EUROPEAN COMMISSION
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Summary of contributions to the public consultation on 'Covered Bonds'

This document provides a factual overview of the contributions to the public consultation on 'Covered Bonds'. The content should not be regarded as reflecting the position of the Commission.

Contents

1. INTRODUCTION 3

2. OVERVIEW OF RESPONDENTS AND RESPONSES 3

3. SUMMARY OF RESPONDENTS' FEEDBACK 4

Part I – Covered Bond Markets: Economic Analysis 4

Market Fragmentation: Evidence and Reasons 5

Cross-border Investment/Issuance 5

Regulatory Treatment 6

Part II – Exploring the Case for a More Integrated Framework 6

General Views on Harmonisation 6

Options 7

Part III – Elements for an Integrated Covered Bond Framework 8

Covered Bond Definition 8

Covered Bond Issuers and Systems of Public Supervision 8

Dual Recourse and Insolvency/Resolution Regime 9

Eligible Assets: Residential and Commercial Loans 10

Eligible Assets: Public Sector Loans 13

Eligible Assets: Other Asset Classes and Mixed Pools 14

Coverage Requirement and Overcollateralisation (OC) 15

Market and liquidity risks 17

Transparency 19

1. INTRODUCTION

On 30 September 2015, the European Commission launched a public consultation on Covered Bonds in the European Union. The consultation closed on 6 January 2016.

Covered bonds are a very important source of bank funding in many Member States used to refinance mortgages and, to a lesser extent, other asset classes.

The purpose of the consultation, which is part of the Capital Markets Union Action Plan, was to evaluate weaknesses and vulnerabilities in national covered bond markets as a result of the crisis and to assess the convenience of a possible future integrated European covered bond framework that could help improve funding conditions throughout the Union and facilitate cross-border investment and issuance in Member States currently facing practical or legal challenges in the development of their covered bond markets.

The consultation paper was structured in three parts:
1. Part I - Covered bond markets: economic analysis;
2. Part II - Exploring the case for a more integrated framework;
3. Part III - Elements for an integrated covered bond framework.

The Commission received 76 responses and would like to thank respondents for their contributions.

This summary recaps the issues raised. It seeks to provide a factual overview of the contributions received. It is not an exhaustive list of all contributions and does not assess the validity of the respective claims. The contents of this document therefore cannot be regarded as reflecting the position of the Commission.

Overall, stakeholders agreed that covered bond markets showed increased yield divergence between Member States since 2007. Although stakeholders agreed that a robust legal framework would help to reduce volatility and ease market access in times of distress, they did not generally regard an absence of EU-level harmonisation as the most significant factor causing market fragmentation.
While respondents were concerned that harmonisation based on a one-size-fits-all approach could risk impairing well-functioning markets and reducing flexibility and product offering, at the same time, they showed cautious support for EU targeted action, provided that harmonisation is principles based, build on existing frameworks and respect the unique characteristics of national frameworks.

2. OVERVIEW OF RESPONDENTS AND RESPONSES

- Total number of respondents: 76
- Type of stakeholder:
  - Public sector: 19
  - Private sector: 57

Issuers	27
Investors	11
Other	19

- Respondents in "Other" category include:

Cross-industry and consumer associations	9
Rating agencies	3
Surveyors	3
Service providers	2
Individuals	2

- Breakdown by Member State:

Cross-Europe	2
Austria	3
Belgium[1]	13
Czech Republic	3
Denmark	3
Finland	1
France	5
Germany	9
Ireland	1
Italy	3
Luxembourg	2
Norway	1
Poland	4
Slovakia	1
Spain	4
The Netherlands	4
Sweden	2
United Kingdom	15

3. SUMMARY OF RESPONDENTS' FEEDBACK

Part I – Covered Bond Markets: Economic Analysis

The Consultation Document set out an assessment of recent trends in European covered bonds markets, with a particular focus on issuance and outstanding data and secondary market pricing. In light of those trends, the Consultation Document requested stakeholder feedback on three main sets of topics.

[1] Includes a number of Cross-Europe respondents based in Brussels

Market Fragmentation: Evidence and Reasons

Consistent with the assessment made in the Consultation Document, stakeholders agreed that covered bond markets exhibited increased yield divergence between Member States after 2007-8. However some respondents argued that this divergence should not necessarily be diagnosed as an undesirable market feature (e.g. fragmentation) but rather as a normal readjustment in the light of new circumstances.

According to the majority of stakeholders, the main driver for yield divergence during this period was contagion from the respective issuer's sovereign risk. Issuer's credit risk and the specifics of each covered bond programme (structure, collateral quality, legal framework and market liquidity) would also influence pricing. After 2007, rating actions on issuers and sovereigns led to the downgrade of many covered bond programmes and, as a result, the homogeneity of AAA ratings that had existed for virtually all covered bonds in Europe was lost. Thus, market distress and rating changes made investors more discerning with regard to the risk posed by individual issuers and programmes than before.

Stakeholders also opined that the Eurosystem's purchase programmes (CBPP1, CBPP2 and CBPP3) greatly influenced pricing conditions. While CBPP1 would have helped to reinvigorate the primary market and secure demand on the secondary market, spreads remained more sensitive to the issuer's creditworthiness and the national legal framework. Since the start of CBPP3 in October 2014, spread convergence in the covered bond markets of the euro area seems to be completely dominated by monetary policy implementation. In relation to this, some investors are concerned that CBPP3 may be having negative effects on market liquidity and the price building process. Covered bond issuers are concerned about the market's shape once the Eurosystem ends its purchase programme, as traditional investors may be reluctant to re-enter the market due to high entry costs.

Although most stakeholders agreed that a robust underpinning legal framework would help to reduce volatility and ease market access in times of distress, they did not agree that lack of harmonisation at an EU level was a significant factor in market fragmentation. Furthermore, even robust legal frameworks cannot fully isolate the covered bond programme from issuer's specific risks. It was pointed out that investment mandates operate on the basis of credit lines by country: where those lines are cut for any given country, investors will tend to reduce their exposure to those country's covered bond programmes, regardless of the quality of the underlying legal framework. Most stakeholders concluded that a harmonised covered bond framework would not have prevented spread fragmentation.

Among,investors, respondents pointed to the lack of good quality disclosure on the cover pool, the uncertainty of the post-default scenario in most legal and contractual frameworks and other structural weaknesses as important factors for covered bond pricing.

Cross-border Investment/Issuance

Despite differences in underlying legislative frameworks, stakeholders agreed that there is already significant cross-border investment in covered bonds within the European Union. Stakeholders argued that harmonisation could encourage and facilitate additional cross-border investment, provided that it helped to reduce the complexity and costs of undertaking comparative credit analysis across multiple jurisdictions. However, stakeholders do not favour complete harmonisation and investors, in particular, value product diversity in covered bond markets.

In terms of issuance of covered bonds on the back of multi-jurisdictional cover pools, stakeholders indicate that there are significant legal and practical obstacles across European Union. Legal obstacles result from the legal variations between Member States on asset eligibility and segregation, constitution of guarantees, taxation on the assets, etc. Other obstacles may result from operational issues such as different IT systems. Investors, however, appear to undertake credit analysis mostly on the basis of a single country of asset origination and, as a result, a majority of them would not look favourably at multijurisdictional cover pools.

Regulatory Treatment

Stakeholders consider that the preferential regulatory treatment of covered bonds in EU law is justified and should be maintained. Stakeholders also argue that such preferential treatment is also justifiable vis-à-vis other collateralised instruments (namely, securitisation bonds).

However, some public authorities said that the regulatory framework of covered bonds should be enhanced with greater risk-sensitivity and reduced reliance on external ratings.

Some issuers and investors were concerned by what they view as unintended consequences of the regulatory treatment. For instance, the minimum issuance size of >€500M for LCR Level 1 eligibility was criticised for creating a market access barrier for smaller issuers and lower demand for private placements of covered bonds. Some argued that the regulatory treatment may be failing to prevent certain negative behaviours by issuers (split of covered bond pools, rating withdrawals, changes to contractual documentation, counterparties or redemption profile without prior investor consent, etc.).

Part II – Exploring the Case for a More Integrated Framework

The Consultation Document queried stakeholders about their views on a potential more integrated "EU Covered Bond Framework" and the legal shape that such a framework should take. The Consultation Document suggested two high level options and two sub-options:

(a) Option 1: subsidiarity and indirect harmonisation;

(b) Option 2: EU product regulation.

Within option 2, the Consultation Document elaborated further on two additional sub-options: a Directive/Regulation to harmonise national covered bond laws or a 29th regulation Regime that would operate as an alternative to those laws.

General Views on Harmonisation

There is consensus among stakeholders that a more integrated covered bond market would deliver a number of benefits, albeit not all those mentioned in the Consultation Document. Respondents, however, warn that detailed harmonisation could have unintended negative consequences, especially for well-functioning markets, neutralising possible benefits.

The benefits would vary depending on the choice of instrument and the regulatory approach followed. Those could include:

(a) a more consistent treatment of covered bonds as liquid assets and, as a result, a more liquid and deeper market overall;

(b) improved comparability of issuances originating in different countries and reduced moral hazard;

(c) level playing field for issuers across Europe, insofar as bias against individual jurisdictions would be mitigated;

(d) improved market discipline and efficiency;

(e) enhanced legal certainty, clarity and simplicity for investors, which could facilitate cross-border investment within Europe and from third countries;

(f) beneficial framework for issuers in smaller markets.

A number of issuers regard 'supporting legislation' (e.g. namely mortgage and insolvency law) as key to the efficient functioning of covered bond markets, but caution that harmonisation in these areas may be very difficult.

To counter the above positives, stakeholders point to various risks/challenges, such as:

(a) reduced flexibility and product on offer;

(b) market fragmentation on jurisdictional lines will continue to exist because of the strong link between the credit performance of the cover pool assets and the macro-economic performance of the country in which the issuer is located and the credit rating of "the sovereign" (investors, issuers);

(c) additional costs that may result from regulatory change; and

(d) difficulty of finding a viable alternative to external ratings.

In relation to market-led initiatives, respondents regard them as valuable but insufficient. For instance, while stakeholders consider the European "Covered Bond Label" as a positive step towards better integration of the covered bond markets, most acknowledge that there are certain limitations to self-regulation: voluntary arrangements cannot form the basis for a specific regulatory treatment so they need to be complemented by sound regulatory treatment, at national or European level. Public authorities in particular noted that a significant weakness of voluntary standards is that it would be up to issuers to comply with them in times of crises.

Options

Stakeholders are of the view that further integration should be pursued only on the basis of a high-level principles approach and Member States should retain the power to set detailed or more stringent requirements. Stakeholders also agree that harmonisation at an EU level should be built on existing frameworks and seek to preserve national specificities. More precisely, there is wide consensus that the Commission should at least improve the existing EU regulatory framework for covered bonds.

By contrast, there was no significant support for a 29th Regime and there is little confidence that this option would work in practice, as least in the short-term. Overall, stakeholders do not believe the 29th Regime can be currently designed to provide an attractive alternative.

Regarding the elements of a hypothetical EU covered bond framework, stakeholders regard the list put forward in the Consultation Document as sufficiently comprehensive. While some respondents think the Commission should seek to develop all the elements, others consider it more appropriate to focus only on a subset. However, all stakeholders favour giving priority to the target areas identified by the EBA Report and some even advocate for a higher level of detail in each area.

Part III – Elements for an Integrated Covered Bond Framework

The Consultation Document invited stakeholders to express their views on a suggested list of "elements" for a hypothetical EU covered bond framework (the "Framework") largely based on the best practices recommended by the EBA Report.

Covered Bond Definition

New legal definition

The Consultation Document suggested a "new legal definition" of covered bonds which would build in substance on the content of Article 52(4) of the UCITs Directive. Stakeholders would support an update of the current definition but raise concerns about the specific proposal set out in the Consultation Document which they regard simply as a basis for further work. Stakeholders note that any such definition should be broad enough to fit all current covered bond models used in the EU, while CRR compliant covered bonds should be subject to more stringent eligibility criteria as currently.

Several issuers raised a related concern that any use of the word "regulated" at an EU level should prevent "reverse discrimination" against covered bonds regulated at a national level relative to a potential EU instrument. This concern is also predicated in relation to any discrimination of an EU covered bond against a non-EU instrument. Stakeholders opposed the suggestion that all references to covered bonds in EU law be changed to mean “regulated” covered bonds.

Third country equivalence regime

Stakeholders, notably all respondents in the "investor" category, would welcome the proposal to introduce an equivalence system for third country covered bonds. There is, however, concern among several issuers that an equivalence system would be challenging to implement as they regard it difficult to assess with certainty the robustness of third country legal arrangements for insolvency remoteness and dual recourse.

Covered Bond Issuers and Systems of Public Supervision

Issuer models and licensing requirements. The roles of SPVs

Stakeholders are against a one-size fits-all authorisation/licensing system for covered bond issuers and programmes. In their view, this subject matter should remain the exclusive domain of national laws, as the special features of each system make it difficult to find one model that suits them all. Some stakeholders point out that a one-off authorisation system is already current practice in several Member States, but views were split on what should

constitute the appropriate arrangements for such a one-off authorisation system. Some originators and public authorities take the view that, as an alternative to authorisation, a pre- or post-issue notification to the competent authority could be enough.

Investors caution against a too simplistic system: oversight of new issuers or programmes should include an individual assessment of compliance with all the required legal criteria and on-going supervision by competent authorities.

With regard to issuer structures, the strong message from all respondents is that whatever the pooling mechanism that may be used (cover pool, specialist issuer or SPV), it should be legally effective to segregate the assets under the applicable law. An EU covered bond framework should permit all existing models.

Some stakeholders, however, counter that the very different covered bond structures that exist across jurisdictions in the EU result in expensive due diligence processes to satisfy investors and advocate some degree of market integration in this area.

On-going supervision and cover pool monitoring (pre-insolvency)

Stakeholders are in favour of setting out common duties and powers on competent authorities in an EU covered bond framework and regard the EBA recommendations in this area as a useful starting template to define those duties and powers. The ECBC comprehensive list of duties and powers is also referred to and supported. Only a minority considers that existing supervision is already enough and that this is an issue for national law only.

Stakeholders support including provisions concerning independent cover bond pool monitors in an EU covered bond framework. However, there is broad agreement that there should be no requirement no appoint a cover pool monitor where similar tasks are being carried out by a competent authority. In this context stakeholders also argued that duties and powers of cover pool monitors vary according to each national regime so a EU covered bond framework should clearly set out general principles only and be sufficiently flexible to accommodate national specificities.

Covered bonds and the SSM

Stakeholders are of the view that supervisory powers in relation to covered bond issuance should remain the exclusive domain of national competent authorities and see no role for the ECB/SSM. They acknowledge, however, that the SSM should have access to all necessary information for it to perform its supervisory function.

Dual Recourse and Insolvency/Resolution Regime

Definition of the dual recourse principle

The dual recourse principle is enshrined in general terms in Article 52(4) of the UCITS Directive and constitutes one of the key features of covered bond legislation in the EU. Stakeholders agree that the dual recourse principle should be kept in EU law, but a majority opined that additional thinking should be given as to the exact formulation and scope of such principle. Many stakeholders refer to the EBA's recommendation as a very good basis to start working on.

Segregation of the cover assets

With regard to the identification of assets at the pre-insolvency/resolution stage, there are currently various mechanisms in place in the covered bond laws of Member States to achieve effective segregation of cover pool assets. Stakeholders regard the existing asset segregation models as sufficiently effective and an EU covered bond framework should not be so prescriptive as to set out a single segregation mechanism, nor should it prohibit a specific structure.

Administration of the cover pool post insolvency/resolution of the issuer

Stakeholders are supportive of the proposal that an EU covered bond framework should provide for the appointment of a special administrator of cover pool post-insolvency/resolution. Many respondents, however, emphasise that any rules must reflect the diversity and differences that exist in national laws. Stakeholders point to independence and specific professional qualifications as important requirements, and that regular reporting to the competent authority should be obligatory.

Interaction between cover pool and issuer in insolvency/resolution

Stakeholders expressed differing views on whether current EU law provides sufficient protection to covered bondholders in case an issuer enters insolvency/resolution.

While a majority of public authorities are of the opinion that current provisions in EU law are sufficient, issuers, investors and other stakeholder groups point to significant gaps in current legislation. For instance, it was noted that the BRRD does not stipulate how bondholders would be protected in resolution and is completely silent on the status of covered bonds other than in bail-in. Some of those stakeholders also noted that there is some uncertainty as to whether the excess cover assets available for OC purposes would be affected in any way by a bail-in. Furthermore, they noted that no piece of EU law sets out how cover pool segregation should be effected and called for more clarity in the interaction between the bank resolution regime and covered bond legislation.

On the proposal to implement a cut-off mechanism to give finality to the process of cover pool segregation post insolvency/resolution of the issuer, stakeholders are either against it or at least very sceptical. It is pointed out that a mechanism that extinguishes the residual claim on the estate or the successor credit institution before the covered bonds have been fully paid off would unduly restrict the dual recourse principle. In relation to this, investors are concerned that a cut-off mechanism would impair bondholders' protection and, in that sense, would see it as a serious threat to the product. Stakeholders from Member States with a specialist covered bond issuer model regard a cut-off mechanism as unnecessary for their jurisdictions given the specific features of this model.

Eligible Assets: Residential and Commercial Loans

Definition

The Consultation Document suggested defining "residential" and "commercial loans" as an asset class comprising both:

(a) mortgage loans granted to a borrower for residential and commercial purposes where the borrower's obligation to repay principal and pay interests are secured for the benefit of the lender by a security or lien on the property; and

(b) in France, guaranteed residential loans meeting the qualifying criteria set out in Article 129(1)(e) of the CRR

Although stakeholders supported the suggested definition of "residential" and "commercial loans", a number of them recommended the definition be consistent with Arts. 124, 125 and 126 of the CRR. There was almost unanimity in opposing an exclusion of "riskier" mortgage loans from cover pools. Instead, most respondents argued that these assets should remain eligible subject to stricter requirements, such as lower LTVs and more granular disclosure to investors.

French stakeholders were against the EBA's recommendation on guaranteed residential loans.

Legal requirements

The Consultation Document also recommended the following legal requirements for eligible residential and commercial loans:

(a) be "legally valid and enforceable against the borrower in accordance with the applicable law at the time the loan is added to the cover pool"; and

(b) be "first ranking mortgages".

Stakeholders agree with the requirement as referred to in point (a), provided that the mortgage is also legally binding and enforceable against third parties. However, a number of them opposed the reference to "perfection of security" and preferred, instead, "registration" of the mortgage. Stakeholders explained that registration is a requirement for enforceability of mortgages in their Member States, some suggested using the language in Art. 208 CRR which refers to "security enforceable in all jurisdictions" and others recommended referring to "economic first ranking". Virtually all stakeholders were against excluding lower ranking mortgages from the cover pool, with only one public authority taking the contrary view.

Stakeholders opined that enforceability of mortgages in the EU is not equivalent and a number of them said that minimum standards in this area would be useful. A number of issuers argued that such minimum standards should include a requirement that a mortgage be enforceable within a reasonable amount of time and not result in significant financial costs or other obligations for the mortgagee. Investors responding to this question were adamant that minimum standards on enforceability of mortgages would be very positive.

Loan-to-value (LTV)

The Consultation Document recommended subjecting residential and commercial loans to specific maximum LTV ratios, defined as a limit on the principal of the loan relative to the value of the property. LTV limits should distinguish between residential and commercial loan, apply during the entire life of the covered bonds and measured on a specified property value. Covered bondholders should be entitled to any excess over the LTV cap on a priority basis and such excess should count for OC purposes. In most covered bond laws, LTV levels may be used in two different ways: to calculate coverage of liabilities (OC levels) and/or determine eligibility of individual loans for cover pool purposes.

Stakeholders' views on LTV proposals can be summarised as follows:

(a) all of them were in favour of setting LTV levels as minimum standards for covered bonds and distinguish between residential and commercial loans (with lower LTV levels for the latter);

(b) a very large majority of issuers, public authorities and "other respondents" were in favour of using LTV levels only as a "soft limit" and not as a requirement for the eligibility of individual loans ("hard LTV limits"). That is, loans above the LTV limit would still be eligible for inclusion in the cover pool, but such loans would have a discounted value when calculating the OC and be subject to regular revaluation. Stakeholders argued that using "hard LTV limits" would reduce the availability of long-term funding to credit institutions and expose covered bond issuers to liquidity risk;

(c) consistent with the preference for using LTV limits as a soft limit, stakeholders said that they should not be used to determine eligibility of individual loans. If they did, some stakeholders argued that compliance with the applicable LTV limits should be determined only at inception of the programme;

(d) no stakeholder expressed any objection to covered bondholders' having a priority claim on any excess value of the mortgaged property over the LTV levels; and

(e) a large majority of stakeholders from the issuer and public authority communities were against requiring additional average LTV eligibility limits at a portfolio level;

Although stakeholders agreed that it is necessary to harmonise the valuation basis as a condition to have comparable LTV levels, views on whether it would be appropriate to use mortgage lending value as a basis were split. On the inconsistency of LTV levels, one stakeholder pointed out that the LTV calculation itself may not be clear on (1) whether all prior/junior ranking loans secured on the property are included; (2) the method of property valuation; (3) the frequency of property revaluation; (4) for commercial property, aggregation of borrowers and properties.

Some of the investors responding to this question expressed dissenting views to the ones outlined above.

Valuation of the cover assets

The Consultation Document provided that the valuation of the properties should be based on transparent valuation rules and carried out by an evaluator that is independent from the credit granting process.

A very large majority of stakeholders advocated replicating in the Framework the requirements on valuation of real estate assets set out in Arts. 208(3) and 229(1) of the CRR, both of which currently apply to covered bonds for preferential risk weights purposes under Art. 129(3) of the CRR.

In relation to the criteria that should apply to the evaluator, stakeholders referred to the high-level principles in the final limb of Art. 208(3) of the CRR, which requires the valuer to "possess the necessary qualifications, ability and experience to execute a valuation and be independent from the credit decision process".

On the criteria that should apply to the valuation process, a number of stakeholders advocated adopting the provisions set out in Recital 26 of the Mortgage Credit Directive which provides

that "in order to be considered reliable, valuation standards should take into account internationally recognised valuation standards, in particular those developed by the International Valuation Standards Committee, the European Group of Valuers' Associations or the Royal Institution of Chartered Surveyors."

Non-performing loans (NPLs)

The Consultation Paper suggested making non-performing loans ineligible for cover pools both at the time of issuance and on an on-going basis. Accordingly, the issuer would be obliged to replace non-performing loans in the cover pool.

Virtually all issuers and some stakeholders from the "other respondents" category were against the proposal to exclude NPL's from cover pools. Danish and French stakeholders pointed out that it would be impossible for specialist issuers to apply such requirement, other than through an increase in equity. These stakeholders said that NPLs should remain in the cover pool, written down and disclosed. Impairments will result in reduced OC levels.

Mortgage-backed securities (MBs) as eligible assets

Stakeholders agreed with the EBA's prudential concerns on the use of MBSs in cover pools. However, there was a divide in stakeholders' views on whether these assets should be eligible subject to limits as currently, or not:

(a) almost all issuers advocated that MBSs should continue to be eligible for cover pool purposes, subject to the 10% limit currently set out in Art 129 CRR; and

(b) by contrast, almost all public authorities were in favour of completely excluding MBSs from cover pools.

As a potential compromise, some stakeholders suggested excluding MBSs from cover pools, but instead allowing STS securitisations to qualify as "substitute assets" for liquidity purposes. It was noted, however, that STS securitisations include all types of ABSs, not just MBSs.

Eligible Assets: Public Sector Loans

The Consultation Document suggested that "public sector loans" and "guarantees" be eligible as cover assets subject to a number of requirements. Exposures to non-EEA countries would be subject to an additional test of "equivalence" of the covered bond framework.

Stakeholders were generally dissatisfied with the wording used in the Consultation Document to describe "public sector loans" or "guarantees", which they deemed as too narrow or ambiguous. Instead, stakeholders favoured:

(a) keeping the language currently used in Art. 129.1(a) CRR which refers generally to "exposures to or guaranteed by central governments, the ESCB central banks, public sector entities, regional governments or local authorities in the Union";

(b) for a number of issuers, re-defining the term "public sector entity" to include a broader scope than currently in Art. 4 of the CRR.

On third countries, stakeholders were against requiring an equivalence assessment for public sector loans originated in those jurisdictions, preferring instead the language in Art. 129.1(b) CRR.

<u>Eligible Assets: Other Asset Classes and Mixed Pools</u>

Aircraft, ship and SME loans

The Consultation Document suggested removing or not allowing other assets (aircraft, ship and SME loans) in cover pools of "regulated covered bonds". Stakeholders' views on this question were split between:

(a) public authorities who favour excluding ship, aircraft and SME loans from cover pools of "regulated covered bonds";

(b) issuers who favour recognising aircraft and ship loans, but not SME loans. For a number of issuers, both ship and aircraft loans can deemed as standardised assets, insofar as they meet they following conditions:

- they are physical assets;
- they are enforceable as security over longer maturities;
- their value can be appraised; and
- their enforceability is recognised by international treaties.

A minority of issuers suggested that aircraft and ship loans should be allowed as cover assets subject to specific restrictions: for instance, they should not be mixed with mortgages and public sector loans in the cover pool;

(c) investors and other stakeholders were mostly split along the above lines.

On the eligibility of SME loans:

(a) a number of stakeholders recommended that these qualify as cover assets for other instrument, such as for "European Secured Notes" – a market-led initiative by the European Covered Bond Council (ECBC) to develop a dual recourse instrument on the back of loans to SMEs;

(b) only a small subset of stakeholders chose to answer the question on whether it is possible to identify a category of "prime" SME loans as cover assets. The slim majority that responded "no" to this question said that SME loans do not lend themselves easily to categorisation between "prime" and "below prime" due to their diversity and lack of available data. Those respondents that said yes suggested various potential ideas, but it seemed clear that there is not a widely accepted methodology that could be used offhand.

Mixed Pools

There were broadly three positions from the various stakeholder groups to answer the question on whether mixed pools should be permitted and, if so, subject to what limits:

(a) issuers overwhelmingly support mixed pools with no or only few limitations, subject to appropriate transparency on the cover pool. Issuers view mixed pool as a necessary

discretionary funding option for lenders and as providing investors with diversification;

(b) public authorities generally support mixed pools but would like to impose certain limitations. Some of them point to the provisions in Art. 129 CRR as a good starting point to design such limitations;

(c) investors would prefer homogeneous pools and, accordingly, would be in favour of preventing mixed pools or impose very strict composition and concentration limits. It should be noted, however, that only a very small sample of investors (4) responded to this question; and

(d) lastly, French stakeholders were against the proposed 35% limit on guaranteed loans for *obligations foncieres*.

Coverage Requirement and Overcollateralisation (OC)

Options to formulate the coverage requirement

Stakeholders were generally in favour of formulating the "coverage requirement" for the purposes of an EU covered bond framework using both nominal and Net Present Value (NPV) under stress requirements. One respondent pointed out that an NPV under stress coverage test is necessary to deal with cash flow mismatches between cover assets and covered bonds and ensure coverage in case of rare but not unrealistic market price movements such as big jumps in interest rates or exchange rates. Some stakeholders note that it may be challenging to strike the right balance between consistent and comparable stress tests for all issuers and the need to design these taking into account local market conditions.

Preference for either option A (general formulation of the coverage requirement as currently in Art. 52(4) UCITS Directive) or B (nominal coverage) among a significant minority of stakeholders is driven by various reasons. Some argue that a general requirement would be more consistent with a "principles-based" type of harmonisation. Nominal coverage is regarded as simple and easy to compare and monitor. Some public authorities suggested that a nominal coverage should be supplemented with a targeted requirement on the issuer to disclose data on the cover assets and liabilities that would allow third parties to calculate and apply the NPV.

NPV under stress coverage: stress scenarios

Issuers were almost unanimously against setting specific stress test requirements in an EU covered bond framework and, instead, would prefer to leave this matter to national authorities. Stakeholders argued that the types and parameters of stresses depend on the specific features of each mortgage market and harmonisation would not be possible or desirable. One issuer pointed out that banks are currently subject to stress tests of liquidity and solvency, and shortly they will be required to have additional capital to cover the interest rate risk. Accordingly, they see no reason to introduce additional stress tests.

By contrast, virtually all investors and public authorities were in favour of setting some level of common requirements at an EU level.

There were different views on what should be the right type of stress scenarios, but a majority pointed to stresses on interest rates, currency exchanges and on the value of underlying assets.

Treatment of derivatives for coverage purposes

The majority of stakeholders said that derivatives entered into to hedge cover pool risks should be taken into account to determine the coverage requirement. They noted that although derivatives are neither substitution nor cover assets, they create a net exposure which may vary over time depending on market fluctuations of interest and forex rates and, accordingly, the resulting changes in the exposure should be taken into account in the net present value calculation of the cover pool.

The contrary view put forward by a minority of respondents (including some issuers and the public authorities from one Member State) was that the only purpose of derivatives in the cover pool is protection against interest rate and/or currency risk, rather than collateralising covered bonds. Accordingly, emphasis should be placed on ensuring that all collateral posted is effectively segregated and clearly identified as such collateral posted for the benefit of cover pool derivatives.

Treatment of exposures to credit institutions for coverage purposes

Stakeholders generally agree that exposures to credit institutions should be taken into account to determine the coverage requirement, but should also be subject to certain limits and eligibility such as those set out in Art. 129(1)(c) of the CRR.

A number of issuers recommended that certain exposures to credit institutions such as deposits, money claims or bank bonds be eligible as substitute assets for liquidity management purposes. Other stakeholders opined that exposures to credit institutions in the form of derivatives should not be treated as such exposures and, therefore, subject to any applicable limits provided that they are adequately collateralised.

Quantitative mandatory minimum OC level

The Consultation Document requested feedback on the EBA's recommendation to set a common "quantitative legal/regulatory minimum OC level" as a best practice to safeguard the credit quality of covered bonds.

A large majority of stakeholders from all groups agreed with the EBA recommendation but views on the precise OC level were split. Most stakeholders agreed that the required levels of OC may vary depending on a number of factors such as the characteristics of the covered bond programme, the cover assets and market conditions. Accordingly, stakeholders recommended leaving room to national authorities or domestic laws to set higher OC levels should a minimum level be set at an EU level.

Stakeholders opposing a minimum OC level did so on the grounds that it may be difficult to set a common OC level for the whole of the EU. Danish stakeholders raised a more fundamental objection related to the particular structure of specialist mortgage issuers. In their view, cover pool specific minimum requirements on over collateralisation and liquidity would duplicate requirements "already in place", insofar as the OC benefit for investors is provided in this case by the minimum capital requirements that these issuers must meet as regulated credit institutions under the CRR (eg the subordination of equity and hybrid instruments relative to covered bondholders would be equivalent to a formal OC requirement).

Stakeholders almost unanimously opposed both:

(a) any potential exception to the minimum OC requirement for certain covered bond structures; and

(b) a maximum level of permitted OC in the Framework. Public authorities responding to this question noted the connection with asset encumbrance, but said that the covered bond framework should not be used to reduce asset encumbrance and, rather, the assessment and prevention of potential risks should be left to supervisors.

Treatment of voluntary OC in the event of insolvency/resolution of the issuer

Stakeholders agreed on the principle that the treatment of "voluntary OC" should be clarified for insolvency/resolution purposes and expressed the view that any such "voluntary OC" should belong fully to the cover pool and not be returned to the insolvent state or bank in resolution, until the cover bonds have been redeemed in full. In this sense, "voluntary OC" should cease to be "voluntary" and, instead, be subject to the same rules as mandatory OC.

One rating agency noted that they give "limited value" to voluntary or non-contractual OC once the issuer's credit quality falls below a certain level, or no value at all where it is unclear from a legal perspective that OC would remain in the cover pool. The agency said that should the EU covered bond framework provide for the treatment of "voluntary OC", it would add certainty to an area where it is currently lacking, which would in turn assist in the credit analysis of the covered bond programme.

In addition, investors and some public authorities pointed to the risk that a lack of legal protection would allow issuers to reduce OC levels before default. Some advocated limitations on the issuer's ability to manage "voluntary OC" levels, which should be set out in the covered bond programme and subject to disclosure.

Market and liquidity risks

Use of OC to mitigate liquidity risks

The view from stakeholders is that OC levels are useful but not sufficient to mitigate adequately market and liquidity risks. The view is held by a large majority of public authorities in particular.

Stakeholders explained that the main purpose of OC is to "cover administration costs and credit risk", whilst liquidity risk should be managed through other tools such as liquidity buffers or soft bullet structures and market risk through derivatives or stress tests subject to minimum criteria. However, one issuer stated that where the legal coverage requirement is based on a net-present value under stress, the resulting OC on nominal values "should be adequate to mitigate market and liquidity risk at least based on the regulator's assumptions".

Stakeholders from the UK said that their domestic law imposes specific requirements to ensure the "timely repayment of claims attaching to the bonds" through arrangements involving one or more of maintained OC levels, maintained interest coverage levels, swaps, reserve funds, pre-maturity tests/prefunding of certain ongoing amounts, accumulation ledgers, extension periods, orderly asset sales, and ongoing stress testing by the competent authority.

Danish stakeholders expressed concern that mandatory minimum OC levels are detrimental to fully-matched structures such as the specialist issuer system used in Denmark.

Requirements on the use of derivatives

Stakeholders generally agreed that there should be a high level framework of requirements on the use of derivatives as suggested by the Consultation Document, but there was no agreement on some of the specific items listed therein.

The most contentious point relates to the potential prohibition of intragroup hedges. Virtually all issuers opposed the proposal on the grounds that it would have a very negative impact on the market. Many respondents from the issuer community warned that external hedging may be unavailable or difficult to obtain for many issuers (in particular, smaller ones), which would then be prevented from hedging the cover pool risks or would have to do so at a much higher cost. By contrast, a majority of public authorities would favour this prohibition and so would two investors.

The potential to restrict eligibility of counterparties on the basis of external rating was also met with concern. A number of issuers noted that setting a hard minimum rating threshold, such as CQS1, would be very detrimental insofar as the downgrade of the counterparty would leave the cover pool unhedged. Instead, these respondents suggested a requirement to post collateral be imposed upon the counterparty being downgraded below the threshold. A number of issuers also pointed out that the population of counterparties with a CQS1 is very small and outright inexistent in certain jurisdictions as a result of the application of sovereign ceilings.

Some respondents commented that there is confusion among market participants as regards how to interpret the reference in the Consultation Document to "an explicit obligation on issuers to hedge", as issuers in some jurisdictions do not use formal hedges and, instead, apply "natural hedging strategies" between fixed rate and floating rate assets and liabilities.

On a potential list of eligible counterparties based on their legal form, stakeholders suggested public sector entities, credit institutions, investment firms, insurers and clearing houses.

Stakeholders generally agreed on the remaining items as proposed by the Consultation Document:

(a) restrict the use of derivatives to hedging purposes only;

(b) require the derivatives to continue after issuer's default; and

(c) preclude the priority of derivatives' counterparties claims, which at most would be allowed to rank pari passu with covered bondholders' claims.

Management of cashflow mismatches

Issuers admitted that cashflow mistmatches between assets and liabilities normally arise in covered bond programmes and agreed that a robust liquidity management is key to mitigating the risks arising from such mismatches and ensuring the timely repayment of the covered bonds. Respondents said that a number of liquidity risk management techniques already existing in some domestic laws should be available to issuers and covered pool administrators for mitigation purposes, such as:

(a) giving the issuer or the covered bond administrator the option to issue additional bonds, rollover maturing bonds through “soft bullet” structures, dispose of assets or procure additional funding;

(b) in the case of the covered bond administrator post-default, they should be appointed promptly upon the issuer's default and given wide discretionary powers to manage the cover pool;

(c) a liquidity buffer, in the form of a cash reserve and liquid assets which could be sold in the market or discounted at the Central Bank (provided such assets are not needed to maintain OC above the mandatory minimum level);

(d) provisions requiring stress tests be conducted on interest rate, currency volatility and property values; and

(e) access to central bank liquidity if the cover pool is incorporated as a regulated credit institution.

Although only a very small number of investors answered this question, all of them would welcome more transparency from issuers on the management of cashflow mismatches.

EBA's Recommendation on "Liquidity Buffers".

The liquidity buffer is generally considered an appropriate liquidity risk management tool by stakeholders although some pointed to other tools such as conditional pass-through structures. Those supporting the liquidity buffer also underline that any 'double count effect' with reference to LCR requirements should be avoided and the buffer should be deducted from the LCR.

A minority of respondents (mainly issuers and some public authorities) oppose the systematic introduction of a liquidity buffer for different reasons. For instance, they noted that the LCR already acts as a sufficient risk mitigation instrument or, alternatively, the liquidity buffer should only be required where needed having regard to the asset/liability structure and characteristics of the cover bond programme.

A number of issuers and public authorities would favour only high level liquidity risk mitigation requirements at an EU level, without imposing any specific mitigation technique.

Stakeholders who support the liquidity buffer (either as a mandatory requirement or as one of the possible instruments to address liquidity risk) favour a six months' horizon as time frame for calibration. In relation to eligibility criteria for the substitution assets, three possible set of criteria were suggested:

(a) assets eligible under the ECB/Central Bank collateral framework;

(b) criteria in Article 129(1);

(c) criteria for level 1 assets under the LCR Regulation.

<u>Transparency</u>

Stakeholders considered the disclosure requirements under Art. 129(7) of the CRR as insufficient to address investors' needs and favoured the disclosure of additional data in particular on credit, market and liquidity risk. Some stakeholders said that it is necessary to

provide consistent definitions of certain terms (LTV, OC, NPL, legal maturity) commonly used in the covered bond documentation. The harmonised templates developed by the industry are considered as an appropriate tool to allow investors to undertake a comprehensive risk analysis, but some would welcome legislative initiatives to support the use of such industry templates. Some respondents (mainly investors and public authorities) suggest having the disclosure performed through a common platform (as for ABS) or competing centralised locations.

As far as granularity is concerned, most stakeholders responded that loan-level data disclosure is not necessary or useful for covered bond investors.

Stakeholders supported only voluntary disclosure of information on counterparties, limited to relevant counterparties (hedging counterparties and counterparties with large exposures to the issuer) and subject to confidentiality. Public authorities, by contrast, were in favour of forced disclosure of information on counterparties.

With regard to frequency of disclosure almost all respondents supported quarterly disclosure. One respondent argued in favour of disclosure 'within 1 month of the interest payment date'.

Finally, stakeholders:

(a) supported applying the same disclosure requirements to all categories of covered bonds having regard in particular to the important role of private placements in this market;

(a) do not see any reasons for differentiating between the pre and post-insolvency disclosure regimes; and

(b) opined that covered bonds from third countries should be eligible for the same preferential treatment as instruments issued within the EU subject to meeting CRR requirements or requirements that are 'equivalent' to those laid down in the CRR.