EMF | ECBC
EUROPEAN MORTGAGE FEDERATION
EUROPEAN COVERED BOND COUNCIL

ECBC GLOBAL ISSUES WORKING GROUP **Brochure**

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SECTION I. INTRODUCTION

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

COVID-19

In the context of the current COVID-19 outbreak and the significant impacts that this is now expected to have on the global economy, the European Mortgage Federation – European Covered Bond Council (EMF-ECBC) stands ready to act in the interests of consumers, lenders and investors to help secure financial stability and stimulate socio-economic recovery. In particular, we are acutely aware of and concerned about the potential consequences of this outbreak on the economic well-being of each and every European citizen in terms of changes in their income and ongoing living costs, as well as the potential impacts on the entire value chain, the functioning of capital markets and ability of investors to conduct due diligence.

As a first concrete step towards supporting efforts to address current and future economic challenges in the context of the COVID-19 outbreak, the EMF-ECBC has established a special Task Force on COVID-19. At the time of writing, the work of the Task Force is already underway to, in the first instance, analyse the impacts on mortgage and covered bond markets, compile relevant national, European and international measures, and gather critical statistics. Using this intelligence, the Task Force will move into a second stage, during which it will identify market best practices and solutions with a view to delivering market coordination and support to a future recovery plan. Crucial to this will be a dynamic dialogue with EMF-ECBC members in Europe and globally, as well as European and international institutions and organisations.

A QUICK GLANCE AT THE GLOBAL PICTURE

For over 250 years 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. Moreover, with the adoption of a Covered Bond Directive in the EU, further clarity as what is considered to be a covered bond is achieved. 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.

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.

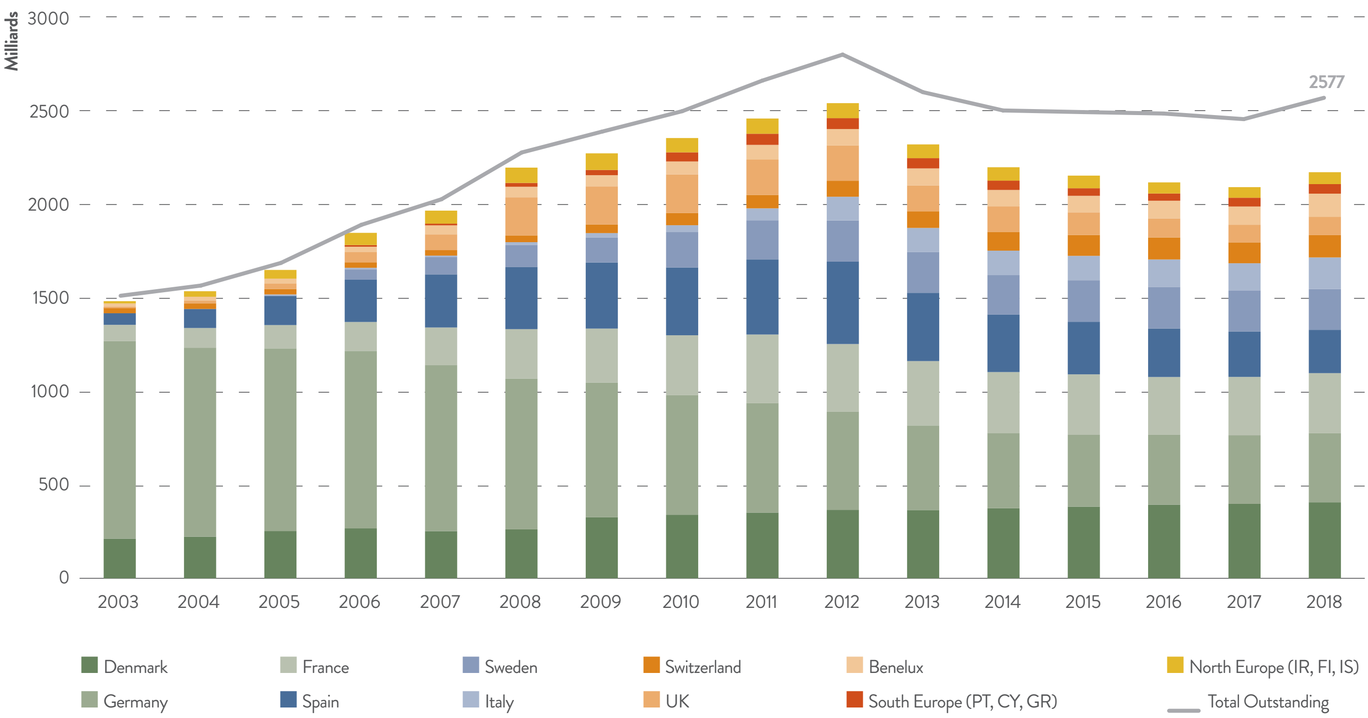
Moreover, the EU adopted, end of 2019, the Covered Bond Legislative Package, comprising a Covered Bond Directive and a Regulation amending Art 129 of the Capital Requirement Regulation, namely the article focusing on covered bonds. The Directive entered into force on 8 January 2020 and will be fully effective after 30 months, i.e. 8 July 2022. Specifically the 18-month implementation period of the directive will definitely have an impact on the covered bond markets, bringing new risks and opportunities at both European and 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 2018, for the first time in five years' time, the outstanding covered bond market grew by 4.7% to EUR 2.58 tn. Since its peak reached in 2012 (EUR 2.8 trillion), outstanding volumes have nevertheless fallen by 13%, a drop mostly driven by the public-sector backed covered bonds[1]. This positive development has widespread routes with 32 out of 36 active covered bond markets showing an expansion. New issuances in 2018 surpassed the EUR 500 bn mark showing an increase of 12.3%. with respect to 2017. The most common collateral used for covered bonds is a mortgage which accounts for EUR 2.2 tn or 88.3% 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 51.6% (**Figure 1, Figure 2**).

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 2019.

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 January 2020, 132 labels have been granted to 111 issuers from 20 countries, covering over EUR 1.8 tn of covered bonds outstanding, where over 5,300 covered bonds include information on the Liquidity Coverage Requirement (LCR) maturity structures, regulatory treatment, etc.

In this context, covered bond issuers from these 20 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. As last addition in 2019 the HTT reporting tool has been developed which enables to visualise on the Covered Bond Label website the information contained in the HTT thanks to a set of predetermined charts.

The critical mass achieved by this initiative (over 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. It is important to highlight currently three non-EEA countries, Canada, Singapore and South Korea in aggregate hold 12 labelled cover pools, linked to 146 covered bonds which account for over EUR 132 bn, equivalent to 42% of the non-EEA covered bond market share.

LOOKING AHEAD

The Industry has demonstrated that through market initiatives such as the Covered Bond Label and the European Secured Note (ESN) 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.

In line with the general trend of the growing presence of sustainable finance, also the covered bond industry has already embraced the challenge and at the time of writing on the Covered Bond Label 26 sustainable covered bonds worth over EUR 16 bn have been registered by a variety of jurisdictions. The challenges ahead are characterised by agreeing on a shared set of definitions in order to define sustainable and ESG criteria for the underlying assets in the cover pool.

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 Economic Area

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

Covered bonds represent an over EUR 2.6 tn 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). In 2018 after a stall in 2017 the non-EEA market share continued to increase reaching 7.6% thanks also to the first ever covered bond issuance in Brazil and Japan. In terms of growth, the Americas lead the pack with 16%, followed by Asia/Pacific at 7% and Europe at 4%.

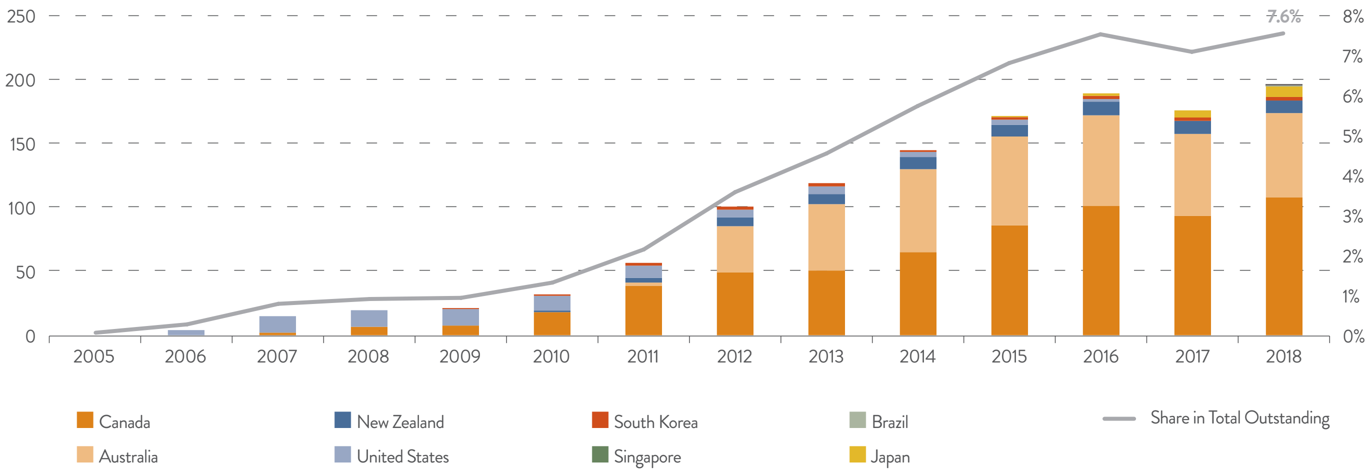
The global financial crisis proved that covered bonds can be a resilient source of funding in times of wider market turmoil. Even in the European countries most affected by the crisis, such as Italy and Spain, banks were able to tap the covered bond market despite other sources of wholesale funding evaporating.

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 have created favourable conditions to establish covered bond programs in new countries. We believe that market conditions will remain supportive for covered bonds in new jurisdictions in the next few years. 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, OUTSTANDING AMOUNTS (EUR BN) AND SHARE OF THE TOTAL



Source: EMF-ECBC Statistics Department

NORTH AMERICA

Canada represents one of the most successful covered bond markets outside Europe, with over 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: Canadian Market by Lily Shum, Canada Mortgage and Housing Corporation (CMHC) 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)

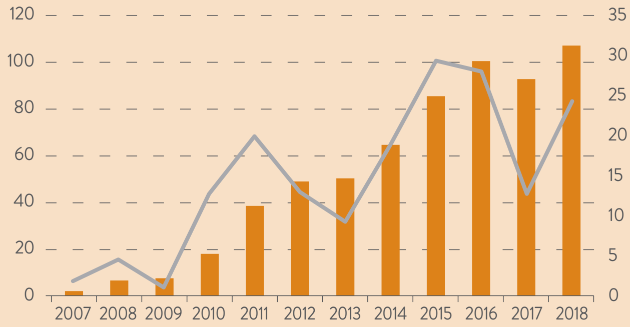
CANADA

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 ISSUANCE AND OUTSTANDING FIGURES FROM CANADIAN ISSUERS, 2007 - 2018, 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 2018, issuances denominated in Euros represented 53% 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 issue in October 2012. Panama does not have a specific legal framework for covered bonds, and these are based on contractual agreements. Chile is the only other covered market in the region, with 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 be changing thanks to the completion of covered bond regulations in Brazil in 2018 and the development of the local market during 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 LIGs. At the end of 2018, four banks announced local CB programs, and by December 2019, the total outstanding volume of LIGs was BRL 10.2 billion (approximately EUR 2.3 billion), all of which were privately placed given the lack of specific local market public placement regulation. Local BRL-denominated issuance is expected to gather speed during 2020, especially in the 2nd half of the year, following publication by the Brazilian Securities and Exchange Commission (the CVM) of the public placement rules for LIGs.

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

- The 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 issuer's balance sheet in favour of the covered bond holders is guaranteed by law, including precedence over fiscal and labour claims.
- Minimum overcollateralisation of 5%.
- A fiduciary agent must be appointed to 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 programs 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.
- The 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).

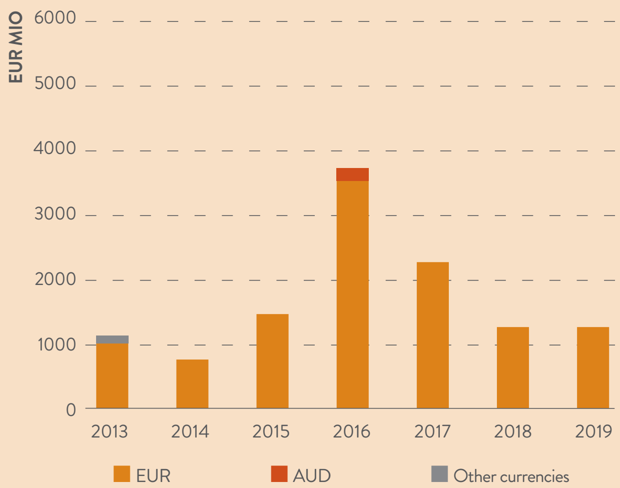
OCEANIA

Australia and New Zealand together have made up roughly 4% of overall EUR Covered Bond benchmark issuance in 2019, and have thus fallen a little behind their Canadian peers in terms of their primary market share. While there are now 11 established Covered Bond issuers in the region, only 6 (4 from Australia, 2 from New Zealand) have accessed the EUR markets in benchmark format during 2019 for EUR 4 bn and 1.25 bn, respectively. Two of the four Australian EUR benchmark issuers have, however, also issued sizeable USD Covered Bond benchmarks. One visited the GBP market and another the CHF in benchmark format, respectively. A new development has also been the appearance of Australian issuers in the private placement market for Covered Bonds.

As a result, issuers from the region now account for roughly 3% of total EUR outstandings for a total volume of just over EUR 60 bn for Australia and EUR 10 bn for New Zealand. On the regulatory front, both jurisdictions maintain asset encumbrance limits at 8% for Australia and 10% for New Zealand.

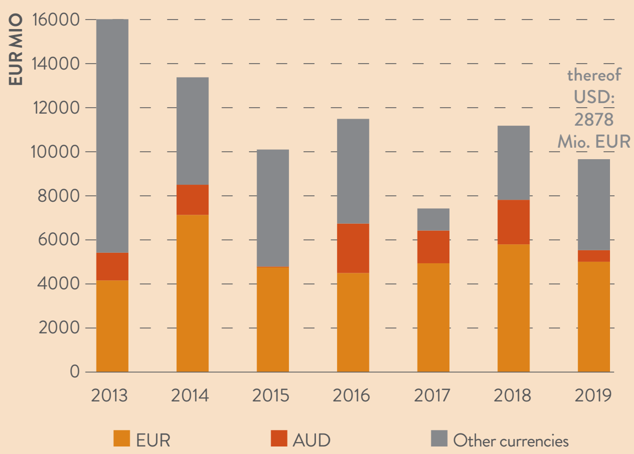
FIGURE 4 | AUSTRALIA AND NEW ZEALAND CHARTS by **Thomas Cohrs**, HELABA

PRIMARY MARKETS ACTIVITY NEW ZEALAND COVERED BONDS



Source: 2013-2018 ECBC, 2019 Bloomberg

PRIMARY MARKETS ACTIVITY AUSTRALIA COVERED BONDS



Source: 2013-2018 ECBC, 2019 Bloomberg

EUR has remained the currency of choice for most of 2019 issuance across both jurisdictions, but in somewhat less active circumstances for most issuers. After an impressive run in 2018, issuers from the Oceanian countries appear to be taking a breather in line with other issuers in the region. Reasons for this may be found both in the recent preference of European investors for long duration assets which the newer members of the global Covered Bond issuers' family have so far not provided in benchmark format and the fact that the global interest rate environment has provided ample alternative sources of funding for the banks in the region.

ASIA

South Korea and Singapore have made great advances in establishing legislative frameworks and launching covered bond programs. 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 April 15, 2014, and the Korea Housing Finance Corp. (KHFC) Act. There are currently two active covered bond issuers: Kookmin Bank and KHFC. 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. In 2019 KHFC issued the first social covered bonds in Asia and obtained the first Covered Bond Label granted to South Korea which was followed by a second one early 2020.

The regulatory framework for the issuance of covered bonds by banks incorporated in Singapore was established on Dec. 31, 2013, and refined on June 4, 2015, through the Monetary Authority of Singapore (MAS)'s Notice 648 (see Box 3.)

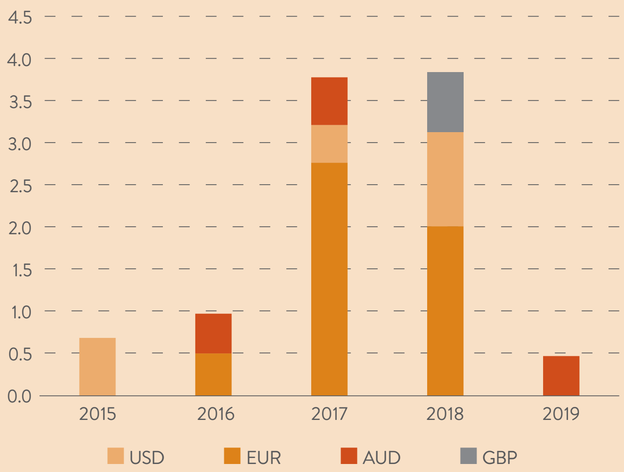
Since the legislative framework was set in place, we have observed a stable flow of covered bonds as issuers seek to maintain and manage their programs. The three domestic major banks have already set up their programs, and a few larger foreign banks also have well-entrenched and stable market share, so more covered bond programs 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 3 | 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 8.55 bn as of 31 December 2019 and issued 1 covered bond in 2019 of AUD 750 mn (Figure 5). As the market continues to grow, foreign banks incorporated in Singapore are also considering setting up covered bond programs here to tap on demand.

FIGURE 5 | COVERED BOND YEARLY ISSUANCE FROM SINGAPOREAN ISSUERS 2015-2019, EUR BN



Source: 2013-2018 ECBC, 2019 Bloomberg

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 with a slow-down in 2018. 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. 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 4 | TURKISH MARKET

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.

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 bonds 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 do not 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

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 few 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 regulatory harmonisation process 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.

Overall, the preferential treatment of covered bonds for risk weight purposes or within the scope of the liquidity coverage and net stable funding ratio requirements remains still largely a European phenomenon. Outside Europe, the treatment of covered bonds is mostly aligned with the Basel stipulations, meaning that covered bond are barely treated more favourably than senior unsecured instruments. Even the eligibility of covered bonds for central bank collateral purposes is not common place and typically restricted to national currencies.

Apart from that, the requirements for a preferential treatment of covered bonds are not always very detailed, which prompted the GIWG to conclude the currently applicable requirements for a preferential treatment of covered bonds on a global level do not offer an appropriate starting point for fundamental principles of covered bonds.

In Europe they mostly refer to Article 52 (4) of the UCITS-Directive, which also does not require much detail. This will change however under the European Covered Bond Directive. Namely, covered bonds issued as off 8 July 2022 will at least have to meet all the mandatory requirements of this Directive to remain eligible for a favourable treatment. Also covered bonds issued before that date would have to meet certain requirements from the Directive on top of the UCITS 52(4) requirements per 8 July 2022 at the latest. These include for instance the investor information requirements and certain covered bond special supervision requirements. Elsewhere, in non-European countries, the relevant laws or regulations often merely require a 'dedicated' covered bond law without outlining more details or definitions.

Having said that, the recognition and protection of the secure nature of covered bonds seem to be spreading beyond Europe. For instance, the Canadian regulator explicitly decided to shield secured liabilities such as covered bonds from the bail-in tool applicable to domestic systemically important banks (D-SIBs) under the Canadian resolution regime effective since September 2018. Furthermore, the Basel III reforms announced at the end of 2017 do plea for a more favourable risk weight treatment for covered bonds, paving the way for a preferential treatment of covered bonds on a global scale.

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 (BCBS) finalised its post-crisis regulatory reforms. These include preferential risk-weights for covered bonds on global level for the first time as of 1 January 2022. The requirements set by the Basel Committee are founded on the more general conditions according to Article 52 (4) of the UCITS-Directive and similar to the additional requirements according to the current Article 129 of the CRR.

Covered bonds are defined as bonds issued by a bank or mortgage institution subject by law to special public supervision designed to protect bondholders. Proceeds of bond issuance must be invested conform the law in assets that are, during the whole period of validity of the bonds, capable of covering claims attached to the bonds. In the event of a failure of the issuer these proceeds would be used on a priority basis for the reimbursement of the principal and the payment of accrued interest.

The eligible cover assets are restricted to public sector assets and to claims secured by residential and commercial real estate subject to LTV cut-off percentages of 80% and 60% respectively. Claims on banks (A- or better rated) are eligible up to 15% of outstanding covered bonds. Additional collateral may also include substitution assets and derivatives entered into for the purpose of hedging risks related to the covered bond programme. In contrast to Article 129 of the CRR, ship mortgages do not qualify as eligible assets.

The transparency requirements are more or less in line with the current Article 129 of the CRR, but Basel requires a nominal overcollateralization of 10%, which goes beyond the requirements at European level. While the European Covered Bond Directive agreed late 2019 does not require a mandatory overcollateralization, the amendment of Article 129 CRR asks for a minimum nominal level of overcollateralization of 5% on a statutory, contractual or voluntary basis. Hence even where national legislations may not provide for the minimum (statutory) overcollateralization level required for a preferential risk weight treatment, issuers themselves may decide to either contractually commit to or voluntarily hold sufficient overcollateralization to meet the requirements. The Basel reforms do require issuing banks to publicly disclose on a regular basis that the 10% overcollateralization target is met in practice.

FIGURE 6 | RISK WEIGHT TREATMENT FOR EXPOSURES TO RATED COVERED BONDS

External rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-
Basel III (reformed)	10%	20%	20%	50%	100%
Basel III (current)	20%	50%	50%	100%	150%
CRR (current)	10%	20%	20%	50%	100%

Source: Basel Committee on Banking Supervision, European Commission

FIGURE 7 | RISK WEIGHT TREATMENT FOR EXPOSURES TO UNRATED COVERED BONDS

Risk weight issuing bank	20%	30%	40%	50%	75%	100%	150%
Basel III (reformed)	10%	15%	20%	25%	35%	50%	100%
CRR (current)	10%	–	–	20%	–	50%	100%

Source: Basel Committee on Banking Supervision, European Commission

THE STATUS ON THIRD COUNTRY EQUIVALENCE WITHIN THE EU

In Europe, the equivalent treatment of covered bonds issued by non-EEA credit institutions was left outside the scope of the Covered Bond Directive and the amendments to Article 129 of the CRR. Instead, the European Commission will submit a report on third country equivalence to the European Parliament and Council within two years after the provisions of the Directive have to be applied. This report may be accompanied by a legislative proposal on whether or how an equivalence regime should be introduced. However, EU member states are given until 8 July 2021 to transpose the Directive into national law, while the provisions of the Directive and amendments to Article 129 CRR will not have to be applied until 8 July 2022 at the latest. Hence, the timespan for the third country equivalence discussions in Europe may even stretch more than two years beyond the date the Basel III reforms should enter into force in January 2022.

Albeit one year shorter than the deadline initially proposed by the European Commission for the third country equivalence report, the two year outcome is still less favourable than the European Parliament's initial stance. The European Parliament was of the view that the Commission would already have been able to 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"*. The Parliament also argued that the Commission should, in cooperation with the European Banking Authority (EBA), monitor the effectiveness of the structural covered bond requirements in third countries and regularly report on this to the Parliament and Council. If the equivalent requirements would be insufficiently applied by third country authorities, or if there is a material regulatory divergence, the Commission could consider withdrawing the equivalence recognition based upon a pre-defined transparent procedure.

Even though the third country equivalence discussions will have a longer term horizon, European regulators do seem committed to consider an equivalent treatment of third country covered bonds. Judging the European Parliament's proposals for earlier adoption of delegated acts on third country equivalence, the Directive's structural requirements for covered bonds will probably be an important reference point for the equivalence assessments. Bearing this in mind, the next paragraph provides some insights in the alignment of global covered bond regimes with the European Covered Bond Directive, building upon the work of the ECBC Global Issues Working Group.

GLOBAL BEST PRACTICES – TO WHAT EXTENT ARE GLOBAL REGIMES ALIGNED WITH THE EU DIRECTIVE AND CRR AMENDMENTS?

In the past few years, the ECBC Global Issues Working Group analysed on several separate occasions how different global covered bond regimes meet the *proposals for covered bond harmonisation* in the EU. The first analysis, aimed to identify to what extent the different global covered bond regimes met the proposals for covered bond harmonisation in the EU, disclosed by the EBA in December 2016. The focus here has been solely on the legal frameworks of the global jurisdictions with benchmark covered bond debt outstanding.

In this section, we share some takeaways from the most recent analysis based upon the EU Covered Bond Directive and the amendments to Article 129 of the CRR in Europe as published in the Official Journal of the European Union on 18 December 2019. This update also considers the Brazilian covered bond legislation.

The results of the analysis reveal that most global covered bond regimes are fairly strongly aligned with the principles based EU Covered Bond Directive and would in most cases probably not require significant amendments to become fully aligned. This is an important observation in light of any future EU third country equivalence assessment. Importantly, there is full alignment with the Directive's dual recourse and an almost full alignment with the bankruptcy remoteness and asset segregation requirements. 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 for example the intragroup covered bond funding is just an option for national legislators. Hence there is no obligation to implement it.

Global covered bonds are for obvious reasons typically secured by assets located outside the Union. The Directive allows for inclusion of these assets in cover pools if these assets meet the Directive's eligibility criteria and 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 Article 129 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 the type of cover assets that should contribute to the coverage requirement, i.e. being the primary assets, substitution assets, assets held for liquidity buffer purposes or payment claims related to derivative contracts. Moreover, several jurisdictions lack the requirement to take into account the expected costs related to the winding-down of the covered bond programme.

The minimum required nominal overcollateralization level of 5% as specified in the amended Article 129 CRR, is only met by one country on the level of the legal framework (statutory). It is often met on an issuer-by-issuer basis on a contractual level. When the voluntary overcollateralization is considered too, all jurisdictions would meet this requirement. According to the Article 129 CRR a lower overcollateralization requirement of at least 2% may also be applied if the calculation of the overcollateralization is either based upon a formal approach that takes into account the underlying risk of the assets, or on a formal approach where the valuation of the assets is subject to the mortgage lending value.

Most global covered bond jurisdictions do not explicitly provide for a 180 days liquidity rule, even though other types of liquidity provisioning can often be found in global frameworks. While commonly allowed, also the use of extendable maturity structures is not necessarily defined by law. That said, while global legal frameworks lack objective extension triggers, maturity extension triggers are, where applicable, mostly specified in detail in the contractual terms and conditions.

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 should not be regarded as a misalignment with the EU Directive.

IN SUMMARY

The overall conclusion is that the European Covered Bond Directive and the amendment of Article 129 CRR, as the final outcome of the European harmonisation process that started with the EBA's best practices proposals in 2014, 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). It is interesting to see that these are criteria that are also broadly covered by the qualitative standards for covered bonds under the Covered Bond Label Convention.

FIGURE 8 | 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

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 Union decided to leave the third-country equivalent treatment of non-EEA covered bonds outside the scope of the Covered Bond Directive, but not without commitment to assess the relevance hereof by 8 July 2024 at the latest. This all underscores the strengthening of the covered bond footprint on a global level as a secure and important funding instrument for banks, serving global economic purposes.

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