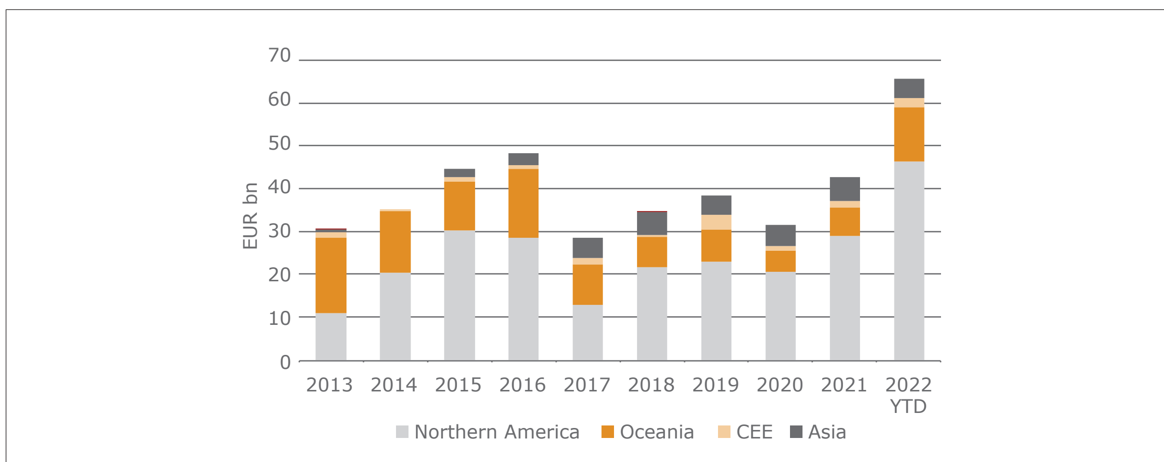
1.11 THE RISE OF NEW COVERED BOND MARKETS

By Antonio Farina, S&P Global Ratings, Colin Chen, DBS & Chairman of the ECBC Global Issues Working Group, Richard Kemmish, Consultant, and Maureen Schuller, ING Bank N.V.

OVERVIEW

Despite extended coronavirus containment measures that pushed the world into the deepest recession since the Great Depression, the covered bond market remained open throughout the crisis, reaffirming the product's role as a reliable funding tool in times of financial turbulence. Banks were able to find investors even at the peak of the market turmoil, both in traditional and in new covered bond markets. Cheap central bank funding partly replaced covered bond issuance, but investor-placed benchmark volumes in 2020 were only slightly down in new markets compared to the year before. Inflationary pressures and the easing of the COVID-19 pandemic meant that monetary policies began to normalize across several countries in the second half of 2021. As soon as central banks terminated their crisis-era liquidity facilities, covered bond volumes surged as issuers' funding plans began to normalize. Benchmark covered bond volumes in new markets already comfortably exceeded previous full-year totals by mid-2022, at over EUR 50 billion.

> Figure 1: Issuance In New Markets Surged Post-COVID, Led By Australia And Canada



Note: Non-European benchmark covered bond issuance. Year-to-date figures as of August 2.
Source: S&P Global Ratings

Looking ahead, weakening macroeconomic conditions will constrain asset growth, so we expect the stimulus for further issuance will come principally through legislative and regulatory initiatives and evolving market conditions.

POLICY DEVELOPMENTS

On the policy front, the transposition of the harmonization directive and the implementation of the Basel reforms are gaining prominence.

The Transposition Of The Harmonization Directive

The main regulatory development in Central and Eastern Europe (CEE) has been the rapid evolution or update of covered bond laws to comply with the covered bond directive (the Directive), initially supposed to be transposed into national legislations by July 2021, and applicable by July 2022. In practice, notwithstanding some infringement notices launched by the European Commission as the 2021 deadline passed, July 2022 has been interpreted as the 'real' deadline.

Several CEE countries had either no covered bond laws or had antiquated frameworks that had fallen into disuse and had to be rewritten from scratch. These include:

> Latvia, which passed its law, fully compatible with the Directive, in May 2021. Although Latvia had a covered bond law in the past, it had not been used for many years and was rewritten from scratch. The Latvian framework, like those in Estonia and Lithuania, was drafted under a cooperation agreement between all three Baltic states to allow standardisation of conditions and ease of cross-border transfer of assets, wherever possible. That reflects the fact that many banks operating in the region operate on a cross-border basis and wish to use collateral from all three countries to back their covered bonds.

> Croatia passed its covered bond law in May 2022. This was the culmination of a long project undertaken in cooperation with the European Bank for Reconstruction and Development (EBRD), which had been 'on hold' pending other priorities and the need for clarity regarding the Directive to ensure full compliance with the new rules.

> Bulgaria, like Croatia, passed its covered bond law in early 2022, although after a much shorter preparation phase. Like Latvia, Bulgaria also had an existing, but unused covered bond law.

> In Lithuania, after a long period of development, the covered bond law was passed and came into force a few days after the July 8 deadline.

> Slovenia has had a covered bond law for several years and granted at least one license to issue bonds in 2012, but this was never utilised. According to the Bank of Slovenia, the ample liquidity in the banking system and the small mortgage portfolios made covered bonds uneconomic. The law was revised in September 2021, came into force in July 2022, and is now fully in accordance with the Directive. In particular the law allows pooling, in an attempt to address the problem of small mortgage portfolios.

Other CEE countries with established covered bond frameworks, including Slovakia, Hungary, and Poland, had to undertake some modifications to ensure that their frameworks were fully compatible with the Directive:

> The Slovakian law had been updated in 2018 in cooperation with the EBRD and with the expectation of the passage of the Directive. It introduced most of the features required under the Directive, such as the possibility of soft-bullet bonds, the 180 day liquidity requirement, and mandatory 5% minimum overcollateralisation (OC). The only subsequent amendment that was made was to align the asset class definition with the directive and allow assets other than residential mortgages to back covered bonds. Whether issuers will use this new option, given the availability of high class residential mortgage assets, is unclear.

> In Hungary revisions to the covered bond law were passed in 2021. These introduced some new features allowed or required in the Directive, including a requirement for a 180 day liquidity facility, the possibility of soft-bullet structures, and a more detailed role for the national bank as supervisor of the programmes.

> In Poland, minor changes to the, already mainly aligned, law were passed in April 2022. The small changes needed included aligning reporting requirements and swap counterparty rules. Two less common aspects of the Polish framework had to be addressed: Poland was one of the few countries to previously require OC over 5% – which has now been reduced to bring it into line with the directive – and mandatory conditional pass-through rules meant that the trigger events came more into focus. The mandatory rules are only triggered in the event of issuer insolvency, not resolution or restructuring as in some countries. Finally, it was decided that the new rules would also apply retroactively to existing bonds.

> In Czechia the law was amended in April 2022, introducing several features required by the Directive, such as a 180 day liquidity buffer, a requirement to take into account servicing costs (of 1%) in OC calculations, the possibility of soft-bullet bonds (which were previously possible but not mentioned in regulation), enhanced investor reporting, and a requirement to obtain permission from the Czech National Bank

before issuing bonds. The minimum OC for mortgage bonds remains at 2%, in line with the permission granted to national authorities to set a level lower than 5%, but is now 10% for public covered bonds. There is no requirement for a cover pool monitor, as is allowed under article 13 of the Directive, but in practice we expect most issuers to appoint a cover pool monitor voluntarily (without the need to comply with requirements set out in the Directive) and set a higher OC level.

Third country equivalence in Europe

The equivalent treatment of covered bonds issued by non-European economic area (EEA) credit institutions was left outside the scope of the Directive and of the amendments to Article 129 of the Capital Requirements Regulation (CRR). Instead, the European Commission will submit a report on third country equivalence to the European Parliament and Council by July 2024 at the latest. This report may be accompanied by a legislative proposal on whether or how an equivalence regime should be introduced. It is important to bear in mind however, that from July 8, 2022, the amended CRR no longer refers to the UCITS 52(4) requirements as one of the conditions for preferential risk weight treatment. Only for covered bonds issued before July 8, 2022 most old CRR requirements, including the UCITS 52(4) reference, may still be applicable under the transitional measures. Instead, from July 8, 2022, the new definition for covered bonds per Article 3(1) of the Directive becomes leading for preferential risk weight treatment. Unlike UCITS 52(4), Article 3(1) of the Directive does not reference the fact that covered bonds have to be issued by a credit institution with a registered office in an EEA member state.

However, without third country equivalence provisions, this would still imply that to benefit from a preferential treatment, third country covered bonds would a) have to meet all the mandatory requirements of the Directive per Article 3(1) of this Directive, plus b) the further requirements of the amended CRR with reference to the monitoring of property values, minimum 5% overcollateralization, and eligible substitution assets. In a separate Q&A document, the European Banking Authority (EBA) also confirmed on December 17, 2021, that as long as an equivalence regime has not been introduced, covered bonds that do not meet the criteria and requirements for eligible covered bonds according to the amended CRR Article 129(3), (3a) and (3b), in conjunction with Article 3 of the Directive, should not use the favourable 11.25% LGD for covered bonds under the internal rating based approach (CRR Article 161), but the 45% LGD for senior exposures instead.

The impact on the LCR treatment of third country covered bonds

Third country covered bonds are already eligible as level 2a high quality liquid assets under the European Union (EU) LCR delegated regulation if they meet the applicable requirements. The European Commission delegated regulation of February 10, 2022, amending the LCR delegated regulation, aligns the European LCR regulation with the amended Article 129 of the CRR and the covered bond Directive. The amendments apply as of July 8, 2022 and affect third country covered bonds as follows:

> The (semi-annual) transparency requirements of CRR Article 129(7) are replaced with the more detailed (quarterly) investor information requirements of Article 14 of the covered bond Directive.

> The valuation requirements of the covered bond Directive in Articles 6(2), 6(3)(a) and Article 6(5) should be met where the pool comprises loans secured by immovable properties. These replace the previous CRR Article 208 and Article 229(1) valuation requirements.

> The asset eligibility criteria for third country covered bonds remain virtually the same as they already excluded securitisation notes as eligible assets, but the Article 129(1)(c) minimum rating requirements for exposures to credit institutions will become more lenient.

The LCR amendments did not further discuss the required equivalence of the supervisory and regulatory arrangements of third countries to those applied in the EU. We do believe though, that the mandatory spe-

cial supervision requirements from the covered bond Directive will probably be seen as the reference for the equivalence assessment of third country supervisory and regulatory arrangements as of July 8, 2022.

The Basel III reforms

In December 2017, the Basel Committee on Banking Supervision (BCBS) finalised its post-crisis regulatory reforms, which provide for the preferential risk-weights for covered bonds globally. The Basel-III reforms (often dubbed as Basel IV) should be implemented by January 1, 2023, after a one year postponement due to COVID-19.

The Basel III reforms on covered bonds

Definition of covered bonds

Covered bonds are defined as bonds issued by a bank or mortgage institution subject by law to special public supervision designed to protect bondholders. Bond proceeds must be invested conform the law in assets that can cover claims attached to the bonds during their term. In the event of a failure of the issuer, these proceeds would be used on a priority basis for the (re)payment of the principal and accrued interest.

Asset eligibility

The eligible cover assets are restricted to:

- Claims on/guaranteed by, sovereigns, their central banks, public sector entities or multilateral development banks;
- Claims secured by residential real estate with a loan-to-value (LTV) ratio of 80% or lower that meet the applicable requirements on legal enforceability, the claim of the bank over the property, and the ability of the borrower to pay, among others.
- Claims secured by commercial real estate with an LTV of 60% and lower that meets the applicable requirements;
- Claims on banks that qualify for a 30% or lower risk weight 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.

Overcollateralisation

The nominal OC should be at least 10%. Where national legislations do not provide for a 10% minimum OC, the issuing bank should regularly disclose that the 10% requirement is met in practice.

Disclosure requirements

For covered bonds to be eligible for preferential treatment, the banks investing in the covered bonds should be able to demonstrate that it receives (at least semiannually) portfolio information on at least:

- The value of the cover pool and the outstanding covered bonds;
- The geographical distribution and type of cover assets, loan size, interest rate, and currency risks;
- The maturity structure of the cover assets and covered bonds; and
- The percentage of loans more than 90 days past due.

> Figure 2: 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

Several countries outside Europe have published their proposals translating the Basel III reforms into national law, although only some of them intend to provide for a preferential risk weight treatment of covered bonds. Singapore and South Korea do plan to fully implement the Basel requirements for such preferential treatment, for example. Australia aims to introduce favourable risk weights, but only for rated covered bonds. In Canada, the Office of the Superintendent of Financial Institutions (OSFI) does adopt the asset eligibility and disclosure requirements for covered bonds of the Basel reforms, but with a minimum OC requirement of 5%. Nonetheless, covered bonds will only receive a similar risk weight treatment as similarly rated (unsecured) bank exposures. In New Zealand, the banking prudential requirements of June 2021 do not make reference to separate risk weights for covered bonds.

MARKET OUTLOOK

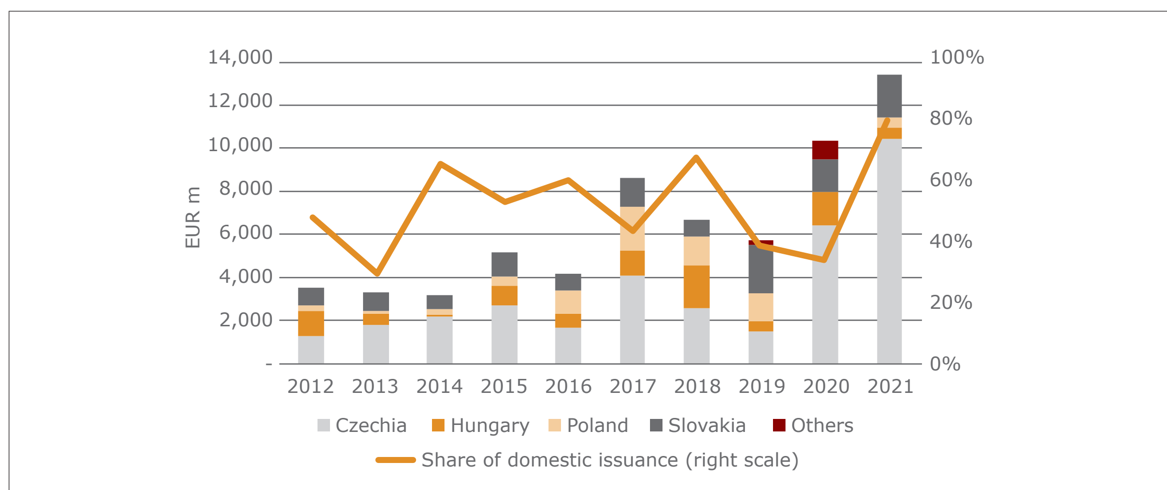
Central and Eastern Europe

The lack of funding needs for most banks in the region and strong demand from investors in local currencies meant that euro covered bond investors were again disappointed by supply from the region, with only one euro-denominated benchmark bond issued in 2021, and some smaller public transactions from Estonian issuers.

In Hungary the Mortgage Funding Adequacy Ratio, which stipulates the percentage of mortgages that must be funded with long-term securities, is set to be increased to 30% from the current 25%. The date of this increase was delayed for a year as a response to the pandemic. The National Bank also announced that their covered bond purchase programme would be replaced by a green mortgage bond programme.

Local currency issuance continues to dominate in Hungary, to the frustration of Eurozone investors, whilst issuance from Poland continues to be more balanced between the domestic and euro markets.

> Figure 3: Local Currency Issuance Boosts Volumes in Central And Eastern Europe



Note: Covered Bond Issuance. Sources: ECBC

As usual though there is optimism for future issuance. At least two Polish issuers have announced their intention to issue new green covered bonds, and in more general terms the funding needs in the region are growing as house prices increase and inflation eats into deposit balances.

The passage of laws in Croatia and Bulgaria is of particular significance for future supply prospects as both countries are now in the Exchange Rate Mechanism 2 mechanism and expect to fully adopt the Euro in 2023.

This will allow easier access to euro investors and, if precedent in other countries is to be believed, may result in significant growth in the mortgage market, which will require wholesale funding.

Outside the EU there was also progress on covered bonds in Georgia, where at time of going to press parliament was about to pass the covered bond law.

Outside Europe

Benchmark covered bond issuance outside Europe surged since the second half of 2021, as monetary policy normalization curtailed issuers' access to cheap central bank funding. Issuance was particularly strong in Canada and Australia, but banks in Singapore, Korea, and New Zealand were also active.

Current volatile market conditions, caused by geopolitical turbulence, tightening monetary policies, and a deteriorating economic outlook, could further support issuance. Established, highly rated issuers will probably use their covered bond programs more, especially if other sources of funding, such as senior unsecured bank debt, become relatively more expensive or difficult to place with investors.

Legislative and regulatory initiatives could also help. The first two Japanese programs have been established based on a contractual structure, due to the lack of dedicated legislation, but many market participants expect that the authorities will step in and introduce a dedicated framework as issuance grows. This may encourage new banks to set up programs and issue covered bonds. Asset encumbrance limits, which constrain volumes by capping the amount of banks' assets that can be included in cover pools, can also be revised. The Monetary Authority of Singapore has recently increased the asset encumbrance limit to 10% from 4% of the issuer's total assets. This could lead to an increase in existing programs' sizes and might incentivize new banks to establish programs.

In the medium term, we believe that Asian covered bonds should grow further, with new Asian banks benefiting from the funding diversification that they provide. We expect that housing finance needs in the region will grow substantially, and covered bonds could become an important instrument for mobilizing private capital toward mortgage financing, especially in emerging Asia.

Covered bonds in Latin America have a short and limited track record. Panama was the first country to see a covered bond issuance in October 2012. Since it does not have a dedicated legal framework, covered bonds were based on contractual agreements. Chile also saw limited and locally distributed covered bond issuance in the past. One factor preventing financial institutions in the region from issuing covered bonds is the lack of a dedicated legal framework. However, things are changing thanks to the legislative developments in Brazil.

In October 2014, Brazil introduced a framework for Brazilian local covered bonds ("letra imobiliária garantida" or "LIGs"), which became law in January 2015. Banks only began issuing LIGs after the presidential election of 2018, with private domestic placements. At the end of 2020, the Brazilian Securities Exchange Commission allowed public placements for LIGs, which could further support domestic issuance. The market is still waiting for legal and regulatory clarification on how international issuances could be done. Once this clarification is obtained, we believe that Brazilian banks will try to issue offshore LIGs targeting foreign investors. If covered bonds prove successful in Brazil, we may see other countries in the region follow its lead.

The outlook for covered bonds in Africa looks grim. Authorities in both Morocco and South Africa tried and failed to introduce dedicated legal frameworks. But things could change as the growth of the local middle class increases demand for mortgage funding, and authorities will try to help financial institutions diversify their funding tools.