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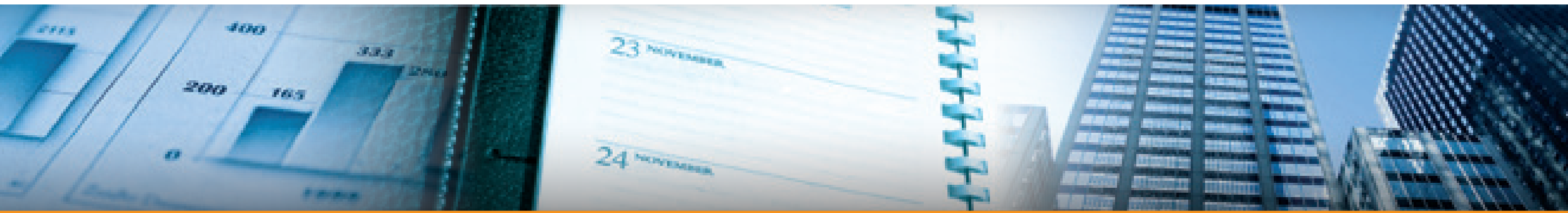

Summary

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European Covered Bond Council

Covered Bonds: Mapping a New World

By Waleed El-Amir, Head of Group Finance, UniCredit & Chairman of the European Covered Bond Council (ECBC)

On the 23rd of June 2016, a new and significant page in the history of Europe was written. The political and market dynamics triggered by the decision of the United Kingdom to leave the European Union (EU) are giving rise to completely new and unpredictable perspectives on the Old Continent.

Once again, mortgage lenders and covered bond issuers are exposed to an unprecedented macroeconomic landscape with an extremely fragile and vulnerable political, institutional and social framework. In our view, however, one thing is sure: covered bonds will continue to serve as an effective crisis management tool providing an essential long-term financing instrument.

During the financial crisis of 2008 and subsequent years, the covered bond community made immense efforts to bring about convergence in market best practices and to offer a common set of market initiatives to the EU institutions, presenting a robust and consistent asset class amongst what were very fragmented national legal and macroeconomic landscapes.

Looking back over the last year, it is clear that the covered bond space has been fundamentally impacted upon by major waves of monetary policy, supervisory review and regulatory change. These developments and the new perspectives that they bring with them are reshaping market dynamics as well as the environment in which the asset class operates.

In September 2014, the European Central Bank (ECB) announced the launch of the third covered bond purchase programme (CBPP3) alongside a first asset backed security purchase programme (ABSPP). This was closely followed in Q1 2015 by the public sector purchase programme (PSPP), complementing the existing private sector assets operation with one focused on government debt. The expansion, in both size and scope, of the ECB's monetary stimuli aims at propelling the Eurozone out of its current deflationary path. Moreover, for the first time, lenders and investors in some parts of the EU were faced with the unprecedented challenge of a negative interest rate environment.

At the beginning of November 2014, the new European Commission started its five-year term and the EU began a new chapter in the process of European integration. The Juncker Commission set itself the ambitious political task of fostering growth whilst maintaining financial stability in (the then) 28 EU Member States, and has focused its attention and actions on galvanising Europe against the risk of further recession and deflation by coordinating structural reforms, investment, and budgetary, fiscal and monetary policies. These initiatives will affect the lives of more than 500 million citizens. European Commission President, Jean-Claude Juncker, announced a EUR 315 billion Investment Plan at the end of 2014, which is intended to change how public money is used for investment in Europe. The Commission's subsequent call for the creation of a Capital Markets Union in 2015 has put the spotlight on the role of the banking sector in supporting the growth agenda and on the contents of the long-term financing toolkit at the disposal of stakeholders.

Looking at the process of European integration in more detail, an additional fundamental building-block was put in place in November 2014 when the ECB fully assumed the supervisory tasks and responsibilities given to it in the framework of the Single Supervisory Mechanism (SSM), thereby taking charge of the euro area's 129 biggest credit institutions. This represents the biggest expansion of the ECB's powers since the introduction of the euro. The SSM, which is based in Frankfurt, represents the first established pillar of the Banking Union and is harmonising 19 sets of national supervisory practices aiming at a single pan-European framework, and oblige banks to take more precautions against crises.

The second pillar of the Banking Union, the Single Resolution Mechanism (SRM), was agreed upon in 2014 and implemented through the end of 2015. The main objective of the SRM is to ensure that potential future bank failures in the Banking Union are managed efficiently, with minimal costs to taxpayers and the real economy. The SRM is managed by the Single Resolution Board in charge of the decision to initiate the resolution of a bank, and in some cases can it step up funding the resolution procedure using the Single Resolution Fund (SRF) war chest. Now the debate has shifted to the completion of the Banking Union by the introduction of its third pillar, the European Deposit Insurance Scheme (EDIS). EDIS introduction will be accompanied by risk reduction measures.

The changes of recent months to the regulatory and policy environment in Europe are having a significant impact on the long-term financing and housing finance sectors. When considering how best to shape the future European banking landscape and build the Capital Markets Union that will ensure the capability of the Industry to support the growth agenda and provide long-term financing to the real economy, several areas of reflection can be identified:

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

POLITICAL PERSPECTIVE & THE ROLE OF THE ECBC

The path to the achievement of a common market offering free movement of goods, services, people and capital has been a long and gradual one. Starting in the 1950s with the signing of the Treaties of Paris and Rome, the process really started to take shape in 1985 with the initiative of the Delors Commission to design the Single European Act (SEA), and was developed further in the 1990s and 2000s with the signing of the Treaties of Maastricht, Amsterdam and Lisbon. Very much in line with the spirit of Delors, the Juncker Commission is revamping and extending what has gone before through its growth agenda and its plans to create deeper and more integrated capital markets in the EU Member States by way of the CMU.

At present, after several years of financial crisis, the three dimensions of the European project – financial, political and economic – are converging in a "unicum", which is rapidly accelerating the process of European integration. However, this acceleration is also dramatically highlighting the frictions, lack of convergence and institutional gaps of the current European mechanisms. The outcome of the UK referendum can arguably be listed as an unintended consequence of this process.

This is where the financial services industry, which is a fundamental element of the European political and social landscape, can potentially play a crucial role in facilitating convergence and integration by enhancing transparency and market best practices. Furthermore, understanding the transmission channels that exist between the financial and other sectors of the economy is critical when assessing growth and financial stability. The latter is crucial as robust financial systems are viewed as those that do not adversely affect the system itself, and those that are capable of withstanding shocks and limiting disruption in the allocation of savings to profitable investment opportunities.

Thus far, politically, the financial services sector has acted as a scapegoat for the financial crisis, for market fragmentation and for political uncertainty. In this challenging political atmosphere, the EU institutions have initiated an overarching reform of the financial sector. In doing so, regulators have walked – and continue to walk – a difficult and dangerous path, in their quest to find a balance between harmonisation on the one hand and respect for national market traditions on the other, whilst at the same time limiting adverse collateral effects and ensuring social cohesion.

This new transition period is giving rise to challenges, expectations and emotions which have a much broader and deeper impact generally in EU society than ever before. The Industry is faced with the challenge of harnessing these new dynamics and contributing to the integration process by playing a proactive role in building the CMU so as to ensure financial stability and lending capacity, and to support economic growth, which remains at the heart of the European project.

Taking stock, it is clear that the European financial world has entered a completely new market and regulatory environment. In this context, the ECBC is now playing, more than ever, the role of market catalyst and think-tank, which is, in turn, allowing the market to converge and coordinate by speaking with one voice. Moreover, the role played by the ECBC in this new context ensures the smooth functioning of the market itself by identifying and implementing common qualitative standards and quantitative parameters. Looking ahead, the ECBC is determined to continue to act as the Industry discussion forum and market "lighthouse", developing a clear vision of the challenges and opportunities on the horizon amongst market participants and, subsequently, guiding the Industry through these uncharted waters.

REGULATORY RECOGNITION

In light of the current debate on Basel IV, more than ever the covered bond community is determined to ensure that the qualitative characteristics of the covered bond asset class will be appropriately captured in the future regulatory landscape. Since the beginning of the financial crisis, a diverse set of financial regulations has been approved by the European institutions, all aimed at strengthening the financial sector and rendering it more resilient to shocks. Amongst the most notable legislative proposals are: the Basel III framework for capital requirements; the Banking Union, which encompasses the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) including the framework for resolving banks (Bank Recovery and Resolution Directive – BRRD) and the newly proposed rules for a European Deposit Insurance Scheme (EDIS); together with the revamping of the

European capital market structure. In particular, the implementation of the Capital Requirements Regulation (CRR) / Capital Requirements Directive (CRD) IV package in the EU is the backbone of the EU's Single Rulebook for banks, which aims at providing a single set of harmonised prudential rules that all financial institutions throughout the EU (approximately 8,300 banks) must comply with, thus helping complete the single market in financial services. SME and mortgage lending, key drivers of recovery in the real economy, are predominately based on bank lending principles that are rooted in the banking supervisory tradition, which thereby facilitates due diligence for investors and proper risk assessment. Looking at the numbers, roughly 85% of financing in the EU is provided by banks. The overall financial strength of the European economy is strongly correlated to banks' ability to lend to both the private and public sectors. This capacity has been impinged as a result of new global rules that require banks to increase their capital ratios.

The implementation of the Basel rules, together with the proper treatment of covered bonds and High Quality Securitisation, raises questions about how a level playing field can be ensured at the global level, especially for economies strongly reliant upon these funding instruments, such as in Europe. More importantly, as has been clearly indicated by their recognition in the ECB's CBPP3 and ABSPP, these instruments play a pivotal role in the creation and development of a Capital Markets Union as key long-term financing tools and as a means for a common monetary policy to be effectively transmitted to the real economy.

This strong macro-prudential recognition was further confirmed by the publication of the Liquidity Coverage Ratio (LCR) delegated act by the European Commission the 10th of October 2014, in which covered bonds have been categorised as Extremely High Liquid Assets (Level 1). The ECBC welcomes the Commission's recognition of the macro prudential value of covered bonds. Indeed, the inclusion of covered bonds in Level 1 will facilitate the aim of delinking the sovereign from the banking sector.

A REAL ECONOMY LONG-TERM FUNDING TOOL

Covered bonds represent a key funding tool for the future European banking industry. They are an effective way of channelling long-term financing for high quality assets at a reasonable cost. They improve banks' ability to borrow and lend over long-term horizons and, therefore, represent a stable source of funding for key banking functions such as housing loans and public infrastructure.

For instance, long-term financing is crucial for housing finance. Building or purchasing a home is the most significant investment for the majority of European citizens, representing typically four to five times their annual income. In the 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 their annual savings capacity. Long-term funding tools for banks are therefore required 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 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 to 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 play an essential role in ensuring the flow of capital in financing long-term growth and the real economy. They offer key safety features such as a strict legal and supervisory framework, asset segregation, and a cover pool actively managed in order to maintain the quality of the collateral. 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 increasing the burden for taxpayers and public debt.

The growth agenda debate has also dominated economic and political discussions beyond the EU, raising the key questions of how to finance economic growth and how to create an efficient and robust long-term financing toolkit. This debate has a very high political profile as it engages key stakeholders at both an international and a national level. Furthermore this raises fundamental questions regarding the fine-tuning of the Basel III parameters and the right calibration between enhanced risk assessments, reduction of systemic risks and continued lending capabilities of the banking sector. Such discussions belong, traditionally, to an emerging market landscape, where the World Bank has always played a pivotal role in assisting the development of capital market infrastructures which aim at ensuring economic growth and social development.

Looking at the numbers produced by the World Bank, 8.3 billion people are expected to be alive by 2030, with 60% of them living in cities. Consequently, the global demand for new dwellings is foreseen to rise by 565 million over the same period. Furthermore, the World Bank considers that in emerging markets, five permanent jobs are created for every new housing unit built, with the figure being even higher in the developed world, thus making housing a key driver for economic growth and social stability.

MARKET DEVELOPMENTS

Covered bonds are at the heart of the European financial tradition, having played a central role in funding strategies for the last two centuries. The strategic importance of covered bonds as a long-term funding tool is now recognised at a global level. Outside Europe, Australia, Canada, New Zealand and South Korea have already implemented covered bond legislation in recent years. Major jurisdictions including Brazil, Chile, India, Japan, Mexico, Morocco, Panama, Peru, South Africa and the United States, are either in the process of adopting covered bond legislation or are investigating the introduction of covered bonds. In recognition of the global spread of covered bonds and with a view to ensuring that the key quality characteristics of the asset class remain its foundation around the world, in late 2015 the ECBC established a Global Issues Working Group (GIWG), which held its first meeting in Singapore in March 2016. This year's ECBC Fact Book *(see the News in Brief section of this newsletter)* provides comprehensive coverage of related new legislative frameworks and developments, and shows how the ECBC, through the GIWG amongst other channels, is further strengthening its role as the principal voice of covered bonds, not just in Europe but globally.

During the recent years of market turmoil, covered bonds demonstrated a strong degree of resilience. Throughout the crisis, they played a pivotal role in bank wholesale funding, providing lenders with a cost-effective and reliable long-term funding instrument for mortgage and public-sector loans. The Industry continues to build on the lessons learnt from the financial crisis while maintaining a focus on the essential features and qualities that have made the asset class such a success story. The ECBC firmly believes that the quality of the asset class will continue to be the basis of our strength in the future.

The success of covered bonds also lies in the Industry's capacity to respond to the challenges of the current crisis and its ability to share market best practices. This allows a continuous fine-tuning of European covered bond legislation and facilitates a strong level of transparency for the asset class. As indicated above, the instrument has enabled European Member States to continue to channel private sector funds to housing markets and maintain efficient lending activity without an additional increase of burden for taxpayers or public debt. Furthermore, the on-balance sheet nature of covered bonds is an efficient and simple alternative to complex originate-to-distribute products ensuring financial stability.

The commitment to contribute to European efforts to enhance financial stability and transparency has led the covered bond industry to launch a quality Label. The Covered Bond Label was developed by the European issuer community working in close cooperation with investors and regulators, and in consultation with all major stakeholders such as the European Commission and the European Central Bank. The Label is based on the Covered Bond Label Convention, which defines the core characteristics required for a covered bond programme to qualify for the Label.

The Covered Bond Label and its transparency platform (www.coveredbondlabel.com) have been operational since January 2013, providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. As of August 2016, 91 labels have been granted to 77 issuers from 14 countries, covering over EUR 1.4 trillion of covered bonds outstanding.

In this context, covered bond issuers from these 14 different jurisdictions have come together to develop a Harmonised Transparency Template. From 2016 onwards (with a one year phase-in period), this provides cover pool information in a harmonised format, which allows for both the recognition of national specificities, with the National Transparency Tabs, and the comparability of information required to facilitate investors' due diligence.

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

- The ECBC website continues to be the primary site for aggregate covered bond market data and comparative framework analysis; and
- The ECBC Fact Book, now in its eleventh edition, remains the most widely read source of covered bond market intelligence.

LOOKING AHEAD

In conclusion, the ECBC believes that the quality of the covered bond asset class will be the basis of our strength in the future. Over the last two centuries the asset class has made a significant contribution in Europe to supporting the real economy and ensuring financial stability. The Industry has demonstrated that through market initiatives such as the Covered Bond Label and the recently proposed European Secured Note (ESN), it is possible to build, from the bottom up, proposals based on market consensus in order to initiate pan-European solutions which enhance transparency, comparability, convergence of markets and best practices. Furthermore, it has been possible to do this without over-regulating and, thereby, potentially jeopardising the capabilities of lenders to support the growth agenda. More work needs to be done, but we believe that the initiatives underway will strengthen the asset class and facilitate the convergence of market and supervisory best practices. The increased recognition by policymakers and regulators of the central role that the asset class plays for the banking system and also for wider financial stability reinforces the need for an appropriate regulatory framework for covered bonds at both European and international levels. This will be our objective for the coming years.

Quo vadis ECB?

By Frank Will, Head of Covered Bond Research, HSBC and Chairman of the ECBC EU legislation Working Group

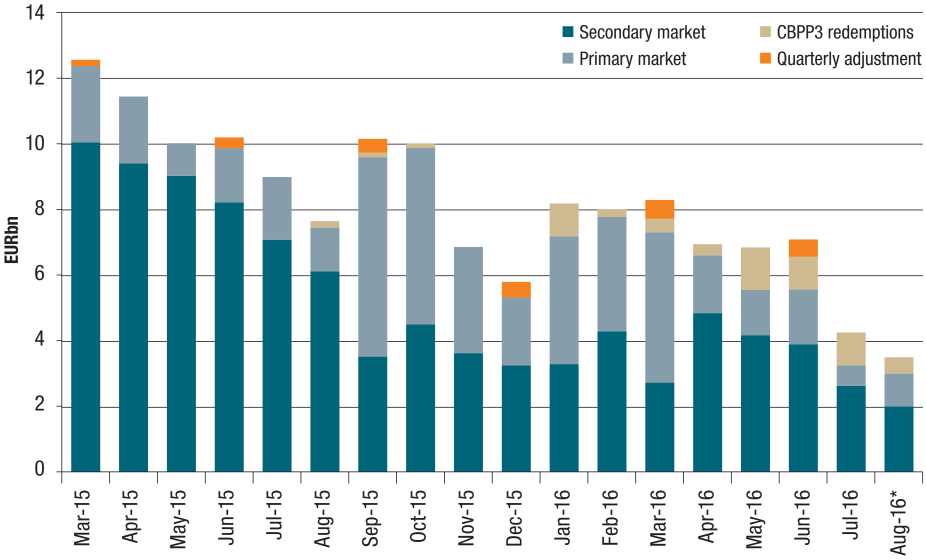
The upcoming second anniversary of the European Central Bank's (ECB) Covered Bond Purchase Programme (CBPP3) is a good opportunity to analyse the impact of the CBPP3 in terms of supply volumes, spread performance as well as market liquidity and to discuss if the purchase programme can be regarded as a success. The CBPP3 was announced on the 4th of September 2014 and the actual covered bond purchases started a few weeks later, on the 20th of October 2014. Since then, the ECB has bought a staggering amount of almost €200bn of covered bonds, representing about a third of the eligible benchmark market.

At the beginning of the programme, the ECB bought between €10-13bn of covered bonds each month. This year, the monthly CBPP3 volumes have been much lower, even if redemptions and quarterly adjustments are included. In April the purchases were less than €7bn despite the rise of the overall monthly purchase target from €60bn to €80bn. The ECB achieved the monthly volumes by higher PSPP purchases and the start of the CSPP purchases in June. In June and July, the corporate purchases significantly exceeded the covered bond volumes, which hit a new all-time low of just €3.3bn in July and accounted for just 4% of the ECB's total purchases. The figures of the first three weeks indicate that the CBPP3 purchases will remain low in August and will again be a fraction of the CSPP purchases. Year-to-date, the covered bond purchases have been roughly €35bn lower than in the corresponding period last year. Taking into account CBPP3 redemptions and quarterly adjustments does not alter the overall trend. The ECB lowered its monthly gross covered bond purchases from €8bn in Q1 to €7bn in Q2. In July, the gross volume fell further to €4.3bn reflecting the lack of new issue activity and secondary market liquidity. The gross figure for August should stay low given the subdued levels of new issuance in the first three weeks of the month and the relatively low redemption volumes. However, once the primary market activity increases in September and October, the CBPP3 purchases will probably rise again, but the average monthly volumes until year-end should remain below the volumes seen in the first half of the year.

SPREAD IMPACT DIFFERS ACROSS THE VARIOUS MARKET SEGMENTS

The spread impact of the CBPP3 on the covered bond market has been immense, but not all mar-

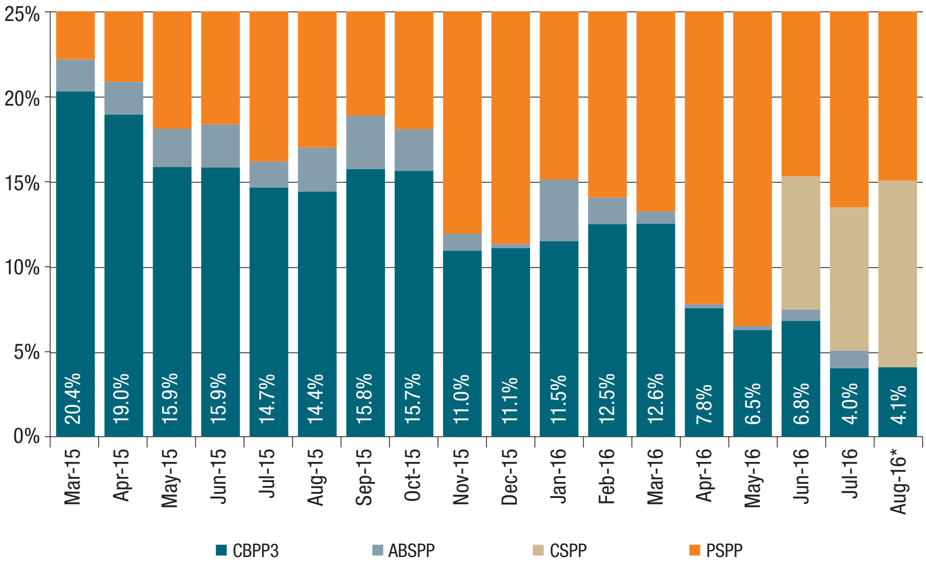
Chart 1 ▶ CBPP3 purchases



Source: HSBC, Bloomberg

* HSBC estimate

Chart 2 ▶ CBPP3 in % of total monthly purchases



Source: HSBC, Bloomberg

* First three weeks

ket segments have benefitted to the same extent. The comparison of the spread levels of eligible and non-eligible covered bonds before the announcement of the CBPP3 on the 4th of September 2014 with the levels of mid-August 2016 shows that Italian, Spanish, Portuguese and Irish covered bonds benefitted the most from the programme (see chart 3). Core and semi-core covered bonds also performed strongly but not as much as their peers in the periphery. The swap spread levels of non-eligible covered bonds, however, are almost unchanged compared to September 2014. In terms of maturity, eligible covered bonds at the longer end of the curve outperformed swaps more than those with shorter maturities. However, as chart 4 shows, the spread tightening of the Eurozone covered bonds was by no means a linear development, bearing instead a striking resemblance to a rollercoaster ride.

Over the last couple of months, covered bond spreads tightened strongly reflecting both the lack of primary market activity as well as the fact that the central banks of the Eurosystem vacuumed up the last breadcrumbs of liquidity in the secondary market. These artificially low spread levels increase the setback risks as investors will painfully remember when thinking about September and October 2015.

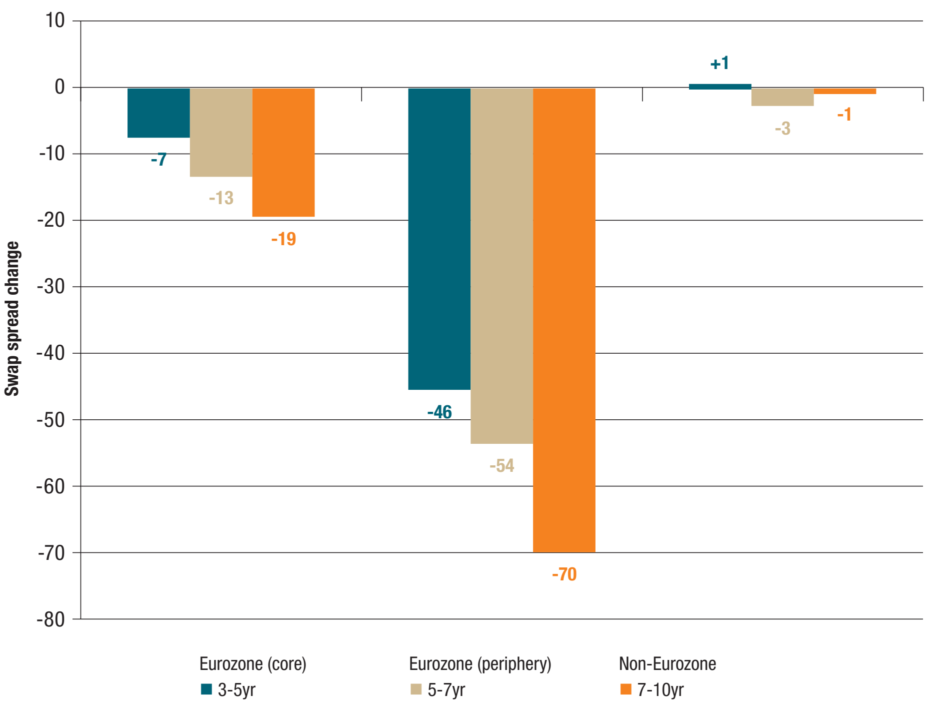
WAS THE CBPP3 A SUCCESS?

So can the CBPP3 be viewed as a success story? It depends on the aims of the programme. The inflation in the Eurozone remains stubbornly low (June 2016: 0.1%) and inflation expectations (based on the 5y5y inflation swap rate) have even fallen from 2.0% in September 2014 to 1.3%, which probably count as a miss. The lending volumes in the Eurozone have started to slowly increase again – though the respective figures for the periphery countries remain lacklustre. Lowering the funding costs of banks has surely had a positive impact on their lending activity. The ECB was actually so successful in lowering the yield levels of covered bonds (and many other asset classes) that many traditional covered bond investors have been crowded out by the central banks and have been driven into other more risky, higher yielding asset classes. Currently more than four-fifths of the EUR covered bond market have negative yields with some bonds at the short end of the curve trading even below the -0.4% deposit rate threshold of the ECB. Since the introduction of the CBPP3, the supply volumes have increased significantly but again it is difficult to tell where they would have been without the programme. Nonetheless, there is the trend of lower covered bond purchases by the ECB despite the significant increase of the overall purchase target in April. The big question is, however, if the observed fall in the CBPP3 volumes signals a change in the ECB purchase behaviour or if it is rather driven by the lack of available bonds.

GLANCE INTO THE CRYSTAL BALL

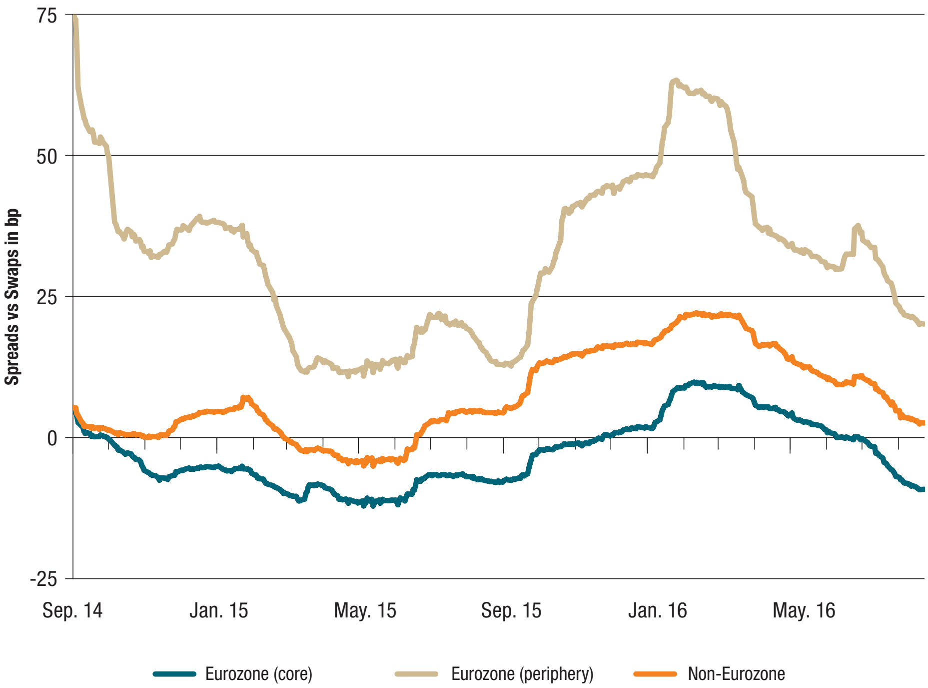
Given the stubbornly low inflation rates in Eurozone and the gloomy inflation expectations, the ECB will probably continue to throw everything but the kitchen sink at the problem. Having said that, the CBPP3 purchases have continuously fallen this year despite the increase in the overall purchase volumes. The full-year CBPP3 purchase figure will therefore probably turn out significantly below last year's figure of €114bn. It remains to be seen whether this reduction is enough to revive the secondary market or if the ECB purchase programme will continue to distort the market by withdrawing liquidity and increasing volatility in a product which has proved in the past to be very resilient.

Chart 3 ▶ Changes since CBPP3 announcement



Source: HSBC, Thomson Reuters

Chart 4 ▶ Swap spread development of covered bonds



Source: HSBC, Thomson Reuters

ECBC Covered Bond Statistics 2015

By Florian Eichert, Head of Covered Bond & SSA Research, Crédit Agricole CIB and Chairman of the ECBC Statistics & Data Working Group

The ECBC Statistics and Data Working Group has been collecting statistics on the outstanding volume and annual gross supply of covered bonds at year end for 13 years now. From the start its aim has been to provide a complete set of numbers that can serve as guidance for interested parties from issuers and investors to regulators.

The collection of statistics is a significant undertaking each year which is only possible thanks to the cooperation of the Working Group members, covered bond issuers and banking associations. One representative per country (the list of country representatives can be found on the ECBC website here) undertakes the initial data collection by approaching each issuer separately in most countries. These figures are then cross checked on the basis of publicly available data by a small number of Working Group members. The 2015 numbers were cross checked by Agustin Martin from BBVA, Alexandra Schadow from LBBW as well as myself and Adam Krawiec from Crédit Agricole CIB.

GENERAL REMARKS ON THE 2015 STATISTICS

The aim of the ECBC statistics is to paint as realistic a picture of the actual market and picture relevant trends as accurately as possible. After the methodology changes in 2012 (more realistic public vs. private placement buckets) and 2013 (introduction of the number of programmes) we have kept the framework unchanged in 2015.

We have tried in the past and will continue to try to improve the quality of the data even for previous years. It is always possible that we miss a bond or still include a bond that has been repaid early (just think of retained covered bonds). Wherever we realise that there was a mistake in last year's data we amend the numbers. As a result of this, there are some slight differences in the numbers for 2015 compared to what was published last year. In our view, these adjustments are perfectly normal and we would rather adjust historic data to reflect a more realistic picture than mechanically hold on to data that was once published but proven incorrect wherever we have sufficient information to make the change.

Before going into the actual statistics, we want to make some general remarks about the figures which are necessary to interpret them correctly:

- Covered bonds are divided into those denominated in euro, those in domestic currency (if not the euro), and those in a currency other than the euro and the domestic currency. The exchange rate used to convert all outstanding volumes at the end of 2015 in non-EUR-denominated bonds is the end-of-year 2015 rate published by the European Central Bank.
- For the purpose of counting the number of issuers and of new issuers the following applies. Issuers are entities with at least one outstanding covered bond at year-end. Issuers with multiple programmes still only count as one. The only exception to this rule is French covered bonds. In case of France, the actual issuer is a specialised bank rather than the mother company. As a result, one mother company with two covered bond programmes also counts as two issuers as the issuance actually comes from two separate legal entities. New issuers are entities with at least one outstanding covered bond at year-end, but with no outstanding covered bond at the prior year-end.
- Spain: Spain's covered bond statistics are based on the data provided by Spain's AIAF (*Asociación de Intermediarios de Activos Financieros*). We have complemented this with USD denominated Cédulas issued under Reg/S or 144a documentation that are not listed in the AIAF as well as registered unlisted covered bonds from the ECBC Covered Bond Label Database. The breakdown into public and private placements as well as the breakdown into fix and floating coupons in Spain is entirely based on non-AIAF sources. Up to 2011, the number of issuers provided by AIAF included the new financial institutions established as part of the restructuring of the Spanish banking sector as well as all the former financial institutions with outstanding covered bonds at the end of 2011 – even if as a consequence of the aforementioned restructuring they were integrated into a new institution. Because of this the number of issuers had been going up rather than down which is what one would have expected. When adjusting for the merger activity, the number of issuers at the end of 2011 was 42 rather than 64. From 2012 we have changed the way we calculate the number of Spanish issuers to only include those that are separate legal entities and disregard any previous entities that have by now been merged.
- Canada: Covered bonds backed by mortgages insured against borrower default by the Canada Mortgage and Housing Corporation are classed as mortgage covered bonds.
- Sweden: Sweden's covered bond statistics exclude retained transactions used for the purpose of accessing central bank liquidity, and include only converted *bostadsobligationer* (mortgage bonds) and *säkerställda obligationer* (covered bonds).

Before we dive into the numbers, we have one last comment. The ECBC Covered Bond Label has become a widely used tool by issuers. It covers more than 57% of the covered bond market at the end of 2015. Part of the Covered Bond Label is the Label database which lists all labelled covered bonds. When comparing the label statistics to those presented in the ECBC Covered Bond Fact Book there are discrepancies in the public-private classification in especially Nordic countries such as Denmark and Sweden. The reason for these discrepancies is the different market structure those two countries have where bonds are frequently tapped, repurchased and then tapped again.

The Covered Bond Label as well as the ECBC statistics definitions require a bond to be listed as well as syndicated to be classified as public and while Danish and Swedish covered bonds are listed, the way they are issued does not comply with the syndication requirement. In the ECBC Covered Bond Fact Book statistics presented below we try to capture the "liquid" part of the market with our classifications and in justified cases can be more flexible than the Covered Bond Label database. We have therefore tried to eliminate the differences between both data sets wherever possible. But we have granted Denmark and Sweden an exception and consider bonds that for the Covered Bond Label database are classified as private as public as long as we are talking about liquid benchmarks by these two countries' standards.

EVOLUTION OUTSTANDING VOLUMES 2015

Covered bond markets had been a growth story ever since we started collecting data for the ECBC Covered Bond Fact Book statistics in 2003. Even the first crisis years did not put an end to this trend as there was sizeable public issuance even during those days and issuers used retained covered bond issuance to secure central bank liquidity. This trend did however come to an end in 2013 when the market contracted by 8% for the first time. 2014 was still characterised by a slight fall in volumes but the speed slowed down quite substantially (-4%). In 2015 the downward trend in outstanding volumes has virtually come to a complete standstill.

At EUR 2,498 bn, global covered bond markets contracted by a mere EUR 6 bn equivalent or 0.25%.

Compared to 2014 we can welcome one new market to the covered bond family – Singapore. This shows yet once more how global a product covered bonds have become over the years and brings the number of countries that had covered bonds outstanding at the end of 2015 to 30. The number of issuers remained broadly stable in 2015. At 317 active issuers (that operate a total of 434 covered bond programmes), the net number has gone up by 5. In gross terms we had new issuers appear in Austria (1), Germany (2), Italy (1), Korea (1), Netherlands (2), Norway (2), Poland (1), Singapore (1) and Spain (2).

Out of these 30 countries, 18 saw their market grow in 2015. Growth did however take place predominantly in either smaller countries within Europe (i.e. Belgium continued to grow dynamically with outstanding volumes growing by EUR 5 bn / 37%) or in countries outside of Europe. Markets such as for example Norway (up by 5% / EUR 5 bn), Switzerland (up by EUR 11 bn / +11%) or Sweden (up by EUR 12 bn / +6%) are among the notable exceptions to this rule. The biggest overall increase in outstanding volumes came from Canada (up by EUR 21 bn / 32.3%).

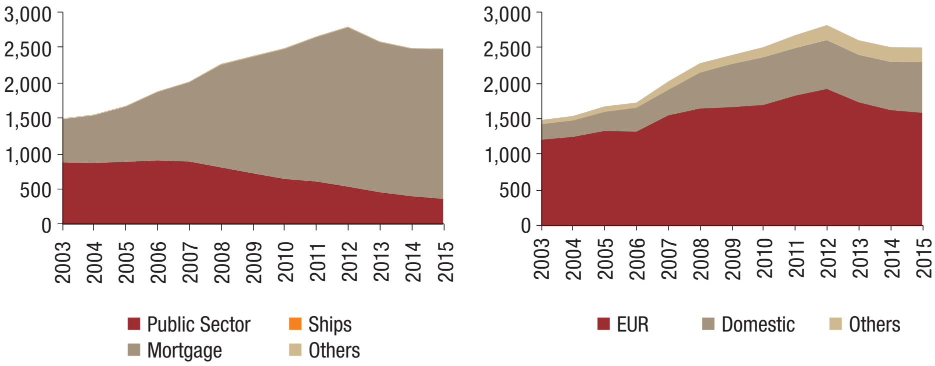
Out of the top seven countries by outstanding volumes five still recorded falling numbers, with Spain (down by EUR 27 bn / 9%), Germany (down by EUR 18 bn / 4%) and the UK (down by EUR 16 bn / 12%) experiencing the most pronounced drops in outstanding volumes.

Looking at the ranking of countries by size, there were no major changes in the top ten compared to 2014. Germany still features the largest market by outstanding volumes (EUR 384 bn) ahead of Denmark (EUR 383 bn) (Denmark does have the largest mortgage backed covered bond market though) and France (EUR 323 bn). The only change we had in 2015 is Italy and the United Kingdom swapping places with Italy moving up one place to 6th while the UK dropped by one to 7th.

As can also be seen from the figures above, despite the many discussions about covered bonds being used for additional collateral types, the market is heavily focused on the two most traditional collateral classes – mortgages (85% after 83% in 2014) and public sector assets (15% after 16% in 2014). Ship and aircraft mortgages only represent 0.4% of the market roughly keeping the same share as in 2014.

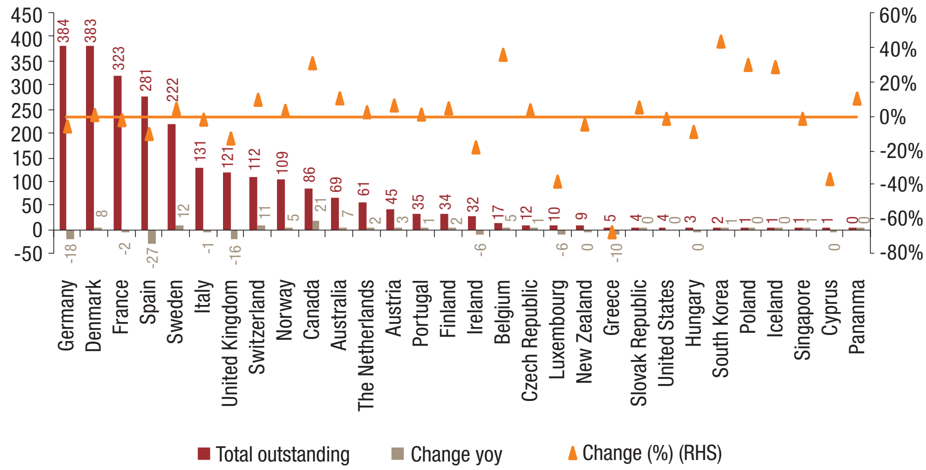
Having seen a big surge in volumes as banks in a number of countries used retained covered bonds as repo collateral during the crisis, the private placement category saw a big drop in 2013 (-85 bn or 11%) as European lenders paid back part of their long-term refinancing operations (LTRO) money and consequently cancelled out retained covered bonds. In 2014 this category did continue to fall (EUR -26 bn or 4%) but similar to the overall market it has stabilised in 2015. The biggest increase

Figure 1 ▶ Outstanding covered bonds by collateral type (LHS) as well as currency (RHS) in EUR bn



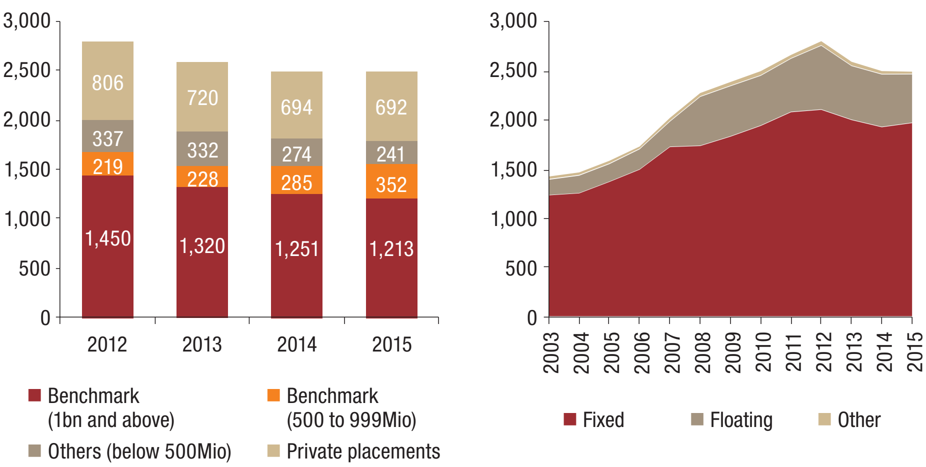
Source: Crédit Agricole CIB

Figure 2 ▶ Outstanding covered bonds by country as well as change vs. 2014 (EURbn)



Source: Crédit Agricole CIB

Figure 3 ▶ Outstanding covered bonds by issue type (LHS) as well as by coupon type (RHS) in EUR bn



Source: Crédit Agricole CIB

compared to 2014 took place in the EUR 500-999 m benchmark category, having already been a growth driver in 2014. Outstanding covered bonds in this category increased by EUR 66 bn or 24%.

Covered bond markets continued to be dominated by fixed rate bonds. Despite the low interest rate environment this coupon type continues to make up 79% of the market, a slight increase by two percentage points vs 2014. Floating rate covered bonds are predominantly either from domestic covered bond markets in the Nordics or retained bonds by issuers. Much of the retained covered bonds were issued in FRN format to minimise ECB repo haircuts. But other than for senior unsecured, covered bonds' role as long-term investments that investors use to build up duration has prevented a surge in FRN with ultra-low yields in EUR and subsequent questions around negative FRN coupons tilting the market even more into fixed coupon territory.

Looking at the breakdown by currencies, contractions in EUR (down by EUR 38 bn) were offset by growth in domestic currencies (up by EUR 37 bn). When thinking about the countries with the biggest absolute drop in volumes (Spain and Germany), this should not come as a surprise. Other currencies (so i.e. Canadians issuing in USD or Germans issuing in GBP) fell slightly by 3%.

EVOLUTION OF COVERED BOND ISSUANCE 2015

We have written about outstanding volumes stabilising in 2015. Looking at issuance 2015 is in fact the second year running with substantial increase in issuance volumes. In 2013 covered bond issuance still took a fairly severe beating compared to 2012 as volumes dropped by EUR 277 bn or 39% to EUR 429 bn. In 2014 new issue volumes registered some cautious gains again growing by EUR 28 bn. 2015 new issuance has continued this positive momentum growing by EUR 82 bn to EUR 540 bn.

Denmark is still by far the country with the largest new issuance volumes (EUR 164 bn). This represents 43% of the existing Danish covered bond stock and is due to the way the market operates with its auction system as well as ongoing tap issuance of existing bonds. The gap to the second largest country in terms of issuance is quite substantial despite the Danes shifting more issuance from short dated bond auctions to longer maturities. With EUR 61 bn Sweden occupies that second spot.

The biggest growth in new issuance compared to 2014 did however take place in France (up by EUR 19 bn), Spain (up by EUR 18 bn) as well as Canada (up by EUR 10 bn). In all three countries the growth came from benchmark issuance rather than private placements. The latter category has clearly been hurt by the low interest rate environment and we have seen smaller issuers that used to only rely on private placements enter public markets. This is also one driver for why out of the four placement categories we use the smaller benchmark issuance did grow the strongest in 2015 (up by EUR 31 bn).

Last but not least, looking at currencies, issues in EUR went up the most (EUR +47 bn). Since EUR also saw the largest amount of redemptions, growth in outstanding volumes was larger in domestic currency covered bonds despite new issuance growth in this space only coming in at EUR 25 bn. Other currency issuance still is a rather modest portion of overall issuance. It did grow by EUR 10 bn but at EUR 33 bn it only makes up 6% of the overall covered bonds issued in 2015.

HOW HAS 2016 STARTED AND WHAT COULD THE REST OF THIS YEAR HOLD IN STORE…?

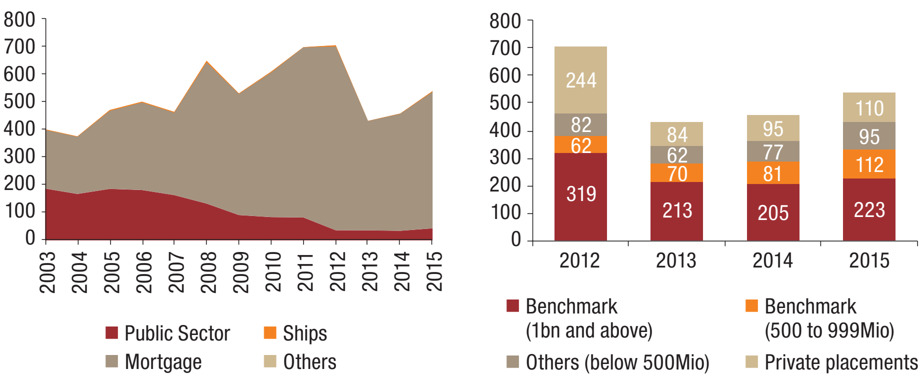
Covered bond benchmark issuance across currencies has seen a very active start in 2016. In fact at EUR 78 bn benchmark issuance in EUR as well as EUR 91 bn equivalent in overall EUR, USD and GBP benchmark issuance, the first four months of 2016 have been well above 2015 (EUR 51 bn EUR benchmark issuance and EUR 66 bn equivalent in overall benchmarks). Issuance did slow down with the announcement of the TLTRO II but even so, H1 2016 still is well above 2015.

The TLTRO II together with ultra-low yields have also led to predominantly longer issuance. We have seen the first EUR benchmark new issue price in negative yield territory (BHH 3Y priced at a reoffer yield of -17bp) but it has remained the sole exception. The average initial term at issuance in EUR benchmark markets has moved up to eight years in Q2 from around seven years in Q1 and slightly less than that in 2014.

Another phenomenon we have seen is more pronounced issuance from non-Eurozone countries. The TLTRO II has especially driven down issuance from peripheral countries and issuers from countries such as Canada have seized the chance to place EUR benchmarks successfully and Turkey managing to get their debut EUR benchmark covered bond off the ground.

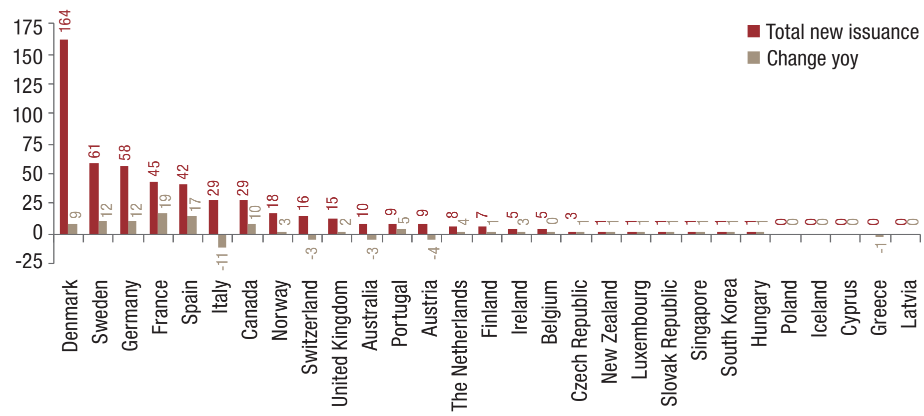
Looking forward towards the end of this year, issuance will continue to come in at a much slower pace than the one we saw early this year. The TLTRO II will however not have as dramatic an effect as some might feared. Covered bonds still are a viable alternative for issuers, especially at the long end of the curve. And in countries that are struggling with the net lending benchmark due to large loan prepayments on the back of ultra-low yields, covered bonds can even compete on cost grounds with the Eurosystem.

Figure 4 ▶ Covered bond new issuance by collateral type (LHS) as well as placement type (RHS) in EUR bn



Source: Crédit Agricole CIB

Figure 5 ▶ Covered bonds new issuance by country as well as change vs. 2014 (EUR bn)



Source: Crédit Agricole CIB

Brexit: Potential Impact on Covered Bonds

By Guenther Scheppler, CEFA, Senior Covered Bond Strategist, DZ BANK AG

The vote in favour of Brexit by the British people marks the start of a journey into the unknown, particularly for the United Kingdom (UK). Depending on future developments in the UK, the country's covered bonds may also be affected by the changes. An economic downturn could have a negative impact on the quality of cover pools. New, alternative refinancing options for covered bond issuers could also lead to an increasing contraction in the volume of outstanding UK covered bonds, and the segment could thus decline in importance.

In the referendum at the end of June, a majority of the British (52% of those who voted) voted to leave the European Union (EU). Will the country now definitely exit the EU? Not necessarily, since the result of the referendum is not binding for the British parliament. However, none of the elected representatives will seriously want to risk not carrying out the will of the people. Brexit will therefore presumably go ahead. The new Prime Minister, Theresa May, has also already signalled that "Brexit means Brexit".

Meanwhile, the timescale remains uncertain. Under Article 50 of the EU treaties, the UK must first of all officially inform the EU of its plans. After this has happened, withdrawal negotiations must be completed within a maximum of two years. The negotiating period will be the really interesting time.

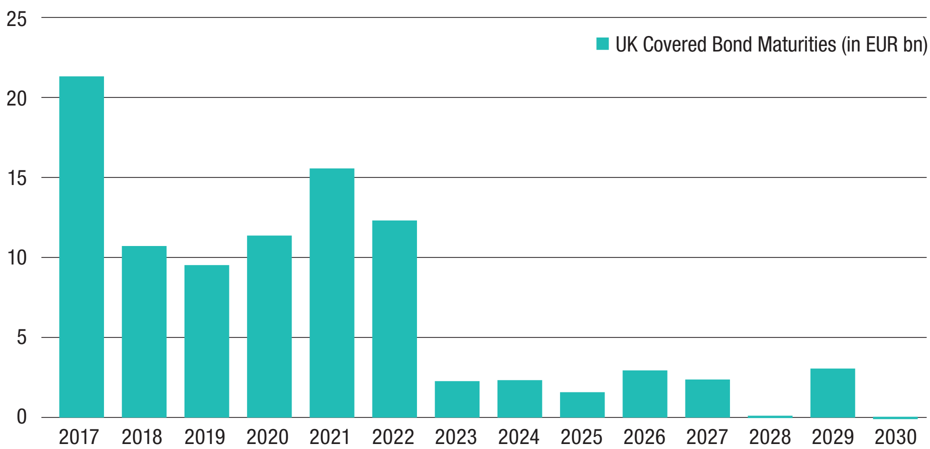
In any event the British government wants to maintain very close economic links with the EU. For the EU the UK has always been an important trading partner in the past. Nonetheless, the negotiations will be anything but easy. If the trade links between the EU and the UK alter only slightly after Brexit, this could trigger referendums in other EU countries and that could lead to more withdrawals. Conversely, if the EU takes a very hard line and more or less severs all preferential trade relationships with the biggest island in Europe, this could have undesirable economic consequences for both sides. Given the forthcoming political balancing act, forecasts about the future outcome for the UK are very difficult.

Possible alternatives for future relations between the EU and the UK are a free trade agreement, or the "Norwegian model". As a non-EU country, Norway does have virtually unrestricted access to the EU single market but it has to pay for the privilege by contributing to the EU budget. If a free trade agreement or a model similar to that of Norway cannot be achieved, the UK will be at risk of losing access to the EU single market. If this were to happen, import and export duty would probably be imposed on UK goods, leading to a decline in demand for British products in the EU. Foreign investors who previously regarded the UK as the "gateway to the EU single market" could have second thoughts when deciding where to locate their operations. Second round effects could then be expected to include a steep economic downturn, an increase in unemployment and a visible decline in property prices. At this stage, there would also inevitably be an impact on the cover pools of British covered bond programmes.

If house prices were to spiral downwards, this could have a negative medium-term impact on the credit quality of the mortgage books of British banks and their credit profiles. So long as the relevant issuer ratings for UK covered bond programmes do not deteriorate dramatically, it should be possible for issuers to maintain their current covered bond ratings, although higher over-collateralisation ratios might be required than at present. On the other hand, if Brexit leads to downgrades of two to three notches or more for the issuer ratings of UK banks, based on the agencies' rating models this would automatically trigger the first rating downgrades for some UK covered bond programmes. The spreads of the corresponding UK covered bonds would then subsequently widen disproportionately compared to their direct peer group.

At this point, the question which needs to be asked is what constitutes the direct peer group for British covered bonds at that time. By answering this question the issue of whether the UK remains a member of the European Economic Area (EEA) plays a crucial role. If the EU agrees with the UK to base the future economic relationship on the Norwegian model, the cover pools of British covered bank bonds could continue to meet the criteria of Article 52 (4) of the UCITS Directive, or respectively of Article 129 (1) of the CRR. One of the advantages of this would be that UK covered bonds could still qualify for the Level 1 category within the Liquidity Coverage Ratio (LCR) in future. The risk weighting of the bonds would not alter either. In this scenario, the peer group would consist mainly of Norwegian covered bonds. Conversely, if the UK is no longer a member of the EEA, the covered bank bonds of British issuers would also no longer meet the UCITS/CRR criteria and could thus only qualify for at maximum the Level 2A category of the LCR. Their risk weight would increase from 10% to 20% under the credit risk standard approach. UK covered bonds could nevertheless still be used as collateral for refinancing transactions with the European Central Bank, since the UK is one of the G10 countries, similar to Canada. The spread levels of Canadian covered bonds could then act as a

Chart 1 ▶ Maturities of UK covered Bonds in the coming years

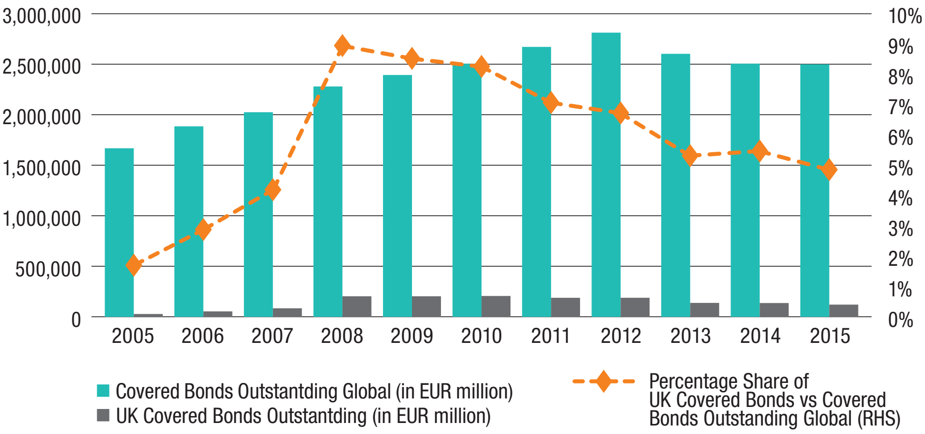


Source: Bloomberg, DZ BANK Research presentation and calculations good benchmark for the future valuation of British covered bonds. However, if the ratings of British banks are downgraded to a significant degree, the corresponding covered bonds could be expected to continue to trade on average at a risk premium to their Canadian counterparts, whose issuers all currently have ratings in the AA sector.

An expected shortage of British covered bonds should most likely have a braking effect on a spread widening trend. Looking ahead to the maturity of British covered bank bonds in the coming years, there is a very high volume of EUR 21 bn in 2017. In the three subsequent years, the average figure is still a good EUR 10 bn. Based on forthcoming maturities, there will certainly be a refinancing requirement.

However, it is unclear at the moment how many of the maturing UK covered bonds will in fact be replaced with corresponding new bonds. Issuers currently have the option of several attractive refinancing channels for their mortgage business. The Term Funding Scheme (TFS) launched recently by the Bank of England also offers UK banks a very flexible and low-cost means of refinancing for their mortgage business. Since the maximum term of the TFS is limited to four years, new UK covered bond issues at the short end of the maturity curves are likely to remain in short supply until the TFS is concluded, as currently projected, at the end of February 2022. British banks can also refinance their mortgage business by selling traditional Residential Mortgage Backed Securities (RMBS), with the added advantage of removing mortgage risks from the bank's balance sheet via true sale. The actual future funding requirements of the British banks are also unclear, given the ongoing contraction of balance sheets.

Chart 2 ▶ Importance of UK covered bonds in decline



Source: ECBC, DZ BANK Research presentation and calculations

Even if, as indicated above, the expected decline in issuing activity in the British covered bond segment does act as a brake in a phase when spreads are generally widening, there is the other side of the coin: the segment will continue to decline in importance relative to the global covered bond market. Whereas, in 2008, British covered bonds still had a global market share of 8.9%, the figure has fallen in recent years to 4.9% (2015). We expect the market share to continue to decline in the years ahead. The UK covered bond segment will nonetheless remain important in future, since it has been one of the driving forces for many useful innovations over the years.

NEWS IN BRIEF

EBA Consultation on Guidelines on Regulatory Disclosure Requirements

On the 29th of June 2016 the European Banking Authority (EBA) launched a consultation on a set of Guidelines on regulatory disclosure requirements following an update of the Pillar 3 requirements by the Basel Committee in January 2015. These Guidelines are part of the EBA's work to improve and enhance the consistency and comparability of institutions' disclosures and aim to ensure market discipline. The consultation, further details about which can be accessed here, runs until the 29th of September 2016.

The revised Pillar 3 framework, which applies as of the 31st of December 2016, provides for common format and harmonised frequencies for the disclosure of existing requirements as well as adds certain new requirements.

The incorporation of the revised Pillar 3 into the Capital Requirements Regulation (CRR) would require an update of the disclosure requirements laid down in the CRR, which will only take place as part of a comprehensive review process of the regulation. In the meantime, EU banks will face market pressure to provide disclosures in line with the revised Pillar 3 when it becomes applicable.

The aim of these Guidelines is, therefore, to provide guidance to institutions to enable them to comply with the CRR provisions while implementing the revised Basel Pillar 3 requirements. The Guidelines apply to Globally and Other Systemically Important Institutions (G-SII and O-SII) and do not waive the requirements for these and other institutions to comply with the other CRR disclosure requirements for which the Guidelines offer no guidance.

The Guidelines will apply for the year-end 2017 disclosures. However, G-SII are recommended to implement a limited subset of disclosures relating to risk-weighted assets (RWA) and capital requirements as soon as year-end 2016 so as to provide users with information suitable for comparison with international peers.

EBA Publishes Report on Asset Encumbrance

On the 5th of July 2016 the European Banking Authority (EBA) published its second analysis of the level of asset encumbrance across EU banking institutions. The report, which is available here, is part of a regular annual monitoring of asset encumbrance, aims to provide important elements for EU supervisors to assess the sustainability of banks' funding sources and their ability to withstand funding stress.

This preliminary analysis conducted by the EBA shows that in December 2015, the overall weighted average encumbrance ratio stood at 25.6% against 25.2% in December 2014. However, the report highlights a wide dispersion across institutions and countries, which is consistent with what was observed in the previous report. As already observed in the first report, the highest values of above 80% are mostly reported by specialised mortgage institutions.

The main sources of asset encumbrance, such as balance sheet liabilities for which banks posted collateral, continue to be repos, covered bonds and central bank funding. Not all unencumbered assets can be used to generate funding. A proxy for the marketability of unencumbered assets, also under stressed conditions, can be the eligibility for central bank funding. In total, the encumbrance of central bank eligible assets slightly decreased over the quarters from 45% in December 2014 to 42% in December 2015, albeit again with a high dispersion across countries.

The main rationale for the monitoring of asset encumbrance is related to the consequences of the changes in funding sources across the EU. In particular, an increase in the use of secured funding due to reduced access to unsecured instruments and a move towards collateralisation of other transactions such as derivatives could lead to a steep increase in asset encumbrance. Based on this monitoring, there is no strong evidence of a steep increase at the EU level during the five quarters covered by this report, even though asset encumbrance is high in some jurisdictions and has increased for certain banks.

When the weighted averages are computed at country level, the asset encumbrance ratio ranges from close to 0% for Estonia to 55% and 47% in the cases of Denmark and Greece respectively.

Similar to the previous report (available here), in countries with relatively high levels of asset encumbrance, this is driven by large and established covered bond markets (notably Denmark and Sweden), by a high share of central bank funding in countries severely affected by the sovereign debt crisis (e.g. Greece), and by a high share of repo financing and collateral requirements for over-the-counter derivatives (e.g. the UK and Belgium).On the other hand, the level of asset encumbrance due to central bank funding, as well as the encumbrance of assets eligible for central bank funding, is still relatively high for those countries that were severely affected by the sovereign debt crisis.

The report shows that banks seem to have increased the level of asset encumbrance for loans advances due to covered bond issuance. The most significant sources of increase in encumbrance (besides covered bonds) are repurchase agreements and central bank funding, which, during the year, have replaced the dominance of over-the-counter derivatives shown in the data reported by banks for 2014.

ECON Committee Report on Total Assets versus Risk Weighted Assets

On the 5th of July 2016 the European Parliament's Economic and Monetary Affairs (ECON) Committee published a report on "Total Assets versus Risk Weighted Assets: does it matter for MREL requirements?"

The report, which is available here, discusses the role of risk weighting in the determination of minimum requirements for eligible bail-in-able liabilities of banks (MREL), i.e. liabilities that are not exempt from the bail-in tool in bank resolution and that can be written down or converted into equity if losses on assets exceed the available equity and such bailing-in is required to re-establish bank solvency so as to provide a basis for maintaining systemically important operations in resolution. Whereas some liabilities of banks are exempt from being bailed in, the Bank Recovery and Resolution Directive (BRRD) calls on resolution authorities to specify minimum requirements for eligible bail-in-able liabilities (MREL). The question is whether these requirements should be determined in relation to a bank's total assets or in relation to their risk weighted assets, as used in assessing capital requirements for banks.

The main conclusions are:

- Generally, the dual approach suggested by the Financial Stability Board, namely refer to both risk-weighted and total assets and impose the stricter of the two requirements, seems like the most reasonable way forward.
- For small banks that do not have access to capital markets, the MREL regulation may reduce the extent to which they can provide liquidity transformation. For large banks with access to bond markets, this is not a concern. For such banks, the costs of minimum requirements for bail-in-able liabilities are mainly private costs that are matched by benefits elsewhere in the system, in particular benefits to taxpayers. The difference between banks suggests a regulatory approach that discriminates between types of banks, introducing a Pillar I approach for large banks, in particular for systemically important banks while keeping the current Pillar II approach for small banks, in particular small banks that are not systemically important.
- The paper is sceptical about a reliance on risk-weighted assets. Even for capital regulation, risk weighting is problematic because the statistical basis for doing the risk analysis properly is sorely lacking and in practice risk weights can be used to manipulate the regulation. Major risks are in fact not adequately considered at all.
- In setting MREL, there is the added concern that prior probabilities of investments going sour are much less important than in capital regulation. What matters is the extent of losses once things go poorly and the conditional expectations given this event of returns on those investments that do not yet seem to be impaired. Relying on the same risk weights as for equity regulation is likely to be a serious source of distortions, but procedures for doing the requisite risk analysis properly are even less satisfactory.
- "Total assets" are not really "total". Because of netting rules and other privileges, important risks do not actually appear in banks' balance sheets.

There is also a quantitative analysis in the paper:

- A quantitative assessment suffers from a lack of data about the institutions (the small ones and specialised such as mortgage banks) where a choice between risk-weighted and total assets for MREL would make a difference (unlike globally systemically important institutions for which the FSB mandates that both be used).
- Since risk weighting is particularly important in the context of real estate loans and in the context of sovereign exposures, a proxy measure is obtained by consider the distribution of these exposures. While the overall effects are likely to be small, they are particularly pronounced for Italy and Spain where public debt and sovereign exposures of banks have gone up significantly during the crisis.
- If many small institutions are involved they may end up being systemic after all. It should be noted that such an occurrence is most likely when many institutions have engaged in similar risks, e.g. in real-estate lending, the very kind of activity that is privileged by risk-weighting.

BCBS Updated Standard for the Regulatory Capital Treatment of Securitisation Exposures

On the 11th of July 2016 the Basel Committee on Banking Supervision (BCBS) published an updated standard for the regulatory capital treatment of securitisation exposures that includes the regulatory capital treatment for "simple, transparent and comparable" (STC) securitisations. This standard, which is available here, amends the Committee's 2014 capital standards for securitisations (available here).

The capital treatment for STC securitisations builds on the 2015 STC criteria published by the Basel Committee and the International Organisation of Securities Commissions. The standard published by the BCBS sets out additional criteria for differentiating the capital treatment of STC securitisations from that of other securitisation transactions. The additional criteria, for example, exclude transactions in which the standardised risk weights for the underlying assets exceed certain levels. This ensures that securitisations with higher-risk underlying exposures do not qualify for the same capital treatment as STC-compliant transactions.

Compliance with the expanded set of STC criteria should provide additional confidence in the performance of the transactions, and thereby warrants a modest reduction in minimum capital requirements for STC securitisations. The Committee consulted in November 2015 on a proposed treatment of STC securitisations. Compared to the consultative version, the final standard has scaled down the risk weights for STC securitisation exposures, and has reduced the risk weight floor for senior exposures from 15% to 10%.

EBA Review of the Single Rulebook Q&As

On the 5th of August 2016, the European Banking Authority (EBA) published the outcome of a review of its Single Rulebook Q&As, which provides an overview of possible errors, inconsistencies as well as fundamental issues in relation to the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD) observed via the Single Rulebook Q&A tool managed by the EBA.

The input provided to the Commission includes both a general assessment as well as more specific findings, which are further detailed in twelve annexes grouped by topics of the CRR-CRD texts covered in the legislative review.

The EBA will use the outcome of its review to continue its technical discussions and collaboration with the EU Commission services in the context of the CRR/CRD review.

European Commission Publishes Summary of Responses to the Green Paper on Retail Financial Services

On the 14th of July 2016, the European Commission published its summary of all responses received (428 in total) to the Green Paper on Retail Financial Services (more information is available here). Concretely, the Commission's summary of responses and the related annex are available here and here, respectively.

As background information, the purpose of the Green Paper was to consult all interested parties on how the European market for retail financial services – namely insurance, loans, payments, current and savings accounts and other retail instruments – could be further opened up, bringing better results for consumers and firms, whilst maintaining an adequate level of consumer and investor protection.

KEY MESSAGES FROM THE CONSULTATION:

Many **individual consumers** expressed interest in easier access to simple financial products. They saw most need for change in the area of currency exchange transactions as well as certain digital financial services, e.g. on-line financial advice. They were generally of the view that more cross-border supply and increased transparency could bring more choice in retail financial services and possibly lower prices. However, respondents also raised some concerns with regards to cross-border purchasing of financial services. In this regard, they highlighted the difficulties in dealing with documents written in foreign languages, with certain access limitations (e.g. geo-blocking) and diverging national legislation.

Consumer organisations, on the other hand, often referred to "simple products" as most appropriate for future cross-border sales. In their view, consumers need more simple, better products but not necessarily more products. They also emphasised the importance of consumer trust and some expressed doubts as to whether consumers could already today trust sufficiently financial service providers in cross-border situations.

Firms, on the other hand, pointed to insufficient demand from consumers who would simply not want to purchase products when sold cross-border. Many firms emphasised that they do not provide services cross-border as they do not see a business case for it. They also raised concerns that they face specific obstacles when trying to offer services cross-border, many of which are outlined in the Green Paper, such as:

- Local financial regulation, consumer protection requirements and supervisory practices which, even when harmonised at EU level, diverge substantially as a result of national gold-plating (i.e. additional requirements going further than EU legislation at national level that may create barriers);
- Tax laws, which can fundamentally change the benefits of some products and create administrative burdens for firms;
- Access to data and information on consumers and national trends, alongside standards for property valuation and procedures for enforcing debts which, they feel, vary too greatly to make lending or insurance decisions;
- Local network for claims handling in case of insurance; and
- Divergent national interpretations of the anti-money laundering directive (2015/849/EU)) across Member States and financial firms which can act as a barrier to consumers' access to financial services and restrict their mobility within the Single Market.

Throughout the consultation, many **companies (primarily banks), industry associations and other respondents** called for the Commission to ensure that there is a "level playing field" (i.e. fair competition) between different types of market players, between firms in different Member States and between EU and non-EU firms. They pointed to the different regulatory requirements as a key reason why this does not currently exist.

Consumer organisations shared this analysis but also suggested focusing on better enforcement of existing EU consumer protection rules, whilst fostering more cooperation between national authorities, more intervention and streamlining of EU-level supervisors, as well as assessing whether local authorities have the right mandates and objectives to enforce EU-level standards effectively.

There was no common view from **national public authorities**: many supported consumer protection organisations' preference for strengthened enforcement actions, while others supported firms in wanting, first, a removal of remaining barriers and more harmonised regulation before any further market integration.

As **next steps**, work is ongoing in the European Commission services on a follow-up initiative which might take the form of an Action Plan.

24th ECBC Plenary Meeting

On the **14th of September 2016**, the 24th ECBC Plenary meeting will take place in **Düsseldorf**, Germany, with the kind support of **DZ Bank**.

The ECBC Plenary meetings are the key covered bond bi-annual networking events. They gather more than 300 participants including decision makers from the covered bond industry, issuers, investors, government and regulatory officials at both national and EU level, as well as rating agencies, journalists and other stakeholders from covered bond jurisdictions around the world.

The theme of the 24th Plenary meeting is ***Covered Bonds: Mapping a New World*** and topics on the Agenda will include discussions on the latest regulatory and legislative developments concerning covered bonds in both Europe and at a global level. Please click here to consult the draft Agenda for the event.

ECBC members who have yet to confirm their place at the 24th Plenary meeting are reminded that the **deadline for registrations** in the **8th of September 2016** *(please note that this event is only open to ECBC members and guests invited by the EMF-ECBC Secretariat; please contact the EMF-ECBC Secretariat directly for further details).*

EBA Recommends the Introduction of an LR Minimum Requirement in the EU

On the 3rd of August 2016, the European Banking Authority (EBA) published its report on the impact assessment and calibration of the Leverage Ratio (LR), available here, recommending the introduction of a LR minimum requirement in the EU to mitigate the risk of excessive leverage.

BACKGROUND

The European Commission is due to publish a report on the impact and effectiveness of the leverage ratio by the 31st of December 2016, which might be accompanied by a legislative proposal on *"the introduction of an appropriate number of levels of the leverage ratio that institutions following different business models would be required to meet"*.

As part of the preparation for this, the EBA was mandated by the Capital Requirements Regulation (CRR) to elaborate this calibration report. In the context of the drafting of its report, the EBA was requested by the European Commission (and the Banking Stakeholder Group (BSG) of the EBA) to take account of the principle of proportionality, by specifically assessing the impact of the requirements on banks with different business models.

To this end, the EBA isolated four business models which could warrant a specific treatment under the LR: mortgage banks including pass-through financing mortgage banks, building societies, locally active savings and loan associations/cooperative banks, public development banks. 12 mortgage banks were included in the sample for the mortgage bank business model; the identities of these are unknown (also to the EBA). The models were extracted from amongst the twelve identified for the purposes of the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

MAIN RECOMMENDATIONS

- In line with the agreement reached by the Basel Committee's Group of Governors and Heads of Supervision (GHOS), a mandatory ('Pillar 1') minimum level of 3% should be introduced for the LR based on Tier 1 capital and this minimum requirement should generally apply to all credit institutions within the scope of the existing CRD IV/CRR requirements for LR, as applicable.

  The only exceptions should be Central Counterparty Clearing Houses (CCPs) and Central Securities Repositories (CSDs).

- The international timetable, which envisages the application of the minimum level of 3% from 1 January 2018 onwards, should be followed; the EU banking sector has been preparing actively, and there does not seem to be a need for a longer transition as a general rule.

- A higher LR level requirement in the specific case of Global Systemically Important Institutions (GSIIs, or G-SIBs in Basel terms). Specifically, GSII credit institutions could be subjected to a prudential LR level requirement above the general minimum of 3% in order to mitigate elevated leverage related risks. This is topical since the Basel Committee for Banking Supervision (BCBS) is working, and just consulted stakeholders, on an amended framework which entails a higher LR for GSIIs.

- The benchmarking results would not strongly suggest a deviation from the general minimum level of 3% for other types of credit institutions (including mortgage banks), or smaller credit institutions. In a nutshell, the EBA has decided to overlook the proportionality issue raised by its BSG and the Commission.

OTHER RECOMMENDATIONS

- The LR numerator should consist of Tier 1 capital. A potential cap on the use of Additional Tier 1 (AT1) should be confined to GSIIs and should be in line with the eventual Basel standard. Any inclusion of (gone-concern) Tier 2 capital elements in the LR's capital measure by basing the calculation on total own funds would not be appropriate.

- The EBA recommends no immediate changes to the calculation rules of the CRR LR with respect to areas mentioned in Article 511(3) of the CRR, which include the application of the Original Exposure Method (OEM), the conversion factors for undrawn credit facilities which may be cancelled unconditionally at any time without notice and the Tier 1 capital measure. Future developments at the level of the BCBS should be monitored carefully in terms of the exposure measure.

MORTGAGE BANK FOCUS

With regards to specialised lenders, as anticipated the quantitative results show that LRs vary considerably across different categories of business models, with the median ranging from 2.8% in the case of "public development" banks to 8.7% in the case of "automotive & consumer credit banks". Given these results, EBA recognises that prescribing a level of 3% for the LR may impact business models in profoundly different ways. At the same time, it is an objective of the LR to ensure the maintenance of a certain minimum level of capital relative irrespective of risk estimates; this generally also includes those credit institutions which apply, on average, low risk-weights.

Only some mortgage banks and public development banks reported a lower than 3% leverage ratio as of June 2015. The simulations-based analysis confirms that these firms will shrink their exposures (unless they raise capital) to meet the 3% threshold. The analysis also points out that the other banks, the ones already above the 3% threshold, would be theoretically able to absorb those shunned exposures. However, caution is warranted due to the local specificities of these market segments which may complicate a smooth reshuffling of exposures among credit institutions in certain cases.

For mortgage banks, the EBA has assessed qualitative aspects to complement the quantitative benchmarking outcome which, as mentioned above, indicated that mortgage banks would not be exposed to more or less Risk of excessive leverage (REL) in total. Additional considerations for mortgage banks, which put the benchmarking outcome into a broader context, are that they have some common features such as a specialisation in directly originating or servicing mortgage loans, and they are predominantly funded through the issuance of covered bonds. Therefore, these banks often do not maintain a network of regional branches which would give them broad access to retail deposits, but they may compensate for this through "match-funding" their long-term loans by means of long-term bond issuances as a mechanism for managing their leverage.

However, it should also be considered that risk estimates and collateral values of the mortgages can fluctuate through the economic cycle and that conditions in wholesale funding markets, on which mortgage banks often rely, can change. These aspects may provide evidence against lowering the LR requirements for mortgage banks.

In conclusion, the EBA does not deem appropriate to differentiate the LR requirement in the case of public development banks and mortgage banks. This conclusion is based on the benchmarking outcome which suggests neither a higher nor a lower exposure to REL for these entities, additional qualitative considerations regarding their business model and also the difficulty of scoping any specific treatment without jeopardising the objectives of the LR as a non-risk-based supplement and without compromising the comparability of the LR.

EFFECT ON COVERED BONDS AND REAL ESTATE EXPOSURES IN THE WORST CASE SCENARIO OF THE IMPACT SIMULATION

In its impact analysis, the EBA tested four different scenarios, whose variable is the degree to which institutions raise capital or reduce exposures has different implications for an institution's balance sheet. To take account of this, different combinations of capital increases and exposure reduction were investigated when simulating how non-compliant institutions would eliminate the capital shortfalls induced by the imposition of hypothetical LR requirements at various calibrations. The results did not swing much between the scenarios.

For a matter of brevity in this summary we will only focus on scenario 4: extreme adjustments with no capital increase and only exposure reduction. Banks would reduce covered bond exposure at an LR calibration of 3% in this extreme adjustment scenario (at 3.5% in the Baseline scenario). Overall the simulation analysis results do not suggest a substantial impact of the LR on exposure classes such as SME exposures, residential real estate and other retail exposures as long as the calibration of the LR does not exceed a level of 4-4.5%. Residential real estate exposures are, however, estimated to be reduced at calibrations of 4.5% and beyond in the adverse adjustment scenario. Under differentiated calibrations, residential real estate starts to be affected at calibrations of 3.5% [+/- 1%] in the adverse adjustment scenario.

ECBC Publishes 2016 Edition of the European Covered Bond Fact Book

On the 22nd of August 2016, the European Covered Bond Council (ECBC) published the 11th (2016) edition of its European Covered Bond Fact Book, which builds upon the success of previous editions and cements its place as the most comprehensive source of information in terms of market, regulatory and legislative developments and statistical data on the covered bond asset class.

With nearly €2.5 trillion outstanding at the end of 2015, covered bonds play a key role in European capital markets, contributing to the efficient allocation of capital and, ultimately, to economic development and recovery. The €539 bn of issuance during 2015 evidences the ability of the asset class to provide essential access to long-term capital market funding. Covered bonds' consistently strong performance and quality features attract the attention of regulators and market participants worldwide, which, in turn, leads to an increasing recognition of the macro-prudential value of the asset class.

The 11th edition of the European Covered Bond Fact Book 2016 features the following content:

- **Chapter I** presents an analysis of 11 key themes of the year, offering an overview of the Industry's views on these developments.
- **Chapter II** provides a detailed explanation of covered bond fundamentals, including reviews of some of the current European regulatory changes that have had/are bound to have a direct and significant impact on covered bonds, mainly the Capital Requirements Directive and Regulation (CRD IV and CRR), Liquidity Coverage Ratio and Solvency III. This chapter also includes articles outlining the repo treatment of covered bonds by central banks, investigating the relationship between covered bonds and other asset classes, such as senior unsecured and government bonds, and describing the USD and GBP denominated covered bond markets.
- **Chapter III** presents an overview of the legislation and markets in 37 countries, which demonstrates the worldwide success and recognition of the asset class.
- **Chapter IV** sets out rating agencies' covered bond methodologies.
- **Chapter V** provides a description of trends in the covered bond market, as well as a complete set of covered bond statistics up to the end of 2015.

Commenting on the publication, EMF-ECBC Secretary General Luca Bertalot said, *"Over the past years the ECBC Covered Bond Fact Book has represented a clear response of the Covered Bond Industry to the call for enhanced transparency in the covered bond space. The 11th Fact Book edition (2016) reinforces its position as the leading compendium of essential covered bond information offering a complete overview of market, regulatory, legislative and statistical developments at the global level."*

The European Covered Bond Fact Book 2016 can be downloaded on the ECBC website here.

The hard copy of the Fact Book will be presented and made available at the ECBC Plenary Meeting in Düsseldorf on the 14th of September 2016. For more information on the upcoming ECBC Plenary Meeting, please refer to the agenda available on the ECBC website here.

The ECBC welcomes the broad range of views expressed in this revision of the Fact Book and thanks all contributors whose enthusiasm and dedication have once again produced an outstanding publication, especially the Chairmen of the ECBC Fact Book and Statistics & Data Working Groups, Mr Wolfgang Kälberer and Mr Florian Eichert, respectively.

EBA Consultation on Interim Report on the Implementation and Design of the Minimum Requirement for Own Funds and Eligible Liabilities (MREL)

On the 19th of July 2016, the European Banking Authority (EBA) published a public consultation on its interim report on the implementation and design of the minimum requirement for own funds and eligible liabilities (MREL) (available here). The interim report is addressed to the European Commission, and it will inform a future legislative proposal on the implementation of the Financial Stability Board's "total loss-absorbing capacity" (TLAC) standard in the EU and the review of MREL.

This interim report on the MREL framework is intended to provide timely input into the Commission's deliberations, ahead of the preparation of the EBA's final report, due on the 31st of October 2016, and to elicit input from other stakeholders. It has been prepared by the EBA in close cooperation with the Single Resolution Board (SRB) and national resolution authorities, in order to draw lessons from their experience so far of the early stages of MREL implementation. The Single Supervisory Mechanism (SSM) and European Commission were also involved.

EBA'S PROVISIONAL RECOMMENDATIONS

The interim report contains a number of provisional recommendations relating to the MREL framework. These recommendations may be revised in the final report based on further analysis or feedback, including broader impact analysis that could not be achieved in this interim report. The interim report does not seek to address all of the issues in the mandate. The remaining issues will be further developed in the EBA's final report.

NEXT STEPS

The interim report has been drafted in accordance with Articles 45(19) and (20) of the BRRD, which mandate the EBA to deliver a report on the implementation of MREL to the European Commission by 31st October 2016. The report must cover a number of areas, including proposals on appropriate adjustments to the parameters of the minimum requirement, and consistency with international standards.

The European Commission has committed to bringing forward a combined legislative proposal implementing the FSB's TLAC standard in the European Union and reviewing MREL, by the end of 2016. In order to provide timely input into the European Commission's deliberations and to gather input from other stakeholders, the EBA has issued this interim report ahead of the mandated final report. The interim report does not cover all of the items in the BRRD mandate for the MREL report; additional elements will be covered in the final report.

This consultation ran until the 30th of August 2016.

European Commission Consultation on EU Macro-Prudential Framework

On the 3rd of August 2016, the European Commission launched a public consultation on the functioning of the EU macro-prudential framework (available here). As this complex framework was developed progressively over a number of years, the European Commission aims to avoid overlaps and inconsistencies.

The framework is currently made up of five separate pieces of legislation: two European Systemic Risk Board (ESRB) Regulations, the Capital Requirements Directive IV (CRD IV), the Capital Requirements Regulation (CRR) and the Single Supervisory Mechanism (SSM) Regulation. By addressing all five component parts in a comprehensive review, the Commission aims to eliminate any possible inconsistencies. The consultation includes a broad range of questions on narrowing and refining the scope of existing macro-prudential instruments (such as capital buffers), making the rules more consistent with one another, as well as examining the role and organisational structure of the ESRB and its relationship with the European Central Bank. For an overview of the EU macro-prudential policy framework in its various components please refer to the recent parliamentary briefing "Macro-prudential Policy in the EU".

This consultation aims to align the different elements of the macro-prudential framework. The key aim is to ensure the right balance between national flexibility, and community control is achieved. This may involve streamlining the toolset of instruments, changing the activation procedures for these instruments, enhancing the role of the ESRB as a macro-prudential hub, and clarifying the SSM's role in the framework. In more detail, the Commission consults on the following aspects of the framework:

- The way the different macro-prudential tools overlap (it is not always clear which risks are being addressed when a macro-prudential buffer is used).
- The activation mechanisms required to use these tools (Member States tend to use the tool that requires the least amount of coordination with other Member States).
- The complex co-ordination needed to manage the cross border impacts of some of these measures (a largely voluntary framework, agreed within the ESRB framework).
- The role of the ESRB in the framework (it is perceived by some to be too close to the ECB, and too reliant on its resources to provide fully independent analysis).
- The role of the SSM in using the macro-prudential buffers on the banks under its supervision.

There are at least two questions that affect the mortgage industry directly:

- **Question 3:**
  Do you see a need to strengthen the coordination between designated and competent authorities when using stricter Pillar 1 measures for real estate exposures to address systemic risks? If you see a need, how should their coordination be strengthened?
- **Question 5:**
  Do you consider a Countercyclical Capital Buffer (CCB) for sectorial imbalances (e.g. in the real estate sector) a useful complementary instrument? If yes, how would you see the interaction of this sectoral CCB with the CCB already in place?

The EMF-ECBC is assessing these questions and the wider consultation, which runs until the 26th of October 2016, and considering a formal response.

Coming Soon: Hypostat 2016

Hypostat is the EMF-ECBC annual flagship statistical publication and the latest edition, Hypostat 2016 (covering data for 2015), is currently being finalised for publication in the coming weeks. To recap, the Hypostat presents annual data and analyses on the mortgage and housing markets of the twenty-eight Member States of the European Union, as well as data from seven additional countries (Australia, Iceland, Japan, Norway, Russia, Turkey and the United States).

A full report on the content of Hypostat 2016 will feature in a subsequent edition of Market Insights & Updates, but as a taster, please find below a summary of the key findings:

- **House prices** in aggregate terms continue the positive trend of the previous year with some exceptions. The situation between and within different jurisdictions remained highly fragmented, with some markets recovering, while others continuing to decline. Nonetheless, rate of decline seemed to have slowed down across the board.
- **Housing supply** has remained more or less static since 2009, with building permits showing timid signs of increase during the last two years.
- Total **outstanding lending** surpassed EUR 7 trn for the first time growing by 3.5% y-o-y. Also, for the first time since 2008 **gross lending** again surpassed the EUR 1 trn mark. This increase can be explained by both effectively augmented residential lending and the appreciation in 2015 of the British pound and Swedish krona, the currencies of the largest non-euro residential markets.
- **Interest rates** on mortgage loans either continued to decrease or maintained the very low interest levels of the previous years as a reaction to the expansionary monetary policy stance of the ECB and other central banks in the EU. Nonetheless, over 2015, some timid signs of marginal rebounds have been observed in a number of countries.

European Commission Adopts Implementing Decision on EURIBOR Benchmark

On the 12th of August 2016 the European Commission adopted an Implementing Regulation establishing a list of “critical” benchmarks, i.e. those indexes that are of particular importance for financial markets and consumer contracts. This enables supervisors to make use of certain provisions of the Benchmarks Regulation (EU 2016/1011) in advance of its entry into application in 2018.

EURIBOR (Euro Interbank Offered Rate), one of the most important interest rate indexes in the EU, is the first to be included in the list established by the Implementing Regulation. The Commission will review and update this list regularly and will include, in due course, other benchmarks that fulfil certain criteria. The Implementing Regulation will ensure that supervisors are in a position to allow the continuation of “critical” benchmarks where their cessation would have a severe adverse impact on market participants and undermine the functioning and integrity of markets. In particular, classifying EURIBOR as a “critical” benchmark will facilitate supervisors in requesting data contributions from banks, if they deem it necessary to ensure the benchmark’s representativeness.

Further information on his subject is available here.

AGENDA

SEPTEMBER 2016

07-09/09	Eurofi Financial Forum 2016 – Bratislava
12-13/09	European Commission Workshop on Advisory Support for SME Access to Finance – Brussels
13/09	European Covered Bond Council (ECBC) Steering Committee Meeting – Düsseldorf
13/09	Covered Bond Label Committee Meeting – Düsseldorf
14/09	24th ECBC Plenary Meeting – Düsseldorf
15/09	Euromoney Conferences / European Covered Bond Council (ECBC) Covered Bond Congress 2016 – Düsseldorf
16/09	European Covered Bond Council (ECBC) Global Issues Working Group Meeting – Düsseldorf
20-21/09	1st Build Upon European Leaders' Summit – Madrid
21/09	4th Energy Efficiency Financial Institutions Group (EEFIG) Workshop – Brussels
22/09	ECBC Technical Issues Working Group Meeting – Madrid
28/09	European Parliament Financial Services Forum (EPFSF) Event on the UK's EU Referendum – Brussels
30/09	European Mortgage Federation (EMF) Statistics Committee Meeting – Brussels

OCTOBER 2016

04/10	Hungarian Green Building Council Conference on Economic, Environmental and Social Aspects of Green Buildings – TBC (Hungary)
05/10	European Covered Bond Council (ECBC) Supervisory Task Force Meeting with the European Banking Authority (EBA) – London
06-07/10	15th International Conference on Credit Risk Evaluation: Credit Solutions for the Real Economy: Implications for Investors, Financial Stability and Policy Design – Venice
07/10	European Mortgage Federation (EMF) Legal Affairs Committee Meeting – Bucharest
14/10	European Mortgage Federation (EMF) Economic Affairs Committee Meeting – Amsterdam
19/10	European Parliament Financial Services Forum (EPFSF) Event on Cyber Security – Brussels
21/10	Maastricht University Conference on Sustainable & Healthy Homes – Maastricht