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EUROPEAN MORTGAGE FEDERATION
EUROPEAN COVERED BOND COUNCIL

ECBC GLOBAL ISSUES WORKING GROUP **Brochure**

EMF-ECBC
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SECTION I. INTRODUCTION

By **Luca Bertalot**, EMF-ECBC, **Colin YS Chen**, DBS Bank & Chairman of the ECBC Global Issues Working Group and **Christopher Walsh**, Clifford Chance

A QUICK GLANCE AT THE GLOBAL PICTURE

For precisely 250 years, 2019 being the quarter-millennial anniversary of their first use in Europe, covered bonds have proven to be an efficient debt instrument enabling banks to mobilise private sector means and capital towards long-term investment with a wide public benefit and, in particular, real estate loans and public-sector debt. During the years of market turmoil, covered bonds demonstrated a strong degree of resilience. Throughout the crisis, they played a pivotal role in bank wholesale funding, providing lenders with a cost-effective and reliable long-term funding instrument for mortgage and public-sector loans. The Industry continues to build on the lessons learnt from the financial crisis while maintaining a focus on the essential features and qualities that have made the asset class such a success story.

The ongoing EU Capital Markets Union (CMU) and Basel IV discussions are now, more than ever, opening new frontiers for covered bonds at both EU and international levels. The covered bond financing instrument is being exposed to critical evolutions which can bring about both new opportunities but also new risks. The covered bond market is faced with new regulatory, policy and supervisory developments, while market innovation, the continuous process of globalisation and national implementation of the covered bond concept will also leave their mark on the asset class.

In view of these considerations, the covered bond industry firmly believes that, in any evolution, there is a clear need to preserve the key nature of the product as a crisis management tool rooted in robust qualitative and macroprudential characteristics which are the basis for ensuring a regulatory recognition at global level.

ROLE OF THE ECBC GLOBAL ISSUES WORKING GROUP

In order to develop synergies between traditional, new and emerging covered bond markets as the joining of forces should allow the development of a more levelled playing field for all at a global level, the European Covered Bond Council (ECBC) established its ECBC Global Issues Working Group (GIWG) in 2015. So far, the work undertaken by the GIWG has been instrumental in ensuring a proper recognition of the macro-prudential value of the covered bond asset class while securing an appropriate, homogenous and cross-border regulatory treatment by different jurisdictions at a global level.

To this end, ECBC members have identified an important role to be played by the Working Group as a discussion forum for exchanging market best practices and as an educational platform for issuers and global investor communities. The overarching aim of the Working Group is to enhance transparency and convergence, and to ensure that there is a progressive common understanding of the covered bonds concept, with similar market solutions and infrastructures, and more important comparable regulatory treatments. For this reason, the Working Group has been closely looking into the following topics which were initially allocated to the following topical Work Streams within the Group:

- **Work Stream 1 –** "Identification of the guiding fundamental principles of covered bonds at global level" with Coordinator Maureen Schuller, ING Bank
- **Work Stream 2 –** "Ensuring a principle-based convergence and common regulatory treatment and developing a matrix of regulations that are at issue" with Coordinator Sascha Kullig, vdp
- **Work Stream 3 –** "Mapping of covered bond market best practices as well as critical elements and challenges" with Coordinator Christopher Walsh, Clifford Chance
- **Work Stream 4 –** "Mapping of investors' appetite for covered bonds" with Coordinator Franz Rudolf, UniCredit Bank
- **Work Stream 5 –** "Coordination of activities at Basel Committee level" with Coordinator Peter Jayaswal, Finance Denmark
- **Work Stream 6 –** "Coordination of activities at EU level to extend the UCITS definition to include non-EEA countries" with Coordinator Lily Schum, Canada Mortgage and Housing Corporation (CMHC)

POLICY DEVELOPMENTS

Looking back over the past months, it is clear that the covered bond space has been fundamentally impacted by major waves of monetary policy, supervisory review and regulatory change which is having a significant impact on the long-term financing and housing finance sectors.

At EU level, for example, an ambitious initiative called the Capital Markets Union (CMU) that will ensure the capability of the Industry to support the growth agenda and provide long-term financing to the real economy has identified the following areas of reflection:

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

The European Commission published in March 2018 its legislative proposal for a EU-framework for covered bonds. The Economic and Monetary Affairs Committee (ECON) of the European Parliament published amendments to the proposal during the summer 2018 and its final position was adopted by the EU parliament in plenary in late November 2018. In parallel, the European Council (a representation of all EU member states governments) finalised their proposal to the text in October 2018 under the Austrian Presidency. Since December up until Q1 2019, Trilogues negotiations have taken place between the European Commission, the EU Parliament and the European Council now under the coordination of the Romanian Presidency since January 2019. The approval of the final version is expected to take place before the end of the parliamentary mandate this year (European elections are scheduled in May 2019), opening the doors to an expected implementation period of two years. The approval and implementation of this legislative package will definitely have an impact on the Covered Bond markets, bringing new risks and opportunities at European level and at a more global level (see section III for a more detailed analysis). In this context, the ECBC remains committed in liaising with the EU institutions on a regular basis regarding this key policy file and its implementation with the invaluable support of the ECBC Task Force on the EU Framework for Covered Bonds.

MARKET DEVELOPMENTS

Covered bonds are at the heart of the European financial tradition, having played a central role in funding strategies for the last two centuries. The strategic importance of covered bonds as a long-term funding tool is now recognised at a global level. Outside Europe, Australia, Brazil, Canada, New Zealand and South Korea have already implemented covered bond legislation in recent years. Major jurisdictions including Chile, India, Japan, Mexico, Morocco, Panama, Peru, South Africa and the United States, are either in the process of adopting covered bond legislation or are investigating the introduction of covered bonds.

In 2017, the outstanding covered bond market remained virtually stable at around EUR 2.5 trillion with respect to the previous year, abide a small contraction by a mere 1.25% from 2016. Since its peak reached in 2012 (EUR 2.8 trillion), outstanding volumes have nevertheless fallen by 12%, a drop mostly driven by the public-sector backed covered bonds[1]. New issuances in 2017 reached EUR 445 billion, declining by 8% with respect to 2016. The most common collateral used for covered bonds is a mortgage which accounts for EUR 2.1 trillion or 86% of the outstanding market and this share has been constantly increasing since in 2003, when the figure was at 40%. The major players remain Denmark, Germany, France and Spain, which account for 53% of the outstanding in the market (Figure 1).

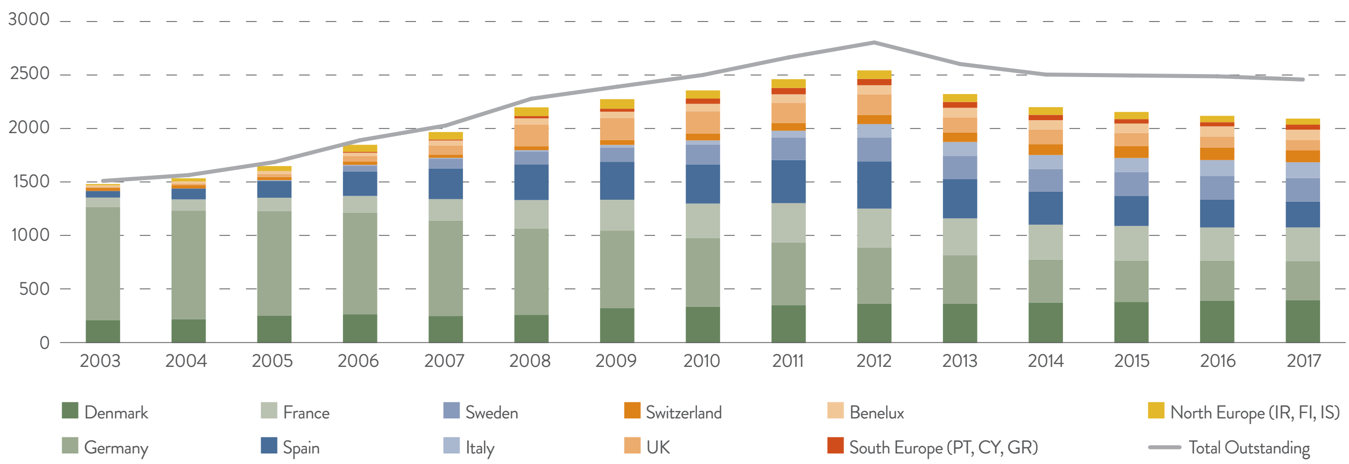
One interesting development in 2017 was that the last outstanding covered bonds matured in Panama and the United-States. However, Panama has issued again at the end of 2018. Since it surpassed Germany last year, Denmark is still the largest issuer, by far, with a new issuance volume of EUR 126 billion in 2017. On the other side, outstanding covered bonds from non-EU countries accounted for more than 16% of the total in 2017, a 1.7 pps increase with respect to previous year.

COVERED BOND LABEL

The firm commitment to contribute to European efforts to enhance financial stability and transparency led the covered bond industry to launch a quality Covered Bond Label in 2012. The Covered Bond Label was developed by the European issuer community working in close cooperation with investors and regulators, and in consultation with all major stakeholders such as the European Commission and the European Central Bank. The Covered Bond Label and its transparency platform (**www.coveredbondlabel.com**) have been operational since January 2013, providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. As of December 2018, 122 labels have been granted to 105 issuers from 18 countries, covering over EUR 1.7 trillion of covered bonds outstanding, where 5.006 covered bonds include information on the Liquidity Coverage Requirement (LCR) maturity structures, regulatory treatment, etc.

In this context, covered bond issuers from these 16 different jurisdictions have come together to develop a Harmonised Transparency Template (HTT). Since 2016, this has been providing cover pool information in a harmonised format, which allows for both the recognition of national specificities, with the National Transparency Tabs, and the comparability of information required to facilitate investors' due diligence.

FIGURE 1 | OUTSTANDING COVERED BONDS IN EUROPE (EEA + SWITZERLAND), EUR BN



Source: EMF-ECBC Statistics Department

[1] See more in the chapter 5. Covered Bonds Statistics of the **ECBC Factbook** 2018 (https://hypo.org/ecbc/publications/fact-book/).

The critical mass achieved by this initiative (c. 70% of covered bonds outstanding globally hold the Label) is a clear sign that the Industry recognises the need to respond to the requirements of new classes of investors by providing higher levels of transparency to aid investment decisions. Equally, it is important to highlight the progress that has been made in recent years in terms of collating and distributing relevant macro-level information on the covered bond sector.

LOOKING AHEAD

The Industry has demonstrated that through market initiatives such as the Covered Bond Label and the European Secured Note instrument developed by the market experts of the ECBC ESN Task Force (previously Long-Term Financing Task Force), it is possible to build, from the bottom-up, proposals based on market consensus in order to initiate pan-European solutions which enhance transparency, comparability, convergence of markets and best practices. Taking stock of where we have come from, where we are now and where we are heading, it is clear that the market and the environment in which it operates is constantly evolving and as such the work of the ECBC and its Global Issues Working Group is always in progress. This provides us with an ongoing challenge and we believe that the ECBC initiatives underway will strengthen the asset class and facilitate the convergence of market and supervisory best practices. We are ready to support the creation of a common regulatory framework for covered bonds which is fit for purpose and enables the market to flourish further to the benefit of all, to help build the CMU at EU level and do everything we can to support the covered bonds asset class at international level.

The ongoing harmonisation of the covered bond asset class at EU and now also global level represents a new era for the Industry. While principle-based harmonisation as proposed by the European Commission with its EU Framework for Covered Bonds represents an opportunity for further developing the market, it is also clear that the Industry is faced with new regulatory, policy and superiority developments. In conjunction with these, market conditions, developments and new trends are all impacting and shaping the product here and now and will continue to do so going forward.

SECTION II. MAPPING

The Current State of Play and Outlook for Covered Bonds Outside European Union

By **Luca Bertalot** – EMF-ECBC, **Colin YS Chen** – DBS Bank & Chairman of the ECBC Global Issues Working Group, **Thomas Cohrs** – NordLB, **Antonio Farina** – S&P Global, **Filipe Pontual** – Brazilian Association of Real Estate Loans and Savings Companies (ABECIP) and **Lily Shum** – Canada Mortgage and Housing Corporation (CMHC)

Covered bonds represent a EUR 2.5 trillion global asset class. Initially dominated by European issuers, the product is becoming increasingly relevant in many other markets, such as Australia, Canada, Singapore, and South Korea (see Figure 2).

The global financial crisis proved that covered bonds can be a resilient source of funding in times of wider market turmoil. Even in the European countries most affected by the crisis, such as Italy and Spain, banks were able to tap the covered bond market despite other sources of wholesale funding evaporating.

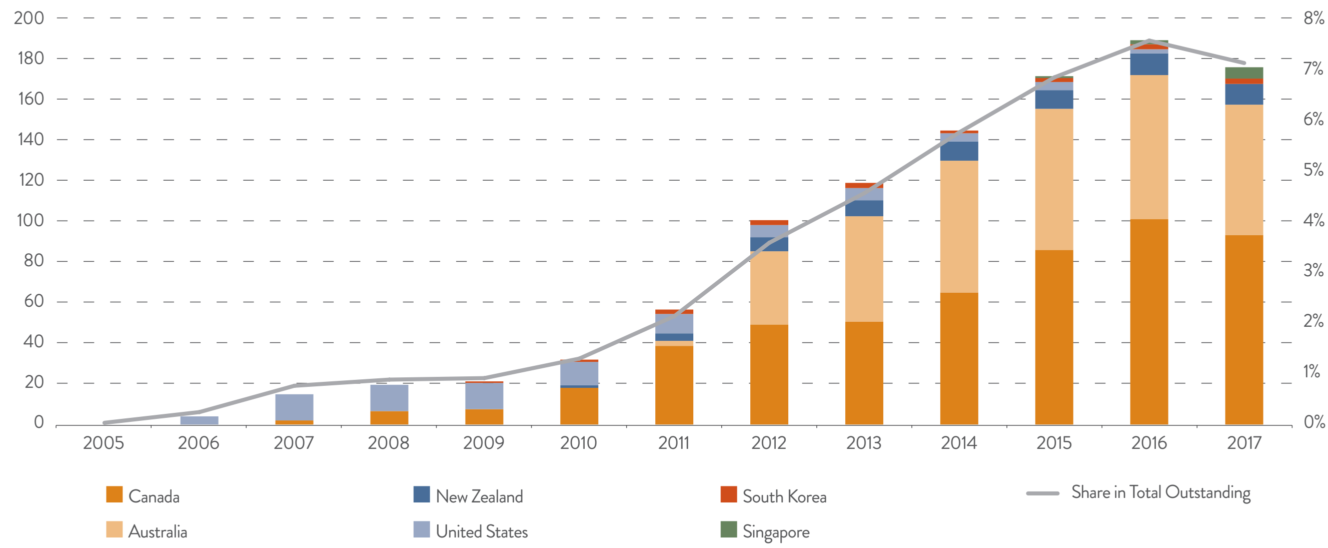
Issuers and regulators outside the traditional European markets duly noted banks' ability to issue covered bonds in time of stress and expedited the approval or the amendment of legislation governing the issuance of covered bonds. Covered bond issuance picked up quickly in most of these countries once the dedicated legislation was approved.

Over the past few years, accommodative monetary policies in Europe and the Americas, and the European Central Bank (ECB)'s Covered Bond Purchase Program (CBPP3), have created favourable conditions to establish covered bond programmes in new countries.

We believe that market conditions will remain supportive for covered bonds in new jurisdictions in the next few years, despite the gradual removal of monetary support from central banks. Moreover, an expected increase in mortgage lending will drive bond supply by increasing lenders' need for wholesale funding and the availability of eligible collateral. Finally, the legislative and regulatory environment remains favourable to covered bonds.

We present here an overview of the major covered bond markets outside the European Economic Area.

FIGURE 2 | NON-EEA COVERED BOND MARKET, VOLUME AND SHARE, EUR BN



Source: EMF-ECBC Statistics Department

NORTH AMERICA

Canada represents one of the most successful covered bond markets outside Europe, with 10% of the entire mortgage market funded by covered bonds. While Canadian banks issue opportunistically in a number of currencies to build a globally diversified funding platform, issuances denominated in Euros represented just over half of total bonds outstanding (please see Box 1 below).

Covered bonds proved less successful in the US. No covered bond legislation has been passed yet despite several attempts in the post-crisis period. Moreover, the previously issued structured covered bonds have now matured and there are currently no outstanding US covered bonds. As long as government-sponsored enterprises such as Fannie Mae and Freddie Mac guarantee the majority of all the new mortgages, there will be little appetite for market-based alternatives such as covered bonds.

BOX 1 | CANADIAN MARKET by **Lily Shum**, Canada Mortgage and Housing Corporation (CMHC)

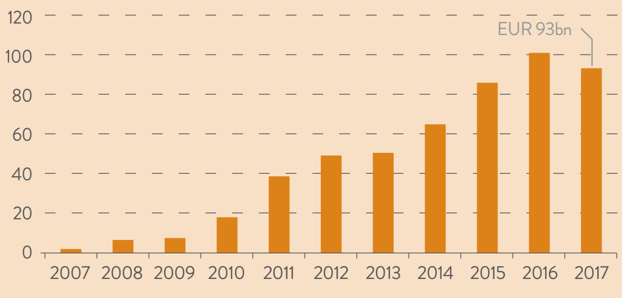
CANADA

From 2007 until 2012, Canadian covered bonds were issued pursuant to a contractual framework. In 2012 Canada implemented legislation that gives covered bond investors statutory protection. Canada Mortgage and Housing Corporation ("CMHC") is responsible for the administration of the legal framework in Canada and registers issuers and programs, maintains the issuer registry, and develops and updates the Canadian Registered Covered Bond Programs Guide ("CMHC Guide") which specifies the framework requirements. Currently there are 8 registered covered bond issuers. Through continuous enhancements based on international best practices, CMHC plays an important role in ensuring that a robust, globally recognised legal framework is in place.

Growth of Covered Bond Issuances

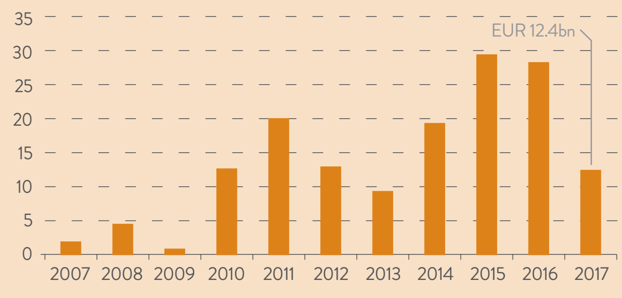
Since the first covered bond issued by Royal Bank of Canada in 2007, outstanding issuances have grown steadily – please see Figure 3 below. Further growth in issuances followed after the passage of a dedicated covered bond legislation that established a statutory covered bond regime in Canada. As a result, record issuances occurred in 2015 and 2016. This rapid growth over the last few years has fundamentally shifted the Canadian banks' wholesale term funding profile.

FIGURE 3 | COVERED BONDS OUTSTANDING FROM CANADIAN ISSUERS, 2007 - 2017, EUR BN



Source: EMF-ECBC Statistics Department

FIGURE 4 | COVERED BONDS ISSUANCE FROM CANADIAN ISSUERS, 2007 - 2017, EUR BN



Source: EMF-ECBC Statistics Department

With a large overseas market, covered bond issuances are largely targeted outside of Canada to broaden the sources of funding geographically. As a nascent domestic market, the Canadian dollar-denominated covered bond market has also emerged, with issuances to date from Royal bank of Canada, Toronto Dominion bank and Bank of Montreal. In Canada, covered bonds are not eligible for conversion under the bail-in regime that came into force in September 2018. Looking forward, covered bonds remain a strategic source of funding for Canadian issuers.

Globalisation, Cross-Markets and Beyond

Canadian issuers remain key participants in international covered bond markets, issuing opportunistically in CAD$, EUR€, USD$, GPB£, CHF and AUD$ markets to build a globally diversified funding platform. As of the end of 2017, issuances denominated in Euros represented 54% of outstanding issuances. The US investor base continues to provide important diversification.

CENTRAL AND SOUTH AMERICA

Covered bonds in this region have a short and limited track record. Panama was the first country to see a covered bond issuance in October 2012. Panama does not have a specific legal framework for covered bonds, and covered bonds are based on contractual agreements. Chile is the other only covered market in the region, with a limited, locally distributed covered bond issuance.

The lack of a dedicated legal framework is probably one of the main reasons for the lack of covered bond issuance in the Latin America. Things may change thanks to the completion of the covered bond regulation in Brazil in 2018 and the development of this market expected for 2019. If covered bonds prove successful in Brazil, we may see other countries in the region follow its lead, such as Argentina, Peru, Mexico, or Colombia.

BOX 2 | BRAZILIAN MARKET by **Filipe Pontual**, ABECIP (Brazilian Association of Real Estate Loans and Savings Companies)

BRAZIL

The main framework of the Brazilian covered bond, the LIG - Letra Imobiliária Garantida –, was established by law in 2015. Based on international best practices, between 2017 and 2018 the Brazilian National Monetary Council ("CMN") and the Brazilian Central Bank published the secondary legislation and the operational details for the LIG. At the end of 2018, four banks announced local CB programmes, three of whom issued a total of BRL 2 billion (EUR 470 million). Local BRL-denominated issuance is expected to gather speed during 2019 as operational details are sorted out.

The **main characteristics** of Brazilian Covered Bonds are:

- Debt instrument is issued by financial institutions, guaranteed by an asset pool of real estate loans owned by the issuer.
- Asset Pool segregation on the issuers balance sheet, in favour of the covered bond holders, is guaranteed by law, including precedence over fiscal and labour claims.
- Minimum overcollateralisation of 5%.
- Requires a fiduciary agent who will monitor the asset pool quality and represent the note holders' interests should the issuer default.
- Notes and assets within the asset pool must be deposited/registered with a depositary agent authorised by the Brazilian Central Bank.
- LIG programmes must be authorised by the Brazilian Central Bank.
- The law delegates to the National Monetary Council ("CMN") and the Brazilian Central Bank the issuance of secondary regulation.
- CMN Resolution establishes Asset Pool stress testing and minimum liquidity rules.
- The maturity structure is left to the discretion of the Issuers (hard bullet, soft bullet or Conditional Pass-Through).

OCEANIA

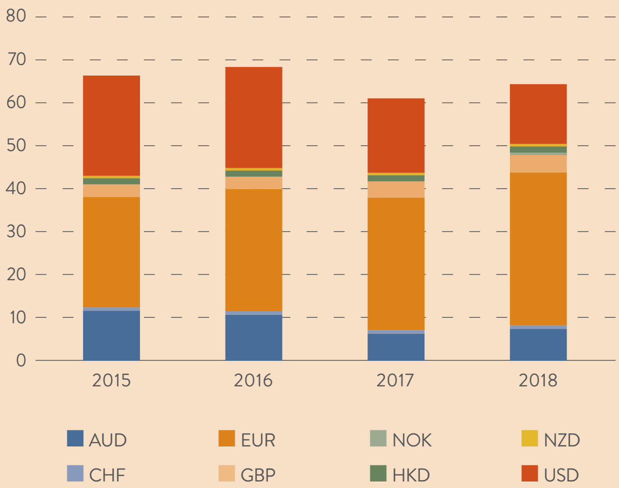
While considerably less prominent than their Canadian counterparts, all major banks from Australia and New Zealand have been issuers of Covered Bonds over the last 4 years.

BOX 3 | AUSTRALIA AND NEW ZEALAND by **Thomas Cohrs**, Nord LB

AUSTRALIA AND NEW ZEALAND

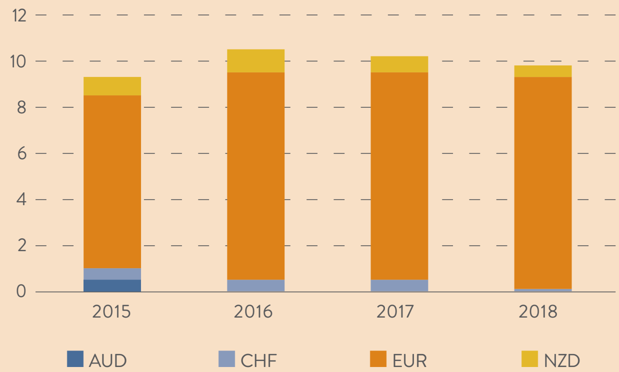
In total, 11 issuers (6 in Australia, 5 in New-Zealand) currently account for an outstanding volume of over EUR 70 billion (see figures below).

FIGURE 5 | COVERED BOND OUTSTANDING FROM AUSTRALIAN ISSUERS 2015-2018, EUR BN



Source: ECBC Global Issues Working Group

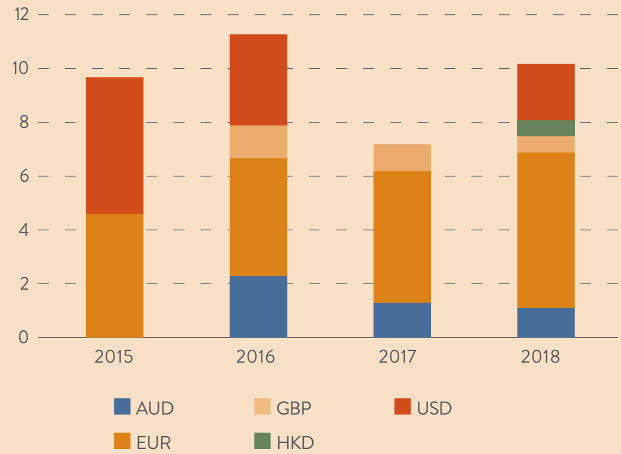
FIGURE 6 | COVERED BONDS OUTSTANDING FROM NEW ZEALAND ISSUERS 2015-2018, EUR BN



Source: ECBC Global Issues Working Group

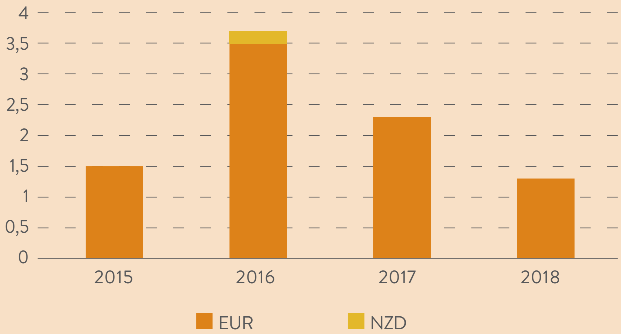
While the bulk of issuance is in EUR to provide access to the most important investor base for Covered Bonds, a number of issuers have also provided NZD, AUD and CHF issues (New Zealand based Kiwibank being active in CHF only). Given their geographic position, non-EUR issuance is largely aimed at neighbouring jurisdictions albeit in significantly lower volumes than concurrent EUR issuance (see figures below).

FIGURE 7 | COVERED BOND ISSUANCE FROM AUSTRALIAN ISSUERS 2015-2018, EUR BN



Source: ECBC Global Issues Working Group

FIGURE 8 | COVERED BONDS ISSUANCE FROM NEW ZEALAND ISSUERS 2015-2018, EUR BN



Source: ECBC Global Issues Working Group

Australia, not only being the home of the region's largest banks and mortgage market but also providing ownership of most large New Zealand issuers, naturally dominates issuance of Covered Bonds and is likely continue doing so.

ASIA

South Korea and Singapore have made great advances in establishing legislative frameworks and launching covered bond programmes. As these countries have ample liquidity, their primary motivation in establishing covered bond capabilities was to have another risk management tool rather than funding.

Covered bonds in South Korea have been issued through one of the following legislations: the ABS Act, the Covered Bond Act, which came into effect on 15 April 2014, and the Korea Housing Finance Corp. (KHFC) Act. There are currently two active covered bond issuers: Kookmin Bank and the Korea Housing Finance Corporation. For South Korean banks, customer deposits remain the main funding source. Nonetheless, we expect covered bond issuance from South Korean banks to be limited and opportunistic, based on market conditions and encumbrance limits but also the structural makeup of the South Korean market.

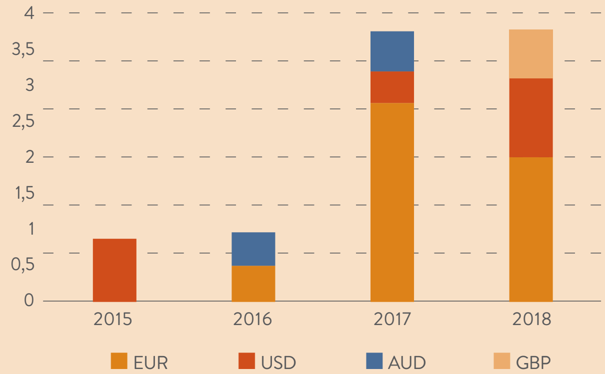
The regulatory framework for the issuance of covered bonds by banks incorporated in Singapore was established on 31 December 2013, and refined on 4 June 2015, through the Monetary Authority of Singapore (MAS)'s Notice 648 (see Box 3.) Since the legislative framework was set in place, we have observed a stable flow of covered bonds as issuers seek to maintain and manage their programmes. The three domestic major banks have already set up their programmes, and a few larger foreign banks also have well-entrenched and stable market share, so more covered bond programmes may be set up in the near future. However, the overall supply of covered bonds from Singapore will likely be limited because banks in Singapore are mostly funded by depositors. Moreover, the regulatory limit for cover pool assets -they may amount to no more than 4% of the issuer's total assets- could also subdue the issuance of covered bonds.

BOX 4 | SINGAPOREAN MARKET by **Colin YS Chen**, DBS Bank & Chairman of the ECBC Global Issues Working Group

SINGAPORE

Covered bonds as a funding tool for banks came into existence in Singapore after revisions to the final covered bond legislation MAS Notice 648 were introduced in 2014. DBS Bank Ltd performed the country's inaugural covered bond issuance. Since then, the nascent market has grown to include OCBC and UOB as issuers, and the local market cumulatively issued the equivalent of EUR 8.46 billion as of 01 January 2019 and issued 8 covered bonds in 2018 for a total amount of more than EUR 3.7 billion (Figure 8). As the market continues to grow, foreign banks incorporated in Singapore are also considering setting up covered bond programmes here to tap on demand.

FIGURE 9 | COVERED BOND YEARLY ISSUANCE FROM SINGAPOREAN ISSUERS 2015-2018, EUR BN



Source: ECBC Global Issues Working Group

Singaporean covered bonds rely on structural arrangements to provide security over the cover pool. The covered bond market is regulated by MAS Notice 648, which stipulates requirements on issuers (financial institutions incorporated in Singapore), cover pool assets (residential mortgages), asset encumbrance limit (4%) and overcollateralisation (103%), among other things.

So far, Singaporean banks have issued across a mix of currencies (predominantly EUR and USD) according to each institution's funding requirements. This is expected to continue in response to banks continued local and regional expansion. Singapore is fully supportive of the global harmonisation efforts, with all Singapore issuers being ECBC Label holders and adhering to global best practices.

To the Future, and Beyond

The covered bond market in Singapore has been on an upward trend since the first issuance in 2015. Future issuance pipeline is strong, with banks indicating commitment to a regular presence in the market for benefits including market access maintenance, investor-base diversification and funding diversification.

Further, market participants engage with each other and the regulator through the Association of Banks Singapore (ABS) Standing Committee on Covered Bonds. This committee represents the commitment from industry and highlights the support from / collaboration with the local authorities that will mark the next phase of growth for the Singapore covered bond market.

Customer deposits predominantly fund banks in India currently, but issuers and regulators are considering alternative sources of wholesale funding. While the structured finance market is growing rapidly, it has also so far been domestic and rupee-denominated. Covered bonds may have the potential to further facilitate the development of the Indian capital market and provide an additional tool to attract external funding for financial institutions. Similar to other Commonwealth countries such as Australia and the U.K., India does not have specific legislation governing securitisation. Rather, the legal framework for India's securitisation market is based on existing trust, contract, and property law, and a series of guidelines issued by the Reserve Bank of India (RBI). We believe that structured covered bonds may be issued without European-style special covered bond legislation, but regulators' guidance is likely to be required. Key clarifications required will include whether the issuance of covered bonds is permitted under Indian legislation generally, whether existing securitisation guidelines can be applied to covered bonds, how asset segregation can be achieved, the treatment of assets in an issuer insolvency scenario, and whether there are any challenges from a tax perspective, including stamp duty and withholding tax.

BOX 5 | TURKISH MARKET by **Antonio Farina**, S&P Global

TURKEY

The Capital Markets Board of Turkey issued a covered bonds communiqué in January 2014. This repealed two earlier communiqués on assets and mortgage covered bonds and aimed to boost interest in structured capital markets products. In September 2014, the Capital Markets Board amended the January communiqué to clarify certain aspects, such as the treatment of derivative instruments and required overcollateralisation ratios and enable the issuance of Turkish covered bonds.

The Turkish framework contemplates on-balance-sheet issuances by eligible issuers, such as banks, of covered bonds that may be backed by a variety of assets including mortgage loans, consumer loans, financial leases, or factoring receivables. The basic issuance structure under the Communiqué calls for the issuer to segregate a pool of assets, registered in a cover registry, and set aside to service and repay the covered bond creditors, who also have recourse on the other assets of the issuer on an unsecured basis in case of default (the dual recourse principle). Among other things, the Communiqué allows derivative instruments to be included in the asset pool to mitigate the risk exposures on issuances. It also enhances the underlying asset ratio (to 15% for consumer or mortgage loans, for example). The Communiqué also regulates the use of cash flows collected from the pool assets and provides for a third party – the cover monitor – to control the cover pool and the issuer's compliance with its obligations.

Turkey has generally low household and residential mortgage debt, and we expect to see sustained loan growth. This will increase the pool of assets that issuers could use as collateral for covered bonds. However, market volatility and political uncertainty has slowed down the development of a covered bond market. In April 2016, Turkiye Vakiflar Bankasi TAO (Vakifbank) was the first bank in issuing euro-denominated mortgage-backed covered bond benchmarks. In 2017, Vakifbank also placed the first Turkish lira-denominated covered bond away from development banks, which has opened the market for privately placed covered bonds in local currency.

AFRICA

Morocco was the first country in the region to release draft covered bond legislation. However, it has not yet approved the final law, which is a testament to the difficulties that can be encountered in the legislative process.

South Africa has historically ruled out covered bonds because of concerns about their seniority over depositors. In 2014-2015, these regulatory concerns seemed to diminish, thanks to a discussion regarding resolution regimes, and specifically, the anticipated introduction of retail depositor guarantees.

However, domestic investors – who provide a considerable amount of domestic bank funding – remain resistant to the idea of a covered bond framework. This is due to investors' concerns about the potential pressure on the pricing of their senior unsecured debt, the losses if an issuer becomes insolvent and what could happen to the ratings on this debt. As a result, we don't expect any covered bond market development in South Africa in the near future.

SECTION III. HARMONISATION AND GLOBAL BEST PRACTICES

Identifying Fundamental Principles of Covered Bonds

By **Sascha Kullig**, Verband Deutscher Pfandbriefbanken (vdp) and **Maureen Schuller**, ING Bank
With special thanks to **Elena Bortolotti**, Barclays, **Colin YS Chen**, DBS Bank, **Thomas Cohrs**, NordLB, **Franz Rudolf**, UniCredit and **Lily Shum**, CMHC for their past and recent help on the legal framework analysis

Covered bonds are meanwhile widely used around the globe, but their regulatory treatment varies. In order to achieve their global convergence, the Global Issues Working Group (GIWG) of the ECBC aims to develop fundamental principles of covered bonds on a global scale. A common understanding of such fundamental principles could also support countries that consider introducing a covered bond framework. With this purpose, the GIWG has in the past three years conducted different types of analyses, including on the preferential treatment of covered bonds across the globe as well as on the alignment of global regimes with the proposals on regulatory harmonisation within Europe.

THE REGULATORY TREATMENT OF COVERED BONDS ON A GLOBAL SCALE – ON DIFFERENT TRACKS

As a reference for developing fundamental principles of covered bonds on a global level, the GIWG first conducted an analysis of the requirements covered bonds have to meet globally in order to receive preferential regulatory treatment. The focus was on preferential risk weightings for banks and insurance companies, the qualification as liquid assets according to the LCR, the treatment within the NSFR framework, the exemption from Bail-In, exposure limits, investment limits and the eligibility for central bank liquidity.

The feedback received from the Eurozone and on Canada, Denmark, South Korea, Sweden and Turkey revealed that covered bonds are recognised as liquid assets according to the LCR in all countries, albeit to a different extent. However, such consistent preferential treatment is rather the exception than the rule.

Differences exist, for instance, with regard to risk weighting, where outside Europe hardly any preferential treatment of covered bonds exists in the countries we were looking at, neither for banks nor for insurance companies. The preferential treatment in central bank funding seems to be a European speciality, too.

Apart from that, the survey shows that the requirements for a preferential treatment of covered bonds are not always very detailed. Instead, it is often referred to Article 52 (4) of the UCITS-Directive, which does not require much detail. In non-European countries the relevant laws or regulations often require a 'dedicated' covered bond law without outlining more details or definitions.

Based on these results, the GIWG concluded that the current requirements for a preferential treatment of covered bonds on a global level do not qualify as an appropriate starting point for fundamental principles of covered bonds.

GLOBAL BEST PRACTICES – NEW ANALYSIS BASED ON THE FINAL POSITION OF THE EUROPEAN PARLIAMENT AND THE COUNCIL REGARDING THE EU DIRECTIVE AND REGULATION PROPOSAL OF MARCH 2018

As a next step, the GIWG analysed if and how different global covered bond regimes meet the proposals for covered bond harmonisation in the EU, disclosed by the European Banking Authority (EBA) in December 2016. The results can be found in the chapter "Global Best Practices – Measured on the basis of the EBA's Harmonisation Proposals".

However, as the legislative procedure on the European Level is more advanced, the GIWG conducted a second analysis, this time based on the final position, agreed in late November 2018, of the European Parliament and the Council regarding the EU Directive and Regulation proposal for a harmonisation of covered bond frameworks in Europe, which was published by the European Commission in Mid-March 2018. While the positions of the European Parliament, the Council and the EU Commission are in many aspects very close to each other, it should not be forgotten that changes are still possible in the upcoming negotiations.

The results of the second analysis reveal that most global covered bond regimes are somewhat better aligned with the more principles-based EU Directive proposals than they were with the EBA's harmonisation proposals (see Figure 10). Importantly, there is full alignment with the Directive's dual recourse and bankruptcy remoteness requirements and almost all countries fully meet the asset segregation requirements (see Figure 11). On the other hand, virtually none of the global regimes provide for intragroup or joint funding options. The non-alignment in this field is not particularly relevant, especially since, at least, the intragroup covered bond funding is just an option for national legislators and there is no obligation to implement it.

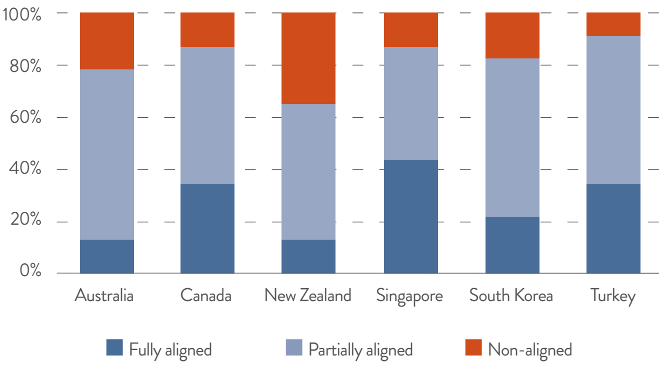
Global covered bonds are for obvious reasons typically secured by assets located outside the European Union. The Directive allows for inclusion of these assets in cover pools if these assets meet the Directive's eligibility criteria and the realisation of the assets is legally enforceable in a similar way to assets located in the EU. Most global covered bond regimes have established asset eligibility criteria and as such partially meet the Directive's requirements. For example, residential mortgage loans would generally be eligible up to the soft LTV limit of 80% specified in the (amended) CRR. However, not all frameworks explicitly provide for credit quality restrictions on exposures to institutions or third country public sector exposures or provide for the required legal certainty or property valuation in line with the CRR language.

Global covered bond regimes do provide for nominal coverage, but are not always as detailed as the Directive with reference to a) the cover assets that should contribute to the coverage requirement, i.e. being the primary assets, substitution assets, assets held for liquidity buffer purposes, claims related to derivative plus the statutory overcollateralisation, or b) with reference to the specific exclusion of defaulted claims from the cover pool.

The minimum required nominal overcollateralisation level of 5%, as specified in the amended CRR, is only met by one country on the level of the legal framework. It is often met on an issuer-by-issuer basis on a contractual level. Only when the voluntary overcollateralisation is considered too, all jurisdictions would meet this CRR requirement. However, according to the proposed amendment of the CRR, EU Member States may apply a lower overcollateralisation requirement of at least 2% if the calculation of the overcollateralisation is either based upon a model that takes into account the underlying risk (weights) of the assets, or a model where the valuation of the assets is subject to the mortgage lending value.

None of the countries explicitly provide for a 180 days liquidity rule, even though other types of liquidity provisioning can often be found in global frameworks.

FIGURE 10 | DIRECTIVE ALIGNMENT (NON-EEA)



Source: ECBC Global Issues Working Group

Global covered bond regimes are subject to covered bond public supervision but would for instance not explicitly require by law that competent authorities should have the expertise, resources, operational capacity, powers and independence necessary to carry out the function of covered bond public supervision. Global covered bond regimes require permission from the competent authority to issue covered bonds, but some countries lack detailed requirements for permission. Provisions for supervision in insolvency or resolution are also often not as detailed as stipulated in the Directive, while there are notable differences between the global frameworks on the reporting requirements to the competent authorities. Not all global covered bond regimes fulfil the requirements for an independent covered bond monitor. But since this feature doesn't have to be implemented by EU Member States, this could not be regarded as a misalignment with the EU Directive.

Equivalent Treatment of covered bonds issued by credit institutions outside the EEA

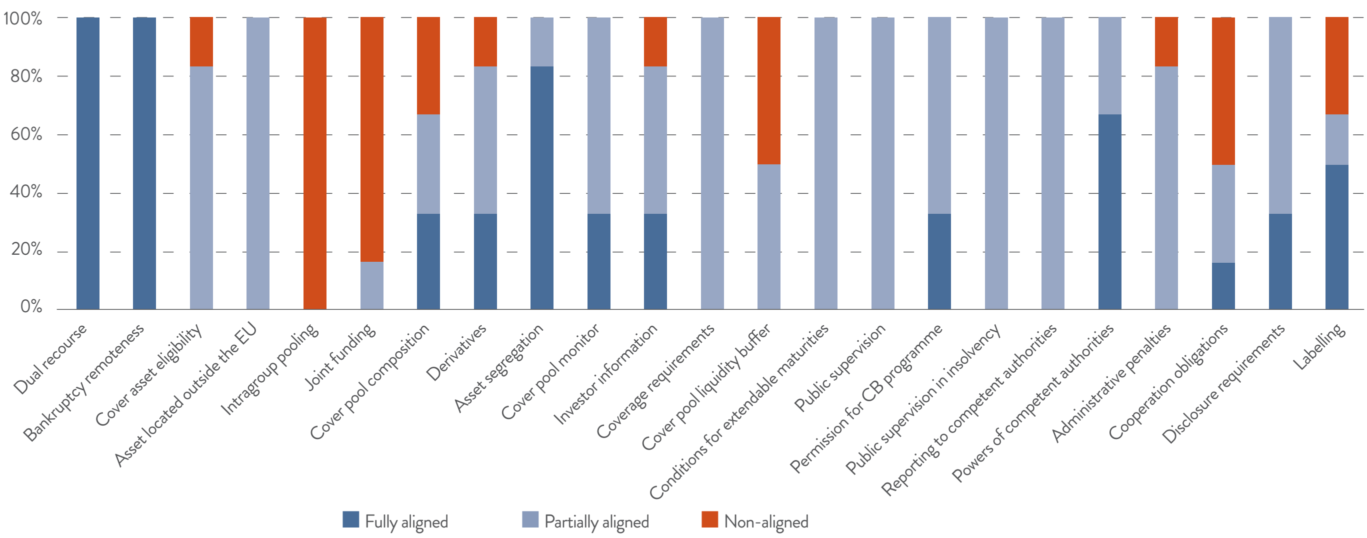
While the European Commission intended to assess the need and relevance of an equivalence regime for third-country issuers and investors in covered bonds first, the European Parliament proposes to start the process of introducing an equivalence regime right away. Therefore, alignment of the regulatory treatment of EEA covered bonds and their comparables outside the block remains an important work in progress.

GLOBAL BEST PRACTICES – MEASURED ON THE BASIS OF EBA'S HARMONISATION PROPOSALS

In the previous chapter we analysed the alignment of global covered bond regimes with the EU Directive and Regulation proposals. This analysis is a follow up to previous research of the GIWG on the positioning of global covered bond regimes with reference to the EBA's harmonisation proposals. We summarise the findings of the latter analysis in this section.

As input to the European Commission's work on the covered bond Directive and Regulation, the EBA suggested in December 2016 a three-step approach covering important features of covered bonds.

FIGURE 11 | DIRECTIVE ALIGNMENT PER REQUIREMENT (NON-EEA)



Source: ECBC Global Issues Working Group

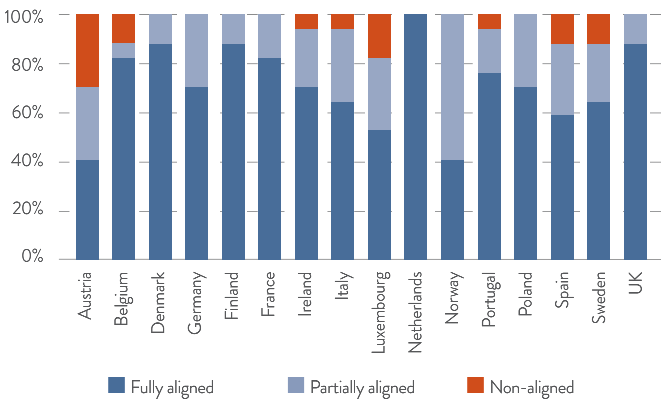
- According to the proposal, in **step 1** the following aspects should be addressed by a *European covered bond framework*: Dual recourse, asset segregation, bankruptcy remoteness; coverage, liquidity, derivatives; asset monitor, issuer supervision, post insolvency supervision, administration; transparency and rules regarding soft bullet and conditional pass-through structures.

- In **step 2** the *conditions for preferential risk weighting*, specified in Article 129 of the CRR, should be enhanced. In order to receive a preferential risk weight, covered bonds need to comply with the requirements of the European covered bond framework and on top of that with enhanced requirements of Article 129 CRR, which should cover conditions on eligible and substitution assets, LTV-limits and minimum overcollateralisation.

- **Step 3** proposals comprise the cover pool composition, assets in non-EEA jurisdictions, LTV measurements and stress tests, all of which should be subject to *voluntary convergence*.

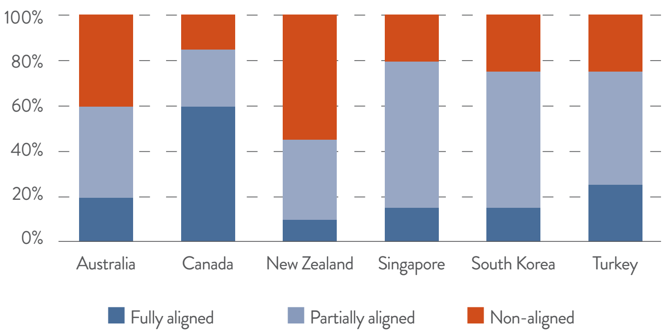
The GIWG concentrated its analysis on non-EEA countries, as the EBA had already disclosed the alignment of EU countries with the EBA's 2014 best practices proposals (please see Figure 12 below). The results were very interesting. Despite, at first sight, a more moderate full alignment with the harmonisation proposals in non-EEA countries (please see Figure 13 below), the level of compliance with a large number of the EBA's covered bond proposals was not that different for non-EEA countries from the EU.

FIGURE 12 | BEST PRACTICES ALIGNMENT (EEA)



Source: EBA

FIGURE 13 | HARMONISATION ALIGNMENT (NON-EEA)



Source: ECBC Global Issues Working Group

In more detail, the EBA proposals regarding dual recourse and asset segregation are more or less already fulfilled on a global level and to a large extent, there is compliance with LTV-limits. While the requirements concerning bankruptcy remoteness are generally fulfilled, operational plans are hardly to be found.

Rules regarding the appointment of a cover pool monitor are generally in place, but the description of its reporting duties vis-à-vis the competent authorities is not always as detailed as in the EBA's proposals. The requirements for the going-concern supervision of the issuer are in most cases not fully met. The national rules regarding post insolvency supervision and administration are also often not in line with EBA's proposals.

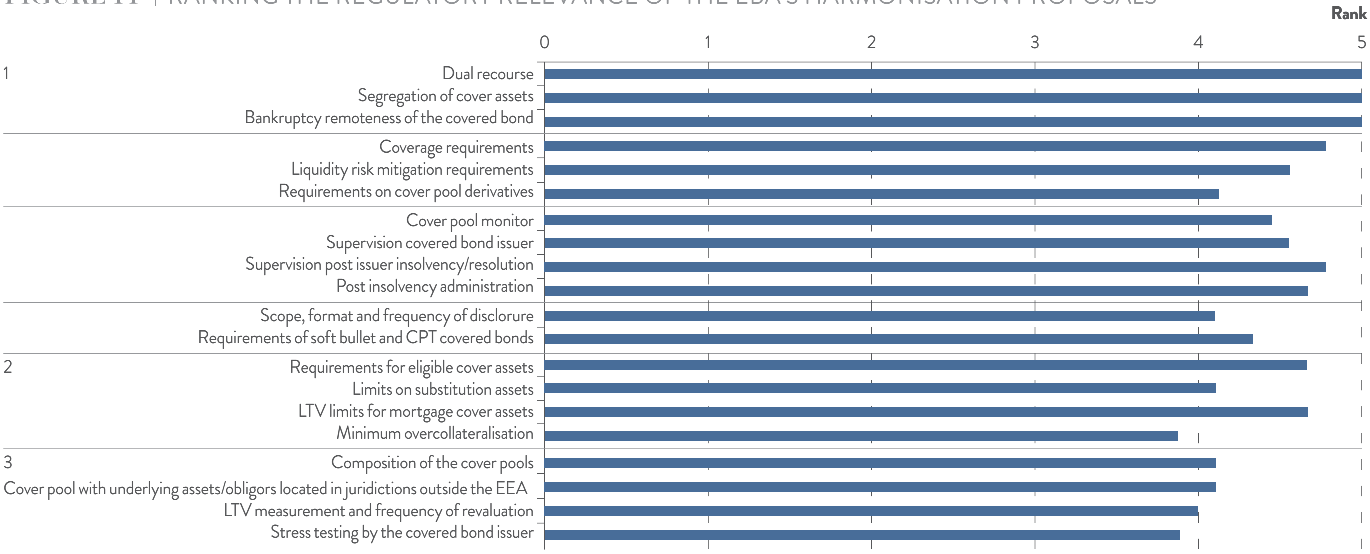
Almost all non-EEA covered bond regimes require a minimum overcollateralisation, even though sometimes lower than 5%. However, the national coverage requirements usually do not address administrative costs post issuer insolvency and liquidity buffers are not common in non-EEA covered bond frameworks either. Finally, some jurisdictions do not provide for transparency requirements at all, while others do partially or even fully meet them.

Mapping the relevance of the harmonisation proposals

The EBA's harmonisation proposals marked a detailed and valuable set of guidelines for regulators across the globe establishing or rethinking the regulatory requirements for covered bonds or the preferential regulatory treatment thereof. However, to offer some indication regarding the level of importance of all these proposals for the purpose of (drafting) covered bond regimes, the GIWG sought to identify the most important aspects that should be regulated as a minimum. To this purpose, nine global covered bond experts within the GIWG independently assigned scores to all the EBA's harmonisation proposals, including the specified details underlying each generic requirement.

The results show that on a scale of 1 (irrelevant) to 5 (highly relevant), all the generic harmonisation requirements are either relevant (4) or highly relevant (5), with an average score ranging from 4 to 5 (please see Figure 14 below). With the highest possible average score of 5, all respondents were unanimous in their judgment that the requirements assuring dual recourse, the asset segregation and bankruptcy remoteness of the covered bonds should be regulated in detail.

FIGURE 14 | RANKING THE REGULATORY RELEVANCE OF THE EBA'S HARMONISATION PROPOSALS



Source: EBA, ECBC Global Issues Working Group

Almost as equally important are the specification of minimum coverage requirements, the cover asset eligibility criteria, including LTV restrictions for mortgage cover assets, and the establishment of requirements for supervision post issuer insolvency/resolution and the post insolvency administration of the covered bond programme.

The conditions for voluntary convergence, including criteria for the composition of cover pools, cover pools with assets located in non-EEA jurisdictions, LTV measurement and the frequency of revaluation and stress testing are also relevant, but not as highly relevant as the aforementioned conditions. The same holds for certain step 1 and 2 requirements related to cover pool derivatives, disclosure criteria, limitations on substitution assets and a minimum overcollateralisation level.

It is interesting that the harmonisation requirements highlighted in **Figure 13** as the most relevant, such as dual recourse, asset eligibility criteria, coverage requirements and supervision of the covered bond issuer, show a strong overlap with the qualitative standards for covered bonds indicated in the **Covered Bond Label Convention** (please see Table 1). This confirms the high-added value of the Covered Bond Label as a quality mark for covered bonds.

TABLE 1 | THE COVERED BOND LABEL CONVENTION CRITERIA

I. LEGISLATION SAFEGUARDS

a) The CB programme is embedded in a dedicated national CB legislation;

b) The bond is issued by -or bondholders otherwise have full recourse, direct or indirect, to- a credit institution which is subject to public regulation and supervision;

c) The obligations of the credit institution in respect of the cover pool are supervised by public supervisory authorities.

II. SECURITY FEATURES INTRINSIC TO THE CB PRODUCT

a) Bondholders have a dual claim against:
   i. The issuing credit institution as referred to in point I b);
   ii. A cover pool of financial assets (mortgage, public sector or ship assets), ranking senior to the unsecured creditors.

b) The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times.

c) Issuers are committed to providing regular information enabling investors to analyse the cover pool, following the Harmonised Transparency Template and in compliance with the transparency requirements of Article 129(7) of the CRR.

Source: ECBC, Covered Bond Label

Not all specified details are equally relevant

Despite the (high) relevance of the generic requirements, not all the EBA's suggestions detailing them are considered equally important. To assure bankruptcy remoteness for instance, it is highly relevant that a covered bond framework assures that there is no automatic acceleration of payments upon issuer insolvency and grants covered bondholders a priority claim to the cover assets. However, the importance of the establishment of an operational plan to assure continuity of the administration function post issuer insolvency is disputed, with some respondents considering this even irrelevant.

Liquidity risk mitigation requirements are also considered very relevant, but it is for instance not that important that the liquidity buffer is segregated and held separately from the other cover assets within the cover pool or remains segregated from other liquid assets held for the purpose of the LCR.

Table 3 provides an indicative overview of the most relevant regulatory requirements to cover in a covered bond framework. All the suggested requirements that are scored at least 4.5 by the GIWG are included in the "very relevant" column, while all proposals that obtained a score of at least 4 or higher (albeit below 4.5) are in the "relevant" column. The table indicates for instance, that in order to assure dual recourse, it is of utmost importance that covered bondholders have a) a claim on the covered bond issuer, b) a priority claim on the cover assets, and c) a claim on the issuer's insolvency estate that is pari passu to the claim of unsecured credits (but not senior to this claim, unless the issuer is a specialised covered bond issuer).

THE CURRENT STATE OF PLAY ON THE INTRODUCTION OF PREFERENTIAL RISK WEIGHTS FOR COVERED BONDS AT GLOBAL LEVEL

Basel III reforms pave the way for preferential risk weight treatment on a global level

In December 2017, the Basel Committee on Banking Supervision finalised its post-crisis regulatory reforms. This includes preferential risk-weights for covered bonds on global level for the first time. The requirements set by the Basel Committee are built on the more general conditions according to Article 52 (4) of the UCITS-Directive and similar to the additional requirements according to Article 129 of the CRR. The eligible cover assets are restricted to public sector assets and to claims secured by residential and commercial real estate. Claims on banks are eligible up to 15% of outstanding covered bonds. In contrast to Article 129 of the CRR, ship mortgages do not qualify as eligible assets.

While the transparency requirements are more or less in line with Article 129 of the CRR, Basel requires a nominal overcollateralisation of 10%, which goes beyond the requirements at European level. However, national legislations do include overcollateralisation requirements, which vary strongly. In its proposal for a harmonisation of European covered bond frameworks the European Commission asks for an overcollateralisation of 5% and Member States may apply a lower overcollateralisation requirement of at least 2% if the calculation of the overcollateralisation is either based upon an approach taking into account the underlying risk of the assets, or an approach where the valuation of the assets is subject to the mortgage lending value.

TABLE 2 | RISK WEIGHT TABLE FOR RATED COVERED BOND EXPOSURES ACCORDING TO THE BASEL COMMITTEE

Issue-specific rating of the covered bond	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-
"Base" risk weight	10%	20%	20%	50%	100%

Source: Basel Committee on Banking Supervision; Basel III: Finalising post-crisis reforms

The status on third country equivalence within the EU

As discussed earlier in this article, the European Commission decided to leave the equivalent treatment of covered bonds issued by non-EEA credit institutions outside the scope of its proposals for a covered bond Directive and Regulation. Instead, the Commission proposed to submit a report to the European Parliament and Council within three years after the provisions of the Directive have to be applied. The Council is of the view this should be done within two years.

The European Parliament, in turn, believes that the Commission should already start adopting delegated acts on third country equivalence to supplement the Directive. These acts would determine that *"the legal supervisory and enforcement arrangements of a third country are I) equivalent to the Directive's requirements on the structural features of covered bonds and covered bond public supervision, and II) effectively applied and enforced in an equitable and non-distortive manner in order to ensure effective supervision and enforcement in that third country"*. Covered bonds of an issuer in an equivalent third country should, as such theoretically, have met the Directive's requirements on the structural covered bond features.

The European Parliament also proposes that the Commission should, in cooperation with the EBA, monitor the effectiveness of the requirements on the structural features of covered bonds in third countries and should regularly report on this to the European Parliament and the Council. If the equivalent requirements are insufficiently applied by third country authorities, or if there is a material regulatory divergence, the Commission could consider withdrawing the equivalence recognition of a country's legal framework based upon a pre-defined transparent procedure.

It remains to be seen what the result of the trilogue negotiations will be and how long the finalisation of the legal bases will take. However, while there is some uncertainty regarding the timing, all involved parties appear to be committed to an equivalent treatment of third country covered bonds.

IN SUMMARY

The overall conclusion is that the proposals for a European Covered Bond Directive and the EBA's earlier harmonisation proposals, can be considered a good starting point for fundamental principles of covered bonds at a global level. These principles should cover the following aspects: dual recourse, bankruptcy remoteness, asset segregation, asset eligibility criteria (incl. LTV), minimum coverage requirements and special supervision (incl. asset monitor). These are criteria that are also broadly covered by the qualitative standards for covered bonds under the Covered Bond Label Convention.

The introduction of preferential risk-weights for covered bonds in the Basel framework is a great success and could potentially boost the use and investment in covered bonds worldwide. However, it should not prevent the covered bond industry from defining fundamental principles for covered bonds going beyond the Basel requirements. The European Commission decided to leave the potential equivalent treatment of non-EEA covered bonds outside the scope of its Directive proposals, but not without commitment to assess the relevance hereof within three years. This all underscores the strengthening of the covered bond footprint on a global level as a secure and important funding tool for banks, serving global economic purposes.

TABLE 3 | LISTING MINIMUM REGULATORY REQUIREMENTS – THE MOST RELEVANT HARMONISATION PROPOSALS ACCORDING TO THE MEMBERS OF THE GIWG

REQUIREMENT	VERY RELEVANT (≥4.5)	RELEVANT (≥4.0)
1) STANDARD STRUCTURAL REQUIREMENTS		
Dual recourse	Claim on the covered bond issuer	
	Priority claim on the cover assets	
	Pari passu claim unsecured creditors	
	Specialist issuers: senior to unsecured	
Asset segregation	Effective legal segregation of assets	
	Legally binding and enforceable	
	Segregation agreement incl. primary and substitution assets	Segregation agreement includes assets liquidity buffer, cover pool derivatives, voluntary OC
Bankruptcy remoteness	Covered bondholders have priority claim	Issuer should have an operational plan
	No automatic acceleration payments	(updated at least annually, availability cover pool data, IT system readily available to administrator)
Coverage requirements	Payments on assets equal to obligations on covered bonds	
	Scope assets: Principal, interest,	
	Scope liabilities: Principal CB,	Cover pool derivatives
	Coverage: Nominal,	Interest CB, Operational costs
		Soft LTV restrictions
Liquidity risk mitigants		Establishment liquidity buffer
		LCR Level 1 and 2a assets, exposures to institutions
		Should be part of coverage requirements
Derivative requirements		Derivative contracts allowed exclusively for hedging
		Standard industry master agreement
		Part of the cover, no termination upon issuer insolvency
		Counterparty eligibility requirements
Cover pool monitor	Duties of reporting to supervisor	Rules on appointment and dismissal
		Eligibility criteria and specification main duties
		Should be separate from issuer's ordinary auditor
Going concern supervision	Special supervisory role supervisor	Issuer should have adequate operational procedures
	Monitoring compliance with requirements	Legal restrictions should be met by the issuer
	Approve establishment programme	Cover pool should meet the minimum requirements
	Regular reporting by the issuer	Distribution tasks between competent authority, resolution authority, asset monitor and administrator
	Notification in case of ownership transfer	
Supervision post insolvency	Description powers competent authority and administration of programme	Approval of transfer of assets and obl. to other issuer
		Coordination of information between competent authority, special administrator and resolution authority
Post insolvency Administration	Independent management CB programme	Detailed provisions duties/powers administrator
		Rules on appointment of the special administrator
		Rules on objectives and duties of the administrator

Transparency	Information on required coverage, contractual and voluntary OC	Scope: credit risk, market risk and liquidity risk features
	Information on structure covered bond	Information on counterparties, methodology for property valuation and LTV calculation
		Transaction documents should be published
		Information should be disclosed at least quarterly and standardised format from a common point of access
Requirements SB and CPT		Maturity extension may not be affected by the issuer
		Maturity extension may only be affected at the discretion of the special administration
		Covered bond investors and pari passu creditors must be treated equally after maturity extension

2) CONDITIONS FOR PREFERENTIAL RISK WEIGHTING		
Requirements eligible assets	Exposures to EU and 3rd country entities	Residential guaranteed loans
	Exposures to institutions (up to 15%)	Ship loans
	Residential and commercial mortgages	Scope of assets should not be widened
Limits substitution assets		Cover assets identified under CRR Art 129(1)(a-c) should be eligible, subject to limits Art 129(1)
LTV limits mortgage assets	80% residential mortgage loans	
	60% commercial mortgage loans	
Minimum OC	Treatment of voluntary OC in a resolution should be specified by statutory law	Minimum effective OC should be 5%
		In case of partial transfer voluntary OC should be subject to the segregation requirements (not separate)
		Partial transfer may never result in under-coverage

3) VOLUNTARY CONVERGENCE		
Composition cover pool	Mixed pools for mortgage loans	Mixed mortgage pools should be subject to disclosure and safeguards
Non EEA assets	For mortgage assets outside the EEA, CRR Art 208(2) should be met and underwriting standards should be similar to the EU	
LTV measurement		Mortgage enforceability requirements CRR Art 208 and valuation principles CRR Art 229 should be met
		Expansion property valuation rules Art 208 & 229 CRR
		Annual valuation to determine LTMV
Stress testing	Stress test on coverage requirements:	
	-Shift of interest rate curves	-Shift in currency pairs
		-Stress on market prices of physical underlying assets
		Summary of stress test results should be published

Source: EBA, ECBC Global Issues Working Group

SECTION IV. INVESTOR SURVEY

By **Franz Rudolf**, UniCredit Bank and **Lily Shum**, Canada Mortgage and Housing Corporation

The first part of the GIWG investor survey aims to capture the investors' perspectives on key features of covered bonds. The second part of the survey examines the investors' views on EEA covered bonds vs non-EEA covered bonds. The purpose of the survey is to capture the investors' view on EBA proposals and on preferential regulatory treatment of covered bonds from non-European third countries.

Survey results were gathered from 24 respondents, of which 19 were investors from banks, insurance companies and asset managers and 5 respondents were issuers, rating agency analysts and credit analysts. For global representation, respondents were based in Germany, Denmark, France, UK, Canada, USA, Switzerland, Luxembourg, Italy, Poland and Greece.

KEY FEATURES OF COVERED BONDS IN INVESTMENT DECISIONS – NOT ALL FEATURES A "MUST HAVE"

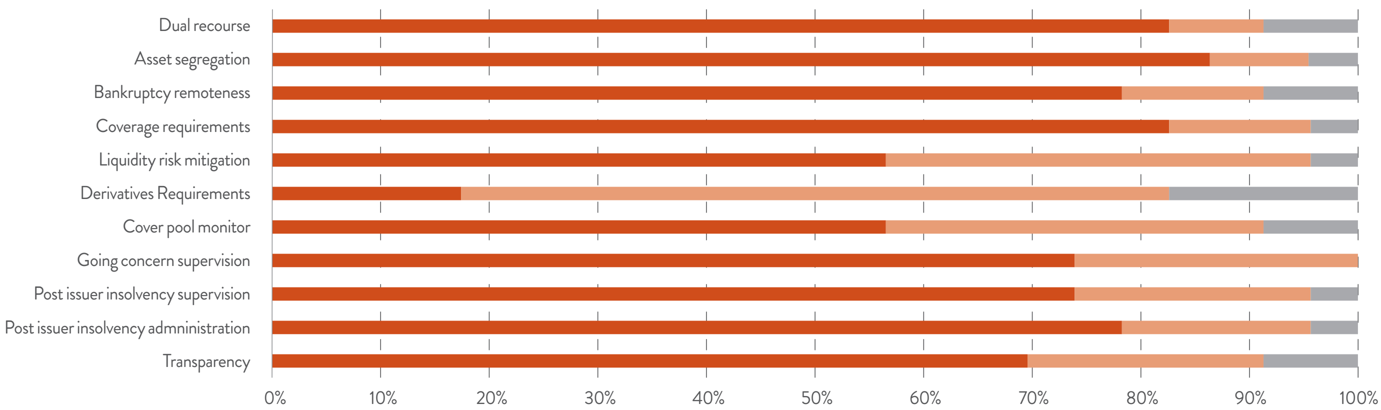
Respondents were asked to evaluate the key features of covered bonds. Over 75% of respondents identified the features of dual recourse, asset segregation, bankruptcy remoteness and coverage requirements as necessary features consistent with the observations outlined in Section III. Derivatives requirements was a "nice to have" by 65% of respondents.

COVERED BONDS FROM NON-EEA COUNTRIES

Respondents were then asked whether they see a price advantage for covered bonds enjoying preferential regulatory treatment (e.g. regarding risk weight, LCR etc) assuming all else equal. Almost all the respondents (91% of respondents) stated there was a clear price advantage associated with covered bonds enjoying preferential regulatory treatment, with most estimating the price advantage to fall between 3-10 bps.

Respondents were also asked how their investment decisions are impacted by the extension of preferential regulatory treatment to non-EEA covered bonds, in which half of the respondents indicated there would be greater interest in non-EEA covered bonds, and 39% indicating relative pricing of non-EEA covered

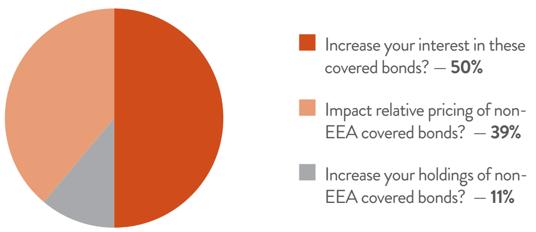
FIGURE 15 | KEY FEATURES OF COVERED BONDS IN INVESTMENT DECISIONS



Source: ECBC Global Issues Working Group survey, n = 24

FIGURE 16 | EXTENSION OF PREFERENTIAL REGULATORY TREATMENT

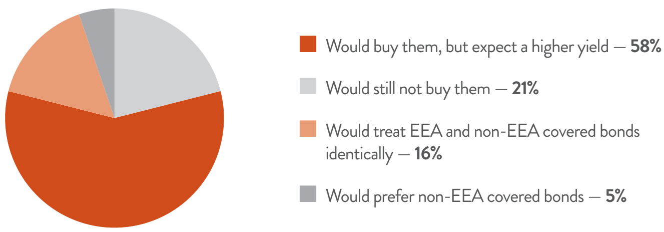
Does the extension of preferential regulatory treatment to non-EEA covered bonds



Source: ECBC Global Issues Working Group survey, n = 24

FIGURE 17 | EXTENSION OF PREFERENTIAL REGULATORY TREATMENT

If preferential regulatory treatment was extended to non-EEA covered bonds



Source: ECBC Global Issues Working Group survey, n = 24

bonds would change (Figure 16). Of special interest, if preferential regulatory treatment were extended to non-EEA covered bonds, over half of the respondents (58%) would then buy non-EEA covered bonds, but only with a higher yield (Figure 17). So, while extension of preferential regulatory treatment to non-EEA covered bonds could narrow the pricing differential between EEA and non-EEA covered bonds, there may still be a higher yield compared to EEA covered bonds, based on investor expectations.

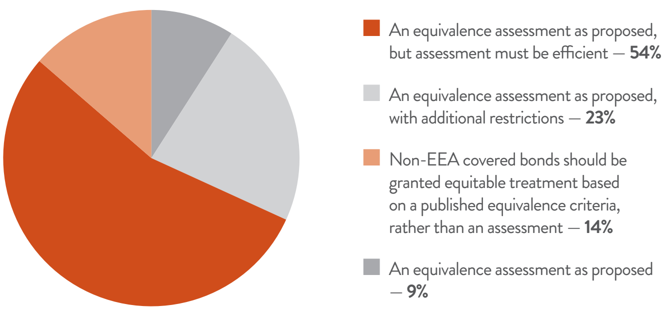
Finally, views were sought on an equivalence assessment as a means to qualify covered bonds from non-EEA countries for equitable treatment. Responses were mixed with over half of respondents indicating that an equivalence assessment must be efficient, while 23% recommended an equivalence assessment with additional restrictions (in addition to examining legal, institutional and supervisory environment) and 14% preferred published equivalence criteria over an equivalence assessment conducted. Based on the mixed views, the criteria for the recognition of equivalence need to be further assessed in light of the recent Basel recommendation of preferential risk weights for covered bonds.

IN SUMMARY

Not all features specified in EBA proposals are identified as necessary by investors, however, features such as asset segregation, dual recourse, bankruptcy remoteness and coverage requirements still emerge as key critical features for investors. Providing equitable treatment to non-EEA covered bonds would raise greater awareness and interest in non-EEA covered bonds, with some even indicating relative pricing of non-EEA vs EEA covered bonds would be impacted. Greater investor interest can help facilitate further cross-border capital market activities and provide greater geographic diversification in investment portfolios, in particular for bank treasury portfolios, which is an important contribution to stability. Assuming all else equal, investors view a price advantage to be associated with covered bonds enjoying preferential regulatory treatment, however, investors may still expect a higher yield even if equitable treatment was extended to non-EEA covered bonds. The criteria by which the covered bond definition is extended warrants more discussion, in light of the recent Basel recommendation.

FIGURE 18 | COVERED BONDS IN NON-EEA COUNTRIES AND EQUIVALENCE ASSESSMENT

Covered bonds in non-EEA countries and equivalence assessment



Source: ECBC Global Issues Working Group survey, n = 24

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