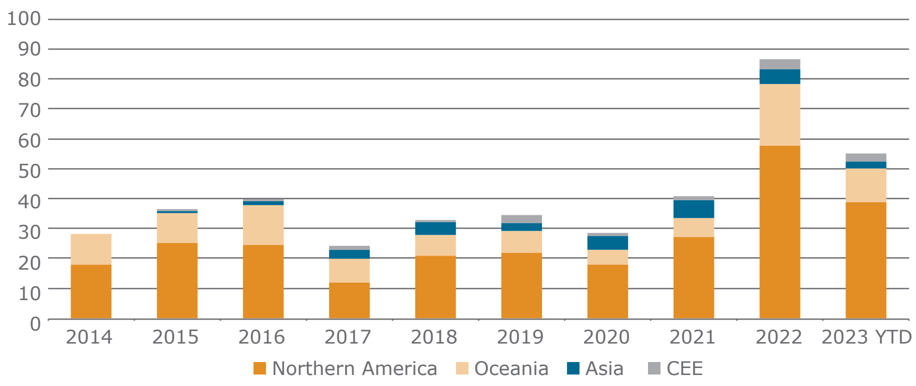
1.10 COVERED BONDS EVOLVE AS THEY EXPAND BEYOND TRADITIONAL MARKETS

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

ISSUANCE IN NEW MARKETS REACHES RECORD LEVEL

Since the second half of 2021, surging inflation and the consequent normalization of monetary policy in most advanced economies has led to a rebound in covered bond volumes, which reached record levels in 2022. Despite global bank wobbles causing a marked slowdown in mid-March 2023, European investor-placed issuance exceeded €125 billion in the first half of 2023, the highest for the past decade, on the back of hefty targeted longer-term refinancing operation (TLTRO) redemptions and in anticipation of reduced European Central Bank (ECB) intervention. Volumes surged outside Europe too, especially in countries where issuers partially replaced central bank funding with covered bonds, such as Canada.

> FIGURE 1: ISSUANCE IN NEW MARKETS SURGED POST-COVID-19, LED BY CANADA AND AUSTRALIA



Note: Investor-placed benchmark covered bond issuance (bil. €). CEE – Central and Eastern Europe (Slovakia, Poland, Hungary, Estonia, Czech Republic, and Turkey). Oceania--Australia and New Zealand. Year-to-date figures as of June 30, 2023. Source: S&P Global Ratings.

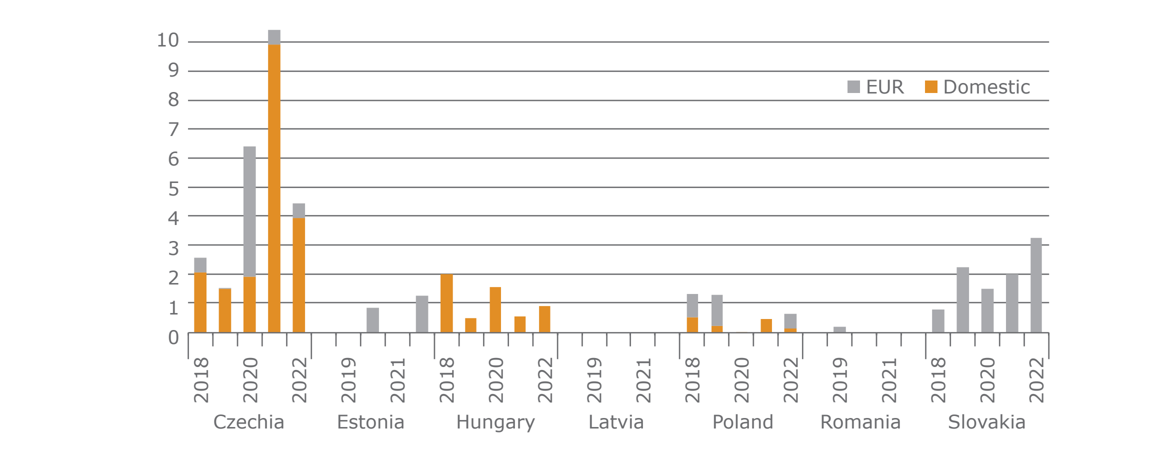
We anticipate that issuance in new markets will increase further, though with significant regional and national differences.

LIQUIDITY AND MARKET SENTIMENT DRAG ON CEE ISSUANCE

In 2022, euro-denominated benchmark covered bond issuance in Central and Eastern Europe (CEE) exceeded the pre-COVID-19 peak, but overall volumes remain fairly limited--lower than those in Australia and even in Singapore, countries with a smaller GDP and much smaller populations. We expect that euro-denominated issuance will remain subdued, with several factors explaining this paucity. Domestic issuance, predominant in countries such as the Czech Republic and Hungary, is partially replacing international issuance, while euro-denominated issuance is robust in countries that have already joined the euro, such as Slovakia. But other factors also contribute to depress overall volumes. Economic growth and mortgage lending are slowing, reducing the availability of eligible assets but also funding needs, and liquidity remains strong while issuers continue to favor issuance of MREL-eligible debt (minimum requirement for own funds and eligible liabilities), further decreasing the need for covered bond funding for now. Finally, an uncertain economic outlook and headwinds from a prolonged Russia-Ukraine conflict have reduced investor demand, as reflected by increased execution risk.

We believe that issuance will grow more robustly once economic and financing conditions stabilize and mortgage lending picks up again, supported by renewed investor appetite, increased funding needs, and the benefits of the transposition of the EU's Directive For The Harmonization Of Covered Bond Frameworks.

> Figure 2: Most Issuance In CEE Is In Local Currency



Source: ECBC.

The transposition of the Directive is largely complete in CEE. Countries such as Croatia and Bulgaria passed their new covered bond laws in the first half of 2022, but no issuers have so far made use of them. The lack of issuance from these new jurisdictions shows that the approval of a dedicated legislative framework is not sufficient for the establishment of covered bond programs: limited funding needs probably reduced the incentives to do so.

ACHIEVING COVERED BONDS THIRD-COUNTRY EQUIVALENCE

The Directive also defines the pathway to achieve third country equivalence for capital requirement purposes. Currently, covered bonds issued by credit institutions outside the European Economic Area (EEA) and purchased by European investors receive less favorable regulatory treatment than covered bonds issued by EEA-based credit institutions. However, European authorities could, in future, decide to grant equivalent treatment to covered bonds issued by non-EEA credit institutions. Alignment of third-country covered bond frameworks with the Directive will be a key factor. Article 31 of the Directive stipulates that the European Commission (EC) will submit a report on third-country equivalence to the European Parliament and Council by July 2024.

ARTICLE 31 OF THE COVERED BOND DIRECTIVE

Three steps appear necessary to achieve third-country equivalence. First, a report justifying the introduction of an equivalence regime and defining the technical requirements. Second, a legislative proposal (directive or regulation) transposing these requirements into a legal act and empowering the EC to take an implementing decision. Third, EC recognition of the equivalence, after thorough assessment of the third country's covered bond framework. Ideally, the EC would table both the report and a legislative proposal in July 2024. The latter must be adopted through the ordinary legislative procedure, the duration of which is difficult to predict, due to the upcoming European Parliament elections in May 2024 and a new Commission taking office in November 2024. Also, the technical requirements or criteria applicable to the equivalence assessment itself are missing from the Directive, meaning that almost all technical requirements guiding the equivalence assessment are at the full discretion of the EC. It will be relevant to understand both the fundamental principles that will be considered and the level of technical detail required.

The EC's legislative proposal could cover the following areas: 1) issuance by a credit institution; 2) existence of a legal basis; 3) dual recourse; 4) asset segregation (bankruptcy remoteness); 5) eligible cover assets (quality requirements in terms of asset types, derivatives, loan-to-value ratios, valuation); 6) coverage requirements; 7) special public supervision; 8) liquidity rules; and 9) transparency (reporting and disclosures).

Regarding the extent of technical specifications, there are good arguments for pursuing a principles-based approach, as it will be challenging to strike the right balance between the safety features of product components and the necessary flexibility for third countries and their market traditions.

Over the past few years, the ECBC's Global Issues Working Group (GIWG) has analyzed the alignment of global covered bond regimes with the Directive. The GIWG updated its analysis in 2020, based on the text of the legislative package as published in the Official Journal of the European Union in December 2019.

While some time has now passed since this analysis was conducted and some third countries may already have made adjustments to their covered bond regulations, we believe that it still provides a fairly accurate picture of current alignment.

The equivalence analysis by the GIWG revealed that non-EEA frameworks were already fairly well aligned with the Directive, and in most cases, would probably not require significant amendments to achieve full alignment. However, the process remains fraught with uncertainty, for example, regarding how detailed the technical specifications will be, and how general financial policy criteria will be considered. As regards timing, the EC will probably not take an implementing decision on equivalence recognition until after 2024.

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, did align the European LCR regulation with the amended Article 129 of the CRR and the covered bond Directive. As such, for LCR purposes third country covered bonds already have to meet some of the requirements from the covered bond Directive since 8 July 2022. These include the quarterly investor information requirements of Article 14 of the covered bond Directive, and the valuation requirements of Articles 6(2), 6(3)(a) and Article 6(5) of the covered bond Directive if loans secured by immovable properties are part of the cover pool. Also the CRR Article 129(1)(c) minimum rating requirements for exposures to credit institutions apply to third country covered bonds for level 2a LCR eligibility.

LEGISLATIVE DEVELOPMENTS WILL DRIVE GROWTH OUTSIDE EUROPE

We expect that issuance outside Europe will increase further, supported by new issuers in countries with an established legislative framework, such as South Korea and Singapore. But plenty of available liquidity and weaker lending growth will limit the overall increase. Further growth will come once new legislative frameworks are established, granting issuers in new markets access to covered bond investors.

While the creation of a European benchmark could facilitate the introduction of new dedicated frameworks in other regions, it could also delay the process if local legislators decide to wait and understand the conditions to achieve equivalent treatment of covered bonds.

In 2022, almost a decade after the introduction of the draft law, Morocco approved the first dedicated covered bond framework in Africa. While covered bonds can play a significant role in supporting housing finance in the continent, the experience in Morocco shows that the legislative process can take longer than expected. Georgia also approved dedicated covered bond legislation in 2022. We understand that covered bonds will initially be used as collateral under existing funding operations with the central bank and only at a later stage will they be distributed to private investors, probably initially domestic ones. This points to the challenges that traditional covered bonds may experience as they expand outside Europe.

Covered bonds – an overwhelmingly European phenomenon for most of their 250-year history – have recently proved very popular in new markets such as Australia, Canada, Korea and Singapore. These developed economies aligned their models to European best-practice: local banks typically issue 'AAA'-rated covered bonds, backed by prime residential mortgage loans, and under an established legal framework. But the greatest growth potential is probably in emerging markets, where the middle-class will expand the most in the coming decades. Countries such as China, India, Mexico, and Indonesia could greatly benefit from a dual recourse instrument helping them mobilize private capital toward financing their growing economies. But as dual recourse financing expands in these markets, we can expect to see new issuers, assets, structures, and ultimately investors, challenging the established definition of what constitutes a covered bond.

While covered bonds in new markets have so far primarily targeted the traditional European investor base, Brazilian covered bonds have initially attracted domestic investors. And we have seen how Georgian banks will initially use covered bonds as collateral under the local central bank's liquidity facility, rather than placing them with international investors. More generally, we can expect that a larger share of covered bonds issued outside Europe will target domestic investors, at least initially. While covered bonds are typically issued by banks, we anticipate an increasing interest from non-bank financial institutions, such as housing finance companies in India, or even non-financial entities. And some of these new issuers will consider covered bonds backed by non-traditional assets, such as the recent examples of Indian covered bonds secured by gold loans or vehicle loans, or Turkish covered bonds backed by unsecured loans to small and mid-sized enterprises (SMEs). Turkish banks have issued SME covered bonds since unsecured SME loans are eligible collateral under the local legal framework. Banks elsewhere may consider issuing SME covered bonds even if SME loans are not eligible collateral under the local framework, or even in the absence of a local framework. This is because in certain legal contexts covered bonds can be issued without a dedicated legal framework. Issuers can establish programs that replicate the main features of legislation-enabled covered bonds by means of contractual arrangements (so-called structured covered bond programs). For example, the first two Japanese programs have been established based on a contractual structure, due to the lack of a dedicated legislation. Such contractual arrangements grant greater flexibility outside of an established legal framework, for example in terms of eligible collateral.

The global success of covered bonds will lead more issuers to use the covered bond label for their dual-recourse issuance. This will create benefits but also risks. New issuers and investors will benefit the entire covered bond market – by increasing its depth and systemic importance –, the development of local capital markets – by improving liquidity and broadening the investor basis –, and society at large – by funding the growth of housing markets and economies. But new issuers, assets, and structures may also introduce risks to an asset class characterized by 250 years of unblemished credit history. In Europe, the Directive mitigates this threat, by introducing a common definition aligned with regional best practices. Outside Europe, market participants and regulators will have to collaborate to enhance transparency and make sure that investors are fully aware of the product characteristics and, ultimately, the risks that they are taking.

For more information, the following QR code leads you to the ECBC Studies Section, where to find, among others, the ECBC Global Concept Note on Third Country equivalence for covered bonds.