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Summary

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European Covered Bond Council

Driving a Thriving Energy Renovation Market Through Stable Financial Incentives

By Riccardo Viaggi, Secretary General, European Builders Confederation

The construction sector is one of the main pillars of the European economy and provides solutions for social, climate and energy challenges. By making up for 9% of the GDP of the European Union (EU) with its total turnover of €1,241 billion in 2015, it is in fact the single industrial sector with the highest contribution to the EU's GDP. There are 3 million enterprises active in this sector, 92% of which have less than 10 workers. Furthermore, construction companies employ a direct workforce of 18 million people, adding to the sectors' vital importance for our society.

However, the construction sector and its SMEs were severely hit by the financial crisis, suffering from the double-dip recession close to the 2008 meltdown. Since then the construction industry has been shrinking. But businesses are seeing some encouraging signs, which would benefit both the sector and the European Union as a whole, because every job created in construction results in two additional jobs elsewhere, as a Commission analysis claims. Hence it is of vital importance to bring the construction sector back on track.

THE RENOVATION MARKET AS A KEY OPPORTUNITY

The most promising way to put the construction sector up to its old strength is by stimulating the renovation sector, which represented 57% of the construction sector's turnover in 2015, a strong increase from 47% in 2005. A constantly growing part of this work is made up by energy renovation works. In fact, buildings are responsible for about 41% of total energy consumption and thus form an integral part in reaching the goals set within the 2030 framework for climate and energy, and in achieving the COP21 commitments. Compensating for other sectors where it is even more difficult or less cost-effective to reduce emissions, buildings need to move towards being "nearly-zero carbon". A promising chance for the construction sector to return to its state before the crisis hit Europe and even excel it.

In 2015 energy efficiency improvement works were worth over €100 billion, roughly 15% of the total turnover of construction activities in the EU. The vast majority of this turnover is created in the housing sector. A continuous increase in the coming years has the potential to boost the EU's energy performance and to increase employment numbers, especially among young people in local areas. In 2015 energy renovation works employed directly close to 900,000 people.

FINANCING ENERGY EFFICIENCY IS THE BIGGEST CHALLENGE

However, one of the biggest issues hampering the increase of energy renovations lies in the structure of the existing building stock and its related financing possibilities.

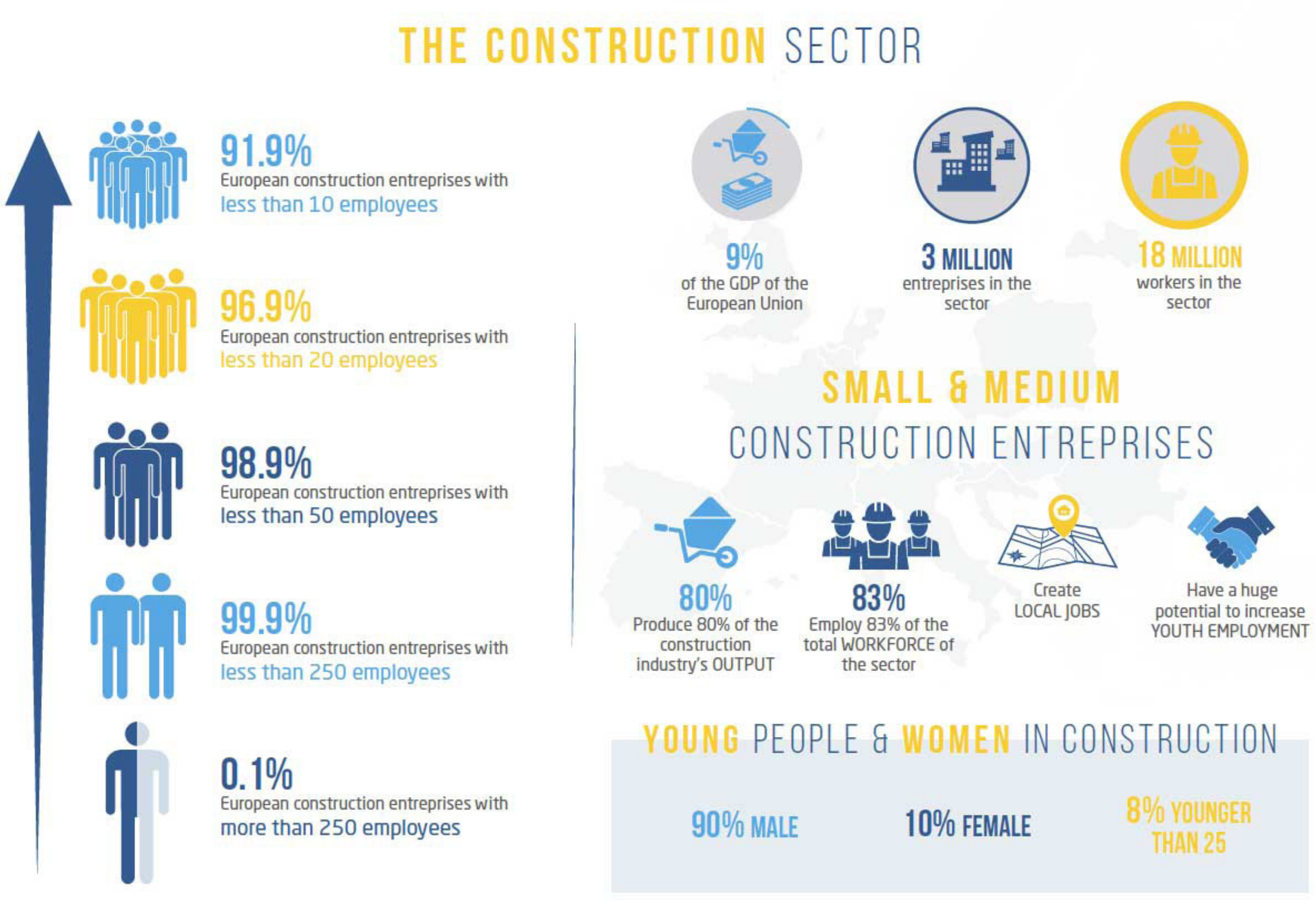
75% of the square meters in the existing housing stock in the EU lie in residential buildings. Considering that about 65% of the energy renovation works are done in this kind of housing stock, it is also the most important sector for construction companies. In fact, by looking at the data in a bit more detail it becomes visible that 70% of people in the EU live in a self-owned flat and about 60% of the EU population in an individual house. It is also worth noting that about 43% of the people who own a house don't have a mortgage on it. Therefore, split incentive issues between landlords and tenants are less of a problem. Instead, providing private landlords with information and adequate as well as attractive financial incentives to enhance the energy efficiency of their building is one of the main tasks ahead.

The challenge of boosting the energy efficiency of existing buildings can only be met if sufficient and stable financial incentives are made available and easily accessible. Indeed, energy efficiency in housing is an interesting issue for homeowners as European households spend on average 6% of their expenses on heating/cooling. Nonetheless, it is slowed down by the fact that upfront costs are often high with a long return on investment. Therefore, it is essential that private owners/tenants are put in a position where they can afford to start retrofitting works to improve the energy performance of their building.

THE EUROPEAN BUILDERS CONFEDERATION SUPPORTS THE ENERGY EFFICIENT MORTGAGE INITIATIVE

The European Builders Confederation thus considers the European Energy Efficient Mortgage initiative (see here) of the European Mortgage Federation – European Covered Bond Council (EMF-ECBC) an effective way to unlock the market potential and supports its launch. This initiative offers better borrowing rates on mortgages in return for either purchasing more energy efficient homes or committing to implement energy saving works within properties via the use of preferential interest rates. In this way it gives incentives to new homeowners to invest in energy efficiency measures and thus to strongly reduce the total energy consumption of buildings in the EU.

Boosting the energy renovation market is indispensable to help the EU reach its ambitious energy and climate goals. Additionally, it offers the chance to develop a true energy renovation market that can boost the economy, because the renovation of the building stock is a labour intensive activity. A prediction by Ehrhardt-Martinez and Laitner (2008) for example states that 8.1 jobs, directly and indirectly related to the construction sector, are created per €1 million invested in energy renovation: a fact that does not only help the construction sector out of the still tangible crisis but also gives a push to the EU economy as a whole.



Capital Markets Union and the Potential Role of the ECBC and Dual Recourse Instruments

By Boudewijn Dierick, BNP Paribas, Moderator of the ECBC Task Force on Long-Term Financing & Chairman of the ECBC Rating Agency Approaches Working Group

CAPITAL MARKETS UNION: WHAT IS THE PURPOSE THE EC IS TARGETING?

The Capital Markets Union (CMU) plan, outlined in the 2015 European Commission's Green Paper, aims to develop better regulation by means of market initiatives that can support growth and lending to the real economy, in its role as market catalyst. The CMU should help channel private funds to all companies, including SMEs, and infrastructure projects in order to facilitate expansion and thereby create jobs. By linking savings with high-growth investment opportunities, the CMU will offer new opportunities for both savers and investors.

Brexit, portmanteau for "British Exit" from the European Union (EU), might have far reaching effects on the European Commission's agenda. The CMU is the brainchild of Commissioner Jonathan Hill who resigned in the aftermath of the British referendum and the victory of "Leave" camp on the 23rd of June 2016. The possible departure of the UK, a strong supporter of capital markets funding, can have an effect on the approach that the European Commission will have to the CMU plan. However, there is broad support across the EU for the CMU as a concept, though its components might change in order to accommodate different priorities within the remaining 27 Member States and we will have to see how this will impact timing and next steps.

ECBC ROLE

The ECBC decided to assist and support the development of any market initiative going forward that has the potential to play a crucial role in financing growth and the real economy while preserving the strength of the traditional covered bond market it represents.

The ECBC established a Task Force on Long-Term Financing, the purpose of which was to investigate the possibility and viability of the creation of new capital instruments that make use of some key features that have made covered bonds one of the safest and most successful financial tools in use in Europe, and which played a central role in the crisis management toolkit of banks during the financial crisis by providing a safe and reliable source of funding. This article reflects the main findings of the ECBC Task Force which formed the basis of the ECBC letter to the European Commission in response to the Green Paper on Building a Capital Markets Union.

The ECBC response to the Green Paper aims to provide clear building blocks for a market initiative on a pan-European dual recourse long-term funding instrument, which would allow for the financing of asset classes beyond the traditional covered bond collateral types of mortgages and public sector assets such as small and medium-sized enterprise (SME) or infrastructure assets.

The ECBC's proposal represents a market initiative creating a new pan-European funding instrument, the European Secured note (ESN). This initiative would require a limited legislative intervention at national level and would respond to several of the priorities for early action foreseen in the Green Paper, in particular: (i) widening the investor base for SMEs, and (ii) building sustainable high-quality securitisation.

On several occasions, the European Central Bank, the European Commission, the European Investment Bank and a number of national regulators have praised the ECBC for the ESN project.

This initiative, designed outside of the traditional covered bond space, combines existing techniques and market best practices for the establishment of a funding solution for lenders that is also accessible in a stress scenario.

Traditional covered bonds have ensured financial stability and access to capital markets during the crisis thanks to very precise macro-prudential characteristics. It is important to clearly distinguish any funding solutions for SME and infrastructure loans using similar dual recourse techniques from the traditional covered bond space.

One of the key success factors is the common adoption of the same set of micro foundations and technology, in particular in terms of eligibility criteria, definitions, risk parameters, data disclosure and IT solutions across European countries. If correctly implemented, supported by a minimum level of regulatory recognition as a very high-quality product under a clear legislative and supervisory framework, it could facilitate issuers and investors in terms of due diligence, risk analysis, pricing and funding diversification.

HOW WOULD SUCH INSTRUMENTS DIFFER FROM TRADITIONAL COVERED BONDS?

Despite the similarities between the on balance sheet version of the ESN (please see below for more details) and covered bonds, it is important to highlight the features that distinguish covered bonds from ESNs. The main distinguishing feature is the different collateral used to secure ESN in comparison to the collateral of covered bonds. Covered bonds use highly standardised and low-risk assets, mainly mortgage loans and claims against public sector entities, as collateral. The high level of standardisation of cover assets is a key element that facilitates the analysis of covered bonds, limits research effort and increases comparability within the covered bond sector. Using highly standardised assets also makes it easier to define eligibility criteria for the cover assets that can be used on a relatively broad basis, i.e. in a larger number of jurisdictions.

The use of low-risk assets as collateral is one cornerstone of the high level of investor confidence that covered bonds enjoy. The concept of dynamic collateralisation based on asset substitution through the issuer is more acceptable for investors if new assets which are added to the cover pool will meet certain minimum criteria. For issuers the use of high quality collateral means more a stable credit quality of the cover pool and ultimately less frequent asset substitution. The use of other, potentially more risky asset classes for ESN makes a clear distinction between traditional covered bonds and ESN necessary as the risk profile of the two instruments could vary significantly.

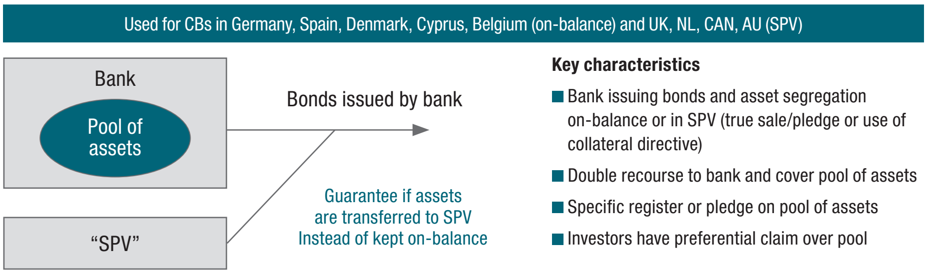
A further distinguishing factor between covered bonds and ESN, at least at an initial stage, would be the established track record that covered bonds enjoy. Together with robust national legal frameworks, the long standing track record of covered bonds has helped to make them more reliable and stable. The long track record, which is the basis for a deep and diversified investor base, helps to support market access of covered bond issuers also in time of stress. The robust market access itself in an important stabilising factor for covered bonds. Drawing a clear line between covered bonds and ESN will help to protect the track record of covered bonds against potential dilution that could occur through the introduction of instruments that bear similarities to covered bonds but may have a different risk profile.

DESIGNING DUAL RECOURSE INSTRUMENTS FOR THE LONG-TERM FINANCING OF THE REAL ECONOMY

With the spirit of the Capital Markets Union in mind, the ECBC Task Force on Long-Term Financing tried to design new bank funding tools aiming at improving banks' ability to lend to the real economy, while at the same time stimulate the growth of SMEs by promoting the use of SME loans as collateral for new ESNs. The outcome of the discussion was the proposal of two possible ESN structures, each with slightly different characteristics, aimed at providing different benefits to the lender as well as to the borrowers and investors. The first type of ESN would be closer in design to covered bonds in the sense that the originating bank would be the issuer of the ESNs and the investor would have dual recourse to both the pool and the issuer. The second type of ESN would resemble more closely what is referred to as high-quality securitisation. This could involve risk transfer (and capital relief) for the issuing institution (as the collateral would be transferred onto an SPV[1]), but also still could retain a form of dual recourse. In both cases, the collateral could be SME loans or infrastructure loans. Though, the first on balance sheet appears more appropriate for SME loans and is focused on funding only. The off-balance sheet solution, instead, could be more suitable for infrastructure loans.

These two major lines of development (on-balance sheet and risk sharing) could be implemented through a bottom-up approach, which would aim at amending the current legislative frameworks by adopting common definitions, risk parameters and market best practices (even if this may be implemented *de facto* through different legal options/solutions at national level). This combination of common European guidelines, flexibility and adaptability in the implementation at national level should ensure a smooth adoption of this structure in what remains a heterogeneous market, as well as supervisory and legislative landscape.

Figure 1 ▶ On-balance sheet european secured note



Source: ECBC

ON-BALANCE SHEET EUROPEAN SECURED NOTES (ESN) USING COVERED BOND FUNDING TECHNIQUES

The on-balance sheet ESN would be similar in structure to a covered bond. As such, it could have the obvious advantage of benefiting from regulatory recognition, thus providing the issuer with an additional tool to fulfil liquidity requirements such as the Liquidity Coverage Requirement (LCR). In fact, the transformation of SME loans into an ESN could improve the regulatory and prudential treatment of such assets, by making the bond UCITS[2] compliant, and therefore exempt from bail-in, and eligible for a number of prudential and regulatory requirements, such as under Solvency II. In this context, two elements are necessary in order for the ESN to successfully play this role: (i) a robust specific legal framework around the creation of such an instrument; and (ii) a sufficiently high level of transparency regarding the asset pool and its performance.

The existence of a legal and supervisory framework is one of the major strengths of covered bonds. This should also be developed for on-balance sheet ESNs, whereby the asset pool would have to fulfil specific criteria. These include, but are not limited to: a harmonised definition of SME loans allowed as eligible collateral; clear rules on the segregation of the pool for the safety of the investor; appropriate levels of over-collateralisation (OC); and clear *pari-passu* priority claims of the investor to the issuer's assets in the case of default and insufficiency of the pool to cover the value of the bond.

In addition, the eligibility criteria for SME loans need to be developed. A good starting point for this may be the European Central Bank's (ECB) collateral framework which allows the use of credit claims as collateral for repo operations[3]. This alignment would ensure greater marketability and liquidity of the ESN. The second requirement, i.e. transparency, is very much linked to the first point, as it is a necessary condition for the accurate assessment of the true underlying risk of the SME assets used in the pool. High levels of transparency would facilitate due diligence and allow investors to effectively understand the underlying risk. More importantly, it would allow issuers to effectively manage their portfolio. Therefore, it is of paramount importance to develop an effective transparency framework, which would entail a close cooperation with the SMEs whose loans are included in the pool.

Also, the framework of the Italian version of the ESN could serve as a blueprint for some of its characteristics (please see the section below for more information).

RISK SHARING EUROPEAN SECURED NOTES (ESN) – USING HIGH QUALITY SECURITISATION TECHNIQUES

This ESN structure would provide benefits to both the issuer and the investor which would share some risks and be remunerated accordingly. It could offer both funding and some capital relief to the issuer, which would thereby be able to use freed-up capital for additional lending; this would also have the advantage of lowering capital requirements. For the investor, this ESN structure, while maintaining the alignment of interests between originator and investors, would potentially be more interesting in terms of yield, which is a central aspect in the current environment of low interest rates.

This alternative ESN structure would, in some respects, have analogies with the securitisation techniques in the sense that the assets used in the pool would be transferred to an SPV via true sale or pledged using, for example, the collateral directive to prevent the need of a true sale at closing. In this case, as for traditional securitisation, the pool could either remain static or have a replenishment period of a few years, which would represent a difference *vis-à-vis* traditional covered bonds where the pool is dynamic (which would also be a characteristic of the "on-balance sheet ESN") throughout the life of the covered bond programme. In fact, the dual recourse principle could apply, although in a different way to that for the "on-balance sheet ESN", for example via the issuer providing a guarantee for part or all of the ESNs issued.

As with traditional securitisation, this second ESN structure would have one or more tranches of notes and each tranche would be secured by the portfolio of SME credit claims. Two basic general principles should be satisfied: (i) the originator must comply with the retention requirements ("skin in the game") by either retaining the junior tranche of 5% or more, at least 5% of each tranche or a 5% portfolio of similar risk on its balance sheet; and (ii) public/international institutions could play a role in investing in or in guaranteeing some tranches (senior to equity) of the security in the spirit of promoting the development of the securitisation market and the financing of the real economy through SMEs.

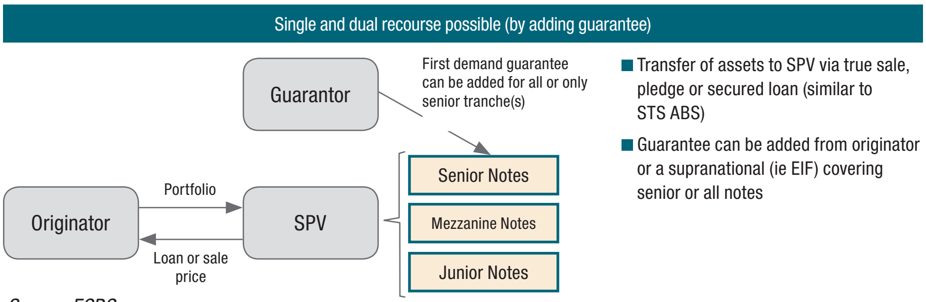
The design for this kind of instrument would be one where the originator (issuer), and/or another highly-rated financial institution, guarantees the senior tranche of the ESN. The equity and/or mezzanine tranches could be guaranteed by institutions such as the European Investment Bank Group (EIB Group, in particular the European Investment Fund), government-owned development banks (such as

1 Special Purpose Vehicle (SPV).

2 http://ec.europa.eu/finance/investment/ucits-directive/index_en.htm.

3 https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp148.pdf.

Figure 2 ▶ Off-balance sheet european secured note



Source: ECBC

KfW Development Bank in Germany, Cassa Depositi Prestiti (CDP) in Italy, Instituto de Crédito Oficial (ICO) in Spain or Caisse des Dépôts et Consignations (CDC) in France), again, to encourage public involvement and the sponsoring of securitisation as a means of financing the real economy.

This ESN structure could, through its features, aim at tackling the fragmentation of EU capital markets, and encourage a cross-border market for SME financing throughout the Union. Moreover, the legal safeguards and flexibility of using an on-balance sheet approach and/or risk sharing techniques would reduce the pro-cyclicality of the ESN instrument, thus rendering it especially useful in enhancing the resilience of long-term financing in times of crisis.

It is important to note that, as for the "on-balance sheet ESN", the "risk sharing ESN" would need to rely on robust transparency requirements, as well as a legal framework to safeguard investors and issuers. In addition, this ESN structure would also depend on the willingness of such international/public institutions to support the instrument through guarantees. Nonetheless, there is a clear intention by EU and national authorities to support the securitisation market, as well as the financing of the real economy. Of course, it is pivotal that the risks involved are accurately identified, standardised and mitigated where necessary. This is a *conditio sine qua non* for the involvement of other parties in these transactions.

STEPS FORWARD: THE WORK OF THE TASK FORCE AND THE ROUNDTABLES

Following on from the results of the ECBC Long-Term Financing Task Force meetings, the ECBC kicked off the ESN project in October 2015 with a high level Roundtable in Milan, attended by a wide range of representatives from the European banking industry, investors' community and regulators.

Following the Roundtable in Milan, the ECBC has been holding several high level meetings with key stakeholders from both the private and the public sector in order to push forward this new instrument initiative aimed at fostering investment in SMEs and infrastructural projects. Italy was the first Member State to adopt a regulation on an ESN-like instrument in April 2016.

The ESN project has been gaining traction also in core EU countries such as Germany and Austria where the initiative is considered a smart and effective way of funding a number of infrastructural projects. It is important to highlight the value of such a product in Germany, where the "Energiewende", i.e. the transition to a low carbon, environmentally sound, reliable, and affordable energy supply, and other infrastructure projects will need additional funding in the coming years. Among other things, funding such projects via ESNs would be advantageous with respect to the, much used, syndicated loan methodology.

Following the introduction of the Italian legislative ESN framework on the 6th of April 2016, the Secretariat organised a second Roundtable in Milan in May 2016 to follow up and build on the recent developments. During the meeting, a broad range of stakeholders and authorities, both national and European, debated on the nature of the ESN, the state of play in the interested counties, funding needs of SMEs and infrastructures, and the possible eligibility criteria for the cover assets.

THE FIRST ESN FRAMEWORK: THE ITALIAN BLUEPRINT

The Italian government proposal to amend the securitisation law in order to introduce the ESN framework has been approved by the parliament on 6th of April 2016 and subsequently converted into law. The primary legislation allows the issue of bonds (which may be called Obbligazioni Bancarie Collateralizzate – OBC), collateralised by SME loans, leasing, factoring, ship loans and other types of commercial assets. The structure is similar to the existing covered bonds (Obbligazioni Bancarie Garantite – OBG), though the law clearly differentiates between the two products. Secondary regulation will specify some features of the new instrument such as the exact definition of eligible assets and identification definition of licensable issuers.

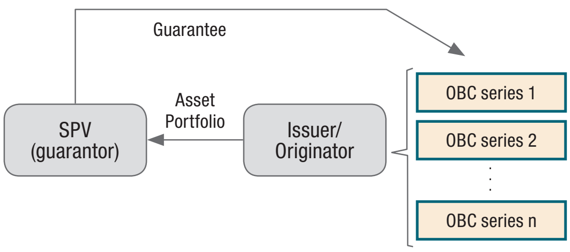
OBCs will be under public supervision. This is a key element as public supervision is a pre-requisite for the ESN to be UCITS compliant, and therefore exempt from bail-in, and eligible for a number of prudential and regulatory requirements such as under Solvency II. Other characteristic features will be the bankruptcy remoteness of the segregated assets, which will be assigned to an SPV. This is the so-called true sale mechanism. Two major rating agencies have already expressed their support to the Italian ESN underscoring the success of the implementation in the "Bel Paese".

To further support the development of the ESN initiative, the ECBC has worked on building a market platform where regulators, treasuries, Central banks and Supervisory authorities can meet with key market players to discuss a smooth implementation of the ESN.

THE WAY FORWARD: THE ROLE OF INSTITUTIONS AND THE MARKET

Looking ahead, the success of these ESN instruments would rely on both a robust legal framework and a high level of transparency regarding the underlying assets. The development of centralised credit registers[4] with harmonised levels of information would provide the ideal tool for the achievement of full transparency (while complying with confidentiality laws), and the subsequent increased level of security of these ESNs. All parties involved would be able to accurately assess risks and thereby differentiate their portfolios accordingly, contributing to the quality of the instruments. This

Figure 3 ▶ The italian ESN structure



Source: ECBC

4 One example of this could be the Analytical Credit Dataset (AnaCredit) "The development of a steady state approach for an analytical credit dataset will continue in 2015 in close collaboration with the FSC. This entails drafting a new ECB regulation and guideline for the collection of granular credit data and the development of an IT tool for data collection, maintenance and dissemination.", source: http://www.ecb.europa.eu/stats/pdf/2015_ESCB_statistics_work_programme.pdf?ef1338e0f89fd91d3fd02f033aad73a6.

Figure 4 ▶ Three phases of the ESN project

> **Phase 1**: This phase aims to be a preliminary institutional investigative period. During phase 1 key issues of developing the regulatory and market infrastructure needed for the ESN will be addressed.
> **Phase 2**: This phase will focus on an actual market analysis. Identifying market appetites and legal elements to take into consideration when developing on-balance and off-balance sheet options will be the major tasks of this phase.
> **Phase 3**: Ad hoc work streams focusing on implementation will be activated. This should be done by interacting actively with market participants, European and national authorities.

Source: ECBC

links closely to the other condition, i.e. a robust legal framework, which among other things would focus on determining which assets can be used as collateral. Having transparent information regarding these SME loans is a central aspect of this issue.

Moreover, the issuer, regulatory and investor community should work together to develop common eligibility criteria for assets (which could be inspired by the European Central Bank (ECB) collateral eligibility criteria for credit claims as well as EIB Group activity). Establishing a pan-European standard in terms of securities backed by SME or infrastructure loans would be a cornerstone of the strength of this product. Regulatory frameworks and existing laws should be amended to allow these new asset classes to be used as collateral within the regulatory and prudential framework.

In order to drive the effort forward, contributions from the institutional side as well as the market side should include the following points which have been designed by the ECBC Long-Term Financing Task Force:

CONCLUSION

The success of covered bonds and in particular their resilience during the financial crisis have made them an obvious choice as a model for the creation of a new pan-European funding instrument. The creation of such instruments is an important step towards establishing deeper and more integrated capital markets, which is a key objective of the Capital Markets Union initiative. Drawing from the experience of a long standing but also dynamically expanding covered bond market will help to save time and increase efficiency when creating a new funding instrument. At the same time it is important to draw a clear line of distinction between covered bonds and the ESN. ESNs are steadily taking shape with structures and certain key features that will allow broad market acceptance. Contributions from the institutional side as well as the market side are helping to further increase the chances of a successful introduction of ESNs in the European markets.

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

NEWS IN BRIEF

European Parliament Publishes Analysis of Banks' Internal Rating Models

On the 4th of November 2016 the European Parliament published an In-Depth Analysis on "Banks' internal rating models (IRB) – time for a change? The system of floors as proposed by the Basel Committee" – available here. This paper was prepared at the request of the Parliament's Economic & Monetary Affairs (ECON) committee.

In the paper the authors, Rainer Haselmann and Mark Wahrenburg from Goethe University and SAFE, take a very critical position towards capital floors and the limitation of use of the IRBs. A summary of their conclusion is as follows:

Assessment of restrictions for the use of IRB models (Proposal 1). The authors recommend to maintain the IRB model approach and not to shift exposure classes back the standardised approach (SA). The current deficiencies of the IRB approach should better be addressed by continuing the ongoing initiatives that aim at increasing IRB model quality and homogeneity. With the new European supervisory structure in place (single supervisory mechanism / EBA), Europe is well positioned to successfully complete this process and to take full advantage from well-functioning IRB models in the future.

Assessment of IRB output floors (Proposal 2). The authors do not recommend the use of IRB output floors because this does not address the major problem (model heterogeneity) and has many unintended negative side effects. For example, introducing output floors at a high level potentially results in a distortive credit allocation incentivising banks to invest in more risky projects and forgo less risky investment projects.

Assessment of IRB input parameter floors (Proposal 3) and the harmonisation of IRB parameter estimation procedures (Proposal 4). In areas where default data is scarce, the proposed IRB input parameter floors are appropriate measures to prevent over-optimism and to achieve an appropriate level of conservatism and comparability. With regard to limiting the range of estimation practices of model parameters under IRB approaches, this measure is likely to reduce banks' incentives to develop and improve their risk management practices and methodologies.

Assessment of the European situation. It is also necessary to assess the potential consequences of the Basel Committee on Banking Supervision (BCBS) proposal with regard to the European situation. The following considerations are important: First, Europe has just created a new strong central supervisory structure. The authors are confident that under this structure, it is likely that supervisors will be able to address RWA heterogeneity better without implementing the BCBS proposal. Second, the implicit assumption behind the BCBS proposal is that Pillar I is a binding constraint. In Europe, Pillar II already constitutes an effective backstop for RWA heterogeneity and increasingly determines minimum capital requirements for many banks in practice. Third, the BCBS proposal potentially has a more detrimental impact for European banks as for banks in other regions. The reason is that RWA output floors would be unique for specific asset classes throughout the world while the underlying risks for these asset classes may differ substantially in different regions (e.g. mortgage loans in the US tend to be more risky than in Europe). If this is the case, the BCBS proposal would have a drastic impact on capital requirements for European banks relative to banks in other regions.

EBA Issues Recommendations on the Implementation of New Counterparty and Market Risk Frameworks

On the 4th of November, the European Banking Authority (EBA) published a Report in response to two calls for advice to assist the European Commission in the adoption into European legislation of two new international frameworks proposed by the Basel Committee on Banking Supervision (BCBS): (i) a new standardised framework for counterparty risk (CCR), i.e. the so-called SA-CCR, and (ii) a new market risk (MKR) framework – the so-called fundamental review of the trading book (FRTB). In the Report, which is available here, the EBA focuses on the envisaged impact of these two frameworks, for both large and small firms, and issues recommendations on their implementation.

The Report assesses the impact that the implementation of the two frameworks is likely to have on institutions, both from a qualitative and quantitative perspectives, as well as on certain business lines and/or markets, and highlights a number of interpretative and operational issues that might need to be addressed before the rules are fully implemented. In addition, given the technical complexity that the new requirements might entail, the Report assesses the convenience of introducing greater proportionality into both frameworks.

Based on its assessment, the EBA is including in the Report some recommendations, which are addressed to the European Commission:

- Increasing the threshold value for small trading book business below which institutions are able to use the non-trading book approach for the computation of capital requirements.
- Introducing a threshold for small derivative businesses below which institutions are allowed to use simple approaches currently used for the computation of CCR capital requirements, subject to recalibration.
- Considering additional proportionality solutions for banks outside the traditional scope of the Basel standards that could include, for both CCR and MKR purposes, the use of approaches that are simpler and more conservative than the ones developed in Basel.
- Implementing large technical parts of these international standards using delegated acts or mandates for Regulatory Technical Standards (RTS), so as to allow the EBA to reflect key changes in the regulation in a timely fashion.
- Including more granularity in COREP reporting to provide a better overview of institutions' CCR exposures and the information needed to monitor the computation of the different proportionality thresholds included in legislation.

EBA Launches Consultation on Guidelines for Estimation of Risk Parameters for Non-Defaulted Exposures

On the 14th of November 2016, the European Banking Authority (EBA) launched a consultation on its draft Guidelines on the estimation of risk parameters for non-defaulted exposures, namely of the probability of default (PD) and the loss given default (LGD), and on the treatment of defaulted assets. The EBA Consultation can be accessed here.

These draft Guidelines are part of the EBA's broader work on the review of the internal ratings based (IRB) approach (opinion and report) aimed at reducing the unjustified variability in the outcomes of internal models, while preserving the risk sensitivity of capital requirements.

In particular, as to non-defaulted exposures, the draft Guidelines detail the estimation of probability of default (PD) and loss given default (LGD) parameters, including specification of main definitions, requirements for the data used and clarifications on modelling techniques. In case of defaulted assets, these Guidelines provide clarifications on the estimation of risk parameters such as best estimate of expected loss (ELBE) and LGD in-default based on the requirements specified for the LGD for non-defaulted exposures.

In addition, these Guidelines specify other aspects that are common to all risk parameters, such as the judgmental component when developing and applying internal models, the appropriate level of conservatism that should be included in risk parameters, as well as the need for regular reviews of the models so as to ensure the necessary changes are applied in case of their deteriorated performance.

The EBA is planning to carry out a qualitative survey to assess the impact of the proposed requirements on the rating systems, the results of which will be taken into consideration when finalising these Guidelines.

Considering the material changes to numerous rating systems that these Guidelines may entail, the proposed time for their implementation is end-2020.

European Commission Proposes New Rules for Recovery and Resolution of Central Counterparties

On the 28th of November 2016 the European Commission proposed new rules to ensure that both central counterparties (CCPs) and national authorities in the European Union have the means to act decisively if a CCP were to fail. The main objective of the proposed regulation is to ensure that CCPs' critical functions are preserved while maintaining financial stability and preventing the costs associated with the restructuring and resolution of failing CCPs from falling on taxpayers.

CCPs act as the counterparty to both sides of a transaction in a financial instrument. They clear a range of financial instruments including bonds, equities, derivatives and commodities (such as agricultural products, oil and natural gas). Certain types of derivatives have to be cleared through CCPs under G20 requirements and EU rules so that the importance of CCPs is set to increase further in the future.

Full details concerning the Commission's proposals can be accessed here.

COP22 – A Climate Change Mitigating Housing Market

On the 15th of November 2016, during the United Nations Climate Change Conference (COP22) in Marrakech the European Mortgage Federation – European Covered Bond Council (EMF-ECBC) presented its ground-breaking Energy Efficient Mortgages Initiative (see here) at the UNEP FI-IPEEC Event on "Scaling-up financing for energy efficiency". Finance was a key discussion point during the COP22, the aim of which was to characterise the crucial next steps for operationalising the COP21 Climate Change Agreement adopted last year in Paris.

The EMF-ECBC believes that the European building stock, which constitutes the largest single energy consumer in the EU, via a financing mechanism for private banks can provide decisive action on climate change by encouraging energy efficient improvements of households by way of financial incentives linked to the mortgage. The development of a pan-European Energy Efficient Mortgage concept gained high-level interest at the COP22 Conference from both international institutions and global stakeholders.

In term of next steps, the EMF-ECBC will, in collaboration with its project partners the Ca'Foscari University of Venice, RICS, European Regional Network of Green Building Councils, E.ON, and SAFE Goethe University Frankfurt, present its preparatory groundwork at a European stakeholder meeting in February 2017.

Finnish Sp Mortgage Bank Plc. Becomes 81st Issuer to Join the Covered Bond Label

On the 15th of November 2016, Finland's Sp Mortgage Bank Plc became the 81st issuer to join the Covered Bond Label. Following the bank's accession, the total number of cover pools under the Covered Bond Label now stands at 97.

Commenting on this latest development, Luca Bertalot, Covered Bond Label Foundation Administrator, said: *"The decision of Sp Mortgage Bank Plc to join the Covered Bond Label confirms the willingness of core covered bond market participants to significantly enhance transparency by broadly implementing the Harmonised Transparency Template (HTT). This reinforces the Covered Bond Label's recognition as the industry quality benchmark. We are confident that the Labelled issuers' commitment to harmonisation and transparency facilitates investors due diligence and supports them in making informed investment decisions. Furthermore, the Covered Bond Label Initiative highlights the importance of the covered bond asset class in the current political debate on the establishment of the European Capital markets Union."*

To recap, the Covered Bond Label is a quality Label which responds to a market-wide request for improved standards and increased transparency in the covered bond market. The Covered Bond Label is open to all covered bond programmes that are compliant with the Covered Bond Label Convention.

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

ESMA Finalises Guidelines on the Validation and Review of CRA's Methodologies

On the 15th of November 2016, the European Securities and Markets Authority (ESMA) published its Final Report on Guidelines on the validation and review of Credit Rating Agencies' (CRAs) methodologies. The Final Report can be accessed here.

The Guidelines clarify how CRAs should validate and review their methodologies as of Art 8 (3) and 8(5) of the CRA Regulation.

The Guidelines are intended to increase the quality of the quantitative measures used by requiring CRAs to review their methodologies in discriminatory power, predictive power and historical robustness.

Of note amongst the issues raised by others considering the use of quantitative techniques and predictive power, a respondent considered setting absolute targets would not be appropriate since it does not target specific default or loss rates for its rating categories. The ESMA replied that CRAs could also define their expectations through ranges, thus giving flexibility and allowing CRAs to implicitly recognise the impact of potential factors that could influence the expectations of CRAs on rating behaviour. The ESMA will assess the rationale and appropriateness of CRAs' chosen approaches through on-going supervision in order to ensure the quality of credit ratings and a level-playing field.

These Guidelines focus on quantitative measures as the ESMA has assessed that the Industry requires more clarity in this area. However, the ESMA believes that a good quality validation of methodologies strikes a balance between the application of quantitative and qualitative techniques. While stressing the importance of objectivity, added by quantitative analysis to the process, validation should include both techniques.

The Guidelines become effective two months after their publication on ESMA's website.

EMF-ECBC Debate with the European Commission & the European Banking Authority

On the 17th of November 2016, on the occasion of its final board meetings of the year, the members of the EMF Executive Committee and the ECBC Steering Committee participated in a high-level panel debate on European mortgage and covered bond markets and the housing landscape. This event, hosted at the Concert Noble in Brussels, featured an exchange of views and discussion with **Martin Merlin**, *Director – Regulation & Prudential Supervision of Financial Institutions, DG FISMA, European Commission*, and **Isabelle Vaillant**, *Director of Regulation, European Banking Authority (EBA)*, together with the EMF and ECBC Chairmen, on the state of play and implications of covered bond harmonisation and the ongoing discussions of the Basel Committee on Banking Supervision. In particular, Isabelle Vaillant kindly provided attendees with a preview of the positions and proposals that the EBA announced the following day during its Public Hearing on Covered Bonds in London.

A photo gallery of the event can be accessed online here.

European Investment Fund Representative to Join Covered Bond Label Advisory Council for 2017-2018 Mandate

COVERED BOND · LABEL ·

On the 17th of November 2016, The Covered Bond Label Foundation (CBLF) announced the new list of representatives for the Covered Bond Label Advisory Council for the upcoming 2017-2018 mandate.

Of particular relevance is the appointment of Mr Alessandro Tappi, Director of Guarantees, Securitisation & Microfinance at the **European Investment Fund** (EIF), as a new Observer Representative to the Covered Bond Label Advisory Council. Mr Tappi's appointment will take effect immediately. The participation of a representative of the EIF, the EIB Group's specialist provider of risk finance to benefit SMEs, as a new institutional Observer will make a significant contribution to the work of the Advisory Council.

Further to the appointments, the Label Advisory Council's full membership for the mandate 2017-2018 will be as follows:

Observer Representatives:

- Loïc Chiquier, Chief Technical Officer and Senior Advisor of the Finance & Markets Global Practice, World Bank Group
- Andreea Moraru, Senior Banker – Local Currency and Capital Market Development Team, European Bank for Reconstruction and Development (EBRD)
- Lars Overby, Head of Unit – Regulation, European Banking Authority (EBA)
- Emilio Rodríguez, Head of the Asset Management Division, Banco de España
- Alessandro Tappi, Director of Guarantees, Securitisation & Microfinance, European Investment Fund (EIF)
- Ad Visser, Head of the Financial Markets and Collateral Section in the ECB's Market Operations Analysis Division, European Central Bank (ECB)

Market Representatives *(Based on a rotation principle):*

- Andreas Denger, Senior Portfolio Manager at Meag Munich Ergo Asset Management GmbH
- Hélène Heberlein, Managing Director, Covered Bonds, Fitch Ratings
- Gavin Purtill, Banking & Payments Federation Ireland
- Amer Siddiqui, Senior Associate, Capital Markets, Clifford Chance

National Authority Representatives:

- François Haas, Deputy General Manager, DG Operations, Banque de France
- Michal Klestinec, Senior Portfolio Manager, National Bank of Slovakia
- Lily Shum, Canada Mortgage and Housing Corporation (CMHC)

Commenting on the appointments, Luca Bertalot, Covered Bond Label Foundation (CBLF) Administrator, stated: *"We welcome the support of the European Investment Fund for the Covered Bond Label Initiative. We are confident that Mr Tappi's expertise, in particular in the area of long-term financing, together with the other new representatives, will surely enrich the debate within the Covered Bond Label Advisory Council and support the continuous enhancement of the Covered Bond Label."*

To recap, the Label Advisory Council is the Covered Bond Label Foundation's think-tank. As such, it has an advisory role vis-à-vis the Label Committee and is responsible for supporting the development of the Covered Bond Label in the market and promoting the prudential role of the covered bond asset class. The Council realises its objectives by providing opinions/advice on consultations, offering a forum for discussion amongst covered bond stakeholders and making proposals for the further development and strengthening of the Label.

EBA Public Hearing on Covered Bonds

On the 18th of November 2016 the European Banking Authority (EBA) hosted its public hearing on Covered Bonds at its offices in London.

A large number of representatives from the Industry, from several different countries, attended the meeting. The EBA was represented by the team in charge of the file and by Adam Farkas, EBA's Executive Director. The latter outlined how covered bonds had proven to be a successful tool and their going global is a testament to this success. The EBA, he continued, is acting to integrate EU capital markets and it is following up on its previous report on covered bonds and the ESRB recommendations.

Lars Overby, EBA's Head of Unit – Credit Market and Operational Risk Policy, delivered the presentation, previously published on EBA's website, outlining the main recommendations that the EBA intends to deliver to the European Commission.

The presentation, as with the draft report, was divided into three chapters:

1. Assessment of covered bond frameworks across the EU, including their alignment to the EBA's best practices;
2. Analysis of the market and regulatory developments since 2014; and
3. Detailed recommendations on harmonisation of the covered bond frameworks in the EU.

The bottom line of the regulatory and market analyses, **chapters 1 and 2**, was that covered bond frameworks, for some aspects, still differ substantially from the EBA's recommendations of 2014. As such, the EBA maintains that more harmonisation is needed.

The EBA has, at the same time, praised some of the market developments that have occurred since 2014. For instance, the EBA mentions the upgrades of some rating methodologies and takes stock of a better dynamic in issuance and the diffusion of new structures such as the Conditional Pass Through (CPT).

The **Covered Bond Label** and its **Harmonised Transparency Template** were quoted on several occasions as a good market initiative enhancing transparency. In addition, the EBA added that its own proposal on Transparency was "very much inspired by the Covered Bond Label".

In **chapter 3** the EBA outlines the new framework that it envisages. Here below is a short summary of its three-step approach:

Step I	
Covered Bond Framework (Directive)	
Areas Covered	**Relation to the current regulatory treatment**
Dual recourse, segregation of cover assets and bankruptcy remoteness of the CBs:	
- Dual recourse	Extension/ Amendment of existing rule
- Segregation of cover assets	New rule
- Bankruptcy remoteness of the covered bond	New rule
Requirement on coverage, liquidity risk mitigation and cover pool derivatives:	
- Coverage requirements	Extension/ Amendment of existing rule
- Liquidity risk mitigation requirements	New rule
- Requirement on cover pool derivatives	New rule
System of special public supervision and administration:	
- Cover pool monitor	New rule
- Supervision of covered bond issuer going concern	New rule
- Administration of the covered bond programme post issuer's insolvency / resolution	New rule
Transparency requirements:	
- Scope, format and frequency of disclosure	Extension/ Amendment of existing rule
Requirements for soft bullets and CPTs:	
Requirements for soft bullets and CPT covered bonds	New rule

Step II	
Amendments to CRR related to preferential regulatory risk weight treatment	
Areas Covered	**Relation to the current regulatory treatment**
Conditions for preferential risk weight treatment:	
- Requirements on eligibility of cover assets	Extension/ Amendment of existing rule
- Requirements on substitution assets	New rule
- LTV limits	Extension/ Amendment of existing rule
- Minimum overcollateralisation	New rule

Step III	
Voluntary convergence	
Areas Covered	**Relation to the current regulatory treatment**
- Composition of the cover pools	New rule
- Cover pools with underlying assets located in jurisdiction outside the EEA	New rule
- LTV measurement and frequency of re-valuation	Extension/ Amendment of existing rule
- Stress testing by the covered bond issuer	New rule

For more detail on the proposal please refer to the EBA's full presentation.

The proposal of the EBA was scrutinised by the Industry in a long Q&A session. The focus of the questions was primarily on step 1 and step 2. Whereas, for step 3, the EBA had already clarified that more work was needed on its side to understand where to make recommendations. A study of national specificities would be central to this effort. Generally speaking there was praise from the Industry for the work of the EBA, but also awareness that a number of issues were still outstanding. From the EBA side, there appeared to be a good receptiveness of the arguments of the Industry.

The EBA will present its report in December 2016.

Changes in ECBC Steering Committee Mandate 2017-2018

On the 17th of November 2016 the European Covered Bond Council (ECBC) announced the new list of its Steering Committee representatives for the mandate 2017-2018, as proposed by the current ECBC Steering Committee.

Subject to the formal approval of the proposed incoming membership by the EMF-ECBC's General Assembly, from 1st of January 2017 onwards the full membership of the ECBC Steering Committee for the mandate 2017-2018 will be as follows:

Issuer Members:

- Jens Tolckmitt, Association of German Pfandbrief Banks vdp, DE
- Morten Bækmand Nielsen, Association of Danish Mortgage Banks, DK
- Olivier Avis, Crédit Foncier, FR
- Alex Valencia Baeza, La Caixa, ES
- Martin Rydin, Association of Swedish Covered Bond Issuers, SE
- Waleed El-Amir, Italian Banking Association ABI, IT
- Gary Staines, UK RCBC, UK
- Per Sagbakken, DNB Boligkreditt, NO
- Jac Besuijen, Dutch Banking Association, NL
- Katarzyna Kapeller, Raiffeisen Bank International AG, AT
- Ana Marques, Caixa Geral de Depósitos S.A., PO

Non-Issuer Members

- Cristina Costa, Société Générale CIB
- Boudewijn Dierick, BNP Paribas
- Florian Eichert, Credit Agricole CIB
- Bernd Volk, Deutsche Bank

For more information on the ECBC Steering Committee and the activities of the ECBC, visit our website.

European Commission Publishes Package of Reforms to Strengthen Resilience of EU Banks

On the 23rd of November 2016, the European Commission published a comprehensive package of reforms to further strengthen the resilience of EU banks. The Commission's proposal builds upon existing EU banking rules and aims to complete the post-crisis regulatory agenda by making sure that the regulatory framework addresses any outstanding challenges to financial stability, while ensuring that banks can continue to support the real economy.

The new proposals amend the following pieces of legislation:

- The Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD), which were adopted in 2013 and which set out prudential requirements for credit institutions (i.e. banks) and investment firms and rules on governance and supervision; and
- The Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR), which were adopted in 2014 and which spell out the rules on the recovery and resolution of failing institutions and establish the Single Resolution Mechanism.

The European Commission's full package of reforms can be accessed using the following links:

- Amendments to the CRR and CRD IV and related documents
- Amendments to the BRRD and related documents
- Amendments to the SRM and related documents
- Frequently Asked Questions: Capital requirements (CRR/CRD IV) and resolution framework (BRRD/SRM) amendments

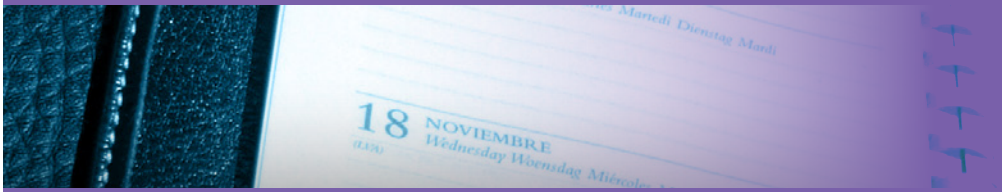
These measures touch upon a number of very relevant topics for the mortgage and covered bond industry, among others:

- The introduction of a stable requirement funding
- The introduction of a leverage ratio
- The review of trading book including treatment of covered bonds
- The review of the large exposures framework

To recap, the measures proposed by the Commission in this context are also part of its ongoing work to reduce risk in the banking sector, as set out in the Communication "Towards the Completion of the Banking Union"(November 2015). They are also in line with the conclusions of the ECOFIN Council in June 2016, where the Commission was invited to put forward relevant proposals no later than the end of 2016. The proposal will now be sent to the European Council and the European Parliament and the co-decision process will begin.

The European Parliament will now look to choose the rapporteurs for these files. It is customary, but not mandatory, that the rapportuers of the original texts will then follow up on the amendments. To recap, the rapportuers of the original files were:

- Othmar Karas (EPP-AT) for the CRR / CRD IV
- Gunnar Hökmark (EPP-SE) for the BRRD
- Elisa Ferreira (S&D-PT) for the SRM but she resigned in 2016.



AGENDA

DECEMBER 2016

07/12	European Parliament Financial Services Forum (EPFSF) Event on Impact of Regulatory Reforms on Market Liquidity – Brussels
08/12	BUILD Upon Workshop – Helsinki
16-17/12	Italian Banking Insurance and Finance Federation (FeBAF) Rome Investment Forum 2016 "Financing Long-Term Europe" – Rome

JANUARY 2017

18-19/01	Executive Agency for Small and Medium-Sized Enterprises (EASME) Conference on Energy Efficient Finance Market Place – Brussels
25/01	European Parliament Financial Services Forum (EPFSF) Event on Capital Markets Union (CMU): Insolvency Law Chapter – Brussels