater proportion. Any ratio should be done on an individual bank level and in such a manner that recognises that the funding and asset structures of banks are heterogeneous and that one size would not fit all.

Since asset encumbrance has become such a mythical issue, more transparency would clearly help a return to reality and discussions over the past years have identified several indicators or measures for asset encumbrance. Evidently, depending on the issuer's business model, one indicator could present a more appropriate picture than the other. However, from the point of view of the senior unsecured bondholder, it is most important to know which assets cover his claim in case of default. So, it is not actually the commonly cited share of encumbered assets to total assets that matters to unsecured creditors of banks, but rather the ratio of unencumbered assets to unsecured liabilities (which is more directly relevant to unsecured creditors worried about getting paid back in the event of default).

The ECBC believes that a straightforward way to increase market discipline and lower excessive encumbrance is by enhancing transparency. Over the last few years we have seen a clear commitment to enhance transparency in the covered bond market through the establishment of the Covered Bond Label. This initiative undertaken by the issuer community was based on an intense and constructive dialogue of the investor community, major national and European authorities, as well as with the main law firms active in the covered bond arena who have supported and followed the creation of the Covered Bond Label Foundation and its website. The Covered Bond Label and the respective National Transparency Templates provide detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. Overall, such a transparency tool presents very detailed asset and liability side information which facilitates the investors' due diligence when comparing different issuer models, products in different markets and national supervision.

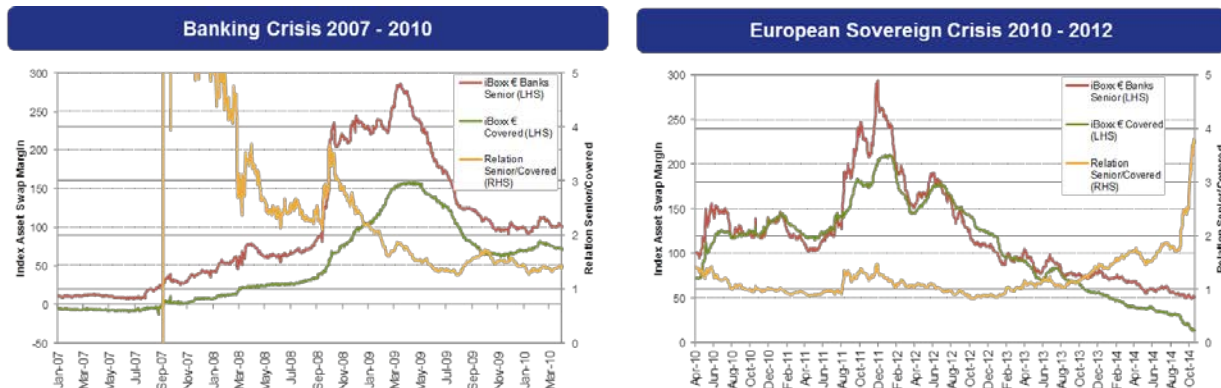
In the recent years, Industry initiatives and legislative developments in the covered bond space have achieved a number of important goals: (1) enhanced transparency, (2) a converging legislative environment, as designed by the European Institutions under the Single Rule Book, and in particular (3) a more coordinated role played by supervisors under the Banking Union on macro- and micro-prudential issues. This dynamism, enhanced by stakeholder debates, is triggering an unprecedented convergence process. This is bringing the covered bond asset class into a more comparable and harmonised territory with (1) the identification of common market and supervisory best practices at European level, (2) more transparent and comparable data on over-collateralisation and (3) the introduction of more explicit supervisory protection mechanisms for bank creditors (such as soft caps on issuances and close monitoring by supervisors). All these elements are reinforcing and confirming the role played by covered bonds as a long-term financing instrument, ensuring financial stability and investors' confidence and highlighting their strategic importance in the Capital Markets Union debate.

## Annex I: Quantitative Evidence

### Pattern of Performance of Covered Bonds vs Senior Unsecured Bonds and Financial Stability

#### 1. Covered Bonds vs Senior Unsecured: Fundamentals Dominate

*Covered bonds outperform senior unsecured in times of market stress*

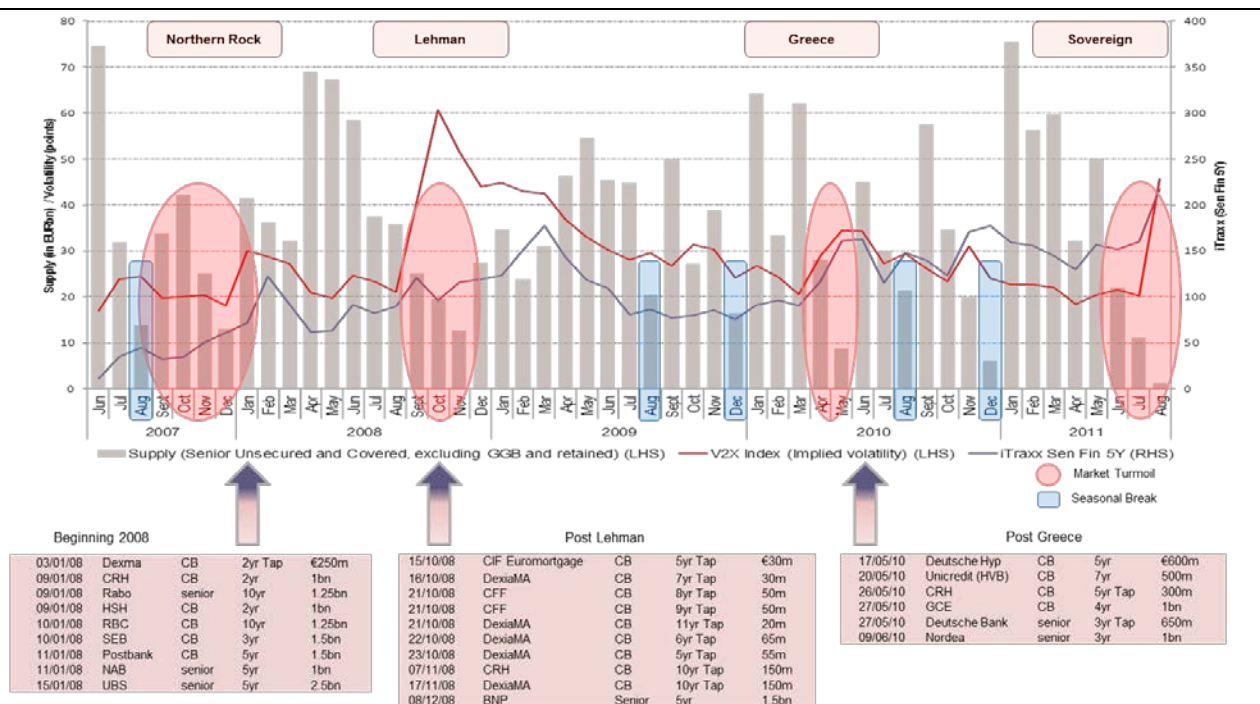


Source: Société Générale, ECBC

- Both the banking crisis of 2007-2010 and the European Sovereign crisis of 2010-2012 provide evidence that covered bonds outperform senior unsecured bonds. The main fundamental reasons for these patterns are lower probability of default and higher recovery rate of covered bonds, zero/low bail-in risk for covered bonds, regulatory privileges (including better central bank repo eligibility and lower haircuts) and higher rating stability of covered bonds.
- The outperformance of covered bonds is particularly evident for the Banking Crisis where the relation between senior unsecured and covered bonds (yellow line) “exploded” in late 2007 on the back of the Northern Rock events and then again in 2008 following the Lehman default. As the crisis spread into the banking sector, into lending markets and the economies, covered bonds could not escape completely and spreads saw some general widening. However as our analysis below shows, the covered bond market was pivotal in reopening wholesale funding markets in those volatile times.
- The evolution of the spread indices during the European Sovereign Crisis followed a similar pattern but had some phases of exceptional outperformance of the iBoxx Banks senior index during 2011 and 2012. This outperformance was a direct result of the downgrades of European peripheral senior bank debt to HY ratings and the subsequent exclusion of those bonds from the iBoxx Banks senior index. Both senior and covered bond primary markets were open throughout 2011 and 2012 (except for peripheral names) and issuers used covered bond issuance for more volatile market phases. With the introduction of bail-in and the slowdown of covered bond supply, covered bonds started to outperform again in 2013 and 2014.

#### 2. 2007-2010 Banking Crisis: Covered Bonds Key for Market Reopening

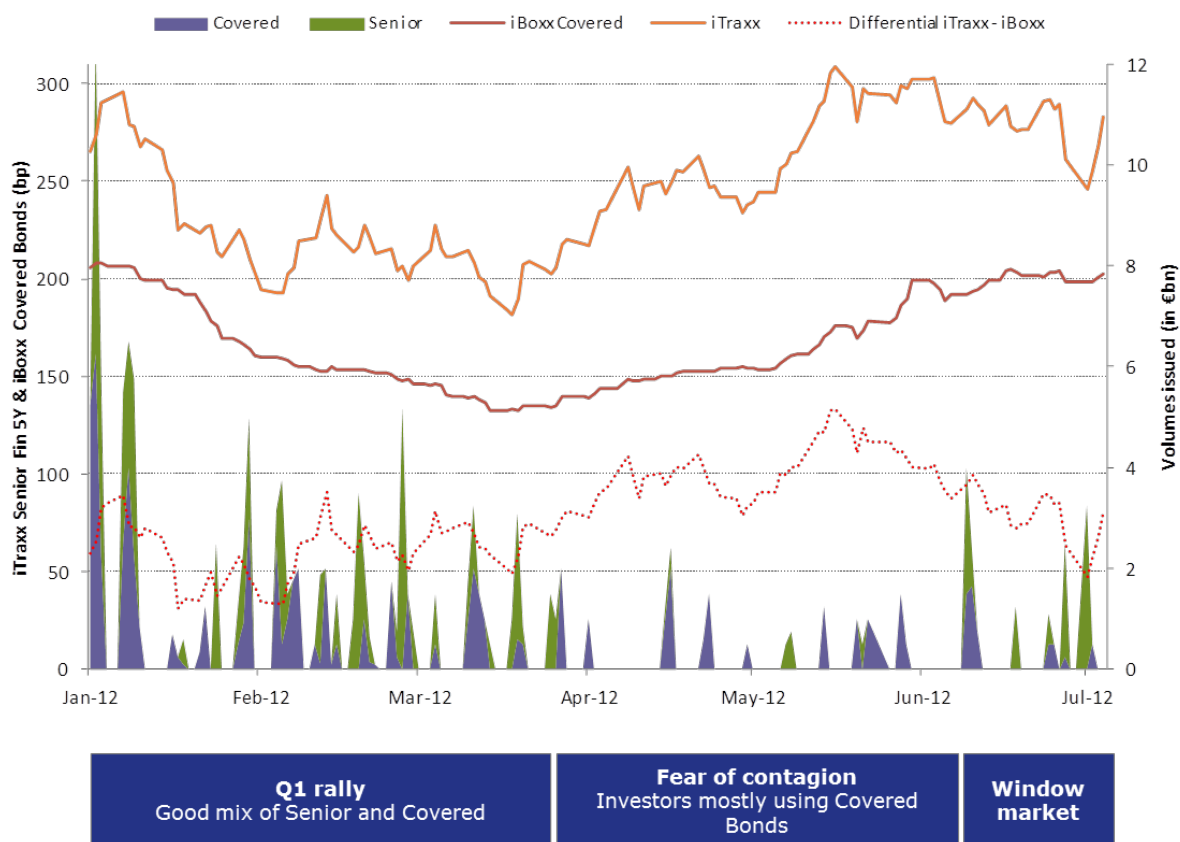
*Covered bonds at the forefront of market reopening – senior unsecured from strong names also possible*



Source: Société Générale Analytics, ECBC

### 3. 2012 Euro Sovereign Crisis: Covered Bonds for the Rainy Days

Issuers prefer senior unsecured as long as the market is supportive, keeping covered bonds for more difficult times

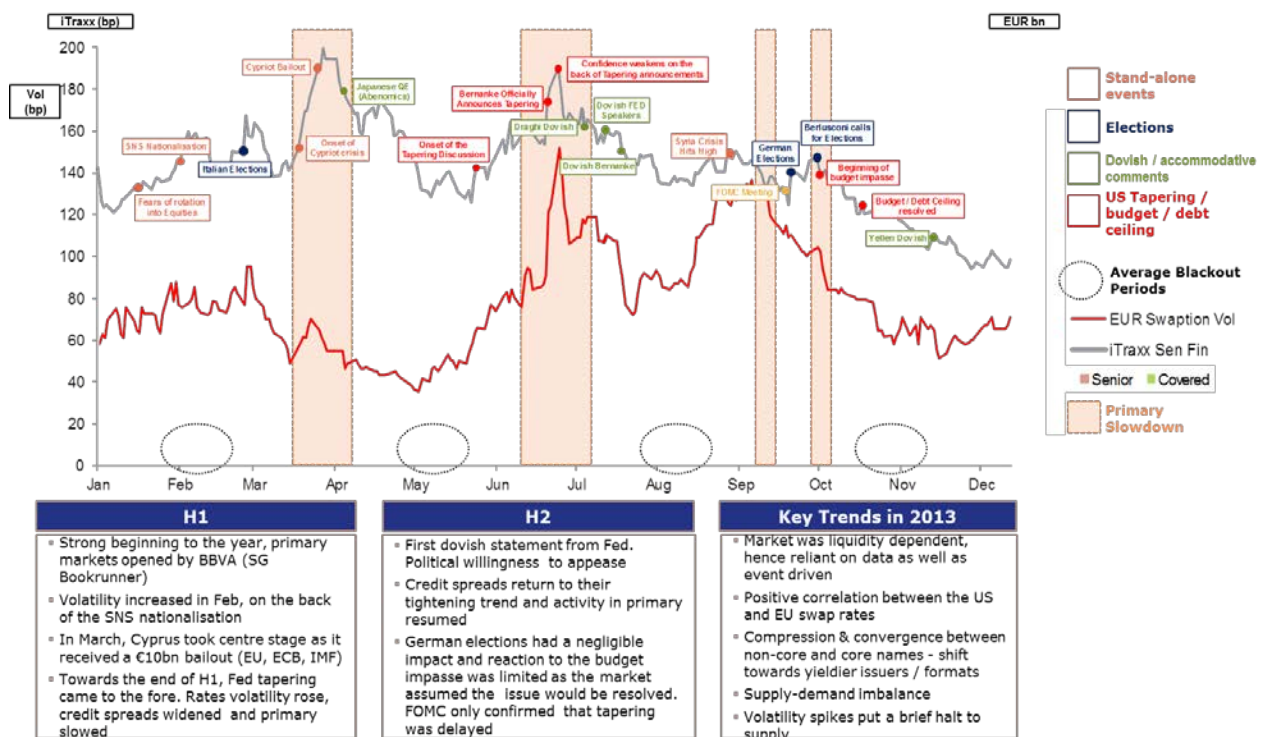


Source: Bloomberg, Société Générale Analytics, ECBC

- Market conditions were optimal in both asset classes in Q1-2012 and issuers made use of both formats:
  - As expected, the covered bond market was less volatile, but overall both sectors tightened
  - The differential between senior and covered bonds was around 62bp on average;
- At the end of March 2012, renewed concerns about a potential contagion of the Greek crisis to other peripherals sent senior spreads much wider, so investors focused on covered bonds
  - Covered bond spreads underperformed as well, but were rather resilient in core paper, the widening being concentrated on peripherals;
- Towards the 2<sup>nd</sup> half of 2012, the market became extremely volatile but showed some good albeit short-lived windows. During these periods, issuers favoured the senior format to keep their covered capacity for more troubled times as they feared a reclosing of the senior unsecured market;
- Mario Draghi's "Whatever it takes" speech on 20<sup>th</sup> July 2012 improved the market sentiment, reduced volatility and kept senior market open.

#### 4. 2013 Covered Bonds vs. Senior Unsecured: Punctuated by Macro-driven Volatility

*Various periods of compression and convergence throughout the year*

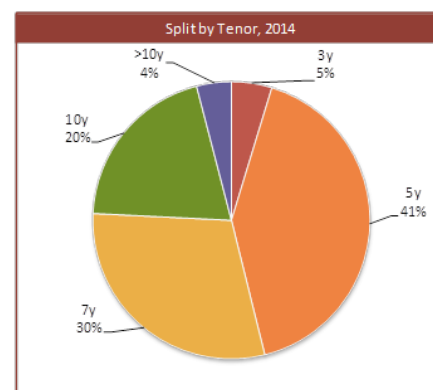
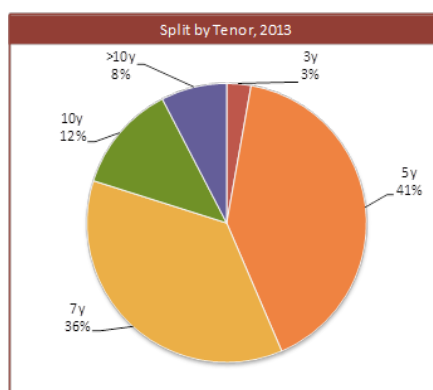
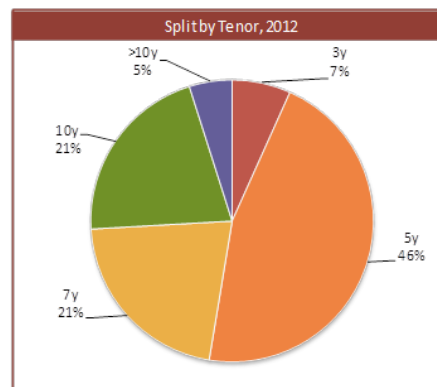
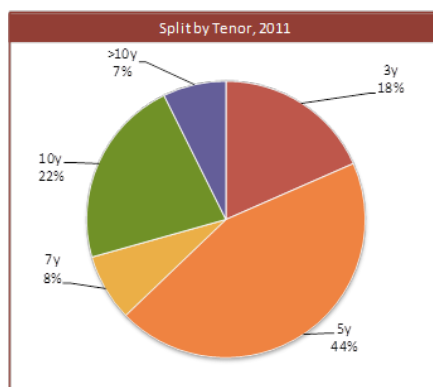
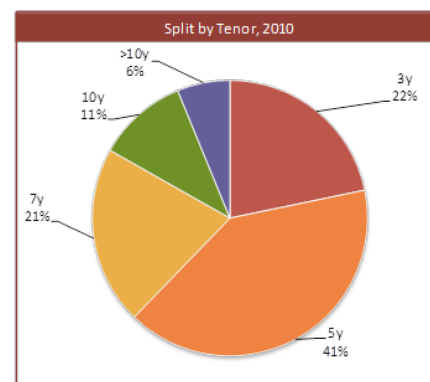
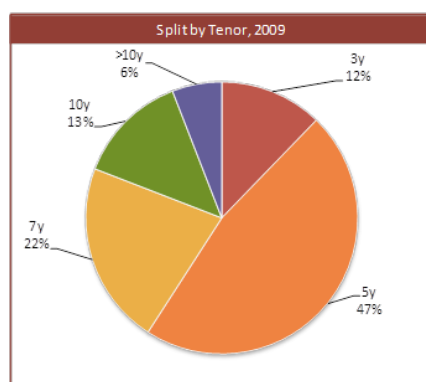
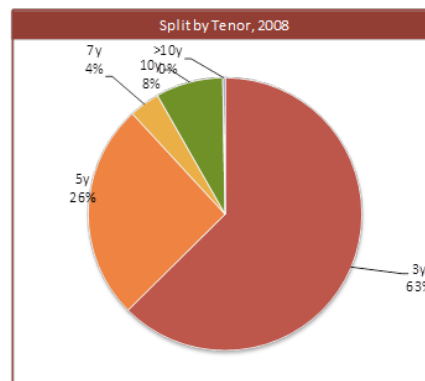
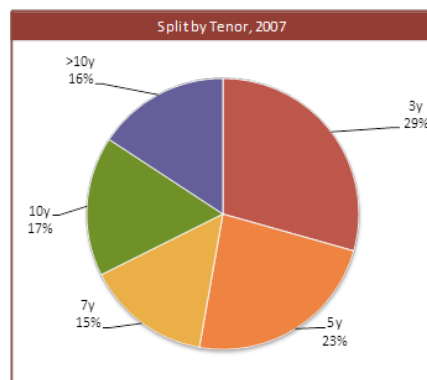


Note: EUR European Swaption Normal Vol ATM Libor Discount v. EUR006M Index 3MoX10Yr usually used as a tool to track European rates volatility

Source: Markit, Bloomberg, Société Générale Analytics, ECBC

## 5. The Role of Term Funding via Covered Bonds

### Breakdown of covered bond issuance by tenor 2007 - 2014



Source: Société Générale Analytics, ECBC