EMF | ECBC
EUROPEAN MORTGAGE FEDERATION
EUROPEAN COVERED BOND COUNCIL

ECBC GLOBAL CONCEPT NOTE ON THIRD COUNTRY EQUIVALENCE FOR COVERED BONDS

EMF-ECBC
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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

AN INDUSTRY CONCEPT NOTE ON THIRD COUNTRY EQUIVALENCE FOR A GLOBAL IMPLEMENTATION OF THE COVERED BOND DIRECTIVE

The implementation of the European Union (EU) Covered Bond Directive represents a real legislative lighthouse driving harmonisation and alignment of market best practices with a principle-based approach in the 30 countries of the European Economic Area (EEA). The Directive offers an overarching legislative benchmark which is leading structural convergence of legal fundamentals and market best practices, and delivering a stable long-term funding tool that allows for solid diversification of funding strategies for lenders and provides a safe harbour for investors. Furthermore, the Directive facilitates a systemic consolidation of macroprudential features securing financial stability in times of geopolitical turmoil and reinforcing the objectives of the Capital Markets Union (CMU).

More importantly, this legislative blueprint also serves as a point of reference for other developed economies and emerging countries in terms of how to ensure long-term access to capital markets and optimise private capital in the interest of housing markets.

The European Covered Bond Council (ECBC) and the International Secondary Mortgage Market Association (ISMMA) are acting as market think-tanks and catalysts in order to secure a level playing field globally, and the Covered Bond Label is the principal global market portal facilitating investors' and issuers' due diligence.

The Covered Bond Label provides clear and transparent information on structural legislative characteristics jurisdiction by jurisdiction; detailed and harmonised data on cover assets; and unique liability data points on a bond-by-bond basis. This up-to-date and transparent knowledge platform, together with the European Mortgage Federation (EMF) Hypostat, which reports housing market data and trends, and the ECBC Covered Bond Fact Book, is boosting harmonisation and dissemination of best practices. Together, they help to facilitate open access to reliable data for investors and to increase market liquidity by enabling market participants to make rapid and informed decisions as they navigate the evolving regulatory landscape.

Facing the turmoil created by the collapse of Silicon Valley Bank (SVB) and Credit Suisse early in 2023, covered bonds once again demonstrated their solidity and their safe harbour characteristics. Equally importantly, they also showed their capability to function as the market opener after intense disruptions. Throughout their more than 250 years of existence, covered bonds have played a pivotal role in banks' 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 financial crises while maintaining a focus on the essential features and qualities that have made the covered bond asset class such a success story.

Ongoing geopolitical instability, the aftermath of last year's energy crisis and the urgent need to retrofit the housing building stock are today, more than ever, opening new frontiers for housing finance and covered bonds at both EU and international levels. The covered bond asset class is being exposed to critical evolutions which may bring about both new opportunities and new risks, in the ESG space in particular. 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.

With the recent approval of covered bond legislation in Georgia (in November 2022) and the first African covered bond law (in Morocco in September 2022), four continents in addition to Europe have now introduced covered bond frameworks, which is opening perspectives for the development of a new investor base at the global level. The third country equivalence regime of the Covered Bond Directive represents a further opportunity to harmonise the policy landscape and reinforce the regulatory treatment of the asset class from a prudential perspective. In parallel, the Covered Bond Label has already helped greatly in harmonising the covered bond landscape, particularly in the area of disclosure, and provides a unique quantitative database and qualitative benchmark, with more than EUR 2.3 tn of bonds outstanding globally as of end 2023, of which over EUR 135 bn are sustainable covered bonds.

In view of the official international recognition of the covered bond asset class in the Basel Committee on Banking Supervision (BCBS, "Basel") framework, the Covered Bond Label has been built around the regulatory compliance perimeter defined by the Directive, the Capital Requirements Regulation (CRR) and the Liquidity Coverage Requirement (LCR) eligibility, rooted in the implementation of Basel III. This compliance has been established at a global level, setting a significant quality bar that will prevent qualitative dilution of the covered bond brand. In turn, this has reinforced and enhanced transparency in disclosures as well as legislative and regulatory alignment.

Implementation of covered bond legislation incentivises the creation of a domestic covered bond investor base, which over the medium to long-term translates into access for the global investor community, thereby further enhancing liquidity and global recognition of the asset class.

In particular, the Environmental, Social and Governance (ESG) covered bond angle reinforces the links of global financial markets to the European regulatory leadership which is promoting green housing finance in developed and emerging economies.

In view of these considerations, the covered bond sector firmly believes that there is a need to preserve the key principles of the asset class as a crisis management tool rooted in robust qualitative and macroprudential characteristics, which are the basis for ensuring its regulatory recognition at the global level through the Basel rules.

ROLE OF THE ECBC GLOBAL ISSUES WORKING GROUP

To develop synergies between traditional, new and emerging covered bond markets, provide advisory on best practice harmonisation and join forces for the establishment of a more level playing field for all at a global level, in 2015 the ECBC established its Global Issues Working Group (GIWG). To date, 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. In September 2022, the ECBC Steering Committee mandated the GIWG to elaborate a Concept Note on third country equivalence, to act as a roadmap helping global authorities and stakeholders in aligning policy and market best practices around the Covered Bond Directive.

In doing so, ECBC members have acknowledged the important role played by the Working Group as a global discussion forum for the exchange of market best practices and as an educational platform for issuers and the global investor community. 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 bond concept, with similar market solutions and infrastructures, and more importantly, comparable regulatory treatment. In this context, the Working Group has been looking into the following topics via dedicated topical Work Streams:

POLICY DEVELOPMENTS

Looking back over recent years, the covered bond space has been fundamentally impacted by major waves of monetary policy, supervisory review and regulatory change, which have all had significant consequences for the long-term financing and housing finance sectors.

At EU level, for example, the Capital Markets Union (CMU) initiative, which seeks to ensure the capability of the financial services sector to support the growth agenda and provide long-term financing to the real economy, has given rise to the following areas of reflection:

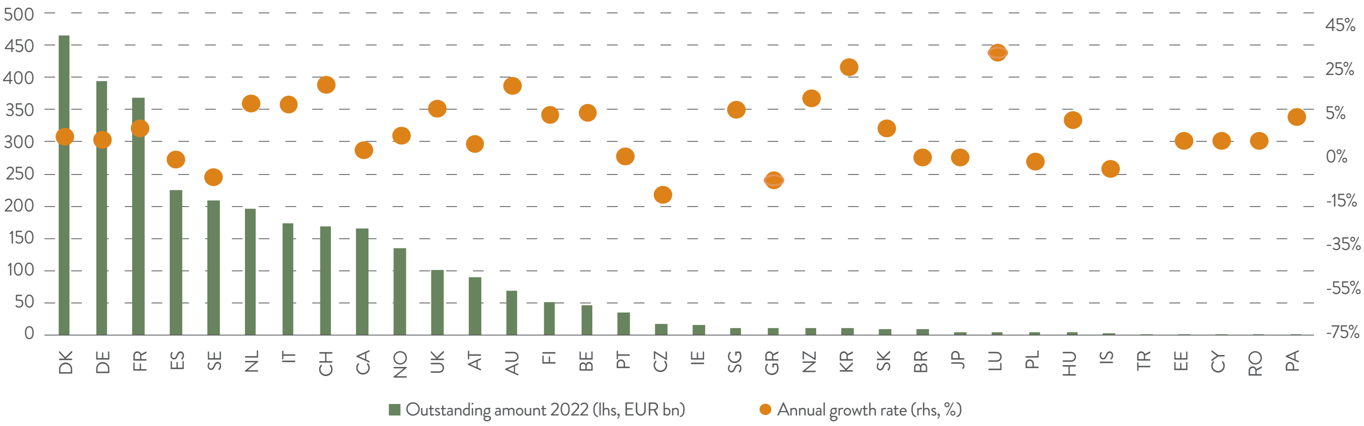
- Striking the right balance, in terms of a level playing field, between international banks operating in the European Union and European actors operating both internationally and domestically.
- Carefully examining the market impact of several key regulatory developments and trying to secure the European banking pillars in the BCBS 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 of small and medium sized enterprise (SME) financing, and how lending to the real economy is becoming increasingly multi-faceted.
- The role of covered bonds and the Industry's firm commitment to achieve a higher degree of harmonisation, in line with EU objectives and market preferences.
- Developing the concepts of Energy Efficient Mortgages and Green Covered Bonds for the benefit of EU citizens and the environment.

MARKET DEVELOPMENTS

Covered bonds sit 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. In this context, Armenia, Australia, Brazil, Canada, Chile, Georgia, Morocco, New Zealand, Singapore, South Korea, and Turkey have implemented covered bond legislation in recent years. Major jurisdictions including India, Indonesia, Japan, Kazakhstan, Malaysia, Mexico, North Macedonia, Panama, Peru, Saudi Arabia, South Africa, Tunisia, the United States, and Uzbekistan are either in the process of adopting covered bond legislation or are investigating the introduction of covered bonds.

The outstanding amount of covered bonds broke through the EUR 3 tn mark for the first time and rose by EUR 89 bn to EUR 3.03 tn at the end of 2022.

FIGURE 1 | TOTAL AMOUNT OF OUTSTANDING COVERED BONDS BY COUNTRY AND ANNUAL CHANGE END 2022



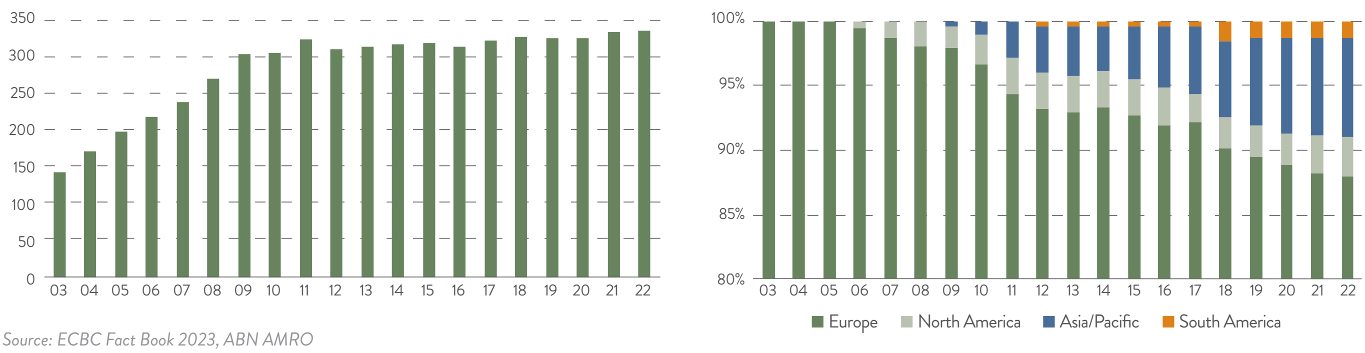
NOTE : Growth rates of Brazil (112%) and Estonia (147%) are not shown in graph.
Source: ECBC Fact Book 2023, ABN AMRO

This was the fifth consecutive year of growth and set a new record, taking over from 2021. The pace of growth in the amount outstanding accelerated again to 3.1% in 2022, almost tripling from 1.1% in 2021. In contrast to 2021, the increase only stemmed from issuance of mortgage covered bonds (+EUR 154 bn) in 2022, with public sector and ship covered bonds (and others) declining. A further decline in private placements (including retained covered bonds) and the continuing trend of strengthening public placements in 2022, clearly reflects that banks started to rely more heavily on capital market funding, rather than cheap central bank borrowings offered after the outbreak of the COVID-19 pandemic. Another observation to highlight in this context is that covered bonds continued to strengthen their global footprint, as the share of outstanding covered bonds outside Europe increased in 2022. Overall, the figures once more underline the significant importance of covered bonds as a bank funding tool, not only in Europe but also around the globe.

The top five countries ranked by size of outstanding covered bonds (see Figure 1) in 2022 remained unchanged from 2021 with only Sweden and Spain changing their ranking: Denmark (EUR 463 bn) retaining the top spot, followed by Germany (EUR 394 bn), France (EUR 368 bn), Sweden (EUR 225 bn) and Spain (EUR 209 bn).

At the end of 2022, 334 covered bond issuers were active around the globe (see Figure 2). The regional breakdown (see Figure 3) shows that the majority (88%) of all 334 issuers are located in Europe, while the share of the Asia/Pacific-based issuers rose to 7.8% last year (2021: 7.7%). The share of North America-based issuers amounted to 3%, while that of South America-based issuers remained roughly stable at 1.2%. The rising share of covered bond issuers outside Europe was also mirrored by an increase in the share they have in the total amount of outstanding covered bonds, which was almost 10% in 2022, compared to 7% in 2017, corresponding to the number of issuers shown in Figure 2 and 3.

FIGURE 2-3 | NUMBER OF COVERED BOND ISSUERS (LEFT) AND THEIR REGIONAL SHARE (RIGHT)



Source: ECBC Fact Book 2023, ABN AMRO

COVERED BOND LABEL

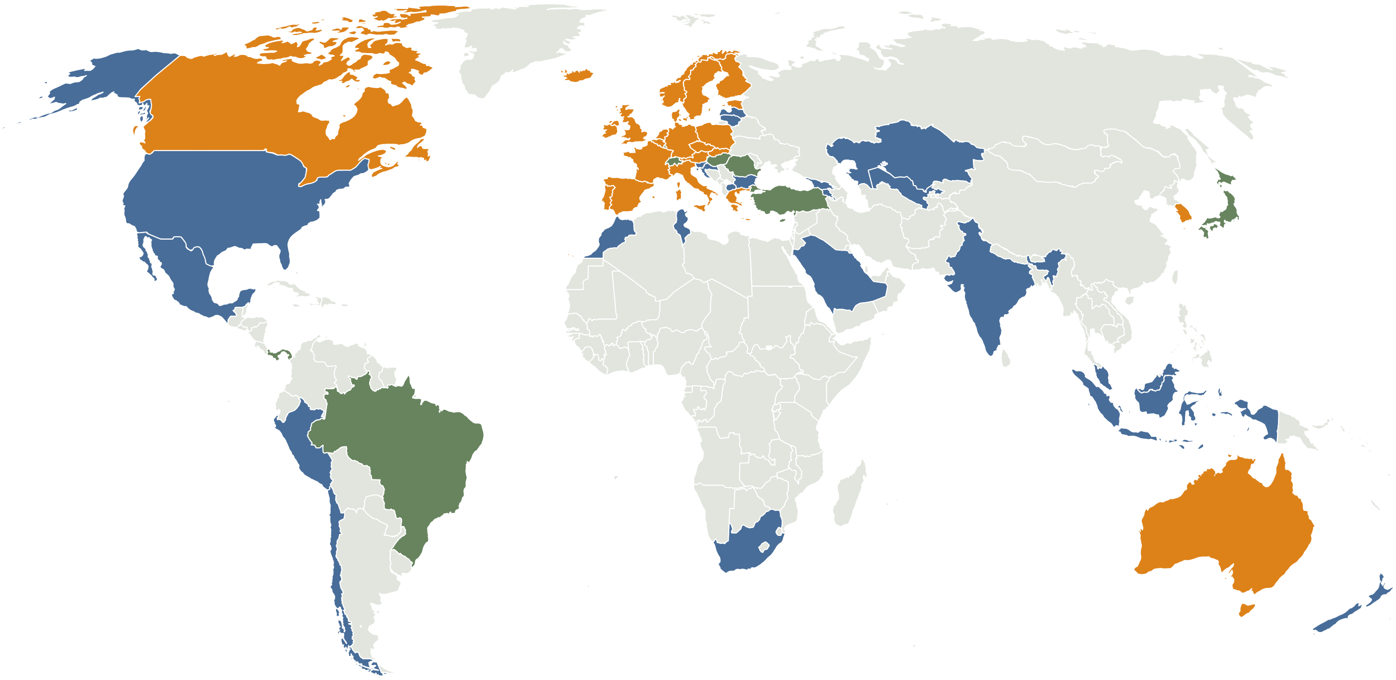
The firm commitment to contribute to European efforts to enhance financial stability and transparency led the covered bond industry to launch a quality label in 2012. The Covered Bond Label was developed by the European issuer community – led by the ECBC – working in close cooperation with investors 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 went live 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 November 2023, 176 labels have been granted to 137 issuers from 24 countries, covering over EUR 2.3 tn of covered bonds outstanding, where over 5,600 covered bonds include information on the LCR, maturity structures, regulatory treatment, etc.

Over the last decade, by supporting better data monitoring, harmonised rating criteria and deeper screening of factors influencing investment value, the Covered Bond Label has become a beacon for investment professionals, enabling market participants to make informed decisions and navigate the evolving regulatory landscape with confidence. With a focus on regulatory compliance with the Covered Bond Directive, the LCR and alignment with sustainability goals, the Label represents a transparency and quality benchmark for the covered bond sector around the world.

In this context, covered bond issuers from these 24 different jurisdictions have come together to develop a Harmonised Transparency Template (HTT). Since 2016, the HTT has been providing cover pool information in a harmonised format, which allows for both the recognition of national specificities, with the National Transparency templates, and the comparability of information required to facilitate investors' due diligence. In particular, to align with the requirements of the Covered Bond Legislative Package, in June 2022 the Covered Bond Label published an updated provisional HTT, fully aligned with Art. 14 of the Covered Bond Directive, before the deadline for the implementation of national transposition laws, which was formally approved in September 2022.

The critical mass achieved by this initiative (over 76% of covered bonds outstanding globally are now included in the label) demonstrates the Industry's recognition of the need to respond to the requirements of new classes of investors by providing higher levels of transparency to aid investment decisions. In this context, it is important to highlight that at present five non-EEA countries (Australia, Canada, Singapore, South Korea and the UK) on aggregate hold 35 labelled cover pools, linked to 554 covered bonds, which account for over EUR 363 bn, equivalent to over 64% of the non-EEA covered bond market share.

FIGURE 4 | GLOBAL COVERED BOND PRESENCE



■ No active covered bond market ■ Active covered bond market but no Covered Bond Label ■ Initial stakeholders' debate on covered bonds ■ Covered Bond Label presence

Source: Covered Bond Label, ECBC Fact Book 2023

LOOKING AHEAD

The Industry has demonstrated its capacity to drive innovation and implement global transparency benchmarks through market initiatives such as the Covered Bond Label and the European Secured Note (ESN) instrument. More importantly, the community, by acting as a market catalyst, has facilitated investors' compliance with their due diligence obligations and provided a key contribution in the building of the Capital Markets Union in Europe. This market principle-based approach, in parallel with the introduction of the Covered Bond Directive, has shown that it is possible to build, from the bottom-up, proposals and outcomes based on market consensus to initiate global solutions that enhance transparency, comparability, convergence of markets and best practices. Taking stock of where we have come from, where we are 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 currently underway will help further strengthen the asset class and facilitate the convergence of market and supervisory best practices.

In line with the ever-growing importance of sustainable finance, the covered bond Industry has embraced the urgency and challenges of this issue, and, at the time of writing, 142 sustainable covered bonds, collectively worth over EUR 135 bn issued by 43 issuers in 14 jurisdictions are registered under the Covered Bond Label. Moreover, to provide more asset-related information for labelled covered bonds which are flagged as sustainable, starting from Q1 2023 labelled issuers were requested to complete the F1 Tab of the Label's Harmonised Transparency Template (HTT), which is specifically dedicated to sustainable mortgages in the cover pool. From Q1 2024, the ESG disclosure in the HTT is further developed by providing issuers the possibility to indicate whether their sustainable covered bonds are sustainable-collateral-asset-based or are linked to (re)financing of sustainable projects without sustainable assets in the cover pool. The challenges that lie ahead in this area are characterised by agreeing on a shared set of definitions to define "sustainable" and the specific ESG criteria for the underlying assets in the cover pool.

The ongoing harmonisation of the covered bond asset class at both EU and at the global level represents a new era for the Industry. Alongside this, market conditions, political and environmental developments and new trends are all impacting and shaping the product here and now, and will continue to do so going forward.

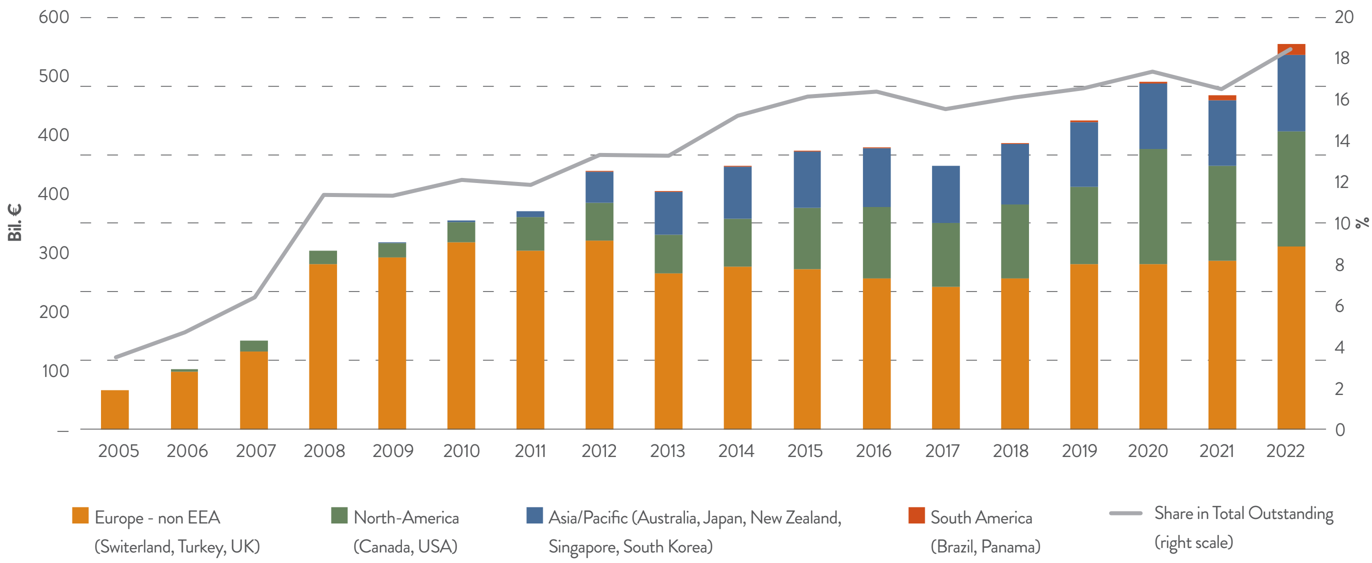
SECTION II. MAPPING

The Current State of Play and Outlook for Covered Bonds Beyond the European Economic Area

By **Antonio Farina,** S&P Global Ratings, **Ian Stewart**, UK Regulated Covered Bond Council (UK RCBC), **Lily Shum**, Canada Mortgage and Housing Corporation (CMHC), **Filipe Pontual**, Brazilian Association of Real Estate Loans and Savings Companies (ABECIP), **Robert Gallimore,** Australian Securitisation Forum (ASF), **Thomas Cohrs**, Helaba, **Colin YS Chen**, DBS Bank & Chairman of the ECBC Global Issues Working Group, **Elena Bortolotti**, Barclays and **Riku Yamashita**, Barclays

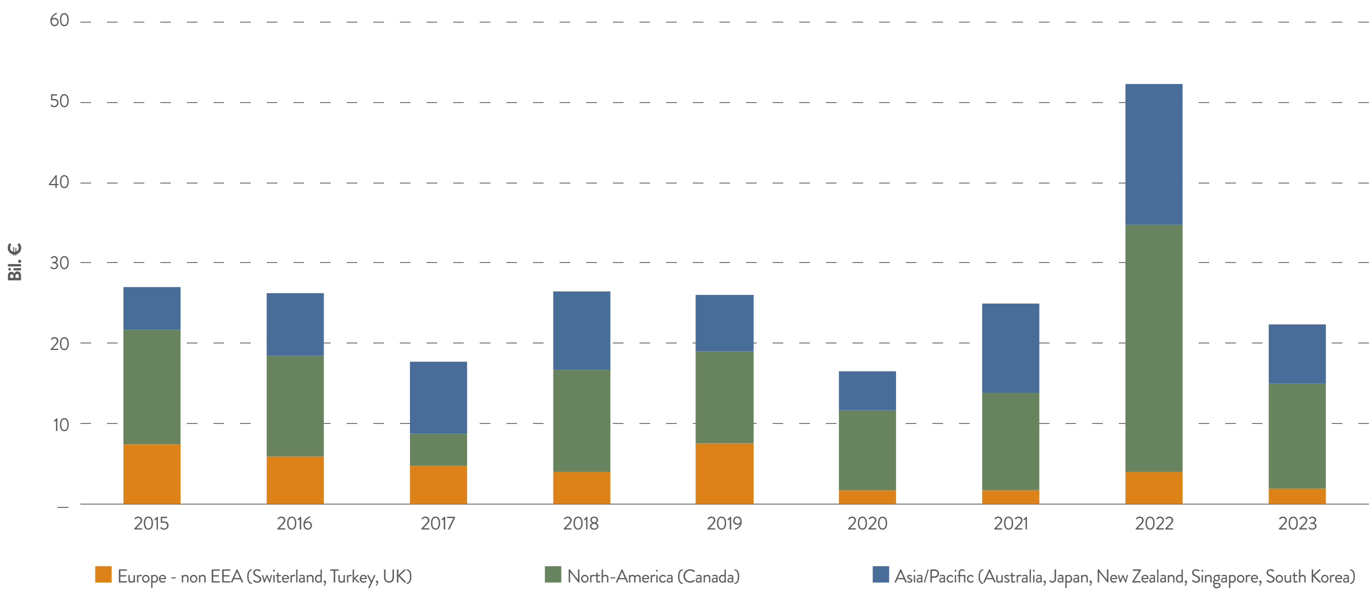
Covered bonds represent an over EUR 3 tn global asset class. Initially dominated by European issuers, covered bonds are gaining popularity in many other markets, such as Australia, Canada, Japan, New Zealand, Singapore and South Korea (see Figure 5A).

FIGURE 5A | NON-EEA COVERED BOND MARKET, OUTSTANDING AMOUNTS



Source: EMF-ECBC

FIGURE 5B | NON-EEA COVERED BOND MARKET, EUR-DENOMINATED BENCHMARK ISSUANCE



Source: Helaba

The global financial crisis of 2008 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 noted banks' ability to issue covered bonds in times of stress and expedited the approval or the amendment of dedicated legislation. Since then, covered bond issuance has picked up quickly in most of these countries.

Despite extended COVID-19 containment measures that pushed the world into the deepest recession since the Great Depression of 1929, the covered bond market remained open throughout 2020 and banks were able to find investors, even at the peak of market turmoil. Cheap central bank funding partly replaced investor-placed covered bonds, but also supported issuance of retained covered bonds. Volumes outside Europe have surged since the second half of 2021, as monetary policy normalisation curtailed issuers' access to cheap central bank funding. Issuance was particularly strong in Canada and Australia, but banks in Singapore, South 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 programmes more, especially if other sources of funding, such as senior unsecured bank debt, become relatively more expensive or difficult to place with investors.

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

NON-EEA EUROPE

BOX 1 | UK MARKET by **Ian Stewart**, UK Regulated Covered Bond Council (UK RCBC)

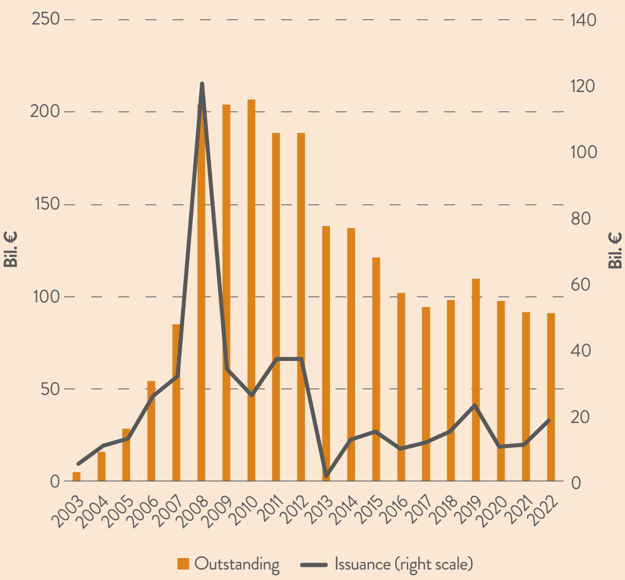
UK

From the first UK covered bond issued in 2003 until the introduction of UK covered bond regulations in March 2008, UK covered bonds were issued under general English law and structured finance principals. The Regulations overlaid the contractual structures and were designed to meet the statutory requirements of the time. The Financial Conduct Authority (FCA) is responsible for the supervision of issuers and programmes, maintains the issuer registry and has a wide range of enforcement powers. Following the UK's departure from the EU in January 2021, the Covered Bond Directive will not be implemented in the UK until third country recognition is achieved. UK covered bond regulations are closely aligned to the Directive and the majority of issuers hold the Covered Bond Label. There are currently 13 UK issuers with regulated covered bond programmes, which are all members of the UK RCBC. Over twenty years the market has evolved to represent an important European and domestic source of funding, as well as an efficient means to access central bank funding through the use of retained bonds as collateral.

Development of Covered Bond Issuances

Initially, outstanding issuances grew rapidly, peaking in 2010 (see Figure 6). These included a large volume of retained issuance. The maturities of these early issues then outstripped new issuance for a number of years. The level of outstanding balances has been broadly stable in recent years and the market has been primarily for public bonds for both domestic and overseas investors. The aggregate balance at the end of 2022 was EUR 91 bn. At that time, 37% of all UK regulated covered bonds were denominated in EUR, with GBP making up the majority of the balance at 58% and other currencies representing only 5% of market share. The amount of the market represented by GBP issuance has been steadily growing over recent years as an increasingly deep and efficient wholesale funding source for UK issuers. GBP transactions issued since 2014 are almost exclusively 3–5-year floating rate bonds. Since 2018 this has been based on a compounded daily Sterling Overnight Index Average (SONIA) rate. The issuances in EUR tend to be fixed rate, with the vast majority in the 5–10-year tenor. For a number of years, all new issuance has been soft-bullet maturities with under 3% of outstanding bonds at the end of 2022 having hard-bullet maturities.

FIGURE 6 | COVERED BONDS OUTSTANDING AND ISSUED, UK ISSUERS



Source: EMF-ECBC. Please note that this data includes private placements, floating rate covered bonds and self-retained issuances that may have been used to access central bank liquidity.

BOX 2 | SWISS MARKET by **Robert Horat** and **Lasse Christensen**, Pfandbriefbank schweizerischer Hypothekarinstitute AG

SWITZERLAND

The Swiss Pfandbrief® is based on a special law which came into force in 1930 and is a classic joint refinancing model with two dedicated central issuers. By law, these two special institutes have an exclusive right to issue Swiss Pfandbriefe®. Conversely, the Pfandbrief Act also severely restricts their scope of business: their sole purpose is to issue Swiss Pfandbriefe® to support the refinancing of the mortgage business of its affiliated member banks. Pfandbriefe and loans to member banks are matched. The bank must cover received loans from its Pfandbrief institute with its own dedicated cover pool in accordance with the provisions of special legislation and regulations.

As at the end of 2022, "Pfandbriefzentrale der schweizerischen Kantonalbanken" had CHF 77 bn Swiss Pfandbriefe® for the 24 cantonal banks outstanding, "Pfandbriefbank schweizerischer Hypothekarinstitute AG" counted 291 affiliated member banks and an outstanding Pfandbrief volume of CHF 85 bn. Swiss Pfandbriefe® are always issued in CHF and covered with mortgages on Swiss properties.

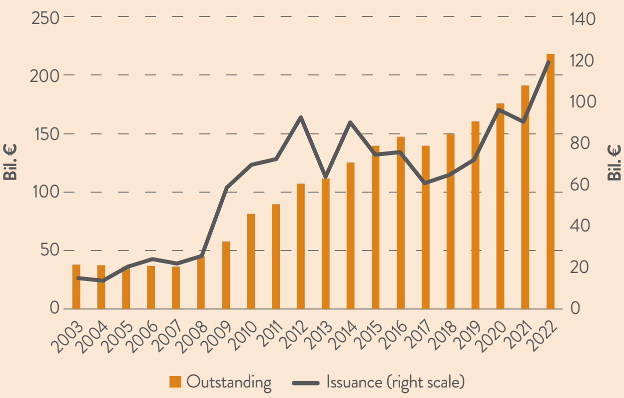
In 2010, UBS and Credit Suisse launched structured covered bond programmes in addition to the secured refinancing via Pfandbriefbank. As at the end of 2022, six banks had structured covered bond programmes outstanding with a total amount of approximately CHF 10 bn (dominated by Credit Suisse and to a small extent in EUR, USD and NOK).

Development of Swiss Pfandbrief® Issuances

Not least because of the strong Swiss franc, the ECBC Fact Book 2023 shows Swiss Pfandbrief® and structured covered bonds represent the seventh largest covered bond market worldwide and the largest non-EEA covered bond market (ahead of Canada). Nevertheless, Swiss Pfandbriefe® are predominantly domestically orientated due to the Swiss withholding tax on interest payments and the strong financial market demand. The Swiss Pfandbrief® is proven to be a resistant and stable success model. The Swiss Pfandbrief® is highly standardised and forms its own stable, dense yield curve, which is used as an alternative reference curve on the Swiss capital market. All Swiss Pfandbriefe® are hard-bullet and fixed rate. According to market conditions, issued durations are usually between 5 and 15 years, but short-term and long-term bonds with maturities up to 30 years can also be issued. Volume growth increased significantly since 2010. The Swiss Pfandbrief® refinances around 14% of the mortgage volume of Swiss banks.

As part of the Swiss implementation of Basel III, all Basel requirements for privileged regulatory treatment are to be integrated into the laws and ordinances as minimum requirements for Swiss Pfandbriefe® (incl. a minimum OC of 10 %).

FIGURE 7 | SWISS PFANDBRIEFE® OUTSTANDING AND ISSUED, SWISS ISSUERS



Source: EMF-ECBC

NORTH AMERICA

Canada represents one of the most successful covered bond markets outside Europe, with 13% 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 almost half of total bonds outstanding (see Box 3: Canadian Market by Lily Shum, Canada Mortgage and Housing Corporation (CMHC)).

Covered bonds have achieved less success in the USA, where no covered bond legislation exists despite several attempts in the post-crisis period. Moreover, the previously issued structured covered bonds have now matured and no USA covered bonds are currently outstanding. As long as government-sponsored enterprises such as Fannie Mae and Freddie Mac guarantee most new mortgages, appetite for market-based alternatives such as covered bonds will be minimal.

BOX 3 | CANADIAN MARKET by **Lily Shum**, Canada Mortgage and Housing Corporation (CMHC)

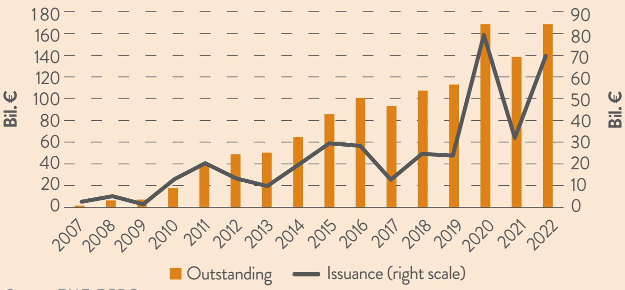
CANADA

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. The Canada Mortgage and Housing Corporation (CMHC) is responsible for the administration of the legal framework in Canada and registers issuers and programmes, maintains the issuer registry, and develops and updates the Canadian Registered Covered Bond Programmes Guide (CMHC Guide), which specifies the framework requirements. Currently, there are 10 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 (see Figure 8). Further growth in issuances followed the passage of a dedicated covered bond legislation that established a statutory covered bond regime in Canada. This growth in covered bond issuances since the programme's inception has fundamentally shifted the Canadian banks' wholesale term funding profile.

FIGURE 8 | COVERED BONDS OUTSTANDING AND ISSUED, CANADIAN ISSUERS



Source: EMF-ECBC

In April 2018, the Government of Canada published the Bank Recapitalisation (Bail-in) Conversion Regulations, SOR/2018-57, under the Bank Act and CDIC Act (Bail-in Regulations). The Bail-in Regulations specify the prescribed shares and liabilities that are eligible for bail-in conversion and their conversion terms. Covered bonds are specifically excluded from prescribed liabilities under the bail-in regulations.

Globalisation, Cross-Markets and Beyond

Canadian issuers remain key participants in international covered bond markets, issuing opportunistically in CAD, EUR, USD, GBP, CHF, NOK and AUD markets upon favourable basis swaps and strong market technicals to build a globally diversified funding platform. A domestic Canadian dollar-denominated covered bond market has also emerged, yet remains less than 10% total outstanding issuances. As of Q3 2023, EUR-denominated issuances represented 49% of outstanding issuances, followed by USD-denominated and GBP-denominated issuances.

CENTRAL AND SOUTH AMERICA

Covered bonds in this region have a short and limited track record. **Panama** saw the first covered bond issuance in 2012. Here, issuance is based on contractual agreements due to the lack of a specific legal framework for covered bonds. **Chile** is the only other covered bond market in the region, with limited, locally distributed covered bond issuance.

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 approval of covered bond regulations in **Brazil** in 2018 and the development of the local market since 2019. If covered bonds prove successful in Brazil, we may see other countries in the region follow its lead, such as Argentina, Peru, Mexico and Colombia.

BOX 4 | BRAZILIAN MARKET by **Filipe Pontual**, ABECIP (Brazilian Association of Real Estate Loans and Savings Companies)

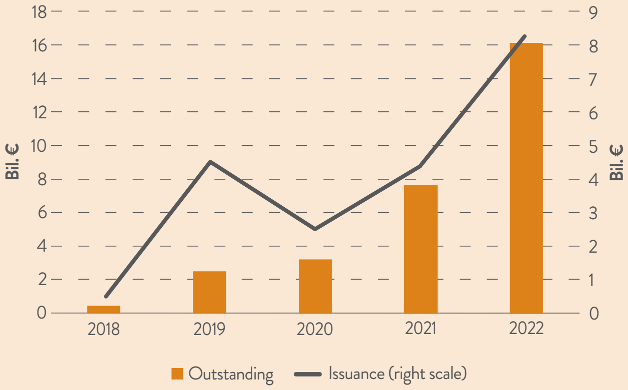
BRAZIL

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 covered bond programmes, and by December 2019, the total outstanding volume of LIGs was BRL 10.2 bn, approximately EUR 2.3 bn. Three years later, in December 2022, the total outstanding volume stood at BRL 89.6 bn (about EUR 16.1 bn), a robust growth of more than 700%. In September 2023 the outstanding volume was equivalent to EUR 20.7 bn.

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 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.
- 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).

FIGURE 9 | COVERED BONDS OUTSTANDING AND ISSUED, BRAZILIAN ISSUERS



Source: EMF-ECBC

AUSTRALIA AND NEW ZEALAND

Australian banks first issued covered bonds in 2011, following the enactment of legislation and the establishment of prudential guidance and oversight. Banks in New Zealand started issuing covered bonds in 2010 as the statutory regime did not limit the issuance of covered bonds in the same way as the Australian Banking Act.

With approximately EUR 14 bn in new EUR benchmark issuance in 2022, Australian and New Zealand issuers have returned to the market following a period of relative absence during the COVID-19 pandemic. Australian issuers have issued in EUR, USD and GBP, and, as such, their share of the overall global covered bond market across currencies has increased relative to prior years.

2022 was the first year since 2016 that all licensed issuers in the region have printed new EUR benchmarks in covered bonds. While EUR has remained the most active issuance currency in Australia, representing two-thirds of all new bonds in volume, USD and GBP issuances have seen strong demand as well as issuances in CHF and AUD. New Zealand remained focused on EUR issuance only.

In terms of overall market share, with close to EUR 45 bn outstanding, the region has regressed from its previous high of around 3% in 2019 and is now closer to 2% of all EUR denominated covered bond benchmarks.

With the Term Funding Facility (TFF) for Australia and the Funding for Lending Programme (FLP) for New Zealand, issuers in both countries had access to liquidity at very competitive rates and saw a corresponding reduction in market issuance. Neither programme was available beyond the end of 2022. Therefore, covered bonds are a key component in ensuring well-diversified wholesale funding portfolios for Australian and New Zealand issuers and, as such, issuance is expected to increase moderately or at least remain stable over the next few years.

Australian and New Zealand issuers remain key participants in international covered bond markets, issuing in EUR, USD, GBP, AUD and other currencies across different tenors to maintain a globally diversified funding platform.

BOX 5 | AUSTRALIAN MARKET by **Robert Gallimore**, Australian Securitisation Forum

AUSTRALIA

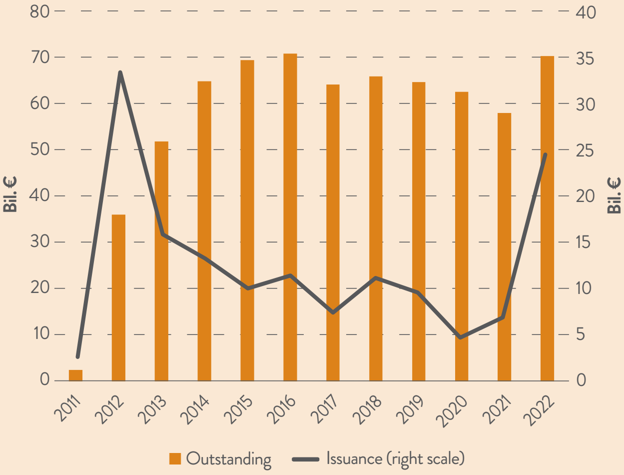
The Australian Banking Act was amended in 2011 to provide a legislative framework to enable issuance of covered bonds by Australian Authorised Deposit Taking Institutions (ADIs). The Australian Prudential Regulation Authority (APRA) is the prudential supervisor and can, in specific circumstances, give directions in relation to covered bond issuances and the cover pool assets. APRA's Prudential Standard APS 121 Covered Bonds sets out further regulatory requirements in relation to the issuance of covered bonds.

The Australian regulatory framework allows ADIs to issue covered bonds secured up to 8% of an ADI's total assets in Australia. The cover pool can consist of residential or commercial mortgages, which must be beneficially held by a bankruptcy remote covered bond special purpose vehicle. Covered bond holders have dual recourse: first against the issuer, and then, following certain trigger events including payment default, against the cover pool assets. The minimum legislative overcollateralisation requirement is 3%. The Loan to Value Ratio (LVR) for residential mortgages is capped at 80% and for commercial mortgages at 60%. A cover pool monitor is required to be appointed to each programme to provide an independent oversight of the covered bond programme and the cover pool.

The main characteristics of Australian covered bonds are:

- The debt instrument is issued by an ADI with a guarantee provided by the covered bond guarantor, which is secured by a pool of residential or commercial mortgages.
- Cover pool assets are protected from the claims of other creditors of the ADI legislatively through the Australian Banking Act and through separation of the cover pool of assets from the ADI such that they are set aside and held by the covered bond guarantor, which is a bankruptcy remote special purpose vehicle.
- In addition to the minimum legislative overcollateralisation of 3%, all Australian covered bond programmes share a minimum contractual overcollateralisation of >5%.
- The legislation requires that an independent cover pool monitor be appointed which meets certain qualifications and which must provide reports in respect of the cover pool assets, including as to compliance with the statutory overcollateralisation requirements, compliance of the assets in the cover pool with the eligibility requirements under the legislation and the accuracy of the cover pool register.
- APRA's Prudential Standard requires issuing ADIs to have in place policies, procedures and systems to manage all exposures to their covered bond vehicles.

FIGURE 10 | COVERED BONDS OUTSTANDING AND ISSUED, AUSTRALIAN ISSUERS



Source: EMF-ECBC

BOX 6 | NEW ZEALAND MARKET by **Robert Gallimore**, Australian Securitisation Forum

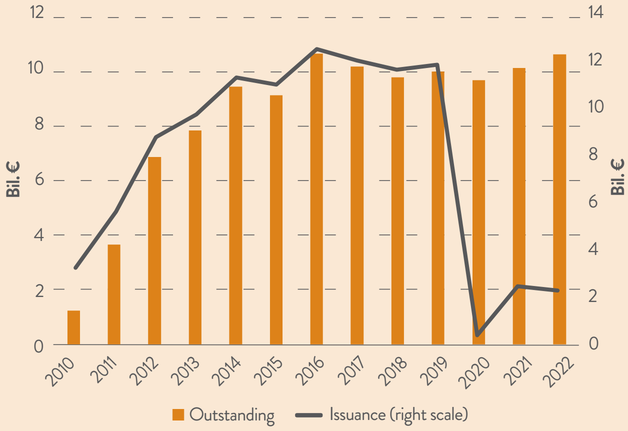
NEW ZEALAND

Covered bond programmes in New Zealand are similar to those of Australian issuers. Like Australia, covered bond holders in New Zealand have dual recourse against the issuer and, following certain trigger events, against the cover pool assets. As with Australian programmes, this second level of recourse is provided by the special purpose bankruptcy remote covered bond guarantor providing a guarantee for the benefit of covered bond holders, which is secured over the cover pool assets. In New Zealand, only residential mortgages are held by the covered bond guarantor.

The Reserve Bank of New Zealand (RBNZ), as the prudential supervisor of banks in New Zealand, does not prescribe what assets can be sold to the covered bond guarantor. However, it does have the ability to register covered bond programmes under class designations based on the types of assets in the cover pool. In addition, the conditions of registration that apply to New Zealand issuers limit the amount of total assets that may be owned by the relevant covered bond guarantor to 10% of that bank issuer's total assets.

While banks in New Zealand were able to issue covered bonds without any changes in law, the Banking (Prudential Supervision) Act was amended in 2013 to provide covered bond holders with greater certainty that their security over cover pool assets would remain enforceable if the issuing bank failed. The Act requires the RBNZ to maintain a public register of covered bond programmes and specifies that banks in New Zealand may only issue covered bonds under registered covered bond programmes. Each bank's programme is reviewed by the RBNZ before it is registered. Similar to Australia, the Act also requires the appointment of an independent cover pool monitor to report on the accuracy of the coverage tests included in the relevant programme and cover pool register. The Banking (Prudential Supervision) Act does not provide for a minimum amount of overcollateralisation but does require that the value of the cover pool assets is at least equal to the principal amount of outstanding covered bonds. Covered bond programmes in New Zealand embed the overcollateralisation in the programme documents. Each covered bond programme in New Zealand provides for the overcollateralisation to be the greater of the contractually specified amount and such other amount required by the relevant rating agency to maintain the current ratings of the covered bonds.

FIGURE 11 | COVERED BONDS OUTSTANDING AND ISSUED, NEW ZEALAND ISSUERS



Source: EMF-ECBC

ASIA

South Korea and Singapore pioneered covered bond issuance in developed Asia. As customer deposits primarily fund local banks, their main motivation in establishing covered bond programmes was to manage asset liability mismatch risk and diversify their funding sources.

Covered bonds in **South Korea** can be issued through the Covered Bond Act and the Korea Housing Finance Corporation Act. The Korea Housing Finance Corporation (KHFC) has issued covered bonds since 2010 and was joined by Kookmin Bank in 2015. Since then, KHFC issued the first social covered bond from Asia and the first South Korean euro-denominated covered bond in 2018. KEB Hana Bank established its own covered bond programme and inaugural euro-denominated issuance in January 2021. A few years ago the Korean Financial Services Commission adopted several measures to encourage covered bond issuance, including reduced registration fees for issuance and lower capital requirements for investors. These measures incentivised the issuance of South Korean won-denominated bonds and, since 2019, five financial institutions, including KHFC, have issued covered bonds in the domestic market.

The regulatory framework for the issuance of covered bonds by banks incorporated in **Singapore** was established in 2013 and refined in 2015 through the Monetary Authority of Singapore (MAS)'s Notice 648. With the legislative framework in place, the three major domestic banks have already set up their programmes and issued, cumulatively, the equivalent of more than €14 bn as of mid-2022. The increase of the asset encumbrance limit to 10% (up from 4%) of the issuer's total assets since October 2020 has provided more headroom for further issuance. However, overall supply will likely be limited because banks in Singapore are mostly funded by depositors and have limited foreign currency funding needs (see Box 7).

BOX 7 | SINGAPOREAN MARKET by **Colin YS Chen**, DBS Bank & Chairman of the ECBC Global Issues Working Group

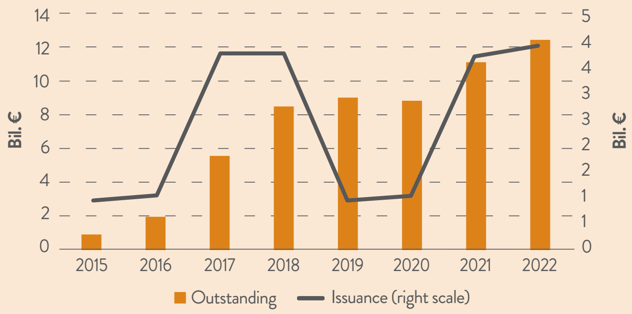
SINGAPORE

Covered bonds were introduced as a funding tool for banks in Singapore in 2014 after revisions to the final covered bond legislation, MAS Notice 648. 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 15 bn as of 31 December 2021 and issued four covered bonds in 2021 equivalent to EUR 3.7 bn (see Figure 12). As the market continues to grow, foreign banks incorporated in Singapore are also considering setting up covered bond programmes in the country to tap demand.

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 (10%) and overcollateralisation (3%), among other things.

So far, Singaporean banks have issued across a mix of currencies (EUR, GBP, AUD, USD) according to each issuing 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 Singaporean issuers holding the Covered Bond Label and adhering to global best practices.

FIGURE 12 | COVERED BONDS OUTSTANDING AND ISSUED, SINGAPOREAN ISSUERS



Source: EMF-ECBC

To the Future, and Beyond

The covered bond market in Singapore has been on an upward trajectory since the first issuance in 2015, with a slow-down in 2019. The future issuance pipeline is strong, with banks indicating their commitment to a regular presence in the market for benefits including market access maintenance, investor-base diversification and funding diversification. 2022 covered bond issuance levels have seen a return to the levels witnessed in 2017/2018.

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

Sumitomo Mitsui Banking Corporation (SMBC) issued the first covered bond in Japan in November 2018, and Sumitomo Mitsui Trust Bank (SMTB) followed in October 2020. Since then, the two banks have issued 11 tranches of public benchmark covered bonds in EUR and USD, raising a total amount of over EUR 8.0 bn.

BOX 8 | JAPANESE MARKET by **Elena Bortolotti**, Barclays & Chairwoman of the ECBC Rating Agencies Approaches Working Group and **Riku Yamashita**, Barclays

JAPAN

After the COVID-19 pandemic, there was a temporary reduction in the issuance of Japanese covered bonds, partly due to the Bank of Japan providing liquidity supply facilities. However, with the discontinuation of these facilities by the Bank of Japan, we saw a resurgence in issuance in 2023 with an annual volume of EUR 1.75 bn. Both SMBC and SMTB intend to be frequent covered bond issuers. Other major Japanese banks are also showing increased interest in accessing the covered bond market.

The size of the Japanese residential loan market, with an annual new lending amount of JPY 21 tn and a total balance of JPY 216 tn (as of March 2023), is notably large even when compared to other advanced countries. This underscores the significant growth potential of Japanese covered bond market.

If a covered bond regulatory framework is introduced in Japan in the future, it could serve as a catalyst for further increasing the number of Japanese covered bond issuers. Currently, Japan lacks a regulatory framework, leading both SMBC and SMTB to issue in the form of a structured covered bond. This aligns with the approach taken by the UK, Canada and New Zealand, where structured covered bonds were issued prior to the establishment of a regulatory framework. Since September 2018, the major Japanese banks have been regularly advocating to regulatory authorities for the introduction of a framework. Currently, the Japanese Financial Services Authority (FSA) is looking very closely at how best to implement a covered bond regulatory framework.

Additionally, in the Japanese Basel III finalisation, set to take effect from March 2024, covered bonds will be granted preferential treatment in terms of RWA in Japan for the first time. Consequently, it is expected that covered bonds in Japan will garner increasing attention not only from issuers but also form investors.

In the absence of a covered bond regulatory framework, Japanese covered bond programmes have been established in a way to replicate as closely as possible legislative covered bonds. Japanese covered bonds are issued by banks acting as Trustee and the cover pool is segregated by operation of law in the Trust Account. Dual recourse is achieved by allowing covered bond holders to have recourse to the bank's assets available to general creditors, in addition to exclusive recourse to the cover assets held in the Trust Account.

The bank, acting in its proprietary capacity, will be the Total Return Swap (TRS) Counterparty, the Initial Servicer as well as the Initial FX Counterparty. The cover pool assets are transferred from the Bank Proprietary Account to the Issuer, using a TRS. The Trust Account pays the cash flows generated by the cover pool assets to the Bank Proprietary Account, and the Bank Proprietary Account pays to the Trust Account the covered bonds' interest and principal amounts, which are then passed to the covered bond holders.

Japanese covered bonds benefit from a soft-bullet maturity extension. Following, a TRS Default Event (defined as failure to pay, credit support default including breach of the Asset Coverage Test (ACT), bankruptcy of the Issuer, merger without assumption) the cover assets will be liquidated, and the realisation period starts. The realisation period is akin to the extension period in soft-bullet covered bonds, it is a nine-month period during which the Selling Agent can either sell the RMBS or unwind the RMBS and sell the underlying mortgages to repay the covered bond holders by the realisation redemption date.

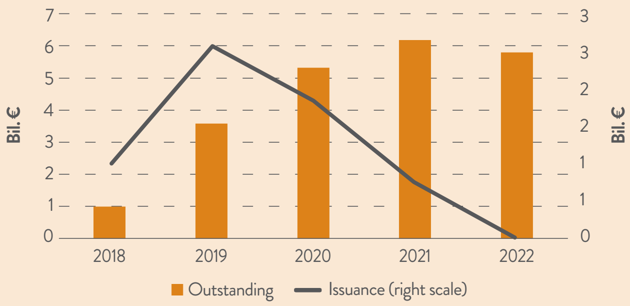
Cover assets consist of self-originated senior tranches of residential mortgage-backed securities (RMBS), Japanese Government Bonds and/or cash. As the cover assets are RMBS, the 80% Loan to Value is satisfied by applying an Adjusted LTV Limit Factor of 80% in the ACT. The minimum overcollateralisation (OC) requirement has contractually been set well above the European OC levels at 25%.

The programmes do not have a liquidity buffer but do provide for an Interest and Expenses Reserve which covers for nine months of interest due on all covered bonds outstanding and senior expenses.

In line with the new disclosure requirements under the Covered Bond Directive, issuers publish on a quarterly basis, investor reports which include detailed information on the underlying mortgages of the RMBS as well as information on the covered bonds.

Finally, both Japanese covered bond programmes have an Asset Monitor (an Accounting Firm) that typically checks and reports to the transaction parties, on a quarterly basis, on the compliance or non-compliance of the ACT and the maintenance of sufficient funds in the Interest and Expenses Reserve.

FIGURE 13 | CCOVERED BONDS OUTSTANDING AND ISSUED, JAPANESE ISSUERS



Source: EMF-ECBC

Issuers in **China** have expressed increased interest in dual-recourse issuance in the past few years. Since larger banks in China benefit from abundant liquidity and strong deposit bases, the appetite for covered bonds mainly reflects increasing risk awareness and, more specifically, the importance of having alternative tools for banks to plan for rainy day funding, rather than current funding needs. Aside from limited issuers' supply, several other legal and regulatory questions should be considered. The incumbent asset issue is a primary challenge for covered bond issuance. China has regulations on the protection of deposit holders and the arrangement to ringfence specific banks' assets to benefit covered bond holders could be complicated without a dedicated legal framework. Moreover, legally, deposit holders enjoy a very high ranking in the allocation waterfall after banks' liquidation in the region. Because these assets' ringfencing and deposit ranking relate to the sovereign banking laws, regulators may find it difficult to have flexibility, even if they support the development of covered bond issuance. Finally, it is unclear whether an on-shore special-purpose vehicle could validly provide a guarantee for payments. So, while banks in China are likely to investigate covered bond options, it will probably take regulatory and deal-arranging efforts for issuance to materialise.

India has a significant shortage of affordable housing and a young and growing population. Moreover, household debt as a percentage of GDP is below that of other emerging markets. These factors suggest significant growth potential for the country's housing finance sector. Currently, customer deposits are Indian banks' primary source of funding, but issuers and regulators are considering alternative sources of wholesale funding, including covered bonds. For example, in 2019 the Reserve Bank of India (RBI) constituted a Committee on the Development of the Housing Finance Securitisation Market, which recommended, among other things, an enhanced role for the National Housing Bank and further amendments to reduce the securitisation transaction costs. Like other Commonwealth countries, such as Australia and the UK, India does not have specific securitisation legislation. Rather, the legal framework for India's securitisation market is based on existing trust, contract and property law, and a series of RBI guidelines. If covered bonds are issued in India, they may (at least initially) be issued under a general-law framework with an appropriate supportive regulatory framework. In this context, key clarifications required will include whether issuance 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, and whether any tax challenges would apply, including stamp duty and withholding tax.

AFRICA

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 across the continent, the experience in Morocco shows that the legislative process can take longer than expected.

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 their concerns about the potential pricing pressure on their senior unsecured debt, the losses if an issuer becomes insolvent and ratings implications for this debt. Hence, it is unlikely a covered bond market will develop in South Africa any time soon.

SECTION III. HARMONISATION AND GLOBAL BEST PRACTICES

Identifying Fundamental Principles of Covered Bonds

By **Cristina Costa**, Barclays, **Sascha Kullig**, Verband Deutscher Pfandbriefbanken (vdp) and **Maureen Schuller**, ING Bank

Covered bonds are widely used around the globe, but their regulatory treatment varies. Based on the previous work of the ECBC Global Issues Working Group (GIWG) this article analyses how well third country covered bond frameworks are aligned with the European Covered Bond Directive and Article 129 of the CRR. Moreover, the article also zeroes in on the risk weight, LCR and collateral treatment of covered bonds outside Europe.

THE REGULATORY TREATMENT OF COVERED BONDS ON A GLOBAL SCALE

The preferential regulatory treatment of covered bonds is still largely a European phenomenon. Outside Europe, the regulatory recognition of covered bonds is mostly aligned with the Basel Committee on Banking Supervision (BCBS)' stipulations, meaning that covered bonds are generally treated less favourably from a risk weight or liquidity coverage ratio (LCR) perspective, and subject to less comprehensive conditions and detail for such treatment. Even the eligibility of covered bonds for central bank collateral purposes is not commonplace and typically restricted to national currencies.

In Europe, since July 2022 the preferential treatment of covered bonds is based on the Covered Bond Directive and the amended CRR Article 129. Covered bonds issued from 8 July 2022 at minimum have to meet all the mandatory requirements of this Directive and the revised requirements of Article 129 of the CRR to be eligible for a favourable risk weight treatment. In addition, covered bonds issued before that date must meet certain requirements from the Directive on top of the UCITS 52(4) and CRR Article 129 requirements applicable on their issue date. These include the investor information requirements and certain covered bond special supervision requirements.

The EU will start applying Basel 3.1 (CRR 3) from 1 January 2025, thereby introducing a more granular risk weight approach for unrated covered bond exposures, but without changing the risk weights for rated covered bonds. CRR 3 will also revise the Article 229(1) property valuation rules. However, the amended CRR Article 129(3) no longer refers to the Article 229(1) requirements. Since 8 July 2022; property valuation is covered by the national laws implementing the Covered Bond Directive.

The Basel III reforms (i.e. Basel 3.1 or Basel IV) also paved the way for a preferential treatment of covered bonds on a global scale. Various countries outside Europe already apply Basel 3.1 as of the intended implementation date of 1 January 2023, but not all jurisdictions introduced a favourable risk weight treatment for covered bonds in line with the Basel III reforms.

BASEL III REFORMS PAVE THE WAY FOR PREFERENTIAL RISK WEIGHT TREATMENT AT A GLOBAL LEVEL

In December 2017, the BCBS finalised its post-crisis regulatory reforms, providing for the preferential risk-weights for covered bonds at a global level (see Box 9). The requirements set by the BCBS were founded on the more general conditions according to Article 52 (4) of the UCITS-Directive and the additional requirements of the old CRR Article 129.

BOX 9 | The Basel III Reforms' Requirements for the Preferential Risk Weight Treatment of 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 bond holders. In line with the law, bond proceeds must be used to finance assets capable of covering the 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 an LTV of 80% or lower that meet the applicable requirements on, for example, legal enforceability, the claim of the bank over the property and the ability of the borrower to pay.
- 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 overcollateralisation should be at least 10%. Where national legislations do not provide for a 10% minimum overcollateralisation, 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 semi-annually) 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.
- The percentage of loans more than 90 days past due.

FIGURE 14 | RISK WEIGHT TREATMENT FOR EXPOSURES TO RATED COVERED BONDS

CREDIT QUALITY STEP	1	2	3	4	5
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%
EU CRR (current)	10%	20%	20%	50%	100%

Source: Basel Committee on Banking Supervision, European Commission

FIGURE 15 | 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

On the back of the Basel III reforms several countries outside Europe have meanwhile provided for a preferential risk weight treatment of covered bonds. Singapore and South Korea fully implemented the BCBS requirements for such preferential treatment. Similarly, Australia introduced favourable risk weights, but only for rated covered bonds. Switzerland makes a distinction between Swiss Pfandbriefe (the only special law based domestic covered bonds) and foreign covered bonds. To simplify the administrative work of Swiss banks, the Swiss Pfandbrief regulation was adapted to make sure that every Swiss Pfandbrief fulfils the BCBS requirements for preferential treatment. Therefore all covered bonds issued in accordance with the Swiss Pfandbriefgesetz will benefit from a 10% risk weight under the Standardised Approach. Foreign covered bonds will benefit from a favourable risk weight treatment along the lines of the BCBS requirements.

In Canada, the Office of the Superintendent of Financial Institutions (OSFI) adopted the asset eligibility and disclosure requirements for covered bonds of the Basel reforms, but with a minimum overcollateralisation requirement of 5%. Credit quality step (CQS) 1 rated covered bonds meeting these requirements still only benefit from a 20% risk weight. If the requirements are not met, the covered bonds would be risk weighted based on the external credit rating of the issuing credit institution.

Elsewhere, in New Zealand, the banking prudential requirements (BPR) 131 of 1 October 2023 do not provide for separate risk weights for covered bonds. BPR131 only includes risk weights for claims on a bank according to their rating grade. For rated exposures with an original maturity of more than three months these risk weights are comparable to the old Basel III requirements. Even CQS 2 exposures (covered bond and unsecured) are still assigned a 50% instead of 30% risk weight.

The UK still applies the old EU CRR Article 129 provisions applicable before 8 July 2022 for the risk weighting of covered bonds. As per the UK Financial Services Act 2021, certain provisions of the EU CRR were revoked post-Brexit and replaced by UK CRR rules related to these provisions, but not the old CRR Article 129 provisions on covered bonds. Box 1 in section II of this Brochure explained that the EU Covered Bond Directive will not be implemented in the UK until third country recognition is achieved. The UK will implement the Basel 3.1 framework though on 1 July 2025 and will then also apply the changes to the risk weight treatment for unrated covered bonds as per the Basel reforms. The UK Prudential Regulation Authority (PRA) aims to introduce separate due diligence requirements for covered bonds under the standardised approach to reduce the "mechanistic" use of external credit ratings for risk-weighting covered bonds. Covered bond exposures should be assigned at least a one notch higher CQS than based on the external rating if a due diligence analysis would identify higher risk characteristics than implied by the counterparty's rating.

FIGURE 16 | APPLICABLE RISK WEIGHT TREATMENT TO COVERED BONDS IN A SELECTION OF GLOBAL COVERED BOND REGIONS

EXTERNAL RATING	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	Below B-	Asset eligibility	Min OC	Disclosure	Effective	Effective as per Basel III reforms
Australia	10%	20%	20%	50%	50%	100%	✓	10%	✓	–	1 Jan '23
Canada	20%	30%	50%	100%	100%	150%	✓	5%	✓	–	1 Feb '23
New Zealand	20%	50%	50%	100%	100%	150%	–	–	–	1 Oct '23	–
South Korea	10%	20%	20%	50%	50%	100%	✓	10%	✓		1 Jan '23*
Singapore	10%	20%	20%	50%	50%	100%	✓	10%	✓		1 Jul '24
Switzerland	10%	20%	20%	50%	50%	100%	✓	10%	✓		1 Jan '25
UK	10%	20%	20%	50%	50%	100%	✓	–	✓	1 Jan '14	1 Jul '25
EAA	10%	20%	20%	50%	50%	100%	✓	5%	✓	8 Jul '22	1 Jan '25

* Multiple South Korean credit institutions already started implementing the Basel III credit framework between end of June '20 and end of June '21, ahead of the scheduled 1 January 2023 implementation date.

Source: National regulators, ING

THE STATUS OF 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. Article 31 of the European Covered Bond Directive tasks the European Commission to submit several reports to the co-legislators on the implementation of the covered bond framework and additional related matters, together with any related legislative proposals, if deemed appropriate. In preparing these reports, the EU Directive requires the European Commission to consult the European Banking Authority (EBA). On 27 July 2023, the EBA received a Call for Advice (CfA) from the European Commission to, among others, assess to this purpose whether and how an equivalence regime could be introduced for third country covered bonds. The European Commission has asked the EBA to deliver a response to the call for Advice to the European Commission by 30 June 2025.

BOX 10 | The Relevance of Third Country Equivalence After the Introduction of the EU Covered Bond Directive

As of 8 July 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 8 July 2022 most old CRR requirements, including the UCITS 52(4) reference, may still be applicable under the transitional measures. Instead, as of 8 July 2022 the new definition for covered bonds as per Article 3(1) of the Covered Bond Directive is leading for preferential risk weight treatment. Unlike UCITS 52(4), Article 3(1) of the Covered Bond Directive does not refer to the fact that covered bonds must be issued by a credit institution with a registered office in an EEA Member State.

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 Covered Bond Directive as per Article 3(1) of the Directive; plus b) the further requirements of the amended CRR with reference to the monitoring of property values, minimum 5% overcollateralisation and eligible substitution assets.

In a Q&A document, on 17 December 2021, the European Banking Authority (EBA) confirmed for instance 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 combination with Article 3 of the Covered Bond Directive, should not use the favourable 11.25% Loss Given Default (LGD) for covered bonds under the internal rating based approach (Article 161 CRR), but the 45% LGD for senior exposures instead.

The Call for Advice requests the EBA:

1. To give advice on the appropriate criteria for the determination of third country equivalence; and
2. To cover the impact that such a hypothetical regime would have on EU markets.

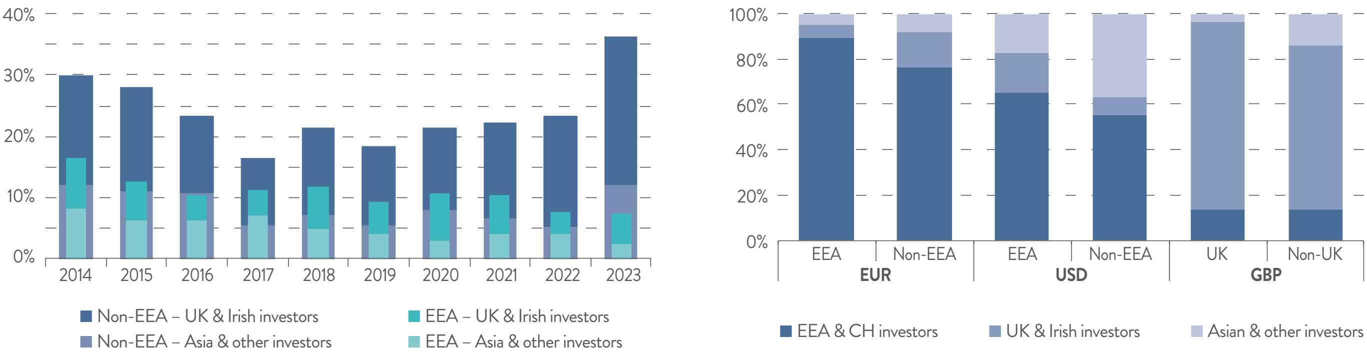
To the latter purpose, the EBA should assess the holdings of third country covered bonds by EU credit institutions, plus the holdings of EU covered bonds by credit institutions in third countries. The EBA was also asked to look at the performance of covered bond markets in significant third country markets.

PRIMARY MARKET INSIGHTS INTO CROSS-MARKET COVERED BOND HOLDINGS

Primary market distribution statistics offer some insight into cross-market covered bond holdings. These statistics show that, during the past decade, non-EEA investors (Asian & others) have bought on average 5% of the EUR covered bond transactions of EEA credit institutions in the primary market and 8% of the non-EEA EUR covered bonds. These percentages increase to 11% and 24% respectively when allocations to UK (and Irish) investors are added.

This suggests that the holdings of EEA EUR covered bonds by non-EEA credit institutions is relatively modest, with banks participating on average by 40% in both the EEA and non-EEA EUR covered bond transactions. During the last two years third country investments in new EEA EUR covered bonds have even declined slightly despite the reduced and ending allocations to the Covered Bond Purchase Programme 3 (CBPP3) for Eurozone covered bonds and the introduction of preferential risk weights for covered bonds in several countries outside Europe.

FIGURE 17-18 | PARTICIPATION NON-EEA & UK INVESTORS IN EUR COVERED BONDS OF EEA AND NON-EEA BASED CREDIT INSTITUTIONS* (LEFT) AND PARTICIPATION PER INVESTOR LOCATION IN EUR, USD AND GBP COVERED BONDS OF EEA/NON-EEA AND UK CREDIT INSTITUTIONS (RIGHT)



*UK covered bonds are part of the EEA until 2021, thereafter they are non-EEA. EEA investors exclude Irish investors, which are aggregated with the UK.

Source: IGM, ING

*UK covered bonds are part of the EEA until 2021, thereafter they are non-EEA. EEA investors exclude Irish investors, which are aggregated with the UK.

Source: IGM, ING

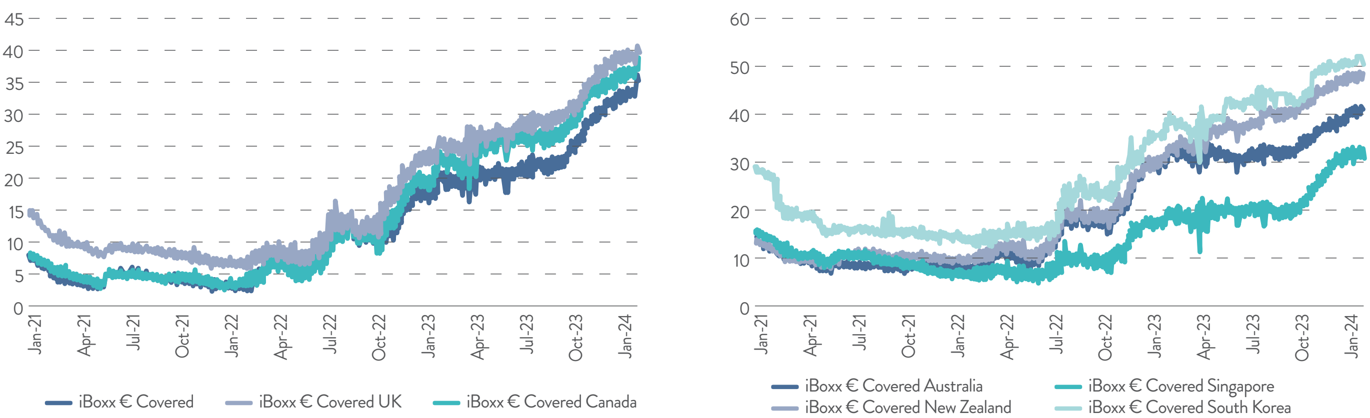
The relatively low allocations to non-EEA investors are the other side of the coin to the strong "home country" investor demand for EUR denominated EEA covered bonds. Particularly as these covered bonds offer EEA investors the benefits of a preferential regulatory (and sometimes collateral) treatment over comparable non-EEA bonds. The home country and local currency investor bias is also strongly visible for GBP covered bonds, which are mostly placed with UK investors. Non-European investors are generally more present in the smaller USD covered bond market than in the EUR or GBP markets.

While EEA investors are by far the most dominant primary buyers of the EUR covered bonds of EEA credit institutions (at 89%), they are also the largest buyers of third country EUR covered bonds in the primary market (at 76%). Considering that approximately 40% of these investments are made by banks, a third country equivalence regime for non-EEA legislative covered bonds will therefore likely be welcomed warmly by EEA investors.

PERFORMANCE CONSIDERATIONS ON THIRD COUNTRY COVERED BOND MARKETS

Spreads of covered bonds have widened since June 2022 both for EEA and non-EEA covered bonds. As the charts in Figures 19-20 show, there is increased spread differentiation between the different non-EEA segments.

FIGURE 19-20 | ASW SPREADS OF COVERED BONDS HAVE WIDENED SINCE JAN-22 (LEFT) ... BUT SPREAD DIFFERENTIATION BETWEEN DIFFERENT NON-EEA SEGMENTS PERSISTS (RIGHT)



Source: S&P Markit, Barclays Research

Source: S&P Markit, Barclays Research

The next section provides some insights into the alignment of global covered bond regimes with the European Covered Bond Directive, building upon the work of the ECBC Global Issues Working Group and publications by the rating agencies Fitch and Moody's.

GLOBAL BEST PRACTICES – TO WHAT EXTENT ARE GLOBAL REGIMES ALIGNED WITH THE EU DIRECTIVE AND ART. 129 CRR?

As explained in Section IV of this Brochure, for an equivalence assessment the fundamental covered bond principles that have to be fulfilled should be determined as a first step. Without prejudging the deciding parties, these could be the following aspects based on the EU Covered Bond Directive: dual recourse, bankruptcy remoteness of covered bonds, asset segregation, eligible cover assets, investor information, coverage requirement, covered bond public supervision and reporting to the competent authorities.

Over the past few years, on several separate occasions the ECBC Global Issues Working Group analysed how different global covered bond regimes met – at that time – 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.

In 2020, the ECBC provided an update based upon the proposed 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 analysis revealed that most global covered bond regimes were already 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.

These findings were confirmed by the rating agencies Fitch[1] and Moody's[2], even though there might be slightly different interpretation on specific aspects.

Importantly, there is full alignment with the Directive's dual recourse requirements and an almost full alignment with the bankruptcy remoteness and asset segregation requirements. On the other hand, virtually none of the global regimes is fully aligned with the joint funding requirements.

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 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 covered bond frameworks explicitly provide for credit quality restrictions on exposures to institutions or third country public sector exposures. Nor do they provide for the required legal certainty or property valuation in line with the language of the CBD/CRR. The non-alignment of the legal frameworks in this field might not be particularly relevant, since the requirements of Article 129 CRR could also be fulfilled contractually. On the other hand, derivative exposure could become a problem given that Article 129 of the CRR limits the exposure of credit institutions to a maximum of 15% of the nominal amount of outstanding covered bonds. Derivatives are explicitly mentioned in this context. But as derivatives are hedging instruments and not "normal" cover assets, this requirement needs to be fundamentally changed.

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 overcollateralisation 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). This is often met on an issuer-by-issuer basis on a contractual level. When the voluntary overcollateralisation is considered too, all jurisdictions would meet this requirement. According to the Article 129 CRR, a lower overcollateralisation requirement of at least 2% may also be applied if the calculation of the overcollateralisation 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, the use of extendable maturity structures is also 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 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

[1] "Fitch Ratings: Australia, Canada, UK Covered Bonds Well Placed for EU Equivalence", 24 August 2022 and "Fitch Ratings: Singapore Covered Bonds On a Good Path for EU Equivalence Consideration", 28 November 2022.

[2] "Covered Bonds – Global EU equivalence regime would be credit positive for third-country covered bonds", 6 September 2023.

FIGURE 21 | THE ALIGNMENT OF THIRD COUNTRY COVERED BONDS WITH THE EU COVERED BOND DIRECTIVE

ARTICLES IN EU DIRECTIVE	Australia	Canada	Korea	New Zealand	Singapore	United Kingdom	Examples of directive standards that are not reflected in third-country laws*
Art. 4 – Dual recourse	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	
Art. 5 – Bankruptcy remoteness	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	
Art. 6 – Eligible cover assets	Partially aligned	Substantially aligned	Partially aligned	Not aligned	Partially aligned	Partially aligned	*Rating-based limits for exposures to credit institutions; provisions on property valuations and insurance; criteria for non-CRR assets*
Art. 7 – Foreign assets	Substantially aligned	Substantially aligned	Partially aligned	Not aligned	Substantially aligned	Partially aligned	*Verification requirements for foreign assets*
Art. 8 – Intragroup structures	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	
Art. 9 – Joint funding	Partially aligned	Substantially aligned	Partially aligned	Partially aligned	Partially aligned	Partially aligned	*Requirement for issuers to assess origination standards of non-credit institutions*
Art. 10 – Composition of cover pool	Substantially aligned	Substantially aligned	Substantially aligned	Not aligned	Substantially aligned	Substantially aligned	*Rules on cover pool composition*
Art. 11 – Derivatives	Not aligned	Substantially aligned	Not aligned	Not aligned	Not aligned	Not aligned	*Counterparty eligibility criteria*
Art. 12 – Segregation of cover assets	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	
Art. 13 – Cover pool monitor	Partially aligned	Partially aligned	Partially aligned	Partially aligned	Partially aligned	Partially aligned	*Rule against issuer's auditor acting as cover pool monitor*
Art. 14 – Investor information	Partially aligned	Substantially aligned	Substantially aligned	Not aligned	Substantially aligned	Substantially aligned	*Need for investor information to be provided quarterly*
Art. 15 – Coverage requirements	Partially aligned	Substantially aligned	Partially aligned	Partially aligned	Partially aligned	Substantially aligned	*Requirement to cover interest on covered bonds and wind-down costs; exclusion of uncollateralised non-performing exposures*
Art. 16 – Liquidity buffer	Not aligned	Partially aligned	Not aligned	Not aligned	Not aligned	Not aligned	*Requirement for liquidity reserve to cover six months' interest payments and principal payments on hard bullets*
Art. 17 – Extendable maturities	Not aligned	Not aligned	Not aligned	Not aligned	Not aligned	Not aligned	*Criteria for permitted extension triggers and restriction on inverting sequencing of maturities*
Art. 18 – Public supervision	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	
Art. 19 – Permission for programmes	Not aligned	Substantially aligned	Substantially aligned	Substantially aligned	Not aligned	Substantially aligned	*Rule requiring permission from covered bond regulator to cooperate with the resolution authority*
Art. 20 – Public supervision post insolvency	Partially aligned	Partially aligned	Not aligned	Partially aligned	Not aligned	Partially aligned	*Requirement for covered bond regulator to cooperate with the resolution authority*
Art. 21 – Reporting to competent authorities	Partially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Substantially aligned	*Need for reporting on regular basis*
Art. 22 – Powers of competent authorities	Partially aligned	Substantially aligned	Substantially aligned	Substantially aligned	Partially aligned	Substantially aligned	*Power for covered bond regulator to implement supervisory guidelines*
Art. 23 – Penalties	Not aligned	Partially aligned	Partially aligned	Substantially aligned	Not aligned	Partially aligned	*Requirement for penaltiesrelating to violations of covered bond laws*
Art. 24 – Publication of penalties	Not aligned	Partially aligned	Not aligned	Not aligned	Not aligned	Not aligned	*Need to publish administrative penalties*
Art. 25 – Cooperation obligations	Not aligned	Not aligned	Not aligned	Not aligned	Not aligned	Not aligned	*Requirement for covered bond regulator to cooperate with regulators in other countries*
Art. 26 – Disclosure requirements	Not aligned	Substantially aligned	Substantially aligned	Substantially aligned	Not aligned	Substantially aligned	*Publication obligations for covered bond regulators*
Art. 27 – Labelling	Not aligned	Not aligned	Not aligned	Not aligned	Not aligned	Not aligned	*Restrictions on use of covered bond labels*

■ Substantially aligned ■ Partially aligned ■ Not aligned

*Each example applies to one or more third-country laws classified as "Partially aligned" or "Not aligned".

Source: Moody's Investors Service

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.

The country reports in the ECBC Fact Book 2023 provide a good overview and, in addition, the ECBC's covered bond comparative database is particularly recommended. This is a unique tool to compare key features of each covered bond jurisdiction, access links to issuer's cover pool information and access national covered bond legislation (in English). The database can be accessed at https://compare.coveredbondlabel.com/.

Furthermore, it is also worth highlighting that many issuers from third countries use the Covered Bond Label. The Label covers the most relevant fundamental covered bond principles, such as dual recourse, asset eligibility criteria, coverage requirements and supervision of the covered bond issuer. This confirms the strong overlap between the core principles of the European Covered Bond Directive and market practices around the globe.

FIGURE 22 | THE COVERED BOND LABEL CONVENTION CRITERIA

I. Legislation Safeguards

a) The covered bond programme is embedded in a dedicated national covered bond legislation.

b) The bond is issued by – or bond holders 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 Covered Bond Product

a) Bond holders 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 bond holders at all times.

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

Source: ECBC, Covered Bond Label

THE LCR TREATMENT OF THIRD COUNTRY COVERED BONDS IN THE EU

The European LCR Delegated Regulation allows covered bonds to be included as Level 1, Level 2A or Level 3 high quality liquid assets if they meet the Covered Bond Directive's Article 3 definition for covered bonds or were issued before 8 July 2022 and meet the UCITS 52(4) requirements, which makes them eligible for preferential risk weight treatment. Apart from that, the covered bonds must meet the requirements on exposures to institutions, transparency, issue size, minimum rating and overcollateralisation applicable to the relevant haircut bucket. Third country covered bonds are also eligible as Level 2A high quality liquid assets under the EU LCR regulation if they meet the requirements listed in Box 11.

BOX 11 | The EU LCR requirements for third country covered bonds

Exposures in the form of **covered bonds issued by credit institutions in third countries** which comply with the following requirements:

i) They are covered bonds in accordance with the national law, which defines them as debt securities issued by credit institutions or by a wholly owned subsidiary of a credit institution which guarantees the issue and secured by a cover pool of assets in respect of which bond holders have a direct recourse for the repayment of principal and interest on a priority basis in the event of issuer default.

ii) The issuer and the covered bonds are subject by national law to special public supervision to protect the bond holders and the supervisory and regulatory arrangements applied in the third country must be at least equivalent to those applied in the European Union.

iii) The covered bonds are backed by a pool of assets of one or more of the types described in Article 129(1) CRR, points (b), (d), (f) and (g):

- Credit Quality Step (CQS) 1 third country public sector exposures or CQS 2 third country public sector exposures subject to a 20% cap versus the outstanding covered bonds.
- Residential property loans up to 80% of the value of the pledged properties.
- Commercial property loans up to 60% of the value of the pledged properties (70% if the OC exceeds 10%)
- Ship loans up to 60% of the value of the pledged ship.

Where the pool comprises loans secured by immovable properties, the requirements set out in Article 6(2), Article 6(3)(a) and in Article 6 (5) of the Covered Bond Directive must be met regarding the claim for payment of the credit institution and on property valuation.

iv) Exposures to institutions in the cover pool meet the Article 129(1) (c) and Article 129(1a) CRR requirements.

v) The credit institution investing in covered bonds and the issuer meet the transparency requirements of Article 14 of the Covered Bond Directive.*

vi) The bonds are at least CQS 1 (AA- or better) rated, have an equivalent short-term rating, or if non-rated have a 10% risk weight.

vii) The cover pool meets at all-times an asset coverage requirement of at least 7%, or 2% for covered bonds with a minimum €500 m issue size (or the equivalent amount in domestic currency).

** These entail minimum portfolio information on the value of the cover pool and the covered bonds outstanding, a list of the ISINs of all covered bonds issued under the programme (if one has been attributed), the geographical distribution and type of cover assets, their loan size and valuation method, details in relation to market risks (interest rate and currency) and credit and liquidity risks, the maturity structure of the cover assets and covered bonds plus an overview of the applicable maturity extension triggers, the levels of required and available coverage, and of statutory, contractual and voluntary overcollateralisation, and the percentage of loans where a default is considered to have occurred pursuant to Article 178 CRR, and in any case where the loans are more than 90 days past due.*

THE LCR TREATMENT OF COVERED BONDS OUTSIDE THE EU

Outside the European Union, the criteria for the LCR eligibility of covered bonds are generally more lenient than in the EU as they are mostly founded upon the basic Basel Committee stipulations. This means that covered bonds are recognised as Level 2A qualifying liquid assets (subject to a 15% haircut) if:

a) they are not issued by the credit institution itself;

b) have at least an AA- credit rating (or internal probability of default rating equivalent);

c) are traded in large, deep and active repo or cash market characterised by a low level of concentration; and

d) have a proven record as a reliable source of liquidity in markets even during stressed market conditions.

In the UK however, the PRA Rulebook still contains LCR rules related to the old EU CRR. So far, these have not been revoked post-Brexit. The rules are UK aligned with the EU LCR Delegated Regulation applicable before 8 July 2022. Qualifying CRR covered bonds can therefore still be recognised as Level 1 assets in the UK and benefit from a 7% haircut. Third country covered bonds may qualify as Level 2A assets subject to a 15% haircut.

As the UK LCR rules do not incorporate the revisions made to the EU CRR and LCR Delegated Regulation since Brexit, third country covered bonds should still meet the (semi-annual) transparency requirements of the old CRR Article 129(7) rather than the more detailed (quarterly) investor information requirements of Article 14 of the EU Covered Bond Directive that currently apply under the EU LCR rules. The same holds true for the Article 208 and Article 229(1) CRR valuation requirements, instead of the Directive Articles 6(2), 6(3)(a) and Article 6(5) requirements on the credit institution's claim for payment and valuation of physical collateral assets.

FIGURE 23 | HAIRCUT TREATMENT OF COVERED BONDS FOR LIQUIDITY COVERAGE RATIO (LCR) REQUIREMENTS IN DIFFERENT COUNTRIES

HQLA	Minimum rating	EU	UK	Minimum rating	Australia	Canada	South Korea	Singapore	Switzerland	Minimum rating	New Zealand
LEVEL 1	AA-	7%	7%								
LEVEL 2A	A- (AA- 3rd country)	15%	15%	AA-	15%	15%	15%	15%	15%	AAA	(19%)*
LEVEL 2B	–	30%	30%								

*The 19% haircut applies to covered bonds issued on a single name basis. Liquid asset eligibility varies from 0-5% subject to an asset encumbrance ratio.

Source: National regulation, ING

New Zealand never adopted the Basel liquidity metrics (liquidity coverage ratio and net stable funding ratio), but uses its own liquidity measurements, such as the one-week and one-month mismatch ratio and the one-year core funding ratio. AAA rated residential mortgage-backed securities, including covered bonds, do currently qualify as primary liquid assets (PLA) in New Zealand. However, the Reserve Bank of New Zealand (RBNZ) is in the process of reviewing its liquidity policy. The potential adoption of the Basel liquidity framework is part of this assessment. Moreover, the RBNZ plans to tighten the eligibility criteria for qualifying liquid assets (PSLA/HQLA) to those that do not solely derive their liquidity from central bank collateral eligibility. Covered bonds will lose their eligibility as liquid assets on these grounds. They will qualify for a new Committed Liquidity Facility (CLF) that may be established to address a shortage of liquid assets in New Zealand.

THE COLLATERAL TREATMENT OF COVERED BONDS WITHIN AND OUTSIDE EUROPE

As part of their monetary policy, central banks globally provide liquidity to the banking sector. This is often done in the form of repo transactions which require eligible counterparties to provide collateral in order to receive liquidity from the central bank. Central banks - in Europe and abroad – have strict eligibility criteria for these collateral assets (in terms of currency, minimum rating, minimum size) and demand different haircuts for certain assets depending on the credit quality of the assets and their maturity.

Covered bonds are eligible for repo purposes in many jurisdictions. There are differences in treatment. In the EU for instance, the ECB accepts legislative covered bonds from G10 jurisdictions as repo collateral. This creates differences in trading levels between G10/non-G10 covered bonds as some bank treasury accounts might have more limits for ECB repo-eligible covered bonds.

Covered bonds are also eligible as marketable assets in some non-EEA jurisdictions, although differences exist in terms of jurisdictions eligible and currency.

- The Bank of England accepts covered bonds as Level B Collateral when the underlying assets are 'UK or EEA public sector debt, social housing loans or residential mortgages'. It accepts covered bonds as Level C Collateral (ie, higher haircuts), if they are UK, US, EEA covered bonds where the underlying assets include SME loans or commercial mortgages;
- The Fed only accepts triple-A rated Jumbo German Pfandbriefe as collateral (ie. No other covered bonds);
- Bank of Canada accepts as collateral ' covered bonds from programs that are registered with the Covered Bond Registrar and are compliant with the federal legislative framework for covered bonds. These securities must meet the criterion of sufficiently high quality as determined by the Bank. Sufficiently high quality for these securities will be broadly equivalent to a rating of AAA.';
- Singapore's MAS accepts legislative covered bonds as repo, but distinguishes between domestic currency covered bonds (Category 1) and foreign currency covered bonds Category II).

The table overleaf provides an overview of the different repo treatments of covered bonds.

FIGURE 24 | OVERVIEW OF THE DIFFERENT REPO TREATMENTS OF COVERED BONDS

Central bank	Operation	Covered bonds eligible?	Eligible covered bonds	Currency	Minimum rating	Rating treatment	Minimum size
ECB	Repo Operations (Main and Long term refinancing operations)	Yes	Legislative covered bonds (EEA and non-EEA G10 countries)	EUR, USD, GBP, JPY	UP to BBB-	Best rating	n/a
FED	SOMA Operations	No	None	USD	n/a	n/a	n/a
BOE	Operating Standing Facilities, Short term OMOs	No	n/a	GBP, EUR, USD, AUD, CAD, CHF, SEK	n/a	n/a	n/a
	Level B Collateral (ILTR, DWF, CTRF and FLS)	Yes	UK, French, German regulated covered bonds		Broadly equivalent to AAA	Rating references are indicative, BoE forms its own independent view	GBP1bn or EUR1bn (depending on issuance currency)
	Level C Collateral (ILTR, DWF, CTRF and FLS)	Yes	UK, US & EEA (based on the location of the underlying assets)		Broadly equivalent to A-/A3		None
SNB	Repo Standing Operations, Standing Facilities	Yes From 2013 on, covered bonds must be eligible under the Swiss LCR framework	Any covered bond fulfilling the eligible security and rating criteria, but not issued by a Swiss bank	CHF	Security and issuer's country: AA-/Aa3	Second-highest rating	CHF100mn equivalent (issuance amount)
			Any covered bond fulfilling the eligible security and rating criteria, but not issued by a Swiss bank	EUR, USD, GBP, DKK, SEK, NOK	Security: AA-/ Aa3 with various exceptions	n/a	n/a
NORGES BANK	Repo operations	Yes	Any covered bond fulfilling the eligible security criteria	NOK, SEK, DKK, EUR, USD, GBP, JP, AUD, NZD, CHF, CAD	Domestic currency: none but BBB- for favourable liquidity category (II not III)	Second-highest rating	Domestic currency: NOK300mn
					Foreign bonds: A/A2		Foreign currency: EUR100mn equivalent
RESERVE BANK OF AUSTRALIA (RBA)	Repo operations	Yes	Any covered bond fulfilling the eligible security criteria	AUD, CAD, CHF, DNK, EUR, GBP, JPY, SEK	AAA or BBB+ for domestic covered bonds > 1y	Lowest rating (of at least two rating agencies)	None
RESERVE BANK OF NZ (RBNZ)	Repo and/or swap of NZ government bonds	No	None	n/a	n/a	n/a	n/a
	Overnight repo operations, bond lending facilities	Yes	Any covered bond fulfilling the eligible criteria on the cover pool composition	NZD	AAA from at least two rating agencies. If more than two ratings, then at least two agencies must rate the issue AAA, and no rating is below AA+	None	No
BANK OF CANADA	Standing Liquidity Facility; Standing Term Liquidity Facility; Emergency Lending Assistance	Yes	Registered covered bonds compliant with federal framework	CAD, USD	Sufficiently high quality broadly equivalent to AAA rating	n/a	CAD $1mn
DANMARK NATIONALBANK	Credit facilities	Danish covered bonds	DKK/EUR	n/a		EUR1bn or equivalent in DKK (higher haircut for smaller issuance size)	n/a

RIKSBANK	Repo operations, Standing facilities	Yes	EEA (based on the location of the underlying assets)	SEK, USD, GBP, DKK, EUR, JPY, NOK	AA-	Lowest rating	SEK100mn (or the quivalent in foreign currency)
MONETARY AUTHORITY OF SINGAPORE (MAS)	Emergency Liquidity Assistance	Yes	SGD-denominated covered bonds: eligible under Category I and Category II	SGD	Category I (AA- and above) and Category II (A+ to BBB-)		
			Foreign currency denominated: eligible under Category II	USD, EUR	Category II (BBB- and above)		

Source: ECBC Fact Book, Barclays Research

BOX 12 | The eligibility of covered bonds under the monetary policies of EEA and non-EEA central banks as a factor for equivalence assessment by Maria Green, Knowledge Counsel, Allen & Overy

Beyond the technical assessment of the equivalent legal framework, it is expected that the European Commission (and the European Banking Authority during the feasibility study phase) will also consider other general financial policy criteria.

In this context, it is worth turning one's mind to the role of covered bonds in monetary operations of the EEA and non-EEA central banks not least because the domestic and/or foreign issued covered bond eligibility under the applicable collateral framework is also a valid indicator of the marketability and general acceptance of this financial instrument. The central bank's backing gives a certain amount of liquidity in the primary and secondary markets (in particular at the time of market stresses), which is helpful from the financial stability perspective.

To put it into context, an EU CRR firm, when investing in a non-EEA covered bond, would care about whether such investment is eligible for the purposes of liquidity operations of central bank:

- in its own EEA jurisdiction – for example, for the purposes of Eurosystem, non-EEA G10 legislative covered bonds are accepted, provided all other criteria are met; and/or
- in the non-EEA jurisdiction – for example, in the jurisdiction of the non-EEA covered bond issuer – as it will enable such EU CRR firm to sell this investment more easily in the secondary market to the eligible market participants who can use such investment as eligible collateral with its non-EEA national central bank.

IN SUMMARY

The fundamental covered bond principles, laid down in the European Covered Bond Directive and Article 129 CRR already represent global best practice to a large extent. This applies to the following aspects in particular: 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. However, it remains to be seen how detailed the specifications of the fundamental principles will be in an equivalence assessment, since the level of technical details could be the second dimension of an equivalence test (as explained in Section IV).

SECTION IV. THE EQUIVALENCE ASSESSMENT PROCEDURE OF THE EUROPEAN COMMISSION AT A GLANCE

By **Wolfgang Kälberer**, EMF-ECBC Strategic Adviser

ARTICLE 31(1) EU COVERED BOND DIRECTIVE (CBD)

Article 31(1) CBD defines the pathway for the European Commission to approach the equivalence assessment of third countries' covered bond regimes. It stipulates:

"By 8 July 2024, the Commission shall, in close cooperation with EBA, submit a report to the European Parliament and to the Council, together with a legislative proposal, if appropriate, on whether and, if so, how an equivalence regime could be introduced for third country credit institutions issuing covered bonds and for investors in those covered bonds, taking into consideration international developments in the area of covered bonds, in particular the development of legislative frameworks in third countries."

In the meantime and in line with the cooperation requirement with EBA, the European Commission issued on 27 July 2023 a Call for Advice to the EBA on the performance and review of the EU covered bond framework where one of the items to be covered consists of the 'third country equivalence covered bond regime'. More precisely, the EBA is requested to provide input in order to determine the appropriate data and principles that should guide the determination of the equivalence exercise. EBA is furthermore invited to collect and assess comparative data on the performance of covered bond markets in significant third country markets.

As the EBA is required to provide its response to the European Commission no later than 30 June 2025, there is evidence that the Commission will not be able to table its report or even a legislative proposal to the European Parliament and to the Council on time (8 July 2024). A delay of third country covered bond equivalence decisions is becoming apparent.

Before taking a more specific look at the third country covered bond equivalence regime, it is useful to collect more general information dealing with equivalence assessments at EU level. Indeed, there are two documents available providing some insight into the equivalence procedure of the EU Commission:

- Commission Staff Working Document of 2017: *EU equivalence decisions in EU financial services policy: an assessment*
  https://finance.ec.europa.eu/eu-and-world/equivalence-non-eu-financial-frameworks_en
- Communication from the Commission of 2019: *Equivalence in the area of financial services*
  https://finance.ec.europa.eu/publications/commission-sets-out-its-equivalence-policy-non-eu-countries-and-presents-its-recent-eu-equivalence_en

MAIN FEATURES OF THE EU EQUIVALENCE ASSESSMENT PROCEDURE

Both documents make clear that the equivalence decision is a unilateral and discretionary act of the EU Commission, both for its adoption and any possible amendment or repeal. Typically, a Commission equivalence decision takes the form of an Implementing Act (Level II Delegated Act) which can be adopted only after confirmation by representatives appointed by the Member States in a vote of the Regulatory Committee. The Commission's assessments of equivalence are usually based on technical advice from the European Supervisory Authorities (EBA, European Securities and Markets Authority – ESMA or European Insurance and Occupational Pensions Authority - EIOPA).

The equivalence decision requires the corresponding empowerment by the basic legal act which sets out the conditions, criteria and extent to which the EU may take into account the regulatory and supervisory framework of a third country. As regards the assessment process itself, proportionality and risk management as regards the cross-border activity underpinned by equivalence are the two guiding principles for the assessment process.

Beyond the technical assessment of the equivalent legal framework on the basis of the identified fundamental principles of covered bonds embedded in effective supervision and enforcement by third country authorities (see Section III above), a number of more general financial policy criteria are taken into consideration by the European Commission. More precisely, these aspects could consist of:

- risk to reputation and long-term stability of the EU financial sector;
- compatibility with EU policy priorities and international standards;
- requirement for corresponding recognition/equivalence possibilities in a third country (reciprocity and/or supervisory cooperation arrangements);
- principle of proportionality (high impact vs. low impact third countries); and
- good tax governance, anti-money laundering and terrorist financing considerations.

Hence, the Commission may look on a case-by-case basis, beyond the specific technical solutions envisaged and focus on the regulatory objectives pursued and the outcomes delivered by that framework, particularly regarding the impact of the third country regime on EU markets. In this context, factors such as the size of the relevant market, the importance for the functioning of the internal market, the interconnectedness between the markets of the third country and the EU, or the risks of circumvention of EU rules may play a role. The Commission also factors in wider external policy priorities and concerns, in particular with respect to the promotion of common values and shared regulatory objectives at international level.

Finally, the monitoring and enforcement of third countries' ongoing compliance with the equivalence criteria set out in the relevant EU legislation are also taken into consideration. This is complemented by the European Supervisory Authorities engaging and taking the lead in specific monitoring tasks (following regulatory developments in the third country and its supervisory record, cooperation between supervisors in the EU and in the third country). Equivalence decisions can be reviewed at any time and may result in the Commission unilaterally withdrawing equivalence.

From the outset, the whole process typically involves an intensive technical dialogue with the competent authorities of the third country. Third country authorities are invited to contribute to fact-finding exercises relating to the way in which their regulatory and supervisory frameworks deliver the outcomes as set out in the corresponding EU framework.

ASSESSMENT OF ARTICLE 31(1) OF THE EU COVERED BOND DIRECTIVE

To confirm the findings in Section III above, Article 31(1) CBD neither contains an empowerment for the EU Commission to take an equivalence decision (implementing act) nor does it define tangible technical requirements or criteria applicable to the equivalence assessment itself. Article 31(1) CBD only requires the EU Commission/EBA to submit a report on the "whether" and "how" an equivalence regime could be introduced. This report can be combined with a legislative proposal, but the Commission might consider that such a proposal is not (yet) appropriate. The submission of the report is mandatory, the legislative proposal is not.

Therefore, a "three steps" approach seems to apply: a report would justify the introduction of an equivalence regime for third countries in the EU and define the underlying requirements. A legislative proposal (Directive or Regulation) would then transpose these requirements into a legal act and provide the empowerment for the EU Commission to take an implementing decision. And finally, the Commission would recognise the equivalence after thorough assessment of the third country's covered bond framework.

In terms of timeline, the European Commission is required by Article 31(1) CBD to table both the report and a potential legislative proposal in July 2024. As already mentioned, the July 2023 Call for Advice to the EBA will trigger a delay of the equivalence procedure as a whole and the duration of the postponement cannot be determined from a today's perspective. Keeping in mind that a potential legislative proposal must be adopted through an ordinary legislative procedure, the overall schedule might be stretched to 2026 or even beyond.

In terms of content, Article 31(1) CBD provides only little guidance. Relevant aspects are the investors' perspective and international developments in the area of covered bonds (developments of legislative frameworks in third countries). This is also where the Basel III rules on the supervisory regime of covered bonds can be taken into account.

To conclude, almost all technical requirements guiding the equivalence assessment are at the full discretion of the European Commission (assisted by the EBA). As regards timing, a Commission implementing decision on equivalence recognition will probably not be available during 2025 but rather at a later stage.

THE POTENTIAL COMPONENTS OF THE EQUIVALENCE ASSESSMENT EMBEDDED IN A LEGISLATIVE PROPOSAL

The European Commission's report and legislative proposal – for equivalence recognition purposes – might concentrate more on those aspects which were classified by EBA in 2016 as "step 1" criteria (see Section III of this Note), combined with a strong focus on public supervision by domestic competent authorities. Reliance on the third country supervisor appears fundamental here. Both components will certainly be complemented by a compliance analysis with general financial policy targets of the EU.

Consequently, two dimensions appear intrinsic to the equivalence assessment: first, the extent of fundamental covered bond principles which shall be considered equivalence-relevant; and second, the level of technical detail as there is evidence that the more prescriptive equivalence requirements are drafted in terms of technical features, the higher the impact on equivalence recognition of third countries' covered bond regimes.

Inspired by the UCITS Directive (former Article 52 IV) and by the EBA harmonisation principles of December 2016, the following aspects could be addressed by the legislative proposal of the European Commission: 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, LTV ratios, valuation); 6) coverage requirements (OC); 7) special public supervision; 8) liquidity rules; and 9) transparency (reporting & disclosures).

As regards the extent of technical specifications, there are good arguments for pursuing a principles-based approach. There will be a challenge in striking the right balance between the safety features of product components and the necessary flexibility for third countries and their market traditions. As an example, the requirement to issue covered bonds on the basis of a law doesn't exclude the use of statutory rules for a wider range of technical provisions, but when it comes to bankruptcy rules such as asset segregation or priority claims against the cover pool, they should be enshrined in law in order to provide legal certainty against potentially competing or even contradictory general bankruptcy law in place (lex specialis takes precedence over lex generalis).

Similar challenges exist regarding the definition of eligible cover assets and quality requirements. Recognition of equivalence might not necessarily require a restriction of eligible cover assets to mortgages, ships and/or exposures to the public sector. But the dual recourse element shall secure a stand-alone economic value of cover pools in favour of covered bond creditors in case of default of the issuing institution, ensuring that foreclosure or recovery measures of collateral/securities enable full reimbursement of the principal and interest. The collateral would be required to have an intrinsic value on its own.

Each of the nine fundamental principles referenced above should be scrutinised accordingly. It is obvious that EBA's advice to be delivered on June 2025 at the latest will 'de facto' have a significant impact on the Commission's final approach although it is officially noted in the Call for Advice that the EBA's assessment as per its response will not prejudge the Commission's final reports under Article 31 of the CBD.

For the overall scrutiny process, the EMF/ECBC Covered Bond Label referenced under Section I can play a pivotal role. It appears indeed particularly appropriate to center both the EBA's and the Commission's assessments around the EMF/ECBC Covered Bond Label platform because it delivers asset clarity, product comparability and transparency thus supporting the definition of the equivalent-relevant criteria for the recognition process. And the data provided by the Label platform will obviously assist and/or complement the technical dialogue and the fact-finding exercises to be conducted between the competent third country and EU authorities.

In the latter context, it is to be expected that the legislative proposal to be submitted by the European Commission will also address general financial policy issues such as the potential impact of the third country covered bond regime under scrutiny on EU financial stability, market integrity, investor protection and the level-playing field in the internal market. At the same time, the benefits resulting from an equivalence recognition for the preservation of an open and globally integrated EU financial market combined with better market access will obviously also be relevant. Sections I and II of this Note provide the necessary data.

ECBC GLOBAL CONCEPT NOTE ON
THIRD COUNTRY EQUIVALENCE FOR COVERED BONDS

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