The European Covered Bond Council (ECBC) held its 25th Plenary Meeting in Oslo, Norway with the kind support of Finance Norway and The Norwegian Covered Bond Council, bringing together over 250 key stakeholders in European and global covered bond markets.

Hosted in the stunning Oslo Opera House, the meeting sought to address the key issues currently facing the asset class. These included panel discussions focusing on Norwegian covered bonds, the ongoing debate regarding potential harmonisation of covered bonds at a European level, the global outlook for covered bonds and the financing of energy efficiency and the role that green covered bonds and the EMF-ECBC Energy Efficient Mortgages (EeMAP) Initiative can play in this area. For those of you who were unable to join us in Oslo, we are pleased to announce that a series of short videos summarising the key issues considered during these panels are now available to watch via the EMF-ECBC YouTube Channel, here.
In addition to these panel discussions, a number of speeches were delivered by senior representatives of Finance Norway, the European Banking Authority (EBA), DG FISMA and DG ENERGY of the European Commission, and the European Bank for Reconstruction and Development (EBRD). Please click here to access the full Agenda for the event.

To open the event, we were delighted to welcome Jon Nicolaisen, Deputy Governor of Norges Bank (the Central Bank of Norway), who delivered a keynote speech entitled “Covered bonds and their impact on investors, banks and the real economy”, which we reproduce below.

In terms of the next, 26th ECBC Plenary Meeting, we are pleased to confirm that this will take place in Barcelona, Spain on the 13th of September 2017 and that further details regarding the organisation of this event – together with the following day’s Euromoney Conferences & ECBC Covered Bond Congress 2017 – will be announced shortly.
Good morning and thank you for inviting me. Today, I will briefly discuss three issues that I believe will be central to further market development. First, the role of covered bonds in asset markets in general; second, the impact of covered bonds on the balance sheet of banks; and, third, the potential impact on the allocation of capital between households and enterprises. The market for covered bonds is perhaps especially interesting for us, given the strong growth of covered bonds in Norway over the last 10 years.

Covered bonds remain a key funding tool for residential mortgage loans in many European countries. They have confirmed their position as a resilient source of funding also under stressed market conditions. This has been particularly evident in the Nordic region.

**ROLE IN ASSET MARKETS**

Covered bonds provide investors with a liquid and safe asset. The small premium above government bonds indicates that these securities are considered almost as safe as triple-A sovereign debt. Relative to senior bonds, covered bonds now appear more attractive than before the financial crisis.

The fundamental characteristics of covered bonds support this pricing. Covered bonds are secured primarily by a preferential claim on a pool of residential or commercial mortgage loans. They are protected from potential bail-in under the new crisis resolution regime and are subject to special supervisory monitoring.

The European Commission has determined that covered bonds may be included as level 1 qualifying assets in fulfilling banks’ liquidity coverage ratio requirements. Covered bonds also receive favourable treatment both under Solvency 2 and in the regulation of large exposures. In addition, the European Central Bank’s Asset purchase programmes have supported market liquidity.

Covered bonds have a long history of strong performance in general and they have survived and developed during shifting market conditions.

**The safety of covered bonds supports high and stable ratings. It also drives demand and market depth, confirming their position as liquid assets. Large falls in house prices may present a key risk for the covered bonds market, given the dominance of residential mortgages as collateral. At Norges Bank, we have looked at this risk and we have so far concluded that Norwegian covered bonds are quite robust against a potential decline in house prices.**

In the 2015 Financial Stability Report, Norges Bank estimated that a 40% fall in house prices would

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1 The text of Mr Nicolaisen’s speech at our event together with the supporting slides can also be accessed via the Bank for International Settlements (BIS) website, [here](#).
reduce the eligible cover pool by around 20%. In such an extreme scenario, refinancing costs may rise for covered bonds. However, the rise in costs would probably be somewhat limited compared with the rise in refinancing costs for unsecured funding. Thus, even under extreme market conditions, covered bonds would remain attractive, at least in relative terms.

**ROLE IN BALANCE SHEET OF BANKS**

While covered bonds provide investors with a broad range of options to the investment opportunity set and contribute to deep and liquid markets, they also impact banks' balance sheets.

When banks use covered bonds as a source of funding, a proportion of the banks' assets become pledged to covered bond creditors. One issue that arises is what effect this may have on the quality of the balance sheet of banks.

At the outset, a banking group’s liquidity and credit risk will rise since covered bonds reduce the volume of encumber-able assets available to the bank. In addition, banks are often both significant issuers and holders of covered bonds. Such interconnection may increase systemic risk. However, market participants may assume that resolution rules and liquidity and capital requirements nonetheless limit the risk.

For example, all banks are subject to regulation of their core equity – notably through the Basel III standard of the Basel Committee, implemented in Europe through the CRD4/CRR regulation. This is the primary insurance for tax payers and investors against the potential failure of large banks. Sufficient equity and a resilient banking system will always be the main instruments to ensure stability in the financial system as a whole. This is why senior bonds are also considered a relatively safe asset.

**IMPACT ON THE SUPPLY OF CREDIT AND CAPITAL ALLOCATION**

How do covered bonds impact the supply of credit and capital allocation?

Capital requirements under Basel II and III incentivise banks to supply residential mortgage lending. The introduction of IRB models for calculation of capital requirements have resulted in low risk weights for residential mortgages. This may encourage leveraging. Some countries where large shares of covered bonds are backed by residential mortgages, have experienced relatively strong growth in residential mortgage lending and brisk house price growth. The availability of a large and liquid covered bond market may have facilitated this development.

One would expect that the emergence of a vibrant residential covered bond market would generally deepen fixed income markets through larger volumes and better liquidity. The cheaper financing of residential mortgages through covered bonds has been reflected in household lending rates. In combination with very low risk weights and corresponding low capital requirements on residential mortgages, banks may have favoured such lending.

As a result, corporations seeking financing may be pushed into bond markets through a crowding out effect. In addition, a vibrant market could make bond financing more attractive and pull corporate borrowers to the market. Higher interest rates on banks’ corporate loans may contribute to this effect. In some of the markets in Europe that have seen substantial deleveraging, loans to SMEs have been provided at steep interest rates. However, the economic situation and investment demand in general are probably much more important in determining overall growth in investment financing by banks. In general, banks still provide loans to profitable enterprises.

To sum up: The covered bond market provides investors with a broad set of investment opportunities, banks with cheap funding and house buyers with ample credit. At the same time, extensive regulatory measures safeguard the solvency and liquidity of the banking system as a whole. A well-capitalised banking system with stable and liquid funding options is a prerequisite for markets to develop and thrive. That includes the covered bond market.

Thank you for your attention.
I. INTRODUCTION

International, institutional and investor interest in energy efficiency finance has increased in magnitude in recent years, supported by the successful conclusion of the COP21, a universal legally binding global climate action plan to limit global warming to well below 2°C. This has worked as a catalyst for energy efficiency finance across financial markets and imposed a new trajectory for European Union (EU) Member States’ engagement in energy consumption. In the EU, buildings are responsible for 40% of the total energy consumption and 36% of CO2 emissions, and around 75-90% of the existing building stock is predicted to remain standing in 2050. By improving the energy efficiency of buildings alone, the EU’s total energy consumption could be reduced by 5-6% and CO2 emissions by 5%-1.

The EU has set itself an overall 20% energy efficiency savings target by 2020 and is now considering increasing this to a 30% target by 2030. The scale of investment needed to meet the 2020 target is estimated at around €100 billion per year, with it considered necessary to invest around €100 billion a year up to 2050 in the EU building stock in order to deliver Europe’s commitments on climate change. With about 35% of the EU’s buildings being over 50 years old, massive thermal renovation of the building stock is a necessity to reach the climate goals. The International Energy Agency has called investments in energy efficiency and particularly in buildings a priority for all countries.

This is why the European Mortgage Federation and the European Covered Bond Council (EMF-ECBC), in cooperation with their membership and key stakeholders, have launched a European market initiative for energy efficient mortgages. The idea is to mobilise mortgage financing to incentivise borrowers to move their property out of the “brown zone”, and into the “green zone” in return for a preferential interest rate on the mortgage and the retrofitting funds. Clearly segregated “green” assets, via labelling, would act as collateral for green covered bonds likewise and support the integration of energy efficiency in portfolio management strategies and increase investor confidence in sustainable funding.

Considering that the European building stock constitutes the largest single energy consumer in the EU, and that the value of the European mortgage market is equal to 53% of EU’s GDP, there is huge potential to unlock the benefits of mortgage financing to support energy efficiency to the benefit of all.

II. EMF-ECBC PROPOSAL – ENERGY EFFICIENT MORTGAGE

The structure underpinning the EMF-ECBC initiative provides a clear three-dimensional aspect which interrelates with a broader set of political priorities:

> Financial Stability:

Banks have a key role to play in improving the quality and energy performance of housing so as to free-up disposable income and, in parallel, reduce credit risk for borrowers, lenders and investors. The EMF-ECBC initiative will trigger market due diligence for consumers, issuers and investors, reduce probability of borrowers’ default, facilitate de-risking of banks’ balance sheets and management of non-performing loans, and enhance transparency and pricing in the market by adding a green factor to real estate.

> SMEs & Growth:

The initiative will boost the development of market & technological innovations and provide dedicated resources for specialised SMEs active in retrofitting.

> Energy Efficiency:

The initiative will motivate borrowers, by way of preferential financial conditions linked to

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1 The Paris Climate Change Agreement adopted during COP21 in December 2015 sets out a global action plan that helps avoid dangerous climate change by limiting global warming to well below 2°C. It was adopted by 195 countries as the first-ever universal, legally binding global climate deal. The Agreement is due to enter into force in 2020.


3 European Commission. Available at: https://ec.europa.eu/energy/en/topics/energy-efficiency/buildings

4 Source: EMF-ECBC

5 The Ca’ Foscari University is well-known for its research on energy and renowned for holding the world’s oldest green building certificate.

6 Buildings are responsible for 40% of energy consumption in the EU. For more information, please refer to https://ec.europa.eu/energy/en/topics/energy-efficiency/buildings
their mortgage, to make energy efficiency investments and in this way reduce the energy consumption of their dwelling and improve their financial resilience. This will enhance the long-term affordability of energy efficiency investment for borrowers.

With a clear business case and certain energy performance indicators in mind, the EMF-ECBC is designing a pan-European “energy efficiency label” for mortgages which will mobilise finance to support energy efficiency of residential buildings. By means of a lower interest rate and additional refit-funding to improve the energy performance of the property, thus freeing-up disposable income and, in parallel, reducing credit risk for borrowers, European lenders and investors will follow in the footsteps of their American, Canadian and Asian partners and thereby help to respond to Europe’s commitment to climate change.

This initiative is built on a clear incentive chain which rests in particular (but not exclusively) on two key tenets:

- **Energy efficiency drivers impacting market characteristics**
  - Retrofitting positively affects property value, ensuring wealth conservation & loss mitigation by preventing “brown discount”
  - Energy efficiency reduces the impact of energy costs to household income, reducing borrowers’ probability of default.

**Figure 1**

Preliminary results from a comprehensive study conducted by CRIF analysing the added value of energy efficiency in properties by isolating the “green value” in house prices, shows a positive correlation between energy efficiency and “green value”. The study also investigates the impact of this correlation on the borrowers’ payment behaviour, with the preliminary results indicating that borrowers of the worst energy classes have twice the observed ‘delinquency’ rates than the registered behaviour of best energy classes. Consequently, this reduces credit risk as a result of the lower probability of default and lower loss given default (LGD) associated with energy efficient mortgages. Similar French, British, American, Canadian and Japanese studies confirm the positive correlation between energy efficiency and “green value”.

**Underpinning Incentive Chain**

As indicated above, the initiative is built on a clear incentive chain, with each of the stakeholders in the chain obtaining a micro-economic advantage:

**Borrowers:**
- Borrowers are incentivised to improve the energy efficiency of their homes in return for a preferential interest rate after a certain period of time and/or additional funds at the time of the origination of the mortgage on the same terms as the mortgage on the property (as opposed to at the higher rate of a consumer loan).
- In addition to the better mortgage conditions, by making energy efficiency improvements, borrowers increase the value of their property, thereby protecting their homes against a “brown discount,” ensuring wealth conservation. This “green value” in residential buildings is increasingly identifiable and quantifiable in terms of price, according to several pieces of recent research.
- Borrowers also benefit from the lower running costs for the building, reducing the overall costs of owning a property which should compensate the upfront investment.

**Lenders:**
- Research7 in the US shows that borrowers financing energy-efficiency properties have a 32% lower probability of default on their loan. This is because the energy costs, which represent a large share of the monthly payments by the borrowers, are lower. This reduces not only the overall costs for the borrower but also the volatility of the monthly payments as the share of the energy costs sinks. The lower risk of the household is also recognised in Canada, where households receive a 10% discount in the interest rate for a new build property with an energy rating of A or B.
- The preferential interest rate would be determined on the mortgage on the same terms as the mortgage (as opposed to at the higher rate of a consumer loan).
- A discount in the interest rate for a new build property with an energy rating of A or B.
- A discount in the interest rate after a certain period of time and/or additional funds at the time of the origination of the mortgage on the same terms as the mortgage on the property. This discount would be known as the energy efficiency delta. In this way, borrowers are incentivised to move their property out of the “brown zone” – energy rating H–E, and into the “green zone” – energy rating D–A.

Moreover, price differentiation typically occurs in economic downturns. This initiative would therefore also protect borrowers/lenders/investors against brown discount once the market distortions of the quantitative easing come to an end or the economic climate worsens.

**III. CONCEPT & METHODOLOGY OF ENERGY EFFICIENT MORTGAGE**

Based on a predetermined set of energy efficiency indicators to measure the energy efficient improvement of the property (explained below), lenders would offer:
- **New Build/Nearly Zero Energy Buildings (NZEB):** A discount in the interest rate for a new build property with an energy rating of A or B.
- **Existing property to be renovated:** A discount in the interest rate after a certain period of time according to the improvement in the energy rating of the mortgaged residential property. This would be known as the energy efficiency delta. In this way, borrowers are incentivised to move their property out of the “brown zone” – energy rating H–E, and into the “green zone” – energy rating D–A.

The preferential interest rate would be determined on the basis of a progressive scale, which would incentivise more significant improvements in properties at the lower end of the energy rating A-D i.e. the consumer would receive a larger percentage of the discount.

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For an existing property to be renovated, at the time of Additional Funds – Supporting the EU’s calculation of the bank’s capital requirements.

The discount itself would be calculated as a function of the reduced risk weighting of the mortgage in the context, Mr Pierschel underlined the likelihood of the impact of “brown discount” on property prices in the future.

EMF-ECBC Panel Debate in Venice – Banking Supervision

Frank Pierschel, a representative of BaFin and Co-Chair of the Basel Committee’s Task Force on Standardised Approaches, was a panelist on the EMF-ECBC’s high level panel debate on “The Future Development of EU Mortgage and Covered Bond Markets, and Implications of the Energy Efficiency Debate” which took place the 3rd of June 2016 at Ca’ Foscari University in Venice, Italy.

During the panel debate, Mr Pierschel indicated that the preferential treatment of energy efficiency mortgages could be a possibility in the future, implementable via the introduction of a sub-class in the Standardised Approach for Credit Risk, conditioned on data showing a reduction in PD and LGD and increased asset value due to energy efficiency retrofitting.

Mr Pierschel also noted that environmental issues are currently under discussion in Basel from a financial stability perspective, with climate developments impacting on the insurance industry, which, in turn, impacts on property prices and the assets within banks’ balance sheets. In this context, Mr Pierschel underlined the likelihood of the impact of “brown discount” on property prices in the future.

Additional Funds – Supporting the EU’s growth agenda

For an existing property to be renovated, at the time of origination, the lender would factor in both the additional funds and the increased value of the property due to the retrofitting, meaning that the risk along with the LTV for the bank remains the same. The possibility to take account of an energy efficiency mortgage label which, as shown above, impacts upon the value of the property is suggested in the Second BCBS Consultation on Revisions to the Standardised Approach for Credit Risk from December 2015, which, at point 52 on page 35, states that: “modifications made to the property that unequivocally increase its value could also be considered in the LTV”.

This mechanism: i) allows the increase in value due to retrofitting to be factored in at origination, ii) enables the borrower to carry out retrofitting on the purchase of the property and iii) provides a flow of capital into the real economy trigger jobs and supporting SMEs active in the retrofitting sector, thereby supporting the EU’s growth agenda. Improving the energy efficiency of the European building stock would also help reduce the EU’s reliance on energy imports, with 61% of gas imports destined for buildings, of which 75% for residential

buildings, and be in keeping with the Commission’s Energy Efficiency Directive (Article 7) which requires Member States to establish an “energy efficiency obligation” scheme, which obliges EU energy companies to achieve yearly energy savings of 1.5% of annual energy sales to final consumers.

Energy Efficiency Indicators – Three Pillar Approach

The Energy Performance Certificate (EPC), introduced by the EU by way of the Energy Performance of Buildings Directive (EPBD), provides information, as the name suggests, on the energy efficiency of buildings (consumption and demand) and recommended improvements. Given that this is an EU standard, the EPC will be a key energy indicator on which the EMF-ECBC initiative will be based. However, as a result of concerns about data availability and reliability as well as qualification, control and monitoring of energy inspectors, the EPC is not (in its current form) a robust enough tool on its own to measure a property’s energy performance. The EPC will therefore be accompanied by a consumption and demand indicator, constituting a three pillar approach (figure 3).

Given the current issues with the EPC, as described above, it would be preferable to move towards a demand indicator. Recent developments in the IoT (internet of things) suggest that it is realistic to provide a real time view on the performance of the property before and after retrofit in the near future, using a mix of sensor technology and machine learning algorithms. This would allow the possibility to provide a real time delta between the energy used by the property after retrofit versus what the property would have used pre-retrofit under the same conditions; in form of a ‘Negawatt’ metre which measures the energy savings. Such an approach would be preferable, particularly from a lenders perspective, as it would give an accurate and on-going view of the performance of the property itself.

Figure 3 EMF-ECBC’s three pillar approach to certification of energy performance

Source: EMF-ECBC

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9 http://www.bis.org/bcbs/publ/d347.pdf.

Source: EMF-ECBC
To ensure the correct expertise, the evaluation of the improvement of the energy efficiency of the property based on the three indicators would be delivered by external/ third party providers.

Consumer behaviour

It is also worth highlighting that by combining a demand indicator with a consumption indicator, the methodology can also influence consumer behaviour and practices by encouraging good energy behaviour, thus ensuring a reduction in energy consumption (energy bills). A growing body of evidence in academic literature demonstrates that there is potential for energy savings up to 20% via measuring targeted behaviour.

Addressing Risks Management

The underlying structure of the EMF-ECBC energy efficiency label is designed in such a way that, in addition to an increased property value and a reduction in LGD, three essential areas of (potential) risks in dealing with debt instruments would likewise be addressed, in turn contributing to financial stability:

- Credit Risk: is potentially reduced for the lender as a result of the lower probability of default and lower LGD associated with EE mortgages;
- Asset Risk: as a result of the EE improvements, the property is protected against the “brown discount,” and will actually increase in value; and,
- Performance Risk: a robust assessment of the energy performance of the property both before and after the retro-fitting of the property ensures that the EE measures taken actually result in an improvement to the energy efficiency of the property, to the households’ energy spending, and to the value of the property.

While the EMF-ECBC proposal is entirely independent from public funds, tax incentives or utility rebates, national governments aiming to further drive thermal renovation could consider complementary interventions, such as a variable tax rates for the purchase of properties based on the energy efficiency of the property.

Data Warehouse & Energy Passport

Two key elements of the proposed EMF-ECBC initiative will be to create: i) a “data warehouse” intended to (a) establish the correlation between energy efficiency and borrowers’ probability of default and LGD, and (b) clearly register and record the link between property, energy rating and loan performance, so that these assets can be identified for “green” funding purposes; and ii) an energy passport recording the energy efficiency history of a property from energy rating to energy rating by recognising improvements made (or the reverse) over time.

To obtain a preferential regulatory treatment, institutional representatives have stressed the importance of gathering market data, which can verify the underlying business case and support the preliminary results already gathered across several countries, such as UK, France, Italy, the US, Canada and Japan. Moreover, gathering and processing data on the actual financial performance of energy efficiency investments would create a new flow in data which, in addition to aiding the rating of the “green value” of buildings in property valuation, would generate data evidence/track records of banks’ utilised collateral and asset pricing. In parallel, this would protect portfolios against the “brown discount”, thus mitigating risks.

Moreover, available market evidence suggests that saleability and letability of green buildings improve compared to traditional real estate. Similarly, total operating costs seem to be 5-10% lower for green buildings than those for non-sustainable properties. Thus, during a building’s lifetime, the savings on so-called “life-cycle costs” could be substantial.

MARKET PERSPECTIVE

Over the last few years, green and sustainable covered bonds have been a fast growing capital market segment. The first issuers of green bonds were supranational issuers such as European Investment Bank and International Finance Corporation (part of the World Bank Group). Since then a wide variety of corporate and agency issuers as well as local and regional authorities have entered the market. Also banks have entered the market and we have seen green senior unsecured bonds from issuers such as ABN AMRO, Credit Agricole CIB, HSBC and ING. In 2015, almost USD 50 bn of green bonds were issued by about 70 issuers and 2016 should become another strong year in terms of green bond supply.

In line with the growing issue volumes, investors have become more comfortable with green bonds and their underlying definitions. We see two major trends in the investor community: First, the number of dedicated green institutional investors and/or funds continues to increase in terms of volumes and numbers. Second, even some of the traditional investors have started to disclose the share of green and sustainable. However, there is still a need for further standardisation of the product and for improving transparency to ensure the integrity of the asset class. The Green Bond Principles – which have been developed by issuers, investors and intermediaries in close cooperation with the International Capital Market Association (ICMA) – are an important step into the right direction as they provide guidance for both issuers and investors and should help to further promote the mainstream acceptance of the green bond market.

FIRST ISSUANCE – Münchener Hypothekenbank e.G. and Berlin Hyp AG

The development of a sustainable and green covered bond market provides a wider range of approaches and most institutional investors have begun introducing sustainability criteria into their investment strategies. Against this background, an increasing investor demand for diversification in different green bond structures can be expected.

EMF-ECBC Panel Debate in Venice – Clear Business Opportunity

Among panellists and participants in Venice, representing the interests of European investors, issuers, valuers, academics, the European Commission and the Basel Committee on Banking Supervision (BCBS), there was a strong common agreement that the EMF-ECBC energy efficiency mortgage initiative could provide a clear business opportunity for the industry.

The combination of the regulatory challenges in terms of capital costs observed in the market today and the business case underpinning the EMF-ECBC initiative has the potential to provide banks with a welcome business opportunity, by introducing a reduction in asset risk, credit risks and performance risks and, potentially, a preferential treatment (if market data can be gathered to support the preliminary result already showing a positive correlation between energy efficiency and “green value” and reduction in LGD).

Furthermore, it was also highlighted that the business opportunity embedded within the EMF-ECBC initiative would assist banks in their competition with other green institutional investors and/or funds continues to increase in terms of volumes and numbers. Second, even some of the traditional investors have started to disclose the share of green and sustainable. However, there is still a need for further standardisation of the product and for improving transparency to ensure the integrity of the asset class. The Green Bond Principles – which have been developed by issuers, investors and intermediaries in close cooperation with the International Capital Market Association (ICMA) – are an important step into the right direction as they provide guidance for both issuers and investors and should help to further promote the mainstream acceptance of the green bond market.

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IV. GREEN COVERED BONDS – SUSTAINABLE FUNDING

From a funding perspective, the EMF-ECBC initiative has the potential to segregate “green” collateral benefitting many investment banks which have already established purely “green” trading desks to deal with the increased demand for sustainable investments. A clearly defined energy efficiency label for mortgages would, on its own as well as through collateral for green and sustainable covered bonds, help reduce uncertainty regarding investments in energy efficiency and increase investor confidence, as well as support the integration of sustainable funding in portfolio management strategies for institutional investors and/or fund managers. This would also have an impact from a risk management point of view by segregating the “green” from the “brown discount”, thus creating an incentive to make existing “green” assets visible, i.e. segregate energy efficient assets which are currently included in the cover pool without earmarking.
One approach could be to put more emphasis on social, environmental and governance criteria (ESG Principles). Another option consists of focusing more on the funding of green buildings in a stricter sense. However, covered bond funding of green buildings is not a plain vanilla exercise as it triggers further questions: Would it be sufficient to build a green covered bond concept only on certified or green labelled properties? How to identify green buildings within a cover pool which is by definition a dynamic structure and does not allow for the creation of green buildings’ subclasses?

The first ‘Sustainable or Green Pfandbriefe’ issued by Münchener Hypothekenbank e.G. and Berlin Hyp AG provide some evidence at that respect. Both institutions shared a similar approach by choosing an independent second party opinion (sustainability rating agency oekom research) for the labelling of the respective issues in order to provide transparency and credibility to the market.12

**Munich Hyp:** Munich Hyp was the first issuer of an Environmental, Social and Governance (ESG) covered bond along the lines of the Green Bond Principles. The EUR300m 5-year mortgage Pfandbrief was launched in September 2014. The ESG-Pfandbrief complied with strict requirements regarding the use of the proceeds from the issue, the process of project evaluation and selection as well as the management of the proceeds and reporting. The Pfandbrief was then labelled by the oekom research as compliant with the ESG principles.

Munich Hyp uses the proceeds of its ESG Pfandbriefe to refinance loans to housing cooperatives in Germany. The funds are employed to purchase, build and improve the energy efficiency of housing and maintain housing for socially disadvantaged sections of the society. The focus of this approach was definitely more on social rather than environmental criteria. However, it is important to note that ESG covered bond investors rank pari passu with other mortgage Pfandbrief investors and do not have a preferential claim on the ESG assets in the cover pool of the issuer. According to Munich Hyp, its inaugural ESG Pfandbrief back in September 2014 covered 12% of the respective issues in order to provide transparency and credibility to the market.13

**Berlin Hyp:** In April 2015, Berlin Hyp followed with its inaugural green mortgage Pfandbrief which had a benchmark size of EUR500m and a maturity of seven years. In contrast to Munich Hyp’s ESG Pfandbrief, the deal was a genuine green covered bond and reached benchmark size (EUR500m). The issuer stated in its press release that the deal attracted many new investors and that 48% of the issue was placed with sustainable investors.

Berlin Hyp committed to use the proceeds of its green Pfandbrief for the financing of ‘green buildings’ in Germany, France, the UK, the Netherlands and Poland. These assets are included in Berlin Hyp’s ‘normal’ mortgage Pfandbrief cover pool and the Green Pfandbrief – in line with the treatment of Munich Hyp’s ESG Pfandbrief – will rank pari passu with the other mortgage Pfandbriefe of the issuers. In case of issuer insolvency, investors will have a claim against the entire cover pool without having a preferential claim on the green cover assets over and above other ‘normal’ mortgage Pfandbrief investors.

Berlin Hyp used the below bespoke green building certificates for commercial properties as the primary eligibility criterion. Additional sustainability criteria were to be met in order to deliver a green label to the respective covered bonds. They were delivered by the Green Bond Framework as defined by the oekom rating agency14 and most notably address environmental and social components which are not taken into consideration in a satisfactory way by green building certificates, if at all.

### Oekom’s Framework

According to this framework, environmental components cover environmentally harmful building materials, resource consumption, emissions and waste. Social criteria address healthy and safety of tenants and other building users, working conditions on construction worksites and supply chain standards for renovation materials. Finally, controversial business activities in the buildings are excluded.

In order to secure the allocation of the proceeds coming from the issuance of covered bonds to the green buildings, the issuer is supposed to sign up to the following two commitments: The first commitment ensures that the existing cover pool will always include green assets for an amount at least equivalent to the net proceeds. Second, the issuer commits to reallocate funding to eligible green assets for an amount equivalent to the net proceeds of the green pfandbriefe until their maturity date.

The final layer of requirements for a green covered bond consists of transparency, documentation and reporting. Issuers of sustainable and green covered bonds have to provide investors as well as bond labelling agencies with regular information about the loan structures of mortgage cover pools, the amounts and maturity structures of loans dedicated to the funding of green assets in the pool, property types, their certification level etc.

### Market Volume and Spreads Differences

In terms of volumes the market for green and sustainable covered bonds has so far not taken off and is still relative small compared to the green senior unsecured volumes issued by banks or even more so compared to the green issuance by the supranational and agencies sector.

In terms of spreads, the market does not distinguish between green and sustainable bonds on the one hand and ‘normal’ covered bonds on the other hand despite the larger investor base of the former. The new issue levels of Munich Hyp’s ESG Pfandbrief as well as Berlin Hyp’s green covered bond were not substantially tighter than those of a ‘normal’ Pfandbrief transaction and both deals also traded more or less in line with the other German mortgage Pfandbriefe (see Figure 4). This likely reflects the fact (i) that the green and sustainable (covered) bond market is still in its infancy and (ii) that the generally spread environment is very compressed. Moreover, the fact that from a risk perspective the cover pool assets backing the Pfandbriefe are identical for ESG/green covered bonds and ‘normal’ mortgage covered bonds in case of issuer insolvency plays probably also an important role.

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13 oekom research second party opinion, see [http://www.gruener-pfandbrief.de/startseite](http://www.gruener-pfandbrief.de/startseite)
14 oekom research, annex 1 to the second party opinion referenced under FN1.
Commercial Real Estate

While the EMF-ECBC energy efficient mortgage initiative does not include commercial real estate at present, it is worth shedding some explanatory light on this market. There are around 30 voluntary rating systems worldwide that try to meet the conceptual complexity of the term ‘sustainability’ of the commercial real estate sector. As a sample, green building certificates are delivered by BREEAM (Building Research Establishment Environmental Assessment Method), LEED (Leadership in Energy and Environmental Design) or DGNB (Deutsche Gesellschaft für Nachhaltiges Bauen). While these labels are not fully comparable, the strength of certification systems is based on a horizontal approach which not only measure lower energy consumption but take also environmental, economic and socio-cultural criteria into account. To improve the comparability and transparency of this industry, the Energy Performance of Buildings Directive (EPBD) requires the European Commission to adopt, in consultation with the relevant sectors, a voluntary common European Union certification scheme (VCS) for the energy performance of non-residential buildings in order to improve international standardisation and uniform conditions in energy performance certification of non-residential buildings.

The emergence of a true green buildings market in commercial real estate is still hampered by the relatively low market penetration of certification systems, with green commercial real estate being concentrated in metropolitan markets and consisting to a large extent of new or heavily renovated buildings. However, it is likely that this situation will quickly evolve with investors, users as well as regulators focusing more and more on the need to build green buildings and to retrofit existing buildings into sustainable properties. Therefore, it is likely that sustainable real estate will become the market standard in the medium to long term.

V. CONCLUSION

The increased interest in and commitment to tackling climate change across governments, financial markets, industries, non-governmental organisations, valuers, academia and the media is a testament to the global focus on ensuring a greener future. This year, the European Commission is revising both the EPBD and the Energy Efficiency Directive, and other related initiatives are in the political pipeline. Creating ambitious legal frameworks is important prerequisite, but the implementation of these targets set by legislators requires mobilising public and private stakeholders and financing.

To ensure the successful implementation of the EMF-ECBC market initiative, the preliminary results illustrating the underlying business case must be supported by further market data. The initiative has the potential to not only foster financial stability and economic growth and support SMEs but also provide a clear business opportunity to the European banking sector which is facing many challenges in the form of increased capital requirements impacting the cost of capital. The preconditioned international, institutional and investor support for any such initiative to be implement is, as emphasised throughout this article, already present in the EU. The upcoming COP22, which will take place in Marrakech in November 2016, will not only cement the actions required to implement the Paris Agreement but, significantly, give emphasis to “green finance” as a key theme, underlining the relevance and timeliness of the EMF-ECBC Initiative.

The investor base for green covered bonds is growing fast and several large institutional investors have already switched parts of their investments portfolios into green and sustainable assets. While both investors and banks have yet to be fully disposed to the new reality of green investments on their balance sheet, a clear incentive chain, as the one underlining the ECBC-EMF energy efficiency mortgage initiative, will help the transformation of greener investment.

In light of this, it is worth highlighting once again that considering the European building stock constitutes the largest single energy consumer in the EU, and that the value of the European mortgage market is equal to 53% of EU’s GDP, there is huge potential to unlock the benefits of mortgage financing to support energy efficiency for the benefit of all.

Energy Efficient Mortgages – Next Steps

The EMF Executive Committee has formally agreed to take forward the EMF-ECBC energy efficient mortgage initiative. As a next step, a first pilot phase will be launched with the aim of identifying challenges and technical solutions in order to structure the governance of the initiative and provide the dataset necessary to support it.

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.
EBA Provides Guidance on Bail-In Under the BRRD

On the 5th of April 2017 the European Banking Authority (EBA) issued three sets of final Guidelines on bail-in under the Bank Recovery and Resolution Directive (BRRD). These Guidelines complement existing regulation and guidance to facilitate the use of the bail-in power as a way of absorbing losses and recapitalising banks in resolution. In particular, the Guidelines clarify how valuation information should help determine the terms of bail-in.

The first set of Guidelines focuses on conversion rates in bail-in (available here). It highlights guiding principles resolution authorities are to apply when setting debt-to-equity conversion rates both in a bail-in context, or when the power to write down and convert capital instruments is not applied in conjunction with any resolution tool. These Guidelines point out the role of the valuation of assets and liabilities of failing institutions, mandated by the BRRD, in defining the expected value of the combined equity and debt claim after resolution, and their expected value in the hypothetical case the institution had entered normal insolvency proceedings. In addition, the Guidelines clarify when to set differential conversion rates for different classes of creditors.

The second set of Guidelines deals with the treatment of shareholders (available here). It aims at clarifying the circumstances under which it is appropriate to cancel, transfer, or severely dilute shares or other instruments of ownership. In particular, resolution authorities should only favour dilution over cancellation where the net asset value of the institution is positive under the ex-ante valuation. Where more than one choice (cancellation, dilution or transfer) is available to Resolution authorities, the choice should be guided by the need to meet the resolution objectives. In this regard, national or EU company law may affect the appropriate choice, for example shares with special voting rights might be more appropriate to cancel than to transfer or a transfer of shares of a listed company would avoid an interruption of listing.

The third set of Guidelines (available here) on the interrelationship between the BRRD and the Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR) clarifies the treatment of instruments which meet the criteria for recognition as AT1 as per Article 52 of the CRR but are progressively grandfathered as per Article 484 of that Regulation due to the fact that they do not contain a Point Of Non-Viability (PONV) clause. These Guidelines prescribe that these instruments should be treated identically to AT1 instruments. In addition, they clarify the treatment of T2 instruments, which are progressively amortised in the final five years of residual maturity as per Article 64 of the CRR. Finally, these guidelines prescribe that the Resolution Authority should treat those instruments in the same way as T2 instruments included in the same class.

Moody’s Proposes Revisions to its Approach to Assessing Counterparty Risks in Structured Finance

On the 22nd of March 2017 Moody’s published a request for comment (RFC) on its proposed revisions to its approach to assessing counterparty risks in structured finance.

In this RFC, Moody’s proposes to consolidate and replace the following five cross-sector credit rating methodologies with one cross-sector methodology that will describe its approach to counterparty risks in structured finance, including, where applicable, covered bond programmes:

- Approach to Assessing Swap Counterparties in Structured Finance
- Cash Flow Transactions
- Global Structured Finance Operational Risk Guidelines
- Moody’s Approach to Assessing Set-off Risk for Australian Securitisation and Covered Bonds Transactions
- Moody’s Approach to Assessing Set-off Risk for EMEA Securitisation and Covered Bonds Transactions
- Moody’s Approach to Temporary Use of Cash in Structured Finance Transactions: Eligible Investments and Account Banks

At the same time, Moody’s proposes several analytical changes to its approaches to assessing counterparty risks, as well as some substantial modifications to the descriptions and illustrations of the approaches.

Some of the analytical changes proposed are driven by changes in market regulation (for example, proposed changes addressing margin rules for swaps). Other analytical changes result from a review of new information (for example, proposed changes to its set-off risk approach). Some modifications are prompted by Moody’s periodic review of its analytical approaches aiming to further enhance clarity and considering incremental data observed over recent history (for example, the revisions proposed to its operational risk approach), especially during the financial crisis that started in 2008.

If adopted, the proposed changes would have mostly a limited impact of one to two notches affecting approximately 210 to 220 structured finance transactions. Moody’s does not anticipate that ratings of covered bonds would be impacted.

In the remainder of the RFC, Moody’s describes: the proposed changes; how the proposed changes would likely impact outstanding ratings; the RFC process and implementation; and details of the proposed cross-sector rating methodology.

The final deadline for comments on the RFC is 22 May 2017 and the ECBC Rating Agency Approaches Working Groups is currently considering whether or not to comment as part of this process.
ESRB Publishes Review of Macroprudential Policy in the EU

On the 13th of April 2017 the European Systemic Risk Board (ESRB) published its Review of Macroprudential Policy in the EU in 2016 (available here). Naturally residential real estate measures are central to the review. Here below you will find the executive summary of the review:

“In 2016 most elements of the macroprudential framework were in place and fully operational in all the Member States. The ESRB Recommendation on intermediate objectives and instruments of macroprudential policy has to a very large extent been implemented by all the Member States. There were the first two applications of the voluntary reciprocity framework developed by the ESRB. The frameworks for the countercyclical capital buffer (CCyB) and systemically important institutions (SIs) became fully operational in all Member States and the first assessments were made under the framework developed by the ESRB for the CCyB of third (non-EU) countries.

Most macroprudential measures taken in the EU in 2016 were of a tightening nature and related to the residential real estate (RRE) sector and SIs. The RRE sector continued to be an area of concern for financial stability. This resulted in the issuance of public Warnings by the ESRB to eight Member States about medium-term vulnerabilities resulting from this sector. Several Member States further tightened measures that were already in place. Sometimes, these measures aimed to prevent excessively loose credit standards; often, they were combined with the aim of affecting different risk channels (lender, borrower and collateral) so as to increase overall effectiveness.

All Member States completed the identification process of their SIs and started imposing capital buffer requirements, often phased in over a period of two to four years. The number and characteristics of such institutions vary strongly across countries. A substantial part of these around 200 institutions are part of 30 larger cross-border groups. Finally, there were relatively minor changes in the frameworks for the systemic risk buffer already in place in several Member States.

The year 2016 was the first year that all Member States had a CCyB framework that was fully operational. Four Member States decided to have a non-zero buffer rate in place for domestic exposures, but only one Member State had a non-zero rate already effective in 2016. The credit-to-GDP gap is the main reference indicator in setting the buffer rate, but Member States use a wide variety of approaches to the number and types of additional indicators used to activate or increase the buffer. This diversity reflects specificities of national economies, heterogeneity of financial systems and differences in data availability.

The framework for CCyB for third (i.e. non-EU) countries developed by the ESRB became operational in 2016 as well, with the identification and monitoring of third countries that are material for the EU as a whole and for individual Member States. The first practical experience with this framework shows that the number of identified third countries varies greatly across Member States and that they take different approaches to monitoring the material countries at EU level identified and monitored by the ESRB.

The past year also saw the first applications of the framework for voluntary reciprocity developed by the ESRB. These applications related to a real estate measure adopted by Belgium under the CRD IV / CRR’s national flexibility arrangement and a systemic risk buffer measure by Estonia. These first cases show that the decision to reciprocate or not to reciprocate differs widely across Member States, for example in terms of the cost/benefit assessment or the time perspective taken in such decisions; conceptual and implementation issues play a role as well.”

ESAs Highlight Main Risks for EU Financial System

On the 20th of April 2017 the Joint Committee of the European Supervisory Authorities (EBA, EIOPA and ESMA - ESAs) published its spring 2017 Report on risks and vulnerabilities in the European Union’s financial system. The Report (available here) highlights the risks to the stability of the European financial sector in an environment subject to political and economic uncertainties. In particular, the protracted period of low profitability of banks and the difficulties faced by insurers to generate adequate returns to meet long-term liabilities in a low growth and low-yield environment remains a major challenge. In addition, the steepening of the yield curve may benefit earnings across all sectors but it also raises valuation concerns and, in the short-term, may not be sufficient to alleviate the low profitability concerns. The Report also highlights the high valuation risk linked to search for yield strategies and repricing of risk premia. Rising operational risks related to information and communication technologies are increasingly requiring supervisory attention. Key issues flagged in the Report include the following.

LOW PROFITABILITY OF FINANCIAL INSTITUTIONS

High levels of non-performing loans (NPLs), continuously high litigation costs, overcapacity, and lack of focus in strategies to return to sustained profitability affect the banking sector, notwithstanding a further steady strengthening of the capital ratios. Addressing NPL challenges requires a comprehensive and coordinated European response, including stepping up supervisory action, making progress in structural reforms, and improving the efficiency of secondary markets. Insurers face substantial challenges arising from prolonged low interest rates, especially those with material exposures to life insurance contracts with interest rate guarantees. In the European Union’s fund industry, rates of returns are subdued and remained mostly negative.

VALUATION RISKS AROUND SEARCH FOR YIELD AND REPRICING OF RISK PREMIA

Increased asset price volatility coupled with lingering liquidity concerns has heightened risks around the adequate valuation of asset prices. Risks are exacerbated by political uncertainties. As a matter of fact, the recently observed steepening of the yield curve, while benefitting the profitability of banks, insurers and pension funds, poses additional valuation concerns. For the insurance sector, a sudden substantial increase of the interest rate might expose companies to an increasing probability of lapses.

INTERCONNECTEDNESS WITHIN THE FINANCIAL SYSTEM

Interconnectedness, in particular via asset price contagion and direct financial exposure, adds to financial sector risks. Highly correlated equity price movements for insurers and banks, and high exposures of EU insurers to EU banks indicate risk concentration within those two sectors. Persistent search for yield intensifies the potential of price contagion among risky asset classes and reinforces valuation risk. Interconnectedness with the wider financial system is also on the rise, as cross-sectoral exposures, asset price commonalities and the interdependency of business processes increase.

CYBER RISKS AND IT-RELATED OPERATIONAL RISKS

Fast technological change is expected to have a significant impact on the existing business models of financial institutions over time. Many financial intermediaries have to deal with ageing core IT systems, hence the need for extensive IT investments, which further aggravate profitability. In addition, cyber risk threatens data integrity and business continuity in an interconnected financial system. Against this background, the demand for cyber insurance is expected to grow while cyber coverage products are still relatively new in the market, with limited underwriting experiences. Unlike other types of insurance, there is a severe lack of historical data that can be used for pricing purposes. The ESAs are responding to cyber and IT-related risks by, e.g., drafting Guidelines on ICT risk assessment for supervisors, assessing cyber security capabilities of central counterparties (CCPs) and assessing the potential accumulation of risk at insurers deriving from newly developed cyber security coverages.
EBA Finds German and Polish Waivers on Covered Bonds Justified

On the 11th of April 2017, the European Banking Authority (EBA) published an Opinion addressed to the German Federal Financial Services Supervisory Authority (BaFin) (available here) and an Opinion addressed to the Polish Financial Supervision Authority (FSA) (available here) following the Competent Authorities’ notifications of their decision to introduce a partial waiver of Article 129 (1)(c) of the Capital Requirements Regulation (CRR), which specifies the conditions for the eligibility of covered bonds in relation to risk weight preferential treatment. Given the significant potential concentration problem in Germany and Poland, the EBA is of the opinion that the application of a partial waiver is adequately justified.

For covered bonds to be eligible for risk weight preferential treatment, their total exposure to institutions that qualify for credit quality step 1 (CQS1) must not exceed 15% of the nominal amount of outstanding covered bonds of the issuing institution, as specified in Article 129(1)(c) of the CRR. This requirement may be partly waived by a Competent Authority, after consulting the EBA, if significant potential concentration problems in the Member States concerned can be documented. The partial waiver allows for exposures to institutions that qualify for credit quality step 2 (CQS2) for up to 10% of the total exposure.

Following the German BaFin’s and Polish FSAs notifications of their decision to partially waive Article 129(1)(c) of the CRR, the EBA has assessed the evidence provided to support the measures, namely the current classifications of German and Polish credit institutions in relation to the CQSs assigned, the current compositions of the German covered bond market, and the types and natures of exposures to credit institutions that covered bonds regularly assume.

With regards to the opinion for Germany, on the basis of the evidence provided, the EBA is of the opinion that Germany has a significant potential concentration problem stemming from the application of the CQS1 requirement and, therefore, the partial waiver is adequately justified. BaFin’s general administrative order was issued on 22 December 2014 and came into effect on 1 January 2015, and was published on the BaFin’s website and in the Federal Gazette (Bundesanzeiger).

EMF Publishes Full Quarterly Review - Q4 2016

On the 25th of April 2017 the European Mortgage Federation (EMF) published the full version of its Quarterly Review of European Mortgage Markets for the fourth quarter (Q4) of 2016. Produced in cooperation with the Federation’s national experts, the Quarterly Review presents the latest short-term developments in mortgage and housing markets across the EU. The publication provides expert analytical commentary together with data tables and charts on the following key indicators:

- Mortgage interest rates;
- Total outstanding residential mortgage lending;
- Gross and net residential mortgage lending; and
- Nominal house price indices.

The full Quarterly Review – Q4 2016 and the archive of previous editions (back to Q3 1998) are available on the EMF website here.

Principle-Based Approach Critical for the Establishment of a Harmonised EU Covered Bond Framework

On the 19th of April 2017 and in the context of the European Institution’s ongoing consideration of a potential European framework for covered bonds, the European Covered Bond Council (ECBC) issued a statement supporting the concept of a high-quality principle-based framework, which will act as a regulatory and qualitative market benchmark for both European and global market participants.

In its statement, the ECBC expresses its appreciation of the careful market analysis which has been undertaken by the European Parliament, the European Commission and the European Banking Authority over recent months.

The ECBC calls for an inclusive approach to be adopted which would permit the full integration of the current regulatory treatment of covered bonds into the potential new European framework for the asset class. Any modification of the current regulatory recognitions for CRR or UCITS compliant covered bonds would have severe consequences for investor confidence and the anti-cyclical, crisis management role played by this strategic asset class during the financial crisis.

In terms of collateral assets, the ECBC fully supports a two-tier, principle-based approach consisting of: (i) the traditional collateral assets group of covered bonds; and (ii) an additional group of UCITS compliant dual recourse instruments, with different requirements in terms of eligible cover assets and regulatory treatment, and which should have a different name, such as European Secured Note, to mark a clear distinction from traditional covered bonds.

Against this background, the ECBC would like to highlight the two market-led initiatives it has established with the aim of enhancing transparency for investors:

- The Covered Bond Label initiative, which provides a unique online database for investors on CRR compliant covered bonds, with a wealth of quantitative and qualitative information on collateral assets and liabilities.
- The European Secured Note (ESN), as proposed by the EMF-ECBC, which is a separate, UCITS compliant asset class for alternative collateral reproducing certain covered bond techniques such as a definite legislative framework, asset segregation, public supervision and dual recourse.

The ESN proposal has been elaborated by the ECBC’s Long-Term Financing Task Force, which consists of covered bond experts from the major covered bond jurisdictions in the EU. This Task Force stands ready to support the relevant institutions at national and European level in the future development of this asset class.

In publishing the statement, Luca Bertalot, EMF-ECBC Secretary General, said “It is important to acknowledge the valuable work already undertaken by the European Institutions on covered bonds. This framework review process offers an opportunity to give a truly shared European profile to covered bonds, which are already the backbone of bank funding across much of Europe. In our view, going forward, it is critical to define a principle based approach maintaining the regulatory recognition of the safe and transparent profile of traditional covered bonds, which have been enhanced by the introduction by market participants of the Covered Bond Label and its Harmonised Transparency Template, and yet give an opportunity to financial institutions to use covered bond techniques for alternative collaterals.”
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11-12/05  Italian Banking Association (ABI) Funding & Capital Markets Forum 2017 – Milan

11/05  Berlin Hyp “Meet Berlin” Event – Berlin

19/05  European Commission & European Central Bank High Level Conference on “European Financial Integration and Stability” – Completing Banking Union and Developing Capital Markets Union – Brussels

23/05  Euromoney Conferences/EBRD/ECBC CEE Covered Bond Conference 2017 – London

30/05  European Parliament Financial Services Forum (EPFSF) Event on Capital Markets Union: Recovery & Resolution for Central Counterparties – Brussels

31/05  EMF-ECBC & European Central Bank (ECB) Annual Meeting – Frankfurt

JUNE 2017

08/06  Covered Bond Label Foundation (CBLF) Label Committee Meeting – Rome

08/06  European Covered Bond Council (ECBC) Steering Committee Meeting – Rome

09/06  European Mortgage Federation (EMF) Executive Committee Meeting – Rome

09/06  Kick-Off Meeting for EMF-ECBC Energy Efficiency Mortgages (EeMAP) Initiative Pilot Phase – Rome

21/06  European Parliament Financial Services Forum (EPFSF) Event – Brussels

21/06  European Parliament Financial Services Forum (EPFSF) Ordinary General Meeting – Brussels

23/06  European Supervisory Authorities (ESAs) Joint Consumer Protection Day – Prague

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