



# The regulatory framework for EU Covered Bonds

The Covered Bond Investor Conference 2015

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# Outline

- Re-cap of EBA recommendations from 2014 report
- Current developments
- Possible EBA initiatives going forward

# Covered bond issuers are not infallible

**List of large covered bonds issuers that were subject to a bail-out to safeguard the financial stability and well-functioning of the covered bonds market**

- Düsseldorf Hypothekenbank (April 2008)
- Hypo Real Estate / Depfa ACS bank (October 2008)
- Dexia (October 2008/October 2011)
- Kommunalkredit Austria (November 2008)
- Crédit Immobilier de France (September 2012)
- SNS Reaal (February 2013)

Covered bonds systems has not been tested in practice, due to bail-out of covered bond issuers.

# Mandates

**1) ESRB – Recommendation E (12/2012):** *‘EBA is requested to deliver to the ESRB an interim report setting out the **principles of best practice in relation to covered bonds** which it has identified together with national supervisory authorities [...] particularly in relation to: the quality and segregation of cover pools, insolvency remoteness of covered bonds, the asset and liability risks affecting cover pools and disclosure of the composition of cover pools’*

## **2) CRR Article 503 and EU Commission Call for Advice (December 2013):**

- Is **preferential risk-weight treatment** appropriate for all instruments qualifying? Are the current qualifying criteria (as per CRR Article 129) appropriate?
- Is preferential treatment appropriate for covered bonds collateralised by **aircraft loans**? (currently not in CRR 129)
- Is preferential treatment appropriate for covered bonds collateralised by **guaranteed residential loans**? (currently in CRR 129)
- Is the **national derogation (CRR Article 496) to the 10% limit for senior RMBS/CMBS** in a cover pool appropriate for the purposes of the preferential treatment?

# Main messages

- The current risk weighting, i.e. 10% for credit quality step 1 issuers (normally AAA-AA-), is appropriate
- Additional safeguards should however be introduced for CRR-compliant covered bonds – EBA suggests the following:
  - Introducing legal/mandatory over-collateralisation requirements
  - Including liquidity buffers
  - Strengthening the role of the supervisor
  - Standardising disclosure requirements
- Further harmonisation of European covered bond markets should be pursued

# Preferential risk weight treatment [CRR Art. 129]

## **Recommendation EU COM 1: Risk-weight preferential treatment regime**

The EBA considers the preferential risk-weight treatment laid down in Article 129 of the CRR to be, in principle, an appropriate prudential treatment, in light of:

- the good historical default/loss performance of covered bonds in the EU;
- the embedded dual recourse principle;
- the special public supervision for the protection of the bondholders mandated by the UCITS directive and given;
- the existence of qualifying criteria in Article 129 of the CRR on eligible assets.

**The EU Commission should consider complementing the qualifying criteria mandated by article 129 of the CRR to cover, at a minimum, equally relevant elements of robustness of the covered bond :**

- i. liquidity risk mitigation: **Recommendation EU COM 1-A**
- ii. legal over-collateralisation: **Recommendation EU COM 1-B**
- iii. the role of the competent authority: **Recommendation EU COM 1-C**
- iv. further specification of existing CRR 129 requirements on disclosure : **Recommendation EU COM 1-D**

# Complementing CRR Art. 129

## **Recommendation EU COM 1 - A: Legal/regulatory minimum over-collateralisation**

A **legal/regulatory minimum over-collateralisation** should be considered as a qualifying criterion for preferential treatment.

## **Recommendation EU COM 1 - B: Liquid assets buffer**

A requirement to mitigate liquidity risk in the covered bond programme, by means of liquid assets available at all times to cover the total net out-flows of the covered bond programme over a certain time horizon, should be considered as a qualifying criterion for preferential treatment.

## **Recommendation EU COM 1 - C: Role of the national authority**

Provisions over the role of the national authority covering: i) supervision prior to issuance, ii) on going supervision, iii) supervision post default/resolution of the issuer should be considered as qualifying criteria for preferential treatment.

## **Recommendation EU COM 1 - D: Disclosure to investors**

The scope and detail of current disclosure requirements in Art. 129 should be clarified by means of EBA binding technical standards

# Coverage principles and over-collateralisation

## Recommendation ESRB 5: Coverage Principles and over-collateralisation

The coverage requirement should **include all the liabilities of the covered bond programme**, including liabilities towards counterparties in derivative contracts and, as applicable, liabilities towards managers/administrators, servicers, trustees, cover pool monitors and similar entities involved in the process of the covered bond issuance.

The EBA considers that a **legal/regulatory minimum over-collateralisation** constitutes a regulatory best practice

# Role of the Competent Authority and monitoring of the cover pool

## Recommendation ESRB 7-B: **Supervision of the covered bond Issuer**

The competent authority **approves the establishment of a new covered bond programme**

The authority should be satisfied, at least on the basis of information received from the issuer, that:

- i) adequate operational policies, procedures and controls are put in place by the issuer for the management of the covered bond programme, including in an issuer's insolvency or resolution scenario;
- ii) where provided by the national framework, the restrictions applicable to the issuer are met;
- iii) the features of the cover pool meet the applicable requirements.

The legal/regulatory covered bond framework should provide a clear and sufficiently detailed illustration of the **duties and powers of the competent authority regarding the on-going supervision** of covered bond transactions.

# Role of the Competent Authority and monitoring of the cover pool

## **Recommendation ESRB 7-C: Duties and powers of the national authority in a scenario of issuer's insolvency**

The legal/regulatory covered bond framework should provide sufficiently detailed description of what the duties and powers of the competent authority are on the covered bond programme, and its independent administrator, in a scenario of issuer's default.

# Disclosure to investors

## Recommendation ESRB 8-A: **Scope of disclosure**

Issuers should be required to disclose aggregate data on:

- the credit risk
- market risk
- liquidity risk
- the levels of contractual and voluntary over-collateralisation
- other relevant information, including information concerning the counterparties involved in the programme.

**The information should be disclosed to a level of detail which enables investors to carry out a comprehensive risk analysis.**

## Recommendation ESRB 8-B: **Frequency of disclosure**

Disclosure of the information mentioned under recommendation 8-A should occur **at least on a quarterly basis.**

# Recent developments

Commission green paper on Building a Capital Markets Union

*“The development of a more **integrated European covered bond market** could contribute to cost-effective funding of banks and provide investors with a wider range of investment opportunities. The success of covered bonds as funding instruments is closely linked with the development of specific national legal frameworks. The Commission will consult in 2015 on the merits and potential shape of an EU covered bond framework and present policy options to achieve greater integration in covered bond markets, based on experience gained from well functioning national frameworks. The Commission will also reflect on whether investors should be provided with more information about the collateral underlying covered bonds and other structured debt, similar to loan data disclosure requirements on structured finance instruments.”*

# EBA work going forward

Will focus on transparency elements in its work going forward.

*7. Exposures in the form of covered bonds are eligible for preferential treatment, provided that the institution investing in the covered bonds can demonstrate to the competent authorities that:*

*(a) it receives portfolio information at least on:*

*(i) the value of the cover pool and outstanding covered bonds;*

*(ii) the geographical distribution and type of cover assets, loan size, interest rate and currency risks;*

*(iii) the maturity structure of cover assets and covered bonds; and*

*(iv) the percentage of loans more than ninety days past due;*

Continued review of Covered Bonds markets, which includes Opinions issued on Denmark and Sweden on exposures to lower-rated institutions in the cover pool

Stand ready to provide support to the European Commission

# Concluding remarks

- There are plenty of aspects, where European covered bond frameworks differ today, which can be harmonised further
- The creation of a common European covered bond market should ensure:
  - Increased cross-border investor demand for covered bonds
  - That uncertainties about the differences in legal frameworks are removed
  - That defaults of covered bond issuers, when finally put to the test, leads to none or very limited losses
  - The creation of a prudentially sound covered bond framework
  - The creation of transparency and comparability across issuers

