1.10 ACHIEVING THIRD-COUNTRY EQUIVALENCE

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Since July 2022, the regulatory treatment of covered bonds within the European Union (EU) is based on a harmonization framework which consists of a directive, that introduces a common definition of covered bonds, and a regulation, that amends the EU's Capital Requirements Regulation. The directive also defines the pathway to achieve third-country equivalence – the alignment of the regulatory treatment of covered bonds issued by credit institutions inside and outside the European Economic Area (EEA).

European covered bonds receive preferential regulatory treatment that extends beyond risk weightings to include:

> Favorable treatment under the liquidity coverage ratio and the net stable funding ratio standards;

> The definition of exposure and investment limits;

> The eligibility rules as collateral in central bank liquidity schemes; and

> The exemption from bail-in.

While the Basel III reforms implementation has made preferential risk weights for covered bonds purchased by banks outside Europe possible, not all the countries that have already implemented the Basel III reforms have decided to provide such favorable treatment.

Importantly, covered bonds issued by credit institutions outside the EEA and purchased by European investors still receive a less favorable regulatory treatment than covered bonds issued by EEA-based credit institutions.

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 bondholders. 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. If the issuer defaults, these proceeds would be prioritized for the (re)payment of the principal and accrued interest.

Asset Eligibility

Eligible cover pool assets are restricted to:

> Claims on/guaranteed by, sovereigns, their central banks, public sector entities or multilateral development banks.

> Claims secured by residential real estate with a loan-to-value (LTV) ratio of 80% or lower that meet the applicable requirements on, for example, legal enforceability, the bank's claim over the property, and the borrower's ability to pay.

> Claims secured by commercial real estate with an LTV ratio of 60% and lower that meet the applicable requirements.

> Claims on banks that qualify for a 30% or lower risk weight of up to 15% of the outstanding covered bonds.

Additional collateral may also include substitution assets and derivatives entered for the purpose of hedging risks related to the covered bond program.

Overcollateralization

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

Disclosure requirements

For covered bonds to be eligible for preferential treatment, banks investing in covered bonds should demonstrate that they receive (at least semi-annually) portfolio information on at least:

> The cover pool's value and the outstanding covered bonds.

> The geographical distribution and type of cover pool assets, loan size, interest rate, and currency risks.

> The maturity structure of the cover pool assets and covered bonds.

> The percentage of loans more than 90 days past due.

HOW EU EQUIVALENCE WORK

European authorities could, in the future, decide to grant equivalent treatment to covered bonds issued by non-EEA credit institutions. Alignment of third-country covered bond frameworks with the directive will be a key factor. Article 31 of the directive stipulates that the European Commission (EC) will submit a report on third-country equivalence to the European Parliament and Council, which may be accompanied by a legislative proposal on whether or how an equivalence regime should be introduced. The EC's assessments of equivalence are usually based on technical advice from European Supervisory Authorities, such as the European Banking Authority (EBA). In July 2023 the EC issued a call for advice (CfA) to the EBA on the performance and review of the EU Covered Bond Directive, including third-country equivalence. The EBA is required to provide its response before the end of June 2025, which includes input on the appropriate data and principles that should guide the determination of the equivalence exercise.

EU financial services acts may contain "third-country provisions", which empower the EC to decide on the equivalence of foreign rules and supervision for EU regulatory purposes. These legal acts define the conditions, criteria, and extent to which the EU may consider the regulatory and supervisory framework of a third country.

Beyond the technical assessment of the equivalent legal framework, the EC will also consider other general financial policy criteria. These will include:

> Risks to the EU financial sector's reputation and long-term stability ;

> Compatibility with EU policy priorities and international standards;

> Requirements for corresponding recognition/equivalence possibilities in a third country;

> Principles of proportionality (high impact versus low impact third countries); and

> Good tax governance, anti-money laundering, and terrorist financing considerations.

The EC will also consider the framework's regulatory objectives and its outcomes, particularly on the impact of the third-country regime on EU markets. Finally, the EC will review wider external policy priorities and concerns, in particular, the promotion of international common values and shared regulatory objectives.

From the outset, the entire process typically involves an intensive technical dialogue with the third country's authorities. These authorities are invited to contribute to fact-finding exercises relating to how their regulatory and supervisory frameworks deliver the outcomes set out in the corresponding EU framework.

The directive does not empower the EC to take the equivalence decision. Article 31 only requires the EC to submit a report on whether and how an equivalence regime could be introduced. This report can be combined with a legislative proposal, but the EC might consider that such a proposal is not (yet) appropriate. While submission of the report is mandatory, the legislative proposal is not.

Three steps appear necessary to achieve third-country equivalence. First, a report justifying the introduction of an equivalence regime and defining the technical requirements. Second, a legislative proposal (directive or regulation) transposing these requirements into a legal act and empowering the EC to take an implementing decision. Third, EC recognition of the equivalence, after a thorough assessment of the third country's covered bond framework.

Missing from the directive are also the technical requirements or criteria applicable to the equivalence assessment itself, meaning that almost all technical requirements guiding the equivalence assessment are at the EC's full discretion. An understanding of both the fundamental principles to be considered and the level of technical detail required will be important.

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

Striking the right balance between the safety features of product components and the necessary flexibility for third countries and their market traditions will be challenging. Technical specifications would therefore benefit from a principles-based approach. Local regulators will most probably prefer as a starting point the definition of covered bonds and the specific requirements set out in the Basel III framework. While they are not obliged to follow EU provisions, they are likely to implement the Basel requirements.

Several aspects of the equivalence regime remain both uncertain and potentially significant from a market perspective. In particular:

Does 'country by country' equivalence preclude contractual features addressing shortfalls in the regime?

Several more detailed requirements of the Covered Bond Directive are not addressed by existing covered bond laws but instead by voluntary features adopted by issuers under contract law or covenants of their covered bond programs. If equivalence is decided on a country-by-country basis (rather than issuer-by-issuer) how will equivalence work when one issuer has introduced voluntary features but another has not?

In one covered bond regime currently under development, many mortgages do not meet the EU's definition of eligible collateral, while others do. One issuer has indicated that it would voluntarily exclude such mortgages from its program to gain an equivalence ruling from the EU. As this is a voluntary feature that may not be copied by peers, is this sufficient?

Can upgrades to a covered bond law make a regime non-equivalent

Several articles in the directive are optional (the "if...then" articles, for example, if a covered bond law allows derivatives, then the member state must lay down certain rules). In some non-EU countries such rules might not be included in the covered bond law, for example because there is no functioning derivative market or the covered bond law does not lay down rules for derivative counterparties. This should not prevent equivalence. But, what if a derivative market subsequently develops and issuers decide to hedge exposures by including derivatives in the pool? Will this mean that an equivalent regime could then become ineligible for equivalence?

Will reciprocity be required? And how will it be defined?

If covered bonds from a non-EU country benefit from preferential treatment for EU investors, it seems only reasonable that EU issued covered bonds should be fairly treated by investors in that non-EU country. This may seem an academic point, given the EU is almost entirely an importer of covered bonds. But as the more sophisticated non-EU markets (such as Australian dollars or Sterling) develop their own covered bond investors it will become increasingly important.

That said, what does 'fair treatment' mean? Does it mean investors in that country must treat EU covered bonds in the same way that they would treat domestic covered bonds? Or, does it mean that all covered bond prudential rules will be aligned with those outstanding in the EU? Given some EU rules derogate the Basel rules (for example, their eligibility in the EU as first tier liquidity assets for bank treasurers) this might be difficult for some jurisdictions to accept.

What will equivalence grant a country?

Although important, the EU's definition of an equivalent covered bond is not the only definition used in the EU. In particular, central banks will not necessarily be bound by an equivalence ruling when setting their collateral framework rules – a very significant factor for many investors. Whilst it would seem reasonable for all central banks to follow the EU's definition it cannot be taken for granted.

Considering the timeline for the EBA response and that a potential legislative proposal must be adopted through an ordinary legislative procedure, the overall schedule might be stretched to 2026 or even beyond.

CURRENT ALIGNMENT WITH THE DIRECTIVE

Established in 2015, the European Covered Bond Council's Global Issues Working Group (GIWG) aims to promote a better global understanding of covered bonds and foster convergence between countries towards similar market solutions, infrastructure, and regulatory treatment.

Over the past few years, the GIWG has analyzed the alignment of global covered bond regimes with the covered bond harmonization directive. In February 2024 the GIWG published a Concept Note on third country equivalence, the result of a consultation with market participants such financial analysts, issuers' representatives and investment bankers, and local authorities.

The analysis revealed full alignment with the 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 provide for intragroup or joint funding options. However, the lack of alignment with these requirements is not particularly relevant because, for example, the intragroup covered bond funding is only an option for national legislators. Hence there is no obligation to implement it globally.

The directive already allows for non-EU assets to be included in cover pools if they meet the directive's eligibility criteria, and their realization is similarly legally enforceable to EU assets. Most global covered bond regimes have established asset eligibility criteria that already partially meet the directive's requirements.

Asset coverage may require further clarification. This is because non-EEA regimes provide for nominal coverage but are not always as detailed as the directive about the type of cover pool assets that should contribute to the coverage requirement. The minimum required nominal overcollateralization level of 5% as specified in the amended Article 129 of the CRR is only included in one single third-country legal framework.

But issuers often meet this requirement on a contractual level, and if voluntary overcollateralization is considered too, all jurisdictions would meet this requirement.

Most global covered bond jurisdictions do not explicitly provide for a 180-day liquidity rule, but their frameworks often include other types of liquidity provisioning. While commonly allowed, the use of extendable maturity structures is also not necessarily enshrined in law. And while non-EEA frameworks lack objective extension triggers, maturity extension triggers are, where applicable, mostly detailed in the contractual terms and conditions.

Global covered bond regimes are subject to covered bond public supervision, but the law does not explicitly require competent authorities to have the expertise, resources, operational capacity, powers, and independence necessary to conduct public covered bond supervision.

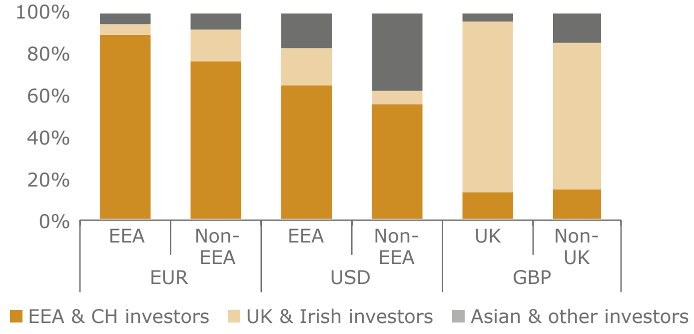
Global covered bond regimes require permission from the relevant authority to issue covered bonds, but some countries lack detailed requirements for permission. Supervision provisions in insolvency or resolution regimes are also often not as detailed as stipulated in the directive, while the global frameworks differ significantly in their reporting requirements to the authorities.

THE IMPORTANCE OF THIRD-COUNTRY EQUIVALENCE

As part of the CfA, the EBA must consider the impact of a hypothetical third-country regime on EU markets. To do that, the EBA will assess the holdings of third-country covered bonds by EU credit institutions and the holdings of EU covered bonds by credit institutions in third countries.

Primary market distribution statistics show that, during the past decade, non-EEA investors (Asian and others) have bought on average 5% of the euro-denominated covered bond transactions of EEA credit institutions in the primary market and 8% of the non-EEA euro-denominated covered bonds. During the last two years third-country investments in new EEA euro covered bonds have even slightly declined despite the reduced and ending allocations to the covered bond purchase programme (CBPP3) for eurozone covered bonds and the introduction of preferential risk weights for covered bonds in several non-European countries. The implementation of the Basel III reforms has therefore so far not unlocked a visible additional investor demand from third-country markets for European covered bonds.

> Figure 1: Participation per Investor Location in EUR, USD and GBP Covered Bonds of EEA/non-EEA and UK Credit Institutions

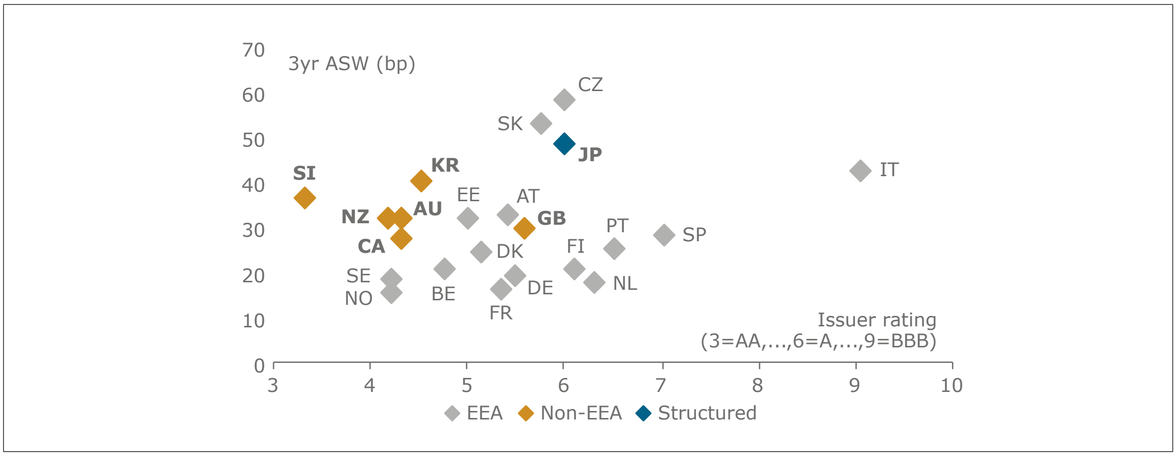


*UK covered bonds are part of the EEA until 2021, thereafter they are non-EEA
EEA investors exclude Irish investors, which are aggregated with the UK
Source: IGM, ING

While EEA investors are by far the most dominant primary buyers of the euro covered bonds of EEA credit institutions (at 89%), they are also the largest buyers of third-country euro covered bonds in the primary market (at 76%). For that reason, EEA investors will probably welcome a third-country equivalence regime for non-EEA legislative covered bonds. For third-country issuers, an equivalence regime will likely have the supportive side effects of broadening the interested European investor base for their covered bonds and reducing funding costs.

Third-country covered bonds trade persistently wider than covered bonds issued by EEA banks. This reflects the less favorable risk weight and LCR treatment for these bonds within the EU. Unless the issuing bank is based in a G10 country (such as Canada or the U.K.), third-country covered bonds are also not accepted for ECB collateral purposes.

> Figure 2: Third-Country Covered Bonds Trade 15bps Wide to Nordics



Source: IHS Markit, ING

Figure 2 shows how average spread levels across different jurisdictions for euro covered bonds issued in the 2027 maturity segment differ. This is where the largest group of covered bond issuers has euro covered bonds outstanding. The legislative covered bonds of non-EEA banks from Australia, Canada, New Zealand, Singapore, and South Korea are quoted (at the time of writing) on average at about 15 basis points wider than the legislative covered bonds of Norwegian or Swedish banks.

To access the ECBC Global Concept Note on Third Country Equivalence for Covered Bonds and other interesting publications, scan the QR code below.